EVOLUTION OF EM FUNDAMENTALS

By Phil Torres, Director of Sovereign and Emerging Markets Research

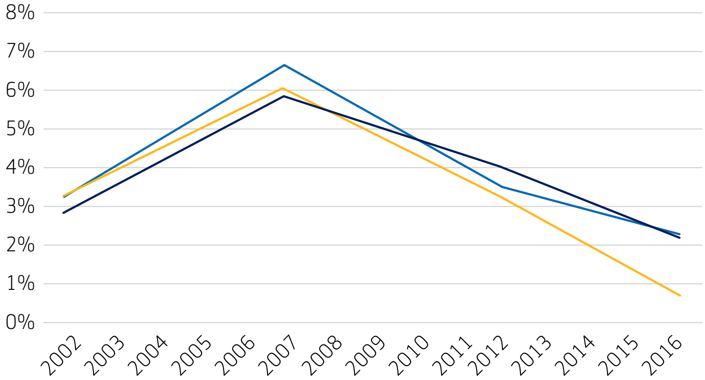
Given the low growth and low yields prevailing in the developed world, emerging markets (EM) have become the de rigueur investment choice. How much of the surging inflows to the sector are based on fundamentals, and how much is just a yield grab?

One way to answer this question is to evaluate EM economy fundamentals, which have certainly improved in the decades since the Asian and Russian crises of the late 1990s. Yet over the last fifteen years, notably between 2002* and 2016, economic fundamentals for the JPMorgan Emerging Market Bond Index – Global Diversified ("Index") are remarkably close to unchanged. When looking at four core metrics – GDP growth, reserves-to-GDP, external debt-to-GDP, and central and local debt-to-GDP—we can note that while growth is notably weaker, reserve levels are a touch better (but falling) and debt loads are modestly lower (and rising) (Exhibits 1-3). What's more, over the last ten years EM fundamentals have actually deteriorated demonstrably.

Relative to developed markets, EM fundamentals are still promising, on average, but the data does not show a substantive improvement in EM economies over the last decade.

Exhibit 1: Growth is weaker

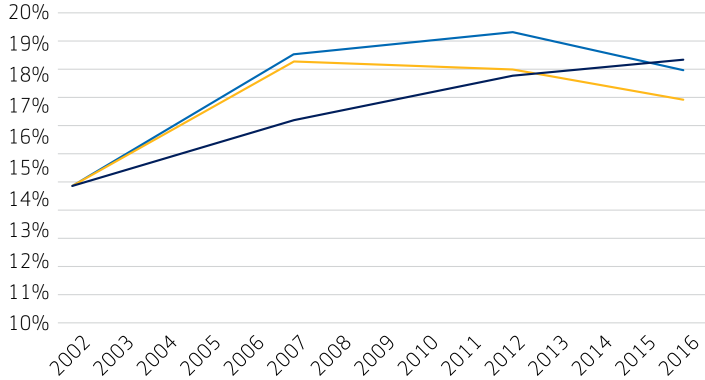
EM GDP Growth (year-over-year % change)



Contemporaneous Index Weight
2002* Constant Index Weight
Simple Average
Source: Bloomberg, as of June 2017; JPM EMBI Global Diversified Index

Exhibit 2: Reserves are higher, but falling

EM Foreign Exchange Reserves (% of GDP)



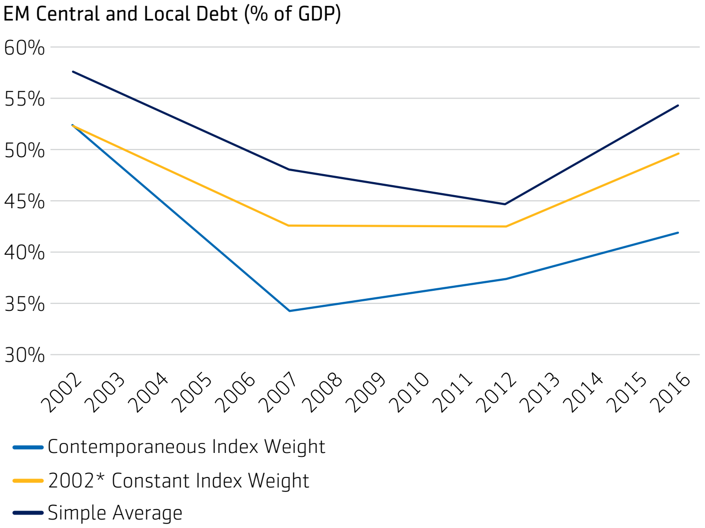
Contemporaneous Index Weight
2002* Constant Index Weight
Simple Average
Source: Bloomberg, as of June 2017; JPM EMBI Global Diversified Index

Emerging market bond fund inflows totaled in excess of $90 billion, year-to-date through September. The annual record for EM bond fund inflows was $103 billion, set in 2012. At the current pace, the market is poised to break that record.

