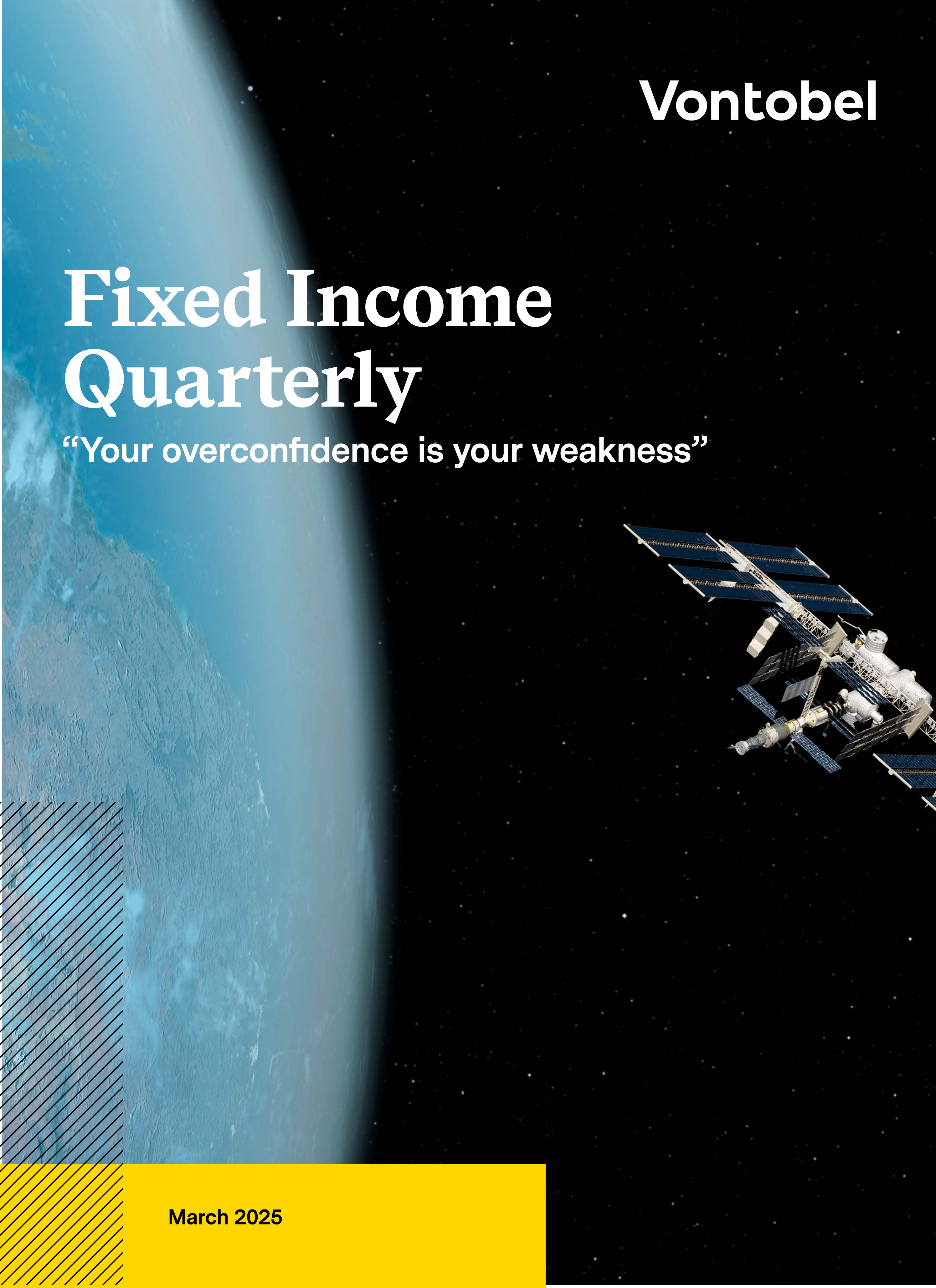
Vontobel

Fixed Income Quarterly

“Your overconfidence is your weakness”



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Embracing uncertainty can lead to opportunity

Whether you're Luke Skywalker or an investor navigating the markets, making decisions based on a misperception of certainty can be dangerous. Geopolitical and macroeconomic outcomes today are as unpredictable as the twists in the Star Wars saga. But alpha opportunities await risk-aware, active investors who don't fall to the dark side of overconfidence.

One of the great challenges in writing an editorial is to strike the right balance between engaging narratives and thoughtful market-related commentary. The temptation to delve into the impact of volatile shifts that we are seeing in geopolitics is exceptionally high. Indeed, we are compelled to comment on the implications. Yet, in our view, it is likely that recent shifts in global power will only have a marginal impact on Fixed Income markets. As a result, we are more constructive about future market prospects than the dramatic outcomes implied in current headlines.

In our last Fixed Income quarterly publication, the rates section leaned heavily into the uncertainty theme and proved accurate in its predictions. We still foresee much uncertainty on the horizon and our positive view on Fixed Income remains tinted with caution. Our key takeaway this quarter is that while we do not anticipate significant potential for more short-term beta returns from Fixed Income, we do see substantial alpha opportunities, and indeed we are actively harvesting them as you read.

Current market conditions (even after the pullback in US stocks) are not pricing in anything beyond an infinitesimal probability of a major escalation giving rise to a financial crisis. When examining the apparent shift in the US's foreign policy with respect to the Russia-Ukraine crisis, the following implications and considerations arise:

1. The probability of a peace deal in the near term is significantly higher than it was a year ago.
2. While a peace deal may take longer to be reached than was expected a few weeks ago, it is still likely to occur in 2025.
3. A coalition of willing partners—most European leaders and Canada—have rallied around Zelensky to provide support but refrained from making pro-war statements. The narrative has definitively shifted towards achieving peace, yet European leaders want lasting peace with security guarantees.
4. Europe's approach to Russia after the peace deal will be pivotal.
5. Uncertainty around the strength and shape of global alliances is at multi-decade highs.

