



**PRICE
POINT**[®]

August 2018

In-depth analysis and insights
to inform your decision-making.



Benjamin Robins
Portfolio Specialist

Fixed Income

DO VALUATIONS OFFER AN ENTRY POINT TO EMERGING MARKETS DEBT?

KEY POINTS

- The recent sell-off in emerging markets (EM) debt has potentially resulted in an attractive entry point as it currently offers investors one of the highest-yielding opportunities within fixed income.
- Valuations in key EM are currently cheap to both developed market asset classes as well as to EM fundamentals.
- A disciplined, active approach remains essential to uncover the best potential opportunities across sovereign, corporate, and local currency debt.
- Although risks remain, many of the catalysts for first-half weakness have subsided, leaving a potentially better environment ahead for EM debt markets.

ARE VALUATIONS A REASON TO RETURN TO EMERGING MARKETS DEBT?

Emerging markets (EM) debt have suffered a difficult first half of 2018 amid destabilizing geopolitical headlines alongside tightening monetary conditions in developed markets. However, widespread selling pressures have resulted in improved valuations, and, speaking broadly, many sectors of EM fixed income now sit at cheap-to-fair value levels relative to their history. So, are cheaper valuations a compelling enough reason to return to the asset class?

Certainly, valuations are more supportive, but the recent underperformance has also opened up a wider-than-usual value gap over developed markets investment-grade and high yield assets. Local currency assets are particularly cheap relative to

other areas of fixed income. Average yields across local currency bonds are currently in excess of 6.50%, which is very attractive by most standards. Hard currency sovereign and corporate bonds also offer many compelling opportunities, with average spreads at their widest point in recent years.

Furthermore, the last time yields and spreads in EM were this attractive, fundamentals across the asset class were far less favorable. Today, however, the picture is much brighter. Even with a mild easing in EM economic growth and increased pressures on EM currencies, most EM countries are in a far better state to weather the headwinds of global volatility. Many economies benefit from well-contained levels of inflation, still solid growth, and central banks boasting healthy reserve levels.

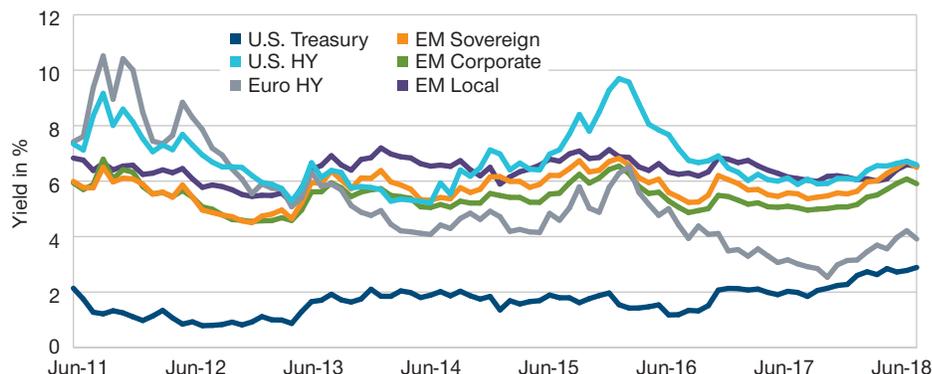
The diversity of EM debt is one of its primary benefits, and this is becoming even more important considering the recent divergence in global economic growth and monetary policy.

It is also important to remember that much of the volatility that sparked recent EM debt underperformance has come from external sources rather than internal ones. Monetary tightening in developed markets, political uncertainty, and concerns over global trade protectionism have weighed heavily on these markets even though underlying fundamentals remain supportive in most cases. However, we are more optimistic because markets are becoming more comfortable with these pressures and are now refocusing on the fundamentals of these markets. Therefore, rather than focusing on the recent underperformance, investors should instead search for opportunities to add to potentially oversold and now undervalued areas of EM. Encouragingly, we are finding many of these opportunities through our rigorous research.

For example, leading Latin American economies, Brazil and Mexico, suffered from political uncertainty as well as wider currency pressures earlier this year. However, the election of Andrés Manuel López Obrador in Mexico in early July has not been the market-negative event that many had feared, and the regional market has potential to stabilize, going forward, following a rocky first half. Brazil will also hold a general election later this year, and while the markets may see blips of volatility in the runup, we believe that improved valuations alongside better economic fundamentals make this market an attractive opportunity.

FIGURE 1: Emerging Markets Yields vs. Core Markets

As of July 31, 2018



U.S. Treasury: J.P. Morgan par 6yr Treasury rate data; EM Sovereign: J.P. Morgan Emerging Markets Bond Index Global (EMBIG); EM Corporate: J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI BD); EM Local: J.P. Morgan Government Bond Index–Emerging Markets Global Diversified; U.S. HY: J.P. Morgan Domestic HY Index; Euro HY: J.P. Morgan Euro HY Index. Source: J.P. Morgan. 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.

Meanwhile, on the credit side, well-managed companies across many EM geographies are continuing to enjoy increased earnings, improved balance sheets, and reduced external vulnerabilities. Additionally, default rates remain at cyclical lows. With this in mind, investors can now locate some of the best risk-adjusted value globally in high yield emerging markets corporate bonds while also benefiting from lower average duration. Getting more specific, we view the Asian credit markets as particularly compelling following the recent concerns over slowing growth in China. Now that the People’s Bank of China is easing policy to ensure growth remains intact, this could offer an excellent buying opportunity in some of the sectors we favor, like Asian real estate and technology.

