Helene Williamson
Head of Global Emerging Markets Debt

Amalia Nunez
Senior Investment Specialist

First State Investments

Colonial First State Global Asset Management

Investing in a low growth environment.

The Investment Report.

Emerging Markets Debt

The headwinds are turning

The performance of the world economy in the aftermath of the 2008 Global Financial Crisis has been characterised by an unusually slow and uneven recovery, notably in the United States (Chart 1). This weak performance has come in spite of extraordinarily loose central bank monetary policies and an unprecedented amount of Quantitative Easing. Several explanations have been put forward for the unevenness of the recovery: "a debt overhang" (Harvard Economics Professor Kenneth Rogoff), "global savings glut" (former Federal Reserve Chairman Ben Bernanke) or "liquidity trap" (City University of New York Professor Paul Krugman). Most recently, the US Federal Reserve seem to have adopted a central view close to Harvard Professor Larry Summers' "secular stagnation theory", which implies that neutral rates (r*) post-crisis are likely to be much lower than they were in the past. This suggests that absent a generous fiscal easing, which remains politically difficult to achieve, rates and global yields are likely to remain extremely low for an extended period of time, and possibly move lower.

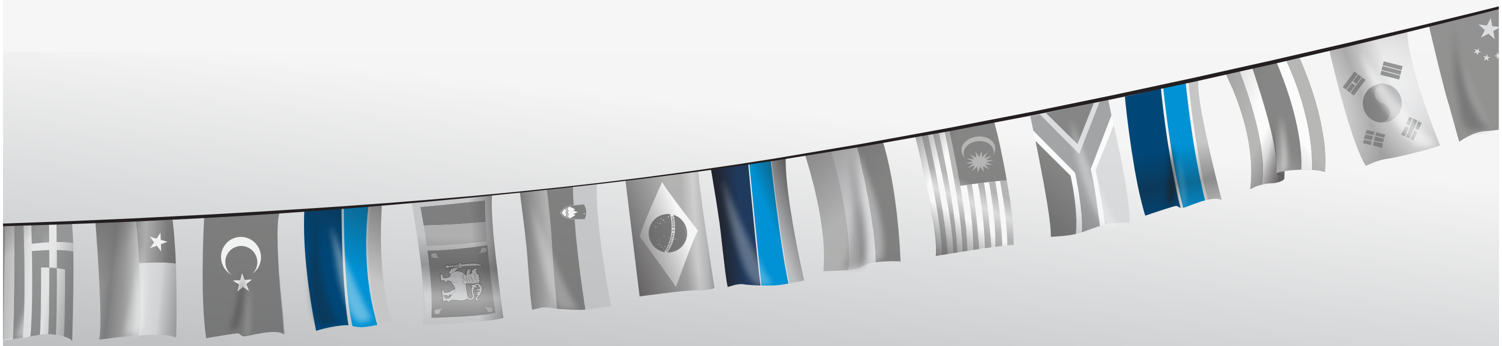
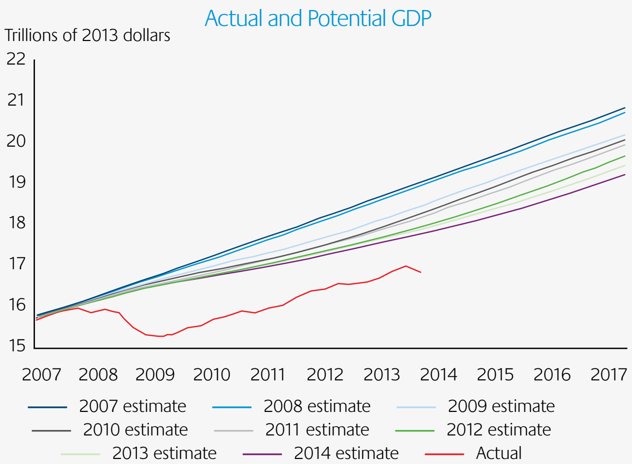