Meanwhile, Ukrainian bonds are still among the best performing across all of Fixed Income year-to-date, indicating a significant level of optimism in the markets about reaching a deal. However, the potential for missteps is considerable. The scenes witnessed in the Oval Office and the UN Security Council are unprecedented in living memory. Markets should look through

Key takeaways

1. Geopolitical and US economic uncertainty is high and is not being priced in by the markets.
2. We remain cautiously optimistic about Fixed Income returns, particularly against other asset classes.
3. Credit spreads are tight; credit market beta does not look attractive by historical standards.
4. Alpha opportunities abound for active managers in 2025.
5. Emerging market sovereign debt / GDP ratios continue to appear broadly positive.

this to focus on the underlying developments, and most likely they will. But as a "grumpy" Fixed Income investor, it would be remiss of me not to point out that markets may not. For that reason, we believe tail risks are very elevated, which dampens our confidence in "risk-on" markets.

Most editorials would naturally segue into conversations around macro observations. Indeed, there are several tempting observations to make: yields are down and spreads are up, Europe is outperforming the US, banks had a great year in 2024 but will likely see lower net interest margins in 2025, and of course, realized volatility remains high while complacency also seems elevated.

However, for me, the huge missing piece of the conversation is not whether asset class X offers better value than asset class Y on an average basis, but rather:

Alpha is worth a lot more than beta in this market.
Our scorecard (see page 7) indicates that we are not as bullish about Fixed Income returns as we were in the last two quarters. Indeed, we have been stating for a while now that there is less beta in Fixed Income markets than there was a year ago. However, this has not prevented active managers such as us from delivering exceptional value for their clients. In fact, some of the Vontobel Fixed Income funds generated more than 50% of their returns in 2024 from alpha[1]. Fixed Income is still in a good place in beta terms. Credit fundamentals are solid, the recent increase in spreads suggests that there is still some value, and the technicals for the asset class are exceptionally strong. But in year-to-date terms, our returns are heavily skewed towards alpha, which we see as very valuable for investors who, like us, find it challenging to perfectly predict every next step in this rapidly changing world.

What is alpha in Fixed Income and why is it so relevant now?
First, let us examine a few things that are not alpha but often get "dressed up" as alpha:

- Taking more risk than your benchmark in a rallying market is not alpha
- Taking less risk than your benchmark in a declining market is not alpha
- Investing in an asset class that is not comparable to your benchmark is not alpha
- Outperforming a benchmark without the asset class having experienced a sell-off is not alpha

And yet there are many ways to actually generate alpha, particularly in complex and structurally rich asset classes like Fixed Income. In my view, the sources of alpha broadly fall into three categories:

1. Macro
2. Relative Value
3. Micro-Arbitrage

[1] In 2024, Vontobel Fund – Emerging Market Debt (I share class) had a total return that was more than double that of its benchmark, J.P. Morgan EMBIG Diversified. The majority of this return was from bond selection and the remainder from country selection. Similarly, Vontobel Fund – Emerging Market Blend (I share class) also outperformed in the same year with a total return that was three times higher. The majority of this outperformance came from country allocation, of which more than a third came from off-benchmark issuers.

I rank them in this order for two reasons. Firstly, this is the perceived “glory” or “intellect” ranking. Stories abound of great investors predicting the next crisis and spotting the perfect entry point for the next sharp rally. Secondly, this is a “blood, sweat and tears” ranking. Squeezing every last basis point out of markets through precise and accurate trading may not be the premise for the next Big Short (or blockbuster film about Wall Street), but it is a form of alpha.

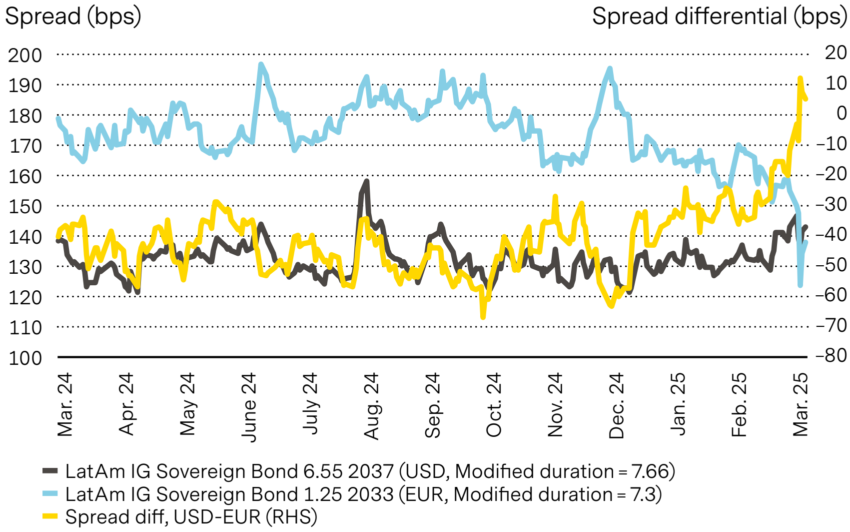
Every basis point of return is of equal value to me, but I acknowledge that markets rarely offer opportunities in all three sources simultaneously. Arbitrage requires reasonable levels of liquidity, though not perfect liquidity, and can be likened to treading on ants. Relative value likely exists at all times but is most valuable immediately after or during major macro moves. Macro alpha is most likely a matter of spotting the conditions precedent for a regime shift and positioning ahead of it, which can be seen as patiently hunting for the major return driver.

And so where are we now?
After conducting the largest financial experiment in history with Quantitative Easing (QE) and Zero Interest Rate Policy (ZIRP) driving central banks into coordinated action, and then reaction as inflation shook the world, we are now entering that post-easing or ending easing phase. The big macro moves may be behind us, although a note of caution is warranted as we may still see a substantial risk-off period in 2025. Relative value still abounds, and indeed you can see our views on this throughout this publication. There is clearly hard-won alpha to be generated here, and when you speak to asset managers and read editorials, much of their focus will be here. This type of alpha makes for compelling stories and is relatively easy to understand.

