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Q&A

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Outlook on Emerging Markets
Bonds and Currencies

Portfolio manager Rob Neithart discusses his outlook for emerging markets bonds and currencies

Why have emerging markets fallen so sharply in recent months and where are they headed? Global bond portfolio manager Rob Neithart offers his perspective on the current sell-off and his long-term views on the U.S. dollar and the global economy.



Rob Neithart is a fixed-income portfolio manager with investment management responsibilities in global bond and emerging markets debt portfolios. He has been with the Capital Group for 25 years and is based in Los Angeles.

How do you view the recent sell-off in emerging markets bonds and currencies?

This market sell-off is different from others since the financial crisis of 2008. The previous sell-offs were generally caused by concerns that the global economy would experience a liquidity crunch and enter recession, or that Europe would break up. So, they were based on fears of weaker economic activity, potential default in Europe and more deflationary scenarios.

This most recent sell-off is not due to that at all. No one is forecasting a global recession. This is the first sell-off due to concerns that the U.S. economy might be strong enough to induce a change in policies so that interest rates will be reset and that quantitative easing will be unwound to more normal levels. This sell-off is also very heavily concentrated in the emerging markets and has affected all emerging markets assets – currencies, bonds and stocks.

It is true that growth rates in some major emerging markets economies – China, India, Brazil – have come in lower than consensus forecasts, which has exacerbated the sell-off. On the corporate front, profitability has come under pressure in some sectors and markets.

However, one should keep in mind that, although growth is slowing in several developing economies, it is nothing like it was in 2008. Not even close. It is not as if suddenly the whole growth premise and fundamental thesis of emerging markets has unraveled. Rather, one could say that several of these economies are at different phases of the business and market cycle than the developed markets.

Does that make you a buyer?

Certainly there are pockets of substantial value, given the indiscriminate sell-off. I am increasing investments in several local currency sovereign bond markets. I also think we have to be nimble and tactical to take advantage of some near-term opportunities.

From a medium-term perspective, I am not sure we have seen the dust settle yet. If U.S. rates tighten and capital is flowing back into the U.S, funding will be less readily available. Then, in order to attract the capital that developing economies need, emerging markets bonds may need to settle at higher yields and currencies may reach weaker levels than we have seen in aggregate over the last couple of years. From a secular perspective, even at these higher levels, most emerging markets local bond yields will still be lower than they were prior to the financial crisis.

Investments are not FDIC-insured, nor are they deposits of or guaranteed by a bank or any other entity, so they may lose value.

How do you think about the volatility? Do you worry about it as you increase your investments in these currencies and local currency bonds?

There is no doubt that increased foreign ownership of emerging markets assets has really amplified volatility in recent years. To me, this means that you need to have a higher yield spread or a greater discount in the currencies and local bonds. We try to take advantage of this as long-term investors and go against the prevailing sentiment in the market: we buy when people are selling, or sell when people are buying.

In general, the trend toward greater foreign ownership has made me want to be more diversified and get paid a little bit

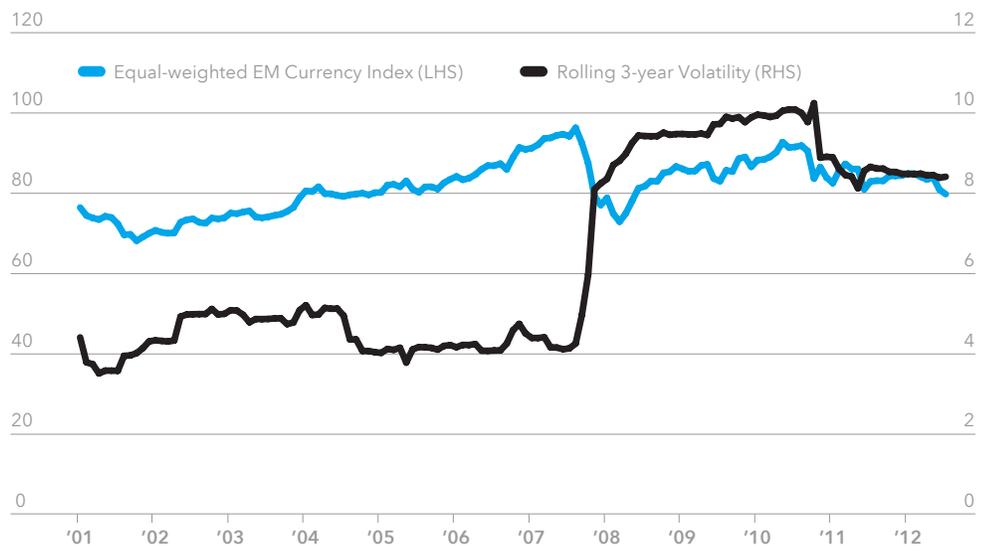
more for investing in the bonds because I realize it can hurt when foreign investors suddenly flee.

Do you think emerging markets interest rates are bound to rise if U.S. rates rise?

