

Emerging Markets Bond

Monthly Review and Outlook

February 2016

- First State Emerging Markets Bond Fund primarily invests in debt securities issued or guaranteed by governments, financial institutions or companies in emerging market countries.
- The Fund invests in emerging markets which may involve a greater risk than developed markets including sharp price movements, liquidity risk and currency risk. The Fund may invest in below investment grade, unrated and high yield debt securities. This exposes the Fund to greater liquidity risk, default risk and price changes due to change in the issuer's creditworthiness. The Fund invests in fixed income securities which may be impacted by movement in interest rates. It is possible that the entire value of your investment could be lost.
- All or part of the Fund's fees and expenses may be paid out of capital resulting in an increase in distributable income and effectively a distribution out of capital. Similarly in certain circumstances dividends may be paid out of capital. This amounts to a partial return of an investor's original investment, or from any capital gains attributable to that original investment, and may result in an immediate decrease of the Net Asset Value per share.
- You should not base your investment decision solely on this document. You should not invest unless the intermediary who sells it to you has advised you that the Fund is suitable for you and explained how it is consistent with your investment objectives.

Key highlights:

- Emerging markets (EM) debt delivered a return of 1.9% (US dollar terms) over the month.
- Oil credits were the strongest performers, notably Venezuela, Ecuador, Gabon and Angola.
- The portfolio remained cautiously positioned in less liquid credits.
- We expect continued differentiation among country returns.

Market review

Emerging markets (EM) debt delivered a return of 1.9% in (US dollar terms) over the month. A firmer oil price, following an agreement between Saudi Arabia, Russia, Qatar and Venezuela to freeze production levels, and expectations of policy support in China were helpful for emerging markets (EM) debt. Oil credits were the strongest performers, notably Venezuela, Ecuador, Gabon and Angola.

The yield on EM debt came down to 6.28% with the spread narrowing by 9 basis points (bps) to 454 as US 10-year yields rallied a further 20 bps to 1.73%. For financial markets in general it was another volatile month and early February saw further sharp falls in the oil price and equities. On top of concerns over the outlook for China and the global economy fears over the profitability and solvency of European banks also dented risk appetite.

Positive political-driven momentum continued in Argentina as President Macri secured a deal with holdout creditors effectively bringing an end to a 15-year debt blockade. The deal, which is subject to approval from Congress in Argentina, involves a \$4.7bn settlement with four holdouts who together account for 85% of the remaining claims against Argentina. Argentine bonds gained 5.5% over the month.

There was fresh political uncertainty and instability in Ukraine (-3.3%) as reform-minded technocrat economics minister Aivaras Abramovicus resigned. After a research trip to Ukraine, we bought some bonds as we believe that early parliamentary elections can be avoided. While there is a lot of funding potentially available for Ukraine from G7 countries and the IMF, there is also frustration at the slow progress in addressing corruption. The dismissal of General Prosecutor Shokin, who has consistently blocked reforms, is unlikely to be sufficient. Until more progress is made, the next IMF disbursement of funds will be held up. Later on in February, Prime Minister Arseniy Yatsenyuk survived a no-confidence vote and two small parties exited the coalition. We believe that the government re-shuffle will take time, but expect an eventual resumption of IMF funding.

In Venezuela, President Maduro announced an adjustment to the exchange rate system, effectively devaluing the currency, and an increase in gasoline prices. These are helpful measures but likely insufficient. The country faces a big challenge to remain solvent and an increasing risk of social unrest.

Portfolio positioning

We participated in the Philippines 25-year bond issue which was attractively valued, particularly relative to the 25 year bond issued early last year, and looked to have good technical support. The issue also reduced the Philippines' overall cost of debt financing and extended the maturity of its debt. The portfolio remained cautiously positioned in less liquid credits. Toward the end of the month, we added some positions in Latin America as valuations looked attractive, particularly relative to Central and Eastern Europe. Duration overweights remain in Mexico, the Dominican Republic, Indonesia and Hungary. In Mexico, the central bank held an extraordinary meeting last month and implemented pre-emptive measures while the government announced a significant public spending cut, in order to address concerns over the fiscal outlook and financial stability.

performance. We added duration to the portfolio in January, including in Thailand, Malaysia, The Philippines, Russia and CE3. In FX space, we have trimmed the long US dollar bias of the portfolio as the drivers for further EMFX weakness somewhat subsided with soft US data and stable oil prices.

Performance

In USD terms, the First State Emerging Markets Bond Fund returned +1.2% in February.¹

Outlook

Emerging markets performance continues to be driven by developments around China's economic policies, the prospects for Fed rate hikes and the evolution of commodity prices. After a period of consistent underperformance, Latin American credits have the potential to retrace tighter, alongside certain commodity exporters where economic policy has had an appropriate response to the terms of trade shock. The market in general is supported by the low amounts of new issuance, especially at the long end of the curves. We expect continued differentiation among country returns.

¹ The Fund's calendar year performance: 0.2% (2015); 7.1% (2014); -4.5% (2013); 17.3% (2012); -0.5% (performance from inception date 8 Nov 2011 to 31 Dec 2011).

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