BlueBay
Asset Management

Insights

EM Corporate Credit Outlook 2015

2014 was an eventful year for emerging market (EM) corporate debt. Against a backdrop of lacklustre growth and weaker commodities, a number of themes played out within EM including a noteworthy election calendar, a strong US dollar, heightened geopolitical risk and ongoing idiosyncratic event risk. Nevertheless, EM corporates (as represented by the JP Morgan CEMBI Diversified) delivered a solid return of 5.7%.

We believe the year ahead will be characterized by similar themes to those we saw in 2014. However, despite the potential for idiosyncratic credit events and an uncertain macro backdrop, we believe the asset class continues to look compelling from a valuations perspective. While we anticipate a slight uptick in defaults (albeit from a low base in 2014), we believe that a lot of these are well telegraphed and the market is priced accordingly. However we do see pockets of value and expect modest credit spread compression to offset an anticipated move higher in US Treasuries. Overall we believe returns of 4–6% for the asset class are achievable this year. Furthermore, we believe the theme of differentiation will continue to play out and as such 2015 should be a good environment from an alpha generation perspective

We believe returns of 4–6% are achievable for the asset class beta with scope to generate positive alpha over and above that

2014 – a year in review

2014 forecasts revisited 12 months on

Winding back the clock to the end of 2013 and revisiting our outlook at the time, we had the following expectations for 2014.

2014 Prediction	Outcome	Comment
2014 returns will be largely driven by yield	✓	A return of 5.7% for EM corporate debt in 2014, driven largely by carry
US rates drift higher	✗	US Treasury rates rallied some 85bps over 2014
Credit differentiation theme	✓	Significant dispersion of returns by country, sector, credit bucket etc.
Slight spread compression	✗	Credit spreads widened circa 50bps over the year
Default rates expected to be lower	✓	Observed high yield default rate of 2.7%, lower than historical averages
Latin America expected to outperform	✗/✓	Latin America significantly outperformed Europe and Africa, but underperformed Asia and the Middle-East
BBB/BB expected to outperform	✗/✓	BBB/BB significantly outperformed the very low credit quality segment of the market, but underperformed very high-quality credit
Defensive sectors expected to outperform	✓	Defensive sectors such as utilities, TMT and infrastructure were among the best performing sectors in 2014
Metals & mining expected to underperform	✓	Metals & mining was the worst-performing sector of the year

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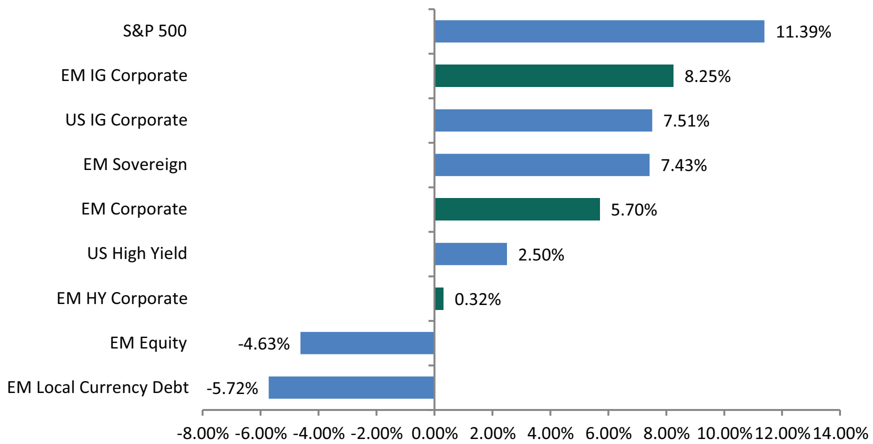
On balance, it is safe to say that although 2014 proved to be a challenging year to predict, emerging market (EM) corporates managed to deliver a robust return of 5.7%. However, the path to get there was different to what we expected. To put this return in context, versus other EM asset classes and other risk asset classes more broadly, EM corporate debt fared pretty well. The investment grade section of the market performed particularly well in the first half of the year given its longer-duration characteristics in a strong Treasury market, while in the second half of 2014 it compounded its outperformance versus EM high yield corporates, proving more resilient in the more volatile market environment given its defensive credit fundamentals and higher weighting to the tighter spread, less commodity-sensitive Asian credits.

2014 was a year of credit differentiation, yet the asset class delivered a solid return of 5.7%

2014 market performance

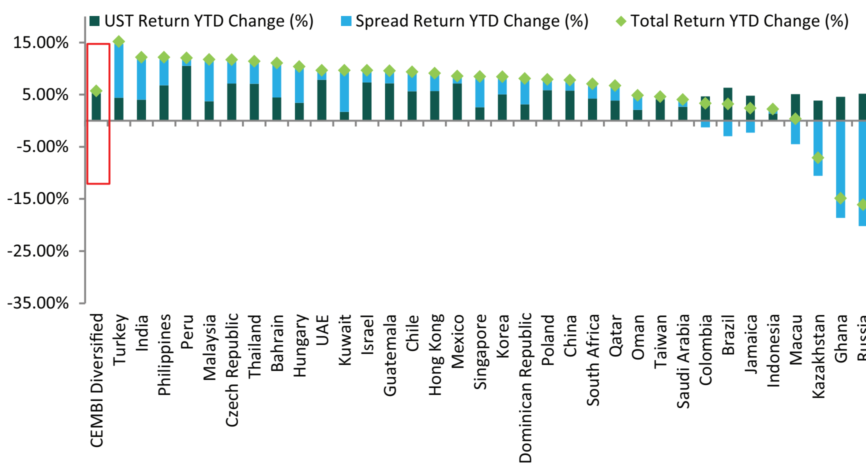
Fig. 1 2014 total return by asset class



Data source: JP Morgan and Bloomberg, as at 31 December 2014
Note: Please refer to the footnotes at the end of the document for index descriptions

