First State Investments

Emerging Markets Bond

Monthly Review and Outlook

July 2016

Key highlights:

- We expect somewhat higher volatility in the next three months, as the US election and various EU events could cause some noise.
- Prospects for Europe remain uncertain amid a continued lack of clarity on the implications of Brexit and difficult conditions for the banking sector.
- We participated in new issues over the month in Uruguay, Sri Lanka and Trinidad and Tobago which were attractively priced.

Market review

Geopolitical and macroeconomic events dominated in the month of July, notably a terrorist attack in Nice, France, and an attempted military coup in Turkey. In the US, Donald Trump and Hilary Clinton were confirmed as the presidential candidates. Global monetary policy remained highly-accommodating. The FOMC left interest rates unchanged as expected although appears to have left open the possibility of a rate hike later this year. The Bank of Japan announced a fresh round of stimulus albeit on a smaller scale than expected. Following the Brexit referendum, new UK Prime Minister Theresa May met with her counterparts in Europe, but without achieving any greater clarity of the situation.

The positive environment for risk assets - low inflation, mediocre global growth, supportive central banks and low core interest rates - remained in place. Risk assets continued to rally despite oil prices coming off after the strong recovery since February. Emerging markets (EM) debt returned a further 1.8% (US dollar terms). The yield on EM debt came down 21 basis points (bps) to 5.17% and the spread fell by 20 bps to 368 bps. US 10-year yields were little changed at 1.46%.

In EM, higher yielding and higher duration credits continued to outperform as we anticipated; EM high yield returned 2.5% in July compared to 1.2% for investment grade. El Salvador (13.4%), Venezuela (6.6%), Egypt (6.2%), Mongolia (6.2%) and Sri Lanka (5.1%) were among the strongest performers. El Salvador's poor fiscal situation is becoming more acute. The opposition party, which holds the most seats in the legislative assembly, is calling for the government to seek an IMF deal, seemingly raising the expectations of the market. In Egypt, there was confirmation that IMF talks had begun.

Eastern Europe continued to underperform the market in July, returning only 0.4%. Turkey fell 3% following an attempted coup by a section of the army. In response, President Erdogan has clamped down on opponents with tens of thousands of judiciary, military, civil service and education personnel being detained, suspended or placed under investigation. This has caused tensions between Turkey and its Western allies. S&P downgraded Turkey to BB, two notches below investment grade, and assigned a negative outlook. Oil related credits were the other weak performers, among them Angola (-2.8%), Iraq (-1.3%), Colombia (-0.3%) and Russia (0%).

Portfolio positioning

We participated in new issues over the month in Uruguay, Sri Lanka and Trinidad and Tobago which were attractively priced. In Africa, we added to our position in the short-end in Angola, and added to Zambia and Kenya. We see scope for EM high yield to continue its outperformance, with further credit differentiation likely. In Asia, we added to our exposure in Indonesia, which remains a core position and one of the strongest fundamental stories across EM. We reduced our exposure to Central and Eastern Europe moving to an underweight as we cut our position in Turkey significantly following the attempted coup, and reduced Hungary; a number of the CEE economies potentially face a negative impact on trade as a result of Brexit. We remain neutrally positioned in terms of risk exposure overall.

Performance

In USD terms, the First State Emerging Markets Bond Fund returned 1.77% in July.

Outlook

We expect the current scenario of mediocre growth and low inflation in the developed world to continue to support global bond markets, but we expect somewhat higher volatility in the next three months, as the US election and various EU events could cause some noise. In EM, growth is showing signs of bottoming, which supports EM outperformance. We envisage that global and technical factors will remain big drivers of EM debt for now and continue to be constructive on the market. We see the main risks as further weakness in oil prices, an equities sell-off damaging risk appetite and geopolitical events. Prospects for Europe remain uncertain amid a continued lack of clarity on the implications of Brexit and difficult conditions for the banking sector.