

Monthly commentary / 30.9.2024

Vontobel Fund – Emerging Markets Debt

Marketing document for institutional investors in: AT, CH, DE, ES, FI, FR, GB, IT, LI, LU, NL, NO, PT, SE, SG (Professional Investors only).

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Market developments

The US Federal Reserve (Fed) finally initiated its long-anticipated rate-cutting cycle in September, much to the market's approval. The Fed surprised with a somewhat larger-than-expected 50 basis-point (bps) rate cut, although markets had already partially priced this in ahead of the meeting. Economists had generally forecasted a cut of 25bps. There had been prior concerns among investors that such a substantial cut might signal underlying economic issues that the market is unaware of, but those fears were dispelled as Fed Chair Jerome Powell successfully reassured markets that the US economy "is in solid shape."

In our view, the recent labor market data gave the Fed the confidence to begin the easing cycle. This included downward revisions to historical data and weaker non-farm payrolls over the past three months. Had the Fed known about these softer labor figures earlier in the year, they likely would have acted sooner, but with this updated data in hand, they are now adjusting accordingly.

US 10-year Treasury yields fell by 12bps over the month, closing at 3.8%. Meanwhile, Bund yields dropped by 18bps to 2.1% as the European Central Bank (ECB) also cut rates by 25bps. Inflation in the Eurozone was weaker than expected, with a 0.1% drop in consumer prices month-on-month and year-on-year inflation slipping below the ECB's 2% target to 1.8%, the lowest in over three years. Risk assets, including global equities, performed well, with the S&P 500 Index rising by 2% over the month.

In China, policymakers appear to be conducting a significant U-turn, launching a series of combined monetary, fiscal, and real estate-focused stimulus measures with an aim to boost its economy and stabilize the ailing property market. On the monetary front, the People's Bank of China (PBoC) cut the reserve requirement ratio (RRR) by 50bps and its policy rate by 20bps, building on an earlier 30bps cut. The PBoC has also provided forward guidance for an additional 25-50bps RRR cut later this year. The PBoC also set up two facilities to support the equity market.

While specific fiscal measures have not been fully detailed, the Politburo has vowed to strengthen "countercyclical adjustments" of fiscal and monetary policy and committed to implement "necessary fiscal spending". There's an expectation that the government will provide cash handouts for low-income households, rural elders, and unemployed college graduates, as well as increased subsidies to encourage childbirth.

On the real estate side, the PBoC has refined its lending facility to help regional governments buy back unsold properties. Downpayment requirements for second homes have been lowered from 25% to 15% and restrictions on second homes have been relaxed in some tier-1 cities.

Markets reacted positively to this stimulus, with emerging market (EM) equities rising by 6.4% in September. The Shanghai Shenzhen 300 Index surged by an impressive 25% in the last week of the month. Commodities also benefited from the stimulus, with the Bloomberg Industrial Metals Index rising by 6.4% and the Bloomberg Agriculture Subindex rising by 7.2%.

The Middle East conflict is heating up with Israel killing the most important leaders of Hezbollah, ground and air operations in Lebanon are ongoing, and Iran launched another missile strike against Israel that is unlikely to remain unanswered. Despite this, the Brent oil price was down 8.9% on the month and remained contained (~\$71/b) in early October as the global oil balance is expected to be in surplus in 2025.

EM bond indices performed well on the month and EM bonds received their first two consecutive weeks of inflows following the Fed cut. There were \$541m in inflows during the third week of September driven by ETF flows into hard-currency, and \$1.3bn in inflows during the fourth week of the month, this time joined by non-ETF flows, and to both hard-currency (+\$550m) and local currency (+\$730m).

Hard-currency sovereign bonds (EMBIG diversified) rose by 1.8% in the past month, driven by HY bonds (+2.4%) amid the risk-on environment while the IG segment rose by 1.3%. HY spreads tightened by 66bps on the month more than fully reversing the early-august spread widening. Meanwhile IG spreads were roughly stable. Regionally, LatAm performed best (+2.3%), closely followed by Africa (+2.3%). The Middle

East lagged a bit (+1.1%) due to its higher concentration of IG issuers.

