Emerging Market Debt – Quarterly update

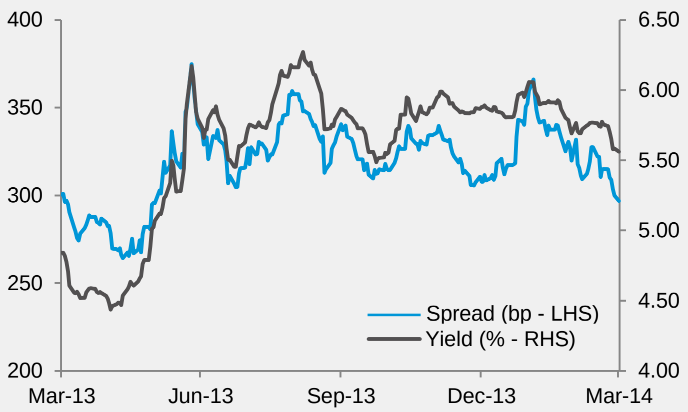
Review of Q1 2014 and Outlook

April 2014

Review of Q1

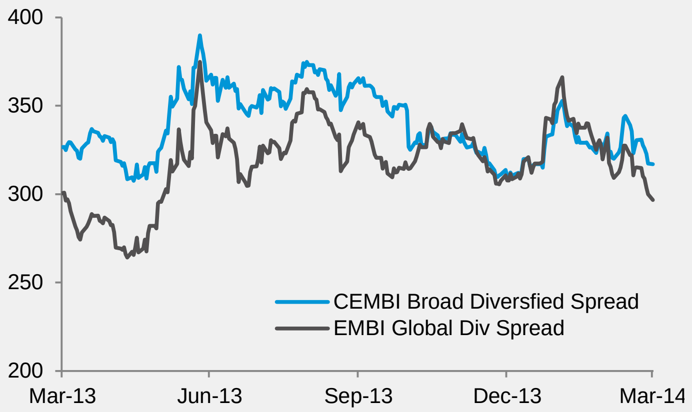
Emerging Market ("EM") dollar-denominated debt returned 3.73% in the first quarter as the yield on the benchmark fell from 5.9% to 5.56%. EM spreads tightened from 308 to 297 basis points and the underlying US Treasuries rallied sharply. Despite the start of the Fed's "tapering" of asset purchases, the weak US employment numbers and the generally disappointing US growth data in the first quarter buoyed Treasuries and the yield on 10-year Treasuries fell from 3% to 2.72% during the quarter. Returns were similar for EM high-yield and EM investment grade("IG") bonds: IG EM returned 3.66%, while high yield EM returned 3.9%. In terms of maturity buckets, long duration bonds outperformed strongly, returning 5.7% as the US Treasury curve flattened. Dispersion among country returns was high: the three best performers were the relatively illiquid bonds of Honduras (+12.6%), Belize (+12.1%) and Jamaica (+10.7%), followed by Morocco (+8.4%), the Ivory Coast (+7.9%) and Egypt (+7.6%). Bonds with negative returns were those of Ghana (-2.9%), Russia (-1.8%) and Mongolia (-0.2%).

EMBI Global Diversified spread and yield



Source: JP Morgan, Bloomberg as of March 31, 2014

EMBI Global Div. v CEMBI Broad Div Spread (bps)



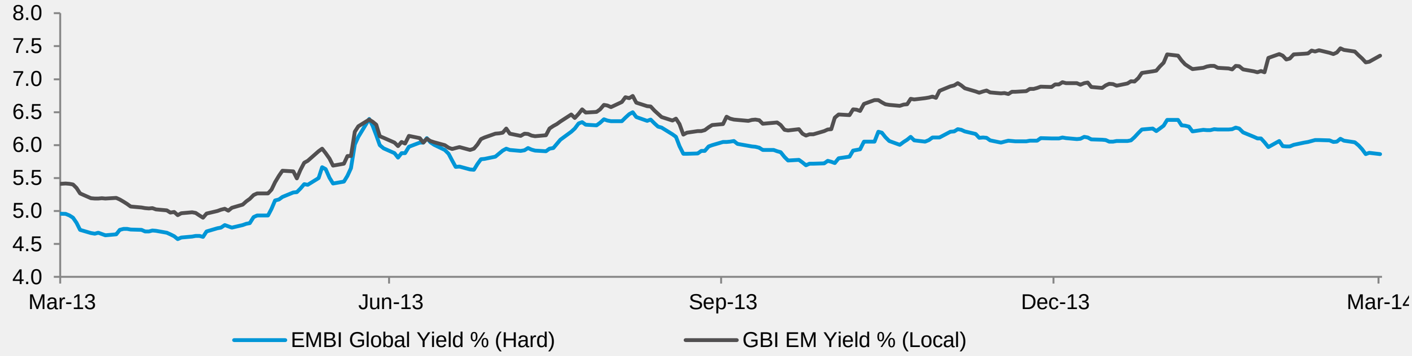
Source: JP Morgan, Bloomberg as of March 31, 2014

