

# DIVERGENT EMERGING MARKET OUTCOMES IN AN UNEVEN RECOVERY

In this paper, portfolio managers and emerging market debt specialists Jennifer James and Ales Koutny analyse emerging market (EM) country fundamentals and consider how they influence opportunities for investors.

## Key takeaways

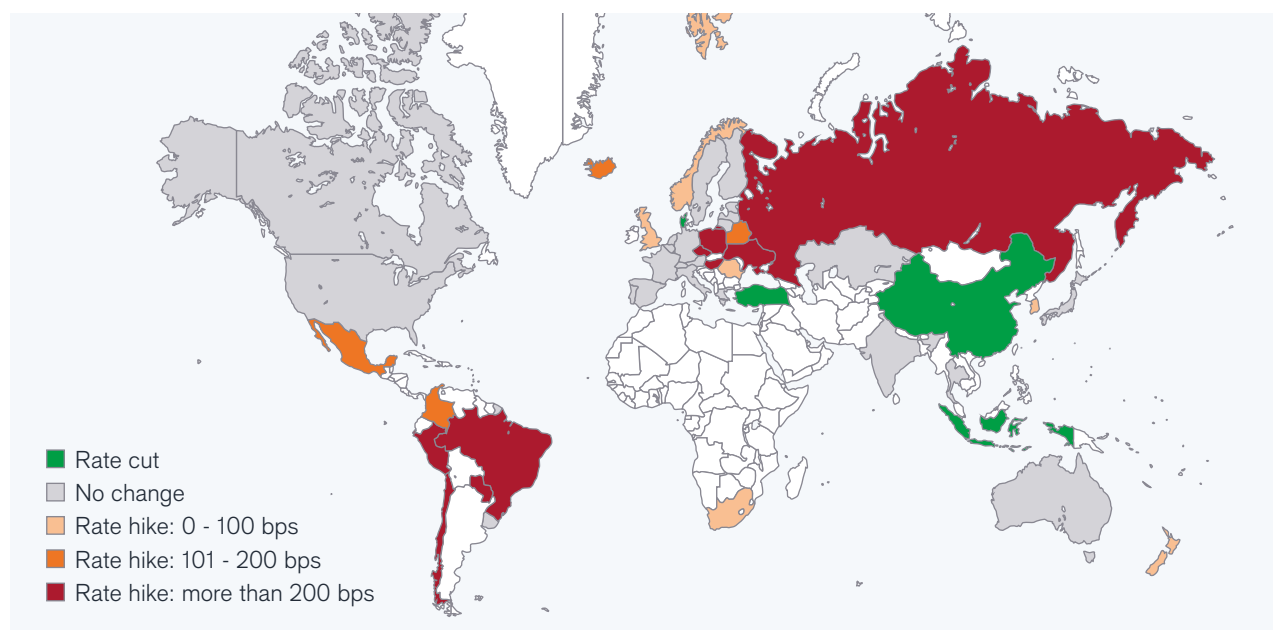
- EMs are ahead in their tightening cycles relative to developed markets (DMs), but further divergence between countries will emerge in their differing paths to normalisation.
- Assessing economic fundamentals can indicate how the inflation and growth outlook could look for EM countries this year and their resilience against volatility from a rising rate environment.
- As inflation wanes during the second half of 2022, we believe real rates could turn more positive in some EMs while lessons learnt from how EM asset classes perform during a rate hiking cycle could be instructive for investors and asset allocation decisions.

## A well-trodden path to normality

Policy tightening in developed markets is at the forefront of investors' minds, but most EMs are already well on this journey. In March last year, the net number of hiking countries turned positive as more EM countries were hiking than not<sup>1</sup>. Those that are hiking

have lifted policy rates an average of over 286bps from the end of 2020<sup>2</sup>. While most of the developed world is synchronised in its steps towards tightening, more variation exists within emerging markets given differing progress on the path to recovery.

## EMs are further ahead in the tightening cycle



Source: Bloomberg, 27th January 2022.

<sup>1</sup> Source: Reuters, Reuters calculations via Refinitiv Datastream, May 2021.

<sup>2</sup> Source: Bloomberg, 27 January 2022.

Some EMs are earlier in their tightening cycles, such as Eastern Europe and Latin America, than others in Asia for example. Even easing could be on the horizon for a few countries, such as Russia, Brazil and the Czech Republic<sup>3</sup> which appear to be approaching the final stage of tightening. Most of Asia is further behind, including tourism-driven ASEAN economies which have a more benign inflation outlook. China has an easing bias to promote economic and credit growth. Meanwhile Korea has hiked rates three times, as it has seen inflation surge at its fastest pace in almost 10 years<sup>4</sup>. Turkey remains an outlier in EM, as the central bank has deviated from conventional monetary policy in cutting rates despite high inflation, dampening its currency.

