



YEAR-END LETTER FOR 2023

Emerging Country Debt Team

Dear Client,

On behalf of the GMO Emerging Country Debt team, thank you for your continued investment with us. In 2024 we will celebrate the 30th anniversary of our hard currency strategy, which has delivered 367 bps of net-of-fees alpha on an annualized basis since inception. GMO was a pioneer in 1994, and our bottom-up, instrument-selection focus continues to be unique both when applied to hard currency, local currency, and cash (total return) benchmarks. The asset class continues to evolve around us – more countries, more quasi-sovereign and pure corporate issuers, more currency and interest-rate markets from both “standard” and “frontier” markets – yet our arbitrage-oriented philosophy has remained entirely unchanged. “Will it add alpha to EMBIG-D, GBI-EMGD, or cash?” is the question we ask over and over. Some of our clients have heard me paraphrase our investment approach as “[time to make the donuts](#),” a nod to a Boston-based donut maker advertisement from my childhood. In it the protagonist wakes very early and marshals his team to deliver an excellent, always-the-same, well-priced product. For a gal whose alarm clock strikes at 4:06.a.m., and whose team’s net-of-fees alpha lands in the top quartile or decile depending on the period, I’m grateful that my team understands how to create an excellent, repeatable, well-priced donut (I mean investment product). In this year’s letter, I’ll reflect on where emerging debt is in its journey back to excess returns versus cash, including current valuations; strategy outperformance; the team; asset flows; research; and new strategy developments.

As presaged at this time last year, given 2022’s historic drubbing, there seemed to be nowhere else to go but up. Based on our [4Q22 Quarterly EM Debt Update](#) publication, we thought hard currency debt spreads should compress (as they have by 69 bps), but we were agnostic about U.S. 10-year rates (which went on to roughly round trip from 3.9% to 5% back to 3.9%). Consistent with the scenario highlighted on the left below, for the full year 2023 EMBIG-D has returned 11.1%. In local debt, given both FX and interest-rate valuation, we were more optimistic. And, consistent with the table on the right, GBI-EMGD has returned 12.7%.

2023 RETURN SCENARIOS AS OF 12/31/2022:

Hard Currency

EMBIG-D Spread (29 bp Increments)	5.5%	9.3%	7.1%	4.8%	2.6%	0.3%	-1.9%	-4.2%
	5.2%	11.3%	9.1%	6.8%	4.6%	2.3%	0.1%	-2.2%
	4.9%	13.3%	11.1%	8.8%	6.6%	4.3%	2.1%	-0.2%
	4.6%	15.3%	13.1%	10.8%	8.6%	6.3%	4.0%	1.8%
	4.3%	17.3%	15.1%	12.8%	10.6%	8.3%	6.0%	3.8%
	4.0%	19.3%	17.1%	14.8%	12.6%	10.3%	8.0%	5.8%
	3.8%	21.3%	19.1%	16.8%	14.5%	12.3%	10.0%	7.8%
		2.9%	3.3%	3.6%	3.9%	4.3%	4.6%	4.9%

USD Yield Associated With EMBIG-D
(33 bp Increments)

Local Currency Debt

GBI-EMGD FX (1.6%) Higher = Depreciation	1.59	6.9%	5.3%	3.7%	2.0%	0.4%	-1.2%	-2.8%
	1.56	8.5%	6.9%	5.3%	3.6%	2.0%	0.4%	-1.2%
	1.54	10.1%	8.5%	6.9%	5.3%	3.6%	2.0%	0.4%
	1.52	11.7%	10.1%	8.5%	6.9%	5.2%	3.6%	2.0%
	1.49	13.3%	11.7%	10.1%	8.5%	6.8%	5.2%	3.6%
	1.47	14.9%	13.3%	11.7%	10.1%	8.4%	6.8%	5.2%
	1.44	16.5%	14.9%	13.3%	11.7%	10.0%	8.4%	6.8%
		5.9%	6.2%	6.5%	6.9%	7.2%	7.5%	7.8%

GBI-EMGD Yield (33 bp Increments)

As of 12/31/2022 | Source: Source: GMO calculations based on data from J.P. Morgan

Scenarios use +/- 1 standard deviation around current levels (based on trailing three years). The total return scenarios above are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. The total returns scenarios above do not represent the past or future performance of any GMO fund or strategy. They are subject to change at any time based on market and other conditions. Actual results may differ materially from the scenarios above.

