Morgan Stanley

INVESTMENT MANAGEMENT

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International

MSIM Forward

How our investment managers navigate volatile markets

Summary

- When the U.S. Federal Reserve hiked rates by 75 basis points (bps) in June—with projections of comparable increases leaving the federal funds rate at 3.25% to 3.50% by the end of 2022 and 4.0% in 2023—that marked the start of a new, more aggressive stage in its battle with inflation.
- Chair Jay Powell said the Fed is "acutely focused on returning inflation to our 2% objective." But the gap between that target and the most recent 8.5% jump in the CPI—the largest spike in 40 years—clearly worried investors, and the Fed's surprising hawkishness injected more uncertainty and volatility into both equity and fixed income markets.
- Yields increased across the curve: Both 2-year and 10-year U.S. Treasurys touched near 3.5% in mid-June—meaning that the widely followed "2s-10s" yield curve is almost flat.
- U.S. and international equities all experienced sharp declines through June 21; for example, the S&P 500 Index gave up 6.1% during the week ended June 17—the worst sell-off since the pandemic lows in March 2020.
- Credit spreads widened as recession concerns took their toll; on June 21, for instance, the spread on the U.S. BofA High Yield Index surpassed 500 bps— the widest since October 2020.
- In our view, times like these underscore the value of active management. We believe in carefully assessing the fluctuations driven by all kinds of disruptions, and in taking dynamic actions that best serve the long-term interests of our clients.

Contents

EQUITY MARKETS

Edward J. Perkin, CFA
Chief Investment Officer, Eaton Vance Equity

Be Wary of Confusing Signals from Nominal versus Real Measures of Value

- One of three key attributes of good money is serving as a "unit of account." In an inflationary environment, however, fiat money struggles to fulfill this basic function.
- Inflation makes it much harder to count things properly—just one of the many problems it causes; under an inflationary regime, the value of money through time is no longer a constant, as with, say, an ounce of gold.
- In a free market economy with a stable currency, fluctuating prices are welcome, as they help signal where to direct resources:
  - Higher gasoline prices? Drive less and/or drill for more oil.
  - Not enough Uber drivers on a rainy afternoon? Deploy surge pricing to incentivize more to show up (although that might be mistaken for gouging desperate customers, rather than serving their needs).
- If the price fluctuations are monetary in nature, they can send confusing signals.
- For an equity analyst, it is always important to disaggregate revenues into price and units to understand what is really going on.
- Pricing power is a much-sought-after trait, but for intermediary businesses like retailers, higher prices may simply reflect higher costs:
  - A hypothetical retailer might put up a healthy sounding same-store-sales "comp" of 5%.
  - With CPI currently running at 8%, however, volumes would actually be down -3%.
- Likewise for capital spending figures:
  - In the first quarter, year-over-year growth in capital expenditures for companies in the S&P 500 Index clocked in at a seemingly robust 20%.
  - That level was likely a peak, however, and with the Producer Price Index (PPI) running at 16%, a year-over-year decline in "real" capital spending may be in the offing.
- In such an environment, we would favor European and U.S. markets over Japanese equities, and health care and real estate over financials and consumer staples.

	Unfavorable –						+ Favorable
Regions	Europe				✓		Inexpensive way to gain cyclical exposure, interest rates less of a headwind
	U.S.				✓		U.S. companies are strong, and valuations have improved
	Japan			✓			Divergent monetary policy offers both risk and opportunity for global investors
	Emerging Markets (EM)		✓				Investors overestimate the secular earnings growth in EM
Sectors: 3 Most Favored	Health Care					✓	A microcosm of the growth versus value debate; secular growth and attractive valuations
	Real Estate				✓		Inflation hedge plus dividend yield
	Information Technology			✓			Previously our least favored sector, now more reasonably valued since the pullback
Sectors: 3 Least Favored	Energy		✓				After roughly 150% outperformance over about 18 months, time to take profits
	Consumer Staples		✓				A sector that is defensive, but too expensive
	Financials	✓					This group has been over-earning on capital markets, credit quality and rates

Risk Considerations: The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. The value of equity securities is sensitive to stock market volatility.

