Commentary
Fixed Income

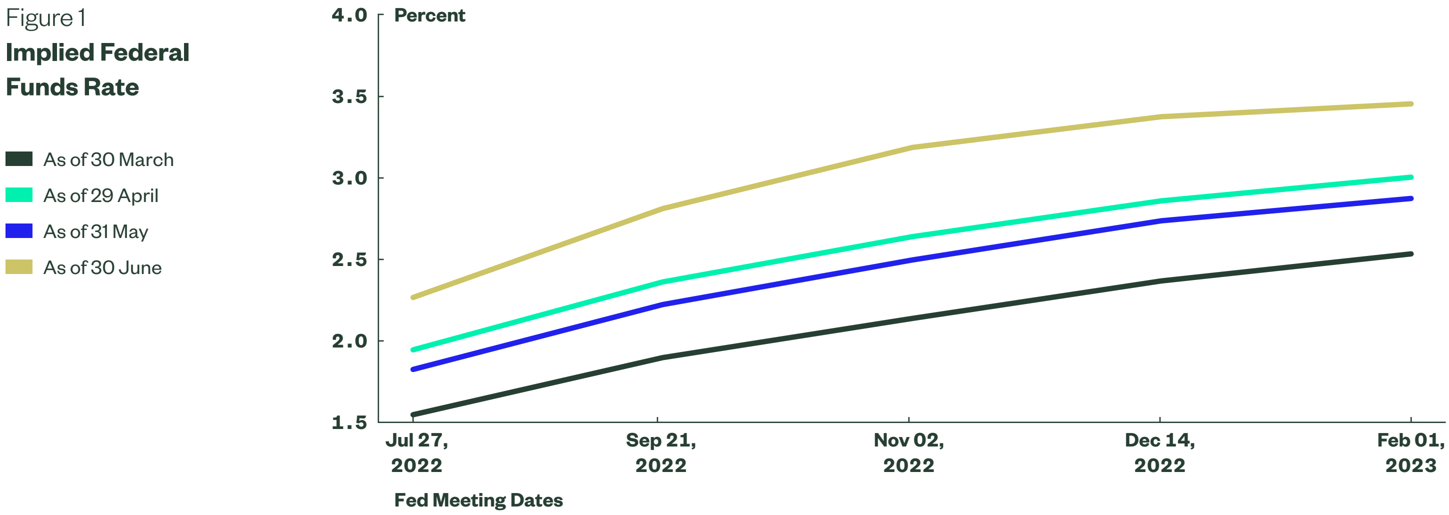
June 2022

Emerging Market Debt
Market Commentary Q2 2022

Chart of the Quarter: Inflation Dynamics Drive Up Implied Rates

The implied federal funds rate moved sharply higher through the second quarter as investors grappled with concerns around high inflation and the prospects for recession.

Figure 1
Implied Federal Funds Rate



Source: Bloomberg Finance L.P., as of 30 June 2022. The information above is for illustrative purposes only.

EMD Commentary — Q2 2022

Emerging markets (EM) debt experienced another sharp correction in Q2 2022 amid challenging macro conditions for EM assets, with investors' concerns widening from the war in Ukraine to the stagflation threat. West Texas Intermediate (WTI) crude oil stayed below $125 per barrel through Q2, with prices moderating from the March peak. The threat of a Russian gas embargo looms after the European Union (EU) partially banned Russian oil imports, an action that could strike a material blow to Europe's economy — Russian gas accounted for 45% of the EU's gas imports in 2021. Recession concerns emanating mostly from weakening G7 growth weighed on the commodity FX, particularly in Latin America (LatAM). More positively, the COVID situation in China improved with lockdown restrictions relaxed in Shanghai as the national daily cases count fell below 200, underpinning a rebound in the manufacturing purchasing managers' index (PMI) to 50.2 in June. This followed three consecutive months of contraction — readings above 50 are indicative of growth.