In dollar-denominated EM bonds, sovereigns outperformed corporates in the first quarter, mainly because of the higher duration of sovereign bonds which benefited more from the flattening of the US Treasury curve. EM corporate spreads tightened by 8bps for the quarter, from 324bps to 316bps. In EM corporates, IG bonds outperformed HY bonds, returning 3% compared to 2.3% return for HY bonds.

Local Currency Debt returned 2.20% year to date, underperforming dollar-denominated debt. The return was made up of capital gains in the duration component (+0.37%), added to the total carry (1.86%), while FX remain broadly unchanged. The best performing market over that period was Indonesia (+13.5%), which benefited from an improved investor perception following the positive lagged impact of last year's monetary tightening on its trade balance. Brazil also performed strongly (+9.2%) thanks to the revival of investors appetite for high carry and an anticipation for the end of the tightening cycle. The worst performing market was Russia (-12%), which suffered from the unexpected onset of the Crimean crisis.

On a regional basis, Asia was the best performing region (+6.16%), followed by LatAm (+5.71%), while EMEA produced negative returns (-2.29%) due to the contagion from the Crimean situation.

Local versus Hard currency yields (%)



Source: JP Morgan, Bloomberg as of March 31, 2014

The first quarter was eventful in EM. In the **Ukraine**, president Yanukovich fled the country after months of street protests against his pro-Russian policies. The new interim government led by prime minister Yatseniuk has turned to the IMF and the West for financial support of the embattled economy. The IMF, the EU and the US have promised a rescue package in exchange for economic reforms. We believe that the required economic reforms will be challenging to implement for the Yatseniuk government, particularly since the country is politicially polarized between the Eastern part of the country, which has close economic ties to Russia, and the Western part. Shortly after the interim government assumed power, Russian troops moved into the Crimea to "defend the rights of the Russian speaking population". A referendum was then held on March 8 where a majority of the population voted to join **Russia.** Western reaction to this de facto annexation of the Crimea was a round of economic sanctions against Russia, primarily targeted at Putin's entourage. We expect continued political unrest in Eastern Ukraine until the scheduled presidential elections in the Ukraine on May 25. Given the economic linkages of the Ukraine with Russia (26% of its exports go to Russia, most of its energy imports are from Russia and Russia is an important creditor), it will be interesting to see how the resolution of the economic and political issues between the two countries will evolve. What is clear is that Russia will pay an important economic price for the annexation of the Crimea: we would expect capital outflows to accelerate, economic growth to suffer and interest rates to remain high. Whether further sanctions against the energy and banking sectors are forthcoming will depend on Russia's objectives in the Eastern Ukraine.

Turkey was also frequently in the headlines this quarter, as the opposition to the ruling AK party leaked tapes with damaging corruption allegations against prime minister Erdogan. Erdogan's response was to dismiss judges, prosecutors and police involved in the investigations. Before the municipal elections at the end of March, more tapes were leaked and Erdogan banned Twitter, blaming social media for dissemination of misinformation. In the end, the AK won the municipal elections and it appears that prime minister Erdogan will run for president in the elections scheduled for later this year.

The two largest Latin American countries had changes in their credit ratings: **Mexico** was upgraded to A-, as the reform course of president Pena Nieto is being rewarded. Pena Nieto has done a fiscal reform and the country is embarking on a wide-ranging reform of its energy sector which is expected to attract foreign investment into the oil sector. **Brazil**, on the other hand, was finally downgraded to BBB- by S&P where it had been on negative outlook for a while. Investor reaction was one of relief and Brazilian debt rallied as the downgrade had been fully priced in. Some analysts had expected that S&P would retain its negative outlook on the rating, but Brazil's rating outlook is now stable.

