Outlook for 2023

Executive summary: After two consecutive down years of total return in emerging markets debt, we are more positive on the total return outlook for 2023. At the time of writing, the current level of yields at around 7-8% potentially translates into attractive carry, offering protection against further interest rate hikes or spread widening before total returns can turn negative. We believe credit differentiation in emerging markets remains key. With challenging global liquidity, it is paramount to focus on a credit's refinancing profile and market access ability for 2023. We like credits with what we view as positive performance catalysts, such as India's renewable energy sector.

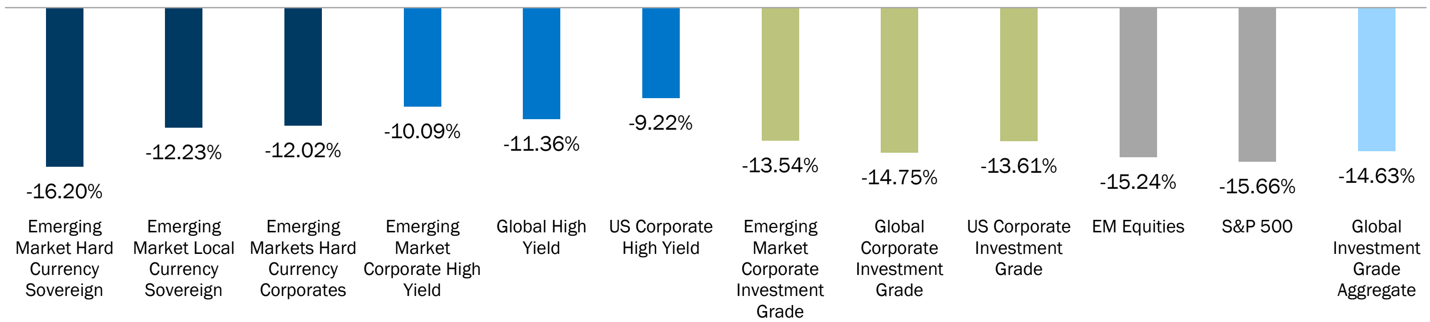
More Favorable Total Return Outlook

The fixed income market had volatile and negative returns in 2022, with emerging market debt being no exception. Elevated levels of inflation followed by the aggressive US monetary policy hiking cycle, the Russia-Ukraine conflict and its negative impact on commodity prices and investment sentiment, and the problematic China growth outlook as a result of its real estate sector collapse and zero-Covid policy, have all contributed to the challenging financial market returns this year.

For emerging market debt, at the time of writing, based on widely used JP Morgan indices, emerging market hard currency sovereign debt has returned around -16% year-to-date. This is with both emerging market hard currency corporate debt and emerging market local currency sovereign debt delivering around -12%. If we examine these total return numbers in more detail, in the hard currency space, the dominant negative return attribution factor has been interest rate repricing, whereas spread widening has only resulted in -5% of the negative total return for both emerging market sovereigns and

FIGURE 1: FIXED INCOME MARKET PERFORMANCE YTD 2022

YTD PERFORMANCE



Emerging Market Hard Currency Sovereign = JPM Emerging Market Global Diversified External Sovereigns Bond Index; Emerging Market Local Currency Sovereign = JPM Emerging Market Global Diversified Local Sovereigns Bond Index; Emerging Markets Hard Currency Corporates = JPM Corporate Emerging Market Broad Diversified Composite; Emerging Market Corporate High Yield = JPM Corporate Emerging Market Broad Diversified High Yield; Global High Yield = Bloomberg Global High Yield; US Corporate High Yield = Bloomberg US Corporate High Yield; Emerging Market Corporate Investment Grade = JPM Corporate Emerging Market Broad Diversified High Grade; Global Corporate Investment Grade = Bloomberg Global Aggregate Corporate; US Corporate Investment Grade = Bloomberg US Corporate Investment Grade; EM Equities = MSCI Emerging Markets Equity; S&P 500 = S&P 500 INDEX; Global Investment Grade Aggregate = Bloomberg Global Aggregate Index.
Please see index definitions and descriptions at the end of the document.
Source: JP Morgan, ICE Data, Bloomberg.

corporates. For emerging market local currency sovereign debt, total return has been more evenly distributed between foreign currency weaknesses against the US Dollar and interest rate losses. We believe there are two reasons for the above performance attributions. First, the most prominent macroeconomic theme this year is the elevated level of US inflation not seen in the past 40 years, which has resulted in much more aggressive rate hikes and the subsequent rapid and large rise in US treasury yields from very low levels. Second, the fundamentals of emerging market sovereigns and corporates, at the asset class level, have been on an improving trajectory. Therefore the risk premia repricing, measured by spread widening, has been much more orderly and resilient.

