Nordea

NEWSLETTER
Emerging Market Debt

Second quarter 2017

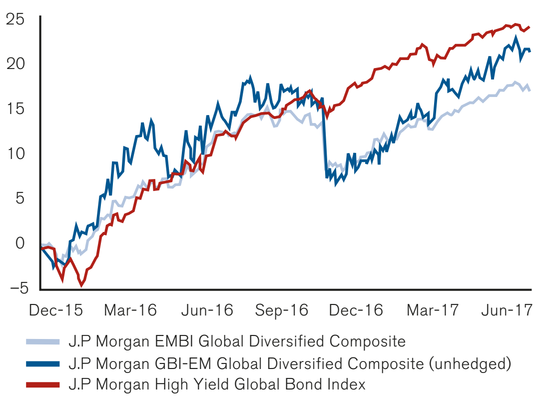
Q2 2017 Market Review and Outlook

Highlights for EM Debt

- Q2 2017 saw the continuation of the post-US election rebound of EM debt, with smaller NEXGEM countries generally being the top performers of the hard currency segment
- There were a number of notable idiosyncratic country events which impacted the markets – we will touch upon Brazil, Mexico and Turkey
- As the summer continues, the markets often experience lower levels of liquidity: as a result, pockets of volatility could emerge over the next couple of months

Emerging market (EM) bonds continued their post-US election rebound in Q2, as an improving global growth outlook, diminished protectionism fears, and low developed market interest rates continued the strong demand for higher-yielding assets. The strong EM returns represent a partial retracement of their underperformance vs. developed market assets since November of 2016.

EM Debt Still Recovering vs. DM Following U.S. Elections



Source: Bloomberg as of June 30, 2017

During the quarter, EM hard currency bonds returned +2.24 %, although index spreads were only 1 bp tighter. Smaller NEXGEM countries were generally the top performers in hard currency, with Cameroon (+6.66 %), Ethiopia (+4.87 %), Ghana (+7.19 %), Suriname (+5.18 %) and Ukraine (+5.90 %) providing the highest returns.

The EM local bond index returned 1.22 % on the quarter. In currencies, emerging Europe currencies such as Czech Koruna (+9.47 %), Turkish Lira (+6.38 %) and Polish Zloty (+7.20 %) outperformed, due in part to their higher correlation with the euro which was approximately 5 % stronger versus the USD during the quarter. The Mexican Peso (+5.87 %) also outperformed, continuing its rebound from a difficult 2016 on diminishing concerns over trade tensions with the US Hedged local bond returns were more subdued, with Hungary (+2.05 %) and Peru (+2.99 %) beating out the higher yielding countries such as Brazil (–0.03 %) and Turkey (+1.40 %).

Emerging Market Debt Performance

	Total Return (%)		Spread/Yield Change (bps)		OAS (bps)/ Yield (%)
	Q2	YTD	Q2	YTD	30.06.17
EM Hard Currency	2.24	6.19	–1	–32	310
EM Local Currency (hedged)	1.22	2.8	–40	–64	6.16
EM FX	1.93	7.12	52	–38	4.25
EM Corporates	1.98	5.01	–5	–23	292

Source: J.P. Morgan as of June, 2017. **Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index.**

There were a number of notable idiosyncratic country events during the quarter which impacted the markets. In Brazil, Temer's presidency was threatened by the release of tapes implicating him in a hush money scandal. While the constitutional court did not remove him from office, he is clearly weakened and the outlook for social security and labor reform is likely diminished. Brazilian hard currency bond spreads and local yields are approximately 60 and 45 bps wider respectively since the scandal broke, and the currency sold off by 6 %. We have reduced our exposure to the BRL, but maintain our overweight in local bonds due to our expectations for up to 200 bps of additional reductions to the central bank rate. We also continue to hold our overweight in the hard currency bonds due to the very low levels of external government debt and an improving current account position. Moody's and S&P put Brazil's ratings on negative outlook and negative watch, respectively.

