



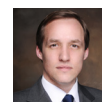
How EM Investors Can Succeed in a Dovish Monetary Backdrop

Central bank support should not shift investor focus away from fundamentals.

August 2019

KEY INSIGHTS

- Despite growth concerns, we believe emerging markets (EM) can perform well as they form an important source of real income in a backdrop of low developed market government yields.
- Local currency assets could stand out if the U.S. dollar weakens. EM currencies lagged the rallies in early 2019 and are currently undervalued.
- However, EM are at risk should the macro backdrop shift. Investors should look beyond this near-term binary choice of a risk-on or risk-off backdrop and seek out strong fundamentals.



Andrew Keirle
Portfolio Manager

The current emerging markets (EM) backdrop can appear puzzling at first glance. On one hand, dovish central bank policies could boost EM assets. However, global growth uncertainty and trade wars dominate headlines. Should investors be looking to reduce EM risk exposure? Or should they follow the axiom of “don’t fight the Fed” and expect central banks to support a risk-on backdrop?

While conditions could spur further EM rallies this year, we maintain that EM investors should look beyond this binary choice of a risk-on or risk-off macro backdrop. There is a lot to like within EM themselves. Investors who seek out areas with strong long-term fundamentals can help shield themselves from swings in macro sentiment.

Monetary Policy Creates Room to Run

Global central banks are giving investors reason to remain upbeat. Currently, the market anticipates that the Federal Reserve could follow its July rate cut with additional cuts this year. The European Central Bank (ECB) is also talking about rate cuts or even restarting monthly bond purchases. Several other global central banks have either begun or are poised to ease policy in the coming months. While these easing measures are not certainties, major central banks are likely to take broadly accommodative stances as long as the economic picture remains mixed. Therefore, we are optimistic about EM for several reasons:

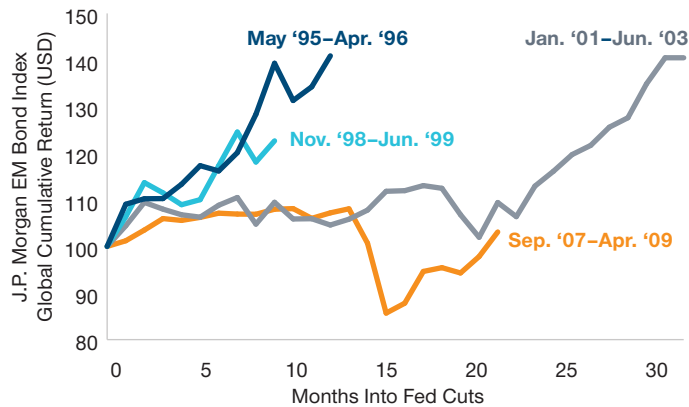
↓ ↓ EM asset classes could see further inflows. In the first half of the year, EM enjoyed strong fund flows, particularly hard currency assets, when

(Fig. 1) Rate Cut Boosts for EM

EM debt* during Fed rate cuts and falling yields

As of June 30, 2019

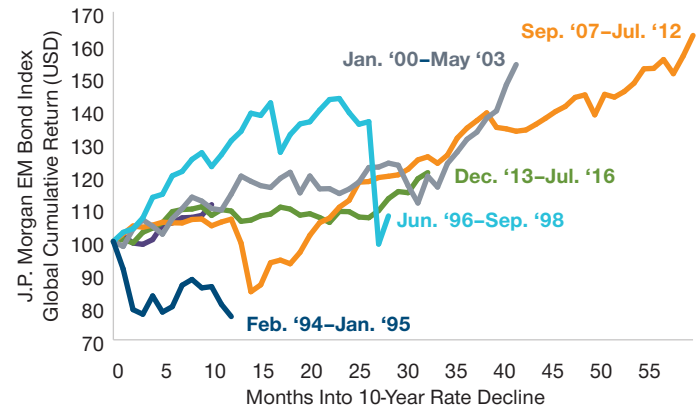
Returns During Fed Cutting Cycles



*EM debt refers to J.P. Morgan Emerging Market Bond Index (USD).

