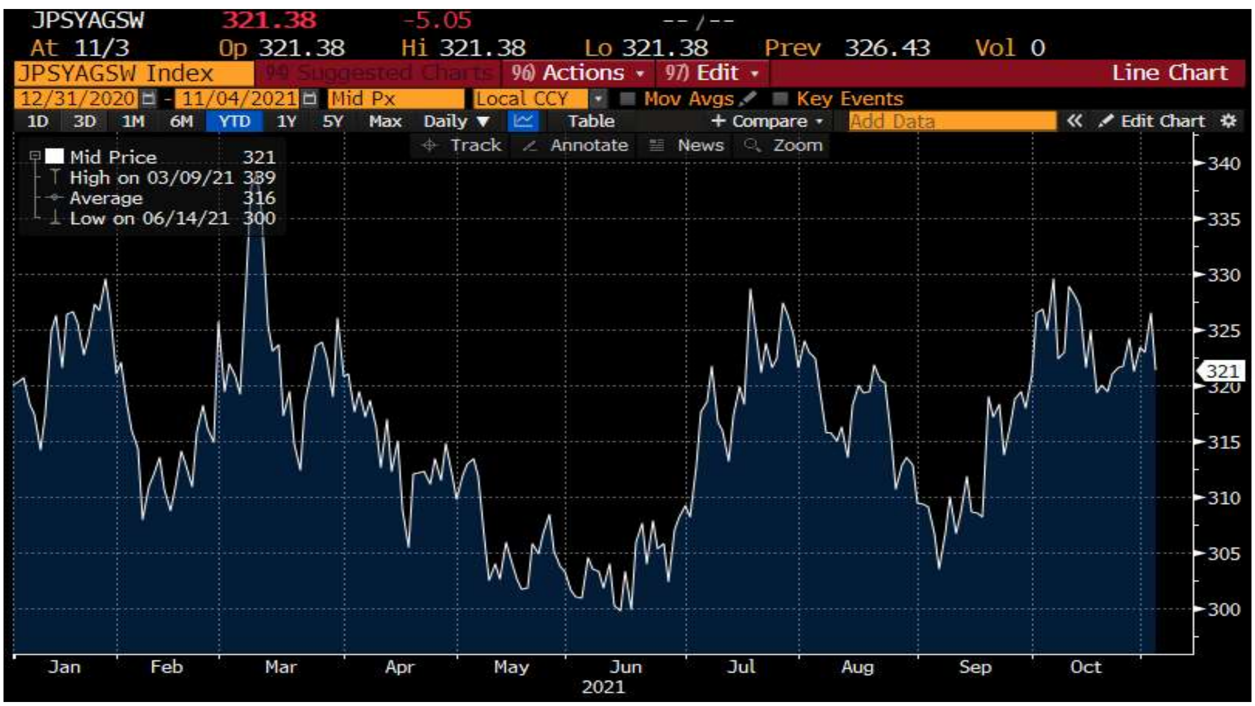
Emerging Markets Update

OCTOBER 2021: STRATEGY UPDATE & OUTLOOK

- **Performance:** The JPM EMBI Global (EMBIG) total return for the month was slightly positive at 0.06%, bringing the year-to-date return at 10/31/21 to -1.47%. Investment grade returns outperformed high yield returns by 54 bps (+0.28% vs -0.26%) as a flattening yield curve saw 30-year US Treasury yields fall 11 bps while short and intermediate yields rose. Overall spreads widened only 3 bps on the investment grade portion of the index while high yield spreads moved 8 bps wider. Local market debt continued to underperform hard currency sovereign debt with the JPM GBI-EM Global Diversified Index posting a -1.33% total return for the month of October, bringing the year-to-date return down to -7.62%.

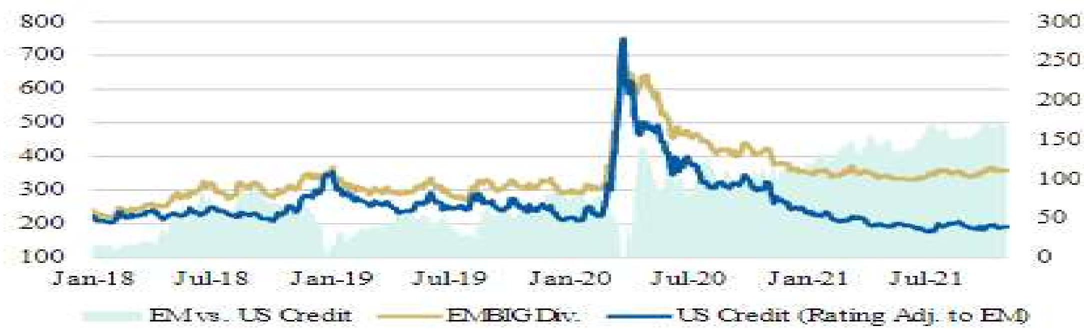
- **Positioning**: Our EM exposure remains near historical lows in our portfolios as we remain more constructive on U.S. corporate credit sectors, including floating rate-based leveraged loans. In addition, despite material underperformance from local market debt, we still do not see significant opportunity there and retain our view to hold no exposure. Monthly retail fund flows were negative over the past four weeks while new issue volumes were average.

- **Hard Currency Valuations:** Overall, EM index spread remains in the middle of its recent 300-350 bps range and we maintain our stance of being better buyers at the top of that range. Index spread valuation is relatively rich on a historical basis versus the 5-year average spread of 353 bps and the 10-year average spread of 358 bps.



