Emerging Market Local Currency Review
4th Quarter 2017

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The most widely followed emerging market ("EM") local currency benchmark, the JP Morgan GBI-EM Global Diversified Index (the "Index") returned 0.82% for the 4th quarter of 2017 bringing the 2017 return to 15.21%. The yield on the Index rose 15 basis points (bps) to end the quarter at 6.14% while the yield on 5-year maturity US treasury bonds rose 27bps to 2.21%.

The positive 2017 return of the Index came primarily from the EM domestic treasury bonds which returned 8.91%. The remaining returns were due to the strengthening of EM currencies versus the US Dollar.

The EM domestic treasury bond return was primarily driven by the relatively high yields of the asset class but yield compression also contributed as the yield on the Index fell 65bps over the year. This can partly be explained by the relatively easy monetary policy and falling inflation across many emerging markets. Looking forward however, we believe there is significant opportunity in EM currency exposure, especially versus the US Dollar.

To make the case for EM currencies, we look at the historical returns of these currencies versus the US Dollar. In Chart 1, we show the return series of the currency component of the Index versus the US Dollar Index (a general indication of the international value of the US Dollar). We can clearly see the considerable weakness experienced by EM currencies from April 2011 until about the end of 2015. At the time, we highlighted that the cheaper EM currencies would act as a rebalancing mechanism for their economies by helping to boost the competitiveness of their external sectors.

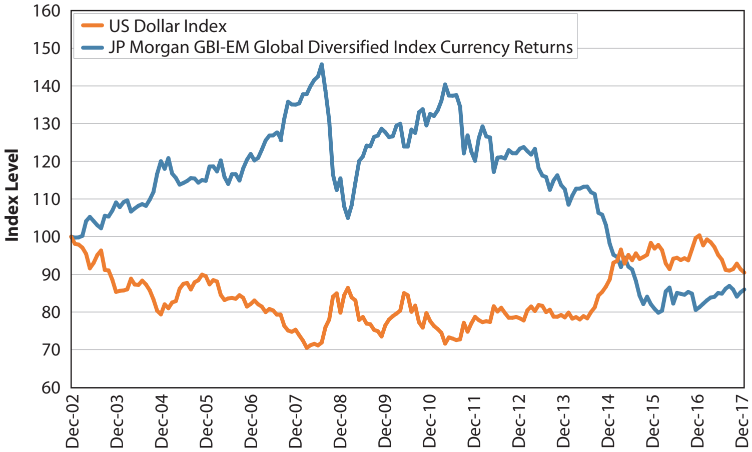
Subsequently, we have seen the strong export growth numbers from many of these EM's which have helped support a recovery in these markets. So why haven't we seen as strong a recovery in EM currencies as we did in EM domestic treasury bonds and EM equities in 2017? In a period where the overall growth outlook improved for many emerging markets, their currencies seemed to lag the strength seen in other EM asset classes. In Chart 1 we can see that the US Dollar Index has retreated somewhat from its recent peak in 2016 but EM currencies have traded mostly sideways.

We believe this is partly due to the easing monetary policies across many emerging markets. Some cases were particularly dramatic during 2017; for example, the Brazilian Central Bank's SELIC target interest rate was slashed 675bps from 13.75% to 7.00%. This reduced the attractiveness of the Brazilian Real to interest carry focused investors.

This, however, may all change in 2018. The US Dollar remains relatively strong but economic growth looks likely to continue to improve across the EM universe, in our opinion. We believe strong economic growth may shift EM central banks' focus from their dovish stance to policy rate normalization thereby improving the outlook for EM short-term rates. Strong growth globally has the potential to also support EM exports and their currency reserve accumulation.

By our valuation measures, which include purchasing power parity rates versus the US Dollar, EM currencies are attractively priced. There may be considerable differentiation across the asset class as some emerging markets wade through political crises and global events, however, we believe the underlying economic and fundamental factors are in place to support a cyclical uptrend in EM currencies.

Chart 1: **EM Currency Index vs US Dollar Index**



Source: Bloomberg, 12/31/2002-12/31/2017.

Market Review:

Emerging Market Treasury Bond Yields:

The yield on the Index rose 15bps to 6.14% over the quarter but the disparity across the subset of emerging markets was large. The modified duration on the Index at the end of December 2017 was 5.09.

Ten-year maturity EM domestic treasury yields rose significantly in the Philippines (+109bps), Mexico (+78bps) and Turkey (+70bps). Indian 10-year yields rose 66bps to 7.33% as consumer price index (CPI) inflation in India rose from 3.28% to 5.21% over the quarter.

Hungary experienced a sharp decline in 10-year bond yields as economic data remained mixed including CPI inflation which fell from 2.5% to 2.1% over the period. Yields also fell marginally across Indonesia (-18bps), Peru (-12bps) and Colombia (-10bps).