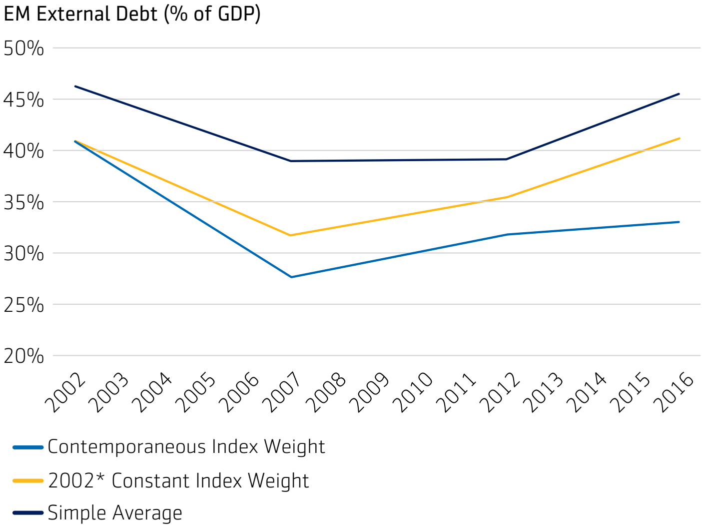
Still, there remains much to like about investing in EM economies at this juncture. Tamed inflation, flexible currencies, and improved governmental institutions have enhanced the sector's ability to withstand external shocks. Concerted efforts to build resiliency are an important factor in reducing the likelihood and magnitude of significant risk events, and should contribute to lower uncertainty and tighter spreads.

Given the positive role structural buffers to shocks are playing, leadership from multilaterals deserve much of the credit. Today's EM countries, and investors in them, benefit from organizations like USAID, the World Bank/IFC and regional development banks. Their in-country work reforming the institutional structures and developing capital markets is bearing important fruit while these countries have otherwise been battered by the developed world's cyclical and secular struggles.

Exhibit 3: Debt levels are lower, but rising



Source: Bloomberg, as of June 2017; JPM EMBI Global Diversified Index

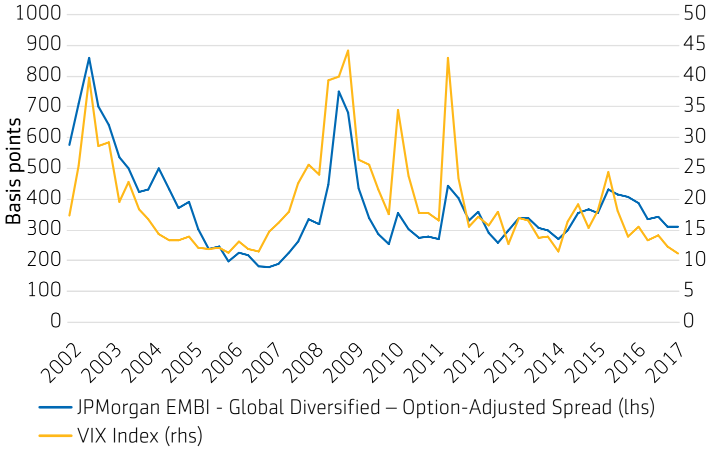


Source: Bloomberg, as of June 2017; JPM EMBI Global Diversified Index

In addition to looking at fundamentals, it is important to consider the global price environment. Prices, particularly the prevailing index spread levels, have certainly narrowed in recent quarters (Exhibit 4). Perhaps more critically, investors must also consider the general uncertainty attending the current spreads. Our proxy for global uncertainty is the CBOE Volatility (VIX) index, which measures implied 30-day S&P 500 price volatility. VIX is persisting at historically low levels. Furthermore, realized volatility is low and the spread between realized volatility and implied volatility is well within recent historical ranges, suggesting VIX itself is not necessarily wrong (Exhibit 5). Here, investors could maintain a higher tolerance for owning the tight spreads because risks are attenuated by reasonably priced hedges as measured by that volatility spread.

