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EMD Outlook 2017

The Head of NN Investment Partners' EMD team and the Lead Portfolio Managers of the EMD strategies give their views on emerging markets, the prospects for the strategies they manage and the positioning in their portfolios.

- **EMD may continue to perform well (+3% to +8% in 2017) in an environment of rising US bond yields and a stronger US dollar**
- **Economic growth prospects are improving and we have seen some important fundamental improvements in the past years**
- **Real interest rates in emerging markets are high, inflation is on a declining trend and currencies are undervalued**
- **Uncertainty is high in the near term, mainly coming from the US, but we think president Trump will not be a disruptive force**

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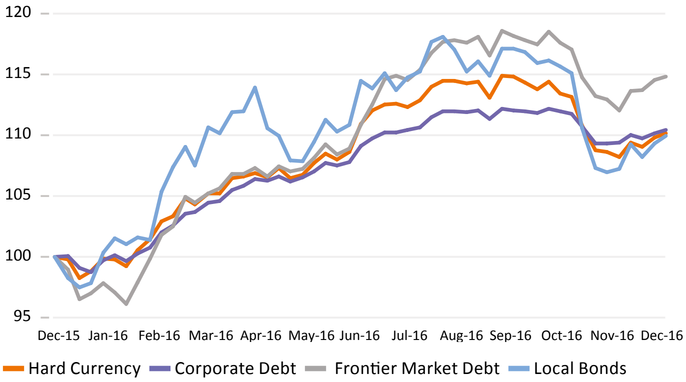
EMD Outlook 2017: On a firmer footing

Key points

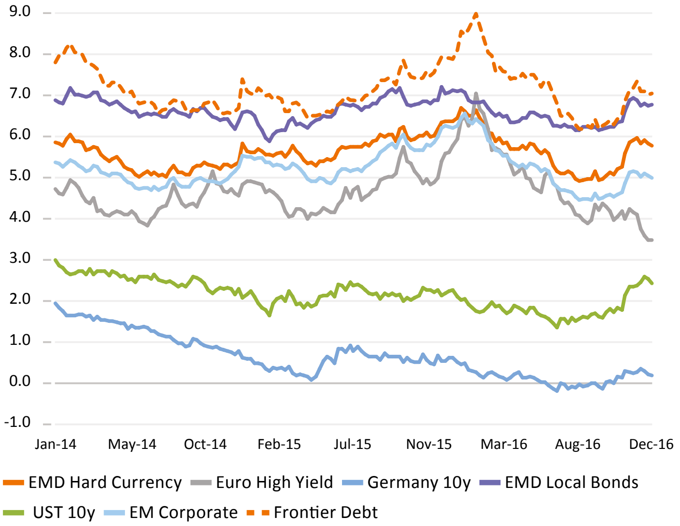
- Despite quite some volatility, 2016 proved to be a very strong year for emerging market debt (EMD). Hard currency bonds, local currency bonds and EM corporate debt all realized returns of 10% or more.
- We believe that – despite some headwinds in the near term – emerging markets can continue to do well in an environment characterized by rising US bond yields and a stronger US dollar.
- The economic growth outlook in emerging markets is improving, while the external balances of EM countries have improved considerably. Real interest rates are high, inflation is on a declining trend and currencies are undervalued. In addition, higher commodity prices also support EM growth.
- The global interest rate environment remains supportive of EMD. Interest rates have increased in the US, but are still near historic lows in regions like Europe and Japan. There is still a huge amount of negative yielding bonds in developed markets. In such a low-yield environment, EMD provides an attractive investment alternative.
- Uncertainty in the short term is relatively high, however. US policy is the main risk factor, although our base case is that the US will pursue a pragmatic, growth-focused economic agenda. We believe president Trump will not be a disruptive force for emerging markets.
- The Federal Reserve was a bit more hawkish than expected at its December meeting. Large fiscal stimulus in the US, resulting in rising inflation expectations, could force the Fed to hike more than currently expected. We believe in a gradual normalization of monetary policy by the Fed, but we need to keep a close eye.
- We expect Chinese GDP growth to remain around 6.5% in 2017 on the back of fiscal and monetary stimulus, but acknowledge that growth has to come down at some point. China needs to focus on its reform agenda, which we expect to happen after the change of leadership in November 2017.
- Despite the near-term uncertainty, we are positive about the outlook for EMD in 2017 and expect positive total returns for all sub-asset classes. US bond yields may rise further, but this will be offset by spread tightening and the carry. Expected total returns range from 3-5% for Asian hard currency bonds to 7-8% for Frontier Market Debt.

Figure 1: Strong performances of EMD sub-asset classes



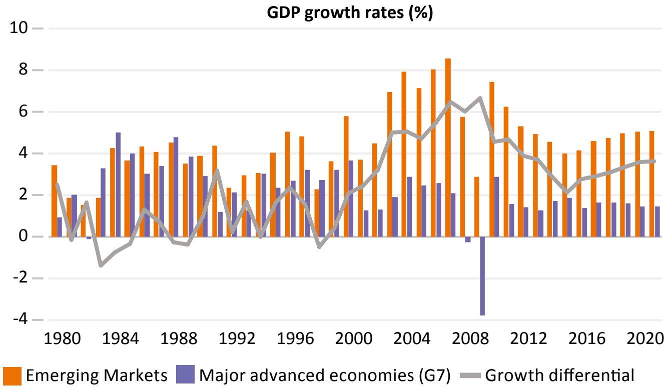
Source: Bloomberg, JP Morgan (data as of end December 2016)

Figure 2: Attractive yield pick-up in EM bonds (%)



Source: Bloomberg, JP Morgan (data as of end December 2016)

Figure 3: EM-DM growth differential expected to widen



Source: IMF World Economic Outlook (October 2016)

EMD Blended Strategies / EMD Opportunities

- EM growth finally turned the corner in 2016
- Fundamental backdrop has improved substantially
- US policy under Trump main risk in the near term
- EMD should continue to perform well in 2017

Marcelo Assalin

Marcelo is Head of Emerging Market Debt at NN Investment Partners. He is also Lead Portfolio Manager of the EMD Blended Strategies and the EMD Opportunities Fund.

2016 saw a turning point for EMD

2016 has been a very strong year for EMD. Hard currency debt investment returns were above 10%, both in the sovereign and the corporate space. Local bond returns were also very strong, close to 10%, mostly driven by the rates component. Not only in terms of performance was it a strong year for EMD, but also in terms of portfolio flows. Despite some outflows following the outcome of the US presidential elections, we saw close to USD 45 billion of net inflows to EMD. While hard currency debt portfolios received most of the flows, local market portfolios also experienced significant inflows.

