Emerging Markets Update

Newfleet
ASSET MANAGEMENT
A Virtus Investment Partner

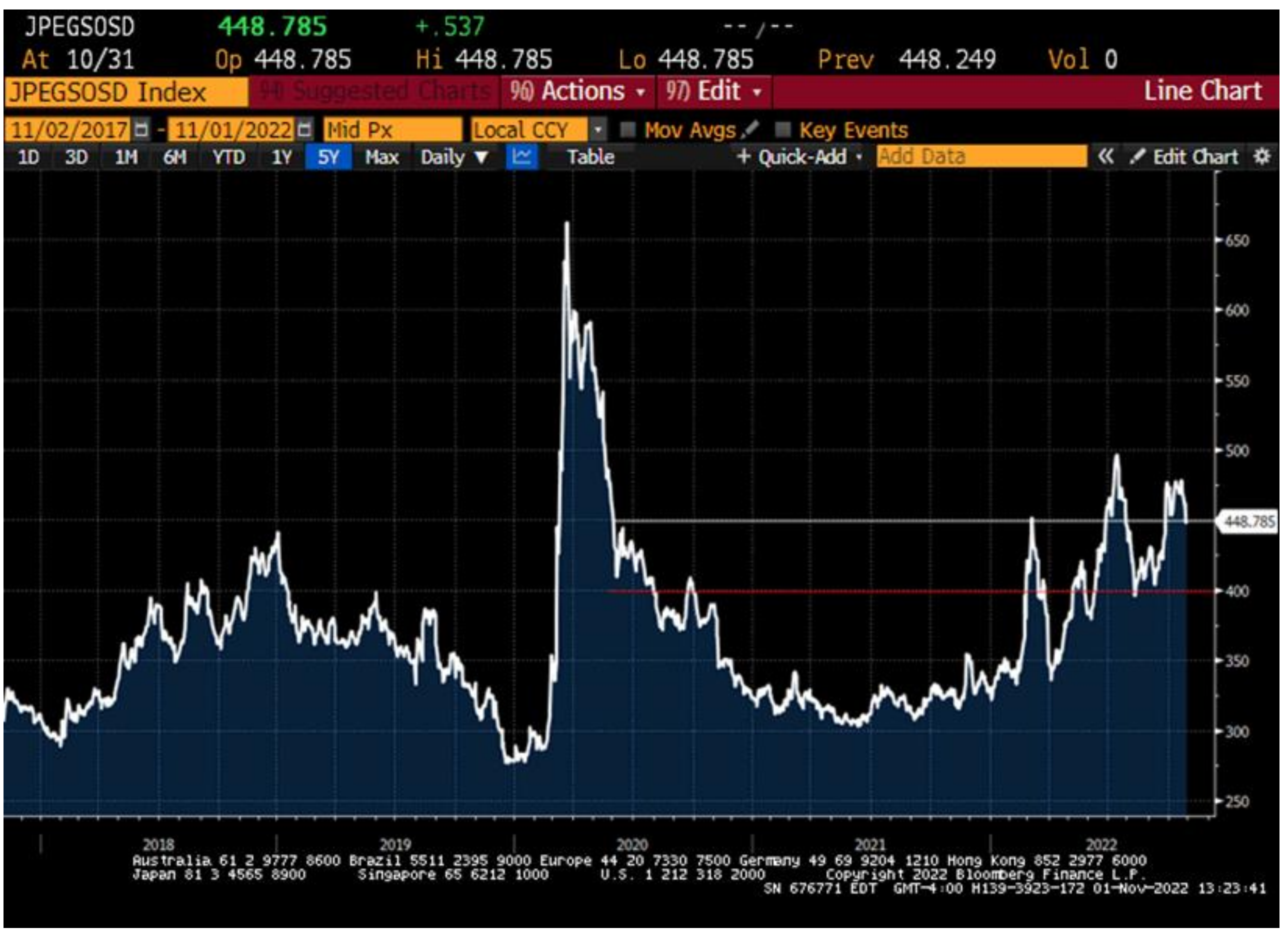
OCTOBER 2022: MARKET UPDATE & OUTLOOK

PERFORMANCE: Flat, but a lot going on within the month

- Pressure on emerging markets debt (EMD) continue in early October. The market declined by 2.62% during the first three weeks of the month, bringing the YTD total return drawdown to -24.27%. However, the EMD market bounced enough during the last week of October to enable it to post +0.08% for the whole month – essentially a flattish return. This looks good compared with the broader bond market, which was down by 1.30% in October.
- The drivers of late month strength were a rebound in risk assets, followed by a reprieve in the U.S. Treasury market sell-off. Note that it took relief in both core markets to stabilize the EMD market. From a valuation perspective, the month-end EM risk spread finished Oct at 449 basis points (bps) – the middle of the recent range.

STRATEGY: Continue to add exposure on drawdowns

- After the 23.18% draw-down this year, we now see value in several EM bonds. However, we still think macro volatility is still in play. Thus, we are waiting before issuing an all-clear buy recommendation.
- Strategically, we are continuing to use pullbacks to re-enter countries we like – but only at the right price.
- Fortunately, the fact that our EMD exposure remains near our all-time lows means that we have room to add. While not a hard and fast rule, we have been adding exposure when the EMD risk spread trades in the upper 400s. On the flip side, we have been reducing our exposure when the risk spread (below) trends toward the lower 400s.