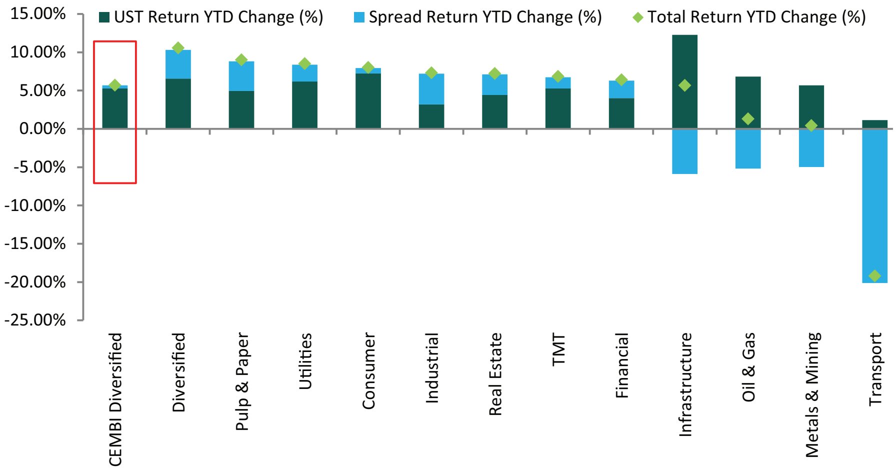
EM corporate returns in 2014 were largely driven by US Treasuries rallying. Despite expectations to the contrary, the US 10-year Treasury declined some 85bps, from 3.03% to finish the year at 2.17%, on the back of slowing growth, disinflation and weaker commodities. However, the spread component of EM corporate performance varied significantly by country and by sector, reinforcing our long-held view that we would be in an environment of credit differentiation, which certainly played out over the year.

Fig. 2 EM corporates return by country



Data source: JP Morgan, as at 31 December 2014

Fig. 3 EM corporates return by sector



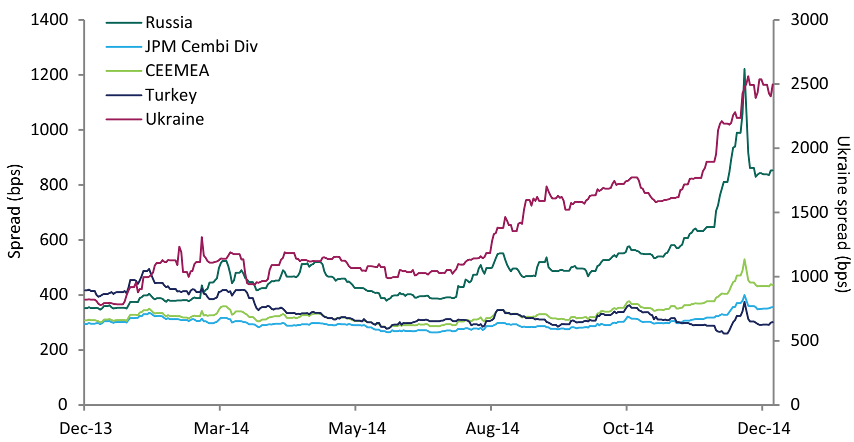
Data source: JP Morgan, as at 31 December 2014

Strong credits with good stories on a positive trajectory performed well, while weaker credits on a deteriorating path underperformed in relative terms. As you can see from Figures 2 and 3, the range of returns by country was very wide, with Turkey returning close to 15%, while Ukraine was down approximately 35%. Likewise, on a sector basis, diversified/pulp & paper saw approximately 10% returns for the year, while troubled sectors such as oil & gas and metals & mining were only barely in positive territory. (Note the -20% of transport is an outlier given it is such a small part of our universe and simply reflects the sharp price decline in FESHRU, the Russian shipping company, which dropped from the 90s to the 40s over the year.)

What was positive to see was a lack of contagion that has affected EM debt in previous years. This year the market did a good job of isolating certain problem cases, without contaminating the rest of the asset class, as was the case in previous EM crises. The most apparent example of this was the price action in the wake of the ongoing geopolitical unrest in Russia/Ukraine. Instead of capital fleeing the asset class totally, investors sold out of Russia and Ukraine but reallocated to other neighbouring markets; Turkey was one of the main beneficiaries and hence the top performer over the year (Fig. 4).

The market did a good job of isolating certain problem cases, without contaminating the rest of the asset class

Fig. 4 Returns of Russia, Ukraine and Turkey versus CEEMEA and the EM corporate index



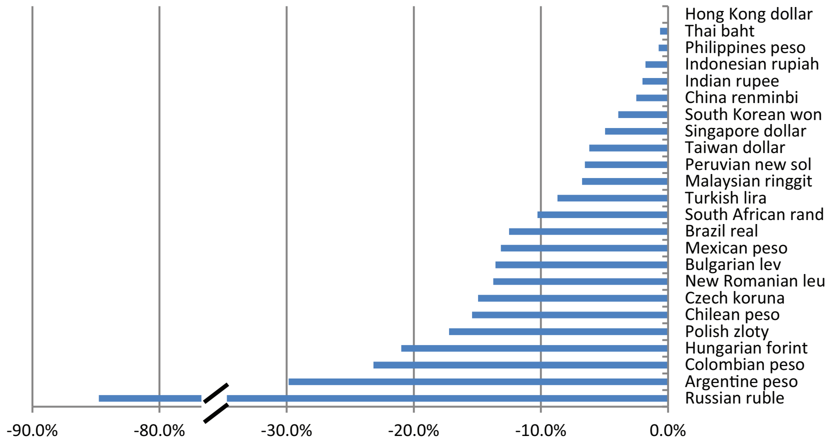
Data source: JP Morgan, as at 31 December 2014

Macro backdrop; lacklustre growth and softer commodity prices

The global macro backdrop throughout 2014 was largely one of disappointing global growth, softer data, disinflationary pressures and, for the most part, dovish central banks extending their run of accommodative policies that resulted in persistently lower core government bond yields. As such, tighter spread markets such as Asia and the Middle East traded very well over the course of the year given their higher-beta to US Treasury moves.

Another theme that played out in our markets was the persistent strength of the US dollar.

Fig. 5 EMFX versus US dollar in 2014



Data source: Bloomberg, as at 31 December 2014

Every single EM currency in our universe declined against the US dollar in 2014 (Fig. 5). The sharpest moves were in oil-dependent countries such as Russia and Colombia, while the lower-beta countries and less commodity-sensitive in Asia proved more resilient.

