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AUGUST 2021

CAPTURING INFLATION-RELATED OPPORTUNITIES IN EMERGING MARKETS

INFLATION IS CREATING OPPORTUNITIES ACROSS EMERGING MARKET (EM) DEBT. WE BELIEVE THE ENVIRONMENT WILL FAVOUR INVESTORS WITH THE 'FULL TOOLKIT' AT THEIR DISPOSAL.

INFLATION MAY GENERATE OPPORTUNITIES ACROSS EM RATES, CREDIT AND CURRENCY MARKETS

Inflationary forces may be creating many more investment opportunities across emerging markets than they are in advanced economies.

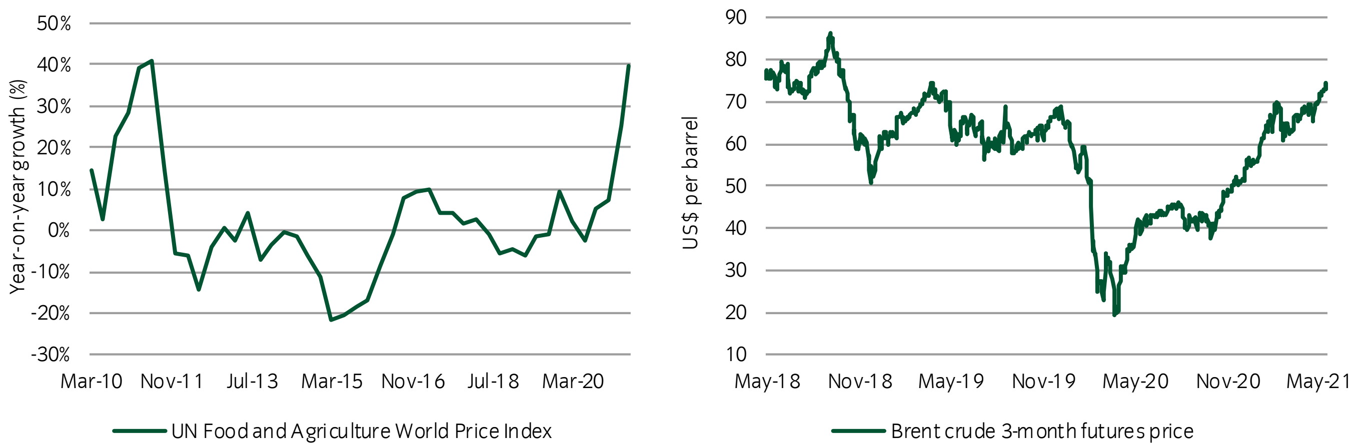
In advanced economies, we believe inflation risks currently appear transitory, likely to normalize without sweeping monetary policy reversals, potentially justifying a 'buy the dips' playbook. However, in emerging markets, in many cases inflation forces are amplified, requiring central bank intervention. Furthermore, inflation forces are highly varied across countries, given uneven' recoveries.

Investors with the appropriate toolkit may be best placed to target potential absolute and relative long or short opportunities within and across many EM countries in EM rates, credit and currency markets.

INFLATION RISKS OFTEN LEAD TO MORE EXTREME OUTCOMES IN EMERGING MARKETS

Many EM economies are acutely sensitive to rising global food and oil prices. World food prices are at their highest rate in a decade, while oil prices are approaching early 2019 levels (Figure 1) given elevated demand and activity, which is led by markets such as China.

Figure 1: Rising global food and oil prices have helped stoke inflation[1]

