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# Emerging Markets Debt.
# CALMER WATERS AHEAD?

**EXECUTIVE SUMMARY**

Investors who haven't been involved and witnessed the challenges facing emerging markets debt over recent years may have been patting themselves on the back. Yet investors could be missing out by continuing with negligible or underweight positions through 2015, particularly when it comes to hard currency bonds.

Despite the recent run of far-from-smooth sailing, Mike Conelius, Emerging Markets Debt Portfolio Manager believes the pieces are in place for a performance revival.

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## WHAT ARE THE MAJOR HEADWINDS THAT CURRENTLY FACE INVESTORS IN EMERGING MARKETS DEBT?

There are two factors that are fairly benign and another two headwinds to be more concerned about.

The more benign headwinds are low growth and foreign exchange challenges. The first - low growth - has been with us for some time and, coupled with low commodity prices, has represented a major challenge for EMD investors. This, however, is now fully priced in and growth has already bottomed out. That said, there is a great deal of disparity between countries in terms of forecasts.

The second benign challenge is the FX mismatch for dollar-denominated credit. There have been concerns about hard currency corporate debt as the U.S. dollar appreciates. There is a sense that some creditors may not be able to pay out their debts in dollar terms and there may be an increase in defaults. Yet most companies are well positioned to withstand this pressure: some have hedged their payments, some have substantial hard currency reserves and so forth.

The two issues that are more concerning are idiosyncratic risk and Fed tightening. The former has been very challenging lately: think of Ukraine and Russia, Venezuela, Argentina, Brazil and the Petrobras scandal.

Investor sentiment continues to be very fragile. People are definitely keeping money on the sidelines. On a more positive note, much of this should clear up in the next twelve months. There's optimism about Argentina's October elections, for example, and predictions that the country will become open to foreign capital again. In Venezuela there shouldn't be a near-term default, which is what markets are pricing in today. In fact, we're taking some tactical positions in Venezuela right now - not very large holdings but they offer a pretty hefty income.

The prospect of Fed tightening will undoubtedly bring liquidity challenges over the next few months. At least this will be a short-to-medium-term problem. The broad consensus - and our view also - is that we'll see a hike in June or July followed by another hike later in the year. Yet these rises won't be large, perhaps 25 basis points in the first and another 25 in the second. We prefer to see the period of liquidity constraint as a buying opportunity rather than an obstacle.

### WHAT ARE YOUR EXPECTATIONS FOR LOCAL VERSUS HARD CURRENCY DEBT?

In 2015 at least, hard currency emerging markets debt should outperform local currency debt.

Local currency debt has certainly had an interesting ride. Everyone loved this space in 2009-10; many wanted to get into it. Now they've backed off. Investors are asking us if they should be looking at this space and whether it's a bad trade. The reality is that people need to understand the risks associated with local currencies. Currency is the most volatile aspect of investors' fixed income portfolios.

When thinking about emerging markets currencies relative to the U.S. dollar it's perhaps easier to frame expectations on what will happen to the dollar. The appreciation trend will persist for a little while but is unlikely to continue over the mid to long term. What has really fuelled this movement is the growth of the U.S. economy but it can't continue to grow unilaterally and shouldn't hit four or five percent.

### WHAT ABOUT SOVEREIGNS VERSUS CORPORATES?

Sovereigns do tend to have longer duration, so they will face greater headwinds in a rising rate environment; the corporate space has lower duration but faces the challenge of low growth. Overall, you could expect high single digit returns for both.

### WHAT'S YOUR PERSPECTIVE ON HOW INVESTORS ARE VIEWING EMERGING MARKETS DEBT?

There's still a large secular underweight. Many institutions still don't have any EMD exposure. Recent troubles have perhaps strengthened convictions: investors who haven't been involved and witnessed the challenges of the asset class may have been patting themselves on the back! Yet in doing so they risk missing out: the performance will come back and you need to be involved early if you want to benefit.

### WHAT'S YOUR PERSPECTIVE ON THE EVOLUTION OF THE INVESTMENT UNIVERSE?

There have been dramatic changes. Back in the 1990s when this asset class emerged it only included dollar-denominated debt. Over time, as countries' creditworthiness improved, they began to issue in their local currencies.

The evolution of the (hard currency) corporate market has been very recent: it only came of age around 2007.

One interesting trend today is greater fragmentation in terms of what investors ask for. At T. Rowe Price, we have been getting enquiries for very specific areas: high-yield EM corporates only; investment grade sovereigns only; Mexican bonds only; Indonesia only. There is increasing appetite from some investors for more sophisticated, targeted exposures.

Another development during the past five years, particularly from buyers who haven't invested in this space previously, is a leaning towards an unconstrained approach. That's fine, but it's important that investors set the right expectation for potential volatility, especially when it comes to FX exposure if the manager is taking currency bets.

Going forward it will be interesting to see how the local currency corporate bond market evolves. It will still be another few years before it's mature enough for us to consider: it's still fairly illiquid and the yields are low because local investors such as domestic pension funds hold - or have to hold - these securities. Over time, companies will likely gravitate towards issuing in local currencies as much as the market will let them, since it's a better match for their financial activities.

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