



# Why EM Debt Can Continue to Challenge the Doubters

EM debt's diversity helps it overcome many common investor concerns.

April 2019

## KEY INSIGHTS

- Emerging markets debt can continue to perform going forward after a strong start to 2019. Its diversity and growth mean that many concerns are no longer valid.
- Emerging markets offer many defensive opportunities that have performed similar to developed market sectors during periods of volatility.
- Positive reforms and fundamentals mean that many areas of EM show favorable growth outlooks with less risk of policy error sell-offs.



**Ben Robins**  
*Portfolio Specialist*

Emerging markets (EMs) are off to a strong start to 2019, and we are confident that EM still offers many long-term investment opportunities. However, after a difficult 2018, many investors continue to question the rebound and the longer-term outlook for the asset class based on a misconception that it is a high-risk and high-beta investment. We address some of the common investor questions and explain why the concerns either are no longer true or only tell part of the story.

## 1. Is EM a high-risk investment should volatility return?

Contradicting the stereotype of a volatile, higher-beta asset class, many regions and sectors of EM offer defensive opportunities that can outperform other asset classes during periods of risk

aversion. The breadth of opportunities in EM is one of its key strengths.

This is not to suggest volatility is not a concern. Rather, it means investors need to do their homework and identify sectors and regions with lower-beta track records when looking for defensive assets. Many areas of EM debt have behaved more defensively than some developed market (DM) counterparts. With many sources of the 2018 volatility still lingering in the current outlook, investors can actively seek out certain areas of EM rather than solely look at DM safe havens.

EM corporates stand out as a defensive sector due to their strong fundamentals. Asia credit, which has grown substantially in recent years, has performed more in line with DM investment-grade, for example, than other higher-volatility EM sectors.<sup>1</sup> The defensive sectors of

<sup>1</sup>Asia IG: JPM JACI Diversified, z spread; US IG: Bloomberg Barclays U.S. Aggregate Corporate Investment Grade Index, OAS; Euro IG: Bloomberg Barclays Euro-Aggregate Index, OAS.

“The strong start to 2019 should not come as a surprise. It also should not be treated as a short-term rebound.”

EM also offer opportunities to diversify portfolios away from DM regions with the most concerning growth outlooks and large debt accumulations.

EM is also becoming less correlated to some of the higher-risk sectors of DM. Traditionally, U.S. high yield and EM debt have displayed a degree of correlation due to an overlap of investors seeking higher yields than investment-grade DM debt.<sup>2</sup> However, this correlation has fallen in the past year and is below long-term averages. We believe this trend demonstrates the increasing idiosyncratic behavior of EM debt. Therefore, investors may achieve more consistent performance by locating segments and specific names within EM that offer strong fundamentals, rather than focusing primarily on wider market tone.

EM debt offers one of the most attractive opportunities for investors to gain exposure to these still strong fundamentals. Compared with EM equity, hard-currency sovereign bonds boast absolute returns double that of EM equities over the past 25 years.<sup>3</sup>




## 2. Is the risk of policy error significant?

While negative surprises in political or monetary policy can impact both EM and DM investing, an active approach can help avoid sudden sell-offs. The positive reforms in many EM countries mean that most are no longer just one or two bad decisions away from a crisis. Bottom-up, on-the-ground research can identify countries that are committed to consistent, market-friendly policy directions and reducing investors' exposure to policy error and help avoid those that are slipping in the wrong direction.

Even when significant sell-offs do hit certain EM countries, we don't believe this constitutes a systemic risk to the wider asset class. For example, Turkey and Argentina dominated the headlines for much of 2018 as markets quickly lost confidence in the ability, or the will, of policymakers in each country to manage their currencies and fiscal accounts. Some investors pulled out of EM as a whole at the height of these crises as they sought safety in more familiar core DM assets.

### EM Debt Reality Reduces the Risks

EM diversity helps overcome many common concerns

RISK	REALITY
 <b>Heightened Volatility</b>	EM contains defensive sectors and opportunities.
 <b>Global Economic Uncertainty</b>	Positive reforms mean many countries poised for strong growth.
 <b>Policy Error</b>	Active approach to avoid sell-offs or identify when to reenter.

<sup>2</sup> Source: J.P. Morgan. Data analysis by T. Rowe Price. J.P. Morgan. 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.

<sup>3</sup> As of December 31, 2018.

Sources: J.P. Morgan and MSCI. Data analysis by T. Rowe Price. J.P. Morgan (see footnote above). MSCI (see Additional Disclosures). EM debt is based on the JP Morgan EMBI Global Index. EM equity is based on the MSCI Emerging Markets Index.