Interestingly, Lebanese bonds were the best performing sovereign debt on the month (+24%) as the death of Hezbollah's leaders heralds a potential positive regime change for the country and therefore an increased likelihood of an eventual restructuring of its long-defaulted bonds. Maldivian bonds recovered 13.1% on the month after having dropped 20.1% in August amid very low FX reserves and credit rating downgrades. India provided some financial support to the archipelago by purchasing the equivalent of \$50m in local-currency T-bills, which is not yet enough to save the country from default. LatAm high yielders Argentina (+8.7%) and El Salvador (+8.4%) were also among the top performing sovereigns. In Argentina, the ongoing tax amnesty has resulted in an increase of more than \$12bn in domestic dollar deposits (+57%) since mid-August, and almost \$2bn in gross FX reserves. FX deposits and gross FX reserves are likely to increase further in October but probably not by as much as in September. In El Salvador, President Nayib Bukele promised to deliver a balanced fiscal budget in 2025 and the new proposed budget cuts spending by 10% in 2025. The market is also pricing in a high probability of El Salvador getting an IMF program in the short-term following official communication with investors during a non-deal roadshow.

Hard-currency corporate bonds (CEMBI BD) rose 1.2% on the month also led by HY (+1.3%) vs IG (+1.2%). At a regional level, EM Europe performed best (+1.5%) while Middle East lagged a bit rising by 1%. EM corporate HY spreads also tightened on the month (-9.5bps), while IG spreads were almost stable (-1.6bps).

EM local-currency bonds (GBI-EM) outperformed for a third consecutive month rising by 3.4% in September, which is not surprising given the ongoing dollar weakness. The DXY index dropped 0.9% and EM FX did even better accounting for 2% of the 3.4% total return seen for the month. South Africa continued to lead local-currency returns rising by another 7% as inflation came below expectations at 4.4% y/y in August and the central bank (SARB) cut rates by 25bps to 8% as expected. Latin America also performed well on the month recovering 3.2% while Asia and Europe underperformed (+1.5%). On the currency front, Asian currencies continued to do particularly well led by THB with total returns of +5.4%, and followed by MYR (+4.1%), and IDR (+2.7%). The BRL recovered nicely (+2.9%) after having underperformed for a few months. The TRY carry trade also performed nicely (+3.8%).

Portfolio review

As the benchmark spread tightened into the lower half of this year's range, we started to reduce credit risk again. We reallocated exposure in Africa by selling bonds in Cameroon, Kenya, Nigeria, and Ivory Coast, while adding bonds in Angola, Egypt, Senegal, and Zambia. We reduced quasi-sovereign exposure in Azerbaijan, Kazakhstan, and Hungary, while adding exposure in Uzbekistan. To reduce our exposure to Turkey and protect the portfolio against broader market weakness, we bought credit default swaps on Turkish sovereign bonds once spreads retested recent lows. We reduced our overweight in Petroleos Mexicanos after they outperformed Mexican sovereign bonds. We reduced exposure to supranational

bonds. We added exposure in the United Arab Emirates, through new bonds of the Abu Dhabi National Oil Company. We bought EUR-bonds of the Emirate of Sharjah after they had underperformed the rest of the curve. In return, we sold some bonds of the Emirate of Abu Dhabi. In Saudi Arabia, we switched from EUR into USD bonds. In Ecuador, we moved into longer, lower cash-price, bonds after an impressive curve normalization over the last three months. In Ukraine, we did the opposite by switching from longer into shorter bonds to profit from the strong curve inversion.

Performance analysis

The fund outperformed its benchmark by 0.61% in September (net, I share class). The portfolio profited from overweight positions in Petroleos del Perú and Petroleos Mexicanos. The former received extensive financial support from the Peruvian government, while future governmental support for the latter was reaffirmed by the new administration in Mexico. The overweight positions to Argentina, Ivory Coast and the Bahamas contributed positively to relative performance. In Saudi Arabia, the portfolio's selection of sovereign and quasi-sovereign bonds outperformed the benchmark. The main detractor of relative performance was the exposure to a Brazilian refinery. We were a bit early in reducing exposure to El Salvador and Kenya, hence, the portfolio missed some of the performance towards the end of the month. The underweight position in Turkey had a negative impact on relative performance as well.

