Emerging Debt Report

April 2017

Biggest Movers in Spread:
12/30/2016 to 3/31/2017

	Spread Change	Spread Level	Total Return
EMBIG	(34)	331	3.9%
Country Sub-Index:			
Belize	(1182)	655	61.3%
Mozambique	(250)	1803	-0.3%
Mongolia	(241)	456	12.7%
Iraq	(104)	581	8.2%
Bolivia	18	102	0.0%
Ecuador	20	666	1.6%
Ghana	55	638	-0.2%
Venezuela	209	2377	-1.3%

Biggest Movers:
Spot Emerging Currencies

	Total Return
ELMI+*	5.2%
Mexico	9.4%
Russia	8.3%
Korea	8.0%
Taiwan	6.2%
Egypt	0.4%
Hong Kong	-0.2%
Philippines	-0.9%
Turkey	-3.4%

* Total return

Biggest Movers:
Emerging Rates

	Total Return
GBI-EMGD**	3.2%
Hungary	0.2%
Romania	0.3%
Thailand	1.2%
Malaysia	1.5%
Philippines	4.7%
Peru	6.3%
Indonesia	6.7%
Brazil	7.0%

** Local Currency Total return

Quarterly Update on Valuation Metrics in Emerging Debt

We review some of our favored valuation metrics for external and local emerging debt markets.[1]

The punch line: By our metrics, local currency debt continues to look attractive at current valuations, especially for dollar-based investors, but the degree of attractiveness has fallen over the past quarter, due to a strong rally. External debt bonds moved further into expensive territory during the first quarter, amid a strong tightening of 34 bps in the index spread.

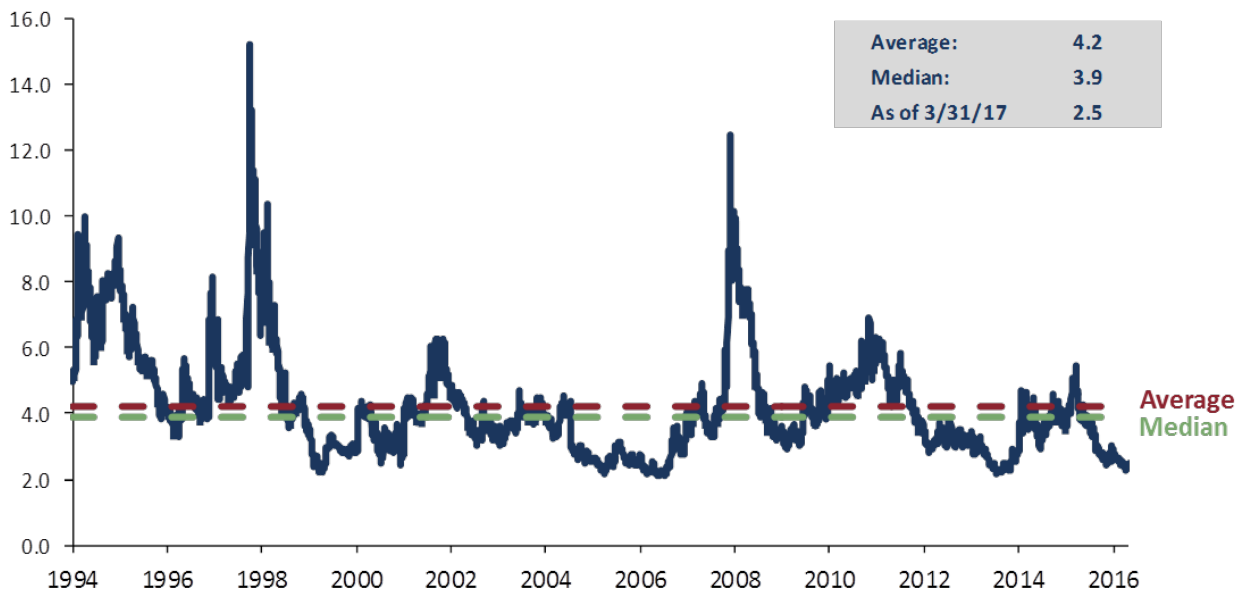
External Debt Valuation

Exhibit 1 shows our familiar valuation chart for external sovereign debt. We calculate a "fair" spread of the EMBIG over US Treasuries, accounting for the credit rating profile of the EMBIG, default probabilities, and recovery values under default scenarios, based on rating agency studies of the historical experience. We then take the ratio of the actual EMBIG spread to the fair value spread and compare it to the historical norm. Assuming a long-term investment horizon, the chart suggests that the market shows signs of being attractive when the fair value multiple is above the long-run average and median lines, and unattractive when it lies below.