Because of president-elect Donald Trump's pro-growth campaign rhetoric, US bond yields moved sharply higher after the outcome of the US election. Investors anticipate significant fiscal expansion in the US under the new administration, which should result in higher inflation and higher interest rates in the medium term. While rising US interest rates normally create headwinds for fixed income assets in general and EMD specifically, EMD has so far been extremely resilient. We believe such a strong resilience is related to the fact that the fundamental backdrop in EM has improved over the past years. EM countries are in a stronger position today than they were during the taper tantrum episode in 2013.

After a few years of disappointments, economic growth prospects in EM countries are on the rise again. Actual economic growth numbers finally started to exceed expectations earlier in 2016 and momentum accelerated going into year-end. Improving growth dynamics in developed economies and stable-to-rising commodity prices should provide a tailwind for EM countries in 2017.

In addition to improving economic growth, another important fundamental development in EM has been the remarkable reduction in external refinancing needs, enabled by a sharp reduction in current account deficits that took place in most EM countries. Moreover, inflation in EM is declining after a few years of being above target levels, while real interest rates are still high. Importantly, EM currencies remain significantly below their long-term averages. All this creates a very positive combination of supportive factors for EM countries.

Several fundamental improvements in emerging markets

We believe in a further improvement in the EM growth outlook, driven by the recovery in commodity prices. In addition, some major EM economies will be coming out of recession. Russia and Brazil, which have been in recession for the past two years, will very likely start printing positive growth numbers in 2017. And Chinese growth will remain well-supported by monetary and fiscal policies. What's more, the positive growth differential between emerging and developed economies is expected to start widening again. History teaches us that capital flows are directly correlated with this growth differential. With a rising growth differential we do expect continued capital flows into EM.

Next to growth, another very important fundamental improvement in EM has been the external account. Remember that during the taper tantrum in 2013, investors were panicking because of the so-called "fragile five"; major EM countries with very large current account deficits. If we look at the benchmark for local bonds, the current account deficit of the countries in this benchmark was on average close to 2% in 2013. Today, these countries run on average a current account surplus. So there has been a major adjustment. EM countries are now much less vulnerable to external shocks than they were back then. This should provide a strong cushion in an environment of globally rising interest rates and a potentially stronger dollar.

Another fundamental improvement has been on the interest rates side. Real interest rates in emerging markets remain very elevated, especially when we compare them with the negative real interest rate environment in developed markets. Not only do higher real interest rates in EM countries provide higher risk premiums for investors, but they also provide local central banks with more degrees of freedom to implement monetary stimulus to support economic growth, especially now that inflation is declining. Especially Russia and Brazil should be able to lower interest rates significantly.

Finally, a very important improvement has been on the EM currency valuation side. Currencies have deteriorated significantly since 2013, some even more than 30% or 40%. This has been a very strong adjustment which in turn helped these countries to rebalance their external accounts. It was not only a matter of depreciation versus the US dollar, but also on a trade-weighted basis EM countries gained a lot of external competitiveness.

Global interest rate environment remains benign

Looking at the global interest rate environment, interest rates have moved higher in the US, but let's not forget that in other parts of the world, like Europe and Japan, there is still a significant part of the fixed income market that is still displaying negative interest rates. As of mid-December this was still around USD 9 trillion. Even though we have seen some increase in bond yields in Europe, also after the ECB's decision to extend QE, they have not risen to such an extent that this huge amount of negative yielding bonds has significantly decreased. This provides an anchor to US rates, as it is very difficult to see US rates moving materially higher in an environment where rates in Europe and Japan remain extremely low. In this environment of global rates rising but remaining low from a historical perspective, emerging markets provide a very attractive investment alternative.

If we look at the EM bond universe, the yield is close to 7% in local bond space and in the hard currency segment the yield is close to 6%. Given the improvement in fundamentals, these valuations in emerging markets are attractive, especially compared to the 0.3% yield on German Bunds. This yield differential remains a crucial driver behind flows. In 2016, we had around USD 45 billion of inflows into EMD. The high point was close to USD 55 billion, but after the US elections we saw significant outflows. In December flows stabilised. We expect flows to be positive again this year, because of the fundamental improvement and due to global rates remaining below long-term averages.

Assessing the change in US policy under Trump

When talking about our outlook for emerging markets, we obviously cannot ignore the change in US policy following the election of Donald Trump. The main risk for investors and financial markets going forward is the policy mix of the Trump administration. We see two possible scenarios: a pragmatic Trump and the confrontational Trump.

In the first scenario, which is our base case, there will be a very strong focus on growth, tax cuts, deregulation and some fiscal stimulus. However, there are limitations as it will prove very difficult to get all the Republicans in Congress on board for a massive fiscal spending plan. We expect some fiscal spending, but not to a point that will turn the Fed much more hawkish and drive US interest rates much higher. We think that in this pragmatic agenda, protectionism and immigration will take the back seat, Fed independence will not be an issue, and there will positive cooperation with international leaders, especially Russia.

The risk to our base case is a confrontational Trump, who clashes with Republicans in Congress on fiscal and trade issues. The Republican mind-set is pro-trade and against big government. So if Trump faces difficulties in carrying out his fiscal plans, he may instead turn to protectionism and immigration. That can derail sentiment big time, especially if he decides to start a trade war against China for example. This would result in rising geopolitical risks too.

For emerging markets, a pragmatic Trump means that moderate fiscal spending and infrastructure projects will not only support US growth but also global growth, including emerging markets. Commodity prices would remain well-supported and global capital flows would remain intact, benefiting emerging markets. On the other hand, in case of a confrontational Trump we could see trade wars that disrupt global trade, causing a slowdown in global growth and falling commodity prices. That will obviously impact emerging markets. Overall risk aversion will increase, affecting EMD spreads, EM currencies and rates. We think the probability of this scenario is low, but we need to be cautious and monitor the situation closely.

US dominant theme in the near term, China in the medium term

US policy is a prominent risk factor and therefore uncertainty will remain high in the near term. Although we expect a pragmatic Trump, there is a risk that he will not. We have to see how this turns out in the first 100 days of his presidency. This is likely to keep investors on the side lines.

Then we have the Fed, which was more hawkish than expected in December. This caused US bond yields to rise by about 20 basis points, both at the short and long end of the curve, and the US dollar to appreciate further. This gives us an indication of what can happen if the new US government will indeed stimulate a lot on the fiscal side and the Fed has to adopt a more hawkish stance. So we need to have a close look on US policy and what it means for the reaction function of the Fed.