## A rocky road in 2022?

Investors typically access EM for superior growth potential. According to JP Morgan forecasts, however, the EM-DM growth differential will decline from 1% in 2021 to just 0.4% in 2022, much lower than historical averages<sup>5</sup>. It says this is due to slower DM growth affecting EM, changes in the drivers of the Chinese economy, the withdrawal of domestic policy supports and lower terms of trade – the ratio between a country's export prices and its import prices – gains. This masks a divergence within EM though as, for example, improved domestic activity together with higher vaccination coverage may be a driver of growth and inflation in some countries, as exports to China slow and global demand shifts from goods to services. This could provide a recovery tailwind for ASEAN economies. As services activity rebounds, how prices pass through to consumers on the back of increased producer prices will be key to inflation stickiness. A recovery in service inflation is evident in some countries, such as Russia<sup>6</sup> and India<sup>7</sup>, already. Undoubtedly slowing global growth is a headwind for EM growth and thus countries' debt profiles, external positions and dependence on foreign capital flows will be key in determining their individual growth and inflation outlooks in 2022 and beyond.

## Balance of trade dynamics drive differentiation

Emerging markets are acutely sensitive to rising prices given the extent of economies' dependence on exports or imports. Moreover, demographic trends are more inflationary when compared to developed markets given their growing, rather than shrinking, working age population. This inflation sensitivity is reflected in the divergence in the resilience of growth between those countries benefiting from the commodities rebound and those dependent on imports and impacted by the drop-off in tourism. This can be visualised in the difference in terms of trade seen across EM, which has improved in some countries and worsened in others since the onset of the pandemic.

<sup>3</sup> Source: HSBC, Peak prospects for prices and implied EM policy rates, 17 January 2022.

<sup>4</sup> Source: Trading economics, South Korea, interest rates, 21 January 2022.

<sup>5</sup> As at 24 November 2021.

<sup>6</sup> Source: World Bank, Russia Economic Report | No 46., 1 December 2021.

<sup>7</sup> Source: Reserve Bank of India, State of the Economy, 15 December 2021.

## Differentiation in EM countries' terms of trade

Country	31/12/2021	30/06/2021	31/12/2020	30/06/2020	31/12/2019
South Africa	24.6	26.4	23.7	15.7	13.4
Indonesia	5.6	-2.8	-5.3	-14.7	-12.3
Mexico	9.2	9.2	11.9	13.4	13.2
Turkey	-24.9	-25.4	-20.9	-15.9	-16
Brazil	14.0	20.2	14.5	-0.1	0
Russia	63.4	59.4	37.1	23	45.4
India	-46.7	-40.2	-35.4	-29	-33.2
Czech Republic	-9.4	-8.9	-6.5	-5.3	-6.7
Poland	-6.4	-7.4	-4.5	-3.2	-5.3
China	-29.8	-28.5	-20.6	-12.1	-16.2
Thailand	-26.1	-23.3	-17.3	-14.9	-17.2

Source: Bloomberg, 31 December 2021.

Contrasting examples are Russia – the world's second largest oil exporter benefiting from an uptick in global demand – which is advanced in its hiking cycle and Thailand – a significant importer of energy – which has endured a demand shock from tourism fuelling low inflation, where rates are not expected to rise until 2023<sup>8</sup>. With the reopening of tourism in 2022, Thailand's current account could return to a surplus, in our view, supporting its currency later this year. In Russia, the yield curve is inverted, implying that markets forecast longer-term rates to be lower than current ones and rate cuts after six months' time<sup>9</sup>. Some EMs could reach easing before DM as they were quicker off the mark to tighten, which could create opportunities for investors.

## Higher real rates in sight for EM?

EM versus DM real yield spreads are close to multi-year highs<sup>10</sup>, but this is reflective of DM real yields being so low, particularly in the US. Back when the US Federal Reserve (Fed) started hiking rates in 2016, real rates were significantly higher in EM than they are now (as shown in the chart overleaf), offering more cushion against this headwind. However, rate hiking cycles have further to go in most places and have not kept pace with inflationary pressures.

Nevertheless, bright spots emerge from the divergence in EM. Indonesia offers one of the highest real rates in EM, given its benign inflation outlook and strong external balance, strengthened by foreign direct investment (FDI) flows<sup>11</sup>. Higher real yields support its currency and local rates, as well as providing a buffer against broader EM volatility. China and Russia also offer positive real rates. Longer-dated government bonds in countries where real yields are higher offer better carry and, selectively, an opportunity to benefit as policy easing resumes earlier than others.

<sup>8</sup> Source: BNP Paribas, Thailand: Another year of living carefully, 29 November 2021.

