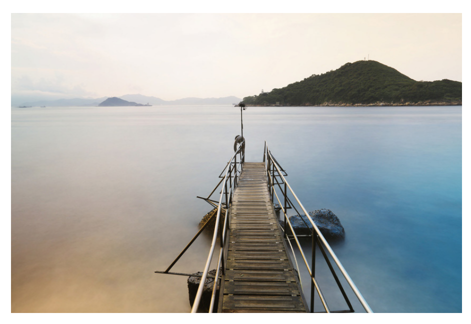
Nordea
ASSET MANAGEMENT

EMERGING MARKET DEBT – QUARTERLY NEWSLETTER

First quarter 2019



Market Review and Outlook[1]

Highlights for EM Debt

- While DM and EM policy uncertainty will dominate the global backdrop, there is scope for recovery in EM debt
- The best way to take advantage of very attractive valuations is to focus on short-maturity hard-currency bonds, over-sold local bond markets, and EMFX relative value rather than the direction of the US dollar

Emerging markets entered 2019 at varying stages of economic and political cycles. Some major countries – such as Mexico and Brazil – have sworn in new and untested governments. Early choices by these administrations suggest an increased likelihood of divergent narratives. On the one hand, recent developments in Mexico – most prominently, the government's decision to cancel Mexico City's new airport – have triggered increased market skepticism regarding the populist administration of Andrés Manuel López-Obrador (AMLO). On the other hand, President Bolsonaro has sent encouraging signals regarding his readiness to address Brazil's macroeconomic vulnerabilities; yet, questions linger as to whether the political backdrop will be supportive of these reforms.

Other countries – including Argentina, India, Indonesia, Poland, South Africa, and Thailand – are approaching elections that may dictate the direction of economic policy. For instance, the continuity of macroeconomic adjustment under the IMF program will be on the line in Argentina; elections in India will be a vote on PM Modi's reforms; while in Indonesia, a fiscal rule and other institutional constraints should help limit any fallout from the elections.

In any event, emerging markets are likely to continue to face a challenging global environment. Besides tighter liquidity conditions and lower oil prices, geopolitical tensions are poised to continue, while the outlook for global trade remains uncertain. The agreement on NAFTA 2.0 is a positive development, although there are risks to its ratification by the three countries' legislatures. Nevertheless, as a sign of mature policymaking, many countries have not abandoned prudent policies, often with the help of the IMF (Argentina, Ukraine, and Mongolia) or thanks to strong orthodox institutions (Mexico, South Africa, and Russia). The outlook for Turkey is something of wildcard – the economy is slowing significantly, and a fiscal boost cannot be ruled out.

All in all, EM growth (excluding China) is projected to be a tad below 4% this year, essentially unchanged from 2018. Argentina and Turkey are the only countries expected to contract, while growth is projected to remain strong among Asian EMs, especially in India and Indonesia.

As we consider the EM outlook for 2019, we start with the surprise of Q4 2018, which was the outperformance of EM local bond markets – particularly local hedged bonds and EMFX – relative to EM hard currency assets.

1) Views from PGIM Fixed Income Emerging Markets Team. PGIM Limited is the investment sub-manager of the Nordea 1 – Emerging Market Bond Fund and Nordea 1 – Emerging Market Bond Opportunities Fund.

*** investing for their own account – according to MiFID definition**

Emerging Markets Debt Performance

	Total Return (%)		Spread/Yield Change (bps)		OAS (bps)/ Yield %
	Q4	YTD	Q4	YTD	31.12.18
EM Hard Currency	−1.26	−4.26	80	130	415 bps
EM Local (hedged)	2.32	0.75	−12	36	361 bps
EM FX	1.2	−3.33	−7	176	5.30 %
EM Corporates	−0.04	−1.65	61	100	371 bps

Source: J.P. Morgan as of December 31, 2018. **Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index.**

In local bonds, there was clearly dominant outperformance in select countries (e.g. Brazil and Turkey), while Mexico was the clear underperformer.

