Outlook on

Emerging Markets

OCT 2022

Summary

- The stronger US dollar, higher inflation, and tighter financial conditions weighed on emerging markets equities in the third quarter. Looking ahead, we are watching elections in Brazil and the National Communist Party Congress in China in October for signs of policy direction.
- We believe this is an attractive entry point for emerging markets equities: Valuations are attractive relative to history and to developed markets; profitability, free cash flow, and dividend yields have all moved higher; and earnings growth is expected to recover in 2023.
- Emerging markets debt suffered a fifth consecutive quarter of negative returns, and the blended asset class is now well into its worst-ever drawdown. However, bottom-up fundamentals are generally solid, valuations are attractive, and investor positioning is light.
- With recession warning signs flashing, we are currently positioned very conservatively in emerging markets debt. We have reduced US interest rate duration and moved up in credit quality as we await better entry points to increase risk.

Equity

In the third quarter, the MSCI Emerging Markets (EM) Index finished down more than 11%, bringing the year-to-date decline to 27%. By comparison, the developed markets MSCI World Index declined 6% in the most recent quarter, bringing this year's decline to 25%. The stronger US dollar, higher inflation, and tighter financial conditions have weighed on emerging markets equities. Additionally, Russia's war on Ukraine passed the six-month mark, and relations between the United States and China came under greater strain as both countries tried to secure their supply chains and worries over Taiwan intensified.

From a regional perspective, Latin America led Europe, the Middle East, and Africa (EMEA), as well as Asia. While Turkey led all markets following its 7.6% year-over-year growth in GDP in the second quarter, higher commodity prices supported countries like Brazil, Chile, Qatar, and Saudi Arabia. However, China, the only country in positive territory in the second quarter, finished at the bottom of the pack as increasing local economic troubles as well as geopolitical tensions weighed on share prices. From a sector perspective, energy, utilities, consumer staples, and financials led the way, while real estate, communication services, consumer discretionary, and information technology lagged.

The price of oil also declined sharply, from around US$120 per barrel in June to near US$90 in late September. Russia, whose 2022 budget surplus significantly deteriorated in the third quarter, had to discount its oil further to encourage new buyers, such as India, China, and Turkey, to purchase barrels that would previously have gone to Europe. The ban by the European Union (EU) on shipped Russian crude imports is expected to come into effect in December.

Looking ahead to the fourth quarter, developments in two major emerging markets will influence policy and performance to come: Brazil, with a presidential run-off election at the end of October; and China, where President Xi Jinping is set to preside over the country's 20th National Communist Party Congress in mid-October amid still-rising tensions with the West.

As Brazilians were preparing to vote in the presidential elections, the decline in the quality of life was at the forefront of their minds.

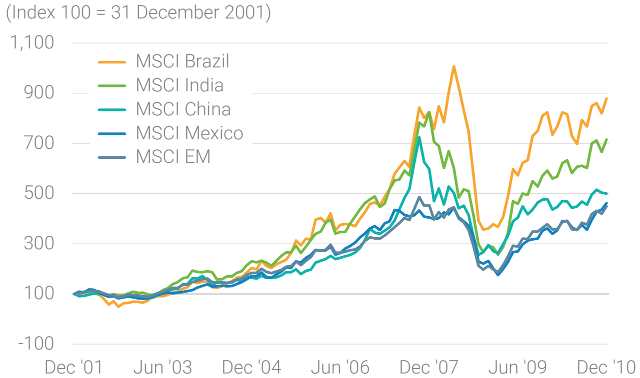
Brazil: Lula's Return or Bolsonaro's Second Term?

Going into Brazil's elections, the main issues seemed to be first, the economy—inflation, unemployment, and concern over the potential for an economic crisis—and second, social issues, such as hunger, poverty, and housing. According to pollster Genial/Quaest, economic concerns ranked highest at 37%, followed by social issues at 20% and health care at 16%. Corruption and security, two issues on which the conservative incumbent, President Jair Bolsonaro, was polling strongest, were at the bottom of voters' priorities. Furthermore, voters with negative sentiments about their own and the country's economic condition outnumbered those with positive feelings. The likely reason was that real and disposable income have not yet recovered to pre-COVID-19 levels.

