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The View from 1167 | The Carville Doctrine

"I used to think if there was reincarnation, I wanted to come back as the president, or the pope, or a .400 baseball hitter – but now I want to come back as the bond market. You can intimidate anybody."[1]

A quarter to intimidate anybody …

In Q1 2021, we all got a brutal reminder of just how true James Carville's famous verdict on the US Treasury market is.

The US yield curve staged one of its biggest ever quarterly sell-offs – exceeded in only three other quarters (Q4 2016, Q3 2009, and Q1 1994) since Bill Clinton's chief election strategist made his comments in 1993. The 30 year US Treasury bond crashed nearly 20% in price terms between January 1 and March 18.

Global markets have been duly intimidated. In the risk-on space, the more speculative equity sectors have taken a hit and some high-profile leveraged strategies have come unstuck. Meanwhile in the risk-off arena gold (-11.2% as of March 30) has had its worst start to the year since 1982, and German Bunds (-7.4%) and UK Gilts (-6.8%) have found themselves sucked firmly into the US Treasury down-draught.

EM local currency government bond markets have not escaped the turmoil emanating from the US either. The GBI-EM GD index was down -8.8% in price terms as of March 30 – with approximately half the move attributable to lower bond prices (higher yields), and half to a stronger US dollar.

Quite rightly, investors are asking what this US Treasury sell-off means – and whether (and where) it is an opportunity to buy in, or a chance to de-risk.

EM bond yields: a reset to Q2 2020 levels

As the table below shows, Q1 2021 has returned 10 year government bond yields in major EM markets to levels last seen in Q2 2020 – 9.5% in South Africa; close to 7% in Russia, Indonesia, Mexico, and Colombia; 6% in India; and 5% in Peru, for example – with most between 1.0 and 1.5 percentage points higher than at the end of 2020 following last year's strong bond market rallies, and many close to their highs of the last 12 months (L12M).

From a strategic perspective, this retracement to higher yields is a welcome sight for EM bond investors – because these are levels which make it much easier to assemble a diversified portfolio of high quality sovereign bonds which together will fund an income yield of 6.0% or more.

[1] James Carville (Bill Clinton's chief election strategist), quoted in the *Wall Street Journal*, p. A1, 25 February 1993.

	Current YTM	End-2020 YTM	*Current vs End-2020*	L12M High YTM	*Current vs L12M High*
South Africa	**9.5%**	8.7%	*+0.8%*	11.4%	*-1.9%*
Russia	**7.0%**	5.9%	*+1.1%*	7.2%	*-0.2%*
Colombia	**6.9%**	5.4%	*+1.4%*	6.9%	*0.0%*
Mexico	**6.8%**	5.5%	*+1.3%*	7.3%	*-0.5%*
Indonesia	**6.7%**	5.9%	*+0.8%*	8.1%	*-1.4%*
India	**6.2%**	5.9%	*+0.3%*	6.5%	*-0.3%*
Peru	**4.8%**	3.5%	*+1.3%*	5.0%	*-0.2%*

Nevertheless, from a tactical perspective, the question is whether to seize the moment and lock in these higher yields now; or instead to take a chance on Q1 repeating itself in Q2 – which might provide an even better entry point over the coming months.

Our view is that the *context* of Q1's retracement in yields is key:

1. **Q1's upward adjustment in yields has been driven by the turmoil in the US Treasury market, rather than idiosyncratic EM stories.** As evident from the table above, it has been synchronized and fairly indiscriminate across even the higher quality sovereigns.

2. **The more dramatic crises in a couple of countries that we have long argued are to be avoided (Turkey, Brazil) are the exceptions that prove the rule.** Turkey has been a casualty of drastic policy errors culminating in negative net foreign reserves and the sacking of its latest central bank governor. Brazil is in the grip of political crisis even as its public debt spirals and growth disappoints. It's no surprise that their bond markets are significant negative outliers YTD as a result (-20.8% and -14.8% respectively).

3. **If the US yield curve stabilizes at current levels, the opportunity to buy into quality EM government bond markets at these yields may not last.** Because they have sold off, the yield differentials between EM and DM remain generous. The natural result would be for these differentials to re-exert themselves by attracting yield-seeking capital.

4. **If, moreover, EM central banks show their mettle with orthodox policy responses, that opportunity may be even more fleeting.** Those EM central banks which cement their credibility with orthodox policy responses have the opportunity of triggering a classic virtuous circle. By keeping inflation in check, they can convert the current high nominal yields into an expectation of high real yields. That is likely to draw in both domestic and foreign investors – with inflows from the latter adding the kicker of upwards pressure on the currency as well.

Our current assessment is that the signs on 4 – the prospects for EM central banks getting ahead of the curve – are looking pretty good. In the last ten days, we have already seen orthodox policy responses underway – from Mexico and Indonesia's calling time on easing, to Russia's return to hiking.

Not every EM central bank is going to prove an ally of bondholders over the coming quarters (though it's almost impossible any of them could prove as unfriendly as the Fed, the ECB, or the BOJ), of course. That's where an active approach can add value. But our bet is that a good number of the leading ones – the ones we have in our portfolio – are likely to deliver on their targets.

Fund review and outlook

Q1 featured a combination of hits and misses that was frustrating for us in a way that will probably be familiar to many of you:

- **The Fund's EM bond holdings performed significantly better than the GBI-EM GD index.** This was down to two main factors: (i) our zero weightings to Brazil and Turkey, and (ii) our decision to rein in both portfolio duration and EM FX exposure (both by around 25%) in late 2020. Of course, in retrospect, it would have been nice to have pared back risk even more, and so to have avoided more of Q1's US-led drawdown. Given our strategic views, however – positive on EM yields, negative on the US dollar – we thought paring risk back further would have been rash.

