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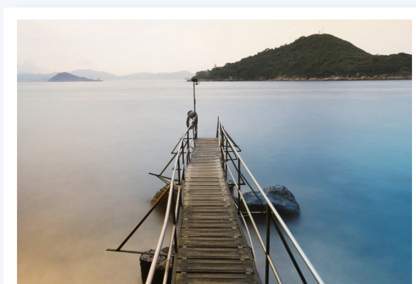
Quarterly Newsletter
Emerging Market Debt

Nordea
ASSET MANAGEMENT



Third quarter 2020

Market Review and Outlook[1]

Highlights for EM Debt

- After the negative performance in the first quarter of 2020, EM assets staged a strong recovery in Q2
- EM markets are likely to continue to benefit from improvement in liquidity, better growth outlook, ongoing market access and support from the IMF
- Spreads for certain EM sovereign and corporate issuers across the credit spectrum are likely to tighten

Market Review

EM assets staged a strong recovery in Q2. Higher yielding assets, which had been hit the hardest during the height of the March selloff rebounded significantly from oversold levels. Likewise, in spread terms, the sovereign index tightened from the wides of +721 bps and are still about +170 bps wider on the year. There is a wide dispersion of spreads of issuers in the index. At about 817 bps, EM high yield spreads remain elevated and trade about 200 bps wide of U.S. high yield spreads. While EM issuers do not benefit from the support being offered to DM credit, the sector will continue to benefit from the broad improvement in liquidity, a better growth outlook along amid the bounce in oil prices, ongoing market access, and support from the IMF and other avenues for the those sovereigns confronted with a sudden stop scenario.

Every country, with the exception of China, which joined the local rate benchmark index in February, experienced a rally in rates all along the curves. The primary driver of this impressive performance was aggressive easing by EM central banks, which utilized conventional and unconventional monetary measures. The unprecedented easing by the Fed and the ECB provided a tailwind for EM policy makers, and the lack of inflation passthrough further boosted the case for lower rates without concerns about FX depreciation. As a result, the main policy rates were cut to all-time lows in most countries, and the steepening in most local curves caused by March's massive delevering also reversed.

EM currencies retraced a bit more than half of their Q1 losses in Q2. The positive EMFX performance began on May 18th when the French-German Recovery Fund proposal and optimism regarding a virus vaccine triggered broad USD selling. The unwinding of heavily skewed long USD market positioning also played a major role in many of the vulnerable currencies outperforming during this period. We were correct in our view that the recovery in EMFX was going to lag the recovery in credit and rates, and we remain cautious on the asset class.

Emerging Markets Debt Performance

	Total Return (%)		Spread (bps)/ Yield Change (%)		OAS (bps)/ Yield (%)
	Q2	YTD	Q2	YTD	30.06.20
EM Hard Currency	12.26	−2.76	−152 bps	184 bps	474 bps
EM Local (hedged)	5.01	3.51	−0.85	−0.71	4.51
EMFX	3.42	−5.34	−1.57	−1.47	1.89
EM Corporates	11.15	−0.16	−160 bps	128 bps	439 bps

Source: J.P. Morgan as of June 30, 2020. **Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index.**

Outlook

In spite of the positive turn in economic data and market performance, debates regarding valuation versus fundamentals and the "second wave" of the virus will dominate sentiment and risk appetite going forward. The extent to which the deterioration in EM fundamentals increases defaults or questions on debt sustainability will be a central focus for investors. Looking over a longer horizon, we see the economic challenges of the virus as only one of the several factors determining EM vulnerabilities. The episode's more lasting effects are likely to be less correlated with the distribution of cases across countries and more correlated with underlying macro and financial fundamentals. However, the longer-term resiliency of issuers is often overlooked, particularly given the sector's near-term funding needs, which are manageable.

1) Views from PGIM Fixed Income Emerging Markets Debt Team. PGIM Limited is the investment sub-manager of the Nordea 1 – Emerging Market Bond Fund and Nordea 1 – Emerging Market Bond Opportunities Fund.

*investing for their own account - according to MiFID definition

EM Hard Currency: EM spreads across the credit spectrum still have room to compress, and we continue to find value in "up-in-quality trades" as well as lower-rated issuers that still trade with default probabilities that are too high. We think many of the sector's vulnerabilities are already priced in, including those of distressed names as well. In an environment where the trajectory of the recovery disappoints, we don't expect a repeat of March given the support from DM and EM policymakers. We would anticipate that multilateral institutions would also increase their support.

EM Corporates: Given the normalization of commodity prices and improvement in financial conditions, we believe the worst can be avoided with respect to EM corporate fundamentals. EM corporate high yield defaults will likely trend towards the low end of our 6–8% forecast for 2020 (YTD actual defaults are 1.7%). Companies have been able to draw credit lines, negotiate asset sales, cut capex and even access the bond market, which seemed unthinkable as Q1 concluded. EM corporate spreads have tightened over 200 bps from the wides of late March (vs. a long-term average of mid 300 bps), but valuations are still attractive from a medium- to long-term perspective. While the supply pipeline remains heavy, issuance in certain sectors, such as Chinese property, has been less than feared as companies were able to take advantage of low borrowing rates in the local market. New issue concessions have compressed to near zero, but demand has remained healthy. In terms of positioning, we continue to favor higher-quality, high-yield names and are underweight sub-scale oil & gas and commodity firms.