A third factor is China. We remain constructive on China, but we turned a little bit more cautious. We are not concerned about growth, as we think it will remain close to 6.5% on the back of fiscal and monetary stimulus. We are more concerned about the progress of the reform agenda. Instead of going ahead with the liberalisation of its capital account and opening up its local market to foreign investors, the country is moving in the opposite direction. Recently the renminbi started to depreciate again, not only versus the US dollar but also against the basket of currencies that China is tracking. This incentivises Chinese investors to move capital abroad and China is afraid of large capital outflows like we saw at the end of 2015 and early 2016. We sense that the government wants to implement more capital controls. So we could see the reform of the economy moving to the back seat and we all know that China has too much leverage in the private sector, overcapacity in some industrial sectors and demographic headwinds in the longer term. China therefore needs to move on with reforms. If it focuses too much on short-term growth and too little on improving the institutional framework of the country and increasing productivity levels, the probability of a hard landing in the future increases. So in the medium to longer term we see higher risks in China.

Commodity prices will be a support factor for emerging markets. Not only because Chinese growth should hold up well in the near term, but also because US policy is expected to be supportive of sentiment towards commodities. Deregulation could help the energy sector, and the same holds for the December agreement of OPEC and non-OPEC members on cutting oil production. The latter was very well received by the market and we think production cuts will remain on the table should prices move substantially lower. At the same time we do not expect prices to move significantly higher because if they do, US oil production will ramp up. US shale producers managed to lower production costs and now they can be more efficient with oil prices above USD 50. We already see indications that US production will increase and if oil prices remain above USD 50 or 55 that should happen faster. Larger supply will then push prices back to somewhere between USD 40 and 50.

EMD should continue to perform well

Our forecast for US 10-year yields is a rise to close to 3% at the end of 2017. This does not mean that EMD spreads should widen. Historically, most of the times when US interest rates moved higher because of an improving growth outlook, EMD spreads tightened. So while US 10-year rates may move up to around 3%, we see spreads in Hard Currency space, both sovereigns and corporates, tightening towards 300 basis points. This could result in a total return of the asset class between 5% and 6%.

Our forecast for local bonds is similar. We expect the return of the GBI-EM index to be between 4% and 6%. Most of this will be driven by the carry of the asset class which has a yield of close to 7%. In an environment where the dollar is likely to appreciate because of stronger US growth, the contribution from EM currencies is expected to be slightly negative.

In our blended strategies, in terms of asset allocation between the different sub-asset classes we expect to be quite active. At the moment we have a neutral stance, but we have a bias to be overweight hard currency and underweight local currency in the beginning of the year, until we have more clarity on the risks around the US policy agenda. As we expect volatility to be high, we think we can add performance by switching actively between the categories throughout the year.

EMD Hard Currency and Frontier Market debt

- Strong return and substantial capital inflows in 2016
- Commodity-related countries main outperformers
- We have a constructive outlook for 2017
- We forecast a total return for 2017 of 5% to 6%

Marco Ruijer

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Strong returns in an eventful year

The start of 2016 was quite volatile; the first six weeks were characterised by a strong sell-off in EMD markets. China was one of the main reasons, as investors were afraid of a hard landing. We also had ongoing declines in commodity prices, with oil reaching a trough of USD 26 in early February. EMD HC spreads widened substantially, to around 500 basis points. We however believed that the market was overreacting and that China worries were a bit exaggerated. So we decided to add risk to the portfolio, which proved to be correct because since then we saw a recovery. Especially the first five or six weeks the rebound was strong, but it also proved to be a sustainable recovery throughout the year as most worries dissipated.

Of course there were a few other risk events, like Brexit which came as a surprise to many. But what was even more surprising is that prices went down only for about 12 hours in our markets to recover quickly thereafter. Investors believed that due to Brexit central banks would step up their efforts and that interest rates could go even lower. The result was that we saw significant inflows in EMD. We already saw some money flowing in since March, but after Brexit the inflows were broad-based and substantial. Due to these massive inflows spreads tightened even more. So the year was going really well, until we had the next big political event: the election of Donald Trump. This was also quite a surprise, although we had already taken precautions and reduced risk in the portfolio before the elections. This helped our performance, as we saw outflows from EMD because some investors became concerned about the possibility of trade impeding measures which Trump had advocated during his campaign.

Despite all that, the return of 10.2% for the EMBI GD index (the EMD Hard Currency benchmark) proved to be higher than we expected at the beginning of the year. After a quite volatile ride, Treasury yields roughly ended quite close to our forecast of 2.65%. But spreads tightened clearly more than we had estimated, ending at 342 basis points while we had forecasted 380 basis points.

Commodity related countries were the big winners

The winners were mostly the high beta/high yield countries, which were punished a lot in 2015 and early 2016. A lot of them are commodity related and had tough times in 2014 and 2015, but were able to recover as commodity prices bottomed. This is also why frontier markets have outperformed the broader market with a rise of 14.8%. In Africa, for example, some of the bonds rallied significantly, the likes of Zambia and Ghana are up more than 30% for the year.

Latin America in general also performed very well, as it is sensitive to the recovery in commodity prices, but also for country specific reasons. Brazil was a clear outperformer, as the changes on the political front, including the impeachment of president Dilma, were positive for investor confidence. Star performer however was Venezuela with a return of more than 50%. For most of the year we were overweight Venezuela, and towards the end of the year we scaled it back to close to neutral. In last year's outlook we said that it would be a make-or-break story, so it really turned out to be a make. Venezuela proved to be willing to pay its debt; it has done a debt swap in which short-dated bonds were partially swapped into a new bond. In principle, all oil producers performed well, Ecuador for example gained 40%. Also oil related quasi-sovereign bonds such as Brazilian Petrobras had a good year.

We had negative surprises as well, Turkey probably being the best example. Turkey underperformed in 2016, not only because of the coup but also because of Erdogan's reaction. The subsequent purge across armed forces, police and the education system has left those in a weakened state. In 2017 there will probably be a referendum to consolidate even more power with the president, moving from a parliamentary system to a presidential one. For a long time we had an underweight position in Turkey, but after the downgrade in September from investment grade to below-investment grade, causing some forced selling, too much bad news had been priced in so we went to an overweight position. We will however reconsider the overweight, as Turkey is typically vulnerable when the Fed starts hiking and Treasury yields move higher. Turkey has a lot of external financing needs and we have seen the currency weakening already quite a bit recently. And there is of course also still a security issue, as the recent attack in Istanbul proved.

