M&G (Lux) Emerging Markets Bond Fund

A year in review

Claudia Calich – Fund Manager & Head of Emerging Market Debt

January 2021

- Emerging market fixed income staged an impressive recovery since the coronavirus-induced sell-off earlier in 2020 and ended the year in a buoyant mood, with spreads tightening significantly in the fourth quarter on optimism following the US election result and positive vaccine news.
- Investor focus has now shifted towards determining what kind of economic recovery lies ahead in 2021, with the journey out of the crisis potentially being dogged by virus mutation uncertainty and delayed vaccine roll-outs.
- We believe that a weaker US dollar, an easing COVID-19 backdrop and investors' hunt for yield are all factors that should support investment returns in the asset class going forward.

The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise and you may get back less than you originally invested.

The COVID-19 crisis

If you were to look only at the investment performance of emerging market bonds for the calendar year 2020, you would never guess that anything unusual had taken place during the year. Despite one of the deepest and fastest sell-offs in risky assets ever seen, combined with an oil market collapse, emerging market bonds registered fairly unremarkable single-digit positive returns for the year (in US dollar terms).

March's coronavirus-induced sell-off in global markets was followed by a strong recovery over the remainder of 2020. While self-imposed restrictions such as the forced closure of businesses and national lockdowns inflicted immense economic damage around the world, markets were still able to largely recover their lost ground. An important technical factor supporting the recovery in risky debt was the huge levels of government and central bank support. These continued to buoy investor sentiment, despite a slew of extremely poor economic data that reflected the severity of the COVID-19 crisis on the global economy.

However, investors in most parts of the emerging market bonds asset class did not initially experience the recovery rally to the same extent as bondholders invested in developed market instruments. The latter were underpinned by the monetary policy responses of their large and influential central banks. The US Federal Reserve (the Fed) even went as far as purchasing investment grade corporate bonds for the first time, to prevent capital markets from seizing up. As a result, many higher-yielding emerging market instruments, such as the bonds issued by many 'frontier market' countries – economies that are less developed than those of more mainstream emerging markets – lagged the returns of safer, investment grade issuers.

But emerging markets were not left out entirely; many nations were also able to cut interest rates and borrow more cheaply. In some cases, governments widened their central banks' remits and embarked on quantitative easing-type policies, thereby safeguarding market liquidity and providing finance for pandemic-related spending. Furthermore, the International Monetary Fund (IMF) and other international financial institutions were on hand to provide emergency funding to countries without such flexibility.

Despite these measures, it wasn't until news of successful COVID-19 vaccine trials emerged at the start of November, together with some clarity over the highly contentious US election result, that this difference in performance started to narrow significantly and widespread confidence in emerging market bonds returned. Despite an alarming resurgence of COVID-19 cases in the US and Europe during the period, emerging market bond valuations continued to recover.

Investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries.

After becoming the initial epicentre of the virus at the start of the year, China managed to largely remove itself from the shackles of lockdown restrictions early on. As a result, its economy and those of its neighbours contracted less relative to European countries and the US, providing a boost to the emerging market economies in the region. The IMF's recently announced economic growth projections indicate a likely continuation of this trend in 2021.

Fund performance and positioning

We have always maintained a preference for investing the fund in a diversified way, across many of the different regions and segments in emerging markets, with allocations to both corporate and government bonds, denominated in either local or hard currencies. This approach was no different as the COVID-19 crisis began to unfold, as we sought not only to protect the portfolio from excessive country and security-specific risk but also prepare it to take advantage of any valuable investment opportunities presented by the sell-off.

Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the fund. The fund can be exposed to different currencies. Movements in currency exchange rates may adversely affect the value of your investment.

5-year fund performance (%)

	2020	2019	2018	2017	2016
M&G (Lux) Emerging Markets Bond Fund EUR A Acc	-4.1	17.7	-2.4	-0.5	13.7
Benchmark*	-3.6	16.0	0.8	-2.4	13.3

Past performance is not a guide to future performance.

* 1/3 JPM EMBI Global Diversified, 1/3 JPM CEMBI Broad Diversified, 1/3 JPM GBI-EM Global Diversified.

The benchmark is a comparator against which the fund's performance can be measured. The composite index has been chosen as the fund's benchmark as it best reflects the scope of the fund's investment policy. The benchmark is used solely to measure the fund's performance and does not constrain the fund's portfolio construction.

