INSIGHT

VIEWPOINT

Opportunities in EM Local Currency Debt

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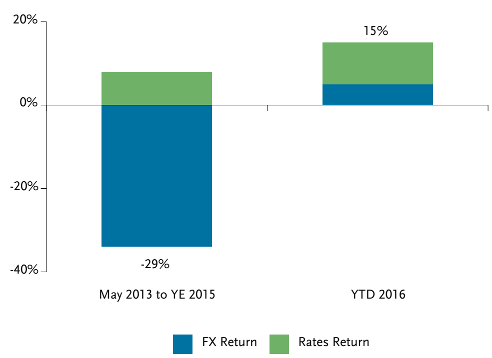
The "taper tantrum" which kicked off in May 2013 drove a multi-year depreciation of Emerging Market currencies (EMFX) versus the US dollar. This resulted in a return of -29.2% for the GBI EM Global Diversified (EM local currency index, "GBI-EM GD") from May 2013 through the end of 2015, with all of the gains from local rates (+7.8%) erased by currency losses. We have seen a reversal of this trend in 2016, with most major EMFX markets recovering. Year to date through August 31st, 2016, the GBI-EM GD has returned 14.75%, and has outperformed hard currency EM debt for the first time since 2010.

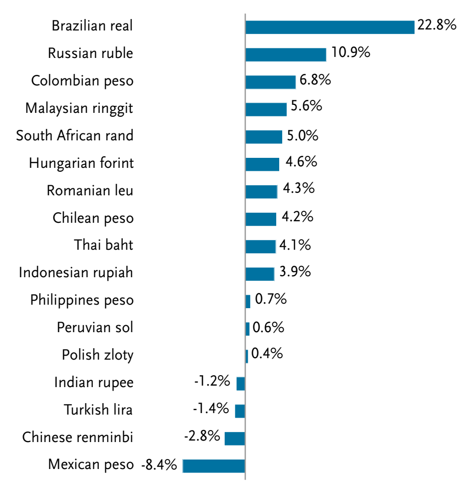
This rebound of course begs the question – is the trade over? Is the worst behind us or are we at risk for another significant depreciation in EMFX? In order to answer these questions, we first briefly examine the risk factors which initially weighed on EM currency markets, and the extent to which those risks have abated. We also provide our outlook on the asset class, exploring shifts in both fundamentals and technicals. In short, we believe that the improved EM growth backdrop, combined with attractive carry, stable currencies, and healthy technicals has created attractive opportunities in EM local currency debt, even with this year's rebound. We see this as a long-term opportunity, and would take advantage of any sell-offs (for example those related to concerns around a more aggressive Fed) to tactically add risk. Also, while in this piece we focus on the broader market opportunity, keep in mind that differentiating between local markets is still critical, with country selection remaining one of the most important elements of investing in this asset class.

FX Depreciation Weighed on EM Local Currency Debt in 2015, Followed by a Rebound in 2016



Source: TCW EM Research, JP Morgan; Data as of August 31, 2016

Year-to-Date EM Currency Returns



Source: Bloomberg; Data as of August 31, 2016

The "Perfect Storm"

The main drivers of the EMFX selloff were the following: 1) an unexpected shift in U.S. policy towards higher rates, 2) the end of the commodities "super-cycle", and 3) uncertainties surrounding China's FX policies. In addition, technical positioning was heavy; from the start of 2012 through May 2013, EM local debt funds received $62 billion of inflows, as investors sought out higher yields as developed markets were undergoing extensive QE programs.

