EMERGING MARKET LOCAL DEBT SOARS

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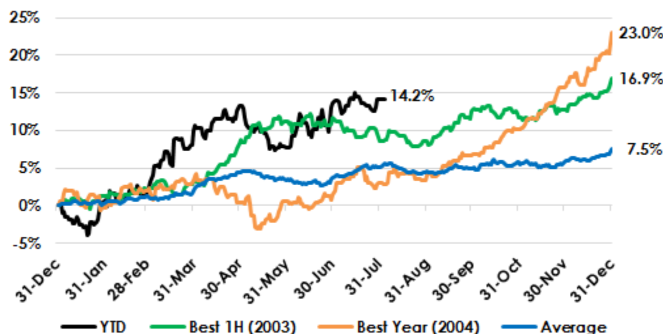
Coming off three consecutive years of losses and the worst calendar-year performance in the history of the asset class, emerging market (EM) local debt[1] has rallied over 14% year-to-date.[2] Driven by investor flows to high-yielding assets, a global decline in interest rates and a rebound in EM currencies against the U.S. dollar, EM local debt is among 2016's best-performing fixed income asset classes. As we first highlighted back in April, investors have a variety of options for making allocations to emerging markets. **1H 2016: A Historical Retrospective** So far, 2016 has outpaced 2003 as the best start to the year in the history of the asset class. After a difficult January, a rebound in commodity prices, combined with a much less hawkish Federal Reserve (Fed), has created a perfect storm of falling bond yields and positive EM currency performance. In terms of attribution, 60% of returns has been driven by bonds, whereas 40% has come from positive Foreign Exchange (FOREX, FX).[3] Interestingly, this is nearly identical to the strong performance in 2003. While this is great news for investors who allocated in January, what might the second half of 2016 have in store for the asset class? Below, we highlight some key risks and opportunities. **EM Local Debt Performance, 2003-2016 YTD**



Source: Bloomberg, as of 8/3/16. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns.

Current Risks

Understandably, it feels uncomfortable to buy assets that have appreciated by double digits. However, this snap-back in performance should be tempered by the fact that EM local debt may be emerging from three years of losses that averaged nearly 10% per year. Regardless, August has generally tended to be a poor performer for many EM currencies. The current logic is that risk-taking among investors declines during summer months, asset flows into emerging markets are reduced, and trade balances tend to deteriorate. In our view, investors should not be surprised to see a pullback in performance over this period. Additionally, performance for the asset class remains intrinsically linked to investment flows. With the Fed likely waiting (at least) until the end of the year to hike rates and other developed market central banks poised to expand their balance sheet, emerging markets have been a logical destination for many. A risk to EM would be an improvement in U.S. economic data that alters the expected pace of Fed tightening. In this scenario, it may be possible to see capital outflows similar to what investors experienced during the "taper tantrum" of 2013. Finally, a fair amount of good news has been priced in for many EM countries. Large economies such as Brazil have seen their local bonds return nearly 50% in U.S. dollar terms while South Africa returned 24% in U.S. dollar terms. With all eyes on Brazil during the Olympics and the South African economy teetering on the brink of recession, it may be possible to see

markets pause or reassess. **Focus on Fundamentals and Income** That being said, these risks are well known to the market. In many EM countries, growth expectations may be bottoming. With a potential rebound in growth, the high yields offered by many EM countries may appear compelling, particularly in light of the paltry bond yields in most developed markets. In fact, with yields of nearly 6.5% (even after a strong rally), investors have the opportunity to tap yields similar to U.S. high-yield corporate debt for assuming currency risk in currencies that have lost significant value over recent years. Additionally, after many years of downgrades by credit ratings agencies, the fundamentals that many investors voiced concern over in 2013 have improved, in our view. Concerns about current account deficits have narrowed markedly as EM currencies have depreciated. While the thesis for sustained EM performance relies on a stabilization followed by improvement in fundamentals, heavily depreciated currencies and high current yields may appear compelling in the second half of 2016. **Conclusion** In our view, investors who have shunned EM fixed income over the last several years should consider adding to their positions during market pullbacks. While currency volatility guarantees that the path will not always be straight, the ability to tap many markets trading at steep discounts compared to their history could represent an opportunity. In our view, biasing portfolios away from a strict EM market capitalization-weighted approach could make sense over market cycles. For investors who agree with this alternative approach, the WisdomTree Emerging Markets Local Debt Fund (ELD) could provide exposure to the asset class while still being conscious of fundamentals. [1]As measured by the J.P. Morgan GBI-EM Global Diversified Index, as of 8/3/16. [1]Source: Bloomberg, as of 8/3/16. [1]Source: J.P. Morgan, as of 8/3/16.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. 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. Derivative investments can be volatile, and these investments may be less liquid than other securities, and more sensitive to the effects of varied economic conditions.

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline. Unlike typical exchange-traded funds, there is no index that the Fund attempts to track or replicate. Thus, the ability of the Fund to achieve its objective will depend on the effectiveness of the portfolio manager. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs.

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Interest rates : The rate at which interest is paid by a borrower for the use of money.

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

Foreign Exchange (FOREX, FX) : The exchange of one currency for another, or the conversion of one currency into another currency.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

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.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securitie.

Corporate debt : Bonds a company issues in order to raise money.

Credit ratings : An assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation. Credit assessment and evaluation for companies and governments is generally done by a credit rating agency such as Standard & Poor's, Moody's or Fitch.

Current account deficit : Situation where a country has a greater level of imports than exports.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.