The Global Environment and Market-Drivers for EM Debt in 2014

The focus of global markets remain

1. the normalization of US monetary policy
2. global growth and growth of world trade
3. developments in China, which tend to affect EM sentiment given China's pivotal role in world trade and its importance as a commodity importer.

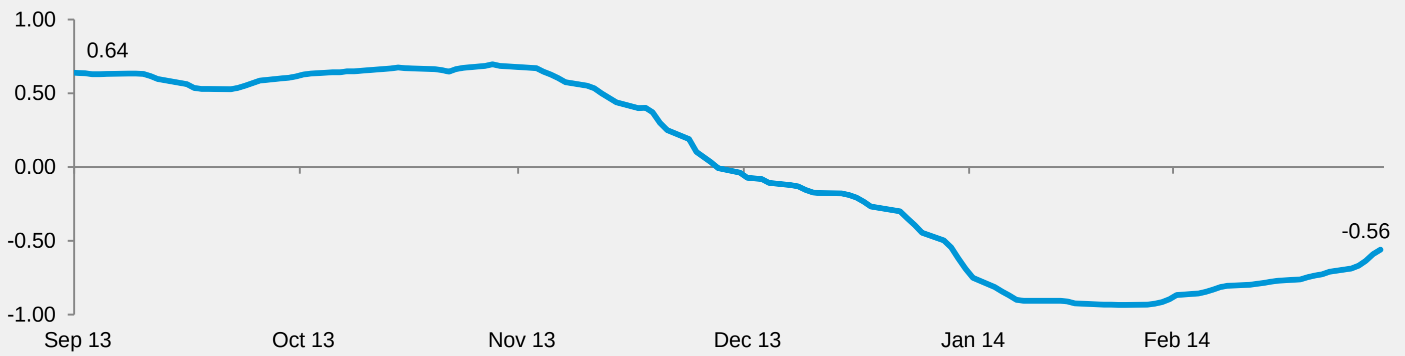
Chinese growth disappointed in the first quarter. Given the extent of the sell-off in copper and iron ore in the first quarter,we would expect market reactions to weaker Chinese data and headlines about corporate defaults to become more muted as a somewhat slower Chinese growth path now appears priced in. In the US, the focus has shifted from uncertainty about Fed tapering to the timing of the first interest rate hike, as the Fed indicated that a change in the tapering of asset purchases would require large downside surprises in economic data. US growth disappointed in the first quarter – some of the weakness in the data is blamed on distortions from weather-related factors and the effects of the inventory build-up in Q4, and analysts are split on the pace of future improvement particularly in employment data. With fairly dovish Fed rhetoric and few signs of wage inflation picking up in the US, US Treasury yields are likely to rise significantly only when economic data starts to surprise on the upside.

Citi economic surprise indices - US and China

Source: Bloomberg, Citi as of March 31, 2014

Encouraging for EM performance is that after the positive correlation observed between US Treasury yields and EM spreads in the May-September tapering panic, the correlation between EM spreads and US Treasury yields has returned to its usual negative relationship. Similarly, correlations among EM assets have dropped, indicating a return to more normal market conditions

Rolling 60 day correlation – 10 years UST and EMBIG Div spread



Source: Bloomberg, as of March 31, 2014

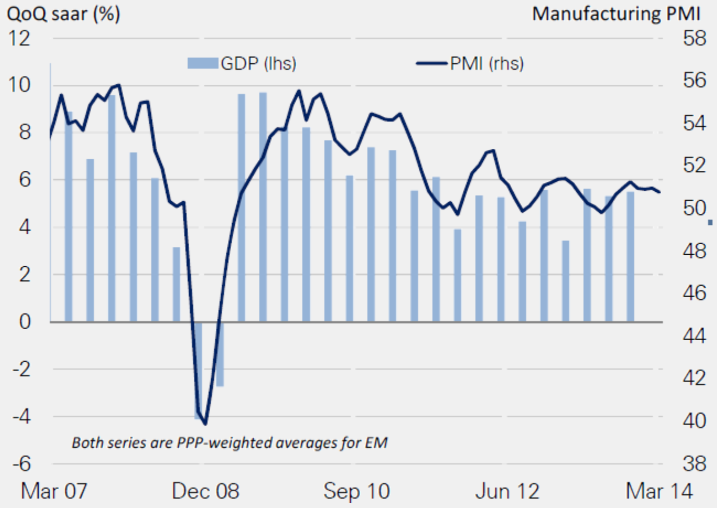
EM Debt Outlook

EM Fundamentals:

2014 has so far been characterized by a stabilization of EM macro fundamentals and a gradual improvement in current account balances, which bodes well for the structural EM picture. However, it is fair to say that a significant part of the positive performance can also be attributed to the rally in US treasuries caused by disappointing US economic data. This supportive external picture may not persist over the next quarter, which could re-ignite volatility in the weaker markets.

Economic growth in EM countries as a whole has shown few signs of improvement in the first quarter, but some countries – particularly in Central Europe, Africa and Asia - have seen growth pick up. We believe that we will continue to see very differentiated economic performance in EM countries in 2014, with Russia and most countries in Latin America continuing to see little economic expansion. Tighter monetary policy and higher real interest rates in many EM countries are weighing on growth. Also, few EM countries have the fiscal space to provide fiscal stimulus to growth. Countries where growth surprised on the upside are largely those which benefitted from growing exports, such as the Central European economies.

EM growth still flat-lining

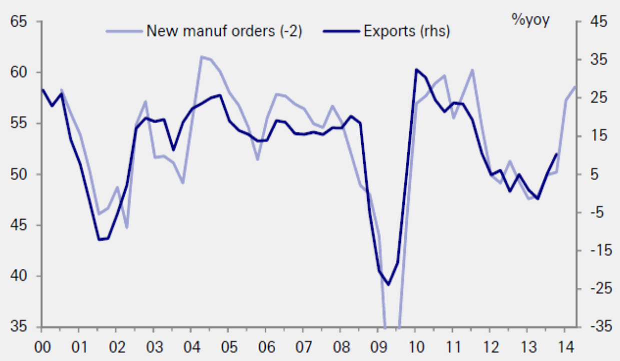


Source: Haver Analytics, Deutsche Bank as of April 2014

But: Exports in Eastern Europe surge while Russia stagnates

Source: Haver Analytics, Barclays Research, March 2014

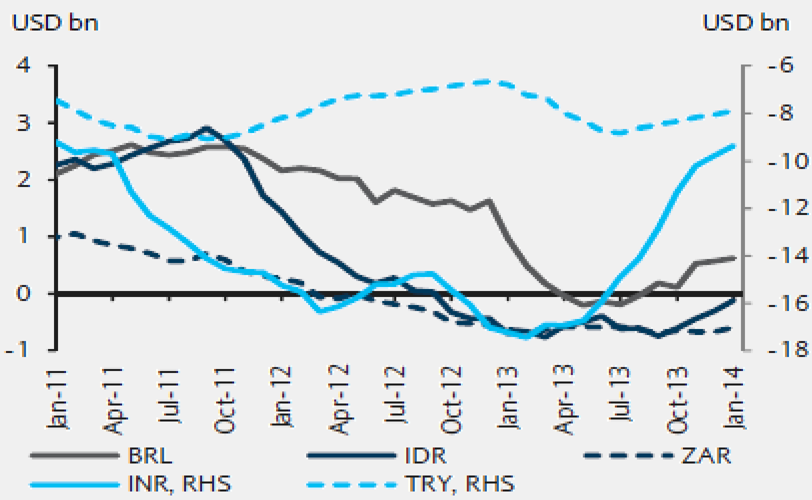
Asian exports and the US and EU manufacturing orders



Source: CEIC and Deutsche Bank Research, Global Economic Perspectives, February 2014

In terms of the external deficits of the so-called “fragile five countries” (Brazil, India, Indonesia, Turkey and South Africa), trade balances are adjusting, partly on the back of tighter monetary policy and weaker currencies. India’s trade deficit has seen the largest adjustment, followed by Indonesia and Brazil.