## Turkey: Knowing How to Approach Distressed Assets

Our regular country visits helped us avoid the worst of the 2018 sell-offs and then reenter certain distressed market segments when assets appeared oversold.


Our research teams regularly visited Turkey and met with policymakers and business leaders in 2016–2018. This process confirmed our concerns over the regime’s priorities of maintaining loose monetary policies despite inflation pressures. We were able to reduce our exposure to Turkish assets before the sell-off hit in early 2018. Our continued visits then helped us recognize dislocated sectors to reenter as the prospects for reform improved in late 2018.

“The positive reforms in many EM countries mean that most are no longer just one or two bad decisions away from a crisis.

However, this contagion-driven sell-off was short-lived and actually created better long-term opportunities. An active, disciplined approach can reveal lower-beta corners of EM, such as selecting Chinese state-owned enterprises that are likely to be less affected by sell-offs elsewhere. Furthermore, sudden downturns can create opportunities to go against the grain and buy cheap assets. By uncovering when to reenter a distressed credit or sector, investors can improve their potential for long-term gains.

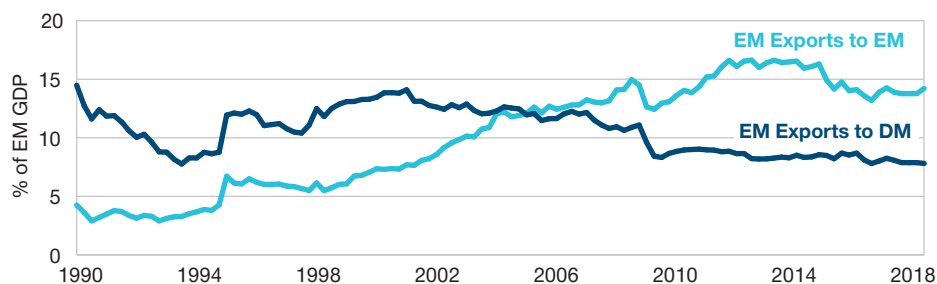
### 3. Can EM assets perform amid a mixed global economic outlook?

The growth of EM as an asset class in recent years means that investors can find a wealth of investment opportunities in different global economic environments. While we do recognize that strong growth is important for the prospects of EM, this must be kept in perspective as we see several reasons for continued optimism.

 First of all, many EM countries enjoy favorable economic growth rates supportive of fundamentals. Investors need to cast aside any

### (Fig. 1) EM Economies Are Less Reliant on Trade With DM


EM exports to developed versus other emerging markets countries  
As of June 30, 2018



Source: Goldman Sachs Global Investment Research/Haver Analytics.

preconceptions of EM being a single investment opportunity and take the time to look at individual EM sectors and regions to find attractive investments.

Currently, we are confident that many areas of EM can perform even if China or major DM economies cannot resurrect their growth rates. Countries that have committed to positive fiscal and political reforms can continue to thrive. Many EM economies display a growing middle class that is underpinning domestic demand. Consequently, EM is no longer just an export-driven investment reliant on DM, or even Chinese, economic growth. EM economies are trading with other EMs now more than they are with DMs.

 Second, EM credit is on a strong footing. Corporate fundamentals remain favorable despite the difficult 2018. The emerging market corporate default rate is at its cyclical lows. Issuers have relatively low debt levels, and companies have been able to extend bond maturities and buffer balance sheets.

 Growth concerns in key global markets could also become tailwinds as central banks appear to be shifting to more accommodative policies. While a slowdown in China will impact some EM economies, China's willingness to ramp up stimulus measures should provide a floor to growth levels. Similarly, the U.S. Federal Reserve changed its messaging in early 2019, and we now expect a sustained pause in interest rate hikes. Meanwhile, the European Central Bank is reacting to slowing growth by maintaining its low interest rates and overall accommodative stance.

