Q1 2020

UBAM – EMERGING MARKET CORPORATE BOND SHORT DURATION

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 too, 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, EM corporate bonds lost -10.0% over the quarter, with spread widening by 283 bps to 573 bps.
- Short-dated bonds suffered as credit curves inverted due to market stress. 1-3-year EM corporate bonds were down -7.06% with spread widening by 503 bps, while 3-5-year bonds were down -10.8%, with spreads up by 453 bps.

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.

- Amongst all maturity bonds, High Yield bonds underperformed (-15.4%) as spreads widening by 441 bps to 890 bps. Investment Grade bonds returned -6.5%, with spreads widening by 210 bps to 397 bps.
- At a regional level, the best performance came from Asia (-5.7%) and the Middle East (-8.0%). In contrast, Africa (-23.7%) and Latin America (-14.9%) underperformed.
- 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%) as the market started to price in a high risk of default for Tullow Oil following the collapse in oil prices. Argentina (-30.4%) and South Africa (-27.9%) also underperformed. In the latter, the downgrade from the sovereign to high yield weighed on corporate issuers, and led to the downgrade of Sasol.
- At a sector level, the best performance came from Financials (-5.9%) and Diversified companies (-6.7%). In contrast, Transport posted the worst performance (-37.9%) as the lockdowns weighed on airlines companies. Commodities sectors also underperformed due to the expected global economic slowdown (Metals & Mining -17.9%, Pulp & Paper -15.2% and Oil & Gas -15.1%).

Performance Review

- Over the quarter, the fund returned -10.60% net of fees as spreads on short dated bonds and on HY CDX widened sharply over the period.
- All regions contributed negatively, The worst performance came from Latin America and Africa.
- At a country level, the worst performance came from our holdings in Brazil, Ghana, Chile, Colombia and South Africa.
- In contrast, allocation to Bahrain, Jordan, Kazakhstan or Tanzania had neutral to only marginally negative effects on performance.
- At a sector level, the worst performance came from Industrials, Sovereigns and Oil & Gas.
- Allocation to DM HY CDX contributed negatively over the quarter as spreads in US and European HY widened.

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.
- Over the quarter, we increased holdings in Asian and European issuers at the expense of Latin America.
- In Asia, we favoured China (Real Estate, Utilities), Indonesia (Utilities) and Mongolia (Sovereign) at the expense of India (Financials, Metals & Mining).
- In Europe, we increased exposure to Russia (TMT, Metals & Mining).
- In Latin America, we reduced our holdings in Chile (Consumer, Utilities) in favour of Brazil (Transport, Consumer) and Guatemala (Sovereign).

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- In the Africa, we reduced holdings in Ghana. In contrast, we added exposure to Senegal (sovereign), South Africa (TMT, Utilities) and Ethiopia (sovereign).
- At a sector level, we added holdings in Sovereign, Transport and TMT at the expense of Oil & Gas, Utilities and Financials.

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.
- 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 small) inflows into EM debt markets, primarily driven by the historically cheap valuations.

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- Still, the rebound is unlikely to be fast and smooth. Issuer selection will be of paramount importance in the current 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 country level, our largest positions are in Russia, Brazil and China.
- At a sector level, our largest positions are in Metals & Mining, Financials and Sovereign.

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