First State Investments

First State Emerging Market Debt

2019 Outlook

RISK FACTORS

This document is a financial promotion for First State Emerging Markets Bond Fund for professional clients only in the EEA or elsewhere where lawful. Investing involves certain risks including:

- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- **Credit risk:** the issuers of bonds or similar investments may not pay income or repay capital when due.
- **Interest rate risk:** interest rates affect the value of investments; if rates go up, the value of investments fall and vice versa.
- **Emerging market risk:** emerging markets may not provide the same level of investor protection as a developed market; they may involve a higher risk than investing in developed markets.
- **Charges to capital risk:** the fees and expenses may be charged against the capital property. Deducting expenses from capital reduces the potential for capital growth.
- **Below investment grade risk:** below investment grade debt securities are speculative and involve a greater risk of default and price changes than investment grade debt securities due to changes in the issuer's creditworthiness. In periods of general economic difficulty, the market prices may fluctuate and decline significantly.

Reference to specific securities or companies (if any) are included to explain the investment strategy and should not be construed as investment advice, or a recommendation to invest in any of those companies.

For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document.

If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

Outlook for EM Debt – A better year is ahead

2018 was a challenging year for all Emerging Markets (EM) assets and EM hard-currency debt was no exception: losses from higher US Treasury yields and higher EM risk premia outweighed the running yield and resulted in negative returns for the asset class. Since 1999, 2018 was only the third year in which the asset class produced negative returns, the other loss-making years being the year of the global financial crisis (2008) and the taper tantrum (2013) when Fed chair Bernanke announced the reduction of asset purchases by the Fed.

This year was an unusual one for EM debt performance. US Treasury yields are mostly negatively correlated with EM spreads, so in most periods, losses from rising Treasury yields are compensated by lower EM risk premia. In 2018, however, the US fiscal stimulus led to sharply higher US policy rates, US growth surprises and a strong US$. The US$ strengthened not just against EM currencies, but also against the Euro, as growth disappointed in the Eurozone and EM. Other than the strong US$ and higher US rates, which created a negative environment for capital flows to EM, rising uncertainty about global trade also affected EM countries negatively, as did higher market volatility. After such a difficult year for EM debt, we do not think these headwinds will persist, so a more positive outlook for the asset class is warranted. We believe that EM debt will perform better in 2019, firstly because we expect some of the 2018 headwinds for the asset class to fade, and secondly because valuations of EM US$ debt have adjusted significantly in 2018.

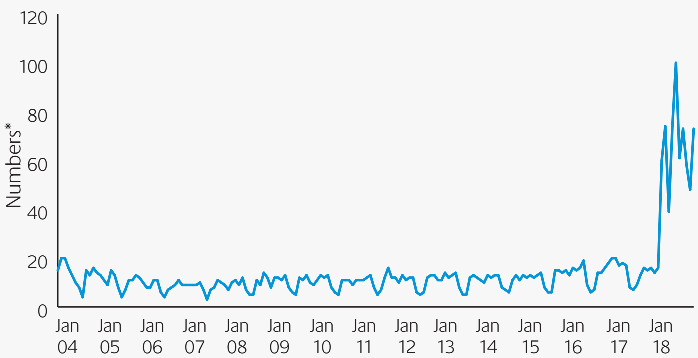
Global environment

Our strongest conviction for 2019 is that asset price volatility will remain high, for various reasons. One is that the global expansion is moving towards the end of the cycle, another is that the quantitative tightening of G3 Central banks is accelerating as the ECB is set to end its asset purchases. Meanwhile, geopolitical noise is likely to remain high and fuel volatility. The unpredictable nature of US economic policy is itself a major source of volatility for EM.

Amid higher volatility, we nonetheless expect the global environment to turn more positive for EM debt in 2019. The large moves we saw in US short rates in 2018 are unlikely to be repeated in 2019 as the Fed moves to pause resulting from the US policy rate having now moved closer to the neutral rate. As for global and Chinese growth, we expect a slower pace of expansion in the near term, but no recession is in sight as overall global growth remains robust. Among EMs we expect to see a recovery of growth in selected countries over the next two years, particularly in Latin America and would expect EM growth to pick up relative to developed market (DM) growth as US growth falls closer to potential.

Regarding global trade, we believe that a fairly bearish scenario has been priced into markets, but with the recent de-escalation of the US-China trade war we should see sentiment improve, especially as far as EMs are concerned. Nonetheless, US-China economic tensions will not disappear but remain a potential source of geopolitical risk.

