Wellington Emerging Local Debt Fund

WELLINGTON MANAGEMENT®

MARKET REVIEW

Emerging markets external debt returned 1.85 as measured by the JP Morgan Emerging Markets Bond Index Global Diversified (EMBIGD) in US-dollar terms. Spreads narrows 27 basis points to 361 bps, contributing to performance, while a decrease in US treasury rates had a positive impact. Latin America was the best-performing region in the index, while the Middle East lagged. Investment grade issuers underperformed non-investment grade issuers. From a country perspective, Lebanon, Argentina, and El Salvador were the best performers in the index during the period, while Venezuela, Angola, and Senegal lagged.

Emerging local markets debt returned 3.39% in US-dollar terms, as measured by the JP Morgan Government Bond Index - Emerging Markets Global Diversified (GBI-EMGD). Emerging Markets (EM) currencies appreciated, driving positive performance, along with EM rates contributing. Middle East/Africa was the best-performing region in the index, while Europe lagged. From a country perspective, South Africa, Thailand, and Chile were the best performers in the index, while Uruguay, the Philippines, and Hungary lagged. Among the benchmark countries, Colombia (-50bps to 10.25%), Dominican Republic (-25bps to 6.50%), Mexico (-25bps to 10.50%), Peru (-25bps to 5.25%), Czech Republic (-25bps to 4.25%), Hungary (-25bps to 6.50%), South Africa (-25bps to 8.00%), and Indonesia (-25bps to 6.00%) decreased their benchmark interest rates, while Brazil (25bps to 10.75%) increased their benchmark interest rates.

EM corporate debt, as measured by the JP Morgan CEMBI Broad Diversified Index (CEMBIBD), posted a total return of 1.23% in US-dollar terms. Credit spreads narrowed by 6 basis points to 263 bps. Investment grade credits underperformed non-investment grade credits. TMT and consumer were the best performers, while financial and oil & gas lagged.

In September, the U.S. Federal Reserve, the European Central Bank, and a number of EM central banks eased interest rates. The conflict in Ukraine saw continued hostilities, with Russian forces launching new offensives in the eastern regions. In the Middle East, tensions escalated as clashes between Israeli forces and Hezbollah fighters intensified. In the U.S., the presidential campaigns of Vice President Kamala Harris and former President Donald Trump continued to gain focus. In Venezuela, protests continued as the opposition challenged the legitimacy of President Nicolas Maduro's administration, drawing international attention and calls for new elections. In Sri Lanka, left-leaning candidate Anura Kumara Dissanayake was elected president in the second round of voting.

FUND PERFORMANCE AND ATTRIBUTION

- The portfolio modestly underperformed its benchmark during the month.
- Security selection detracted from results. Security selection within Brazil detracted due to an overweight to short- and mid-dated local debt. Security selection within Colombia had a negative impact on performance due to our underweight to short-dated local debt. Our overweight to short-dated local debt within China also detracted from results. Security selection within South Africa contributed due to an overweight to long-dated local debt. Positive security selection within Turkey came from an overweight to long-dated local debt.
- The portfolio's currency positioning detracted from results. Our underweight to the Malaysian ringgit and Chilean peso detracted from performance.
- Duration strategies contributed to performance over the period. Specifically, our overweight positioning in local duration in Mexico, South Africa, and Colombia contributed to relative performance.

FUND POSITIONING AND OUTLOOK

The Federal Reserve kicked off their long-anticipated easing cycle in September with a 50 basis point cut, prompting the market to look ahead to the scope of easing that can be expected over the final quarter of 2024 and into 2025. Hard currency fixed income will directly benefit from developed market interest rate cuts while local yields, even those where central banks have already commenced cutting cycles, should benefit as well.

