Monthly commentary / 30.8.2024

Vontobel Fund – Sustainable Emerging Markets Debt

Marketing document for institutional investors in: AT, CH, DE, ES, FI, FR, IT, LI, LU, NO, SE.

Market developments

August brought back volatility, but it was a round trip. A brief market panic ensued during the first week of the month triggered by an unexpectedly hawkish rate hike by the Bank of Japan (and the consequent unwinding of some JPY-funded carry trades) and by a faster than anticipated slowdown in the US labor market. US nonfarm payrolls increased by 114,000, way below the consensus expectations for a 175,000 rise. Later in the month, the prior numbers for 12 months until March 2024 were revised down by 818,000, indicating that the US labor market was never as hot as previous data had suggested. The consequent selloff of risk assets was mostly driven by the repricing of a higher probability of a US recession than before. US Treasuries rallied hard as the market started to price in four Fed rate cuts by year end – one more than before the labor data release. US 10y yields ended the month 13bps lower at 3.9 percent while German 10y bunds were stable at 2.3 percent.

More aggressive rate cut expectations by the Fed and the potential end of US exceptionalism translated into a weaker dollar, with the DXY losing 2.3 percent on the month. Commodity prices experienced a mixed performance. Gold rose by another 3.1 percent on the month amid expectations of lower US interest rates. Copper was relatively stable at +0.1 percent and Brent oil priced dropped by 2.4 percent amid concerns about China's growth and despite supply disruptions in Libya, lack of progress on cease-fire negotiations between Israel and Hamas, and discussions about a likely postponement of OPEC+'s 180 kboepd supply increase that was planned for later this year. Chinese data was anything but encouraging: manufacturing PMIs remained in contraction in August at 49.1, while non-manufacturing PMIs remained near stagnation level at 50.3.

All EM fixed income indices performed well in August, but the asset class continued to see outflows despite good year-to-date performance, with $2.5bn leaving the asset class in August (USD 1.2 billion from hard-currency and USD 1.3 billion from local-currency).

Hard-currency sovereign bonds (EMBIG GD) rose by 2.3 percent on the month. Africa was the best-performing region, rising by 2.8 percent, while Asia under-performed with a still positive 1.5 percent return. A high yield Latam trio ranked on top. Argentine bonds performed the best (+5.9 percent). On the politics side, there are signs of a deteriorating relationship between President Milei and the legislature. Regardless of a well-publicized spat over the opposition-supported extra spending measures, successfully being pushed through despite the president's veto, more importantly for bondholders, in our view, Economy Minister Caputo said that the country will repay all external debt service obligations in 2025 without market access. The presented plan seems credible to us. Ecuador bonds rose 5.5 percent on the month. The country appears on track with economic stabilization and is still supported by the IMF; meanwhile President Noboa looks poised for re-election in February 2024 as he enjoys a popularity level of 55 percent. El Salvador bonds jumped 5.2 percent on the month following a surprising statement by the IMF indicating that there has been quite some progress on the negotiation of an IMF program. In Brazil, Gabriel Galipolo was appointed as the next central bank governor as was widely expected. His appointment should help re-anchor inflation expectations given that he's aligned with the current governor Campos Neto's hawkish stance.

The largest negative surprise of the month was the Maldives, whose bonds dropped 20 percent following a downgrade from CCC+ to CC by Fitch (the second downgrade in just two months). While not a particular surprise for those who followed the country's fundamentals, the sudden attention it brought added urgency to its precarious financial situation. Venezuela was the second-worst performer on the month, with bonds dropping by 8.4 percent following July Presidential elections. Most western countries have not recognized the election results and the opposition has presented alleged proof of electoral fraud. Sri Lankan bonds dropped by 5.6 percent on the month amid some political uncertainty as the September 21 Presidential elections approach, and the ongoing debt restructuring appears likely to be delayed until after the elections.

Ukraine successfully completed its hard-currency debt restructuring as expected. The new bonds are now trading in the market with yields ranging between 12.5 percent and almost 18 percent depending on the specific maturities and bond characteristics. Ukraine's weight in the EMBIG Diversified index will increase to approximately 14bps to 1.05 percent.

