Strategy notes:

BNY MELLON EMERGING MARKETS DEBT LOCAL CURRENCY FUND

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Manager of BNY Mellon Emerging Markets Debt Local Currency Fund

KEY FACTS: LOCAL CURRENCY EMERGING MARKET DEBT

- Over its history – from 2003 to 2017 – annualised returns for the asset class, as measured in US dollars, is 7.9%.
- Over the same period, it has also recorded annualised ex-post volatility of 12.0%.
- Rolling three-year annualised volatility in that period has been between 8.0% and 16.0%.

Source: Standish. Benchmark returns from January 2003 through February 2017. Data as at 28 February 2017.

1 Investment Managers are appointed by BNY Mellon Investment Management EMEA Limited (BNYMIM EMEA) or affiliated fund operating companies to undertake portfolio management activities in relation to contracts for products and services entered into by clients with BNYMIM EMEA or the BNY Mellon funds.

Emerging market (EM) currencies, equities and fixed income offered among the best returns in 2016. Here Standish[1], a BNY Mellon company, outlines the case for EM investing through local currency bonds.

For Federico Garcia Zamora, manager of the BNY Mellon Emerging Markets Debt Local Currency Fund, 2016 was all about a renaissance in emerging markets. A 33%, in US dollar terms, sell-off from May 2013 to January 2016 gave way through the second part of the year to steadying commodity pricing, improved economic fundamentals and rising inflows into EM bonds.[2]

The result was an up-lift for both emerging markets and for the BNY Mellon Emerging Markets Debt Local Currency Fund. The Fund witnessed a 15.5% return over the 12 months to 28 February 2017, ahead of the 15.0% return from the comparative index.[3] And that, says Garcia Zamora, has begun to get people's attention. "Emerging market fixed income investing has come in from the cold," he says. "A powerful combination of domestic and external forces has underlined the case for the asset class. We believe we're moving in the right direction and our forecast is for an 8-10% return for the EM local currency debt asset class in 2017."

2016 performance and positioning

Looking back over the 12 months Garcia Zamora points to improving economic fundamentals as one crucial factor driving performance.

He notes how during the selloff, emerging market oil producers in particular felt the impact of the collapse of oil pricing on their fiscal policies. Weakness in domestic currencies, rising inflation and political upheavals in core EM countries such as Brazil all contributed to the gloomy picture.

The investment team responded by increasing cash, reducing EM currency exposure in countries such as South Africa, Turkey, Hungary and Peru.

Since then, says Garcia Zamora, countries such as Colombia, Indonesia and Brazil have worked hard to improve their current account deficits. Central bank efforts to fight inflation have also been successful. In Brazil, for example, inflation hit a five-year high of close to 11% in January 2016. Subsequently, inflation has fallen month-on-month to its current 5.4% rate. In Russia too – where inflation hit a five-year 16.9% high in March 2015 – the current rate is now 4.6%.[4]

2 Source: Standish as of 30 September 2016, US$ terms.
3 Source: Lipper as at 28 February 2017. Fund performance based on euro C class shares, calculated as total return, based on net asset value, including charges, but excluding initial charge, income reinvested gross of tax, expressed in share class currency. The impact of the initial charge, which may be up to 5%, can be material on the performance of your investment. Performance figures including the initial charge are available upon request. The comparative index is the JP Morgan GBI-EM Global Diversified Index TR.
4 Source: Trading Economics, accessed 15 March 2017.

