

Multiple Perspectives. One Approach.™

Emerging markets have become diverging markets.



James Hurlin

Fixed income investment specialist

Based in London

26 years of experience
(as at 31 December 2014)

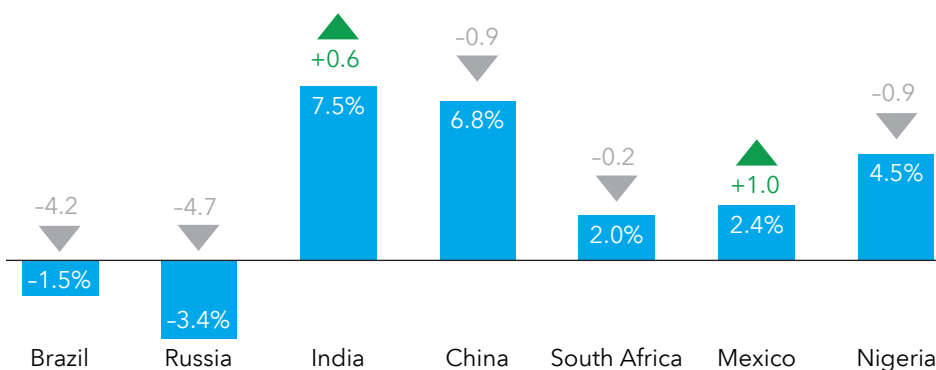
Emerging markets face many challenges, from a potential rise in US interest rates to low commodity prices and slower economic growth. It may seem that now is not the right time for emerging market debt. And yet, for long-term active investors the universe is broad enough and deep enough to continue to offer plentiful opportunities. Indeed, volatility in the asset class – sometimes due to the risk-on/risk-off approach of many investors – should provide attractive entry points for selective research-driven investors with good valuation discipline.

Summary

- Emerging market economies are undergoing a period of adjustment as a result of significant structural changes in the global economy.
- Diverging economic growth patterns are likely to drive compelling return differences among emerging market bonds and currencies.
- Valuations in many parts of the emerging markets universe already discount slower growth rates and looser monetary policies, but there could be further adjustments in some markets.
- Commodity-driven economies are implementing new macroeconomic policies in order to adapt to their new reality. In many cases, the full impact of those policies has yet to be felt.
- Lower oil prices, while supportive for global growth overall, have a mixed impact on emerging markets: good for oil-importing countries such as India, and less positive for oil-exporting countries such as Colombia and Nigeria.
- Emerging market debt should continue to offer attractive return potential for selective investors who are focused on finding pockets of opportunity.

Emerging economies are diverging

Economic growth (2015 gross domestic product and percentage point change since 2013)



September 2015

A period of adjustment is underway

Six years ago, the global economy was emerging from recession in the wake of the financial crisis. At that time, developing countries such as China, India and Brazil were the engines of global growth, while emerging market debt was a source of strong investment returns for bond investors.

Today, with the notable exception of India, growth in many of the larger economies has slowed. Indeed, the economies of two emerging powerhouses – Brazil and Russia – are expected to contract in 2015. Bond and currency markets have reflected some of these challenges. Returns over the past two years have been decidedly mixed, with the JPMorgan EMBI Global Index of US dollar bonds registering a negative 1.4% return for 2013 and 2014 combined.

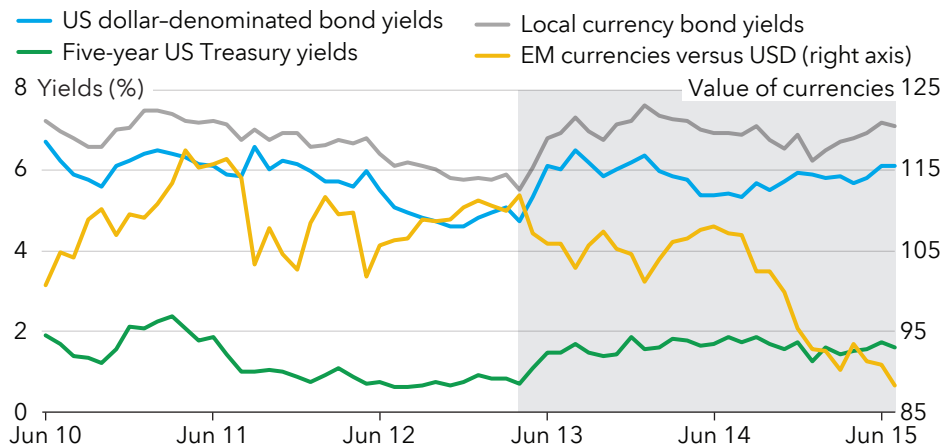
Dollar-based investors have seen broad dollar strength surpass advances in many local-currency bond markets. Over the same 2013–2014 time period, cumulative returns from the JPMorgan GBI-EM Global Diversified Index were 7.9% in local currency terms but -14.2% in unhedged US dollar terms. In some ways, the market sell-off of May 2013 (widely referred to as the taper tantrum) was an early indication that broad investor sentiment regarding emerging markets was losing some of the newfound

