EMD Market Outlook 2019

December 2018

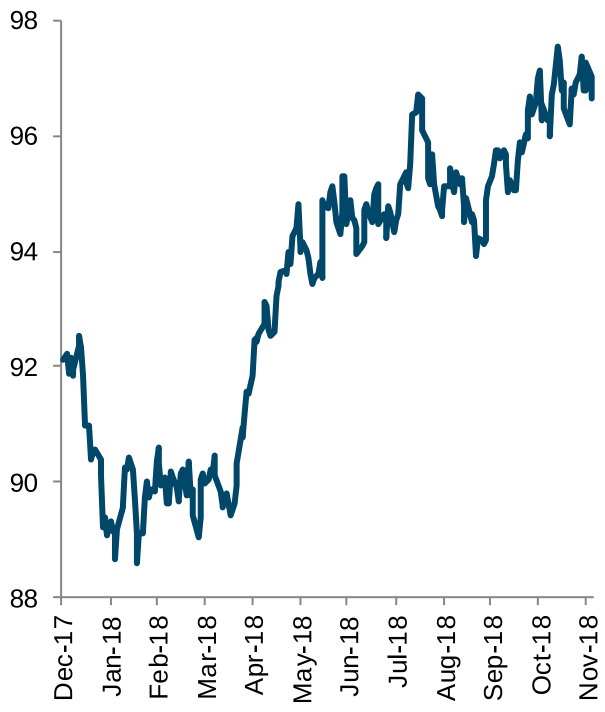
2018: YEAR IN REVIEW

After two years of stellar performance, 2018 was a challenging year for EMD with all sub-segments posting negative returns – EM Corporates outperformed (-2.9%) EM HC Sovereigns (-6.5%) and EM LC (-8.3%). EM Currencies (-9.6%) recorded their worst year since 2015.

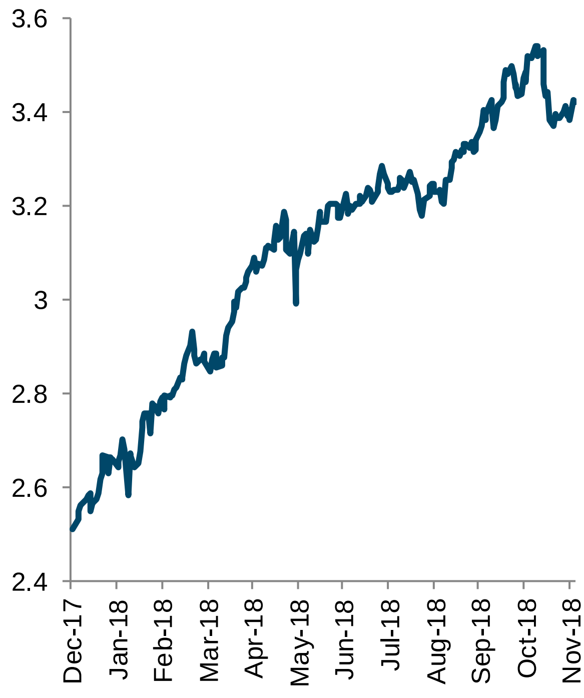
EMD disappointed expectations as almost everything that can go wrong did and uncertainty kept rising throughout the year. The thesis of synchronized global recovery across DM and EM that can support Chinese growth and commodities did not materialize. European and EM growth disappointed while the US growth was boosted by fiscal stimulus and bank deregulation. The Fed had all reasons to retain a tightening bias while the ECB and the BoJ remained on hold.

This growth and monetary policy divergence led to wider interest rate differentials between US and DM core interest rates, and to a stronger US dollar. 10Y US Treasuries rose by 60bps, to 3% and DXY rallied 5%, to end November, while the 2Y UST-Bund differential widened to 3.4%, or to its widest level since the introduction of the Euro at the end of 1999. US equity and US HY outperformed all other global risky asset classes including EMD.