Outlook

Market uncertainties persist but the market's risk appetite remains elevated, and EM can continue to do well in this context. In the US, the outcome of the presidential election remains wide open, and it will surely have consequences for fixed income markets and for some EM too. However, we think that while the US political cycle is likely to bring significant short-term volatility, the US economic cycle will probably dominate over politics in fixed income markets over the next 12 months. Focusing on the next 12 months, it's clear that the Fed will continue to cut rates until it reaches at least a neutral monetary policy stance, and we tend to agree with the markets view that the ~3% level for the Fed funds' rate will be reached by mid-2025 rather than in 2026 as foreseen by the latest Fed's dot plot published in September.

In China, it's still unclear whether the policy U-turn will suffice to bring the real estate crisis to an end and re-accelerate growth sufficiently to achieve the government's objective. But it's a very welcome policy change that will surely have positive effects on China and on the global economy. Commodity prices have already started to react to this, and EM economies will get a boost from the additional demand of imported goods that will result from a faster growing Chinese economy. Israel is now at war with Hezbollah and the likelihood of war with Iran has continued to increase. However, the impact of this war on the global economy and markets is expected to be much more limited than that of the Russia-Ukraine war in 2022. As noted earlier, global oil markets are projected to be oversupplied in 2025, which should help contain any significant rise in oil prices. Therefore, we believe the chances of the Middle East conflict derailing the ongoing global disinflation and disrupting fixed-income markets are relatively low.

As the Fed and other central banks in developed markets

(DM) continue in their easing cycle, we believe EM are ripe to benefit through multiple channels:

The first channel is the flows, after three and a half years of almost continuous outflows, it looks like the tide is finally turning and inflows have already begun during the last two weeks of September. Multi-decade high risk-free interest rates were partly to blame for the lack of interest in EM debt from asset allocators, as investors didn't feel like they needed to take additional risks to obtain a good enough expected return. As risk-free rates will continue to decline over the next year or two, asset allocators will be incentivized to re-allocate to EM fixed income, which is currently a heavily under-owned asset class. This will provide material support to EM spreads, which are likely to remain lower than their historical average in a context of a likely soft-landing in the US and for the global economy.

The second channel is through lower borrowing costs. As global rates continue to decline, EM issuers will be able to roll over their debts at more reasonable costs compared to the last few years. This will also lower the cost of capital for future investments, making more investments economically viable and resulting in faster economic growth in EMs. This in turn

will improve debt sustainability for sovereign and corporate issuers and increase profitability for EM corporates.

Local-currency bonds are poised to benefit from the second channel as well. Lower DM rates are also providing space for EM central banks to cut rates further, which will boost EM local-currency bond prices, as well as reduce EM local-currency borrowing costs for sovereigns and corporates alike.

The third channel is a more significant weakening of the US dollar. The greenback has been declining for three consecutive months amid weaker US economic data. If the trend continues and it marks the end of the US exceptionalism (i.e., the US starts to grow more in line with other DMs) without resulting in a US recession, the US dollar could weaken further.

This would greatly boost the market sentiment towards EMs as a whole and would benefit EM local currency returns. However, while the first two channels are quite certain to occur, this third channel is quite uncertain. A US soft landing remains our base case, but a hard landing cannot be ruled out. And if that's the case, the safe-haven appeal of the US dollar would provide effective support for the greenback.

Fund characteristics

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|------------------------|---|
| Fund name | Vontobel Fund – Emerging Markets Debt |
| ISIN | LU0926439729 |
| Share class | I USD |
| Reference index | J.P. Morgan EMBI Global Diversified Index |
| Inception date | 15.5.2013 |

Historical performance (net returns, in %)

| Time period | Fund | Ref. index | Time period | Fund | Ref. index |
|-------------|-------|------------|-------------|--------|------------|
| MTD | 2.5% | 1.8% | 2023 | 14.3% | 11.1% |
| YTD | 14.5% | 8.6% | 2022 | -19.9% | -17.8% |
| 1 year | 26.5% | 18.6% | 2021 | 1.0% | -1.8% |
| 3 yrs p.a. | 1.0% | -0.4% | 2020 | 1.4% | 5.3% |
| 5 yrs p.a. | 2.1% | 0.9% | 2019 | 14.8% | 15.0% |
| 10 yrs p.a. | 3.9% | 3.3% | 2018 | -6.5% | -4.3% |
| ITD p.a. | 3.8% | 3.1% | 2017 | 17.0% | 10.3% |
| | | | 2016 | 12.7% | 10.2% |
| | | | 2015 | -0.3% | 1.2% |
| | | | 2014 | 6.6% | 7.4% |

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