Emerging Market Local Currency Review
2nd Quarter 2018

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The JP Morgan GBI-EM Global Diversified Index (the "Index") returned -10.40% for the 2nd quarter of 2018 as emerging market ("EM") assets came under increasing pressure. The yield on the Index rose 59 basis points (bps) over the quarter to 6.59% while similar duration 5-yr maturity U.S. Treasury bond yields rose 18bps to 2.74%.

A significant contributor to the weaker quarterly returns came from weaker emerging market currencies versus the U.S. dollar. These weaker currencies on average contributed -8.34% to the Index return. Higher emerging market bond yields contributed to the remaining negative returns.

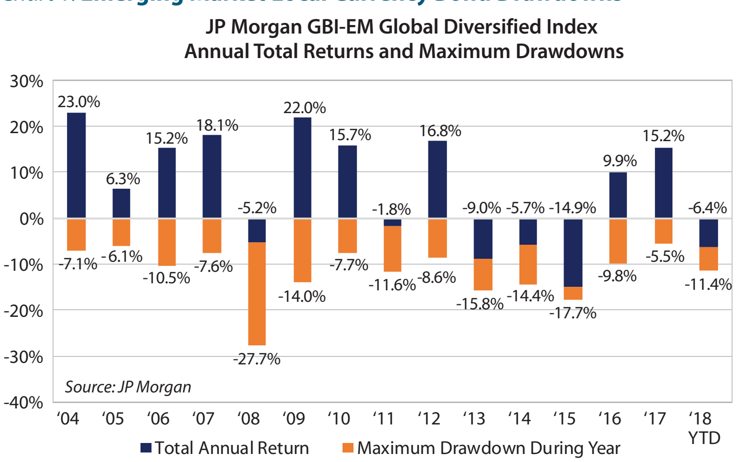
The drawdown (percentage peak-to-trough decline in total return over the period) of around -11.4% from the beginning of the year to the end of the second quarter has rattled many investors in emerging markets. This drawdown is significant although when looking historically, it is not necessarily an exceptional one. (Chart 1) In fact, if we look at annual drawdowns for the asset class since 2004 the average has been -11.7%. Understandably these drawdowns may cause angst for many investors, but we believe they also provide opportunities as asset class yields are now pushed back above 6%.

Considering that the drawdown we have seen year to date is around average, we view this weakness as not necessarily a trend change for emerging markets but rather a consequence of a number of largely exogenous factors impacting sentiment towards the asset class. Tighter U.S. monetary conditions, increasing trade tensions and the stronger U.S. Dollar have all had an impact.

In spite of this, emerging market fundamentals have not deteriorated significantly to justify the broad-based weakness, in our view. There are a few individual countries where the fundamental or political developments have certainly been negative (Argentina and Turkey) but by and large this has not been the case more broadly. We continue to see robust Purchasing Manager (PMI) and commodity prices remain well supported, both indicators pointing towards strong to stable growth across emerging markets.

While past performance is no guarantee of future results, historically, investors who have taken advantage of the drawdowns in emerging markets have been well rewarded by the cheaper valuations on offer particularly, as the long-term case for having exposure to emerging markets remains in place with stronger demographic profiles, improving productivity and lower debt levels relative to developed market economies.

Chart 1: **Emerging Market Local Currency Bond Drawdowns**



Market Review:

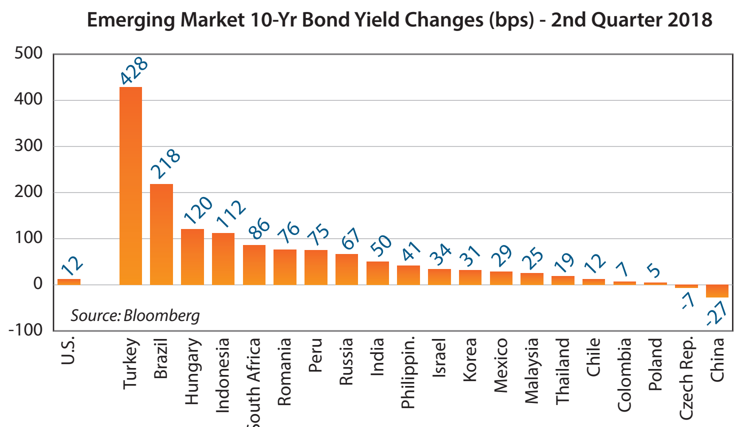
Emerging Market Treasury Bond Yields:

The yield on the Index rose sharply over the quarter with yields rising across most emerging markets. Yield rises were particularly acute in a handful of countries.

Ten-year maturity domestic treasury yields rose 428bps in Turkey and 218bps in Brazil over the second quarter. Hungary and Indonesia also saw yields rise by more than 100bps. The political challenges in Turkey and persistently high consumer price inflation intensified the weakness in Turkish bonds over the period.

