Emerging Market Local Currency Review
1st Quarter 2018

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The widely followed emerging market ("EM") local currency benchmark, the JP Morgan GBI-EM Global Diversified Index (the "Index") returned 4.42% for the 1st quarter of 2018. The yield on the Index fell 13 basis points (bps) over the quarter to 6.01% while 5-year U.S. Treasury bond yields rose 35 bps.

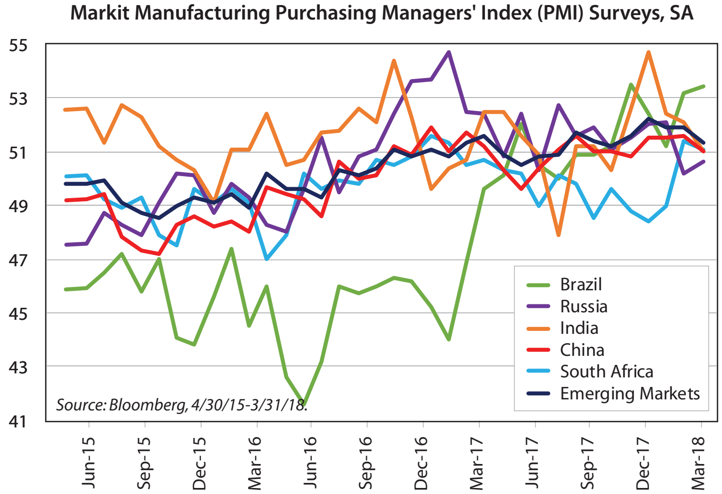
Stronger emerging market currencies resulted in a gain of 2.08% for the Index over the quarter as these currencies strengthened versus the U.S. dollar on average. The remaining return for the Index came from the return of the emerging market domestic treasury bonds.

Through the first quarter we continued to see economic fundamentals improve across many emerging market countries. The uptrend in economic growth can be seen by the steady improvement in manufacturing surveys across regions.

The chart below shows the Markit manufacturing purchasing indices of some of the major emerging market countries, China, India, Brazil, Russia and South Africa as well as the combined Markit Emerging Markets Manufacturing PMI Index. Numbers over 50 indicate periods of improving economic conditions while under 50 indicates periods of falling economic conditions. There has been a steady improvement in these surveys since the end of the first quarter of 2015 for most emerging market countries with a slightly more protracted period of weakness seen in Brazil.

Part of the reason sentiment continues to improve is the dramatic easing we have seen in many emerging market countries in response to lower inflation and their stronger currencies. The average monetary policy rate of the 20 emerging market countries we follow most closely has declined from 4.83% at the beginning of 2015 to 3.86% as of the end of the 1st quarter of 2018. We believe the lower interest rates are a strong impulse to help stimulate domestic demand and broader economic growth going forward.

Chart 1: **Emerging Market Manufacturing Sentiment Surveys**



Market Review:

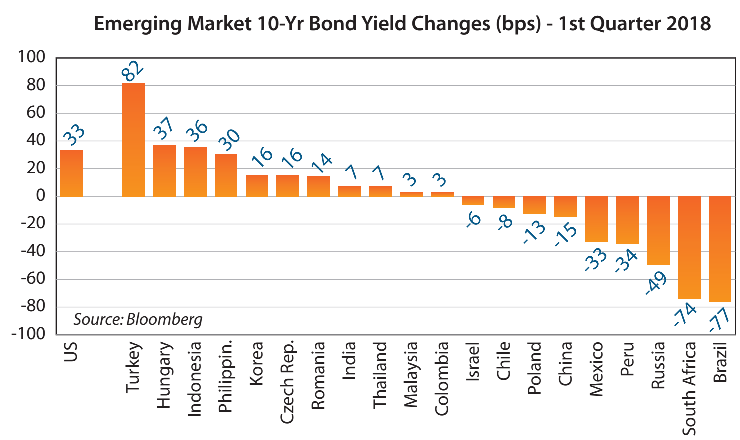
Emerging Market Treasury Bond Yields:

While the yield on the Index fell over the quarter, there was considerable divergence regions and countries.

Ten-year maturity domestic treasury yields rose in Turkey (+82bps), Hungary (+37bps) and Indonesia (+36bps). Inflationary pressures remained high in Turkey with consumer price inflation ending the quarter at 10.23%.

Yields declined sharply in Brazil with the 10-yr bond yields falling 77bps over the quarter. Consumer price inflation fell to 2.68% in Brazil as of the end of the period. Yields also fell in South Africa (-74bps), Russia (-49bps) and Peru (-34bps), over the same period.