As previously mentioned, some of the Vontobel Fixed Income Funds delivered significant returns from alpha in 2024, both in absolute terms and as a proportion of total returns. The start of 2024 was a mix of sources 1 and 2. By the third and fourth quarter, alpha was more a mix of sources 2 and 3.

Currently, however, the bottom feeders of the Fixed Income markets are feasting on the detritus falling out of the volatility in the upper ocean. This is a period in which one can generate real returns without adding risk or materially shifting views, just by checking (and double checking) that every single second of every single hour of every single day you own the best instrument to express the view you hold. Passive investors are entirely unable to harvest this return optimization.

Chart 1: Case study—Spread optimization in the context of EUR rates sell-off driven by the German budget splurge promise



For illustrative purposes only as a means of demonstrating our investment management processes and to further illustrate the subject under discussion. References to holdings and/or other issuers should not be considered a recommendation to purchase or sell any security nor should any assumption be made as to the profitability or performance of security associated with them. Information provided should not be viewed as a certainty or indication of similar or future outcomes in connection with our investment management approach and processes.
Source: Bloomberg, as of 7.03.2025

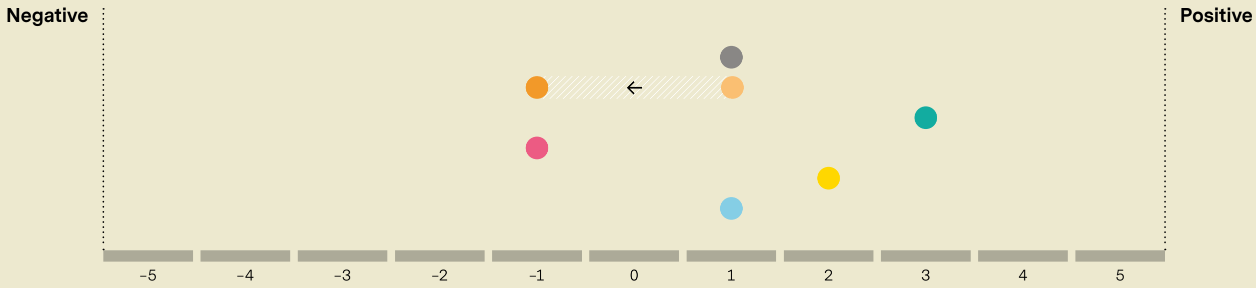
In this case study (illustrated in Chart 1), EM EUR-denominated bonds sold off the week of March 3rd 2025, but much less so than Bunds. Therefore, EM EUR-denominated spreads tightened. Strategically, we tend to position on EUR-denominated paper in certain countries and hedge the FX via forwards and rates exposure shorting Bund futures to obtain a higher yield after hedging for the same credit risk.

Tactically, in the first week of March, we:
- Sold EM EUR-denominated paper that experienced spread tightening: LatAm investment grade sovereign bond 2033 bond
- Bought USD-denominated paper of the same issuer: LatAm investment grade sovereign bond 2037
- Bought Bund futures to keep our EUR duration unchanged (close to zero)
- Sold US Treasury futures to keep our USD duration unchanged (close to our benchmark duration) and same position regarding the FX exposure (we keep 98 – 100 % of our EMD portfolio in USD almost all of the time)

While we have sold a bond that sold off, which may seem odd, we have simultaneously locked in a higher spread for the same credit risk. Over time, we would expect the EUR-denominated spreads to normalize vs Bunds, so these bonds we've just sold are likely to underperform in the near term after having outperformed Bunds (assuming that the Bunds sell-off is permanent). Once that happens, we could reverse the trade.

It's not glamorous, but it does deliver consistent returns and while we lack high degrees of confidence about the macro landscape, we are delighted to continue to harvest the results. Given our cautious views on beta within markets more generally, though slightly less so for Fixed Income, we will continue to bang the table for alpha in the expectation that active managers should have plenty of opportunities in 2025.

Scorecard



Source: Vontobel. For illustrative purposes only. As of 7.03.2025

Economic outlook

Unchanged at 1

We see growth potential in both Europe and the US. After a flurry of elections and large shifts in politics around the world, we see both the ECB and the Fed continuing to track their stated paths fairly closely. This should have a reasonable likelihood of keeping inflation well bounded. (See also Tail Risks)

Credit fundamentals

Unchanged at 2

Corporates continue to deliver strong results and an ability to refinance their debt. Leverage levels and debt maturity walls look historically very positive at this point in the cycle. European and US global banks have delivered strong results in 2024 and look resilient with improved capital ratios. Emerging market sovereign debt / GDP ratios continue to appear broadly positive.

Valuations

Unchanged at –1

Credit spreads remain tight and compressed. While opportunities remain, credit market beta does not look attractive by historical standards. Recent spread widening has been short lived.

Technicals

Unchanged at 3

Fixed income technicals continue to appear robust and are likely to be further supported by shifts in market participant allocations away from cash and money market instruments as rates decline. We expect flows into the sub-asset classes that were less supported in 2024, where flows are likely to turn positive as investors hunt for value. We do, however, expect volatility and pockets of illiquidity ahead.

Tail risks

Move to –1 from 1

Uncertainty remains very high. Geopolitical and US economic uncertainty are at recent highs. Uncertainty is not being priced in by the markets.

Overall

Unchanged at 1

We remain cautiously optimistic about Fixed Income returns, particularly against other asset classes. If we were to overlay the potential for alpha onto our view, we would be moving to a +2 score.

