



FINDING VALUE IN EMERGING MARKETS DEBT

SEPTEMBER 2017

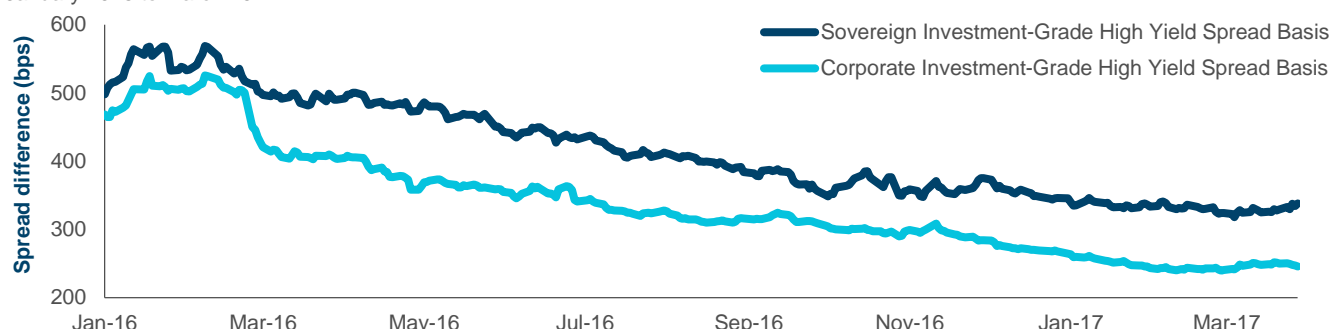
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Buoyed by strong investor inflows, emerging markets debt has delivered strong returns so far this year, with little differentiation across sector, region, or credit quality (see Figure 1). As a consequence of this recent run of positive performance, valuations have become somewhat stretched and dispersion has fallen—particularly in the larger emerging markets—leaving attractively valued opportunities harder and harder to find.

Figure 1: Rising Correlations—Sovereign vs. Corporate Investment-Grade High Yield Spread Difference

January 2016 to March 2017

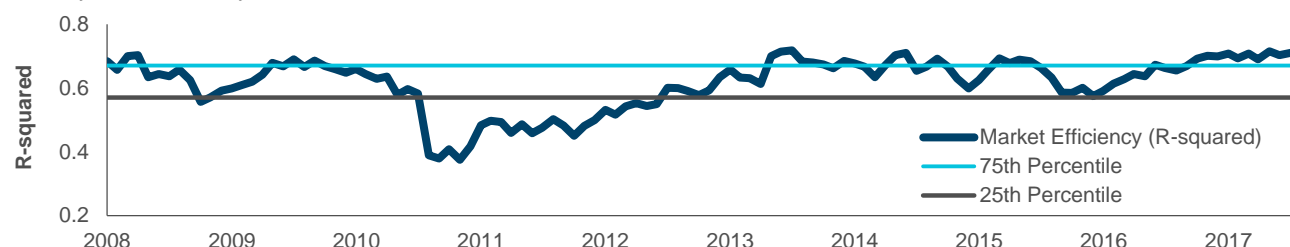


Sources: FactSet, Sovereign: J.P. Morgan Emerging Markets Bond Index Global Investment Grade, J.P. Morgan Emerging Markets Bond Index Global High Yield, Corporate: J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified Investment Grade, J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified High Yield.

There are also macroeconomic headwinds present: The potential for rising interest rates in developed markets may weigh on returns in emerging markets debt, and while the recent low levels of market volatility and strong investor flows into emerging markets have been supportive for the asset class, a reversal in either could lead to a sharp correction. Furthermore, market dispersion is declining: One measure we regularly track—the proportion of bonds trading at fair value—was over 70% as of the end of August, posing further challenges to investors seeking underpriced assets (see Figure 2).

Figure 2: Declining Dispersion—Proportion of Bonds Trading at Fair Value

February 2008 to January 2017



R-squared showing percentage of bonds in the J.P. Morgan Government Bond Index-Emerging Markets that deviate from the fair value defined by credit rating and duration.

Sources: FactSet, data analysis by T. Rowe Price, J.P. Morgan.

