Emerging Markets Local Currency Dynamic Debt

Market background

It was a solid quarter for emerging market (EM) fixed income and currency markets. The global rally in government bond yields, together with an improved appetite for risk among market participants, provided a supportive backdrop for the asset class.

In the US, falling inflation and expectations of rate cuts led to a sharp drop in Treasury yields. The Federal Reserve subsequently reduced interest rates for the first time in four years in its September meeting; after much debate across markets around its potential size, the 50bps cut reflected a slowing labour market and increased confidence around inflation dynamics.

In local currency emerging markets, the flagship index (JP Morgan GBI-EM) had a particularly strong quarter. A strengthening of EM currencies (EM FX) was the primary driver of this, but local bond markets also boosted overall returns; bond prices rose across regions, notably in South Africa and Latin America. The former was helped by falling inflation and a positive election outcome, while the latter continued to benefit from rate cuts by central banks in the region. In EM FX markets, gains were most apparent in Asia as these currencies tend to benefit more from the US dollar weakening and the gap between domestic yields and US Treasuries falling. However, currencies in Latin America suffered from a sharp rally in the Japanese yen after the Bank of Japan turned more hawkish than expected. This caused an unwinding of carry trades in the region, which were funded by the lower-yielding Japanese currency.

Performance

The Strategy outperformed its benchmark over the quarter, gross and net of fees*.

Exposure to local bonds in Peru helped relative performance. Falling global yields and easing domestic inflation allowed the central bank to resume its rate-cutting cycle during the quarter and this benefited the bond market.

Political noise in Mexico weighed on the currency over the quarter; the controversial reform was passed in September, weakening judiciary independence. This led to a statement from Moody's that the country's credit rating may be negatively affected. Underweight positioning in the peso cushioned the portfolio against weakness here.

Further rate cuts from the Hungarian central bank, plus the global rally in duration, helped Hungarian local bonds. Overweight exposure added to the performance.

Exposure to South African local bonds boosted performance. These were helped by the more constructive global rates backdrop and improving domestic inflation data.

Turning to detractors from performance, the Thai baht's close correlation with the gold price, combined with weakness in the US dollar, led to a rally in the currency. The portfolio's underweight positioning early in the quarter held back performance. We have since moved to a neutral position.

In Chile, the central bank cut rates by 25bps in September in a unanimous decision. The accompanying comments were dovish, reflecting the central bank's concerns around domestic growth; it has signalled that it will bring monetary policy back to neutral by the first half of 2025 and this boosted Chilean local bonds. The portfolio's underweight positioning detracted from relative performance. We have since closed the underweight.

The Chinese renminbi was a beneficiary of the broader US dollar weakness; underweight positioning held back 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.

The Nigerian naira came under continued pressure from domestic demand for US dollars and the central bank rebuilding its reserves. Although the central bank tightened monetary policy, real rates remain negative. Exposure detracted from performance.

Portfolio activity

The portfolio increased exposure to Asian currencies. We closed the portfolio's short in the Philippine peso due to a narrowing in the country's trade deficit and an increase in foreign direct investment, and we closed our underweight in Thai baht. We moved overweight the Indonesian rupiah as it is relatively sensitive to moves in the US Treasury market, thus we expect it to benefit from the lower US yield environment and a weaker US dollar. In Malaysia, the central bank continues to believe the ringgit is undervalued, and we expect further repatriation flows to continue to support the currency; we increased exposure to overweight. In contrast, we moved to a short position in the Korean won – we expect US dollar buying by the country's large National Pension Service to continue to weigh on the currency. Turning to local bonds, the market is pricing in substantial rate cuts in South Korea but we expect a delay given the central bank's concerns over financial stability, so we moved underweight.

In Latin America, we moved underweight the Colombian peso due to concerns about a weaker US growth outlook, risks to commodity prices, and the possibility that the central bank may accelerate its rate-cutting cycle, thereby reducing carry. Given risks to the inflation outlook, we also reduced exposure to Colombian local bonds. After a dovish pivot from the central bank in Chile, we closed out of both the overweight in the peso and underweight in local bonds. We took off our underweight in the Peruvian sol given stronger growth data, plus external accounts are performing well. We saw attractive value in the Brazilian real, and on the back of hawkishness from the central bank we added to our overweight in the currency. Additionally, we increased our exposure to local bonds in Mexico to overweight due to supportive inflation dynamics, weaker growth, and the central bank signalling it would start cutting rates at a more regular cadence.

In the CEEMEA region, we reached our target valuation levels in the Polish zloty and reduced exposure to neutral as a result. Following the underperformance in the Czech koruna, we halved the portfolio's underweight, but increased exposure to local bonds due to the weak domestic growth outlook and benign inflation backdrop.

Outlook and strategy

The global economy had shown some signs of slowing, with the US labour market cooling and the manufacturing sector weakening. In September, the US Federal Reserve (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.

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 increased exposure to 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.

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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