QUARTERLY COMMENTARY

TCW Emerging Markets Fixed Income

SECOND QUARTER 2019

Performance

For the three months ended June 30, 2019, the TCW Emerging Markets Total Return Strategy ("Strategy") returned 4.34% gross (4.30% net of fees and expenses) versus the JP Morgan Emerging Markets Bond Index Global Diversified ("Index"), which returned 4.08% for the same period. Year-to-date the Strategy returned 12.64% gross (12.36% net of fees and expenses) versus the Index return of 11.31% for the same period.

Outperformance for the quarter was driven by security selection in sovereign dollar-denominated debt, along with off-index allocations to local currency and corporate debt. Long duration positioning relative to the benchmark also contributed to outperformance. From a country perspective, outperformance was driven primarily by 1) security selection in Brazil, with an emphasis on long duration corporates, 2) overweight positioning in Qatar, and 3) overweight positioning and security selection (corporate exposure) in South Africa. Risk aversion in May negatively impacted the portfolio's high yield holdings in particular, but we made this up as sentiment improved in June.

From a regional perspective, we are overweight the Middle East and Africa region. Our overweight to the Middle East is driven by its investment grade ratings plus attractive spreads relative to global investment grade. As for Africa, our investments are generally in countries that are undergoing structural reforms and/or have IMF[1] support, with stable/attractive carry. We are neutral Latin America with overweights in Brazil (continued progress on pension reform) and Argentina (political backdrop has started to improve), against an underweight in Mexico, given our concerns about slower growth, potential policy/institutional deterioration, and the need to support Pemex. Larger underweights are in Asia and Central and Eastern Europe, where the growth backdrop remains weak and spreads are relatively tight.

Almost all of the exposure is in dollar-denominated debt. However, greater signs of U.S. growth slowing could put the dollar under more sustained pressure, which could present opportunities to add local currency exposure in the second half of the year.

Investment Environment

The second quarter was characterized by an escalation in global trade tensions, weaker global growth, and a rise in geopolitical risk. In response, both the Fed[2] and ECB[3] took a sharply dovish turn, helping to offset the impact of these factors. The subsequent rates rally helped support fixed income, including Emerging Markets (EM) debt, with sovereign dollar-denominated debt[4] returning 4.08%, local currency debt[5] returning 5.64%, and corporate debt[6], 3.50%.

Industry Breakdown* (%)

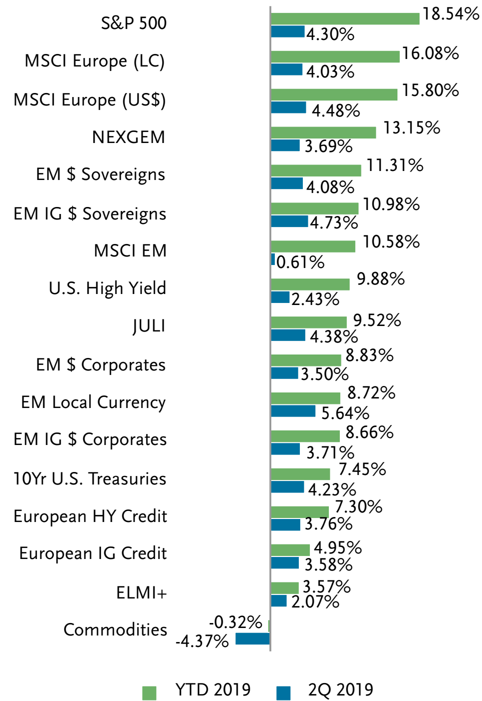
Sovereign	63.05
Oil & Gas	9.60
Metals & Mining	6.20
Financial	5.15
Utilities	3.90
Technology Media & Telecom	2.60
Real Estate	2.11
Transportation	1.49
Infrastructure	1.28
Industrial	1.01
Pulp & Paper	0.90
Consumer Products	0.44

Country Breakdown** (%)

Brazil	7.03	Oman	1.99
Indonesia	6.04	India	1.87
Turkey	4.69	Lebanon	1.68
Russia	4.41	Uruguay	1.66
South Africa	3.89	El Salvador	1.42
Colombia	3.87	Angola	1.36
Saudi Arabia	3.86	Ivory Coast	1.16
Qatar	3.66	Azerbaijan	0.99
Argentina	3.49	Kenya	0.98
Ukraine	3.48	Paraguay	0.92
Sri Lanka	3.38	Venezuela	0.90
Egypt	3.11	Mongolia	0.87
Kazakhstan	2.97	Chile	0.71
Dom. Republic	2.61	Senegal	0.62
Nigeria	2.59	Pakistan	0.62
Panama	2.52	Guatemala	0.61
Ecuador	2.49	Iraq	0.58
Bahrain	2.47	Zambia	0.55
Costa Rica	2.18	UAE	0.40
Ghana	2.14	Tunisia	0.29
China	2.11	Tanzania	0.25
Mexico	2.05	Belarus	0.24
Peru	2.02		

Source: TCW Portfolio Analytics
Portfolio characteristics and holdings are subject to change at any time.
* As a percentage of the total portfolio. Sovereign and cash percentages not shown.
** As a percentage of the total portfolio. Cash percentage not shown.