INCOME MARKETS

Eric Stein, CFA
Chief Investment Officer, Global Fixed Income

Spread Widening Opens Up Opportunities in Some Sectors

Unfavorable – + Favorable

		–				+	
Corporate	Investment Grade (IG)				✓		European IG appears better value than U.S. IG. Going forward rate risk is less of concern given the tightening in the market. Should perform if market starts to worry about recession risk.
	Floating-Rate Loans		✓				"Cleanest dirty sheet" among credit sectors YTD, given the limited duration risk. Fundamentals could deteriorate from here on lower growth and as floating rates move through to debt service.
	U.S. High Yield			✓			All-in yields of 8.5% on the ICE BofA U.S. High Yield Index put the "high" back in high yield. Valuations are wide of 10-yr averages and back to long-term fair value. Decent convexity due to lower $ prices. A lot of debt is termed out at low coupons with limited refinance risk in the intermediate horizon. In a recession, rates should be able to absorb some of the spread widening.
Municipal	High-Quality Investment Grade				✓		On a YTD basis, municipal funds have experienced a total of $69 billion in outflows, which has resulted in some forced selling. This has resulted in improved value, as muni yields have increased by 150 to 190 basis points (bps) across the curve since the beginning of the year.
	High Yield (HY)			✓			We remain selective in HY munis. Municipal credit quality is strong, but spreads remain tight on a historical basis.
Securitized	Agency MBS				✓		Overweight higher coupon agency MBS and neutral on longer duration lower coupon bonds. Higher coupon agency MBS look extremely compelling for a safe government agency space to ride out volatility, with nominal spreads hovering around 150 bps over Treasuries, spreads are roughly 80 bps wider than where they began the year.
	Nonagency MBS			✓			Moving to neutral as spike in mortgage rates to 6% has extended the weighted average lives of many of the legacy deals and also decreased home price appreciation (HPA) assumptions going forward. While spreads have widened dramatically to start the year, the extension risk of many existing deals brings on additional risks of eventually taking losses. We believe the best value lies in shorter 3+ year old deals with a significant HPA cushion.
	CLOs				✓		We still see spread widening across the capital stack, with most noticable widening and variation at the AAA level. Spreads have continued to widen as a result of increased risk awareness and in sympathy with other IG asset classes. The floating-rate nature of CLOs acts as a natural hedge against rising rates, and marks have held up better than many other competing assets. We expect spread levels to remain flat to potentially tighter. Reduced new issue CLO supply should also provide some technical support for spreads. We continue to believe spread levels are attractive, barring exogenous shocks to the markets.
Emerging Markets	Sovereign – Local Currency				✓		Higher U.S. rates will be a headwind for EM local assets, but EM central banks are generally way further along the curve in normalizing monetary policy, which will support rates and foreign exchange valuations.
	Sovereign – U.S. Dollar				✓		Spreads have widened and are starting to look interesting.
Other	Inflation Breakeven			✓			The war in Ukraine pours fuel on the global inflationary fire. Long-end breakevens don't have enough risk premium built in to account for the possibility that inflation is slow to come down.

Source: Morgan Stanley Investment Management, as of 6/1/22.

The impact of the coronavirus on global markets could last for an extended period and could adversely affect a strategy's performance.

Risk Considerations: An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There can be no assurance that the liquidation of collateral securing an investment will satisfy the issuer's obligation in the event of non-payment, or that collateral can be readily liquidated. The ability to realize the benefits of any collateral may be delayed or limited. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. Investments rated below investment grade (typically referred to as "junk") are generally subject to greater price volatility and illiquidity than higher-rated investments. As interest rates rise, the value of certain income investments is likely to decline. Bank loans are subject to pre-payment risk.

INFLATION

Jim Caron
Chief Fixed Income Strategist

The Fed Cannot Contain Inflation Alone—Fiscal Policy Is Required

Containing inflation

- In my view, the Federal Reserve cannot lower inflation and keep it contained within a 2% to 2.5% target range all by itself; to sustainably rein in significant inflation risks, what is required is coordination of both monetary and fiscal policy.
- These were the tools used to lower and contain inflation in the 1980s, and they are again necessary to lower inflation to target levels and—most importantly—keep it there.
- If the Fed relies on raising interest rates alone, it may only succeed at deflating asset valuations, which might also create a recession, while inflation may remain sticky and bounce even higher once the economy recovers. It is imperative that productive capacity is increased, requiring a supply-side policy response.