Broader factors behind the performance in local EM consisted of a more benign global inflation outlook, lower oil prices (a result of Trump's flexibility regarding Iran sanctions as well as supply dynamics), and a moderation in the US dollar's FX dominance. The latter relates to a slowing of US growth, the outcome of the US mid-term elections, and a repricing of Federal Reserve policy expectations. Higher-yielding EM currencies that were some of the worst performers over the prior two quarters outperformed in Q4 (Argentina, Turkey, Indonesia, Brazil, India) while oil sensitive and euro sensitive currencies lagged (Colombia, Mexico, Hungary, Poland, and Czech Republic).

When we delve into the performance of EM hard currency assets in Q4, we note that much of the relative underperformance took place in October and November. Not surprisingly, oil sensitive and exporting countries underperformed (i.e. Mexico and Nigeria), while other underperformers included Argentina and Ukraine.

Outperformers included Brazil, Turkey, and the idiosyncratic stories of Mozambique and Zambia. EM hard currency assets have performed well since the G-20 meeting in early December and specifically the initial signal that there was more scope for negotiations on tariffs between the US and China in 2019, which supported the broader tone across the sector. In December, EM hard currency rose 1.35 % while the local markets posted a slight negative return. Hard currency spreads remained resilient, topping out at +400 bps at the end of November, subsequently tightening into +390 bps before ending the quarter slightly wider at 415 bps amid volatility in the US stock market and other risk assets. One relevant rebound to end 2018 was the recovery in Mexico, rebounding about 2.3 % in December.

What We are Watching...

The themes that dominated 2018 (pricing in tighter global liquidity, surprising US growth outperformance, and US dollar dominance) should present less of a headwind in 2019. While it is hard to express a high degree of conviction about tailwinds in 2019, several factors should support the sector. This includes valuations, a potentially benign base case for US/China trade relations, and a more dovish Federal Reserve. EM fundamentals should be supported by adequate growth, and access to financing – key for many EM sovereigns, quasi-sovereigns and corporates – will be a key driver of returns. This access will depend on broader risk sentiment as well as the willingness and ability of EM policymakers to adjust to the new global conditions. The IMF, China, and other bilateral funding sources are likely to continue to provide support to EM countries. The election calendar is busy in 2019 (Ukraine, Indonesia, India, El Salvador, and Argentina), yet aside from Argentina's elections in October, the other polling events are likely to result in less binary outcomes. The following provides some additional detail on early 2019 themes:

- EM growth should be slightly higher next year – our forecast is 4.7 % compared with 4.6 % in 2018. While select EM central banks have been hiking rates, EM inflation is broadly under control (with the exception of a few outliers), and rate hikes have been modest.
- US/China trade tensions: there is a solid case to expect a compromise on the China/US trade war in Q1. While clearly issues of intellectual property and technology transfer are the main points of contention, these are likely to be longer-term challenges. In the short term, it is in both President Xi and President Trump's best interest to present a "win-win" solution.
- Commodity prices and oil prices in particular. The level of oil prices presents a mixed bag for EM countries. However, if the recent OPEC agreement holds as broader oil geopolitics play out, EM can perform well with oil prices in the $ 65 range.
- Country specific developments in Brazil (where we expect progress on pension reform), Mexico (ability to meet budget objectives, the outlook for PEMEX, and central bank policy), Argentina (IMF program implementation, elections), Turkey (future policy responses given the slowing economy, local debt rollovers), Russia (oil prices and sanctions), as well as elections in Ukraine, India, and Indonesia.

- In spite of populist victories and agendas of late – on both the left and right – EM countries' responses regarding fiscal, monetary, and other confidence measures remain key.
- EM flows and technicals: strategic flows are still positive, but retail flows in the different EM sectors deserve monitoring. It will be interesting to see if the new year brings some relief for some of the more crowded positions. We anticipate the inclusion of the five GCC countries (Saudi Arabia, Kuwait, UAE, Qatar, and Bahrain), which will amount to over 11% of the J.P. Morgan EMBIGD Index, may bring meaningful supply from these countries. The inclusion of local China government bonds in several local bond indices is also of note. Clearly, the implication is that there could be substantial capital inflows into China's local bond market, and this could provide relief, as well as challenges, to Chinese policymakers.

