AMUNDI FUNDS EMERGING MARKETS LOCAL CURRENCY BOND

Monthly Portfolio Update

31/03/2025

Meet the Team

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Market review:

Emerging markets debt ended the first quarter of 2025 with positive returns. Though the quarter was marked by a sell-off across risk assets, led by sensitivity to short-term policy uncertainty, shifting geopolitical dynamics and a mismatch between optimistic valuations and underpriced negative risks in the US economy.

Since taking office on 20th January, President Trump has issued executive orders at an unprecedented pace early, introducing new tariffs on adversaries and allies alike. These include new blanket tariffs of ~20% on Chinese goods, a 25% tariff on imports of steel and aluminium, a 25% tariff on USMCA non-compliant goods and most recently a 25% tariff on imported cars from all countries, that will also go in effect on April 2nd. In retaliation the EU has so far responded with counter-tariffs on ~$28bn of US goods – including a 50% duty on American whiskey, which prompted Trump to threaten a 200% tariff on European spirits. Canada introduced new duties on ~$20bn of US goods, while China responded with up to ~15% duties on US farm goods, which came into effect in early March.

The Fed kept policy rates unchanged in a range of 4.25-4.5% for a second straight meeting in March and announced a slowdown in the pace of quantitative tightening. Powell's comments reflected the Fed's concern that growth could slow more than they previously anticipated, which in turn would pull inflation down as well. The median projections for 2025 indicated higher unemployment, lower growth and higher inflation expectations compared to December projections. The median dot plot showed two rate cuts in 2025, two in 2026 and one in 2027. Against that backdrop, the 10-year US treasury yield has moved lower by 36 bps over the quarter to end at 4.21%, with the market pricing in two and a half rate cuts for the rest of year.

Turning to EM central bank policy actions over the quarter: in Latin America, the Brazilian Central Bank raised policy rates by 2% to 14.25%, the central bank of Mexico cut policy rates by 1% to 9%. In CEEMEA, the Czeck National Bank cut policy rates by 25bp to 3.75% and the South African central bank cut policy rates by 25bp to 7.5%. In Turkey, the central bank convened an interim MPC meeting and increased its overnight lending rate by 200bps to 46% while the 1-week policy rate did not change. Consequently, the effective increase is 350bps. In Asia, the Reserve Bank of India cut policy rates by 25bp to 6.25%, commencing an easing cycle. The Bank of Korea also cut rates by 25bp to 2.75% over the quarter.

Emerging markets have been remarkably resilient in the face of the combination of heightened policy uncertainty and poor US equity performance. The JP Morgan EMBI Global Diversified Index returned -0.76% in March, leading to a cumulative YTD return of 2.24%. The JP Morgan CEMBI Broad Diversified Index returned 0.06% in March, leading to a cumulative YTD return of 2.43%. In local markets, the GBI-EM Global Diversified Index returned 1.55% in March and 4.31% YTD. Per data from JP Morgan, YTD flows into EM bond and equity funds stand at -$3.8bn and -$7.1bn respectively.

Performance attribution:

The portfolio outperformed its benchmark in the first quarter of 2025, led by our overweight Latin America vs. underweight Asia positioning. Specifically, an overweight bias to Mexican local rates was the strongest driver of excess returns. We maintained an overweight bias, taking advantage of one of the few EM curves with positive real yield. Yields moved lower as the Mexican central bank continued to cut policy rates. Minutes from Banxico's meeting and the Quarterly Inflation Report suggested that the 'catch-up' easing phase would continue for a longer period, to better align the monetary policy stance (which remains tight) with the macroeconomic cycle (characterised by soft economic activity and inflation within target). We expect the central bank to cut rates (at least) twice more by 50 basis points and a couple more by 25 basis points to 8% by year-end. We believe Mexico is likely to be one of the first countries to get past the US tariff hurdle. After suffering depreciation following the surprise outcome of the Mexican elections and prospects of tough negotiations with the new Trump administration, the peso has shown remarkable resilience since November 2024.

Portfolio positioning:

At the end of the first quarter, we are overweight both yield and duration vs. the benchmark. We retain a preference for EM local rates over currencies – EM rates valuations are more attractive after recent moves in core yields. Our 12-month expected returns are higher than that of DM fixed income, both in absolute terms and on a risk-adjusted basis. The dollar has weakened in 2025, following significant strength on the back of expectations of Trump's policies. We are selectively long EM currencies, which still offer good carry, thanks to prudent monetary policy in the past. While core rates and geopolitical uncertainty are likely to weight on EMFX, high carry and light positioning should provide some cushion to any significant sell offs.

The macro configuration remains supportive of EM local currency assets, with the Fed still likely to cut policy rates amid a non-recessionary backdrop for US growth, sizable market repricing given the uncertainties and clean investor positioning. We expect EM local currency bond yields to decline – EM central banks have been proactive in anchoring inflation. Following the US election, we anticipated near-term dollar strength, we now closely watch for additional policy details from the Trump administration, that will impact the medium-term outlook for the dollar.

In emerging markets, there are plenty of country-level idiosyncrasies led by different growth and inflation profiles, varying pace of monetary policy adjustments and heterogeneous currency outlooks. We see opportunities in countries where domestic fundamentals are steady, policies remain supportive and risk premiums remain well reflected. Frontier local markets remain a relative bright spot, backstopped by a combination of IMF support, managed currency regimes and lower sensitivity to US trade policy. Select markets such as Egypt and Nigeria offer value after large FX devaluations since they remain mostly uncorrelated to major global currencies. We remain constructive as these trades still offer enough carry to compensate for any outflow-induced FX weakness.