External deficits are adjusting, albeit at different speeds (trade balance, seasonally adjusted)



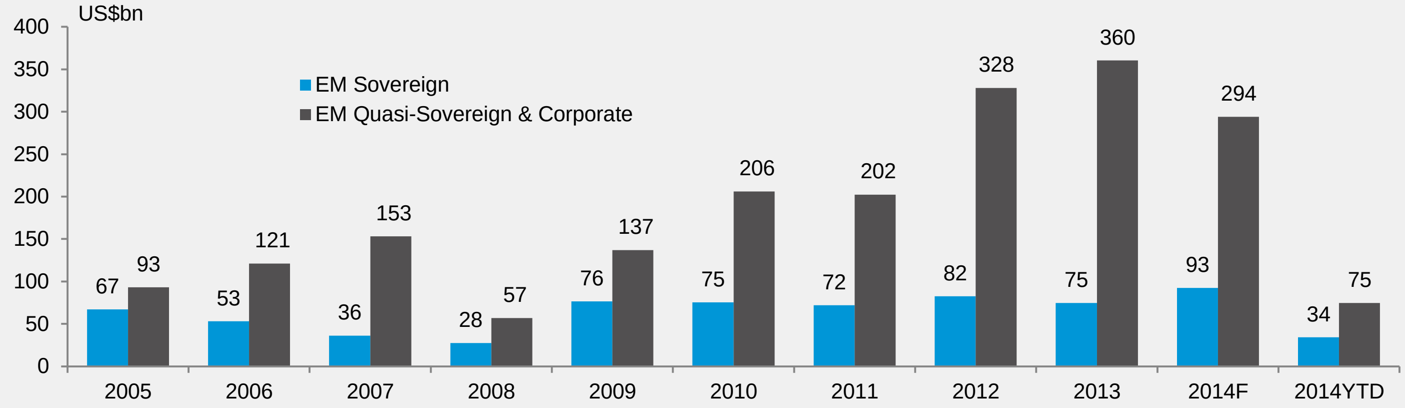
Source: National Statistics, Barclays Research, The Emerging Markets Quarterly April 2014

We believe that EM economies will have very diverse economic performance and **credit differentiation, structural reform and politics** will remain important themes. We would expect returns from EM hard-currency investments to be highly dependent on selecting credits which have the potential to be re-rated by the market or credits where the consensus is too bearish.

EM Technical Position

The technical position in EM hard-currency sovereigns for the remainder of 2014 is very positive, as issuance was very front-loaded in the first quarter. EM countries have already issued $34bn. this year and estimates for net issuance for the rest of the year are close to zero.

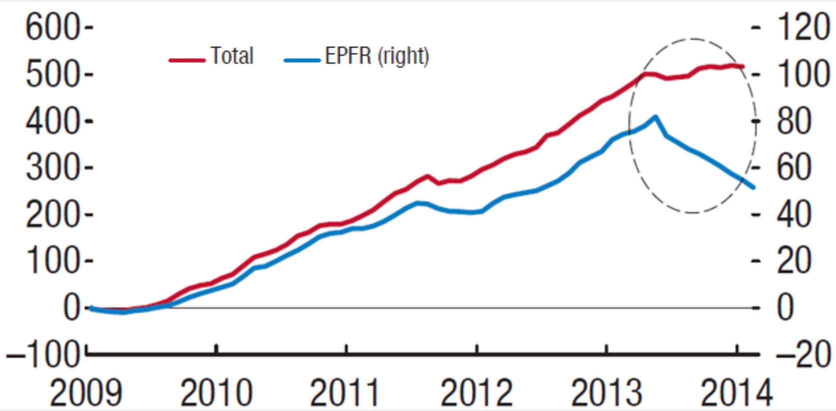
EM Sovereign- and Corporate Gross Issuance (US$bn)



Source: JPMorgan, April 2014

In terms of demand for EM debt, the well-advertised outflows from retail funds have been compensated by stable institutional inflows which are less well publicized, as the graph below indicates.