Constructive outlook for 2017

We are constructive on the market outlook for 2017. Actually, we are more optimistic than a year ago. The global growth outlook looked very fragile then, and January and February were proof of that. There is a risk of a slowdown in global activity if Trump takes a confrontational and protectionist stance on trade, but overall we see less risk now than at the end of 2015. The oil price situation looks better now too, as the OPEC and non-OPEC deals have clearly reduced the risk of the oil price falling back to levels of USD 30 or lower. This however does not mean that it will lead to higher returns in 2017 as well, as markets price such developments quickly. So to a certain extent this is already reflected in current spread levels.

We expect 10-year US Treasury yields to move up to around 3%, which will be offset by spread tightening. Probably Treasury yields and spreads will balance each other out, so the total return of 5-6% will then be in line with the yield of the index. For frontier markets returns can be 1% to 2% higher, i.e. around 7 to 8%.

Our estimates incorporate an increase in fiscal stimulus by the Trump administration and a further normalisation of monetary policy by the Fed. There is however a real probability that we have seen the spike in Treasury yields already and that the rise will start to level off. This may certainly be the case if Trump does not get the entire fiscal stimulus he wants through Congress, as markets have already priced this to a large extent. In that case yields could stall somewhere around 2.60-2.80% and the Fed would not have to hike the three times as it indicated in December.

Figure 4: Spread and return forecasts for EMD HC

	10-year US Treasury Yield (%)				
EMBI GD Spread (bps)	**2.50**	**2.75**	**3.00**	**3.25**	**3.50**
250	11.8	10.2	8.6	6.9	5.3
275	10.1	8.4	6.8	5.2	3.6
300	8.4	6.8	**5.1**	3.5	1.9
325	6.7	5.1	3.5	1.9	0.2
350	5.1	3.5	1.9	0.3	-1.4
375	3.6	2.0	0.3	-1.3	-2.9

Source: J.P. Morgan, Thomson Reuters Eikon, NN IP calculations; For the calculations, we use UST7Y (at 25bps below UST10Y), as it is a closer match to the benchmark duration. US Treasury 10Y yield at 2.454% and JPM EMBI GD spread at 339 bps, as of 3-Jan-2017

Obviously, the policies of the Trump administration could have a significant impact on the outlook for emerging markets. In the end, we think Trump will take a pragmatic stance. If he wants to generate growth and jobs in the US, starting a trade war will not help. If he puts tariffs on Chinese or Mexican goods for example, inflation will increase substantially. A vast majority of manufactured goods comes from either China or Mexico, so US consumers will end up paying much more for their iPhones or other electronics. That will be very negative for consumer confidence and purchasing power. In the end we think Trump will implement some pro-growth measures which will help EM fundamentals to improve slightly.

High beta countries and frontier markets may outperform again

The high beta countries, including the frontier markets, should be able to outperform again. Initially, they are better protected against rising Treasury yields because of their generally lower duration. And when higher growth kicks in, they also have more room for spread tightening as their vulnerabilities decrease. However, a too strong dollar could dent the recovery in commodity prices. In 2004, when the last Fed hiking cycle started, commodity prices went up and spreads tightened considerably. Such a scenario is now also possible, but a too strong appreciation of the dollar would be detrimental. EM countries then maybe could not cut their rates which would be negative for growth.

Important year for Venezuela and Argentina

2017 can again be labelled as a make-or-break year for Venezuela. It can service its debt for another six months, but beyond that it is difficult to foresee. A lot will depend on oil price developments; Venezuela can continue until the end of the year if oil moves higher. Given that its yield on US dollar denominated debt is still astonishingly high (over 23%), Venezuela could then easily become the best performer of the year again. But the social situation is really dire and it could also break down. In that case it could easily be the worst performing country in our universe.

Argentina is on top of many lists. Last year it came to the market with a huge bond issue of USD 16.5 billion. The new government finally resolved the issue with the hold-outs and normalised the relations with the capital markets. Argentina outperformed in the first half of the year, but underperformed in the last few months of 2016. Markets became saturated from the large supply, while data on growth, inflation and the fiscal deficit disappointed. These figures need to improve quickly, because Argentina has mid-term elections in October. The government has currently a minority and a gain in the elections will be important for President Macri to pursue his reform policies. So, the more pronounced the economic recovery will be, the more likely he will gain in the elections. But if we do not see improvements soon, and in view of the big supply that is expected to come to the market in 2017, Argentinian bonds may underperform.

Opportunities in Africa

In Africa we see several opportunities, especially if commodity prices improve further. In some countries, large infrastructure works are about to be completed or have already been completed. This is expected to increase GDP growth. In Kenya, for example, a gigantic railway project is being constructed, connecting Nairobi with the coast. This journey used to take about 1 to 2 weeks, but this will be dramatically reduced to only 4 hours. This will really make a big difference for moving capital goods from the port to the capital city. For the time being, however, we are closer to neutral in Kenya as elections will be held in August 2017. Furthermore, Ghana may do relatively well. It has an IMF programme and finally the debt-to-GDP has stabilised. There is an oil and gas field coming online which helps to increase GDP growth substantially in 2017. Angola and Gabon are some weaker oil-related credits but they could still do well if the oil price could rise somewhat further. They have very high spreads and should be able to perform in line with their running yield. But if spreads tighten a bit, they can have decent returns. In Zambia there is still upside risk in case it applies for an IMF programme. The incumbent president won the elections and said he would like to go for an IMF programme. But given the recent increase in copper prices he may not want to implement an IMF programme. Finally we still like Cameroon, where we had an overweight position throughout 2016 which delivered a nice return of over 25%.

Europe is underweight, Ukraine and Turkey may outperform

In Europe, many countries have relatively low yields and are not so attractive in terms of valuation. In addition, the busy European election schedule might also bring uncertainty. So we are underweight Europe. An interesting country is Ukraine. We do not expect much fundamental improvement, but the carry is sufficient to expect the country to outperform the benchmark. With a return of 14% Ukraine outperformed the index in 2016. Finally, it will be interesting to see if Turkey could become the next Russia or Brazil in terms of comeback potential. We think Turkey is still oversold, which is why we are still overweight, but we are watching the developments closely. In the end we think it can outperform, but not to such an extent as Russia has done in 2015 or Brazil in 2016.

