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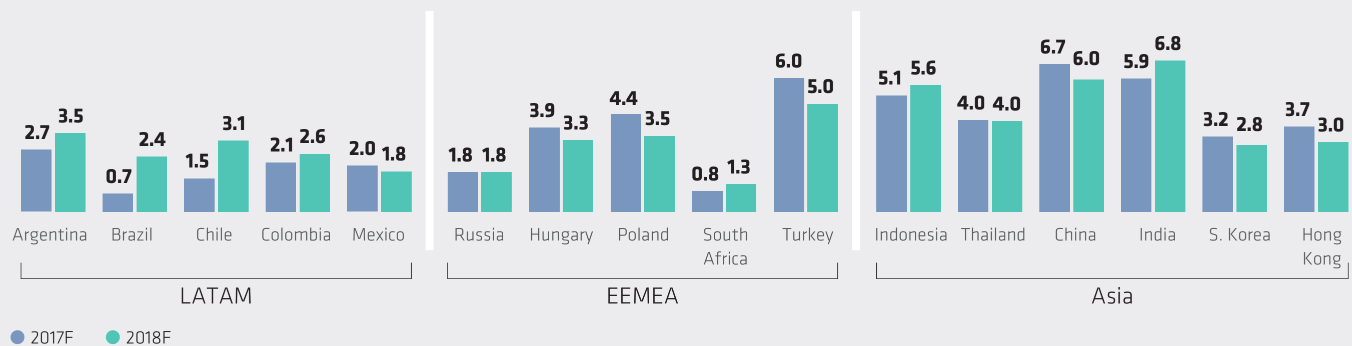
EMERGING-MARKET DEBT: OUR OUTLOOK FOR 2018—AND BEYOND

Emerging-market (EM) bonds delivered strong returns in 2017, and we think the sector has more potential in 2018. From São Paulo to Shanghai, improving economic fundamentals and smarter policies are leading to healthier economies. Even so, global economic and geopolitical risks abound, making it more important than ever for investors to be selective.

DISPLAY 1: MANY EM ECONOMIES ARE GROWING AGAIN

Emerging Markets' GDP Growth Forecast (Percent)



As of January 3, 2018

Current analysis does not guarantee future results.

AB economic forecasts

Source: AB

Emerging-market debt (EMD) got off to a rocky start in 2017. Investors worried that rising US interest rates and a stronger dollar would draw money out of EMD and put pressure on EM government and corporate balance sheets. US President Donald Trump's antitrade platform and pledges to rip up trade pacts didn't help sentiment.

But investors who stayed the course did well. In 2017, major indices for EM government and corporate bonds—both US-dollar and local-currency denominated—returned between 8% and 15%.

Why has the EMD sector been so resilient? Part of the answer has to do with the health of the global economy. After nearly a decade of subpar growth, developed-market (DM) countries are finally starting to gain traction. This is good news for the developing world, because stronger growth in the US and other advanced economies tends to boost economic activity elsewhere.

Emerging economies may not soon regain the breakneck pace of growth that many enjoyed a decade ago. But after several challenging years, many key economies moved back into expansion mode in 2017, and we expect growth in many economies to accelerate (*Display 1*).

In 2018, however, investors will have to exercise caution. EM fundamentals remain strong and EMD valuations are broadly attractive. But macroeconomic and geopolitical risks abound, and the global environment has become less certain. The Federal Reserve could disrupt markets by tightening US monetary policy more aggressively than expected. China's economy could slow further, putting pressure on commodity prices.

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These risks and others are difficult to forecast. But any one of them would lead to elevated market volatility and have implications for a wide array of assets, EMD included. That's why we think it's essential to stay active and take a highly selective and tactical approach to build portfolios that can deliver long-term results.