resilience of the previous few years. The 2013 sell-off was sparked by comments from the US Federal Reserve's then-chair, Ben Bernanke, who indicated that the official bond purchases (quantitative easing) could be scaled back sooner than widely anticipated.

The ensuing turmoil affected many areas of global financial markets – including US Treasuries. The jump in emerging market bond yields was especially pronounced, and they have remained elevated, trading in a range close to where they were during the taper tantrum. Meanwhile, emerging market currencies have depreciated substantially in recent years. Compared to some other market segments, emerging market debt valuations arguably already reflect some degree of normalisation of US monetary policy.

With yields elevated since mid-2013 and currencies generally weaker relative to the US dollar, valuations already appear reasonable in a number of emerging countries. Volatility – perhaps due to country-specific political or economic challenges, as well as changes in global economic conditions and monetary policy – could, in our view, create compelling return opportunities for longer-term investors.

Currencies trended lower, while yields jumped higher after the May 2013 taper tantrum – creating some attractive valuations



Source: JPMorgan

Through 31 July 2015. Month-end yields for US dollar-denominated bonds and local currency bonds are drawn from the JPMorgan Emerging Markets Bond Index (EMBI) Global Diversified and JPMorgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified, respectively. Emerging market exchange rate (rebased to 100 on 30 June 2010) implied by latter bond index.

China's transition reverberates across the globe

"Global demand for certain metals and agricultural commodities is still dominated by China. Among emerging economies, Brazil is therefore relatively exposed to a Chinese growth slowdown."

– Stephen Green, economist

Slowing growth in China also poses a near-term challenge to other emerging markets. However, it is important to keep in mind that the reforms being spearheaded by President Xi Jinping are aimed at improving efficiency and pursuing a more sustainable (albeit slower) pace of growth. In the longer term, this outcome could benefit global growth and the global economy.

In stark contrast to the mid-2000s – when China's share of global demand rose substantially across a range of commodities as diverse as copper, soybeans and crude oil – recent data suggest that China's demand for some commodities is growing more slowly, and in certain cases declining. The structure of China's economy is changing. Fixed asset investment grew at about 15% in 2014, according to official figures. This rate is about half the level of five years earlier, when the government introduced massive financial stimulus to counter the effects of the global financial crisis.

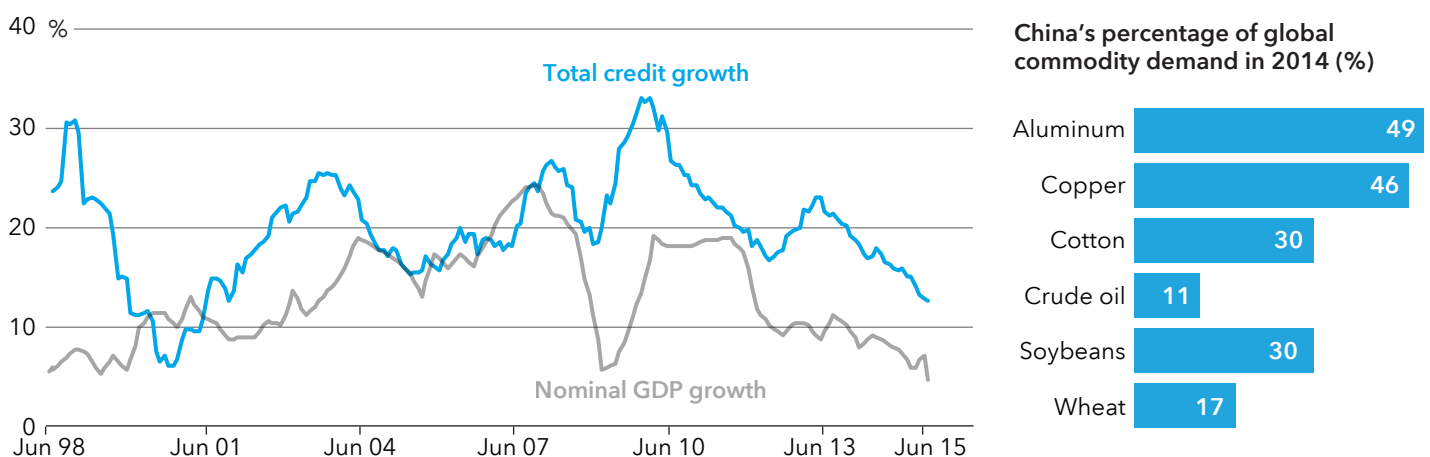
China's transition away from investment-led growth toward an economic structure more reliant on consumption means a painful period of economic