Another key talking point over the year was commodity weakness, particularly during the second half of the year, with oil prices collapsing on the back of over-supply and waning demand. This had an important impact on some of our markets, most notably Venezuela, where bond prices collapsed as the market began to price in a greater probability of default, given the country's reliance on oil revenues to service its debt.

2014 saw a strong dollar, weaker commodities, a busy election calendar and heighted geopolitical risk

Other commodities that experienced a weak year included iron ore and coal, driven lower by the slowing demand in China and Europe. This had the effect of causing further strain on the already highly-leveraged balance sheets of certain metals and mining companies in our market.

A year of important elections in emerging markets

The year 2014 was also important from a political perspective, with a number of key countries, including 2013's "Fragile Five", hosting elections. In most cases, favourable outcomes emerged – e.g. in India the Modi-led Bharatiya Janata Party recorded a landslide victory paving the way for much-needed structural reforms; as a result the market responded positively. Likewise in Indonesia the victory for 'change candidate' Jokowi was well received by the market and subsequently Indonesian corporates performed well.

In other countries such as Turkey and South Africa, where fundamentals are weaker and the willingness and ability to deliver reform is arguably less evident, the fact that elections are out of the way removed one additional source of uncertainty and the markets responded positively.

The Brazilian presidential election was something of a rollercoaster ride and dominated headlines for much of the second half of the year. Going into the campaign it looked set to be a clear Dilma Rousseff victory, which the market took negatively given her lack of credibility in driving through the necessary reforms to drag Brazil out of the doldrums. Then, in the wake of the tragic death of PSB presidential candidate Eduardo Campos, Marina Silva gained in popularity and momentum in the run-up to the first round of elections, upon which the market looked favourably. This proved to be short lived however, when Marina was eliminated in the first round and Aecio Neves of the PSDB party came from behind to force a second-round run-off. Although the final vote was one of the tightest in Brazil's history, Dilma prevailed to secure a second term. The market's initial response was negative, with spreads widening in the immediate aftermath (compounded by the escalating Petrobras scandal). It remains to be seen whether she has the ability and willingness to address Brazil's macroeconomic challenges, or if she will rely on her old interventionist policies in her second term.

Heightened geopolitical risk

2014 was also a year in which geopolitical risk came to the forefront again, most notably with the ongoing crisis in Russia and the Ukraine, where tensions escalated following

Russia's annexation of the Crimea and allegations by the West earlier in the year that Russia was increasing its efforts to supply weaponry and advice to the pro-Russian separatist movement in Eastern Ukraine, in an effort to destabilize the region and for Russia to gain greater influence. The situation came to a head in July after Malaysian Airways flight MH17 was tragically shot down. This led to an intensification of violence in the region and ultimately the broadening of more punitive sanctions on Russian individuals and corporates, designed to raise the cost of capital and of dollars to Russia. The situation dragged out until a ceasefire was declared; the conflict moved to a 'frozen state' with no near-term signs of resolution, and sanctions began to weigh on the local economies and on bonds spreads.

Idiosyncratic risk events

Another significant market event during 2014 was the ongoing "Operation Carwash" corruption and money-laundering scandal relating to Petrobras in Brazil, where there are allegations that its refining business overpaid on construction contracts as part of a scheme whereby a portion of the inflated price was skimmed by individuals in the company, the contractors and government officials. This scandal had for a long time been bubbling under the surface, but came to a head in the fourth quarter when PWC announced that it would not sign off Petrobras' third quarter accounts, as it needed more time to "gain greater understanding from the ongoing investigations by the independent law firms, and make any adjustments to the financial statements". The spotlight was shone on a whole of host of construction companies in Brazil, offices were raided, a number of arrests were made, and this affected sentiment for Brazilian spreads generally, but in particular in implicated names such as OAS, which teeters on the brink of default as a result.

In China we saw a continuation of the anti-corruption campaign with some high-profile events grabbing the headlines. Agile and Kaisa experienced high-profile senior management resignations, equity trading suspensions and were heavily implicated in the ongoing investigations surrounding the suspected corruption of local government authorities. The result was sharp price declines in the high yield rated Chinese real estate sector, which compounded weakness on the back of oversupply and slowing demand in the Tier 3 and Tier 4 cities.

Fundamentals in 2014

EM corporate fundamentals remained robust and it was another bumper year for issuance

Despite some of the negative stories, EM corporate fundamentals remained robust and earnings were largely in line with expectations. That said, there were a small number of defaults and the official high yield default rate for the asset class came in at 2.7%, which was below historical averages. These were for the most part well telegraphed by the market and most had been trading at deeply distressed levels prior to default.

The defaulted issuers list for calendar year 2014 is shown in Figure 6.

Fig. 6 2014 defaulted issuers

Region	Ticker	Issuer	Total (US$m)
Latin America			**6,079**
	NIHD	Nii	4,350
	OCEANO	Oceanografia	495
	IMPSA	IMPSA	413
	INVALS	Alsacia	347
	ARALCO	Aralco	250
	GEOMAQ	Geo Maquinaria	149
	SIFC	SIFCO	75
EM Europe			**2,952**
	NWORLD	New World Resources	1,039
	ALLIBK	Alliance Bank	854
	MRIYA	Mriya	472
	VABANK	VAB Bank	176
	ZLOM	Zlomrex	161
	CCBAD	Corporate Commercial Bank	150
	FICBUA	Finance and Credit Bank	100
Middle East & Africa			**1,279**
	ABLSJ	African Bank	1,279
Asia			**1,197**
	BUMIIJ	Bumi	1,000
	HIDILI	Hidili	197
Global EM			**11,507**

Data source: JP Morgan, as at 31 December 2014

The most noteworthy name is NII Holdings (Latin American wireless telcom with aging technology and a lack of scale), which at US$4.35 billion was the single-largest default since JP Morgan began compiling the statistics in 2000. Other major themes were the secular decline in the coal sector, which saw the default of Bumi Resources (Indonesian coal mining company) and New World Resources (Czech hard coal and coke producer) whose levered balance sheets proved unsustainable as coal prices fell. African Bank was also a significant event after it was placed under curatorship by the South African Reserve Bank following record losses. Elsewhere, the defaults were largely idiosyncratic in nature.

