UBAM – EMERGING MARKET DEBT OPPORTUNITIES

Quarterly Comment

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

Market Comment

- After the sharp collapse in risk assets in March, triggered by the COVID-19 pandemic, the second quarter saw a strong rally. This was supported by the series of massive monetary and fiscal packages put in place by DM and EM central banks and government authorities to cushion the effects of the lockdowns on the world economy. Indeed, while these measures will not prevent a global recession, estimated at -4.9% by the IMF, market participants saw them as a sign that a worse outcome would be avoided.
- Also, as the quarter advanced, there were signs that the pandemic was receding, with lockdowns being gradually eased in several countries, which led to a pick-up in economic activity, notably in China.
- US treasury yields continued to come down, especially at the short end of the curve, on the back of quantitative easing, but with much reduced volatility: 2-year US Treasury rates were down by -10 bps to 0.15% while 10 year rates fell by -1 bps to 0.66%.
- Commodities rebounded, with the CRB index up by over 13%. Oil prices had their best quarter in 30 years after the OPEC+ finally reached an agreement to cut production by 9.7 million barrels per day starting May 1 – agreement which was extended early June to the month of July (-9.6 bbl/day). Some weakness was felt late June as new cases of the virus appeared in some countries, raising fears that this could trigger a return of lockdowns. But this was compensated by a reduction in US crude stockpiles later in the month. Overall, Brent prices jumped by 81%, ending the quarter over $41/bbl, while WTI almost doubled to $39/bbl. Metal prices also shot up, with silver and iron ore rising by 30%, copper +22% and gold +13%.
- In EM bond markets, this better tone helped liquidity to come back gradually, outflows to stop and the primary market to reopen.
- Amongst the different EM debt sub asset classes, hard currency bonds outperformed EM local bonds, which returned 9.8% in USD terms.
- EM sovereign bonds performed best (+12.3% over the quarter), thanks to a spread tightening of 152 bps to 474 bps. But there was a lot of dispersion in performance, with the best-performing country, Angola, returning +119.4%, while Venezuela was the worst performer, with bonds down -39.6%.
- Other strong performers included Gabon (+45.8%), Zambia (+40.5%) as well as Tajikistan (+40.3%) and Ecuador (+40.1%). Most of these countries benefited from investors' stronger risk appetite and the rise in commodities prices.

- In contrast, other underperformers included Suriname (-32.2%) and Belize (-21.7%). Lebanon also posted negative performance, though to a lesser extent (-4.9%), as prospects of an imminent restructuring receded.
- EM corporate bonds returned 11.5% over the quarter, with spread tightening by 159 bps to 414 bps. The best performance came from commodity sectors: Metals & Mining (+19.9%), Pulp & Paper (+18.8%) and Oil & Gas (+16.0%). Industrials (+16.6%) also performed well. In contrast, Transport companies underperformed (-9.0%) as lockdowns and the bankruptcy of Latam Airlines weighed on the sector. Diversified companies (+7.3%) and Financials (+7.6%) also underperformed.

Performance Review

- The fund returned 16.16% net of fees over the quarter, and 16.37% gross of fees. As an indication, the performance of the JP Morgan EMBI Global Diversified* ex CCC is estimated at 11.67%.
- Performance attribution shows that the fund benefited primarily from our credit selection (spread effect + carry spread) as well as from its curve positioning and more marginally, from its FX positioning.
- 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 corporate selection in South Africa, Ghana and Colombia.
- In contrast, the worst performance came from our zero exposure in Angola, which rebounded by over 100% over the period. Our zero weight in Bahrain and selection in Kazakhstan also proved costly.

Portfolio Activity

- Over the quarter, our scorecard pointed gradually towards a more positive environment, as volatility fell across market and risk appetite returned. We thus increased our spread duration but remained neutral interest rate duration
- We favoured corporate and sovereign issuers at the expense of quasi-sovereign ones.
- Region-wise, we increased Latin America and Africa at the expense of the Middle East and Europe.
- In Latin America, we added exposure to Brazil (Industrial, Consumer), Colombia (Oil & Gas, Sovereign) and Paraguay (Sovereign).
- In Africa, we added to our positions in South Africa (Industrials).
- In Asia, we sold our positions in Mongolia and Pakistan. In contrast, we increased holdings in Indonesia sovereign (long end)
- In the Middle East, we sold our exposure in Oman (Financials, Utilities) and reduced Qatar (Sovereign).
- In Europe, we sold holdings in Georgia (Infrastructure, Financials), We added to our positions in Russia sovereign and bought exposure to Slovakia (Oil & Gas). In Romania, we switched out of Real Estate in favour of the sovereign.
- Sector-wise, we favoured Oil & Gas, Industrials and Sovereign at the expense of Financials, Infrastructure, Real Estate and Utilities.

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.

Outlook

- Volatility has come down and liquidity has improved but the impact of the pandemic-induced lockdowns on global growth is sharper than initially expected. 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. The US Federal Reserve's Quantitative Easing will put pressure on the US Dollar, which in turn will continue to reflate financial assets and commodities.
- While the world is entering a global recession, EM economies are expected to fare better than DM thanks to the earlier rebound of Asia, as well as to the vast diversity of EM economies. We thus expect the gap in economic activity between EM and DM to widen again, which should contribute to attract further capital flows towards EM.
- Already, inflows into EM bonds have picked up again and supported the better tone in the market experienced since early April. Primary markets have reopened allowing many sovereign and corporate issuers, both IG and HY, to refinance.
- Still, the economic slowdown has a negative impact on issuers' creditworthiness, leading to a rise in the number of rating downgrades and for some even, default. Issuer selection remains thus of paramount importance. We are relying on our 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)

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

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