UBAM – EMERGING MARKETS FRONTIER BOND

Quarterly Comment

For Professional Investors in Switzerland or Professional Investors as defined by the relevant laws.
The classification of the fund(s) as per the Sustainable Finance Disclosure Regulation (SFDR) is available on ubp.com or in the latest prospectus.

Market Comment

- US interest rates were relatively volatile this quarter. While movements over the quarter were stable (2-year US Treasuries were 3bps up to 0.28% and 10-year US Treasuries rose 2bps to 1.49%), inflation and Fed tapering concerns saw yields surge towards the end of the quarter; the 2-year US Treasuries peaked at 0.30% and 10-year US Treasuries reached 1.54%.
- In terms of the risk environment, we remain slightly positive, although market sentiment toward the Chinese real estate market has deteriorated rapidly in the last few weeks relative to the concerns with Evergrande, with all Chinese real estate bonds seeing their spreads widen sharply.
- Flows into the asset class have been more muted over the course of the last quarter. After a strong first half of 2021 with over $50bn allocated to the asset class, August and September 2021 were more subdued in terms of flows, with small outflows of -$1.6bn and -$0.6bn respectively in those two months.
- In this lower risk environment, frontier bonds, as measured by JP Morgan NexGEM index posted a performance of -1.19%, underperforming the broader EM sovereign bond market (-0.70%) as spread widened by 41 bps to 598 bps.
- Following the good progress of vaccination campaigns in developed markets, the reopening of economies across the globe has boosted demand for industrial metals, oil and other commodities. Oil exporters have been key beneficiaries from the on-going rise in oil prices.
- At a regional level, the best performance came from the Middle East (+1.03%) and Europe (+0.58%). The weakest performance was from Latin America (-3.34%), Asia (-1.57%) and Africa (-0.48%).
- At a country level, the best performance came from Belize (+26.29%), Suriname (+5.13%) and Belarus (+3.74%).
- In contrast, countries that performed the worst were El Salvador (-16.45%), Tunisia (-7.47%) and Ghana (-5.37%).

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 El Salvador, the debt sustainability continues to be a key issue. We see rising deficit level as the key issue in the medium term, with Debt to GDP levels predicted to rise to 110%. After adjusting for intra-public sector liabilities with pension funds, the public debt comes down to 67% of GDP, which is nonetheless below the 71% sustainability threshold held by the IMF for EM economies. With limited room to contract more debt, the IMF has advocated for an adjustment with a focus on the public wage bill, revenue measures and pension reforms to bring down the deficits and lower borrowing costs. El Salvador is continuing discussions with the IMF on an Article IV programme, which is likely be considered by the IMF board before year-end.
- In Tunisia, there was a power grab from President Saied after he suspended parliament in July 2021. The social situation has worsened significantly, with higher food prices and the Covid situation being one of the worst in Africa. Conversely, the Central Bank has been building reserves and now stand at an adequate level of $7.5-8bn, which should allow for a stable FX.
- In Ghana, we expect growth at 4.6% thanks to gold and oil holding up, offsetting cocoa drag. A good policy response should help with the rebound, but the debt load has however risen sharply (75% of GDP) despite being brought down by a GDP rebasing exercise. Of concern is the 3.5-years stimulus package (26% of GDP) that the government announced last year. Debt affordability is increasingly challenging as interest payments is close to 50% of revenues. The “Ghana Beyond Aid” domestic rhetoric also makes another IMF programme politically difficult.
- Belarus, which has historically been fiscally conservative and highly reliant on Russia, has seen protests die down following Lukashenko announcement of his departure following a constitutional reform. With the recent plane hijacking, the country has become an ESG nightmare for investors, with sanctions put on new debt. This is a clear negative for their ability to access both international markets and FDI, but support from Russia has mitigates the technical picture.

Performance Review

- Over the period, the fund returned 0.16% net of fees, delivering positive performance in what was a challenging period for emerging markets.
- Carry and spread contribution were the main contributors to performance, with the duration element proving to be a minor drag over the course of Q3 2021.
- At a regional level, the best performance came from our holdings in Africa and CEEMA. In contrast, Europe and Latin America were the biggest drags on performance.
- Country-wise, the largest contributors to performance were the Dominican Republic, Zambia, and Belarus.
- In contrast, El Salvador, Guatemala, and Ukraine were the biggest detractors from performance.
- Year to date, the fund has returned +2.11% net of fees.

Portfolio Activity

- Over the quarter, we increased holdings in Europe and Latin America at the expense of Africa.
- In Africa, we increased our exposure to Cameroon, Egypt and Senegal at the expense of Benin, Ghana and Kenya.
- In Latin America, we opened a position in Argentina, investing in two USD-denominated Sovereign bonds.
- In Asia, we sold out of our exposure to Pakistan.
- In Europe, we open a new position in the KZT.
- Quarter-to-date, we selectively added local currency exposure. In total, we currently have around 16% exposure in local currencies (Dominican Republic, Kazakhstan, Egypt, Uganda, Uzbekistan, Uruguay, Ghana and Ukraine).

Outlook

- Despite some delays in the roll-out of vaccines across the world, the global economy is recovering with major economies leading the growth. On a positive note, export of vaccines to emerging markets is set to increase, which will help EM countries in their recovery from the pandemic. In the meantime, central banks remain accommodative until economies recover fully and will only tighten their monetary policy gradually as global investors expect. The rise in commodity prices will help exporter countries fare better, however, the risks associated with the new Covid-19 variant and subsequent new waves remain.
- The outlook remains constructive on the fundamentals of frontier markets, and particularly in the names we are invested in. In part due to global growth in 2021, and in part due to ample liquidity relief provided by bilateral and multilateral creditors. In addition, the successful issuance of Eurobonds by many of Frontier sovereigns in the first half of 2021, which included liability management and a level of issuance already ahead of projections at an aggregate level, is a positive. Altogether, these should offer decent liquidity support and a continued constructive outlook for frontier markets.
- While inflows have decelerated over Q3 2021, we expect investors to resume investment as systemic risks subside and the chase for yield resume. Many fixed income assets may face an uphill battle generating attractive returns in the period to come, in the face of rising core yields. We believe that investors with broad enough mandates should consider frontier markets, where considerable positive returns can still be generated.

- At a regional level, our largest exposures are in Africa and Latin America.
- At a country level, our largest positions are Nigeria, Côte d'Ivoire and Egypt.
- In FX, our largest exposure are DOP, KZT and EGP.

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