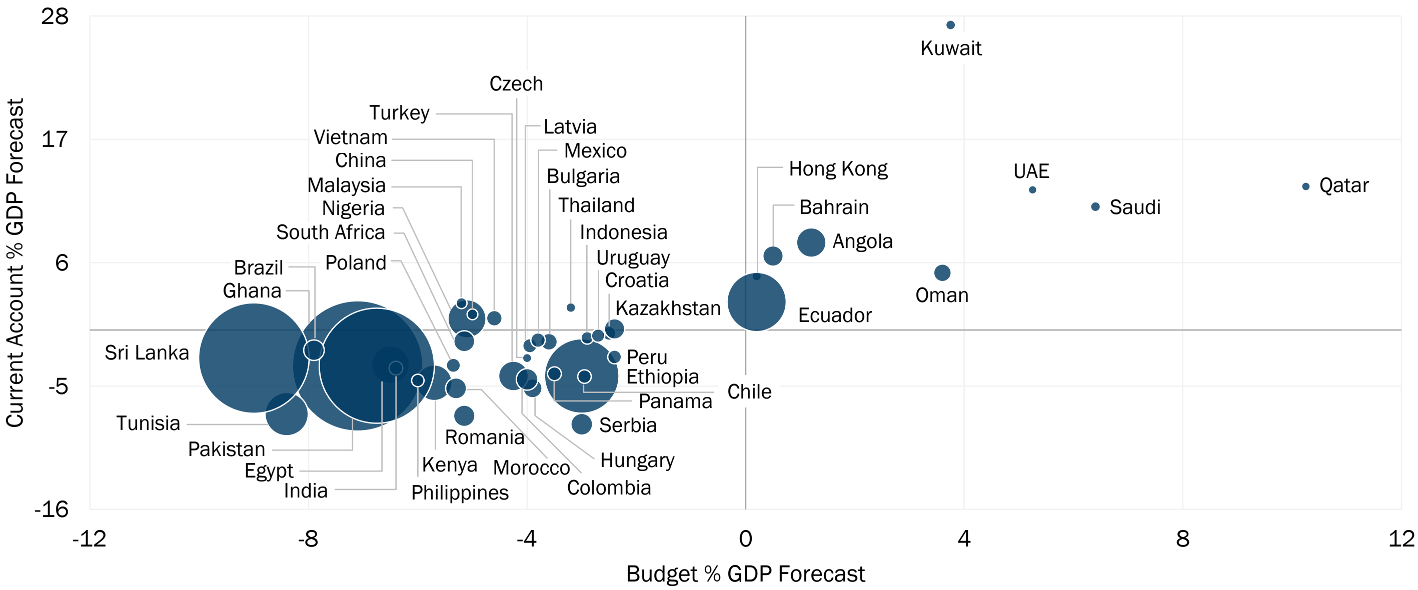
Going into 2023, these developments have resulted in a much higher level of starting yields for emerging market debt relative to the beginning of 2022, providing a decent level of carry. In turn, the asset class can absorb further interest rate rises and credit spread widening before total returns turn negative. With the majority of interest rate repricing likely behind us in 2022, we believe the outlook for underlying US interest rates is more balanced for emerging market debt next year. While further credit spread widening from here is plausible, we believe current credit spreads are well priced for a shallow downturn in global growth, with balance sheet health better positioned relative to the end of historical economic cycles. Furthermore, after suffering a torrid year of outflows and the end of an influx of liquidity from central bank quantitative easing programs which turned to quantitative tightening, many metrics, such as debt supply and investor positioning, now point to a much cleaner technical outlook for the asset class. All the above factors, combined with still relatively strong fundamentals, lead us to have a more positive total return outlook for emerging market debt in 2023.