Tariffs, threats and (trade) wars

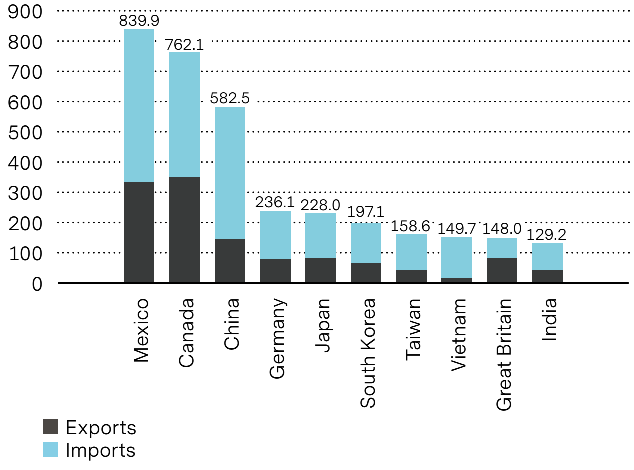
As Donald Trump seeks to "Make America Great Again", his agenda is polarizing public opinion and market participants are now divided into two distinct camps.

—
Daniel Karnaus
Portfolio Manager,
Fixed Income,
Vontobel

On one hand, Trump has exerted pressure on Mexico and Canada, the US's largest and third-largest trading partners in terms of imports, respectively, (see Chart 1), to take more decisive action against illegal border crossings and drug smuggling by threatening to impose import tariffs of 25%. On the other hand, he has threatened to levy a 25% tariff on steel and aluminum imports, regardless of their origin, in an effort to stimulate domestic production and jobs creation. Furthermore, he plans to enforce reciprocal tariffs on imports if the originating country imposes higher tariffs on US products. He has also proposed tariffs on other imports, including cars, pharmaceuticals, and semiconductors, with the aim of further safeguarding the American economy.

Chart 1: Largest important trading partners of the US by total volume of foreign trade in 2024

Trading volume in billions (USD)



Source: de.statista.com/statistik/daten/studie/1384206/umfrage/wichtigste-handelspartner-der-usa-nach-gesamtvolumen-des-aussenhandels/

At the same time, under the leadership of Elon Musk's Department of Government Efficiency (DOGE), Trump is eliminating unnecessary government spending, such as development aid, and enhancing the efficiency of the federal administration through workforce reductions. He is also seeking to swiftly end the war between Russia and Ukraine, thereby reducing expenditures related to supporting Ukraine. In exchange for these services, he is demanding access to Ukraine's natural resources. He views the European NATO allies as responsible for providing security assurances to Ukraine.

At present, only a 10% additional tariff on goods imported from China, the US's second largest import source (see Chart 1), has been implemented. Nevertheless, the direction of this strategy is evident:

- Increase the attractiveness of domestic production in the US through tariffs, combined with tax cuts for companies that manufacture within the country as an additional incentive;
- Enhance border security with neighboring countries to the north and south to address domestic issues related to drug trafficking and illegal immigration—this includes the deportation of undocumented immigrants; and
- Reduce government spending by terminating support for Ukraine and reducing administrative personnel.

This approach aims to increase tax revenue while simultaneously lowering expenditures, thereby reducing the budget deficit. The US's withdrawal from the Ukraine conflict compels EU countries to take action. Consequently, European NATO allies will likely need to significantly increase their defense budgets and ramp up the production of military equipment. The US is also expected to benefit from this through increased arms exports. Additionally, the proposed tariffs could serve as leverage for European concessions regarding increased energy imports from the US. The plan anticipates that fewer imports, coupled with simultaneous export growth, will help shrink the US trade deficit.

There is a camp that believes Donald Trump's plan is likely to succeed. Consequently, concerns regarding the US budget deficit would prove unfounded, and the national debt would not escalate uncontrollably. In the best-case scenario, the imposed tariffs would not significantly increase inflation, and the supply of new US government bonds could even decrease. As a result, US interest rates would decline, reducing borrowing costs for both the public sector and private households. This perspective is further supported by the commitment of Secretary of the Treasury Scott Bessent, who aims to continue issuing more Treasury bills with maturities of one year or less, rendering the expansion of bond issuance with maturities of two to 30 years obsolete.

A significantly more pessimistic perspective on US protectionism is held by the other camp of market participants. They view the financing of the tax cuts approved by the House of Representatives' Budget Committee through spending cuts and tariff revenues as unrealistic, particularly since other countries are likely to retaliate against US tariffs, as China has done. The ensuing disruptions in international trade could cause consumer goods prices to rise. Furthermore, an expansion of LNG exports from the US may be hindered, given that the EU already sources 40 % of its LNG imports from the US. Additionally, energy prices are likely to fall if the conflict between Russia and Ukraine ends and the supply of Russian gas to Europe increases again. As a result, trade deficits would decrease less than anticipated. Due to the price increases resulting from the trade war, the US Federal Reserve (Fed) would be compelled to adopt a more restrictive monetary policy, which would strengthen the US dollar. This, in turn, would make US exports more expensive in foreign markets while making imports cheaper, potentially counteracting the intended effects of the tariffs.

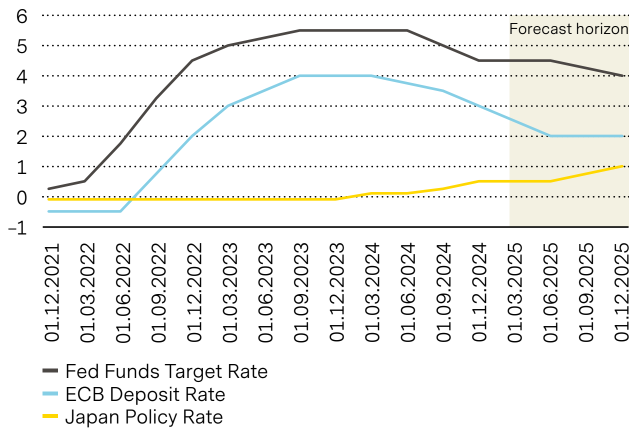
It is still too early to determine which camp will be proven right. We expect the Fed will not be proactive in this environment but will react once it has more information. In our last Fixed Income Quarterly report, we suggested that Trump's bark is worse than his bite, which is why we believed the Fed would further ease monetary policy. Those predictions have since been proven incorrect, leading us to believe that the Fed has no choice but to wait until clear trends emerge regarding inflation and the labor market against the backdrop of Trump's policies.

