Quarterly commentary / 28.6.2024

Vontobel Fund II – Fixed Maturity Emerging Markets Bond 2026

Marketing document for institutional investors in: AT, CH, DE, ES, FR, GB, IT, LI, LU, SG (Professional Investors only).

Market developments

The pure risk-on market seen during the first quarter of 2024 was followed by a market of consolidation, although largely constructive for risky assets, such as emerging market (EM) bonds. 10-year US government bond yields rose from 4.2% to 4.7% at the peak towards the end of April and then partially came back, ending June at 4.4%, while the US dollar strengthened by about 1%, as measured by the DXY index. Investor expectations of when the US central bank Fed would cut its key rate kept changing on a par with published inflation and labor-market data. Now, with four months left until the US presidential election and the Fed still holding its key rate steady, the likelihood of a cut taking place before the elections dwindles. The price of Brent crude oil started and ended the quarter at roughly 86 US dollar (USD) per barrel (bbl), fluctuating in between within a range of 91 to 78 USD/bbl. It still has support from supply limits by the Organization of the Petroleum Exporting Countries and their allies (OPEC+), despite continuing tensions in the Middle East.

Against this background, the EM bond market moved downwards, but only moderately, so investors' attention was drawn to positive developments. These included the first green shoots of the economic rebound in China, the de-facto end of Israel's operation in the south of the Gaza Strip (spoilt in June by the escalation with Hezbollah in the north), primary markets remaining open for a wide variety of EM issuers across the credit spectrum, and the resolution of several long-lasting legacy restructurings that came about in the aftermath of the start of the war in Ukraine in 2022. Interestingly, even though EM bond funds in hard currencies saw outflows during most of the second quarter, they ended it in positive territory, albeit barely with USD 0.7 billion.

Spreads of EM government bonds widened from 340 to 400 basis points (bps), as measured by the EMBI GD. Two-thirds of this move were due to the re-inclusion of Venezuelan bonds in the index. Spreads of EM corporate bonds remained flat at 270 bps, as measured by the CEMBI BD.

Of relevance for EM were several summits held by the BRICS+ member states (Brazil, Russia, India, China, South Africa, Egypt, Ethiopia, Iran, United Arab Emirates) and their potential new joiners, by the G7 countries (Germany, France, UK, Italy, Japan, Canada USA), and by other Western organizations. Particularly noteworthy is the conference dedicated to peace in Ukraine, that convened in June in Switzerland. It raised the awareness of the cleavage between the so-called 'West', which unequivocally supports Ukraine, and the BRICS-led group of countries largely concentrated in the so called 'Global South', which are either reluctant or outright opposed to condemning Russia. We now see an interesting trend among EM trying to navigate between the two camps, with the aim of remaining politically independent while maintaining economic partnerships with both.

Country-wise, three big pivotal elections took place in South Africa, India, and Mexico. In South Africa, the ruling African National Congress (ANC) party lost the majority for the first time since the country's transition to democracy, and therefore a broad coalition was formed to keep the more extreme parties away from government. Such a government of national unity is positive news, though it remains to be seen how durable and viable it will be. In India, Prime Minister Narendra Modi did not get the expected majority but quite easily managed to form a coalition with friendly parties. In Mexico, Claudia Sheinbaum, protégé of the incumbent president Andrés Manuel López Obrador (AMLO), unsurprisingly won presidency. Less expectedly, their party, Movimiento Regeneración Nacional (Morena), also garnered the constitutions two-thirds majority in the Congress and an almost equal one in the Senate, paving the way for a rather controversial political agenda to come soon.

Portfolio review

The fund size hovered around USD 500 million throughout the second quarter and stood at USD 497 million at the end of June. Outflows totaled USD 10 million (first quarter: USD 5 million), which we deem healthy for a closed-end fund that is barred from inflows.

Besides some 'portfolio clean-up' trading (see below), we occasionally traded because of shifts in the exchange rates between the US dollar (USD) and the euro (EUR) or Swiss franc (CHF), given a significant portion of investors hold share classes hedged in the latter two currencies. Moreover, the two Colombian quasi-sovereigns Ecopetrol and Ocensa lost their investment-grade status. Hence, we decided to sell Ecopetrol, because it now trades at a way too tight spread compared to our other high-yield (HY) bond positions (which together already come close to the 30% maximum exposure the fund is allowed to have in this bond segment). Instead, we bought several new names, such as Iraq, Cencosud, Energo Pro, and several Hungarian names. We also sold Grupo Axo in Mexico, a lucky opportunity: The bond used to trade at 95 cents until its issuer decided to mature it at above 101 cents. Without waiting for the formal procedure, we sold our position roughly at that level, and reinvested elsewhere. Such opportunity is rare in the market, but when it occurs it means the issuer's fundamentals have improved.

There were no new cases of permanent credit loss. At end-June, 1.4% of fund assets were in bonds with prices below 65 cents (end-March: 2.0%). This portion declined in the second quarter because 1) we sold part of Credivalores bonds (which repriced from 30 to 25 cents) and our entire position in Petrofac and MetalCorp (the latter finalized its restructuring), and 2) while the portion of our position in Vanke bonds (whose price rose to 64 cents) increased, our position in Longfor bonds (whose price rose to 80 cents) left the 'below 65 cents' bracket.