To put the above reasoning in numerical context, the current yield of emerging market hard currency sovereign debt is over 8%, which has increased by more than 3% in 2022. Of this 3% or 300 basis points, 90 basis points was driven by higher emerging market credit spreads, and the remainder by interest rates repricing upwards. If we were to assume no more significant repricing of interest rates up or down in 2023, credit spreads can increase by a further 100 basis points (more than 2022's increase) before total returns turn negative. The same case applies for hard currency corporate debt, with a total return breakeven of 150 basis points of spread widening, nearly double the 80 basis points of widening seen in 2022. We do not think further spread widening would be of this magnitude, supporting the case for positive total returns in 2023.

Credit Differentiation Is Key

While the prospect of positive total returns in 2023 at the asset class level is an encouraging and attractive starting point, it is not enough as market timing can be difficult and dispersion of individual credit performance within the asset class can remain large. We see clear evidence of credit differentiation playing out in 2022 in the backdrop of overall challenging investment returns and poor sentiment, and we believe credit differentiation will continue to playout in 2023. In 2022 we have seen markets rewarding countries with proactive and prudent monetary policy (e.g. outperformance of the Brazilian Real), credits that are net energy exporters (e.g. outperformance of credits in the Middle East) and countries that have credible structural reforms and an IMF program in place (e.g. Costa Rica). In the hard currency space, one consistent credit differentiation theme, which we believe will remain in sharp focus next year, is a credit's refinancing profile and market access ability. We prefer countries and companies that continue to improve their fundamentals, especially their debt and leverage, and have low refinancing needs or more diversified refinancing channels with strong onshore or IMF support. Although the external funding market may improve in 2023, we believe it will remain challenging. A few sovereign examples that have low refinancing needs for next year are Indonesia and the Middle East in the high grade space, and Angola and Ecuador in the high yield space. It is important to note that financing needs, while crucial, are just one aspect of the macroeconomic narrative for these countries; other factors will also impact their performance, such as political headlines and oil prices.

FIGURE 2: CURRENT AND FISCAL ACCOUNTS OF SOVEREIGNS

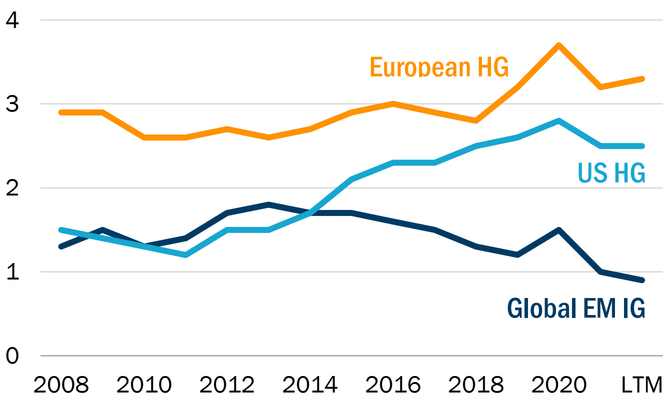


Data as of December 15, 2022
Bubble Size = 5y Sovereign CDS spread. (i.e. Angola 496 bps; Ecuador 1,960 bps)
Horizontal axis = 2023 forecasted budget balance as a percentage of GDP
Vertical axis = 2023 forecasted current account balance as a percentage of GDP
Countries in the top right corner with large bubble size are preferred, as they have a more favorable refinancing profile and attractive valuations. In this case Angola and Ecuador stand out.
Source: Bloomberg

