Q3 2020

UBAM – EMERGING MARKETS FRONTIER BOND

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 market optimism seen in Q2 continuing over 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.
- **Sri Lanka** has recovered significantly from the lows seen earlier this year, following a peaceful election with a reasonably constructive outcome, from a market perspective. The country has reaffirmed its commitment to servicing its external debt. Still, refinancing needs remain relatively high for the coming years, and the debt load has grown considerably. Also, later in the quarter the State Finance Minister downplayed the need for an IMF programme, which led to some underperformance in September.
- **Angola** finally got the IMF disbursement, which had been delayed since August. This combined with the G20 debt relief, and agreements with Chinese lenders, helped address short term liquidity concerns. The solvency concerns remain, however, with Angola's debt load expected to peak above 120% of GDP. The country's Eurobonds rallied, but only temporarily, as the overall market sentiment turned sour and the technical position heavy in September (most EM debt investors are already overweight; at current levels, the bonds are no longer attractive to distressed investors but still too exotic for cross-over funds).
- Over the period, frontier bonds, as measured by JP Morgan NexGEM index returned 2.2%.
- At a regional level, the best performance came for Asia (+5.8%) and Latin America (+4,9%). In contrast, Africa (-0.4%), Europe (0.3%) and the Middle East (-0.4%) underperformed.
- At a country level, the best performance by far came from Suriname (+36.7%), followed by Costa Rica (+8,4%) and Sri Lanka (+7.9%). In contrast, Zambia (-4.2%), Ivory Coast (-3.4%) and Ghana (3.0%).

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, AUMs continued to grow to USD 160 mln from USD 110.7 mln on June 30.
- Over the period, the fund returned 12.31% net of fees, and 12.47% gross of fees.
- Performance came primarily from carry and spread tightening.
- All regions contributed positively, with Africa and Latin America being the best performing ones, while the contribution of the Middle East was marginal.
- Country-wise, the largest contributors to performance were Paraguay, Dominican Republic and Sri Lanka.
- **Paraguay**: high quality Caribbean issuer. In the first two months, most frontier names performed well, without too much discrimination. During the selloff in September, however, the BB-rated names in Latin America generally outperformed. Investors looking to de-risk their funds into election uncertainty largely sold lower rated names in Sub Saharan Africa. As a result, Paraguay was able to hold onto the majority of the gains it made in the beginning of the quarter during the broad market rally
- **Dominican Republic**: similar to ParaguayDomRep had returned around 11% at the end of August, but gave up only 2% of those gains in the September selloff. This compares very favourably to most of the frontier universe. The country had an election early July which was won decisively by Luis Abinader. The new President has signalled a prudent policy making stance, and has strong momentum to advance his agenda. The country issued bonds during the quarter which caused some very short term relative underperformance. However, this was very short lived, and the bonds curve quickly rallied subsequently.
- **Sri Lanka**: Unlike Paraguay and the Dominican Republic, Sri Lanka had a very bad September. However, the first two months of the quarter were exceptionally strong, with the country returning nearly 30% over July and August. Sri Lanka initially underperformed in the rally during Q2, so much of the performance in the beginning of Q3 could be attributed to the country “catching up” with the rally other countries enjoyed earlier. The country’s bonds continue to be priced in distressed territory, as worries remain about the debt load and liquidity management in the second half of 2021.
- In contrast, our exposure to Ivory Coast, Ghana, Angola and Ukraine proved costly.
- **Ivory Coast**: Ivory Coast was an underperformer through the third quarter. The country saw a strong rally during the second quarter, so valuations didn’t offer much cushion going into Q3. Early in July, the country’s Prime Minister, and the Presidential candidate of the ruling party, died unexpectedly. This caused significant political noise, ultimately ending in the incumbent deciding to run for a third term. The opposition has contended that this goes against the constitution and that his candidacy is illegitimate. The Constitutional Court eventually approved his bid for a third term, causing some protests in the country and increased political noise heading into the election at the end of October.