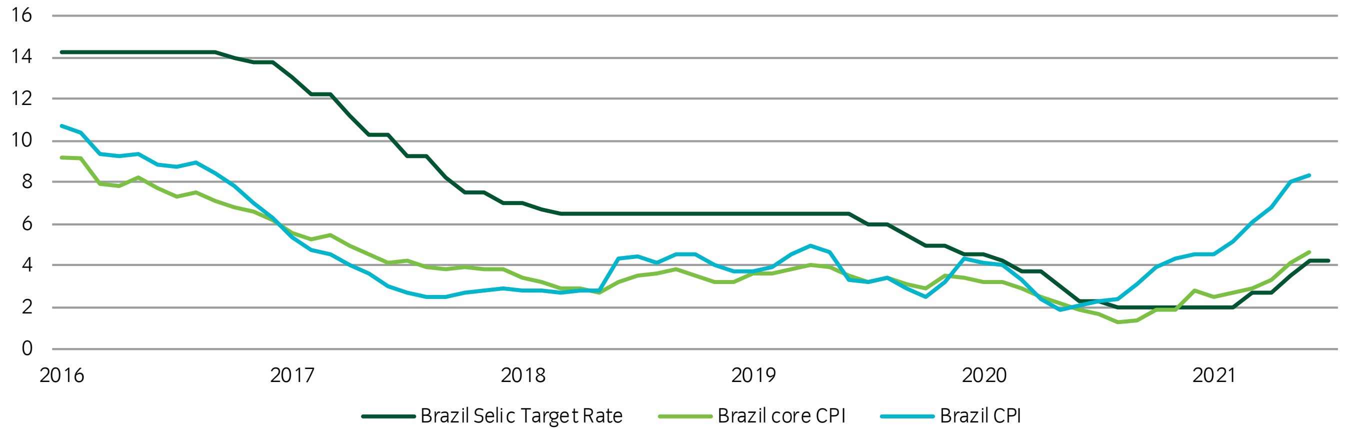


Brazil, for example, has seen pressure on both fronts. Food inflation comprises 22% of the Brazilian CPI basket (compared to ~15% in the US). Petrobras[2] (the Brazilian energy multinational) increased domestic diesel prices during a painful wave of COVID cases. The price rises even led to popular anger and widespread worker strikes, political backlash and high-profile resignations, reminiscent of the 1970s crises in the West.

[1] Bloomberg, June 2021.
[2] The mention of a specific security is not a recommendation to buy or sell such security. The specific securities identified are not representative of all the securities purchased, sold or recommended for advisory clients. It should not be assumed that an investment in the securities identified will be profitable. Actual holdings will vary for each client and there is no guarantee that a particular client's account will hold any or all of the securities listed.

Amid the inflation pressure, the central bank has been forced to tighten monetary policy (Figure 2).

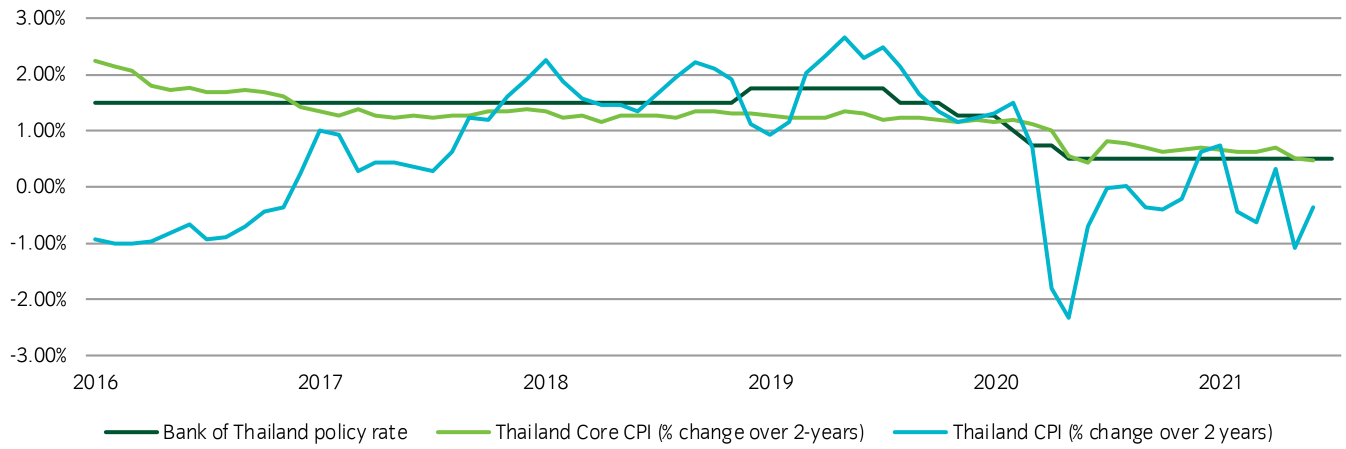
Figure 2: Food and oil prices have helped pushed Brazil into a hiking cycle[3]



The effects have been the opposite in other cases, particularly large net commodity exporters. An example is Thailand, which has even been flirting with deflation. A lack of commodity pressure has compounded the fact that the economy is 20% reliant on tourism, with the Delta variant further challenging the recovery.