EM Local Bonds and FX: In absolute terms, the yields on the overall local index and individual country index trade at historical lows, but relative to core rates, the spread between EM and DM yields still has room to tighten. Alpha opportunities in Q3 will come from three sources: 1) focusing on the front end of the curves where the central banks have room to cut rates; 2) taking an active view on the shape of the curves amid various QE measures; and 3) playing correlation between EMFX and EM rates.

With the Fed on hold for the next two to three years, the five-year point of the curve is the new point from which the term premium can be derived. The spread of the benchmark index to the five-year U.S. Treasury note is an attractive 425 bps. While the long end of EM curves may be vulnerable to increasing debt and deficit levels, the 5- to 7-year segments of the curve are the preferred tenors for expressing a view on duration.

Policy rates in Mexico, Russia, Indonesia, and China remain higher than historical lows, and they could conceivably decline to match those in other countries, such as Brazil and South Africa. We think policy rates in Mexico, Russia, and Indonesia will have a 3% handle by end of the year, and we are expressing this view via interest-rate swaps and bonds in the 2- to 5-year part of the curves in these three countries. Rates in China appear too high relative to economic fundamentals, and money market liquidity is likely to revert to Q1 levels once the PBoC closes various arbitrage loopholes. With negative real rates and all-time low nominal policy rates in Chile, Peru, Czech Republic, and Brazil, QE policies may also provide alpha opportunities. Turkey is the only country where inflationary pressures have started to rebuild, which warrants consideration for underweight positioning.

We don't think the turnaround in EMFX is sustainable if the flow picture doesn't improve. In Q2, there were net outflows from both EM local bonds and EM equities. EMFX market positioning is now closer to home rather than heavily skewed toward long dollar positioning. Looking forward, the performance of EMFX hinges upon the performance of global risk assets, which will be dependent on the type of recovery that will unfold over the remainder of the year. If the recovery is faster and stronger, then inflows are likely to return to local bonds and EM equities, providing some support to currencies. Conversely, a disappointing recovery will likely present a challenging backdrop now that the technical picture is more neutral. Our conviction rests more on relative-value opportunities. We think FX benefitting from factors, such as relatively high carry, higher growth, strong external balance positions, and less reliance on globalization benefits, are likely to outperform. We favor currencies such as the IDR, RUB, KRW, SGD, THB, and to a lesser extent MXN and European currencies. We are cautious on the BRL, CLP, COP, ZAR, and TRY-currencies with relatively sizeable fiscal deficits, higher current account deficits, lower growth, and low to negative real rates.

In summary, our outlook is positive. We continue to find value in EM spreads. Many issuers pre-funded anticipated deterioration in economic conditions and fiscal slippage. Spreads for certain EM sovereign and corporate issuers across the credit spectrum are likely to tighten. Further alpha in local rates may emerge from curve positioning as well as in markets with positive real rates and expectations for policy rate cuts. We are more cautious on EMFX and recognize attractive relative-value opportunities between variously affected currencies.

Nordea 1 – Emerging Market Bond Fund

Performance Q2 2020	
Nordea 1 – Emerging Market Bond Fund (BP-USD)	16.66%
Nordea 1 – Emerging Market Bond Fund (BI-USD)	16.80%
Benchmark[2]	12.26%

Source: Nordea Investment Funds S.A. Period under consideration: 31.03.2020 – 30.06.2020. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. The value of shares can greatly fluctuate as a result of the sub-fund's investment policy and cannot be ensured, you could lose some or all of your invested money.**
2) JP Morgan EMBI Global Diversified.

In the second quarter, the **Nordea 1 – Emerging Market Bond Fund** outperformed largely its benchmark. Long spread duration in Argentina, Angola, Ukraine, and Ghana along with short spread duration in Ecuador, Malaysia, and Lebanon contributed to performance. Argentina rallied after publishing a new debt offer that shortens its payment moratorium to two years. Oil-producers, oil-sensitive names, and other high beta countries

outperformed on the quarter as oil rebounded and the market rallied from March lows. Long spread duration in Belize, Croatia, and El Salvador along with short spread duration in Chile, Philippines, Panama, and Uruguay offset some of these gains. Sovereign positioning in the long-end of Israel, short-maturity paper in Angola, Argentina, Chile, Ecuador, and Mexico contributed to performance. Positioning in Venezuela, Romania, and Oman detracted. Corporate and quasi-sovereign positioning in South Africa (ESKOM, SASOL), Mexico (PEMEX), Turkey (EXCRTU), and Brazil (PETBRA) contributed. Positioning in Venezuela (PDVSA) detracted.

