UBAM – EMERGING MARKET DEBT OPPORTUNITIES

Quarterly Comment

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

Market Comment

- The year had started positively with a “phase one” trade deal between the US and China and strong inflows into emerging debt. However, with the spread of the coronavirus, first across China and Asia then worldwide, markets started to sell off late February and collapsed in March. This was further accentuated by tensions between Saudi Arabia and Russia which pushed oil prices into freefall.
- Decisions by the Fed to cut rates and extend quantitative easing led US rates down: 2-year US Treasury rates fell by -132 bps to 0.25% while 10-year rates were down -125 bps to 0.67%.
- Commodities sold off, with the CRB index down by over 34%. Oil started to tumble after Saudi Arabia decided to sell its oil at depressed levels to counter Russia’s decision not to cut production. Crude posted its worst quarter ever, down about 66%, and Brent reached an 18-year low ($22.74 on March 31) as lockdowns became the new norm, leading to a collapse in global demand. Metal prices also suffered, with copper down close to 20% for instance. Gold benefited from its safe haven status and gained 3.9% over the period.
- After inflows in the first two months of the year, EM debt markets saw outflows accelerate in March with the risk-off sentiment, reaching USD -28.9bn of which 18.7bn from EM hard currency bonds. EM sovereign-focused funds were the most impacted (USD -13.3 bn) while EM corporate funds proved more resilient (-3.6bn). Outflows conjoined with poor liquidity to amplify price movements.
- By the end of the quarter, while volatility remained at very high levels, market participants took some comfort in the widespread responses of governments and central banks worldwide. Indeed, in addition to the Fed, several other central banks across Emerging and Developed markets also decided to cut rates, or use quantitative easing, to limit the impact of the virus on their economies. Similarly, major fiscal spending plans were announced in the US and Europe. In Emerging countries, this was more limited, which we see as a positive to avoid sharp fiscal slippage in those countries where fiscal deficit is already high.
- Overall, all EM debt sub asset classes suffered, with EM local bonds underperforming over the period (-15.2% in USD terms).
- Within EM hard currency bonds, EM corporate bonds proved more resilient, once again (-10.0%), while EM Sovereign bonds lost -13.4%, due partly to their longer duration as well as to larger outflows.
- Among EM sovereign bonds, the best-performing countries were Lithuania (+2.3%), Slovakia (+2.1%) and China (+2.0%).

- In contrast, the worst performance came from the weakest issuers, as market prices reflected an increased risk of default or already pre-announced restructuring (Ecuador -67.0%, Angola -62.6%, Lebanon -61.5% or Zambia (-40.2%).
- Similarly, among EM corporates, the best-performing countries were Taiwan (+1.7%), Korea (-0.1%) and Poland (-0.2%). In contrast, Ghana was the worst performing country (-60.9%) followed by Argentina (-30.4%) and South Africa (-27.9%).

Performance Review

- The fund returned -14.14% net of fees over the quarter, and -13.7% gross of fees. As an indication, the performance of the JP Morgan EMBI Global Diversified* ex CCC is estimated at -12.9%.
- Performance attribution shows that the fund sufferd primarily from its duration positioning, as well as from its currency exposure. In contrast, our credit selection was beneficial. Overall, our overweight in corporates at the expense of sovereign was positive, but our selection proved costly.
- In hard currency, at a country level, the best contributors were our zero exposure to Ecuador, Angola, Sri Lanka and Lebanon. Our overweight and selection in Mongolia (quasi-sovereign) and Georgia (quasi-sovereign/ corporates), also contributed positively.
- In contrast, the worst performance came from our overweight and selection in Ghana, Colombia and South Africa, as well as from our underweight in China.
- The fund benefited also from having raised its cash holdings and from its protection strategy implemented in February.
- On the FX side, the fund suffered from its long position in UYU, RUB and CZK.