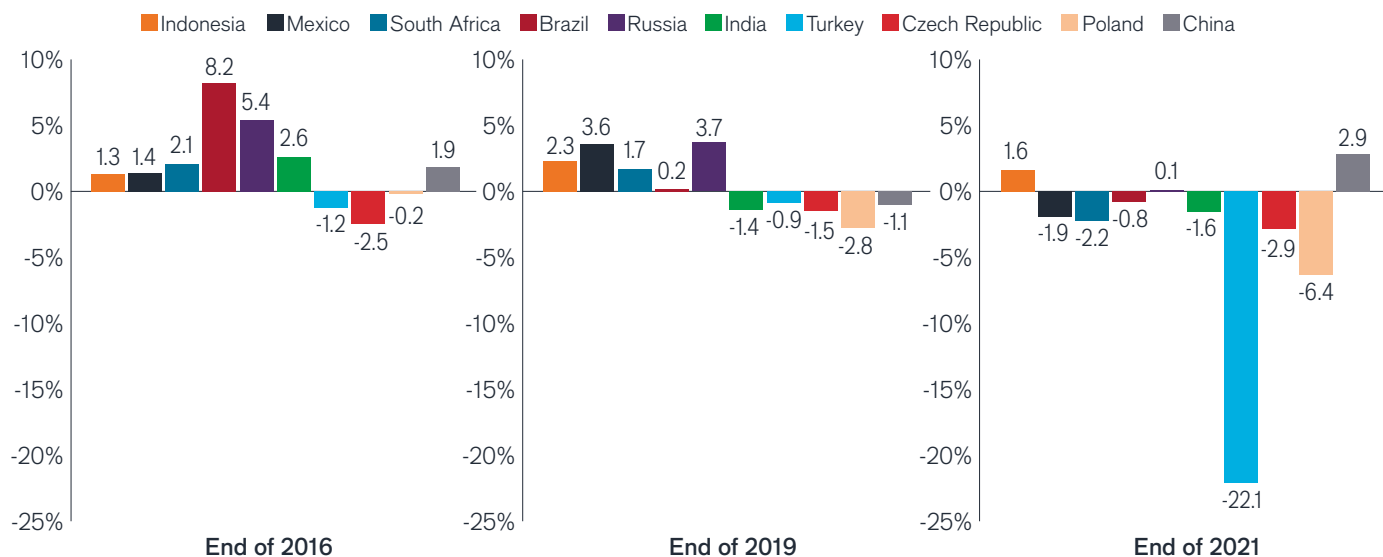
<sup>9</sup> Source: Bloomberg, 14 January 2022. Based on the Russia Fed Loan MTY Curve.

<sup>10</sup> Source: JP Morgan, Bloomberg Finance, Emerging markets outlook, 24 November 2021.

<sup>11</sup> Source: HSBC, CEIC, EM Rates 2022: Pockets of value, 2 December 2021.

In 2022, real yields could turn positive in EM, in our view, as inflation wanes. A peak in inflation could be seen in some EM countries this year – due to high base effects, slowing global growth and higher prices reducing disposable income. According to Barclays inflation forecasts and market pricing, positive real rates could emerge in parts of Latin America, South Africa and India by the end of this year<sup>12</sup>.

### Real rates (%) have fallen since the pandemic



Source: Bloomberg, 12 January 2021. Data shown is the latest y-o-y CPI change. The countries shown through this paper's economic analysis are the largest EM countries with the biggest exposure in indices and are a good representation of the general EM complex.

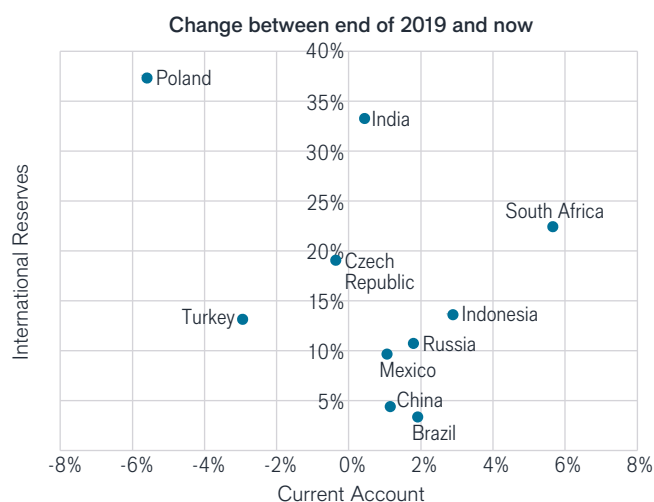
Suppressed real yields are challenging for rates (government bond) markets, but such large drawdowns in the local bond market have been historically followed by strong rebounds (as shown later) and so could represent buying opportunities. Nevertheless, investors should stay cognisant of potential headwinds on the horizon, such as Omicron, rising US rates and geopolitical risks, such as rising Russia-Ukraine tensions. We now will assess EM resilience from three aspects – debt, external position and foreign capital flows – which has implications for how investors allocate to EM.

### External position strengthens

While real rates have fallen during the pandemic, countries' external positions – exposure to international assets and liabilities – have strengthened. A rebound in exports and pick-up in services activity has boosted current accounts, which have increased across most large EM economies (see chart on the right). Coupled with the accumulation in international reserves, this reduces EMs' reliance on foreign capital, which increases stability and lessens sensitivity to global rate moves. Conversely, a weak current account balance means foreign currency (through FDI/portfolio flows) is needed to fund the deficit and therefore rates need to be competitive on a relative basis to attract capital. Countries with stronger external positions could therefore be more resilient against broader EM volatility and rising rates.

Less reliance on foreign capital is also reflected in improving terms of trade as discussed earlier. Coupled with any export softness, input and output price weakness in 2022 could affect terms-of-trade and current account balances. By the same token, a domestic demand recovery, perhaps driven by a rebound in services activity, could increase imports. Such changing dynamics highlight the potential for further divergence in external positions.

