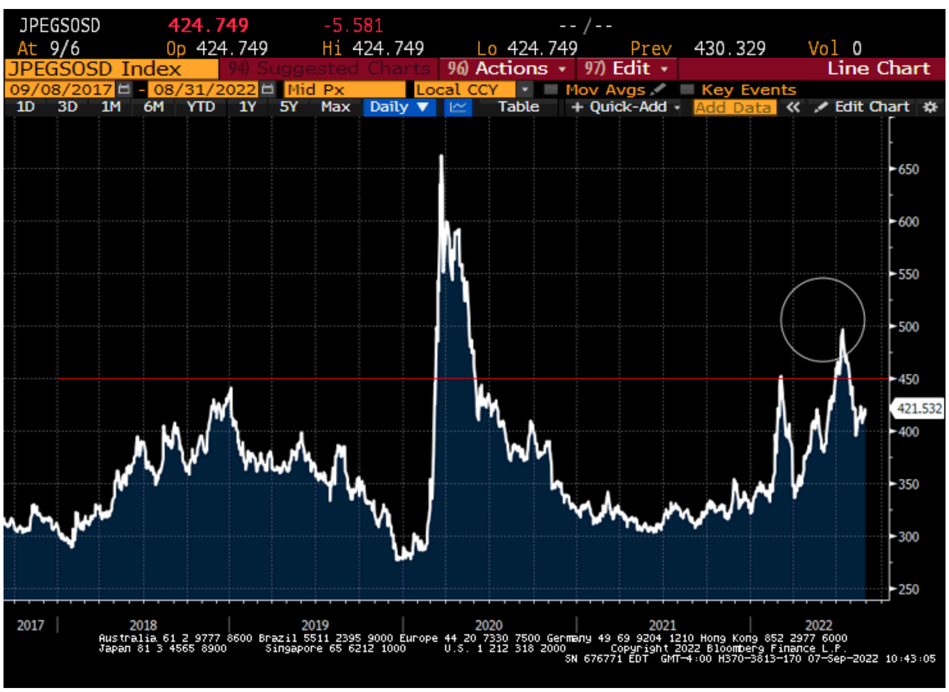
# Emerging Markets Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

## AUGUST 2022: MARKET UPDATE & OUTLOOK

### PERFORMANCE: No place to hide, except the US dollar

- Emerging markets debt (EMD) gave back much of its 3.2% July gain in August, declining by 1.17%. This brought the YTD EMD debt total return to -17.21%, which is about 1.6x the -10.75% drawdown of the broader bond market (U.S. Agg).
- At the macro level, the old market adage, “never fight the Fed,” was fully in play. Like much of this year, both risky and safe-haven financial assets declined.
- Expectations of further Fed tightening drove weakness in financial markets, which showed a high degree of cross-asset correlation. Treasuries moved first. Yields across the entire curve rose consistently by about 60 basis points (bps) during the month. This was first driven by the market’s anticipation that Fed Chair Powell would strike a more hawkish tone at Jackson Hole, and later confirmed by his actual comments. The Fed clearly emphasized fighting inflation even at the expense of weaker growth. The subsequent absorption of the growth implications added further pressure. The S&P 500 declined by 8.1% during the second half of August. Global equity markets followed. This pushed credit risk spreads wider, and EMD was no exception.
- Fortunately, our exposure is near our all-time lows. We added 1-2% across accounts in late July through early August, when the EMD risk spread was above 450 bps – the widest levels over the past five years except during the COVID sell-off (The graph below depicts the EMD risk spread for the past five years, with the late July/early August point marked with a circle):

