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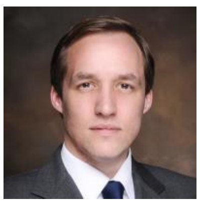
Emerging Markets Debt
7 QUESTIONS CLIENTS ARE ASKING



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1. Is today's background of higher oil prices, rising rates and a strong dollar bad news for emerging markets?

The recent combination of high oil prices, rising rates and a strong dollar has had a negative impact on emerging market (EM) assets. However, we take some comfort that these risks appear to be broadly priced in. So far, we have seen only moderate outflows of capital from the asset class, suggesting there has not been a full-scale change in investor sentiment.

The effects of higher oil prices are mixed, as some countries benefit (Russia, Colombia, Malaysia) while others don't (India, Turkey, Central and Eastern Europe). In aggregate, the universe is roughly neutral to oil prices. If a more typical relationship between commodity prices and the dollar reasserts itself, it should provide something of a cushion to EM currencies (FX).

Rising US rates were felt in the hard currency EM debt (EMD) market in the first quarter, but local yields have remained close to January 2018 levels. We don't think 10-year Treasuries at 3% will fundamentally change the value proposition for EM, though investors may rotate away if rates continue rising. We think the market has largely priced in the present US rate outlook, but there is some risk if US growth or employment surprise on the upside.

The dollar is the hardest to call in the near term. A rebound in European growth would likely slow or arrest dollar appreciation, as would further EM rate hikes. Longer term, we are focused on fundamental FX valuations, which look (generally) cheap in EM.

2. Will inability to finance current account deficits trigger an EM crisis?

The average current account is balanced across EM, and some countries (Russia, Brazil) have enough reserves to cover all of their external liabilities. However, external liabilities are a risk for certain countries (Argentina, Turkey) and remain something we watch very closely both from a fundamental and technical perspective.

3. Will sovereign and corporate issuers be unable to repay US dollar borrowing?

Understanding the ability of EM issuers to repay borrowing requires country-by-country and company-by-company analysis. But at both a corporate and national level, US dollar liabilities are not presently a point of widespread vulnerability. Most corporate borrowers and countries prefunded their medium-term spending needs early in 2018 or in 2017 when markets were more accommodative.

There are, however, countries and companies that are very dependent on external funding, such as Turkey, Argentina, and lower-quality financials and real estate developers.These we have avoided.

4. Against a backdrop of widespread political turmoil, how do you see geopolitical risk?

Some of the weakness in countries like Brazil is a justified reaction to political uncertainty, while outcomes in Mexico and Russia may be more benign than the market expects. We tend to tackle these issues country-by-country and try to reduce or partially hedge exposure if we are not getting paid for the volatility.

Broader geopolitical risks (euro-area stress, North Korea, Iran, US trade policy etc.) are harder to forecast and hedge, as their materialization would likely catalyze a broad sell-off across all risk assets. We hold small positions in safe havens or hedges (such as the Japanese yen or CDS) against these types of risks but will not try to make wholesale changes to positioning, as we do not think we (or anyone else, for that matter) have an edge in precisely forecasting geopolitical flash points.

5. Many investors went long EM in their hunt for yield. Higher developed-market rates are forcing a painful technical unwinding. Do these EM outflows reflect the beginning of problem?

Thus far we have not seen a wholesale change in risk appetite (flows are actually positive year to date), but emerging markets have recently seen notable outflows from shorter term or retail-based investors. It is not our base case, but there is a risk this could turn into a vicious cycle if capital outflows lead to more fundamental problems, as they have in Argentina.

However, we think the combination of good fundamentals and a still-significant yield premium will keep many investors in their EM positions. This is consistent with flow data and what we are hearing from institutional clients.

6. If they are forced to tighten interest rates to defend their currencies, will EM economies slow down, or even collapse?

This is certainly a risk in some markets, but not currently a major concern as monetary conditions remain broadly neutral. That said, Indonesia and India have made defensive rate hikes recently and Argentina and Turkey have made aggressive adjustments to address cyclical and external risks.

At this point we have not seen widespread tightening, but we may see more tightening and slowing growth if currencies are still under pressure in two to three months. However, most EMs have rate hikes priced into expectations, so market disappointment may be limited.

7. Will currency declines lead to deleveraging and negative consequences across emerging markets?

At this point, emerging markets stresses are predominantly idiosyncratic. However, if countries with good fundamentals come under significant pressure, there is the risk of a self-fulfilling prophecy whereby FX depreciation leads to rate hikes, leading to stagflation. However, a significant proportion of EMs–including many in Asia and CEE but also the Andean countries (Bolivia, Colombia, Ecuador, Peru)–have seen limited fallout from recent volatility, underscoring our view that it remains a case-by-case phenomenon.

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