Only two of the emerging market countries we follow most closely saw declining yields over the period, China and the Czech Republic. Ten-year maturity bond yields in China declined 27bps over the quarter as monetary policy rhetoric shifted more dovish.

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



Emerging Market Currencies:

Emerging market currencies had a difficult quarter with broad-based weakness. This weakness accounted for a substantial -8.34% of the JP Morgan GBI-EM Global Diversified Index quarterly return. The U.S. Dollar strengthened with the U.S. Dollar Index (DXY) rallying 5.0% over the quarter. The Argentinian Peso was the worst performer, weaker by -30.4% versus the U.S. Dollar as confidence in the currency evaporated given a host of domestic concerns. The Brazilian Real, Turkish Lira and South African Rand depreciated -14.7%, -13.9% and -13.7% respectively. (Chart 3)

On the other end of the spectrum, the Peruvian Sol, Philippine Peso and Indonesian Rupiah were the best performers relative to the U.S. dollar, weakened by -1.4%, -2.2% and -3.9%, respectively. The stress in emerging market assets was mainly reflected in the emerging market currencies however we remain of the view that emerging market currencies are substantially undervalued versus the U.S. Dollar on a purchasing power parity basis.

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

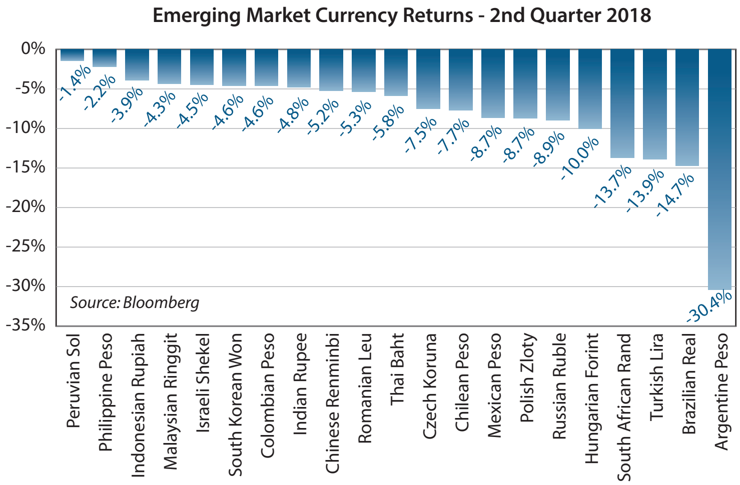
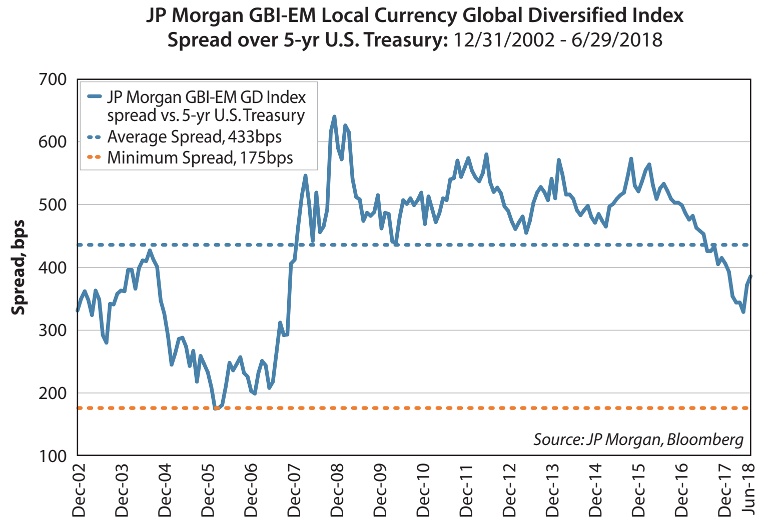


Chart 4: **Average Emerging Market debt spreads**



Outlook:

The spread between the yield on the Index and similar duration 5-yr maturity U.S. Treasuries rose to 386bps at the end of the quarter from 344bps at the end of March 2018. Over this period, the yield on the Index rose to 6.59% while the yield on 5-yr maturity U.S. Treasuries rose to 2.74%.

The wider spreads are below the long-term average since the Index's inception (December 2002) however, these spreads are meaningfully wider than the tights of 175bps seen before the financial crisis.

Despite the recent volatility, emerging market economic fundamentals remain encouraging with continued signs of stronger growth rates and improving PMI's. In addition, we believe the longer-term drivers place these economies in a good position going forward.

The quarter-end yield on the emerging market asset class at 6.59% for the Index, is one of the more attractive across global fixed income asset classes. We believe that the emerging market asset class paired with emerging market currencies that remain significantly undervalued versus the U.S. dollar, based on our purchasing power parity valuations, provides a potentially attractive addition to investors' fixed income holdings, provided investors can withstand interim periods of increased volatility as we've seen during the second quarter.

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