BEHIND THE QUOTE: THE DECOUPLING OF MEXICAN & AMERICAN BONDS

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"In normal times, there's this connection between Mexico and U.S. interest rates due to the coordination of their business cycles. In times of extreme risk aversion, it just breaks down."—A. Urbina

- Yields on Mexican M Bonos typically track those of U.S. Treasuries, but in recent weeks, this correlation has been broken
- Growing increasingly risk-averse on fears of a European collapse, investors have sold Mexican and other EM assets, while purchasing the perceived safety of the American dollar and U.S government securities
- Silva Capital believes that EM assets have been oversold and that current prices are unreflective of fundamental values

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Recent weeks have seen a broad-based selloff of EM assets that has decoupled the traditionally correlated movements of Mexican M Bonos and U.S. Treasuries. In an interview with Bloomberg News this past Monday, Alejandro Urbina, Silva Capital's lead Fixed Income Portfolio Manager, discussed both the connection between these securities and the cause of their present split.

Because of the strong positive relationship of markets in the United States and Mexico and the coordination of business cycles throughout the North American economy, the assets of these two countries have tended to move in step. The United States and Mexico are bound together through trade, and news that pushes growth up or down in one market should push it in the same direction in the other. This connection has set their sovereign bonds in sync, and a graph of the two over the last five-year period shows a tight track.

However, this relationship is not impermeable, and breakdowns occur in periods of extreme risk aversion—such as those which have characterized the last few weeks. Mexican yields have steepened sharply since mid-September, reflecting the uncertainty surrounding the possible default of Greek sovereign debt and the impact that this event would have on the global financial system. The current atmosphere in markets is reminiscent of that which surrounded the collapse of Lehman Brothers in 2008, as investors clam up on fears of systemic risk.

A Greek credit event would be felt most acutely by European investors. Greek banks would be severely affected, and some would surely go bankrupt should a default occur. Yet the most worrying issue for North American markets is the risk of contagion.

It is this possibility of wide systemic risk that has motivated the recent rout of EM assets and split M Bonos from Treasuries. Fearful investors bought the perceived safety of U.S. Government bonds and sold almost everything else. As Urbina told Bloomberg, nothing has been spared from the resulting flight to quality. Every type of asset in the emerging markets investment world has been hit.

We believe that the brinksmanship of European governments has heightened the fear of contagion among investors. Markets have become illiquid, and prices now reflect unrealistic asset valuations given the fundamentals of most credits. This is particularly true in the EM space. We nonetheless believe that, as has been the case in other episodes of peak market fear, decision-makers will find the strength to take the steps necessary to defuse the situation.

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