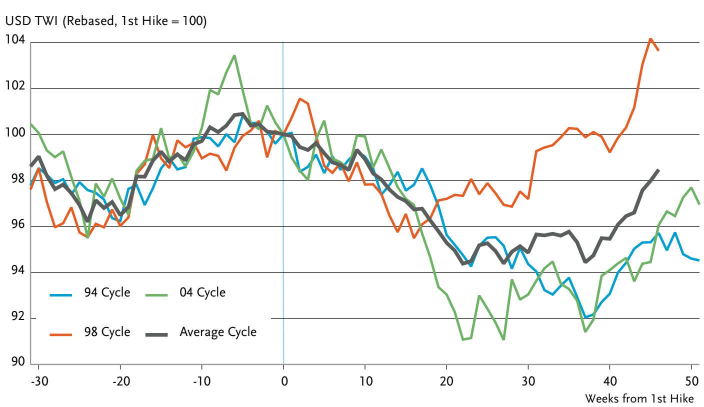
We believe that each of these risks has abated. Consider the following:

1) The USD appreciates in anticipation of the first Fed Hike, but then...

...historically depreciates. The start of this current cycle has proved to be no different, as the USD peaked on a trade-weighted basis just heading into the first rate hike in December 2015 but has since given back 5% of those gains. In other words, the bulk of dollar strength tends to occur prior to the first rate hike, rather than after.

In addition, the initial fear that this would be the start of an aggressive U.S. rate cycle has waned, and as rate hikes have been priced out of the market, EMFX has rallied. *If Fed policy does indeed follow the market-implied pace of tightening over the coming years, we expect the impact on EMFX to be minimal.*

USD Appreciates Into First Rate Hike, Depreciates After



Source: Morgan Stanley

2) Commodity prices dropped significantly over the past two years, but...

...supply side adjustments to lower prices have contributed to a better balance of supply and demand in many commodity markets. Put simply, commodity price stabilization is key to EM currency stabilization. We have seen oil markets lead the way, due to their shorter capex cycle. Other commodities have adjusted more slowly given their longer capex cycles and the cost of capacity shutdowns, but in most of these markets we are starting to see stabilization.

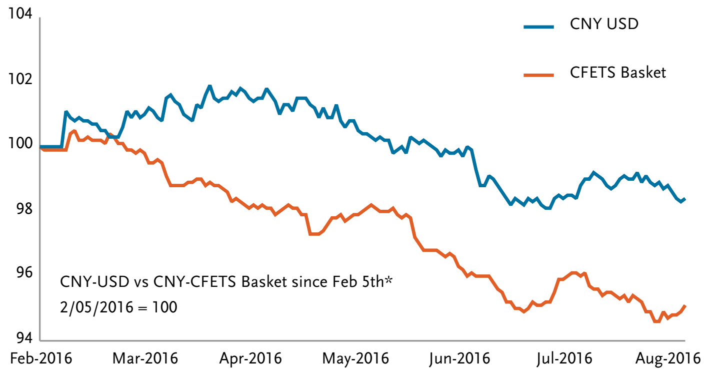
While we don't expect commodity markets to retest the historical highs anytime soon, we do believe that we have hit a floor, particularly in energy, given the supply/demand adjustments that have occurred.

3) The markets worried that China will both want and need to allow the CNY to depreciate significantly, but then...

...earlier this year, the Chinese authorities reduced the uncertainty around their FX policies, by managing an orderly depreciation of their currency and lessening outflow pressures. The fears of a potential "mega-depreciation" of the Chinese renminbi had helped drive other EMFX markets weaker in anticipation of the impact that a sharp devaluation of the renminbi would have on the global economy. Currencies in countries that sold to the Chinese market (commodities/consumer goods) and/or competed against Chinese exporters were considered particularly vulnerable.

A statement clarifying policy in December 2015, together with FX management in early 2016, made it apparent that the Chinese authorities were not targeting CNY depreciation vs the USD, but rather managing the CNY against a trade-weighted basket of currencies. Since the peak of market uncertainty in February, the CNY has only depreciated by 0.8% vs the USD, even as it lost 4.7% versus the trade weighted basket, and the pace of FX outflows has slowed significantly. *Given the strong focus on maintaining stability into China's Party Congress in the fall of 2017, we expect the tail risk of an aggressive devaluation for the CNY to be limited and believe that EM FX markets are unlikely to react to moderate CNY depreciation from here unless capital outflows reaccelerate.*

