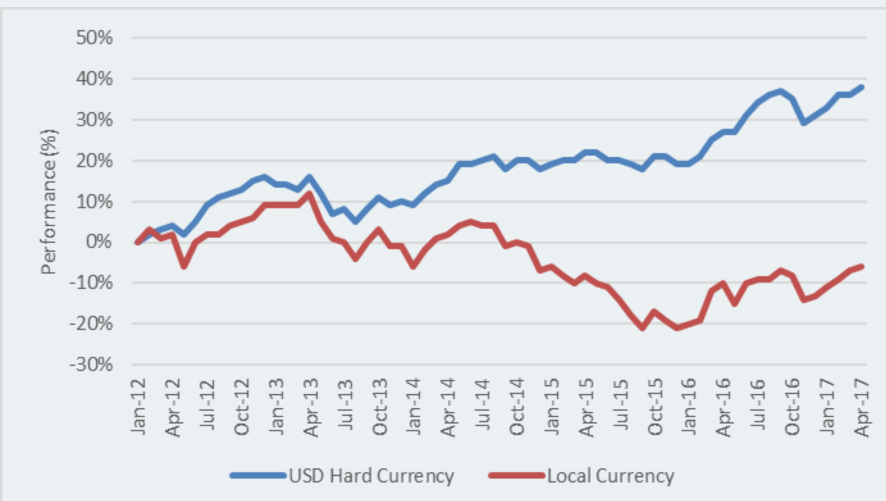
Local Currency Emerging Markets Debt:

Why Now May Be the Time to Opportunistically Invest.

U.S. Dollar Hard Currency Emerging Markets Debt has had a strong run over the last five years, pushing up valuations on both an absolute basis and relative to the local currency sector. However, given current valuations and a shifting global environment, Yong Zhu, Senior Portfolio Manager for DuPont Capital's opportunistic Emerging Markets Debt strategy, has indicated he is finding an increasing number of attractive investment opportunities within local currency. Below, Mr. Zhu outlines why he believes local bonds in Brazil, Mexico, and some Eastern European countries have become more desirable.

- **Attractive Valuations.** The USD space has significantly outperformed local currency over the last five years (see chart below). Hard currency and local returns were fairly synchronized leading up to this period, but began to diverge in 2013 when emerging market currencies took a significant hit. The dispersion in returns continued to widen over the next five years, settling at around 50% at the close of 2016. As a result, the risk adjusted return potential of local currency bonds in some markets is now more attractive than USD bonds on a relative basis.



Source: JP Morgan

- **Improving Fundamentals.** While in aggregate, the local currency market is undervalued, investors should be cautious of the investments they select. Currencies can be cheap for a reason, especially within emerging economies, highlighting the importance of understanding the risk characteristics and underlying fundamentals.

  Within Emerging Markets, the Russian and Brazilian economies are currently on a positive trajectory. Brazil's new administration has pushed through significant structural reforms that are key to long-term debt stability and growth. The country has achieved macro stability with lower inflation, an improving trade surplus, and recovery in the currency. Russia bottomed out with the low in oil prices and is now benefitting from the recent

Yong Zhu, PhD, CFA

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Mr. Zhu is a member of the CFA Society of Philadelphia, and a member of the CFA Institute.

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Select opportunities are emerging from the local currency Emerging Markets Debt sector following an extended period of weak performance and improving fundamentals in many emerging economies.

recovery. Many Eastern Europe countries have benefited from competitive currency dynamics and the Euro Zone recovery.

From a global perspective, growth has improved over the last year. Investors are optimistic about the U.S. pro-business, pro-growth agenda. Europe is weathering its challenges and China's risk of a hard landing remains small. In aggregate, these trends contribute to a more favorable growth environment for emerging market economies.

- **Political Risks Likely Already Priced-in.** Currency markets appear to have already priced in the most prominent political risks, including Brexit or potential changes to U.S. trade policy. In addition, while protectionist trade policy reforms were a staple of the Trump campaign, Mr. Zhu believes the administration is cognizant of the balance between currency strength and job creation. To create additional manufacturing jobs domestically and fuel economic growth, it will be important to temper any further appreciation of the dollar. A stabilizing dollar improves the outlook for emerging markets, particularly local currency bonds.

Despite the more favorable conditions for local currency bonds, Mr. Zhu stresses that investing in the space can be tricky due to the wide ranges within which Emerging Market currencies can fluctuate. He continues to stress the importance of thorough research to assess both a country's overall credit fundamentals and valuations for EMD bonds in both hard and local currencies. Mr. Zhu and his team maintain their view that opportunistic investing across both EMD sectors offers the best long-term risk adjusted return potential, and stand prepared to adjust portfolio exposures as warranted.

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