MACKAY SHIELDS
A NEW YORK LIFE INVESTMENTS COMPANY

INSIGHTS & PERSPECTIVES
Emerging Market Debt Team

OCTOBER 2022

Emerging Market Insights

Authored by Philip Fielding,
Co-Head of Emerging Markets Debt

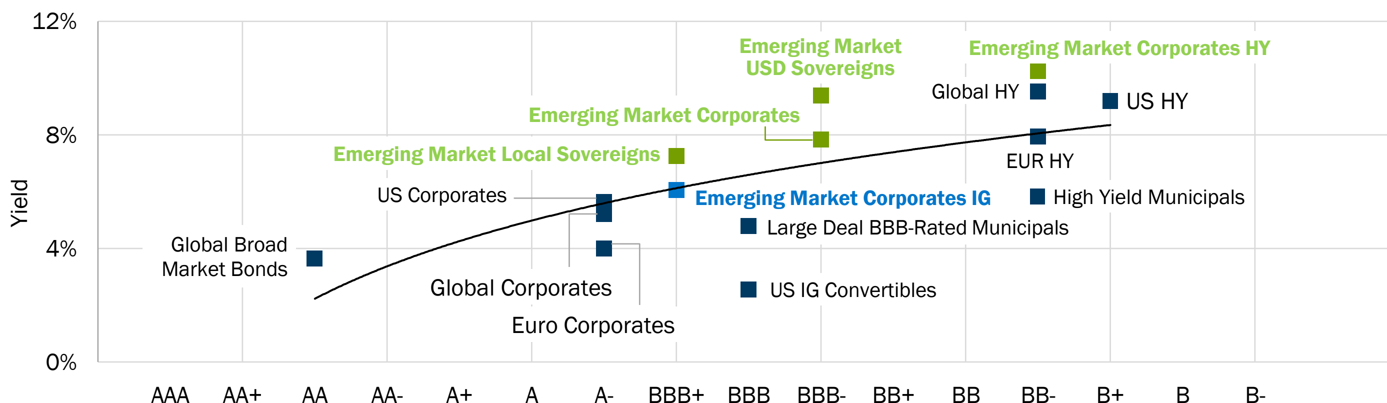
The year 2022 so far had significant drawdowns in store for many fixed income asset classes. The move higher in developed market interest rates was accompanied by spread widening for the sovereign and corporate segments of Emerging Market debt, while in local markets accelerating inflation, though often accompanied by timely policy adjustments still meant that local interest rates also surged higher.

As valuations for emerging market fixed income assets have now repriced to reflect significantly negative scenarios already, we are relying on our disciplined approach to find attractively valued opportunities in sovereign and corporate markets. While we are overall still cautious, yields for emerging markets are starting to look attractive, and when combined with strong fundamentals, the asset class could become an interesting opportunity in fixed income markets for the patient investor. Looking at the chart below, we believe the investment grade portion of emerging market corporate bonds is fairly valued, while all other emerging market asset classes offer attractive valuations.

