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Exploiting the potential of emerging market short-term debt

- Strong economic fundamentals underpin emerging markets.
- Emerging market (EM) debt benefits from a range of positive factors, such as:
 1. Low levels of public, private and corporate debt.
 2. Valuation anomalies relative to developed market debt.
 3. More stable return prospects relative to volatile EM equities.
- Short-term EM debt offers compelling investment opportunities:
 1. Given that QE has increased global inflation risks, short-dated bonds are less exposed to the risk of rising interest rates.
 2. Short-dated EM sovereign and corporate debt markets are very liquid.
 3. Well-diversified portfolios spread risk across many borrowers.

We believe that short-dated EM debt offers compelling investment opportunities, enabling bond investors to capitalize on the potential of developing countries with some protection from the inflation risks that massive levels of global quantitative easing could ignite.

Investors are generally well versed in the long-term positive fundamentals driving emerging markets; many economies have strong economic fundamentals, with robust levels of growth, low levels of debt relative to their developed peers, competitive labour costs and favourable demographic profiles. However, given that there are still some lingering uncertainties in the global economic outlook, the key question is how to capture the potential of emerging markets' growth without taking on excessive risks in the risk on/risk off environment.

We believe that for those investors prepared to accept some degree of risk by investing in emerging economies, EM bond markets offer attractive potential returns, with considerable valuation anomalies relative to developed market debt. Emerging economies generally bear lower levels of public, private and corporate debt than their developed counterparts, while corporates benefit from the supportive backdrop of high levels of economic growth in their domestic and local markets. Additionally, the emergence of the consumer class in many EM countries looks set to continue to present opportunities for companies to tap into rising levels of disposable income. Meanwhile, EM debt markets offer investors the prospect of more stable returns relative to the more volatile EM equity markets.

Macroeconomic uncertainties will undoubtedly continue to affect financial markets in 2013. However, at least some of the extreme outcomes that investors feared in 2012 – such as the Chinese leadership change, a complete and disorderly breakup of the eurozone and the US fiscal cliff – are now much less of a concern than they were previously. We have held a very cautious view of the global economy for some time and we expect that the economic outlook will remain challenging in 2013, with the overhang of debt across many of the developed economies set to cast its heavy shadow for an extended period.

On a more positive note, we believe there may be grounds for expecting some further improvement in macro data in the near future. In the US, there have been a number of better-than-expected data released recently, with third quarter GDP revised up from 2.7% to 3.1% on an annualised basis and the jobless rate sliding to a four-year low of 7.8%. Meanwhile, the housing market is showing further signs of recovery, even before any uplift from the Fed's QE3 commitment to pursue large-scale purchases of mortgage debt – using newly-created money - until the jobs market improves significantly. The announcement of recent measures to tackle the US fiscal cliff is also supportive and may release some pent-up demand in the more predictable environment that should follow. Against this rather more benign backdrop, we believe that the prospect of a further recovery in investors' appetite for risk is likely to be of particular benefit to emerging markets.

While global interest rates look set to remain low for the time being as policymakers struggle to boost the sluggish global economy, central banks, principally the Fed, have also embarked on unprecedented levels of money creation via QE. Given the unknown and potentially serious long-term inflationary effects of on-going QE – both on developed and emerging economies - we believe that a focus on short duration debt should provide investors with some protection from the risk of higher-than-expected inflation problems impacting on global debt markets, with less exposure to the risk of rising interest rates than longer-dated debt. While we cannot predict with any certainty when precisely G3 bond yields will rise significantly and inflationary worries will return in earnest, we believe that longer-dated bonds remain much more vulnerable than short-term debt as the real cost of QE becomes apparent over a longer timeframe.

Moreover, in addition to the reduced duration risk, an actively managed strategy with a diversified portfolio of short-term debt holdings spread across a range of selected sovereign and corporate issuers means significantly reduced exposure to the risk of poor performance – or default - by individual borrowers. We believe that this approach should also provide an attractive level of income relative to portfolios focused solely on government bonds. Short-dated EM debt strategies can offer high levels of yield in the region of 4%, an attractive premium over sovereign bond yields of, for example, 0.35% in the case of 5-year Singapore government bonds.

Although many of the worst-case investment scenarios some had feared in 2012 have been avoided, given ongoing economic uncertainties, we believe that a flexible approach is appropriate when investing in EM debt. By combining investment in both government and corporate bonds, we believe that asset managers have greater scope to deliver attractive risk-adjusted returns. For example, with improving global economic data now reflecting the unprecedented support lent by central banks in 2012, should growth rebound ahead of forecasts, asset managers have the flexibility to focus on corporate debt, an area that should outperform government bonds as investors' rising risk appetite is reflected in narrower spreads between government and corporate bonds. However, should economic conditions weaken unexpectedly and the corporate earnings outlook deteriorate, an active, flexible strategy is essential to provide asset managers with the option to increase exposure to the safe haven of government debt.

Yet even with the EM bond universe, wide disparities exist between the prospects for individual economies, giving active short-term EM debt managers considerable scope to add value through country selection. In country terms, we presently strongly favour

Venezuela, taking the view that the bolivar's likely devaluation this year should prove positive for the fiscal and external accounts as Venezuela's main export earners are priced in dollars whereas expenditure is priced in bolivars.

Conversely, however, we are currently a little more cautious on Brazilian debt as the country is not presently on the credit improvement path that it has been on in recent years. However, we view Mexico as more attractive as we believe that the new government will embark on structural reforms in sectors such as energy, developments that should help Mexico to maintain its growth prospects.

In summary, we believe that EM debt offers investors an opportunity to capitalise on the longer-term competitive advantages of emerging economies. Moreover, we believe that a focus on short-term rather than longer-dated debt can offer the reassurance of a higher degree of protection from the as-yet unknown medium-to-long term inflationary consequences of the wave of money electronically-created by leading global central banks.

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