### Current accounts and accumulated reserves increased over the pandemic



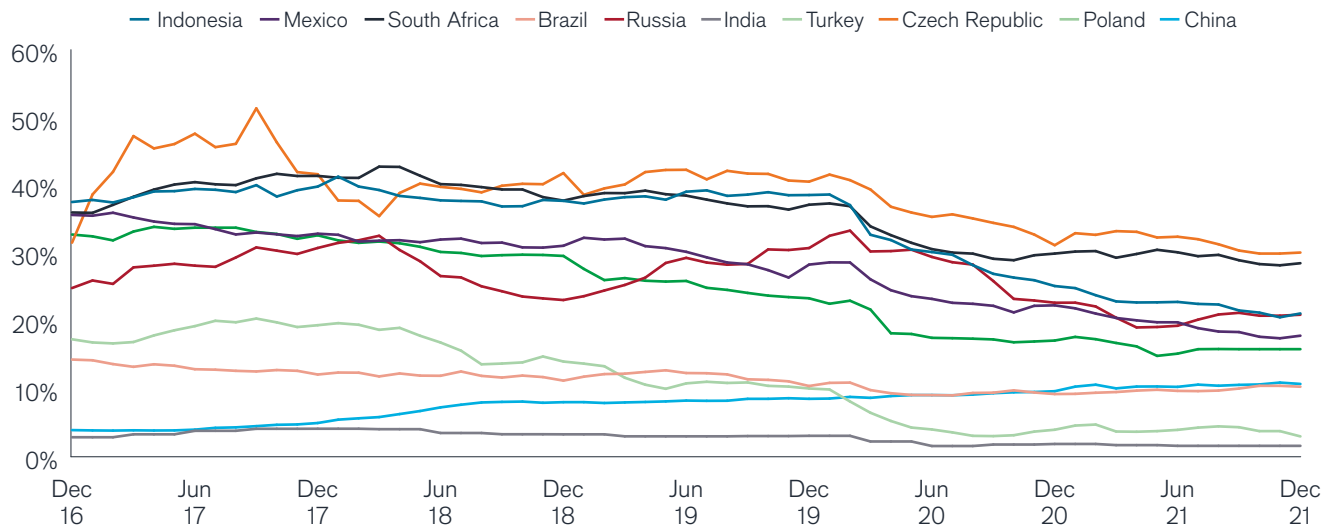
Source: Bloomberg, 12 January 2022.

<sup>12</sup> Source: Barclays, Emerging markets quarterly, 22 November 2021.

## Foreign capital flows to return to EM?

### Foreign ownership of bonds (% of outstanding debt) at low levels

Similarly, foreign ownership of bonds reached the lowest levels seen over the past five years and it could be argued that we have seen a bottoming of this trend with the potential for foreign investors to return to market, supporting bond prices.

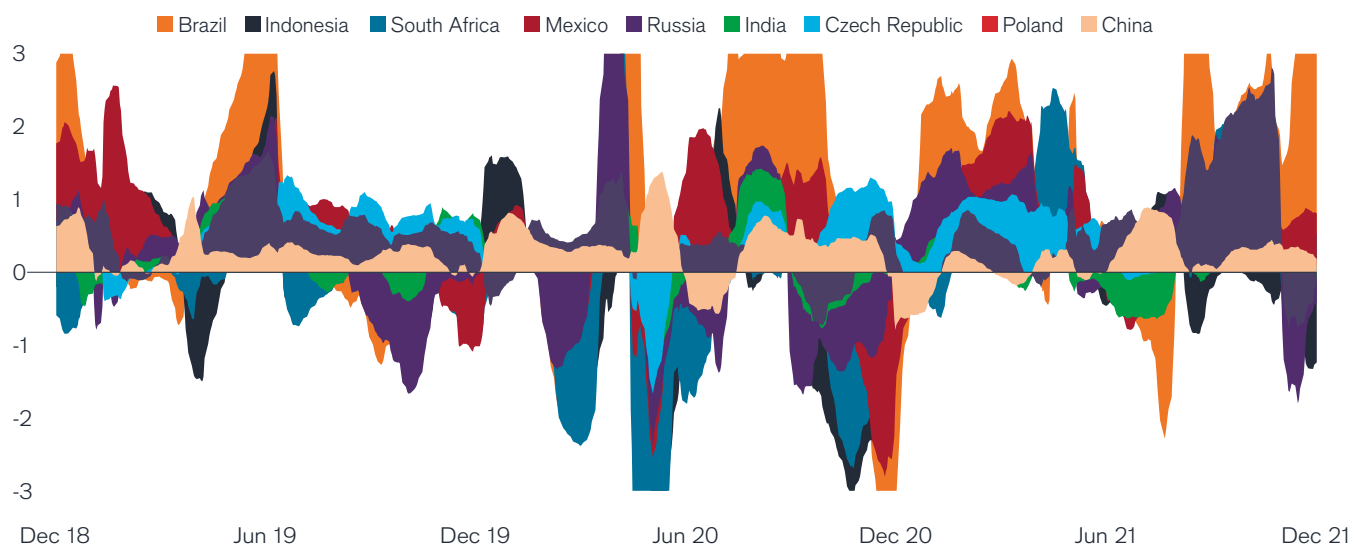


Source: Bloomberg national central banks and finance ministries, 31 December 2021.

