CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

Candriam Sustainable Bond Emerging Markets

Market overview

The new year began with calm markets as investors cautiously awaited the U.S. Presidential inauguration and the anticipated wave of executive orders, prompting a wait-and-see approach in the first half of the month, with some repositioning already underway in anticipation of new tariff measures.

Major tariffs were indeed announced, including a 25% levy on all imports from the U.S.'s primary trading partners, Mexico and Canada, and a 10% tariff on Chinese imports, all set to take effect on the second business day of February. Additionally, in a surprising move, a 25% tariff was briefly imposed on Colombia, allegedly in response to its failure to honour an agreement to accept deported migrants from the U.S. Following political negotiations, the tariff was swiftly revoked, reinforcing the market's assumption that minor concessions could lead to similar policy reversals. Given the intense focus on Mexico, asset prices had already adjusted, resulting in a muted market reaction in January.

In relatively quiet markets, optimism about the new U.S. administration's potentially risk-positive stance fueled gains in equities. The S&P 500 rose +2.7%, while the NASDAQ added +1.66%, despite a sharp selloff in AI-related stocks on January 27th. The turmoil was triggered by Chinese AI startup Deep Seek, which claimed to have replicated advanced AI models at significantly lower costs without access to Nvidia's most sophisticated chips. Emerging market equities performed in line with broader trends, as MSCI EM climbed +1.81%. Meanwhile, Japan's Nikkei dipped (-0.81%), while German equities outperformed (+9.16%), benefiting from policy divergence between the European Central Bank, which cut rates on January 30th, and the Federal Reserve, which held steady on January 29th.

The commodities sector saw broad-based gains, with Brent crude up +2.84%, copper rising +6.27%, iron ore advancing +4.85%, and gold continuing its rally (+6.63%), alongside silver (+8.31%). However, natural gas declined by +1.74%. The U.S. dollar also softened slightly, losing +0.11%, while emerging market currencies (EMFX) gained +0.92%.

In fixed income, the U.S. Treasury market posted modest gains, with the 2-year yield declining by -4 basis points and the 10-year yield rallying -3 basis points. Emerging market sovereigns returned +1.44%, with investment-grade (IG) bonds contributing +0.69% with high-yield (HY) bonds outperforming by +2.13%, continuing last year's trend. Meanwhile, EM corporate bonds gained +0.80%, with IG returning +0.63% and HY leading at +1.03%.

Portfolio Highlights & Strategy Review

In January, the fund generated +1.03% (net of fees, in USD terms), underperforming its benchmark* by –41bps. During the month the market saw a continuation of last year's trend of outperformance of distressed debt, with ESG-Eligible but ratings-excluded Ecuador being the biggest detractor with -0.17% (with bonds rallying by +14.6%) in expectation of an easy win by Daniel Noboa in the February 9th Presidential elections. Underweights in other distressed names such as Venezuela (-0.10%), Egypt (-0.07%), and Lebanon (-0.06%) also detracted from performance. At this stage, the outperformance of CCC and lower-rated credits has significantly diminished, as only a few remain at deeply distressed levels with low cash prices, drawing market focus to capitalize on the final phase of 2024's distressed outperformance theme.

The Fund prioritized exposure to countries with strong technicals. To mitigate potential tariff-related disruptions, we shifted our overweight position from Mexico to Brazil, where fiscal underperformance was already priced in, and FX-denominated debt remains low at 5% of GDP, with Ministry of Finance guidance indicating a future range of 3–7% of GDP. We believe the Brazilian government's decision to forgo refinancing maturing bonds in early January provided a signal of reduced future supply.

Indeed, tariffs against Mexico were announced and then postponed, but our reallocation helped with Brazil ending up the largest outperformer for the month in relative terms, with 0.16% outperformance for the month. Mexico underperformed, with a contribution to the benchmark of +0.02% only, while our decreased allocation contributed 0.01% to the portfolio.

January is traditionally a very heavy month for new issuance. We only participated in the Hungary new issue, where we bought newly issued green bonds. Hungary does not plan to issue more bonds this year, as they are very close to their target of 30% debt to GDP in foreign currency bonds. Hungary was the second best contributor to outperformance, with our holdings outperforming the benchmark by +0.09% in relative terms.

Other contributors to outperformance were core overweight's such as our position in Colombia, which weathered the tariff storm with +0.05% contribution above benchmark, the same as off-benchmark Macedonia. Ivory Coast, Costa Rica, and Senegal all contributed +0.04% each to outperformance, while Poland added +0.03%.

We further reduced the exposure to Romania during the month as all indications were that the 2025 budget would be too optimistic and there were large scale protests in the capital in support of the extremist presidential candidates, thus increasing the probability that the rerun of presidential elections will result in the same outcome. Last year we switched the Romania overweight into Poland and both countries had new issues during the month. While demand for Romania bonds was lackluster and barely covered the issue size (1/4 of the projected issuance for the year), demand for Poland's first bond offering was higher than the country's projected issuance for the entire year.

* net of fees in USD terms

Portfolio Activity

The global macro environment is likely to support further US dollar strength due to robust US economic performance, driven by potential tax cuts, deregulation, and tariffs under the Trump administration. However, for the rest of the world the new administration poses a potential source of volatility with the resumption of tariffs and confrontational trade tactics. The fundamentally sounder picture across many EM countries together with a very low expected default rate gives us reasons for optimism, as global growth seems to have stabilized and a number of countries are projected to grow faster than in 2024, with the growth momentum sufficient to absorb external shocks.

On the other hand, shocks coming from the US via less accommodative monetary policy in response to inflation risks could lead to reduced investment flows into emerging markets due to weaker growth prospects resulting from decreased trade. Slippage in fiscal consolidation in developed and emerging markets remains a critical risk, with countries such as Brazil and some economies in Eastern Europe facing a potential market backlash for loose fiscal policies. Conversely, fiscal improvements in South Africa and Turkey's economic reforms have bolstered investor confidence. This dispersion of performance of issuers is likely to present a source of alpha for actively managed strategies. The balance of risks however remain uneven due to the compressed level of spreads, but external shocks should benefit defensive strategies with active management.

Given the expected fiscal consolidation in a number of countries, overall financing needs should be lower on balance, but with net financing needs in hard currency being quite small, the bulk of the issuance to cover fiscal deficits should be in local currency. This would also be cheaper for sovereigns in an environment of strengthening USD, so technicals in local markets will be weaker on balance and will be weighed against the room that central banks will have to cut rates.

In hard currency, we expect gross issuance to be slightly below 2024, but with increased debt servicing cashflows via coupons, and significantly higher amortizations, net financing needs for EM sovereigns are projected to be the lowest since 2015, with the exception of 2022, when net financing was negative. This should be positive for the asset class, everything else being equal. We expect some HY issuers to return to the market in the new year, given the marginally more attractive funding conditions.

Absolute yield levels at 7.6% for hard currency are at historically attractive levels, so we expect fund flows to stabilize in 2025. Overall spreads are at the tighter end of the spectrum and are unlikely to meaningfully compress from here although tight levels of spreads are somewhat justified by our expectations of very low default rates and very low net issuance in 2025. Assuming 10Y US Treasury yields between 4.25%-4.75% and EM spreads between 330 and 360 bps, EMD HC returns are likely to be around 4% - 7% over the next 12 months.

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