Building Better Outcomes

Unearthing opportunities in an altered landscape

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Boston – In 2022, we expect emerging markets may embark upon a road to recovery, albeit with potential bumps along the way. While slower but ongoing recoveries in economic growth and global trade combined with reasonably attractive valuations for emerging-markets (EM) debt should act as tailwinds. That said, continued headwinds from higher inflation, tightening monetary conditions, developments in China and uncertainty linked to the evolution of COVID-19 will likely remain challenges.

Ultimately, the broad and diverse nature of the EM universe means that these trends will play out differently at the individual country level.

Global Growth Supportive Despite Vulnerabilities

After a brisk expansion in global economic activity in 2021, growth is set to moderate to slightly less supportive levels this year. Global demand conditions remain relatively strong, with business activity still recovering from the pandemic-induced lockdowns. Less positively, however, the economic jolt of re-openings has been met by capacity constraints in developed and emerging economies, which is whipping up price pressures.

In response, the world's central banks are gradually abandoning pandemic-era stimulus in a move to normalize monetary policy. The U.S. Federal Reserve (the Fed), which has started tapering its asset purchases already, is expected to hike rates three times in 2022. Here, it is important to highlight that despite increases, rates will remain at extremely accommodative levels. Furthermore, with three hikes anticipated, it is unlikely that the Fed will surprise with more aggressive policy action, in our view.

In terms of other areas of risk, China, the world's second largest economy and a key trade and investment partner with other emerging markets, is showing signs of additional slowing. The government has stepped up regulatory crackdowns in sectors such as real estate, technology, private education and gaming – moves that have caused Chinese stocks to gyrate.

We are now seeing defaults by property developers, which we are continuing to monitor closely – not least because real estate is the largest sector in the Chinese economy. In terms of other policy, the government signaled a recommitment to "common prosperity," a term that many interpret as wealth redistribution, which has given markets reason for pause.

Lastly, no country is out of the woods as far as COVID-19 is concerned, particularly in light of the Omicron variant's fast global spread. Public health risks differ by country—with varying levels of vaccination rates and medical capacity across EMs—but most remain susceptible to the broader macro risks that further pandemic restrictions on cross-border trade and investment would entail.

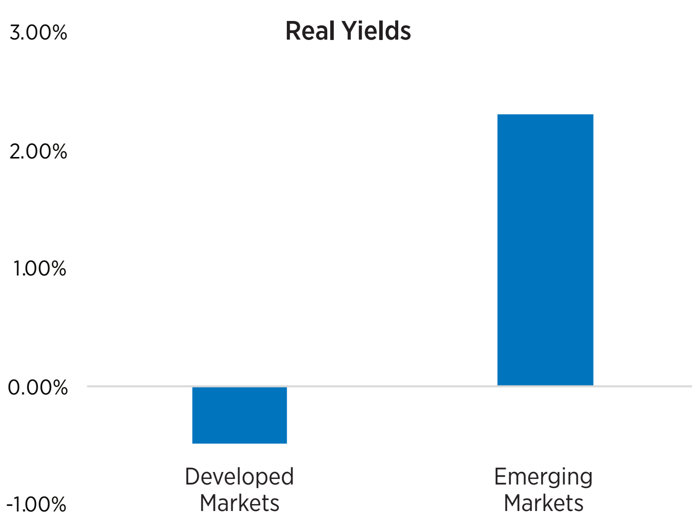
Valuations Particularly Attractive in Local Rates

Notwithstanding the importance of growth, economic activity alone is not the key determinant for the performance of emerging-markets debt, as we saw in 2021 – a year of economic renewal and underwhelming performance on EM debt indexes. On balance, we remain neutral to slightly positive on the main performance drivers for the asset class, as outlined below:

- **Rates:** Relative rates between emerging and developed markets remain attractive, with a wide and positive differential. We believe rates will be a key return driver for EM local debt in 2022.
- **Currencies:** Foreign exchange is an area where we see pockets of value, but broadly currencies appear fairly priced relative to the risk. On a nominal and real effective exchange rate basis (REER), EM currencies experienced a broad weakening over 2021, but we continue to see attractive opportunities on a selective basis.
- **Sovereign spreads:** The compensation available in the hard-currency sovereign market is starting to look slightly more compelling, with value opening up as spreads edged above long-term averages in late 2021.
- **Corporate spreads:** Spreads also widened for corporate EM debt late last year, but remain relatively tight outside of Asia. Opportunities remain on a selective basis for mangers able to dig deeper in order to unearth value.

Exhibit A

EM Debt Offers an Attractive Yield Advantage



Sources: Bloomberg, J.P. Morgan, Eaton Vance. As of December 20, 2021. Real yields are calculated as nominal yield minus headline inflation expected in 18-30 months by economists surveyed by Bloomberg. Excludes Argentina, Turkey, and Romania. Data provided is for informational use only. Past performance is no guarantee of future results. See end of report for important additional information.

Off the Beaten Path

While we foresee a somewhat supportive macro backdrop in 2022, a number of broad risks remain. In such an environment, capitalizing on the full breadth of EM opportunities is necessary to identify idiosyncratic country stories, which can drive performance and add diversification to portfolios.

For every country like Turkey, where heterodox policy is cause for concern, there are lesser known and overlooked EM success stories, such as Egypt and Ukraine.

As a case in point, Egypt is set to relist on the J.P. Morgan Govt. Bond Index-EM (GBI-EM) Global Diversified at the end of January in recognition of the country's efforts to simplify access to its local bond market.

Ukraine is another GBI-EM candidate for inclusion later in the year. While the country's leadership has done much to strengthen the economy and public finances, it must be noted that external risks emanating from a retaliatory Russia complicate the picture.

Bottom line: We remain cautiously optimistic in our outlook for 2022, given the still favorable backdrop for global growth as well as EM debt valuations – which are particularly attractive in the local rates segment. That said, several macro risks remain and should be monitored closely. As ever, we believe that the best opportunities are to be found at the country level, where broader macro risks can be mitigated by tapping into unique and differentiated performance drivers.

Risk Considerations

Investing entails risks and there can be no assurance that any strategy will achieve profits or avoid incurring losses.

Emerging Markets Debt - 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. 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.

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Date-of Data: As of December 27, 2021.

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