EMERGING MARKET LOCAL-CURRENCY DEBT POTENTIALLY OFFERS VALUE DESPITE RECENT RALLY

AVIVA INVESTORS

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Key points

- The asset class has rallied strongly following the lows reached in January 2016
- Stabilizing commodity prices, dollar weakness and heavy inflows from yield-hungry investors drove the upturn
- We continue to explore opportunities for long-term investors
- A selective approach is important given short-term risks and challenging fundamentals
- Overall, the long-term emerging-market story remains intact

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Despite a strong rally in emerging-market local-currency debt in 2016, a widening yield differential with US rates points to the long-term value of the asset class, says Liam Spillane.

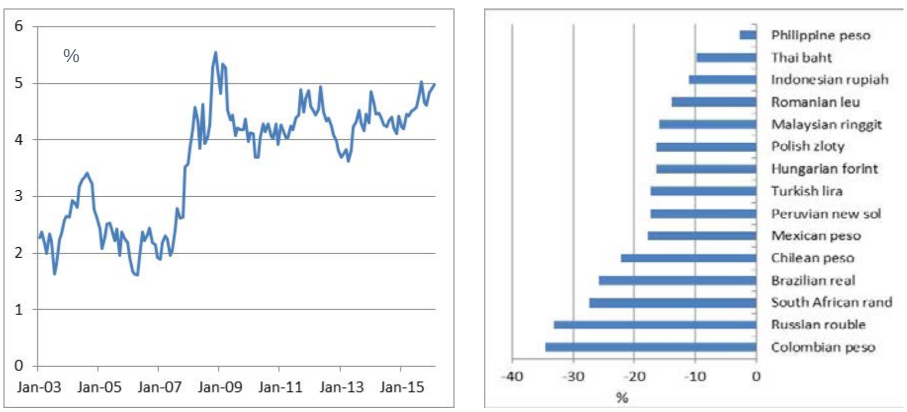
Emerging-market local-currency debt has rallied in 2016, supported by the dovish stance of global central banks and, in particular, the US Federal Reserve's apparent commitment to increasing rates gradually. A more balanced medium-term outlook for the Chinese economy, and greater stability for the US dollar and commodity prices, has also highlighted the attractive long-term value in local-currency assets. Long-term investor inflows into the asset class have picked up notably in recent months.

Evidence of this recovery can be seen in the performance of the JP Morgan GBI-EM Global Diversified index, the widely-used benchmark that we manage against and which tracks liquid local-currency government bonds and currencies. The index fell significantly in late 2015 and the first half of January 2016 as a result of global market volatility. By April 20, the index had increased by around 13.5 percent in Euro terms and almost 18 percent in US dollar terms from the lows seen in mid-January 2016.[1]

The pick-up of emerging-market debt relative to developed markets is perhaps a more relevant indicator of the potential remaining significant opportunities for long-term investors. At the end April 2015, for example, the nominal yield differential between local-currency emerging-market bonds and US rates was around 4.4 percent.[1] That differential has since grown to about five percent. We believe the current macroeconomic backdrop provides an environment for the asset class to continue to outperform if stable commodity prices persist and US monetary policy remains supportive. As a result, we are currently positioned overweight in terms of both duration and foreign exchange. The need for differentiation on an actively managed basis across local-currency markets, however, remains firmly in place. Currently, we have overweight positions in Mexico, Poland, Brazil, Russia, and Indonesia, and underweight positions in Thailand, Hungary, and Turkey in our local currency debt portfolios.

Chart 1: Valuations have reached attractive levels for long-term investors

Nominal yield differentials with US rates* | **Real FX adjustment since January 2013**



Source: JP Morgan, April 2016. **Past performance is no guarantee of future results.**
*Yield differential between JPMYUS (US government bond) Index and JGENVHYG (EM local currency debt) Index

[1] Source: JP Morgan, April 20, 2016

Pricing the risks

An improvement in external macroeconomic factors, such as the stability of the US dollar and commodity prices, has largely driven the rebound in local-currency markets since January. However, and more recently, there are tentative signs that the outlook for cyclical domestic economic fundamentals across the economies in the investable local-currency universe may also be stabilizing and possibly even improving. This follows many years of deterioration and we would still suggest a degree of caution at this stage. However, if the recent stability can at least be sustained, this will potentially be another significant tailwind for the asset class. Moreover, we believe that if external conditions remain supportive the asset class should continue to perform well. We will monitor the recent cyclical fundamental improvement for further positive signals. Despite the potential for further periods of volatility, the long-term emerging-market story remains firmly in place and favourable demographics and productivity, as well as relatively stable debt and reserve levels, support the asset class.