Emerging Markets Update

JUNE 2022: MARKET UPDATE & OUTLOOK

PERFORMANCE: EM debt resumed its trend of underperformance in June.

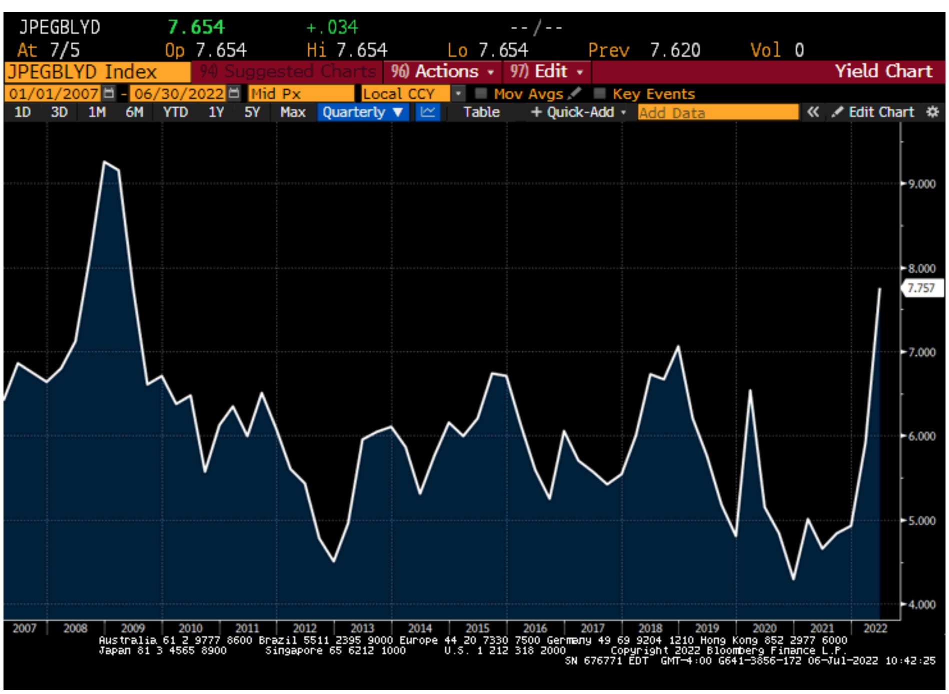
- Emerging markets debt (EMD) dropped by 5.54% in June, bringing the year-to-date total return to -18.83% − by far the worst performing sector in the bond market. EMD's YTD drawdown was 848 basis points (bps) worse than that of the Bloomberg U.S. Aggregate Bond Index (US Agg), which dropped by 10.35% YTD. Even excluding the impact of Russia, which accounted for about 300 bps of the YTD decline, EM debt still underperformed by a lot.
- While our multi-sector bond portfolios' returns were hurt by their EMD holdings, our exposure has been, and remains, at its lowest levels in our history.

MACRO BACKDROP: Same issues, but they are now better reflected in prices

- We still believe that central banks will continue to tighten despite growth slowing, as they are now prioritizing price stability. We believe the central banks waited too long to hike policy rates and manage their enormous balance sheets.
- One of the risk factors is that both the Fed and ECB may overtighten to set policy rates closer to inflation. We doubt G7 real policy rates will be ratcheted up to positive territory, as the current growth trends could not handle it due to the risk of recession. However, we do believe policy rates should at least be less negative, and we expect this to be the outcome for this cycle.
- We expect the Russia/Ukraine war to move sideways. The situation could get worse if natural gas supply to Europe is disrupted. Also, let's not forget Russia's potential response to Norway and/or Sweden joining the EU.
- We think that China will continue to strike the right balance between COVID containment and labor force mobility to keep growth above 4.0%. We believe they have sufficient policy capacity, and the willingness to do it.

STRATEGY: Still waiting to re-enter more aggressively, while acknowledging cheaper bond prices

- We have been paid to wait before re-entering many of our EMD positions. This has been the right call, but at some point, it will no longer be valid.
- The silver lining is that the EMD market now has several cheap bonds, and our funds have ample capacity to add exposure. The all-in EMD market YTM is now at its highest level since the global financial crisis (GFC):



- However, we are still very focused on renewed downside protection due to our macro concerns.
- Our bottom line is that while risk premiums have risen meaningfully, credit risk spreads are still not wide enough to induce us to buy aggressively.

EM COUNTRY HIGHTLIGHTS

- In Colombia, Gustavo Petro secured the win in the second round of presidential elections on June 19th. Bonds widened 10-20 bps on his win initially, as his stated agenda signaled a shift away from the country's general conventional approach toward economics and fiscal policy. Petro picked a moderate, Ocampo, for his finance minister, which the market took as a sign of some fiscal stability and the likely curtailment of some of Petro's aggressive spending plans. The central bank raised rates 150 bps to 7.5% to keep inflation in line. Economic activity remains strong in the country.
- High food and energy prices continue to hurt Egyptians and will continue to be a concern for government, partly because subsidies aren't easy to reduce or take away. Despite higher inflation, the central bank did not raise rates at the June meeting, choosing to monitor the data before moving again. Egypt continues to have financial support from GCC countries, and an IMF program is in the works. PMI faded in June and was 45.2 vs. May's 47 print.
- Ecuador experienced protests across portions of the country demanding additional fuel subsidies and other measures. Protests negatively impacted oil production and transportation networks but ended in early July as the government gave in to some of the demands. The situation leaves the government in a much-weakened position to achieve more reforms. The IMF remains supportive, but bonds took a major hit, with the Ecuador sub-index down -21.6% in June.
- South Africa experienced some of the worst rolling blackouts in recent years as worker protests over wage negotiations caused reduced electricity output at Eskom, the state-owned electricity company.
- The conflict in Ukraine continues to grind on, with Russian forces achieving additional gains by taking territory in the eastern Donbas region. Meanwhile, Russia officially defaulted on its hard currency Eurobonds in June.
- Kenya: As countries face prevalent funding pressures, Kenya is no exception. Officials in June, after holding off for several months, scrapped their plan to tap the Eurobond market for $1 billion after citing higher costs. Instead, they sought a syndicated loan from a consortium of banks. However, even those plans fell through due to elevated pricing. Proceeds would have been used to plug the deficit gap for the 2021/2022 fiscal year that ended June 30th, which was previously expected to come in at -8.1%/GDP, with further deteriorating risks on high energy and food costs. While this is one example within EM, we highlight the challenges many HY issuers face in this uncertain environment.
- Argentina looks to be on course to default again. The recent appointment of Silvina Batakis as the country's new Economy Minister is unlikely to set the stage for an improvement in the country's dire fundamentals. However, US$ denominated bond prices around $20 already reflect anticipation of a default.
- Kazakhstan's investment grade fundamentals will likely enable the country to continue to service its external debt. However, the country's strong commercial and political ties with Russia will likely prevent bond prices from recovering to pre-war levels. As a result, we expect prices in the intermediate to long end of the yield curve to remain in the 80s.

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