Total and retail flows in USD Billions

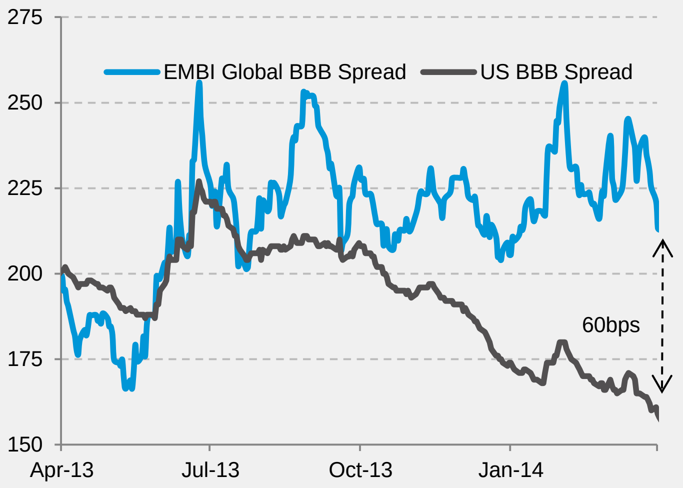


Source: IMF Global Financial Stability Report 2014

EM valuations

EM valuations have adjusted significantly since last summer and EM spreads relative to US and global credit spreads are very wide. One can argue that it is difficult to compare EM debt to other asset classes because the index includes countries with very diverse ratings, from AA to C. We therefore also look at valuations of only BBB rated countries and compare these to Global and US BBB corporates. Both comparisons confirm that the bearish sentiment for EM is priced: against US BBB rated corporates, EM BBB spreads have widened to 60bps, while EM BBBs are almost 60bps wider than BBB global corporates.

EMBI Global v US BBB Corporates - spread (bp)