Amidst a heavy year of elections across both emerging and developed markets, political stability and governance remain at the forefront. The first half of the year brought the first leadership change in over a decade to Indonesia, better than expected performance from the Regeneration Movement (Morena) in Mexico, and underperformance relative to expectation for the Bharatiya Janata Party (BJP) and African National Congress (ANC) in India and South Africa's elections, respectively. The balance of the year will be focused primarily on the US elections in November, with important implications for both US domestic and foreign policy and the potential to have acute impacts on emerging markets. We continue to monitor other key global factors including the conflicts between Israel and Hamas and Russia and Ukraine, questions around oil market supply and prices, and ongoing efforts by China to stimulate improvements in growth and inflation dynamics.

In many EM countries fundamentals remain largely constructive, supported by manageable balance of payment positions, improving fiscal deficits, supportive commodity prices, and waning inflation. Within the cohort of distressed and defaulted countries with weaker policies and a lack of access to capital, we continue to find select opportunities. Multiple weaker EMs, having undergone debt restructuring over parts of 2023 and 2024, are beginning to reach final resolutions with stakeholders and move towards necessary structural reform. Many EM corporates continue to exhibit considerable financial strength amidst rising cost pressures and elevated refinancing costs. While improvements to corporate fundamentals may have reached a plateau, attractive opportunities in the sector continue to be met with demand from both dedicated emerging markets investors as well as crossover buyers.

In the third quarter, spreads tightened across both EM sovereigns and EM corporates, with high yield spreads moving tighter while investment grade spreads lagged and ended the quarter modestly wider. Dispersion within the opportunity set still provides an opportunity to leverage our deep country and corporate analysis as well as to utilize relative value in security selection.

EM local market yields are still high by historical standards in many countries, and rate cutting cycles are in their early stages. Throughout much of Latin America and in parts of Central and Eastern Europe, many EM central banks such as Colombia, Uruguay, Chile, Hungary, and the Czech Republic have initiated rate cutting cycles. Several other EM central banks, having reached pause points as they awaited further clarity on the trajectory of Fed rate cuts, are now likely to move more decisively into an easing cycle. Turning to EM currencies, several factors dominate, including USD directionality and rate volatility. In the long term, we anticipate that proactive action by EM central banks and wide US fiscal and external deficits will eventually pose a challenge to USD strength.

In the third quarter, hard currency and local currency funds saw outflows, though outflows early in the period gave way to inflows in the final month of the quarter. Both EM sovereign and corporate new issue supply increased in September, and we expect issuance to continue into the beginning of the fourth quarter. However, we anticipate a slowing to the new issue calendar is possible as we move further into the quarter and US elections take center stage.

The strategy has a positive outlook on local bonds and a more conservative lean on currencies, reflecting the view that local rate markets have a favorable tailwind from the economic cycle and still-compelling valuations. EM local rates allocations are focused where central banks preemptively and aggressively raised rates to address inflation and are now in a position to ease significantly as inflation recedes. In Latin America we see opportunities in Mexico and Peru while in Europe we favor Czech and Hungary. We are also moderately constructive in South Africa as bond yields remain elevated relative to history, inflation remains under control, and markets seem to be underpricing the potential for easing over the coming months. In many countries in Asia, however, policy rates remain low and local rate market valuations are less attractive. We remain cautious specifically in China, Thailand, and Malaysia. Over the longer term, proactive efforts by most EM central banks and supportive commodity prices leave us constructive on select EM currencies. Our emphasis remains on exchange rates where fundamental, technical, and valuation factors are consistently supportive. There is meaningful dispersion among currencies which provides opportunities for alpha in proper currency selection without taking undue beta risk. We favor fundamentally attractive, higher yielding currencies in Central Europe and Latin America that have room to appreciate including the Brazilian real and Polish zloty. We also find currency yields in Turkey to be compelling now that the central bank is firmly focused on controlling inflation with orthodox policy. In contrast, we are limiting exposure to the Mexican peso and Chilean peso. We maintain exposure to select Asian currencies including the Indian rupee, though we remain less constructive on the Malaysian ringgit.

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