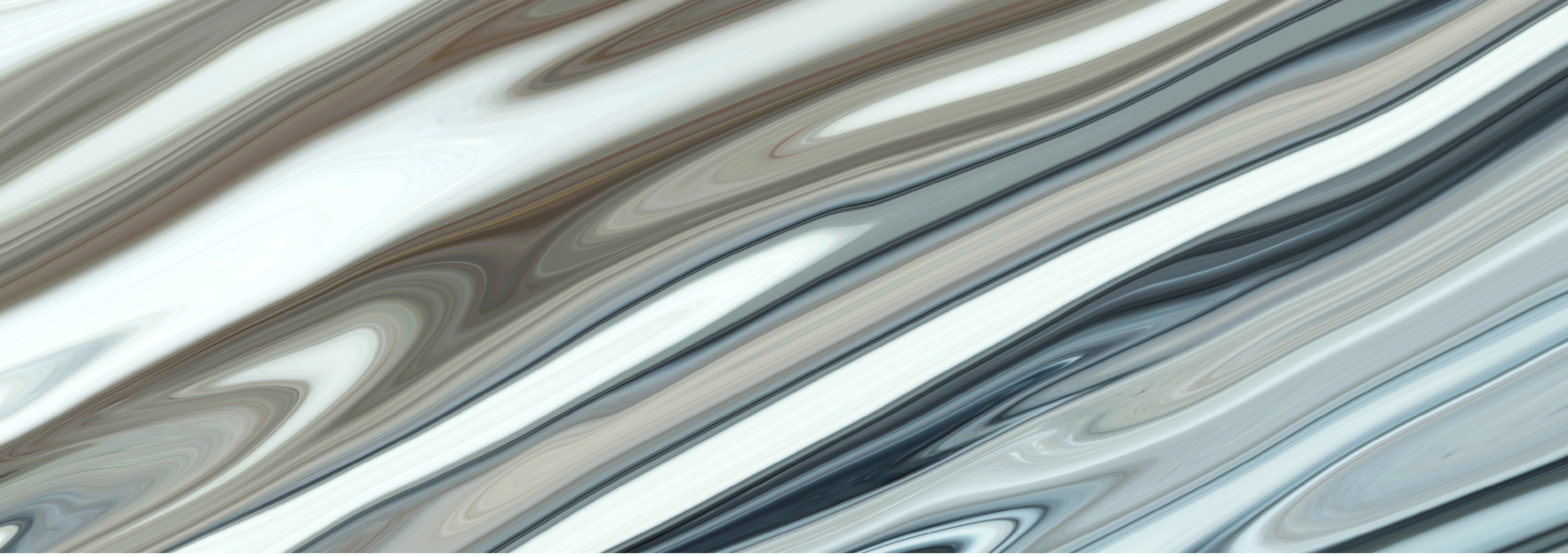

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Are Emerging Markets Robust Enough? History Suggests They Are

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Emerging markets this year have shown some strong returns both in the equity and fixed-income markets; the MSCI Emerging Market Index returned 28% year-to-date, while the USD denominated JP Morgan Emerging Markets Bond Global (EMBI Global) Index and the local currency JP Morgan Government Bond Index - Emerging Markets (GBI-EM) Global Diversified returned 8.5% and 14.5%, respectively. But how robust are these markets really? News headlines seem to constantly highlight the idiosyncratic risks in emerging markets—President Nicolás Maduro in Venezuela, Kim Jong Un in North Korea, ISIS in the Middle East, corruption in Brazil and Russia in Ukraine. Yet, if history is a guide to the future, then the answer is simple: emerging markets will be okay. Even during the worst of the global financial crisis of the last decades, emerging markets as an asset class continued to grow resiliently. We believe that this momentum will continue. However, due to the growth that the asset class has experienced over the past forty years, positive returns are now more dependent than ever on active management through asset allocation and security selection.

Let's take a step back and dive into history to underpin our belief that the growth trend in emerging fixed-income markets will persist. First of all, while it may seem that the term 'emerging markets' has been around for a long time, it is in actuality only 36 years old. Antoine van Agtmael, as a representative of the World Bank's International Finance Corporation (IFC), was the first person to coin the term during a speech at a Thai investor conference in 1981. Before then, fast-growing, but poor, economies were referred to as 'newly industrialized countries' or 'NICs.' These countries included Argentina, China, India, South Korea, Chile and Poland.

The changes of the 1980s were rapid and encouraging, albeit not equal everywhere. By the end of the decade, the Soviet Union was on its last legs, the Berlin Wall had come down and global economic growth was booming. In Asia, the four tigers Taiwan, Singapore, Hong Kong and South Korea were roaring loudly, each undergoing rapid industrialization with GDP growth rates in excess of 7% annually. However, some of the more established emerging markets, such as Argentina and Brazil, were struggling. By 1990, Argentina was already squarely in the middle of its first substantial debt crisis, with inflation reaching 5,000%. Inflation was rising so fast that some supermarkets gave up updating price tags and instead announced their prices over intercoms.

