Ninety One

Emerging Markets Sustainable Blended Debt

Market background

The combination of higher sovereign bond yields and a persistently strong US dollar weighed on the emerging market 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 backdrop, the EM hard currency sovereign debt market showed resilience, posting a relatively contained decline in US dollar terms. This was driven entirely by investment-grade issuers, which bore the brunt of the rise in US Treasury yields. In contrast, the high-yield segment of the market produced a slight positive return, reflecting a rise in some lower-rated countries' bond markets over the quarter, led by Lebanon, Argentina and Ukraine. The EM corporate bond market also showed resilience against a backdrop of rising government bond yields. As was the case in the EM sovereign debt market, negative performance was driven by investment-grade bonds, as a tightening in credit spreads was insufficient to outweigh the negative impact of the rise in US Treasury yields. Here too, the high-yield segment returned a slight positive, boosted by spread tightening.

EM currency weakness was the main culprit for a challenging period in the local currency bond market. US dollar strength drove this, boosted by hawkish comments from the US Federal Reserve and the subsequent rise in US Treasury yields. Trump's victory in the US presidential election also helped the dollar. The hedged local bond market fared better, falling only slightly over the quarter in total return terms. Asian rates markets outperformed, while Latin American markets struggled.

Performance

The Strategy performed in line with its benchmark (50% JPMorgan GBI-EM Global Diversified/50% JPMorgan EMBI 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 portfolio's short position in the Korean won added to performance. The currency came under significant pressure from political turmoil in December. We have since closed the position.

Underweight positioning in the Mexican peso and Mexican local currency bonds helped relative performance. The assets suffered as the market priced in risks relating to Trump's potential trade policies, and were further hampered by the risk-off move in December.

The portfolio's underweight positioning in the Chinese renminbi added to relative performance. The currency weakened given the continued strength of the US dollar.

In contrast, exposure to the Taiwan dollar and the Singapore dollar detracted from performance. Both currencies weakened given the broad strength of the US dollar over the quarter. Overweight exposure to the Malaysian ringgit at the start of the quarter also hurt performance. We did not expect the central bank to allow a strong sell-off in the currency, based on previous behaviour; lack of intervention by the bank against the backdrop of a stronger US dollar caused the currency to underperform.

*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.

The Chilean peso weakened over the quarter due to the central bank's interest rate cuts eroding the carry of the currency, the strength of the US dollar, and the peso's sensitivity to weak Chinese growth. Exposure detracted from performance.

The portfolio's exposure to more interest rate-sensitive assets such as hard currency bonds in Chile and Paraguay detracted from performance. These weakened given the sharp rise in US Treasury yields over the quarter.

The portfolio's overweight in Colombian local bonds detracted from performance. Bond yields rose due to market concerns over fiscal policy following the government's approval of a revenue redistribution law, which allocates a larger share of revenue to local governments. Additionally, the central bank's decision to slow the pace of interest rate cuts in December disappointed the local bond market.

Overweight positioning in the Brazilian real detracted from performance. The currency came under significant pressure from the market's concerns around the country's fiscal strength.

Portfolio activity

In Asia, we took profit on our short position in the Korean won; the currency weakened following political instability caused by the declaration of martial law. We added an overweight in the Philippine peso after a combination of underperformance and seasonal factors into year-end created an attractive entry point for the currency. In Thailand, growth and inflation are weak, and there is a risk of further rate cuts from the central bank. We closed the underweight position in Thai rates. Given the sensitivity of the Indonesian rupiah to the US dollar, we moved from neutral to underweight after strong economic data was reported in the US. We closed exposure in the Singapore dollar after a dovish pivot from the central bank, translating into the bank allowing a slower appreciation of the currency. We increased the underweight the Indian rupee; balance of payments dynamics turned more negative, and we suspect that the new central bank governor to adopt a more flexible approach to the currency. We reduced our overweight in Malaysian local bonds because inflation is expected to rise next year and growth remains robust.

In Latin America, we moved overweight the Peruvian sol. The currency is well supported by strong terms of trade due to metal prices recovering, plus market positioning in the currency is light. We reduced the overweight in Peru's local bonds, taking profit. We closed the overweight in the Brazilian real; fiscal deterioration is driving asset prices and stimulus measures are supporting consumption, which is not helpful for the real. We moved underweight Mexican local bonds, after strong economic data in the US reduced the likelihood of rate cuts from the Fed, which Mexico's yield curve is sensitive to. We took off the overweight in the Uruguayan peso as we believe it has become overvalued. Geopolitical tensions have pushed up oil prices and that has significantly improved Colombia's terms of trade. We added a new overweight in Colombian hard currency bonds 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 increased fiscal risks, so we moved from overweight to underweight in the country's hard currency bonds.

In CEEMEA, in reflection of the risk of the US imposing tariffs on the EU, we moved underweight the Polish zloty. We reduced our overweight in Czech local bonds, since the near-term inflation outlook does not seem appear supportive for the country's debt. 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. We reduced the portfolio's overweight position in Serbia after strong performance there.

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 risk perspective, we have kept our target at neutral. This reflects a combination of neutral positioning in local rates, a slight underweight in EMFX, and a small overweight in hard currency debt. We remain positive on the overall outlook for the asset class and continue to express our bottom-up investment views through active relative-value positioning across this increasingly diverse opportunity set.

While the US election result may pose risks to the inflation outlook, we remain constructive on local rates on a longer-term basis: 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. While the magnitude of cuts priced into the market has reduced, the overall trajectory of Fed policy gives us increased confidence that EM central banks will be able to continue cutting rates. Regarding EM FX, the Trump win poses risks relating to tariffs and higher US Treasury yields, both of which may weigh on EM currencies; we are underweight as a result.

In EM hard currency, our top-down target remains slightly overweight, with exposure concentrated in the higher yielding portion of the market. Here, we remain constructive on markets that are supported by positive country specific dynamics and sufficiently high yields to cushion against potential volatility. In addition, increased bond supply in January will provide an opportunity to add to higher quality duration risk.

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.

Important information