HOW EMERGING MARKETS BUILT UP SHOCK RESISTANCE

The good news is that critical reforms and stronger economic fundamentals have reduced many emerging markets' vulnerability to external shocks and sudden portfolio outflows. We have seen positive developments in the following areas:

+ **Inflation:** Inflation rates have held steady or declined in most EM economies in recent years, and we expect aggregate inflation to remain low. That should give select countries room to ease monetary policy, which should bolster growth.
+ **External Accounts:** Not long ago, EM countries were on a borrowing binge. But the flood of foreign capital flowing into their economies eventually dried up, forcing EM countries to reduce their current account deficits. That makes them less dependent on often capricious portfolio inflows—money invested into domestic stock and bond markets or deposited in local banks—to finance their spending.
+ **Politics and Fiscal Reform:** EM countries are increasingly shifting to the political and economic center. Governments have embraced fiscally responsible policies and reforms, including caps on public spending growth (Brazil), simpler tax systems (India), and the end of energy and other subsidies (Indonesia, Argentina). Less populism and more fiscal responsibility bodes well for growth and should improve the credit quality of EM bonds.
+ **Anti-Corruption Campaigns:** Corruption hasn't disappeared entirely. But popular anger at past state-sanctioned corruption has led to a sea change in the political culture. Governments from Asia to Latin America have stepped up their efforts to root out fraud and make politics and business more transparent. And voters, investors, and an independent media and judiciary are holding leaders' feet to the fire, as the recent presidents of Brazil and South Korea would come to understand.
+ **Commodities:** Improving global growth has helped to stabilize prices for oil, gas, metals and other natural resources. Barring a sudden slowdown in China, we expect this trend to continue, which should bolster the finances of many EM commodity producers.

GLOBAL INVESTORS STILL OVERLOOKING EMD

These developments help to explain why demand for EMD has recovered over the past couple of years (*Display 2*). Yet investors remain underinvested. This means EMD valuations are often more attractive than those in other sectors of the global credit market—many of which look stretched today.

IT PAYS TO BE CHOOSY

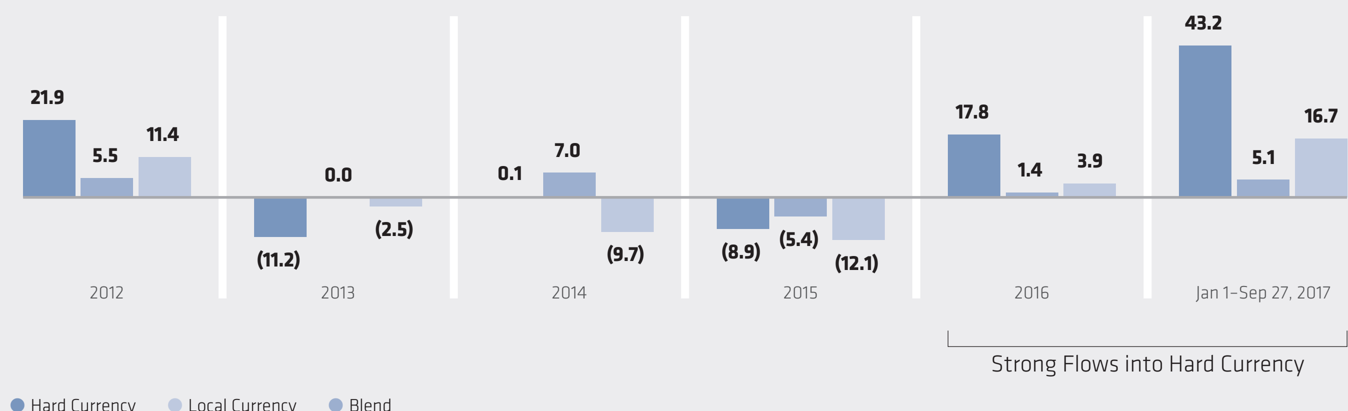
Stronger fundamentals should provide EMD with a cushion it did not have just a few years ago. In other words, the sector should be more resilient to sudden shocks, or what investors broadly refer to as "risk-off" events.

Even so, investors should be selective when it comes to their EM exposure. A one-size-fits-all approach is rarely a good one in any sector. But it's never advisable when it comes to emerging markets. Country and sector selection matter, because political and economic risk varies across the developing world.