Resilient Emerging Markets—Reaping Rewards from Early Policy Responses

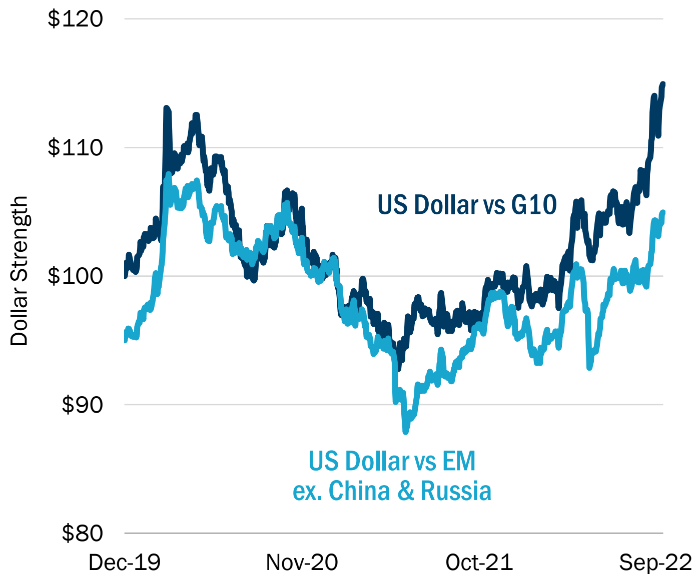
The third quarter of 2022 was dominated by a sharp move higher in developed nations' interest rate markets. In the United States, the yield increases were accompanied by frequent communications by the Federal Reserve's Open Market Committee members, who expressed their strong desire to anchor inflation expectations. After setting the scene in Jackson Hole, Wyoming, Fed chair Powell and his colleagues were looking to send increasingly hawkish signals to markets. Resulting from this was a significant move higher in US treasury yields, with the 2 year benchmark surging from 1.3% to 4.3%, while the 10 year note rose from 0.8% to 3.8% over the quarter. Yield curve inversion, where short-term interest rates are higher than longer dated maturities is often seen as an indicator of an impending recession, but it also draws

FIGURE 1: YIELD VS. RATING



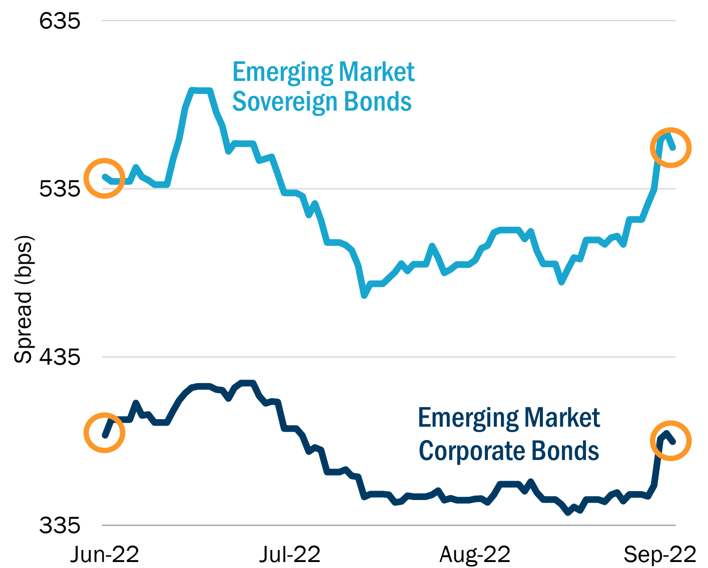
As of October 5, 2022
Please see appendix for index definitions and descriptions.
Source: JP Morgan, ICE Data, Bloomberg.

FIGURE 2: DOLLAR STRENGTH



As of October 13, 2022
Source: Bloomberg.

FIGURE 3: RISK PREMIUM



June 30, 2022 to September 30, 2022
Emerging Market Sovereign Bonds = J.P. Morgan EMBI Global Diversified Index; Emerging Market Corporate Bonds = JP Morgan CEMBI Broad Diversified Index.
Source: JP Morgan, Bloomberg.

capital to United States money markets. Together with 'flight-to-quality' flows, this led to appreciation pressures for the US dollar. Looking at third quarter exchange rate performances, the US dollar outperformed all G10 currencies and also appreciated against emerging market currencies. Remarkably, the Mexican peso, Indonesian rupiah, Brazilian real and Indian rupee performed better against the dollar than all other G10 currencies.

Emerging markets often find an environment of higher US interest rates, an appreciating dollar and fickle investor confidence as a recession nears difficult to navigate. In addition, the on-going war in Ukraine and its impact on global energy markets further complicates policy responses and removes options from emerging market decision makers. Many had to resort to aggressive monetary policy responses, but we have also seen an increasing need to resort to capital controls and import or export restrictions in order to preserve domestic resources for production and consumption. Analogous to outperforming emerging market currencies, against a challenging backdrop, risk premiums for emerging market sovereign bonds issued by sovereigns have risen only very modestly (EMBI global diversified index: +17bps) in the third quarter. Even more impressively, the most commonly followed emerging market corporate bond benchmark ended the quarter at the same risk premium it started, weathering global headwinds seemingly with ease.