Technical picture

On the technicals side, 2014 was another bumper year in terms of EM corporate new issuance with some US$368 billion (JP Morgan estimates) of new issuance. This is quite an achievement given that Russia is typically a large issuer of EM corporate debt and was effectively cut off from the capital markets during the second half of the year. At US$193 billion however, Asia more than compensated and in 2014 we saw a large number of deals come out of China, in particular in the Additional Tier 1 banking space (Bank of China and ICBC), and the blockbuster US$8 billion Alibaba issue in October.

Asset flows stabilised after a challenging 2013. A large proportion of the retail asset base left the asset class in 2013 following the Federal Reserve (Fed) "taper tantrum" and "Fragile 5" concerns. Although some retail investors returned, institutional money continues to dominate the space and as such positioning feels a lot cleaner than it has in recent years. However, flows in developed market credit were not as resilient when in July Fed Chair Janet Yellen identified US high yield as an asset class where valuations looked stretched. This sent shock waves through the market and triggered an outflow-led sell-off. There was some contagion to our market given the presence of crossover buyers, which was felt in the price action in names such as CEMEX, Digicel and other names widely held by developed market investors.

2015 Outlook

Overview

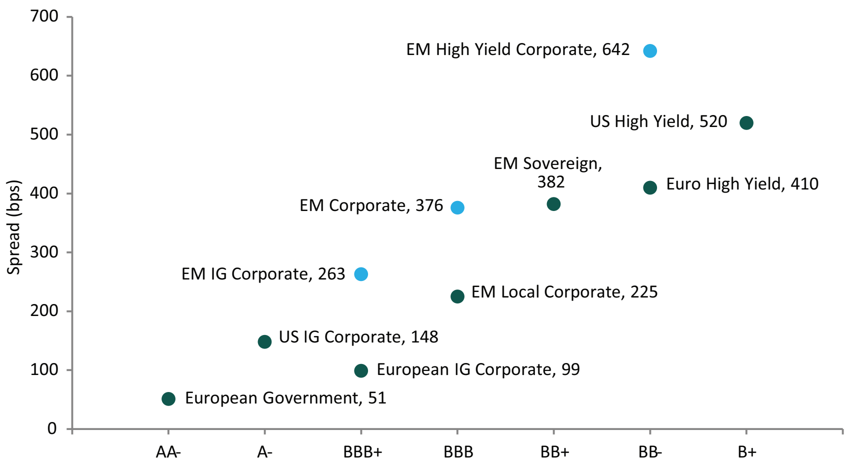
Looking ahead there is almost a sense of déjà vu; despite all that has gone on over the past twelve months our expectations for 2015 are broadly similar to those of 2014. These include lacklustre growth and a modest increase in US Treasury yields to be offset by some scope for credit spread compression. In addition, we expect a modest pick-up in defaults (albeit from a low base of 2.7%) to approximately 5% for the EM high yield market. In our view, these should culminate in an expected return for the asset class in the region of 4–6%. However, there is significant scope for additional alpha generation given expectations for credit dispersion and a number of upcoming credit events that skilled bottom-up fundamental analysis should identify and provide protection for portfolios.

Valuations

We believe valuations look quite attractive at current levels, in particular after the sell-off we witnessed in the latter part of 2014 (Fig. 7).

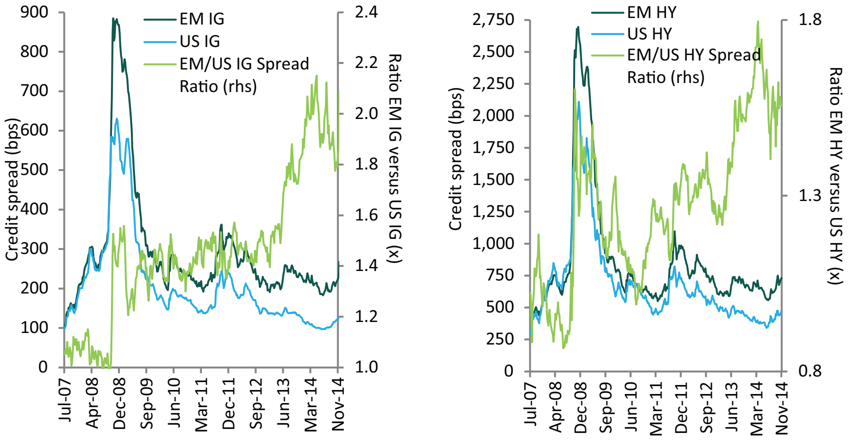
Valuations appear attractive versus other fixed income asset classes

Fig. 7 EM corporate valuations appear attractive compared to other asset classes



Data source: JPMorgan, BOAML as at 9 January 2015
Note: Please refer to the footnotes at the end of the document for index descriptions

Fig. 8 EM versus US credit indices, spread performance



Data source: Data source: BOAML as at 31 December 2013
Note: Please refer to the footnotes at the end of the document for index descriptions

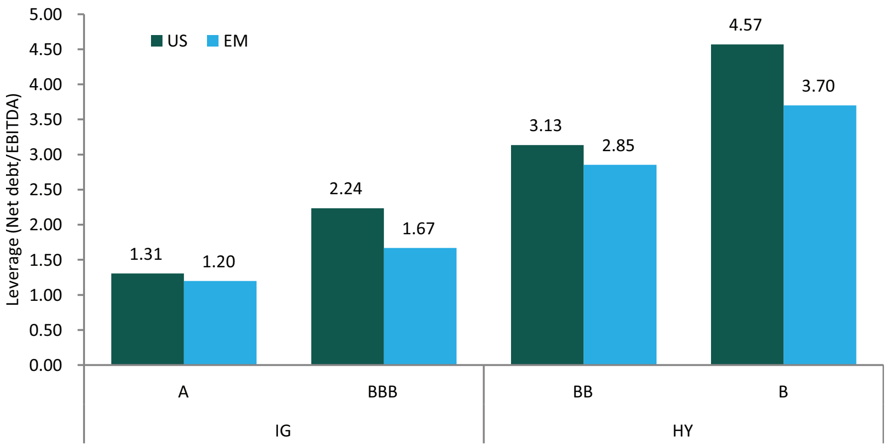
As such, relative to other fixed income products on a standalone yield basis, we believe the carry in EM corporate debt is quite compelling with investment grade yielding 4.62% and high yield at 8.04% as at year end. Furthermore, looking at the spread pick-up one receives for investing in EM corporates relative to DM corporates, this ratio is at an all-time wide, and as such in our view the relative value arguments for asset class are pretty robust.