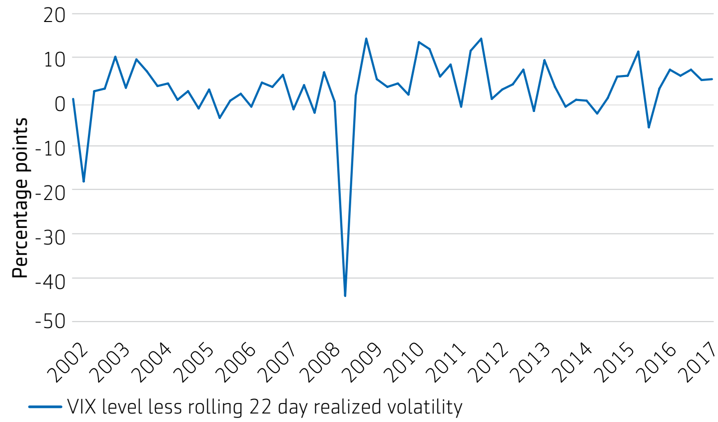
In other words, the prevailing costs to hedge risk events is relatively in line with historical norms. If the market was exceedingly concerned with negative generalized global risk events, these particular costs would likely be higher than historical norms. In this

Exhibit 4: EM spreads and uncertainty



Source: Bloomberg, as of June 2017

Exhibit 5: VIX less realized volatility



Source: Bloomberg, as of June 2017

simplified example, the decision to invest in the emerging markets is driven by the ex-ante returns from owning the asset class and the cost of owning the hedge. So long as the fundamental rewards for holding the asset class are favorable compared to the hedging cost, the investment should not be overwhelmed by a global risk event. Therefore, investors will likely be in a position to buy the asset class, which itself could further tighten spreads. Herein lies the key to determining value in the context of global uncertainty: spreads may be near historical tights, but there is still value to be found.

Arguments that the asset class is rich simply because spreads are tight ignores other key factors for determining a valuation. By taking country-level fundamentals together with prices in the context of uncertainty, we arrive at a valuation for the asset class which seems rather fair, in our view, and does not warrant any particular investor aversion.

* Our preferred starting point for all EM analyses is 2002. We believe this is a fair demarcation point for major shifts in global political economy, including China's ascension to the WTO and the full adoption of the euro.

Disclosures

The archived content contains information that is historical in nature and may be outdated. This material is provided for informational purposes only and should not be relied upon for investment decisions.

Aegon USA Investment Management, LLC (AUIM) is a US-based SEC registered investment adviser, is registered as a Commodity Trading Advisor (CTA) with the Commodity Futures Trading Commission (CFTC), and is a member of the National Futures Association (NFA). AUIM is a member company of Aegon Asset Management, the global investment management brand of the Aegon Group.

The information has been developed internally and/or obtained from sources believed to be reliable but AUIM does not make any representation as to its accuracy or completeness. This material contains current opinions of the manager and such opinions are subject to change without notice. AUIM is under no obligation, expressed or implied, to update the material contained herein. This material contains general information only on investment matters; it should not be considered a comprehensive statement on any matter and should not be relied upon as investment advice or a recommendation for the purchase or sale of any security. If there is any conflict between the enclosed information and AUIM's Form ADV, the Form ADV controls. The information contained does not take into account any investor's investment objectives, particular needs, or financial situation. Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to you. The value of any investment may fluctuate.

Past performance is not indicative of future results. AUIM may trade for its own proprietary accounts or other client accounts in a manner inconsistent with this report, depending upon the short-term trading strategy and/or guidelines for a particular client as well as other variables.

Recipient shall not distribute, publish, sell, license or otherwise create derivative works using any of the content of this report without the prior written consent of Aegon USA Investment Management, LLC, 4333 Edgewood Rd NE, Cedar Rapids, IA 52499.

This document contains "forward-looking statements" based on AUIM's beliefs and a number of assumptions concerning future events based on information currently available to AUIM. These statements involve certain risks, uncertainties, and assumptions which are difficult to predict. Consequently, such statements cannot be guarantees of future performance, and actual outcomes and returns may differ materially from statements set forth herein. In addition, this material contains information regarding market outlook, rates of return, market indicators and other statistical information that is not intended to be and should not be considered an indication of the returns or results of any AUIM managed product or portfolio.