The fund's largest hard currency overweights are Argentina, Ukraine, and Brazil and the largest underweights are Chile, China, and Philippines. The biggest changes over the quarter were adding to Hungary, Philippines, and Poland and reducing Turkey, Egypt, and Mongolia.

Nordea 1 – Emerging Market Bond Fund: Top 10 Positions

	Portfolio (%)	Benchmark[3] (%)	Difference (%)
Mexico	5.46	4.55	0.91
Indonesia	4.66	4.59	0.06
Ukraine	4.34	2.50	1.84
Brazil	4.19	2.99	1.19
Russian Federation	3.87	3.55	0.31
South Africa	3.25	2.44	0.82
Argentina	3.11	1.17	1.93
Qatar	3.04	3.67	–0.63
Turkey	3.02	3.34	–0.32
Saudi Arabia	2.62	3.92	–1.30

Source: PGIM Ltd. as of June 30, 2020. Note: Figures based on the model portfolio allocation and can deviate from official fund data. 3) JP Morgan EMBI Global Diversified.

Nordea 1 – Emerging Market Bond Opportunities Fund

Performance Q2 2020

Nordea 1 – Emerging Market Bond Opportunities Fund (BP-USD)	14.16%
Nordea 1 – Emerging Market Bond Opportunities Fund (BI-USD)	14.31%
Benchmark[4]	11.05%

Source: Nordea Investment Funds S.A. Period under consideration: 31.03.2020 – 30.06.2020. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. The value of shares can greatly fluctuate as a result of the sub-fund's investment policy and cannot be ensured, you could lose some or all of your invested money.** 4) 50% JP Morgan EMBI Global Diversified and 50% JP Morgan GBI-EM Global Diversified.

In the second quarter, the **Nordea 1 – Emerging Market Bond Opportunities Fund** also outperformed largely its benchmark. Long spread duration in Argentina, Angola, Ukraine, and Ghana along with short spread duration in Lebanon contributed to performance. Angola secured a three-year moratorium on payments related to Chinese loans. Argentina rallied after publishing a new debt offer that shortens its payment moratorium to two years. Long spread duration in Belize and Turkey along with short spread duration in Chile, Uruguay, Philippines, and Panama offset some of these gains. Belize was downgraded in May by Moody's to Caa1 from B3. Sovereign positioning in the long-end of Israel, in Angola, Mexico, and Ecuador contributed, while positioning in Oman and Romania offset some of these gains. Corporate and quasi-sovereign positioning in Mexico (PEMEX), South Africa (ESKOM), Argentina (BUENOS), and Brazil (PETBRA) contributed. Long duration in Mexico, South Africa, Indonesia, and Peru along with short duration in Colombia and Malaysia contributed to performance. South Africa's Reserve Bank cut its benchmark rate in May for the fourth time in four months. Long duration in China and short duration in Russia, Brazil, Philippines, and Romania offset some of these gains. An underweight to the belly of the Russian curve contributed. Positioning in Romania and Brazil contributed, while positioning in Indonesia detracted. Overweight positioning in the Indonesian rupiah, Kazakhstani tenge, Russian ruble, and Czech koruna along with underweight positioning in the Brazilian real, Korean won, and Turkish lira contributed to performance. Overweight positioning in the Mexican peso and Polish zloty along with underweight positioning in the Chilean peso and Colombian peso offset some of these gains. Higher beta more oil-sensitive currencies, such as the RUB, outperformed in Q2.

The fund's largest hard currency overweights and biggest changes over the month are the same ones described above for the Nordea 1 – Emerging Market Bond Fund. In local rates, the fund added Chile and India and reduced Israel. In FX, the fund added to KRW and BRL and reduced INR.

Nordea 1 – Emerging Market Bond Opportunities Fund: Top 10 Currency Positions

	Portfolio (%)	Benchmark[5] (%)	Difference (%)
Indonesia	8.27	7.12	1.14
Mexico	8.13	7.19	0.95
Brazil	6.43	6.00	0.43
South Africa	5.37	4.92	0.45
Malaysia	4.28	4.80	–0.52
Poland	4.16	5.00	–0.84
Thailand	3.84	4.58	–0.74
Colombia	3.34	4.34	–1.01
Ukraine	3.11	1.25	1.86
China	3.05	4.12	–1.07

Source: PGIM Ltd. as of June 30, 2020. Note: Figures based on the model portfolio allocation and can deviate from official fund data. 5) 50% JP Morgan EMBI Global Diversified and 50% JP Morgan GBI-EM Global Diversified.

Source (unless otherwise stated): Nordea Investment Funds S.A. Period under consideration (unless otherwise stated): 31.03.2020 – 30.06.2020. Performance calculated NAV to NAV (net of fees and Luxembourg taxes) in the currency of the respective share class, gross income and dividends reinvested, excluding initial and exit charges as per 30.06.2020. Initial and exit charges could affect the value of the performance. **The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. The value of shares can greatly fluctuate as a result of the sub-fund's investment policy and cannot be ensured, you could lose some or all of your invested money.** If the currency of the respective share class differs from the currency of the country where the investor resides the represented performance might vary due to currency fluctuations. 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