Emerging Markets Update

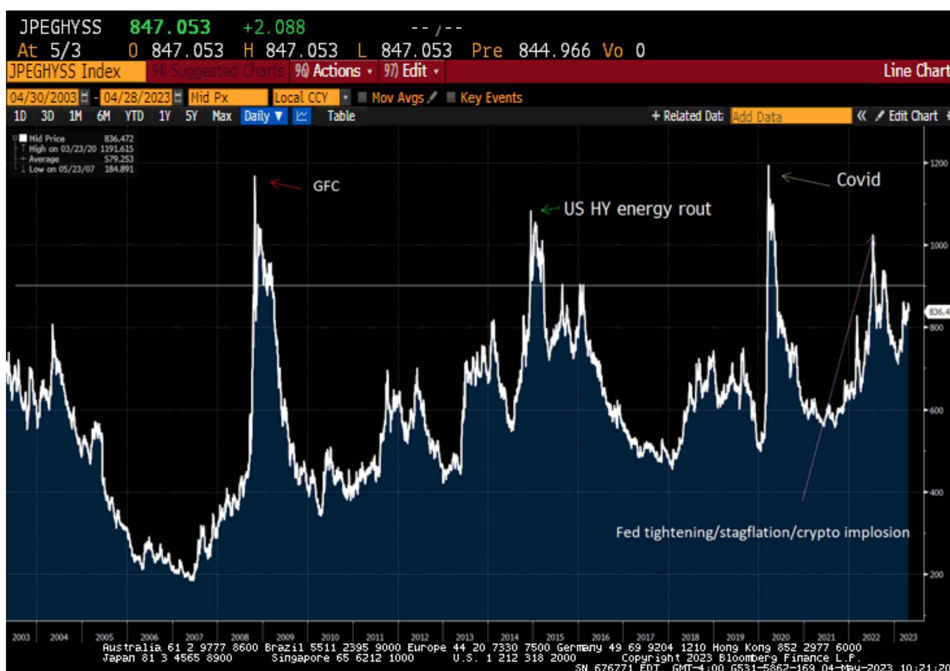
Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

APRIL 2023: MARKET UPDATE & OUTLOOK

PERFORMANCE: Up with the broader bond market & equities

- Once again, better performance in the core markets drove emerging markets (EM) debt performance in April. EM's monthly performance, which had been lagging the broader bond market, came close to matching the overall bond market's total return in April. The JP Morgan EMBI Global Index delivered a monthly total return of 0.50%, bringing its YTD total return to +2.76%. However, the U.S. Agg was still up by more − +0.61% and +3.59% for April and YTD, respectively.
- Up till now, we have noted a recurring theme of positive EM performance that nevertheless underperforms U.S. corporate credit across the credit quality spectrum. However, last month we noted that EM is starting to catch up.
- For April, EM investment grade (IG) outperformed U.S. IG corporate credit. However, the same has yet to happen in the high yield (HY) space. EM HY still lagged U.S. HY by 181 bps in April, which brought the YTD margin of relative underperformance to 400 bps.
- We think there are two reasons:
    - As global financial conditions tighten and access to financial markets becomes more challenging, higher-risk EM countries may experience greater stress than developed markets (DM). Additionally, when banks face potential systemic distress, HY EM credit has typically underperformed DM credit as investors grow leery about exposure to risky countries. So are we.
    - The global economy is slowing. Recessionary fears are reflected in a yield curve that remains near its most inverted level since the Volcker years in the early 1980s. We think this will result in weaker energy and base metal commodity prices, which may contribute to weakness in Africa.