As Brazil heads into the second round of voting, what can we expect from each candidate?

Leftist former President Luiz Inácio Lula da Silva ("Lula"), who took 48% of the vote in the first round on 2 October but lacked the simple majority needed to win, looks to be in a better position if the run-off boils down to who can more credibly promise a better economic future that addresses social pain points. His main asset is his association with good economic times and caring for the poor. During Lula's two terms in office from 2003–2010, he presided over an economy with exposure to the commodity super-cycle that propelled returns in Brazil above those of China, India, Mexico, and the broader MSCI EM Index (Exhibit 1).

Exhibit 1
Brazil and Lula Rode the Commodity Super-Cycle Wave



As of 30 September 2022
Source: MSCI

On the other hand, Brazil's economy is currently outperforming expectations, which could translate into votes for Bolsonaro, who received 43% of votes in the first round. Average growth forecasts for 2022 went from 0.3% in January to 2.1% and will likely push closer to 3% following strong data for the second quarter. Meanwhile, inflation seems to be moderating, with levels coming down in July and August. Finally, unemployment has declined to 9.1% from a 14.9% high in January. Along with an increase in the cash transfer Auxilio Brasil social welfare program, Bolsonaro's administration is banking on these improvements translating into enough votes to outpace Lula.

The policy views of the two candidates diverge, especially on the fiscal side (Exhibit 2). Bolsonaro's proposals suggest a continuation of his current economic agenda: a liberal approach, continuity of the fiscal adjustment, privatizations, and a reduction of the state's role. On the other end of the spectrum, Lula's proposals and economic messages point to a bigger role for the state, use of public banks to fuel economic growth, change of the spending-cap fiscal rule, and a pull-back in privatizations.

The two also differ on environmental policy. Under Bolsonaro, deforestation of the Amazon, Brazil's leading driver of greenhouse gas emissions, has soared to a 15-year high. During Lula's terms, Brazil reduced its deforestation rate by more than 70%. However, for any conservation effort to prove successful, it must not only fight illegal logging but also offer economic alternatives to the deforesters. Lula has pledged to combat environmental crimes, work toward net-zero deforestation, and meet Brazil's emissions-reduction targets set out in the Paris Agreement. While he has voiced support for the idea of energy transition, Lula has also pledged to expand drilling and refining of oil and gas to maintain "energy security."

Should Lula defeat Bolsonaro in the second-round run-off on 30 October, many wonder whether Bolsonaro will accept the result or cry election fraud, particularly if Lula wins by a narrow margin. Whatever the outcome, the next president could enjoy the benefits of a better economy as more robust economic activity, lower unemployment, and lower inflation could reduce pressure for a more expansionary fiscal program.

China: COVID Policy and Lower Growth

At China's 20th Communist Party Congress—slated to begin on 16 October—President Xi Jinping is expected to officially secure an unprecedented third five-year term. The event should also reveal China's broad policy direction, including the next leadership lineup, although it is unlikely that Xi will announce a potential successor at the congress. Thus far, no apparent political heir has emerged, which is likely by design as it allows Xi to preserve his influence. To further cement his rule, at the National People's Congress in March 2023, legislators are expected to reappoint Xi as state president and vote on the new premier to succeed Li Keqiang, as well as other senior government officials.

While China's zero-COVID policy has clearly been a drag on the country's economic growth, a dramatic shift away from the policy during this five-month leadership transition is unlikely. For Xi, the political and health costs of a severe outbreak significantly outweigh any foreign or domestic discontent with the policy. When the leadership transition is completed in March of next year, China should be in a better position regarding vaccination of the elderly and treatment stockpiles. However, delays on these efforts remain possible, which could prolong the commitment to zero-COVID and potentially delay an economic recovery.

