EM Blended

Market context

September was a strong month for EM fixed income assets.

The global market backdrop was supportive, with developed market bond yields falling as the European Central Bank and the US Federal Reserve (Fed) both cut rates over the month – by 25bps and 50bps respectively. This marked the first rate cut in over four years in the US, where the inflation picture has continued to improve. The Fed's decision, combined with some more encouraging data on the US economy, boosted risk assets across the globe.

Across emerging markets, several central banks in Latin America continued to ease monetary policy, boosting local bond markets; the exception was Brazil, where a resurgence of inflation prompted a rate hike. Several countries are also battling a severe drought, which is impacting energy production and causing wildfires. In Asia, Chinese policymakers announced a raft of stimulus measures aimed at boosting confidence and supporting the equity market, while Asian currencies benefited from US dollar weakness caused by the fall in US bond yields. In Central and Eastern Europe, growth data remained on the weak side, and several markets were impacted by significant floods.

The local bond market (JP Morgan GBI-EM) returned 3.4% in September, with local rate markets and currencies appreciating. Among hard currency assets, the sovereign debt market (JP Morgan EMBI GD) gained 1.8%, while the corporate market (JP Morgan CEMBI BD) returned 1.2%, with high-yield and investment-grade market segments contributing positively to the latter.

For a more detailed global market background, please read our market review.

Performance

The Strategy outperformed its benchmark (JP Morgan EM Blended Hard Currency/Local Currency 50-50) over the month*, gross and net of fees. Performance was driven by positioning in local and hard currency sovereign debt. EM FX also helped, while corporate bonds detracted slightly.

Overweight positioning in Mexico's local bonds and underweight exposure to the peso both added to performance. The country's bonds benefited from the rally in US Treasuries and a rate cut by the Mexican central bank. The peso came under pressure from the passing of the controversial judicial reform bill, which Moody's suggested will impact Mexico's credit rating.

Local bonds in Czechia rallied along with the rest of the European rates market. Exposure added to performance.

Argentinian hard currency bonds gained from the rally across more risk-sensitive assets and were further boosted by the government's announcement around a tax amnesty. Overweight positioning helped the portfolio.

Exposure to the Turkish lira added to performance. The continued tightening of domestic financial conditions and the resumption of inflows into the currency boosted the lira.

In contrast, the central bank in Chile was more dovish than expected, hurting the peso and weighing on the portfolio's exposure.

Underweight positioning in the Korean won held back performance, as the weaker US dollar benefited Asia FX.

Political noise in Uruguay relating to the upcoming elections caused concern among investors, leading the market to reduce exposure to the peso. The portfolio's overweight position weighed on performance.

*Where performance is gross of fees, returns will be reduced by management fees and other expenses incurred. Net performance is net of highest institutional segregated portfolio management fee.
Not all securities held have been discussed. For further information on how the overall strategy performed during the period covered, please reference the relative performance noted in the Performance review section.

Past performance does not predict future returns; losses may be made.

Outlook

The global economy had shown some signs of slowing, with the US labour market cooling and the manufacturing sector weakening. In September, the Fed began its rate-cutting cycle with a reduction of 50 basis points (bp). Chair Powell signalled that the Fed was more comfortable with the US economy's inflation trajectory and that a 'recalibration' of monetary policy was needed. More recently, however, US labour data has surprised to the upside; this, combined with other economic activity data releases and commentary from Powell, has caused the market to price out the chance of further 50bp cuts this year. We believe there could be further rate-market volatility. But this should not distract from the main underlying theme that the US and global economy is cooling, inflation is close to targets, and monetary policy is easing. Furthermore, the recent stimulus announcement from China has boosted sentiment and may prove to have a fundamental longer-term positive impact on growth, consumption and investment, with possible spillover to the broader EM universe. That said, our base case expectation is that the Chinese stimulus will not materially impact the trajectory of global growth or inflation.

While financial markets are likely to remain volatile, we continue to be constructive on the medium-term outlook for returns from the EM debt asset class. Many EM economies have solid fundamental foundations, and the more fragile economies continue to receive plenty of support from the IMF and other multilaterals. EM bond market valuations look attractive – with some markets still pricing in significantly more risk than we believe is justified.

From a top-down perspective, we continue to have a positive overall risk target. The front-loading of interest rate cuts from the Fed, reduced recession risks for the US economy, and broader fundamental improvements within EM economies continue to support our constructive view. We have reduced our overweight position in local rates to neutral, increased our FX position from slightly underweight to neutral, and remain overweight hard currency.

Regarding local rates, modest improvements in global growth are less supportive of duration, and although inflation in EM economies is generally low, the recent oil price rebound could pose risks. Therefore, we plan to reduce top-down local rates risk and lock in positive performance ahead of the US elections, which could lead to a pick-up in volatility. However, from a longer-term perspective, we remain constructive; a broad softening of inflation across EM economies means that real (inflation-adjusted) yields remain attractive, which is a key driver of long-term returns. Rate cutting cycles have further room to go, and the overall trajectory of Fed policy, as well as dovish commentary, gives us increased confidence that EM economies have the ability to continue cutting rates.

In EM FX, we have a neutral top-down target. A slightly stronger global growth outlook, coupled with lower US dollar yields, highlights attractive carry differential opportunities in the asset class.

In EM hard currency, our top-down target is overweight as the recent front-loading of interest rate cuts by the Fed should be supportive for higher-yielding EM bond markets in the short term.

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