Q3 2020

UBAM – EMERGING MARKET DEBT OPPORTUNITIES

Quarterly Comment

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

Market Comment

- The third quarter was split in two, with the continuation of the market optimism seen in Q2 in July and August and renewed concerns in September amid signs a resurgent virus could lead to more lockdowns and a deeper global recession.
- Over the quarter, US treasury bonds appear fairly stable, masking a rally in July, a sell-off in August when expectations that the worst had been avoided were predominant, and a new rally in September when the pandemic accelerated again. Overall, the curve steepened slightly, with 2-year US Treasury rates down -2 bps to 0.13% and 10-year rates up +3 bps to 0.68%.
- Commodities were also weak in September, on concerns of lower demand but overall stronger over the quarter. The CRB index was up by 7.6%, thanks notably to the rally in metal prices (silver +28%, iron ore +18%, copper +11%, gold +5.9%). Oil prices underperformed, however, up only 2.4%. The OPEC cut demand estimates for its oil by 1.1 million barrels a day, while surplus stockpiles of crude and refined products continue to build up.
- Contrary to many countries around the world, there are already signs that economic activity is picking up in China. Industrial production was up in August by 5.6% yoy. Manufacturing PMI came at 51.5 in September, while non-manufacturing PMI stood at 55.9.
- EM corporate bonds outperformed, up 2.3% over the quarter, with spread tightening by 29 bps to 386 bps. The best performance came from Pulp & Paper (+7.3%), Transport (+5.5%) and Infrastructure (+5.3%). In contrast, Oil & Gas underperformed (1.5%) reflecting the sell-off in crude prices in September. TMT (+2.1%) and Consumer companies (+2.2%) also underperformed.
- EM sovereign bonds returned +2.3% over the quarter, thanks to a spread tightening of 42 bps to 432 bps. At a country level, the best-performance came from Suriname (+36.9%), Ecuador (+10.9%) and Costa Rica (+8.4%). n In contrast, Lebanon was the worst performing country (-11.2%), followed by Zambia (-4.2%) and Ivory Coast (-3.4%).
- EM local bonds returned 9.80.61% in USD terms, and 0.87% in local terms.

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.

Performance Review

- The fund returned 3.71% net of fees over the quarter, and 3.98% gross of fees. As an indication, the performance of the JP Morgan EMBI Global Diversified* ex CCC is estimated at 2.07%.
- Performance attribution shows that the fund benefited primarily from our credit selection (spread effect + carry spread) as well as from its duration positioning. Ours FX positioning proved marginally negative.
- The allocation effect (overweight in corporate bonds) was costly this quarter, but the selection effect in both sovereign and corporate issuers was positive.
- In hard currency, at a country level, the best performance came from our overweight and selection in Argentina, Brazil, Paraguay as well as from our selection in South Africa.
- In contrast, the worst performance came from our selection in Ghana, overweight in Ivory Coast and zero exposure to Sri Lanka.

Portfolio Activity

- Over the quarter, our scorecard remained in “balanced” territory, though the overall score trended down in September as fears of a second pandemic wave weighed on investors’ risk appetite.
- We favoured corporate issuers at the expense of sovereigns.
- Region-wise, we increased Latin America and the Middle East at the expense of Africa and Europe.
- In Latin America, we increased our positions in Peru (Metals & Mining, Sovereign), Brazil (Pulp & Paper, Consumer), Chile (Consumer) and the Dominican Republic (Sovereign) at the expense of Argentina (Sovereign, Provinces) and Uruguay (local currency, sovereign)
- In the Middle East, we bought Jordan (Industrial) and added to our positions in Qatar (Sovereign).
- In Asia, we reduced our positions in India (Oil & Gas) and Indonesia (Sovereign). In contrast, we increased holdings in China (Real Estate) and Malaysia (local currency sovereign).
- In Africa, we sold our exposure in Ghana (Oil & Gas) and reduced holdings in Nigeria (Sovereign) and Senegal (Sovereign).
- In Europe, we reduced holdings in Kazakhstan (Sovereign), We added to our positions in Ukraine (Metals & Mining)
- Sector-wise, we favoured Industrials, Real Estate, and Consumer companies at the expense of Sovereign, Oil & Gas and Metals & Mining.

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Outlook

- We expect the pick-up in volatility seen in September to remain in the short-term, given the increased risk of new lockdowns and the upcoming US elections. Still, we remain constructive on emerging debt for the medium-term.
- Indeed, the pandemic-triggered recession is likely to be less severe in emerging markets than it will be in Developed Markets (DM), and the rebound next year is expected stronger. In its World Economic Outlook, published early October, IMF forecasts emerging economies to slow by 3.3% this year and bounce back by 6.0% in 2021, vs -5.8% and +3.9% respectively for DM.
- Also, investors' appetite for yield remains high and valuations of EM bonds appear attractive especially compared to US and Euro credit, where the combined actions of G3 central banks have pushed Developed Market yields to extremely low levels.
- Importantly, if considering corporate issuers, fundamentals appear more solid than in DM, as leverage for both IG and HY issuers remains lower in EM than in DM. As it is, year-to-date, the default ratio in EM corporate remains lower than in US High Yield credits.
- Still, we recognize that the economic slowdown will have a negative impact on issuers' creditworthiness. Hence, thorough issuer selection remains of paramount importance. We thus rely on our sovereign and credit analysts to avoid negative credit events, with special focus on:
    - Issuers' capacity to generate operating cashflows and maintain a good level of activity, and keep adequate liquidity
    - Their capacity to refinance
    - Their ability to support the leverage accumulated during the crisis
    - Valuations to identify attractive opportunities (overly penalised issuers)

- Overall, we continue to favour corporate bonds over sovereign ones.
- At a regional level, we favour Latin America and Middle East & Africa.
- Our largest country exposures are in Colombia (sovereign, corporate,), Brazil (corporates), Indonesia (sovereign, quasi-sovereign), , Chile (corporates) and South Africa (corporate).
- At a sector level, our main exposure is in Sovereign, Oil & Gas, Consumer companies and TMT.
- In FX, we have a net long exposure of 7.5%, with long exposure to UYU, MYR, CNY and PEN.

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