

Emerging Markets Bond

Monthly Review and Outlook

October 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:

- US Treasuries sold-off as economic data in the US improved, strengthening expectations of a US rate hike in December.
- We reduced duration risk in October, taking profit particularly in some long-dated bonds which had performed very well.
- Trump is also expected to undertake fiscal stimulus, through tax cuts, and infrastructure spending, likely leading to higher US rates, Treasury yields have moved higher following the election.

Market review

US Treasuries sold-off as economic data in the US improved, strengthening expectations of a US rate hike in December. Investors also re-assessed the likelihood of further policy action in the EU and Japan. In the US election campaign, the likelihood of a Hillary Clinton victory increased mid-month before falling back, keeping uncertainty elevated. In emerging market (EM), October saw significant issuance and Saudi Arabia's inaugural sovereign bond issue raised \$17.5bn, surpassing Argentina's \$16.5bn issue in April.

EM debt (in US dollar terms) was down on the month (-1.24%) as US 10-year yields rose 23 basis points (bps) to 1.84%. EM spreads widened marginally to 340bps with the yield increasing to 5.24%. Long-dated investment grade (IG) EM bonds sold-off as the US Treasury curve steepened, while high yield (-0.9%) held up better than IG (-1.5%).

The worst performing bonds were those of Mozambique (-28.1%), as the government announced a potential restructuring as debt had risen to unsustainable levels. Venezuelan bonds also fell (-8%) amid the national oil company PDVSA offering a voluntary swap to

holders of short-dated bonds in a bid to preserve cash. The investor participation rate fell some way short of the 50% targeted amount. Colombia declined (-3.4%) in the wake of the referendum result rejecting the peace agreement in September, which may delay fiscal reform and possibly result in less comprehensive reforms.

Positive performers comprised mainly a mix of high yield credits including Ecuador (+4.4%), which reversed the decline seen in the wake of its \$1bn 2022 bond issue in late-September, Ghana (+3.1%), Pakistan (+2.5%) and Ukraine (+1.7%).

Portfolio positioning

We reduced duration risk in October, taking profit particularly in some long-dated bonds which had performed very well. Given event risks in November and December (US election, OPEC meeting, potential US interest rate hike), we wanted to reduce portfolio risk. We also reduced higher-risk African credits where we believed that a lot of potential positives were already priced in. We added some shorter-dated bonds in Bahrain and Russia.

Performance

In USD terms, the First State Emerging Markets Bond Fund declined by 1.1% in October¹.

Outlook

The election of Donald Trump as president in the US introduces significant uncertainty over the future course of the global economy, geopolitics and financial markets. While the precise implications of a Trump presidency are as yet difficult to fully predict, in view of the president elect's rhetoric during the campaign there is a risk of significant disruption to the current global

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).

environment, especially if the US introduces protectionist policies as expected, which would be negative for EM. We now see greater risks to EM countries where a high share of exports go to the US and where remittances from the US are high. Trump is also expected to undertake fiscal stimulus, through tax cuts, and infrastructure spending, likely leading to higher US rates, Treasury yields have moved higher following the election, impacting countries with high external financing needs.

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