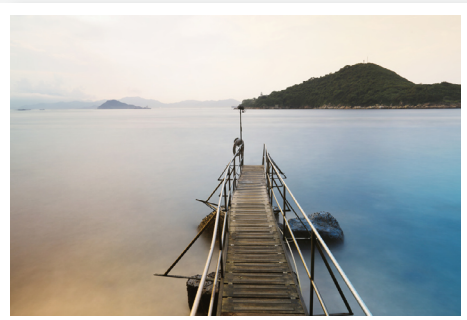


EMERGING MARKET DEBT – QUARTERLY NEWSLETTER

Fourth quarter 2018



Market Review and Outlook¹

Highlights for EM Debt

- Despite significant monthly variability, Emerging Markets debt sector rebounded this quarter, with Hard Currency sovereigns leading the way
- A few outliers significantly underperformed, therefore we saw as well some countries exhibiting relative resilience justified by fundamentals
- Developments regarding escalating trade tensions will be important to monitor, as well as idiosyncratic drivers, in particular for Brazil, Argentina and Turkey

After a tough Q2, the Emerging Markets (EM) debt sector rebounded with Hard Currency (HC) sovereigns leading the way. There was significant monthly variability throughout the quarter, particularly within Argentina, Turkey and Ecuador, amid concerns about vulnerability to tighter global financial conditions and idiosyncratic, issuer-specific factors. Macro developments in Q3 included periods of dollar resilience and escalating trade war rhetoric. The expectations of strong US growth relative to other developed markets and EM has posed a headwind for EMFX and similarly limited the performance in hedged local bonds.

Emerging Markets Debt Performance

	Total Return (%)		Spread/Yield Change (bps)		OAS (bps)/Yield %
	Q3	YTD	Q3	YTD	30.09.18
EM Hard Currency	2.3	-3.04	-34	50	335bps
EM Local (hedged)	-0.25	-1.54	3	48	6.62%
EM FX	-1.11	-4.48	42	183	5.37%
EM Corporates	1.3	-1.6	-15	63	286bps

Source: J.P. Morgan as of September 30th, 2018. Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index.

Interestingly, when we examine year-to-date returns for the array of countries within the hard currency

universe, many countries performed similarly or better than the Bloomberg Barclays 10-20 year US Treasury Index, which posted a year-to-date return of -4.14% through Q3. Therefore, a few outliers significantly underperformed in Q3, including Turkey (-9.39%), Argentina (-16.25%), Lebanon (-9.06%), and Zambia (-28.87%). Why mention these idiosyncratic cases? Because given the challenges facing the sector, along with persistent headlines concerning risks in Argentina and Turkey, it's easy to "throw the baby out with the bath water." Indeed, although some of the more troubled issuers have attempted orthodox steps to address concerns (e.g. Argentina tightened fiscal policy even more than anticipated and received increased and front-loaded IMF funding), EM has underperformed other fixed income with spreads widening by +50 bps on the year. That said, some countries have exhibited relative resilience that has been justified by fundamentals, or by expectations of access to bilateral or multilateral funding. This includes larger issuers, such as Mexico, which has outperformed the hard currency index year-to-date even with the election of a left leaning, populist government, and smaller countries that are considered NexGem (frontier credits). Countries including as Angola, Pakistan, and Mongolia have posted positive year-to-date returns. Country performance was the dominant explanation of returns for EM corporates.

Similar themes are apparent in local hedged bonds, where there were significant outliers in performance. Here again, Turkey and Argentina had negative double-digit year-to-date returns and have had to hike rates significantly given severe currency weakness and elevated inflation. Argentina hiked rates more than 3,275 bps and Turkey hiked rates 625 bps. Policy credibility remains an issue in both countries. Given some of the headwinds from EMFX, other central banks have also hiked, including Indonesia, the Phil-

* investing for their own account – according to MiFID definition

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.

ippines, and Russia. Additional central banks could follow suit, but given that inflation, with a few exceptions, is contained, the hikes should be modest.

In EMFX, Q3 started with a backdrop of US growth outperformance on the back of fiscal stimulus and lower growth forecasts for the euro zone and several EM countries, notably in Latin America. Trade policy uncertainty was also high throughout Q3. These factors, along with the market pricing in a more aggressive Fed hiking path relative to the rest of G10 central banks, facilitated USD strengthening over the past two quarters.

What We are Watching...

Developments regarding escalating trade tensions will be important to monitor as they can impact the trajectory of EM growth. Arguably, some of this may be priced into EM assets already. Going forward, we expect China to use fiscal policy to mitigate the impact of additional increases in trade tariffs imposed by the U.S. Likewise, China is lowering tariffs on imports from countries other than the US.