DXY Index evolution (YTD)



US vs. German 2 year differential (YTD)



Source: Bloomberg, November 2018

The US exceptionalism was exacerbated by hawkish US trade rhetoric from April onwards, that turned into a full blown trade war between the US and its main trading partners (Eurozone, Canada, China, Mexico) by the end of the year. In this this environment of tighter global financial conditions, EM growth expectations collapsed as did EM growth realizations. EMD suffered a long outflow streak since the $24bn June peak (as per JP Morgan monthly EMD survey) and countries with weak external sector balances and excessive dependence on portfolio flows like Argentina and Turkey experienced currency corrections of more than 50%. EM Currencies lost more than 13% and EM Spread over US Treasuries widened by 54bps since their late January peak. In the second half of the year, EM central banks aggressively tightened monetary policy to restore risk premiums versus the US and stabilize their currencies.

Argentina approached the IMF for a funding program and received the largest ($57bn) package for an EM country on record which next to the introduction of an extremely tight domestic liquidity target and 60%+ policy rate, finally managed to stabilize the ARS in October. The Turkish central bank also moved into crisis fighting mode by late July hiking the policy rate to 24%. The TRY only started recovering September onwards as the Turkish authorities acknowledged the need for current account and growth adjustment in their medium term outlook.

Argentina and Turkey did not manage to generate contagion across the rest of the EMD although rising trade tensions between the US and China in 4Q, concerns over the impact of trade tariffs on Chinese, US and global growth and a 30%+ correction in Oil depressed sentiment for risky assets in October and November.

Domestic political risks were elevated in Latin America throughout the year as a number of Latin American countries held general elections in 2018. While a presidential candidate from the establishment party won in Colombia in May, the election results in Mexico in July and Brazil in October were less straightforward ushering in left-leaning (AMLO) or right-leaning populist presidents (Jair Bolsonar) with untested governance records.

2019: GOING FORWARD

The long list of headwinds from 2018 may not be repeated in 2019 and we are, therefore, cautiously optimistic on our EMD outlook for next year

- We expect that the US economy will continue expanding in the first half of the year but that it will slow down in the second half as the effects of the fiscal stimulus wane and trade tariffs start hurting the US economy
- The Fed is likely to continue tightening policy but is also likely to pause by mid-year which results in an expectation of two rather than the current FOMC members' dot projection of three hikes
- The US dollar is likely to reverse some of its 2018 gains as US growth divergence versus the rest of the world fades
- Eurozone growth will stabilize or at least its differential with US growth might not deteriorate further. Risks to this view are mostly political – Brexit resolution by March, Italian medium-term fiscal plans, ECB presidential transition in 1Q, European parliamentary elections in May.
- China will continue slowing towards low 6% in 2019 from mid-6% in 2018 but will also implement moderate fiscal stimulus to offset the estimated 1% growth impact from the implementation of the announced 25% trade tariffs on all US imports from China ($504bn in 2017).
- Commodity prices, including Oil, stabilize around current levels and stage a 0-10% recovery in 2019 on the back of demand support from Chinese fiscal stimulus and re-establishment of supply constraints
- The US administration driven trade tensions are difficult to forecast in the absence of a long term target or exit strategy but are still likely to decline after the sharp escalation in 2018.
- In this precarious environment EM fundamentals remain broadly stable. EM growth stabilizes around its 2018 level with larger dispersion between CEE and Asia which slow down and Latam which recovers on the margin. EM inflation remains subdued on the back of output gaps and growth headwinds. EM debt sustainability metrics do not signal solvency issues in the near term. EM debt levels have deteriorated since the global financial crisis but average EM public debt of 51% of GDP is still materially lower than the 100% of GDP counterpart for DM. Total EM private debt is high around 113% of GDP but excluding China

the number drops to a more manageable 76% of GDP. China's high level of private sector debt is more of a medium term issue that will not be resolved in 2019.

There are numerous risks to the view – the main ones being centered around our US/Chinese growth, US rates and trade tension outlook – that we will continue following closely.

The accumulation of headwinds to EMD in 2018 pushed HC and LC risk premiums to attractive levels. We believe that given our moderately constructive outlook, HC and LC valuations are offering much better entry points into EMD HC and LC now than late 2017 and technicals are supportive. We expect mid-single digit returns for both EMD HC and LC on a one year horizon.