Fundamentals - default outlook

From a bottom-up fundamental standpoint, we believe that broadly speaking corporates remain in pretty good shape. Leverage remains low and cash balances high. Anecdotally we have also not seen much evidence of late-credit-cycle behaviours (share buybacks, M&A etc.) from EM company management teams which, for the most part, remain quite conservative, unlike what we are seeing in developed markets across the credit quality spectrum.

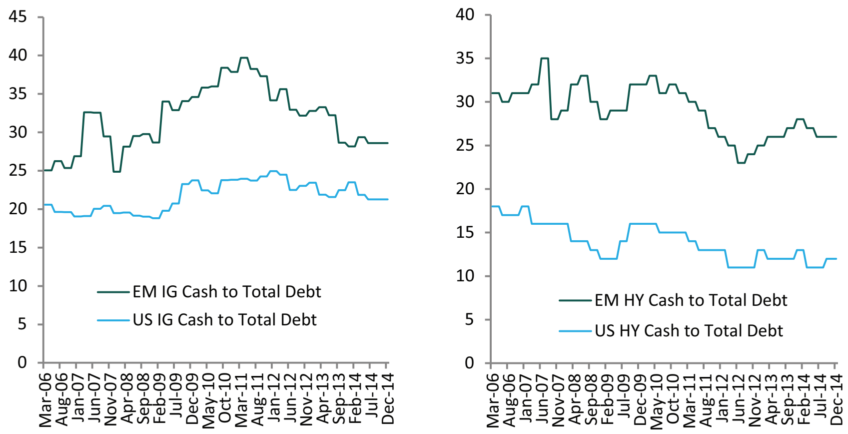
From a fundamental perspective corporates remain in good shape

Fig. 9 EM versus US corporates by credit rating



Data source: BOAML as at 31 December 2014

Fig. 10 US, EM IG & EM HY, Cash as % of total debt



Data source: BOAML as at 31 December 2014
Note: Please refer to the footnotes at the end of the document for index descriptions

That said, there will always be problem credits that will struggle to meet their obligations when growth slows and commodity prices fall. We have recently gone through our annual exercise where we review every credit in our universe and form a view on whether it will default in the next twelve months - in our base case and in stressed scenarios. In summary, we believe that the high yield default rate will likely rise to about 5% for 2015. This is largely driven by: i) Ukrainian corporates and weaker Russian financials most impacted by the conflict and by sanctions, ii) higher leveraged metals and mining companies hurt by low commodity prices, and iii) some weaker Chinese real estate credits. We believe prices largely reflect the weakness in points i) and ii), but for iii) it is more mixed.

Macro themes

We expect the theme of US dollar strength to continue in 2015

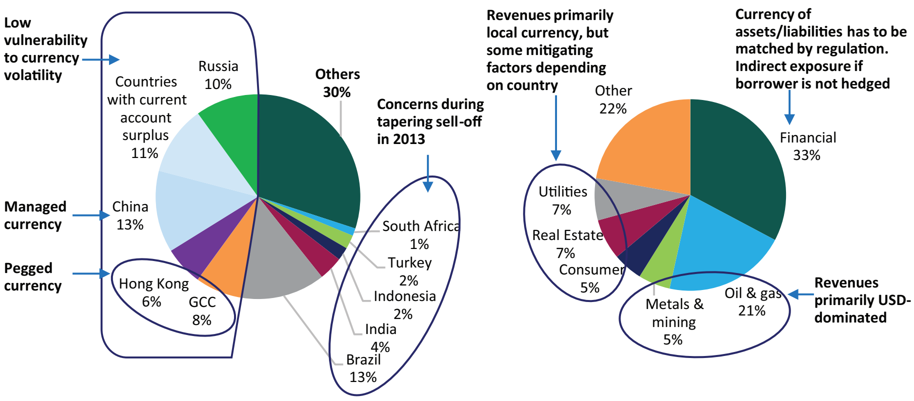
There are currently a number of key macro themes at play in our markets: oil prices in the 40s, a persistently stronger US dollar and weaker EMFX, continued global growth concerns and divergent central banks with the US likely set to hike rates this year. Meanwhile the European Central Bank (ECB) flirts with the idea of full-blown sovereign quantitative easing (QE) to battle deflation, with Japan and China also adding stimulus in various forms. Our base case is that the Fed will look to begin its hiking cycle in 2015, though the lower inflation prints we expect to come out in the early parts of the year will to a large extent determine the timing of this, with market consensus that it may be later in the year.

With respect to oil, longer-term we expect lower prices are a net positive for growth and inflation in EM. However, given the sharpness of the decline, in the short term it is proving to have a negative impact on sentiment and in particular for the weaker high yield oil and gas names in the exploration and production space. We do not explicitly forecast oil prices, although looking at what the forward curve is currently pricing in, we do not expect a V-shaped recovery in oil prices in 2015. As such we expect the weakness to continue this year, with oil-dependent markets such as Russia, Colombia, Kazakhstan and some of Africa set to be most impacted, with the net importers in Asia (ex-Malaysia) best-placed to perform well in such an environment.

US dollar strength

Given the macro backdrop, with the US leading the way in growth and entering a hiking cycle, we expect the theme of US dollar strength to continue in 2015. Much has been made of this and the impact of on EM corporate balance sheets. From our perspective, weak EMFX is not necessarily a negative across the board (particularly given floating FX regimes and buffers in a number of countries), rather we believe that, depending on the sector and the country, the impact varies greatly, as illustrated by Figure 11.