- **Ghana**: We had turned positive on Tullow Oil credit in April-2020 following the company's announcement that it had agreed the sale of its assets in Uganda for US$575 mn in cash. At the same time there was a recovery in the oil price from the end of April and throughout the summer months. We added Tullow 2022 bonds as we believed the company had a good chance of selling assets in Kenya in order to close a funding gap. However, on 9th of September during 1H20 results, the management made the announcement that Kenya farm-down was suspended as the project economics did not really work. The project was viable in US$50+ oil price environment. Therefore, the management was looking to rework the project by reducing costs, which could be challenging to do practise, in our view. Without the sale of assets in Kenya, Tullow could be facing a liquidity shortfall to service its short-dated debt. Hence we decided to exit our position.
- **Angola**: Angola had a fantastic second quarter, returning north of 100%. In the third quarter, initially an IMF disbursement was delayed causing a small wobble in the bonds. When the disbursement eventually happened, it appeared there were more people waiting to "sell the fact" than there were marginal buyers. Angola is a consensus overweight in the dedicated EM Debt community, and the bonds are no longer trading at valuations that would compel distressed debt funds to invest. Meanwhile, the name is probably too exotic/risky to entice cross-over investors. So with dedicated funds largely overweight, there was little buying following the positive IMF news.
- **Ukraine**: In Ukraine, the Central Bank governor submitted his resignation on July 1st, claiming he was facing political pressure. Given that Central Bank independence (and anti-corruption measures) are at the top of the priority list for the IMF, this caused significant concern amongst investors. Following this, a couple of other members of the Central Bank resigned. Like Angola, Ukraine was a broader overweight, and so with a bit of bad news and slightly negative technicals, this caused the risk premium to increase and the country to underperform over the whole quarter.

Portfolio Activity

- Over the quarter, the fund continued to see inflows, reaching USD 160 mln from USD 110 mln at the end of June. These inflows were invested favouring primarily Africa and Europe over other regions,
- In Africa, we bought exposure to Angola (long end), adding notably in September, taking advantage of market weakness. The current yields and projected recovery rates, combined with the lower liquidity risks and cheaper bonds prices, make it a compelling case despite the remaining longer term solvency risks. We also increased holdings in Kenya, Gabon and Ivory Coast. In contrast, we reduced exposure to Senegal and Nigeria.
- In Europe, we bought Belarus. In Ukraine, we reduced our holdings in the sovereign at the long end but bought exposure to a metal & mining company.
- In Asia, we increased exposure to Sri Lanka.
- In Latin America, we increased our exposure to the middle of the curve in Jamaica and Guatemala. In contrast, we reduced holdings in distressed issuers like Argentina and Ecuador, as well as in Honduras.

Outlook

- We remain constructive on EM spreads in general, and frontier debt in particular. By the end of August, we had recovered a significant portion of the extreme spread widening we saw in March, but September saw frontier spreads widen back out. As a result, we see frontier bonds offering attractive carry and potential for further spread tightening in the coming months.
- Spreads vs US high yield, which tend to be range-bound over longer periods ended the 3rd quarter near historically wide levels at almost 200 basis points. This compares to an average spread of 50-75 basis points through the investment cycle. In a world where core yields are likely to stay low for a considerable time, the near 7.5+% yield offered by frontier debt looks very attractive.
- We believe the names in our space that are at risk of distress are already pricing a high probability of default, when considering our projected recovery values.
- That said, the main threat facing the asset class is likely to rear its head again this month as we enter the (now virtual) IMF meetings in October. After the G20 DSSI (Debt Service Suspension Initiative) was announced back in April there was a lot of commentary around forcing private sector involvement (PSI) and getting bondholders to offer relief as well. This discussion is likely to resurface, but ultimately, as we did back in April, we find it highly unlikely that this will come to pass. The savings of, for example, one year of coupons, is just not significant enough for many of the countries to justify the negative effects of attaining them.
- We expect volatility to continue over the coming weeks, with a number of events coming up such as IMF meetings, potential PSI discussions, the US Presidential election in November. But ultimately, when taking a longer perspective, we continue to be constructive and have a positive outlook for frontier markets debt.

- At a regional level, we favour Africa and Latin America.
- At a country level, our largest positions are Guatemala, Paraguay, Côte d'Ivoire, Nigeria and the Kenya.

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