On the other hand, the European Central Bank (ECB) is currently facing a situation in which European NATO member states are grappling with short-term political uncertainties and higher budget deficits resulting from increased defense spending in the medium to long term. Additionally, a trade war appears to be on the horizon. Given decelerating wage growth, we maintain that the ECB is likely to further reduce its deposit rate to 2 % (see Chart 2). Conversely, ten-year German Bunds are expected to trade within a range around 2.75 %, with the interest rate spread to swaps likely widening due to increasing supply after the future Chancellor Merz presented his "what ever it takes" fiscal program."

Regarding the Bank of Japan (BOJ), we maintain our long-standing belief that the BOJ will raise interest rates to 1 % (see Chart 2) this year, driven by accelerating wage dynamics. However, unlike our previous assessment, we anticipate that this will take more time due to uncertainties surrounding potential US tariffs. Nevertheless, the long end of the yield curve is likely to continue to move towards higher interest rates, potentially exceeding 1.5 % in the 10-year range.

Chart 2: Central bank rates are stagnating in the US, falling in the EZ, but rising further in Japan

In %



Forecast based on external analysis; not guaranteed; and actual outcomes may differ materially.
Source: Federal Reserve / European Central Bank / Bank of Japan, own forecasts, as of Jan 2025

US corporate hybrids: a good opportunity for investors?

In our last Fixed Income Quarterly, we highlighted the significant level of corporate bond issuance. US corporate hybrid securities are one driver of this trend, creating opportunities for investors.

Investment grade

—
Christian Hantel
Portfolio Manager,
Global Corporate Bonds,
Vontobel

—
Claudia Fontanive-Wyss
Portfolio Manager,
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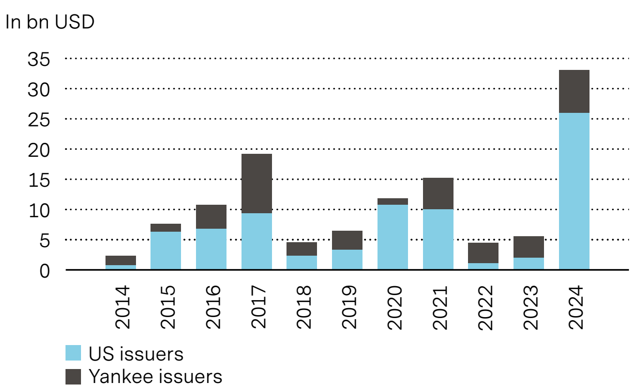
What happened? During 2024, Moody's changed its methodology towards corporate hybrids in the US, as the equity credit for these instruments increased from 25% to 50%. Hence, we experienced a surge in bond supply in this segment. Due to the equity credit, the issuance of hybrids can help stabilize credit ratings during periods of anticipated higher leverage. Even though these instruments may be more costly than senior unsecured bonds, companies often prefer to pay higher hybrid coupons in interest expense rather than issue equity to help fund increasing capex programs. So far, most hybrids have been issued in the Utility and Telecom sectors, both of which are defensive in nature, with good visibility on future cash flows and typically stable credit metrics.

Chart 1: US corporate hybrids: a growing market segment



Source: JP Morgan, Vontobel, February 2025.

What can go wrong? Investors should be aware that hybrids are subordinated instruments and are typically rated one to two notches lower than senior unsecured debt. The coupon payments can be skipped and there is no explicit understanding that the issuer will call the security on the first call date.

Despite these risks, hybrids can offer attractive yields and spread pick-up for investors, as most recent deals were issued with a yield of approximately 6.5% in USD, which is almost 1.5% higher than for most senior bonds. We expect hybrid issuance to increase in 2025, particularly from the Utility sector, which should contribute to the growth of this market segment.

Shifting our focus to Europe, Reverse Yankee bonds are another expanding market segment.

> **"Due to the equity credit, the issuance of hybrids can help stabilize credit ratings during periods of anticipated higher leverage."**

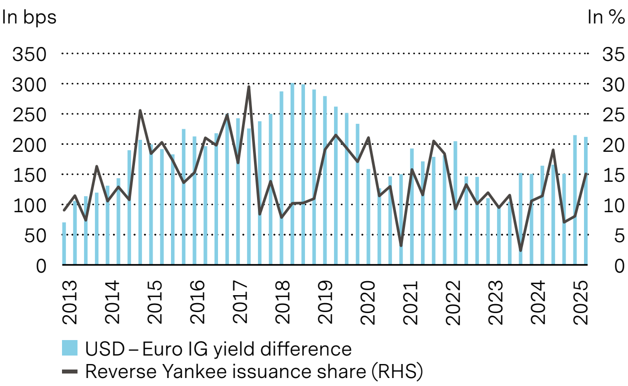
Reverse Yankee issuance on the rise and welcome
Reverse Yankee bonds are euro-denominated bonds issued by non-European companies, such as T-Mobile or IBM. Issuance has picked up since mid-2024, following two years of subdued activity.

Advantageous yield differentials, driven by monetary policy divergence, suggest that the Reverse Yankee trend may be a lasting one. While EUR IG spreads were wider than their US counterparts for most of 2024, recent tightening has brought them closer to cycle lows, increasing US corporate treasury interest in the EUR IG market.

2024 saw the second-highest annual volume for Reverse Yankee issuance (excluding financials), with €67 billion, accounting for approximately 20% of IG non-financial EUR supply. In early 2025, the trend is even stronger, with more than 15% of issuance already coming from US companies—driven largely by €10 billion from T-Mobile, IBM, and Johnson & Johnson.

On average, Reverse Yankee issuers left 5 basis points (bps) of New Issue Premium (NIP) on the table, with recent supply underperforming slightly—tightening 3 bps versus 9 bps for senior IG bonds. Some large multi-tranche deals contributed to this underperformance, but we do not view it as a significant concern. In fact, we welcome this continued diversifying issuance, particularly as most issuers originate from sectors likely to remain resilient against potential (US) tariffs.

