Emerging Markets Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

FEBRUARY 2023: MARKET UPDATE & OUTLOOK

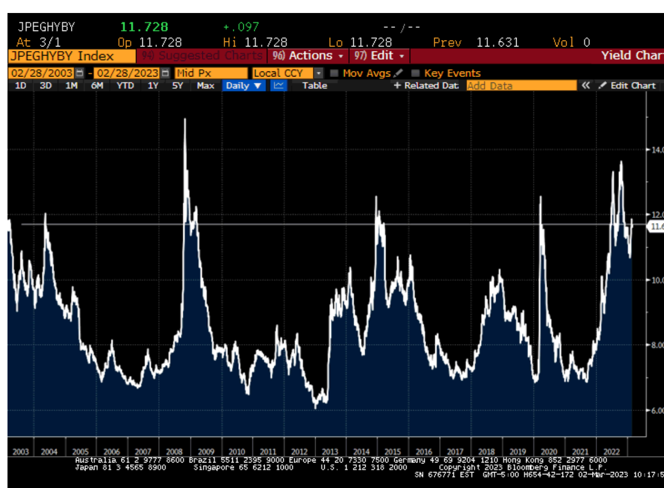
PERFORMANCE: Much of January's gains were given up in February. Duration was the culprit – again.

- The emerging markets debt (EMD) market, which had a YTD total return of 4.98% as of February 2, gave back much of those gains the rest of the month. The market declined by 4.61% from February 2 through February 21, which brought the YTD total return down to 0.84% as of the end of February.
- The full-month total return was -2.21% − a bit better than the return of the broader bond market as represented by the Bloomberg Agg, which was down by 2.59%.
- The primary culprit for both was interest rate duration. We have seen this pattern a few times over the past year: a large macro driven sell-off, followed by a partial relief rally, only to be followed by yet another Treasury-driven decline.
- At the sector level, relative returns by credit quality show that EMD has continued to underperform U.S. corporate debt in both investment grade (IG) and high yield (HY). However, we sense the performance gap is closing.

	YTD tot ret (%)	
Sector	Investment grade	High yield
US	0.70	2.47
EM	0.47	1.35
Diff: US less EM (bp)	23	112

STRATEGY VIEW: Neutral

- We remain neutral on EMD. We are buying on weakness, as we have ample capacity. We reduced our already historically low level of exposure on strength earlier this year.
- From a macro perspective, though we still think interest rates could move higher, we now feel that a lot of negative inflation news is reflected in the rates market. Markets are highly attuned to the policy rate hikes and reducing their balance sheets. The question is still, "How much more?"
- The Treasury-driven selloffs may have a positive side: EM debt now has better value than even just over a year ago. The all-in yield-to-maturity of high yield EM debt is at historically attractive levels when looking back 20 years:



- Moreover, a lot of monetary policy tightening (price and quantity of money) has already occurred:
  - Higher price of money: 450 bps of policy rate hikes in just under one year is the most aggressive rates move since the early 1980s, when macro conditions faced worse obstacles, including stagflation, the Volcker Fed, the Arab oil embargo, and the LDC debt crisis.

- Lower quantity of money: The much-anticipated reduction in central bank liquidity is underway. For example, the Fed has reduced the size of its balance sheet by $583 billion since its peak size on April 13, 2022. This, in turn, corresponded with the all-time high in the S&P 500 on January 3, 2022. While the S&P 500 peaked three months earlier, equity markets tend to be forward-looking.
- There are now more pockets of value in the overall bond market. Bond yields are now competitive with earnings yields and wide versus dividend yields. The list includes EM bonds.

► Nevertheless, February's performance is a clear reminder that risks remain. Despite the Fed's actions, more tightening is on the way:
- Actual realized inflation continues to exceed expectations. Let's not forget about the European Central Bank, which must contend with inflation that still exceeds 9%.
- The labor market continues to remain very tight, which could push labor costs higher.
- Earnings growth has turned negative, which could cause credit risk spreads to widen.

COUNTRY HIGHLIGHTS:

► Ecuadorian President Guillermo Lasso's unpopularity was confirmed in regional elections on February 5 when his referendum to change the constitution was hit with a resounding "no" vote. This led some members of his administration to resign. In contrast, former President Rafael Correa's opposition party had a good showing. Ecuador's bonds were down 27% in February, and many politicians switched parties amid continued calls for the president's impeachment.

► Most of our exposure to South Africa is held via Eskom, the government-owned electric utility. We reduced our exposure on strength based on budget updates from South African Finance Minister Godongwana. Specifically, he said the country would boost debt relief to the tune $13.9 billion over the next three years. The Eskom bonds had outperformed year-to-date (+8%) and the credit spread relationship versus the sovereign compressed from +400 bps down to +175 bps.

► Pakistan's bonds got a boost when Finance Minister Ishaq Dar submitted several new tax bills to the country's parliament to raise $630 million. The bills would enact a 1% sales tax increase that would bring it up to 18%, increase taxes on luxury items to bring it up to 25% from 17%, and increase gas and electricity prices. These measures come as the country's credit was downgraded by Fitch the prior week, and as they attempt to restart their $6.5 billion IMF program. Of course, these changes will not be popular socially given the unstable nature of the political landscape, and with elections coming in the back half of the year. Pakistan's reserves fell just under $3 billion − enough to cover roughly two weeks of imports. IMF talks wrapped up today without a finalized staff-level agreement.

► Russia announced it is planning to cut oil output by 5% in March in response to Western sanctions.

► A magnitude-7.8 earthquake struck Turkey, leaving at least 40,000 people dead in Turkey and neighboring Syria. Meanwhile, Turkish inflation fell to 57.68% year-over-year versus 64.27% in December. Industrial production improved slightly to 1.6% month-over-month from -1.1% in December. Year-over-year prints are still weak at -0.2% for January, albeit better than December's -1.3%.

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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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