SELECTIVITY STILL ESSENTIAL

The diversity of EM debt is one of its primary benefits, and this is becoming even more important considering the recent divergence in global economic growth and monetary policy. However, structural difficulties within specific EM countries could result in some sectors and geographies continuing to underperform. For example, in Turkey, while both lira-

and U.S. dollar-denominated corporate and sovereign bonds stand out as historically cheap, the longer-term policy direction of the government is likely to result in further weakness.

For this reason, it is essential to go beyond the numbers and identify areas of EM that exhibit both improved valuations as well as a commitment to implementing structural reforms and realizing long-term potential. South Africa stands out, in this regard, with the recent election of Cyril Ramaphosa as president. He is helping to drive structural reform, and we view both the rand and the country’s sovereign debt as attractive as long as the country continues on its constructive path. Another example where improved valuations combine with favorable reforms is in Serbia. The country has strengthened its fiscal situation and there are strong signs that policy action is reducing their current account deficit meaningfully.

In Asia, constructive reforms in Indonesia and India underpin the case that the recent improvement in valuations forms an opportunity to buy local currency assets as well as dollar-denominated credit from these countries’ markets.

EM debt is currently offering investors some of the most attractive opportunities in both its recent history as well as across the current global fixed income universe.

RISKS ARE DIMINISHING

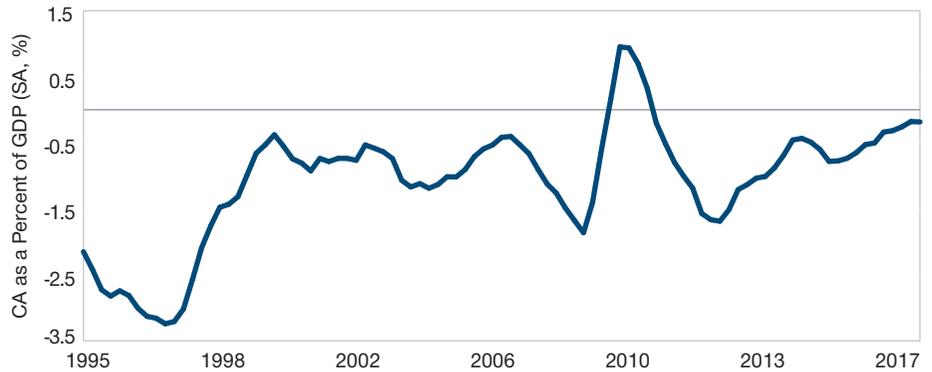
We recognize that risks remain in the coming months and that cheaper valuations alone may not be enough to provide shelter should a sustained period of risk aversion feature in the near term. The ongoing concerns regarding further escalations in global trade protectionism remain an issue that could have a negative impact.

However, even if 2017's global economic growth peak is gone, we believe that the wider macro backdrop within EM is more robust than the market tone currently reflects, trade wars notwithstanding. Election uncertainties that hung over markets earlier in the year are now largely past, and oil prices have stabilized.

While the headwind from U.S. monetary tightening and a stronger dollar will likely persist, much of the downside has now been priced into the market. Growth in the U.S. may ease in the second half following an above potential pace in recent months that would reduce the risk of the Federal Reserve tightening faster than expected. For us, investors should

FIGURE 2: EM Current Account Balance

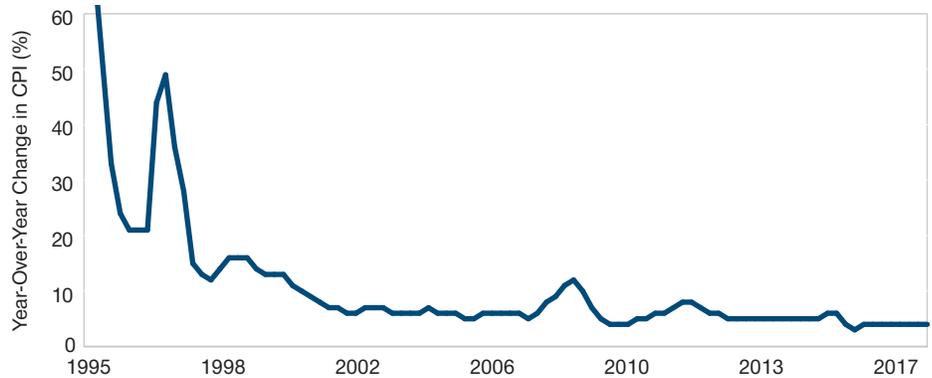
Four-quarter rolling average as of March 31, 2018



Current account (CA) balances include all available country constituents of the J.P. Morgan EMBIG and J.P. Morgan CEMBI BD.
Source: International Monetary Fund/Haver Analytics; data analysis by T. Rowe Price.

FIGURE 3: EM Inflation History

As of June 30, 2018



Source: International Monetary Fund/Haver Analytics; data analysis by T. Rowe Price.

be focusing less on the developed market monetary tightening and a gradual slowdown in economic growth to focus more on the divergence between regions and countries to identify areas where still strong fundamentals stand alongside much-improved valuations. EM debt is currently offering investors

some of the most attractive opportunities in both its recent history as well as across the current global fixed income universe. Rather than seeing the first-half weakness as a reason to turn away from EM, we see it as a window to employ a disciplined and global approach to find undervalued assets.

INVEST WITH CONFIDENCE®

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

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request.

It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA—Issued in the European Economic Area by T. Rowe Price International Ltd, 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

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