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EMERGING MARKETS OUTLOOK 2018

2017 Review

2017 was another strong year for emerging market (EM) fixed income, with markets reflecting a continued improvement in EM fundamentals, after an inflection point in early 2016. Overall in 2017, local debt was the best performing segment in EM (up 15% - JPM GBI EM GD), followed by external debt (up 10% - JPM EMBI GD) and corporate debt (up 8% - JPM CEMBI BD).

2017 turned out to be a repeat of 2016 in many ways. Much like 2016, most of the sources of risk we identified at the start of the year failed to have a significant impact on the market - unable to derail the powerful bull market and ongoing search for yield.

One of our key risks for 2017 was US protectionism, yet so far the US administration has been quite pragmatic, and the only noticeable impact has been on the Mexican peso, having underperformed the rest of the market since NAFTA re-negotiations started in August.

At the start of the year, we also had concerns about the evolution of government policy in China. The focus on domestic stability, and the preference for quality over quantity of growth meant that the authorities could well miscalculate the appropriate response to signs of economic trouble. This risk could have taken the form of a significant slow-down followed by an excessive reflation of asset bubbles, leaving the economy with higher leverage and hence more fragile than before. Fortunately, the slow tightening of monetary conditions and the crackdown on wealth management products and shadow banking has gone smoothly and did not trigger any market panic.

On North Korea, we were concerned that the Trump administration could retaliate against the rogue state, and thus trigger a crisis in Sino-American relations. Ultimately, the US pushed hard to tighten sanctions and even deployed some Navy forces in the area, but escalation was avoided.

The year also brought another wave of political risks in Europe, yet none of them materialized. French elections didn't lead to the far-right euro-sceptic National Front taking power; the traditional parties were severely sanctioned as expected but the void was filled, against the odds, by a pro-European centrist movement lead by Emmanuel Macron. Later in the year, stability ultimately prevailed in Germany. Merkel's position was undeniably weakened as her generous immigration policy faced some resistance, but in the absence of any strong challenger, she has remained Chancellor (but as of yet been unable to form a Government). Ultimately, from being a source of concern at the start of the year, Europe became synonymous with stability and strong economic growth.

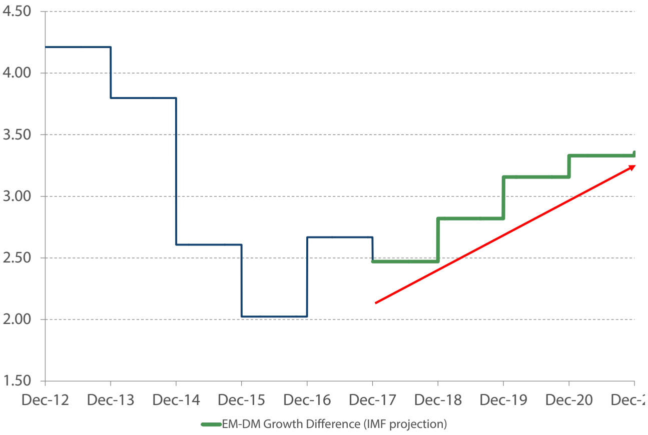
Finally, in EM, Turkey and South Africa delivered their typical share of surprise and volatility. Turkey's economy has been overstimulated by cheap and easy credit and now needs tighter monetary conditions to anchor inflation expectations. The reluctance to do so by the Central Bank has led to renewed pressure on the currency and market confidence can now only be restored by a decisive rate hike. South Africa had a rollercoaster year as well. Standard & Poor's downgraded the country rating to junk at the end of November on concerns over the lack of fiscal discipline. Then mid-December Cyril Ramaphosa, the market friendly anti-corruption candidate, was elected as the new ANC leader, bringing renewed hope that the incumbent ANC president, Jacob Zuma, could step down early and hence lead to a more lenient stance from rating agencies.

