THE DRIVE YOU DEMAND

UBAM – EM INVESTMENT GRADE CORPORATE BOND

Quarterly Comment | Q4 2018

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws.

Market Comment

- Trade tensions, fears of a sharper slowdown in the US and in China and signs of disagreements between President Trump and the Federal Reserve on the future path of US rates, weighed on risky assets in Q4.
- This pushed down commodity prices. The CRB index lost about 13% over the quarter. Oil was down by over 35%, despite the decision of the OPEC+ (OPEC members plus 10 co-operating countries including Kazakhstan, Mexico and Russia) to cut production by 1.2m bpd early December. Non-precious metal prices also suffered (e.g. copper -5%).
- In contrast, precious metals, seen as safe havens, held well (gold +7.7%, silver +5.7%). Similarly, US treasury bonds rallied, and the curve flattened further (2-year rates -33 bps to 2.49%; 10-year rates -38 bps to 2.68%).
- Overall, EM investment grade corporate bonds returned +0.39%, as the lower US rates helped offset the widening in credit spreads (+53 bps to 245 bps).
- At a regional level, Europe (+1.2%) and Asia (+1.1%) outperformed, while Latin America (-0.8%) and Africa (-0.3%) underperformed.
- At a country level, the best performance came from Taiwan (+2.3%, Formosa Group – Industrials, the company was upgraded by Moodys to A3, thanks to its on-going deleveraging). Korea (+1.7%) and Thailand (+1.5%) also performed strongly, due notably to some long duration bonds (Korea Gas due 2042, Thai Oil due 2048, PTT PCL due 2042).
- The worst performance came from Oman (-3.6% as Oztel Holdings bonds gave back part of their Q3 outperformance, following their downgrade to non-investment grade on the back of the sovereign's rating cut by Fitch)). Mexico (-1.4% - Infraestructura Energetica, Fibria Uno) also suffered after president-elect Lopez Obrador, who took office on December 1st, agreed to a referendum which cancelled the planned construction of a new Mexican airport, creating regulatory uncertainty and MXN volatility. Israel issuers also underperformed (0.4% - Israel Electric - Utilities).
- At a sector level, the best performance came from Financials (0.7%, Oversea-Chinese Banking Corporation - Singapore, ICBC - China), Oil & Gas (0.7%, Thai Oil) and Utilities (0.7% - Korea Gas Corp.). In contrast, Consumer companies (-0.5% - Cencosud, Chile) and TMT (-0.3%, Televisa, Mexico) underperformed.

Performance Review

- Over the quarter, the fund returned 0.15% net of fees. Gross of fees, the fund was up by 0.38% in line with the JP Morgan CEMBI Diversified High Grade Index (0.39%).

All performance figures are given net of fees. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

- Over the period, losses linked to our duration positioning were offset by gains from carry, spread and curve positioning.
- In terms of credit selection (carry spread effect plus spread duration effect):
    - At a country level, the best performance came from our overweight in China, our selection in India and our underweight in Chile. Our selection in South Africa, favouring gold mining companies, also contributed positively.
    - In contrast, the worst contributor to performance was our underweight in Korea and Hong Kong, which, as lower beta assets, held well in the sell-off. Our selection in Mexico also proved costly, due notably to the underperformance of off-benchmark holdings in PEMEX, which suffered from lower oil prices as well as the mixed statements of President Lopez Obrador with regards to the continuation of the energy reform.
    - At a sector level, the main sources of outperformance were our underweight in the Consumer sector and overweight in Industrials.
    - Our selection in the Oil & Gas sector, in contrast, weighed on relative performance, as did our underweight in Financial companies.
- Over the year, the fund returned -2.04% net of fees. The main source of underperformance was our credit selection, while the contribution of duration and curve positioning was marginally positive. At a country level, Turkey was the worst contributor, followed by Brazil. In contrast, our selection in South Africa, China, and Chile contributed positively. At a sector level, our selection in Oil & Gas and our underweight in Financials were the main detractors.

Portfolio Activity

- Over the quarter, given the volatility, we reduced our market exposure by buying back protection in the CDX index IG Asia ex Japan.
- At regional level, we slightly increased holdings in Latin America at the expense of Asia and Central & Eastern Europe.
- In Latin America, we increased our exposure to Brazilian issuers following the election of right-wing candidate Jair Bolsonaro. Market participants expect that the new government, including liberal Finance Minister Paulo Guedes, will reduce regulatory intervention and favour privatization and asset sales. We favoured industrial corporates, but reduced our exposure to Metals & Mining. In Chile, we increased exposure to Utilities and Pulp & Paper.
- In Europe, we took some profit on our overweight in Russia, and reduced holdings in commodity-linked sectors (Oil & Gas, Metals & Mining) which were under pressure due to growing concerns over a potential global slowdown.
- In Asia, we reduced our overweight in China as valuations appeared less attractive and concerns over global trade were mounting. We primarily cut down our holdings in Financials and in Metals & Mining companies. We also reduced holdings in Indonesia (Utilities, Oil & Gas), moving from overweight to neutral, as the country is likely to suffer from lower commodities prices. In exchange, we reduced our underweight in Hong Kong (Diversified, Industrials, TMT) and Korea (Financials, Utilities and Industrials).
- In the Middle East, we reduced our overweight in the United Arab Emirates (Oil & Gas), due falling oil prices. In contrast, we reduced our underweight in Qatar (Financials), where valuations appeared more attractive.

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- At a sector level, we moved to neutral in the Oil & Gas sector and reduced our exposure to Metals & Mining. In contrast. we increased our holdings in Industrials, Utilities and Real Estate.

Outlook

- We believe that emerging fixed income should bottom out in the coming months, helped by still robust fundamentals, sound economic growth in the majority of EM countries, limited upside in US rates and improved market technicals.
- As investors reposition their portfolios for 2019, EM fixed income's attractive valuations should translate into inflows.
- We expect the performance in EM hard currency bonds to be in the mid-single digits for the year, thanks to the high carry and some spread-tightening partly offsetting higher US rates.
- Given the reduced liquidity and heightened volatility in the last two weeks of 2018, we entered the year cautiously positioned, but are looking to gradually increase our market exposure over time to take advantage of these attractive valuations.
- At a country level, our largest overweights are in Singapore, the UAE and Oman.
- Our largest underweights are in Saudi Arabia, Peru and Qatar.
- At a sector level we favour Metals and Mining, Real Estate and Industrials at the expense of TMT and Utilities.

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