Fig. 11 EM corporate external bond stock breakdown by country and industry



Data source: JP Morgan, as at 31 October 2014

2015 key watch-points

We believe 2015 is also likely to see a number of key events play out. As we start the year, a few are at the forefront in countries that represent a large proportion of our benchmark. Russia, Brazil and China together account for approximately a quarter of the JP Morgan Corporate Emerging Market Bond Index (CEMBI) Diversified market value as at 31 December 2014.

Russia/Ukraine

We believe that the 'frozen conflict' in Russia and Ukraine is showing no signs of resolution. We expect 2015 will likely be a challenging year in particular for Ukraine, where fundamentals are very weak and there is a reasonably heavy maturity schedule due. We expect a continuation of the debt extensions that we saw in 2014 in Ukraine to persist this year.

In Russia we expect economic growth will continue to slow, potentially into negative territory, due to lower oil prices and the impact of sanctions. It is also likely to be affected given inflation has picked up (over 10% as at year-end) as the currency has weakened and sanctions have reduced the supply of certain goods. However, the sovereign balance sheet remains very strong with more reserves than external debt, the current account remains in surplus and the fiscal accounts remain roughly balanced as the ruble has depreciated by more than oil prices. In 2015, import substitution is likely to reduce inflation pressure. We are monitoring liquidity, given companies' (both sanctioned and non-sanctioned) limited access to foreign capital markets, and feel banks are the most vulnerable, where bank capital ratios at banks do not leave room for a material increase in non-performing loans (NPLs). On the flipside, large Russian oil companies benefit from both a large US dollar revenue stream and the weakness in the ruble, meaning their cost of production decreases.

Brazil

President Rousseff's second term in office begins in earnest in 2015. We will continue to scrutinize her policy decisions and the extent to which she has the ability to make the necessary reforms to get Brazil's fiscal accounts in order, the country on a sustainable growth path and avoid a sovereign downgrade, or if she will revert to the same interventionist politics for which she was elected in the first place.

In addition, the ongoing "Operation Carwash" corruption scandal is likely to be an ongoing source of volatility. At the epicentre of this lies Petrobras, that at the time of writing has not yet released its third quarter accounts and will be under closer scrutiny as and when audited 2014 accounts must be signed off by PwC to avoid a technical default. Although we think the probability of this is low, we have low visibility as to the magnitude of the balance sheet adjustments needed and the size of the potential fines, so we will be closely monitoring the situation.

China anti-corruption

Over the course of the year, China's new premier has been leading an anti-corruption campaign, which to date has impacted individuals and not companies. However, it looks like high yield rated real estate company Kaisa Holdings has been caught in the net and, as the company has missed the interest payment on one of its bonds, this may lead it to default; if it occurs it would be the first default of an offshore real estate bond from China. We are watching to see if this materialises and if (as we believe) it is a one-off, or whether other companies could get caught in the same campaign. In addition, we will be monitoring the technical impact on other high yield issuers and how the recovery process plays out.

Conclusion: Total return expectations

Beta

We believe the broad asset class will likely deliver in the region of 4–6% at the index level for 2015, driven mainly by carry. Central to this forecast is our assumption that:

- In our base case, default rates not go above 5%, based on our fundamental bottom-up research
- Recovery rates are in line with historical averages (30 cents on the dollar)
- Treasuries at the 7-year point of the curve (equivalent duration of the JP Morgan CEMBI Diversified index) move wider by approximately 35bps (as implied by the 7yr1yr forward rate)
- Credit spreads compress by approximately 25-50bps, based on our assessment of where we are at current valuations, and possibility for retracement versus long-run historical averages

We believe the broad asset class will likely deliver in the region of 4–6% at the index level for 2015

That said, visibility is not as good as in previous years and as such the confidence interval around this forecast is wider. We have not ruled out the possibility of a significantly higher default rate in a stressed scenario, or the chance of a sudden spike in interest rates, although we do not believe either of these are likely. As you can see from Figure 12, the range of possible outcomes is very wide.

Fig. 12 Total expected returns for the asset class in 2015

Year-end spread level (bps)	HY Default Rate in bps: 0	100	200	300	400	500	600	700	800	900	1000
250	9.08%	8.87%	8.66%	8.45%	8.24%	8.03%	7.82%	7.61%	7.40%	7.19%	6.98%
275	7.70%	7.49%	7.28%	[illegible]	6.86%	[illegible]	6.44%	6.23%	6.02%	5.81%	5.60%
300	6.33%	6.12%	5.91%	5.70%	5.49%	5.28%	5.07%	4.86%	4.65%	4.44%	4.23%
325	4.95%	4.74%	4.53%	4.32%	4.11%	3.90%	3.69%	3.48%	3.27%	3.06%	2.85%
350	3.58%	3.37%	3.16%	2.95%	[illegible]	2.53%	2.32%	2.11%	1.90%	1.69%	1.48%
375	2.20%	1.99%	1.78%	1.57%	1.36%	1.15%	0.94%	0.73%	0.52%	0.31%	0.10%
400	0.83%	0.62%	0.41%	0.20%	-0.02%	-0.23%	-0.44%	-0.65%	-0.86%	-1.07%	-1.28%
450	-1.93%	-2.14%	-2.35%	-2.56%	-2.77%	-2.98%	-3.19%	-3.40%	-3.61%	-3.82%	-4.03%
500	-4.68%	-4.89%	-5.10%	-5.31%	-5.52%	-5.73%	-5.94%	-6.15%	-6.36%	-6.57%	-6.78%

Data source: BlueBay Asset Management as at 31 December 2014
These forecast figures are based on assumptions and are subject to change without notice. There are frequently sharp differences between forecasts and actual results. These forecasts may also differ from those of other credit strategists or portfolio managers at BlueBay Asset Management LLP as a whole, and are not intended to be relied upon. BlueBay Asset Management LLP disclaims all liability or responsibility arising from any use or interpretation of, or reliance upon these forecast figures.

However, when compared with other fixed income asset classes, we feel EM corporate debt is better equipped given the spread buffer inherent in the asset class, and its lower sensitivity to a rise in interest rates versus other asset classes. We believe EM corporates should be more immune to a rise in interest rates given the spread cushion and lower sensitivity to Treasury moves.