Together, these factors make it increasingly challenging for investors to take active risks and generate excess returns in emerging debt markets. However, there are select pockets of value in both sovereign and corporate bonds, especially in some of the lesser-known emerging markets providing one is able to conduct in-depth research. Owing to some of these headwinds, we are managing these risks by positioning our portfolios more defensively while seeking idiosyncratic ideas and identifying active positions that still offer attractive value within this environment.

SOVEREIGN OPPORTUNITIES

Within sovereign bonds, Egypt is one emerging market where we see particular value. Just a few years after undergoing major social unrest, Egypt has stabilized politically and has started on a path to fundamental economic reform. The Egyptian government has taken significant steps to effect fiscal consolidation through adjustments to both sides of its ledger, including making cuts to its subsidy regime and increasing tax rates. Egypt also benefits from International Monetary Fund (IMF) support as part of a three-year program initiated in late 2016.

Local currency-denominated and external Egyptian government bonds offer relatively high interest rates compared with Egypt's emerging markets peers, with the local debt particularly attractive. Egyptian debt also has defensive qualities owing to its relatively low correlation to international bond markets, and therefore can help to provide downside risk management in the event of a wider sell-off.

Sri Lankan bonds also offer good value. The Sri Lankan government has improved the country's fiscal position and has plans to implement tax reforms in order to boost its tax revenues, which are currently among the lowest in the world in terms of income. Like Egypt, Sri Lanka secured a three-year loan facility from the IMF in 2016, and a recent deal to sell a majority stake in Sri Lanka's Hambantota port to a Chinese state enterprise could open the way for further foreign direct investment.

Sri Lanka's local currency government bonds present an attractive opportunity for us, offering among the highest real rates in the world. However, a key risk investors in Sri Lankan bonds face is the country's high level of indebtedness: A large portion of the government's revenue goes toward servicing its debt. What's more, as in many emerging markets, there is political risk in Sri Lanka as the coalition government faces frictions as it attempts to enact constitutional changes.

CORPORATE BONDS

There are also attractive opportunities in emerging markets corporate debt. For example, we see value in Argentine banks. The Argentine banking system is well capitalized and underleveraged compared with those in many other emerging markets. Shifts in economic policy and a new regulatory framework under President Mauricio Macri's government should encourage sustained credit expansion, given that Argentina is at an early stage of its credit cycle. Argentine banks have also been bolstered by a supportive macroeconomic backdrop as the country's growth continues to undergo a cyclical recovery amid economic reform.

Elsewhere, select quasi-sovereign corporate bonds offer good value. In particular, we favor certain Brazilian quasi-sovereign companies in the oil and gas industry. These bonds offer attractive valuations relative to Brazilian sovereign debt and other Brazilian corporate bonds, and they also benefit from a more liquid market than many other emerging markets quasi-sovereign names.

Active management in emerging markets debt allows the flexibility to tactically invest in pockets of value within the universe while also mitigating risk. By taking active positions in attractively valued opportunities such as those highlighted above, the composite performance of our Emerging Markets Bond Strategy, Emerging Markets Corporate Bond Strategy, and Emerging Markets Local Currency Bond Strategy each outperformed their benchmarks in the year-to-date to 31 August, 2017 and annualized over three- and five-year periods to 31 August, 2017.¹ This has been achieved while maintaining a defensive positioning with a relatively conservative exposure to market risk. We remain alert to other such opportunities.

¹The performance details refer to each of the corresponding strategy's composite (i.e. Emerging Markets Bond Composite, Emerging Markets Corporate Bond Composite, and Emerging Markets Local Currency Bond Composite). The benchmarks for Emerging Markets Bond Composite, Emerging Markets Corporate Bond Composite, and Emerging Markets Local Currency Bond Composite are the J.P. Morgan EMBI Global Diversified, the J.P. Morgan Corporate Emerging Market Bond Index Broad Diversified, and the J.P. Morgan GBI-EM Global Diversified respectively.

However, while these lesser-known markets can offer good value, they also carry a number of idiosyncratic risks. It is therefore essential to combine active management with in-depth fundamental research and a risk-aware approach in order to mitigate market inefficiencies in the asset class and exploit these opportunities.

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