Selective opportunities in Asia

In Asia we see selective opportunities, mainly driven by structural reforms. We remain constructive on Indonesia. President Jokowi has effectively consolidated political power and has clearly gained popularity with his pro-business reform agenda, at home and abroad. Sri Lanka is likely to continue its fiscal consolidation path, targeting a reduction in the overall fiscal deficit, through rebuilding tax revenues via a comprehensive reform of both tax policy and administration. For Mongolia, we expect an IMF standby arrangement to be reached with the new investor-friendly government, despite tough negotiations.

EMD Local Bonds and Currencies

- High level of carry and declining yields supported 2016 returns
- Brazil and Russia should continue outperformance of 2016
- Many opportunities to play relative value trades
- Expected 2017 returns for local bonds between 4% and 6%

Marcin Adamczyk

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Volatile but strong year for local bond markets

Although quite volatile, 2016 was a very good year for EM local bonds. As EM currencies were on balance broadly in line with the US dollar, the 10% return of the local bonds benchmark (the GBI-EM index) for 2016 was almost entirely realised by the rates component. About half of this came from the carry, and the other half from price appreciation as yields came down during the year. We can distinguish three different phases for the market in 2016. The start of the year until about mid-February was very volatile, with a very negative sentiment towards emerging markets. There were big worries about Chinese growth, very high capital outflows and concerns about policy mistakes by the Chinese authorities. At the same time commodity prices were falling and the outlook for Fed monetary policy was very uncertain.

In our 2016 outlook, we argued that the prospects for EM should start to improve somewhere in the first half of 2016. As usual with local bonds, the market reversal happened quite rapidly and was very strong. The extremely negative sentiment and very cautious investor positioning at the start of the year fuelled a strong recovery. The rally in the local bond index lasted for several months and reached a peak in August with almost 18% of return since the start of the year and 23% from the January lows. From early February, we saw a gradual removal of market fears as oil bottomed out and worries about China started to fade. Additionally, markets started to reprice the expectations for Fed tightening, while the BoJ and ECB continued with very easy monetary policy, moving rates into negative territory. This fuelled the search for yield and strongly supported flows into emerging bond markets. The peak in inflows was not long after the Brexit vote, as markets then expected global monetary policy to become even more accommodative.

From August onwards, returns started to flatten out, as it became clear that the loose monetary policy of the main central banks had reached its limits and discussions about the negative side effects of negative rates mounted. Moreover, once the US elections were getting closer markets started to get nervous. Countries most exposed to the election rhetoric, like Mexico, started to underperform. Needless to say, the 10% weight of Mexico in the GBI-EM index was being felt, although countries like Colombia and Brazil still performed very well.

Finally, after the US elections, we entered the final phase of the year, marked with an abrupt fall in the market and a spike in volatility. The election of Donald Trump re-enforced the reflationary theme, pushing US Treasury rates higher, while the threat of protectionist US policy on trade and a stronger US dollar caused substantial damage to EM currencies in particular. In a couple of days the GBI-EM index lost about 7% to 8%. Afterwards we saw some recovery until the year-end, even as the Fed hiked rates and moved up its rate hike projections for 2017.

Russia and Brazil star performers, Mexico and Turkey disappoint

In our 2016 outlook, we mentioned high yielding countries like Brazil and Russia as potential outperformers. Both were expected to witness the turn in inflation, while Russia would be supported by the recovery in oil prices. Pre-condition for Brazil to outperform was the political change, allowing for a reduction in fiscal risks and triggering lower yields, while from a balance of payment standpoint the Brazilian real was already close to be balanced. Eventually we did get the political change by the impeachment of President Dilma. Hence, Brazil became the best returning bond market in the local bond universe while the real was the best performing currency, closely followed by the Russian rouble.

On the other hand, Mexico disappointed. For obvious reasons, which were difficult to foresee at the beginning of the year. Not only from the direct impact of Trump's campaign rhetoric, but also the proxy hedging from investors as they used the Mexican peso as a hedge against all Trump-related risks for emerging markets. Another very weak performer was Turkey. During the local bond rally in the spring, Turkey was doing very well, but chances of a sustainable performance of Turkish assets were ruined by the political situation. Later in the year, rising US Treasury rates exposed one of the weaknesses of the Turkish economy: a low level of official reserves and politically driven reluctance to hike interest rates.

Challenging environment of rising US yields and strong dollar

Looking at the top-down picture for local bonds the question arises: can they perform well in an environment of rising US rates and the expectation of a stronger dollar? Uncertainty is very high at this point and this will surely result in a volatile environment. It is worth noting, however, that EM countries are now better prepared for rising global bond yields – and US yields in particular – than they have been during e.g. the 2013 taper tantrum. First, this time the increase in US yields is not driven by the expectations of a decrease in global liquidity caused by the tapering of asset purchases by the Fed. At that time, US growth was not expected to improve. Now, US yields are rising because of an improving growth outlook which is clearly a less unfriendly environment for EM assets as it underpins global growth as well as commodity prices.

Growth and inflation prospects have clearly improved

It is fair to say that the obvious vulnerabilities that were visible in 2013, 2014 and 2015 have to a considerable extent diminished, if not removed. Especially the growth prospects are better now, mostly because we expect big EM countries like Russia and Brazil to emerge from recession. This could be enough for a stabilisation and eventually an improvement in overall EM growth. Moreover, inflation is declining, particularly in several Latin American countries like Brazil, Colombia, and Chile and also in Russia. So this expected fall in inflation is mostly concentrated in the higher yielding countries. In low yielding countries, for example in Asia and Central and Eastern Europe (CEE), inflation is expected to rise due to base effects and rising commodity prices, but this is still from very low or even deflationary levels. We will definitely not see inflationary pressures that will force central banks in those countries to hike rates soon. Overall, the inflation trend will support rate cuts in several countries like Brazil, Colombia and Russia – even against a backdrop of Fed policy normalisation.

Real rates in EM countries are still attractive

After a good year for local bonds from a price action perspective, valuation is still positive especially if we look at real interest rates – the differential between short-term rates and inflation. This is in sharp contrast to the situation in 2013 and particularly striking when compared to the real rates in the developed world. Although the latter have moved up in 2016, the gap is still very wide. We think the valuation on the rates side should provide enough buffer for rates to perform well even in an environment of rising US rates. The currency picture is more complicated. EM FX is still very cheap on a real effective exchange rate basis, but the valuation anchor is often overlooked in acute situations of rising volatility or pronounced US dollar strength. However, when volatility subsides, the focus usually turns back to the attractive valuation, creating an additional justification to buy EM local bonds.