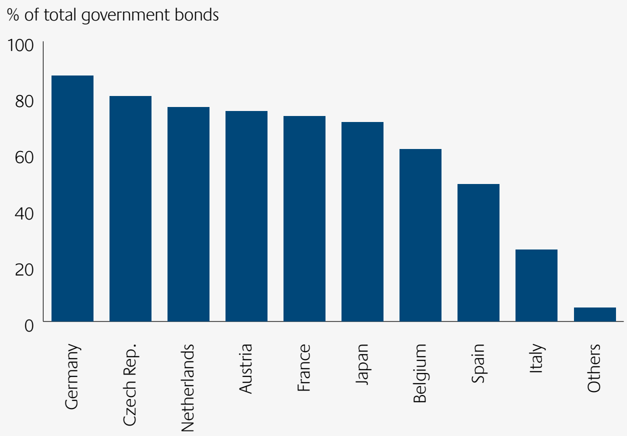
Chart 1: Long-term US economic projections have been consistently revised lower



Source: Summers, CEPR.

In the case of emerging markets (EM), the growth recovery has also been uncharacteristically slow, especially since 2012. The strong US dollar (USD) combined with tepid global growth has weighed on commodity producers who still represent a major share of the EM universe. In addition, manufacturing exporters, who should have benefited from the commodities repricing, have faced a slowdown in global trade. The structural transition in China from an investment-led to a consumption driven growth model has automatically caused weaker growth in its national economy (and global impacts). Finally, some countries (Brazil and Russia notably) suffered from one-off political shocks which led to very poor growth over that period. As a result, global investors initially retrenched from the asset class due to a weakening in credit metrics. However, it is important to note that unlike previous episodes of global tightening and commodity shocks, EM neither experienced a 'crisis' nor witnessed large scale capitulation from institutional investors. This demonstrates a level of maturity for the asset class which has now become a core part of the fixed income universe.

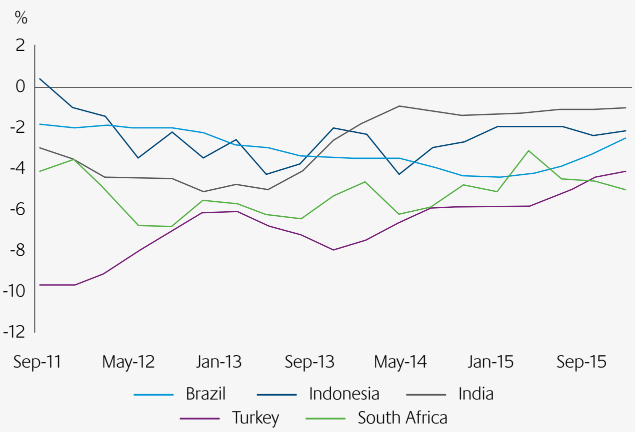
Chart 2: Negative yielding bonds now constitute a major share of the global sovereign bond universe



Source: IIF.

Since the start of the year, it appears that many of those growth headwinds have started to fade. The most striking fundamental improvement for EM has been the correction in the large trade deficits and current account imbalances (Chart 3) that were present in previous years and led to the moniker of 'Fragile-Five' in the case of Brazil, South Africa, Turkey, India and Indonesia. The current aggregate external position in EM (ex-China) is at its strongest surplus since 2009. Capital outflows from China have stabilised for more than six months following the introduction of a managed floating currency basket regime and the moderate depreciation of the renminbi has put the Chinese economy on a better footing (although many other risks related to excessive leverage remain to be addressed). Global foreign exchange (FX) reserves in EM have stabilised and real rate differentials with developed markets have widened, offering a further buffer against volatility in global liquidity. EM currencies have arguably undershot their fair value from a purchasing power perspective and continue to provide a competitiveness advantage.

