INSIGHTS & PERSPECTIVES

Emerging Market Debt Team

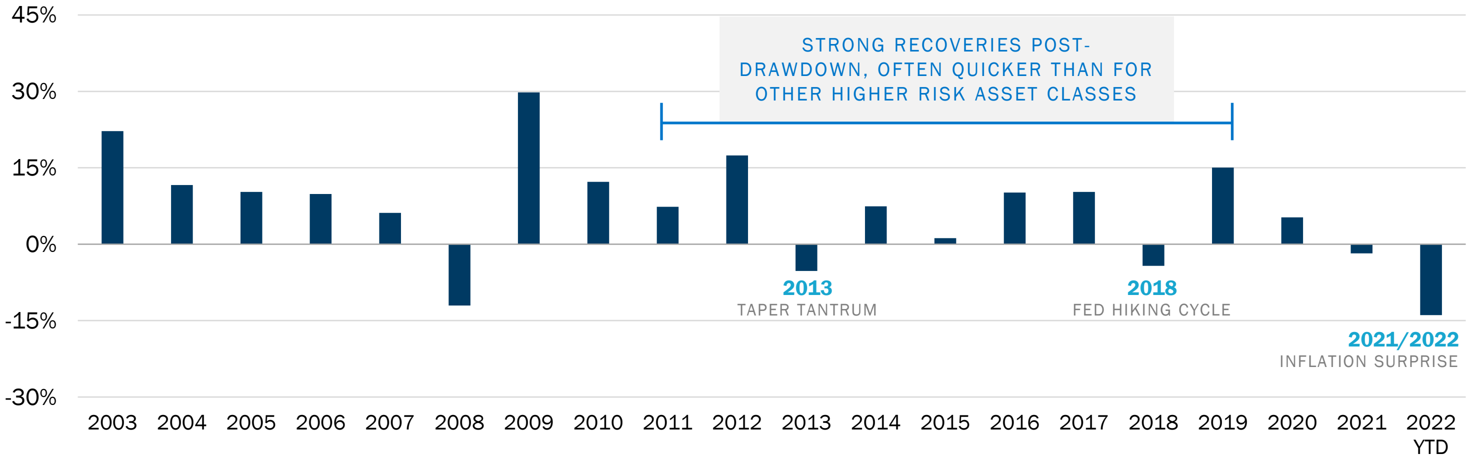
MAY 2022

After the First Quarter Shock: Investing in Emerging Market Debt

Most financial markets sold off sharply in 2022's first quarter in response to the war in Ukraine, rising inflation and expected interest-rate hikes. The S&P 500 delivered a -4.6% total return for the quarter, and the Bloomberg Aggregate U.S. Bond Index a -6.0% total return, due mostly to rising Treasury yields. Emerging markets debt did even worse in the broad-based flight from risk. The J.P. Morgan EMBI Global Diversified Index for hard currency sovereign bonds had a total return of -10.02%, which is only the fourth occurrence of a double-digit negative quarterly return since the index inception in 1994.

Widening credit spreads accounted for -4.0% of the EMBI's negative return; rising Treasury yields, for the other -6.2% with a small positive contribution from interest returns. It's rare for credit spreads and Treasury yields to detract from returns simultaneously; typically, they move in opposite directions, cushioning investor returns (Figure 1). In the past decade, there were only two other periods of concurrent spread widening and Treasury yield rising: during the "Taper Tantrum" of 2013 and in 2018. In both cases, a surprising change in financing conditions loomed large.

FIGURE 1: TREASURY YIELDS AND EM BOND SPREADS RARELY RISE TOGETHER
EMERGING MARKET BOND INDEX RETURNS | HARD CURRENCY



Data as of April 26, 2022. Emerging Market Bond Index: JPMorgan EMBI Global Diversified Index (Hard Currency); GFC = Global Financial Crisis.
It is not possible to invest directly in an index. See disclosures for index descriptions. **Past performance is not indicative of future results.**
Source: JPMorgan.

In 2013, the Federal Reserve's surprising decision to taper asset purchases provoked the market "tantrum." In 2018, the Fed's surprising decision to hike the Fed Funds rate from 1.50% to 2.50% caused a sell-off; the market had not responded strongly to rate hikes from 0% to 1.50%.