However, rising US Treasury yields are another wildcard for EM and are dampening sentiment towards the asset class. Considering which markets are exposed to this through fundamental analysis can therefore be instructive, particularly as the beta magnitude in local rates can be tricky to predict (see chart below), with the correlation of individual markets and the overall beta shifting over different periods. On a longer-term horizon, local rates in Russia and China have low correlation with global rates<sup>13</sup> given the idiosyncratic aspects to their markets.

### Frequent shifts between positive and negative beta:

#### 3-month magnitude and direction of EM vs US 10-year rates



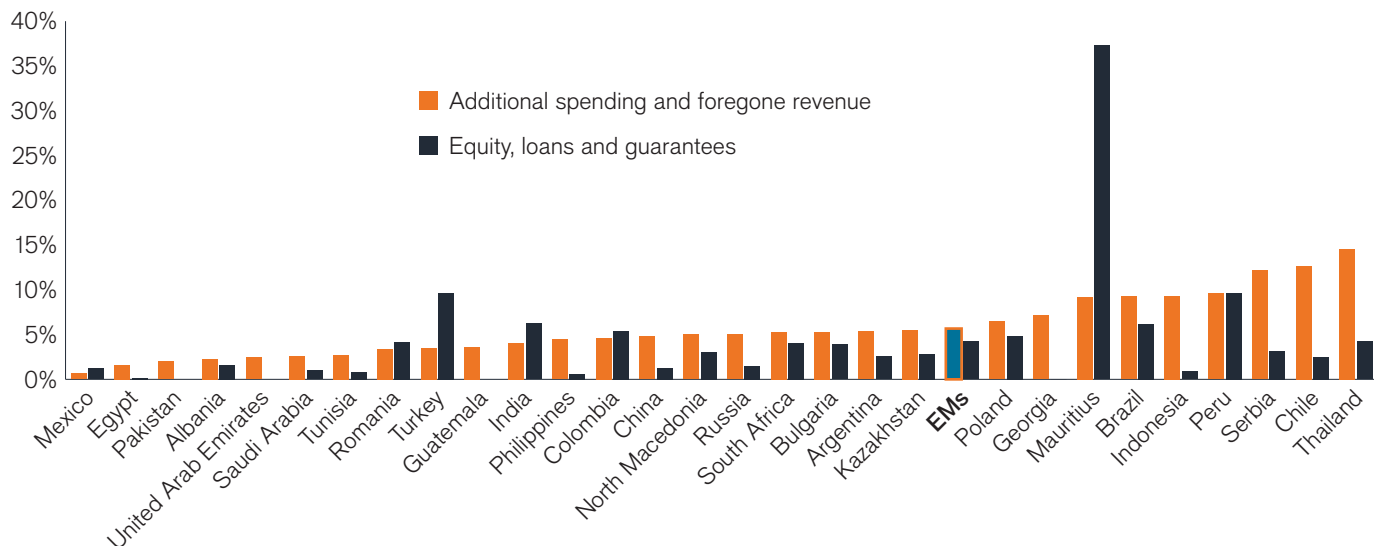
Source: Bloomberg, 27th January 2022.

<sup>13</sup> Source: HSBC, EM Rates 2022: Pockets of value, 2 December 2021.

## Survival of the fittest?

While the “fiscal cliff” has become part of the lexicon describing the US, a similar situation also faces some EMs. Most countries have exacerbated fiscal deficits through additional spending and capital provision (see chart below) in response to the pandemic, which will now need to be reined in as economies normalise financial conditions. Deficits will be consolidated by some – such as South Africa which has specific targets – and funded by others. Countries spending below the EM average could be more resilient, such as Africa, Mexico and the Middle East. For example, concern about Mexico enduring a sovereign downgrade has dissipated given less need to scale back spending.

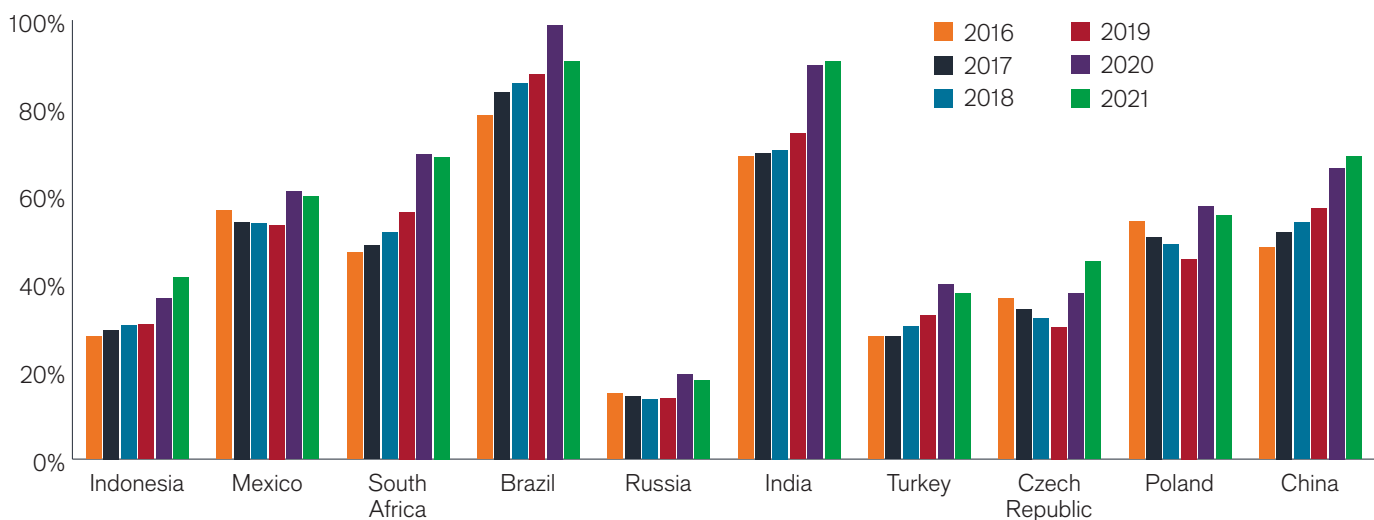
### Additional spending and foregone revenue in response to the pandemic (% of GDP)



