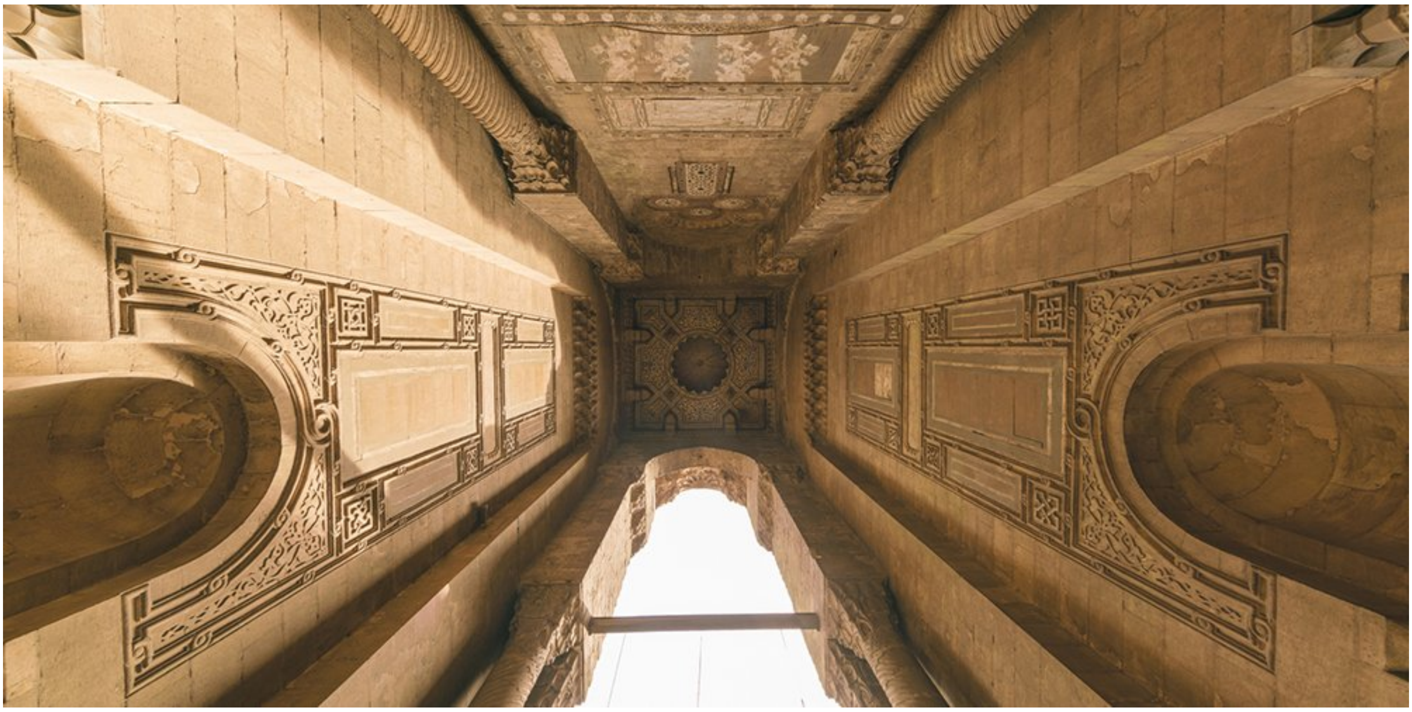

Beta-Bucket Update: Positive Outlook

August 25, 2021

To achieve an efficient deployment of our risk budget, we divide the investable emerging markets (EM) debt universe into three risk buckets—high-beta countries, medium-beta countries, and low-beta countries. And as of the end of the second quarter, this segmentation had us overweight Egypt, Ukraine, and Argentina (in the high-beta bucket); Bahrain, Brazil, and Guatemala (in the middle-beta bucket); and Romania, Serbia, and India (in the low-beta bucket).

Conditions Improving

With improving global growth and favorable liquidity conditions likely to support investor sentiment throughout the third quarter of the year, our outlook for EM debt is positive. And many EM debt valuations remain attractive, especially in the high-yield space, where credit spreads remain above long-term averages.

With this as a backdrop, we are overweight the high-beta and medium-beta universes because we expect returns to be driven by further compression in high-yield spreads, where the risk premia continue to overstate credit risks. We remain underweight low-beta countries, where valuations are broadly unappealing and sensitivity to rising U.S. Treasury yields is higher.

We continue to see opportunities in selected distressed debt:

- where existing bond prices do not reflect realistic assumptions for recovery values;
- in countries that have easier access to financing, especially those with strong relationships with multilateral

and bilateral lenders;

- in countries that have strong potential to recover as we exit the crisis, particularly commodity-dependent economies; and
- in corporate credit, where we see ample opportunities.

Overall, we have a strong preference for less interest-rate-sensitive credits because we are cautious about the direction of U.S. Treasury yields.

That leads our current beta-bucket model to look as shown in the table below.