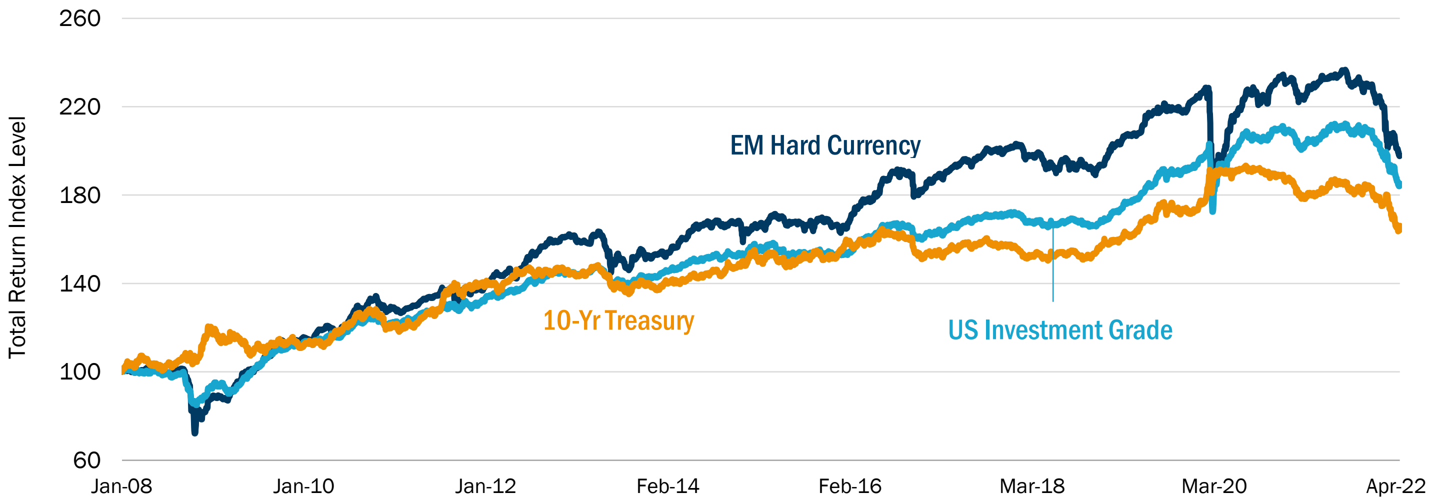
Similarly, in Q1 2022 the Fed said it would raise rates faster and sooner than the markets had expected. In this case, the Fed was responding to a one-two punch: a broad-based inflation surge (due to pent-up demand and supply-side disruptions) and a commodity price shock related to Russia's invasion of Ukraine. The unexpected tightening of global financial conditions shocked the markets, negating the typically negative correlation between Treasury yields and credit spreads.

This Too Will Pass

But surprises tend to dissipate, and expectations do adjust. Sharp declines in emerging-market debt indices have typically been short-lived, and often the rebound has been rapid. After the sharp selloffs in 2013 and 2018, investors were rewarded for staying in the asset class or using market weakness as an entry point (Figure 2). There have also been periods in the last decade when both Treasury yields and credit spreads have declined, delivering exceptionally strong returns—most recently, in 2019 and early 2020. The pandemic rudely interrupted that "Goldilocks period" for Emerging Market Debt investors.

We believe that financial markets are likely to soon deliver the diversified sources of return that are key to asset allocation. While historical returns do not necessarily predict future returns, we maintain that credit spreads and Treasury yields are likely to return to moving in opposite directions, cushioning returns. Research and active management will be crucial to garnering the full potential benefit of a rebound, in our view. Once the initial shock wears off, markets should start to differentiate again among countries, companies and individual bonds, and returns will likely diverge sharply. We maintain that investors would benefit from research to identify the likely winners and losers.

FIGURE 2: EMD INDEX HAS HISTORICALLY BOUNCED BACK QUICKLY AFTER PRIOR DROPS
TOTAL RETURN INDEX LEVEL, ALL SERIES REBASED TO 100 ON JANUARY 1, 2008



Through April 26, 2022
EM Hard Currency: J.P. Morgan EMBI Global Diversified Index; 10-Yr Treasury: Bloomberg US Government 10-Year Term Index Total Return; US Investment Grade: ICE BofA US Corporate Index.
It is not possible to invest directly in an index. See disclosures for index descriptions. **Past performance is not indicative of future results.**
Source: JPM, Bloomberg, ICE Data.

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.

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Philip Fielding
CO-HEAD & PORTFOLIO MANAGER

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The following indices may be referred to 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.

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