First State Investments



# First State Emerging Market Debt

Q4 2018 Review

**RISK FACTORS**

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## Market review and portfolio strategy over the reporting period

Equities and Commodities across the board were weak in the fourth quarter and emerging market (EM) debt (JPM EMBI global diversified in US$) lost 1.25% in the quarter as the EM risk premium (spread) rose from 3.35% to 4.15%. 10-year US Treasury yields rallied strongly in the quarter from 3.06% to 2.69% as market concerns over the US-China trade war and its impact on global growth increased. The yield on EM debt rose from 6.41% to 6.86% in this risk-averse environment and higher-quality investment grade EM countries (-0.65%) outperformed lower quality EM HY countries. Bonds of oil-exporting countries in particular underperformed, and the worst performers in the quarter were Venezuela (-14.5%), Oman (-8.3%) and Nigeria (-7.5%), as the oil price fell by more than 35% given higher than expected US production and limited supply impact of the Iran sanctions. The best performers in the quarter were Mozambique (+11.6%) which reached a restructuring agreement with its creditors, Brazil (+5%) where the market greeted the win of right-wing President Bolsonaro over the left-wing PT candidate Haddad with relief, and Zambia (+7.2%) which retraced some of its YTD underperformance. Other credits which showed positive returns in the quarter were higher quality Asian and Eastern European credits.

### Annual Performance (% in USD) to 31 December 2018

| Period | 12 mths to 31/12/2018 | 12 mths to 31/12/2017 | 12 mths to 31/12/2016 | 12 mths to 31/12/2015 | 12 mths to 31/12/2014 |
|---|---|---|---|---|---|
| First State Emerging Markets Strategy USD | -4.67 | 10.11 | 9.27 | 0.89 | 7.37 |
| JPMorgan EMBI Global Diversified | -4.26 | 10.26 | 10.15 | 1.18 | 7.43 |

These figures refer to the past. Past performance is not a reliable indicator of future results. For investors based in countries with currencies other than the share class currency, the return may increase or decrease as a result of currency fluctuations.

Performance data is calculated on a net basis by deducting fees (a model fee of 60bps has been applied) from a gross of fee return. The internally calculated gross of fee return excludes all costs (e.g. custody costs), save that it does not exclude costs associated with buying or selling securities within the portfolio. Income is re-invested on a gross of tax basis. Source: Lipper IM / First State Investments (UK) Limited.

The global environment, in particular the ongoing trade tensions between China and the US as well as tightening financial conditions in the US, were important drivers for EM debt in the fourth quarter. As widely expected, the Federal Reserve raised short-term interest rates for the fourth time in 2018 by a quarter of a percent in December, but acknowledged that rates are now closer to neutral.

During the fourth quarter of 2018, the Strategy continued to favour higher quality credits such as Bermuda, Qatar and Israel and to be selective in high yield countries where domestic developments were unfavourable, or where demand/supply dynamics ahead of new issuance were less positive. We reduced our positions in Costa Rica and Oman where we expect limited fiscal consolidation, but added to our positions in Paraguay, the Dominican Republic and Colombia. Given the large spread widening in Africa in December, we took advantage of the attractive valuations in select credits and added some risk there.

## Market outlook and portfolio implications

After a challenging 2018 for EM debt, we expect a more positive 2019 for two reasons: 1. we anticipate a less negative global environment for EM and 2. EM valuations have adjusted dramatically – the yield on the overall index rose from 5.3% to 6.9% during 2018. At current EM valuation levels, we believe that a very bearish external scenario has been priced in. While we expect continued geopolitical noise and volatility, we see a more positive global environment for EM debt in 2019. The large moves we saw in US short rates in 2018 are unlikely to be repeated in 2019 as the Fed moves to pause. As for global and Chinese growth, we expect a slower pace of expansion in the near term, but no recession is in sight as overall global growth remains robust. Among EMs we expect to see a recovery of growth in selected countries over the next two years, particularly in Latin America and would expect EM growth to pick up relative to developed market (DM) growth as US growth falls closer to potential.

Regarding global trade, we believe that a fairly bearish scenario has been priced into markets, but with the recent de-escalation of the US-China trade war we should see sentiment improve, especially as far as EMs are concerned. Nonetheless, US-China economic tensions will not disappear but remain a potential source of geopolitical risk.

We expect that future economic and asset price performance among EM countries will be varied; thus careful and forward-looking country analysis will be rewarded in a market with such performance dispersion. We continue to prefer quality investment grade credits such as Bermuda, Kazakhstan and Qatar and are more cautious on Mexico where we could see a deterioration of policy under the new president. We are selective in higher-yield credits where we prefer short-dated bonds with less volatility. High-yield credits where we see stable to improving fundamentals, which are not yet fully priced in, are the Dominican Republic, Paraguay, Croatia and Azerbaijan.

The main performance differentiators will be politics and policy, particularly fiscal policy. This will be in focus in Brazil (pension reform), in Mexico (re-orienting government spending) and in some smaller countries such as Costa Rica, Ecuador and Ghana. In Turkey, we expect monetary policy to remain in the spotlight, as the economy experiences a hard landing.

Regarding politics, Argentina, South Africa, Ukraine, Nigeria and Indonesia among others will see elections. While a Jokowi win is likely in Indonesia, election outcomes in Argentina and Ukraine are more uncertain. If President Macri can recover some of his popularity, Argentine assets could perform strongly, as the market would price in a continuation of policy normalisation and the prospect of capital inflows.

**Chart 1: Emerging Market Debt: the yield over 2018**

Source: JP Morgan, Bloomberg, EMBI Diversified Index as at 31 December 2018

**For further institutional enquiries contact institutionalenquiries@firststate.co.uk**

**For wholesale enquiries contact enquiries@firststate.co.uk**

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