Commentary
Fixed Income

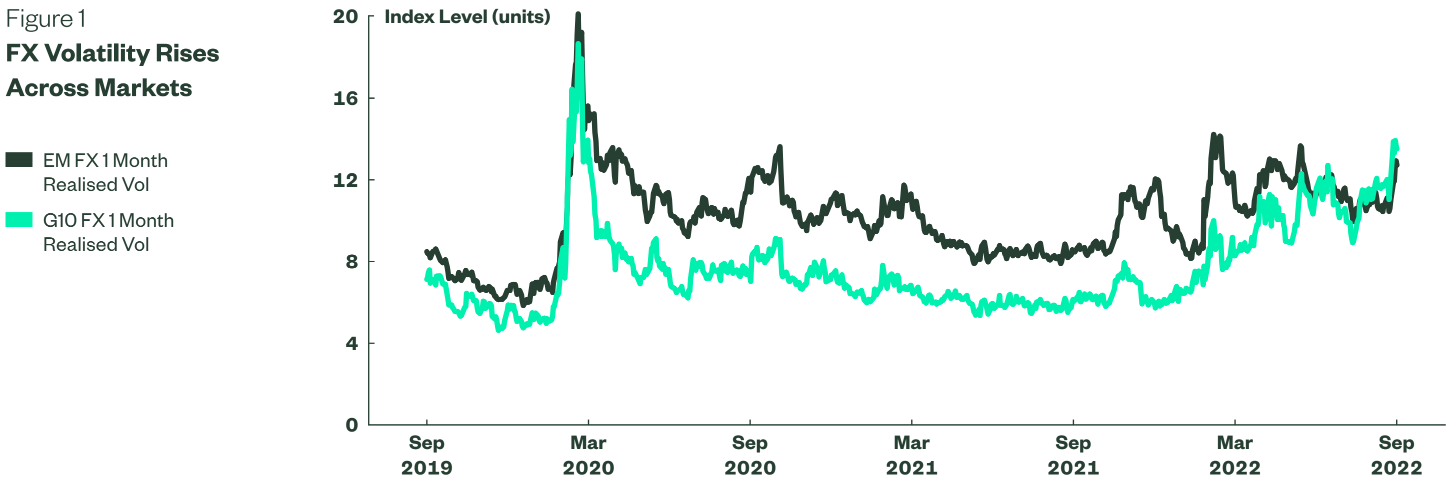
Q3 2022

Emerging Market Debt Market Commentary

Chart of the Month: Heightened FX Volatility in Developed Markets

In a reversal of long-standing roles, emerging market currencies have proved less volatile in recent months than their developed market counterparts. Indeed, developed market FX volatility hit levels not seen since the depths of the COVID crisis.

Figure 1
FX Volatility Rises Across Markets



Source: Bloomberg Finance L.P., JP Morgan as of 30 September 2022. Past performance is not a reliable indicator of future performance.

EMD Commentary — Q3 2022

Emerging market debt (in USD terms) had a volatile and ultimately negative third quarter amid extreme volatility across markets, as seen even in core rates and G10 foreign exchange movements (see Figure 1). A more hawkish stance from the US Federal Open Market Committee (FOMC) in its September meeting contributed to a sell-off of major risk assets, as did surprisingly expansive fiscal plans presented by the new UK government which met an adverse reaction from the UK Gilt market — this resulted in some contagion across developed market rates and prompted the Bank of England to intervene. Furthermore, fears of a halt to gas shipments from Russia to Europe through the Ukrainian pipeline also weighed on sentiment. Rising yields and a preference for 'safe haven' assets led to a strong US dollar, an outcome that has proven to be a dangerous mix for EM — there was significant FX weakening and an increased risk of default among frontier countries. A tentative turn in EM hard currency flows in August proved short-lived, with September seeing -$7.0 billion of outflows. There were -$3.2 billion of outflows in EM local currency as investors took cognizance of the increasingly fragile outlook for vulnerable EMs due to the presence of a number of external shocks and idiosyncratic factors. This took year-to-date flows to -$36.3bn in HC and -$33.7bn in LC, according to JP Morgan.

