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.
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 political 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.

Source: Nikko AM, Bloomberg

**Chart 2: Italian Election Polls**

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%.

**Important Information**

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (Nikko AM) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or circumstances as may be permitted by applicable laws. This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM’s investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor a guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

**Japan:** The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association/Japan Securities Dealers Association.
United Kingdom and rest of Europe: This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

United States: This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity.

Singapore: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you.

Hong Kong: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong.

Australia: Nikko AM Limited ABN 99 003 376 252 (Nikko AM Australia) is responsible for the distribution of this information in Australia. Nikko AM Australia holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice.

New Zealand: Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme and the Nikko AM NZ Wholesale Investment Scheme. This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor’s objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or that have not taken advice from their investment adviser, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website www.nikkoam.co.nz).

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategies has not been licensed for offering in Kuwait by the Kuwait Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME. This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Bank group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document neither constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies Law of Oman (Royal decree 4/17A) or the Capital Markets Law of Oman (Royal Decree80/98, nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein is not constitute a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.
The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.