Sector	Tot ret (%) Apr	YTD
Macro drivers		
S&P500	1.56	9.16
US Treasuries	0.54	3.56
Bloomberg Agg	0.61	3.59
EMBIG	0.50	2.76
Diff: Agg-EM (bp)	11	83
Credit quality		
US IG	0.77	4.29
EM IG	1.40	4.24
Diff: US less EM (bp)	(63)	5
US HY	1.00	4.60
EM HY	(0.81)	0.60
Diff: US less EM (bp)	181	400
Distressed/restructuring		
US avg Caa-D	1.43	2.17
EM C	(4.69)	(2.03)
Diff: US less EM (bp)	612	420
EM regions		
Africa	(2.48)	(4.30)
Asia	1.00	4.10
Europe	0.48	2.80
Latin America	0.25	3.26
Middle East	1.37	3.17



- The abovementioned factors have produced good value in EM HY debt. We think its credit risk spread gets attractive near 900 bps (see horizontal line on left) – it is now 836 bps. As we can see, it takes a major risk-off event to get it there. However, historically, spreads do not stayed at the 900 level for very long. We view the macro backdrop that pushed the EM HY spread to its current level as a continuation of the forces that pushed it briefly to above 1000 bps last July.

MACRO & STRATEGY: Neutral macro environment & neutral-to-positive strategy view, despite probable bouts of disruption

- We expect inflation, though still elevated, will continue to decline as growth remains subdued, reducing demand-pull pressure on prices. We also expect risk markets to produce positive total returns.
- We expect mid-to-upper single digit returns from credit sectors of the bond market, including EM debt.
- At the same time, we also expect further bouts of market volatility as the effects of near-record central bank tightening ripple through economies, most of which we expect to be manifested in banks.
- March's bank stress was caused by the rapid removal of monetary policy accommodation over the past year. This change in policy follows an easing stance after the Great Financial Crisis.
- We think current drivers of volatility include higher policy rates and removal of central bank liquidity. The only time money supply contraction was greater was during the Great Depression. M2% change:

- We think it is overly optimistic to think the speed bumps are over. The key is in determining how systemic these stresses become. We are monitoring whether the stress thus far caused by poor asset-liability management (ALM) also extends to impairment of asset quality (mainly loans).
- If the problems remain confined to ALM, then regulators should be able to deal with future problems on a case-by-case basis. If loan quality becomes an issue, then further risk-off could occur.
- We give a slight edge to thinking the problems will be ring-fenced, and we do not think we are heading back to a 2008 global meltdown.
- In summary, we think overall market conditions, combined with better overall bond market value, should support positive total returns in bonds this year. Such a backdrop favors credit, including EM debt. As a result, we remain buyers on dips, given:
  - The relatively stable backdrop, excluding the two important key drivers (how long the Fed will retain its tighter policy stance, and bank stress).
  - Our low level of exposure (we have been selling into rallies).
  - EM debt now offers better value than even a year ago. This is particularly apparent within EM HY.
  - Much of the tightening needed to tame inflation has already occurred: 450 bps of policy rate hikes in one year is the most aggressive move in over forty years, and inflation has likely peaked.

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COUNTRY HIGHLIGHTS:

- Colombian president Gustavo Petro has lost his majority coalition in congress after asking most of his cabinet to resign. Bonds sold off as market-friendly finance minister Ocampo was replaced by Ricardo Bonilla. Bonilla is a former secretary of finance for Bogota when Petro was mayor. It is expected that some fiscal prudence will be maintained despite Bonilla's left-of-center tilt.
- Egypt's slide lower continued in April. At this point, the country has little shock absorbing capacity. The structural shift to a private sector and export-driven growth model is not an overnight phenomenon. Authorities are still waiting on a $3 billion IMF program that will help bridge the financing gap and give confidence to multilaterals (World Bank) and bilaterals (GCC allies) to lend further support. Proceeds from privatization of SOEs has been moving more slowly than the government had forecasted. We continue to wait on further devaluation (toward free float) on its currency, which has already lost 50% of its value in the last 18 months.
- Ecuador partially retraced some of its year-to-date losses with an 11% gain in April on the news of a debt buyback proposal made late in the month.
- China's reopening gave a boost to Mongolian exports, which rose in March to $1.52 billion, the most since the data's inception in 1997.

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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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