Chart 1: Trade war in google



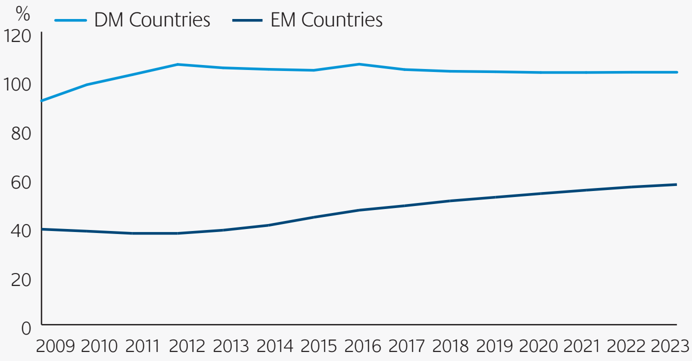
Source: Google

*Numbers represent search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. A score of 0 means there was not enough data for this term.

EM fundamentals - Balance sheets, policy and politics

While it is increasingly difficult to discuss EM countries as a group, given the large and growing diversity of EM countries which have issued US$ debt, debt levels in most EM countries are still relatively low at 51% of GDP (see IMF projection) and are bolstered by strong reserve positions.

Chart 2: Government Gross Debt, 2009-2023 (% of GDP)



Source: IMF Fiscal Monitor, October 2018

Furthermore, many of the EM countries which are most vulnerable to higher US rates and tighter global liquidity have entered International Monetary Foundation (IMF) programs (with Argentina agreeing the largest ever IMF program in September) where reforms are a condition of IMF disbursements.

We expect that future economic and asset price performance among EM countries will be varied; thus careful and forward-looking country analysis will be rewarded in a market with such performance dispersion. We currently prefer quality investment grade credits such as Bermuda, Kazakhstan and Qatar and are more cautious on Mexico, where we could see a deterioration of policy under the new president. We are selective in higher-yield credits where we prefer short-dated bonds with less volatility. High-yield credits, where we see stable to improving fundamentals, which are not yet fully priced in are the Dominican Republic, Paraguay, Serbia, Croatia and Azerbaijan.

The main performance differentiators will be politics and policy, particularly fiscal policy. This will be in focus in Brazil (pension reform), in Mexico (re-orienting government spending) and in some smaller countries such as Costa Rica, Ecuador and Ghana. In Turkey, we expect monetary policy to remain in the spotlight, as the economy experiences a hard landing.

Regarding politics, Argentina, South Africa, Ukraine, Nigeria and Indonesia among others will see elections. While a Jokowi win is likely in Indonesia, election outcomes in Argentina and Ukraine are more uncertain. If President Macri can recover some of his popularity, Argentine assets could perform strongly, as the market would price in a continuation of policy normalization and the prospect of capital inflows.

EM valuations

EM debt started 2018, with a yield to maturity (JPMorgan EMBI Global Div.) of 5.3% and a risk premium of 285bps. At the end of 2018, the yield to maturity is now close to 7% and the risk premium (spread) has risen to 415bps, so the asset class has re-priced substantially and entry levels look a lot more compelling than at the start of the year when valuations were stretched. We believe that the outlook for the total return of the asset class for the year is positive, as a substantial rise in the overall EM yield would be necessary in 2019 to erode the carry provided by the now much higher running yield.

Chart 3: Substantial re-pricing of EM debt in 2018: EM debt yield

Source: Bloomberg

EM debt also looks attractive relative to other fixed income asset classes, and particularly US High Yield. Given that EM debt consists of roughly 50% debt with investment grade rating and 50% debt with high-yield rating, the risk premium of EM relative to US HY looks large from a historical perspective.

EM technical position

2018 saw more than $140 billion of EM issuance, after a record issuance of $182 billion in 2017. We expect much more subdued issuance levels in 2019, as large 2018 issuers like Argentina will not issue debt. Market estimates for gross issuance in 2019 vary between $110 to $125 billion. Given that EM countries have large repayments and amortizations, in 2019 net issuance is anticipated to be much lower than in the last three years. This should create a much more positive technical backdrop for the asset class.

In terms of flows into and out of the asset class, flow data seems to indicate that there were outflows from retail investors, but that institutional investors have remained invested. Given valuations and an improved global backdrop for EM, we would expect that dynamic to continue.

As mentioned earlier, we believe that EM valuations look attractive given EM fundamentals, a more positive technical situation in 2019 with subdued gross and net issuance and a less challenging global backdrop for the asset class. The higher dispersion of country returns gives active managers opportunities to take advantage of market overreactions and dislocations.

For further institutional enquiries contact institutionalenquiries@firststate.co.uk

For wholesale enquiries contact enquiries@firststate.co.uk

MAR000389_EU/UK_12/18