FUND MANAGEMENT DIARY
Meeting held on 22nd May 2018

How troubling is the rise in EM public debt?

- Emerging market debt, in aggregate, has risen to its highest share of gross domestic product since the 1980s – when there were a spate of debt crises

- But there are large differences across countries, in terms of the level of debt, its change over the last decade, external financing needs and the potential impact of rising global bond yields

- Immediate fiscal risks are greatest in Venezuela and Ukraine, but there are also longer-term concerns about the fiscal positions in South Africa, Egypt and Brazil

Emerging market debt has risen, but aggregate figures mask differences across countries

The International Monetary Fund has recently drawn attention to the rise in the ratio of aggregate emerging market general government debt to gross domestic product. This ratio has grown by thirteen percentage points over the last ten years to reach 49 per cent – the highest level since the 1980s, when emerging markets were afflicted by a spate of debt crises. What's more, the International Monetary Fund projects that this ratio will rise to 58 per cent by 2023.

However, this aggregate emerging market figure masks big differences between countries. While public debt ratios have increased across most of the emerging world over the past decade, the change has varied enormously. It has risen by less than ten percentage points of gross domestic product in Hungary, Korea and Poland, but by more than 25 percentage points in South Africa and over 60 percentage points in Ukraine and Bahrain. What's more, debt ratios vary widely across countries, from 15-30 per cent of gross domestic product in parts of the Middle East and Latin America, to over 100 per cent in Egypt.

There are also big differences among the largest emerging market economies. The debt ratio has increased the most in Brazil and China (by around twenty percentage points) over the last decade and has actually fallen modestly in India (under five percentage points). In Brazil's case, the rise in the debt ratio means that it has the highest level of the four BRICs – at around 84 per cent of gross domestic product. Meanwhile, Russia has the lowest debt as a share of gross domestic product (seventeen per cent).

Financing needs differ across countries

The debt ratio, or its change, aren't the only factors that determine the risk of a public debt crisis. Other factors include the share of debt held at short maturities (rollover risks), how much is denominated in foreign currencies and, related to this, the size of the central bank's foreign exchange reserves.

After a couple of decades of financial globalisation, debt obligations now constitute the bulk of most emerging economies' external financing needs – this is the foreign funding required over the next year to finance current spending (i.e. the current account deficit) and to roll over maturing external debt (i.e. held by foreigners). Looking at short-term external government debt as a share of foreign exchange reserves, Venezuela (284 per cent), the Ukraine (130 per cent) and Argentina (123 per cent) are some of the countries that stand out. Indeed, this is the root of Argentina's recent problems.

A final point to consider is the extent to which fiscal policy needs to adjust to prevent debt from rising further. There is a fairly even split between emerging markets that need to tighten fiscal policy and emerging markets that can run larger deficits. But one point that stands out is that big fiscal adjustments are still needed in some oil producers, including Saudi Arabia, Oman and Bahrain, to prevent debt ratios from rising further.

Will rising bond yields be a major problem?

The emerging market economies with the largest debt burdens are (unsurprisingly) most vulnerable to rising global borrowing costs. However, the extent to which emerging markets are actually likely to experience a rise in borrowing costs varies.
Concerns about rising emerging market borrowing costs are rooted in the view, that as developed market central bank tightening pushes up bond yields in the United States and Europe, borrowing costs for emerging markets will also rise. However, the shift by emerging markets over the past decade or so to issuing debt in local currency (rather than foreign currency) has altered the dynamic. In many cases, local developments are more important than moves in global bond markets.

For example, the central bank in China may well lower interest rates this year in response to slower economic growth. This would put downward pressure on local currency borrowing cost for the government. And in several countries (including Egypt, China and, to a lesser extent, Brazil), financial repression (keeping interest rates deliberately low) will also help to anchor local yields. All of this should help to offset any upward pressure on borrowing costs stemming from a general rise in advanced economies' bond yields.

Where do the greatest vulnerabilities lie?

In general, fiscal risks have subsided in the emerging world in recent years, but there are areas of vulnerability. Venezuela is already in the midst of a sovereign debt crisis, and Ukraine looks vulnerable to an acute near-term crisis.

Venezuela's government has missed $1.5 billion of coupon payments in recent months and has failed to make any headway on debt restructuring talks with its creditors. It seems that a full-blown default is only a matter of time. In Ukraine, the dispute with the International Monetary Fund over the disbursement of the fifth tranche of its bailout package is ongoing, and although the country did restructure around $15 billion of its debt in 2015, there may be a need for additional restructuring if bailout funds are delayed further.

Concerns about the deterioration of fiscal positions in South Africa, Egypt and Brazil are also present. Budget plans announced over the past couple of months in Egypt and South Africa aim to rein in fiscal deficits. However, more needs to be done to prevent debt ratios from rising. Meanwhile, public finances are on an unsustainable trajectory in Brazil. The only realistic way to restore the primary budget to surplus without raising taxes or cutting expenditure in other areas to the bone is to rein in pension spending – pensions have accounted for around one-third of the increase in government spending since 2013. Against this backdrop, the recent decision by Congress to push back any vote on pension reforms until after this year's presidential election in October increases fiscal risks.

