Emerging Markets Update

MARCH 2021: STRATEGY UPDATE & OUTLOOK

PERFORMANCE: Down and all Treasury driven – again

- Emerging market (EM) debt took another U.S. Treasury-driven hit in March, declining by 1.04%. This is the third month in a row following the 2.56% and 1.21% declines in February and January, respectively, bringing the YTD total return to -4.75%.
- While we remain involved in the EM debt market, our overall exposure as a percentage of our portfolios' total assets remains near the lowest levels it has been for the past 10 years.
- Also, once again, the EM debt market credit risk spread barely moved. It now sits at 324 bps as of the end of March, which is essentially where it was at YE20 (323 bps). This can be interpreted from both a negative and positive perspective:
    - Negative: the same spread indicates that EM debt, despite the negative YTD total return, does not have any more incremental relative value.
    - Positive: the same spread indicates resilience in the face of the marked weakness in the broader bond market. The EM debt spread "held in" (did not widen) despite meaningful pressure in the broader bond market. The Bloomberg Barclays U.S. Aggregate Bond Index was down 3.37% in 1Q21, its worst start to a year since the Index was created 45 years ago.

MACRO OVERVIEW & STRATEGY SUMMARY: Our interpretation

- We think the positive view above is the correct view over the intermediate term; EM debt will, once again, generate attractive positive total return once the Treasury market settles.
- We are now looking for entry points to increase our EM debt exposure, i.e., on further Treasury-driven sell-offs.
- Our rationale is that we expect positive total returns from credit spread sectors, including EM, when the Treasury market adjusts (higher interest rates) to reflect continued reflation of the global economy; the U.S. and China in particular. The key for us is that we view higher interest rates as reflecting reflation (growth), not just higher prices (inflation).
- The extreme difference in performance between bonds and stocks is evident in the U.S. Treasury market's 4.25% decline, its worst quarter in 40 years despite the 6.17% rally in the S&P 500.
- We expect positive total return from EM debt this year, while acknowledging that the strong post-COVID-19-driven recovery rally of the last nine months of 2020 resulted in a shift in the macro backdrop to a phase where the big capital gains from the rebound in risk assets has passed.
- We still view risk spreads on credit assets, including EM, to be slightly rich based on fundamentals. They are likely to stay that way because of continued ample central bank liquidity provision and a resumption of economic growth as COVID-19 is tamed and activity continues to return to normal.
- We know that the performance of EM debt, like all sectors, is influenced in varying degrees by the performance of the broader bond market. This is especially evident during times of stress. March was no exception. This is why we remain cautious for now, while still expecting solid returns from carry once core markets settle.
- The supporting factors for the macro backdrop, which we think will prevent growth-sensitive EM risk premia from widening, have not changed:
    - Progress on containing COVID-19; lower case count as vaccines are rolled out, despite lingering concerns.
    - Deepening and broadening of the economic recovery, which is still China and U.S. centric.
    - Continued (one could argue excessive) fiscal easing and central bank liquidity provision.
    - This backdrop leads us to expect U.S. Treasury yields to continue moving higher, but not a lot higher – especially after the recent move. Importantly, for credit, we expect solid earnings growth in tandem.
- The key remains whether credit markets can earn sufficient carry to offset a continued slow drift upward in U.S. Treasury yields. We still believe the answer is "yes" and we may be approaching an entry point – at least tactically.
- We believe equity market support will still produce a good backdrop for decent total returns in credit markets, even if Treasury yields continue to rise. All-in, we expect recent volatility in credit markets, including EM, to calm down once recent turbulence in the U.S. Treasury market subsides, which is starting to happen.

EM COUNTRY STRATEGY

- As always, our macro view is expressed in our EM country strategy. We had been overweighting high yield (HY) EM, funded by reducing investment grade (IG) EM. This dimension of our strategy helped performance during the recovery last year and throughout most of 1Q21 when HY outperformed. However, after taking the big hit from duration, IG EM debt got a lot cheaper. IG EM started to perform better relative to HY EM debt and actually outperformed in March of this year. We started to achieve greater balance between our IG and HY EM debt positions in early March and are now striving toward a roughly equal weighting between the two.
- In tandem with our prior overweight in HY, our focus at the regional level was to overweight Sub-Saharan Africa (SSA), especially bonds with wide spreads issued by countries that export commodities (growth/China sensitive). While we still see a lot of attractive opportunities in SSA, we are waiting for more attractive entry points before adding more exposure to this region.
- While we have been adding more IG EM, it has not been in Asia, the region with the most IG countries. We think most of the Asian issuers' bonds still trade too tight, which raises their price sensitivity to changes in Treasury rates.

  This includes a large underweight to China which, again, has spreads that are too tight. A way that we capture incremental carry in IG countries is via quasi-sovereign debt with incremental spread over sovereign debt. The list includes Indonesia, Mexico and Brazil.
- We have turned neutral on oil exporters from our large overweight position. Oil prices doubled from the COVID-19 lows last April through the second week of this March. They subsequently eased from the 2021 highs. We expect them to remain in a range from here. This supports our current neutral stance with support from accelerating global growth. At the same time, the global economic recovery is "in the price", and further unanticipated meaningful strength would require more information, which we do not anticipate. Within the Mid-East oil region, we continue to like Saudi Arabia and the UAE, where we expect fiscal performance to improve.
- We also still have an overweight in Oman, which has a much higher risk profile than Saudi Arabia and the UAE, but its bonds offer sufficient incremental spread compensation.
- We have underweight positions in two idiosyncratic stories with negative fundamental dynamics:
  - Turkey is, once again, taking a hit due to a new bout of heightened political volatility. Financial variables remain under pressure; wider credit spreads, bear flattening of the credit curve, and equity and currency weakness. The now all-too-familiar story centers on President Erdogan disrupting the country's economic technocrats. This time centering on firing the central bank president because of tight monetary policy to contain inflation and to defend the currency, which is precisely what a central banker is supposed to do. While this latest episode is well known, it is still having an impact and no remedial action has been taken.
  - The situation in Argentina, while also well known, is not getting any better. However, bond prices are a lot cheaper. At the end of the day, while we have some exposure due to cheap valuations and enough liquidity to avoid default for now, high inflation (above 40%), dwindling reserves, an inappropriately high fiscal deficit (over 6% of GDP), and government debt in excess of 80% of GDP make debt service sustainability a challenge, to say the least.
- We still do not like local currency EM debt. This market has declined the same as USD-denominated debt this year after lagging on the upside last year; we have not missed anything. The risks remain too large for the incremental carry that is far from enticing. Furthermore, we do not like fighting a key macro trend, which is betting against the USD at a time when the U.S. is performing better than its G-7 brethren – and higher interest rates that support capital inflows.

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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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