Investment Implications

As 2019 progresses, we remain mindful of headwinds (slowing growth in China and Europe potentially leading to slower global trade and US Treasury supply potentially crowding out risk assets), but remain encouraged by what we have observed in Q4 as EM assets responded well to the shifting macro backdrop. If our base case for a more constructive EM outlook proves to be off course, our positioning should weather the downside risk in what could again be a challenging backdrop. A negative environment includes a significant slowdown in US growth and potential recession concerns, potentially brought about by a marked escalation of the trade war, lower commodity prices, and importantly, significantly lower growth in China. Another scenario that is less constructive for EM is one in which there is a repeat of some 2018 themes – surprisingly strong US growth, a more hawkish Fed, and a strong dollar leading to concerns about "dollar scarcity" and outflows from EM broadly. We think the more negative scenarios for EM are less likely to play out, at least from the current vantage point.

Notable premiums have been built into spreads in countries that have suffered in the selloff. While there are distinct vulnerabilities, we believe the risk of a credit event in sovereign and quasi-sovereign issuers in the riskier countries is contained over the near term. We remain overweight spread product in 3–7 year sovereign and quasi-sovereign issuers. As investors became more sanguine about the outlook for the Fed, longer-dated bonds rallied, and we became more balanced overall in our sensitivity to US Treasuries, choosing to focus our overweight positioning in higher-rated sovereigns and quasi-sovereigns. We are positioned in select EM corporates.

We are cautious in EMFX positioning and will focus on relative value among EM currencies. Valuations remain attractive with real effective exchange rates at the bottom quartile of the 20-year range and essentially unchanged since 2004. Lower oil prices have helped more currencies than they have hurt, and current account balances are improving and, therefore, reducing external vulnerabilities. Despite the 2018 selloff in EMFX, the carry potential remains the lowest following a selloff in the post-crisis era. We have increased exposure to EM local markets that have proven resilient and to markets where valuations are attractive given the premium built into curves. There are many markets with highly-attractive hedged yields.

While DM and EM policy uncertainty will dominate the global backdrop, there is scope for recovery in EM debt. The best way to take advantage of very attractive valuations is to focus on short-maturity hard-currency bonds, over-sold local bond markets, and EMFX relative value rather than the direction of the US dollar.

Nordea 1 – Emerging Market Bond Fund

Performance Q4 2018

Nordea 1 – Emerging Market Bond Fund (BP-USD)	–2.13%
Nordea 1 – Emerging Market Bond Fund (BI-USD)	–2.00%
Benchmark[2]	–1.20%

Source: Nordea Investment Funds S.A. Period under consideration: 28.09.2018–31.12.2018. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. The value of shares can greatly fluctuate as a result of the sub-fund's investment policy and cannot be ensured.** 2) JP Morgan EMBI Global Diversified.

Overweight's to Argentina and Ukraine along with underweights to China, Philippines and Poland drove negative performance. Chinese assets rallied after positive statements from US President Donald Trump indicated that the US and China are moving closer to a trade deal and the two countries decided to delay the initiation of tariffs by ninety days. Ukrainian assets faced pressure as the conflict with Russia escalated in November. Ukraine imposed martial law in some regions after Russia fired on the country's navy. Poland's industrial output surged 9.9% in October from a month earlier, much greater than the 9.1% expected increase. Output climbed from 2.8% to 7.4% YoY in October, surpassing the 6.6% consensus.

Stronger performance in the automotive sector along with robust infrastructure spending contributed to the favourable reading. Polish assets rallied after the report was released by the European Union's statistics office. Overweight's to Brazil, Turkey, Bahrain and Indonesia along with an underweight to Oman offset some of these losses. Brazil assets rallied following market-friendly candidate, Jair Bolsonaro's win in the presidential election in late October.

Sovereign positioning in Mexico, Oman, Egypt and Ukraine detracted from performance, while positioning in Argentina, Russia, Brazil and Ecuador contributed. Corporate and Quasi-sovereign positioning in Venezuela (PDVSA), Argentina, Russia (VEBBNK) and Indonesia (IDASAL) contributed to performance, while positioning in Mexico (PEMEX), Brazil, Malaysia (OGIMK) and Jamaica (DLLTD) detracted from performance.