In a bid to shore up confidence and counter slowing economic growth, in the third quarter, China announced an additional ¥1 trillion (US$146 billion) of economic stimulus, largely focused

Exhibit 2

Bolsonaro vs. Lula: Policy Proposals Diverge, Especially on Fiscal Policy

	Bolsonaro	Lula
Spending Cap	▪ Sustain public debt via fiscal adjustment policies ▪ Introduce a public debt target	▪ Prioritize low-income population in budget ▪ Current spending cap to be revoked/adjusted
Privatizations	▪ Reduce state via privatization of state-owned companies' infrastructure concessions, public-private partnerships	▪ Promote state and state-owned enterprises (SOEs) as inducers of economic growth ▪ Halt privatizations ▪ Propose a new fuel and gas pricing policy ▪ Nationalize Eletrobras to use as a tool for tariff-reduction policies
Tax Reform	▪ Simplify tax system ▪ Focus on progressive taxation ▪ Reduce taxes ▪ Expand income tax brackets by 31%	▪ Simplify tax system to reduce consumption taxes ▪ Focus on progressive taxation ▪ Improve taxation over international trade ▪ Exempt products with greater added value and embedded technology
Social Policies	▪ Maintain Auxilio Brasil at BRL600/mo ▪ Expand social assistance program (SUAS) ▪ Create regional program to foster regional socioeconomic development	▪ Raise minimum wage ▪ Rebuild and strengthen SUAS ▪ Renew Bolsa Familia program ▪ Create access-to-housing program ▪ Rebuild social security for broad inclusion of workers ▪ Fight hunger and poverty
Fiscal Policies	▪ Reduce federal and state taxes ▪ Foster open trade policies ▪ Reduce national corporate taxes ▪ Promote 50% reduction in import taxes	▪ Ensure strong public investment program in infrastructure and housing ▪ Strengthen agriculture sector production ▪ Prioritize national, public, and private companies via financing, government purchases, and investment ▪ Reindustrialize via higher public and private investment, lower credit cost, reversal of denationalization
Environmental Sustainability	▪ Make sovereignty of national territory key factor in participation in international initiatives ▪ Develop regional solutions for sustainable development ▪ Issue green bonds ▪ Strengthen control of illegal fires, deforestation, and environmental crimes ▪ Promote land regularization and concession of forests to private sector	▪ Strengthen fight against climate change via sustainable production/consumption ▪ Support an inclusive green economy ▪ Encourage activities with lesser ecological impact ▪ Meet carbon gas emission reduction targets assumed by Brazil at 2015 Paris conference ▪ Fight environmental crimes, illegal deforestation, and predatory use of natural resources ▪ Follow zero net deforestation policy

As of 30 September 2022

Source: HSBC, presidential candidates' governmental plans

on infrastructure spending. China's State Council also unveiled a 19-point policy package, including another ¥300 billion (US$44 billion) in credit support for state-owned banks to invest in infrastructure projects, on top of the ¥300 billion announced at the end of June. Local governments will be allocated ¥500 billion (US$73 billion) of special bonds from previously unused quotas.

These stimulus efforts harken back to the days of investment-driven growth and the Global Financial Crisis. Policy leaders are trying to walk an economic tightrope, unveiling government stimulus and looser monetary policy to moderate slowing growth, while avoiding taking on much more debt. Although Beijing set this year's growth target at about 5.5%, the lowest in three decades, a weak property sector and headwinds from local COVID-19 outbreaks suggest growth will likely be lower. By some estimates, real estate drives approximately one-third of China's economic activity, and housing represents about 70% of household wealth, making it the most important investment for Chinese citizens.

Tensions and Relief Valves

For China, the third quarter has also been marked by greater tensions with the United States and Taiwan, and we expect further strain ahead. China stepped up its military exercises close to Taiwan following US Speaker of the House of Representatives Nancy Pelosi's visit in August, and any future foreign shows of support for Taiwan will likely also bring stronger military responses than in the past.