adjustment for some nations. To varying degrees, the economies and currencies of commodity-exporting nations such as Brazil, Indonesia and South Africa are already feeling the impact of the changing nature of demand. The weakness in their currencies is consistent with historical patterns of US dollar strength (or foreign currency weakness) coinciding with weakness in the prices of industrial commodities. In turn, the weakness of industrial commodity prices is consistent with weaker global industrial production, of which China is an important component.

The policy mix being pursued by China's leadership is seeking to address the structural weaknesses in the economy and reverse the slowdown in economic growth. This is still the second-largest economy in the world and benefits from having a robust manufacturing sector and a high level of savings. While poor investment in state-owned enterprises and past excesses in credit growth will likely lower returns on invested capital, future investments in services and more productive manufacturing capacity should keep China competitive on many fronts.

China's deleveraging and transition to more sustainable growth is likely to have a substantial impact on demand for commodities

Economic and credit growth in China (year on year) and China's proportion of global demand for a selection of commodities



Commodity demand data calculated by Barclays Research using data from US Department of Agriculture, BP, Wood Mackenzie, CRU Group and National Bureau of Statistics of China.

Sources: Barclays Research, Capital Group, CEIC Data

September 2015

A mix of headwinds and tailwinds

Coinciding with the weakness in industrial commodity prices, energy prices have also fallen significantly since the middle of 2014. This has been driven by the growth in supply from new sources in North America as well as some impact from reduced global demand. On balance, lower energy prices are supportive for global growth, but have a mixed impact across producing and consuming economies.

Lower energy prices have provided economic support to energy importers. Some countries, such as India and Indonesia, have taken this one step further and reduced energy subsidies, which allows for the newfound revenue to be used in more productive ways. Exporters of oil such as Russia and Venezuela have been forced to reduce fiscal expenditures in order to meet budget targets. Their currencies have also come under pressure, but this has helped alleviate some of the negative impact of lower oil prices.

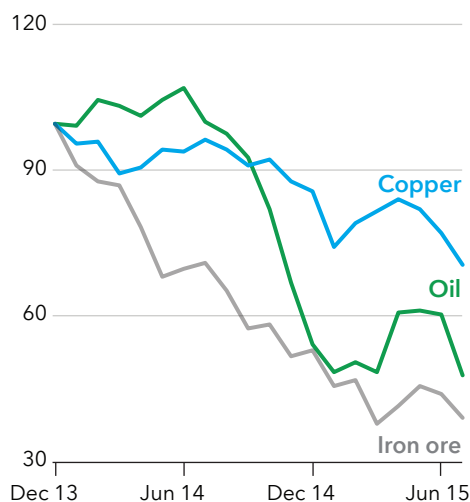
Demographics have traditionally been seen as a tailwind for emerging economies, but this wind is beginning to shift direction for some nations.

In the past couple of decades, growing populations of young and working-age people have helped fuel growth. But in some countries, this so-called demographic dividend is diminishing. In China and several other emerging countries, birth rates are low or falling, and growth of working-age populations is slowing. In the future, aging populations will likely put greater strain on government finances and may cause household savings and investment to decline, leading to slower per-capita economic growth.

That said, it's worth re-emphasising that each country is different. Just as the end of the commodities supercycle is actually a boon for importer nations, demographic trends in some emerging markets countries continue to appear relatively favourable for the next decade and beyond. And over the longer term, India and Indonesia (which, incidentally, are also net importers of oil) are among the countries that stand to reap the benefits of a relatively large working-age population for several decades to come.