Consider Latin America. Brazil and Venezuela share a border—but the outlooks for their economies couldn't be further apart. Brazil is committed to reform, while Venezuela is undergoing a deep political crisis that is ravaging its economy and making it difficult for the government to make its bond payments. But Venezuela is still part of the main EM bond indices. That's why it's essential for EM investors to go beyond the benchmark and invest deliberately, taking a country-by-country and company-by-company approach. (For our outlook on some key EM issuers, *see* "Country by Country: Opportunities and Risks," *page 4*.)

DISPLAY 2: INVESTORS ARE SLOWLY REDISCOVERING EMD

EMD Fund Flows (USD Billions)



As of September 27, 2017
Current analysis does not guarantee future results.
Based on weekly flows
Source: Emerging Portfolio Fund Research Global and AB

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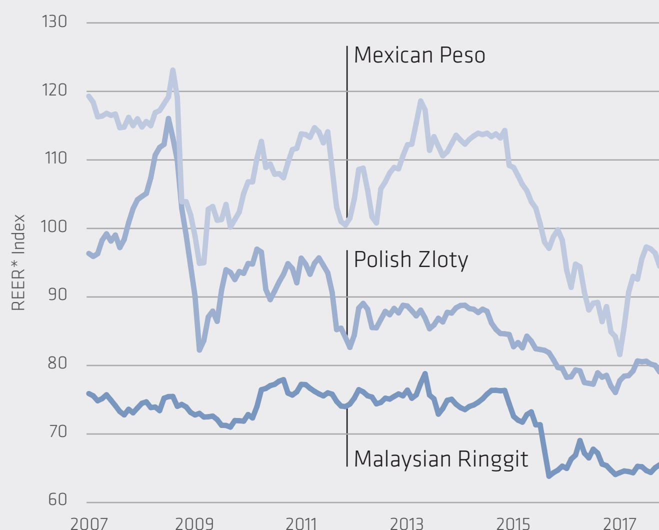
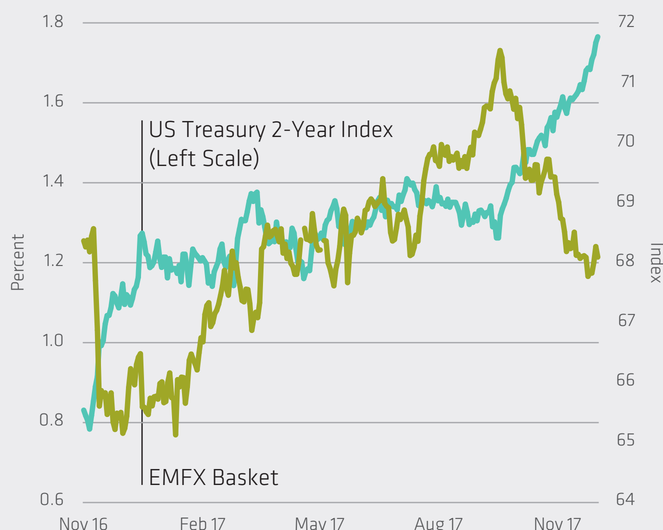
DISPLAY 3: US DOLLAR UNCERTAINTY A KEY RISK IN 2018

Select Currencies Are Undervalued



Changing Rate Differentials Make It Tough to Predict USD Direction



Left display through October 31, 2017; right display through November 20, 2017
Current analysis does not guarantee future results.
***** REER: real effective exchange rate, Balassa-Samuelson adjusted
Source: Bloomberg Barclays

We think that a tactical approach to EMD will be critically important in 2018 because the global outlook is more uncertain than it's been in some time.

The biggest challenge for investors will likely be monetary policy changes in the US and other DM countries. So far, EMD has weathered the past series of gradual Fed rate hikes without difficulty. But with soon to be new leadership at the Fed, the pace of tightening could increase in 2018 by more than the market currently expects. If it does, US Treasury yields could rise, and the recent uptick in the US dollar could accelerate (*Display 3*), putting pressure on some EM currencies and bonds.

Political risk within EM countries shouldn't be overlooked, either. Several countries will soon be holding elections that could lead to significant policy and leadership changes (*Display 4*). Fortunately, political risk tends to be country-specific. Argentina's politics have little to do with Turkey's. This means investors can limit the volatility a single country's political risks might generate by diversifying across EM countries.