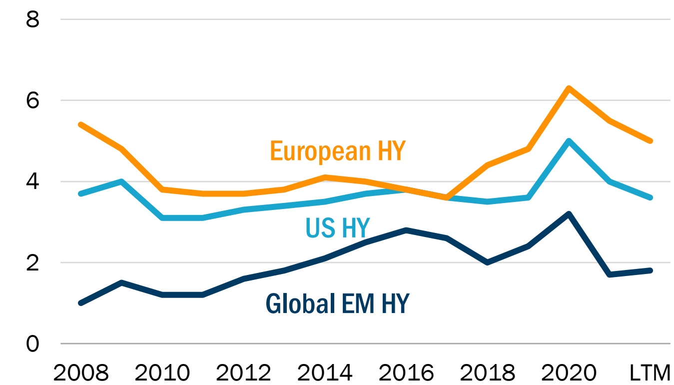
The same reasoning applies to emerging market corporates. The realized default rate year to date has been high, at above 11%, based on the JP Morgan corporate CEMBI diversified index. However, if we exclude Russia, Ukraine and China, the number drops to around 1%. We believe the overall default rate for emerging market corporates may stay elevated for 2023. The path for Russia-Ukraine resolution remains unclear and the level of structural confidence in the Chinese real estate sector is too early to tell despite of the support plan in place. However, for the rest of the emerging market corporate universe, the fundamentals remain largely sound although tightening global financing conditions means companies will continue to be scrutinized. While we have a preference for high yield over investment grade due to valuation, we remain cautious and favor higher quality names in high yield. We focus on credits that have heathy net leverage ratios that we feel are appropriate for their sectors, a sound cash cushion and favorable maturity profile.