[1] For a more detailed explanation of the valuation metrics contained in this report, please refer to the Emerging Debt Report dated April 27, 2015. This may be obtained from your GMO representative.

As shown in the exhibit, the current spread multiple remains well below the level that the market has historically demanded. The multiple stood at 2.5 on March 31, 2017, lower than the 2.7 multiple observed on December 30, 2016, indicating that the market may be becoming more overvalued. During the first quarter, the EMBIG benchmark total return was 3.9%, accompanied by a spread tightening of 34 bps to +331 bps over Treasuries. The historical minimum ratio was 2.1 in April of 2007, when the spread on the EMBIG index was +161 bps over Treasuries.

Exhibit 1 – Long-Term View of the "Fair Market Multiple" for Hard Currency Emerging Debt



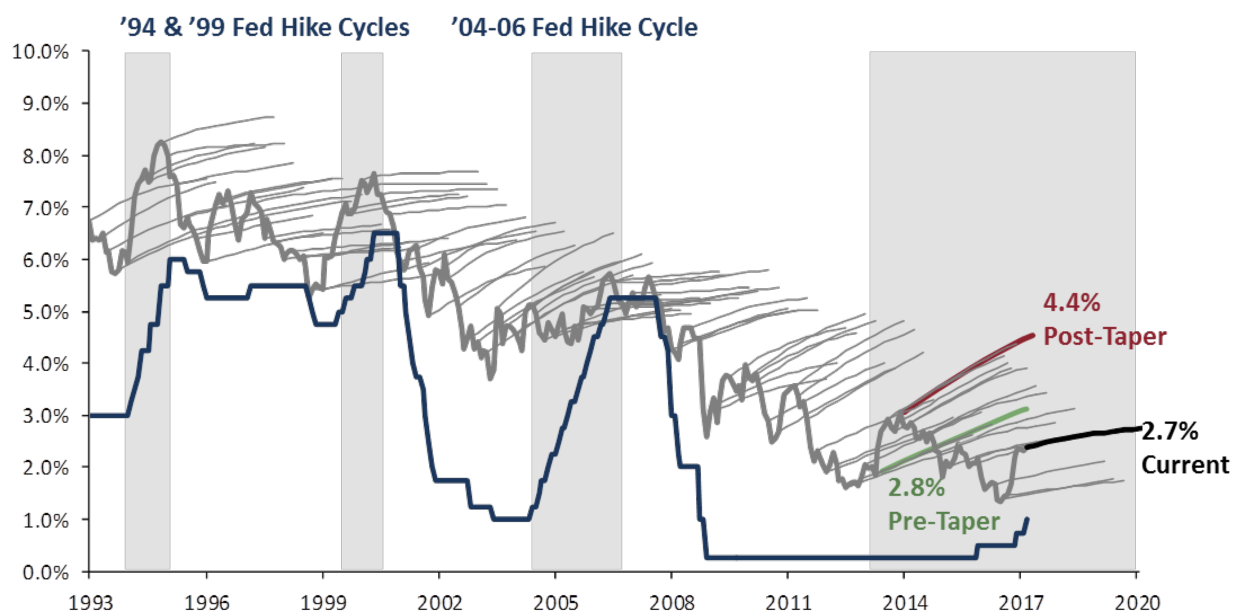
Following the weak final quarter of 2016 in which emerging debt markets were buffeted by the Trump victory and repricing of US Treasury yields, the first quarter of 2017 was very benign. Oil prices, commodity prices overall, and US Treasury yields all fluctuated within reasonable bounds. A somewhat synchronized global recovery also took hold, judging from business and consumer sentiment surveys, Purchasing Managers' Indexes, and some positive data on global trade flows. Perhaps most importantly, the emerging debt markets had more time to absorb the Trump presidency, and seemed to coalesce around a view that harsh policies that might start a global trade war or threaten the global recovery were either unlikely or would be delayed. Debt issuance by emerging sovereigns in hard currencies, which is normally seasonally high in the first quarter, was nearly double the volume of the same quarter of 2016, indicating a market that was comfortable with taking on more exposure. Sovereigns from across the rating spectrum, from single-B names like Ecuador and Egypt, to single-A Poland were able to access international capital markets with little difficulty. Of the 65 countries in the EMBIG benchmark, only 9 saw their bond index spread over Treasuries widen over the first quarter.

