RBC Global Asset Management

RBC Emerging Markets Bond Fund

Commentary as at December 31, 2022

Emerging-market government bonds had one of the worst years in nearly three decades as investors were forced to deal with an unusually large number of negative developments in 2022. Russia's invasion of Ukraine in February put pressure on already strained supply chains and pushed commodity prices higher. The fear that prices would remain high for an extended period prompted the U.S. Federal Reserve (the "Fed") to increase short-term interest rates at an exceptionally fast pace to combat the highest inflation in four decades. At the same time, Chinese policymakers were instituting lockdowns in major economic regions to combat the spread of COVID-19, stifling economic activity and leading to the country's lowest GDP growth rate in decades. Concerns about the Chinese economy and fears of a U.S. recession clouded the outlook for the global economy and drove down prices of emerging-market bonds.

Most of the downdraft in emerging-market government bonds was due to rising U.S. interest rates, which make yields in emerging markets less attractive, and the cloudy global economic outlook, which tends to hit emerging markets harder than developing markets. For the most vulnerable emerging-market governments, including Sri Lanka and Pakistan, economic distress and political uncertainty led to a surge in bond yields and escalating costs to service U.S.-dollar bonds. The portfolio manager was able to largely avoid exposure of the bonds to many of these countries.

In general, the portfolio manager remained more comfortable with exposure to emerging-market governments, such as Egypt, which received financial support from the International Monetary Fund (the "IMF"). The Fund benefited from underweight positions in Russia and Belarus earlier in the year. In contrast, the Fund's returns were negatively affected by overweight positions in Ukraine and Ghana, which also recently received IMF funding.

Given the difficult macroeconomic backdrop and the fact that the Fed is determined to continue raising rates to contain inflation, the portfolio manager remains cautious on the outlook for emerging-market government bonds. That said, a few positives on the horizon may result in a more benign outlook in 2023: the U.S. dollar has begun to weaken; the Fed has indicated that it is near the end of the current round of rate hikes; and there are indications that Chinese officials are easing the world's most rigid COVID restrictions.

The portfolio manager plans to maintain an above-benchmark allocation to emerging-market bonds rated below investment grade given their generally more attractive valuations.

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