A total return of 4%-6% is realistic

In our central scenario of gradual rate hikes from the Fed and a flattening US Treasury yield curve, EM local bonds (in local terms) should be able to provide a return which is close to the carry in 2017. The starting carry on the index level is around 6.8%. Assuming that rate cuts are realized in a number of high yielding markets, the carry might diminish going forward, but this will be compensated by capital gains as yields come down.

In an environment of rising global yields it is difficult to expect a repeat of the strong contribution from duration as it did in 2016. But we foresee no detrimental effect from duration either. EM FX will be the most volatile and uncertain component of the total return of the local bond sub-asset class. We expect only moderate US dollar strength which will probably be mostly visible in the first half of the year. EM FX is expected to be only marginally weaker against the dollar in 2017 and likely stronger versus the other G3 currencies (euro, yen and pound sterling). This leaves us with an expected total return for EM local bonds in US dollar terms of 4% to 6%: a carry of 6.8%, a more or less neutral contribution from duration and a small negative contribution from EM FX.

US policy, European politics and China are main risk factors

This return will likely not be realised without volatility and of course there are risks around our central scenario. A main risk is obviously related to US policy and the probability of trade wars and other protectionist and confrontational campaign declarations from Mr. Trump. While not our base case, it is a risk to be closely monitored. In our view it poses the biggest risk, especially to EM FX, arguably bigger than Fed rate hikes triggered by improving US growth prospects. Another risk is political developments in Europe, although this should affect mostly the CEE region as opposed to Latin America or Asia. From a top-down perspective China continues to be a risk factor, but at this point the growth picture looks much more stable than a year ago. Similarly, capital flight is not as acute now as it has been at the turn of 2015/2016 although the flow picture needs to be very closely monitored, especially in an environment of dollar appreciation.

Cautious in H1 2017, focus on relative value plays

The reflation theme in the US will likely remain dominant in the first part of 2017, putting upward pressure on US Treasury yields and the dollar. Hence, from a top-down perspective we start the year with a rather cautious stance. We think this is not the time to have a high duration in the portfolio and the same holds for the net EM FX position. So we are close to neutral on both on a top-down level. Somewhere over the next two quarters, we think inflation risks will get fully priced into US assets. Opportunities to go long EM duration or EM FX may then quickly arise.

In the meantime we like to play relative value trades. We can implement several themes in the portfolio, such as the divergence in political developments. On the one hand you have some countries that are moving to strong leaders, such as Russia and Turkey, and on the other hand we see a shift to more liberal governments in Latin America, for example in Argentina, Brazil and maybe Chile. Furthermore, as commodity prices rise we can play the different commodity exposures, e.g. exporters (Russia) versus importers (Turkey). Then we have the exposure to global trade, should Trump realise some barriers in this space. In that case we can play short exposure to countries which are vulnerable to disruption in global trade and supply chains versus long exposure to countries with a more closed economy that can rely on the domestic economy. Furthermore, there are countries with an opposite inflation trajectory. There will be countries that have to hike rates, like Mexico or Turkey, and countries that will cut rates, like Brazil and Russia. Finally, we like long exposure in high yielding rates versus short exposure in the low yielding rates. In the latter the real rate and overall carry cushion is not sufficient for any impact of rising global rates.

We like Indonesia, Brazil, Colombia and Russia

This preference for high yielding countries is across the different regions. In Asia, we like Indonesia because of a favourable growth picture, reforms and an economy that relies on domestic strength. Real yields are one of the highest in the region. Inflation may increase as commodity prices and electricity tariffs increase, but should remain benign. We are cautious on currencies in the low yielding Asian countries that are sensitive to global trade, like the Korean won or Singapore dollar.

In Latin America, we like Brazil, both on the rates and FX side. Progress has been made on the fiscal side, inflation is set to move lower and growth is likely to have bottomed. Real rates are at historically high levels and the central bank is likely to speed up its policy easing cycle. We expect significant rate cuts in 2017. We also like Colombia in terms of rates as inflation starts to turn and higher oil prices should have a positive impact on the fiscal balance. Additionally, we keep an off-benchmark exposure to Argentinian local bonds, supported by an attractive yield, a pro-market government and the prospect of index inclusion in early 2017. We are cautious on Mexico as the technical picture is poor due to high foreign ownership of local bonds. The central bank is hiking rates which may prompt more outflows. However, valuation has become very attractive and at some point the market will start focusing on that. Timing the return to overweight Mexico will be key.

In Europe, Middle East and Africa (CEEMEA) we prefer Russia and South Africa over Turkey in the high yielding space. In Russia inflation is coming down strongly, the central bank is expected to resume cutting rates soon while also the oil price is supportive. We are more cautious with regard to the low yielding countries like Romania, Hungary or Poland, where the running yield might not be enough to offset the potential adverse impact of rising global yields, particularly in the situation of an upward inflation trajectory that we will witness in those CEE countries.

Emerging Market Corporate Debt

- Commodity and energy-related names main return drivers
- Latin America and Russia are key overweight positions
- Expected total return for 2017 is 4-6%
- We do not expect substantial trade tariffs from Trump

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Significant spread tightening leads to strong returns

With a total return of 10% for the CEMBI Diversified index, 2016 was a strong year for EM corporate debt, for a large part due to a significant (140 bps) tightening of spreads.

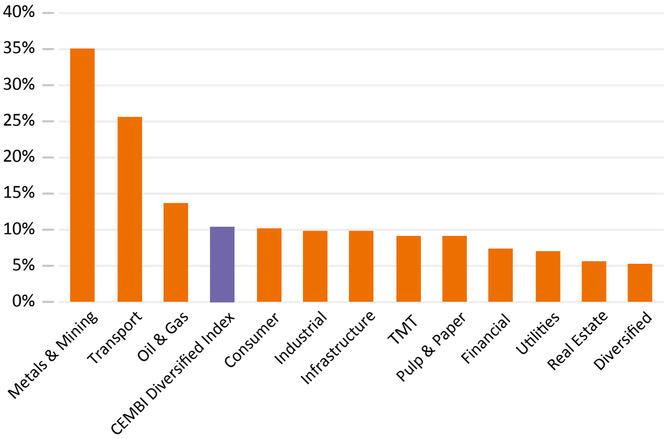
The outlook at the beginning of the year was not that positive. Investors had a lot of concerns about China, commodity and oil prices were moving in the wrong direction and there was political uncertainty in countries like Brazil. This explains why spreads were relatively wide at the beginning of 2016. During the year, EM growth expectations improved, not only on an absolute level, but also relative to developed markets. Concerns about China diminished as data over the last couple of months clearly showed that China was able to stabilise the economy. Oil and commodity prices went up, further supported by the OPEC deal. Finally, we had some positive political developments. In Brazil, the outlook is more promising now and in countries like India and Indonesia, we saw progress on the structural reform side. All these factors combined supported the market and resulted in significant spread tightening.