This is particularly apparent when looking at Thai inflation over 2-years (Figure 3).

Figure 3: Thailand is facing muted core CPI and has needed central bank easing[4]



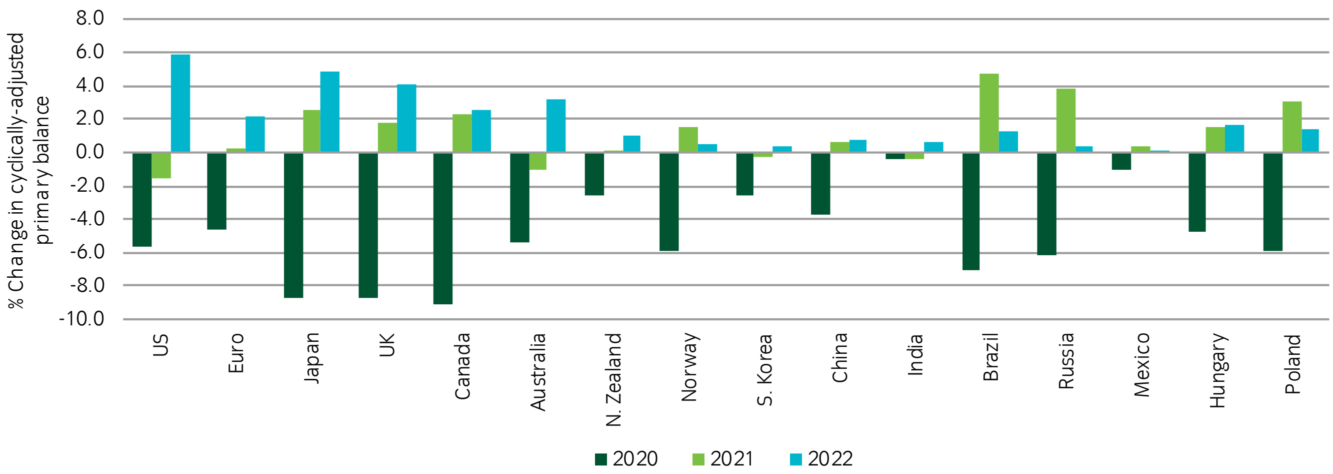
Fiscal and monetary stimulus is also creating severe EM inflation risks

Many economies have lower real rate policies than advanced economies such as the US. Examples include Brazil, Poland and Hungary, where real rates are ~-4.5% or less. This has resulted in currency devaluation, further amplifying the CPI passthrough from commodity prices.

Fiscal policies have also been aggressive in some regions. Brazil, for example, delayed its fiscal consolidation as COVID-19 cases surged. Debt-to-GDP was at ~90% at the end of 2020 versus ~61% from 2006-2019[5]. Meanwhile, Eastern Europe has benefited from loosening EU fiscal rules since the start of the pandemic (Figure 4).