Sources: Database of Country Fiscal Measures in Response to the COVID-19 Pandemic; and IMF staff estimates. Estimates as of 27 September 2021. Numbers in US dollar and % of GDP are based on October 2021 World Economic Outlook.

While debt levels are higher than the last time the Fed began its hiking cycle, overall debt appears well contained in EM when considered against DMs. Some countries that have progressed further in their hiking cycle, such as Poland and Russia, have seen a reduction in debt-to-GDP levels in 2021, which encourages better sovereign ratings from agencies and supports debt markets.

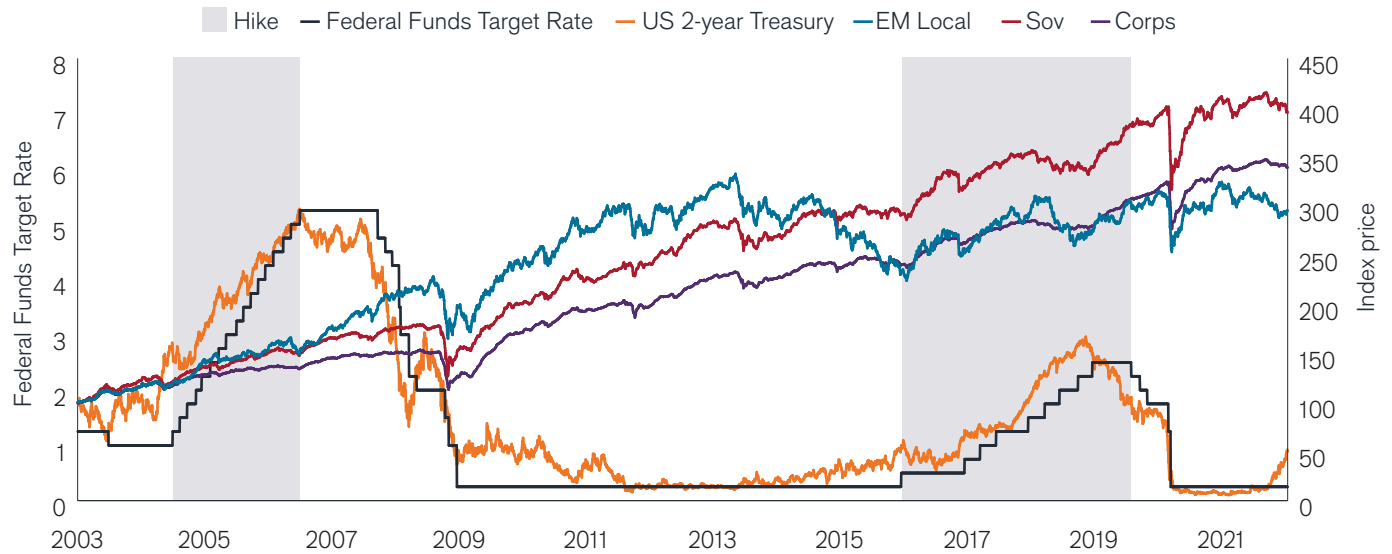
### Some countries are already reducing debt-to-GDP (%) levels



Source: Statista, 31 December 2021. Data as at year end.

The current conundrum facing governments is whether to continue spending and increase debt issuance to sustain GDP growth, or shore up budgets which could create headwinds for economic growth. Limited fiscal consolidation or an increase in the supply of debt can weaken supply and demand technicals in rates markets and dampen investor sentiment, but support FX through growth and demand for that currency. Conversely, countries reducing spending will be positive for rates markets, but this could dampen GDP and local currencies. This highlights the importance of asset allocation not only across EM assets, but different countries as divergence will emerge, in our view, from their different routes to normalisation.

## How EM fares in a rising rate environment



Source: Bloomberg, 13 January 2022. Local = JPM GBI-EM Global Diversified index. Sovereign = JPM EMBI Global Diversified Composite. Corporates = JPM Corporate EMBI Broad Diversified Composite Index.