Going into 2018…

In our view, EM fixed income assets will continue to be driven by the interaction between two strong thematics: EM growth dynamics and the pace of US interest rate rises. With the global economy forecast to deliver another year of above-potential growth, the gap between EM and DM growth is again expected to widen. Risks to monitor for EM asset returns continue to be the pace of US rate hikes, particularly at points when faster than expected Fed hikes and a stronger dollar could raise questions of EM vulnerabilities. Although we see the asset class as being generally much less susceptible to "tantrum" concerns given the reduction of macro fragilities since 2013, there are still countries with weaknesses, and there will be times when we could see some consolidation taking place in certain local markets.

EM growth is forecast to be slightly higher than in 2017, at just below 5%. Despite China being projected to slow down further this year, EM ex-China should improve significantly, driven mainly by a continued recovery in domestic demand. A wider EM-DM growth differential should continue to support foreign direct investments (FDIs) and portfolio flows into the asset class. As in 2017, strong inflows should continue to provide a backstop when risk aversion materializes, as substantial amounts of money remains waiting on the side-line, as investors hope for better entry levels.

Chart 1: EM-DM Growth Difference (IMF Projection):

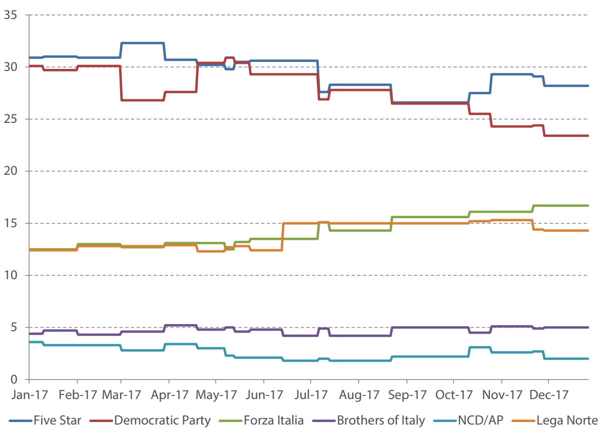


Source: Nikko AM, Bloomberg

EM inflation should finally start to move higher in 2018, but the increase will not be broad-based. After declining steadily from a peak of over 6% in 2011, EM inflation troughed below 3% mid-2017 and likely ended the year slightly above 3%. This trend should continue into 2018, driven by three factors. Firstly, the unwinding of food and energy price disinflation during the first half of 2017; secondly, indirect tax hikes in a number of countries; and thirdly, sticky core prints among low-yielders on the back of closing output gaps. The end of disinflation will also see monetary policy divergence within EM. It is likely that low yielding countries will be the first to hike their policy rates to restore positive real yields, on the back of rising DM rates.

Finally, heavy election calendars in all three regions will create uncertainty for the otherwise positive economic outlook. In EM Asia, there could be six elections next year. The key votes to watch will be the general elections in Pakistan and local elections in Indonesia. In EMEA, many countries are expected to hold elections next year, but only South Africa will likely have a significant impact on the market. We are also following the Italian elections very closely, as the outcome could have a material impact on the future of the European Union (EU) and hence Central and Eastern European countries. Meanwhile, in the coming year Latin America will witness the heaviest political calendar for many years, where we will see key elections in Brazil, Colombia and Mexico.

Chart 2: Italian Election Polls



Source: Nikko AM, Bloomberg

In summary

We remain highly constructive on EM in 2018, with local debt expected to continue to outperform hard currency debt in the year ahead. Local debt is starting the year with a much higher carry (over 6%) and EM FX should benefit from a number of interest rate hikes, specifically in the low-yielding segment of the asset class. High yielding currencies, on the other hand, will generally continue to benefit from stronger commodities prices, a by-product of the synchronised global growth cycle.

In contrast, we expect that external debt could be negatively impacted by Fed hikes. If we add up the carry, plus a modest currency appreciation, EM local debt performance for 2018 could be close to 10%.

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