[3] Bloomberg, July 2021
[4] Bloomberg, July 2021
[5] Trading Economics, July 2021

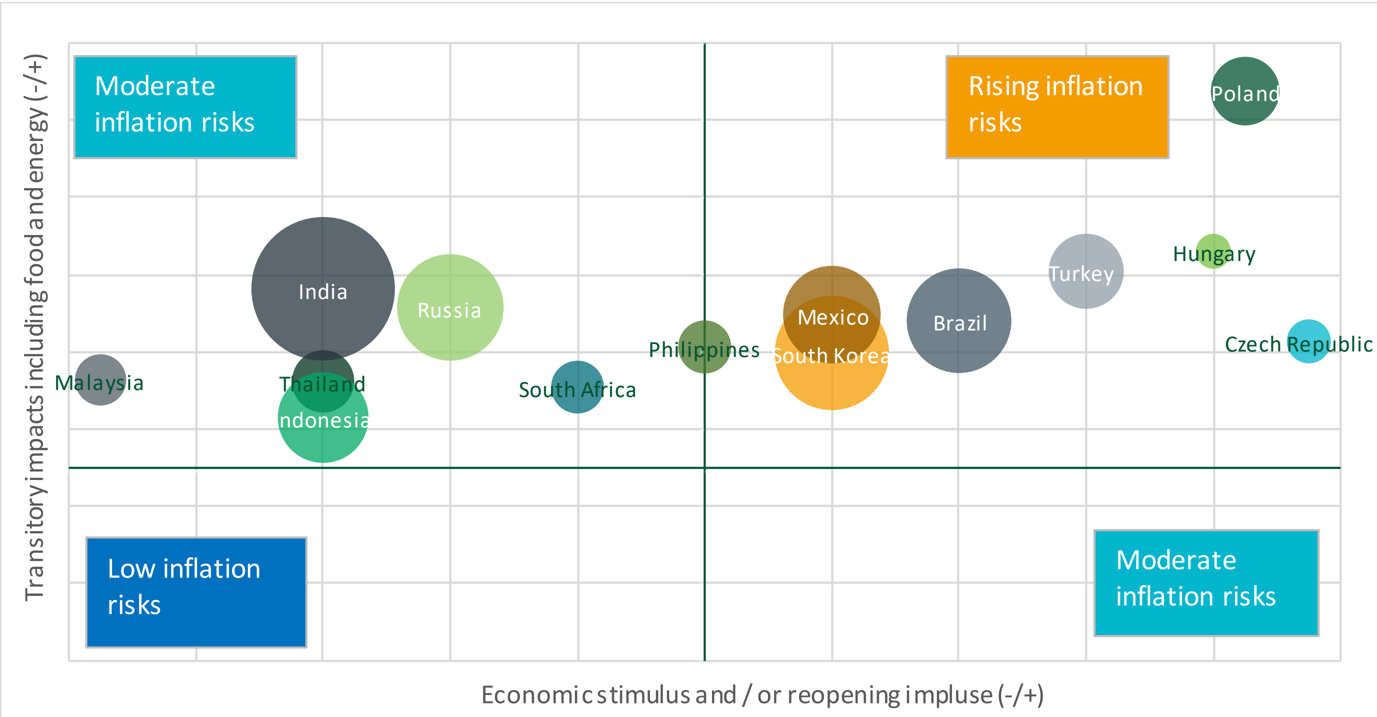
Figure 4: Certain countries have implemented aggressive fiscal stimulus policies[6]



Not all economies have implemented aggressive stimulus, however. Mexico has notably pursued a risk-averse budget balance and continues to hold rates at conservative levels despite a recent surprise 25bp hike in rates and subsequent 25bp tightening in August. This may help keep inflation relatively muted even amid its northern neighbour's reopening push.

Combining policy accommodation and commodity passthrough risks we see seven economies with rising inflation risks (Figure 5).

Figure 5: Seven countries appear particularly at risk of rising inflation[7]