Portfolio review

In August, the fund continued to receive net inflows. Helped also by absolute performance, the AUM rose further to USD 690 million (vs USD 610 million a month ago).

August was one of our more (if not most) active months in the

recent past, so it was not a typical quiet August. At the very end of the month we had one material inflow, which we have not fully invested by the end of calendar month, hence fund metrics need to be understood in the context of having some 6.5 percent of AUM in case, which is above our standard (which would be closer to 2-3 percent). In fact, on the first day of September, right after the Labor Day in the US, we have invested nearly half of this cash in the new issues.
As one trend of August, we were switching our medium-term bonds on sovereign curves into the long end, where it made sense (e.g., Colombia and Guatemala). We also exited or almost exited a few names, while entering some new or long-forgotten ones. Thus, we reduced South Africa, Senegal, and exited Dominican Republic and Papua New Guinea, all of which have tightened a lot recently. On the other hand, we added in Mexico, Nigeria, Ivory Coast (two relatively safer bets within Africa), added Costa Rica and entered its quasi-sovereign hydro utility ICE. Thirdly, we added some less volatile names like Panama and Bulgaria (the later saw spreads widen ahead of another election cycle). Finally, we entered several riskier trades, which in our view have de-risked compared to their past behavior, such as Zambia and Pakistan Water. While primary market was largely non-absent until the very last days of the month, we took part in a couple deals. Net-net, we were mostly adding to our BBB and CCC/D bucket and reducing in both A and BB/B categories.
On the overall characteristics, the fund is still at BBB- average rating (even before the inflow that obviously distorted it more positively on rating quality).
As for duration, as can be seen in performance section below, our explicit underweight on the USD curve has dragged us down as the market did not cease to move lower in yields during August, reflection of pricing in more cuts and pricing out Donald Trump's chances of winning upcoming elections. While we are still tilted to being underweight, we gradually reduced the underweight more than in half and before the big inflow we had about 0.4y of relative negative duration.
On the ESG front, our MSCI rating remains BBB. Our ESG in-house score did not change largely (from 44.7 to 44.8 out of 100).

Performance analysis

The fund has underperformed the index in August. The fund had a return of 2.16 percent vs the benchmark at 2.55 percent. In the context of broad EMD peer category (not only Article 8), a limited but in our view representative group of 25 larger funds, most have returned between 2.20 percent and 2.50 percent. While performing close to market on the bonds, our underweight duration exposure was against us for the second month in a row. About 22 bps out of 39 bps total underperformance is explained by yield curve, partly due to exposure to shorter bonds on the curves, but the rest is explained by open futures positions.
On the bond part of the portfolio, we lost on credit allocation somewhat more than gained on credit selection. There was no single outlier on either allocation or selection, rather across the board moves. On allocation, we were distracted by underweights in the likes of Argentina (CCC), Dominican Republic (BB) and several Middle Eastern monarchies (A/BBB), which reflects generally positive performance in all countries across the credit spectrum. This was partially compensated by exposures in Nigeria, non-exposure in Sri Lanka (a particular case) and exposure to several Air Baltic quasi-sovereigns (Air Baltic, Banco de Credito in Chile) and a private corporate Frigorifico Concepcion in Paraguay. On credit selection, things rather went our way – Poland, Brazil and Senegal explain more than half of total selection relative attribution.
If we zoom out, and look at the YTD picture, the fund still outperforms the benchmark by 0.64 percent (7.13 percent vs 6.49 percent). The largest positive drivers are GLP (corporate from Singapore, most of the upside materialized) and supranationals (each about 35 bps), Angola (22 bps, position fixed) and a few others at about 15 bps each. Egypt (-40 bps), Ukraine (-16 bps), Argentina (-25 bps) and Ghana (-19 bps) were the largest negatives, most of them in 1Q24 when risk-on mood was at full display, and we may lag due to our more defensive bias. A total of 40 bps is yield-curve related underperformance.

