Q1 2020

UBAM – EM INVESTMENT GRADE CORPORATE BOND

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, 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 investment grade corporate bonds were down -6.5%, with spreads up 210 bps to 397 bps.
- At a regional level, the best performance came from Asia (-2.7%) and Europe (-4.1%). In contrast, Africa (-22.2%) and Latin America (-10.7%) underperformed.

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.

- At a country level, the best performance came from Taiwan (+1.7%), China (+0.7%), as well as from Korea and Hong Kong (both flat). In contrast, South Africa (-36.5%) was the worst performing country. The country was downgraded by Moody's late March to Ba1, leading to the downgrade of Sasol to high yield. Sasol was the worst performing issuer of the quarter, as the fall in oil prices intensified its weaknesses (rising leverage putting the company at risk of breaching bank covenants; delays and cost overruns at LCCP, its petrochemical project being built in the USA). Brazil (-15.4%) and Colombia (-13.8%) also underperformed.
- At a sector level, the best performance came from TMT (-2.9%), Real Estate (-3.7%) and Financials (-4.0%). In contrast, Pulp & Paper (-15.3%), Industrials (-15.0%) and Infrastructure companies (-13.2%).

Performance Review

- Over the quarter, the fund returned -7.23% net of fees and -7.02% gross of fees, compared to -6.49% for the JP Morgan CEMBI Diversified High Grade Index*.
- Performance attribution shows that the fund suffered primarily from its credit selection as spreads widened significantly through the sell-off.
- Main contributors to relative performance, excluding the effect of our interest rate duration positioning which is managed at portfolio level:
  - Country-wise, the best performance came from our selection in Chile and underweight in Saudi Arabia. Our overweight in China was also beneficial, as was our selection in South Africa. In contrast, our overweight in India, selection in Mexico and underweight in Hong Kong, Thailand and Singapore proved costly.
  - Sector-wise, the fund suffered primarily from its underweight in Financials, selection in Utilities and overweight in Industrials.
  - Having bought some protection through the CDX Asia ex Japan Investment Grade also contributed positively over the period.

**Index provided for comparison and information purposes only. The fund has no official benchmark.*

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. We thus reduced our risks slightly but did not move our portfolio to a fully "conservative" profile.
- We bought some protection through CDX indices (Asia ex Japan IG) in February and closed our position in March. This helped limit the impact of the sell-off on the portfolio. We also increased holdings in less volatile Asian issuers at the expense of Latin America.
- In Asia, we favoured Korea (Industrial, Oil & Gas, Steel) and Thailand (Financial, Oil & Gas) at the expense of Malaysia (Financials, Utilities).
- In Latin America, we reduced our holdings in Chile (Consumer, TMT) and Colombia (Oil & Gas) in favour of Peru (Financials).

- In the Middle East, we increased holdings in Saudi Arabia, adding Aramco (Oil & Gas) which entered the index over the period. We, however, remain underweight. We also increased our positions in Kuwait (Industrials). In contrast, we reduced our exposure to Qatar (Financials).
- In Europe, we slightly reduced our positions in Russia (Metals & Mining), and sold our holdings in the Czech Republic (Infrastructure).
- At a sector level, we added holdings in Oil & Gas as the weight of this sector increased in the index, but increased our active underweight. We also increased our positions in Industrials early in the quarter. In contrast, we reduced our positions in Financials, Consumer companies and Metals & Mining.

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. Indeed, spreads at the end of the quarter were pricing in a risk of default of over 5% for EM Investment Grade corporate bonds. As a matter of comparison, the historical level of default for such issuers is 0.

- Still, the rebound is unlikely to be fast and smooth. Issuer selection will be of paramount importance in this 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 overweight positions are in India, South Africa and Brazil.
- Our largest underweights are in Saudi Arabia, Qatar and Colombia.
- At a sector level, our largest overweight positions are in Metals & Mining, Industrials and Pulp & Paper. Our largest underweights are in Financials, Oil & Gas, and TMT.

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