Box 1: **Snapshot of EM 10-Year Bond Yield Moves Over the Quarter**

Outperformers:

Hungary -56bps, Indonesia -18bps, Peru -12bps, Colombia -10bps and Poland -7bps.

Underperformers:

Philippines +109bps, Mexico +78bps, Turkey +70bps, India +66bps and Czech Republic +38bps.

As a reference, the 10-year US treasury yield rose 7bps over the quarter.

Emerging Market Currencies:

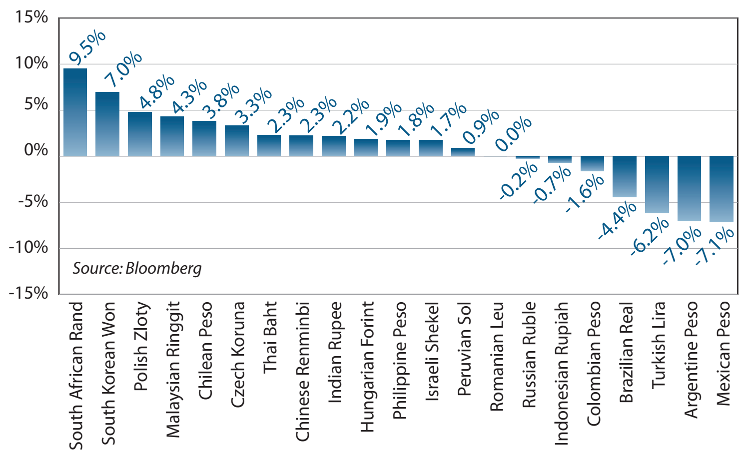
Although the currency return of the Index was 0.00% over the quarter, the returns from individual EM currencies were varied. The sharp 9.5% strengthening in the South African Rand versus the US Dollar followed market friendly political events in the country. We also saw a stronger South Korean Won (+7.0%), Polish Zloty (+4.8%) and Malaysian Ringgit (+4.3%).

On the opposite end, the Argentine Peso experienced a difficult quarter losing 7.0% vs the US Dollar, partly a result of continued high inflation. CPI inflation in Buenos Aires, a key gauge of inflation in Argentina, was at an eye-watering 25.04% on December 31, 2017. Other emerging markets currencies that experienced weakness versus the US Dollar were the Mexican Peso (-7.1%), Turkish Lira (-6.2%) and Brazilian Real (-4.4%).

Overall, however, we saw positive momentum across most EM currencies for the full year 2017, particularly in the central and eastern European currencies as the Euro rallied 14.15% versus the US Dollar.

Chart 2: **Snapshot EM Currency Moves Over the Quarter**

Emerging Market Currency Returns - 4th Quarter 2017

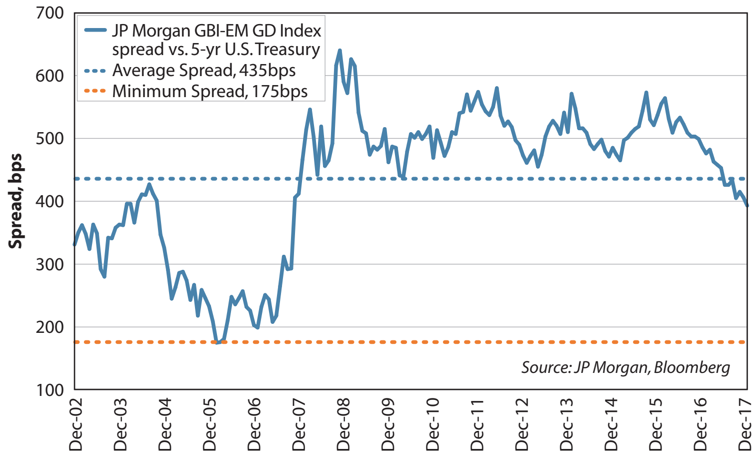


Outlook:

The spread between the yield on the Index and similar duration 5-year maturity US treasuries stood at 393bps at the end of the quarter. This is below the long-term average spread of 435bps since the Index inception but still far from the low of 175bps seen before the financial crisis.

Chart 3: **Average EM Debt Spreads**

JP Morgan GBI-EM Local Currency Global Diversified Index
Spread over 5-yr U.S. Treasury: 12/31/2002 - 12/31/2017



In addition to the attractive yields on EM domestic treasury bonds, the EM currency exposure provides an attractive opportunity and is currently one of the more favorable aspects of the asset class, in our opinion. The underlying fundamentals in EM countries continue to improve and point to a cyclical upswing as shown by the Markit Emerging Market Manufacturing Purchasing Managers' Index ending the year at 52.2, the highest level that it has reached all year. We also continue to see healthy export growth numbers, increasing foreign exchange reserves and continued gross domestic product growth in the EM bellwethers, China, India, Brazil and Russia. We anticipate this cyclical upswing will be supportive of EM assets more generally.