

# Emerging Markets Bond

## Monthly Review and Outlook

As at January 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 fell 0.2% (in US dollars) over the month.**
- **Oil, equities and emerging markets (EM) currencies sold-off in the first two weeks of the year. The focus was on China where the continued slowdown in the economy and a record monthly decline in foreign exchange reserves in December led to risk aversion. Oil reached a 12-year low amid concerns over China and global growth as well as the lifting of sanctions on Iran.**
- **We maintained core overweight positions in Central and Eastern Europe, on the strength of this region's trade links with Europe and a supportive technical picture.**
- **We anticipate sharp differences in the economic performance of EM countries and regions.**

### Market review

Extreme volatility characterised markets in January. Oil, equities and emerging markets (EM) currencies sold-off in the first two weeks of the year. The focus was on China where the continued slowdown in the economy and a record monthly decline in foreign exchange reserves in December led to risk aversion. Oil reached a 12-year low amid concerns over China and global growth as well as the lifting of sanctions on Iran. Geopolitics remained a focus amid raised tensions between Saudi Arabia and Iran.

Monetary easing measures and dovish rhetoric by the European Central Bank managed to dampen volatility as the month wore on, particularly towards month-end as the Bank of Japan announced negative interest rates.

EM debt was down 0.2% (in US dollar terms) over the month. Investment grade credits returned 0.8%, but the high yield sector had negative returns. The yield on EM debt increased 11 basis points (bps) to 6.50% and the spread widened 38bps to 463 as US 10-year yields fell 25bps to 1.91%. Noteworthy was also that the spread of quasi-sovereign bonds widened further relative to sovereigns, partly reflecting the lower liquidity of the sector.

The anticipated busy issuance calendar in EM, which is typical for January, did not materialise as only Mexico, Chile and the Dominican Republic came to market.

Venezuela (-14.7%) was the weakest credit, retracing most of the gains made in the fourth quarter of 2015. The political environment since the national assembly elections eight weeks ago has become increasingly dysfunctional. The government obtained extraordinary powers under an Emergency Economic Decree, but failed to follow through with policy implementation. The oil price decline has brought back into focus the possibility of a default. Ecuador (-6.2%), another high beta oil credit, was weak, along with illiquid and/or oil-related African credits including Zambia, Ghana, Cameroon and Angola.

Brazil (3.15%) performed well having sold-off heavily in 2015. Croatia (2.3%) returned to growth in 2015, following several years of recession, and has seen its external metrics strengthened. The country appointed a government ending the political impasse resulting from the elections in November with a technocrat as Prime Minister, raising hopes of structural reform.

Asia was the strongest region over the month. Low beta credit The Philippines (2.9%) performed well amid volatility, while the government in Malaysia (1.8%) indicated it remains

committed to budget consolidation even though oil prices continue to decline.

### Performance

In USD terms, the **First State Emerging Markets Bond Fund** fell 0.3% in January<sup>1</sup>.

### Portfolio positioning

We remained defensively positioned overall and positioning was little changed from the end of the previous quarter. We maintained core overweight positions in Central and Eastern Europe, on the strength of this region's trade links with Europe and a supportive technical picture, and underweights in commodity-exporting and less liquid investment grade Latin American countries (Uruguay, Peru, Panama and Chile) preferring Mexico, which is more liquid and benefits from reform implementation. We continue to look for a positive political catalyst in Brazil and remain constructive on Argentina. Following an unusually quiet January, the remainder of the quarter may prove busy in terms of primary issuance.

### Outlook

We anticipate sharp differences in the economic performance of EM countries and regions. Differentiators among countries are likely to be: 1. Impact of the global environment (export destinations and funding sources in particular); 2. Politics and policy direction and 3. Issuance needs. In terms of market performance, technical factors and valuations will continue to play a large role given diminished market liquidity, particularly in quasi-sovereign and high beta credits. EM debt has re-priced substantially over the last year, with EM spreads widening by 61 basis points in 2015. A large amount of negative sentiment is therefore priced at current levels in our view. In addition, net sovereign supply is likely to be very small or negative in 2016, so the technical position for EM sovereigns is supportive.

<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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