

MARKET OUTLOOKS

EMERGING MARKETS DEBT

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A strong structural story lying behind the noise

A number of short-term distractions grabbed emerging market headlines over the past eighteen months, including talk of the Federal Reserve (Fed) winding down Quantitative Easing (QE) prompting a widespread sell-off across emerging markets, Chinese authorities' attempts to rebalance their economy away from exports and towards more sustainable domestic consumer demand, and a number of geopolitical risks taking center stage around the globe.

In 2014, markets seem to be shaking off these concerns. Emerging market debt markets have experienced good inflows and strong performance so far this year. Portfolio debt flows to emerging market economies have increased to the highest level since April 2013, according to the Institute of International Finance. Emerging markets debt (represented by the J.P. Morgan GBI-EM Diversified Index, a local currency debt markets index) generated returns of 4.8% in the second quarter and 8.7% in the first half of the year while the J.P. Morgan Emerging Markets Bond Index, a hard currency index, had a second-quarter return of 5.43% and a 9.10% return for the first half of 2014.

This activity and performance underscores our belief that the underlying investment case for emerging markets debt remains simple but compelling. In our view, the emerging markets debt story is less about the short-term oscillations in market direction and more about the long-term, structural changes that are

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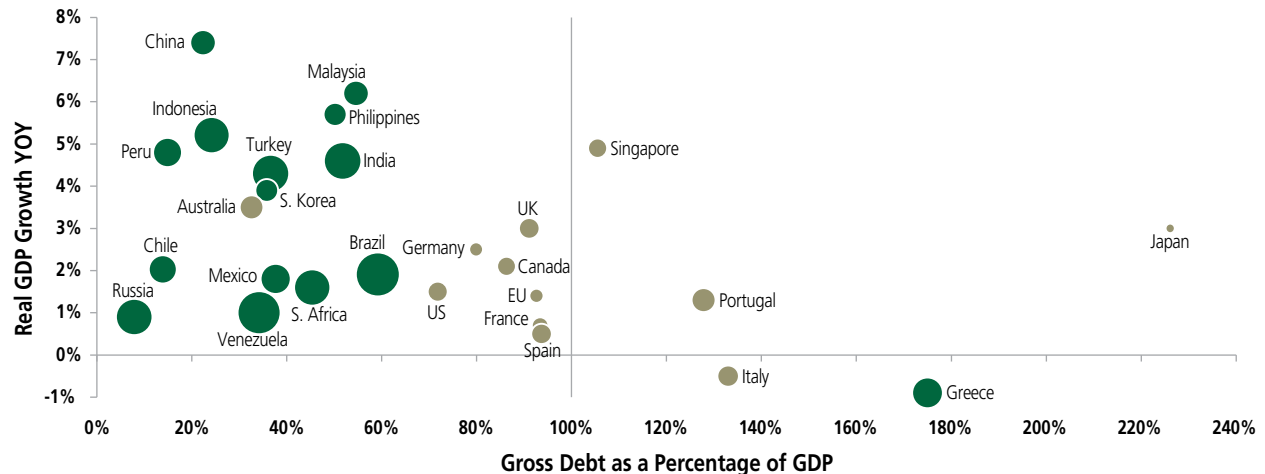
happening at an economic, political and social level in these markets. The asset class is benefiting from a strong and improving credit story, superior economic growth rates, structural demographic trends, and, ultimately, the potential for strong long-term returns on a risk-adjusted basis.

A number of factors contribute to this sound, structural long-term case for emerging markets debt: credit ratings are rising while they have been falling in the developed world; ongoing globalization and urbanization are leading to more stable and better-balanced economies; and a growing middle class is helping to more fully develop local yield curves. Moreover, emerging markets debt remains under-represented in many investors' portfolios. We believe, as emerging markets debt continues to expand — offering investors an increasingly diverse universe of high-quality issuance backed by strong credit fundamentals — this structural case will continue to be compelling.

A strong and improving credit story, superior economic growth rates, structural demographic trends, and the potential for strong long-term returns reinforce emerging markets debt's still-powerful fundamental story.

Faster growth and lower debt have helped raise emerging market credit ratings

Emerging markets boast significantly lower debt-to-GDP ratios compared to developed countries, and are backed by lower levels of both corporate and consumer debt.



Source: JP Morgan, "Guide to the Markets," March 2014.

Despite the volatility and significant outflows from emerging markets prompted by the Fed's tapering, issuance levels within emerging debt markets have hit record levels. We believe this demonstrates that there are secular demand pools for emerging markets debt and that institutional investors' strategic allocation to emerging markets debt will continue to increase.

We view the current US monetary policy backdrop as a win / win situation for emerging markets debt investors. If tapering ends sooner than expected, it will be because demand has surprised on the upside and monetary authorities believe that growth is entrenched and sustainable. For emerging markets exporters, that scenario is clearly good news. If, on the other hand, economic indicators deteriorate suddenly then it is possible that the pace of QE tapering may be put on hold.

The focus on the end of QE in the US, however, overlooks the fact that monetary policy remains loose globally, and that, in aggregate, global liquidity is set to expand further with both Japan and Europe ready to provide additional stimuli to their economies. We expect emerging debt markets to continue to benefit from easy monetary policy globally. Furthermore, the fragility of the economic recovery in developed countries suggests that any meaningful interest rate hikes are still some time away. With aggressive rate hikes in the most fragile emerging market currencies, policymakers are already reinforcing the emerging markets carry trade. We expect capital to continue to flow to emerging markets in this environment.

In terms of specific opportunities, we believe valuations in **Mexico** remain attractive in a long-term context given the country's steadily improving credit backdrop backed by wide-scale industrial reform, strong economic growth rates, lower government debt levels, and prospects for a gradually appreciating currency. Mexico's decision to reform its energy markets, eliminate state monopolies, and open its oil-rich waters to external investment in late 2013 marked a watershed moment in the country's status within international debt markets. Upgrades to investment-grade status have followed, as ratings agencies have welcomed the moves by policymakers aimed at improving Mexico's productivity and ensuring that the country's future growth rates are more sustainable.

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