Nordea

NEWSLETTER
Emerging Market Debt

First quarter 2017

Q1 2017 Market Review and Outlook

Highlights for EM Debt

- Q1 2017 was a strong quarter, with select HC commodity issuers and idiosyncratic names outperforming and a robust performance in EM currencies
- EM technicals have been impressive so far, with over USD 119 billion of gross issuance and inflows reaching around USD 22.9 billion into the sector
- The Fed has increased the room to maneuver for many EM central banks, and local bonds may “catch up” with recent strength in EMFX

In the first quarter of 2017, the outperforming hard-currency sovereign and quasi-sovereign bonds included select commodity (energy) issuers, along with some idiosyncratic names. The top performers were lower-rated credits that posted double-digit returns, such as idiosyncratic Belize (+61.32 % on restructuring), Mongolia (+12.68 % on an IMF program), select African commodity names that were up between 6-7 %, Iraq (+8.21 %), Dominican Republic (+7.74 %), and Brazil (+6.22 %). Even Turkey was up 5.31 % on supportive technicals and valuation, despite a deteriorating policy backdrop and credit ratings downgrade. We expect such trends to continue. We would also note that there are up to eight EM frontier countries with more recently announced IMF programs, which is supporting higher return expectations for the higher-yielding issuers. In addition, the credit ratings outlook was changed to positive on Russia and Argentina, and to stable on Brazil. EM corporates were mixed during the quarter, but select areas of value exist and many have performed well. Relative to EM sovereigns and quasi-sovereign opportunities, we believe EM corporates appear fully valued.

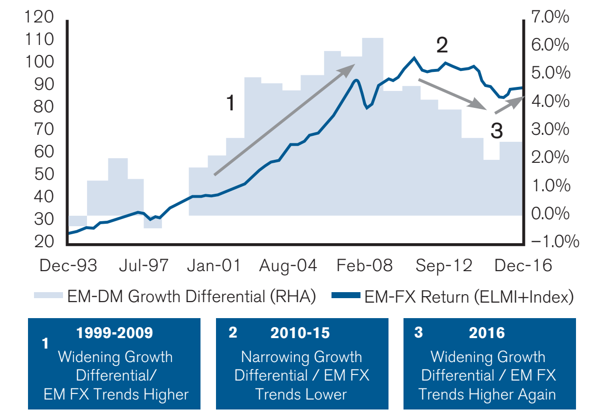
Emerging Market Debt Performance

	Total Return (%) Q1	Spread/Yield Change (bps) Q1	OAS (bps)/ Yield (%) 31.03.17
EM Hard Currency	3.87	–31	310
EM Local Currency (hedged)	2.08	–24	6.55 %
EM FX	5.18	–90	3.73 %
EM Corporates	2.97	–20	295

Source: J.P. Morgan as of March 31, 2017. **Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index.**

The strong performance in EMFX reflected the outperformance of higher-yielding currencies versus the dollar on the reach for yield and the more optimistic growth outlook in EM. As the growth differential between DM and EM widens, this has historical proven to be a supportive tailwind for EMFX, as observed in the following chart. Select EM currencies did well even versus the dollar, with solid returns from the Mexican peso +10.98 %, Russian ruble +9.16 %, and Brazilian real +5.09 %. Underperformers included lower-yielding Asian FX (Malaysian MYR +1.56 %, Chinese RMB +3.28 %, and Philippines peso +0.30 %), in part reflecting uncertainty regarding global trade in the Trump era and a weaker Chinese currency. The large underperformer was the Turkish lira as the outlook has deteriorated from a growth and balance of payments perspective, and returns were negative for the quarter at –1.21 %. Overall, we expect current trends to continue in EMFX with a range-bound USD and higher growth. With EM growth accelerating, the next trade is likely in Central and Eastern European FX, a region which has recently lagged. An improved outlook for the euro calls for reduced euro funding relative to USD funding of EMFX.

