Emerging Markets
VOLATILITY DRIVING DISPERSION IN EMERGING MARKETS

KEY POINTS

- Markets across the world have entered a new era of volatility, with emerging markets (EM) likely to be particularly affected.

- This is bringing dispersion back to EM equity and debt markets, creating new opportunities to invest in assets at attractive valuations.

- For investors in both EM equity and debt, there are many idiosyncratic local risks to consider in addition to broader, market-wide ones.

- The ability to be highly selective, and be agile, may prove to be a very useful attribute in the period ahead.

Investors are facing a new era of volatility as the ultra-calm investment landscape of the second half of 2017 (see Figure 1) makes way for more turbulent terrain marked by higher inflation, tighter monetary policies, and choppy currency markets. It is likely that emerging markets (EM) in particular will be affected by this transition, posing a challenge to investors in the equity and debt markets of developing economies.

The volatility that has characterized markets so far this year has come in two stages. February’s spike in the Chicago Board of Exchange Volatility Index (VIX) was largely a technical event, driven principally by the huge amount of money that had accumulated in volatility-linked products. When the VIX initially rose on the back of inflation fears, these products were forced to rebalance, significantly amplifying the overall spike in volatility.

Although the VIX has since fallen back from the high it reached in February, it has remained elevated compared with last year and is now closer to its historical norm. This second phase of volatility is being driven by more fundamental factors, including fears over the impact of central bank monetary tightening and geopolitical risks related to trade disputes, conflict in the Middle East, and elections in a number of countries. While some of these factors derive from developed economies (the current political situation in Italy is one example), others are likely to affect emerging markets disproportionately, resulting in higher overall volatility for developing economies.

What you own likely matters more in volatile periods than it does during calmer times. Passive strategies can be less effective when markets are dislocating, which may mean that investors have to adopt more active, selective approaches to portfolio construction in order to meet their objectives. While the specific approaches may differ between EM debt and equity, actively managing around dislocations is critical in both asset classes.
Fund, where we seek to identify high-quality businesses at attractive valuations—for investors with the insight and resources to identify them.

The most attractive companies for growth investors tend to be those with strong capital structures, internally generated free cash flows, and structural competitive advantages that are likely to strengthen their market positions during periods of crisis. Another key advantage is the absence of a currency mismatch, whereby assets and liabilities are denominated in different currencies. Companies that obtain cheap U.S. dollar debt then see their home currencies devalue can find themselves in trouble, as happened to many Mexican companies during the Tequila Crisis of 1994 and to firms in a number of East Asian countries during the Asian financial crisis of 1997–1998.

Volatility is less of a consideration for our Emerging Markets Value Stock Fund, which uses a growth investment approach, the return of volatility could bring some much-needed differentiation back to the market. Cheap funding and calm markets have enabled many mediocre EM companies to perform well in recent years; if that period is coming to an end, it may allow firms with genuinely strong fundamentals to prove their worth. When volatility first arises it can cause panic, leading to a widespread sell-off in the asset class. This can provide a valuable opportunity to buy high-quality businesses at attractive valuations—for investors with the insight and resources to identify them.

At present, the ratio is closer to 50/50. This makes for a more challenging investment environment because, although localized volatility can be isolated and exploited to some degree, globalized volatility rarely can. We believe that the withdrawal of cheap money currently taking place is a three- to five-year trend and that markets are likely to remain volatile for that period and possibly beyond.

The impact of this on EM debt investors will depend to a considerable extent on whether they are purchasing local currency bonds or U.S. dollar-denominated bonds. The bulk of the volatility in EM local debt comes from currency movements, which can be fast-moving and technically driven. Managing local currency debt therefore sometimes requires smaller and more frequent position changes and the employment of strategies such as relative value pairings.

While dollar-denominated EM debt can also be affected by currency movements, it tends to be more influenced by fundamental factors associated with the issuing country. When evaluating dollar EM debt, we are therefore more likely to look beyond technical-driven volatility and assess whether a bond’s price has drifted far from its fundamental qualities, as we see them.

| FIGURE 1: J.P. Morgan Emerging Market Volatility Index |
| June 5, 2017, to June 4, 2018 |

Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan’s prior written approval. Copyright © 2018, J.P. Morgan Chase & Co. All rights reserved. Source: J.P. Morgan.
In order to benefit from the kind of opportunities that may arise over the next few years—including in countries that the market does not favor—investors may need to consider increasing their exposure to actively managed strategies.