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

Returns During Falling 10-Year Rates



USD 25 trillion¹


Estimated value of bonds with negative real yield globally.

the Fed and ECB began their respective dovish shifts. Going forward, global central bank policies will likely keep core government yields suppressed.

In a world of low, or even negative, developed market yields, EM can continue to attract investors because they form an increasingly rare source of positive real (inflation-adjusted) income. Currently, the estimated value of global debt with a negative real yield is over USD 25 trillion.¹ Should inflation rise when central bank easing takes hold, an even greater share of developed market debt would saddle investors with negative real yields. In this environment, securing much-needed real income could become a larger focus for investors globally.

Furthermore, EM are still under-owned. Although early 2019 saw steady inflows, retail investors have not returned to the levels seen before the 2018 volatility. Signs of committed loose policy stances by major central banks could provide the incentive to many hesitant

investors. After all, historical data show that EM debt typically performs during Fed cutting cycles.

 Valuations in EM still look enticing. Even though valuations are not as cheap as they were at the start of the year, they have improved relative to developed markets in many cases. Also, EM asset prices do not yet reflect potential improvements in the growth outlook should stimulus take hold. The recent rallies have largely stemmed from developed market monetary easing expectations. Should growth data stabilize, asset prices could continue to rise.

Additional stimulus measures in China are also not yet priced into the market. So far, Chinese authorities have been cautious about adding monetary or fiscal stimulus. However, as economic concerns persist, authorities may adopt a more concerted approach to revive growth. This would give a boost to EM sentiment as Chinese growth remains an engine of EM economies.

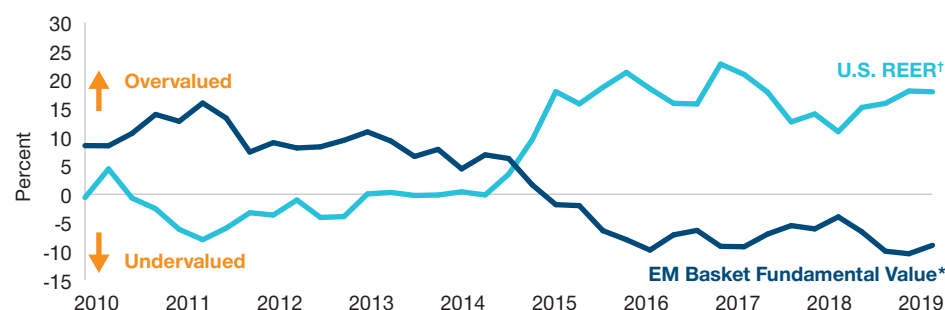
¹ Source: Bloomberg Index Services Limited (See Additional Disclosures), as of July 12, 2019.

“In a world of low, or even negative, developed market yields, EM can continue to attract investors because they form an increasingly rare source of positive real (inflation-adjusted) income.

(Fig. 2) EM FX Looks Attractive

EM currencies have been undervalued versus U.S. dollar

As of March 31, 2019



*EM Basket Fundamental Value = Average Misevaluation of currencies of Brazil, Chile, China, Colombia, Czech Republic, Hong Kong, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Peru, Philippines, Poland, Romania, Russia, Singapore, South Africa, South Korea, Taiwan, Thailand, and Turkey.

†U.S. REER = U.S. dollar real effective exchange rate.

Sources: Thomson Reuters (see Additional Disclosures) and T. Rowe Price.

EM local currency assets could stand out. If the Fed remains dovish and EM growth is sustained, the U.S. dollar would likely depreciate against EM currencies. The greenback's sustained strength in recent years has meant EM currencies lagged the rally in EM hard currency assets in early 2019. Consequently, local currency bonds and foreign exchange markets contain some of the more compelling opportunities should the dollar's roughly seven years of strength fade in the next cycle.

