

Candriam Sustainable Bond Emerging Markets

Market Overview

EMD HC (1%) recovered in February as the EM spread compression (-33bps) especially in HY (-68bps) versus IG rated credits (-12bps) accelerated. 10Y US nominal yields rose by 34bps while real yields rose by 20bps, as recent US activity, inflation and labour market data cautioned that the US economy is not slowing down as fast as indicated by data in prior months. EM risk premiums ignored the US data and declined during the month, contributing to positive Spread (+2.8%) and negative Treasury (-1.8%) returns.

The Fed held the Fed Funds rate in 4Q23 and in January acknowledging balanced risks to growth and inflation considering the third quarter tightening of financial conditions. Chairman Powell's comments in November and December indicated a progressively more dovish stance and FOMC on hold unless US labour markets exhibit resilience and inflation pressures persist. Powell's tone shifted to more hawkish in January stating that the Fed will proceed carefully with interest rate cuts and will likely move at a considerably slower pace than the market expectation of 4 x 25bps cuts by Jan-25. ECB are similarly on hold since October 2023 and likely to launch an easing cycle around mid-year conditional on wage inflation outcomes.

The main focus for markets over the near term remains the US rates evolution and monetary policy bias, and whether activity, inflation and labour market indicators confirm the Fed's view of a "soft landing" of the US economy. We will also continue monitoring the so far fragile Chinese recovery and the authorities' reaction function to the over-leveraged private sector next to EM and eurozone growth and inflation dynamics for guidance on EM risk premium performance.

The rates (MOVE) and equity market volatility (VIX) declined marginally in February and remain close to their lows. Global equity markets posted material gains SP500 (+5.2%), MSCI EM (+4.6%) while credit market performance was muted: US HY (+0.4%), US IG (-1.4%). Commodities' performance was also mixed. Oil (Brent crude up by 2.3%) and gas (European natural gas spot prices down by 16.6% to €24.8/Mwh, TTF 1D) diverged with oil impacted by persistent Red Sea route disruptions amidst tensions in the Middle East. Industrial metals declined during the month - Copper (-1.3%), Iron Ore (-8.7%). Agricultural commodities like Wheat (-4.7%) and Corn (-6.3%) also declined on supply pressures in the main grains exporters like Argentina, Russia and the US.

The trade-weighted US Dollar (+0.9%) strengthened in line with the 20bps upward move in 10Y US real yields (at 1.92% by end Feb-24). EMFX (-0.7%) marginally underperformed the Euro (-0.5%). CCC-rated credits outperformed other categories (7.2%) and the overall index. IG (-0.6%) under-performed HY (+2.6%) as the Treasury correction impacted higher quality credits more heavily due to their longer duration. Egypt (20.9%), Ecuador (+18.6%), and Ukraine (+12.3%) posted the highest, and Ghana (-3.4%), Senegal (-2.4%), and El Salvador (-2.0%), the lowest returns in February.

For 2024, JP Morgan forecast \$143.5bn of gross and +\$7.1bn of net sovereign supply and \$244bn of gross and -\$190bn of net corporate supply. EMD LC issuance, ex China, is expected at \$608bn or 28% up versus the \$477bn realized in 2023. Global EM corporate default rate forecast of 4% for 2024 incorporate an assumption on only marginal deterioration of EM corporate fundamentals.

In line with seasonal trends, January and February were strong issuance month with \$66bn, or 39% of the expected gross issuance placed by EM sovereign issuers. Issuance was concentrated in IG issuers although some HY issuers returned to markets after several years of hiatus (Benin, Ivory Coast, Kenya). The YTD net financing of \$30.9bn was absorbed by investors' cash balances while HC asset class outflows persisted (-\$4.9bn split between -\$4.1bn HC and -\$0.8bn LC). Notably, the EMD asset class continues to receive outflows even after two consecutive years of combined \$128bn of outflows (\$94.1bn in 2022 and \$33.7bn in 2023).

