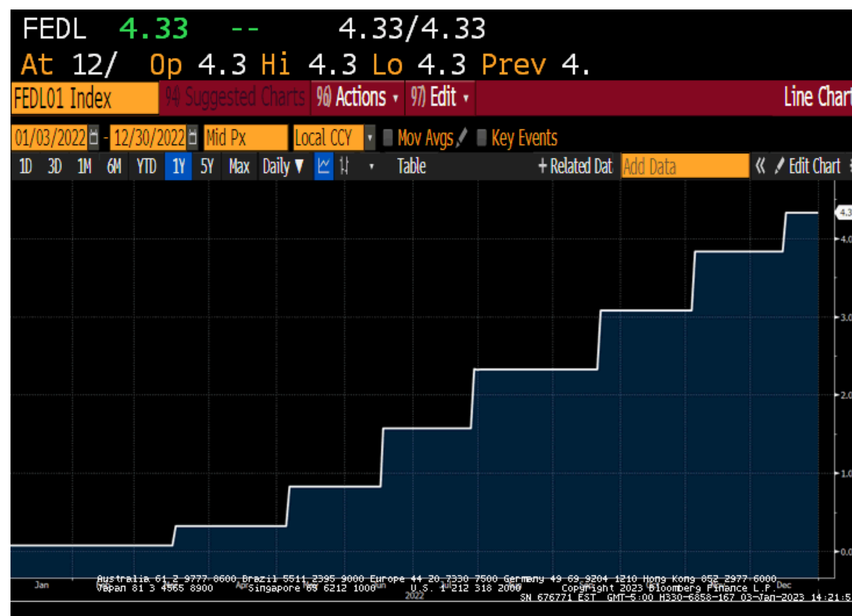
Emerging Markets Update

DECEMBER 2022: MARKET UPDATE & OUTLOOK

PERFORMANCE: Stabilization following the November relief rally

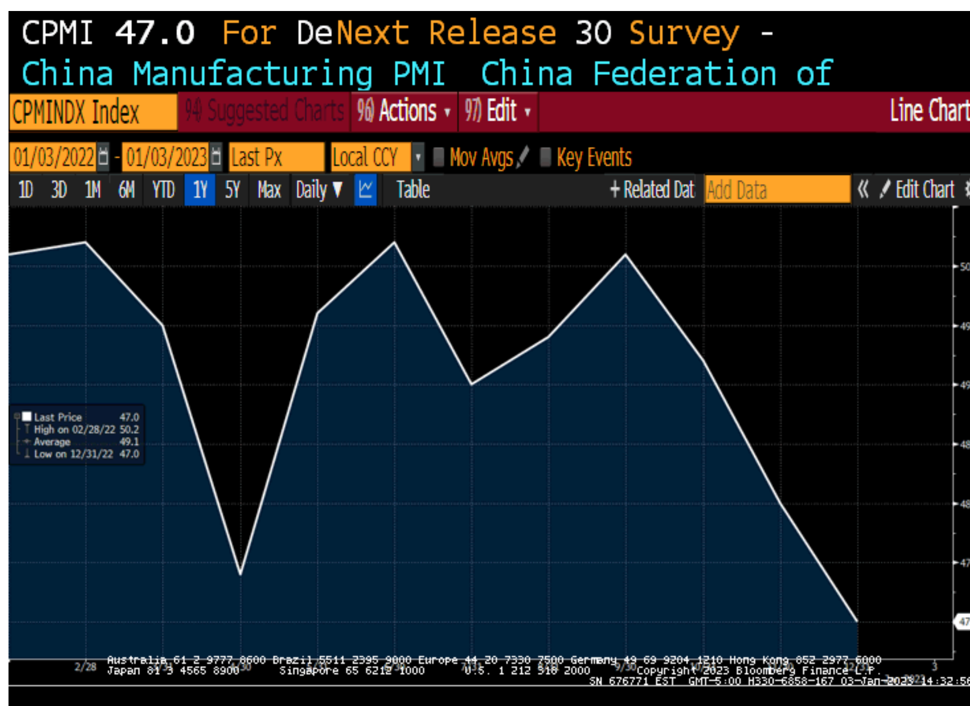
- Emerging markets debt (EMD) posted a slightly positive total return of 0.38% for the month. We view December as a month of consolidation after the relief rally from late October through the end of November.
- Spread compression of 18 basis points (bps), combined with 47 bps of carry, offset the 116-bps duration hit as Treasury yields resumed their ascent.
- This has happened a few times in 2022: a large macro driven sell-off, followed by a partial relief rally, followed by yet another Treasury-driven decline.
- All-in, 2022 was a tough year for credit spread sectors, including EMD, as the EMBIG declined by 16.45% for the year.
- EMD also underperformed U.S. corporate debt. Investment grade EM debt was down -18.39% versus -15.76% for U.S. corporate debt, and high yield EM was down -13.51% versus -11.19% for U.S. high yield.
- 2022 was the worst year for the bond market since the end of World War II, and only the third time in nearly a century when both equities and fixed income posted negative returns.
- This confirms our view that the 2022 selloff was macro-driven, with an emphasis on central bank liquidity retraction.
- Weaker growth is bad for stocks, and thus also for risk spreads. This conspired with supply constraints to push input costs higher. This, in turn, translated into higher inflation and nominal rates. In other words, equity and Treasury markets moved together, with policy rates acting as the key driver.
- The 425-bps increase in the U.S. policy rate was the biggest since 1973. U.S. Fed funds effective rate:



MACRO BACKDROP: Still neutral

- We are keeping our view, formed during the fourth quarter, that the key drivers are well known, and are thus already priced into risk assets.
- We think financial markets (both equities and fixed income) have transitioned from a sharp drawdown to a more range-bound state.
- The key risk to our view on economic fundamentals is that what we have been classifying as mild stagflation persists but does not translate into a hard landing. While the Fed is unlikely to pivot, we maintain our view that it will begin to slow the pace of tightening as growth continues to slow and as the inflation outlook grows more benign. The Fed has already started to ease off the throttle.
- Looking further ahead, we believe the Fed will pivot only when the labor market starts to weaken, and ex-post inflation (not forecasts) shows clearer signs of declining.

- ► While the risk of overtightening is possible – the only time a soft landing was achieved was in 1994-1995 – we think the Fed would be quick to counteract, as they have been very responsive to signals from financial markets.
- ► We are keeping our view that the case is building for a soft landing, and that if the economy enters recession, it will be mild. As a result, we think the worst-case scenarios for the economy are already priced in. A potential downside risk is that the lagging effects of higher rates and overall financial tightening will induce a recession this year.
- ► In China, our long-term view is that their economy will experience structurally lower growth as the country moves to middle income status from EM. We think the country will continue to shift its emphasis from exports to domestic sales. This shift, plus less favorable growth demographics, will be less supportive of growth – though we expect its growth to still be better than that of developed economies. Presently, we expect the government to continue to manage the cyclical growth impact of COVID containment measures, including restrictions on domestic movement and international travel, as well as real estate sector clean-up. We think China's government response is more reactive to changes in the pace of economic growth than to social/health indicators. We do not think China's leadership will tolerate a continued growth slowdown. China manufacturing PMI:



- ► For now, we still see the war between Russia and Ukraine as a stalemate. Going forward, we expect growing Western aid to Ukraine to offset Russia's increased resource deployment into the battle theater.

STRATEGY: Continue to add exposure on drawdowns

- ► We see value in EM debt after the 2022 selloff, and we continue to believe that markets have transitioned to a more sideways pattern versus last year's relentless decline.
- ► Tactically, we are also mindful that the swift rebound in late October through November reclaimed about one-fourth of what was lost in the first three quarters of 2022. Also, we do not think markets are going to "run away" and move sharply to the upside. As a result, we are still waiting for pullbacks to pick our spots to add risk.
- ► We still see better value in high yield EMD than in investment grade, and we remain positioned that way. However, we now see pockets of value in investment grade; particularly in the weak BBB-rated space on the cusp of investment grade and high yield.

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