FIGURE 3: NET LEVERAGE

EMERGING MARKET VS DEVELOPED MARKET INVESTMENT GRADE NET LEVERAGE



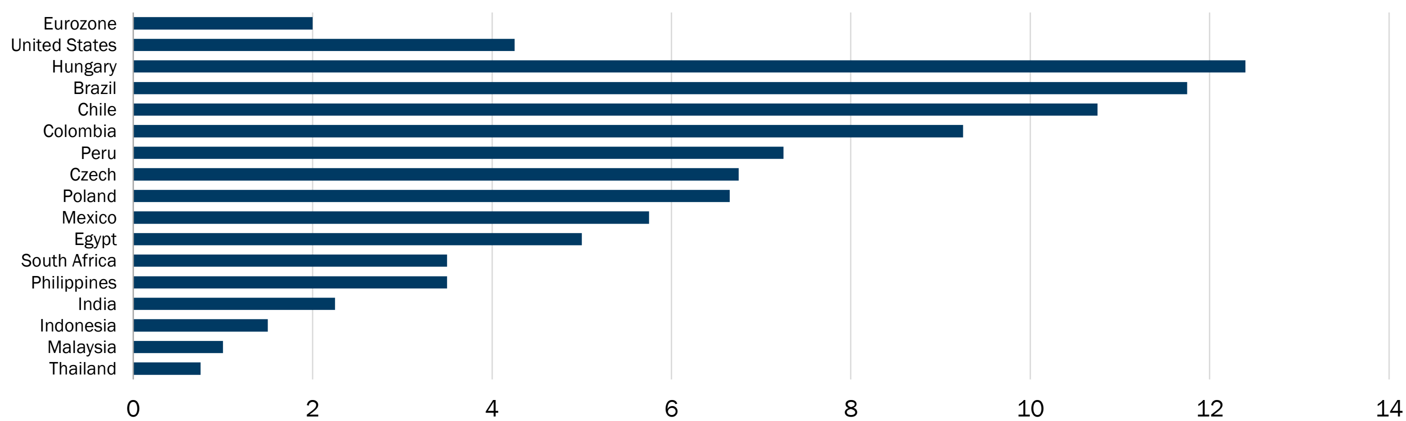
EMERGING MARKET VS DEVELOPED MARKET HIGH YIELD NET LEVERAGE



Source: JP Morgan

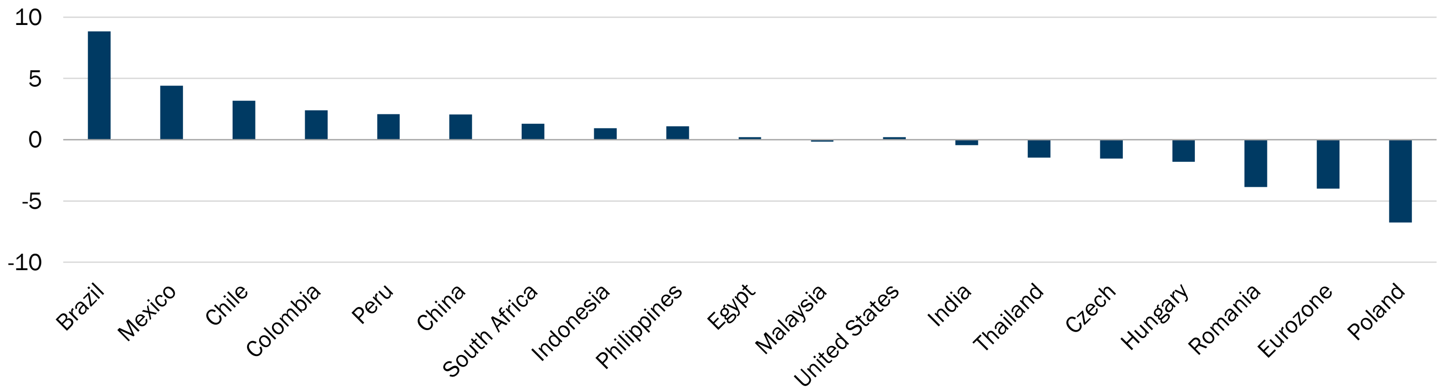
For emerging market local currency sovereign debt, the majority of the monetary policy hiking has likely taken place already, but with regional differentiation. Latin America was the leader, with an average policy rate rise of almost 900 basis points. Brazil started its hiking cycle proactively and decisively in March 2021, raising its policy rate from 2% to 13.75%. Emerging market Central European countries then followed, and the laggard was emerging market Asia, with many countries in this region only starting to hike rates later this year and at a slow pace. However, to assess a country's inflation targeting effort by the speed and magnitude of its policy rate hiking is not enough and further credit differentiation is needed. As shown below in the Real Interest Rates chart [Figure 5], calculating a country's current monetary policy rate minus the inflation forecast by the Bloomberg Consensus for 2023 is a better measure of the success of hiking rates to curb inflation. Again, Latin American countries stand out with positive real interest rates, suggesting that inflation expectations have been suppressed. Whereas Central European countries, despite steep rate hiking cycles, are likely to see inflation expectations remain sticky in 2023. This is because, despite the high and stubborn level of inflation in Europe, they are faced with growth headwinds and the central banks in this region have decided to pause hikes. Therefore, we have a preference for local rates in Latin America for 2023, as some countries in the region may be able to cut rates, depending on the country's fiscal stance and the US Federal Reserve's rate cycle.

FIGURE 4: CHANGE IN POLICY RATE (CURRENT VS DEC 2020) (%)



Data as of December 15, 2022
Source: Bloomberg

FIGURE 5: REAL INTEREST RATES (EX ANTE) – 2023 (%)



Source: Bloomberg as of December 15, 2022

We Like India and its Renewable Energy Sector

To highlight stories we particularly like in 2023, India stands out. Despite its generally weak global growth outlook, India's growth outlook remains strong for next year at almost 7%, according to the IMF's forecast, thanks to its diversified set of economic drivers. It also has relatively strong external accounts. However, being an energy importing country has led to some deterioration this year. India has been using currency depreciation and has run down its foreign reserves in a manageable fashion, mitigating its current account deficit widening. Foreign reserves have dropped from 630 billion USD from the beginning of the year to 560 billion USD currently, which is still very sizeable. One macro imbalance in India is its high level of general government debt. Nevertheless, the government debt is predominately local currency debt, with a large and stable domestic financing base. India also has several large conglomerates that have spare capital to infuse into the economy to further drive economic growth, such as the Adani and Tata groups.

One sector that we were more cautious about throughout this past year but have recently turned more constructive on is the Indian Renewable Energy sector. The Indian government aims to reach net zero emissions by 2070 but the path is challenging due to its heavy dependence on coal and the large amount of funding needed for the energy transition. The government has been very supportive of the sector, with plans to issue sovereign green bonds in 2023. The sector has had a sobering year of recalibration which has removed some of the ESG induced richness in valuations. At present, most companies in the sector trade at attractive spreads, while operators have found alternative sources of funding. A potential catalyst for performance includes state level off-takers being pressured by the central government to pay renewable producers much more quickly. High receivables on balance sheets were a reason for elevated spreads, but we think this can unwind with swifter payments from distribution companies. The Indian non-performing loan problem in the banking system was comprehensively dealt with in 2015. Freed of bad debts, banks have now much greater lending capacity and are keen to provide funding to the sector. We believe that going forward, bond redemptions can be met by direct lending from banks, the syndicated loan market and concessional lending from international financial institutions.