Although China is unlikely to regularly conduct missile tests near Taiwan, or routinely close nearby waters to commercial traffic as it did in August, such actions will probably become less unusual. Beijing may also choose to pursue political interference in Taiwan; boycott substitutable Taiwanese exports and imports; and sanction Taiwanese and other foreign politicians, NGOs, and businesses that it deems supporters of "Taiwan independence."

The strained relations between the United States and China have negatively affected, to varying degrees, the prospects for progress on key bilateral issues such as Chinese export tariff relief, climate change mitigation, technology competition in advanced chip manufacturing, and the overall ease of doing business in China. Key mile-markers to come that we think may signal a deterioration or improvement in US–China relations include China's response to upcoming US freedom-of-navigation operations in the Taiwan Strait, China's language about Taiwan during the 20th Party Congress, a presidents' meeting at the G20 summit in November, and the evolution of the Taiwan Policy Act in the US Congress (see below).

One positive development between the United States and China during the third quarter was a preliminary agreement to permit American auditors to inspect the records of US-listed Chinese companies. The news came amid an ongoing saga between regulators, which has led to great uncertainty over the future of more than 200 US-listed Chinese companies and even the potential delisting of some Chinese stocks. Currently, the US Holding Foreign Companies Accountable Act of 2020 requires that a registered public accounting firm issue an audit of foreign companies' branch offices in the United States. This conflicts with Beijing's stance, which bars foreign inspection of audit documents from local accounting firms due to concerns over national security. Under the new agreement, China will allow the Public Company Accounting Oversight Board access to audit working papers and personnel of US-listed companies.

While the agreement is encouraging, many Chinese companies since the end of 2019 have sought listing status in Hong Kong, via either a secondary listing or a dual primary listing. Additionally, many investors have already started to convert their US-listed Chinese ADRs to Hong Kong shares, which has resulted in a gradual shift in the market capitalization breakdown of Chinese equities to more A-share, or mainland-listed, and Hong Kong focused (Exhibit 3). We would expect to see more of these "homecoming" listings over the coming year.

Furthermore, Chinese initial public offerings (IPOs) in the US market have dried up, particularly in the second half of 2021 and the first half of this year. Amid escalating US-China tension, the mainland A-share and the Hong Kong equity markets are likely to play dominant roles in the equity fund-raising needs of Chinese companies going forward, while the role of the US equity market could dwindle.

US Legislation Adds to Tensions

During her visit to Taiwan, Pelosi met with Mark Liu, chairman of Taiwan Semiconductor Manufacturing Company (TSMC), the world's largest chip manufacturer. The company supplies more than 90% of the world's most advanced chips and is a vital supplier to the United States and other Western nations. On the agenda was the recently passed CHIPS and Science Act, which provides US$52 billion of US federal subsidies and tax credit for global chip manufacturers that establish or expand operations in the United States. The bill specifies that semiconductor producers accepting American subsidies would not be able to expand advanced (defined

Exhibit 3
Chinese Companies Are Increasingly Relying on Home Markets for Capital

Left Chart: As of 30 June 2022

Source: Bloomberg, FactSet, Morgan Stanley Research, Wind

Only exchange-traded Chinese companies with primary listing in the US are counted under US-Listed Chinese stocks (US traded market cap only). Market cap for companies listed in more than one market is not double counted.

Right Chart: As of 30 June 2022

Source: CEIC, FactSet, HKEX, Morgan Stanley Research, Shanghai Stock Exchange, Shenzhen Stock Exchange

as circuits smaller than 28 nanometers) chip manufacturing in China for 10 years. In focusing US restrictions on newer generations of semiconductors, however, the legislation could leave the door open for China to dominate the production of older chips that are used in cars and other consumer products.