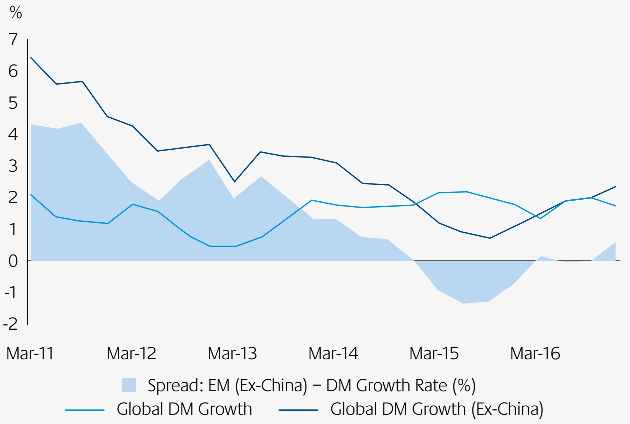
Chart 3: Current account imbalances have corrected



Source: National Statistics Office, Bloomberg.

A direct result of this mediocre global growth and inflation dynamic, combined with the extraordinary monetary stimulus, has been the increased share of negative yielding bonds, from a peculiarity when first introduced by Denmark in 2012, to a global feature with now almost 30% of the outstanding stock of government bonds trading with negative yields (Chart 2). Many income-seeking asset managers do not have the ability to hold those 'assets' and have been forced to seek higher yields. Within fixed income, EM have been a prime target of those inflows (Chart 5), particularly as the disappointment in economic data and rise in political risks seen in developed markets is coinciding with an acceleration in growth in EM (Chart 4) due to the improvement in fundamentals that we highlighted above.

Chart 4: EM growth has accelerated past DM over the past year



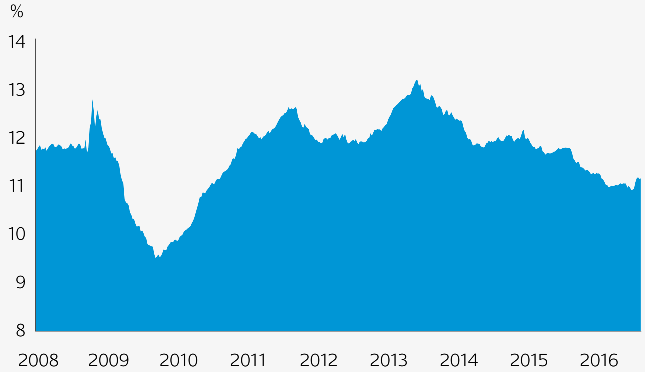
Source: National Statistics Office, Bloomberg, Economist forecasts, World Bank.

Investing in EM fixed income can be done through three main channels: hard currency sovereign bonds (mostly USD-denominated), hard currency corporate bonds and local currency sovereign bonds (denominated in local FX).

Our base case is that over the next stage of the ongoing low global growth environment, EM will continue to experience stronger growth than developed markets. This is likely to lead to a positive reassessment of the credit worthiness of those countries and contribute to a compression of risk premia. In addition, EM currencies, which offer cheap valuations at present would likely reprice favourably.

Going forward, we expect inflows to continue, due to the relative under-investment by global managers in the EM universe over the past several years (Chart 5). One note of caution is that an unusually large share of the most recent inflows has been executed through exchange-traded funds which are liquid and readily available so can be more prone to reversals due to short-term changes in sentiment. The main catalyst for such a reversal would be a further rise in populist political movements in core developed markets. This could lead to expectations of a further deceleration in global trade caused by protectionist measures against mercantilist Asian exporters (US presidential candidate Donald Trump for one supports such measures), and possibly a reduction in worker remittances to Eastern Europe and Latin America. Another potential trigger for a reversal would be that rate differentials start to favour developed markets again.

Chart 5: The share of portfolio allocations to EM has stabilised



Source: IIF, EPFR.

Chart 6: EM credit spreads have room to compress

Source: Bloomberg.

Conclusion

After several years of disappointment, growth in EM countries, particularly relative to developed market growth, is starting to pick up. Commodity prices appear to have stabilised and current accounts in some countries are improving, including in countries that are most dependent on external financing.

The need to avoid low and negative yields has encouraged global asset managers to increase their EM allocation as a share of total assets in recent months. We expect this effect to persist in a low growth environment, leading to further compression in credit spreads and the revaluation of EM currencies.

Disclaimer

This document is directed at persons of a professional, sophisticated, institutional or wholesale nature and not the retail market.