Figure 2
Emerging Market Debt Index Returns — As of 30 September, 2022

	1m (%)	3m (%)	6m (%)	YTD (%)	12m (%)	3yrs (%)	5yrs (%)
In USD							
GBI-EM GD (EM Local Currency)	-4.87	-4.73	-12.95	-18.57	-20.63	-7.06	-3.92
EMBI GD (EM Hard Currency)	-6.36	-4.57	-15.48	-23.95	-24.28	-7.15	-2.62
CEMBI BD (EM Corporates)	-3.83	-2.64	-8.11	-16.21	-16.73	-2.54	0.29
In EUR							
GBI-EM GD (EM Local Currency)	-2.36	1.67	-1.13	-5.47	-6.11	-3.69	-0.24
EMBI GD (EM Hard Currency)	-3.89	1.84	-4.00	-11.72	-10.43	-3.78	1.11
CEMBI BD (EM Corporates)	-1.28	3.90	4.36	-2.74	-1.48	1.00	4.13
In GBP							
GBI-EM GD (EM Local Currency)	-0.84	3.65	2.68	-1.20	-4.13	-3.95	-0.32
EMBI GD (EM Hard Currency)	-2.40	3.82	-0.31	-7.72	-8.55	-4.04	1.03
CEMBI BD (EM Corporates)	0.25	5.92	8.38	1.66	0.58	0.73	4.04

Sources: State Street Global Advisors, Bloomberg, JP Morgan as of 30 September, 2022. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Performance returns for periods of less than one year are not annualized.

Figure 3
Key EM and Macro levels as of 30 September, 2022

Item	Δ 1 Month	Δ 3 Months	Δ YTD	Current Level
GBI-EM GD Yield	43 bps	25 bps	160 bps	7.31%
EMBI GD Yield	120 bps	101 bps	428 bps	9.57%
EMBI GD Spread	58 bps	17 bps	191 bps	559 bps
CEMBI BD Yield	95 bps	86 bps	336 bps	7.95%
CEMBI BD Spread	34 bps	1 bps	93 bps	406 bps
CDX.EM 5y	4 bps	-8 bps	144 bps	331 bps
10y UST	64 bps	82 bps	232 bps	3.83%
Dollar Index (DXY)	3.14%	7.10%	17.19%	—
DOW 30	-8.84%	-6.66%	-20.95%	28726
Oil (WTI)	-11.23%	-24.84%	5.69%	$ 79.49

Source: JP Morgan, Bloomberg Finance L.P., as of 30 September, 2022. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

Local Currency Market Highlights

EM local currency debt returned -4.73% in USD terms in Q3, as measured by the JP Morgan GBI-EM Global Diversified Index. Most of the underperformance occurred in September and in the FX segment, with high beta and currencies sensitive to tighter financial conditions weakening more. Significant US dollar strength has also led to instances of FX intervention by some EM central banks such as the Philippines. Differentials in performance between countries have generally been related to inflation expectations and vulnerability to geopolitical risks. Larger Latin American (LatAm) countries have held up relatively better as growth has been quite resilient in the region on domestic demand and positive terms-of-trade, in contrast to the experience of the majority of the world. Vulnerabilities arising from energy dependence on Russia substantially contributed to Central and Eastern Europe (CEE) ex-Turkey underperformance.

Figure 4
Key Return Drivers of EM Local Government Bond Markets

GBI-EM GD (EM Local Currency)	Monthly Return (%)	3 Month Return (%)	YTD Return (%)
In USD			
Total Return (in $)	**-4.87**	**-4.73**	**-18.57**
FX Return (vs $)	-3.37	-5.33	-9.23
Price Return (Local currency)	-1.98	-0.77	-13.10
Interest Return (Local currency)	0.47	1.38	3.76
In EUR			
Total Return (in €)	**-2.36**	**1.67**	**-5.47**
FX Return (vs €)	-0.85	1.07	3.87
In GBP			
Total Return (in €)	**-0.84**	**3.65**	**-1.20**
FX Return (vs €)	0.66	3.05	8.14

Sources: State Street Global Advisors, Bloomberg, JP Morgan as of 30 September, 2022. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Performance returns for periods of less than one year are not annualized.