Learning from the Volcker era

- Today's narrative is that the Fed needs to cure the inflation infirmity only through monetary policy, much like the former Fed Chair Paul Volcker did in the 1980.
- This is only a half-truth, and a common misunderstanding, because—similar to the 1980s—today's inflation is being driven by a supply shock as well as an increase in demand.
- A broader and more accurate account of that era would indicate that Volcker's policies created not one but two deep, back-to-back recessions that merely served to "interrupt" the rise in inflation; to completely eliminate inflation, corresponding supply-side fiscal policies were necessary.

Addressing supply and demand

- Now, as then, we need a supply-side response supported by fiscal policy, in addition to a monetary policy response, which only serves to decrease demand by increasing the cost of money and credit.
- We understand that the shortages in goods and labor causing higher prices and wages are not transitory; rather, they have resulted in a wage-price spiral creating persistent inflation risks.
- These shortages need to be addressed by fiscal policy—namely government spending, regulation and taxation designed to increase the productive capacity of the U.S. economy such that supply meets demand.

Fiscal policy is a must

- Supply and demand need to work together to bring down inflation more permanently, so we must see a plan for fiscal policy in coordination with monetary policy.
- If the Fed goes it alone, then it will only be using a demand tool to fix what is also a supply problem.
- Unless we see coordinated fiscal and monetary policy, inflation may stick around longer than market consensus suggests.

Risk Considerations: Fixed income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. Longer-term securities may be more sensitive to interest rate changes.

INTERNATIONAL EQUITY TEAM

William Lock
Head of International Equity Team

Bruno Paulson
Portfolio Manager

Laura Bottega
Lead Portfolio Specialist

As investors, we are navigating this environment by continuing to focus on companies with robust fundamentals that enjoy pricing power.

What We Are Seeing

- Against a backdrop of rising rates and inflation, markets are shrinking, in stark contrast to the cost of living.
- March Consumer Price Index data in the U.S. took the annual rate of inflation to 8.5%—the highest since December 1981.
- Inflation has so far been driven by "stuff," a result of goods and commodities shortages due to economic bouncebacks from COVID-19 in developed economies, aggravated by supply shocks in food and energy caused by the Russian invasion of Ukraine.
- Will inflation leak from "stuff" to "staff"? With jobs easy to find and hard to fill, U.S. wage growth has accelerated to 5%—the highest seen so far this century—though still behind the consumer inflation rate, implying falling real wages.

What We Are Doing

- Interestingly, company earnings forecasts are proving largely immune to inflation fears.
- EBIT (earnings before interest and taxes) margins remain at extremely elevated levels, approaching 17% for the MSCI World Index, versus the pre-pandemic peak of 15% and the 20-year average of 13.4%.
- These stretched margins have to be under threat, either from inflation itself or any slowdown caused by the attempts to tackle inflation.
- As investors, we are navigating this environment by continuing to focus on companies with robust fundamentals that enjoy pricing power—the ability to pass on input costs for stuff or staff—to consumers.
  - In the first quarter, for example, a multinational consumer hygiene company we hold reported that its strong portfolio of brands has allowed for "responsible price action"—an increase in pricing of 5% across its business—while a Dutch brewing company we own managed a double-digit "price mix" as it passed on costs helped by the return to bars and restaurants in Europe.
  - This contrasts with the fortunes of general retailers we don't own, which have made the mistake of increasing their inventories of home equipment just as the post-pandemic consumer is shifting towards leisure and services outside the home.

What We Are Watching

- Five months of de-rating has eased our concerns over multiples—though at the top end of their range from 2003 to 2019, they cannot be considered in any way low.
- Our worries about earnings have continued to rise, as have earnings themselves, aggravated by growing risks to stretched margins from either deflation or a downturn.
- Given the risk to earnings, we advocate looking out for compounders—those companies that can grow their earnings steadily across cycles because their pricing power and recurring revenue can make them resilient.