- When we drill down, we see two interrelated distinctions on performance worth mentioning, as both are reflected in our strategy:

- At the multi-sector portfolio level, we still think comparably-rated U.S. spread product is more attractive than EM in both IG and HY. We think that this will reverse when core markets in the G-3 settle, which should induce more investors to invest in riskier markets like EM.
- While the EMD market was essentially flat in October, IG EMD declined 1.29%, while the HY segment was up 2.15%. This aligns with what we see at the macro level. Within the Bloomberg Agg, U.S. IG corporate debt was down 1.03%, while U.S. HY corporate debt was up 2.60%. Essentially, more duration-sensitive IG bond sectors (Treasuries and agencies) continued to be driven lower by higher rates, while more credit risk-sensitive HY bond sectors tracked the bounce in equities.

- At the multi-sector level portfolio level, we prefer U.S. assets over EM.
  - U.S. equity investors reap higher returns on equity than those in most EM countries.
  - The current economic growth differential of EM countries over the U.S. is too low. This casts a near-term pall over EM financial assets and currencies. As of month-end, EM stocks had underperformed the S&P 500 YTD by 1150 bps, and EM currencies were down by 7.1% versus the U.S. dollar.
  - Within EMD, we prefer HY over IG. Our EM credit quality weightings are 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. During bouts of risk-off sentiment, investors can usually find safe haven in Treasuries, but this has not been the case this year. We think this is because the source of investor angst comes from the Treasury market itself. This has produced a positive correlation between Treasuries and risk assets (both are trading down together this year). The result is a concentrated set of macro drivers with U.S. monetary policy (both price and quantity) at the center of it all.

MACRO BACKDROP: Still the ‘big three’

- In our view it comes down to:
  - The Federal Reserve (Fed)
  - The growth impact of China’s COVID lockdown policies
  - Russia’s gas supply to Europe
- We do not think the Fed is likely to pivot yet. We expect it to do so only when:
  - The labor market starts to cool.
  - Actual inflation starts to decline.
- As a result, we see high odds of overtightening. However, this Fed has been very responsive to signals from markets. Thus, if the Fed overdoes it, we think it will tack in the other direction quickly enough to not disrupt growth too much.
- We expect China to slow a bit more than expected due to rigid COVID lockdown policies and our view that the HY US$ denominated property bond crisis, which has spread into IG, will hit the domestic market. While China is likely to save the day with an aggressive policy response, we think the ultimate impact on the banking system will be greater than expected. PMI data just came out below 50, economic data remains soft, and COVID-related lockdowns continue to impinge upon economic activity.
- While the war between Russia and Ukraine will continue to make noisy headlines, the impact to the rest of the world should be limited, as Russian gas supply to Europe is already down by 80%. Also, while the use of tactical nuclear weapons is possible, we see it as a low probability/high impact event.

EM COUNTRY HIGHTLIGHTS: Still prefer HY, but now see pockets of value in IG

- We are still finding value in Africa and are working through some restructuring opportunities where double-digit yields compensate for the risk.
- Egypt reached a staff level agreement with the IMF for $3 billion in the form of an extended fund facility. Another $5-6 billion in bi/multi-lateral funding is expected to close the gap on the country's dicey external funding situation. The central bank announced the move to a more flexible exchange rate regime, in part to meet IMF requirements, and also to bolster reserves. Also, the central bank announced an unexpected rate hike of 200 bps to 13.25% after having paused its tightening cycle over the summer. Annualized inflation is expected to be around 18% this year.

- Moody's raised its outlook on Angola to positive on the B3 rating, citing faster growth and higher government revenues that should allow for progress on reforms going forward.
- South Africa's finance minister announced that the government will move a material amount of debt off the balance sheet of financially troubled state-owned utility Eskom, and onto its own sovereign balance sheet. The debt already carries the guarantee of the state, so it will not add to the overall government debt to GDP, though it will add some interest expense to the government budget.
- Ghana was downgraded to Caa2 from Caa1 by Moody's and is on review for another potential downgrade. No surprise here, as the country is suffering from high inflation, a virtually collapsed currency, heavy debt burden, and now rising rates with no market access. Recent comments from the president suggest officials are not anticipating any haircuts on debt. Negotiations with the IMF appear to be moving forward.
- Ecuador's bonds rallied near month-end after a government debt buyback was announced. Its social and political environment remains challenging.
- Brazilians re-elected Lula. We, like many others, see his leftist tendencies as a negative. However, we believe that his potential for excessive spending initiatives will be constrained by a centrist congress. After the elections, the right-of-center and right blocks together will control 57% in both houses of congress. We await cabinet appointments, including the finance minister.
- As anticipated, Colombia raised rates 100 bps to 11%. Inflation is expected to continue its upward trajectory. The central bank recommitted to the free float of the COP (down +16% YTD) and said an FX intervention program is not on the table.
- Saudi Arabia's 2023 budget shows a reversal of previously detailed spending cuts. This brings government spending to a five-year high, reversing the work of reduced spending the Kingdom has been advancing since 2015. The new budget uses $80/bbl for oil and projects a fiscal surplus of 4.6% in 2023. The country issued $2.5 billion in external debt during the month, which we took part in, as there was a small concession offered.
- Pakistan released a statement signaling their intent to fulfill IMF obligations, and not restructure/extend the country's December maturity. Moody's and Fitch both downgraded the country's external debt this month to Caa1 and CCC+, respectively. The central bank left rates unchanged at 15%.
- Mexico's 3Q22 GDP grew above consensus at 1% quarter-over-quarter, largely due to a growth in services. This pace of growth is unlikely to be sustainable, as many of the sectors that showed growth were those that were hit hard during the pandemic and the rebounds they experienced are coming to end. Q422 growth should be negatively impacted by the global slowdown and base effects.

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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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