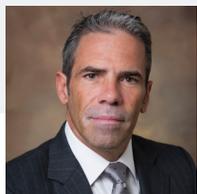




PRICE POINT

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Timely intelligence and analysis for our clients.



Michael J. Conelius
Portfolio Manager,
Emerging Markets Bond Fund



Ben Robins
Portfolio Specialist,
Emerging Markets Bond Fund

Emerging Markets Debt **YIELD PLUS DIVERSITY: THERE'S A LOT TO LIKE ABOUT EMERGING MARKETS DEBT**

KEY POINTS

- The supportive environment of attractive yields and improving economic fundamentals in emerging debt markets looks set to continue over the coming year.
- With monetary policy in developed markets tightening, rates in emerging markets can offer diversification from those in core markets.
- Given the risks inherent to the asset class, the ability to dynamically reposition based on changes in fundamental, valuation, and technical factors is crucial.

Emerging markets (EM) debt was one of the best-performing areas of fixed income last year. Buoyed by attractive yields, improving economic fundamentals, and declining local currency risk, we saw strong returns across the EM debt sub-asset classes. This may help to address EM debt's reputation in the eyes of some as a higher-risk asset class blighted by large-scale sovereign defaults. However, others may still be questioning its ability to maintain gains, especially with a number of headwinds in 2018, including elections in several key countries and concerns over monetary tightening in developed markets.

ATTRACTIVE YIELDS IN A LOW-RATE ENVIRONMENT

Strong yields are likely to remain a key attraction of EM debt. EM bonds—including hard and local currency-denominated sovereign and corporate debt—are in general currently offering a premium of between 3% and 5% over equivalent-maturity U.S. Treasury bonds,

with local currency bonds in particular offering some of the highest yields.

Similarly, the diversification benefits offered by EM debt, given the sheer scale of the market, is another compelling feature for investors. The asset class offers a large and diverse opportunity set, which, at around USD \$6 trillion in size, is comparable to the U.S. Treasury and U.S. investment-grade corporate bond universes (Figure 1). Tactical management of portfolios can provide access to a broader opportunity set than passive portfolios, which track capitalization-weighted indices and so tend to be highly concentrated, especially in the more heavily indebted countries.

Given the scope of the emerging debt markets, it is important to take a selective approach to identifying opportunities. Spanning a dozen “mainstream” countries, around 20 second-tier countries, and around 40 frontier countries, emerging debt markets offer investors a wider array

of interest rate cycles than developed markets. This divergence between countries at different stages of their respective cycles provides active investors with many more opportunities to exploit. In 2017, for example, there were 82 interest rate cuts and 34 hikes by global central banks, and further policy rate moves are likely in 2018.¹

The prospect of monetary policy tightening in developed markets, particularly the U.S., might be regarded by some observers as a headwind to EM bonds. However, returns on EM debt have historically been relatively resilient during previous periods of rising rates in the U.S. (Figure 2). Importantly, they also have a higher correlation to U.S. rates than other fixed income assets, so could potentially perform better as U.S. rates rise. Currently, we are particularly focusing on select local currency markets with a lower beta to U.S. duration, as that can improve diversification and also help to offset the risk of U.S. rates rising at a faster-than-anticipated rate.

Meanwhile, EM fundamentals remain strong, too. The global growth outlook remains positive, synchronized across both developed and emerging markets, which should, in turn, fuel growth in global trade. Current account balances have improved dramatically over recent years, with deficits generally much reduced, while the level of indebtedness among EM countries has also declined noticeably from 2015 peak levels. Meanwhile, the major economies of Brazil and Russia are emerging from their respective recessions, which could provide a further boost for emerging market economies.

Meanwhile, an expanding middle class and growing household wealth across most emerging markets continue to engender strong consumer demand, fueling further economic growth, but also improving current account balances more broadly. For example, improving

FIGURE 1: Emerging Markets Debt Universe—A Large and Diverse Opportunity Set

As of December 31, 2017



Note: U.S. Treasury is represented by the Bloomberg Barclays U.S. Aggregate Treasury Index. U.S. IG Corporate Bonds is represented by the Bloomberg Barclays U.S. Aggregate Corporate Index. U.S. High Yield is represented by the Bloomberg Barclays U.S. Corporate High Yield Index. EM Sovereign Hard Currency is represented by the J.P. Morgan Corporate EMBI Broad Diversified Index. EM Sovereign Local Bonds and Currencies is represented by the J.P. Morgan GBI-EM Global Diversified Index.