Chart 2: Reverse Yankee bonds: increased issuance and advantageous yield differentials



Past performance is not a guarantee of future results.
Source: Barclays, Vontobel, as of February 2025.

High yield

—
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—
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Brazil oil service bonds versus US oil service bonds: which are more compelling for investors?
The economic and market strength, technology boom, and geopolitical dominance in the US have fuelled a resurgence of the narrative around US exceptionalism. This, coupled with low default rates, has compressed US high yield bond spreads to relatively unattractive levels compared to high yield bond opportunities elsewhere in the world.

For example, consider the historically volatile energy sector, which experienced two major default cycles in 2015 – 2016 and 2020. The benign oil price environment, improved balance sheets, and the bid for US risks have driven the US HY energy sector to historically tight levels, not only on a standalone basis but also relative to the broader US HY bond market.

Consider Company A, an offshore service issuer in the US HY energy index, whose senior unsecured bonds are rated CCC+ by S&P and Caa2 by Moody's. The company has a complex debt structure with a substantial amount of secured or priority debt ahead of senior unsecured bonds. The capital structure leverage is as follows:

- LTM leverage through secured debt 2.2×
- LTM leverage through total guaranteed debt 4.6×
- LTM leverage through senior unsecured debt 6.1×

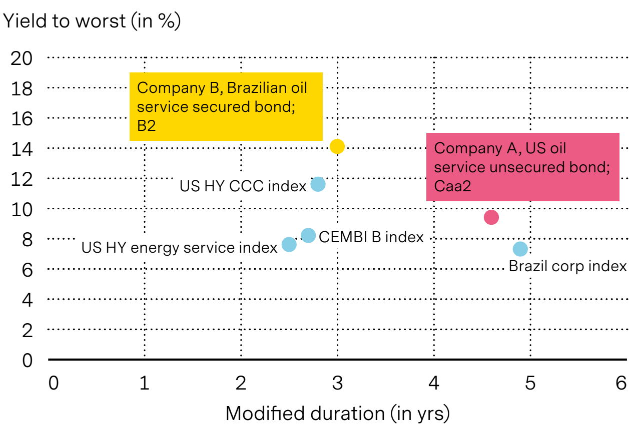
Company A's 6-year senior unsecured bonds offer a yield to worst of 9.5% and a nominal spread of 510 bps, well below the US HY CCC index yield level of 11.6%. Company A's bonds were historically volatile, trading at deeply distressed levels when oil prices crashed. At current trading levels, we see limited scope for Company A's bonds to outperform the market.

Looking south, we see a more attractive value proposition in Brazil's oil service sector. Company B issued a single B-rated secured bond last year, which currently trades at a yield to worst of 14% and a nominal spread of 980bps. The bonds are secured on a first-priority basis by receivables, equipment, vessels, a debt service coverage ratio account, and an escrow account. These secured notes represent the entirety of Company B´s debt. Although the leverage is currently high at 8×, it´s projected to decrease to 3× in the next 12 – 18 months as the company initiates new contracts and uses excess cash flow to de-lever. In an upside scenario, compared to Company A's bonds, Company B's bonds offer better carry and more scope for spread tightening / capital appreciation if it executes its deleveraging plan.

In a downside scenario, we believe that Company B's secured bonds may achieve better bond recovery versus Company A's unsecured bonds due to the first priority claim on a comprehensive collateral package. For context, when company A restructured its debt in 2020, its unsecured bonds traded at 14 cents on the dollar. In our view, Company B's secured bonds are likely to achieve higher bond recovery in the event of a debt restructuring.

The global high yield bond market offers a rich set of opportunities due to its issuer, sector, and geographic diversification. In an environment where overall generic spread levels are tight in certain large capital structure bonds in the US, investors can improve the carry and potential for capital appreciation by moving into select secured bond structures in other parts of world. This provides ample opportunities for active high yield managers investing in a global universe.

Chart 1: Relative value opportunities in the global high yield market



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Source: Bloomberg and Ice Bofa index data

CHF bonds

—

Gregor Kapferer
Portfolio Manager,
CHF Bonds,
Vontobel

After strong outperformance in 2024, the Swiss bond market lagged global peers in early 2025, mainly due to declines in the government segment. The yield differential between Swiss and other major markets, which was previously too wide, has significantly narrowed.

Futures markets have priced out one rate cut and are now pricing in just one more for the rest of the year. Additionally, a record CHF 11.1 billion in new issuance in the first few weeks of the year has put additional pressure on spreads and interest rates. Although we were initially cautious about the large rate differential, we now view the CHF bond market as attractive, with current valuations offering a compelling re-entry point.

A steep yield curve provides a strong carry and roll, and we favor long positions in intermediates (7 – 12 years). In credit, spreads of foreign banks, financial institutions, and insurers look appealing from a cross-currency perspective—attractive to investors but costly for issuers. This dynamic should limit supply and support favorable technical conditions. However, the domestic credit segment appears relatively rich and offers less value.

Resilience in the face of uncertainty

Strengthening fundamentals and clean technicals have supported emerging market (EM) bonds, which have shown remarkable resilience despite heightened trade uncertainty.

Hard currency

—

Carlos de Sousa
Emerging Market Debt Strategist,
Portfolio Manager,
Vontobel

EM bonds were resilient last quarter, and outperformed global equities in the first two months of the year. Despite increased trade policy uncertainty, EM spreads have tightened further over the past three months, raising questions about potential market complacency. However, we believe this concern is more relevant to overall financial markets than to EM bonds specifically. We have not observed exuberance in EM fixed income as it has experienced three consecutive years of outflows, which continued into 2025, albeit at a slower pace.