Divergence between Countries Becomes More Pronounced

Looking at developments within emerging markets more closely, it becomes clear that the overall resilience at the asset class level masks increasingly diverging fortunes for its constituents. After the sovereign default of Sri Lanka in the second quarter, devastating floods in Pakistan exacerbated an already precarious situation for the country. As a result of the flooding and due to political turmoil Pakistan's bond curve is now pricing a very high likelihood of default. In Africa, some countries rely directly on imports of Ukrainian agricultural products, while others suffer from the generally higher price level for essential goods. Many weaker countries have looked to concessionary funding sources as international bond markets are no longer accessible to them.

Political events dominated the news agenda across emerging market regions. In Chile, the voting public comprehensively rejected the draft for a new constitution. Dealing the leftist government of Gabriel Boric a significant blow, markets largely

Purchase and use under license by MacKay Shields LLC. All Rights Reserved.

welcomed the return to the drawing board for the constituent assembly. The proposed changes were deemed too burdensome to implement and could have impaired Chile's growth potential by an excessive amount of red tape. Brazilian voters were gripped by an electoral campaign that put the Senate, Congress and Presidency into play. The focus was naturally on the battle for the presidency between Jair Bolsonaro and Lula, while according to our analysis the composition of Senate and Congress could prove to be much more consequential for Brazil's path. Kenyan and Angolan voters were also asked to opine on who should lead their country next. Both ballots took place in a largely peaceful manner, which is a very welcome departure from the past, particularly for Kenya. This is even more encouraging as the result was extremely close, leading to a challenge in the Supreme Court. Overall we find that political developments during the third quarter have unfolded calmly which markets rewarded in the above mentioned cases.

China at Crossroads

In China, policy announcements around October's Party Congress will be an important barometer on how President Xi Jinping intends to govern during his next five year term in office. How President Xi will react to the serious threat to stability emanating from the unfolding property crash, the weakening currency, the economic fallout from a Zero-Covid policy and rumors around his grip on power might not be revealed to the public, but appointments, promotions and demotions will give a glimpse into where Xi's priorities will lie. The previous doctrine of 'Common Prosperity for all' that sought to diversify growth drivers, bring excesses in the real estate sector under control and clip the wings of powerful entrepreneurs in tech and other sectors has yielded very poor results. So far, public discontent has been muted and in the near future the party's grip on power can suppress any potential rumblings of disapproval. However, as we have seen in other emerging markets, when growth drivers need to shift from investment and infrastructure towards knowledge based and globally integrated sectors authoritarian regimes often struggle to provide the necessary conditions for it. Furthermore, we believe that in the medium term, that President Xi will seek to pursue a policy of autarky and bring all capabilities deemed necessary to accomplish this onto the mainland. The level of growth and particularly a singular numerical target will likely become a much less important focus for Chinese economic policy.

Outlook for the Next Quarter

We anticipate volatile trading conditions to continue in the fourth quarter as the path for global inflation unfolds. Monetary authorities in developed markets have started their hiking cycles considerably later than the early adopters in emerging markets. The latter seem to have learned from past cycles that restoring a positive real interest rate environment can be crucial to fend off capital flight, and restore business and consumer confidence as hyperinflationary threats are contained. In countries where policy decisions have followed a different pattern, due to the lack of monetary flexibility, political choices or general tardiness we find that more rapid and less predictable asset price corrections have followed. One such example is Eastern European countries, where the slower start from the European Central Bank has led to a later adoption on monetary restraint from the region's central banks. Bond markets in Eastern Europe have experienced greater swings than their Latin American counterparts.