While US strategy is leaning toward containing China by blocking off access to the resources needed to develop advanced semiconductors, Xi will likely emphasize the sense of urgency and renew the commitment for China to step up the development of its homegrown chip industry, making it self-sufficient in critical technologies. Chinese leadership has emphasized self-reliance for some time, including the introduction last year of a policy called "dual circulation," which focuses on growing exports while also expanding domestic demand through rising consumption, with the two reinforcing each other.

Taiwan Policy Act

Attempting to remove ambiguity over US strategy on Taiwan, in September the US Senate Foreign Relations Committee approved the Taiwan Policy Act (TPA), legislation that would provide US$4.5 billion in weapons and security assistance to Taiwan for the next four years. The bill, which aims to reshape relations with Taiwan and deter any attack by China, formally designates Taiwan as a major non-NATO ally, and compels the United States to impose sanctions on big Chinese financial firms in response to any hostile actions in or against Taiwan. The TPA would also create a US$2 billion loan facility, allowing Taiwan to buy more weapons and make it eligible to participate in a war reserve stockpile program, and it would amend the 1979 Taiwan Relations Act to say that Washington must provide weapons to Taiwan to help it implement a strategy "to deny and deter acts of aggression" from China. The bill still requires a vote in the full Senate and House, and lawmakers could possibly insert it into another big piece of legislation, such as the National Defense Authorization Act.

Why Emerging Markets Now?

For investors, the steep drop in equity markets so far this year may raise the question of where to find value and long-term opportunity. Below are several reasons we believe emerging markets to be one of the most mispriced asset classes, with valuations at some of their most attractive levels ever.

- Demographic and urbanization trends should provide supportive tailwinds for long-term growth.
- Though growth has slowed, emerging markets continue to trade with an economic growth premium over developed markets.
- Emerging markets central banks raised rates before their developed markets counterparts, and the same may prove true when it comes time to cut rates.
- We believe this is an attractive entry point: Valuations remain attractive vs. history and developed markets; profitability, free cash flow, and dividend yields have all moved higher, and earnings growth is expected to recover in 2023.

Emerging markets investment returns have historically been closely tied to the rise and fall of commodities prices and global growth expectations. Over the past 20 years, however, emerging markets equities have evolved, serving as a source of ever-changing investment opportunities. Liquidity has deepened, and investor interest has steadily increased. Yet, the asset class remains under-owned. Demographic trends and urbanization are supportive long-term tailwinds that can accelerate growth for the asset class. With a growing middle class comes a consumer that is younger, increasingly more educated, and a faster adopter of new technology, with constant changes in consumption patterns and preferences.

Although economic growth forecasts globally have declined over this year due to the effects of the pandemic, the Russia-Ukraine war, and tighter financial conditions to combat inflation, emerging markets equities are still trading with an economic growth premium over those of developed markets. There are reasons to expect higher economic growth going forward: Barring a major global recession, we are likely to enter a period of gradual economic recovery, helped by a combination of infrastructure spending, particularly on energy in Europe, and increasing capital expenditures in developed countries.

At the same time, inflation—and rate hikes—may be peaking in emerging markets countries. The Central Bank of Brazil was the first major emerging markets central bank to begin raising rates last year, leading central bankers across Indonesia, South Africa, the Philippines, Mexico, Korea, and the developed world to tighten policy. While an environment of higher rates to combat inflation is likely with us for the near future, Brazil's central bank recently hinted that rates may have peaked. That is welcome news for investors, especially as other emerging markets central banks may not be far behind.

The current environment, characterized by high commodity prices, has boosted the terms of trade and improved foreign exchange reserves and external balances in many emerging markets. Several countries have undertaken key economic reforms in recent years, and as a result, they may be able to achieve a more stable and higher level of growth and improved fiscal performance. With floating exchange rate regimes and generally more transparent monetary and fiscal policy, they are also less likely to suffer the boom-bust phenomenon that was a feature of emerging markets a couple of decades ago.