This document has been prepared for general information purposes only and is intended to provide a summary of the subject matter covered. It does not purport to be comprehensive or to give advice. The views expressed are the views of the writer at the time of issue and may change over time. This is not an offer document, and does not constitute an offer, invitation, investment recommendation or inducement to distribute or purchase securities, shares, units or other interests or to enter into an investment agreement. No person should rely on the content and/or act on the basis of any matter contained in this document.

This document is confidential and must not be copied, reproduced, circulated or transmitted, in whole or in part, and in any form or by any means without our prior written consent. The information contained within this document has been obtained from sources that we believe to be reliable and accurate at the time of issue but no representation or warranty, express or implied, is made as to the fairness, accuracy or completeness of the information. We do not accept any liability for any loss arising whether directly or indirectly from any use of this document.

References to “we” or “us” are references to Colonial First State Global Asset Management (CFSGAM) which is the consolidated asset management division of the Commonwealth Bank of Australia ABN 48 123 123 124. CFSGAM includes a number of entities in different jurisdictions, operating in Australia as CFSGAM and as First State Investments (FSI) elsewhere.

Past performance is not a reliable indicator of future performance.

Reference to specific securities (if any) is included for the purpose of illustration only and should not be construed as a recommendation to buy or sell. Reference to the names of any company is merely to explain the investment strategy and should not be construed as investment advice or a recommendation to invest in any of those companies.

Hong Kong and Singapore

In Hong Kong, this document is issued by First State Investments (Hong Kong) Limited and has not been reviewed by the Securities & Futures Commission in Hong Kong. In Singapore, this document is issued by First State Investments (Singapore) whose company registration number is 196900420D. First State Investments and First State Stewart Asia are business names of First State Investments (Hong Kong) Limited. First State Investments (registration number 53236800B) and First State Stewart Asia (registration number 53314080C) are business divisions of First State Investments (Singapore).

Australia

In Australia, this document is issued by Colonial First State Asset Management (Australia) Limited AFSL 289017 ABN 89 114 194311.

United Kingdom and European Economic Area (“EEA”)

In the United Kingdom, this document is issued by First State Investments (UK) Limited which is authorised and regulated in the UK by the Financial Conduct Authority (registration number 143359). Registered office: Finsbury Circus House, 15 Finsbury Circus, London, EC2M 7EB, number 2294743.

Outside the UK within the EEA, this document is issued by First State Investments International Limited which is authorised and regulated in the UK by the Financial Conduct Authority (registration number 122512). Registered office 23 St. Andrew Square, Edinburgh, Midlothian EH2 1BB number SC079063.

Middle East

In certain jurisdictions the distribution of this material may be restricted. The recipient is required to inform themselves about any such restrictions and observe them. By having requested this document and by not deleting this email and attachment, you warrant and represent that you qualify under any applicable financial promotion rules that may be applicable to you to receive and consider this document, failing which you should return and delete this e-mail and all attachments pertaining thereto.

In the Middle East, this material is communicated by First State Investments International Limited which is regulated in Dubai by the DFSA as a Representative Office.

Kuwait

If in doubt, you are recommended to consult a party licensed by the Capital Markets Authority (“CMA”) pursuant to Law No. 7/2010 and the Executive Regulations to give you the appropriate advice. Neither this document nor any of the information contained herein is intended to and shall not lead to the conclusion of any contract whatsoever within Kuwait.

UAE – Dubai International Financial Centre (DIFC)

Within the DIFC this material is directed solely at Professional Clients as defined by the DFSA’s COB Rulebook.

UAE (ex-DIFC)

By having requested this document and / or by not deleting this email and attachment, you warrant and represent that you qualify under the exemptions contained in Article 2 of the Emirates Securities and Commodities Authority Board Resolution No 37 of 2012, as amended by decision No 13 of 2012 (the “Mutual Fund Regulations”). By receiving this material you acknowledge and confirm that you fall within one or more of the exemptions contained in Article 2 of the Mutual Fund Regulations.

EX3021_1016_MR