Monthly commentary / 30.9.2024

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

The long-awaited US Federal Reserve's rate-cutting cycle finally began on September 18, much to the approval of the markets. This time, the Fed successfully communicated the move in advance. Chair Jerome Powell reassured markets that, despite the outsized move of 50 basis points (bps), the US economy "is in solid shape".

In our view, recent US labor market data – including downward historical revisions and last three months of weaker nonfarm payrolls – gave the Fed the confidence to initiate the easing cycle. US 10-year yields fell by 12bps during the month, ending at 3.8%. Meanwhile, euro-area inflation was weaker than expected, with consumer prices falling by 0.1% month-on-month, and year-on-year inflation dropped below the 2% target to 1.8%, the lowest level in three and a half years. The European Central Bank (ECB) cut rates by 25 bps for the second consecutive time, and Bund 10-year yields fell by 18bps to end at 2.1%. Risk assets and global equities performed well during the month, with the S&P 500 Index rising by 2%.

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, including top leader Hassan Nasrallah, and several daring attacks on the organization (thousands of pager and walkie-talkie blowups). Israel's armed forced followed up with ground and air operations in Lebanon are ongoing, and Iran launched the first 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.

Hard-currency sovereign bonds (EMBIG diversified) rose by 1.8% on the month led 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 largely 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. Hard-currency corporate bonds (CEMBI BD) rose 1.2% on the month also led by HY (+1.3%) vs IG (+1.2%).

Some notable country-specific events included Sri Lanka's agreement with bondholders on a debt restructuring, just days before a leftist President Anura Dissanayake was elected and promised to revise both the restructuring and the recently approved IMF plan, though not too deeply, as it seems. In Mexico, the Morena ruling party rushed the well-flagged judicial overhaul with basically all judges in the country up for replacement in the next 2 years. On October 1, Claudia Sheinbaum – the successor and flagbearer of incumbent AMLO's cause – took office with many new promises promising for even less fiscal discipline than during the last administration. Brazil was

upgraded by Moody's to Ba1, one step closer back to IG status (BB/BB from S&P and Fitch so far), which continues a solid wave of EM sovereign (and corporate) rating upgrades.

Portfolio review

In September, the fund had net inflows overall. Helped also by absolute performance, assets under management rose further to $707 million (vs $690 million a month ago).

Unlike in August, the fund did not trade very actively in September, but rather in a more targeted manner. Given that it was a very active month on the new issue front, however, a substantial part of our trading was concentrated there. We bought new deals from Indonesia, Uruguay as well as a few quasi-sovereigns – Bank Gospodarstwa Krajowego (Poland sov-guaranteed deal), ADQ (UAE sovereign wealth fund), Fiemex (Mexican electricity generator), Agrobank (bank in Uzbekistan) and some privately-owned banks. The last two names are in fact debutants in the Eurobond market.

On the secondary market, we have added Senegal, instead reducing Kenya. The former has announced snap general elections (as expected), while the latter largely recovered from a recent politically driven turbulence in the bonds. Also, we reduced some Eastern European names, such as Hungary and Croatia, but bought North Macedonia. Also, we exited Bahamas and South Africa.

Another trend of September is continuation of adding of some names at the bottom of the credit spectrum, including entering those we have not held in a while. For example, we entered Pakistan Water after a long absence, as the country was approaching an agreement with the IMF (later confirmed along with Gulf countries' financial support). For the first time since 2021 have we entered El Salvador, which made a huge progress toward an IMF program. On the other side, we reduced GLP which has mostly crystallized the profits since last year, we completely sold Davivienda perpetual (same reason) as well as Bolivia (it did not perform, but did not suffer either since we entered, so we just considered it an unnecessary extra risk in the current market context).

Finally, on the duration management, we have completed the shift we began in August to exit our underweight position. In August, this was achieved through a combination of switching into longer bonds and adding futures. By the last week of September, we moved to a neutral stance using futures on both the USD and EUR curves. In hindsight, this was a misstep over much of the past three months, and we have decided not to take on any additional risk in this area ahead of the US elections.