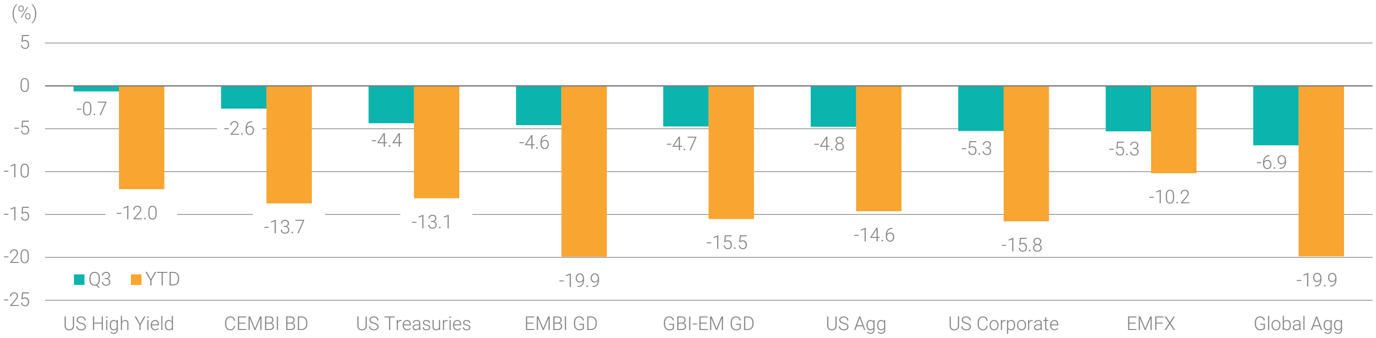
Much capital has left emerging markets in recent years, and many parts of the asset class are under-owned and attractively valued as a result. Overall, emerging markets equities are among these attractively valued assets, with relatively high profitability, or return on equity, free cash flow, and dividend yields. A diverse opportunity set, numerous fundamental drivers, and persistent market inefficiencies make the asset class ripe for alpha generation through active management.

Debt

Like the equity markets, fixed income markets were weighed down by a confluence of factors in the third quarter. For bonds, these included stubbornly high inflation, aggressive central bank tightening, Europe's energy crisis, repeated lockdowns in China, and controversial fiscal policy decisions in the United Kingdom. The rise in bond yields this year has reached historic proportions, creating an abysmal period for fixed income investors (Exhibit 4).

The yield on the Bloomberg Global Aggregate Index has risen nearly 250 basis points (bps) over the past nine months, the steepest and largest rise in the history of the index, exceeding even 1994's epic rise. Equally

Exhibit 4
Global Bond Market Rout Continued in the Third Quarter



As of 30 September 2022
Source: Bloomberg, JPMorgan

unprecedented is the breadth of the drawdown: All corners of the fixed income market have been affected. For the Global Aggregate, more than a decade of returns have been completely unwound in 2022.

The third quarter didn't start out that way. Early on, market participants actually scaled back their expectations of rate hikes from the Fed. However, consistently hawkish comments from Fed officials and August's higher-than-expected US inflation print quickly dashed these hopes. Attention shifted back to the willingness of the Fed and other central banks across the globe to tolerate higher rates for longer to contain inflation, even at the expense of weaker growth. In the final weeks of the quarter, the UK government announced sweeping tax cuts that threw gasoline on the fire, reigniting a sell-off across both fixed income and equity markets and helping to drive the US dollar to fresh all-time highs. The Bank of England quickly responded with an emergency bond-buying program, which helped bring at least a temporary calm to financial markets.

Emerging markets debt was swept up in this storm. Both hard and local currency debt markets suffered a fifth consecutive quarter of negative returns, and the blended asset class is now well into its worst drawdown ever. Since the start of 2021, the asset class has lost 25% of its value. By way of comparison, the peak loss during the Global Financial Crisis in 2008 was around 21%, although that decline was much swifter, occurring over only three months.

