Beta-Bucket Update: Positive Long Term, but Short-Term Headwinds

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Market conditions were challenging for emerging markets (EM) debt investors throughout the fourth quarter of 2021, and we believe investors will continue to experience headwinds in the near term, including disruptions created by the COVID-19 pandemic, rising energy prices, persistently high inflation, and tightening monetary policy globally.

But our medium- to long-term outlook for EM debt is constructive. We believe EM debt offers attractive value to investors with medium- to long-term focus and willingness to tolerate short-term periods of higher volatility. Our largest active positions in each country beta bucket are shown in the chart below.

Beta-Bucket Approach: Largest Active Positions

To achieve an efficient deployment of our risk budget, we divide the investable EM debt universe into three risk buckets—high-beta countries, medium-beta countries, and low-beta countries.

Beta Segment	OVERWEIGHT	UNDERWEIGHT
HIGH	Egypt Ukraine Ecuador Angola	Turkey Senegal Belarus
MEDIUM	Dominican Republic Bahrain Guatemala	Paraguay South Africa Jamaica
LOW	Romania Serbia Bermuda	Malaysia Peru Russia

Source: William Blair, as of January 2022.

High-Beta Bucket

Across the high-beta bucket, our largest overweight positions are in Egypt, Ukraine, Ecuador, and Angola, and our largest underweight positions are in Turkey, Senegal, and Belarus.

Egypt (overweight): This country is one of our core long positions in the high-beta bucket. Valuations are attractive relative to historical spreads, while we see scope for strong fundamental improvement over the short to medium term, particularly in public finances.

Ukraine (overweight): Uncertainty has increased due to Russian-Ukrainian tensions, which raise concerns about a potential military escalation by Russia. Additionally, Ukraine's relationship with the International Monetary Fund

(IMF) has become more complicated recently. However, we received confirmation of the proposed November IMF disbursement as expected, along with confirmation that the program will be extended into 2022. We remain overweight with a concentrated position focused on gross domestic product (GDP)-linked warrants because we expect the downgrade in growth rate to be temporary.

Ecuador (overweight): In Ecuador, we remain overweight because we believe rising oil prices and increased governability of Guillermo Lasso's government increase the probability that IMF-mandated reforms will continue to be carried out.

Angola (overweight): We have confidence in Angola's prudent fiscal and monetary policies. In addition, oil prices and stabilized production volumes are supportive of the external sector.

Turkey (underweight): We believe Turkey's unorthodox economic policy mix has caused a rapid depreciation of the lira and elevated inflation. The announcement to compensate lira depositors for excessive lira weakness has temporarily helped stabilize the currency, but has the potential to put significant pressure on the fiscal balance.

Senegal (underweight): Senegal's budget deficit is large, and its political landscape was uncertain leading up to January's municipal elections. While we welcome the efforts toward fiscal consolidation announced in the latest budget, delivery risks remain and valuations are less attractive than those of other African markets, in our view.

Belarus (underweight): The humanitarian crisis on the Belarus border has shown little sign of improvement and the risks of more sanctions continue to increase. The country's very low environmental, social, and governance (ESG) score—which is driven by the current political environment—makes it very difficult to establish a coherent investment case in this market despite the promise of further financial support from Russia.

Middle-Beta Bucket

In the middle-beta bucket, our largest overweight positions are in the Dominican Republic, Bahrain, and Guatemala, and our largest underweight positions are in South Africa, Paraguay, and Jamaica.

Dominican Republic (overweight): The Dominican Republic remains one of the brightest spots within Latin America in terms of fundamentals, in our opinion. The government announced a preliminary estimate of 12% GDP growth in 2021 as tourism reopened and vaccination rates remained high. Fiscal deficits are also under control, and we believe the deficit will likely fall below 3% when final 2021 numbers are released.

Bahrain (overweight): In Bahrain, our overweight position is driven by valuations relative to the country's oil peers. Although debt levels are uncomfortably high and growing, we believe that current valuations adequately compensate investors for the risks given the strength of regional support and confirmation of measures announced to reduce the fiscal deficit, most importantly the increase in the VAT rate.

Guatemala (overweight): Guatemalan fundamentals remain relatively strong for the region, and we are overweight three high-quality corporate issuers and the long end of the sovereign credit spread.

Paraguay (underweight): We are concerned about droughts in the region, but credit quality remains strong; the primary driver of our underweight position is unattractive valuations.

South Africa (underweight): While signs of political gain, economic reform, and improved external sector performance emerged in 2021, large structural issues, more mixed prospects for the external sector performance, relatively tight valuations, and a troubling fiscal outlook continue to underpin our negative fundamental view of South Africa.

Jamaica (underweight): Despite still relatively high debt-to-GDP levels, Jamaica has shown a strong willingness to consolidate its fiscal position. The administration has a strong relationship with the IMF, and Jamaica will likely be supported if it faces severe economic hardship. Our underweight position is primarily driven by our preference for shorter-duration bonds.

Low-Beta Bucket

Across the low-beta universe, our largest overweight positions are in Romania, Bermuda, and Serbia, and our largest underweight positions are in Malaysia, Peru, and Russia.

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

Bermuda (overweight): We find value in the country versus other low-beta Latin America peers, such as Chile and Peru, which face challenging political and economic outlooks for 2022.

Malaysia (underweight): Rebounding global growth and strong commodity markets should bode well for an economic recovery, but we believe the upside has already been fully priced in; we view valuations in long-duration sovereign and quasi-sovereign bonds are unappealing.

Peru (underweight): Peru's economy was particularly hard hit by COVID-19, and the political outlook is turbulent, with the impeachment of President Pedro Castillo a possibility. The mining sector could come under increased pressure, and valuations are also unappealing.

Russia (underweight): While it is impossible to predict the endgame of Russian tensions with Ukraine, we do not believe that current spread levels compensate investors for the uncertainty around a potentially negative outcome.

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

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