In Mexico, the ruling PRI party won the governor's race in the State of Mexico over a challenger from the leftist Morena party. The Mexican peso rallied approximately 3.5 % while spreads rallied 20 bps on the news. We continue to monitor the political situation in Mexico closely, as presidential elections are scheduled for July 2018 and Morena's candidate Lopez Obrador is currently leading in the early polls. We continue to like a variety of Mexican assets, which were dramatically oversold during the US electoral campaign. The local bonds yield 7 % and there is a high probability that the central bank will start a cutting cycle within the next six to nine months.

*Investing for their own account – according to MiFID definition

Despite its strong performance year-to-date, the Mexican peso is still one of the cheapest currencies in the emerging world, in our opinion. Moreover, we view hard currency quasi-sovereign Pemex bonds that trade at spreads of up to 170 bps wide to the sovereign as attractive.

In Turkey, President Erdogan consolidated his power through passage of a referendum on a package of constitutional amendments that would dramatically increase his power. While the reaction from Berlin, Brussels, and Paris has been uniformly negative, Turkish assets reacted positively to the lessening of near-term pollical risks and an acceleration in local economic activity. We continue to be positive on Turkish assets due to their compelling relative value. The Turkish lira is second only to the Mexican peso in REER cheapness, and the hawkish central bank is keeping the carry close to 11.5 %. Similarly, local bond yields are near the top of their post-2008 range, and we expect inflation to roll over in early 2018. The Turkish hard currency spreads trade at spreads that more than compensate for its Ba1 rating in our view; we particularly favor five-year quasi-sovereigns trading at spreads over 300 bps.

Nordea 1 – Emerging Market Bond Fund

During the 2nd quarter of 2017, the Nordea 1 - Emerging Market Bond Fund returned +2.18 % (BP-USD), which slightly underperformed the benchmark return of +2.24 % (JP Morgan EMBI Global Diversified)[1].

Overweights to Ukraine, Venezuela, Argentina and Ghana along with an underweight to Oman drove performance. Ukraine saw strong demand after receiving a tranche of money from the IMF. Ghana outperformed on improved fiscal performance and a reversal of government officials over potential extension of their IMF program. An overweight to Brazil along with an underweight to Uruguay offset some of these gains. Uruguay outperformed its higher beta and more commodity sensitive peers on improved growth prospects. Brazil was weaker after corruption allegations put to question current president Temer's fiscal reform agenda. Sovereign positioning in Mexico, Hungary and Romania contributed to performance. Corporate and Quasi-sovereign positioning in Mexico, Jamaica (DLLTD) and Russia (VEBBNK) contributed to performance, while positioning in Venezuela (PDVSA) and Brazil detracted from performance. Finally, the exposure to the euro contributed to performance.

The fund's largest overweights are Argentina, Brazil, and Ukraine, and the largest underweights are Poland, the Philippines, and China. The largest position changes during the quarter were Brazil (+0.72 %), Oman (–0.63 %), Hungary (–0.49 %), and Ukraine (+0.46 %).

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

	Portfolio (%)	Benchmark (%)*	Difference (%)
Mexico	6.04	5.26	0.78
Argentina	5.77	3.26	2.51
Brazil	5.77	3.50	2.27
Turkey	4.82	3.96	0.85
Indonesia	4.69	4.39	0.29
Ukraine	4.13	2.64	1.49
Russian Federation	3.96	3.82	0.13
Lebanon	3.08	2.73	0.36
Dominican Republic	2.74	2.30	0.44
Kazakhstan	2.73	2.74	–0.01

Source: PGIM Ltd. as of June 30, 2017. Note: Figures based on the strategy allocation and can deviate from official fund data. * JP Morgan EMBI Global Diversified.

Nordea 1 – Emerging Market Bond Opportunities Fund

During the 2nd quarter of 2017, the Nordea 1 - Emerging Market Bond Opportunities Fund returned +2.39 % (BP-USD), which underperformed the benchmark return of +2.94 % (50 % JP Morgan EMBI Global Diversified and 50 % JP Morgan GBI-EM Global Diversified)[1].

