Emerging Markets Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

JUNE 2023: MARKET UPDATE & OUTLOOK

PERFORMANCE: A very strong month for emerging markets high yield returns as they close the relative value gap

- Emerging markets (EM) debt posted a total return of +1.93% for June and outperformed the broader bond market as represented by the Bloomberg Agg, which returned -0.36% for the month. EM YTD return of +3.81% is now ahead of the broad bond market return of +2.09% after having lagged YTD through May.
- EM HY was the clear winner with a total return of +4.21%, which compared favorably to all bond sectors and beat out the U.S. high yield (HY) monthly return of 1.67% by 254 bps.
- Though EM HY YTD return of +4.46% still trails the U.S. HY return of 5.38%, it has shrunk its relative value and total returns gap considerably.
- EM investment grade (IG) and U.S. IG total return for the month were identical at +0.41%. Year-to-date, EM IG has performed slightly better (+3.36% versus +3.21%).

Sector	Tot Return (%) June	YTD
Macro Drivers		
S&P 500	6.47	15.91
US Treasuries	-0.75	1.59
Bloomberg Agg	(0.36)	2.09
EMBIG	1.93	3.81
Diff: Agg - EM (bp)	-229	-172
Credit Quality		
US IG	0.41	3.21
EM IG	0.41	3.36
Diff: US less EM (bp)	0	-15
US HY	1.67	5.38
EM HY	4.21	4.46
Diff: US less EM (bp)	-254	92
Distressed		
US Caa	3.13	9.39
EM C	18.76	23.32
Diff: US less EM (bp)	1563	1393
EM regions		
Africa	4.30	1.62
Asia	0.81	4.50
Europe	3.09	3.98
Latin America	2.92	5.18
Middle East	0.30	2.00

MACRO ENVIRONMENT & STRATEGY: Neutral macro environment – the recent move in EM valuations makes us a little more cautious.

- We are keeping our neutral view on credit markets. Recent economic data has caused rate expectations to shift higher over the month in the U.S. and other G-10 countries. In our view, overtightening by the major central banks to contain inflation increases the risk of recession.
- Market consensus on U.S. rates has moved directionally toward our view, with at least one more rate hike priced in now, and possibly two by November 2023. However, we still expect a longer time horizon before we see a renewed rate cutting cycle compared to the consensus view, which sees rate cuts starting in March 2024.
- Inflation remains sticky and labor market conditions are still good. We think these are grounds for the Fed to keep its foot on the brakes, especially given that it made the mistake of waiting too long to begin hiking.
- Another key issue is the impact of fiscal tightening coming from the Fed's efforts to shrink its balance sheet more aggressively.
- China economic data has disappointed over the last month, and we are lowering our growth expectations for 2023 to the low 5% range from the high 5% range.
- We expect growth to slow in the coming quarters – a shallow recession in the U.S. is a possibility but not a certainty.
- In this environment, we expect EM spreads to remain rangebound, with total returns in the mid- to high-single digits for 2023. Given the +3.81% total return in the first half of the year, this implies another 2-4% return in the second half.
- The 10-year U.S. Treasury rate, now near 4% at mid-year, is the highest since the 2008 Global Financial Crisis (GFC) era (see below), which seems high. However, with zero interest policy dead and core PCE inflation at 4.6%, rates could still be viewed as a little low compared to rates prior to the GFC. Similarly, the last time the 2-year rate was this high was back in June 2007.

10-Year Treasury U.S. Rate

2-Year U.S. Treasury Rate

COUNTRY HIGHLIGHTS:

- After months of stalled talks, Pakistan and the IMF reached a staff level agreement on a $3 billion nine-month standby agreement. Also, after pausing mid-month, the central bank raised rates 100 bps to 22% in a surprise move at the end of the month.
- Russia paramilitary group, Wagner, staged a brief but significant uprising against the Russian defense ministry in June. Its leader, Yevgeny Prigozhin, was a former Putin insider who had lent his troops to the Russian army to help with the occupation of Ukraine in recent months. A deal was quickly brokered by Alexander Lukashenko, the president of Belarus, and Wagner troops retreated.
- Ghana's first quarter GDP surprised to the upside at 4.2% versus estimates of 2.6%.
- In a surprising move, Egypt announced it will raise its private sector minimum wage beginning in July, contrary to fiscal prudence suggestions by creditors and the IMF. However, the country continues to work with the Fund to reach an agreement and is seemingly making progress. The central bank left rates unchanged this month despite still-high inflation (33%). Market bets on a further currency devaluation, toward free float, have been pushed out.
- After Erdogan's reelection win and vow to return to orthodox policy, newly appointed CB Governor Hafize Gaye Erkan hiked the one-week repo rate 650 bps to 15% in her first meeting, where officials promised to provide further tightening in a "timely and gradual manner" until significant improvement in the inflation outlook is achieved. We acknowledge CPI has continued its decline to +38.2%year-over-year in June from 85.5%year-over-year in October 2022, but remain concerned about the rapid depreciation of the lira, which has lost -28% year-to-date and will more than likely keep pressure on officials to act in the second half of 2023.
- The new government in Nigeria made positive progress on reforms, including the removal of oil subsidies and floating the currency, which led to a 38% depreciation of the naira.
- Sri Lanka made progress on domestic debt restructuring during the month, resulting in a continued rally in bond prices.

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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.

Newfleet Asset Management's industry trends and observations are the result of research conducted by the portfolio management / research team. These observations reflect their industry expertise and have been prepared using sources of information generally believed to be reliable; however, their accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice.

Investing is subject to risk, including the risk of possible loss of principal. Past performance is not indicative of future results.

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