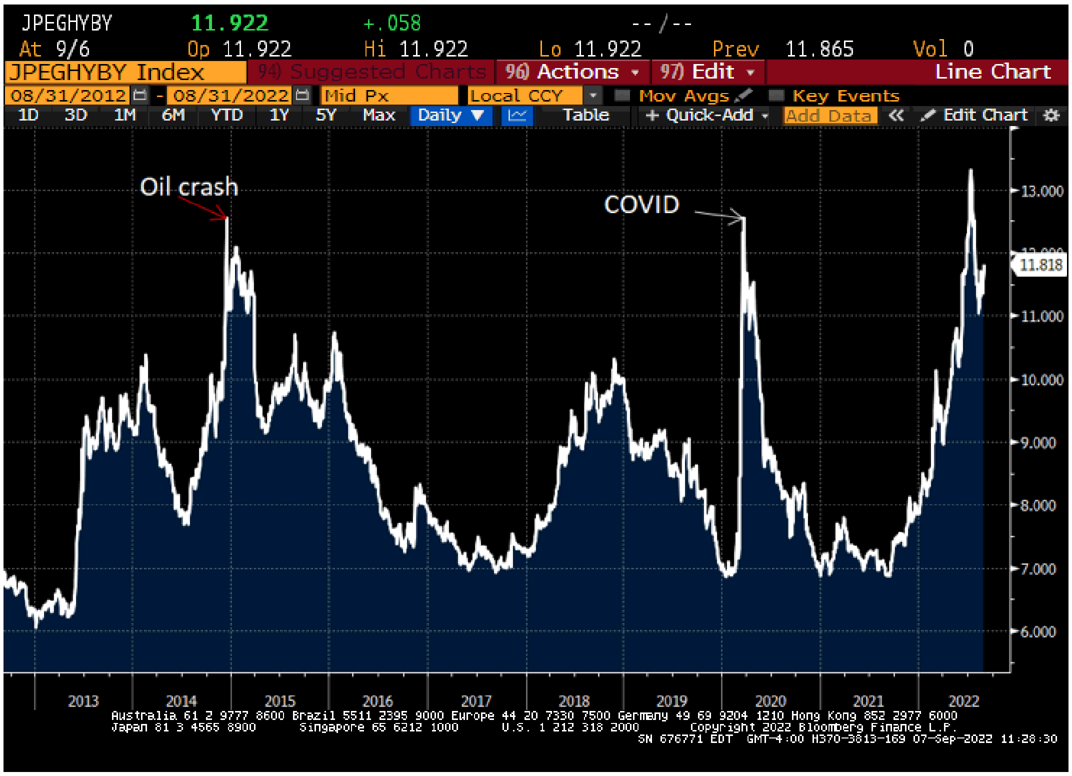



- We are still cautious overall, but opportunistic on certain EM sub-sectors and country stories.

### STRATEGY: Continue to add exposure, but only on dips, and pick our spots carefully

- We started to increase our EMD exposure by a small amount during the last week of July but stopped when prices increased/spreads compressed (circle in chart above). We think the EMD market now has several cheap bonds, and our funds have ample capacity to add exposure. However, we are waiting before adding due to our concerns over G-3 rates and equities.

