Emerging Markets Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

SEPTEMBER 2021: STRATEGY UPDATE & OUTLOOK

PERFORMANCE: EM underperformed in Sep, resulting in its YTD total return moving back into negative territory.

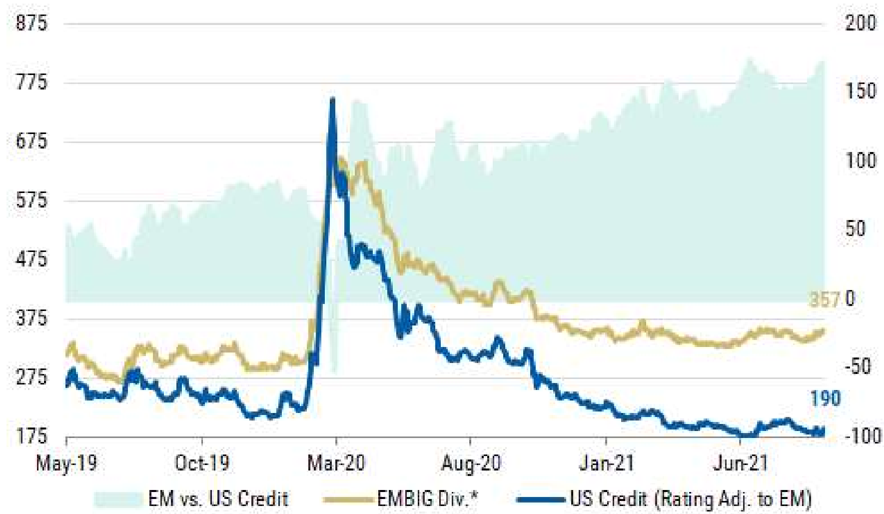
- The JPMorgan Emerging Markets Bond Index Global (EMBI Global) was down by 1.96% in September, more than double the decline of the broader bond market, as depicted by the Bloomberg Barclays Aggregate Bond Index (Agg). As a result, the YTD total return of EM debt flipped back to negative, where it has been most of this year.

Total Return %	Sep 2021	YTD 2021 through Sep
Agg	(0.87)	(1.55)
EM Debt	(1.96)	(1.53)
Diff (bp); Agg-EM	109	(2)

- The in-line YTD performance validates our remaining involvement in EM debt because we want exposure, as we expect it, to eventually resume its outperformance over the long-term.
- At the same time, our somewhat cautious macro view on the broader bond market has resulted in our retaining our EM exposure at the lowest levels we have had for over a decade. Performance in Sep highlights why.
- We only invest heavily in EM debt when we see opportunities for this riskier market to outperform domestic alternatives, which is not the case currently. To reflect this view, we lowered our EM exposure for 2021 to make room for US corporate credit. We did this in both the investment grade (IG) and high yield (HY) credit quality tiers of the risk spectrum. US corporate credit outperformed EM debt in both IG and HY:

Total Return %	Sep 2021	YTD 2021 through Sep
IG		
US	(1.05)	(1.27)
EM	(1.65)	(2.34)
Diff. (US-EM)	60	107
HY		
US	(0.01)	4.53
EM	(2.42)	(0.20)
Diff. (US-EM)	241	473

- Below is an update of a chart that depicts the relative value between EM sovereign and US corporate credit. As a result of the underperformance of EM debt versus US corporate debt during the post-COVID rally in credit spreads, some relative value has opened up in EM debt. EM is the yellow line, US corporate credit is the blue line and the difference between the two is depicted by the green shaded portion:



- ► On the currency side, our strong US$ macro view resulted in our lack of any exposure to any non-$ EM debt – a good miss, and we are retaining our stance.

