FUND COMMENTARY SICAV

Eastspring Investments - Global Emerging Markets Bond Fund

February 2021

INVESTMENT OBJECTIVE

The Fund aims to maximize total returns by investing primarily in US dollar denominated fixed income securities issued by sovereigns, quasi-sovereigns and corporate issuers within the Emerging Markets

FUND DETAILS

Reference Index

JP Morgan Emerging Markets Bond Index Global Diversified Index

Portfolio Manager

Eric Fang

Market review

The global bond rout extended in February as long-term bond yields continued to climb higher. Emerging Markets (EM) USD-denominated sovereign bond prices declined as a result with the JPMorgan EMBI Global Diversified index falling by 2.55%, the biggest decline since March last year.

The weak performance of EM sovereign bonds was driven primarily by the sharp rise in US interest rates. In February, ten-year US Treasuries (UST) yields jumped 34 bps (to 1.40%) in February, the biggest monthly increase since late 2016. Market observers generally cited mounting expectations of faster inflation, on the back of a strong rebound in economic activity, and concerns over central banks pulling back on their ultra-loose monetary policy, as the main factors driving the jump in bond yields. The recovery theme also contributed to a surge in commodity prices with Brent Crude oil prices rising by more than 18%. A key gauge of the market's expectation of annual inflation over the next decade, the ten-year US breakeven rate, rose in February to the highest level since 2014. Nevertheless, with the Federal Reserved expected to keep policy rate unchanged through to 2023, short-end rates remained well anchored over the month.

Across the EM bond markets, the rise in US interest rates dampened investor sentiment as it triggered fears of another episode of taper tantrum. This contributed to a tapering of portfolio flows into EM bonds towards the later part of the month, while sovereign credit spreads in the region widened moderately.

Overall, investment grade EM sovereign bonds bore the brunt of the sell-off given their longer duration profile and lower coupon buffer. Sovereign bonds in Latin America, such as Peru, Paraguay and Panama were among the key laggards amid the rates-induced weakness. Selected high yield sovereign issuers also underperformed, driven mainly by idiosyncratic concerns; Sri Lanka continued to underperform as concerns over its ability to service its foreign debt persisted amid falling foreign reserves, while the lack of progress in Argentina's negotiation with the IMF on debt repayment weighed on sentiment. Belize was another underperformer as its credit rating was downgraded further by S&P from CCC+ to CC amid the country's imminent default due to severe economic and fiscal challenges.

On the other end of the spectrum, key outperformers during the month were mainly high yield sovereign issuers, supported by accrual income. Hopes of potential deals with the IMF to obtain funding also buoyed performance of sovereign issuers such as Zambia and Ecuador.

Performance

In February, while the Fund's duration overweight detracted from relative performance given the broad rise in US rates, positive carry, which was helped by the Fund's allocation to EM corporate bonds, provided a cushion against the duration effects. Further, gains from credit positioning, including the underweights in the Philippines and Peru, more than offset detraction from the underweight in Middle Eastern markets, such as Saudi Arabia and Lebanon, which outperformed.

All data as of 28 February 2021 unless otherwise stated.

Strategy and outlook

Global interest rates have moved up swiftly in recent weeks amid rising optimism of a strong rebound in global growth and higher inflationary pressures. The sharp rise in US interest rates has also raised the spectre of another taper tantrum- style correction in the EM, thereby exacerbating the weakness in pockets of the market.

While the current growth optimism is expected to keep global rates volatile in the near term, we view that the markets have moved excessively to price in the reflation story; Growth conditions, while improving, are normalising to pre-COVID levels, rather then pointing to above-trend growths. We also expect rises in inflation rates to be transitory as secular disinflationary trends and significant output gap keep a cap on inflationary pressures. Major central banks are unlikely to tighten monetary policy in this environment, although market participants have already priced in the first Fed rate hike to happen in 2023, which is earlier than the Fed's "dot plot" projection.

As such, given our view that US rates should eventually stabilise and further rises should be capped, we see opportunities in selected long-dated sovereign bonds which have sold off due to the rates volatility. We are, however, still cautious in our allocation within the high yield sector; While the positive surprises in global growth and the consequent jump in commodity prices are supportive of EM economies, the substantial fiscal needs and varying extent of economic scarring due to COVID will still see uneven recovery across EM. We are thus likely to still see more debt restructuring and downgrades ahead, although we recognise that the proposed allocation of IMF's special drawing rights could be a key development in providing a lifeline to the weaker EM countries.

Nevertheless, for now, we retain our preferences for laggards such as Mexico, as well as high yield issuers with higher visibility for financing, such as Eygpt, and selected commodity exporters which may benefit if the reflation trades gain traction. Additionally, we will seek tactical opportunities through off-benchmark bets in the local-currency space, as well as selective corporates given their healthy spread over sovereign bonds.

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