Beta-Bucket Approach: Largest Active Positions

Beta Segment	OVERWEIGHT	UNDERWEIGHT
HIGH	Egypt	Nigeria
	Ukraine	El Salvador
	Argentina	Mozambique
MEDIUM	Bahrain	Kazakhstan
	Brazil	South Africa
	Guatemala	Azerbaijan
LOW	Romania	Uruguay
	Serbia	Peru
	India	Malaysia

Source: William Blair, as of July 2021.

High-Beta Bucket

Across the high-beta bucket, our largest overweight positions are in Egypt, Ukraine, and Argentina, and the largest underweight positions are in Nigeria, El Salvador, and Mozambique. Our thinking is as follows:

Egypt (overweight): Valuations remain attractive relative to historical spreads. We are also constructive on the prospect of further compression in Egyptian credit spreads, driven by fundamental improvement. The U.S.-dollar-denominated sovereign curve is one of the steepest in the investable universe given front-end support from local Eurobond buyers.

Ukraine (overweight): Although Ukraine's relationship with the International Monetary Fund (IMF) has become more complicated in recent months, we do not believe it is sufficient to derail the program as significant progress has been made in recent weeks.

Argentina (overweight): We believe the provinces have a less complicated path to remaining current on their debt over the medium term compared with that of the sovereign.

Nigeria (underweight): Fundamentals remain weak despite the recovery in oil prices. The poor performance in revenue mobilization and slow pace of reform, particularly in the foreign exchange (FX) market, are key constraints to Nigeria's creditworthiness. Rising oil prices certainly offer support to external and government revenue collections. However, oil production fell to historical lows, limiting the ability for Nigeria to capitalize on this development.

El Salvador (underweight): Following the sacking of the Supreme Court in May, we believe El Salvador has a more complicated path to an IMF program, and President Bukele has mismanaged economic policy. Given the high dollar prices of the bonds, we believe risks are currently too asymmetrical to be overweight.

Mozambique (underweight): The fundamental outlook is clouded by substantial political uncertainty. The escalation of violence in the region, where substantial hydrocarbon developments are ongoing, is likely to weigh on foreign direct investment and delay the potential export and fiscal revenues from these projects.

Middle-Beta Bucket

In the middle-beta bucket, our largest overweight positions are in Bahrain, Brazil, and Guatemala, and our largest underweight positions are in Kazakhstan, South Africa, and Azerbaijan. Our thinking is as follows:

Bahrain (overweight): Although debt levels are uncomfortably high and growing, and the fiscal plan remains unclear, we believe that current valuations adequately compensate investors for the risks given the strength of regional support.

Brazil (overweight): While we are neutral on sovereign bonds because of mediocre valuations, we are particularly constructive on fundamental risks in corporate credit.

Guatemala (overweight): Guatemalan fundamentals remain relatively strong for the region.

Kazakhstan (underweight): Valuations are unattractive and fundamentals are deteriorating as large twin deficits, rising unemployment, and higher inflation pose significant challenges to the country.

Azerbaijan (underweight): We believe relative valuations are stretched, the fiscal deficit is likely to stay elevated on reconstruction spending, and rising levels of COVID-19 cases are once again impacting the economic recovery.

South Africa (underweight): While some signs of political gain, economic reform, and improved external sector performance started to emerge in the second quarter of 2021, large structural issues and a troubling fiscal outlook continue to underpin our negative fundamental view on the country.

Low-Beta Bucket

Across the low-beta universe, our largest overweight positions are in Romania, Serbia, and India, and our largest underweight positions are in Uruguay, Peru, and Malaysia. Our thinking is as follows:

Romania and Serbia (overweight): We find valuations attractive in U.S.-dollar-hedged, euro-denominated instruments relative to U.S.-dollar-denominated benchmark bonds.

India (overweight): Despite the significant impact of the COVID-19 delta variant in the second quarter of 2021, cases have already peaked and economic recovery is back on track, albeit slowly. In particular, we believe corporate credits could continue to benefit from the positive commodity backdrop, local reform stories, and infrastructure boom as economic growth regains strength.

Uruguay (underweight): The country has one of the best COVID-19 crisis-management programs in the region and, unlike its neighbors, has limited the impact of the pandemic on its economy. The better macroeconomic background in Uruguay has led to a significant outperformance of its debt, resulting in rich valuations relative to peers.

Peru (underweight): Peru is one of the South American countries worst hit by COVID-19. Before the pandemic, it had one of the strongest sovereign balance sheets in the region because of a history of strong growth and fiscal discipline. But fiscal deficits are likely to jump to double digits as a percentage of GDP this year. We currently dislike valuations, especially given fundamental and political risks.

Malaysia (underweight): Valuations are unappealing in long-duration sovereign and quasi-sovereign bonds. The rebound of global growth and strong performance of commodity markets should bode well for an economic recovery, but we believe that the upside has already been fully priced in.

We will continue to update our thinking around our beta-bucket insights and post updates quarterly.

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