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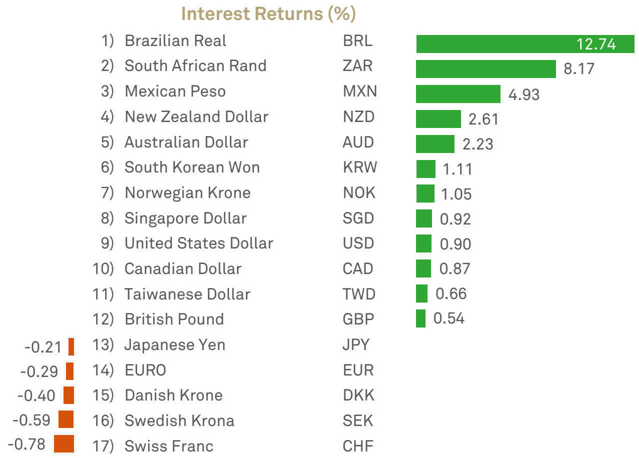
Meanwhile, the recovery of commodity prices – oil is currently trading at around US$50 a barrel, well above its January 2016 low-point of below US$29 a barrel – also provided a fillip to economies of oil producing emerging market countries.

Says Garcia Zamora: "Domestically, EM countries are in a vastly better place than there were at the nadir of the sell-off. External forces are critical to the performance of the asset class and the Fund has benefited from those tailwinds."

EM CURRENCIES ON THE CREST OF THE COMMODITIES WAVE: FX, ONE-YEAR RETURNS TO MARCH 2017



Source: Bloomberg, 3 March 2017

From March 2016, the Standish investment team responded to the more positive mood by systematically raising its exposure to the asset class. It continued to do so through episodes of heightened political risk where markets generally adopted a cautious stance, including the UK's Brexit vote, the election of US President Trump and the Italian referendum. "Wherever markets have traded down we've added exposure and that has helped performance."

Hence, while wider macro-economic drivers were important, bottom-up selection also played a key role in the Fund's improved performance through 2016. Says Garcia Zamora: "In broad terms we can say we picked the right countries. During 2016 we had an overweight to Russia and Brazil, for example, and these were two of the top performers over that 12 months. They were both among the first to adjust their economies in response to the falling oil price and so they have also been among the first to rebound. Indonesia, Argentina and Colombia also performed well and this helped the fund through its overweight in those countries versus the index."

Future opportunities

After the market dislocations of 2015 and the consequent recovery in 2016, says Garcia Zamora, the investment team took the opportunity to selectively add risk. There is, he says, "still scope to continue on the same path through 2017. We believe there are pockets of unexploited opportunity in select markets".

PORTFOLIO CHARACTERISTICS

	Portfolio	Index
# Parent Issuers	27	15
# Tickers	48	21
Wtd. Current Yld	6.42	6.20
Weighted Avg Max Rating Code	BBB-	BBB
Weighted Avg Time to Maturity	7.38	7.32
Weighted Avg Yield to Worst	7.27	6.54
Weighted Avg Coupon	7.26	6.27

Source: Standish data as of 28 February 2017.

One such area is Mexican bonds, but also Turkish debt, where the team has added exposure. In each case, says Garcia Zamora, the market has overreacted to the risks while failing to fully consider the current opportunity. He explains: "In Mexico, for example, the peso was among the worst performing currencies in the final months of 2016 as investors responded to the anti-immigration and anti-free trade agenda of President Trump. But we think the market has gone too far the other way. In our view, the actual policies are likely to be far more muted than the campaign rhetoric suggests."

Portfolio characteristics

TOP 10 HOLDINGS

Description	%
ZA RSA 10.5% 12/21/2026	5.98
Brazil BNTNF 10% 01/01/2023	5.32
Russia RFLB 7% 08/16/2023	4.64
PETROLEOS MEXICANOS 7.19% 09/12/2024	3.90
Colombia COLTE 10% 07/24/2024	3.12
Russia RFLB 7.05% 01/19/2028	3.06
Indonesia INDOG 7% 05/15/2027	2.77
Indonesia IDGB 8.375% 09/15/2026	2.68
Brazil BNTNF 10% 01/01/2025	2.64
South Africa GILTS 8% 12/21/2018	2.61

Source: Standish, 28 February 2017.

CREDIT QUALITY

Rating	Portfolio %	Index %
AAA	3.08	0.00
AA-	0.00	0.10
A	22.80	22.35
A-	2.88	14.39
BBB+	8.90	8.50
BBB	15.09	10.60
BBB-	32.49	32.54
BB	7.96	9.97
B	3.82	0.00
NR	0.00	1.55
N/A	2.99	0.00
Total	**100.00**	**100.00**

Source: Standish, 28 February 2017.

