THE DRIVE YOU DEMAND

UBAM – EMERGING MARKET CORPORATE BOND SHORT DURATION

Quarterly Comment | Q2 2019

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

Market Comment

- The quarter was marked by heightened trade tensions between the US and China, further signs of economic slowdown especially in developed markets, and central banks, like the Federal Reserve or the ECB, adopting a more dovish stance.
- As a result, US Treasury bonds rallied over the period (2 year rates -51 bps to 1.75%; 10-year rates -40 bps to 2.01%).
- In contrast, commodity prices were weak. The CRB index lost -1.5%, with oil down -2.7%, and copper prices down about -8%. Precious metals outperformed (gold +9.1%, silver +1.3%).
- The G20 meeting between President Trump and Xi delivered as we had expected a cordial exchange between the two leaders, the restart of trade negotiations and some grace allowing US companies to temporarily sell some goods and services to Huawei. This plus the Fed continuing to signal interest rate cuts and the ECB indicating willingness to ease monetary policy explain the market rebound in June.
- Inflows into EM bonds have reached USD 45.1 bn in the year to date, of which USD 37.9 bn into EM hard currency debt.
- Overall, EM corporate bonds returned 3.61%, on the back of lower US rates, carry and moderate spread tightening (-2bps to 317bps).
- 1-3 year EM corporate bonds were up 2.3%, while 3-5 year bonds were up 2.9%.
- Amongst all maturity bonds, Investment Grade bonds outperformed (3.65%), thanks to their longer duration and a spread tightening of -3 bps to 207 bps. High Yield bonds returned 3.55%, with spreads tightening by -1 bp to 478bps.
- At a regional level, the best performance came from Emerging Europe (+5.7%) and Latin America (+3.9%). In contrast, the Middle East (2.7%) and the Asia (3.2%) underperformed.
- The best-performing countries were Turkey (+16.8%, Isbank, Yapi – Financials – bonds in the country rebounded in June as support for Erdogan weakened) and Ukraine (+7.6%, MHP - Consumer). Brazilian issuers (5.2%, BRF, Marfrig – Consumer) also performed well, benefiting from the improving economic climate and expectations that the reform agenda would eventually be approved.
- In contrast, Jamaica was the worst performing country (-8.2% - Digicel reported poor fourth-quarter earnings). Israel (1.1%, Teva - Consumer) and Guatemala (1.7%, Comunicaciones Celulares, TMT) also underperformed.

All performance figures are given net of fees for the IC USD share – unless mentioned otherwise. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

- At a sector level, the best performance came from Pulp & Paper (+5.3%, Klabin - Brazil) and Metals & Mining (+4.3%, Petropavlovsk - Russia). In contrast, Consumer companies (+3.0% - Teva - Israel) and Real Estate (+3.1%, Evergrande - China) underperformed.

Performance Review

- The fund returned 2.42% over the quarter, net of fees.
- The fund benefited from its high carry, falling interest rates and spread compression.
- At a country level, the best spread performance came from our holdings in Russia, Nigeria, Ukraine and India.
- Negative contributions came from Argentina and Zambia.
- At a sector level, the best spread performance came from holdings in Sovereigns, Industrials and Financials. In contrast, the Consumer sector detracted from performance.
- Our allocation to CDX indices contributed positively over the period.

Portfolio Activity

- Over the quarter, the fund's assets more than doubled from $133 mln to 308 mln. We added to most positiions and sought also to diversify our portfolio further.
- At a regional level, we increased our exposure to Europe at the expense of Latin America and Asia.
- In Central and Eastern Europe and the CIS, we diversified our holdings, adding Belarus (sovereign) and Georgia (Infrastructure, Financials). We also increased our positions in Russia (Metals & Mining) and Ukraine (Consumer). In contrast, we reduced our exposure in Turkey (sovereign).
- In Latin America, we reduced our exposure to Argentina (TMT, Oil & Gas), Guatemala (Financials) and Mexico (Oil & Gas). In contrast, we increased Oil & Gas holdings in Colombia and Chile.
- In Asia, we reduced exposure to China (through dilution) and Macao (Consumer). We also sold Pakistan sovereign bonds. In contrast, we added exposure in Malaysia (Infrastructure) and Indonesia (Oil & Gas).
- In Africa, we sold our positions in Zambia (Metals & Mining, sovereign) and in regional development banks. We bought Cote d'Ivoire (Sovereign) and increased our Oil & Gas exposure in Ghana.
- By the end of the period, we reduced our overall market exposure by reducing the protection sold in CDX makets.

Outlook

- After a strong first half of the year, we expect the summer to be more range-trading. The global and EM economic climate has improved. And the Fed seems willing to act pre-emptively, cutting before a recession has hit the US and addressing any fears that it might be behind the curve.
- That said, a lot of good news has now been digested by the market. Moreover the ECB meeting on July 25 and the Fed meeting on July 31 are unlikely to deliver more than already priced in. Rate futures markets are pricing in some chance of an ECB 10bps cut and a 75% change of a 25bps cut from the Fed (and 25% chance of a 50bps cut).

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- We thus think the environment will remain generally supportive for EM but given the fast recent gains, a period of consolidation seems appropriate first, before further drop in yields.
- In particular, Emerging Market bonds should attract investors due to the low yield environment, a light political agenda, an increasing gap between EM and DM growth, and sound EM corporate fundamentals.
- At a country level, our largest exposures are in Brazil, Russia, China and South Africa.
- At a sector level, our largest exposures are in Financials, Metals & Mining, Sovereign and Oil & Gas.

Disclaimer