Why EM Debt Can Continue to Challenge the Doubters

EM debt's diversity helps it overcome many common investor concerns.

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KEY INSIGHTS

- Emerging markets debt can continue to perform going forward after a strong start to 2019. Its diversity and growth mean that many concerns are no longer valid.
- Emerging markets offer many defensive opportunities that have performed similar to developed market sectors during periods of volatility.
- Positive reforms and fundamentals mean that many areas of EM show favorable growth outlooks with less risk of policy error sell-offs.

Emerging markets (EMs) are off to a strong start to 2019, and we are confident that EM still offers many long-term investment opportunities. However, after a difficult 2018, many investors continue to question the rebound and the longer-term outlook for the asset class based on a misconception that it is a high-risk and high-beta investment. We address some of the common investor questions and explain why the concerns either are no longer true or only tell part of the story.

1. Is EM a high-risk investment should volatility return?

Contradicting the stereotype of a volatile, higher-beta asset class, many regions and sectors of EM offer defensive opportunities that can outperform other asset classes during periods of risk aversion. The breadth of opportunities in EM is one of its key strengths.

This is not to suggest volatility is not a concern. Rather, it means investors need to do their homework and identify sectors and regions with lower-beta track records when looking for defensive assets. Many areas of EM debt have behaved more defensively than some developed market (DM) counterparts. With many sources of the 2018 volatility still lingering in the current outlook, investors can actively seek out certain areas of EM rather than solely look at DM safe havens.

EM corporates stand out as a defensive sector due to their strong fundamentals. Asia credit, which has grown substantially in recent years, has performed more in line with DM investment-grade, for example, than other higher-volatility EM sectors.[1] The defensive sectors of

[1]Asia Investment Grade: J.P. Morgan Asia Credit Index Diversified, z spread; US Investment Grade: Bloomberg Barclays U.S. Aggregate Corporate Investment Grade Index, Option-Adjusted Spread; Euro Investment Grade: Bloomberg Barclays Euro-Aggregate Index, Option-Adjusted Spread.

> The strong start to 2019 should not come as a surprise. It also should not be treated as a short-term rebound.

EM also offer opportunities to diversify portfolios away from DM regions with the most concerning growth outlooks and large debt accumulations.

EM is also becoming less correlated to some of the higher-risk sectors of DM. Traditionally, U.S. high yield and EM debt have displayed a degree of correlation due to an overlap of investors seeking higher yields than investment-grade DM debt.[2] However, this correlation has fallen in the past year and is below long-term averages. We believe this trend demonstrates the increasing idiosyncratic behavior of EM debt. Therefore, investors may achieve more consistent performance by locating segments and specific names within EM that offer strong fundamentals, rather than focusing primarily on wider market tone.

EM debt offers one of the most attractive opportunities for investors to gain exposure to these still strong fundamentals. Compared with EM equity, hard-currency sovereign bonds boast absolute returns double that of EM equities over the past 25 years.[3]

2. Is the risk of policy error significant?

While negative surprises in political or monetary policy can impact both EM and DM investing, an active approach can help avoid sudden sell-offs. The positive reforms in many EM countries mean that most are no longer just one or two bad decisions away from a crisis. Bottom-up, on-the-ground research can identify countries that are committed to consistent, market-friendly policy directions and reducing investors' exposure to policy error and help avoid those that are slipping in the wrong direction.

Even when significant sell-offs do hit certain EM countries, we don't believe this constitutes a systemic risk to the wider asset class. For example, Turkey and Argentina dominated the headlines for much of 2018 as markets quickly lost confidence in the ability, or the will, of policymakers in each country to manage their currencies and fiscal accounts. Some investors pulled out of EM as a whole at the height of these crises as they sought safety in more familiar core DM assets.

