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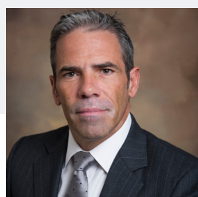

Michael Conelius
Portfolio Manager,
Emerging Markets Bond Strategy

Emerging Markets

EMERGING MARKETS BONDS REMAIN ONE OF THE HIGHEST-YIELDING OPPORTUNITIES IN THE FIXED INCOME MARKET

EXECUTIVE SUMMARY

- Emerging markets (EM) bonds remain one of the highest-yielding fixed income opportunities, offering materially better carry than developed markets
- Following recent volatility caused by contractionary central bank action and protectionist trade policy from the U.S., valuations cheapened, even in some mainstream EM countries
- Long-term fundamental and structural drivers remain solid, including stronger underlying economic growth, more controlled government spending, and significant political reforms in key markets
- We continue to look at Argentina after it came to an agreement with the IMF and are monitoring Brazil ahead of its upcoming presidential elections

Emerging markets (EM) debt has declined so far this year. Is this an attractive entry point for the asset class?

The convergence of rising U.S. interest rates and a strengthening U.S. dollar has weighed on investor sentiment and led to a squaring of positions that drove the emerging markets debt benchmark down 5.2% through the first half of 2018. What we are in now is just a correction, however. Long-term fundamental and structural drivers remain solid, including stronger underlying economic growth, more controlled government spending, and significant political reforms in key markets. Synchronized global growth provides an additional anchor for the asset class.

Following the recent volatility and amid an increasingly uncertain policymaking environment, valuations cheapened, even in some mainstream EM countries. As a result, we are looking to add active risk incrementally.

EM debt has been a relatively underinvested asset class, in part because of prevailing concerns about volatility. Should it occupy a position in most portfolios?

Investors tend to focus on negative headlines when it comes to EM debt, and so they set a high bar on whether to include it in their portfolios because they worry the asset class is too volatile. In reality, EM debt, like most asset classes, can be volatile, but oftentimes we see that when a country goes through a crisis, that tends to stimulate positive change.

The broad direction of financial reform in EM countries may not always be a straight line, but when they slip in their policies, the market will give them

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feedback on what they need to correct. Unlike advanced economies that have the luxury of generating financing through central bank accommodation, EM countries inherently are consumers of foreign capital, so they must make the necessary changes if the market pressures them. This should be a reinforcing process over time. Once you have an upward tilt in wealth creation, society will pursue continued improvement because it has more of a stake in the future and does not want to lose those gains.

Another important point to consider is that EM bonds remain one of the highest-yielding opportunities in the fixed income market, offering materially better carry than developed markets, of which a significant proportion provide low to negative real yields.

What conditions do you look for when considering investment opportunities?

We tend to analyze most closely political or economic crises because they have the potential to create an inflection point for positive change. Sometimes that takes the form of a political transition like when Cyril Ramaphosa assumed the South African presidency upon Jacob Zuma's resignation in February and appointed new cabinet members, which was well received by the market. We are also closely monitoring Brazil and expect that the presidential elections in October will produce a responsible leader able to push through important structural changes like pension reform.

Meanwhile, we continue to look at Argentina after it came to agreement with the International Monetary Fund over a USD $50 billion credit line amid a plunge in its currency value. President Mauricio Macri showed courage with this decision, and it's important that Argentina gets its fiscal house in order quickly. If it can do so, capital markets may reward that.

It is also necessary to identify which EM countries may be trending in a negative direction. Take Turkey, for example. We believe the country's assets will remain under pressure in the near future, particularly as the lira has depreciated to record levels in 2018 after President Recep Tayyip Erdogan vowed to take greater control of monetary policy and the U.S. imposed sanctions on top Turkish government officials.

Why is it important to adopt a bottom-up country selection approach when considering EM debt?

We believe that focusing on idiosyncratic, fundamental developments in individual EM countries is the best way of unlocking long-term value. Rather than taking a top-down view on oil and screening oil producers, for example, we prefer analyzing whether those countries that have the resource also have the capability and intention to use it wisely. Oftentimes, you can have a boon in oil prices, but all you get is poor policies on the other side.

It is also important to bear in mind that the term EM refers to a vast collection of countries throughout the world, each with their own unique political systems, social dynamics, and economic conditions. Some attract ample foreign investment, while others actively reject it. Against this backdrop, managers can turn over countless stones in identifying opportunities to generate alpha.

What are some of the downside risks you are currently monitoring?

Contractionary central bank action and protectionist trade policy from the U.S. have caused market volatility, which has led in part to the decline in EM debt this year. We believe these developed market-led events should pose limited fundamental risk to the asset class, but they could depress global liquidity levels, which leaves us cautious on corporates and some frontier markets.

Meanwhile, local currencies have been volatile over the past few years and have not offered a sufficient risk/return value. We believe that is likely to continue in the near future, especially as trade tensions put more pressure on key currencies like the Chinese renminbi. As a result, our current focus is on U.S. dollar-denominated EM debt and largely hedging local currency exposure.

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