CANDRIAM
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Candriam Sustainable Bond Emerging Markets

Market Overview

Global markets turned their attention to the health of the US labour market as a key measure for the state of the US economy and the likely US interest rate trajectory. September began with a disappointing U.S. non-farm payroll report, revealing just 142,000 new jobs in August, which was well below the consensus expectations of 165,000. Additionally, July's already modest figure of 114,000 jobs was subject to heavy revisions, with net revisions for the past three months totalling a relatively high -86,000, compared to expected revisions of -29,000. Nevertheless, the unemployment rate edged down slightly, after rounding, from 4.3% to 4.2%.

The weaker labour market data prompted the FOMC to initiate its easing cycle on September 18th with a 50 basis point cut in the base rate, a move that had been largely anticipated by the treasury market, which had already priced in more than 100 basis points of cuts by the end of the 2024.

Later in the month, risk sentiment received an additional boost from China, which unveiled a series of measures to support its struggling real estate sector. These actions, officially announced in September, included rate cuts (short-term repo and 1-year), a 50 basis point reduction in the reserve requirement ratio (RRR), lower mortgage rates, and initiatives to bolster equity markets. The measures triggered a strong rally in Chinese equities, further amplified by the consensus underweight positioning and light foreign investment. Reports in the press also highlighted a supplementary package aimed at boosting consumption, equivalent to 1.7% of GDP, funded by state borrowing. This package was earmarked for equipment upgrade programs and direct transfers to families with more than one child.

Following the FOMC rate cut and China's stimulus measures, risky assets rallied towards the end of the month, with equities seeing significant gains, except in Japan. The S&P 500 rose 2.14%, DAX gained 2.21%, Hang Seng surged 18.32%, while the Nikkei fell 1.30%. MSCI Emerging Market Equities advanced by 6.68%. Bond markets also performed well, with the U.S. 2-year Treasury yield dropping 28 basis points, the 10-year yield falling 12 basis points (net steepening of 16 basis points), and the 10-year Bund yield declining by 18 basis points.

Emerging market (EM) sovereigns returned 1.85%, with the investment-grade (IG) segment up 1.26%, compared to high-yield (HY) bonds, which gained 2.43%. EM corporates returned 1.23%, with IG up 1.17% and HY up 1.31%. The U.S. dollar weakened, as the DXY fell 0.90%, while emerging market currencies (EMFX) rallied by 1.88%. Commodities also benefitted from China's stimulus, with copper rising 8.11%, iron ore up 5.20%, and precious metals seeing positive returns—gold increased 5.24% and silver soared 7.95%.

Despite the positive sentiment from China's measures, concerns over global growth weighed on oil, with WTI down 7.31% and Brent crude falling 8.92%.

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Portfolio Highlights & Strategy Review

The Fund returned a positive performance, underperforming the benchmark which rallied on outperformance of the HY portion of the index, while IG names lagged. The biggest contributors to performance were overweights in Africa - Ivory Coast (+9bps vs benchmark) and Kenya (+7bps vs benchmark) due to tightening of credit spreads. Furthermore, OWs in CEE did not benefit from spread tightening but positioning on the yield curve contributed to outperformance in Romania (+7bps), Poland (+7bps), Serbia (+5bps), and Hungary (+5bps). The vast majority of underperformance came from recovering credits that are not eligible for sustainable investment – Argentina (-16bps vs benchmark), Egypt (-9bps), Turkey (-9bps), and El Salvador (-6bps). During the month we continued to reduce exposure to long-dated securities and added in the middle part of credit curves, as well as adding green bonds in carbon-intensive credits to manage carbon intensity KPI of the fund.

Fund Outlook

The U.S. economy is gradually slowing, prompting the FOMC to begin easing with a 50bps rate cut in September. Markets anticipate two more cuts by year-end, with five additional cuts expected over the next 12 months. The ECB has already lowered rates, as German inflation dipped below the 2% target. Similarly, the Bank of England initiated rate cuts in July, signalling a broad rate-cutting cycle across developed markets. The Bank of Japan, however, stands out by raising rates, albeit from a low base.

This easing trend benefits fixed-income assets, providing a boost to emerging market (EM) sovereigns by improving financing conditions and providing high yield issuers with market access. EM fundamentals remain relatively strong, supported by positive real growth and improving current account balances. While many countries aim for fiscal consolidation, slower global growth could hinder these efforts. Across the universe there are countries that stand out with plans for improving debt sustainability despite the less encouraging outlook of global growth. In the U.S., deficits are not expected to shrink substantially, leading to increased long-term Treasury issuance and a higher term premium, potentially widening credit spreads and impacting longer-dated EM bonds. We expect that most of recent debt restructurings to have concluded, limiting future distressed debt returns. The asset class has recently benefited from several ratings upgrades acknowledging some of the improvements we have been experiencing.

Finally, the upcoming U.S. election poses a key risk to EMs, with potential trade tensions, especially tariffs targeting China, which could weaken China's trade partners and commodity exporters in the region. Chinese authorities have begun addressing deflationary pressures by announcing a series of monetary measures with a comprehensive fiscal package being muted, signalling their growing urgency to stabilize the economy. The batch of measures represent a step in the right direction but are likely insufficient to put the economy on a sustained path. While China is seeking to stabilize its property sector and support its domestic growth, US elections could result in steep tariff increases in the run of economic rivalry and technology supremacy and could lead to currency weakness. Fund flows into emerging markets have stabilized recently and we believe we could be about to experience a turnaround, given the fed cutting cycle is underway with investors keen to lock in historically high yields.

In terms if valuations high yield issuers, ex-distressed, versus their IG counterparties screen rich. We see near-term potential for spread decompression in this segment of the market and would aim to profit from any spread widening. At yields of around 7.7% the sovereign market is still attractively priced in a historical context. On an assumption of 10Y US Treasury yields between 3.5%-4% and EM spreads between 400bps, EMD HC returns are likely to be around 5-10% over the next 12 months.

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