Emerging Markets Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

DECEMBER 2021: STRATEGY UPDATE & OUTLOOK

PERFORMANCE: EM outperformed in December by enough to finally bring full year 2021 performance in line with the broader bond market.

- Emerging market (EM) bonds as shown in the JPMorgan Emerging Markets Bond Index Global (EMBI Global) were up by 1.43% in December – 169 basis points better than the broader bond market (using the Bloomberg Agg. as reference), which was down 0.26% for the month. This brought the performance of the two indices to approximately the same total return level for the full year.

Total Return %	Dec 2021	2021	2020
Agg	(0.26)	(1.54)	7.51
EM debt	1.43	(1.51)	5.88
Diff (bp); Agg-EM	(169)	(3)	163

- 2021 was a year of continued equity market strength, but limited net direction for bonds — the S&P 500 rallied another 28.68% while the Bloomberg US Agg went down by 1.54%. In this environment our multi-sector bond funds were still able to post positive returns. Our positive macro view on risk assets resulted in our high exposure to credit spreads, which in turn benefited from strong equity markets. In tandem with this, our cautious view on rising interest rates resulted in lower exposure to duration-sensitive assets.

- When we set our strategy, we also saw another bout of U.S. exceptionalism taking hold. Developed countries (the U.S. in particular) were better equipped than EM countries to deal with COVID. Developed markets (DMs) are typically more technically advanced, have better logistics systems to distribute vaccines, and have greater access to capital markets to finance all of it. Our response was to deploy more capital into US corporate credit in both the investment grade (IG) and high yield (HY) credit quality tiers of the risk spectrum. Over the past two years US corporate credit has outperformed EM debt in both IG and HY. The differential (US over EM) in HY is particularly notable:

Total Return %	Dec 2021	2021	2020
IG			
US	(0.17)	(0.95)	9.89
EM	0.89	(1.31)	7.99
Diff. (US-EM)	(106)	36	190
HY			
US	1.88	5.36	7.11
EM	2.24	(1.69)	1.50
Diff. (US-EM)	(36)	705	561

STRATEGY: After two years of underperformance, we see potential opportunities in high yield EM. We like countries with highly idiosyncratic (bottom-up, country-specific) drivers.

- Though there are plenty of risks in this sector, a lot of it is already priced in – at least in certain segments of the market. We highlight the spread gap between EM and US corporate bonds in the HY space where the credit risk spread differential is near the highest level in five years. Note the spread between EM and US corporate HY spreads below (the opposite is true in the IG space where US corporate debt is cheaper):

- Another positive is that we see wide total return dispersion by country in the HY EM space. This opens the door to total return opportunities from country selection (alpha).
- We still do not have any local currency EM debt. While this has been a good miss for us, we are starting to look at select opportunities, albeit cautiously.

Total Return %	Dec 2021	2021	2020
EM US$ debt	1.43	(1.51)	7.51
Local EM debt	1.56	(8.75)	2.69
Diff. (US$ EM-non$)	(13)	724	482

NOTABLE COUNTRY ISSUES CENTER ON POLITICS:

- China - We still have no exposure because credit risk spreads are still too tight for the endless string of geopolitical headline risks. Two stand out:
  - Growth slows more than expected. Despite estimates coming closer to our more bearish forecast of just under 5.0% for 2022, we think consensus growth estimates of 5.2% (down from 5.6% at the end of Sep 2021) are still too high and that investors are underestimating the ripple effects from further real estate disruptions to the broader economy.
  - The regulatory crackdown continues. Hong Kong newspapers faced police raids, Tencent announced a divesture, while Evergrande was ordered to destroy 39 properties – who's next? Stress in property companies is cited as a problem. We view this as a manifestation of the underlying problems in government policy – easy policies kept the real estate sector propped up and over-valued for a long time. Liquidity reduction removed some key support which in turn drove the current stress.

- CIS region
  - Russia: We still have no exposure. Yields outside of real estate have yet to widen to levels that reflect the country's political risks.
  - Kazakhstan: A long period of relative calm following Nazarbayev's "retirement" has been quickly replaced by violent protests. While initial protestor demands for lower gas prices can easily be met, we see the menu of requests evolving into a more complicated negotiation process. Top it off with multiple deaths and Russian troops on the ground and we have quite a potent political risk cocktail – and bond prices have yet to react much. We maintain our neutral exposure as Kazakhstan's capacity is very high.
  - Ukraine: The key risk factor is whether Russia, which has been building its troop strength recently, invades the country – again. We assign a 1/3 degree of probability to this outcome. Our central case scenario of de-escalation, with a 2/3 degree of probability, would likely lead to rapid price appreciation given cheap valuations.

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