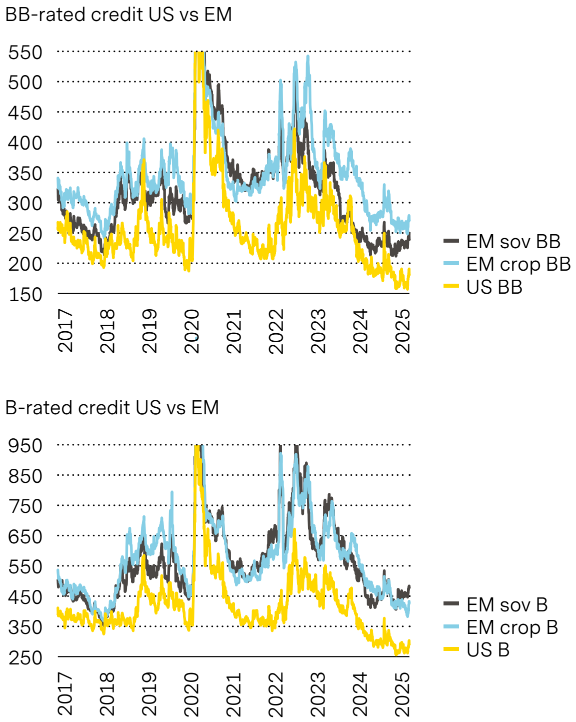
Unlike the situation at the start of 2018—which followed a year of unprecedented inflows—we do not see compression between EM spreads and US High Yield (HY). Instead, we believe EM spreads continue to offer attractive relative value, even though they remain below their historical average. Furthermore, from a fundamental perspective, we continue to observe a trend of credit rating upgrades. The fact that nearly all HY issuers have regained market access significantly reduces refinancing risks, despite still elevated yield levels.

The flurry of tariff threats from President Trump has led some investors to question whether it is a prudent time to invest in EM countries, which may be on the receiving end of tariffs or sanctions. However, developed countries are equally vulnerable; Vice President JD Vance's speech in Munich and Trump's first meeting with Ukraine's President Zelensky suggested that his administration may not maintain friendly relations with Europe. Moreover, with over 70 investable countries and relatively modest concentrations, we believe that hard-currency bonds provide the diversification investors currently need amid the unpredictable nature of Trump's trade policies.

Despite the unpredictability of Trump's tariffs, we can still provide insights on how they may affect EMs. We view the trade war with China as fundamentally different from those waged against other countries. Both political parties in the US see China as a long-term competitor. Consequently, we anticipate that the two rounds of additional 10% tariffs imposed on Chinese imports are likely to remain in place, with the possibility of further tariffs. In contrast, we perceive the tariffs threatened against other nations primarily as negotiation tools, some of which may be implemented, but are unlikely to be permanent.

Amid increased volatility, relative value opportunities abound, creating additional alpha generation opportunities. In the Middle East, for instance, Israel's dominance

Chart 1: EM spreads vs US HY



Source: Bloomberg and Vontobel, data as of 21.02.2025 has contributed to a change in government in Lebanon, where Hezbollah's influence has waned, resulting in the formation of a new government after a two-year stalemate. Markets responded positively to the increased prospect of a restructuring of Lebanese defaulted bonds. These bonds have been the best-performing sovereign bonds, over 40% year-to-date and nearly 200% over the past six months, to approximately 19 cents on the dollar. However, the restructuring will be complex and protracted, likely involving an unusually large haircut due to the country's weak economic fundamentals.

Volatility has also risen across other regions, with Ukrainian bonds among the best performers over the past six months, despite experiencing significant declines after Trump's press conference with Zelensky. Argentina has shifted from among the top two performers in 2024 to the second worst in February, although prospects remain relatively optimistic.

With a yield of nearly 8% for the hard-currency sovereign index (EMBIG Diversified) and almost 7% for its corporate counterpart (CEMBI Broad Diversified), this asset class offers a substantial carry cushion that safeguards it against risk-off scenarios where spreads may unexpectedly widen. Moreover, clean technicals following three years of outflows, along with a favorable spread pick up versus US HY (and a BBB- average rating), make this asset class appealing on a relative value basis, even though spreads are no longer as attractive on a standalone basis.

Local currency

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Local-currency bonds began the year on a strong note, with the Government Bond Index – Emerging Markets achieving total returns of 2.7% in the first two months. Last year, we noted that the outlook for local-currency bonds was binary, with the asset class potentially being either the best or the worst performer in EM fixed income for 2025, contingent upon President Trump's trade policies. His proposals—higher import tariffs and lower taxes—are generally conducive to a strong dollar. The dollar surged by 7.7% in Q4 2024, both in anticipation of and following Trump's electoral victory. But this year, the dollar has been losing ground (–0.8% in the first two months of the year) as the market perceives that Trump's trade bark is worse than his bite, along with preliminary evidence suggesting a deceleration in the US economy, as retail sales and service PMIs have come in weaker than expected.

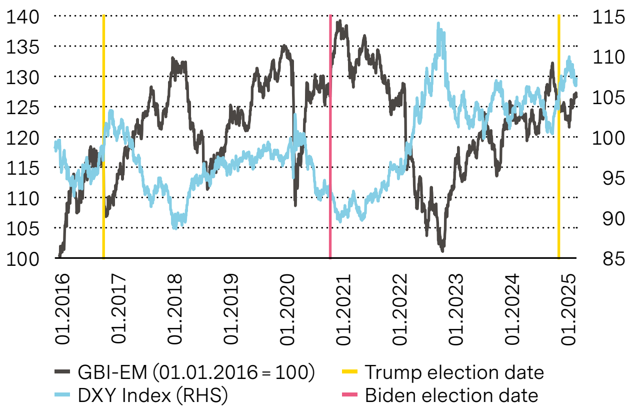
A less severe than anticipated global trade war could further weaken the dollar, potentially increasing EM local-currency returns to high double digits, similar to 2017 (see Chart 2). However, we doubt it will be a smooth ride. We expect only tariffs on China to be permanent, but temporary tariffs may be imposed on other countries to provide Trump with a stronger negotiating position than the mere threat of tariffs, which would increase volatility. This is why we remain cautious about high-beta local currencies, with the exception of the Brazilian real (BRL). Currently, we see a more favorable risk-reward profile in idiosyncratic, high-carry but low-beta countries such as Turkey and select frontier markets, as these are less likely to be impacted by unpredictable US trade policies.