Emerging Market/Developed Markets Growth Differential Compared to Emerging Markets FX



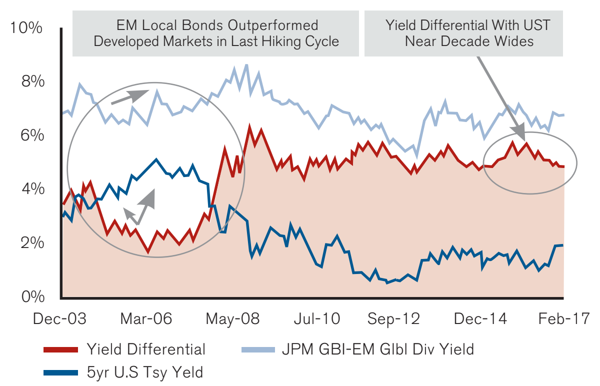
Source: IMF, J.P. Morgan, and PGIM Fixed Income. As of December 31, 2016

EM hedged local bonds have lagged due to the moves in U.S. Treasury yields, but they remain attractive from an overall yield perspective. Brazil was the top performer again, returning +4.57 % as the central bank continues to cut rates and will likely continue to do so at an accelerated pace. Other top performing rates markets were Peru, Indonesia, and the Philippines, all returning more than 4 %. While the policy outlook is mixed in terms of rate-cutting or rate-hiking trajectories, inflation remains relatively benign. Turkey again trailed, with a return of only +0.46 %.

*Investing for their own account – according to MiFID definition

A number of central banks are cutting rates, including Brazil, Chile, Colombia, and Russia. There are adequate premiums over policy rates in markets where the policy rate is going up. In Mexico, the central bank is hiking rates, and local bonds have been improving with the local bond curve flattening. This is likely to continue; the somewhat improved outlook in Mexico makes its bond market very attractive. Rates have lagged the currency and should do well over the course of the year. Given the overall yield level and the outlook for EMFX, we expect EM local rates will do well over the next quarter, notwithstanding additional Fed rate hikes.

Emerging Markets Yields vs. 5-Year U.S. Treasury Yields



Source: Bloomberg. **Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index.**

Nordea 1 – Emerging Market Bond Fund

During the 1st quarter of 2017, the Nordea 1 - Emerging Market Bond Fund returned +4.64 % (BP-EUR), outperforming the benchmark (JP Morgan EMBI Global Diversified) return of +3.87 % by +77bps[1].

Overweights to Mongolia, Brazil and Egypt along with an underweight to Poland drove the performance. Mongolia outperformed after reaching an agreement with the IMF and forming a refinancing plan for its Development Bank of Mongolia maturity in March 2017. Egypt outperformed on the back of positive sentiment and a new deal with the IMF. Overweights to Venezuela, Argentina, Ghana along with an underweight to Uruguay offset some of these gains. Venezuela underperformed after investors questioned PDVSA's (the state-owned oil company) ability to make an upcoming payment. Ghana underperformed after the new government discussed past due arrears which left investors questioning the viability of their current IMF program. Sovereign positioning in Indonesia, Mexico, Russian Federation and Brazil contributed to performance, while positioning in Dominican Republic, Ecuador and Mongolia detracted from performance. Corporate and Quasi-sovereign positioning in Indonesia (PERTIJ), Mexico, Brazil and Malaysia (PETMK) contributed to performance. Finally, exposure to the Euro was a positive contributor to the quarterly development.

The fund's largest overweights are Argentina, Brazil, and Mexico, and largest underweights are Poland, China, and the Philippines. The largest position changes during the quarter were a reduction of the allocation to Kazakhstan (–0.70 %), Indonesia (–0.68 %), and Cote D'Ivoire (–0.45 %).

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

	Portfolio (%)	Benchmark (%)*	Difference (%)
Mexico	6.48	5.29	1.19
Argentina	5.74	3.32	2.43
Brazil	5.21	3.59	1.61
Indonesia	4.65	4.33	0.32
Turkey	4.37	3.85	0.51
Russian Federation	4.34	4.10	0.24
Ukraine	3.58	2.57	1.01
Lebanon	3.22	2.77	0.45
Dominican Republic	3.02	2.39	0.63
Venezuela	2.92	1.95	0.97

Source: PGIM Ltd. as of March 31, 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 1st quarter of 2017, the Nordea 1 - Emerging Market Bond Opportunities Fund returned +6.39 % (BP-EUR), which outperformed the benchmark (50 % JP Morgan EMBI Global Diversified + 50 % JP Morgan GBI-EM Global Diversified) return of +5.19 % by +120 bps[1].

