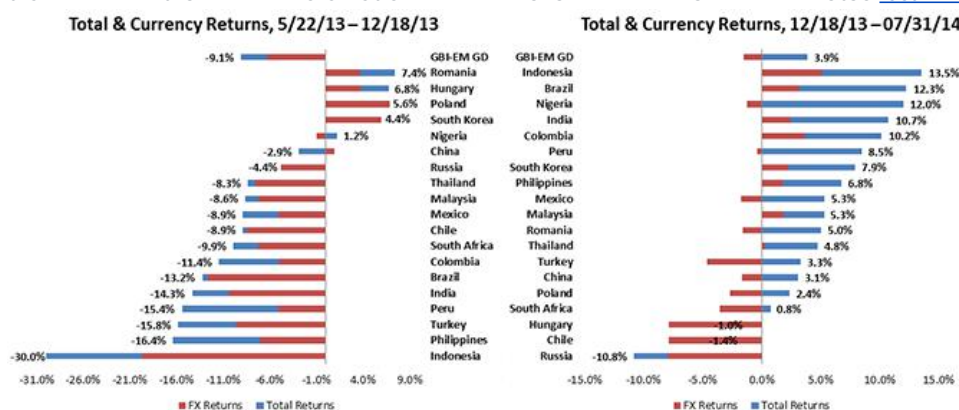


FEDERAL RESERVE TAPERING PART II: EMERGING MARKET LOCAL DEBT PERFORMANCE

Bradley Krom — U.S. Head of Research
08/11/2014

In part two of our discussion, we focus on the impact of recent changes in Federal Reserve (Fed) policy on locally-denominated fixed income across emerging markets (EM).¹ As we noted in [part one](#), higher short-term interest rates in emerging markets helped dampen losses from currency depreciation since the Fed began to “[taper](#)” its bond purchases in December. In this analysis, we take a broader view of the Fed’s change in policy. In the charts below, we show the bond market’s reaction to Ben Bernanke’s taper comments from May 2013 and then look at the impact once the Fed actually started to reduce its bond purchases in December.² Our primary takeaway from this analysis is that even though many emerging markets have rebounded, the rebound has not been particularly widespread. Yields remain considerably higher and currencies lower than May of last year. Compared to other fixed income sectors, we believe there is still opportunity for returns on account of high levels of income and further appreciation in EM currencies. From the end of May 2013 through the end of the year, global fixed income markets came under pressure, and many EM currencies depreciated against the U.S. dollar. As [we noted](#) at the time, countries that were perceived by the market to be dependent on foreign funding came under the greatest amount of pressure. Indeed, many of these countries actually [hiked interest rates](#) in order to stem the depreciation pressures on their currencies. In January, the vast majority of emerging market fixed income and currencies began to bottom out. In our view, this marked a turning point as more investors began to reassess the underlying fundamentals against their valuations. So far in 2014, bond yields around the world have declined. As we outline below, we believe that at current levels, EM local debt continues to appear attractively priced compared to other more traditional fixed income sectors and could prove to be much more resilient than the dramatic move we noted [last summer](#).



Source: J.P. Morgan, Bloomberg, as of 7/31/14. Past performance is not indicative of future results. You cannot invest directly in an index.

For the definition of GBI-EM

GD Index, [click here](#). As shown in the chart above, many of the countries that were the most significant underperformers leading up to the implementation of tapering have been among the strongest outperformers so far this year. In most instances, higher income and the fall in yields from their peaks has helped many of these countries recoup losses experienced in 2013. As we noted in part one of this series, emerging market currencies have not necessarily fully participated in this recovery. In fact, only eight of 19 EM currencies in this analysis have appreciated against the U.S. dollar over this most recent period. Since tapering began in December 2013, currencies remain a modest detractor from overall returns of the asset class. In spite of this tepid rebound, total returns for investing in emerging market debt have

been close to 4% over the period compared to 0.59% investing in five year U.S. Treasury bonds. In our view, this represents the fundamental value of emerging market debt. As long as currencies don't depreciate by significant margins at the same time, emerging market fixed income can help provide investors with much greater total returns than plain-vanilla U.S. fixed income. With currency volatility continuing to be constrained so far this year, we believe that emerging market fundamentals will continue to favor currency appreciation in the long run. **Emerging Market Fixed Income**

Countries	Total Returns	Currency Returns
U.S. 5-Year Treasury	-0.7%	-
GBI-EM GD	-5.6%	-7.7%
Nigeria	13.4%	-2.2%
Romania	12.9%	2.0%
South Korea	12.6%	8.4%
Poland	8.1%	4.1%
Hungary	5.7%	-4.4%
China	0.1%	-0.7%
Colombia	-2.4%	-1.5%
Brazil	-2.6%	-9.9%
Malaysia	-3.8%	-5.5%
Thailand	-4.0%	-7.3%
Mexico	-4.0%	-6.8%
India	-5.1%	-8.2%
Peru	-8.2%	-5.4%
South Africa	-9.2%	-10.6%
Chile	-10.2%	-15.7%
Philippines	-10.7%	-5.3%
Turkey	-13.0%	-13.8%
Russia	-14.7%	-12.3%
Indonesia	-20.5%	-15.6%

Source: J.P. Morgan, WisdomTree, as of 7/31/14.

Returns: May 22, 2013 – July 31, 2014

Past performance is not indicative of future results.

Viewing the cumulative impact of tapering since May 22, 2013 in the table above, we continue to see a high degree of dispersion in the performance of emerging market countries. Again, currencies remain much weaker against the U.S. dollar with only three (Romania, South Korea and Poland) managing to appreciate over the period since Bernanke hinted at a reduction in bond purchases. However, an interesting element of this analysis shows that six out of 19 of these markets are no worse off than investing in [U.S. 5-year Treasuries](#) over this period. While volatility is undeniably higher for emerging market fixed income, yields of 1.75% in the United States provide limited options for attractive returns if rates rise by even a modest amount, in our view. In sum, we continue to believe in the long-term story of investing in emerging market local debt. While currency performance has served as a headwind to total returns, we do not believe this will be the case in perpetuity. In our view, faster economic growth, improving fundamental balances and increases in investor sentiment should continue to provide a positive backdrop for emerging market fixed income in the long run. ¹EM local debt represented by the J.P. Morgan Government Bond Index Emerging Markets (GBI-EM) Global Diversified ²As of 7/31/14.

Important Risks Related to this Article

Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Taper tantrum : a period in which global interest rates rose dramatically in 2013 as a response to a shift in monetary policy by the Federal Reserve.

JP Morgan Government Bond Index – Emerging Markets (GBI-EM) Global Diversified : The JP Morgan GBI EM Global Diversified tracks the performance of local currency debt issued by emerging market governments, whose debt is accessible by most of the international investor base. The index incorporates a constrained market-capitalization methodology in which individual issuer exposures are capped at 10%, (with the excess distributed to smaller issuers) for greater diversification among issuing governments.

U.S. 5 Year Treasury Note : A debt obligation issued by the United States government that matures in 5 years.