While economic fundamental analysis can indicate how EMs could fare in a rising rate environment, we can also consider historical performance of EM debt (shown above). According to Janus Henderson analysis looking at drawdowns over nearly two decades, the worst period for EM debt performance has been when the Fed is cutting rates, as it is indicative of global recessions, followed by periods where a rate hiking cycle is being priced in, like in 2021. This is particularly evident in local rates before the last Fed hiking cycle, which subsequently rebounded. During hiking periods, EM debt performance has held up. So, we could be far through this period of EM underperformance as rate hikes are well priced into the US curve.

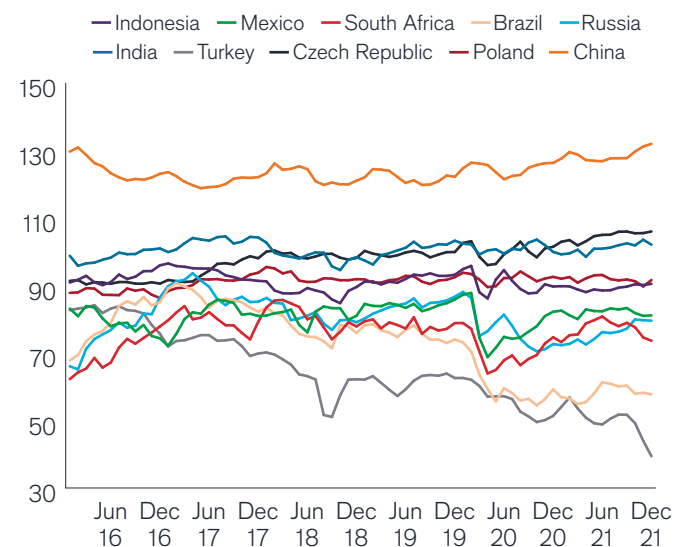
The pace of tightening within economies is also key, as some countries have hiked ahead in magnitude or quicker than market expectations. For example, the Czech Republic has hiked by 350bps since June 2021 while Hungary has hiked 325bps over the same period with two thirds of that occurring over seven weeks<sup>14</sup>. Rate hikes have come ahead of the curve and this lends support to local currencies.

## A tide turn for currency flows?

When considering how currencies could be affected by normalisation, countries with a higher real effective exchange rate (REER) or overvalued currency, high fiscal deficit, low real rate, and high inflation, in our view, tend to be most susceptible to portfolio flows moving quickly. The REER is a weighted average of a country's currency in relation to an index or basket of other major currencies. Notwithstanding the headwinds endured by EMs since 2016, REERs have been broadly stable, except for Turkey where unconventional monetary policy is impacting the currency value. Moreover, bar China which has a significantly overvalued currency, contained valuations should be a tailwind for EM currencies.

<sup>14</sup> As at 21 January 2022. Hungary rate hikes refer to the one-week deposit rate.

## Real effective exchange rates show long-term value in EM currencies



Source: Bloomberg, 31 December 2021.

While US dollar strength generally spells trouble for EM currencies, they do not always behave in a similar fashion and will be influenced more by rising US rates in our view. A similar trend seen in EM bonds is reflected in currencies (shown in the table overleaf). In the lead up to the first Fed hike, currencies suffer against the US dollar as hikes are pre-emptively priced in, but this stabilises as higher yields provide a cushion and better carry. Towards the end of the hiking cycle, currencies tend to recover on the back of relief from such fears as the US approaches its expected terminal rate.



## Currencies price performance through last Fed hiking cycle

	1 year before first hike	1 year after first hike	Rest of the hiking cycle	2021
	2014-2015	2015-2016	2016-2019	03/21-12/21
South African rand	-33.7%	11.2%	-4.4%	-7.9%
New Taiwan dollar	-3.8%	1.6%	5.5%	2.9%
Mexican Peso	-16.6%	-20.5%	5.2%	-0.5%
South Korean won	-7.7%	-2.6%	7.9%	-5.1%
Brazilian real	-49.0%	17.8%	-19.2%	1.1%
Thai baht	-9.5%	0.5%	9.8%	-6.3%
Russian ruble	-24.5%	15.1%	-12.7%	0.6%
Polish zloty	-10.7%	-6.7%	10.7%	-2.2%
Philippine peso	-4.9%	-5.7%	-6.0%	-5.1%
Malaysian ringgit	-22.8%	-4.5%	7.9%	-0.5%
Indian rupee	-4.9%	-2.7%	-2.7%	-1.7%
Indonesian rupiah	-11.3%	2.3%	-6.8%	1.8%
Hungarian forint	-11.0%	-1.3%	4.9%	-5.1%
Hong Kong dollar	0.1%	-0.1%	-1.0%	-0.3%
Czech koruna	-8.8%	-3.3%	12.7%	1.8%
Chinese yuan	-4.6%	-6.9%	1.0%	3.0%
Chilean peso	-16.8%	5.4%	-3.5%	-18.5%

Source: Bloomberg, 31 December 2021. All values are price level changes (excluding carry) versus the US dollar.

Currencies which have already suffered due to changing fundamentals may soon find a bottom as investor flows return. We see potential in countries with robust currency stability such as Thailand, which suffered from the crash in tourism, but could rebound as the pandemic fades later in the year. Similarly, in Korea, where appetite for its tech-heavy stocks indices has recently turned and outflows have been a currency headwind. Flows could be more balanced going forward with rate hikes supportive. As governments scale back liquidity as they normalise policy, this could also support local currencies.