LOOMING ELECTIONS STOKE REGIONAL VOLATILITY

For investors in both EM equity and EM debt, there are currently many idiosyncratic local risks to consider in addition to broader, market-wide ones. Turkey, for example, is generally considered to be very high risk at present because President Recep Tayyip Erdogan, who was reelected in June’s presidential election, seems determined to pursue unorthodox growth policies that are causing long-term damage to the economy. Erdogan’s opposition to rate increases, and his apparent intention to take control of monetary policy from the central bank, has persuaded many investors to underweight or completely avoid Turkey in the current climate. Over the past few months, Turkish stocks fell to their cheapest level in nine years, the yield on the country’s 10-year benchmark bonds has hit record highs, and the currency has weakened considerably. There are no clear indications of when the situation will improve, and while we currently do not believe that the situation in Turkey is likely to lead to a wider EM sell-off, the situation will need to be monitored closely.

Similarly, Andreas Manuel Lopez Obrador’s (AMLO’s) victory in July’s Mexican election has left some investors worried about the impact his left-wing economic policies will have on the country’s business sector. This is in addition to existing concerns about progress on negotiations with the U.S. and Canada to rework the North American Free Trade Agreement (NAFTA). The Mexican peso suffered sharp declines in the run up to the election, but strengthened again as AMLO took pains to stress that there would be no spending shocks or meddling in the Bank of Mexico’s independence. It remains to be seen whether AMLO is true to his word, and concerns remain about the new president’s long-term impact on the Mexican economy, but in the short term we regard Mexico as less of a risk than Turkey.

There is also some investor concern about Brazil, where there will be an election in October. However, we believe this is also overdone. It is clear that whoever is elected president will have to tackle the country’s fiscal deficit if they are to maintain macroeconomic stability, which will necessarily mean passing a comprehensive pension reform bill. In our view, it is likely that such reform will occur irrespective of the result of the election, and as such, we are more positive about Brazilian debt than is currently priced in by the markets.

Outside South America, Russia is another market that many investors are treating with caution, largely due to concerns over the impact that further sanctions from the U.S. and other Western countries may have on asset prices. However, Russia’s fundamentals are reasonably robust—it has reserves equal to government debt; its external balances are strong; and, as a commodity producer, it is benefiting from the rise in oil prices. So the key question is whether tensions between Russia and the West continue and lead to further sanctions, or whether pragmatism ultimately prevails and more normalized relations resume. At present, we are overweight on Russia in our equity funds but underweight in our bond funds.

SELECTIVITY KEY IN TURBULENT TIMES

The period ahead will be challenging for both EM equity and EM debt investors. In addition to being subject to heightened global volatility caused by fears over the looming transition from quantitative easing to quantitative tightening, many are also vulnerable to idiosyncratic local risks derived from country-specific political and economic factors. The period when EM markets tended to move broadly in tandem, reducing the importance of positions in individual assets, appears to be over for now.

At times like these, passive strategies tend to perform less well because they are more vulnerable to market-wide sell-offs than during calmer periods and cannot exploit dislocations in individual markets. In order to benefit from the kind of opportunities that may arise over the next few years—including in countries that the market does not favor—investors may need to consider increasing their exposure to actively managed strategies. The ability to be highly selective, and investment agility, may prove to be a very useful attribute when navigating the period ahead.
T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.
To learn more, please visit troweprice.com.

Important Information
Share prices are subject to market risk, as well as risks associated with unfavorable currency exchange rates and political or economic uncertainty abroad. These risks are heightened by the concentration in emerging markets. Fixed income investing also involves interest rate and credit risks normally associated with investing in bonds as well.

Call 1-800-225-5132 to request a prospectus or summary prospectus; each includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action. The views contained herein are those of the authors as of June 2018 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates.

This information is not intended to reflect a current or past recommendation, investment advice of any kind, or a solicitation of an offer to buy or sell any securities or investment services. The opinions and commentary provided do not take into account the investment objectives or financial situation of any particular investor or class of investor. Investors will need to consider their own circumstances before making an investment decision.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

Past performance cannot guarantee future results. All investments are subject to market risk, including the possible loss of principal. All charts and tables are shown for illustrative purposes only.

T. Rowe Price Investment Services, Inc., Distributor.

T. ROWE PRICE, INVEST WITH CONFIDENCE, and the bighorn sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc. © 2018 T. Rowe Price. All rights reserved.