First State Investments

Emerging Markets Bond

Quarterly Review and Outlook

As at September 2016

Key Highlights

- The Federal Reserve's ('the Fed') annual symposium at Jackson Hole in August was keenly watched, the Fed overall continuing to reaffirm the message that interest rate rises will be gradual and dependent on data.
- Central bank policy and politics remain key drivers for global markets in our view. The key risk event on the horizon is the 8 November US presidential election.
- Inflation and global growth remain moderate, but that there will not be a recession. The improvement in EM should at some point contribute more positively to the global economy.

Market Review

Risk assets enjoyed another constructive quarter. The 'Goldilocks' scenario of low growth, low inflation and low risk of recession persisted, allowing global monetary policy to remain accommodating. The Fed's annual symposium at Jackson Hole in August was keenly watched, the Fed overall continuing to reaffirm the message that interest rate rises will be gradual and dependent on data.

Emerging markets (EM) debt made returns of 4.0% (in US dollar terms) over the quarter taking year-to-date gains to 14.8%. The yield on EM debt came down 39 basis points (bps) to 4.99% and the spread narrowed 52 bps to 336 bps as US Treasuries sold-off slightly with 10-year yields rising 11 bps to 1.60%. The search for yield remained very much in evidence as riskier credits outperformed. The outperformance of high yield (+5.9%) over investment grade (+2.5%) was more marked. Higher-yielding oil related credits performed strongly: Venezuela (+28.4%), Mozambique (+19.2%) and Zambia (+14.2%).

Venezuelan national oil company PDVSA offered investors the option to exchange a 2017 bond with an amortisation in November for a larger quantity of a bond maturing in 2020. Given concerns that the maturities in November would consume a large part of the company's cash, market reaction to the pro-active swap proposal was extremely positive, as it underlines the Venezuelan government's strong willingness to pay its foreign debt. Zambia held elections, following which it began talks with the IMF, while Mozambique restructured debt.

Mexico (0%) was the weakest performing credit as it underperformed the market in September. President Pena Nieto's popularity dropped after the visit of US presidential candidate Donald Trump, and Finance Minister Luis Videgaray resigned. The currency came under pressure, as fears of a victory for Trump and its negative implications for the NAFTA agreement between Mexico and the US concerned the market.

Outlook and Strategy

Global Market Drivers:

Central bank policy and politics remain key drivers for global markets in our view. The key risk event on the horizon is the 8 November US presidential election. Uncertainty would be much higher in the event of a Donald Trump victory, which could be highly destabilising for international relations, geopolitics and global trade. A victory for Hillary Clinton is priced in, but further the US-related noise is likely.

Political uncertainty and concerns about the banking sector in Europe is also growing. The European Central Bank's ('ECB') ZIRP is negatively affecting European banks' profitability and concern about the unfinished banking reform in the EU is leading to market pressure on undercapitalised banks, particularly in Italy and Germany. The Brexit process will begin in earnest in the coming months with potentially negative implications for European trade, while the Italian referendum and the migrant crisis may add to the political noise.

Continued accommodative monetary policy globally should remain overall supportive. However, the somewhat underwhelming impact from the ECB and Bank of Japan's measures has led analysts and economists to begin to talk again about whether fiscal rather than monetary stimulus is now required. The Fed is widely expected to raise the Fed Funds Rate by 25bps in December.

China-related risk has diminished as the authorities have eased-off on the pace of reform in favour of stability, while the depreciation of the renminbi is more readily accepted by the market. Producer price deflation has also eased in China, reflecting some consolidation in some SOE sectors. Weak world trade, lack of demand and productivity remain headwinds to the global economy.

Our base case remains that inflation and global growth remain moderate, but that there will not be a recession. The improvement in EM should at some point contribute more positively to the global economy.

EM Outlook:

EM countries and regions are gradually improving fundamentally, but the EM debt market in our view continues to be driven more by global and technical rather than fundamental factors. The global economic backdrop (moderate growth, low inflationary pressures, low risk of recession) remains supportive, but we expect to see more volatility in the fourth quarter in view of the US elections and potential for some political noise in Europe. We also expect to see the usual end-of-year

seasonal effect of diminishing liquidity and anticipate a busy primary market in the next two months. Technicals appear somewhat less supportive now as we have started to see new issues repricing the secondary market wider. The market is quite dependent on continued inflows.

Investment grade is still marginally attractive in terms of valuation (at a slight risk premium wide to global BBBs), while the outperformance of high yield may start to fade. The long-ends of curves have outperformed and appear vulnerable to some retracement.

EM economies nevertheless are showing signs of bottoming (industrial production stabilising, external conditions improving) and are doing well relative to the rest of the world, while the OPEC announcement to reduce supply is a positive for EM, albeit the extent of any cut is not yet known.

Portfolio Strategy

EM debt has benefited from positive sentiment and the favourable 'Goldilocks' scenario as negative developed market government bond yields have pushed investors to search for more attractive yields elsewhere. However, global markets have become highly correlated and risk appetite seems compatible with a growing level of complacency. Given the potential for political noise in the developed world in coming months and marginally less-supportive technical situation we will look to reduce risk exposure by taking profits in select high yield and longer-duration credits, particularly those which are less liquid, also in quasi-sovereigns, especially those which are expected to issue. We intend to be very selective on new issues and favour higher-quality credits. A considerable proportion of the new issuance is to come from the Middle East, including Saudi Arabia.

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