

# Emerging Markets Bond

## Monthly Review and Outlook

September 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:

- The return on emerging markets (EM) debt was a more moderate over the month. The yield on EM debt was virtually unchanged.
- We remained overweight in select high yield credits with modest risk exposure and maintained overweights in Argentina and Indonesia.
- The continuing global backdrop of low recessionary risk and low inflationary pressure remains positive for EM debt and risk assets.
- We expect to see more volatility in the fourth quarter in view of the US elections and potential for some political noise in Europe.

### Market review

Central bank policy meetings were the key focus of the month. The European Central Bank's announcement that it would not be expanding its quantitative easing programme precipitated a technical sell-off mid-month. Both the Federal Reserve and the Bank of Japan left rates unchanged. Speculation around OPEC's ability and willingness to coordinate supply side adjustments to support oil prices helped global risk appetite and the cartel did announce an agreement to reduce supply quotas to be implemented in November.

The return on emerging markets (EM) debt was a more moderate 0.4% (US dollar terms) over the month following strong recent gains. The yield on EM debt was virtually unchanged at 498 basis points (bps) as was the spread at 336 bps. US 10-year Treasury yields were unchanged at 1.60%. EM debt returns were driven by carry (interest). Investment grade bonds declined modestly, while high yield credits led the gains and quasi-sovereigns rose.

Riskier credits outperformed, notably Venezuela (+16.1%), Mozambique (+11.1%) and Mongolia (+6.2%). In Venezuela, the national oil company PDVSA offered investors the option to exchange a 2017 bond with an amortization in November for a larger quantity of a bond maturing in 2020. Market reaction to the pro-active swap proposal was extremely positive, as it underlines the Venezuelan government's strong willingness to pay its foreign debt.

Mexico (-3.4%) underperformed, as President Pena Nieto's popularity dropped after the visit of US presidential candidate Donald Trump, and Finance Minister Luis Videgaray resigned. Fears of a victory for Trump and its negative implications for the NAFTA agreement between Mexico and the US concerned the market. Turkey (-0.8%) was downgraded to sub-investment grade by Moody's.

### Portfolio positioning

Market conditions continue to be shaped by technical and global factors. We remained overweight in select high yield credits with modest risk exposure and maintained overweights in Argentina and Indonesia. The tax-amnesty collection in Indonesia surprised markets to the upside. In Argentina, there are signs of improvement, notably declining inflation, while investment is forecast to rise in 2017 helped by government infrastructure investment including an ambitious programme of renewable energy development. The country's big challenge is fiscal reform with mid-term elections due to take place in 2017. We participated in the 10-year bond issue from Mexico City Airport Trust, which will be used to finance construction of a new airport in Mexico City. In Brazil, we continue to see better value in the quasi space than in sovereign debt. Like in Argentina, the scope of the fiscal reform needed is a challenge.

We have been slightly reducing our underweight in Turkey on valuations. We reduced exposure to the Ukraine. After a year's delay, the IMF approved a disbursement of \$1bn, less than was expected, due to only partial progress with reforms. The favourable IMF news

is now priced in and we therefore took some profit. Our concern that the market had become overly optimistic on the Peace Process in Colombia proved well founded as the electorate rejected the proposed agreement between the government and Farc. The prospect of needed fiscal reform is now more problematic and we remain underweight. In EMEA, the likelihood of political noise and the fears around the banking sector mean the outlook for Central and Eastern Europe remains fairly mixed.

## Performance

In USD terms, the First State Emerging Markets Bond Fund returned 0.15% in September<sup>1</sup>.

## Outlook

The continuing global backdrop of low recessionary risk and low inflationary pressure remains positive for EM debt and risk assets. EM debt has been driven by this very favourable, 'Goldilocks' global scenario. However, global markets have become highly correlated and risk appetite is compatible with growing complacency. We expect to see more volatility in the fourth quarter in view of the US elections and potential for some political noise in Europe. We would also expect the usual end-of-year seasonal effect of diminishing liquidity and anticipate a busy primary market in the next two months. The outcome of the US election is effectively binary: a Donald Trump victory would be potentially highly destabilising for international relations, geopolitics and global trade. At present, a victory for Hillary Clinton is priced in and is the more likely outcome according to polls. Further US-related noise is very likely however given the difficulty of predicting the election outcome with several states remaining undecided. Political uncertainty in Europe is also growing, while the spectre of a substantial mis-selling fine in the US has raised fresh concerns about Deutsche Bank and the wider European banking sector. EM economies continue to show signs of bottoming with industrial production and external conditions improving. The OPEC announcement is a positive for EM, albeit the extent of any cut is not yet known.

<sup>1</sup> 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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