China has allowed the renminbi to deviate from the basket in order to maintain CNY USD stability



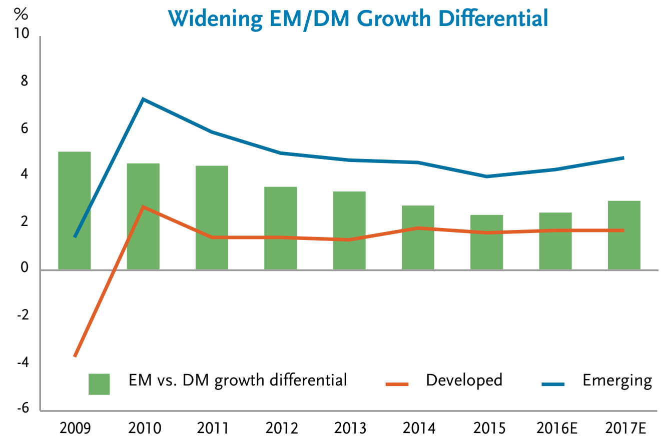
Source: Standard Chartered, Bloomberg; Data as of August 31, 2016
* China Foreign Exchange Trade System (CFETS) remnibi index, a thirteen currency basket comprised of the currencies of China's main trading partners and weighted based upon the relative size and importance of China's total trade with those partners. The PBOC announced in December 2015 that it would manage CNY exchange rates according to the CFETS index.

The Calm After the Storm?

With many of the recent headwinds having passed, can EMFX rally further in the calm after the storm? We believe there is upside potential, even after this year's rebound, for several reasons:

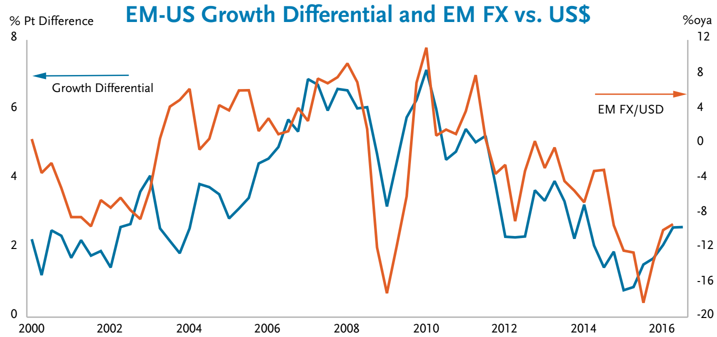
- **Improving fundamentals:** We are starting to see signs of improving EM growth as a number of large economies (Brazil, Russia) appear to be bottoming out. In addition, the differential between EM growth and DM growth is widening. Historically, this has been positively correlated with EMFX outperformance versus the dollar.
- **EM inflation appears to have peaked, allowing for central bank easing:** Inflation in emerging market economies has been declining since the fall of 2015, and we expect it to continue to do so. This has allowed EM central banks to remain accommodative; almost all major EM economies are in an easing cycle or are keeping rates on hold, allowing for increased economic growth potential.
- **Attractive valuations:** Average real rates in EM are much higher than DM; 1.6% vs 0.3% respectively. In addition, close to 70% of developed market fixed income trades with yields below 2%. Furthermore, many major asset classes are trading at the tight end of their ranges, as opposed to EM local currency debt. With average yields of 6%, we believe that EM local currency debt looks attractive relative to DM fixed income.
- **Supportive technicals:** Most institutions remain underweight EM debt, and retail investors largely exited the market in the 2013-2014 time frame. Even with the inflows this year, positioning remains light. In this low growth/low yielding environment, the search for yield by global investors bodes well for EM local currency markets, particularly as EM fundamentals improve.