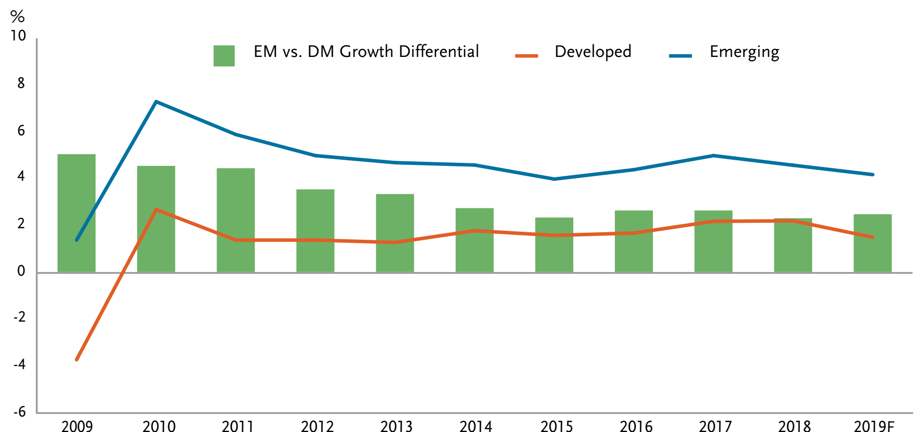
1. International Monetary Fund **2.** Federal Reserve **3**. European Central Bank **4.** JP Morgan EMBI Global Diversified **5.** JP Morgan GBI-EM Global Diversified **6.** JP Morgan CEMBI Broad Diversified



Source: TCW, Bloomberg; Data as of June 28, 2019

We have long stated that a key risk to global markets, in our view, is weaker global growth. At the end of the first quarter, we were starting to see early signs of stabilization in Chinese growth and were awaiting further data to confirm whether this was the start of a true upswing. Since then, Chinese data for April and May has been mixed although largely trending weaker. Additional stimulus measures will likely help offset some of this growth weakness, in our view, to help target growth in the 6-6.5% range. In addition, U.S. growth data prints have started to trend weaker. As such, we have lowered our growth forecasts for 2019 across both Developed Markets (DM) and Emerging Markets, but continue to see an improvement in the growth differential this year and next, which has historically helped provide support for EM.

Spread Between EM and DM Growth Expected to Moderately Improve in 2019



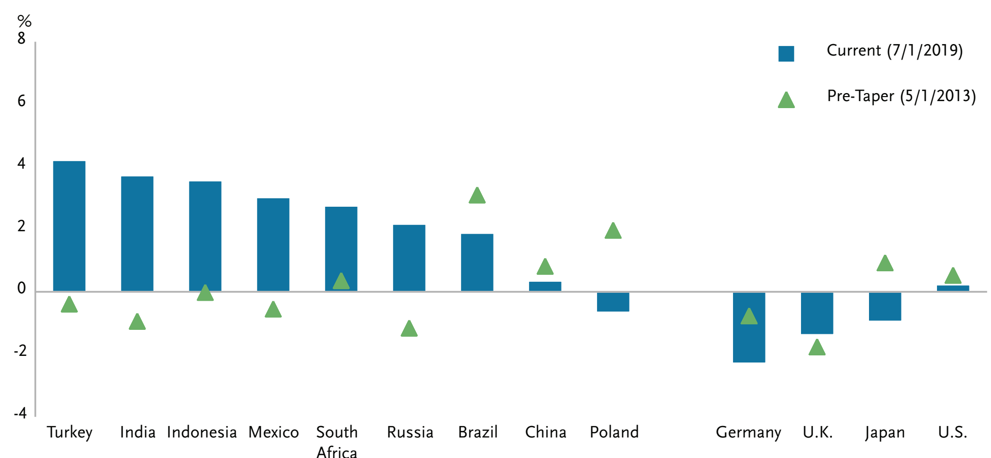
Source: TCW Emerging Markets Research; Data as of June 28, 2019

As for U.S./China trade, despite an agreement to hold off on further tariffs while talks resume, we believe uncertainty is likely to persist and weigh on growth. In addition, we believe that the U.S. administration is likely to further tighten restrictions on trade and investment in technology with China, which will also make it more complicated to finalize a trade deal. While the 'truce' has helped improve risk sentiment and provided some short-term relief, we must acknowledge that talks could fall apart at any time.