US CPI inflation remained elevated in Q2 with the headline annual rate of 8.5% in May ticking up from 8.2% in April. To control the surge in inflation, the US Federal Reserve raised the federal funds rate by 75 bps (its biggest hike in 28 years) at its June meeting, catching many market participants off guard. The Fed also acknowledged the slowdown in the economy by revising its growth forecast for 2022 down to 1.7% from the 2.8% level it projected in March. The US Conference Board's consumer confidence index dropped to 98.7 in June, its lowest level since March 2021. The US dollar appreciated against most EM currencies in the quarter as it was supported by rising Treasury yields and demand for 'safe haven' assets. Over the course of Q2, hard currency outflows were -$14.4bn, while local currency outflows amounted to -$18.9bn.[1]

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

	1m (%)	3m (%)	6m (%)	YTD (%)	12m (%)	3yrs (%)	5yrs (%)
In USD							
GBI-EM GD (EM Local Currency)	-4.45	-8.63	-14.53	-14.53	-19.28	-5.80	-2.31
EMBI GD (EM Hard Currency)	-6.21	-11.43	-20.31	-20.31	-21.22	-5.22	-1.19
CEMBI BD (EM Corporates)	-3.06	-5.62	-13.94	-13.94	-14.25	-1.12	1.25
In EUR							
GBI-EM GD (EM Local Currency)	-2.09	-2.75	-7.03	-7.03	-8.44	-3.07	-0.59
EMBI GD (EM Hard Currency)	-3.90	-5.74	-13.32	-13.32	-10.63	-2.48	0.55
CEMBI BD (EM Corporates)	-0.67	0.45	-6.39	-6.39	-2.73	1.74	3.02
In GBP							
GBI-EM GD (EM Local Currency)	-0.85	-0.94	-4.68	-4.68	-8.18	-4.32	-0.98
EMBI GD (EM Hard Currency)	-2.67	-3.98	-11.12	-11.12	-10.38	-3.73	0.15
CEMBI BD (EM Corporates)	0.60	2.32	-4.02	-4.02	-2.46	0.43	2.62

Source: State Street Global Advisors, Bloomberg, JP Morgan, as of 30 June, 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 annualised.

Figure 3
Key EM and Macro Levels As of 30 June, 2022

Item	Δ 1 Month	Δ 3 Months	Δ YTD	Current Level
GBI-EM GD Yield	30 bps	83 bps	134 bps	7.06%
EMBI GD Yield	112 bps	213 bps	327 bps	8.57%
EMBI GD Spread	94 bps	142 bps	174 bps	542 bps
CEMBI BD Yield	71 bps	141 bps	251 bps	7.09%
CEMBI BD Spread	52 bps	73 bps	92 bps	404 bps
CDX.EM 5y	67 bps	110 bps	151 bps	338 bps
10y UST	17 bps	67 bps	150 bps	3.01%
Dollar Index (DXY)	2.88%	6.48%	9.42%	—
DOW 30	-6.71%	-11.25%	-15.31%	30,775
Oil (WTI)	-7.77%	5.46%	40.62%	$ 105.76

Source: JP Morgan, Bloomberg Finance, L.P., as of 30 June, 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 -8.63% in US dollar terms in Q2 2022, as measured by the JP Morgan GBI-EM Global Diversified Index. This was mostly driven by FX returns (-6.32%), which is largely attributable to USD strength amid rising yields and safe haven demand and as the macro outlook weakened for EM local currency debt. Just as developed markets (DM) central banks appeared to accept that a return to a low inflation environment is unlikely in the short run, EM central banks also adopted a more hawkish approach which saw them extend their tightening cycles beyond earlier expectations and push up the terminal rates across all regions. Recession concerns weighed on commodity currencies, particularly in LatAM and South Africa. The WTI crude oil price fell sharply in June to limit its Q2 increase to a relatively modest 5.46% as uncertainty around economic growth prospects raised questions about the strength of future demand.

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 $)	**-4.45**	**-8.63**	**-14.53**
FX Return (vs $)	-3.64	-6.32	-4.46
Price Return (Local Currency)	-1.29	-3.67	-12.42
Interest Return (Local Currency)	0.47	1.36	2.35
In EUR			
Total Return (in €)	**-2.09**	**-2.75**	**-7.03**
FX Return (vs €)	-1.28	-0.44	3.05
In GBP			
Total Return (in €)	**-0.85**	**-0.94**	**-4.68**
FX Return (vs €)	-0.03	1.37	5.40

Source: State Street Global Advisors, Bloomberg, JP Morgan, as of 30 June, 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 annualised.