The fair value spread, by construction, is sensitive to rating changes, which were fairly benign during the quarter. On the negative side, S&P lowered the outlooks on Chile and Turkey to negative, based on weak economic performance in both countries and the ongoing decline in institutional strength in Turkey. Mozambique was lowered to Selective Default status in January when it missed a coupon on a global bond (its first scheduled coupon). On the positive side, Belize was upgraded out of C-rated status following a debt restructuring agreement with bondholders that resulted in no principal haircut, but a cut in coupons. Russia (BB+) was also given a positive outlook by S&P.

All in all, our calculation of the fair value spread of the EMBIG fell slightly from 139 bps at the end of December to 135 bps by the end of March 2017.

Of course, this analysis says nothing about the level of interest rates, but rather the level of spreads, or credit cushion. What about the interest rate cushion as embedded in the risk-free rate? Exhibit 2 shows the history of the 10-year US Treasury swap rate (heavy solid line), along with the forward curve for the 10-year swap rate (lighter lines) at each point in time (quarterly). In effect it tries to show three dimensions in a two-dimensional chart.

Exhibit 2 – 10-Year US Treasury Swap Curves at Quarterly Intervals

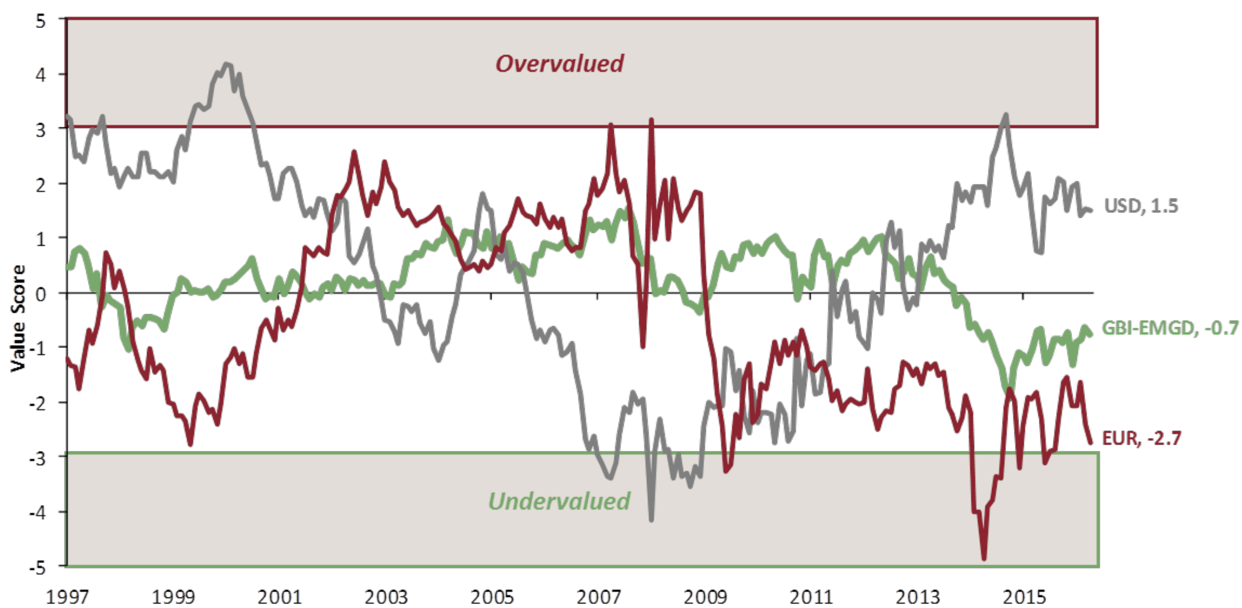