This said, we recognize that there is ground still to be made up to regain the high water marks, particularly when measured against cash:

	<i>Hard currency (EMBIG-D)</i>	<i>Local currency (GBI-EMGD)</i>
High water mark date	9/15/2021	1/4/2021
Max drawdown	-28.1%	-27.4%
Current drawdown (12/31/2023)	-11.2%	-9.7%
FTSE T-bill return since HWM	+6.85%	+6.89%

Fortunately, valuations are supportive, as shown in our [4Q23 Quarterly EM Debt Update](#), and we highlight scenarios we see plausible below:

2024 RETURN SCENARIOS AS OF 12/31/2023:

Hard Currency

EMBIG-D Spread (22 bp Increments)	4.6%	11.3%	8.7%	6.0%	3.3%	0.7%	-2.0%	-4.7%
	4.4%	12.8%	10.2%	7.5%	4.8%	2.2%	-0.5%	-3.2%
	4.1%	14.3%	11.7%	9.0%	6.3%	3.7%	1.0%	-1.6%
	3.9%	15.8%	13.2%	10.5%	7.9%	5.2%	2.5%	-0.1%
	3.7%	17.3%	14.7%	12.0%	9.4%	6.7%	4.0%	1.4%
	3.5%	18.9%	16.2%	13.5%	10.9%	8.2%	5.5%	2.9%
	3.3%	20.4%	17.7%	15.0%	12.4%	9.7%	7.0%	4.4%
		2.8%	3.1%	3.5%	3.9%	4.3%	4.7%	5.1%

USD Yield Associated With EMBIG-D
(39 bp Increments)

Local Currency Debt

GBI-EMGD FX (1.6%) Higher = Depreciation	1.55	5.8%	4.4%	2.9%	1.5%	0.1%	-1.4%	-2.8%
	1.53	7.4%	5.9%	4.5%	3.1%	1.6%	0.2%	-1.3%
	1.50	9.0%	7.5%	6.1%	4.6%	3.2%	1.8%	0.3%
	1.48	10.5%	9.1%	7.6%	6.2%	4.8%	3.3%	1.9%
	1.46	12.1%	10.6%	9.2%	7.8%	6.3%	4.9%	3.4%
	1.43	13.6%	12.2%	10.8%	9.3%	7.9%	6.4%	5.0%
	1.41	15.2%	13.8%	12.3%	10.9%	9.4%	8.0%	6.6%
		5.3%	5.6%	5.9%	6.2%	6.5%	6.8%	7.1%

GBI-EMGD Yield (29 bp Increments)

As of 12/31/2023 | Source: Source: GMO calculations based on data from J.P. Morgan

Scenarios use +/- 1 standard deviation around current levels (based on trailing three years). The total return scenarios above are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. The total returns scenarios above do not represent the past or future performance of any GMO fund or strategy. They are subject to change at any time based on market and other conditions. Actual results may differ materially from the scenarios above.

It is clear we are fans of local currency debt at these valuations. Victoria summarized the value, diversification, and alpha aspects of it in this recent paper [Emerging Local Debt: A Once-in-a-Generation Opportunity?](#) (January 2024). The detailed examination of local debt relative to EM equities was of particular note, as most simply think about hard versus local currency debt.

Very strong positive net alpha (+655 bps in external, +1,132 in local). Strong positive alpha in recovery markets is typical for our strategy, and this year was buoyed by some *one-off* and *opportunistic factors*. Notably:

- In external debt, the easing of sanctions in Venezuela brought a one-off lift to those accounts that have held Venezuela since sanctions were imposed in 2019. Given that Venezuela is not a benchmark constituent, we classify the roughly 240 bps as off-benchmark "security selection." We still hold Venezuela overweight and

are adding it to eligible accounts given the further upside expected. Meanwhile, opportunistic positions in local currency interest rates and currencies – on the long side and, in the case of Turkey, the short side – added 53 bps. Given the acute dislocations there, we are on the hunt for more of these.

- In local debt, the remarking and sale of Russian assets added around 100 bps.

After that, it was business as usual in the two strategies. In external debt we were pleased with the expressive country selection alpha. Notably, Argentina bond prices rebounded after voters so dismayed with perennial policy failures elected a libertarian firebrand president who ran on an economic shock therapy platform. We had around 130 bps of total alpha from our positioning in Argentina, a little more than half the country selection total. In local debt, both the currency and interest-rate strategies had terrific years, contributing around 120 and 180 bps, respectively.

We are confident that forward-looking alpha will reflect the usual elements.

Relatively stable asset flows in external debt, but a large decline in local debt. We read that industry flows for the asset class have continued to be negative, with \$24 billion in outflows from hard currency and \$12 billion outflows from local currency this year. Our local debt assets experienced a decline consistent with this trend, while our hard currency assets have remained stable. Given our performance dispersion, we won a sizable hard currency debt mandate this year away from another manager. This came in the form of three new separately managed accounts, bringing our total to six SMAs, which GMO's implementation of Aladdin enables us to manage effectively.

It was heartbreaking, although understandable, to see the decline in our local currency debt assets. Our largest client had an enormous mismatch between their objective (EURIBOR +5%) and their benchmark (GBI-EMGD), although they appreciated our very strong local debt alpha. We are hopeful that our articulation in [No Stone Unturned](#) (June 2022) may lead them back to us (along with others), as we believe EURIBOR +5% is a very achievable goal. The local currency debt space – particularly when approached in a deconstructed way separating currencies from interest rates as we do – is a terrific one for absolute return implementations.

Which brings us to an exciting new strategy, begun on behalf of an existing client who wanted cash +6% coming from distressed/defaulted EM credit. Over the first several months managing it, we are already delivering on our objective. In an interesting twist, the strategy also includes an ESG engagement angle, and so our regular engagement activities have become more structured in certain cases. For example, in a recent engagement exchange Carl was able to persuade the Sultanate of Oman's debt management office to be more transparent with their fiscal and debt data.