There have been events as well that could have triggered a risk-off environment. However, Brexit did not turn out to have a negative impact on sentiment and also the impact from the US election outcome was not that bad for EM corporates. Spreads recovered quite quickly from an initial widening. Although the rise in US Treasury yields, which accelerated after Trump's election win, had a negative impact on performance, emerging markets did not sell off as US bond yields rose for good reasons, namely an improving outlook for both US and global growth. Moreover, EM fundamentals clearly improved last year. Most emerging markets are now less vulnerable than e.g. during the taper tantrum of 2013. This limited the negative impact on outflows.

Strong performance of commodity and energy related names

Looking into the returns of 2016, commodity-related bonds performed very well. The metals & mining sector returned 34%, which is quite unusual for fixed income. We have been a bit cautious in this sector as there were a couple of companies that would not have survived if commodity prices had not increased. We were therefore not overweight this sector but we had a decent exposure. Our exposure to the energy sector helped performance as well; the oil & gas sector returned 12%. The energy companies we have in our portfolio, mainly in Latin America, had a very good performance.

Figure 5: CEMBI sector returns in 2016



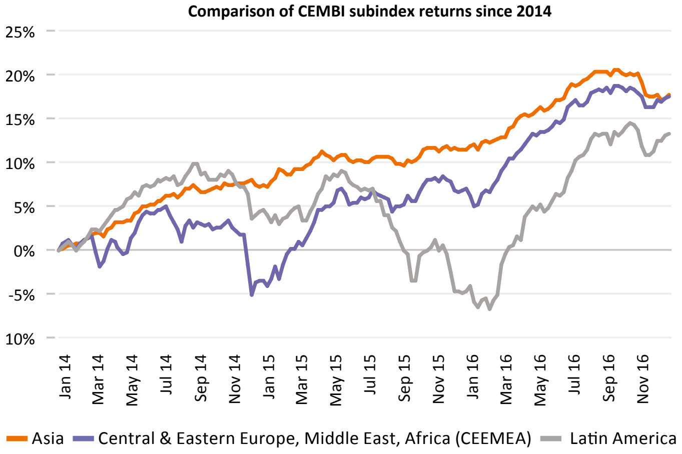
Source: JP Morgan (data as of end December 2016)

Latin America and Russia are our main overweight positions

Regionally, we were (and still are) overweight Latin America which was very supportive of our fund's performance. Latin America has benefited the most from the recovery in commodity prices. The total return of Latin America was 14% in 2016, which made it one of the best performing regions in our universe. Russia, which also has a large energy exposure, showed a 16% total return. What also helped Russia was the technical environment, as new issuance was subdued, while Russian companies have strong profiles and used their cash positions to buy back bonds. Next to Latin America, Russia is one of the key overweight positions in our portfolio.

The more defensive regions in the EM corporate universe, which are safe havens in more difficult times, returned less than the market average in 2016: Both Asia and the Middle East returned 'only' 6%. We have an underweight position in Asia, mainly because of valuation reasons.

Figure 6: Asia is the least volatile region in the CEMBI index



Source: JP Morgan (data as of end December 2016)

Expected total return of 4-6% in 2017

Given the lack of visibility on the US economic policy outlook, it is difficult to predict where Treasury yields will be at the end of the year. Our conviction level is therefore not as high as it normally is. We do believe that Treasury yields will move up, but not that much. We have already seen a substantial increase of more than 100 basis

points since July last year, which is comparable to what we saw in 2013. So we think that much of the expected fiscal stimulus and Fed rate hikes has already been priced in. We still assume an increase of about 50 bps in US Treasury yields from current levels. This means a negative impact of two percentage points of rising US Treasury rates on the total return in 2017. If we deduct this from the current starting yield of EM corporates of 5% we get a 3% return. However, in case of a gradual increase in US Treasury rates, spreads have some room to tighten. There will also be a positive contribution from roll-down as the duration of bonds held in portfolio declines over time and the lower duration justifies lower yields. The latter two should compensate for at least half of the loss due to the rise in Treasury yields. Summing it all up, we then come to an expected minimum total return for EM corporate debt of 4% in USD terms.

The upside risk is that inflation expectations come down somewhat and the market realises that Treasury rates have increased significantly already. In such a scenario we will probably not see a material increase in Treasury rates from current levels. If we assume that Treasury yields and spreads remain where they currently are, the starting yield of 5% plus a bit of roll-down will result in a total return of close to 6%.

The downside scenario is if Trump takes a more protectionist stance compared to what the market currently expects. In our universe, Mexico is particularly vulnerable as it exports considerably more to the US than e.g. China. Exports from China to the US are only 3-4% of GDP. We see Trump's campaign rhetoric more as a kind of opening bid in renegotiating existing trade deals and do not believe that it will lead to big import tariffs. But it is clear that protectionist measures on a global scale would be very detrimental to the global economy.

The share of Asia and China in the EM hard currency corporate debt market keeps increasing; Asia is by far the fastest growing region. We therefore elaborate further on Asia and China in our Asian hard currency debt outlook.

Asian Hard Currency Debt

- Indonesia and India are our preferred countries
- We reduced our exposure to China as concerns rise
- Chinese reform agenda back in focus after leadership change
- Asia is the safe haven in the EM corporate debt universe

Decent return thanks to China and Indonesia

Our Asian hard currency debt fund outperformed its benchmark – the JPMorgan Asia Credit Index (JACI) – for the 8th year in a row in 2016. Last year's gross performance for the portfolio amounted to 7.0%, which is 1.2% higher than the benchmark return.

Positive contributions to the performance came from our positions in China and Indonesia. In China we benefited from the overweight we had in the first part of 2016 in the Chinese property sector as we were earlier than the market to see the recovery there. In Indonesia, we were overweight quasi-sovereign bonds which outperformed sovereign bonds, causing the spread differential to contract. We were also overweight in the energy sector in Asia which benefited from the recovery in oil prices.