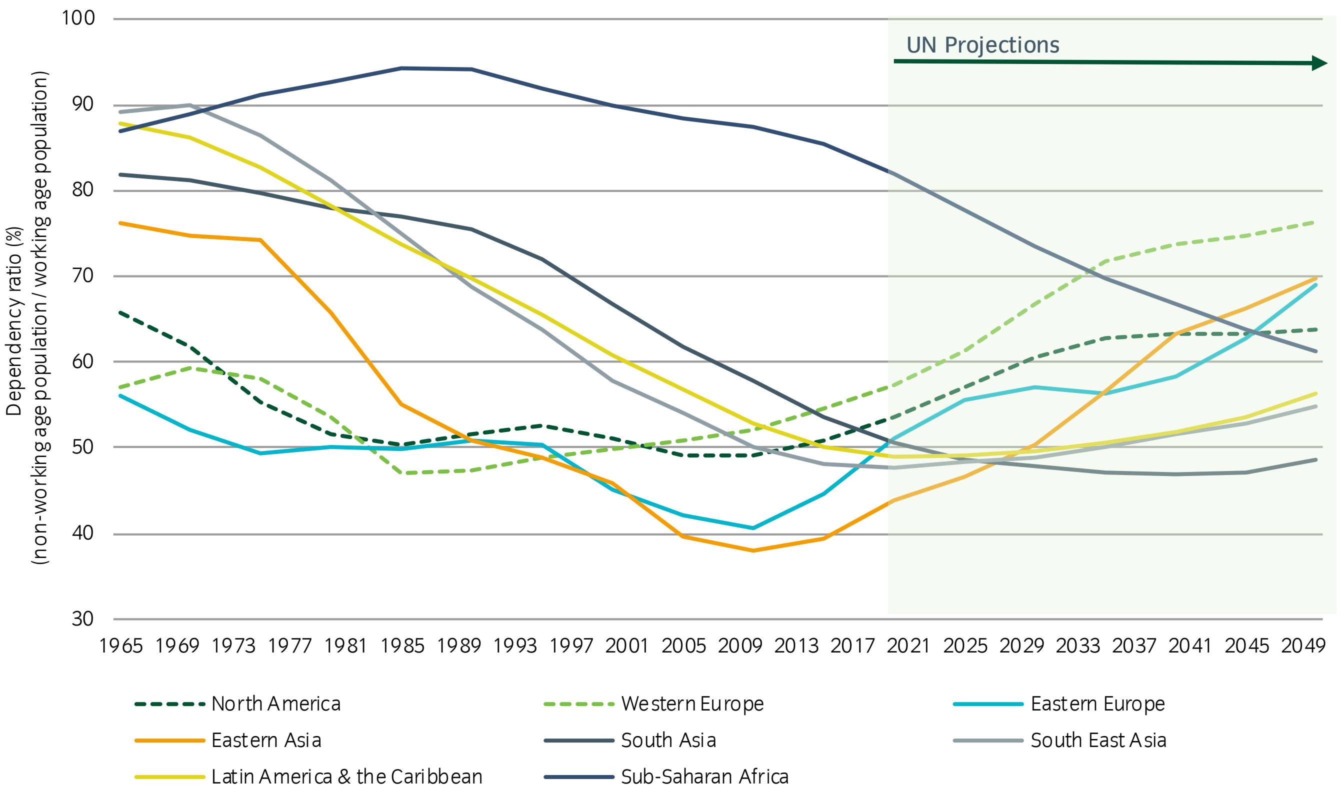
DON'T FORGET TO WATCH EM DEMOGRAPHICS – GIVEN THE POTENTIAL TO EXACERBATE INFLATION

Demographic trends have been a major disinflationary force in advanced economies for the last 30 years[8], but in many cases the opposite is true in EM.

For example: India, South America and Africa have growing working-age share of their populations, as evidenced by falling dependency ratios (Figure 6). A growing working-age population typically means rising demand for goods and services (as more of the population starts earning wages). Young demographics were arguably a factor in sparking the 1970s inflation shock in the West.

[6] IMF fiscal monitor April 2021
[7] Insight, for illustrative purposes only. Y-axis based on headline vs core inflation vs 3-year pre-pandemic trend. X-axis based on trend Google mobility as measured by google data and PMI data.
[8] Older populations have a higher dependency ratio (lower share of working age population) and tend to consume less than younger populations.

Figure 6: Falling dependency ratios could exacerbate inflationary pressures in South Asia, Latin America and Africa[9]



The opposite is true of East Asian countries such as China (a result of its historical 'one-child' policy) and Eastern Europe, where demographic trends more closely mirror advanced economies.