Widening EM/DM Growth Differential



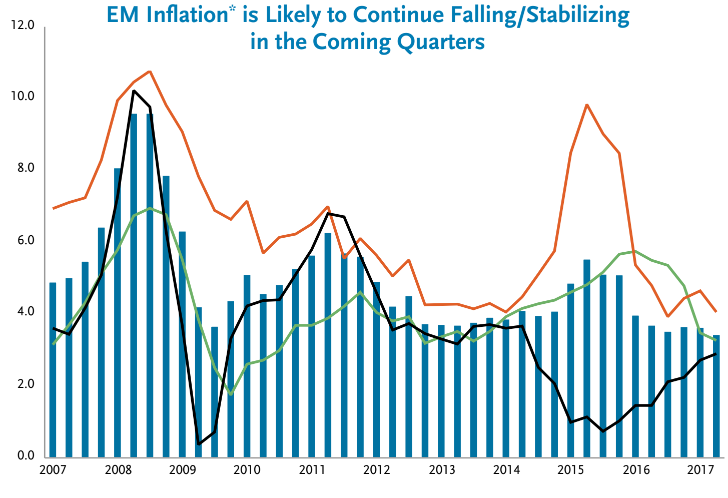
Source: TCW Emerging Markets Research; Data as of August 31, 2016

EM-US Growth Differential and EM FX vs. US$



Source: JP Morgan; Data August 15, 2016

EM Inflation* is Likely to Continue Falling/Stabilizing in the Coming Quarters



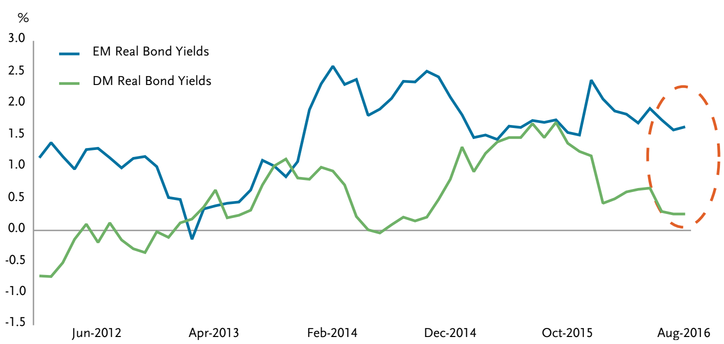
Source: Thomson Reuters Datastream, Bloomberg, HSBC; Data as of August 31, 2016
* Ex-Argentina and Venezuela

TCW

Policy Rate Expectations

EASING	NEUTRAL	HIKING
Argentina	Chile	Mexico
Brazil	Hungary	
China	Peru	
Colombia	Philippines	
India	Poland	
Indonesia	Romania	
Korea	South Africa	
Malaysia	Thailand	
Russia		
Turkey		

Real Rates in EM[1] are Much Higher Than Those of DM[2]



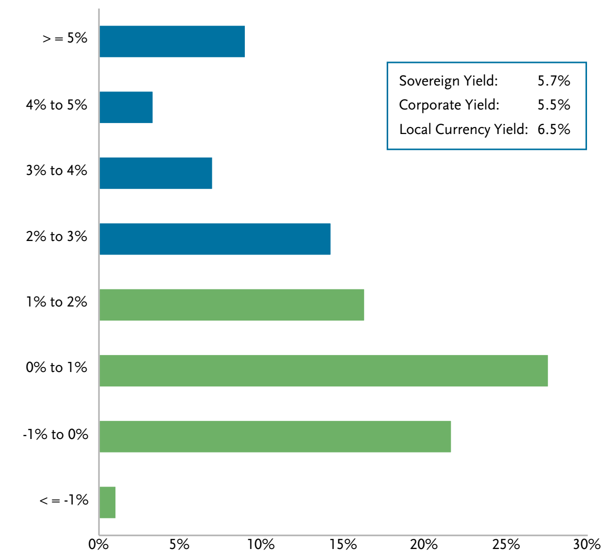
Source: Bloomberg, HSBC; Data as of July 31, 2016. 1 PPP-weighted average for Brazil, China, India, Indonesia, Mexico, Poland, South Africa, and Turkey. 2 PPP-weighted average for Germany, Japan, U.S., and UK.