What all of these emerging markets had in common, though, was their need for funding to kick-start and maintain their high GDP growth trajectories. This growth and global positive outlook had translated to high demand for these high-yielding emerging market (EM) bonds. Following this growing demand, JP Morgan developed its original emerging market bond index, called EMBI, on December 1990 with only Brady bonds from Mexico, Brazil and Venezuela. The index had an original total market capitalization of only $26bn and a blended yield of 15%. By 1995, following continued strong investor demand, JP Morgan set up a more extensive index called the Emerging Market Bonds Index Plus (EMBI+). This new index had a market capitalization of US$110bn, yielding 12.3% with a spread of 850 basis points. Geographically this index covered 20 countries, still predominately from Latin America, with Argentina representing 21% of the index, Brazil 28%, Mexico 19% and Venezuela 8%. The Philippines at the time was the only county representing Asia with 3%, while Russia and Poland represented Europe with 7% and 4% of the index, respectively.

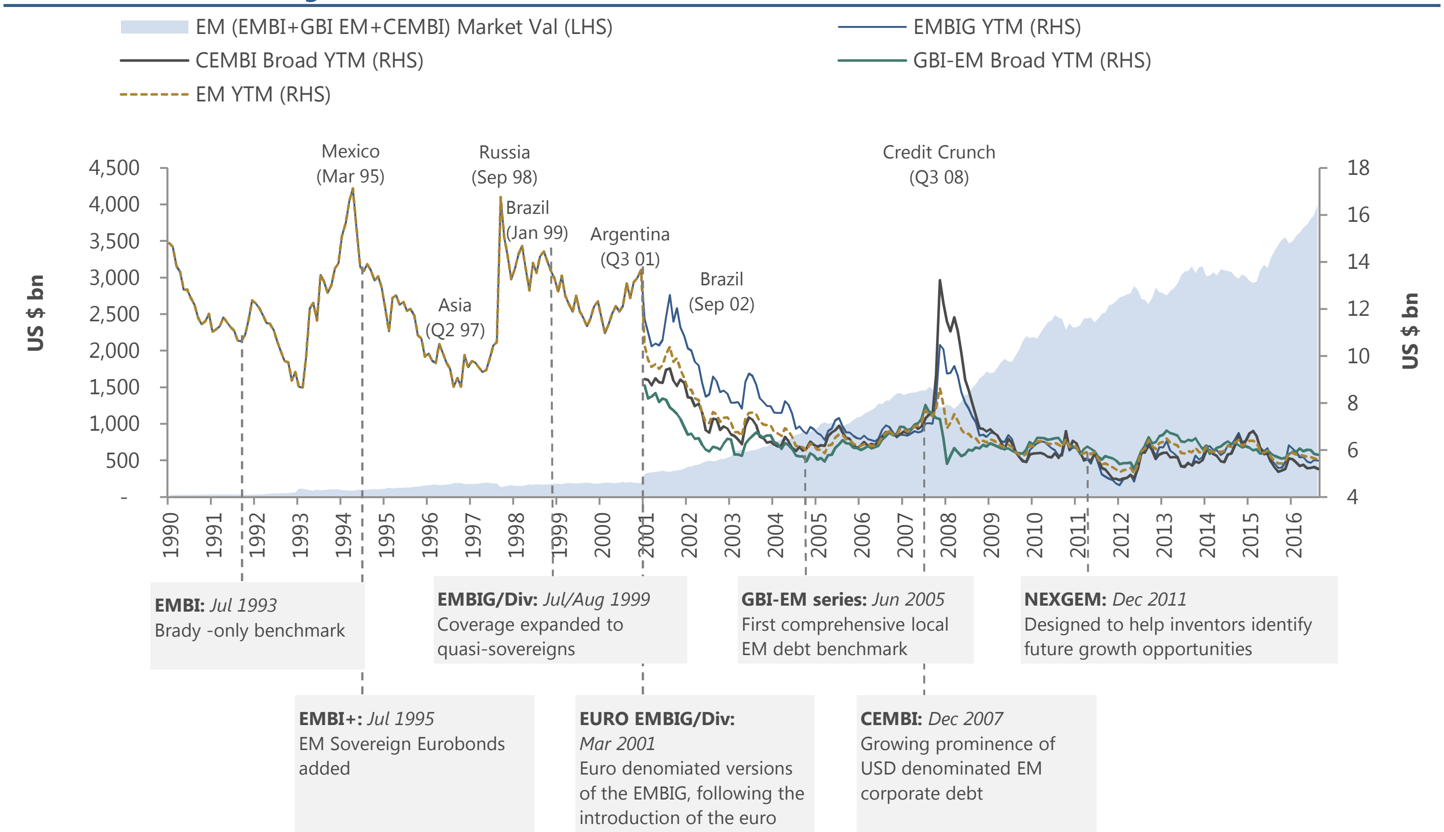
By the mid-'90s, after a decade of rapid economic growth, it became clear that EM growth was masking some important vulnerabilities, not only in Argentina, but also in many other emerging-market regions including Asia. In particular, years of rapid domestic credit growth and weak institutional regulatory oversight by central banks had led to overheated economies and real estate markets. The corporate sector had overleveraged itself with many dubious loan structures, often with short maturities. Many emerging-market countries had depended too greatly on foreign financing to pay for their large current account deficits and showed increasing external debt balances. Also, many countries back then still had fixed USD currency pegs, which exposed the corporate sector to enormous currency risks in their foreign external debt balances. On July 1997, after the Thai central bank dropped its currency peg with the USD, it took only a couple of months before the rest of the region collapsed. A spiral of depreciation, a recession and a collapsing banking sector led to widespread corporate insolvency and defaults. Oil prices declined as a result of the Asian financial crisis, in turn putting pressure on many oil exporting countries like Russia, which already suffered high fiscal deficits. Russia defaulted on its external debt after it was forced to devalue its currency on August 17, 1998. The EMBI index reached its all-time wide on August 10, 1998 at 21.0% and a spread of 1,631 basis points.