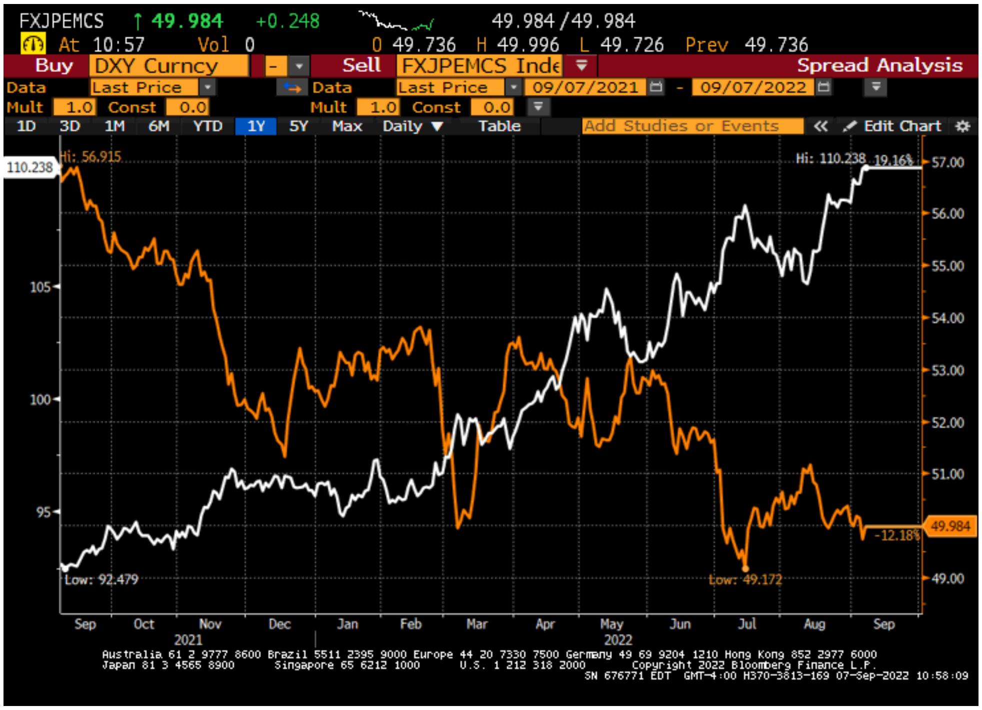
- At the sub-sector level, we prefer high yield (HY) over investment grade (IG) in EM. Our target credit quality weightings are now skewed in favor of HY. Our credit quality mix is now about two-thirds HY and one-third IG, which is the opposite of the market, which has a mix of one-third HY and two-thirds IG.
- The reason why we prefer HY EM bonds in the face of a weak macro backdrop is due to valuations. HY EM yields are near historical highs due to the Treasury sell-off and widening credit spreads. As we can see below, an extreme event is usually required to push HY EM credit spreads to current levels. Thus, while we are not embracing HY EM bonds end masse, we continue to seek out pockets of value. HY EM credit risk yield over the prior decade:




- Our preference is supported by performance in August, when the S&P 500 was down by 4.1%, Treasuries were down 2.5%, and IG EM fell by 1.9%. However, HY EM was essentially flat at -0.09%. We think this shows the potential for outperformance once the macro backdrop stabilizes.
- While we are still focused on downside protection due to our macro concerns, we have been finding value in Sub-Saharan Africa and frontier Asia, and we are doing our homework on some restructuring stories, where we are looking for double-digit yields that are high enough to offer enough country-specific risk spread to offset the Treasury and EM market components of the all-in yields.
- Currently, we are not increasing our IG EM exposure by much because most of the countries' yields do not offer sufficient compensation for credit risk spreads that are still close to comparably rated U.S. alternatives.

**MACRO BACKDROP: Focus on Fed, Russian gas supply to Europe, looming. China noisy but moving sideways.**

- We still do not have any non-dollar exposure. We continue to expect the US$ to remain strong while EM currencies stay weak. US$ index (white line) vs EM currency index (orange line):




- ► We are concerned that the market's implied view on inflation – and the amount of monetary policy tightening that will be required to contain it – is too sanguine. The Fed simply does not have a track record of tightening enough to slow inflation <u>and</u> avoid recession. We see an uneasy balance between negative real rates pushing nominal yields slowly higher while still large central bank bond holdings and a slow pace of quantitative tightening prevent a more meaningful move higher.
- ► We expect the European Central Bank (ECB) to hike by more than expected. We also expect growth to continue to slow, and for the pace of decline to be greater than expected, as the growth impact of an energy supply shortage will be larger than any fiscal countermeasures that are likely to be implemented.
- ► We remain more bearish than consensus on the Russia/Ukraine war. We expect Russia to keep disrupting natural gas supply to Europe, then wait for the onset of winter to shut off supply completely. The economic impact to Europe as the ECB tightens monetary policy could be significant. The geopolitical ramifications are sure to affect more than just the EU.