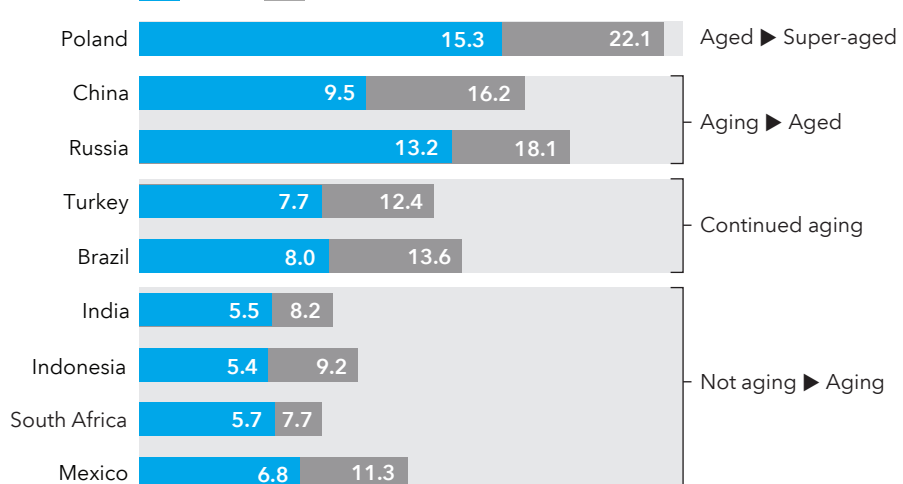
Weaker commodity prices and demographics could be growth tailwinds for India but headwinds for Russia

Commodity prices



Population aged 65 or over (% of total)

2015E 2030E



West Texas Intermediate crude oil price, London Metals Exchange copper price and Thomson Reuters/Jefferies CRB Iron Ore 62% FE CFR China Cash price. Month-end price data (rebased to 100 starting 31 December 2013) through 31 July 2015. Population data and transition characterisation from Moody's Investors Service, using United Nations data. Sources: FactSet, Moody's Investors Service

Varied fundamentals and country-specific risks spell divergence

Currently, there is substantial variation in fundamentals among individual countries. For example, there is deflation in Eastern Europe, but inflation in Latin America. Meanwhile, many Asian countries have current account surpluses (in simple terms, exports and net foreign income exceed imports), while some Latin American economies confront substantial deficits.

Political and geopolitical developments add another aspect to divergence, as amply demonstrated in recent years. Consider Russia, for instance. In terms of fundamentals, Russia is a solid credit – running a current account surplus, a low level of outstanding debt and modest refinancing needs. However, the military conflict in Ukraine, the annexation of Crimea in 2014 and the ensuing international sanctions have




had a meaningful impact on Russia's economy, currency and bond market. Investor confidence took a further hit as the price of crude oil (a major Russian export) began to fall in July 2014 – prompting the rouble to hit an all-time low against the dollar and bond yields to jump higher.

Lower energy and commodity prices have also highlighted structural weaknesses in other emerging economies. In Brazil, the outlooks for growth and inflation have worsened amid declining prices for key exports such as oil, iron ore and soybeans. Meanwhile, the Ghanaian government's finances are under intense pressure and rating agencies have warned that further downgrades are possible given Ghana's substantial budget gap and deteriorating growth.

There are bright spots among major credits, but Brazil, Russia, South Africa and Venezuela face challenging near-term outlooks

High inflation, large current account deficits and wide government budget gaps can all be sources of economic vulnerability.

2015 consensus forecasts for a selection of larger EM economies

-  Suggests factor may be a source of economic vulnerability
-  Suggests factor may be a source of economic resilience
-  Suggests factor may have a neutral effect

	Inflation (%)	% of GDP*	
		Current account	Budget
Brazil	8.2	-4.0	-5.9
Russia	15.0	4.1	-3.0
India	6.2	-1.2	-4.0
China	1.5	2.6	-2.5
South Africa	4.9	-4.5	-3.6
Indonesia	6.5	-2.5	-2.1
Poland	-0.5	-1.4	-2.9
Hungary	-0.1	4.5	-2.6
Turkey	7.2	-4.8	-1.8
Mexico	3.1	-2.5	-3.5
Venezuela	84.0	-2.0	-17.7

* For current accounts, negative and positive figures indicate deficits and surpluses, respectively. For budgets, negative figures indicate government budget deficits.
As at 15 June 2015. Sources: Bloomberg, Capital Group, Datastream

September 2015

Maturing markets enable active investors to be agile.