Meet the MacKay Shields EMD Team

Diverse team with average **17 years experience** brings unique perspectives and skills:

A combination of bond experience across sovereign, local currency, and emerging market corporates

10 unique languages spoken among the team members

Prior to joining MacKay, the team led management of approximately **$4 billion** across EMD sovereigns and corporates.

Valentina Chen
CO-HEAD & PORTFOLIO MANAGER

Philip Fielding
CO-HEAD & PORTFOLIO MANAGER

Henry Stipp
PORTFOLIO MANAGER & MACRO ECONOMIST

Gordana Ilic
CORPORATE ANALYST

Christopher Garcia
QUANTITATIVE ANALYST

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BLOOMBERG AGGREGATE CORPORATE INDEX — The Bloomberg Global Aggregate Corporate Index is a flagship measure of global investment grade, fixed-rate corporate debt. This multi-currency benchmark includes bonds from developed and emerging markets issuers within the industrial, utility and financial sectors. You cannot invest directly in an index.

BLOOMBERG GLOBAL HIGH YIELD INDEX — The Bloomberg Global High Yield Index is a multi-currency flagship measure of the global high yield debt market. The index represents the union of the US High Yield, the Pan-European High Yield, and Emerging Markets (EM) Hard Currency High Yield Indices.

BLOOMBERG GLOBAL AGGREGATE INDEX — The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

BLOOMBERG US CORPORATE INVESTMENT GRADE INDEX — The Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

BLOOMBERG US CORPORATE HIGH YIELD INDEX — The Bloomberg US Corp High Yield Index is designed to track a more liquid component of the USD-denominated, high yield, fixed-rate corporate bond market. The US High Yield index includes only bonds that have a minimum amount outstanding of USD500mn and less than five years from issue date.

BLOOMBERG US GOVERNMENT 10 YEAR TOTAL RETURN INDEX — The Bloomberg US Government 10-Year Total Return Index is a wealth series that starts on January 1, 1999, based on holding US 10yr treasuries (see last chart – showing the complete wealth series to date); calculated in USD; unhedged and rebalanced monthly.

ICE BOFA US CORPORATE INDEX — ICE BofA U.S. Corporate Index tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market.

ICE BOFA US HIGH YIELD INDEX — ICE BofA Merrill Lynch US High Yield Index (H0A0) tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

ICE BBB LARGE DEAL MUNICIPAL BOND INDEX — The ICE BBB Large Deal Municipal Bond Index tracks the performance of U.S. dollar denominated BBB-rated tax-exempt debt publicly issued in the U.S. domestic market by U.S. states and territories as well as their political subdivisions.

ICE BOFA EURO CORPORATE INDEX — The ICE BofA Euro Corporate Index tracks the performance of EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets.

ICE BOFA EURO HIGH YIELD INDEX — The ICE BofA Euro High Yield Index tracks the performance of EUR denominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets.

ICE BOFA GLOBAL BROAD MARKET INDEX — The ICE BofA Global Broad Market Index tracks the performance of investment grade debt publicly issued in the major domestic and eurobond markets, including sovereign, quasi-government, corporate, securitized and collateralized securities.

ICE BOFA INVESTMENT GRADE US CONVERTIBLE INDEX — The ICE BofA US Convertible Index tracks the performance of publicly issued US dollar denominated convertible securities of US companies

ICE HIGH YIELD & UNRATED LARGE DEAL MUNICIPAL BOND INDEX — The ICE High Yield & Unrated Large Deal Municipal Bond Index tracks the performance of U.S. dollar denominated high yield tax-exempt debt publicly issued in the U.S. domestic market by U.S. states and territories as well as their political subdivisions.