Among the largest countries of exposure, China moved up to the first position (9.9% of fund assets), followed by Mexico (9.1%) and Chile (8.6%), pushing former number one Colombia to the fourth position (7.8%), as we sold Ecopetrol.

At the end of June, the fund holds 110 positions (end-March: 113), still with an average BBB- rating and comfortably away from the BB+ category. The yield to maturity (YTM) is 7.6% after hedging into USD (end-March: 8.7%, end-December: 9.4%), 5.8% after hedging into EUR, and 3.2% after hedging into CHF. The major cause for the YTM decline is non-organic: Our former calculations included GF Mega. We decided to exclude this bond (which trades at 35 cents) from our calculation from June, as its servicing has become less likely unless an exchange or restructuring takes place. From our standpoint, the adjustment was necessary to reflect the actual yield of the portfolio. We deem this a one-off incident. We do not envisage such exclusion for the other portfolio positions.

Performance analysis

The fund stayed in positive territory for the seventh quarter in a row, posting a return of 2.0% in the second quarter of 2024. The net asset value (NAV) of the I share class in USD recovered from USD 94.5 to 96.4. Even though the fund is not benchmarked against any index, let's put performance in a context: The benchmark for EM corporate bonds, CEMBI BD, whose short duration is comparable to that of our fund – gained 1.5% last quarter, while most funds focused on EM corporate bonds returned between 1.0% and 1.8% in absolute terms.

Country-wise, there was one outlier delivering this positive return: China (+31 bps), with the two property names Vanke and Longfor responsible for half of that contribution. Both names benefitted substantially from the Chinese government's efforts to stabilize the market and support finalization of unfinished developments, relief purchasing requirements for home buyers as well as direct state- and lower-level banks to finance the property sector. In Vanke's case, the company delivered on the asset sales commitments and repaid its next Eurobond maturity in early June, thus winning investors' confidence. We keep both names (Vanke trades at 62 cents, Longfor at 80 cents on a dollar), as we believe valuations close to par are quite realistic. Other positive contributors include idiosyncratic stories, such as Trans Oil (Moldova) and Mogo (Baltic consumer lender). Both were among the beneficiaries of the primary market reopening to all sorts of issuers (they are both B-rated), hence their prospects of refinancing by the maturity date improve. To recap, Trans Oil was one of the names we invested in 2022 at 65 cents (currently trading at 85 cents), thus helping us compensate partially for losses from Russian bonds since the Ukraine war started. Further large contributors were Mexico (+15 bps) and supra-nationals (+11 bps).

There were only a few detractors: Petrofac (-9 bps), one of the legacy cases that we sold at 30 cents this quarter; Mexican GF Mega (-7 bps), another restructuring case, where we hold on to our position; Petra Diamonds (-5 bps), which suffered from a recent deterioration in operating performance; and some other names.

Outlook

We remain optimistic for EM bond issuers for the next six to twelve months, specifically for short-term bonds that our strategy focuses on. We do not expect massive repricing, as volatility usually diminishes during the summer months, particularly in July, when just a few major summits, elections, or other events of relevance for EM take place. For the fund, however, a steady upward drift in valuation is common, as the coupons keep accruing and the bonds approach their maturities. Other than that, economic and geopolitical topics will probably be more relevant, such as the second parliamentary-election round and formation of the government in France, the tensions between Israel and the Hezbollah, and the war in the Ukraine, which will probably be on snooze until the US presidential election in November.

Investors now start to price in the risk of Donald Trump coming back to the White House. However, this is arguably more relevant for longer-term bonds. One specific aspect that worries investors is yield-curve steepening on expectations of looser fiscal and monetary policy. This is obviously less relevant for our bonds with maturities of 1.5 to three years. Moreover, in several of the recent restructurings with EM issuers, such as Ghana, Sri Lanka, Ukraine (due this month), Unigel, and Oi, we have seen significant progress or expect finalization soon. This means the wave of defaults or troubles triggered in 2022 by the Ukraine war and the interest-rate spike is nearly over, which fosters a positive perception of EM issuers.

Fund characteristics

Fund name	Vontobel Fund II – Fixed Maturity Emerging Markets Bond 2026
ISIN	LU2365110571
Share class	I USD
Reference index	–
Inception date	9.11.2021

Historical performance (net returns, in %)

Time period	Fund	Ref. index
MTD	0.8%	–
YTD	5.1%	–
1 yr	10.1%	–
3 yrs p.a.	–	–
5 yrs p.a.	–	–
10 yrs p.a.	–	–
ITD p.a.	-1.4%	–

Time period	Fund	Ref. index
2023	7.9%	–
2022	-14.1%	–
2021	–	–
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.
- 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.
- CoCo-Bonds may entail significant risks such as coupon cancellation risk, capital structure inversion risk, call extension risk.
- Distressed securities have a high credit and liquidity risk as well as a potential restructuring and litigation risk. In the worst case, a total loss may result.
- 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.
- Asset-backed and mortgage-backed securities and their underlying receivables are often non-transparent. The sub-fund may also be subject to a higher credit and/or prepayment risk.
- The sub-fund's investments may be subject to sustainability risks. Information on how sustainability risks are managed in this sub-fund may be obtained from vontobel.com/sfdr.

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