COUNTRY EXPOSURE VERSUS THE INDEX

Country Exposures	Portfolio %	Index %
South Africa	12.67	10.14
Indonesia	10.61	9.88
Mexico	10.52	10.36
Colombia	10.20	7.78
Poland	8.90	9.65
Turkey	8.27	8.86
Russia	7.99	6.48
Brazil	7.95	10.11
Argentina	4.12	0.00
Hungary	3.65	5.04

Source: Standish, 28 February 2017.

DURATION PROFILE

Years	Fund %	Index %
Dur <= 1	4.31	0.97
Dur 1 – 3	10.79	28.61
Dur 3 – 5	23.28	25.50
Dur 5 – 7	41.78	20.59
Dur 7 – 10	16.72	21.26
Dur 10+	3.12	3.07
Total	**100.00**	**100.00**

Source: Standish, 28 February 2017.

Another area of potential value is Colombian bonds, where the Fund is overweight versus the index on both currency and duration. Here, Garcia Zamora notes, the peace accord offers the government a 'clean' agenda to drive through much-needed fiscal reforms, while also providing breathing space to focus on attracting investment and technical know-how to monetise the country's extensive oil reserves. Meanwhile, interest rates have remained high – even though the inflation rate has fallen steadily since July 2016. This gives the central bank scope to cut rates, which in turn could be a positive for local currency denominated bonds. Indeed, should inflation continue to fall from its current rate of 5% to around 4%, Garcia Zamora believes Colombia's central bank could have room to cut interest rates significantly. "In our view, this could equate to an attractive return for local currency bonds – hence our overweight versus the index. The same theme holds true for Brazil and Russia where interest rate reductions have also lagged falling inflation, thus providing scope for future cuts and an uptick in economic growth."

Both Russia and Brazil experienced a currency collapse in 2014/5 followed by high inflation. But in each case – unlike some of their EM peers – the collapse was accompanied by fiscal retrenchment which in turn allowed the current account to stabilise. In Brazil, the impeachment of former president Dilma Rousseff was then the political catalyst for the private sector to kick-start the economy and for growth to resume. In Russia, the key catalyst was rising oil prices. Both now look attractive for local currency investors even in spite of the gains of the past six months, says Garcia Zamora.

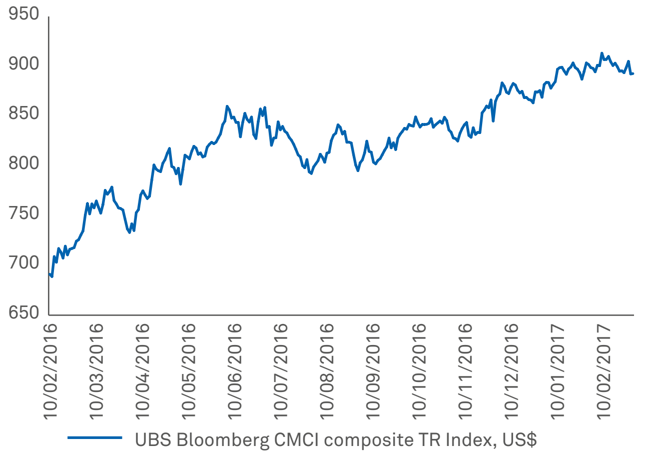
A view on commodities

Given the interdependence of EM countries and the basic materials they tend to specialise in, it's no surprise that commodities pricing is often considered an important underlying driver of the performance of emerging market assets. For Garcia Zamora, one crucial factor is the price of oil. He notes how, during a prolonged sell-off from 2014, spot prices for oil veered wildly as new shale supplies came on tap.