The fund is actively managed. The investment manager has complete freedom in choosing which investments to buy, hold and sell in the fund. The fund's holdings may deviate significantly from the benchmark's constituents.

Fund performance prior to 21 September 2018 is that of equivalent UK-authorised OEIC, which merged into this fund on 7 December 2018. Tax rates and charges may differ.

Source: Morningstar, Inc and M&G, as at 31 December 2020, price to price with income reinvested. Benchmark returns stated in EUR terms.

As fast and indiscriminate selling took hold in the emerging markets space during March, we immediately began building a cushion of cash and other liquid instruments to manage liquidity risk so that potential fund redemptions could be dealt with effectively if required. We selectively reduced exposure to local currency bonds (approximately 11% of the fund) that were either outperforming holdings or had been identified as suitable positions for targeted risk reduction. These included local currency sovereign bonds from Nigeria, Egypt, Serbia, Turkey, Poland, Brazil and index-linked sovereign bonds of Uruguay, and local currency supra-nationals (AAA rated and denominated in Indian rupee and Indonesian rupiah). Holdings of high-liquidity assets increased to 20% and we maintained a high level of portfolio diversification overall.

The fund underperformed its benchmark during this initial period, mainly due to its overweight position in riskier frontier markets (particularly in Sub-Saharan Africa) and an underweight exposure to more resilient bond issuers in Asia. We briefly moved significantly underweight local currency exposure (19% of the portfolio versus 33% for the benchmark) but remained focused on maintaining the overall shape of the portfolio, with one eye on identifying potential outperformers in the event of a market rebound. We maintained a decent amount of risk in the fund, particularly in higher beta parts of the market, which appeared oversold.

We began to gradually add back local currency exposure during April as bonds started to retrace some of their losses. The fund's more cautious stance than the benchmark and its underweight to local currencies meant that relative returns were hampered somewhat during this early recovery phase. However, fund liquidity management remained important, in what was still a highly volatile and uncertain environment.

Our relatively large allocation to hard currency government bonds gradually started to reward fund performance in May and June (and indeed, over the year as a whole) as developed markets central banks' action provided a vital backstop for global bond markets, boosting the returns of hard currency bonds in particular.

Throughout the summer months, regional differences were notable in local currency markets. For example, Latin American currencies underperformed as virus outbreaks worsened in the region, while Asian currencies benefited as outbreaks there appeared to be more under control. This was despite a renewed focus on Asia from global investors, due to the increasingly strained relations between the West and China, provoked by political instability in Hong Kong.

Figure 1. Emerging Market index returns in 2020 (%)

J.P. Morgan EMBI Global Diversified Index	J.P. Morgan GBI-EM Global Diversified Index	J.P. Morgan Corporate EMBI Broad Diversified Index	Benchmark*
-3.4	-5.8	-1.7	-3.6

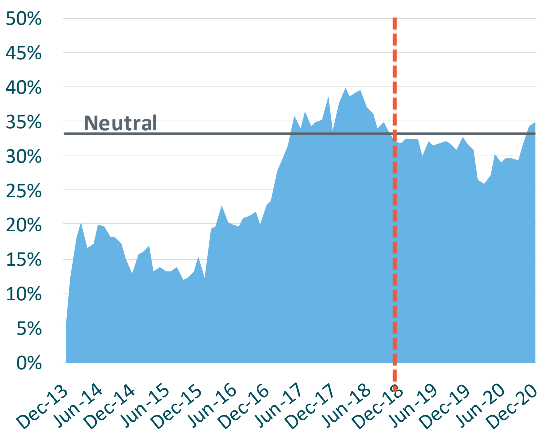
Past performance is not a guide to future performance.

Source: Morningstar, Inc and M&G, as at 31 December 2020. Returns are calculated on a price to price basis with income reinvested. Benchmark returns stated in EUR terms.

* 1/3 JPM EMBI Global Diversified, 1/3 JPM CEMBI Broad Diversified, 1/3 JPM GBI-EM Global Diversified.