Figure 5
Best and Worst Performers Across EM Local Government Bond Markets in USD*

Q3 2022	Country	Total Return USD (%)	Bond Return (%)	FX Return (%)	Index Weight (%)	Index Impact (bps)**
GBI-EM GD		**-4.73**	**0.62**	**-5.35**	—	—
Top 5 Performers	Turkey	20.0	33.3	-13.2	1.1	22
	Dominican Republic	5.1	2.8	2.3	0.1	1
	Brazil	1.7	5.2	-3.5	10.0	17
	Mexico	-0.4	-0.7	0.3	10.0	-4
	Indonesia	-1.7	0.5	-2.2	10.0	-17
Bottom 5 Performers	Poland	-8.0	1.1	-9.1	6.8	-54
	South Africa	-8.4	0.5	-8.9	10.0	-84
	Philippines	-10.8	-4.9	-5.9	0.1	-1
	Colombia	-12.1	-2.9	-9.1	4.3	-52
	Hungary	-18.7	-7.5	-11.2	2.8	-52

Source: State Street Global Advisors, Bloomberg, JP Morgan as at 30 September, 2022. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. * Country and currency performance of JP Morgan GBI-EM Global Diversified Index. **Index impact is calculated by multiplying the period average weight by total return.

Hungary and Poland underperformed in the quarter. Even though the CEE central banks are signaling an end to the tightening cycle, they remain vulnerable to high inflation, tight financing conditions, and are exposed to gas prices. Market participants expect Hungary's year-on-year inflation rate to exceed 20% in early 2023 (from 15.6% in August) — the partial unwind of the energy price cap for households from September, the pass-through of sectoral taxes, and the continued effect of HUF depreciation are expected to drive the rate higher. Progress towards resolving the EU's conditionality mechanism represent a risk, as delays could mean loss of access to EU funding and put Hungary at risk of a balance of payments crisis. Poland also underperformed as the market priced in fiscal risks from potential spending pledges in the 2023 election campaign, and on expectations that inflation would stay above the central bank's target tolerance through 2023, partly driven by strong domestic demand and a labour market that is still tighter than before COVID.

Colombia underperformed on the back of an unexpectedly dovish signal from its central bank, which increased rates by 100 bps in its September policy meeting, a smaller hike than in previous meetings. This has put pressure on the COP, with the currency already facing significant pressures amid the country's large current account deficit. Given an apparently reduced inclination on the part of the central back to raise rates (at least at the previous pace), a more hawkish US Federal Reserve must be adjusted for through a weaker FX.

South Africa was also among the underperformers, mostly due to FX effects. On top of a general risk-off sentiment, investors bracing for more economic weakness resulting from the incessant power outages that are expected to lead to a decline in mining, manufacturing and construction activity. In a statement, Eskom — the country's monopoly power generator — said they had started to implement Stage 6 power cuts, which will likely lead to an unprecedented level of blackouts.

Turkey was the best performer, with gains driven entirely by local rates following another policy rate cut of 100 bps in September. This followed August's 100 bps cut and took the benchmark rate down to 12%. Even as this cycle of rate cuts is maintained, the country retains tight macroprudential measures in place that help slow loan growth, including caps on selected commercial loan rates as a function of its policy rate. Significant risks remain though, as the large current account deficit and external financing needs continue to put pressure on the Turkish lira, while energy imports continue to be high.

Brazil's monetary policy committee kept the Selic rate at 13.75%, observing that it will evaluate the cumulative effects of the aggressive tightening to date and remain vigilant to ensure inflation convergence around the target over the relevant time horizon. Market participants indicated a belief that the tightening cycle is complete for now and expect the central bank to leave rates stable over the medium term. There was also a downside surprise from food and transportation prices that eased inflation pressures, with the annual IPCA-15 inflation rate declining to 7.96% from 9.60%. Markets did not seem particularly concerned ahead of the general election on October 2, as both candidates (former President Lula and incumbent President Bolsonaro) will face the same fiscal obstacles in the 2023 budget.

Hard Currency Market Highlights

EM hard currency (HC) sovereign debt delivered a return of -4.57% in Q3, as measured by the JP Morgan EMBI Global Diversified Index. While spread widening was relatively mild at 17 bps, a sharp sell-off in underlying rates as markets moved away from expectations of a more dovish Fed led to yields increasing by about 110 bps. Silver linings from the still high commodity prices (albeit off their highs) and positive supply in EM HC sovereigns have been overshadowed by the more hawkish tone from the Fed, negative developments in Europe, as well as increasing pressures on externally vulnerable countries from the rapid tightening of global financial conditions.