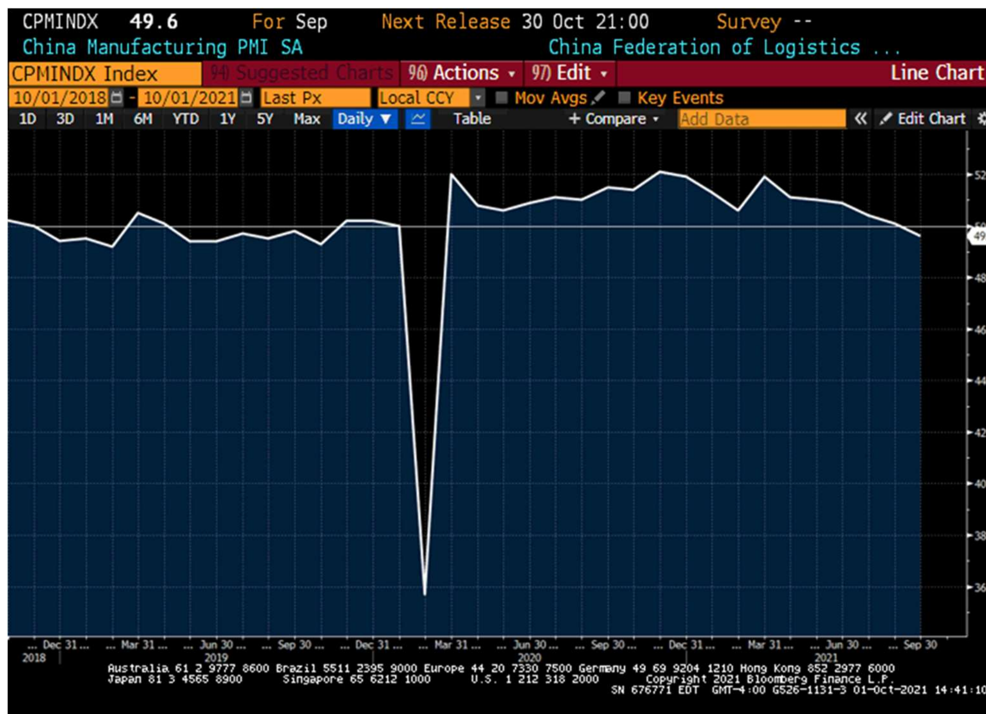
Total Return %	Sep 2021	YTD 2021 through Sep
EM US$ debt	(1.96)	(1.53)
Local EM debt	(3.43)	(6.38)
Diff (US$ EM-non$)	147	485

- ► The overall EM risk spread this year shows that it remains in the middle of the 300-350 range we have been anticipating.

We remain better sellers near 300 and buyers in the mid-300s. Some of the global issues that could get us to wider spreads are outlined below.

MACRO VIEW: We see the factors as interrelated and centered on China & the Fed

- **China:** Evergrande is not the risk – its bond prices are already in the 20s. We think the headline risk is how little growth forecasts for China have come down. Most economists expect growth reduction of less than 1.0%, despite PMI just having moved to below 50, which indicates contraction.



- By extension, since China accounts for more than half of global GDP growth, we think global growth estimates remain too high.
- We see the Chinese government's regulatory crackdown, which includes reining in the heated property sector, as the underlying driver. China's real estate boom was an important contributor to growth and, including related industries, constitutes about a quarter of China's GDP. While we expect Evergrande to be 'ring fenced', we also expect more companies to have similar problems. We also expect the banks to be impacted more than they have thus far. Let us not forget power shortages. Our exposure remains 0%.
- **Fed:** The onset of tapering, which has been well advertised, is not the risk. Also, tapering does not mean balance sheet contraction, and we expect the pace of reduction in bond purchases to be gentle. Our concern is that the scale of support from the world's largest central banks for their financial systems' fixed income assets, the globally coordinated nature of the operation, and the duration of the cycle (close to 13 years) is unprecedented in financial history. We do not question the usefulness of the endeavor to provide support, nor the usefulness of its pending early-phase wind-down. We simply do not expect it to happen without selloffs (buying opportunities) along the way.
- We expect the lingering effects of COVID to remain a source of risk, but for its impact to continue to fade.
- We think supply chain bottlenecks are real – the mounting global energy crunch is an example. Many are structural given the new world order post-COVID – semiconductors, for example. As a result, we think the debate over whether inflation is transitory or permanent lies on a spectrum: inflation is here for now, but declining over time as the underlying issues are addressed.

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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 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 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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