Chart 2 illustrates that local-currency bonds (GBI-EM index) increased by over 15% in USD in 2017, a year when Trump did not implement significant market-negative policies. However, this asset class declined by more than 6% in 2018, coinciding with the onset of the trade war. It is noteworthy that from a non-USD-centric view, euro-based investors have achieved better results (than their USD-based counterparts) in this asset class during years of dollar strength (and euro weakness), and weaker results (in EUR) during years of a weakening dollar (which typically corresponds with an appreciating euro).

Following negative total returns and sharp currency depreciations in 2024, EM currency valuations are now quite attractive, particularly the most affected currencies of 2024, such as the BRL (–21.4% last year). Brazil's fiscal crisis continues, with its government still allocating a third of its revenues to interest payments on its debts. Despite this, Brazilian assets have rebounded, rising 9.3% in the first two months of this year. This moderation in market pessimism is driven by hopes that a new government will adjust public finances after the 2026 elections, and that Brazil will muddle through until then. Lula's approval ratings have declined significantly (latest Datafolha poll). The BRL remains weak and offers high real and nominal rates (>13% and approximately 8%). Thus, we believe that despite its high-beta status, the BRL is unlikely to underperform again, even in a negative global scenario in 2025.

Uncertainty regarding whether this will be the best or worst EM fixed-income asset to own in 2025 will persist as long as Trump's trade policies remain unclear. Currently, the market is favoring it being the best option, but it's not a slam dunk just yet.

Chart 2: Performance of the dollar and local-currency EM bonds during Trump's first and second terms



Past performance is not a guarantee of future results.
Source: Bloomberg and Vontobel, as of 25.02.2025

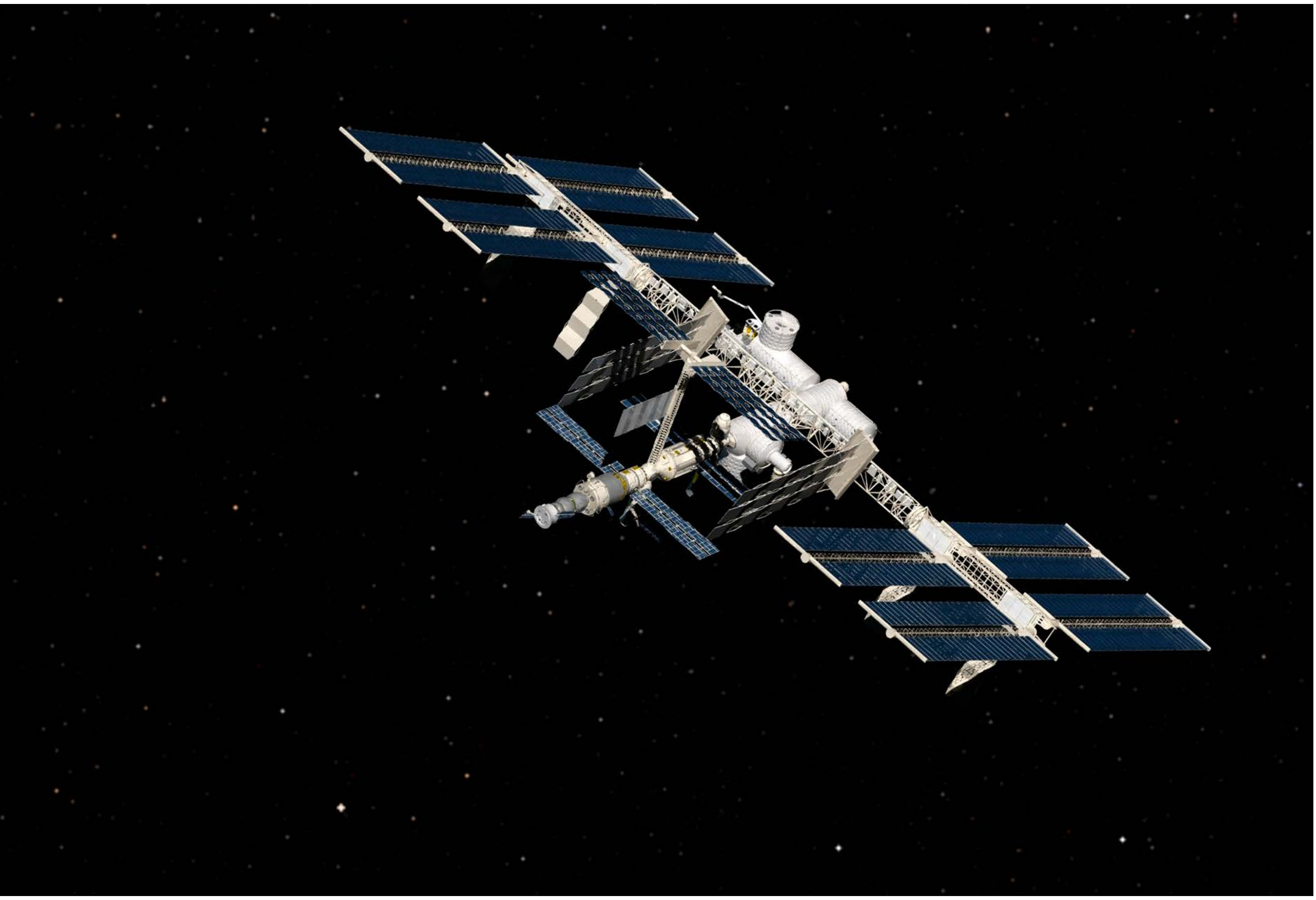
Investment implications

1. Uncertainty is elevated and yet markets appear relatively sanguine. Despite this backdrop, we see continued alpha potential in fixed income, which still looks attractive, return for risk, in terms of relative value.

2. Yield curves in both the US and Europe now look closer to fair value than they did six months ago.

3. Credit spreads are below historical averages but may still have further to go. Yields remain attractive.

4. In our view, opportunities to rapidly recycle risk are a more attractive proposition than a significant bet on stability or an outright rally in risk assets.



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