Emerging Markets Update

APRIL 2022: MARKET UPDATE & OUTLOOK

PERFORMANCE: EM debt losses accelerated in April

- Emerging markets debt (EMD) declined by 5.48% in April. This brought the year-to-date total return down to -14.23%.
- Macro factors predominated again, and no sector of the Bloomberg U.S. Aggregate Bond Index (U.S. Agg) has been spared this year − all are down except loans, which are flat YTD. In relative terms, while 2022 was tough for all fixed income sectors, EMD was the worst performer. The U.S. Agg has declined by 9.50% through the end of April 2022 – down a lot, but still 473 basis points (bps) less than EMD.
- Our exposure has been at its lowest levels ever in our history. Our anticipation of continued upward pressure on U.S. Treasury rates and continued weakness in equity markets have fueled our rationale.
- The upside to this dismal performance is that some value has opened up in the bond market. The all-in yield-to-worst of the U.S. Agg is now higher than it has been at any other time over the past decade, except at the end of 2018.

- While we now see more value in EMD, we must still get comfortable with some key macro issues before we will feel comfortable enough to increase our exposure meaningfully in our multi-sector portfolios.

MACRO BACKDROP: still the Fed, Chinese growth and the Russia/Ukraine war

- The graph above depicts the result of both Treasury yields doubling and credit spreads widening meaningfully in all sectors, including EM, this year.
- Fundamentally, we are retaining our combined macroeconomic and geopolitical view as ‘stagflation light,’ defined as persistent inflation despite slowing growth (not contraction), with continued geopolitically-driven bouts of market disruption.

Emerging Markets Market Update

- ► Fed policy is in focus for all bond and stock markets. We continue to believe the Fed is behind the curve in addressing inflation. We see a meaningful risk of the Fed overtightening as it plays catch-up to tame elevated inflation.
- ► We still think that Chinese growth will remain weak relative to the country's history. The primary near-term issue is the amount of growth disruption China is set to incur due to COVID-related shutdowns – Shanghai in particular. Ultimately, we expect the country to respond to COVID aggressively, but also offset the economic impact with both monetary and fiscal policy easing. Longer-term, China's population is aging rapidly as its growth rate slows. While this is nowhere comparable to the situation in Japan and developed Europe, the trends in China are clear.
- ► We expect the war between Russia and Ukraine to continue to move sideways. However, this remains a major source of potential market volatility.

STRATEGY: Identifying some opportunities given better value & our low exposure

- ► Given our concerns, we are trying to manage the potential for near-term downside. However, fixed income markets have corrected significantly, and we expect the markets to settle eventually. The EMD market is down 16.8% since Sep 15, 2021, and we are looking for pockets of value.
- ► We are looking more closely at high yield (HY) EM countries, many of which have good value compared to U.S. HY. In the EMD selloff since last September, the HY EM credit risk spread has widened to 708 bps from 562 bps, while the investment grade EM credit risk spread has mostly traded around 160 bps versus 172 bps currently. Notably, the HY EM spread of 708 bps now exceeds the U.S. corporate HY spread of 420 bps by a 288-bps margin. EM HY spread versus U.S. corporate HY spread:

- ► While the EM HY spread is wide, obtaining it when executing trades is difficult. Careful country selection in the current environment is critical. So far, in 2022, the bonds issued by Russia have lost almost all their value, Ukraine's bonds are close behind, and 17 others are down by over 15%.

EM COUNTRY HIGHTLIGHTS

- Ukraine's bonds nosedived once again in April as it sustained increasing amounts of war-related damage. Some estimates already put the cost of repair at $500 billion, with that number likely to rise. In addition, IMF officials estimated a cost of $5 billion a month just to keep the government/economy up and running while the conflict continues. While Ukraine may eventually present investment opportunities as it rebuilds with Western support, it is still too early.
- In China, HY credit, particularly the property sector, remains under pressure. In April, three Chinese issuers defaulted on $4.6 billion of US$ debt. Trailing 12-month defaults by issuer count are running at 36.7% for the HY property sector and 21.6% for all HY issuers. This has spread regionally, as shown by an 11.5% Asia HY default rate.
- Oil exporters: Bonds of some HY issuers in this space had only small losses as growth in oil revenues offset the countries' high sovereign risk.
  - Oman is down -3.5%. While its returns are negative, Oman has outperformed the EM index by a lot. Higher oil prices and reform efforts have resulted in positive surpluses in fiscal and current accounts, and S&P rewarded the country with an upgrade in early April to BB-.
  - Angola is down -2.1%. This is one of our top picks in EM that continues to benefit from high oil prices, leading to outperformance versus the EMBIG. During the month, we saw a return to markets as they priced a new $1.75 billion 10-year note at 8.75%. In addition, they announced a tender for 2025 & 2028 maturities, with $635 billion validly being accepted among the 2025s. Newfleet was a participant and will be looking to redeploy those proceeds back into the curve as bonds sold off during the month.
  - Nigeria was down -11.7%. While it did not hold in as well as the two countries above, it still outperformed the broader EM debt market. In a nutshell, higher oil prices supported economic growth, but combined with higher food prices, this put pressure on the budget. While Nigeria exports oil, it is a net energy importer because of its limited refining capacity, leaving less oil revenues to service debt. Also, with oil production at least temporarily at historically low levels, the spike in oil prices has materially increased government oil subsidies, and the administration put off reducing them until after the February 2023 elections. The shock in global food prices also hurt consumer and economic growth.
- Egyptian bonds have underperformed recently because of the supply-driven shock prompted by the war in Ukraine. The country is the world's biggest wheat importer, and its reliance on supply from Russia and Ukraine has negatively impacted the population. Talks with the IMF for a new program are ongoing, and the government has made efforts to meets its demands. Its central bank has raised rates to contain inflation, the government has begun the privatization of some state-owned enterprises to help reduce the stake the military has in the economy, and the central bank has moved to let the EGP float freely. Portfolio flows in this environment will remain a near-term concern, as will the country's debt level. We've recently reduced our position.
- Turkey's bonds are down -1.7% this year. Turkey remains a surprise within EM as its unorthodox monetary policy deters many offshore foreign investors from getting involved. Inflationary pressures persist, with the April CPI print expected to come in at ~68% y/y. At the same time, we continue to hear little in the way of the central bank looking to tackle this by hiking the one-week repo rate from 14%, where it has been since last December. What's driving the outperformance is locals parking their dollar deposits into the dollar Eurobond curve via maturities 5 years and in. We acknowledge this beneficial technical and are seeking involvement for our accounts when the opportunity presents itself via spread widening.

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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.

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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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AR 219012 5/2022