Outlook

With only two months left until the US elections, it is hard to discern whether the markets are more worried about politics or the shorter-term evolution of Fed cuts. We are in the camp of 'soft landing' or, at worst, moderate recession, and hence we think that current expectations of 1 percent cumulative cuts in 2024 are somewhat exaggerated. The market however keeps reacting to every piece of macroeconomic data, while the suspense of close to 50/50 chances regarding US presidential elections (and multiple different combinations when it comes to the Congress and the White House balance between the Republican and Democratic parties) is captivating the minds of forecasters, rather than being directly baked into UST rate levels. An interesting view on the market is that while everybody watches the elections topic closely, most do not do anything to prepare for it, given how hard it is to predict the odds and the outcomes for each of the several scenarios.
The resilience of EM bonds is likely to continue: In our baseline of a US soft landing, we expect US Treasury yields to continue to decline over the next two years. Markets may have overshot the pricing of short-term interest rates, but they are likely correct on the medium-term outlook. This implies that even if EM spreads widen amid persistent macroeconomic uncertainty, borrowing costs for EM issuers are unlikely to rise and total returns should remain positive and above those of most fixed income sub asset classes.
On a narrower level, EM spreads remain relatively tight, even if, in our view, this is justified by stronger fundamentals than in the years past.
In such an environment, uncertainty remains the only certainty and, hence, caution is justified. We do not think it makes sense to completely shun risk, but to take it more consciously and in a diversified manner. For the most part (think of it as core part of the portfolio), however, we would rather play defensive names until the market starts to find direction after November 5th. September-October are always a much more active 'back-to-school' season when liquidity picks up and primary issuance is abundant, hence we hope for and expect more rational markets where opportunities materialize somewhat quicker. Several less-crowded emerging countries will hold important elections in the next two months (Sri Lanka, presidential on the 21st September; Czechia – senate by 28th September; Tunisia, presidential on the 6th October; Mozam-

bique, Moldova, Georgia, Bulgaria, Uruguay – later in October). Some interesting opportunities could emerge there as a result.

Fund characteristics

Fund name	Vontobel Fund – Sustainable Emerging Markets Debt
ISIN	LU2145396086
Share class	I USD
Reference index	J.P. Morgan ESG EMBI Global Diversified Index
Inception date	30.9.2020

Historical performance (net returns, in %)

Time period	Fund	Ref. index
MTD	2.2%	2.6%
YTD	7.1%	6.5%
1 yr	13.8%	12.7%
3 yrs p.a.	-2.3%	-2.5%
5 yrs p.a.	–	–
10 yrs p.a.	–	–
ITD p.a.	1.9%	-0.6%

Time period	Fund	Ref. index
2023	11.0%	10.3%
2022	-20.0%	-18.9%
2021	3.7%	-2.3%
2020	–	–
2019	–	–
2018	–	–
2017	–	–
2016	–	–
2015	–	–
2014	–	–

Past performance is not a reliable indicator of current or future performance. Performance data does not consider any commissions and costs charged when shares of the fund are issued and redeemed, if applicable. The return of the fund may go down as well as up due to changes in the rates of exchange between currencies.

Investment risks

- Using derivatives generally creates leverage and entails valuation risks and operational risks. Leverage magnifies gains but also losses. Over-the-counter derivatives involve corresponding counterparty risks.
- Asset-backed and mortgage-backed securities, and their underlying receivables are often intransparent. The sub-fund may also be subject to a higher credit and/or prepayment risk.
- CoCo-Bonds may entail significant risks such as coupon cancellation risk, capital structure inversion risk, call extension risk.
- Securities with a lower credit quality means a higher risk that an issuer may fail to meet its obligations. The investment value may fall if an issuer's credit rating is downgraded.
- Distressed securities have a higher credit and liquidity risk as well as uncertainty in any potential bankruptcy proceedings.
- The sub-fund also includes sustainability criteria in its investment process. This may mean that the sub-fund's performance is more positive or negative than a conventionally managed portfolio.
- Investments in emerging markets entail increased liquidity and operational risks as these markets tend to be underdeveloped and more exposed to political, legal, tax and foreign exchange control risks.
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