The emerging markets bond market has grown dramatically, with about \$6 trillion worth of local and dollar-denominated sovereign and corporate bonds outstanding according to a recent estimate from the World Bank. "Every developing country is different, but capital markets have become more well-developed overall. Bond markets have much greater depth and breadth, and that enables me to manage risk and return in a nuanced way," says fixed income portfolio manager Rob Neithart.

Certainly, market liquidity – the ease with which bonds can be bought and sold at a fair market price – varies between different markets, and over time. Arguably, however, more mature bond markets mean that active emerging market debt investors now have greater scope to navigate through challenging periods. In recent years, certain markets have clearly reached critical stages in their development. Colombia now features a well-developed local curve. In Indonesia, there are local and dollar curves. In Turkey, there are nominal and inflation-linked curves, as well as a dollar curve. A number of new African credits have also come to market.

Corporate issuance has also increased, particularly among Asian and Latin American firms, which has been a source of concern for some market observers. "Generally, I think a cautious approach to investing in emerging market corporates is sensible, based on valuations and the relative infancy of the market segment," says portfolio manager and fixed income research director Kirstie Spence. "For example, bankruptcy codes in many countries are not that comprehensive, while some prospectuses lack provisions to protect bond investors."

Near-term challenges, longer-term optimism

Clearly, some emerging economies face major near-term challenges. Still, it's also fair to say that – compared to the past – emerging economies are broadly in better shape. If, for example, interest rate hikes by the US Federal Reserve are gradual (as is widely anticipated), many economies and markets appear well-positioned to show greater resilience than they have in past periods of higher US Treasury yields.

Compared to the 1990s and early 2000s, when several emerging economies experienced crises, foreign exchange reserves are generally substantial, and currency pegs are less common. Likewise, in many instances government debt-to-GDP ratios are lower, and where debt loads are heavier, in some cases it's arguably a natural consequence of maturing bond markets.

India and other net importers of energy have made progress in reducing their current account deficits, which could make their currencies less vulnerable to substantial weakening against the dollar. Meanwhile, a number of central banks appear to have the resources and inclination to support economic growth and bond prices with more accommodative monetary

policies, if needed. From an investment perspective, even incremental improvements in economic conditions and stewardship can be supportive of credit fundamentals.

In terms of reform, encouraging progress has been evident in a number of countries. Mexico's improving credit fundamentals and sound growth prospects have been helped by a number of reforms in recent years. In 2014, President Enrique Peña Nieto signed into law comprehensive energy sector reforms that should be of profound benefit to future economic activity. In India, Prime Minister Narendra Modi has been pursuing an ambitious reform agenda since his election in May 2014. Already, Indian capital markets restrictions have been loosened, subsidies on gasoline and diesel have been eased and fuel taxes imposed. Even in Brazil, where a political corruption scandal centered on state-owned energy firm Petrobras has added another cloud to a near-term outlook that includes stubbornly high inflation and mounting fiscal problems, there's some renewed hope for reform. Government officials have indicated that, among other measures, an overhaul of the tax system could be on the horizon.

Fixed income portfolio managers share some of their latest investment thinking



Laurentius Harrer

Based in Los Angeles
26 years of investment
industry experience
(as at 31 December
2014)

Laurentius Harrer on currencies

From a valuation perspective the dollar is looking relatively expensive, while the converse is true for certain emerging market currencies. Though there could still be further widespread depreciation, the present environment argues for reduced currency hedging.

Many emerging market yield curves are flat or inverted. This means that hedging is expensive and in some cases, hedging would likely leave you with a negative carry position. Despite the possibility of modest currency losses, it's my view that a number of local bond markets have the potential for competitive total returns.

This information has been provided solely for informational purposes and is not an offer, or solicitation of an offer, or a recommendation to buy or sell any security or instrument listed herein.

**Kirstie Spence**

Based in London

19 years of investment industry experience (as at 31 December 2014)

Kirstie Spence on new African issuers

Many of the newer African issuers are very traditional kinds of emerging markets, both in terms of the fundamentals that you would like to see and the analytical approach they require. That means that I look for reasonable growth, current credit metrics that should serve as a starting point for improvements, and, ideally, a sound understanding of prospects for economic reform. From a bond investment perspective, there's just a naturally favourable dynamic because these are small economies with innate growth tailwinds, such as demographics and urbanisation.