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

Q2 2022	Country	Total Return USD (%)	Bond Return (%)	FX Return (%)	Index Weight (%)	Index Impact (bps)**
GBI-EM GD		**-8.63**	**-2.31**	**-6.32**	—	—
Top 5 Performers	Turkey	-0.6	13.1	-13.7	0.9%	-1
	Dominican Republic	-1.1	-1.7	0.6	0.2%	0
	Egypt	-1.4	1.4	-2.8	1.7%	-2
	Mexico	-2.8	-1.7	-1.1	10.0%	-28
	Uruguay	-3.8	-6.7	2.9	0.2%	-1
Bottom 5 Performers	Romania	-12.9	-7.2	-5.7	3.2%	-41
	South Africa	-14.1	-3.7	-10.4	10.0%	-141
	Colombia	-15.3	-6.1	-9.2	4.5%	-69
	Chile	-15.6	0.5	-16.1	2.1%	-32
	Hungary	-19.2	-7.1	-12.1	3.0%	-57

Source: State Street Global Advisors, Bloomberg, JP Morgan, as of 30 June, 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 was the worst performing country in Q2 2022, returning -19.2% in USD terms and detracting 57 bps from the index return. Consumer prices rose 10.7% year-on-year (y/y) in May, surpassing expectations to hit a 15-year high. Sentiment turned negative as the EU triggered its 'rule-of-law' mechanism to deny more than €40bn of EU funds to Hungary. The central bank increased the benchmark interest rate by 50 bps to 5.9% on 31 May, which was half the rate hike level implemented in March and April and contributed to the currency's weakness. It increased the benchmark rate by a whopping 185 bps in June (the biggest single rate move since 2008) taking it up to 7.75% and easing some of the pressure on the forint.

South Africa also performed poorly, returning -14.1% in USD terms and detracting 141 bps from the index return. The South African rand weakened by over 10% against USD in the quarter and benchmark bonds sold off as rolling power cuts, infrastructure damage caused by severe floods, and early signs of a COVID comeback added to concerns around the economic outlook in April. The annual CPI increased by 5.9% in April and 6.5% in May, breaching the central bank's target band of 3–6% for the first time in five years. This dried up the local demand for government bonds, pushing the 10-year yield up by over 102 bps in Q2. This hampers the government's plans to reduce the budget deficit and curb the government debt burden. Heightened expectations of a more aggressive US Fed policy tightening path weighed on the rand.

Chile was another of the underperformers, returning -15.6% in USD terms and detracting 32 bps from the index return, mostly driven by the weakening Chilean peso which depreciated by over 15% against USD in the three months — this made it one of the worst performing EM currencies in Q2. The decline in the price of copper, Chile's main export, below $9000 a ton (the lowest since March 2021) contributed to the peso's weakness, which in turn raised concerns about the negative impact on inflation, which is already running at a three-decade high of 11.5% in May (up from 10.5% in April). Persistently high US inflation and a more aggressive rate hike policy by the US Fed also weighed on the peso, while domestic political uncertainty around rewriting the constitution kept investors wary about peso-denominated debt.

Colombia underperformed in Q2, returning -15.3%% in USD terms and detracting 69 bps from the index return. Left-leaning candidate Gustavo Petro won the presidential election on pledges to wean the country off its reliance on raw materials and taxing the rich. Investors are wary of his plans to phase out oil and coal, given that it might impact half of the country's export revenues. The Colombian peso depreciated by over 9% against USD in Q2 amid volatility over the course of the election campaign.

Turkey was the best performing country in Q2, albeit returning -0.6% in USD terms and detracting 1 bp from the index return. Most of the positive local yield returns was entirely offset by negative returns owing to lira weakness. The currency's weakness stemmed from deteriorating external positions, rising inflation (consumer prices rose at an annual rate of 79% in June, up from 73% in April) and the central bank's unconventional monetary policy approach to deal with it, and political divergence with other members of NATO. Surging energy costs and a sharp drawdown of its FX reserves ($60bn as of 24th June) drove the country's weaker external positions. Erdogan reiterated the existing stance on monetary policy and the central bank continued cutting rates, while a cap on rental increases at 25% for one year was imposed to help arrest runaway inflation.

Hard Currency Market Highlights

EM hard currency sovereign debt returned -11.43% in Q2 2022, as measured by the JP Morgan EMBI Global Diversified Index, driven by negative returns from both spread (-7.25%) and treasury (-4.51%) components. US Treasury yields surged the most in April on the back of aggressive rate hike expectations amid sticky inflation. As recessionary concerns took centre stage, core yields stabilised in May before picking up again following hawkish US Fed comments and the 75 bps hike at the central bank's June meeting. Recessionary concerns coupled with food security and inflation challenges weighed on the hard currency spreads of frontier countries and commodity importers as the overall EMBI GD spread widened by 142 bps over Q2.