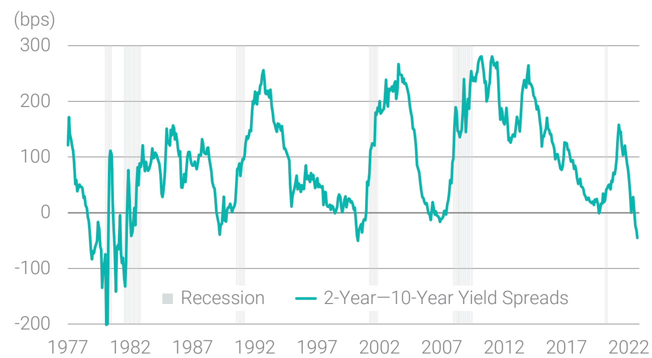
Third-quarter losses in hard currency debt were driven almost entirely by rising US Treasury yields. Spreads were volatile, trading in a range of 470–600 bps, but ultimately ended the quarter close to where they began, in the neighborhood of 550 bps. In local currency debt, the rise in yields was not as intense as in developed markets, but returns were further weighed down by spot depreciation in emerging markets currencies against record strength in the US dollar.

That said, emerging markets currencies have exhibited remarkable resilience compared with developed markets currencies such as the yen and euro. Thus far in 2022, emerging markets currencies are down around 10% versus the dollar, while developed markets currencies are down around 18% against the US currency. This relative strength is likely due to several factors, including aggressive and proactive central bank rate hikes in emerging markets, already cheap valuations, and light investor positioning as a result of significant fund outflows.

Recession Warning Signs Flash

As we headed into the final quarter of 2022, the warning signs of a recession were beginning to flash brighter. An inversion of the US yield curve is widely recognized as one of the most reliable predictors of a recession, and the inversion deepened over the third quarter. The 2-year US Treasury yield rose to more than 4.3% for the first time in more than 15 years; its nearly 3.5% yield increase over 2022 is also

Exhibit 5
Recessions and US Treasury 2-Year–10-Year Yield Spreads

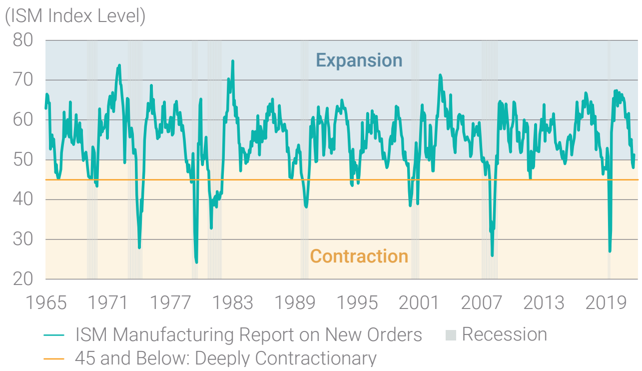


As of 30 September 2022
Source: Lazard, Bloomberg

on par with the historic rise of 1994. Meanwhile, the 10-year US Treasury yield, despite having breached 4% for the first time since 2008, was yielding around 40 bps less than the 2-year at the end of September. The inversion between these two nodes on the yield curve reached as much as 58 bps during the third quarter, marking the deepest inversion since the 1980s (Exhibit 5). Nevertheless, it's

important to keep in mind that while an inverted yield curve is a strong signal that recession looms, it tells us nothing about the timing, length, and severity of an oncoming recession.

Exhibit 6
Recessions and ISM Manufacturing Report on New Orders



As of 30 September 2022
Source: Lazard, Bloomberg, Institute of Supply Management

A second highly reliable leading indicator of recession is the ISM Manufacturing Report on Business New Orders. This measure is a diffusion survey that tracks sentiment among purchasing managers, meaning that respondents simply indicate whether they are optimistic or pessimistic. A level below 50 indicates overall expectations of contraction, and we find that a reading in deep contractionary territory—which we generally define as 45 or below—tends to be a strong leading indicator that a recession is likely soon (Exhibit 6). While the index was slightly above 50 at the end of the third quarter, it dipped into contractionary territory in June and July, so we have been closely monitoring it to gauge recession risk.