CENTRAL BANK TRAJECTORIES REFLECT DIVERGENT FORTUNES

Some central banks are being forced into hiking to contain inflation

Central banks in Brazil, Russia, Mexico, Poland and Hungary have already been forced into hiking. In Brazil, rates started the year at 2%, and the market is pricing in a 8.25% policy rate by year-end. However, policy has so far failed to contain long-end yields. This has aided a sharp recovery in the Brazilian real (BRL).

Poland and Hungary have also already started hiking rates. We expect Poland to turn more hawkish still, as it is already on course to close its output gap this year given relatively advanced vaccination rates, creating potential mispricing opportunities. We expect the Hungarian rate curve to flatten as the central bank acts.

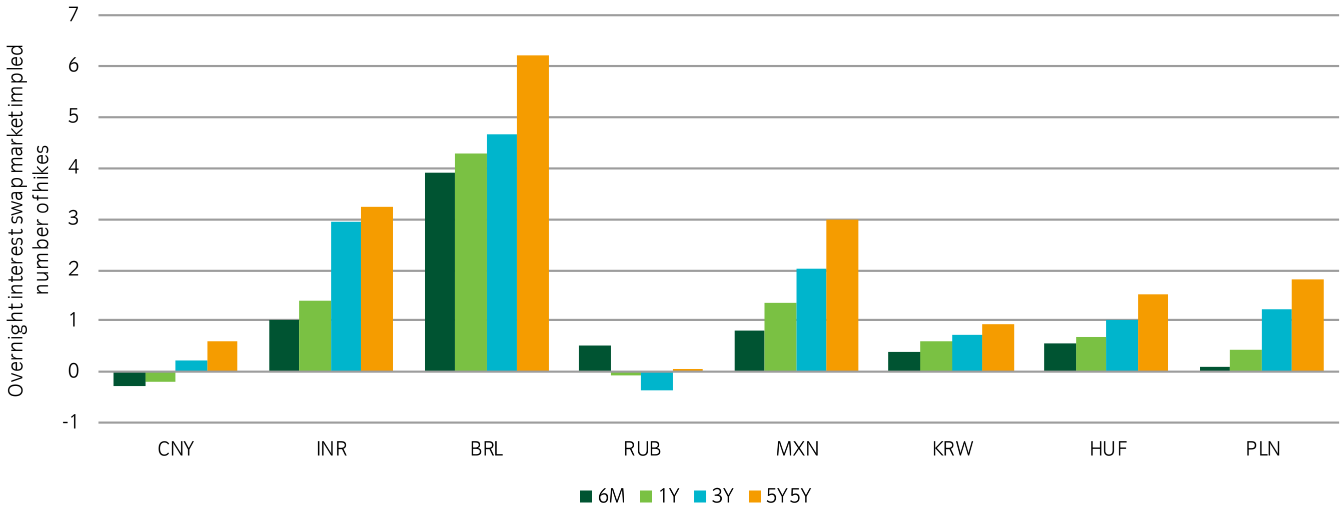
Others are in a trickier spot and keeping policy stable

Thailand, Malaysia and South Africa are mostly seeing 'base effects'-related inflation and are likely to keep rates on hold (similar to the US) while relying on fiscal stimulus to provide a 'floor' to growth. Fortunes could change if the vaccination efforts in the West and China allow tourism to resume, which would be positive for the local currencies.

India, notably, is seeing inflationary pressures from food imports and demographic trends. However, COVID headwinds put the central bank between a 'rock and a hard place'. Notably, this is an environment conducive to volatility (such as in the currency) and it may offer investment opportunities.

[9] United Nations Department of Economic & Social Affairs, July 2021. Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialize or vary significantly from the actual results. Accordingly, the projections are only an estimate.

Figure 7: Markets are pricing in a wide range of hiking cycles[10]



PLAYING DIVERGENT FORTUNES IN EM: USING THE 'FULL TOOLKIT'

In our view, divergent inflation dynamics create a wealth of opportunity across EM rates, credit and currency markets. We believe investors will be best positioned if they can implement long, short and relative value positions across emerging markets where appropriate.

