Q3 2020

UBAM – EMERGING MARKET CORPORATE BOND SHORT DURATION

Quarterly Comment

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

Market Comment

- The third quarter was split in two, with the continuation of the market optimism seen in Q2 in July and August and renewed concerns in September amid signs a resurgent virus could lead to more lockdowns and a deeper global recession.
- Over the quarter, US treasury bonds appear fairly stable, masking a rally in July, a sell-off in August when expectations that the worst had been avoided were predominant, and a new rally in September when the pandemic accelerated again. Overall, the curve steepened slightly, with 2-year US Treasury rates down -2 bps to 0.13% and 10-year rates up +3 bps to 0.68%.
- Commodities were also weak in September, on concerns of lower demand but overall stronger over the quarter. The CRB index was up by 7.6%, thanks notably to the rally in metal prices (silver +28%, iron ore +18%, copper +11%, gold +5.9%). Oil prices underperformed, however, up only 2.4%. The OPEC cut demand estimates for its oil by 1.1 million barrels a day, while surplus stockpiles of crude and refined products continue to build up.
- Contrary to many countries around the world, there are already signs that economic activity is picking up in China. Industrial production was up in August by 5.6% yoy. Manufacturing PMI came at 51.5 in September, while non-manufacturing PMI stood at 55.9.
- Overall, EM corporate bonds returned 2,63% over the quarter, with spread tightening by 29 bps to 386 bps.
- Investment grade and High Yield bonds posted very similar performance of 2.6%.
- At a regional level, the best performance came from Latin America (+4.4%) and the Middle East (+2.8%). In contrast, Europe (+0.7%) and Asia (+2.1%) underperformed.
- At a country level, the best performance came from Brazil (+6.0%), followed by Egypt (5,9%) and Bahrain (5.8%).
- In contrast, the worst performance came from Ghana (-16.5%), Kazakhstan (-8.4%) and Argentina (-0.8%) also posted negative performance.
- At a sector level, the best performance came from Pulp & Paper (+7.3%), Transport (+5.5%) and Infrastructure (+5.3%). In contrast, Oil & Gas underperformed (1.5%) reflecting the sell-off in crude prices in September. TMT (+2.1%) and Consumer companies (+2.2%) also underperformed.
- The shorter end of the credit curve outperformed in spread terms, with 1-3 year spreads tightening by 95 bps while 7-10 year spreads tightened by only 58 bps. Performance-wise, 1-3-year EM corporate bonds returned +1.3%, while 3-5-year bonds were up +2.1%..

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.

Performance Review

- Over the quarter, the fund returned +2.73% net of fees, benefiting primarily from the spread tightening and high carry.
- All regions contributed positively, led by Latin America and Asia.
- At a country level, the best performance came from our holdings in Brazil, South Africa, Colombia, Russia and Chile.
- In contrast, the contribution of our holdings in Belarus, Turkey and Senegal was marginally negative.
- All sectors contributed positively. The best performance came from Industrials, Consumer Products and Metals & Mining.
- The fund benefited also from its allocation to HY US and Europe, via CDX.

Portfolio Activity

- O Over the quarter, our scorecard remained in “balanced” territory, though the overall score trended down in September as fears of a second pandemic wave weighed on investors’ risk appetite. Hence, we reduced our market exposure held through CDX from 24.6% at the end of June to 6.2% at the end of September.
- We increased holdings in the Middle East and Asia at the expense of Latin America, and Europe.
- In the Middle East, we increased our holdings in the UAE (Infrastructure, Real Estate) and bought exposure to Jordan (Industrials).
- In Asia, we favoured China (Real Estate, Industrials).
- In Africa, we bought Morocco (Industrials) but reduced our position in Ghana (Oil & Gas).
- In Latin America, we reduced holdings in Brazil (Consumer, Financials, Oil & Gas), Colombia (Financials) and Mexico (Metals & Mining).
- In Europe, we reduced exposure to Russia (Industrials).
- At a sector level, we added holdings in Real Estate and Industrials at the expense of Sovereign, Oil & Gas and Financials.

Outlook

- We expect the pick-up in volatility seen in September to remain in the short-term, given the increased risk of new lockdowns and the upcoming US elections. Still, we remain constructive on emerging debt for the medium-term.
- Indeed, the pandemic-triggered recession is likely to be less severe in emerging markets than it will be in Developed Markets (DM), and the rebound next year is expected stronger. In its World Economic Outlook, published early October, IMF forecasts emerging economies to slow by 3.3% this year and bounce back by 6.0% in 2021, vs -5.8% and +3.9% respectively for DM.

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- Also, investors' appetite for yield remains high and valuations of EM bonds appear attractive especially compared to US and Euro credit, where the combined actions of G3 central banks have pushed Developed Market yields to extremely low levels.
- Importantly, if considering corporate issuers, fundamentals appear more solid than in DM, as leverage for both IG and HY issuers remains lower in EM than in DM. As it is, year-to-date, the default ratio in EM corporate remains lower than in US High Yield credits.
- Still, we recognize that the economic slowdown will have a negative impact on issuers' creditworthiness. Hence, thorough issuer selection remains of paramount importance. We thus rely on our sovereign and 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 country level, our largest positions are in China, Russia, Brazil, and South Africa.
- At a sector level, our largest positions are in Metals & Mining, Industrials, Sovereigns, Real Estate and TMT.

Disclaimer

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