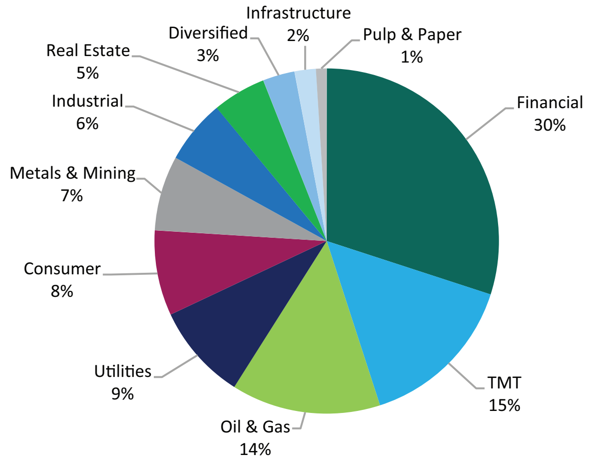
We feel that we are in an environment well suited to active management

Alpha

In terms of our ability to generate alpha in this environment we feel, given the lack of uniform directionality in the market, along with the credit differentiation theme, that it is an environment well suited to active management. In particular we believe active managers focused predominantly on bottom-up credit fundamentals should thrive.

APPENDIX - Sector Specific Outlook

Fig. 13 JP Morgan CEMBI Diversified weighting



Data source: JP Morgan as at 31 December 2014

Financials

While banks will likely face the challenges of lower growth and weaker currencies, most are prepared with good balance sheets; Russia and Ukraine face the largest challenges due to geopolitical issues. The good news is that the banks have had sufficient time to prepare for these challenges as it was broadly expected/has already begun in a number of markets. We see opportunities in the debt of those banks that have built defensive balance sheets and are well hedged within each system. Our focus for the year will primarily be upon on bottom-up credit selection. In Europe, distress in Ukraine and Russia are expected to bring restructurings and dislocations. We anticipate selective defaults and in Russia potential for the triggering of the first Basel III instrument globally. Such volatility will continue to generate major dislocations that may create attractive entry points later in the year. The ever-growing capital requirements under the Basel III rules adopted earlier this year will continue to generate subordinated bond issuance from across EM. Inaugural Basel III issuances from systems that have yet to tap the international markets for capital are expected to generate opportunities as the market struggles to price these complicated structures that vary from country to country.

Telecommunications

In our view, the inherent stability and good top-line visibility should support the broad telecom sector in 2015. It will nevertheless be very important to differentiate at the issuer level. While EM telecom companies in general should be able to continue to grow their top line in the low-single-digits in 2015, more rapid growth becomes harder and harder to achieve. Data (as opposed to voice) remains the big growth driver, both in fixed line and mobile segments, but markets are maturing fast and a declining fixed line business as well as competition, provides headwinds. For that reason effective cost management will remain very important in 2015. Since investment requirements remain elevated, driven by network upgrades and 4G investments, companies with low leverage and hence low interest cost will be better positioned to generate positive free cash flow. Meanwhile companies with high leverage may find it more challenging to grow their way into their capital structure. In addition, equity valuations are no longer providing as large equity cushions as in the past. That is why we prefer lower-levered credits with strong market positioning and proven managements for 2015. Independently, M&A will be an important theme for the sector and we will look to benefit from any upcoming event triggers.

Oil & Gas

We remain cautious on the oil & gas sector. The steep drop in oil prices looks to have some structural elements and will prompt an increase in leverage across a number of issuers focused on exploration and production, while downstream (retail and refining) may be more insulated. In terms of investment grade issuers, we feel standalone credit profiles can accommodate a period of lower oil prices with most issuers currently displaying low starting leverage, capex flexibility and local currency denominated cost bases. However these relative strengths are balanced by strong linkages to government ratings, which may come under pressure due to declining oil-related tax revenues. In the high yield space we expect the drop in oil price will likely severely test business models of more levered and not fully funded exploration focused companies, as expected project internal rates of return (IRRs) decline and lower cash flow results in liquidity strain at many issuers. While there are challenges, this could present investment opportunities if spreads overshoot in their widening. As oil prices stabilise and potentially recover in the second half of 2015, we feel the sector has room to generate alpha and our focus remains on those names with low cost production, some insulation from crude prices, flexible capex budgets and sound liquidity.

We remain cautious on oil & gas and metals & mining but constructive on utilities

Oil & Gas Services

We expect 2015 to be a challenging year for the sector given the sharp decline in the oil price further unbalancing the already weak supply-demand dynamics in the offshore drilling services sector. The sector enters 2015 with high funding needs given scheduled rig deliveries, (in most cases) lack of contracts to oil & gas companies and weakening appetite in bank and bond markets to finance the acquisition of these vessels given the lack of contracts and pressure on asset values. However, certain issuers remain structurally well protected from the market downturn (those with longer-term contracts and little or no-unfunded new rig deliveries). Therefore we will look to selectively take advantage of the current valuations which substantially underperformed the index in the second half of 2014.

Utilities

We are constructive on utilities as a stable and defensive sector in most markets, with the added tailwind of declining fuel costs which are positive near-term for working capital cycles, but ultimately neutral for margins as fuel costs are passed through in most jurisdictions. Certain markets continue to remain challenging for investors due to either an unfavourable policy environment combined with necessary investment (e.g. South Africa) or over-dependence on hydro in a drought period (e.g. Brazil). Away from these idiosyncratic stories, by and large most companies continue to perform in line with underlying gross domestic product (GDP) growth of their host markets and remain among the most defensively positioned of the sectors. We prefer markets with a clear fuel cost pass through and some foreign currency cost pass through.

Consumer & Retail

With slowing growth in most EM countries, the EM consumer had a fairly sluggish year in 2014. Inflation is expected to decrease in 2015 in many countries we follow, which would be positive for consumers, but unemployment trends are more mixed. Consumer non-discretionary sectors such as food producers should prove more resilient, while the retailer and discretionary outlook will vary more by region. Therefore for retailers we focus on opportunities that arise from economies expected to do better next year – Peru and Mexico in particular. We are cautious on retailers with higher exposure to Venezuela, Argentina and

Brazil where we expect further strain on consumers' disposable income. The export-oriented Brazilian meatpackers are enjoying a favourable environment of high beef and chicken prices, together with the weaker Brazilian real helping their competitive position, which has led to a number of upgrades in the sector. However, we are starting to see early signs that further margin expansion will be difficult to achieve and the credit profiles are likely peaking for the segment. We also are likely to find attractive idiosyncratic stories across consumer names that are defensive businesses, are on an improving credit trajectory, or may benefit from industry consolidation.

