Q1 2021

Quarterly Commentary

Aberdeen Standard Investments

Aberdeen Standard Emerging Market Local Currency Debt Fund

Market review

The strong momentum that ended 2020 fizzled out at the beginning of 2021 amid increased economic uncertainty and vaccine rollout challenges. This shifted in February, when risk assets began to climb, driven by higher commodity prices, stronger inflation prospects, positive vaccine sentiment and the passing of the US$1.9 trillion Covid-19 relief package. US Treasuries sold off strongly, rising by 81 basis points (bps) to hit 1.74% at the end of the period. Meanwhile, the Brent crude oil price rose by 22.66% to hit US$63.54 per barrel. Production cuts by the Organization of Petroleum Exporting Countries and 10 other oil producers supported the rising oil price. As expected, the US Federal Reserve kept the federal funds rate unchanged at a target range of 0-0.25% while maintaining the current pace and composition of future bond purchases. In March, it significantly upped its 2021 GDP forecast to 6.5% and its inflation estimate to 2.4%, compared with the 4.2% GDP forecast and 1.8% inflation estimate made in December. However, it noted that monetary policy is not expected to change in the near term. Elsewhere, the European Central Bank affirmed its €1.85 trillion Pandemic Emergency Purchase Programme while noting it would speed up bond purchases to stay ahead of a tightening monetary environment.

In local-currency debt, the JP Morgan GBI-EM Global Diversified Index (unhedged in US dollar terms) returned -6.68% over the period. The Australian dollar weakened over the quarter, so the index total return was -5.45% in unhedged Australian dollar terms. The yield of the index rose by 77bps to 4.99%. Both emerging-market currencies and bonds experienced negative returns over the period. China, the Dominican Republic and the Philippines were among the few countries at the top of the returns table, while Brazil, Colombia and Peru were among the bottom. Both Fitch and Moody's reaffirmed the Dominican Republic's ratings, noting ongoing reforms, relative economic resilience and anticipated economic growth. In Peru, a new iteration of the Pension Fund withdrawal bill passed, which could trigger significant outflows from the local bond market.

Performance

The Fund underperformed the benchmark over the period, mainly due to the curve effect, particularly in Brazil and, to a lesser extent, Mexico. This was partially offset by the positive curve effect from the underweight to Turkey.

Underweight positions in the Chinese renminbi and the Czech koruna, and the overweight position in the Turkish lira heavily detracted from performance[1].

In a rising yield environment, bond market allocations were a source of the weakness, most notably an overweight position in Brazil. Brazil's 2027 and 2029 government bonds were especially weak, and more than offset the positive contribution from not holding Brazil's shorter-term bonds. No exposure to Chinese bonds also hurt performance.

Evidently, exposure to Turkey (or lack thereof), largely determined whether a factor detracted from (or contributed to) performance. A rate hike was expected (and then delivered) at the central bank meeting on the last Thursday of the quarter. The day after the decision, President Erdogan removed the central bank governor from the post, seemingly because the president prefers a low interest rate policy. This triggered an enormous sell-off in longer duration bonds in Turkey. Although the portfolio has been positioned overweight of the lira, it has not held Turkish bonds and continues to hold a zero position. This benefited performance over the quarter. Elsewhere, the underweight exposure to Thai, Chilean and Polish bonds proved beneficial to performance.

Activity

Trading activity largely involved reducing the portfolio's duration risk, especially from February onwards. We sold Colombian 30-year bonds, switched out of 15-year to 10-year bonds in Indonesia and to five-year bonds in Mexico. We reduced duration risk in Russia by switching holdings from 2029 maturity to 2026 maturity bonds to reduce portfolio duration. We also recognised that there was less of a catalyst for duration to perform, with the Central Bank of Russia raising interest rates. High yields are available without taking so much duration risk in Russia. We also increased allocations to some high beta bond markets (Mexico, Brazil and South Africa) where we think yields have moved too far. In Mexico and Brazil, this is more that the market is anticipating a number of hikes that we do not think are plausible – in fact, in

[1] **Past performance is not an indication of future results.**

Mexico, we think it is as likely that Banxico will cut interest rates. In South Africa, the curve re-steepened following the Treasury sell-off, despite the much better fiscal performance shown by the budget. This is why the addition in South Africa was in the longer end of the curve (20-year), compared to the 7-10 year bonds in Brazil and Mexico. Finally, we responded to the change in central bank governor in Turkey by selling the portfolio's position in the lira to zero. We now expect that recent trends of accelerating credit growth will continue and that the currency will be pressured, as a result.

Outlook & strategy

Emerging-market local currency bond markets had steep curves at the start of the year, and have steepened further in response to rising US rates. In addition, short-dated bond markets now price interest rate hikes in emerging markets that, in many cases, we do not think will happen. Where hikes are likely, there will probably not be as many as current prices imply. Inflation should keep rising until the middle of the second quarter, thanks to the base effect (very low inflation a year ago) and rising food and energy prices. This will very likely be a transitory effect because domestic inflation pressures are extremely weak, with economies mostly operating with big output gaps and high unemployment.

Fiscal policy should be tightening in most emerging markets this year, reducing issuance pressure and inflationary pressure further. The exceptions to this are higher credit quality countries such as the Czech Republic and Chile. The main risks to the asset class come from the negative growth side. For instance, a much weaker-than-expected recovery in China or new strains of the virus that mean further repeated shutdowns in emerging markets could cause further temporary currency weakness.

Visit us online

aberdeenstandard.com.au

STA0521595940-001 | DH: AU-180521-149637-24

Aberdeen Standard Investments