Nevertheless, despite various financial crises during the '90s, as well as the crisis in Argentina in 2001, world trade boomed during this period. The overall volume of trade grew 2.5 times faster than world GDP, compared to the average of 1.5 times faster, over the whole period since World War II, according to World Bank data.

Not only did world trade grow, but capital flows to emerging markets expanded rapidly. Private capital flows grew strongly, rising from 1% in the 1980s to more than 4% in the 1990s. Important to note is that this Foreign Direct Investment (FDI) flow was not north-to-south but south-to-south. In other words, multi-plant firms chose to replicate roughly the same activities in many countries to serve the local markets in those countries. Along with technological progress and policy reforms that liberalized trade and finance, this investment led to the creation of global production networks that break up the production of final goods into discrete stages, locating each stage in the country where it can be accomplished at the least cost. As a result, according to World Bank data, developing countries' share of global-parts-and-components exports increased from a mere 7% in the early 1990s to 21% in 2000, though this growth was concentrated largely in five countries: China, Mexico, Korea, Malaysia and Thailand.

Finally, and perhaps in part because of these multiple financial crises, many emerging markets continued on a path of enhancing transparency, financial deregulation, new stock market openings, enhanced data transparency and focus on corporate and institutional governance. These positive efforts led to a higher degree of comfort among international investors, which in turn led to larger international capital market flows. The group of investors in emerging markets grew to include banks, non-financial institutions and pensions funds, as well as individual investors. By July 1999, only two years after the Asian financial crisis and one year after the Russian default, JP Morgan responded to the growing investor interest by introducing a new, more comprehensive emerging-markets index—the EMBI Global. By this time, issuance of EM bonds had grown leading to a market capitalization of the index of $169 billion.

Evolution of the JP Morgan EMBI Index



Source: JP Morgan as of July 31, 2017

Fast forward another 18 years, the emerging market USD asset class now includes corporate, sovereign and local FX securities. The sovereign EMBI Global increased from 27 to 66 countries, while its market capitalization rose from $169bn to $880 billion. Launched in November 2007, The JP Morgan Corporate Emerging Markets Bond Index (CEMBI) Broad benchmark now includes 52 countries and has a market cap of $919 billion, which is approaches the size of the US high yield market cap. Geographically, in the EMBI Global Asia now represents more than 24% of the universe, up 13%, sub-Saharan Africa represents 5.3%, up from 0%, and Latin America now represents 40%, down from 56%. Lastly, as many emerging markets progressed into investment grade ratings, the EMBI no longer yields the original EMBI+'s 12%. Still, today's EMBI Global yield of 5.5% remains decent with the high yield portion (index weight 47%) yielding 7.0% and the investment grade portion yielding 4.1%. We believe this is attractive when compared to the BofA Merrill Lynch US High Yield Index which currently yields 6.1% and the Bloomberg Barclays US Corporate Index, which measures the investment grade, fixed-rate, taxable corporate bond market, yielding 3.1%.

To refer back to our original question, "are emerging markets robust enough?" Despite a number of idiosyncratic risks in the global financial markets, we believe that the growth of the EM asset class will not stop anytime soon. The drivers that grew the supply and demand over the past 36 years will continue to move EM forward. But as we said from the onset, the difference is that positive returns are now more dependent than ever on picking the right bonds, at the right time, among this ever-growing universe.

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