EM Debt Reality Reduces the Risks

EM diversity helps overcome many common concerns

RISK	REALITY
Heightened Volatility	EM contains defensive sectors and opportunities.
Global Economic Uncertainty	Positive reforms mean many countries poised for strong growth.
Policy Error	Active approach can help avoid sell-offs or identify when to reenter.

[2] Source: J.P. Morgan. Data analysis by T. Rowe Price. 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 © 2019, J.P. Morgan Chase & Co. All rights reserved.

[3] As of December 31, 2018.
Sources: J.P. Morgan and MSCI. Data analysis by T. Rowe Price. J.P. Morgan (see footnote above). MSCI (see Additional Disclosures).
EM debt is based on the JP Morgan EMBI Global Index. EM equity is based on the MSCI Emerging Markets Index.

T. ROWE PRICE BEYOND THE NUMBERS

Turkey: Knowing How to Approach Distressed Assets

Our regular country visits helped us avoid the worst of the 2018 sell-offs and then reenter certain distressed market segments when assets appeared oversold.

Our research teams regularly visited Turkey and met with policymakers and business leaders in 2016–2018. This process confirmed our concerns over the regime's priorities of maintaining loose monetary policies despite inflation pressures. We were able to reduce our exposure to Turkish assets before the sell-off hit in early 2018. Our continued visits then helped us recognize dislocated sectors to reenter as the prospects for reform improved in late 2018.

> The positive reforms in many EM countries mean that most are no longer just one or two bad decisions away from a crisis.

However, this contagion-driven sell-off was short-lived and actually created better long-term opportunities. An active, disciplined approach can reveal lower-beta corners of EM, such as selecting Chinese state-owned enterprises that are likely to be less affected by sell-offs elsewhere. Furthermore, sudden downturns can create opportunities to go against the grain and buy cheap assets. By uncovering when to reenter a distressed credit or sector, investors can improve their potential for long-term gains.

3. Can EM assets perform amid a mixed global economic outlook?

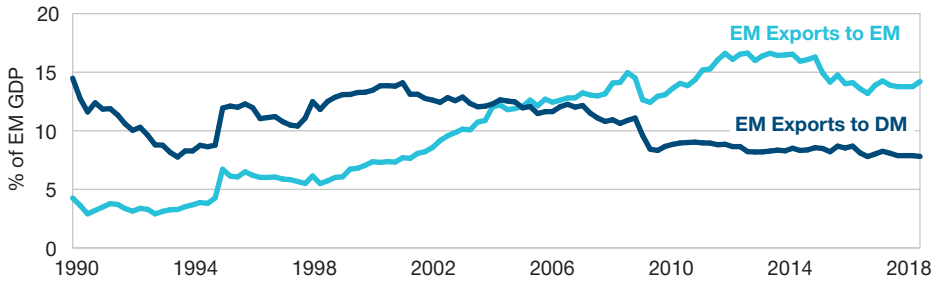
The growth of EM as an asset class in recent years means that investors can find a wealth of investment opportunities in different global economic environments. While we do recognize that strong growth is important for the prospects of EM, this must be kept in perspective as we see several reasons for continued optimism.

First of all, many EM countries enjoy favorable economic growth rates supportive of fundamentals. Investors need to cast aside any

(Fig. 1) EM Economies Are Less Reliant on Trade With DM

EM exports to developed versus other emerging markets countries

As of June 30, 2018



Source: Goldman Sachs Global Investment Research/Haver Analytics.

preconceptions of EM being a single investment opportunity and take the time to look at individual EM sectors and regions to find attractive investments.

Currently, we are confident that many areas of EM can perform even if China or major DM economies cannot resurrect their growth rates. Countries that have committed to positive fiscal and political reforms can continue to thrive. Many EM economies display a growing middle class that is underpinning domestic demand. Consequently, EM is no longer just an export-driven investment reliant on DM, or even Chinese, economic growth. EM economies are trading with other EMs now more than they are with DMs.