Active EM strategies that take country- and company-specific factors into account, and that can underweight and overweight sectors and individual bonds, have paid off. A majority of hard-currency EMD active managers beat the J.P. Morgan EMBIG on a three-year rolling basis in all but two of the years between 2004 and 2016 (*Display 5, page 6*).

It is also important to remember that political risk isn't unique to EM countries and assets. Investors have learned over the past year that developed markets can carry political risk as well. The consequences of Donald Trump's surprise win in the US presidential election, Britain's decision to quit the European Union, and the rise of right-wing populist parties in France and Germany have all injected a new layer of risk into markets and investment decisions.

Investors who can look beyond the headlines and focus on individual country and company fundamentals give themselves a better chance of identifying pockets of value and opportunity.

DISPLAY 4: UPCOMING ELECTIONS LIKELY TO RAISE SOME POLITICAL RISK

Country	Date	Election	Risk
Russia	March 2018	Presidential: six more years of Putin	Low
Colombia	May 2018	Presidential: corruption a key campaign issue	Moderate
Mexico	July 2018	Presidential: policy shift likely if left-wing candidate Andrés Manuel López Obrador wins	High
Brazil	October 2018	Presidential: centrist policies likely to continue	Low
Venezuela	2018	Presidential: will it lead to regime change?	High
Argentina	October 2019	Legislative: a test for President Macri's reform agenda	Low
Turkey	November 2019	Presidential and Legislative: early elections in 2018 a risk	High

Source: AB

COUNTRY BY COUNTRY: OPPORTUNITIES AND RISKS

Building a durable EMD portfolio requires extensive research. Managers must dig deeply into every issuer and bond with an eye toward each country's macroeconomic and political risk and the relative valuations of its assets before deciding where and when to invest.

In 2018, investors will have to weigh the relative merits of specific issuers and assets against some of the overarching risks. These include more aggressive monetary tightening and faster interest-rate increases in the developed world and increased protectionism—a key risk for countries with close trade ties to the US and China.

COUNTRIES WE LIKE

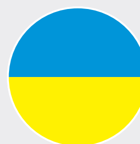
ARGENTINA

By settling a dispute with foreign creditors, Argentina's new government has put the country back on the investment map, clearing the way for its inclusion in a key benchmark bond index. The government has lifted currency controls, devalued the peso, and is phasing out energy subsidies. High yields make many bonds attractive, and with growth likely to accelerate in 2018, we expect more opportunities.

BRAZIL

Political volatility, including a corruption scandal that toppled one president and threatened another, hasn't derailed reforms. Inflation and interest rates are declining, and the government is taking a more market-based approach to state companies. GDP should expand slightly in 2017 and more robustly in 2018. A key risk: the presidential election in late 2018.

UKRAINE



Tensions with neighboring Russia remain elevated, but stark improvement in the country's fiscal balance and foreign currency reserves may present an idiosyncratic opportunity.

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COUNTRIES WE'RE WATCHING

MEXICO

Macroeconomic reforms, solid fundamentals and ample liquidity have lifted Mexican asset prices, but the country's open economy remains vulnerable to protectionist trade policies in the US, particularly a potential renegotiation of the North American Free Trade Agreement. And one of the leading candidates for president has suggested that he will revisit some structural reforms if elected in 2018. More volatility may be on tap. Even so, Mexican investment-grade and energy bonds offer a sizable yield advantage over comparable EM bonds.

SOUTH AFRICA

A cabinet reshuffle unsettled markets in 2017 and provoked sovereign downgrades from the three major rating agencies, which thrust the country's dollar-denominated debt into high-yield territory. Key risks include political obstacles to fiscal reform and a projected increase in debt and public deficits.

TURKEY

The country still has low government debt levels, a manageable fiscal deficit and an attractive high-yielding currency. It also boasts a well-diversified economy that has seen renewed growth this year. On the political front, friction with its allies, including the US and Germany, has increased, and government suppression of opposition groups and journalists following a failed 2016 coup attempt continues. A court case against the officials of a Turkish state-owned bank in the US may stoke volatility. An early election next year is possible.