Stay Alert to the Potential Risks

Investors should remain on guard for potential shifts in monetary policy or the economic outlook, which could disrupt EM. Those who focus solely on short-term macro tailwinds are likely to get burned in the longer run.

- For one thing, EM assets would suffer if markets lose confidence in central banks' ability to resurrect growth. Developed market central banks have less firepower than they have had in the past. The Fed's recent tightening cycle was moderate, leaving interest rates at a historically low starting point. The ECB, meanwhile, did not even begin hiking rates and only ended its

quantitative easing bond purchases at the end of 2018. Any restart of the quantitative easing program would likely be smaller in size. A further escalation in U.S.-China tariffs would also hurt sentiment. EM could face volatility if economic data meaningfully deteriorate, sparking renewed recession fears.

- Alternatively, growth could improve more quickly than expected, prompting central banks to under-deliver on their expected easing policies. This is concerning for EM given that much of the first-half 2019 rally was based on expected EM rate cuts. While we would regard an improved growth outlook as a favorable long-term trend, any sudden shift back to more hawkish central bank policy could trigger bouts of shorter-term volatility.
- The U.S. dollar could also enter another period of strength should economic data in the country surprise materially on the upside or downside. Investors aware of the "dollar smile" concept are likely familiar with this already. The dollar smile posits that the greenback will appreciate during periods of either very weak or very

strong U.S. growth. Currently, the economic data are mixed, and the dollar may weaken as investors look elsewhere for higher returns. However, a pronounced deterioration of the economy would trigger a flight to safe assets, such as the dollar. Conversely, a rejuvenated U.S. economy would also pull in investor money, causing the currency to appreciate as the Fed would likely become more hawkish. Therefore, investors need to be mindful of any sharp shifts, positive or negative, in the data.

Focus on Fundamentals

In the short term, EM could thrive in a mixed “not too hot, not too cold” global backdrop. However, we maintain that investors should look beyond the external macro drivers. By taking an active approach, investors should search for positives within EM and avoid the areas that may suffer most if macro sentiment shifts.

Fortunately, we identify several areas with strong or improving fundamentals even with the current economic concerns and policy uncertainty. Many countries, such as Indonesia and South Africa, are implementing constructive reform programs following recent elections, which could help improve stability through different market cycles. Several EM countries are displaying fiscal discipline, managing healthy external balances, and employing rational economic policies. These positive trends give countries like Brazil increased policy flexibility to cope with shifts in the external environment.

That is not to say these areas of EM won't experience volatility. In our view, though, they can better withstand shifts in the macro backdrop and perform over the full market cycle while also benefiting from the near-term central bank-driven tailwinds.

WHAT WE'RE WATCHING NEXT

We are closely watching economic data in China. Growth indicators, particularly in the manufacturing sector, have trended lower for much of 2019. Despite more resilient data in the services and real estate sectors, a further deterioration in China purchasing managers index figures would likely trigger deepening concerns about the wider EM outlook. Furthermore, although talks remain ongoing, the recent escalations in tariffs on Chinese goods by the U.S. followed by a deterioration of the renminbi suggest a resolution is unlikely in the near term. However, if the data proceed on a downward trend, we will watch for the People's Bank of China to possibly respond with more aggressive stimulus measures. This could form a silver lining as it could release some pent-up demand following the extended period of soft data.

Additional Disclosures

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.

Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively “Bloomberg”). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, “Barclays”), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

Copyright 2019 © Thomson Reuters. All rights reserved.

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.

T.RowePrice®

Important Information

This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action. The views contained herein are those of the authors as of August 2019 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates.

This information is not intended to reflect a current or past recommendation, investment advice of any kind, or a solicitation of an offer to buy or sell any securities or investment services. The opinions and commentary provided do not take into account the investment objectives or financial situation of any particular investor or class of investor. Investors will need to consider their own circumstances before making an investment decision.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

Past performance is not a reliable indicator of future performance. All investments are subject to market risk, including the possible loss of principal. All charts and tables are shown for illustrative purposes only.

T. Rowe Price Investment Services, Inc.

© 2019 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.