In the hard currency allocation, overweights to Ukraine, Ghana and Venezuela along with underweights to China and Oman drove performance. Overweights to Brazil, Kazakhstan and Russia offset some of these gains. Hedged local rates returned +1.22 % in Q2 2017. Regarding the fund allocation, underweights to Colombia, Chile, Thailand, Turkey and Poland contributed to performance; whereas overweights to Brazil, Mexico and South Africa detracted from performance. In more details, sovereign positioning in Hungary and Egypt added to performance, while positioning in Brazil, Venezuela and Ukraine detracted. Corporate and quasi-sovereign positioning in Russia (RURAIL) and Jamaica (DLLTD) contributed to the positive performance, while positioning in Brazil held back some of those gains. Local rates positioning in Mexico, Thailand, Indonesia, Turkey and Poland added to performance, while positioning in Brazil, Argentina and South Africa detracted from performance. Emerging market currencies were marginally stronger in the second quarter, positing a total return of +1.93 % as measured by the JP Morgan ELMI+ Index. Currencies performed well for most of the quarter until volatility occurred in mid-June as G3 central banks signalled the start of monetary tightening. On one hand, overweights to the Mexican peso, Russian ruble and Hungarian forint contributed to performance. On the other hand, overweights to the Polish zloty and Argentine peso along with an underweight to the Thai baht detracted from performance.

The fund's largest hard currency over/underweights and changes throughout the quarter were similar to the ones seen in the hard currency portfolio (see above). In local rates positioning changes, the fund reduced its

1) Source: Nordea Investment Funds S.A.. Period under consideration: 31.03.2017 – 30.06.2017. Performance calculated NAV to NAV (net of fees and Luxembourg taxes) gross income and dividends reinvested, in the base currency of the respective sub-fund, excluding initial and exit charges as per 30.06.2017. Initial and exit charges could affect the value of the performance. **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.**

overweight to Mexico (–0.13 years) and underweights to Uruguay (+0.07 years) and Poland (+0.07 years). In FX, the strategy went underweight the South African rand, reduced its overweight to the Brazilian real, and further increased its underweight to the Thai baht. It also partially reduced its US dollar funding in favour of the euro.

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

	Portfolio (%)	Benchmark (%)*	Difference (%)
Brazil	10.02	6.75	3.27
Mexico	9.34	7.63	1.70
Indonesia	8.59	7.10	1.49
Turkey	7.00	5.98	1.02
South Africa	5.93	5.64	0.29
Argentina	4.05	2.22	1.83
Poland	3.81	6.10	–2.29
Malaysia	3.48	4.67	–1.19
Colombia	3.31	5.18	–1.86
Ukraine	2.62	1.32	1.30

Source: PGIM Ltd. as of June 30, 2017. Note: Figures based on the strategy allocation and can deviate from official fund data. *50% JP Morgan EMBI Global Diversified and 50% JP Morgan GBI-EM Global Diversified.

Outlook

As the summer continues, the markets often experience lower levels of liquidity, and as a result, pockets of volatility could emerge over the next couple of months. Over the medium-term, however, we continue to expect an environment where low developed market rates, moderate global growth, and low inflation supports investors' search for yield and spreads. Additionally, as shown above, the selloff after the US elections resulted in attractive EM valuations versus developed markets. We're comfortable with our current positioning and would look to add to select positions during periods of volatility.

In hard currency sovereigns, we believe the spread tightening theme remains intact, and we're maintaining our barbell positioning, including five-year quasi-sovereigns that provide incremental yield and roll-down opportunities coupled with longer-dated issues that continue to present the potential for spread compression.

In terms of local rates, we see potential rate cuts in several countries, including Brazil where the Banco Central do Brasil is likely to ease, possibly up to a couple hundred basis points over the next six to 12 months. Despite Mexico's recent rate hike, there is the perception that the tightening may be coming to an end and the central bank could start easing within the year. Other rate cut candidates consist of Colombia, Peru, Russia, South Africa, and Turkey.

We've recently reduced our EMFX risk and remain focused on relative value in the asset class. We'll look for stabilization within the commodities complex and for certain higher-yielding names to stabilize vs. lower-yielding names before reassessing our EMFX risk.

In a nutshell, we remain positive on the asset class. We would use periods of volatility as buying opportunities, and we're maintaining a barbell in hard currency sovereigns. In local rates, we see potential rate cuts in several countries while we're emphasizing relative value in EMFX.

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