On this metric, we have a risk-free rate cushion similar to that which we had in the previous quarter. The 10-year US Treasury yield fell 5 bps during the quarter after rising by 85 bps in Q4 2016 in the wake of the US election. Meanwhile, the slope of the 10-year forward curve was broadly stable. It flattened by 2 bps, from about 38 bps (to the 3-year forward point) to 36 bps as of the end of March. This level of 36 bps represents a fairly flat forward curve relative to the recent historical experience, indicating a view in the market that 10-year US Treasury rates are likely to remain low well into the future, even as the Fed normalizes its monetary policy. The post-election sell-off in Treasuries in Q4 2016 helped move the level of the current Treasury rate to more reasonable levels.

Local Debt Markets

Now let's turn to local debt markets, where we consider some simple concepts of currency valuations and interest rate differentials. Exhibit 3 provides a snapshot of our currency valuation methodology. The underlying model analyzes trends in real effective exchange rates and the balance of payments and, via a z-score analysis, measures how far away current values are from their longer-term averages. These are combined into a single value score as shown in the exhibit, where we compare the weighted average of currencies in the GBI-EMGD with values for the USD and EUR. As the chart indicates, scores below the zero line indicate potentially "cheap" currencies while positive scores indicate potentially "rich" currencies.

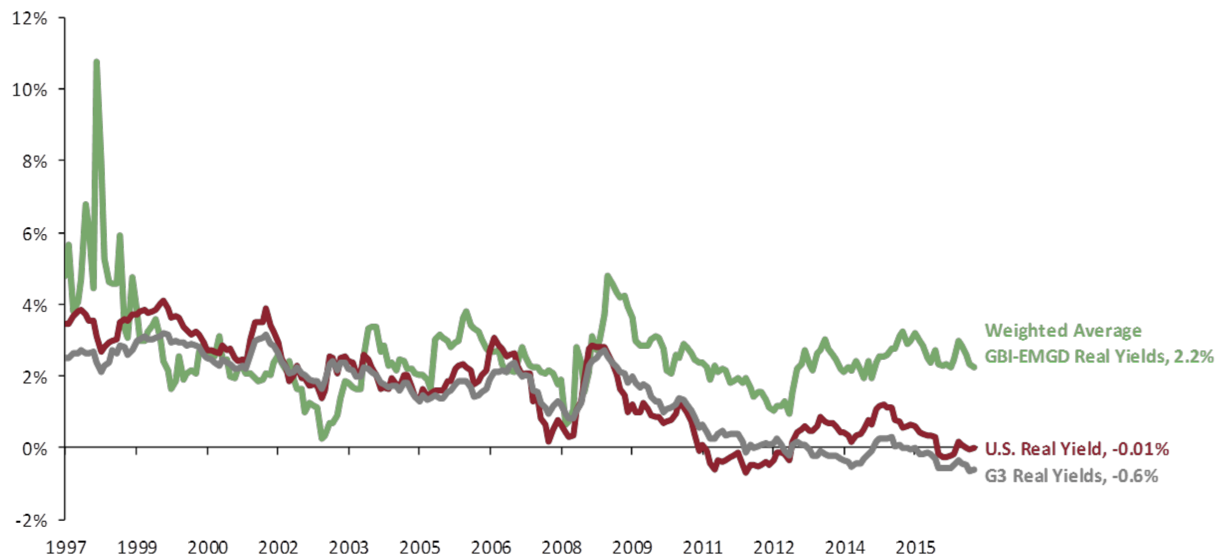
Exhibit 3 – Weighted Average Value Score of GBI-EMGD Currencies vs. USD and EUR