In the hard currency allocation, overweights to Belize and Mongolia along with underweights to Poland, Philippines and China drove performance. Belize outperformed after successfully restructuring its long-term debt. Overweights to Argentina, Ghana, Venezuela, Ukraine and Russian Federation offset some of these gains. Regarding hedged local rates, underweights to Malaysia, Thailand, Hungary, Poland and Russian Federation contributed to performance. An overweight to Brazil along with an underweight to Argentina detracted from performance. Sovereign positioning in Indonesia, Russian Federation, Ukraine, Mexico and Costa Rica added to performance, while positioning in El Salvador detracted. Corporate and quasi-sovereign positioning in Indonesia (PERTIJ), Russian Federation (RURAIL), Ukraine (EXIMUK), Mexico (PEMEX) and Costa Rica (BNALCR) added to performance, while positioning in Brazil detracted.

Local rates positioning in Brazil, Colombia, Thailand, Poland and Turkey added to performance, while positioning in Hungary detracted from performance. Emerging market currencies were stronger since the beginning of the year posting a total return of +5.18 % measured by the JP Morgan ELMI+ Index. EM FX had a strong first quarter on the back of improving emerging market growth, stable-to-improving commodity prices, and rangebound dollar and US Treasury yields. Overweights to the Rus-

1) Source: Nordea Investment Funds S.A.. Period under consideration: 31.12.2016 – 31.03.2017. 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 31.03.2017. 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.**

sian ruble, Mexican peso and Brazilian real contributed to performance, along with underweights to the Thai baht, Colombian peso and Malaysian ringgit 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 (above). In local rates positioning changes, the fund went underweight in Philippines and initiated overweights in Mexico and Argentina. In FX, the strategy went underweight the US dollar, reduced its euro underweight, added overweight positions in the Turkish lira, Argentine peso, Colombia peso, and Hungarian forint, and increased overweight to the Mexican peso.

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

	Portfolio (%)	Benchmark (%)*	Difference (%)
Brazil	10.06	6.80	3.26
Mexico	9.45	7.65	1.80
Indonesia	8.16	7.17	0.99
Turkey	6.01	6.20	–0.19
South Africa	5.48	6.04	–0.56
Argentina	4.42	2.37	2.05
Colombia	3.97	5.57	–1.60
Poland	3.82	6.38	–2.56
Malaysia	2.83	5.13	–2.30
Russian Federation	2.76	5.20	–2.44

Source: PGIM Ltd. as of March 31, 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

EM technicals have been impressive so far in 2017. There has been over $119 billion of new, gross issuance, with a significant amount from sovereigns and quasi-sovereigns. Most of this supply has been readily absorbed. Inflows into the sector reached just under $22.9 billion, with about $15.2 billion going in hard currency assets and $7.7 billion going into local assets. The second quarter presents a significant amount of cash flow that is expected to be reinvested into the asset class amid generally strong interest in the sector.

Risks on the horizon include uncertainty around U.S. trade policy, China, and commodities. The transmission mechanism would be a lowering of global growth expectations. In the case of China, even with a focus on FX reserves and the currency, financial stability and growth are paramount for the Chinese leadership. All indications are that going into the Party Congress later this year, growth will be in the 6.7% range, which should support EM assets. While U.S. trade policy is a wildcard, the business-friendly cabinet is unlikely to go down the road of an all-out trade war where the U.S. stands to lose significantly. Regarding the politics of populism in the EU, the momentum may be fading for now, though we are watching the French elections closely. Even on the back of lower oil prices and the Fed's decision to hike rates in March, we are encouraged at how EM has traded as we appear to be in a "sweet spot" for the asset class.

In a nutshell, EM assets are likely to perform well given attractive valuations and the improved outlook for global growth. The Fed has increased the room to maneuver for many EM central banks, and local bonds may "catch up" with recent strength in EMFX. There are opportunities where spreads are higher than the index and its five-year average, and where yields are well above that of the local index. With positive inflows and supportive technical, EM local rates are expected to outperform.