Looking forward, though, he believes pricing for black gold will be more stable than in the recent past. For one thing, Saudi Arabia, the main global swing producer, is close to initiating an estimated US$2 trillion IPO of government-owned oil titan Saudi Aramco. For a successful listing, stability in pricing will be key. He explains: "We think this means the Saudis will do whatever they can to limit volatility, at least for the foreseeable future – and this in turn should help the oil-producing EM countries improve their balance of payments. The IPO and the perceived need for stability give us confidence for the outlook for the asset class and we expect the price per barrel to trend upwards in 2017 and 2018."

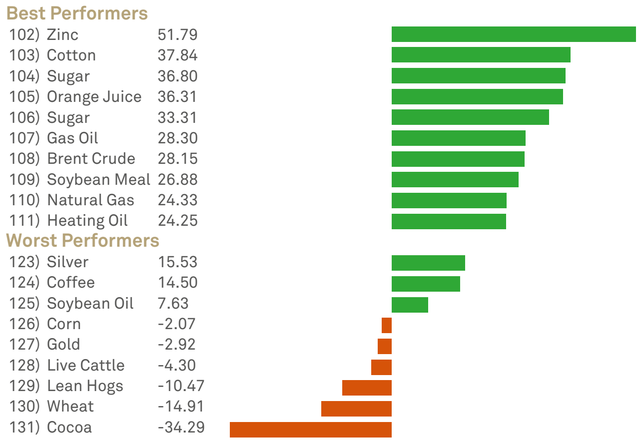
This is even in spite of new US shale oil supplies that could come on tap to make up any shortfall in production should the Saudis turn off their taps. Says Garcia Zamora: "We believe it will be challenging for US production to come back fully at current pricing."

THE COMMODITY PRICE TURNAROUND



Source: Bloomberg, 28 February 2017

COMMODITIES: BEST AND WORST PERFORMERS, ONE YEAR TO MARCH 2017



Source: Bloomberg, 28 February 2017

US interest rates: friend or foe?

Looking forward, Garcia Zamora is optimistic on the prospects for emerging market local currency debt even though he highlights a number of risks. One such possible risk is rising US interest rates – potentially a significant factor given how much US rates influence EM debt.

But here Garcia Zamora is confident of stability rather than a sudden spike. He notes how the market is fully priced for the US Federal Reserve's current plan of two to three interest rate hikes in 2017. "For rates to move materially higher beyond that," he says, "Inflation and economic activity would need to surprise the Fed – and we don't think that's going to happen."

The Trump agenda

One other risk for investors is the question of the Trump agenda, encompassing areas such as trade and immigration – with the new president promising to build a wall on the Mexican border and to brand major exporters such as China as currency manipulators. While both measures would increase pressure on emerging market currencies, Garcia Zamora holds a sanguine view about how far this policy 'noise' will translate into facts on the ground.

For one thing, there is the 'sequential' nature of US politics: that is, legislators tend to work through a focused selection of 'big ticket' items one or two at a time rather than taking a scatter-gun approach to implementing policies. Since Trump has decided to start his presidency by focusing on the vastly complicated area of domestic healthcare, other areas of concern are likely to take a backseat, at least for now, says Garcia Zamora.

Compounding this, he says, is the fact that Congress is divided not just between Republicans and Democrats but even among the majority Republican party itself. This reduces the scope for radical departures from the current status quo and means some of the more headline-grabbing policies set out by the Trump administration "are likely to run into more trouble and take longer to implement than the market currently thinks".

Other proposals announced by Trump include tax-cuts and higher spending on infrastructure. Both these measures are potentially inflationary, leading to the prospect of higher and faster interest rate rises than currently anticipated. Since higher US interest rates are generally considered anathema for emerging markets, this would, in theory be a negative for the Fund.

But here, Garcia Zamora points to a contradiction at the heart of the Trumpian economic doctrine. "In theory, cutting US taxes and pushing up infrastructure spending will increase growth and inflation, which in turn will lead to interest rate hikes, which in turn will make the dollar stronger. By creating a stronger US dollar, Trump's policies will exacerbate the very trade deficits with countries such as Mexico and China the President has vowed to fight. In our view the two goals are mutually incompatible."

Important Information

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