In addition to large macro themes, idiosyncratic developments will impact select country performance and broader EM sentiment. Developments in countries, such as **Brazil** where the presidential election remains very polarized, require continued monitoring. Indeed, whomever wins the election will be challenged with “governance” issues and will have to deal with Brazil’s fragmented political system and slim coalitions. In large part, the concerns in Brazil relate to domestic debt dynamics given the large structural fiscal deficits. Reform of the public sector, including social security reform, needs to take place. While the immediate market reaction will differ depending on who wins, in the medium term, several factors mitigate the concerns about the trajectory of public sector debt dynamics:

- 1) the local bond market is primarily owned by domestic constituents; non-residents only own about 15% of the local market, so there is little risk that the domestic debt does not get rolled over;
- 2) public sector external debt levels are low at around 5% of GDP;
- 3) the current account is very manageable at close to -1-2% of GDP and is more than covered by foreign direct investment;
- 4) the BRL is floating and is used as an adjustment/absorption mechanism; and
- 5) foreign exchange reserves are large at close to \$380 billion.

The local markets have priced in a lot of premium reflecting the uncertainty of the election outcome. Sovereign and quasi-sovereign external debt levels are manageable and long dated and should experience less volatility. While the political backdrop might make it appear difficult for any candidate to be successful in passing and implementing meaningful fiscal reform, it should be recognized that the public sector benefits from the current regime. This, and the existence of a social safety net, should make some reform achievable.

In **Argentina**, the recently increased IMF program—from \$50 billion to \$57 billion, and the announced front-loading of disbursements, along with commitments from the Macri government to further tighten fiscal policy and change the monetary policy regime—helps stabilize the concerns on external debt. More recently, the Argentine peso has posted positive returns. There will be a large correction in the current account this year and in 2019. Local market roll overs have been more successful. While uncertainty will persist given the October 2019 elections, we expect hard currency bonds will continue to rebound given their attractive valuations. In **Turkey**, we will monitor policy actions, particularly from the central bank, along with fiscal performance. The government just announced some fiscal tightening, but its program is short on specifics. We are also monitoring private sector external roll overs in the corporate and banking sectors. Public sector external liabilities largely fall on public sector banks, and the debt dynamics of the sovereign, considered in isolation, remain manageable.

In addition to these examples, many EM countries have demonstrated a willingness to adjust to the more challenging global context with appropriate policy responses. These include hiking rates, allowing their currencies to adjust, and engaging with multilaterals and bilateral entities to cover potential funding shortfalls. This helps avoid a credit event in those countries where external debt levels may be high and/or rollovers may be challenging.

Investment Implications

As the final quarter of 2018 progresses, we are mindful of headwinds in the sector, yet remain comfortable adding risk—particularly in EM hard currency sovereign and quasi-sovereign bonds where valuations are compelling—after we reduced risk earlier in the year.

Notable premiums have been built into spreads in countries where significant selloffs occurred. While there are distinct vulnerabilities, the risk of a credit event in sovereign and quasi-sovereign issuers in Argentina, Turkey, and other lower-rated countries is con-

tained over the near term, and we remain overweight spread product in 3-7 year sovereign and quasi-sovereign issuers. Given the uncertainty of the future extent of Fed tightening, we are more cautious in our longer-dated positioning, choosing to only be positioned in higher-rated sovereigns and quasi-sovereigns in the long end. We are positioned in select EM corporates. After a slowdown in supply in Q2 and Q3, some supply is picking up, and we aim to focus on attractively priced corporate and quasi-sovereign issues. We are also focusing on Middle Eastern sovereign debt that will be added to the J.P. Morgan indices in January 2019.

We are cautious in our EMFX positioning given the strength of the U.S. economy and the relative growth outlook for EM vs. the U.S. The one positive for currencies, particularly in EM, is that valuations are very appealing with the average real effective exchange rate back down to 2016 lows, while real interest rates are quite high in a number of countries, such as Mexico, Brazil, Russia, Indonesia and India. The potential triggers for a reversal in USD strength are easing trade tensions or a more cautious tone from the Fed. Yet, these triggers seem unlikely in the very near term, and the USD is likely to continue to see strength. Select EM local bonds look attractive given the hedged yield and premium priced into certain curves, which already reflect possible rate hikes.

Nordea 1 – Emerging Market Bond Fund

Performance Q3 2018

Nordea 1 – Emerging Market Bond Fund (BP-USD)	2.55%
Nordea 1 – Emerging Market Bond Fund (BI-USD)	2.66%
Benchmark ²	2.30%

Disclaimer: Source: Nordea Investment Funds S.A. Period under consideration: 29.06.2018-28.09.2018. Performance calculated NAV to NAV (net of fees and Luxembourg taxes) in the currency of the respective share class, gross income and dividends reinvested, excluding initial and exit charges as per 28.09.2018. 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.** 2)JP Morgan EMBI Global Diversified.