## EM COUNTRY HIGHTLIGHTS

- ► We have a small position in Argentina because prices are below our estimates of eventual restructuring value and the country is actively engaged in discussions with market and official sector creditors. At the same time, the country's fiscal dynamics make its debt unsustainable, and inflation is out of control.
- ► We hold no exposure to Russia or Ukraine. We still expect opportunities to emerge, but not yet. Ukraine reached an agreement with bondholders during the month to defer all principal and coupon payments for two years. Bond prices reacted positively initially, but later fell back to previous levels.
- ► Egypt's central bank governor resigned, hopefully paving the way for further devaluation of the EGP to improve the current account deficit, which would be a key step toward an IMF deal (estimates suggest a $3-5 billion deal). After a reprieve in June, July inflation in Egypt accelerated to 13.6% year-over-year versus 13.2% in June. Food prices were the largest contributor, rising at an annual rate of 22.4%. Despite this, the central bank left rates unchanged at 11.25% while estimates called for a 25-bps hike.

- The IMF approved a $1.2 billion loan to Pakistan (7th and 8th tranches), easing near-term default concerns. The country is facing a hefty import bill leading to a widening current account deficit, dwindling reserves, political turmoil (former PM Khan faces legal action this week) and extensive flooding. The central bank left rates unchanged at 15%.
- S&P downgraded Ghana to CCC+ from B-, with a negative outlook. Fitch also moved the country's ratings to CCC from B-. The central bank also held an emergency meeting and hiked rates 300 bps to 22% to combat the country's crushing inflation.
- Gustavo Petro took office at the beginning of the month as Colombia's first leftist president. He pledged to continue to fight the war on drugs and begin the distribution of wealth in the country with reforms in taxes, education, and health care.
- In Ecuador, political/social risks are still high. The country's largest city, Guayaquil, declared a state of emergency due to criminal gang violence, including a deadly bomb attack in mid-August that left five dead and injured 17. Additionally, in early August, Luxembourg froze Ecuador assets amid a dispute with Anglo-French company Perenco. The government said its ability to meet external debt obligations had not been affected by this decision. In the meantime, both Fitch and S&P reaffirmed their B- debt ratings with stable outlooks. In its ratings commentary, Fitch highlighted IMF funds that will help meet needs for 2022, but in 2023, the financing picture becomes challenging unless the government can reestablish market access.
- In Nigeria, July CPI increased to 19.6% year-over-year from 18.6% in the prior month, climbing to the highest level since Sep 2005, and more than double the 9% ceiling of the central bank target band. Security issues in the country's food-producing regions, high diesel costs, and continued currency weakness are likely to keep upward pressure on prices. Separately, August PMI data was positive at 52.3.
- South Africa August PMI at 52.1 was much better than expected (48.2) and marked an improvement over the prior month (47.6), as nationwide power cuts eased in August, fuel prices dropped, and flood-damaged facilities owned by Toyota Motor Corp reopened. The country implemented rolling blackouts on only seven days last month versus 22 in July.
- In Kenya's presidential election, William Ruto edged out Raila Odinga with 50.5% of the vote versus 48.95%. Odinga appealed the result, but the country's Supreme Court found no irregularities and upheld Ruto's win. We expect a Ruto government to provide more clarity on fiscal/debt goals, while Odinga brought some concerns when it came to relations with lenders. Our focus now turns to the country's ability to navigate funding in the near term, since market access is shut and reserves have dwindled to recent lows of $7.375 billion, though it is still adequate based on 4.2x monthly import cover.
- Moody's downgraded Turkey to B3 stable from B2 negative, citing concerns over rising payment pressures and unorthodox policy. Both items are nothing new and have plagued the country in recent years, as shown by the central bank's surprise rate cut and weak July trade print during the month. Central bank officials defied high CPI of ~+80% and cut the one-week repo rate by 100 bps. The country posted a record trade deficit in July on the back of rising energy costs, with the print coming in at -$10.7 billion and the trailing 12-month tally widening to -$83 billion – levels not seen since 2018.

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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.

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