'Underweight' rates where central banks are hiking

In Brazil, we believe investors should consider a 'curve flattening' position: i.e. 'underweight' at the front-end of the yield curve and 'overweight' at the 'belly' (3 to 7-years). We also believe in a long bias in BRL given potentially attractive valuations relative to its 5-year real effective exchange rate (REER), carry potential and improving current account balance.

In Poland, we see similar value in an 'underweight' to Polish rates and in 'curve-steepening' trades (as a 'short' at 2-years and 'long' at 5-year maturities using interest rate swaps). Conversely, in Hungary we believe in 'curve flattening' positions from a more pre-emptive central bank approach to tightening monetary policy.

In areas with less inflation risk, such as Mexico, where we see transitory inflation effects similar to the US, we favour tactical opportunities to 'buy the dips' during periods in which we believe markets are 'overpricing' the risks of a hiking cycle (e.g. through tactical 5-year 'overweights' to maximize the 'carry and roll' dynamics and position for less rate hikes than markets expect).

In EM credit, we have recently favoured high yield markets, primarily in sovereigns (e.g., the Dominican Republic, Colombia, Egypt) based on asset class valuations (in percentile terms) and given our expectation that a growth-driven rising interest rate environment will generally be supportive for higher-income, more growth-sensitive risk assets, such as high yield.

Implementing EM opportunities

We believe managers with specialized capabilities in local government, rates, hard currency corporate and sovereign credit and foreign currency capabilities will be best-placed to extract inflation-related opportunities within EM. Tools such as derivative instruments (e.g. credit default swaps, interest rate swaps) and strategies (e.g., outright 'long' and 'short' positions or relative value trades) and potentially unlock value opportunities. A fundamental 'top-down' and 'bottom-up' approach may also be advantageous.

Historically, emerging markets have been more volatile and differentiated than advanced economies, with many idiosyncratic market opportunities. Regarding inflation-related positioning, among other things we also believe investors need to consider:

- The reaction of real yields to changing inflation
- Each central bank's individual 'reaction function'
- The efficacy of monetary policy within an economy
- Sensitivity of foreign currency shifts
- Current account and trade balance dynamics
- Inflation forecasts versus market pricing

In our view, the current environment of divergent inflation profiles in emerging markets offers a wealth of potential for skilled EM investors to capture returns from idiosyncratic market opportunities.

[10] Bloomberg, June 30, 2021.

ABOUT INSIGHT

Insight Investment's EM debt team has experience going back to the 1990s, encompassing many market cycles, periods of crisis and transformation.

We invest across external, local and corporate debt and foreign currency in an integrated fashion to recognize key interactions and feedback effects across them. We also view EM debt in a global context, drawing on Insight's wider global fixed income and credit research expertise with over 110 investment professionals across the business. We currently manage £2.3bn[11] in dedicated EM strategy assets as of June 30, 2021.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

ASSOCIATED INVESTMENT RISKS

Fixed income

- Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.
- A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.
- The issuer of a debt security may not pay income or repay capital to the bondholder when due.
- Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.
- Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.
- Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.
- Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.
- The investment manager may invest in instruments which can be difficult to sell when markets are stressed.
- Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.

ASSOCIATED INVESTMENT RISKS

Currency risk management

- Currency hedging techniques aim to eliminate the effects of changes in the exchange rate between the currency of the underlying investments and the base currency (i.e. the reporting currency) of the portfolio. These techniques may not eliminate all the currency risk.
- Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.
- Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.
- Where leverage is used through the use of swaps and other derivative instruments, this can increase the overall volatility. Any event that adversely affects the value of an investment would be magnified if leverage is employed by the portfolio and losses would be greater than if leverage were not employed.

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[11] Assets under management (AUM) are represented by the value of cash securities and other economic exposure managed for clients. Figures shown in GBP. Reflects the AUM of Insight, the corporate brand for certain companies operated by Insight Investment Management Limited (IIML). Insight includes, among others, Insight Investment Management (Global) Limited (IIMG), Insight Investment International Limited (IIIL), Insight Investment Management (Europe) Limited (IIMEL) and Insight North America LLC (INA), each of which provides asset management services.

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