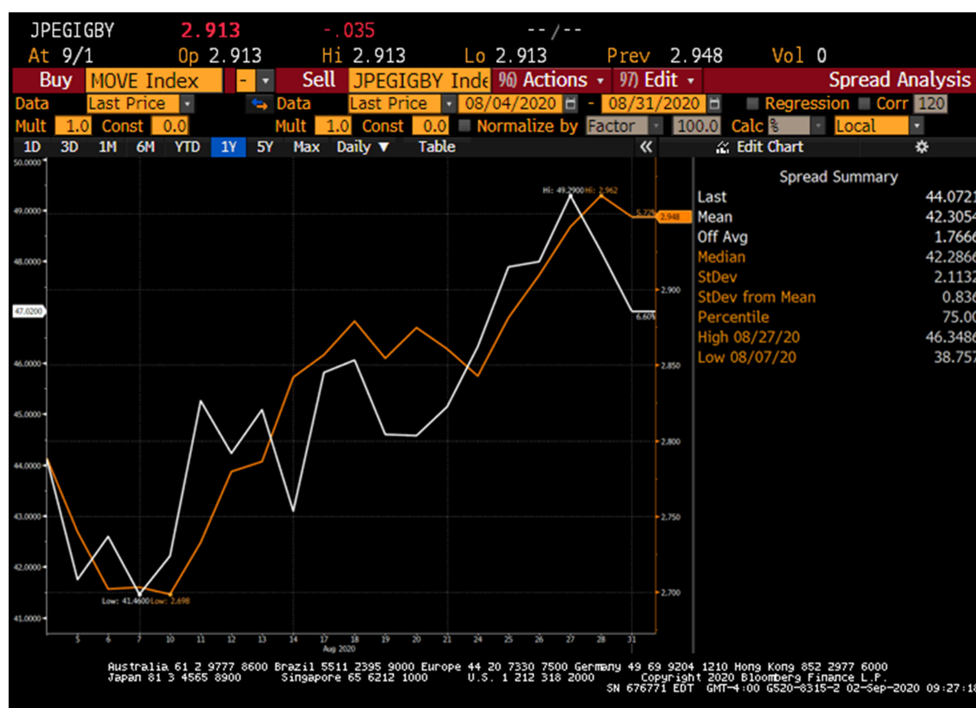
Emerging Markets Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

AUGUST 2020: STRATEGY UPDATE & OUTLOOK

RECENT PERFORMANCE

- Once again, government and central bank policies offset the economic impact of the COVID pandemic. The rally in global risk markets, including emerging market (EM) debt, continued in August. EM debt increased by 0.30%.
- While the pace of gains in EM debt was lower than in recent months, the market still turned in good relative performance as it outperformed the U.S. Aggregate Bond Market Index (-0.81%).
- August was a tale of two EM debt markets:
    1. High yield (HY) EM debt rose by 2.42% in August, largely driven by broad credit spread compression emanating from central bank buying programs (plus the commitment to do more if needed) and continued better-than-expected economic data as countries “normalize” from COVID – once again, largely the same factors that propelled the S&P 500 7.19% higher, despite the still-challenging economic and earnings backdrop. Also supporting the broader risk backdrop were declining COVID case counts across several countries and progress on a vaccine.
    2. By contrast, the investment grade (IG) segment of the EM debt market spent most of August “fighting” the effect of the U.S. Treasury market. The 10-year U.S. Treasury YTM hit an all-time low of 0.51% on August 4 before increasing by 20 bps to 0.71% by the end of August. While this was a fairly small move, it was enough to induce investors to take profits in IG EM debt, which declined by 0.91% in August. The impact on the overall EM debt market, which now has a 63%/37% IG/HY credit quality mix, was meaningful.
- The combination of these two divergent trends produced a slower pace of appreciation of the entire EM debt market. The decline in IG EM was significant enough to offset a large proportion of the 2.42% total return enjoyed by high yield EM. We did not panic and stuck with our strategic view that IG EM debt volatility would settle once the U.S. Treasury found its footing, and this is what happened. Note that IG EM bond yields (orange line) increased in tandem with higher U.S. Treasury volatility (white line), but stopped increasing as soon as the Treasury market settled:



MACRO OVERVIEW & STRATEGY SUMMARY

- Overall, we remain long EM debt. At the same time, spread compression from the March wides has wrung a lot of the beta out of the market. Thus, we are positioning our portfolios to obtain alpha by being very attuned to credit quality (especially where our ratings differ from those of the rating agencies), regional and country themes, and curve positioning within countries (relative value pricing inefficiencies).
- This is an opportune time for us because we expect to see large performance differentials within the EM debt market along a few key dimensions, which we saw in August. Specifically:
    1. Credit quality: HY EM (+2.42%) outperformed the broader bond market meaningfully; IG EM (-0.91%) underperformed.
    2. Region: Africa (+2.45%) vs. Asia (-0.06%)
    3. Country: Sri Lanka (+11.55%) vs. Belarus (-2.77%), which just sold a new issue in June
- We identified higher U.S. Treasury rates as a pending source of tactical risk recently. At the same time, we still say tactical because, while we think U.S. rates are likely to continue to rise for the remainder of 2020, we think the pace of increase will be small and the frequency sporadic. This, combined with still attractive relative valuations, is why we continue to view resultant price dips in IG EM debt (likely emanating from further bouts of Treasury market volatility) as buying opportunities.
- Specifically, while U.S. Treasury yields are likely to eventually grind higher from still-low levels, we expect credit spread products, such as EM and U.S. corporate debt (the focus of Newfleet's strategies) to enjoy positive total returns given:
- Continued G-3 central bank buying.
- Low (and frequently negative) developed market (DM) yields, which should push much of the liquidity created by central banks into bonds with higher yields.
- Despite recent spread compression, credit products still offer average spreads versus their history and attractive spreads versus DM bond alternatives and equities.
- We have received questions about whether we should add local currency exposure to our portfolios, especially with the pace of US$ weakness accelerating recently. This happens frequently during episodes of risk market recovery that demonstrate "staying power". The beta grab induces investors to ask "what's next?" We are always culling the non-US$ universe for opportunities. However, we believe that most EM countries' real (inflation adjusted) policy and market rates are insufficient to defend their currencies. While we are fully cognizant of recent US$ weakness, we note that most of the weakness has occurred against DM currencies (the G-20); the dollar bloc + Norway – commodity exporters, in particular. This dimension of our strategy has worked. Since the low point in late March, EM US$ denominated debt is up 23.60%, which exceeds the 18.66% total return of EM local markets debt by 494 bps. This is not a fluke. The same is happening in the equity space. Since the low points in March, the 57.74% total return of the S&P 500 exceeds the 47.56% total return for EM equities by 1,018 bps. In other words, investors remain skeptical about EM countries. This has worked to our advantage as it provides attractive entry points.
- For both equities and fixed income it's still all about the Fed and other large central banks. Investors buy when they buy (we have covered this exhaustively in our last few updates and we are happy to send the details to you). One nuance is worth mentioning. We typically look at equities as a barometer for movements in credit risk spreads. When equities rally, credit spreads compress and vice versa. We think the causal link has been reversed during the current episode. Credit spreads are now driving equities because tighter spreads reduce default risk, which in turn lowers the required discount rate with which investors discount earnings and/or dividends. This is because the presence of large central banks means they are the critical marginal buyer of risk and they are driven by the attainment of policy objectives, not total return performance. We see this as the primary reason why economic, and by extension, company fundamentals, while important, can still take a back seat to central bank activity (higher stock markets and tighter credit spreads despite earnings contraction). Also, government fiscal spending supplanting lower free market activity buys time, which enables investors to be more forward looking in modeling earnings.
- Key risks:
    1. Inflation: If inflation returns, it could induce the Fed to reduce extreme monetary policy accommodation, which is the key support for risk assets. We think continued normalization of the world's economies will cause rates to move slowly higher – perhaps to a little over 1.0% for the U.S. Treasury 10-year YTM by the end of 2020. Thus, U.S. Treasuries are not attractive and our portfolios' IG holdings, including IG EM, will

continue to be "under threat" of rising Treasury rates. However, we do not expect the Fed to act any time soon, given:

- Significant remaining excess economic slack:
  - U.S. capacity utilization of 70.6% is well below the long-term average of 80.1%.
  - U.S. U-3 unemployment of 10.2% is still higher than the global financial peak in 2009 and is within 0.5% of the all-time high of the Volcker/stagflation days in 1982.
- The Fed has expanded its bond-buying program to record highs, has given every indication that this will continue, and the recent move to average inflation targeting will extend the timeframe for an effective 0% policy rate.
- While not a risk now, given suppressed aggregate demand and economic slack, the quantity theory of money, which states that the general price level of goods and services is directly proportional to the amount of money in circulation, could come back into play. Most people view it as outdated and believe that inflation was vanquished beginning in the early 1980s. We think its relevance could come back if the velocity of money picks up with a resumption of economic activity. The economic impact could be significant as global debt (government + non-financial corporate + consumer) has never been higher, interest rates have never been lower (meaning there is greater risk they move higher than lower), and the pace of debt growth is accelerating due to aggressive fiscal expansion.