Overall we find that at current valuations quite negative scenarios are already reflected in risk premiums. For long term investors this creates an opportunity to gain exposure to fast growing and as the examples above have shown, often resilient countries. Having learned during many crises in the past, decision makers in emerging markets who reacted early and decisively have reaped the rewards during this period of volatility. A pro-active approach has yielded better outcomes wherever it was deployed. However, for us as investors, identifying which countries can navigate the upcoming volatility better than others requires a disciplined process and deep understanding of how markets will react to policy choices. It is the patient investor that will most likely find the greatest reward in emerging markets.

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

SOURCE DISCLOSURES
ICE Data Indices, LLC (“ICE Data”), is used with permission. ICE® is a registered trademark of ICE Data or its affiliates and BofA® is a registered trademark of Bank of America Corporation licensed by Bank of America Corporation and its affiliates (“BofA”) and may not be used without BofA’s prior written approval. ICE data, its affiliates and their respective third party suppliers disclaim any and all warranties and representations, express and/or implied, including any warranties of merchantability or fitness for a particular purpose or use, including the indices, index data and any data included in, related to, or derived therefrom. Neither ICE data, its affiliates nor their respective third party suppliers shall be subject to any damages or liability with respect to the adequacy, accuracy, timeliness or completeness of the indices or the index data or any component thereof, and the indices and index data and all components thereof are provided on an “as is” basis and your use is at your own risk. ICE data, its affiliates and their respective third party suppliers do not sponsor, endorse, or recommend MacKay Shields LLC, or any of its products or services.

“Bloomberg®”, “Bloomberg Indices®”, Bloomberg Fixed Income Indices, Bloomberg Equity Indices and all other Bloomberg indices referenced herein are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited (“BISL”), the administrator of the indices (collectively, “Bloomberg”) and have been licensed for use for certain purposes by MacKay Shields LLC (“MacKay Shields”). Bloomberg is not affiliated with MacKay Shields, and Bloomberg does not approve, endorse, review, or recommend MacKay Shields or any products, funds or services described herein. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to MacKay Shields or any products, funds or services described herein.

NOTE TO EUROPEAN INVESTORS
This document is intended for the use of professional and qualifying investors (as defined in the Alternative Investment Fund Manager’s Directive) only. Where applicable, this document has been issued by MacKay Shields Europe Investment Management Limited, Hamilton House, 28 Fitzwilliam Place, Dublin 2 Ireland, which is authorized and regulated by the Central Bank of Ireland.

IMPORTANT DISCLOSURE
Availability of this document and products and services provided by MacKay Shields LLC may be limited by applicable laws and regulations in certain jurisdictions and this document is provided only for persons to whom this document and the products and services of MacKay Shields LLC may otherwise lawfully be issued or made available. None of the products and services provided by MacKay Shields LLC are offered to any person in any jurisdiction where such offering would be contrary to local law or regulation. This document is provided for information purposes only. It does not constitute investment or tax advice and should not be construed as an offer to buy securities. The contents of this document have not been reviewed by any regulatory authority in any jurisdiction.

This material contains the opinions of certain professionals at MacKay Shields but not necessarily those of MacKay Shields LLC. The opinions expressed herein are subject to change without notice. This material is distributed for informational purposes only. Forecasts, estimates, and opinions contained herein should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Any forward-looking statements speak only as of the date they are made and MacKay Shields assumes no duty and does not undertake to update forward-looking statements. No part of this document may be reproduced in any form, or referred to in any other publication, without express written permission of MacKay Shields LLC. ©2022, MacKay Shields LLC. All Rights Reserved.

Information included herein should not be considered predicative of future transactions or commitments made by MacKay Shields LLC nor as an indication of current or future profitability. There is no assurance investment objectives will be met.

Past performance is not indicative of future results.

INDEX DEFINITIONS— THE FOLLOWING MAY BE CITED IN THIS DOCUMENT

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 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 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 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 EMBI GLOBAL DIVERSIFIED 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.