EMD HC OUTLOOK

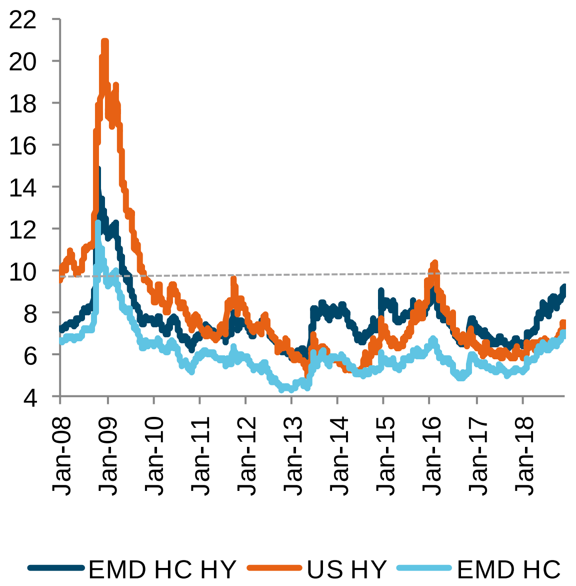
EMD HC Valuation

Valuations in EMD HC are attractive at current levels both in absolute and relative terms having de-rated in 2018, particularly for HY.

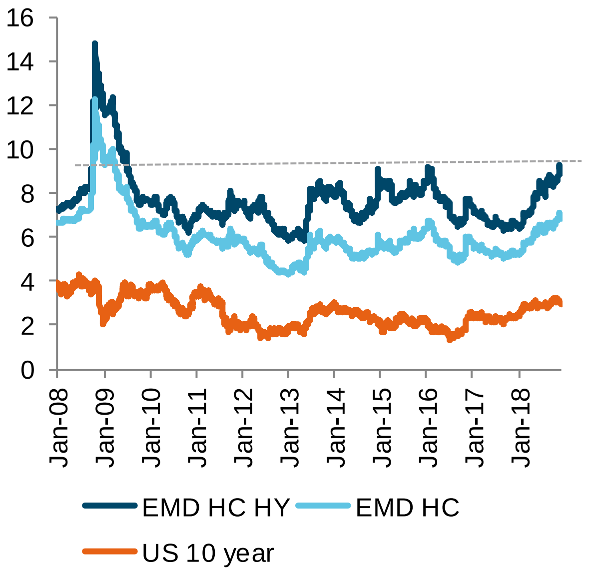
At 7.12%, the EMD HC yield is at August 2009 level having risen by 185bps YTD with US Treasuries contributing 65bps and EM Spreads, the remaining 120bps. At 405bps, the EM Spread to US Treasuries, has arguably, not reached its post global financial crisis peak of 496bps from February 2016, just after Oil prices (Brent) bottomed at $26, but is certainly trading 60bps above its 10Y average of 345bps.

The value is concentrated in HY after a year in which countries with weak external sector balances and dependence on external funding - like Argentina (+362bps), Ecuador (+357bps), Lebanon (+309bps), Sri Lanka (+314bps), Ukraine (+284bps), Turkey (+191bps), Zambia (+795bps) – experienced material Spread over US Treasuries corrections.

EMD HC Yield Evolution (in %, YTD)



EMD HC HY Yield Evolution (in %, YTD)



Source: Bloomberg, November 2018

EMD IG (-4.7%, up only by 59bps in spread terms) outperformed EMD HY (-8.4%, up by in 204bps in spread terms) in 2018. The EMD HY to IG spread, at 400bps (up by 150bps YTD), is also trading close to its February 2016 high (+436bps) which indicates that the de-rating of HY to IG might be close to complete as we do not expect any imminent defaults in EMD sovereign space although investor-friendly restructuring in Zambia for example cannot be ruled out.

Using a base case scenario of 50bps 10Y US Treasury widening and a moderate 30bps EM Spread over US Treasury tightening we expect that EMD HC deliver returns around 6% in 2019.

Given this valuation starting point and our moderately constructive outlook on EMD for 2019 we will continue to favor HY EMD and retain a cautious bias on US Treasury sensitive IG credits but with a view to start reducing this short position as we get data confirmation of a slowing US economy and more dovish Fed.

EMD HC Technicals

EMD Technicals are mixed with weaker flows into EMD HC, extended and concentrated investor positioning but also close to zero net financing needs in 2019.