If we do see a rise in U.S. rates over the next few years, I do not necessarily think emerging markets rates will follow in lock step. Most emerging markets already have higher real rates than the U.S. does. Since developing economies are not accelerating, they could experience lower inflation than we have seen recently. Valuation norms may change, but because real economy and policy cycles are divergent, there is scope for emerging markets bonds to behave independently over the medium term.

Exhibit 1:
Foreign ownership of emerging markets assets has contributed to higher volatility in emerging markets currencies since the financial crisis of 2008.

Currency returns for a basket of equal-weighted emerging markets currencies versus the U.S. dollar and 3-year rolling volatility for currencies*



Source: Reuters, Capital Group. Data as of June 30, 2013.

*Currency basket includes month-end returns for an equal weighting of the Polish zloty, Czech koruna, Hungarian forint, Russian ruble, Turkish lira, South African rand, Egyptian pound, South Korean won, Thai baht, Malaysian ringgit, Indonesian rupiah, Philippine peso, Mexican peso, Argentine peso, Brazilian real, Colombian peso, Peruvian nuevo sol, Uruguayan peso and Chilean peso. Rebased to 100 as of December 31, 1998.

Outlook on Emerging Markets Bonds and Currencies

"I have been adding to non U.S. dollar exposures because of the dramatic valuation changes in recent weeks. I see better valuations and improved opportunities in total emerging markets debt."

How have recent events affected your investment decisions in the emerging markets debt portfolios you manage as well as Capital World Bond Fund?

In emerging markets debt portfolios, I have been lengthening maturities in local bond markets. I am now comfortable being neutral or even holding a greater relative position in local currency bonds in dedicated emerging markets portfolios because these securities have repriced so dramatically and the yields are attractive. I have not done so in U.S. dollar-denominated bonds because the repricing there is not significant enough for me to want to significantly extend duration, even at current yields in the dollar universe.

I am investing more in local bond markets like Mexico, Turkey and Russia that have been hit very hard. Turkey and Russia are especially attractive from a valuation standpoint. I like Russia. I think it has relatively modest funding needs and even more potential for improvement than Turkey because it is expanding from a lower base.

I have not sold my corporate bond holdings. If I were fearful of a recession or some significant shortfall in growth, then I would probably feel that corporates were overvalued. But I do not think the cyclical backdrop is a real threat to corporate credit quality. In fact, I think it should support it. The corporate bonds that I invest in tend to be somewhere in the mid- to high-quality range.

My approach to Capital World Bond Fund has been somewhat similar. I am lengthening duration in emerging markets bond investments. I also recently invested in Ireland bonds. Among the noncore European sovereigns, I believe Ireland is farther along in its adjustment path and most likely to receive support in a stressed market environment. My most significant investment view is a preference for U.S. dollar assets in general. I have more exposure to the U.S. dollar today than at any time in the past 15-20 years.

In general, how much exposure do you think investors should have to emerging markets in the context of broader global portfolios?

It really depends on what an investor's needs are – how much volatility they are willing to take on in exchange for potentially higher returns. I might compare the risks associated with a pure emerging markets fund to that of a corporate bond strategy with a large allocation to high yield. Returns could certainly suffer in a spread-widening environment like we have seen. But if you are interested in long-run total return and want a little more income, emerging markets debt is an attractive place to invest.

I think global bond portfolios should have considerable exposure to the emerging markets, but that they should not necessarily make up a majority of the portfolio. A true all-sector, all-season, diversified global bond fund will naturally get active exposure to the emerging markets. But emerging markets are only one part of the universe and I do not think investors should expect it to be the majority of the portfolio.

If a fund is heavily invested in emerging markets and they make up the vast majority of the assets, then it is an emerging markets bond fund and should be clearly identified as such, since it would have different volatility and return characteristics. I think it is a matter of knowing what you want and what you are getting.

You have written about the "great global U.S. dollar short of 2013" and how you believe the U.S. dollar is likely to strengthen on a longer-term structural basis. Could you elaborate on this trend and the factors driving it?

I think the evolution of the U.S. economy, combined with heavy borrowing in U.S. dollars by corporations and governments over the last 10 or so years could be more supportive for the dollar going forward. There is a lot of data on the stockpile of dollar liabilities in the global economy.

Outlook on Emerging Markets Bonds and Currencies

We know that the main supply of dollars comes from the U.S. current account. But when you compare that number to the increase in the amount of dollar liabilities over the last 10 years, there appears to have been a much larger increase in dollar liabilities than the dollar supply coming from the U.S. current account would suggest.

So where did those extra dollars come from? It is impossible to know for sure, but anecdotal evidence indicates that there has been very heavy borrowing in dollars by non-U.S. entities, particularly emerging markets corporations that borrowed in dollars because they thought that it was a cheap currency with low funding costs. They expected the currency to depreciate and so they would get the double benefit of lower interest rates while being able to pay everything back at a lower value. That was indeed the case for 10 years. But like all good ideas, it can be pushed too far, leading to imbalances in the financial system that create the potential for a move in the opposite direction.

So, there is the structural argument based on a decade-long build-up in cumulative imbalances from heavy dollar borrowing. In addition to that, there is a cyclical

argument that the U.S. economy seems to be improving, with fewer imbalances and better long-term growth prospects than other major developed economies.