Risk Considerations: The value of equity securities can fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than the risks generally associated with investments in foreign developed countries. Derivative instruments can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio's performance. Illiquid securities may be more difficult to sell and value than public traded securities (liquidity risk). The use of futures includes the possible imperfect correlation between the price of futures contracts and movements in the prices of the securities being hedged, and the possible absence of a liquid secondary market for any particular investment. ESG Strategies that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

ACTIVE INTERNATIONAL ALLOCATION

Jitania Kandhari
Deputy CIO of the Solutions and Multi-Asset Group, Co-Lead Portfolio Manager for Active International Allocation, Head of Macro and Thematic Research for Emerging Markets Equity

Ben Rozin
Co-Lead Portfolio Manager for Active International Allocation

We think businesses with improving returns and margins could again outperform those with low returns and deteriorating prospects in the long term, though in the short term, markets may not recognize these higher quality companies.

What We Are Seeing

- Market volatility has continued to be a primary feature of equity markets, with investors apparently fixated on inflation and global central bank responses to rising price measures and inflation expectations.
- Many great companies with defensible moats and favorable industry structures are being sold off due to changes in interest rate expectations, rather than changes in their competitive dynamics or business outlooks.
- Deglobalization, high debt, depopulation and “greenflation” are contributing to structural headwinds that impact global economies and markets—likely slowing global growth momentum while keeping price pressures high—as well as the countries, sectors and stocks in our investment universe.
- Non-U.S. equity markets, as measured by MSCI ACWI (All Country World Index) ex USA Index, outperformed the U.S. in April and May; for the year through May 31, non-U.S. equities have declined 10.7% versus a loss of 14.2% for the U.S.
- Many non-U.S. equities are also supported by attractive valuations—for instance, on a forward 12-month price to earnings (P/E) basis as of May 31, ACWI ex USA trades at 12.5 times while the U.S. is at 17.9 times.

What We Are Doing

- Our core approach invests across developed and emerging markets to navigate the current investment landscape, seeking to identify the most attractive sustainable growth and compelling value opportunities.
- By integrating top-down and bottom-up analysis, we can focus on countries with the strongest equity market potential, sectors and industries with improving pricing power, and companies with robust balance sheets and durable competitive advantages.
- We are using volatility to add to the most solid structural stories and to companies with the most compelling valuations relative to our estimates of their intrinsic value, while rotating away from those that are fully valued to those that are attractive valued.
- Our long-term themes are consumer, macro, technology, healthcare innovation and mispriced cyclicals with structural drivers, and we currently hold a barbell strategy that is focused on long-term thematic winners as well as adding to cyclical companies in supply-constrained industries with growing pricing power to help expand their businesses and margins.

What We Are Watching

- Improving profitability and solid balance sheets are now coming more into focus for investors as capital is getting more expensive: We think businesses with improving returns and margins could again outperform those with low returns and deteriorating prospects in the long term, though in the short term, markets may not recognize these higher quality companies.
- China has eased COVID lockdowns in major cities and further expanded its policy measures to support demand and economic growth.
- Cost increases are hurting consumer sentiment and inflation expectations have risen, which is concerning for demand and economic growth, so we are watching how global central banks focus on responding to price pressures with tightening measures.
- Increases in the commodity supply could shift the current demand/supply deficit into a balance or surplus.
- Geopolitics will remain a focus—both the positive outcomes and the setbacks.

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EMERGING MARKETS LEADERS

Vishal Gupta
Portfolio Manager, Emerging Markets Leaders

The investment thesis for our holdings remains unchanged as we continue to reassess and reflect the changing operating environment: We believe our companies will remain industry winners in the mid- to long-term.

What We Are Seeing

- Higher-than-expected inflation continues to weigh on growth companies globally, and with oil prices already so elevated, the latest spike in the U.S. Consumer Price Index (CPI) has only exacerbated worries of negative spillovers to Emerging Markets.
- The extended conflict between Russia and Ukraine has put further pressure on commodity prices—particularly on food, which is felt more keenly in emerging markets.
- We had noted the possibility of over-ordering by retailers, and we see some of these trends showing up in corporate results.
- However, we are starting to observe a turnaround in consumer companies—especially in China—and recoveries in specific themes in the portfolio; there has been some consolidation in industries such as food delivery, where less competition could unlock more profit potential.