## Capturing divergence through EM corporates

While rates and currencies are tied closely to the US hiking cycle, there is less of a direct influence for corporate credit, with yields less correlated to short- and long-term US Treasuries than other EM local bonds and EM hard currency sovereign bonds. Credit also shows less correlation in asset returns to local bonds and FX than they do with each other and this interplay can be seen in an example.

## Credit adds diversification within an EM allocation

	Volatility	EM Local Unhedged	EM FX	EM Local Hedged	EM \$ Sovereign	EM \$ Corp
EM Local Unhedged	10.0%	1				
EM FX	6.4%	0.93	1			
EM Local Hedged	2.8%	0.77	0.60	1		
EM \$ Sovereign	6.1%	0.65	0.56	0.68	1	
EM \$ Corp	3.5%	0.44	0.36	0.52	0.74	1

Source: Bloomberg, 13 January 2022. EM Local Unhedged = JPM GBI-EM Global Diversified Unhedged USD. Local Hedged = JPM EMBI Global Diversified. EM \$ Sovereign = JPM EMBI Global Diversified Composite. EM \$ Corp = JPM Corporate EMBI Broad Diversified Composite Index. EM FX = JPMorgan Emerging Local Markets Index Plus.

When EM local currencies weaken, as in 2021, this is a tailwind for exporters in credit. As Turkey has cut rates, the lira lost 40% of its value in 2021<sup>15</sup>, which has the equivalent impact on cost reduction for exporters. For Turkish household name corporates, most of their revenues are from the EU and revenue is recognised in this higher value foreign currency. This equates to a net positive impact on balance sheets. Considering how price dynamics of products can change is also important for companies. For example, many oil exporters are factoring a lower price for Brent Crude of US\$65 in 2022<sup>16</sup>, leaving a cushion if prices fall. A focus on companies with strong free cash flow (excess cash) provides another buffer in the event of commodity price weakness.

## All eyes on China property

Another factor that could create divergence in EM is China's growth and a key driver of that is its property sector. We expect looser policy from Chinese authorities to meet their stated 2022 growth targets. In tandem with this, the People's Bank of China (PBoC) in January stated that it would "open the monetary policy toolbox wider, maintain stable overall money supply and avoid a collapse in credit", and be forward-looking and ahead of the curve in responding to market concerns. According to reports, a potential easing of conditions for the property sector is on the cards. Back in December, Chinese leaders acknowledged that some reforms were implemented too hastily and without consideration of its downstream impacts. For example, going forward, local policies in property may be differentiated based on local needs.

<sup>15</sup> Source: Bloomberg, 31 December 2021. Lira versus the US dollar.

<sup>16</sup> Source: According to company research by Janus Henderson Investors as at 27 January 2022.

Two of the largest issuers of US dollar bonds in the property sector are currently undergoing restructuring, which should serve as a guide for how various parties could behave in the future for subsequent restructurings. In addition to onshore and offshore creditors, there are also local and central government actors, not to mention a handful of regulatory and state agencies that will be heavily involved. Those developers fortunate enough to have limited near-term financing needs are likely to escape policy turbulence with little more than asset price volatility. However, failing a total policy reversal by policymakers, the property sector is likely to experience more volatility in 2022.

### A harder environment to navigate

Given the headline risks, a defensive and cautious approach to EM investing feels warranted, yet the potential for increased volatility may present investors with interesting opportunities across FX, credit and rates. The risk/reward balance means investors may be better placed to position for

an initial worsening than a sudden rebound. In rates, for example, there is often some stabilisation before improvement. However, as inflation stabilises or wanes in EM in the second half of 2022, and given EMs have front-loaded tightening, more opportunities could emerge in EMs despite the Fed hiking. As we have seen from our analysis, timing is important when allocating to EM.

While we can draw some lessons from history in how EM performs in a rising rate environment, investors should take heed that relationships are nuanced and can shift while cycles can be different. The variation in EMs' path to normalisation is likely to cause further dispersion in 2022 and beyond. Given the fluidity of such dynamics, EM investing lends itself to active investors who can capitalise on the divergence in outcomes and maximise the opportunity to appropriately diversify risk in portfolios. In our view, being patient and nimble with cash available to capture the right opportunities at the right time will be key to navigating 2022.

### Summary

- As most EMs have been quicker to tighten than DM, potential opportunities could emerge in EM despite the US raising rates. Historically, EM returns have tended to be weakest during recessions, rather than the periods when the Fed is lifting rates.
- EMs' chosen path to normalisation and economic fundamentals, such as external balance, will not only define their resilience, but also the different outcomes that emerge for EM assets.
- We believe a defensive and cautious approach to investing in EM at this stage of the cycle is sensible, while market volatility could create opportunities.



### Glossary

**Fiscal consolidation:** This describes government policy intended to reduce deficits and the accumulation of debt.

**Terminal rate:** The rate that is consistent with full employment and capacity utilisation and stable prices. Also called the natural or neutral interest rate.

**Carry:** The benefit or cost of holding an asset. For a bond investor, this includes the interest paid on the bond together with the cost of financing the investment and potential gains or losses from currency changes.

**Rates markets:** A marketplace for investment in government bonds and associated derivatives.



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