Indonesia and India are our preferred countries

The two countries in Asia we like most at the moment are Indonesia and India, partly on the back of structural reforms. Indonesia has been very stable in terms of growth and inflation expectations, while current account deficits have improved over the last three years. But the most important factors are the structural reforms that both countries have implemented, which bode well for long-term growth. Indonesia passed a tax amnesty bill, which has been very successful in raising money to be invested in e.g. infrastructure. This will positively impact growth in the long term.

While we like Indonesia a lot from a fundamental perspective, Indonesian US dollar bonds are vulnerable to outflows if sentiment towards emerging markets deteriorates. The reason is technical: in the global EM hard currency funds, there are only two large countries in Asia, which are the Philippines and Indonesia. Most global EMD investors are underweight the Philippines as spreads are very tight. As spreads in Indonesia are a bit wider, global EM bond managers typically have overweight positions there. Outflows from these funds, like we saw after the US elections, typically result in selling of Indonesian bonds.

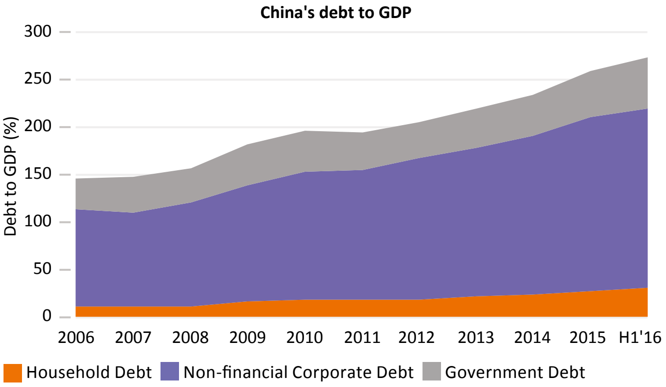
In India we have also seen several positive developments. One of them is the implementation of the value added tax (VAT) which is expected to increase tax collection. Recently India also took out the 500 and 1,000 rupee bank notes out of circulation. The demonetisation of these notes – which comprise almost 86% of the Indian currency in circulation – is aimed at reducing the size of the informal economy. In the near term this will have a negative impact on economic activity, which is often the case when implementing reforms, but in the long term we believe it will be positive for the economy.

Chinese growth has to come down at some point

While we hold on to our overweight positions in India and Indonesia, we trimmed our overweight position in China during the year to a small underweight. We do not think that growth is sustainable in China and it has to come down at some point in time. The longer this takes, the higher the probability that investors get concerned about the build-up of credit in the economy. Although we do not expect a collapse of Chinese growth in 2017, increased concerns about the accumulation of China risks could trigger volatility this year. Chinese growth stabilised in 2016, but this was largely driven by factors that cannot be sustained in the long term. Firstly, policy makers have increased public investments through state-owned enterprises (SOEs) massively since early 2016. Secondly, the property market has done extremely well, in terms of prices and volumes. In contrast to the SOEs, the private sector invested very little, suggesting they do not have much confidence in generating attractive returns by adding more capacity. It would be naïve to assume that SOEs can make returns if the private sector cannot make them. In fact, Chinese SOEs are typically much less efficient so the returns will be lower as well.

In the long term, the property market cannot be the main growth driver of the economy. Property development is a cyclical sector. This means that when prices increase, land bank acquisitions will increase and developers will start more new projects, leading to higher inventories. At some point the market will start to struggle. We already see that some cities take measures to cool down the market as prices went up too much. The contribution to GDP growth from the property sector as seen in 2016 is unlikely to be repeated in 2017, although we still expect some positive contribution.

Figure 7: Chinese debt has kept rising



Source: WIND, CEIC, Leasing Association and ChinaBond.com, Morgan Stanley Research (October 2016)

More focus on reforms after Chinese leadership change

In November there will be a change of leadership in China and it is highly likely that policy makers will continue to support the economy until the change of leadership has taken place. But thereafter they have to allow growth to gradually slow down. China made a lot of promises to implement structural reforms, but when economic activity rapidly declined at the end of 2015 and early 2016, the priority shifted to stabilising growth and reforms took the backseat. The stimulus Beijing provided via the SOEs to stabilise growth was the opposite of what it promised. SOEs should be privatised and the economy should become more market-orientated. But China did exactly the opposite: since the private sector was not investing anymore, the SOEs had to take up the slack. We remain convinced that at some point reforms will be implemented, but we will likely not see a lot of it in 2017. Our base case is that authorities will only shift towards the reform agenda after the change of leadership. We are not concerned about the long-term outlook for China; should investor concerns resurface, it may provide an opportunity to increase our exposure to China at more attractive levels.

Underweight Korea, Philippines; overweight energy, consumer

Next to China, we are also underweight Korea, where spreads are usually tight. On top of that, there is political uncertainty with the impeachment of President Park. Moreover, Korea is heavily dependent on exports so it is vulnerable to potential US trade policies. The Philippines is also an underweight position because of unattractive valuations. Philippine spreads are tight because of strong demand from onshore buyers as Philippine investors have a strong home bias.

Regarding sectors, we hold on to our overweight position in the energy sector. Most of the oil companies in Asia are solid investment grade companies which are linked to the government. Even if the oil price drops, those companies will remain solid because of government support. We also like consumer-related companies in Asia as we believe the increased spending power of Asian consumers will be an important driver of regional growth in the years to come.

Relatively lower expected return, but also lower expected risk

The expected total return for Asian hard currency debt for 2017 is 3-5%, which is about 1% lower than for EM corporate debt. The negative contribution from rising US yields will be partly offset by some spread tightening and roll-over. The starting yield of the Asian debt benchmark is 4%, compared to 5% for the EM corporate debt index.

For this lower return, an investor may also expect lower risk as Asia is considered a safe haven in the EM corporate debt universe. This is reflected in the spreads; spreads in Asia are 2% while in Latin America they are 4%. The ratings also reflect Asia's stability, as Asian US dollar credits have an investment grade rating (80% of the bonds are investment grade), whereas Latin America is rated high-yield. Another factor contributing to Asian debt's resilience in risk-off environments is its relatively short interest rate duration. This helps to mitigate the negative impact on returns in an environment of rising Treasury rates and/or rising spreads.

Finally, also technicals are supportive. None of the EM regions has such a strong technical environment as Asia and China in particular. As the renminbi is in a depreciating trend, it has become more attractive for Chinese investors to invest in bonds denominated in US dollars instead of in the local currency. This results in increased demand for US dollar bonds. For debt issuers it means that it is more attractive to issue in local currency rather than in US dollar, which results in less supply of hard currency bonds. All in all, this creates a strong technical environment, underpinning returns.

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