What We Are Doing

- After reassessing our investment thesis and growth outlook, we have been using the latest bout of share price corrections to add to our themes in athleisure, domestic production, niche finance and digital IT services, which we funded by exiting one of our thematic stocks within the information technology sector.
- We had taken advantage of earlier share price bounces to re-balance positions in the semiconductor industry and to reduce some holdings in India, given the strong performance of the past three to four years through the first quarter.
- We have been spending more time on the road, with visits to Hangzhou and Mumbai, as well as additional research trips planned over the next couple of months.
- The investment thesis for our holdings remains unchanged as we continue to reassess and reflect the changing operating environment: We believe our companies will remain industry winners in the mid- to long-term.

What We Are Watching

- While we are bottom-up investors, we also monitor macro data points, such as the pick-up in the employment participation rate and some moderation in wage increases.
- We are following the rise of local manufacturing opportunities in some EM countries that are investing heavily to increase their capacity toward self-sufficiency.
- We are closely tracking the path to improving profitability of our consumer e-commerce businesses, which we believe could ride through the near-term slowdown and repeated COVID outbreaks to return to growth.

Risk Considerations: The value of equity securities can fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in emerging market countries are greater than the risks generally associated with investments in foreign developed countries.

FLOATING-RATE LOANS

Andrew Sveen, CFA
Director of Floating-Rate Loans

Just as the loan market has proved its resiliency over several decades and business cycles, today we see value in this asset class, and we believe the forward return potential from these levels is bright.

What We Are Seeing

- The historic 75 basis points (bps) hike by the Federal Reserve on June 15 signifies a major boost for floating-rate loans—literally. Rates in this asset class have an average reset period of just over 30 days, and the two key loan benchmarks—Libor and Sofr[1]—both closely track the fed funds rate that the policymakers control.
- The Fed has four meetings on the books through the end of the year, and is projecting that its policy rate will be boosted to more than 3% over that period, and as high as 4.00% next year. So rising yields will likely be a continuing theme in the loan market for the balance of 2022.

What We Are Doing

- The Fed is aiming to thread the needle, in hopes that raising rates sharply will stave off inflation without tipping the economy into recession. We think of these risks in terms of probabilities and degree, assessing what's likely based on what's already "priced in."
- The loan price of $94 on the S&P/LSTA Leveraged Loan Index as of June 17 means that investors are predicting $6 in losses over the five year nominal maturity of typical loans. Our universe of first-lien loans has had an average recovery rate of 75%, based on the S&P Global Loss Stats database. Applying some basic arithmetic, the loan pricing and recovery rates imply that investors expect a 24% default rate.
- That default rate allows us to gauge how fairly priced loans are, if we assume that a recession is likely, based on relevant comparisons. The default rates in the loan market peaked at 8% in the 2001-2002 tech wreck, 10% in the 2008-2009 Global Financial Crisis (GFC) and 4% in the 2020 COVID pandemic. In other words, today's market is pricing in a multiple of the GFC and over five times the COVID recession.
- More recently, the trailing 12-month default figure rounds to zero. The distressed ratio of loans trading under $80, which has been a good indicator of where investors see defaults trending, remains a low 2% to 3% of the market.

What We Are Watching

- The implied default rate of 24% based on current loan pricing appears to be a very large cushion against the most likely economic downturns. Moreover, it suggests that the 9% yield to maturity on loans, as of June 17, offers attractive value—it is the highest of major fixed-income asset classes.
- For investors assessing the current environment, two key factors stand out: First, courtesy of the Fed, loan coupons are poised to rise, and by quite a lot. Second, the discounted price on loans anticipates far more credit carnage than we believe is remotely justified.
- Just as the loan market has proved its resiliency over several decades and business cycles, today we see value in this asset class, and we believe the forward return potential from these levels is bright.

[1] Libor and Sofr are short-term benchmarks commonly used in the pricing of short-term and variable-rate instruments such as bank loans.

