Market review

The deterioration of the global macro backdrop combined with major central banks signaling monetary accommodation weighed on the positive sentiment on risk assets, making total returns in emerging markets (EM) positive in aggregate this quarter. The JPMorgan EMBI Global Diversified Index ("Index") returned 4.08% in the second quarter with sovereign spreads tightening 5 basis points (bps) to 346 bps over US Treasuries. The benchmark 10-year US Treasury yield declined 40 bps to 2.01% at month end down from 2.41% at the beginning of the quarter. The JPMorgan Corporate EMBI Broad Diversified Index delivered 3.50% this quarter. Emerging market stocks (MSCI EM) returned -0.31% reflecting the uncertainty surrounding the trade tensions between US and China, and lagging developed market global equities. The US Federal Reserve decided to leave policy rates unchanged this quarter while communicating readiness to cut rates for the first time since Q4 2015 if the economic outlook deteriorates. The much anticipated meeting between President Trump and President Xi at the G-20 summit in Osaka was not negatively received by the global financial markets. The US will hold off raising tariffs on Chinese imports while negotiations to end the trade war between the two largest economies continues. Slowing global growth and trade was weighed on energy prices with Brent oil posting modest quarterly decline of -2.69%, closing at $66.55/barrel. EM bond funds witnessed noticeable inflows of $10.4 billion, particularly into hard currency debt, while EM equity redemptions were $20.2 billion. Within the EM hard currency sovereign segment, investment grade (+4.73%) outperformed high yield (+3.46%). The investment grade and high yield component of the Index tightened 8 bps and widened 14 bps, respectively. On a quarterly total return basis, Mozambique (+17.09%), Ukraine (+10.18%), and Tunisia (+8.62%) were the best performing countries, while Venezuela (-33.16%), Zambia (-5.69%), and Suriname (-3.06%) with negative returns underperformed the rest of the countries in the Index. Mozambique announced a revised agreement in principle to restructure its external debt obligations. Venezuela was placed on index watch for exclusion due to US Treasury OFAC sanctions that resulted in market disruption. In EM local debt markets, the JPMorgan GB-EM Global Diversified Index (unhedged, in US dollars) returned 5.64%. The best and worst local markets performers were Russia (+10.35%) and Argentina (-4.95%), respectively. In Russia, the VAT hike in January has more than offset the hit to the fiscal accounts from lower oil prices, increasing the budget surplus. The tail risks in the political outlook for Argentina have remained elevated. This has resulted in Argentine Peso FX instability and a rise in inflation expectation, particularly for food items. Other notable local markets performers were Turkey (+10.06%) and Uruguay (-2.27%).

Performance review

The Emerging Markets Global Diversified composite returned 3.79% gross, 3.64% net of fees in the second quarter. The composite underperformed the JPMorgan EMBI Global Diversified Index by 29 bps gross, 44 bps net of fees. Country allocation detracted 10 bps and security selection of 19 bps in excess gross underperformance. The largest contributors to relative performance were positions in Mexico, Indonesia and United Arab Emirates. Mexican relative valuations have improved this quarter, after valuations became historically cheap following negative rating actions from Moody’s and Fitch. The largest detractors to relative performance were Argentina, Uruguay and Russia. Within Argentina, the Fund positioning in Argentine provincial debt of Buenos Aires detracted 6 bps of excess performance. The top three largest country exposures (MV) are Mexico, China, and Ukraine; while the three smallest country exposures (MV) are Serbia, Mozambique, and Cameroon.

Market outlook

Central banks in developed markets and emerging markets have signaled readiness to support the deteriorating global macro backdrop. Emerging markets hard currency Index (+11.31%) have had a strong year; driven by declining US Treasury yields (-68 bps) equally matched by tightening of EM sovereign spreads (-69 bps) this year. Falling inflation expectations and the dovish tone of the Federal Reserve will support risk assets and weaker US dollar. Sovereign fundamentals continue to improve on the margin, aided by structural reforms, prudent fiscal, and dovish monetary policy stance of emerging markets central banks. China is providing significant fiscal and monetary stimulus to alleviate a slowdown in economic activity and this should be supportive of commodity and emerging markets asset class. Country-specific factors will be pivotal in sovereign allocation and security selection, given the political and geopolitical credit events over the coming months. Additionally, emerging markets may face headwinds from global growth weakness, strengthening of the US dollar, and uncertainty of trade tensions between the US and China. US Treasury yields and trade sentiment continue to be primary drivers of EM sentiment and broader risk assets. Hard currency EM fixed income asset valuation (EM Sovereign +346 bps; EM Corporate +333 bps) require validation by trajectory of EM fundamental outlook. We are constructive on the emerging market asset class.
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For comparison purposes, the composite is measured against the JPMorgan EMBI (Emerging Markets Bond Index) Global Diversified, which is comprised of predominantly sovereign and quasi-sovereign bonds denominated in US dollars.

The U.S. dollar is the currency used to express performance. Returns are presented gross and net of management fees and performance-based fees and include the reinvestment of all income.

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