Emerging Markets Update

MAY 2022: MARKET UPDATE & OUTLOOK

PERFORMANCE: EM debt reversed course and posted a slight gain in May. However, it still underperformed.

- Emerging markets debt (EMD) rose by 0.19% in May, bringing the year-to-date total return to -14.07%. The slight bounce was, again, less than that of the Bloomberg U.S. Aggregate Bond Index (U.S. Agg), which rose by 0.64% in May to bring its YTD total return to -8.92%.
- The macro backdrop did not change much. Both equities and interest rates were fairly range-bound. However, the pace of the drawdown in financial markets slowed markedly from the first four months of the year. In fact, the S&P 500 and U.S. Treasury market were both up 0.18% in May.
- Still, our exposure has been, and remains, at its lowest levels in our history.
- Given the moderation in the downward move in financial markets, some value has opened up. This, combined with our low level of EM exposure, has induced us to start looking for bargains.
- The all-in yield-to-worst of the U.S. Agg declined a bit in May, but stays near the highs of the past decade, or, looking more recently, more than three times the August 2020 lows.

MACRO BACKDROP: Fed hiking & tapering under way; China's possible bottoming; Russia/Ukraine stalemate

We maintain our macro view that inflation will persist despite slowed growth due to ongoing geopolitical volatility, the Russia/Ukraine war and its impact on commodity prices, and China's stalled growth.

- We continue to see a meaningful risk of the Fed overtightening as it plays catchup to tame elevated inflation. This same conundrum is also in play in Europe, where growth is even slower and inflation higher. The ECB (European Central Bank) is even further behind the curve than the Fed and looks set to play catchup as well – policy rate hikes from 0% have yet to occur despite inflation having just breached 8%. While debates are intensifying over how rapidly rates should rise, there is little doubt over whether a policy rate of -810 bps is appropriate, especially with the Eurozone unemployment rate at 6.8% – the lowest ever.

- We still think Chinese growth will remain weak compared to the country's history. We see a balance between:
  - Finding a bottom as China's major urban areas reopen. While the economic impact from China's harsh lockdowns is severe, the duration of the drawdown is lower than in other large countries.
  - At the same time, we have consistently seen China's case counts move higher after it loosens restrictions. Moreover, the efficacy of China's vaccine is still in question, along with its data opacity.
- We still expect the war between Russia and Ukraine to continue to move sideways, while the conflict is still a source of potential volatility.

STRATEGY: Looking, but not yet buying very much. Identifying 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. The EMD market has experienced a peak drawdown of 18.0% from September 15, 2021 through May 9, 2022 – a large sell-off. However, there have been two bigger drops this century. EM debt declined by 20.0% from March 4, 2020 through March 19, 2020 due to COVID. EM also saw a 29.3% decline from May 21, 2008 through October 24, 2008 during the Great Financial Crisis.
- Amid the market decline, we are looking for pockets of value, particularly within high yield (HY) EM countries, many of which compare favorably to U.S. HY. During the EMD selloff since last September, the HY EM credit risk spread has widened to 736 bps from 556 bps, while the investment grade EM credit risk spread has mostly traded around 160 bps versus 165 bps currently. The HY EM spread of 736 bps now exceeds the U.S. corporate HY spread of 436 bps by a 300-bps margin.

EM COUNTRY HIGHTLIGHTS

- The rising cost of food and fuel subsidies has become a general theme in places like Nigeria, Kenya, Morocco, Lebanon, Egypt, Jordan, Turkey, and Sri Lanka. Increased costs will result in a negative hit to both the current and fiscal accounts.
- First-round presidential elections in Colombia resulted in frontrunner Petro garnering 40% of the vote and Hernandez, who had been polling in third place, securing the number two spot with 28% of the vote. Because neither candidate captured 50%, the second round will take place on June 19th. A win by either candidate will bring change to the economic and political landscape, as both are anti-establishment.
- Pakistan increased fuel prices by more than 20% at the end of May despite mid-month claims to the contrary. The country continues to exist precariously, facing high inflation, declining reserves, and an elevated import bill. We have no exposure.
- Egypt outperformed the broader market and the HY component with a return of 2.26% (EMBIG +0.19%, EMHY -0.62%) after a volatile month of headlines. The war-driven wheat shortage became a focus for Egypt more than once during the month, but further commitment of aid from its Gulf state allies – specifically another $3 billion pledge for wheat imports – were enough to give bonds a "rebound" status. Meanwhile, its central bank hiked rates 200 bps to 11.25 (deposit rate), totaling 300 bps of tightening since March. We are overweight.
- Chile's central bank hiked its overnight rate by 125 bps to 8.25%, exceeding expectations as inflation continues to soar above its target of 3%. The policy rate has increased 775 bps since July 2021. As everywhere else, price pressures have been fueled by government stimulus and pension withdrawals aimed at helping citizens deal with the COVID fallout. Officials had previously signaled they might be coming to an end in the tightening cycle in their March quarterly projection, which anticipated the upper range (i.e., the worst-case scenario) for the policy rate at 8.25%. However, the country's March CPI print blew through expectations. With April's CPI print once again higher than expected (+10.5% year-over-year, and +1.4% month-over-month), more hikes are likely. The biggest contributors to April's print were food and energy prices, driven by the events in Ukraine.
- Peru's central bank also continued its tightening cycle as it hiked another 50 bps, bringing the reference rate to 5%. Inflation remains high (+6.22% year-over-year in March) along with forward expectations. Officials see price pressures beginning to abate mid-summer, though remaining above their target of 2% (+/- 1%). In addition, the strong post-pandemic rebound is showing signs of weakness as the Economic Activity indicator utilized by its central bank posted

moderate to weaker readings in the past couple of months, while the unemployment rate is showing a reversal from 7.8% at the start of the year, jumping to 9.4% as of March.

- Turkey's central bank continues to go against the tide. Officials kept the one-week repo rate unchanged (14%) at their latest meeting – the fifth consecutive meeting that left the policy rate unchanged despite CPI surging to 70% from 36% and the lira losing 22% against the USD. Officials also signaled the potential for new policy actions, but provided no details. Though Turkey is one of the larger countries in the region, we have no exposure.
- Bank Negara Malaysia hiked its policy rate 25 bps to 2% in a surprise move, marking the first hike since cutting 125 bps in 2020. The hike is viewed as a preemptive move as the economy continues its post-pandemic recovery amid strong exports and tepid inflation in the 2-3% range. In its statement, it acknowledged external headwinds – specifically from surging commodity prices. Growth is expected to remain strong thanks to its recent capacity expansion in the electronics and natural gas sectors. Moreover, at 4.1%, its unemployment rate is moving away from its pandemic high of 5.6% and inching closer toward the country's pre-pandemic level of 3.2%. Officials expect this tightening cycle to be executed in a "measured and gradual manner," with forecasts showing an additional 50 bps of hiking (25 bps each quarter) for the remainder for 2022.

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