We persisted with a moderately lower allocation to local currency bonds relative to the fund's benchmark up to and including the third quarter. However, as valuations among some investment grade bonds in the hard currency segment became less appealing, we started to increase our local currency exposure (see Figure 2) on a selective basis, using an assessment of country and currency fundamentals to identify areas of relative value in the market. For example, we increased exposure to Indian local sovereign bonds in August due to a more favourable outlook for the country's trade position and an increased likelihood that its central bank would leave interest rates unchanged in the near term. We also added exposure to the local sovereign bonds of Kazakhstan, Philippines, Thailand and Uzbekistan (an off-benchmark position) during this period. Towards the end of the fourth quarter, the fund had moved to an above-benchmark position in local currencies, a stance that rewarded its relative performance.

Figure 2. Fund's local currency allocation (%)



Source: M&G, 31 December 2020.

We remained very selective when choosing corporate issuers, particularly in sectors that we felt were vulnerable to further waves of the virus or issuers where we had concerns around fundamentals. Elsewhere, we exited our position in Ethiopia given its ongoing civil war, and the fund continued to have no exposure in Belarus, given its troubling political situation. We were very active in the new issue market, participating in some attractively priced sovereign issues where we felt we were being adequately compensated for risks. In contrast, we reduced some holdings where we assessed fundamentals or valuations were less appealing.

Despite rebounding investor sentiment in emerging market debt in the fourth quarter of the year, local currency bonds underperformed during 2020, as highlighted by Figure 1. Ultimately, this was beneficial to fund returns overall as we remained underweight for most of the year.

Our patience was rewarded in some of our higher beta/lower rated positions that initially underperformed. Many of these positions were maintained in the fund because they appeared to be oversold. Some of them strongly rebounded in the fourth quarter, aiding the fund's outperformance during the second half of the year.

The US dollar depreciated markedly against many currencies and emerging market currencies generally performed well, reflecting the increased optimism around rebounding global economic growth and ongoing levels of financial stimulus and support from governments. The euro was one of the strongest performing currencies versus the US dollar during the year, and its strength detracted from the returns of the fund's unhedged euro share classes, causing them to turn negative for 2020.

We continued to favour investing the portfolio in a diversified way across emerging market regions, with allocations to each of these different segments of the market. This positioning supported the fund's strong showing in the second half of the year, as we were able to flexibly allocate to areas of the market we favoured during different stages of the recovery.

Opportunities in 2021

Despite a resurgence in virus cases lately and uncertainty around virus mutations, the global vaccine roll-out should kick-start an economic recovery that is likely to be supportive for the asset class, particularly for countries with strong links to commodities and tourism. Global monetary policy is expected to remain very accommodative in the near term and should also be a significant supportive factor in 2021. We are mindful of the threat of further virus waves and extended national lockdowns that still hang over many parts of the world, including many emerging markets. The crisis will have undoubtedly left many scars on many emerging market economies too.

The hunt for yield in this low interest rates environment should support investments in emerging market debt, where we think yields remain relatively attractive. While there is some argument that the emerging market investment grade bond segment is now starting to look fully valued, we believe the extra yield over risk-free government bonds that can be found in higher-yielding segments of the market should provide us with an opportunity to add relative value. We also think that emerging market currencies remain broadly undervalued, in an environment where we could see continued pressure on the US dollar. We are likely to keep selectively increasing exposure to higher-yielding local currency issuers if investment grade bond valuations in the hard currency segment continue to tighten.

A thorough analysis of fundamentals, as well as issuer selectivity and portfolio diversification will all remain crucial in order to navigate emerging market risks effectively. M&G's emerging market fixed income team takes a 'go anywhere' approach to the asset class, which we believe stands it in good stead to deal with what is a highly diverse and growing investment universe. This flexible approach means we are not constrained by our benchmark and can invest anywhere in emerging market debt. The team use a combination of top-down analysis of macroeconomic factors with bottom-up issuer selection based on country and company fundamentals. This investment approach leads to a portfolio of 'best ideas' that we believe should help the fund to navigate different market conditions. The fund remains fully invested, holding a small balance in cash and AAA rated risk-free bonds.

The fund allows for the extensive use of derivatives.

Further risks associated with this fund can be found in the fund's Key Investor Information Document.

UCITS HAVE NO GUARANTEED RETURN, AND PAST PERFORMANCE IS NOT A GUIDE TO FUTURE PERFORMANCE

M&G Investments