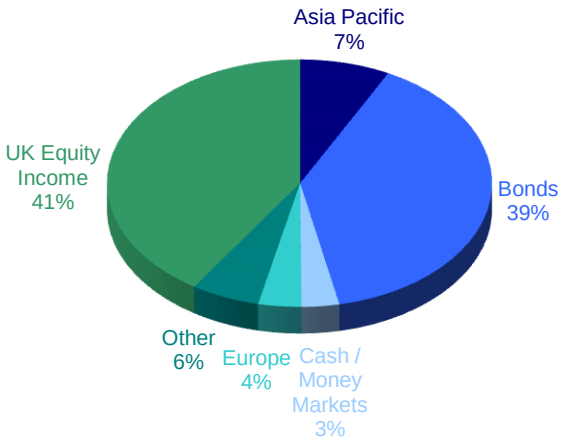
Strategy

Future Money currently invests in Emerging Markets in our highest risk portfolio, Dynamic Growth, however, we do not currently invest in Emerging Market debt. Our experience suggests that Emerging Market bonds offer a similar risk profile to Emerging Market equities, but often with lower risk adjusted returns.

Over recent years, Future Money have noticed a similar pattern in bonds of developed market countries, where bonds do not deliver protection during market falls, or benefit from the market upside. While investors are used to treating bonds as a relatively low risk asset class, we currently believe that bonds have limited upside potential and therefore offer poor risk adjusted returns. This makes equities look like a more attractive asset class on a risk adjusted basis.

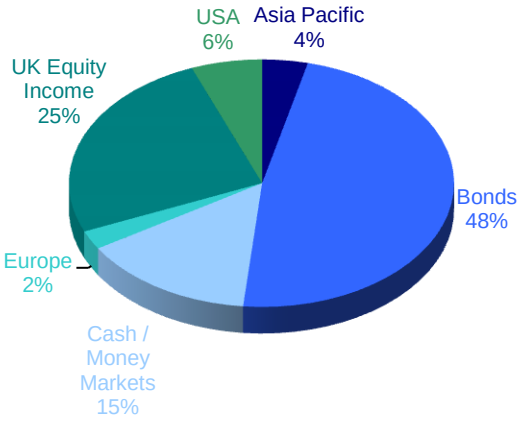
Income

It has recently been announced that Alice Gaskell, one of two managers of BlackRock Continental European Income is leaving the firm. The fund will be run solely by the remaining manager, Andreas Zoellinger. Alice and Andreas have managed the fund together since inception and therefore this will likely be a significant change for the fund. Nevertheless, given the team based approach upon which the fund is managed (20 remaining members) and the consistency in style that is expected, no change will be made to Future Money Income's position in the short term. Instead the fund will be carefully monitored for changes in its style over the coming months.



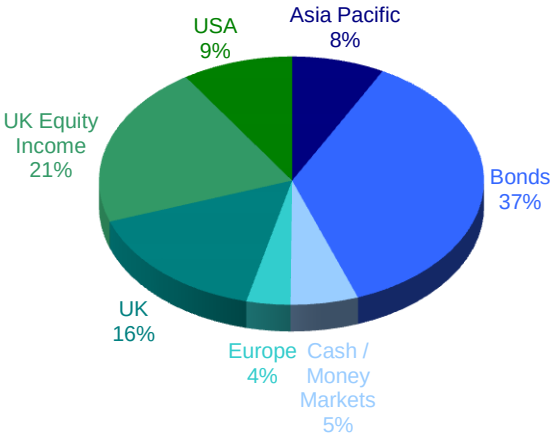
Real Value

The Majedie UK Income fund has been a favoured holding within the UK Equity Income space, but it has now been placed under review. The fund's manager is leaving the firm at the end of June and will be replaced by another member of Majedie's UK team on an interim basis until Mark Wharrier, a previous manager of BlackRock UK Income, becomes available to manage the fund in November of this year. While Mr Wharrier is well regarded by the Future Money team, his style is markedly different to that of the current Majedie manager, Chris Reid. Majedie have stressed that there will be little change to the style of the fund during the interim period. This change will be carefully considered.



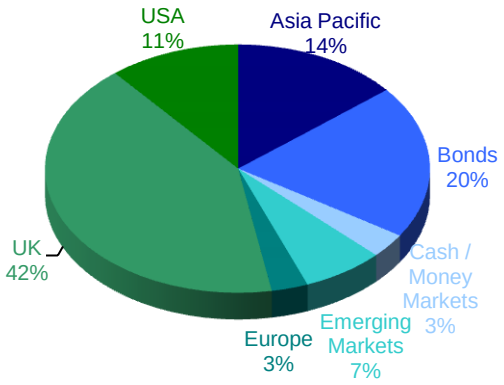
Real Growth

The comments regarding Majedie UK Income made for Real Value also apply to Real Growth. Elsewhere in the portfolio, the Schroder European Alpha Plus fund, which was purchased in February this year is performing well. Over the past 12 weeks the fund has returned 4.3%, 1.8% ahead of its peer group average.



Dynamic Growth

The F&C European Growth & Income fund has had a relatively poor quarter of returns and the reasons for this will be investigated. The rest of the portfolio's holdings are performing in line with expectations.



Important Information

Please note that the contents are based on the author's opinion and are not intended as investment advice. This information is aimed at professional advisers and should not be relied upon by any other persons.

Any research is for information only, does not constitute financial advice or necessarily reflect the views of the author and is subject to change.

It remains the responsibility of the financial adviser to verify the accuracy of the information and assess whether the fund is suitable and appropriate for their customer.

Past performance is not a reliable indicator of future performance. The value of investments and the income derived from them can fall as well as rise and investors may get back less than they invested.

Important information about the funds can be found in the Supplementary Information Document and NURS-KII Document which are available on our website or on request.

For any information about the Future Money funds please contact the authorised corporate director, Margetts Fund Management Ltd, on 0121 236 2380, admin@margetts.com or at 1 Sovereign Court, Graham Street, Birmingham B1 3JR. A copy of their Terms of Business which relates to investments into the funds can also be obtained using these contact details.

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