Source: JP Morgan, Bloomberg as of March 31, 2014

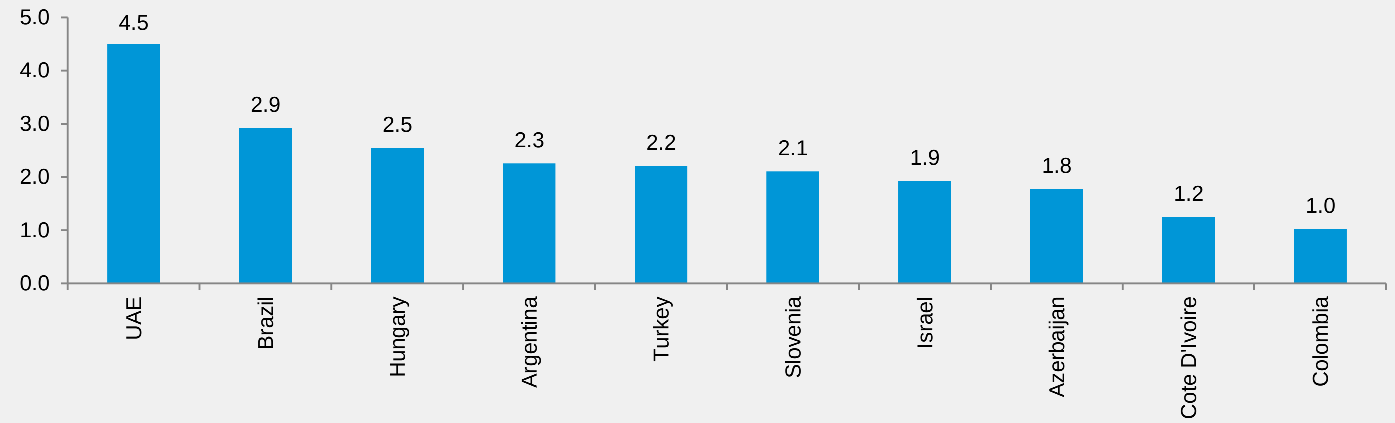
EM BBB vs Global Corp BBB

Source: Deutsche Bank as of March 31, 2014

Fund Positioning

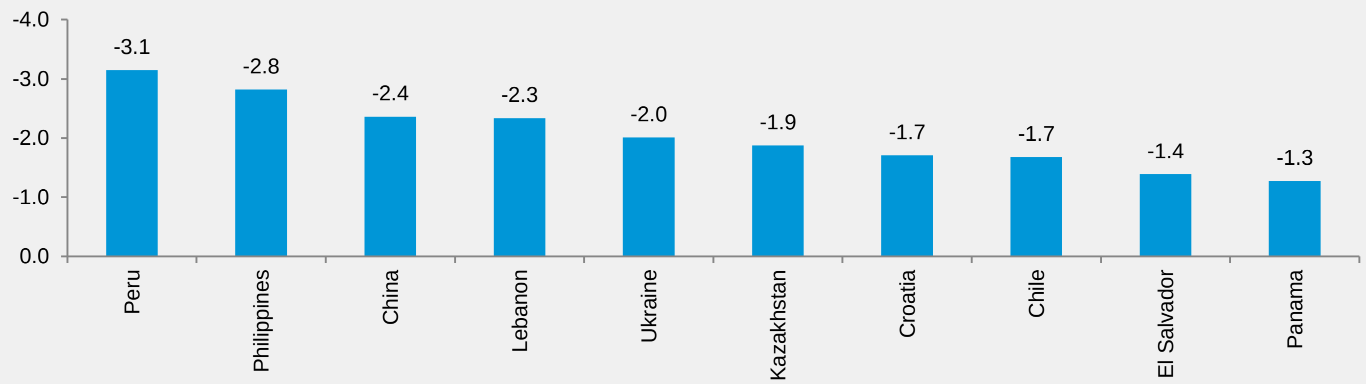
The funds remained underweight in Latin America and Asia where we see a less attractive risk/reward than in Europe or the Middle East. We bought many of the new sovereign issues in the first quarter, which generally came with attractive concessions to the secondary market. We believe that quasi-sovereigns and corporates are fair value here relative to sovereigns, but find that large liquid names particularly in the energy and utility sectors are still attractively priced and therefore overweight in these areas. We held only one small (below 1%) local currency position.

Largest overweight positions (% active)



Source: First State Investments as of March 31, 2014

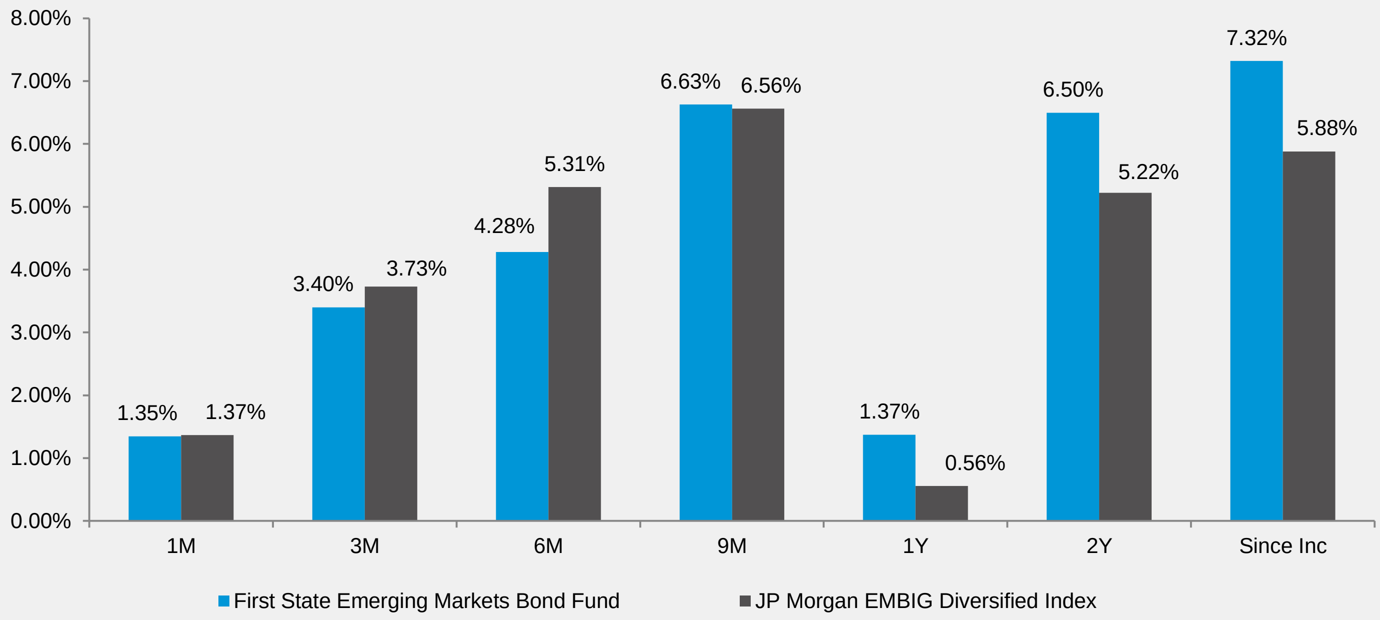
Largest underweight positions (% active)



