Emerging Market Hard Currency Debt

Market background

A rise in sovereign bond yields weighed on the emerging market hard currency fixed income asset class over the fourth quarter. In October, market participants scaled back their expectations of US interest rate cuts; the Federal Reserve's December meeting confirmed this, with the Fed forecasting just two rate cuts in 2025, down from four in its previous meeting.

Despite this challenging backdrop, the EM hard currency sovereign debt market showed resilience, posting a relatively contained decline in US dollar terms. The negative return was driven entirely by the investment-grade part of the market, which bore the brunt of the rise in US Treasury yields. In contrast, the high-yield segment produced a slight positive return, reflecting solid performance by some lower-rated countries' bond markets over the quarter, led by Lebanon, Argentina and Ukraine. The EM corporate bond market also showed resilience. As was the case in the EM sovereign debt market, negative performance was driven by investment-grade bonds, with a tightening in credit spreads proving insufficient to outweigh the negative impact of the rise in US Treasury yields. Here too, the high-yield segment delivered a small positive return, boosted by credit spreads tightening.

Performance

The Strategy outperformed its benchmark (JP Morgan EM Bond Index Global Diversified) over the quarter*, gross and net of fees.

The fiscal adjustments seen in Argentina throughout 2024 continued in the fourth quarter, and are expected to persist into 2025, following President Milei's announcement that spending and tax reforms will remain in place. Adding to the positive sentiment were reports of significant progress in negotiations between the government and the IMF on a new programme, valued at US$26 billion. As a result, December rounded off a strong quarter for Argentina's hard currency bonds; overweight exposure added to performance.

The government in Panama failed to pass its social security reform in time for the 2025 budget, which weighed on hard currency bonds. Underweight exposure to this market helped the portfolio. An absence of exposure to Indonesia and the Philippines protected the portfolio from weakness there; these markets are particularly sensitive to moves in US Treasury yields.

Ghana exited its default status over the quarter after the final stages of the hard currency debt restructuring were completed. This allowed payments to be made to bondholders. Exposure added to performance.

Overweight positioning in Ukraine helped performance, as the country's bonds rallied following the election of Donald Trump and the perceived improvement in prospects for peace. Underweight exposure to Brazil cushioned the portfolio from weakness there; this market came under significant pressure from increased concerns around the country's fiscal strength.

In contrast, the portfolio's exposure to more interest rate-sensitive markets such South Africa, Paraguay and Chile detracted from performance. These weakened given the sharp rise in US Treasury yields over the quarter. South African debt also came under pressure from the risk-off tone in markets over December.

Underweight exposure to Sri Lanka held back relative performance. Post the recent election, the government has pressed ahead with the external debt restructuring and has also reached a Staff Level Agreement with the IMF. Both of these helped the country's hard currency bonds.

The portfolio's zero-weight exposure to Lebanon also held back performance, as the country's bonds rallied following the ceasefire deal between Israel and Hezbollah and the breaking of the deadlock in the election of the president. Hard currency bonds in El Salvador

*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.

rallied on reports that a staff-level agreement with the IMF for a US$1.4 billion three-year programme was likely to materialise in December, which boosted investor confidence. The portfolio's underweight exposure held back relative returns.

Portfolio activity

In CEEMEA, we closed exposure to Hungary as we think orthodox economic policies will be unwound over 2025 ahead of the elections in 2026. We added an overweight in Romania. Spreads widened amid the election-related volatility, creating an attractive entry point, and we think the market is already pricing in the negative fiscal developments. We reduced the portfolio's overweight position in Serbia after strong performance there. We closed exposure to quasi and corporate hard currency bonds in Kazakhstan. Spreads have tightened, making valuations expensive, and we expect bond issuance this year. We added a new position in Jordan. There has been good progress on the country's IMF programme, and fiscal tightening is on track to stabilise debt-to-GDP levels by 2027.

In Latin America, we increased the overweight in Guatemala. Recent underperformance created an attractive entry level, and structural reforms are gaining more political support. We added a new overweight in Colombia given attractive valuations relative to peers and as recent fiscal spending cuts improve the outlook. We did not think that hard currency spreads in Brazil were reflecting the increased fiscal risks, so we closed exposure to the country's hard currency bonds. We also expect bond issuance in early 2025.

In Africa, due to rising geopolitical risks close to Egypt's borders and heavier market positioning, we trimmed the overweight exposure to the country's hard currency bonds, which had performed well. We reduced exposure to Kenyan bonds to neutral. These rallied on the news that the IMF approved its review, and we expect some issuance this year. We participated in Nigeria's new bond issuance, increasing the overweight, as we have a positive view on the country's structural reforms.

Outlook and strategy

The ongoing strength of US economic data, combined with cautious commentary from Federal Reserve (Fed) Chair Powell, hawkish 'dot plots' for 2025 from the Federal Open Market Committee (FOMC), and the anticipation of reflationary policies under the Trump administration, have continued to suppress the market's expectation of rate cuts. The eventual outcome of key policy differences between the Trump administration and the Biden administration — particularly in areas such as trade and tariffs, immigration, fiscal policy, regulation, and Fed appointments — are being closely monitored by the market.

The reaction of emerging market (EM) assets to rising US Treasury yields and a stronger US dollar has been relatively modest. This may reflect several factors: in Trump's prior term, actual policies often diverged significantly from initial threats; many market participants had already reduced market risk leading up to these elections; and the macroeconomic backdrop continues to price in rate cuts for 2025 (unlike the rate-hiking cycle of 2016), providing some stability to broader risk sentiment.

While financial markets are likely to remain volatile, we maintain a positive view on the medium-term outlook for returns of 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 anticipate that the near-term outlook for hard currency assets will favour higher-carry, higher-yielding markets, where valuations appear most attractive. Concerns persist regarding potential policy risks under the Trump administration and their eventual impact on emerging market growth. However, strong US economic momentum into the close of 2024, alongside anticipated fiscal expansion and deregulation under Trump, is likely to provide additional impetus for the US economy, in turn keeping the US dollar-denominated EM hard currency debt market supported.

The strategy's primary focus is currently in BB rated markets with credit-rating upgrade potential, such as Serbia and Paraguay, in contrast to underperforming BBB rated markets at risk of downgrades, such as Panama. Additionally, we maintain targeted exposure to select high-yield markets where we believe excessive risk premia persist and where ongoing fundamental improvements are anticipated. Notable examples include Mexico (namely, state-owned utility issuer, Pemex), Ghana, and Argentina.

Specific risks.

Currency exchange: Changes in the relative values of different currencies may adversely affect the value of investments and any related income. Default: There is a risk that the issuers of fixed income investments (e.g. bonds) may not be able to meet interest payments nor repay the money they have borrowed. The worse the credit quality of the issuer, the greater the risk of default and therefore investment loss. Derivatives: The use of derivatives may increase overall risk by magnifying the effect of both gains and losses leading to large changes in value and potentially large financial loss. A counterparty to a derivative transaction may fail to meet its obligations which may also lead to a financial loss. Emerging market: These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems. Equity investment: The value of equities (e.g. shares) and equity-related investments may vary according to company profits and future prospects as well as more general market factors. In the event of a company default (e.g. insolvency), the owners of their equity rank last in terms of any financial payment from that company. Interest rate: The value of fixed income investments (e.g. bonds) tends to decrease when interest rates rise.

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