Portfolio Highlights & Strategy Review

The Fund underperformed by 121bps in February, net of fees, returning +0.25% vs +1.47% for the JPM EMBI GD Index. The big driver of the underperformance was the outperformance of the CCC and lower rated issuers, which are excluded from

investment. The CCC component of the benchmark returned 7.2% in February, compared to 1.0% for the overall index. Furthermore, the largest single name outperformers this month were in the single B-rated space, but these names are excluded on ESG grounds (Egypt and Ecuador). Egypt, Ecuador, and Argentina detracted a combined 67bps. UWs in Ukraine and Pakistan cost another 8bps. UWs in China and Ghana added positively, as did UWs in Indonesia, Saudi Arabia, and Uruguay.

In terms of positioning changes, the largest additions were made to Romania (+0.76%), Brazil (+0.18%), and Albania (+0.04%). In terms of reductions, Bulgaria (-1.42%), Serbia (-0.81%), and Côte d'Ivoire (-0.25%) saw the largest changes. The absolute (-35bps to 6.90) and relative duration of the Fund (-32bps to 0.36) fell during the month.

Fund Outlook

A Relative EMD HC valuations in EM HY offer some residual value versus asset class fundamentals and DM Credit while EM IG valuations appear fair. Absolute valuations do not screen attractive as EMD HC offers a spread over US Treasuries of 369bps, or 42bps inside its 5-year average of 411bps. The HY versus IG spread over US Treasuries differential is 529bps, or 20bps inside its 5-year average of 549bps, with the value concentrated in the distressed CCC and D-rated universe of 15 countries with 5.9% index weight. At the same time, the EMD HC yield of 8.1% offers 1.6% over its 5-year average of 6.5%, with similar elevated carry levels traditionally attracting some asset class interest.

The medium-term case for EMD is supported by relative valuations in the HY segment, and especially in frontier credits, disinflation, less restrictive central bank policies and a scenario of slowing but not collapsing growth in the US and in the rest of the world. The Russian invasion of Ukraine and the parallel financial and political isolation of Russia fueled energy and food price inflation globally which required central bank tightening in 2022 and most of 2023. We expect that in 2024, the adverse dynamics for fixed income markets are reversed. We expect that inflation continues to decline towards targets and that growth slows but that the US avoids a recession. The Fed should react to the tighter financial conditions it has engineered via its 525bps cumulative rate hikes yet the launch of an easing cycle will remain data dependent. ECB may have over-tightened and the eurozone may enter a short-lived technical recession in 2024 yet with no significant consequences for the rest of the world. China will likely deliver enough stimulus to ensure growth remains in the 4.5-5% range in 2024 while growth in EM ex China will slow marginally but remain just under 4%. The key global macro headwinds to EMD remain deeper than expected DM central bank hiking cycles in response to persistent inflation and subsequent harder landings of the American and European economies.

High funding costs and limited access to external financing may tempt some vulnerable EM countries to default but these risks are mostly priced in by EMD HC sovereign valuations as EM spreads already incorporate an assumption of a 5.5% default rate at a conservative recovery rate of 30%. Uncertainty around the de-rating of the EM universe and the resolution of specific liquidity and solvency issues in some EMs remain, but these are going to be addressed on a case-by-case basis. Our moderately constructive commodities outlook is based on the assumption of slowing but not collapsing global growth. We expect that in the medium term, US Dollar weakness is anchored by the sizeable twin deficits the economy has amassed and by the near doubling of the Fed's balance sheet in 2020. In late 2023 and early 2024, as the US economy slows down, we may observe the beginning of this medium-term soft US Dollar trend that may finally reverse the longer-term weak EM currency trend. Yet US Dollar has outperformed EM FX and G10 FX during recessionary periods which raises the uncertainty around EM currency performance in 2024.

On a one-year horizon, we expect risk premiums to rise but that carry and duration effect support positive total returns. On an assumption of 10Y US Treasury yields between 3.5-4% and EM spreads between 400-450bps, EMD HC returns may be around 4-11%.

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