The overall thrust of this chart has not changed much in the past several quarters, though there has been some convergence in valuations between the "rich" USD and the "cheap" EM currencies over the quarter. On this metric, the USD remains somewhat rich, though less so than at the end of 2016. GBI-EMGD currencies continue to look relatively cheap on a weighted average basis, but, also, a little less so than the previous quarter. The EUR continues to look cheap. On average, EM currencies rallied against the USD during the first quarter. MXN and RUB were the best performing currencies. The MXN strengthened 9.7%, recovering some of its pre- and post-US election losses. The peso likely benefited from the market's perception that the undervaluation of the currency was getting stretched while the current account began to adjust in a favorable direction. In Russia, the Finance Minister began a new temporary FX intervention mechanism in February whereby the government will buy (sell) FX when the oil price is above (below) USD40 per barrel in order to minimize the impact of oil prices on the budget. Following the announcement, the market began to price a weaker RUB and fewer rate cuts going forward. However, the RUB eventually resumed its appreciation trend as growth recovered, inflation fell, and the Central Bank kept a relatively hawkish stance, ending the quarter 8.6% stronger. The PLN was the third best performing currency, appreciating 5.4% in the first quarter. In Poland, economic activity has been rebounding more than expected and inflation is expected to pick up. The TRY was the worst performing currency during the quarter. Most of the depreciation occurred in the first month of the year when the lira depreciated around 7% as the Central Bank failed to tighten liquidity to shore up the currency. However, as the Central Bank decided to temporarily squeeze onshore and offshore liquidity and the lira began to show as being undervalued on different metrics, the currency recovered to end the quarter 3.5% weaker. Political considerations are also weighing on TRY. It is also worth noting that Argentina entered the GBI-EMGD index at the end of February. Since coming into office, the new Argentine government has taken a lot of policy initiatives that are designed to rein in the fiscal deficit, bring inflation down, and boost economic growth. As the government removed impediments to foreign investors to access the ARS and the local bond market, it began to issue local debt bonds to build an ARS yield curve. Argentina had an estimated weight of 1.58% in the GBI-EMGD as of February 28, at the time of entry, but our currency model sees little value in the ARS at recent levels.

As for emerging market local interest rates, the story that has been in place for many quarters (years, actually) remains. They continue to look attractive, as shown in Exhibit 4. Real rates in the G-3 continue to be at or below zero, due in part to a pick-up in inflation but also to continued low nominal interest rates. In the emerging world, the quarter saw a significant fall in the real yield of the GBI-EMGD countries, from 2.8% to 2.2%. Two main factors are responsible for this. First, and most relevant for the quarter's relatively strong performance, was a rally in nominal yields. In particular, the high-yielding countries saw a compression in rates, including Brazil, Colombia, Indonesia, and Russia. In addition, some lower-yielding sovereigns like Peru and the Philippines also saw rates fall. Second, Argentina's entry into the local debt benchmark also served to reduce the benchmark's real yield, because real yields in that country are negative as the authorities work toward a normalization of monetary policy after years of monetary financing of fiscal deficits. Nevertheless, the real yield of the GBI-EMGD (inclusive of Argentina), at 2.2%, is in line with its 5-year average and only slightly lower than its 10-year average. The real yield differential with the G-3 remains fairly high by historical standards.

Exhibit 4 – Inflation-Adjusted Bond Yields



Conclusions and Observations

1. Emerging currency valuations continue to look attractive according to our methodology, especially relative to the USD. Valuations do not look as attractive as the previous quarter due mainly to a rally in most EM currencies against the USD.
2. Local debt markets also look attractive, based on real yield differentials between EM and developed market bonds. Differentials remain well above historical norms, even though the differential has fallen over the past quarter.
3. External debt moved further into "rich" territory on the back of a strong compression in spreads over the quarter.
4. The first few weeks of the second quarter have been eventful, with South African president Jacob Zuma having taken measures to consolidate his power in order to fend off demands for his resignation; in the process, he has fired his well-regarded Finance Minister. This has led to rating downgrades and a collapse in the rand. El Salvador has missed a payment on a local bond, while reassuring markets it will not default on external debt. Meanwhile, rhetoric between the US and Russia over Syria has intensified, but a summit meeting between President Trump and Xi Jinping was cordial with no major pronouncements from either side.

Sources for charts: Bloomberg, JP Morgan, GMO LLC