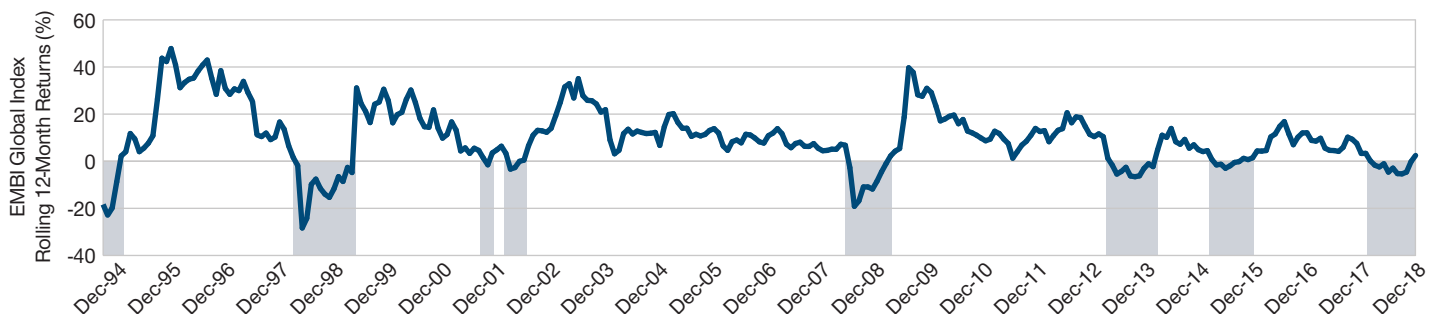
These central bank shifts could suppress core DM yields, which would lend further support to EM assets. Therefore, investors should regard the global economic uncertainty as potentially opening up an opportunity rather than as just a downside.

#### 4. Following the volatile 2018, should investors wait for sustained inflows before committing to EM?

History shows that EM has consistently rebounded and rebounded quickly following downturns. Some EM investors were still licking their wounds

### (Fig. 2) Rebounds Have Typically Followed Negative Returns

EM debt rolling 12-month returns  
As of February 28, 2019



**Past performance is not a reliable indicator of future performance.**

Shaded areas are periods of trailing 12-month negative returns. Chart refers to the J.P. Morgan EMBI Global Index and the J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified.

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

after the difficult 2018, and one could be forgiven for thinking that it could take some time before investors gain confidence again to fuel a sustained recovery. However, EM debt's track record following periods of negative returns is for sharp upturns leading to sustained periods of positive returns.

Therefore, the strong start to 2019 should not come as a surprise. In our opinion, it also should not be treated as a short-term rebound. Based on both history and the strong fundamentals, we believe EM offers ample opportunity for sustained strong performance.

#### WHAT WE'RE WATCHING NEXT

Slower growth in the U.S. could cause the dollar to depreciate, improving potential opportunities in EM local bonds. The greenback has displayed relative strength in recent years against most EM currencies as its economy has outperformed, helped by the late-2017 passing of the Tax Cuts and Jobs Act. However, the fiscal boost is expected to wane, and the market is expecting the world's largest economy to continue to ease in the year ahead. Even if the U.S. growth remains solid, it may fall back into line with much of the rest of the world, which could help EM currencies show improved stability in the months ahead.

---

#### ADDITIONAL DISCLOSURES

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.

J.P. Morgan. 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.

MSCI and its affiliates and third-party sources and providers (collectively, "MSCI") makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI. Historical MSCI data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. None of the MSCI data is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such.

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

## T.RowePrice<sup>®</sup>

### Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

**Australia**—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

**Brunei**—This material can only be delivered to certain specific institutional investors for informational purpose upon request only. The strategy and/or any products associated with the strategy has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

**Canada**—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

**China**—This material is provided to specific qualified domestic institutional investor or sovereign wealth fund on a one-on-one basis. No invitation to offer, or offer for, or sale of, the shares will be made in the People's Republic of China ("PRC") (which, for such purpose, does not include the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the PRC. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the PRC. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the PRC that are expressly authorized under the laws and regulations of the PRC to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the PRC. Potential investors who are resident in the PRC are responsible for obtaining the required approvals from all relevant government authorities in the PRC, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the PRC, or nationals with permanent residence in the PRC, or to any corporation, partnership, or other entity incorporated or established in the PRC.

**DIFC**—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

**EEA ex-UK**—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

**Hong Kong**—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

**Indonesia**—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

**Korea**—This material is intended only to Qualified Professional Investors upon specific and unsolicited request and may not be reproduced in whole or in part nor can they be transmitted to any other person in the Republic of Korea.

**Malaysia**—This material can only be delivered to specific institutional investor upon specific and unsolicited request. The strategy and/or any products associated with the strategy has not been authorised for distribution in Malaysia. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

**New Zealand**—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

**Philippines**—THE STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING OFFERED OR SOLD HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

**Singapore**—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

**Switzerland**—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

**Taiwan**—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

**Thailand**—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

**UK**—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

**USA**—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 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.