Candriam Sustainable Bond Emerging Markets

Market Overview

In July the market was driven by the turnaround in US data. GDP for the second quarter beat expectations (2.8% annualised vs 2.0% expected), as a number of short-term data prints surprised to the downside defying some of the more backward-looking and optimistic Q3 GDP forecasts.

Although July non-farm payrolls came in better than expected, significant revisions to prior months showed that the US jobs market is cooling off. On top of that, the CPI print in the US came in lower than expected month on month, showing further cooling in price levels. Factory orders and ISM Services surprised to the downside, both being in contractionary territory. Factory orders were -0.5% vs expectations of +0.2%, compared to the last reading of +0.7%, whilst the ISM Services reading of 48.8 disappointed vs an expected 52.7, down from 52.8 the previous month. The slew of data fuelled expectations for Fed cuts, which initially supported stocks, but mid-month we saw a rotation from the Magnificent 7 (mega-cap US stocks), into the broader index, and especially into more rate-sensitive sectors.

The S&P 500 still managed to eke out a positive return, reaching a record high on July 16th, but then selling off to finish +1.22% on the month. US Treasuries rallied by -50bp in the 2-year note and -37bp in the 10-year. The 2s10s curve steepened by +13bp over the course of the month, whilst the 10s30s part of the UST curve steepened by +11bp.

Commodities had a poor month on the back of slower growth expectations, with WTI and Brent selling off by -4.45% and -6.58% respectively in price terms. Natural gas sold off by more than 20% on plentiful stocks in Europe and lower demand, whilst industrial metals didn't fare much better than oil, with copper down -4.9% and iron ore down -6.4%. Gold prices continued their strong run, stabilising near the recent highs with a positive monthly return of +5.2%, while the dollar index was down by -1.67% on rate differentials, driven by ramping up of Fed cut expectations. EM FX outperformed the dollar, rising by +0.5%. The emerging sovereign debt market rallied by +1.87% during the month primarily driven by a strong treasury contribution of +2.49% as the spread contribution was negative following +12bps of monthly spread widening, which was largely driven by IG issuers. As a consequence the EM Sov high yield market marginally outperformed posting a return of +1.91%. The EM Corporate market lagged sovereigns, due to the inherent shorter duration, posting a return of +1.5%.

On the last day of the month the FOMC solidified rate cuts expectations, indicating that a 25bp cut was likely to materialise in September, whilst tempering suggestions for a 50bp cut, fuelling a further rally in US Treasuries and the broader government bond universe.

Portfolio Highlights & Strategy Review

The Fund outperformed the benchmark by +0.05% during the month, appreciating in value by 1.92% vs 1.87% for the benchmark index. Although the fund's carry is structurally below the benchmark (by 15bp this month), the positioning along the credit curves with an underweight in long-dated bonds added to performance as the fund long-dated bond underweight generated relative performance from the curve steepening. The net effect of that positioning was positive +26bp vs the performance of the benchmark, while the spread duration OW of the fund detracted by -3bp during the month.

Notable drivers of outperformance were overweight in Romania (+19bp vs benchmark), Colombia (+12bp), the Dominican Republic (+9bp), Poland (+8bp), and Peru (+8bp), while notable underperformance drivers were structural underweights in Ecuador (-8bp) and Ukraine (-9bp) due to the CCC and below rating restriction. Other detractors were China (-7bp) and Saudi Arabia (-7bp), which are excluded from the investment universe due to the authoritarian regimes restriction.

As expected, in July, Ukraine managed to strike a deal with creditors leading to a rally in the government bonds. Going forward, we expect the effect of distressed debt performance to have a less outsized impact on the relative performance of the Fund compared to the last latter part of 2023 and the first half of 2024, where the bulk of distressed sovereign debt performance accrued.*

* net of fees in USD terms

Fund Outlook

As the US economy is showing signs of a gradual slowdown, the FOMC signalled its intention to begin gradually decreasing rates in September. The ECB has already begun cutting interest rates, and it was followed by the Bank of England in July, setting the stage for a gradual rate-cutting cycle (not without interim volatility) in developed markets. The only outlier is the Bank of Japan, which has begun raising interest rates, albeit from a very low starting level. This discrepancy will cause additional volatility, as the Japanese Yen has long been the favourite funding currency for carry trades, and as these unwind we expect periods of market volatility and distress.

One particular problem that we see brewing globally is a deterioration in fiscal balances, which markets don't appear to be pricing in a number of cases. Indonesia, for example, which is starting from relatively low levels of Debt to GDP, is planning a sustainable expansion in government debt levels, investing in value-added activities, as well as in fiscal multiplier-increasing projects, such as free school meals for all schoolchildren. Others countries are in less favourable fiscal situations, so additional debt issuance could contribute to spread widening over the course of the year, offsetting some of the duration gains from a decrease in risk-free rates. Some countries have started implementing ambitious fiscal consolidation efforts, but in an environment of slowing global growth, fiscal slippage is likely. At the same time, deficits are not expected to decrease in the US, which we expect will be accompanied by larger issuance at the longer part of the US Treasury curve and come with an increase in the term premium in long-term US rates. This should push credit spreads wider leading to some impact for longer-dated EM bonds, especially in the high-yield part of the benchmark, where spread compression has been the greatest in recent years.

The Fund is positioned defensively by construction, so the strategy should benefit in such environment. We are seeking to maximise returns, based on relative-value trades to take advantage of sustainability factors benefitting or worsening the fiscal outlook.

On a one-year horizon, we expect risk premiums to rise but we expect carry and duration effects to support positive total returns. On an assumption of 10Y US Treasury yields between 3.5-4% and EM spreads between 400-450bps, EMD HC returns are likely to be around 7-11%.