As always, fascinating research. A novelty for us this year was the GMO "Hackathon" where researchers from around the firm tried using generative AI to increase productivity and provide research insights. Our team partnered with our fixed income quantitative research colleagues to use GAI to parse unstructured fixed income prospectuses (yes, we read these!), and our work scored highest in the categories of Innovation and Applicability. Not too shabby considering our outside director, [Mark Nitzberg](#), has some serious cred here and led the judging panel.

In published pieces, Carl produced [Weighing the Risk of Sanctions in Emerging Debt](#) in June. Sanctions risk – different from credit risk – has unique properties, and we now try to take a more deliberate, anticipatory approach here. Eamon followed up in August with an adjacent piece, [Does Democracy Matter for Emerging Sovereign Debt?](#) a topic he's been interested to explore since he joined the industry back in 2010. We also fielded a number of client requests on various topics. Among them was an update on how Carl's prescient July 2019 piece, [Gaming Out Sovereign Default When China is a Major Creditor](#) has played out in cases such as Ghana, Sri Lanka, Zambia, Suriname, and others. Relatedly, Eamon, Carl, and our legal team were instrumental in pushing Suriname's debt workout to its December 2023 conclusion.

Exciting, high-conviction new strategy ideas. As hinted at this time last year, Eamon's "Does Democracy Matter" paper was really in pursuit of a possible new strategy, one that limits the country universe to those with better Freedom and Democracy characteristics. Unlike an ESG tilt, which masquerades as a quality bias (with the attendant lower yields and spreads), a Freedom and Democracy tilt is return neutral and occasionally helps with sanctions-like outlier price action.

A European-based client redeemed a couple of years ago because they were concerned by the un-democratic nature of some of our investment universe, so we believe there's market demand here.

Separately, Mustafa and Sergey from the quasi-sovereign team are working on a strategy to address Energy Transition in EM. It has huge potential, we think, and, as discussed in [The Mystery of SOE Debt](#) (September 2020), the companies and projects on the front lines of this are quasi sovereigns ("SOEs"). We like the combination of earning an EM and a complexity premium relative to developed market alternatives while sticking to government-like credit risk. While much more labor intensive than, say, assembling a portfolio of "green" labeled and linked bonds (or assembling a portfolio that simply eliminates the worst n-% of issuers based on an ESG score to satisfy some regulatory hurdle), it offers much higher yields and – crucially for us – little in the way of possibility in the diversion of the use of proceeds. After all, the last thing our investors should want is to have money they lent under a green bond structure to be used for something else, which we believe happened with Turkey's pre-election inaugural sovereign green bond. Our proposed approach does require deep fundamental analysis of the kind we routinely do, particularly when understanding a company's energy transition plans (and scooping up bargains in those whose backward-looking ESG score leaves them out of ESG score-oriented portfolios). Stay tuned!

Unchanged team. We like to think we look younger after a year in which the market was kinder, and we moved to a brighter new office:



Front row, left to right: Garret Sullivan, Victoria Courmes, Tina Vandersteel
Back row, left to right: Sergey Sobolev, Mustafa Ulukan, Eamon Aghdasi, Carl Ross

We look forward to seeing you and/or speaking with you in 2024.



Tina Vandersteel and the GMO Emerging Country Debt Team

<i>Annualized Returns as of 12/31/2023 (Net, USD)</i>	<i>Inception</i>	<i>1-Year</i>	<i>3-Year</i>	<i>5-Year</i>	<i>10-Year</i>	<i>ITD</i>
GMO Emerging Country Debt Strategy	04/30/1994	17.13%	-1.21%	3.29%	4.00%	11.64%
J.P. Morgan EMBI Global Diversified+		11.09%	-3.56%	1.63%	2.90%	8.25%

<i>Annualized Returns as of 12/31/2023 (Net, USD)</i>	<i>Inception</i>	<i>1-Year</i>	<i>3-Year</i>	<i>5-Year</i>	<i>10-Year</i>	<i>ITD</i>
GMO Emerging Country Local Debt Strategy	02/29/2008	24.18%	1.19%	3.83%	1.41%	1.93%
J.P. Morgan GBI-EM Global Diversified+		-12.70%	-3.16%	1.14%	0.09%	1.94%

Performance data quoted represents past performance and is not predictive of future performance.

Net returns are presented after the deduction of a model advisory fee and incentive fee if applicable. These returns include transaction costs, commissions and withholding taxes on foreign income and capital gains and include the reinvestment of dividends and other income, as applicable. Fees paid by accounts within the composite may be higher or lower than the model fees used. **A Global Investment Performance Standards (GIPS®) Composite Report is available on GMO.com by clicking the GIPS® Composite Report link in the documents section of the strategy page. GIPS® is a registered trademark owned by CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. Actual fees are disclosed in Part 2 of GMO's Form ADV and are also available in each strategy's Composite Report.**

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