After a record EMD inflows in 2016 and 2017 when investors added $160bn with a bias towards HC (70% allocation in HC versus LC), 2018 was a slower year by comparison with only $19bn of inflows into EMD YTD (40% allocation to HC versus LC). We expect that inflows into EMD are likely to record around $20bn in 2019, or at roughly half the post global financial average of $45bn (as per JP Morgan EM FI monthly survey data) given our only cautiously constructive outlook on the asset class. The positioning in LC versus HC is somewhat cleaner since HC has taken roughly 62% of the inflows over the same period but given that we expect similar returns for both HC and LC we assume roughly equal inflows between HC and LC.

This flow picture is more constructive as higher funding costs for EM issuers are expected to limit supply in 2019. EMD HC net financing of $1.7bn (as per JP Morgan expectations) is very manageable relative to the expected inflows and investor cash levels.

Investor positioning is less supportive with most investors still over-weight EMD HC Sovereigns and with investors positions concentrated in a few higher yielders – Argentina, Ivory Coast, Dominican Republic, Ukraine.

EMD HC POSITIONNING

In EMD HY space we continue to favor two sets of countries – reformers and commodity exporters – as these have underperformed materially in 2018 and are likely to recover in 2019.

- **Reform oriented countries under IMF funding programs like Argentina, Ukraine, and potential new entrants to the club – Angola, Ecuador, Pakistan.** External funding risks are relatively low for these set of countries as IMF provides a funding back-stop as long as policymakers deliver on the agreed upon program conditionality. There are currently a record number of 13 EMD HC countries using IMF's funding arrangements and we do expect that risk premiums in these will be driven by the strength of IMF engagement. We will be biased to remain or go long countries performing well under the IMF programs and be more cautious in countries exiting their IMF programs, especially in HY space (Ghana, Egypt, Sri Lanka).

- **HY commodity exporters** – in 2018, we held a view that oil exporters will outperform which worked only selectively with respect to countries with stronger external balances like Kazakhstan, or countries with genuine reform momentum like Angola where a newly elected president focused on fiscal consolidation and limiting corrupt practices. Oil prices peaked until early October (30% up YTD at that point) on supply constraints (sharp decline in Venezuelan production) and geo-political risks (US breaking the nuclear agreement with Iran) and despite indications for weaker global demand. By end of November the 30% YTD rally was more than fully unwound on stronger than expected OPEC supply, weaker global demand and the US granting six month sanction waivers to eight large Iran oil importers. For 2019, we do expect that Oil prices will rebound from under USD60/bbl to USD60-65/bbl on renewed supply constraints around Iran oil sanctions and declining Venezuela production. As most EM HY oil producers have breakeven oil prices just under this range from fiscal perspective and have de-rated significantly in October/November 2018, we remain long in most of these. We will be looking to selectively reduce positions in countries planning excessive Eurobond issuance and deteriorating fundamentals.

Metals exporters might be in a better position than Oil exporters on the back of Chinese infrastructure directed stimulus to be implemented in 2019 but these are not a homogeneous group and investment decisions will be more country specific.

EMD FX & LC OUTLOOK

EM FX

With an average carry (i.e. 3m annualized) of cca 2.8%, EMFX is offering an attractive entry point for the beginning of 2019.

In 2018, US growth momentum has outpaced that of EM economies. Over the year, the 2018 US GDP growth consensus forecast (compiled by Bloomberg) was revised up by 0.5ppt, to 2.9%, whereas that for Emerging economies (including China) was kept constant at 5%. At the same time, USD 3m Libor rates, a gauge of the tightness of US monetary conditions, rose by 100bps to 2.7% over 12 months. It is worth noting that up until April, the average short term money market yields in EM had not moved up significantly, in a sign that EM central banks did not follow the Federal reserve in tightening monetary policy. Relatively lower growth prospects, combined with lower yield differentials, put EM currencies under pressure, leading to a sharp (-11.6%) average depreciation vs the USD.

However, in the second half of the year, more aggressive action was implemented by central banks, with Turkey (+16%), Argentina (+34%) or Indonesia (+ 1.75%) outpacing the Fed in tightening monetary policy. This leaves EMFX with a hefty carry pick us the USD at the end of 2018, alleviating one of this year's major headwinds.

