INSIGHTS & PERSPECTIVES

Emerging Market Debt Team

MARCH 2022

Geopolitical Uncertainty: Balancing How to Stay the Course in Challenging Times

The Russian invasion of Ukraine has brought war to Europe's eastern borders. Since Russia started its military campaign, Ukrainian civilians are suffering terribly, while even basic western goods will soon become unavailable for most ordinary Russians amid crushing western sanctions. In global markets, inflation is rising across regions; the US Federal Reserve and the European Central Bank are on the cusp of normalizing interest rates, potentially at a rapid pace. It is understandable for investors to start rethinking emerging markets amid the calamitous situation in Ukraine and at a minimum, view the asset class with greater caution in the current market and geopolitical risk environment. However, our research shows that previous crisis episodes are followed by rapid rebounds. We believe that by keeping capital deployed in emerging markets, investors continue to provide means to emerging market countries to help them on their journey to a more prosperous future. Staying invested means that investors may benefit from compounding the structural risk premium that is available in emerging markets.

Timing the market is notoriously difficult, but we maintain that investors in the asset class have historically been rewarded for time in the market. One reason for this, according to our analysis, is that the hard currency sovereign asset class displays a quicker recovery time. As the chart to the right illustrates, emerging market hard currency achieved a shorter time to recovery to a previously achieved high watermark than global equities, US high yield or US equities. Put differently, investors that stayed with the asset class over the long term could have been able to capture attractive returns. Investors who remained in the market when volatility materialized, or even added to positions, potentially experienced the benefits from compounding the structural risk premium over time.

Average Time to Recovery After Drawdown

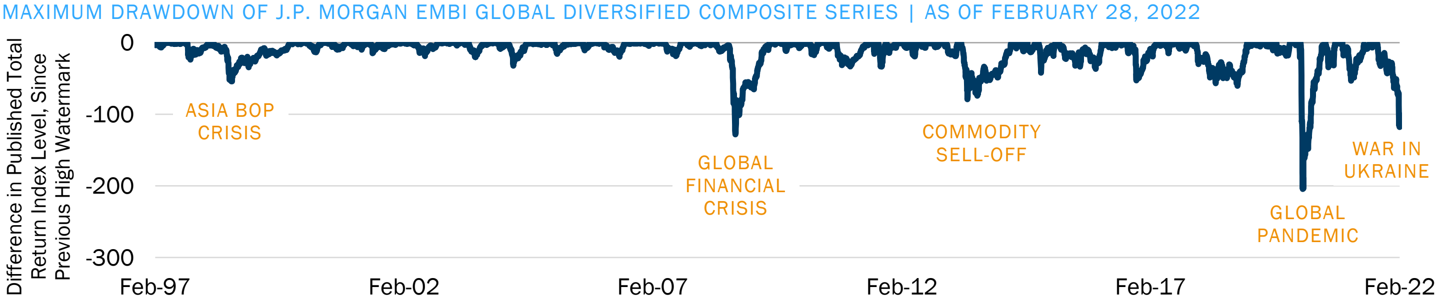
	Years
EM HARD CURRENCY	0.46
US HIGH YIELD	0.65
US EQUITY	0.72
GLOBAL EQUITY	0.92

Over the last 25 years, average time (measured in years) to recover from drawdowns of 5% or more. Drawdown is measured as the loss observed from the previous high watermark.

Source: JPM, Bloomberg, ICE data, MSCI, S&P. EM Hard Currency = J.P. Morgan EMBI Global Diversified Index, US High Yield = ICE BofA US High Yield Index, US Equity = S&P 500 Index, Global Equity = MSCI World Index. It is not possible to invest directly in an index. See disclosures for index descriptions. **Past performance is not indicative of future results.**

FIGURE 1: TIME TO REGAIN ALL-TIME HIGH IS OFTEN VERY SHORT

MAXIMUM DRAWDOWN OF J.P. MORGAN EMBI GLOBAL DIVERSIFIED COMPOSITE SERIES | AS OF FEBRUARY 28, 2022

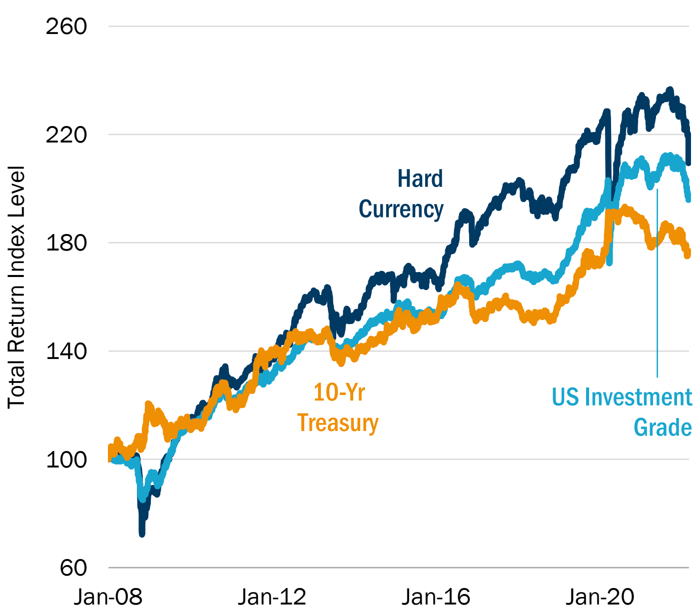


Source: J.P. Morgan EMBI Global Diversified Composite (Source: JPM/Bloomberg)
See disclosures for index descriptions. **It is not possible to invest directly in an index. Past performance is not indicative of future results.**

We discuss the nature of this structural risk premium, how emerging market debt can fit into a portfolio and which themes the team is focused on to best capture the returns available to investors at this crucial juncture.