Chart 2: **Snapshot of EM Interest Rate Moves over the Quarter**



Emerging Market Currencies:

Stronger emerging market currencies versus the U.S. dollar added 2.08% to the Index quarterly return. Similar to the domestic bond, the individual EM currency returns were varied. The Mexican Peso rallied sharply versus the U.S. dollar, rising 8.1% over the quarter, likely driven by more constructive progress on NAFTA negotiation. We also saw a stronger Colombian Peso (+6.9%), Malaysian Ringgit (+4.7%) and South African Rand (+4.6%)

On the opposite end, the Argentine Peso experienced another difficult quarter losing 7.5% vs the U.S. dollar. The lack of progress in tackling the persistently high inflation in Argentina continues to weigh on the currency. Elsewhere we saw a weaker Philippines Peso (-4.3%), Turkish Lira (-4.0%) and Indian Rupee (-2.0%).

Chart 3: **Snapshot of EM Currency Moves over the Quarter**

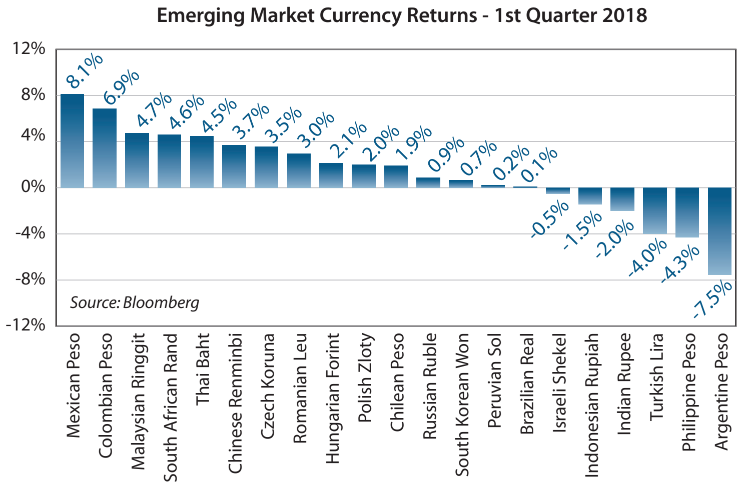
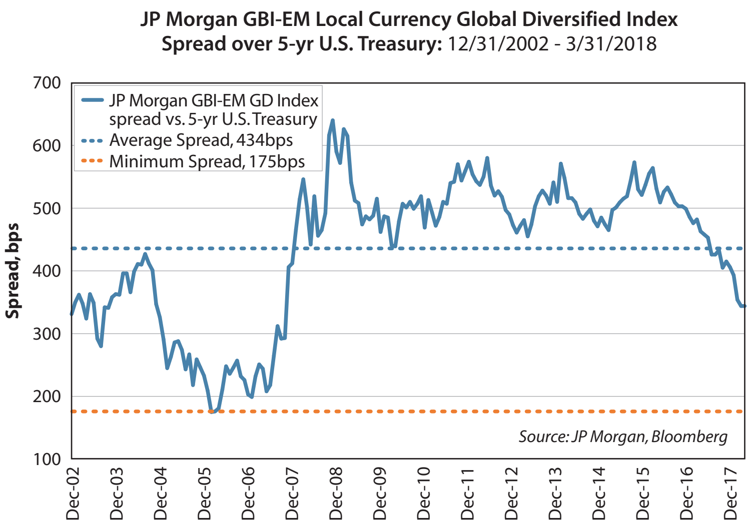


Chart 4: **Average Emerging Market debt spreads**



Outlook:

The spread between the yield on the Index and similar duration 5-yr maturity U.S. Treasuries stood at 344bps at the end of the quarter. This was a meaningful reduction over the quarter driven by 5-yr maturity U.S. Treasury yields rising 0.36% while the yield on the index fell 0.13%. As the spread tightening pressure has primarily been driven by higher U.S. yields and as the average spread is still off the lows of 175bps, we continue to find value in EM local currency bonds.

Emerging market economic fundamentals remain encouraging with stronger growth rates and improving PMIs. In addition we believe the longer-term drivers of positive demographics, lower debt levels and improving productivity may lead to a multi-year cyclical upswing in emerging market economic fundamentals.

Current valuations are attractive, the yield on the asset class of 6.01% is relatively high and many emerging market currencies remain significantly undervalued versus the U.S. dollar, in our opinion. The yields on emerging market domestic treasuries are some of the more attractive across the global fixed income universe, particularly considering that most are investment grade rated.

Finally, we view emerging market currencies as offering the most attractive opportunities for the rest of 2018. Emerging market currency returns have lagged returns of emerging market equities and bonds over the last two years as many central banks in these countries reduced monetary policy rates aggressively in 2017. With economic growth returning to these countries, the outlook for moderating inflation and stabilizing interest rates should help support these currencies going forward.

The JP Morgan Government Bond Index-Emerging Markets tracks local currency bonds issued by emerging market governments.

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