VENEZUELA

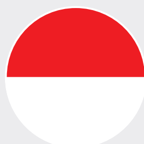
Bond prices plunged after President Nicolás Maduro said in November that he would seek to restructure Venezuela's debt. Yields on Venezuelan bonds are at historically high levels, but risks are high. We wouldn't rule out a regime change, even before the 2018 presidential elections. A more market-friendly administration may not be able to prevent a debt restructuring. But if one did come to power, it's likely that recovery values would be above current market prices.

COUNTRIES WITH SELECTIVE OPPORTUNITIES

CHINA

Growth may slow somewhat in 2018 as environmental-protection measures, overcapacity reduction and state-owned-enterprise reform top the agenda. Expect more financial deleveraging and increased state guidance in most aspects of the economy. Capital controls should remain in place, and the renminbi should remain in a narrow trading band.

INDONESIA



Tepid inflation and middling growth should give the central bank room to deliver more rate cuts. But the current account deficit is down to 1.7% of GDP, and net capital inflows, led by foreign direct investment, have picked up. Foreign exchange reserves have increased, which should underpin the exchange rate and US dollar–denominated sovereign bonds.

RUSSIA

Higher oil prices and easier monetary policy likely helped the Russian economy grow in 2017 and should do the same in 2018. Currency flexibility has helped keep the current account in surplus, offsetting capital outflows. Western sanctions tied to Russia's involvement in Ukraine continue to bite, though, and relations with the US remain frosty.

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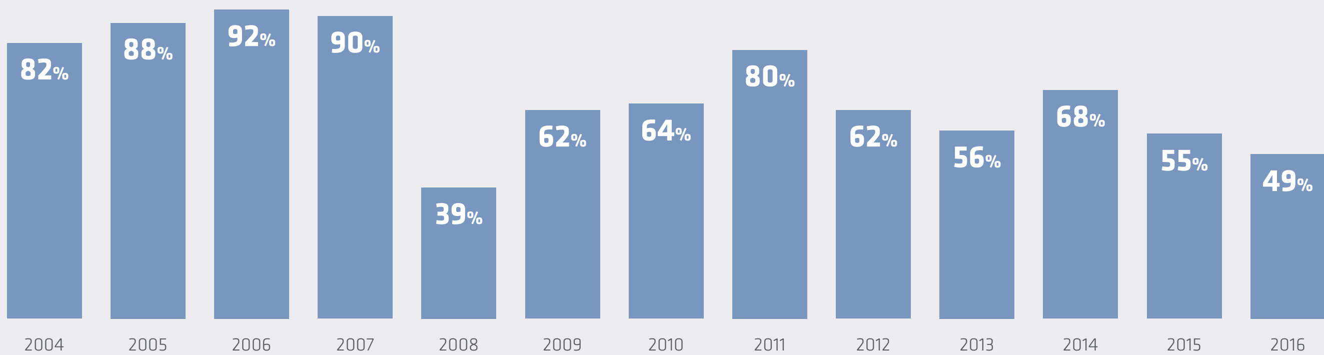
DISPLAY 5: EM ACTIVE MANAGERS HAVE HISTORICALLY OUTPERFORMED

Percentage of Active Managers Who Beat the J.P. Morgan EMBI Global (Three-Year Rolling Returns)



As of December 31, 2016

Past performance does not guarantee future results.

Based on USD returns for managers in the eVestment Emerging Markets Fixed Income—Hard Currency universe

Source: eVestment, J.P. Morgan and AB

OUR TAKE ON EMD SECTORS IN 2018

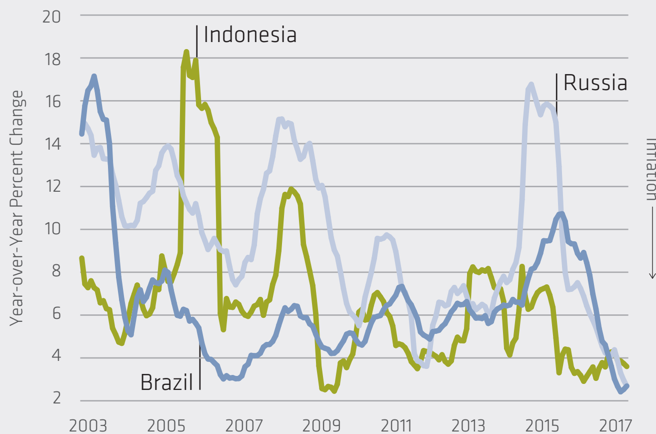
Here's a brief look at what we expect for the three major EMD sectors:

+ **Hard-Currency Sovereign:** These government bonds, denominated in US dollars or other DM currencies, had a strong run in 2017, and we still see value relative to US investment-grade and high-yield corporate bonds. However, these securities get their interest-rate exposure from US rate movements, and may be vulnerable to a pullback if US rates rise more quickly than markets expect.
+ **Local-Currency Debt:** EM and DM inflation have been headed in opposite directions over the past few years. Accordingly, local-currency EM bonds offer real yields that are significantly higher than those for high-grade DM debt. In Brazil, for instance, local government bonds offer equity-like returns thanks to yields that hover near 9%—a far cry from the yields available in the US, the euro area or Japan.

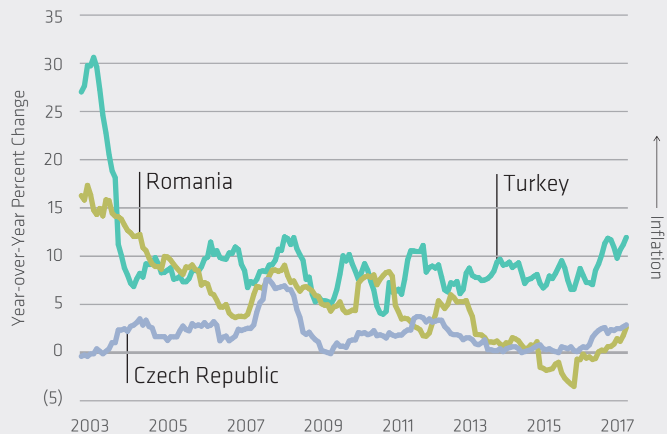
  However, we suspect that the narrowing of the EM-DM inflation gap may be ending. While inflation is still falling in key countries such as Russia and India, it has started to rise in others, notably Turkey (*Display 6*). That means investors should pick their spots carefully and focus on countries where inflation is still declining. Investors should focus on exposure to fair-to-undervalued currencies and on countries that seem the most committed to political change and reform (Brazil, Argentina).
+ **Hard-Currency Corporate:** We think selective exposure to corporates and quasi-sovereigns makes sense. The average credit quality of EM investment-grade corporate bonds has improved sharply in recent years. And through September, credit spreads for hard-currency EM investment-grade corporate debt were roughly 40 basis points higher than spreads on comparable US investment-grade corporates.

DISPLAY 6: INFLATION VARIES ACROSS EM COUNTRIES

Inflation Is Declining in Some Countries…



…While Increasing in Others



Through October 31, 2017

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Source: Haver Analytics and AB

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A MULTI-SECTOR OPPORTUNITY SET

How investors build an EMD allocation will depend on each one's needs, comfort level, return objective and governance constraints. But having access to EMD's multi-sector opportunity set offers the ability to diversify by country, credit and currency and can help to generate stable returns over a multiyear investment horizon.

Over the past 10 years, no single EMD sector has led all the time. But when compared with global investment-grade and high-yield corporate bonds, at least one of the major EMD sectors was among the top two performers in every year but one (*Display 7*).

And the opportunity set for global investors is growing by the day. Through September, outstanding hard-currency sovereign, quasi-sovereign and corporate bonds stood at $2.9 trillion, according to J.P. Morgan data, up from $1.3 trillion in 2010.

The universe of local-currency issuers is likely to grow, too, as countries take steps to win back global investors. For example, the ongoing liberalization of China's domestic bond markets should clear the way over the next year or so for renminbi-denominated bonds to enter global market indices. Peso-denominated Argentine bonds won inclusion earlier this year. We also expect more EM companies to start borrowing in local currency. All this should increase opportunities for investors to benefit from EM countries' strengthening economic fundamentals and to diversify their exposure to the US dollar and the euro.