The fund's 's largest hard currency overweights are Argentina, Brazil, and Turkey, and the largest underweights are China, Philippines, and Poland. The biggest changes over the quarter were adding to Turkey (+0.77%), Indonesia (+0.54%), and Bahrain (+0.54%).

Nordea 1 – Emerging Market Bond Fund: Top 10 Country Exposure

	Portfolio (%)	Benchmark[3] (%)	Difference (%)
Argentina	5.12	2.75	2.37
Brazil	5.34	3.36	1.98
Turkey	5.37	3.69	1.67
Bahrain	1.67	0.00	1.67
Ukraine	4.06	2.57	1.49
South Africa	3.93	2.83	1.09
El Salvador	2.02	0.98	1.04
Pakistan	1.92	0.93	1.00
Iraq	1.64	0.67	0.98
Indonesia	5.52	4.61	0.91

Source: PGIM Ltd. as of December 31, 2018. Note: Figures based on the model portfolio allocation and can deviate from official fund data. 3) JP Morgan EMBI Global Diversified.

Nordea 1 – Emerging Market Bond Opportunities Fund

Performance Q4 2018

Nordea 1 – Emerging Market Bond Opportunities Fund (BP-USD)	−0.28%
Nordea 1 – Emerging Market Bond Opportunities Fund (BI-USD)	−0.15%
Benchmark[4]	0.38%

Source: Nordea Investment Funds S.A. Period under consideration: 28.09.2018 – 31.12.2018. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. The value of shares can greatly fluctuate as a result of the sub-fund's investment policy and cannot be ensured.** 4) 50% JP Morgan EMBI Global Diversified and 50% JP Morgan GBI-EM Global Diversified.

In hard currency, overweights to Argentina, Ukraine, Nigeria, Iraq and Ecuador drove negative performance. Overweight's to Brazil, Turkey and Bahrain along with underweights to Oman and Uruguay offset some of these losses. Regarding local rates, an overweight to Brazil contributed to performance. An overweight to Mexico along with underweights to Russia, Turkey, Hungary and Thailand detracted from performance.

Sovereign positioning in Argentina, Ecuador and Nigeria added to performance, while positioning in Mexico and Oman detracted. Corporate and quasi-sovereign positioning in Venezuela (PDVSA), Argentina (BUEAIR), Russia (VEBBNK) and Indonesia (IDASAL) added to performance, while positioning in Mexico (PEMEX), Malaysia (OGIMK), Brazil and Jamaica (DLLTD) detracted. Local rates positioning in Brazil, Indonesia, Poland, Turkey and Thailand added to performance, while positioning in Mexico, South Africa and Chile detracted from performance.

The fund's largest hard currency over/underweights and changes throughout the quarter were similar to the ones mentioned for the Nordea 1 – Emerging Market Bond Fund (see earlier). In local rates, the fund increasing exposure to Poland (+0.06 years), Thailand (+0.05 years), and Czech (+0.04 years). In FX, the fund increased exposure to the Colombian peso, Brazilian real, and South African rand. It also reduced its long US dollar position.

Nordea 1 – Emerging Market Bond Opportunities Fund: Top 10 Country Exposure

	Portfolio (%)	Benchmark[5] (%)	Difference (%)
Indonesia	9.25	6.99	2.26
Brazil	8.79	6.68	2.11
Mexico	7.66	7.53	0.13
South Africa	6.75	5.64	1.11
Turkey	5.89	4.36	1.53
Poland	4.40	5.72	−1.32
Malaysia	4.17	4.18	−0.00
Colombia	4.06	5.10	−1.04
Argentina	3.40	1.67	1.73
Thailand	3.23	4.17	−0.94

Source: PGIM Ltd. as of December 31, 2018. Note: Figures based on the model portfolio allocation and can deviate from official fund data. 5) 50% JP Morgan EMBI Global Diversified and 50% JP Morgan GBI-EM Global Diversified.