2. Equities: financial markets could correlate again given the intertwined nature of equities and credit spreads, both of which are dependent on the Fed.
   - Valuation: the only time that the trailing P/E of the S&P 500 of 26.9X has been this high was just before the dot com bubble burst in 1Q00.
   - Breadth: earnings and market concentration of mega-cap technology stocks.
3. Qualitative:
   - Increase in COVID case count as students return to school
   - While the U.S. elections are a risk, Trump appears to be gaining ground – at least for now.

EM COUNTRY UPDATES

- Credit quality: we have about 57% of our EM exposure in IG countries (underweight versus the EM debt market) versus 71% last month (overweight versus the EM debt market). This contributed to performance given the magnitude to which HY EM debt tracked equities higher in August while IG EM tracked Treasuries lower.
- We are retaining our overweight positions in bonds with high correlations with equities – the Sub-Saharan African region, in particular. Most have structured funding programs to meet their near-term, debt-servicing needs – largely through multi-lateral financial institutions and countries with which they have strong bi-lateral relationships, such as China. Nigeria bonds were up 4.5% in the period with optimism that the economy is now in a phase of recovery.
- Oil: oil prices rose another 5.8% in August. However, it was not enough to sustain the bid for IG Middle East country bonds, such as Saudi Arabia, which underperformed in August. Our underweight to the high quality names like Saudi Arabia, Qatar, and UAE worked in our favor in August as the rate-sensitive, low-yielding, long duration bonds in the complex underperformed the index. Also, the oil price recovery "beta grab" continued to fade.
- Restructuring stories:
  1. We are retaining our overweight in Argentina. Despite rallying by 4.0% in August, we see further upside given high exit yields following the recent debt restructuring agreement.
  2. We re-entered Ecuador following its recent debt restructuring that provides significant near-term liquidity relief.
- Ukraine continued to outperform, despite concerns that we do not share over the newly appointed leadership at the central bank. We are more focused on whether Ukraine will continue to do what is necessary on the economic reform front to keep receiving the tranches from the country's recent US$5B loan program with the IMF. We do not expect the program to be derailed and we remain overweight.
- We increased Turkey to overweight in time to capture the country's outperformance in August. Turkish bonds simply got too cheap relative to the capacity to service their external debt.

Emerging Markets Market Update

- ► Mexico continues to endure a sluggish economic recovery from the depths of April and May, but bonds outperformed in August led by Pemex where valuations were quite cheap relative to the sovereign bond curve.
- ► Brazil had a slightly negative return (-0.06%) for the month of August. Brazil's recovery from the initial strike of the pandemic has by many accounts been better and stronger than most expected although the country now has the second highest number of deaths due to COVID-19 at 122,596+. The central bank (CB) and government have been fairly supportive in recovery efforts, the CB cut the policy rate by 25 bps to 2.0% in August and left the door open for further cuts as long as inflation remains in check. President Bolsonaro presented a 2021 budget that adheres to the proposed spending cap. Tax reform legislation is more likely than ever to win approval in 2021 and Economy Minister Guedes has unveiled his proposal for a federal value added tax.
- ► Russia had better than expected 2Q GDP contraction of -8.5% YoY, indicating that while the economy has contracted sharply, the recovery is underway. PMI data released early in the month for July was 48.9% and August's figure improved to 51.1%. Retail sales continue to improve and inflation remains steady. There were a number of geopolitical headlines this month that involved Russia, namely in relation to the protests in Belarus and also over the poisoning of opposition leader Aleksei Navalny. Still, credit spreads held in and Russia posted a market-like return.

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The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. The **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. **J.P. Morgan Emerging Markets Bond Index Global (or EMBIG)** is a market capitalization weighted index that tracks total returns for U.S. dollar denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, Eurobonds. J.P. Morgan CEMBI Index tracks U.S. dollar-denominated debt issued by emerging market corporations. **J.P. Morgan GBI-EMGD** tracks total returns for local currency debt instruments issued by emerging markets sovereign and quasi-sovereign entities to which international investors can gain exposure. Indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

The **CBOE Volatility Index**, or VIX, is a is a measure of the implied volatility of the S&P 500 Index.

The **MOVE Index** calculates the future volatility in U.S. Treasury yields implied by current prices of options on Treasuries of various maturities.

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