Overweights to Bahrain, Pakistan, Iraq and Ecuador along with an underweight to China drove performance. Overweights to Argentina, Turkey, Costa Rica and overweight along with an underweight to Oman offset some of these gains. Argentine assets struggled as the confidence crises intensified. Efforts to front-load the IMF financing, and a more articulate explanation by the Macri government about how they will implement the program will help stabilize the situation. Turkish assets underperformed due to negative sentiment around U.S. sanctions and ongoing pressure from the U.S. to release U.S. pastor Andrew Brunson.

Sovereign positioning in Argentina, Oman, Brazil and Indonesia contributed to performance, while positioning in Ecuador and Lebanon detracted from per-

formance. Corporate and Quasi-sovereign positioning in Malaysia (OGIMK) and Mexico contributed to performance, while positioning in Brazil (MINASG) and Argentina (BUENOS) detracted from performance.

The fund's largest overweights are Argentina, Brazil, and Ukraine, and the largest underweights are China, Philippines, and Poland. The largest positioning changes during the quarter were Bahrain (+0.70%), Kazakhstan (-0.40%), and Russia (-0.32%).

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

	Portfolio (%)	Benchmark ³ (%)	Difference (%)
Mexico	5.81	5.14	0.67
Argentina	5.45	2.93	2.52
Brazil	5.02	3.11	1.91
Indonesia	4.65	4.29	0.36
Turkey	4.37	3.45	0.91
Ukraine	4.02	2.56	1.46
Russia	3.89	3.53	0.36
South Africa	3.82	2.77	1.05
Ecuador	3.43	2.66	0.77
Dominican Republic	2.84	2.66	0.19

Source: PGIM Ltd. as of September 30, 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 Q3 2018

Nordea 1 – Emerging Market Bond Opportunities Fund (BP-USD)	0.04%
Nordea 1 – Emerging Market Bond Opportunities Fund (BI-USD)	0.16%
Benchmark ⁴	0.23%

Source: Nordea Investment Funds S.A. Period under consideration: 29.06.2018-28.09.2018. Performance calculated NAV to NAV (net of fees and Luxembourg taxes) in the currency of the respective share class, gross income and dividends reinvested, excluding initial and exit charges as per 28.09.2018. 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.** 4) 50% JP Morgan EMBI Global Diversified and 50% JP Morgan GBI-EM Global Diversified.

In hard currency, overweights to Iraq, Pakistan, Ecuador, Ukraine and Bahrain drove performance. Overweights to Zambia and Argentina along with underweights to Philippines, Oman and Uruguay offset some of these gains. Zambia assets weakened on the news that the IMF's country representative left the country amid deal doubts, suggesting the country will not secure a bailout package in the near to medium-term. Regarding local bonds, underweights to Russia, Turkey, Argentina and Czech Republic contributed to performance. Underweights to Romania and Hungary detracted from performance.

Sovereign positioning in Ecuador and Cote D'Ivoire detracted from performance, while positioning in Argentina, Brazil and Indonesia contributed. Corporate and quasi-sovereign positioning in Russia (VEBBNK) and Argentina (BUENOS) detracted from performance, while positioning in Malaysia (OGIMK) contributed. Local rates positioning in Turkey, Indonesia, Brazil and Colombia detracted from performance.

Emerging market currencies were weaker during the quarter. Exposure to the Turkish lira and Russian ruble along with exposure to the Brazilian real 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). Regarding local bonds, the fund reduced Thailand (-0.04 years) and Indonesia (-0.02 years) while adding to Hungary (+0.02 years). In FX, the fund reduced exposure to the South African rand, Russian ruble, Czech koruna, and Malaysian ringgit. The fund also shifted to be overweight the US dollar and euro.

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

	Portfolio (%)	Benchmark⁵ (%)	Difference (%)
Brazil	8.96	6.55	2.40
Mexico	8.42	7.57	0.85
Indonesia	7.96	6.85	1.11
South Africa	6.31	5.72	0.59
Malaysia	4.63	4.05	0.58
Turkey	4.26	3.79	0.47
Colombia	4.00	5.34	-1.34
Poland	3.54	5.70	-2.17
Argentina	3.47	1.76	1.71
Ukraine	2.65	1.28	1.36

Source: PGIM Ltd. as of September 30, 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.

Source (unless otherwise stated): Nordea Investment Funds S.A. Period under consideration (unless otherwise stated): 29.06.2018 – 28.09.2018. Performance calculated NAV to NAV (net of fees and Luxembourg taxes) in the currency of the respective share class, gross income and dividends reinvested, excluding initial and exit charges as per 28.09.2018. 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.** If the currency of the respective share class differs from the currency of the country where the investor resides the represented performance might vary due to currency fluctuations. 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