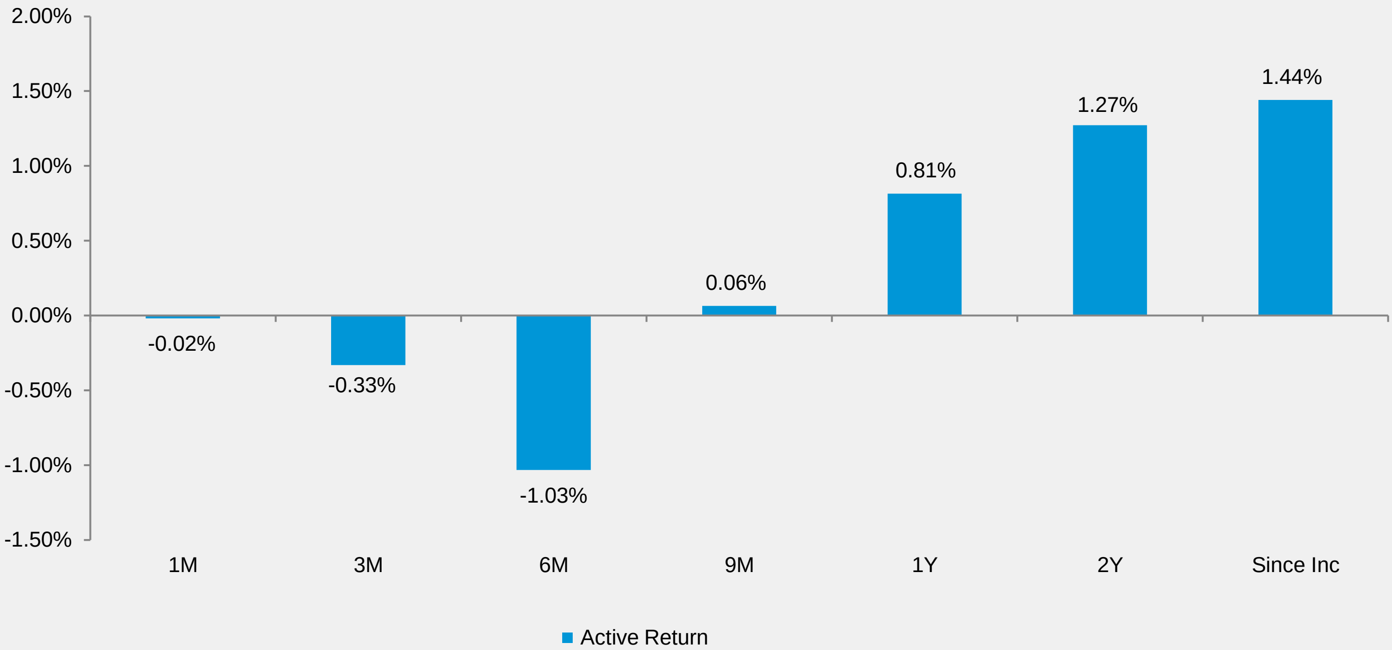
Source: First State Investments as of March 31, 2014

Performance – Emerging Market Bond Fund – Class I

Fund and Benchmark Performance (%)



Active returns (%)



All fund performance are unit price returns in USD, gross of fees and taxes.

Returns for more than 1 year are annualized.

Past performance is not indicative of future performance. The above referenced funds are not available for investment by US persons. Performance figures do not reflect the deduction of investment advisory fees. A client's return will be reduced by the investment fees. If a client placed $100,000 under management and a hypothetical gross return of 10% were achieved, the investment assets before fees would have grown to $259,374 in 10 years. However, if an advisory fee of 1% were charged, investment assets would have grown to $234,573, or an annual compounded rate of 8.9%.

For further information **www.firststateinvestments.com**

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