Candriam Bonds Emerging Markets

Market Overview

EMD HC (-1.3%) gave back some of its end of last year gains as US Treasury yields and EM spreads rose in recognition that market pricing of the timing and extent of US monetary easing for 2024 is overdone. 10Y US nominal yields rose by 15bps while real yields were unchanged, as recent US activity, labour market and GDP data cautioned that the US economy is not slowing down as fast as indicated by data in prior months. EM risk premiums performed in line with core rates - EM spreads rose by 17bps, to 402bps. These contributed to negative Spread (-0.5%) and Treasury (-0.7%) 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 5 x 25bps cuts. ECB are similarly on hold since October 2024 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) rose marginally in January but remain close to their lows. Global equity and credit markets posted mixed performance: SP500 (+1.6%), MSCI EM (-4.7%), US HY (+0.4%), US IG (-0.4%). Commodities' performance was also mixed. Oil (Brent crude up by 2.7%) and gas (European natural gas spot prices down by 2.5% to €29.75/Mwh, TTF 1D) diverged with oil impacted by Red Sea route disruptions amidst rising tensions in the Middle East. Within industrial metals, Copper (+0.6%) was up, and Iron Ore (-0.2%) down. Agricultural commodities like Wheat (-5.2%) and Corn (-4.9%) declined on supply pressures in the main grains exporters like Argentina, Russia and the US.

The trade-weighted US Dollar (+1.9%) strengthened despite that 10Y US real yields (at 1.72%) were stable in January. EMFX (-2.1%) marginally underperformed the Euro (-1.7%). CCC-rated credits outperformed other categories (3.7%) and the overall index. IG (-1.84%) under-performed HY (-0.69%) as the Treasury correction impacted higher quality credits more heavily due to their longer duration. Ecuador (+15.9%), Pakistan (+9.5%) and Tunisia (+5.2%) posted the highest, and Lebanon (-3.5%), Colombia (-3.219%), and Qatar (-3.18%), the lowest returns in January.

For 2024, JP Morgan forecast $136.5bn of gross and -$4bn 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 was a strong issuance month with $46.6bn placed by mostly IG issuers like Chile, Hungary, Indonesia, Mexico, Poland, Saudi Arabia although strong HY-rated issuers like Brazill and Ivory Coast also returned to primary markets. The YTD net financing of $3.4bn was absorbed by investors' cash balances while HC asset class outflows persisted (-$2.4bn split between -$1.9bn HC and -$0.5bn 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 out-performed the index by 32bps, in net terms. The largest contributors to relative performance were the OWs in EM HY like Ghana (reached agreement with official creditors), Ecuador (marginal stabilization of domestic security after army involvement), Ivory Coast (successful issuance of new bonds combined with liability management of front end bonds) and Tunisia (reduction of funding risks around repayment of bonds in Dec-23 and Feb-24), and Ukraine (EU agreement on extending a E50bn aid package). The OW in Romania also contributed despite that the country issued $4bn of new 5Y and 10Y bonds on recovering cross-over demand.

During the month, we took partial profits in EM HY that have outperformed and offer limited upside like Ghana, Ukraine, Colombia and Dominican Republic, but added to Brazil, Egypt, El Salvador and Nigeria. In EM IG space we added to Saudi's SWF PIF and Romania, to maintain OW exposure to both credits.

The absolute (-2bps to 7.23yrs) and relative duration of the Fund (+5bps to +0.6yrs) did not change materially during the month.

* net of fees in USD terms

Fund Outlook

Relative EMD HC valuations in EM HY offer some residual value versus asset class fundamentals and DM Credit while EM IG valuations appear rich. Absolute valuations do not screen attractive as EMD HC offers a spread over US Treasuries of 402bps, or 10bps inside its 5-year average of 412bps. The HY versus IG spread over US Treasuries differential is 585bps, or 40bps above its 5-year average of 545bps, 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 more than 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 fuelled 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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