Portfolio Activity

- Over the quarter, our scorecard gradually pointed to a worsening of the macroeconomic environment, partly offset by the strong reaction of central banks globally and the sharp widening of spreads. We thus reduced our risks slightly but did not move our portfolio to a fully “conservative” profile. We increased our cash holdings and reduced our exposure to EM FX and local bonds, which tend to be more volatile than USD-denominated bonds.
- Region-wise, we increased Europe and Asia at the expense of Latin America and Africa.
- In Europe, we added exposure to Russian quasi-sovereign issuers (Financial). We also closed our long exposure to PLN and our short in Turkish Lira.
- In Asia, the increased exposure was primarily the result of portfolio rebalancing as we reduced exposure to other regions. In addition, we closed our long exposure to IDR.

- In Latin America, we halved our exposure to Argentina sovereign, where the debt restructuring is pending. We also reduced our exposure to Chile (Utilities) as well as our long position in Uruguayan peso government bonds. In contrast, we bought some exposure to the Oil & Gas sector in Colombia and Mexico.
- In Africa, we sold our exposure to South African quasi-sovereign (Utilities).
- In February, we also added some protection, by selling CDS exposure on some Asian sovereign issuers, like Malaysia and Indonesia. We closed our position somewhat too early in the sell-off, however.

Outlook

- The impact of the pandemic-induced lockdowns on global growth is likely to be sharper than initially expected, with several DM and EM economies likely to fall into recession, at least in the first half of the year. This should contribute to maintaining volatility at high levels in risk asset markets for now.
- Over the medium-term, we see as a positive the forceful reaction of public authorities around the world. Many EM central banks have decided to cut rates while some governments have also announced fiscal measures, though with limited signs of fiscal slippage, which is a positive.
- DM central banks are committed to providing ample liquidity, notably through extended QE. For its part, the Fed has also pledged to extend USD swap lines to some EM central banks, like Brazil, Mexico, Korea or Singapore.
- The IMF has made available about $50 billion through its rapid-disbursing emergency financing facilities for low income and emerging market countries, with limited conditionality. It has also confirmed that it “stands ready” to mobilise up to USD 1 trillion in additional loans if needed. Several countries have already asked the IMF, including Georgia, Jordan, Ukraine or Zambia. Other bilateral and multilateral aid should also help provide debt relief to the poorest countries.
- Importantly, while contagion expands across the globe, the peak of the epidemic in China seems behind us, and activity is starting again, though slowly and from very depressed levels. Similarly, the rest of Asia, where the number of new cases is slowing down, is also likely to rebound earlier than the rest of the world, though again at a slow pace, given the sharp drop in industrial production globally.
- The shock on developed countries appears more severe, even if governments and central banks have also announced several measures of monetary and fiscal easing to support economic activity.
- As a result, a global recession in 2020 is likely. Still, EM economies will likely fare better than DM thanks to the earlier rebound of Asia, as well as to the vast diversity of EM economies, some of them being still little dependent on the global demand. We thus expect the gap in economic activity between EM and DM to widen again, which should contribute to resume capital flows towards EM, once current market dislocation is over.

- Anecdotal signs of this appeared as early as the beginning of April where we saw net positive (though still limited) inflows into EM debt markets, primarily driven by the historically cheap valuations.
- Still, the rebound is unlikely to be fast and smooth. Issuer selection will be of paramount importance in this context, as some issuers may not be able to refinance Our analysts are thus currently focusing on reviewing all issuers, paying particular attention to:
  - issuers' sensitivity to the risk of depreciation of their domestic currency
  - issuers' sensitivity to commodities prices
  - risk of default (for the weakest HY issuers)
  - risk of becoming a fallen angel (for the weakest IG issuers)
  - some specific sectors like transport and airlines companies
  - valuations to identified attractive opportunities (overly penalised issuers).

- At a regional level, we favour Latin America and Asia. Our largest country exposures are in Colombia (sovereign, corporates), India (corporate), Indonesia (sovereign, quasi-sovereign) and Chile (corporates).
- In FX, we have a net long exposure of 1.4%, with a long position in UYU.

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