In terms of net changes of positioning resulting from all above trades, notable ones include – adding BB bonds while reducing BBB, B and CCC category. Overall rating of the fund remains unchanged at BBB- (even considering that we had some extra cash at the end of August)

On the ESG front, our MSCI rating remains BBB. Our ESG in-house score did not change (at 44.8 out of 100).

Performance analysis

The fund has performed exactly in line with the index in September (+1.75% for both). 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 1.50% and 2.50%.

While outperforming the market on the bond positions (nearly entirely due to allocation, rather than selection, on an issuer-issue model), our underweight duration exposure was against us for the third month in a row. Some 22 bps of underperformance on duration added to 3bps negative impact of selection but were fully compensated by the allocation. Note that as mentioned in the portfolio overview above, we no longer deviate from benchmark in terms of duration starting from last week of September.

Largest positive trades on the bond side include Air Baltic (+9bps, classified as allocation, while de facto it is nothing but selection) that did well on the rumours/news of possible strategic investor in the face of Lufthansa; Kenya (+6bps), Pakistan Water (+4bps), Frigorifico Concepcion (Paraguayan meatpacker) as well as Indonesia etc. Our underweight in Argentina was the largest underperformer for us (-9bps), Egypt (excluded for the fund, -5bps) and some others had negative impact.

If we zoom out and look at the year-to-date picture, the fund still outperforms the benchmark by 0.62% (9.01% vs 8.39%). The largest positive drivers are GLP (corporate from Singapore, most of the upside materialized), BOAD and Air Baltic (each about 30-35bps) and a few others at about 15-20bps each. Egypt (-45 bps), Argentina (-35bps), Ukraine and Ghana (both about 15-20bps) were the largest negatives, most of them in the 1Q24 when risk-on mood was at full display, the environment in which we may lag due to more defensive bias.

Outlook

For those readers tired of hearing about the US presidential election, there's good news: our next update will come after November 5. While final results may take well into November (or even December) to be confirmed, we believe the most challenging period is nearly over. The uncertainty and speculation that make this period difficult for trading and investing sho9uld soon be behind us. Another marginally positive shift in the outlook is a seemingly more front-loaded path of Fed (and likely the ECB). With the Fed having delivered a 50bps cut in September, markets are now pricing in another 50bps cut, potentially sooner than previously expected. Just like with the elections, as we approach the end of the rate-cutting cycle (or reach a neutral level of rates), markets can shift focus from uncertainty to credit differences, allowing for more confident risk allocation.

China's monetary and policy stimulus also shouldn't be overlooked. While not as aggressive as the 2008-style bazooka, the latest actions could set a floor under China's economic outlook for the next 2-3 years. This has positive implications for commodities and, by extension, could bring emerging markets back into favor.

However, not all news is positive. The escalating conflict in the Middle East could lead to another oil price shock and shifts in the balance of power in the White House and on Capitol Hill may further disrupt fragile geopolitical dynamics.

Our logic tells us to reduce risk somewhat ahead of the elections, while being prepared to capture opportunities while markets start to price in US election results. In general, the end of the year rarely changes the overall performance trend, as seen in 2016 when Donald Trump was elected. As the fourth quarter progresses, investors may start focusing on strong (often double-digit) returns from EM bonds. We maintain a generally positive outlook toward risk but advocate for a

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selective approach given current valuations. We prefer staying neutral ahead of the election.

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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	1.8%	1.8%
YTD	9.0%	8.4%
1 year	19.1%	18.1%
3 yrs p.a.	-1.2%	-1.2%
5 yrs p.a.	–	–
10 yrs p.a.	–	–
ITD p.a.	2.3%	-0.1%

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.
- The sub-fund's investments may be subject to sustainability risks. The sustainability risks that the sub-fund may be subject to are likely to have an immaterial impact on the value of the sub-funds' investments in the medium to long term due to the mitigating nature of the sub-fund's ESG approach. The sub-funds' performance may be positively or negatively affected by its sustainability strategy. The ability to meet social or environmental objectives might be affected by incomplete or inaccurate data from third-party providers. Information on how environmental and social objectives are achieved and how sustainability risks are managed in this sub-fund may be obtained from vontobel.com/sfdr.

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