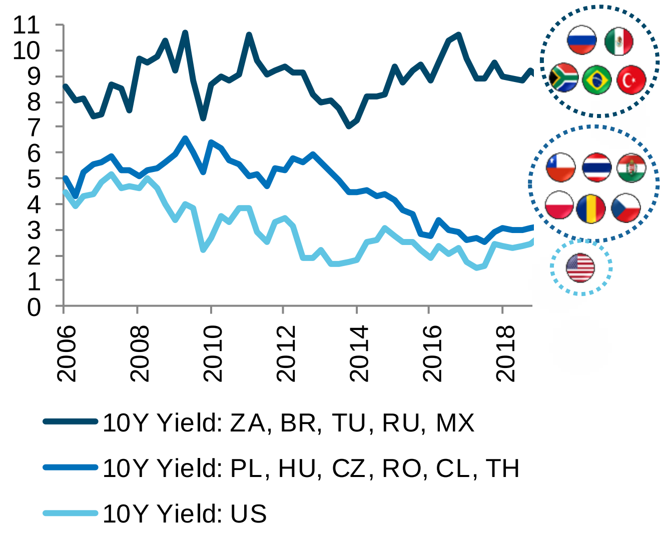
Concerns over trade wars and tariffs have also kept currencies under pressure. The Chinese yuan depreciated by close to 7% vs the USD in 2018, as Chinese growth gave signs of slowing down, and the US imposed tariffs on USD200bn worth of imports from China. However, we believe that as US growth gives signs of being impacted by trade tensions, the willingness to de-escalate trade related tensions will increase for both sides. This should help Asian currencies to stabilize.

EM Local Rates

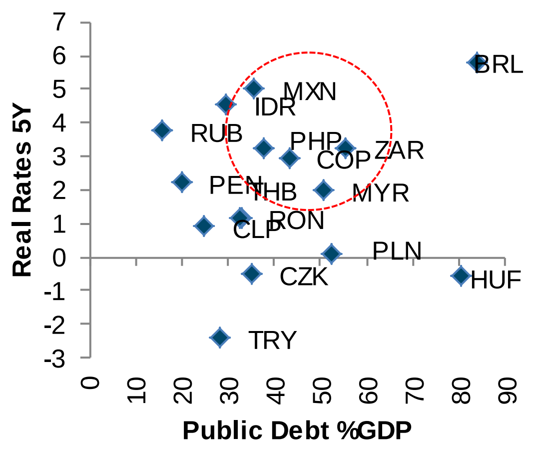
Moreover a number of high current account deficit economies were penalized by their status as oil importers in 2018 (Turkey, South Africa, India, Indonesia, CEE). For 2019, we believe that a tapering off of global demand, together with a less aggressive supply response from the OPEC+ will prevent oil prices from reaching the highs of 2018 again. A stability in oil prices between USD60-65/bbl would allow energy importing economies to diminish their external imbalances, lower inflationary pressure and lower the fiscal cost of subsidies. These elements would prove supportive both for EMFX and for EM rates.

In addition, we do not forecast major inflationary pressures to build up in EM economies in 2019. In Turkey and Argentina, after a spike led by abrupt currency depreciation, we expect inflation to collapse, as FX pass-through wears out and economies slow down. In Brazil, after a temporary increase led by supply disruptions around the truck drivers' strike in August, inflation is expected to come down to below 4% in 2019. Only in CEE do we expect inflation to pick up, led by tightening labour markets and pro-cyclical policies (both monetary and fiscal**). This benign inflationary backdrop will anchor local bond yields, allowing the EMD LC asset class to earn its carry (currently at 6.6% p.a.).**

EMD LC HY vs LY (in %)



Real Rates vs Debt to GDP (EMD LC)



Source: Bloomberg, November 2018

CONCLUSION

The accumulation of headwinds to EMD in 2018 pushed HC and LC risk premiums to attractive levels. We believe that given our moderately constructive outlook, HC and LC valuations are offering much better entry points into EMD HC and LC now than late 2017 and technicals are supportive. We expect mid-single digit returns for both EMD HC and LC on a one year horizon.

As EMD investors, we aim to continue taking advantage of market inefficiencies and dislocations related to specific events. Differentiation will be even more important in 2019 and we believe that our active investment approach focussed on risk control and relative value will continue delivering good risk-adjusted returns across the EMD strategies we manage.

Note: The index, JPM EMBI Global Diversified, is mentioned for informational purposes only. The investment policy does not consist in replicating the benchmark. All performance figures refer to the I Share class (USD, Acc). Past performance is no guarantee of future results and is not constant over time