- **Relative value:** EM spreads look cheap relative to U.S. corporate credit sectors. The chart below depicts EM spread (orange line) versus a same-rating weighted average spread for U.S. corporates (blue line). The light blue shaded area measures the difference, which we can see is approaching 175 bps – its highest level over the period.

Exhibit 2: EM vs. US – credit spreads (bp)*



Source: Bloomberg, Morgan Stanley Research; * US credit is a weighted average of US HY and IG with the weights taken to achieve an equal rating to the EM index. *Prior to November 29, 2019, the EM Index is ex-Venezuela

► **While the EM spread has diverged from its US brethren, we believe it is warranted:**

- While most U.S. corporations have been able to quickly return earnings and overall financial conditions to pre-pandemic levels, the same cannot be said for EM sovereigns, which have suffered permanent scarring to its balance sheets and fiscal budgets.
- However, it is worth noting that most sovereigns will see improvement in fiscal deficits in 2021 and 2022, which, along with solid growth, will stabilize debt burdens in many cases.

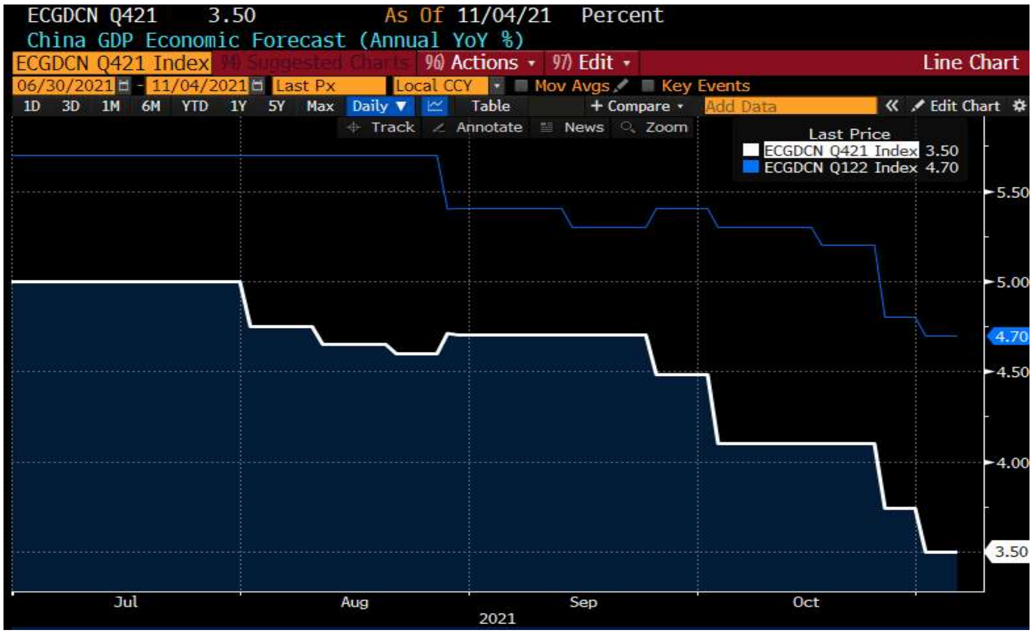
► **Other October Highlights:**

- IMF meetings were held in Washington, D.C mainly centered on the pandemic response and its aftermath. Global energy concerns, the health of the Chinese economy, and global balance sheets also headlined.
- Brazil's political wrangling over additional spending outside of its official spending caps and the approaching Argentine elections led both bond complexes to underperform.
- We also saw central bank rate hikes from Brazil, Russia, and Chile, among others. An increasing number of EM central banks are hiking rates despite an incomplete post-pandemic recovery to battle inflation and keep real rates positive.

► **We see slowing growth in China as a risk to EM fundamentals:**

- The distressed property sector, increased COVID-related shutdowns across several regions, and power shortages present real headwinds on the overall outlook for at least the next couple of quarters, and possibly extending into the second half of 2022.
- The official manufacturing PMI data remains just below 50, in contractionary territory for the last two months.
- The consensus GDP growth forecasts for 2021 and 2022 have come down 0.5% to 8.0% and 0.2% to 5.4%, respectively.
- In addition, 4Q21 (white line in chart below) and 1Q22 (blue line) quarterly consensus growth forecasts have been cut by 150 bps and 100 bps respectively since the beginning of August 2021.

► **Graph: China GDP forecasts for 4Q21 and 1Q21: Marked down meaningfully**



► **A second set of risks involve inflation and the reversal of easy monetary policy by G3 central banks**:

- As we noted last month, we do not expect the wind-down of unprecedented central bank support to happen without selloffs (buying opportunities) along the way. Supply chain bottlenecks and higher energy costs look to be here to stay for at least the next couple of quarters and possibly throughout 2022, putting upward pressure on inflation.
- However, increased productivity, aging demographics in the major economies, and the continued "return to normal" from the pandemic bust-and-boom period will act as counterweights to the higher inflation narrative.
- In addition, the August/September Delta variant wave that swept across SE Asia is waning, which should help ease global supply chain challenges on the margin, though it will not fully resolve them.
- In our view, we are in the final stage of the economic reopening period, with year-over-year comparisons still unusually favorable. However, as demand and supply patterns continue to normalize, we expect inflation to return much closer to pre-pandemic levels (< 3.0% by year end 2022).

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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.

AR 1966477 11/2021