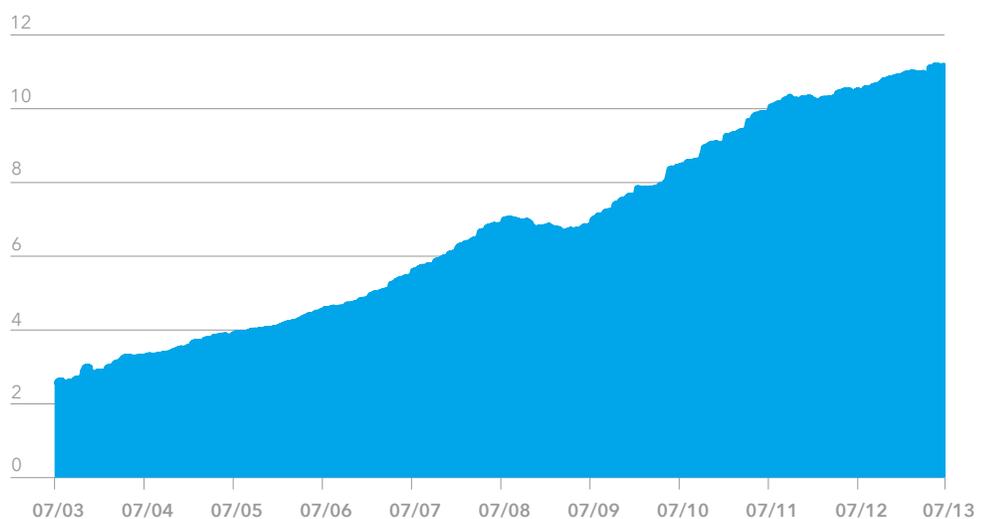
All of this makes me a little more reluctant than I have been in the last 20 years to have unhedged nondollar positions. Despite this longer-term view, I have been nonetheless adding to non-U.S. dollar exposures because of the dramatic valuation changes in recent weeks. I see better valuations and improved opportunities in local emerging markets debt and this is not a time when I want to be more defensive.

Brazil makes up a large portion of the emerging markets debt universe. What is your view of the market?

Brazil is vulnerable to some of the more worrisome global trends. At the same time, it has a number of country-specific issues, including a very challenging policy environment, with heavy government influence on the economy. Reform has been stagnant for the last 10 or so years in the areas of infrastructure privatization, labor market deregulation and anticompetition laws that keep out foreign companies in certain sectors.

Exhibit 2:
The world's supply of U.S. dollar-denominated assets has risen sharply over the last decade. This supply of dollars appears to be much larger than the U.S. current account would suggest, partly due to heavy borrowing by emerging markets corporations and governments in recent years.

Global stock of U.S. dollar-denominated assets, excluding gold (trillions)



Source: Bloomberg. Data as of June 30, 2013.

Outlook on Emerging Markets Bonds and Currencies

“There is going to be more divergence in how different economies perform and related macroeconomic policies than there has been in the past decade. That dispersion will have a greater impact on investment decisions.”

At the same time, Brazilian bonds have some of the highest yields in the world. Even at these prices and spreads, my enthusiasm for Brazil is not very high. I would not increase my investments at current levels, unless the valuations became significantly more attractive.

How do you view the market’s concerns about China and issues related to its shadow banking industry?

I think that there is probably too much fear about the banking problem in China getting out of hand. At the end of the day the Chinese banking system is still almost entirely government-owned and supported, so whether the assets are formally on the banks’ balance sheets or not, or whether it is the shadow banking or wealth management market, the balance sheet is, ultimately, part of the public sector. When you roll everything up together and look at the total stock of liabilities, China is still fairly underleveraged, even with assumptions about loan defaults.

China has problems related to the misallocation of capital and cash flow because the banks do not price loans efficiently. The cash flows on the banks’ loan books do not really reflect the risks they are taking and require indirect subsidies in

the form of deposit caps, for example. But it is a government-controlled system. The Communist Party is still in charge. They have capital controls and they are still underleveraged.

The bigger problem in China seems to be that the corporate sector has experienced a profitability squeeze. Corporate cash flows and corporate profits have really been hit hard because selling prices have come down and labor costs are up. So it looks like they have had severe margin compression. This reduces the ability to sustain high investment levels and is likely to crimp household income.

I think this is the main reason people are marking down their growth forecasts for China. Having said that, if the U.S. economy improves modestly and Europe and Japan remain the same, in my view it should offset the slowdown in China.

In general, I think there is going to be more divergence in how different economies perform and related macroeconomic policies than there has been in the past decade. I think that dispersion will have a greater impact on investment decisions, rather than a belief that things are suddenly going to be much weaker or stronger in aggregate.

Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information is contained in the fund prospectuses and summary prospectuses, which can be obtained from a financial professional and should be read carefully before investing.

The return of principal for bond funds and for funds with significant underlying bond holdings is not guaranteed. Fund shares are subject to the same interest rate, inflation and credit risks associated with the underlying bond holdings. Higher yielding, higher risk bonds can fluctuate in price more than investment-grade bonds, so investors should maintain a long-term perspective.

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