Yield Ranges

	8/31/16	12/31/15	Range since Jan 2012 Low	○ 12/31/15 ◆ 8/31/16	High	Current Percentile vs. Range
GBI-EM GD	6.29	7.13	5.16		7.27	53%
US HY	6.75	9.28	5.03		10.44	32%
EMBI GD	4.98	6.39	4.33		6.78	27%
MBS	2.02	2.73	1.58		3.45	24%
CEMBI BD	4.87	6.42	4.43		6.71	19%
10y JGB	-0.07	0.26	-0.30		1.05	17%
10y UST	1.58	2.27	1.36		3.03	13%
10y Bunds	-0.07	0.63	-0.19		2.05	5%
10y Gilts	0.64	1.96	0.52		3.07	5%
Munis	1.66	2.11	1.57		3.43	5%
Euro HY	3.93	5.78	3.84		9.84	2%
Euro IG	0.55	1.22	0.48		3.76	2%
JULI	3.29	4.29	3.26		4.48	2%

Source: JP Morgan; Data as of August 31, 2016

Nearly 68% of Global Fixed Income Yields 2% or Lower



Source: Standard Chartered; Data as of August 12, 2016

Bottom Line: Currency weakness drove significant underperformance in EM local currency debt in the May 2013-December 2015 time frame. In addition, currency volatility also discouraged inflows into the asset class. We have started to see a reversal of this trend in 2016, as commodities have stabilized, China fears have abated and the U.S. rate hiking cycle appears manageable. We believe that there is continued potential for upside as the EM growth backdrop improves. After several years of underperformance, this asset class is worth revisiting, and we have started to opportunistically increase our allocation to local currency debt in our EM total return portfolios. Country selection will remain critical, however, as we are not calling for upside across the board, but rather in those sovereigns where any mix of the following are underway: 1) improving fundamentals, 2) positive structural reforms, and/or 3) positive political change. ■

Opportunities in EM Local Currency Debt

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Mr. Lee is responsible for emerging markets currency strategy and trading. Prior to joining TCW, Mr. Lee was a Director at Standard Chartered Bank in New York, where he oversaw Asian foreign exchange trading. Before Standard Chartered, he was Head of Local Markets Trading in Asia for Commerzbank. Jae started his career at Bank of America Merrill Lynch where he held FX and Rates trading positions in New York, Hong Kong and Singapore. Mr. Lee is a graduate of Georgetown University, where he received a bachelor's degree in finance, as well as a master's degree in international relations.

Anisha A. Goodly
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Emerging Markets Portfolio Specialist

Ms. Goodly is the Portfolio Specialist for the TCW Emerging Markets group, which includes the Emerging Markets Fixed Income, Emerging Markets Local Currency Income, and Worldwide Opportunities strategies. In this role, she serves as the primary liaison between TCW's Emerging Markets investment team and TCW's client relations and marketing professionals. Prior to joining TCW in 2013, Ms. Goodly spent eleven years at Morgan Stanley, most recently as one of the firm's top-producing EM Fixed Income salespersons. At Morgan Stanley, she also served as the Asia Credit Product Manager, marketing Asian credit products globally to the firm's largest institutional clients. In addition, she spent several years working as part of Morgan Stanley's Institutional Investor-ranked U.S. Credit Strategy research team. Ms. Goodly currently serves on the board of Consano. Ms. Goodly graduated with a BA in Economics from Stanford University.

Spencer Rodriguez
Emerging Markets Research Analyst

Mr. Rodriguez joined TCW's Emerging Markets group in 2015,conducting research on sovereign and corporate fixed income securities. He works closely with the analyst and trading teams as well as the portfolio managers. Mr. Rodriguez holds an AB in History with a certificate in Finance from Princeton University. As a student he worked as a summer analyst for the Financial Institutions Group at Barclays Capital in New York. He also worked as a summer analyst for the Zurich Insurance Group in Tokyo, Japan.

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