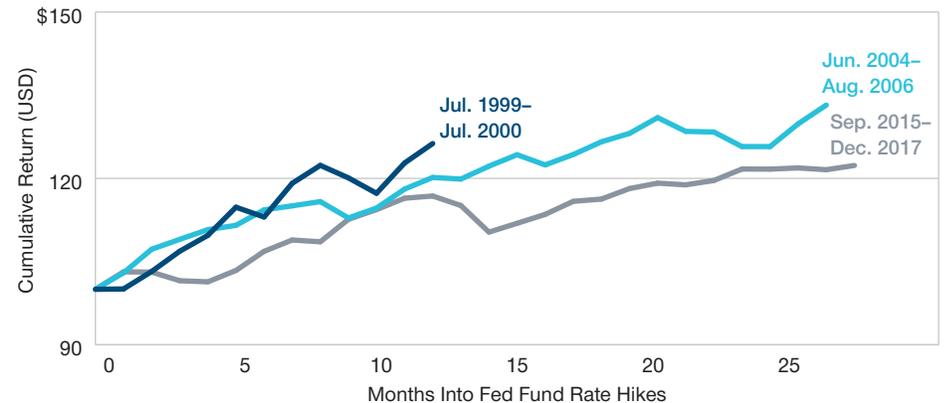
Sources: Bloomberg Barclays and J.P. Morgan Chase & Co.

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FIGURE 2: Emerging Markets Bond Returns During U.S. Fed Hiking Cycles—EM Debt Has Consistently Performed Well During Recent Periods of Fed Rate Hiking

J.P. Morgan Emerging Markets Bond Index Global—Cumulative Returns During U.S. Fed Hiking Cycles, as of December 31, 2017



Source: J.P. Morgan.

Past performance is not a reliable indicator of future performance.

growth and declining inflation in Brazil have fueled demand for consumer credit, creating a supportive environment for corporate bonds in particular, which we

believe offer attractive valuations over Brazilian sovereign debt and benefit from a more liquid market than many other emerging corporate debt markets.

¹Sources: IMF, CB Rates. Analysis by T. Rowe Price. As of December 31, 2017.

An ability to manage currencies efficiently can help to reduce volatility and can also facilitate currency alpha, providing an opportunity to boost a portfolio's risk/return trade-off.

Furthermore, economic reform momentum continues to bolster the asset class as a number of emerging countries implement structural reforms that should support economic growth. India, for example, has increased the independence of its central bank, introduced measures to clamp down on the black market economy, and simplified its taxation system with the creation of nationwide goods and services tax.

We are seeing interesting opportunities in frontier markets, too. The International Monetary Fund (IMF) has seen real change in some of these markets and is supporting them with financial assistance programs that are stimulating foreign direct investment. One such market is Egypt, where the government's efforts to effect fiscal consolidation, including making cuts to its subsidy regime and increasing tax rates, have combined with IMF assistance to create an attractive environment for the country's sovereign

bonds. Ghana, too, has benefited from an IMF loan facility, while its government has cut spending and the country's oil and gas exports have increased.

We are also using currency management to add another dimension to returns. In recent years, coupons have generated most of the returns from EM local currency bonds, while currency has been one of the riskier elements. An ability to manage currencies efficiently can help to reduce volatility and can also facilitate currency alpha, providing an opportunity to boost a portfolio's risk/return trade-off. Furthermore, in spite of the depreciation of the U.S. dollar, EM currencies remain fundamentally undervalued and continue to offer attractive levels of carry.

RISK MANAGEMENT IS KEY

Nevertheless, a number of risks persist. While these markets have historically been resilient to rate increases in developed markets, policy tightening that exceeds market expectations could

potentially lead to a rise in volatility, causing pressure for emerging markets. Similarly, an abrupt slowdown in China—a key driver of emerging markets—could also lead to a flight to quality and a drain on flows.

Political risk is on the rise, too. A number of the larger emerging countries—including Mexico, Brazil, Russia, and Malaysia—are set to go to the polls over the coming year. A correction in commodity prices could also weigh on certain countries.

In the face of these risks, investors will need to be agile. The ability to adjust positions based on changes in fundamental, valuation, and technical factors will be crucial. Monitoring wider global macroeconomic factors is also important as this can have a large impact on these markets. Dynamics such as energy prices, developed market interest rate cycles, and economic growth in China are just some of the potential headwinds that could impact the broader investment context. Tactically investing in select opportunities that offer the best value, while also mitigating risk, is essential to generating consistently strong relative returns. Moreover, with the growth premium in emerging markets set to expand and monetary policy tightening in developed markets, this could be a good time to gain exposure to the asset class.

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