Risk Considerations: Loans are traded in a private, unregulated inter-dealer or inter-bank resale market and are generally subject to contractual restrictions that must be satisfied before a loan can be bought or sold. These restrictions may impede the strategy's ability to buy or sell loans (thus affecting their liquidity) and may negatively impact the transaction price. It may take longer than seven days for transactions in loans to settle. Due to the possibility of an extended loan settlement process, the strategy may hold cash, sell investments or temporarily borrow from banks or other lenders to meet short- term liquidity needs. Loans may be structured such that they are not securities under securities law, and in the event of fraud or misrepresentation by a borrower, lenders may not have the protection of the anti-fraud provisions of the federal securities laws. Loans are also subject to risks associated with other types of income like high-yield bonds described above. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. Changes in the value of investments entered for hedging purposes may not match those of the position being hedged.

SHORT-DURATION INFLATION PROTECTION

Jason DesLauriers, CFA
Portfolio Manager

Brian S. Ellis, CFA
Portfolio Manager

We are still seeking to deliver inflation protection with less interest-rate risk than is typically found with longer-duration, traditional inflation-protection strategies.

What We Are Seeing

- Despite widely held expectations that inflation might have peaked, the May Consumer Price Index (CPI) indicated that U.S. inflation could likely go higher and be more broad-based than expected.
- The ongoing Russia-Ukraine war continues to pressure food and energy prices, while renewed COVID lockdowns in China threaten progress made in taming goods inflation and global supply chain constraints.
- Consumers' longer-term outlook for inflation also spiked higher, which—combined with a tight labor market—could put further pressure on wages and push inflation higher.
- In this inflation cycle, traditional inflation-protection income strategies have generally delivered sharply negative total returns along with the broader fixed income markets. By contrast, shorter-duration, inflation-focused strategies have performed positively.

What We Are Doing

- The strategy was designed precisely for this environment—one in which inflation is high and the Federal Reserve has to raise interest rates quickly to try to contain it.
- We are still seeking to deliver inflation protection with less interest-rate risk than is typically found with traditional longer-duration, inflation-protection strategies. We believe this is best achieved by:
  - Focusing on shorter-duration, inflation-linked assets, which are 1) less negatively impacted by rising interest rates, 2) better correlated with the inflation consumers are experiencing, and 3) more likely to provide inflation protection if inflation continues to surprise by overshooting expectations.
  - Swapping interest rate risk for credit risk. Floating-rate securities, such as bank loans, can potentially enhance total returns and have attractive correlations with inflation. However, we are moderately decreasing this exposure and moving to a more neutral positioning across credit sectors, as the Fed has pivoted to tightening monetary policy more quickly and aggressively than anticipated.

What We Are Watching

- We are keeping a close watch on high-frequency economic data that indicate the direction of the labor market and inflation, which will be key to future central bank policy.
- Corporate earnings reports will start to be released in July. We will monitor these, focusing on:
  - Top-line trends to show the adjustment between goods and services
  - Companies' ability to maintain margins and pass through higher costs
  - Corporate hiring plans to get a sense of intermediate-term labor market conditions
  - Capital allocation decisions to learn how management teams are planning to use their balance sheets
- We are looking at global central banks and their reaction functions, or how effective the banks' policy tools are proving to be.
- Consistently, we are tracking market "technicals" around global capital flows to gauge security supply and demand levels.

Risk Considerations: Loans are traded in a private, unregulated inter-dealer or inter-bank resale market and are generally subject to contractual restrictions that must be satisfied before a loan can be bought or sold. These restrictions may impede the strategy's ability to buy or sell loans (thus affecting their liquidity) and may negatively impact the transaction price. It may take longer than seven days for transactions in loans to settle. Due to the possibility of an extended loan settlement process, the strategy may hold cash, sell investments or temporarily borrow from banks or other lenders to meet short- term liquidity needs. Loans may be structured such that they are not securities under securities law, and in the event of fraud or misrepresentation by a borrower, lenders may not have the protection of the anti-fraud provisions of the federal securities laws. Loans are also subject to risks associated with other types of income like high-yield bonds described above. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. Changes in the value of investments entered for hedging purposes may not match those of the position being hedged.