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	**-6.21**	**-11.43**	**-20.31**
Spread Return	-5.21	-7.25	-11.44
Treasury Return	-1.06	-4.51	-10.01
IG Sub-Index	-3.28	-8.34	-19.69
HY Sub-Index	-9.19	-14.55	-20.96

Source: State Street Global Advisors, Bloomberg, JP Morgan, as of 30 June, 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 annualised.

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

Q2 2022	Country	Total Return (%)	Spread Return (%)	Treasury Return (%)	Index Weight (%)	Index Impact (bps)**
EMBI Global Diversified		**-11.43**	**-7.25**	**-4.51**	—	—
Top 5 Performers	Suriname	1.6	2.8	-1.2	0.7%	1
	Barbados	1.6	3.5	-1.9	3.0%	5
	Papua New Guinea	-0.2	2.2	-2.3	2.9%	0
	Croatia	-1.1	-0.7	-0.4	0.4%	0
	China	-1.5	1.1	-2.6	3.2%	-5
Bottom 5 Performers	El Salvador	-24.8	-23.2	-2.0	2.6%	-65
	Argentina	-28.4	-26.1	-3.1	1.3%	-38
	Ukraine	-33.7	-32.8	-1.3	4.4%	-148
	Sri Lanka	-41.4	-40.8	-1.0	2.9%	-119
	Lebanon	-47.1	-46.7	-0.7	0.7%	-33

Source: State Street Global Advisors, Bloomberg, JP Morgan, as of 30 June, 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.

Lebanon was the worst performer, returning -47.1% in USD terms and detracting 33 bps from the index return. Top Lebanese officials admitted little headway has been made in meeting the conditions set by the International Monetary Fund (IMF) as a part of a preliminary agreement. Officials made a rare outreach to bondholders in May with debt restructuring plans more than two years after the government's debt default. The country is banking on $3 billion of funds from the IMF to restore its financial credibility and unlock future aid, but the inconclusive parliamentary election results cast doubt on the country's ability to deliver requisite reforms.

Among the poorer performers was **Sri Lanka**, returning -41.4% in Q2 and detracting 119 bps from the index return. The country is mired in economic turmoil amid surging inflation (CPI reached 54.6% in June). In early April, the government warned of an unprecedented default and that it would halt payments on foreign currency denominated debts in order to preserve its dwindling dollar stockpile for food and fuel imports (FX reserves slumped to $1.81bn in April from $3.14bn in December 2021). This triggered a series of credit rating downgrades: Moody's cut its rating for Sri Lanka to Ca from Caa2, following similar downgrades by S&P Global and Fitch. The government is expediting talks with the IMF around restructuring its debts and to prevent a hard default. Sri Lanka defaulted on interest payments of $78 million that were due on April 18 as policymakers flagged to creditors that payments couldn't happen until the debt is restructured. It represents the country's first default since independence in 1948.

Ukraine also underperformed, returning -33.7% in USD terms and detracting 148 bps from the index return. The spread on dollar-denominated Ukrainian debt deteriorated as the war situation worsened. Ukraine's government said that the economy contracted by more than 15% y/y in Q1 2022, and the central bank increased its purchases of public debt to finance the country's budget. Ukraine has raised around $3.1 billion (as of May 2022) through war bond auctions since Russia's invasion on February 24 and the IMF also lent support and encouraged other nations to provide grants and donations to Ukraine. G7 countries committed $19.8bn in June alone, which allowed Ukraine to avert an immediate liquidity crisis. Concerns around the government's high debt burden persists and it remains to be seen whether access to international financing continues in upcoming months.

El Salvador was another underperformer, returning -24.8% in USD terms and detracting 65 bps from the index return. The sharp drop in Bitcoin's value weighed heavily on El Salvador as it had approved Bitcoin as legal tender — it has lost $56mn by investing in the digital asset. Investors were concerned around the government's ability to service interest payments of around $382mn this year and an $800mn bond payment due in January 2023. Moody's has cut the nation's long-term foreign debt rating to Caa3 from Caa1 and other rating agencies have followed suit, citing an increased probability of a credit event — restructuring, distressed exchange, or default.

Endnote

1 Source: JP Morgan.

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- Build from breadth
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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of March 31, 2022 and includes approximately $73.35 billion USD 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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ID1115140-3437638.21.1.GBL.INST 0722
Exp. Date: 31/07/2023