Analysing newer African credits today brings back memories of Central and Eastern Europe in the mid-1990s. You actually have to spend a lot of time on the ground. As an investment analyst, being there gives you better access to data and information that may be of real consequence for the economic outlook. But perhaps more importantly, you develop a real feel for what is actually going on in the economy. You visit policymakers, companies and local investors to try to get a sense of what's happening from those involved in the local economy. Then, when you return and repeat that process, you are able to develop an intuition around the direction in which things are moving.

**Rob Neithart**

Based in Los Angeles

27 years of investment industry experience (as at 31 December 2014)

Rob Neithart on structural reforms

Overall, many emerging market economies still have a very long way to go and in many countries reform progress has been stalled for years. But there are a few areas where tangible reform progress is visible. Mexico has taken important steps to reform its economy over the past couple of years. The Mexican government has released its tight grip on energy production and distribution, which could be a significant positive for investment and growth over time. But despite longer-term positives, Mexican bond and currency valuations now reflect quite a substantial risk premium amid broader emerging markets weakness. More recently, nascent reform efforts in India and Indonesia are helping create a more favourable backdrop that may support return potential among local currency government issues.

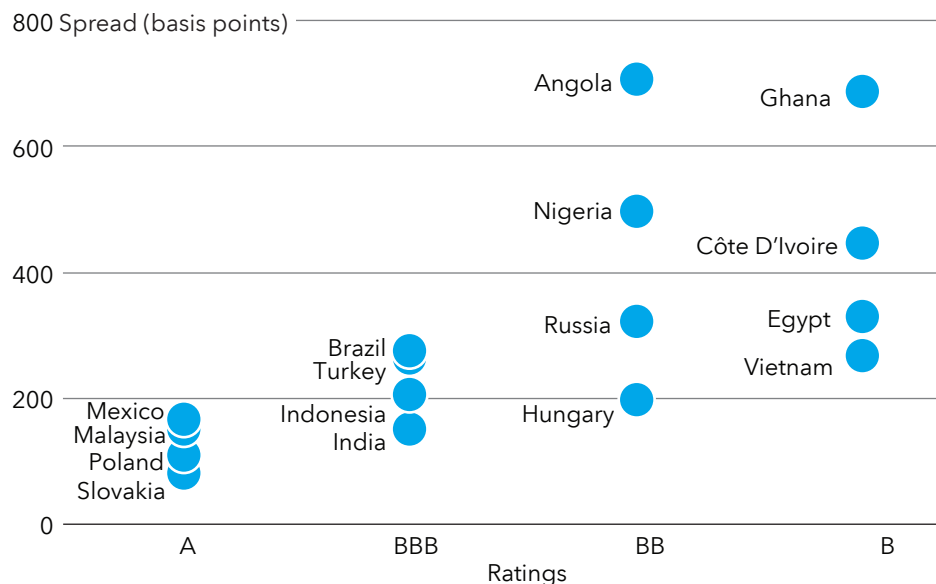
A time when active investing can prove its mettle?

On the surface, there are many headwinds confronting emerging market debt. A tightening of monetary policy by the Federal Reserve could result in some spread widening. Meanwhile, some emerging market countries face their own political, economic and fiscal challenges. Nevertheless, as emerging economies work through various cyclical and structural issues, there continue to

be attractive opportunities for investors who are able to maintain a longer-term perspective. Generally, valuations among emerging market government bonds have become more attractive in recent years. Relative to US credit, for example, below-investment-grade sovereign bonds have offered particular relative value.

Credit spread dispersion is evident across emerging markets bonds.

Five-year government bond yield spreads to US treasuries



As at 31 July 2015. Source: Datastream

Key takeaways

- While further volatility is a distinct possibility, selective investors should continue to find attractive longer-term return potential across local and dollar-denominated markets.
- Country-specific challenges and changes in global economic conditions and monetary policy are creating challenges in emerging markets debt and currency markets.
- Maturing markets mean that active investors now have greater scope to add value by managing duration and currency exposures, or by seeking relative value along the yield curve or between inflation-linked and nominal bonds.

Across markets there is a fairly wide range of risk premiums, with prices generally reflecting differentiation in credit quality. Capital Group has invested in emerging market debt for more than two decades, and over that time it has been our experience that periods of greater spread dispersion have often created compelling longer-term opportunities for research-driven investors. Exchange rate volatility has historically had a meaningful impact on

total returns for dollar-based investors, underscoring the importance of active management of currency exposures. In the near term, there may be further moderate currency weakness. That said, our analysis suggests that expected losses are not as great as the hedging costs in a number of markets. We believe that a selective approach to hedging currency risk, therefore, continues to make sense.

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