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First State Investments

Quarterly update | Emerging Market Debt

First State Emerging Market Debt

RISK FACTORS

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- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
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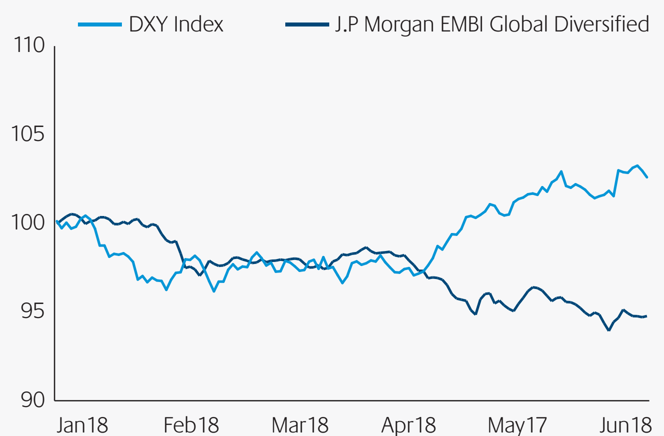
For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document for each Fund.

If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

Market review and portfolio strategy over the reporting period

Emerging market (EM) debt (JPM EMBI global diversified in US$) recorded a 3.5% loss in the second quarter as the global environment became more challenging for EM countries. While global growth remained robust and inflation contained, the second quarter saw US growth outperforming other developed markets. This relative strength of the US economy led to greater divergence in monetary policy, with the European Central Bank signalling that it will maintain the current policy rate until the summer of 2019, while the US Fed continues its hiking cycle and a gradual balance sheet normalization. Higher US short rates came with a strong upward move in the dollar which put pressure on EM FX (foreign exchange).

Figure 1: USD and EM FX



Source: Bloomberg DXY Index (USD index measures the value of the USD relative to a basket of foreign currencies) JP Morgan as at 29 June 2018

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Market sentiment was also negatively affected by more protectionist US trade policies, a risk we had highlighted in our 2018 outlook. The more challenging external environment and higher levels of market volatility led to increased performance dispersion among EM countries. More vulnerable countries, with high inflation, high debt levels and current account and fiscal deficits tended to underperform this quarter. This repricing of countries with greater external vulnerabilities is highlighted in the substantial underperformance of more risky EM High Yield countries (-5.8%) compared to higher quality investment grade countries (-1.3%). The Fund outperformed its benchmark in the quarter because it had selectively reduced risk in the High Yield space in the first and second quarter. As a result, the Fund had very limited or no exposure to the worst performing countries such as Venezuela (-14.5%), Zambia (-13.2%) or Lebanon (-13.1%).

Annual Performance (% in USD) to 30 June 2018

Period	12 mths to 30/06/18	12 mths to 30/06/17	12 mths to 30/06/16	12 mths to 30/06/15	12 mths to 30/06/14
First State Emerging Markets Strategy	**-1.0%**	**5.7%**	**8.4%**	**0.7%**	**11.1%**
JPM EMBI Global Diversified	**-1.6%**	**6.0%**	**9.8%**	**0.5%**	**11.6%**

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 strategy during the second quarter remained to selectively reduce positions in high yield countries where domestic developments were unfavourable or where demand/supply dynamics ahead of new issuance were less positive. Given our constructive view on oil, we added risk in Colombia, Kazakhstan and bought the new issues of Qatar and Saudi Arabia.

Market outlook and portfolio implications

We expect a more volatile external environment for EM in the foreseeable future given rising uncertainty about global trade, but still see robust global growth with contained inflation as our base case and see trade tensions only weighing marginally on the strong global growth picture in the short-term. In this base case, we expect commodity prices and particularly oil prices to be supported. Risks to our base case are an unexpected rise of US inflation which could re-price global rates higher or a substantial escalation of trade protectionism.

Despite the divergence of the growth and monetary policy paths between the G3[1], we expect a more subdued performance of the dollar going forward after this large move since we wouldn't expect US growth to continue surprising to the upside.

While the external environment has become more challenging for emerging markets, **valuations of EM debt** has adjusted meaningfully in the second quarter, with the risk premium increasing dramatically from 3.04% to 3.69%. The 6.53% yield on the asset class and the 3.69% risk premium makes the asset class attractive particularly relative to US HY credit. We believe that at current levels of risk premium and the absolute yield level, the asset class offers value for a longer-term investor and has priced in the less favourable external environment for the asset class.

The risk premium is now similar to the level reached during the 2013 "taper tantrum" when the then Fed chairman Bernanke announced a reduction in asset purchases by the Fed. We would argue that **EM fundamentals** are substantially better than they were in 2013 given the adjustment in current account deficits in the majority of EM countries. This is illustrated in the recent IMF "2018 External Sector report" which highlights that current account deficits of Brazil, India, Indonesia, Mexico and South Africa have shrunk since 2013. Similarly, international reserve positions have increased in many EM countries.

We also expect that the **technical position** of EM debt will improve significantly in the second half of 2018: EM sovereigns have already issued more than $100 billion debt in H1. Significantly, about 35% of debt issued has been brought to market by countries with single B rating, which partly explains the worse performance of the more risky EM HY debt. For the second half of the year, EM gross sovereign issuance is expected to be between $40-50 billion, and on a net basis (after repayments and coupon payments), most estimates are that net issuance will be negative for EM sovereigns. This will create a much stronger technical position than was prevalent in H1.

Within EM countries, we believe that commodity exporting countries will benefit the most from the continuing global recovery and are more insulated from trade protectionist policies. The Fund is overweight relative to the index in oil exporters such as Kazakhstan. Politics should be less of a performance driver in H2, as the elections in Mexico, Colombia and Turkey are in the past. The outcome of the Brazil election is still wide open, and we expect there to be volatility as it becomes clearer who the likely contenders for the second round are.

We anticipate that the external environment, with trade conflicts, geopolitical tensions and US activism in the sanction area, will remain an important driver for the performance of the asset class and will create price volatility. We will look to take advantage of such volatility and buy credits we favour as the technical picture for the asset class turns more favourable. Given divergent credit trends among countries, the Fund will be selective particularly in the HY space.

1 The world's three leading economic blocs - the US, Japan and the EU

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