Second, EM credit is on a strong footing. Corporate fundamentals remain favorable despite the difficult 2018. The emerging market corporate default rate is at its cyclical lows. Issuers have relatively low debt levels, and companies have been able to extend bond maturities and buffer balance sheets.

Growth concerns in key global markets could also become tailwinds as central banks appear to be shifting to more accommodative policies. While a slowdown in China will impact some EM economies, China's willingness to ramp up stimulus measures should provide a floor to growth levels. Similarly, the U.S. Federal Reserve changed its messaging in early 2019, and we now expect a sustained pause in interest rate hikes. Meanwhile, the European Central Bank is reacting to slowing growth by maintaining its low interest rates and overall accommodative stance.

These central bank shifts could suppress core DM yields, which would lend further support to EM assets. Therefore, investors should regard the global economic uncertainty as potentially opening up an opportunity rather than as just a downside.

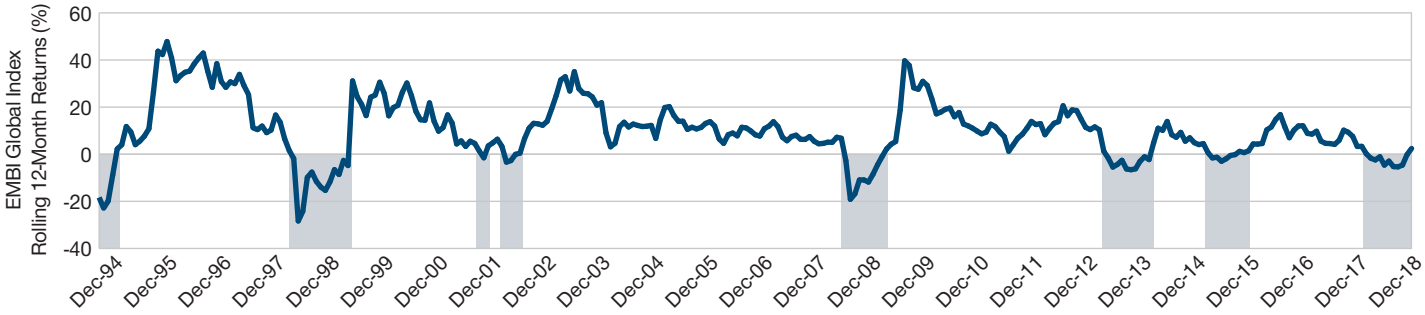
4. Following the volatile 2018, should investors wait for sustained inflows before committing to EM?

History shows that EM has consistently rebounded and rebounded quickly following downturns. Some EM investors were still licking their wounds after the

(Fig. 2) Rebounds Have Typically Followed Negative Returns

EM debt rolling 12-month returns

As of February 28, 2019



Past performance is not a reliable indicator of future performance.

Shaded areas are periods of trailing 12-month negative returns. Chart refers to the J.P. Morgan EMBI Global Index and the J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified.

Source: J.P. Morgan (see Additional Disclosures).

difficult 2018, and one could be forgiven for thinking that it could take some time before investors gain confidence again to fuel a sustained recovery. However, EM debt's track record following periods of negative returns has been for sharp upturns leading to sustained periods of positive returns.

Therefore, the strong start to 2019 should not come as a surprise. In our opinion, it also should not be treated as a short-term rebound. Based on both history and the strong fundamentals, we believe EM offers ample opportunity for sustained strong performance.

WHAT WE'RE WATCHING NEXT

Slower growth in the U.S. could cause the dollar to depreciate, improving potential opportunities in EM local bonds. The greenback has displayed relative strength in recent years against most EM currencies as its economy has outperformed, helped by the late-2017 passing of the Tax Cuts and Jobs Act. However, the fiscal boost is expected to wane, and the market is expecting the world's largest economy to continue to ease in the year ahead. Even if the U.S. growth remains solid, it may fall back into line with much of the rest of the world, which could help EM currencies show improved stability in the months ahead.

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