Metals & Mining

We remain cautious on the metals & mining sector. Capacity increases over the past decade to meet the commodity super cycle has resulted in oversupply as global growth and demand remains lacklustre. Consequently, we have seen steep price declines in many core commodities such as iron ore, thermal coal and coking coal. Unlike oil & gas where supply contractions will be felt mostly by US shale producers, it is less clear when and which producers will adjust supply lower in metals and mining. Many producers are reluctant to shutter capacity they have just built and would rather wait for demand to pick up. In addition, many issuers in the sector in EM are high yield or low investment grade rated, with balance sheets that may not enable them to survive a period of prolonged low prices. That said we see select opportunities despite this bleak outlook and remain focused on those names that are exposed to metals with better supply-demand dynamics, or are first-quartile producers, have hedging in place and sound liquidity.

Industrials

On balance we remain cautious on the sector due to its cyclical nature and the unclear outlook for global growth, which is not necessarily reflected in valuations. However, there are opportunities that good credit selection can create. For example, we expect the stronger US economy and local currency devaluation will likely benefit US export-orientated credits, while secular infrastructure and housing demand across emerging markets, as well as strong asset values, will lend support to building material companies. Also, companies at the low end of global cost curves and strong liquidity will remain sustainable through cyclical weaknesses, should they occur.

Real Estate

We believe 2015 is shaping up to be a challenging year with the key risk being the timing and trajectory of domestic and external interest rates, which will ultimately affect demand for both residential and commercial property. Being a largely domestically-focused sector, currency mismatch is a rising risk in the context of a strong US dollar/weakening EMFX environment. The most challenged market continues to be China, which has to walk a fine line between the necessity of dealing with structural issues (persistent oversupply, transition in the wider economy from investment to consumption, reform in the financial markets and anti-corruption chilling demand as well as activity). We expect continuing differentiation as larger more profitable players with good access to capital continue to outperform a slowing market. The ability to tap domestic and international financing sources through the cycle will be another point of differentiation. (We are positioned for this via a bias for top tier, national scale players who are typically investment grade rated versus the smaller, regional and high-yield rated issuers). Having said this, a key risk which we had been anticipating to arrive in early 2015, (being the large size and number of offshore high yield bond maturities) appears to have been dealt with for the moment, with a number of weaker issuers having chosen to redeem or tender bonds ahead of year end.

2015 will be a challenging year for real estate, in particular for the weaker segments of the Chinese market

Away from China, we expect a normalisation of demand to result in slowing revenue growth but largely stable margins for residential developers and landlords in other major EM markets such as Brazil, Mexico, the Gulf Cooperation Council (GCC), Hong Kong, Philippines, India and Indonesia. Broadly the macro-prudential backdrop has been counter-cyclical in most jurisdictions, so there is room for policy manoeuvre if required. Commercial property developers should continue to be resilient in most markets (particularly Hong Kong, Mexico, Brazil and the GCC) with rents remaining defensive and stable (driven by modest underlying GDP growth and lack of supply) and investors should continue to appreciate their stability, predictability and inflation protection. However, valuations in both the equity and debt securities will be tested in a rising rate environment. The key markets that are at risk of oversupply on the commercial side continue to be China (Shanghai/Beijing, both of which are expecting completions of large amounts of office square footage in 2015 – 2016, which could be a potential risk, especially if the slowing growth rate in China is not sufficiently arrested).

Infrastructure

Infrastructure has been a resilient sector in 2014 and should at least remain stable in 2015. Our infrastructure universe is dominated by ports, which are generally defensive businesses, have demonstrated strong through-put volumes in 2014 and were able to either maintain or reduce their leverage. We continue to see capacity investments either through mergers and acquisitions or organic capital expenditure, however we see the spending cycle shifting from one company to another. The challenge for the infrastructure operators remain balancing the financial strength and flexibility required to commit to opportunistic capacity investments with the prospect of weakening demand. We see opportunities in the sector within those companies that continue to demonstrate robust operating performance and capex discipline, while also benefiting from strong market positions and diversification.

We see opportunities in infrastructure within companies that continue to demonstrate robust operating performance

Pulp & Paper

Hardwood pulp prices were soft in 2014 and, while demand from developed countries is stable, increasing Asian demand should provide support to pulp prices in 2015. On the supply side, capacity is increasing in Brazil while it is being shut in higher-cost regions like Northern Europe and the US. The combination of these factors should leave some Latin American-based pulp exporters in a relatively favourable position that should also benefit from weaker currencies in emerging markets. Weaker volumes are expected in the domestic market due to slower growth in Brazil. In such markets we prefer players, who manufacture higher value-added products.

Transportation

This sector largely represents a mix of strategically important, state-owned railway monopolies at one end of the spectrum and highly-cyclical shipping and airline companies at the other. The key credit characteristics of the former group are foreign currency mismatch, given almost entirely local currency cash flow versus partial hard currency debt, dependence on government subsidies/regulations and high capital expenditure needs in line with government infrastructure plans. The airlines and shipping industries on the other hand are characterized by low EBIT margins, high commodity exposure in the cost structure, currency headwinds, capital intensity and oligopolistic competition. Given the fundamental drivers and the limited control by issuers of these factors, we generally see valuations as unattractive, although we constantly monitor the sovereign, commodity and industry dynamics in order to identify potential opportunities in the sector.

Index names: S&P 500 = S&P 500; EM IG Coporate = JPM CEMBI Diversified Investment Grade; US IG Corporate = BAML US Corporate index; EM Sovereign = JPM EMBI Global Diversified; EM Corporate = JPM CEMBI Diversified; US High Yield = US High Yield Master; EM HY Corporate = JPM CEMBI Diversified index High Yield; EM Equity = MSCI EM Equity index; EM Local Currency Debt = BAML Diversified Local EM Non_Sovereign index