Investing in emerging market debt can be a nerve-racking experience, with events in the developing world often filtering into Western news outfits when crises develop. The current invasion of Ukraine by the Russian military is a case in point, and over the last few years, there were numerous examples of other news events in emerging markets where investors might think investing in this asset class is inherently very risky. Comparing this perceived headline risk with the actual risk taken by investors in emerging market debt, we believe the asset class offers a very attractive risk-adjusted return profile. Our analysis over multiple time frames shows that investors have historically received equity-type returns with fixed-income type volatility. For example, a dollar invested in emerging market debt at the tightest risk premium ever achieved, just before the Lehman bankruptcy in 2008, returned more than safe-haven US Treasuries or developed market investment-grade bonds if the investment was held over time (Figure 2).

FIGURE 2: TOTAL RETURN INDEX LEVEL, ALL SERIES REBASED TO 100 ON JANUARY 1, 2008 | AS OF FEBRUARY 27, 2022



Source: JPM, Bloomberg, ICE data. 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.**

One of the most important reasons for this compelling risk-adjusted return capture is the broad range of investment opportunities that can be found in emerging markets. The universe is comprised of approximately 80 countries with a wide range of securities from hard currency sovereign and corporate bonds, local currency bonds, interest rate products and foreign exchange opportunities. The asset class is also well diversified in terms of credit quality. When proxied by rating agency methodology, we find investment opportunities in AA-rated sovereigns trading at very narrow spreads to developed market yield curves, all the way to deep-in-default countries where bonds trade at 10 cents on the dollar. This means that in most market environments, the opportunity for outperformance exists, but taking advantage requires a disciplined approach.

The universe is also constantly evolving as new countries develop their financial systems and are keen to attract capital for development in local and hard currencies. In the last decade alone, we have seen African sovereigns issuing a wide variety of dollar or euro denominated bonds, and Middle Eastern sovereigns and corporates accessing global capital markets keen to diversify their funding away from only domestic borrowers. In the Middle East, sovereign issuance was also motivated by the desire to provide a benchmark dollar bond curve for local corporates to easily access external funding. In local markets only last month, Egypt saw their efforts to join the investment mainstream rewarded by a much coveted inclusion in the widely followed JP Morgan GBI-EM local currency bond index. Furthermore, we have essentially seen the birth and coming-of-age of emerging market corporates as an asset class in its own right, where we find a particularly interesting combination of potential investment opportunities. From a top-down perspective, many emerging market corporates refrained from financial engineering techniques that were so popular in developed markets during the period of ultra-low interest rates. In our view, this means that fundamentals in aggregate have been on an improving trajectory for the emerging market corporate asset class.

Geographical diversification is a major factor for the overall low correlation with developed markets and over most time periods also within emerging markets. Coming back to the current geopolitical crisis, Russia attacking Ukraine, we believe, has only a very limited fundamental impact on Asian sovereign bonds or Latin American corporates. In fact, it is often the case that a crisis in a region or country can lead to capital getting diverted to other investment opportunities, as was the case when investors exited Argentina in 2018 after the victory by a far left candidate in the primaries. Capital was swiftly deployed into other areas within the high yield universe in Latin America and globally. Returns for the asset class in the months that followed were strong, with the 2019 calendar year returning over 15% for the most widely followed hard currency emerging market sovereign bond index after the modest drawdown of -4.26% in 2018.[1]

Due to its breath of opportunity and diversity of involved parties—from local investors to globally operating funds, domestic pension funds or insurance companies—emerging market bonds are far from easy to navigate and analyze, and we often find that the market is missing key developments. Our process is explicitly designed to capture these. We constantly ask our team members to answer the question: What is the market missing? At this juncture, this could involve an analysis of what the longer-term impact of the current geopolitical escalation could be on countries far from the frontline in Eastern Europe—such as higher, long-term commodity prices that benefit a diverse range of oil exporters in Africa, the Middle East and Latin America. We often find that in volatile periods, markets move indiscriminately, disregarding longer-term fundamentals. In turn, we look for opportunity amidst the volatility to position portfolios for the long term and to harvest the structural risk premium.

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, serving institutional investors

Team members representing 7 countries, 4 of which are emerging markets

10 unique languages spoken among the team members

Prior to joining MacKay, the team managed 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

1. Source: JPM Index referenced is the J.P. Morgan EMBI Global Diversified Index
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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 — The 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

MSCI WORLD INDEX — The MSCI World Index is a broad global equity index that represents large and mid-cap equity performance across 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country and MSCI world index does not offer exposure to emerging markets.

S&P 500 INDEX — The S&P 500 Index is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S.