While resilient labor market data suggest the US will likely skirt recession this year, it is likely that the Fed's actions to bring down inflation will eventually induce a recession some time in 2023. Meanwhile, the other regions across the globe are facing severe downturns in synchrony. A European recession appears imminent as the continent is mired in an energy crisis at a time when it is already facing double-digit inflation, slowing growth, and a tightening cycle from the European Central Bank. Meanwhile, China's growth for 2022 is likely to come in around 3%, well below the government's target of 5.5%, amid ongoing lockdowns related to COVID-19 and an ailing property sector.

This backdrop is likely to result in tighter financial conditions overall and further US dollar strength, both of which would be headwinds for emerging markets and raise the risk of further capital outflows.

Yet Fundamentals Are Strong

In contrast to the macroeconomic environment, bottom-up fundamentals generally have looked solid in emerging markets. That said, there is a high degree of differentiation between individual countries.

Most higher quality countries have the balance sheet strength and access to capital to withstand a prolonged slowdown. Within this cohort, fiscal and current account balances have improved, while debt ratios have receded from recent peaks. Although foreign reserves have declined across most countries, in part because of capital outflows, they remain at comfortable levels. Additionally, commodity-exporting countries have benefited from improved terms of trade.

On the other hand, lower-rated and distressed credits are highly vulnerable to slowing growth and tighter financial conditions. Moreover, most of these countries suffer from one or more of these ailments: significant financing needs with limited access to capital, political instability, poor or unorthodox economic policy, and weak environmental, social, and governance (ESG) characteristics. Turkey and Egypt are two examples that tick several of these boxes. While only a handful of countries are at high risk of default, we expect default rates to remain elevated. Four sovereigns have already defaulted this year, and Ghana recently initiated discussions with bondholders to restructure its local debt.

Similarly, emerging markets corporate balance sheets on the whole remain resilient. Inflationary pressures and central banks hiking rates into a slower global growth environment are expected to lead to falling revenues, rising input costs, and narrowing profit margins for many companies. However, most corporates are entering this period from a position of balance sheet strength, which should allow them to weather the storm without material credit deterioration.

Leverage has decreased from 2020 levels across all regions, with net leverage falling to around 1.5x, which is well below that of developed markets peers. Moreover, some companies, such as commodity producers, may in fact benefit from higher inflation. Thus, we would not expect a mild slowdown to push leverage to uncomfortable levels. Additionally, the corporate market has very little exposure to the stressed sovereigns in frontier markets, which are the most vulnerable due to fragile economies and concerns over debt sustainability. This is not to say that there are not areas of concern in the corporate space. China's property sector remains in distress, but its problems should be relatively well contained.

How We Are Weathering the Storm

We are currently positioned very conservatively across portfolios and expect to remain so for at least the remainder of 2022. Our defensive positioning is much more a reflection of the challenging macro environment than significant concerns around bottom-up fundamentals and valuations. We recognize that a lot of negative news has already been priced in and valuations across emerging markets debt are discounted, both on a stand-alone basis and relative to other segments of the credit market. However, we expect the markets to move deeper into value territory and re-price to reflect a high likelihood that continued rate hikes will induce a recession.

Over the past quarter, we reduced US interest rate duration and have rotated higher in credit quality as we focus on stable and safe sources of carry to weather the storm and await better entry points to increase risk. We are highly selective and favor high quality investment grade

countries, such as Uruguay and Qatar, as well as certain BB rated credits, such as Côte d'Ivoire. We also continue to favor BB rated corporates that offer an attractive combination of strong balance sheets, attractive yield, and short duration.

In local debt, we selectively favor duration in countries that are near or have reached the end of their tightening cycle, such as Brazil, as well as favorable idiosyncratic stories, such as South Africa. With respect to currency positioning, we continue to have minimal active risk because dollar strength is likely to remain a considerable headwind in the near term. Overall, we believe a conservative stance is warranted until we see clear signs that the storm has passed.

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