As such, we believe the key impact of the trade dispute is likely to come from a reduction in global trade and persistent uncertainty, leading to a deferral of investment. While this will impact the trade contribution to growth for both economies, each is primarily driven by domestic demand (roughly 90% in the case of the U.S. and 85% in the case of China). It will also of course affect economies across global supply chains. Some of the countries most affected – Taiwan, Korea, and Singapore – are not included in our benchmark (JP Morgan EMBI Global Diversified). On the other hand, over the long term, there are potential winners as well, such as Vietnam and India, which could benefit from a shift of productive capacity out of China. Both Brazil and Argentina could be alternative sources for China's agricultural imports from the U.S.

As we have seen, the Fed and ECB have responded to the weaker global growth data with much more accommodative policy, and we believe dovish sentiment will persist despite the recent de-escalation at the G20[7]. This accommodation, combined with the lack of inflationary pressure, should continue to keep global rates low for an extended period and support capital flows into EM. Importantly, increased accommodation from developed market central banks has allowed EM central banks – including China, India, Indonesia and Brazil – to turn more dovish to help counteract growth pressure. Moreover, Emerging Markets have built more of a buffer when compared to past periods of weaker growth. EM real rates are significantly higher today than they were at the start of the 2013 taper tantrum. EM inflation is near recent lows and continued slack in the major EM economies ensures that, while further downside surprises are unlikely, an upsurge in EM inflation is equally remote over the near to intermediate term. Finally, debt/GDP has fallen meaningfully for EM sovereigns (from over 100% in 2000 to approximately 50% today), and the bulk of issuance is denominated in local currency debt, thereby significantly reducing the vulnerability of EM sovereigns to extended periods of global uncertainty.

Real Rates: Taper Tantrum vs. Today*



Source: Bloomberg, TCW Emerging Markets. *Real yields defined as 5 Yr. yields deflated by inflation.

7. G20 is an international forum for the governments and central bank governors from 19 countries and the European Union

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In this low rate environment, the yield advantage that carry investors receive in EM is attractive from a risk/reward perspective. To put this in context, Emerging Markets debt yields on average approximately 5.5%. Currently 50% of global fixed income yields 2% or lower, and close to $13 trillion dollars of government debt trades with negative yields.

From a spread perspective, EM sovereign spreads ended the quarter at approximately 345 basis points (bps), in line with long term averages and around 10bps wide to this year's tights on April 17th. As such, EM sovereign spreads appear to be at fair value. However, when compared to developed markets credit, EM sovereign credit continues to appear cheap, as it is one of the few asset classes that trades in the middle of its post-GFC range, as opposed to on the tighter end.

EM versus DM Spread Ranges

Index	6/28/19	4/17/19	Change	Post-GFC* Range: Tight	Post-GFC* Range: Wide	Current Percentile vs. Range
EMBI GD HY	556	522	34	323	766	53%
EMBI GD	346	336	10	237	507	41%
CEMBI BD	333	318	14	243	611	24%
EMBI GD IG	168	164	3	136	338	16%
JULI ex-EM	141	135	6	106	337	15%
US HY	461	410	51	355	1083	15%
Euro HY	424	402	22	290	1260	14%
Euro IG	72	73	-1	44	249	14%

Source: JP Morgan, Data as of June 28, 2019. *Global Financial Crisis

As for local currency debt, EM real rates remain high relative to DM real rates, and inflation remains low. The key question is when the dollar turns. Our base case is for the dollar to be under pressure as the U.S. slows so long as growth in China and Europe stabilizes or deteriorates at a slower pace. Structural issues facing the U.S. economy – a rising U.S. current account and fiscal deficit – have also been dollar negative historically. Local currency debt outperformed hard currency debt in June by over 200bps, and we believe there will be opportunities to increase exposure in the second half of the year.

At this point, the path of trade policy – and the extent of global growth weakness – remains uncertain. In our view, the low rate environment and relatively stable EM growth metrics will continue to help counteract weaker global growth, helping to justify an allocation to Emerging Market debt. While we would remain nimble in light of potential event risk, we believe there are opportunities in those sovereigns undergoing important economic reforms and corporates which are deleveraging. We believe that investors will continue to look for opportunities to increase exposure, particularly as many remain underweight an asset class that now represents 20% of global fixed income.

Sincerely,

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Source: TCW

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