EMD: A PERMANENT PART OF YOUR PORTFOLIO

EM countries account for more than half of the world's gross domestic product when measured by purchasing power parity, and they're growing more rapidly than their DM counterparts. Economists expect the global middle class to double to nearly 5 billion people by 2030, with most of the growth coming from emerging economies.

Investors must be selective about their EMD exposure, however, particularly in times of uncertainty. But in today's world, it no longer makes sense for investors to relegate EM bonds to the periphery of their fixed-income portfolios. In a sense, many developing countries have already emerged, and are essential engines of global growth. In our view, a fixed-income portfolio today would be incomplete without them.

DISPLAY 7: EM DEBT RETURNS VARY ACROSS CYCLES

Returns for EMD Sectors and Global Investment-Grade and High-Yield Corporates (Percent in USD)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Best Return	**DM IG Corporate Debt** (5.1)	**DM HY Corporate Debt** 57.7	**DM HY Corporate Debt** 15.1	**EM Sovereign Debt** 8.5	**EM Local-Currency Debt** 19.9	**DM HY Corporate Debt** 6.5	**DM IG Corporate Debt** 7.6	**EM Corporate Debt** 1.3	**DM HY Corporate Debt** 15.6	**EM Local-Currency Debt** 15.4
	EM Local-Currency Debt (6.9)	**EM Corporate Debt** 34.9	**EM Corporate Debt** 13.1	**DM IG Corporate Debt** 4.8	**DM HY Corporate Debt** 19.2	**DM IG Corporate Debt** 0.1	**EM Sovereign Debt** 5.5	**EM Sovereign Debt** 1.2	**EM Local-Currency Debt** 11.4	**DM HY Corporate Debt** 8.4
	EM Sovereign Debt (10.9)	**EM Sovereign Debt** 28.2	**EM Local-Currency Debt** 13.1	**DM HY Corporate Debt** 3.6	**EM Sovereign Debt** 18.5	**EM Corporate Debt** (0.6)	**EM Corporate Debt** 5.0	**DM IG Corporate Debt** (0.2)	**EM Sovereign Debt** 10.2	**EM Sovereign Debt** 9.3
	EM Corporate Debt (15.9)	**EM Local-Currency Debt** 16.6	**EM Sovereign Debt** 12.0	**EM Corporate Debt** 2.3	**EM Corporate Debt** 15.0	**EM Local-Currency Debt** (5.5)	**DM HY Corporate Debt** 2.6	**DM HY Corporate Debt** (0.7)	**EM Corporate Debt** 9.7	**EM Corporate Debt** 7.9
Worst Return	**DM HY Corporate Debt** (25.2)	**DM IG Corporate Debt** 16.6	**DM IG Corporate Debt** 7.2	**EM Local-Currency Debt** (6.3)	**DM IG Corporate Debt** 10.9	**EM Sovereign Debt** (6.6)	**EM Local-Currency Debt** (6.1)	**EM Local-Currency Debt** (18.0)	**DM IG Corporate Debt** 6.2	**DM IG Corporate Debt** 5.7
Gap between best and worst returns	**20.1**	**41.1**	**7.9**	**14.8**	**9.0**	**13.1**	**13.7**	**19.3**	**9.4**	**9.7**

As of December 31, 2017

Past performance does not guarantee future results. These returns are for illustrative purposes only and do not reflect the performance of any fund. **Diversification does not eliminate the risk of loss.** An investor cannot invest directly in an index or average, and they do not include the sales charges or operating expenses associated with an investment in a mutual fund, which would reduce total returns. EM Sovereign Debt: J.P. Morgan EMBIG; EM Corporate Debt: J.P. Morgan CEMBI Broad Diversified; EM Local-Currency Debt: J.P. Morgan GBI-EM; DM IG Corporate Debt: Bloomberg Barclays Global Aggregate Corporate Index; DM HY Corporate Debt: Bloomberg Barclays Global High-Yield Index

DM index returns are USD hedged

Source: Bloomberg Barclays, J.P. Morgan and AB

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