THE DRIVE YOU DEMAND

UBAM – EM SUSTAINABLE HIGH GRADE CORPORATE BOND

Quarterly Comment | Q4 2019

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

Market Comment

- Emerging Market bonds performed well over the quarter, thanks to improving trade discussion between the US and China and better than expected economic data, alleviating fears of a sharp slowdown in the global economy.
- The Fed reaffirmed its position of pausing interest rate cuts. Although this comforted markets, the Fed also sent signs that it would be ready to resume its rate cuts if necessary. The US Treasury curve steepened, with 2-year rates down 5 bps to 1.57% while 10-year rates rose by 25 bps to 1.92%.
- The improved market sentiment also supported commodities prices. The CRB index rose by about 7%, with Brent up 8.6% and copper up 8.0%. Precious metals underperformed, with gold up 3% only.
- Inflows into EM fixed income (hard and local currency) also picked up over the quarter, ending the year at USD 68.6 billion vs USD 18.7 billion in 2018. More specifically, inflows into hard currency bonds reached USD 56.7 billion vs. USD 9.2 billion in the previous year.
- At the end of the first phase of their negotiations, the United States and China agreed on a partial agreement in November. This provided for a reduction in punitive tariffs, more purchases of American goods by China from the agricultural, energy and commercial sectors, and clarification of certain issues regarding intellectual property. In return, the United States agreed to reduce the punitive tariffs on Chinese goods worth USD 120 billion from 15% to 7.5%.
- The quarter was marked by social protest across Latin America, often triggered by tariff hikes (gasoline price in Ecuador; subway tickets in Chile), leading to significant spread widening. The Chilean economy proved more resilient, however, thanks its robust fundamentals and solid institutions. So, while protests continued in the country in December, financial markets were able to stabilize and rebound.
- In Argentina, the opposition candidate, Alberto Fernandez won the presidential election with 48% of the vote in the first round in October. The new president took office on December 10 and announced his willingness to service its obligations in the short-term, while continuing to work on the debt reprofiling. To that end, the government decided to issue a new 10-year bond to be placed to the Central Bank, hence using foreign exchange reserves to service the country's dollar debt, a solution which, while helping in the short-term, could undermine the country's economic situation for the longer term by monetising the deficit and risking higher inflation. The new government also announced increased taxes on exporters (mainly on agricultural goods), greater flexibility on pensions, higher taxes on USD purchases, as well as a freeze on utility prices.

- The outlook for South Africa's rating was downgraded to negative by both Standard & Poor’s and Moody’s after the government announced further support to the ailing state-owned power company Eskom, which could lead to further deterioration in the country’s fiscal balance.
- Overall, EM investment grade corporate bonds remained well supported and returned +1.06% thanks a spread tightening of 20 bps to 187 bps.
- At a regional level, the best performance came from Emerging Europe (2.0%) and Africa (1.7%). In contrast, Asia (0.8%) and the Middle East (0.9%) underperformed.
- At a country level, the best performance came from Brazil (+3.4%), Mexico (+2.7%) and Russia (+2.2%).
- In contrast, Chile (-0.2%) suffered as protests against the government unfolded. Thailand (-0.0%) and Peru (0.1%) also underperformed.
- At a sector level, the best performance came from Metals & Mining (2.9%) and Diversified companies (1.9%). In contrast, Utilities (0.6%) and Consumer companies (0.7%) underperformed.

Performance Review

- Over the quarter, the fund returned 0.14% net of fees. Gross of fees, the fund was up 0.42%, compared to 1.06% for the JP Morgan CEMBI Diversified High Grade Index.
- Performance attribution shows that the fund suffered primarily from its credit selection.
- Country-wise, the best performance came from our zero exposure in Saudi Arabia, the Philippines, Poland and Taiwan. In contrast, our selection in Mexico, Thailand, and our overweight in Chile and the UAE proved costly.
- Sector-wise, the fund benefited primarily from its selection in the Consumer sector and from its underweight in Utilities. Our positioning in the Oil & Gas sector and in Financials proved costly.
- YTD, the fund returned 10.84% net of fees and 12.01% gross of fees, compared to 12.68% for the index. The outperformance in 2019 of sectors with poor ESG credentials like Metals & Mining and Oil & Gas, and underperformance of Financials, which tend to have better ESG ratings, explains most of the underperformance. At a country level, the best performance came from our off-benchmark position in Romania, underweight in Taiwan and Qatar. In contrast, our selection in Colombia and Mexico, overweight in Singapore, and underweight in Macau weighed on performance.

Portfolio Activity

- During the quarter, we made limited changes to the portfolio.
- In Chile, we switched out of Inversiones CMPC (Pulp & Paper company, rated BBB by MSCI ESG Research), in favour of a new sustainability bond issued by Celulosa Arauco y Constitución (a Pulp & Paper company, whose parent company, Empresas Copec, is rated A by MSCI ESG Research). Arauco is committed to the non-conversion and to the protection of biodiversity and ecosystems of its native forests, many of which are High Conservation Value Areas. The Company also announced in September its goal to achieve carbon neutrality by 2020 and to join the Science Based Targets, a global initiative for companies to reduce their greenhouse gas emissions based on climate science. The bonds follow the Sustainability Bond Guidelines, and aim to finance several green and social projects, aligned with the Green Bond Principles and the Social Bond Principles.

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.

- In Asia, we reduced our holdings in Hong Kong Financials, due to valuations. In Singapore, one of our holdings was called (Financials).

Outlook

- The global risk environment has improved to the benefit of EM, supported by the bottoming out of EM PMIs and the likely peaking of tariffs between US and China. We think that this should improve the outlook for global manufacturing and in turn commodity prices.
- We also see an improved technical backdrop for EM bonds. Flows to the asset class should remain solid on the back of a strong global investors’ search for yield, less downside economic risks in EM and the recycling of large EM bond redemption and coupon payments due at the beginning of the year.
- We thus look to increase our beta. However, after the strong rally experienced in 2019, we will need to be increasingly selective.
- At a country level, our largest overweight positions are in Colombia, Singapore, Chile and the UAE.
- Our largest underweights are in China, Saudi Arabia, Mexico and Qatar.
- At a sector level, our largest overweight is in Financials, due to their sounder ESG credit quality. Our largest underweights are in Industrials, Consumer companies, Metals & Mining and Utilities

ESG Metrics

- At the end of the year, the overall ESG Quality Score of the portfolio stood at 6.5 vs. 3.4 for the index (@2019 MSCI ESG Research LLC).
- The weighted average carbon intensity[1] of the fund was 493 tons CO2e/$M sales revenues v. 800 tons CO2e/$M sales for the index - @2019 MSCI ESG Research LLC).

[1] taking into account subsidiary mapping


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