At an overall portfolio level, we retain our overweight Latin America vs. underweight Asia bias, retaining a selective preference for higher yielding parts of the universe across EM, still finding some ultra-high yielding countries attractive.

In Asia, we are underweight the low yielding rates and FX markets. Our underweight rates positions is mainly in Thailand, where rates are too tight relative to core and unattractive relative to peers. Fiscal risks remain with more government stimulus expected. In China, valuations are not attractive. We expect continued outflows due to geopolitics, but the overall easing bias will keep local bond yields anchored. Within Asian FX, we remain defensive in the Chinese yuan, due to its relatively low yield, slowing growth and loose monetary policy. Our expectation is that tariffs against China could be implemented relatively early in the administration, which would likely pose a challenge next year. We are also underweight lower yielding currency pairs such as the Thai baht–we believe the currency is sensitive to higher energy prices and beta with core rates. In Taiwan, we remain underweight owing to the negative carry and expensive valuations.

In CEEMEA rates, within the higher yielding markets, we are now overweight rates in South Africa–we see real yields as attractive and the curve is steep. We are not yet constructive on Turkish rates–while carry is attractive on the short end of the curve, risks remain on the long end due to inflation uncertainty. In CEEMEA FX, we believe the higher yielding currencies are vulnerable to idiosyncratic risk-off developments–e.g. we reduced our overweight position in the Turkish lira following a period where we took advantage of the high carry. We manage these positions tactically and prefer to have a balanced risk assessment changing on market conditions. In South Africa, we preferred local rates markets over the currency. We keep our position in the Egyptian pound, which should perform well this year in our view. We increased our position post the recent devaluation due to an improved financing situation after the IMF loan deal and better prospects of foreign inflows. We have a small long position in the Nigerian naira and Uzbekistani sum.

In LatAm rates, we are overweight Brazilian rates where we like high real yields. Real rates have become even more attractive, especially after the recent repricing of hikes into the curve. We are also overweight Mexico–where we like the elevated level of yields, Peru–where we like the high carry, stable currency and upcoming rate cut cycle with lots of bad news priced in and Uruguay–where we have an inflation linker position and believe the country should have one of the largest rate cutting cycles in the region. We are also overweigh Colombian rates where we expect more cuts from the central banks, offering attractive real yields and a good risk-reward ratio. In LatAm FX, we are overweight the Brazilian real, Colombian peso and Peruvian sol. Following the recent sell-off, the Brazilian real is now oversold. In our view, aggressive rate hikes & FX intervention, should be positive for the currency. In Colombia, the high carry is attractive, despite the challenging fiscal environment, while in Peru, the relatively low level of volatility offers good risk adjusted returns vs. peers.

We are cautious on EM debt near-term, although there are supportive factors for the asset class in the medium-term. Our near-term vigilance is driven by Trump's punitive tariff policy which has implications for the supply chain across emerging countries as well as global growth. As the effective US tariff rate is now 20%, the highest in 100 years, the market narrative has rapidly shifted from one of US exceptionalism to downside risks to growth in the US and abroad amidst a spike in inflation near-term.It is also unclear how other countries will respond and how long the trade war will last. The downside risks to growth have certainly increased; and as US monetary policy is restrictive, we still believe there is room for the Fed to cut rates later this year.

Despite the uncertainty in markets, both fundamentals and valuations are still solid for EM countries. Starting with the latter, the absolute level of yields in EM debt remains high relative to history. A Fed easing cycle, even if gradual, should further reduce the attractiveness of US assets and drive the search for higher yielding alternatives. USD weakness and lower US treasury yields are also supportive for EM local rates and currencies, although a meaningful downturn in US and global growth would be negative. Most EM countries still have scope to cut rates, although at a measured pace, which should support carry, while real yields are high.

Fundamentals are still supportive for many EM countries, underpinned by IMF support and/or debt restructuring. The only countries who have yet to restructure include Venezuela, Lebanon and Ethiopia, respectively. Investor positioning is also light following nearly $160bn of outflows since 2022. Although hard currency issuance has picked up this year, net issuance should be limited due to heavy cash flows and amortisations. EM corporate net issuance is expected to be negative.

The global macro environment remains highly uncertain, and it is important to consider the possible outcomes of US tariff policy. Trump's tariffs could lead to a sharp downturn in global growth or even a recession. Stagflation is a reasonable possibility, given the upward price pressures from tariffs, potentially exacerbated by an aggressive US deportation policy. These factors may complicate the US rate outlook, especially if unemployment is rising concurrently to inflation picking up. Additionally, a downturn in global growth would be negative for commodity prices and hence, EM commodity exporters.

Given the level of uncertainty in markets, on balance, we prefer those countries that are less directly affected by tariffs and have strong buffers in place to weather an external shock. Some countries, like China, also have flexibility to offset tariffs through various stimulus measures. However, the impact of tariffs on GDP growth will be largest for Asia, a region that we remain broadly underweight, whereas Latin America is only hit by minimal tariffs thus far.

In EM local currency debt, we are selectively long EM rates in countries that offer high nominal and real yields. Most EMs should be able to deliver counter-cyclical rate cuts, although select high yielding markets could still be sensitive to rising global risk premia. Pressure on the USD is likely to continue, while markets assess the downward impact on the US economy. In EM FX, we are selective but like higher yielding countries that provide a carry cushion in the event of further market volatility. We remain selective and avoid positioning in countries where growth and capital flows are likely to be adversely impacted.

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