EMERGING MARKETS DEBT

Marshall Stocker, Ph.D., CFA
Co-Director of Emerging Markets, Portfolio Manager

John Baur
Co-Director of Emerging Markets, Portfolio Manager

Recognizing that country selection continues to matter most, we remain focused on analyzing the direction of policy in each emerging and frontier markets country.

What We Are Seeing

- Further repricing of U.S. Federal Reserve policy has triggered another leg down in the global sell-off in risk assets. Emerging Markets Debt (EMD) has not been spared, performing in line with other asset classes that possess similar risk profiles.
- A notable divergence in commodity prices has been a key driver of performance dispersion between EM countries.
- China is critical for the global economy, and the country's growth picture remains challenged. As EM investors, we need to balance the government's easing of COVID lockdowns and recommitting to "common prosperity" through policy stimulus, with property sector stress, global supply chain challenges and prices for industrial metals.

What We Are Doing

- We've noted that some investors have attempted to apply overly simplistic rules to EM investing, such as "buy commodity exporters, sell commodity importers." In our view, markets are far too complex and fast-moving for such an approach. For example, some net commodity importers continue to have vibrant value-added exports that offset commodity price risk.
- There appear to be more EM countries that will be adversely affected by the uncertainty of the current environment than those that can prosper under it. As a result, our portfolios reflect that reality from the bottom up.
- We still find countries where governments are committed to structural reforms aimed at improving their economies and the prospects for investment. Historically, this has led to better standards of living and ESG outcomes, as well as capital market outperformance and a reduced cost of capital—a powerful combination.

What We Are Watching

- Inflation may be nearing its peak, or may even have already peaked in certain EM countries, which would be positive for those areas where we think local interest rates, in particular, represent compelling value.
- That said, inflation does not appear to have peaked in the U.S., and many other developed-market economies and central banks appear committed to further policy tightening. How much tighter they will get, collectively, is the question haunting most markets, and we will certainly watch how policies unfold.
- The Russia/Ukraine war rages on and continues to impact people and markets around the world. Unfortunately, we remain skeptical of a near-term resolution.
- Recognizing that country selection continues to matter most, we remain focused on analyzing the direction of policy in each emerging and frontier markets country—our nearly 50-person EM team covers more than 100 of them—as well as on how macro challenges might impact each.

Risk Considerations: The value of investments may increase or decrease in response to economic and financial events (whether real or perceived) in the U.S. and global markets. The strategy employs an "absolute return" investment approach, benchmarking itself to an index of cash instruments and seeking to achieve returns that are largely independent of broad movements in stocks and bonds. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. In emerging or frontier countries, these risks may be more significant. Investments in debt instruments may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. Exposure to derivatives involves risks different from, or possibly greater than, the risks associated with investing directly in securities and other investments. As interest rates rise, the value of certain income investments is likely to decline. The value of commodities investments will generally be affected by overall market movements and factors specific to a particular industry or commodity, including weather, embargoes, tariffs, or health, political, international and regulatory developments.

INDEX DEFINITIONS

Bloomberg Municipal Bond Index is an unmanaged index of municipal bonds traded in the U.S.

Citi Inflation Surprise Index is a measure sourced from Bloomberg and Citi U.S. Wealth Management and designed so that a reading above zero means that inflation data are on average coming in above consensus expectations.

Consumer Price Index (CPI) is a measure of the change in the average price level of a fixed basket of goods and services purchased by consumers.

ICE BofA U.S. High Yield Index is an unmanaged index of below-investment grade U.S. corporate bonds.

S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

S&P 500® Index is an unmanaged index of large cap stocks commonly used as a measure of U.S. stock market performance.

MSCI USA Index is an unmanaged index designed to measure the performance of large- and mid-cap U.S. common stocks.

MSCI World Index is a market-cap weighted index that captures large and mid-cap stock performance across 23 developed market countries.

MSCI ACWI (All Country World Index) ex USA Index is an unmanaged free float-adjusted market capitalization-weighted index designed to measure the equity market performance of developed and emerging markets, excluding the United States.

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Date of Data: 6/24/22.

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