Figure 6
Key Return Drivers of EM Hard Currency Government Bond Markets in USD

EMBI GD (EM Hard Currency)	Monthly Return (%)	3 Month Return (%)	YTD Return (%)
Total Return	**-6.36**	**-4.57**	**-23.95**
Spread Return	-2.56	0.37	-11.11
Treasury Return	-3.90	-4.92	-14.44
IG Sub-Index	-6.36	-5.01	-23.72
HY Sub-Index	-6.37	-4.09	-24.20

Source: State Street Global Advisors, Bloomberg, JP Morgan as of 30 September, 2022. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Performance returns for periods of less than one year are not annualized.

Figure 7
Best and Worst Performers Across EM Hard Currency Government Bond Markets*

Q3 2022	Country	Total Return (%)	Spread Return (%)	Treasury Return (%)	Index Weight (%)	Index Impact (bps)**
EMBI Global Diversified		**-4.57**	**0.37**	**-4.92**	—	—
Top 5 Performers	El Salvador	17.8	21.1	-2.7	0.4	7
	Suriname	13.1	16.1	-2.6	0.1	1
	Tunisia	11.0	12.9	-1.7	0.1	1
	Honduras	8.2	12.3	-3.7	0.2	1
	Maldives	7.8	10.5	-2.4	0.1	1
Bottom 5 Performers	Ghana	-19.8	-17.5	-2.8	1.1	-22
	Ukraine	-28.0	-25.3	-3.7	0.7	-19
	Venezuela	-28.5	-28.7	0.3	0.0	0
	Ecuador	-30.4	-27.3	-4.3	1.3	-38
	Pakistan	-36.5	-34.6	-2.9	0.7	-26

Source: State Street Global Advisors, Bloomberg, JP Morgan as of 30 September, 2022. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.
* Country and currency performance of JPM EMBI Global Diversified Index
**Index impact is calculated by multiplying the period average weight by total return.

Pakistan bonds were the poorest performers over the quarter. Even after a bailout from the International Monetary Fund (IMF) of $1.6 billion under its Extended Fund Facility, the country's FX reserves have fallen this year by 50% to just $8 billion, enough to cover only five weeks of imports. Prime Minister Shehbaz Sharif's appeal to rich nations for debt relief in the aftermath of catastrophic floods, as well as a news report that the United Nations Development Programme was set to publish a memo urging the country to restructure its debt, stoked concerns about potential default, leading to a plunge in bond prices near the end of September.

Ecuador's bonds continued to sell off on risks that liabilities arising from ongoing arbitration cases between the country and foreign oil and gas firms could add to financing needs. The sovereign's accounts in Luxembourg were frozen recently for non-payment of a $374 million settlement to French oil firm Perenco. Even though Ecuador's government continues to maintain that its capacity to meet its external debt is not affected by this, investors have become more concerned about the ongoing social and political instabilities in the country, further exacerbated by surging food and fuel prices.

Ukraine's foreign currency ratings were initially downgraded to the default category by both S&P Global Ratings and Fitch, before being then upgraded to ratings of CCC+ and CC, respectively, after bondholders agreed to defer about $6 billion in sovereign principal and interest payments for two years. This deferral takes into account war-related spending needs. Ukraine faces a 35%–45% economic contraction in 2022 and a monthly fiscal shortfall of $5 billion.

Ghana bonds performed poorly as Fitch lowered its long-term issuer default rating to CC in September, reflecting the increased likelihood that Ghana will pursue debt restructuring given mounting financing stress amid surging interest costs on domestic debt and a prolonged lack of access to Eurobond markets. Moody's downgraded its long-term issuer and senior unsecured debt ratings to Caa2. High inflation has dragged on economic activity and the country's local currency, the cedi, has depreciated by around 40% against the US dollar since the start of 2022, adding to the challenges from an already-high debt burden.

El Salvador bonds rallied after it announced the repurchase of more than $500 million of its bonds at a huge discount. However, significant risks remain as this move would further weaken its already tight liquidity position, while the country's experiment with bitcoin as a legal tender has largely been considered a failure.

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* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as June 30, 2022 and includes approximately $66.43 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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