J.P. MORGAN CORPORATE EMERGING MARKET BOND INDEX — The J.P. Morgan CEMBI tracks the performance of U.S. dollar denominated corporate emerging market bonds where the issuer is headquartered in either Asia ex Japan, Latam, Eastern Europe, or Middle East/Africa

J.P. MORGAN CEMBI BROAD INDEX — The J.P. Morgan Corporate Emerging Market Bond Broad Diversified Index tracks the performance of U.S. dollar denominated corporate emerging market bonds where the issuer is headquartered in either Asia ex Japan, LatAm, Eastern Europe, or Middle East/Africa

J.P. MORGAN CEMBI BROAD DIVERSIFIED INDEX — The J.P. Morgan CEMBI Broad Diversified tracks the performance of U.S. dollar denominated corporate emerging market bonds where the issuer is headquartered in either Asia ex Japan, Latam, Eastern Europe, or Middle East/Africa

J.P. MORGAN CEMBI BROAD DIVERSIFIED HIGH GRADE INDEX — The J.P. Morgan Corporate Emerging Market Bond Broad Diversified High Grade Index tracks the performance of U.S. dollar denominated investment grade corporate emerging market bonds where the issuer is headquartered in either Asia ex Japan, Latam, Eastern Europe, or Middle East/Africa

J.P. MORGAN CEMBI BROAD DIVERSIFIED HIGH YIELD INDEX — The J.P. Morgan Corporate Emerging Market Bond Broad Diversified High Yield Index tracks the performance of U.S. dollar denominated sub-investment grade corporate emerging market bonds where the issuer is headquartered in either Asia ex Japan, LatAm, Eastern Europe, or Middle East/Africa

J.P. MORGAN CEMBI BROAD DIVERSIFIED HIGH GRADE BLENDED YIELD INDEX — The J.P. Morgan CEMBI Broad Diversified High Grade Index is a sub components of the J.P. Morgan CEMBI Div Broad Composite Blended Yield Index, which covers the investment grade parts of this composite index.

J.P. MORGAN CEMBI BROAD DIVERSIFIED HIGH YIELD BLENDED YIELD INDEX — The J.P. Morgan CEMBI Broad Diversified High Yield Index is a sub components of the J.P. Morgan CEMBI Div Broad Composite Blended Yield Index, which cover the sub investment grade part of this composite index.

J.P. MORGAN CEMBI DIV BROAD COMPOSITE BLENDED YIELD INDEX — The CEMBI Broad Diversified Composite is a comprehensive USD corporate emerging markets bond index that employs a unique approach which uses only a certain portion of the current face amount outstanding for instruments from countries with larger debt stocks. This helps to limit country weights, while reducing index turnover, when compared with the 10% hard-cap approach employed by the GBI-EM series.

J.P. MORGAN EMBI GLOBAL DIVERSIFIED INDEX — The J.P. Morgan Emerging Market Bond Global Diversified Index (EMBIGD) tracks liquid, US Dollar emerging market fixed and floating-rate debt instruments issued by sovereign and quasi-sovereign entities.

J.P. MORGAN EMBI GLOBAL DIVERSIFIED BLENDED YIELD INDEX — The J.P. Morgan EMBI Global Diversified Index (EMBIG) tracks liquid, US Dollar emerging market fixed and floating-rate debt instruments issued by sovereign and quasi-sovereign entities.

J.P. MORGAN GBI-EM GLOBAL DIVERSIFIED INDEX— The J.P. Morgan GBI-EM Global Diversified index is comprised of local emerging market government bonds. For a country to be eligible for inclusion in the index, its GNI per capita must be below the Index Income Ceiling (IIC) for three consecutive years. JPMorgan defines the Index Income Ceiling (IIC) as the GNI per capita level that is adjusted every year by the growth rate of the World GNI per capita, Atlas method (current US$), provided by the World Bank annually.

MSCI EMERGING MARKETS EQUITY INDEX INDEX— The MSCI Emerging Markets Equity Index captures large and mid-cap representation across 27 Emerging Markets (EM) countries. With 1,391 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

S&P 500 INDEX— The S&P 500 Index is a total return index that reflects both changes in the prices of stocks in the S&P 500 Index as well as the reinvestment of the dividend income from its underlying stocks.