- **However, Fund performance was dragged back down in line with the index as a result of our allocating most of the Fund's spare cash to the Japanese yen.** This was (and is) intended as a cautious allocation – but in Q1, with the yen selling off nearly 7% against the US dollar, the cost of this insurance has been uncomfortably high. It's been an irritating handicap. But we remain of the view that yen exposure would provide a valuable type of ballast for EM portfolios in the event of a severe risk-off environment.

Looking forward to Q2, the context described in 1 to 4 above forms the framework for our decision-making.

The prospect of locking in high yields, and profiting from the classic bond bull markets and currency strength which hawkish policy promises, is enticing. The reductions in risk we made in Q4 2020 mean that there is plenty of room to step both duration and EM FX exposure back up again given the adjustments in pricing. Our next step will therefore be to add back exposure across our favoured positions using this extensive dry powder.

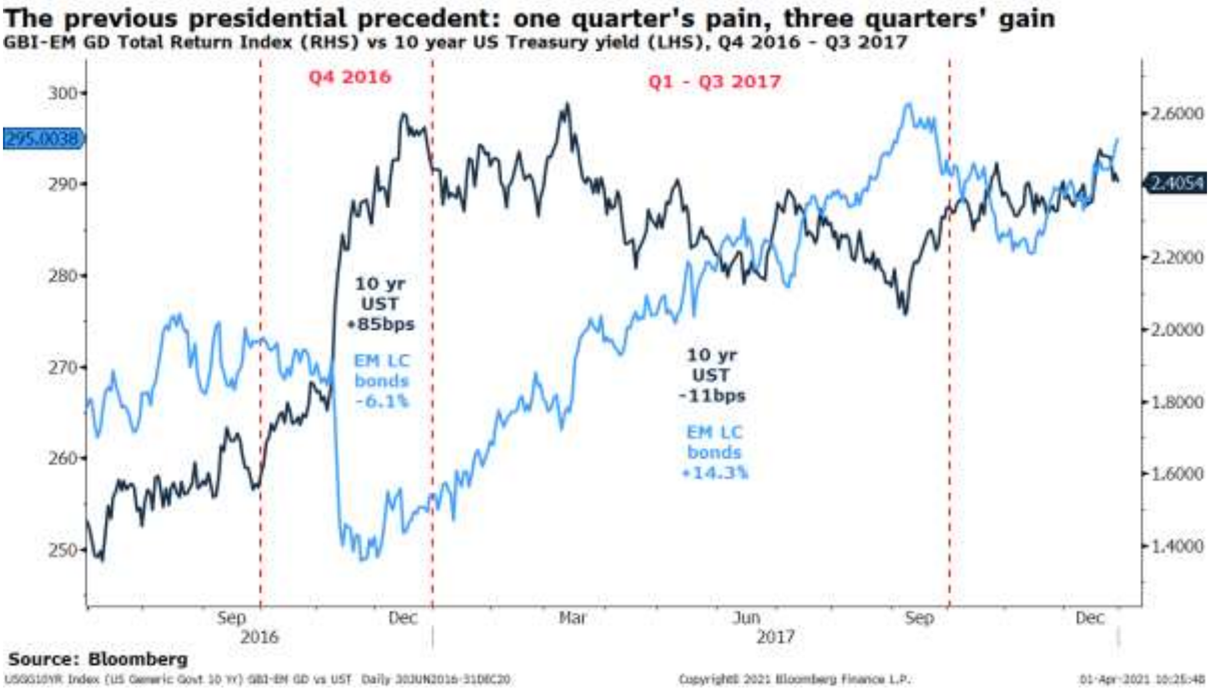
The Previous Presidential Precedent

Much in our minds is the precedent set by the last time the US Treasury yield curve staged such a large quarterly sell-off. As noted above, that was in Q4 2016 – the quarter of Donald Trump's surprise election as US President, and the subsequent excitement over the prospect of large-scale fiscal stimulus reviving the US's economic fortunes.

In that quarter, the 10 year Treasury yield sold off by 85 bps, as compared to 83bps in Q1 2021. EM local currency government bonds had a similarly torrid time then too, with the GBI-EM GD index returning -6.1%, as compared to -6.7% in Q1 2021.

But the next three quarters – Q1 to Q3 2017 – saw US yields stabilize. The result was a huge bounce in EM local currency bonds, with the GBI-EM GD index generating a total return of +14.3%, as both EM bond prices and currencies rebounded strongly.

The lesson we (re-)learned then is that one has to be very wary of being *so* intimidated by the quarterly price action in the US Treasury market that one misses the big picture. As we have often noted, over the long term, the returns to investing in EM local currency bonds have only a modest correlation with US Treasuries – even if short term moves can be quite closely aligned. The Q4 2016 to Q3 2017 period showed the value of keeping this fact in mind.



The Buffett Doctrine

As ever, we don't expect timing our next move to start to step risk back up again to be easy. As James Carville correctly observed, the gyrations of the US bond market are much too scary for that.

Yet as investors, we should never let even the most intimidating markets frighten us out of our senses. As Warren Buffett – an even greater authority on markets than Mr. Carville – is fond of saying:

"Be fearful when others are greedy – and greedy when others are fearful"

Michael Mabbutt & Felix Martin

Fund Managers, 1167 Capital

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01/04/2021

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