THE DRIVE YOU DEMAND

UBAM - EMERGING MARKET SOVEREIGN BOND

Quarterly Comment | Q2 2019

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

Market Comment

- The quarter was marked by heightened trade tensions between the US and China, further signs of economic slowdown especially in developed markets, and central banks, like the Federal Reserve or the ECB, adopting a more dovish stance.
- As a result, US Treasury bonds rallied over the period (2 year rates -51 bps to 1.75%; 10-year rates -40 bps to 2.01%).
- In contrast, commodity prices were weak. The CRB index lost -1.5%, with oil down -2.7%, and copper prices down about -8%. Precious metals outperformed (gold +9.1%, silver +1.3%).
- The G20 meeting between President Trump and Xi delivered as we had expected a cordial exchange between the two leaders, the restart of trade negotiations and some grace allowing US companies to temporarily sell some goods and services to Huawei. This plus the Fed continuing to signal interest rate cuts and the ECB indicating willingness to ease monetary policy explain the market rebound in June.
- Inflows into EM bonds have reached USD 45.1 bn in the year to date, of which USD 37.9 bn into EM hard currency debt.
- Overall, EM sovereign bonds returned 4.08% over the quarter, benefiting from the lower US interest rates, carry and a spread tightening of 5 bps to 346 bps.
- Investment Grade bonds outperformed (4.73%), thanks to their longer duration and a spread tightening of -8 bps to 168 bps. High Yield bonds returned 3.46%, as spreads widened by 14 bp to 556 bps.
- At a regional level, the best performance came from Europe (+5.6%) and Africa (+4.7%). In contrast, Latin America (+3.3%) and the Middle East (3.7%) underperformed.
- The best-performing country was Mozambique (+17.1%) which rallied strongly on the back of a new restructuring deal proposal. Other high yielding sovereign also performed strongly, such as Ukraine (+10.2%) and Tunisia (+8.6%).
- In contrast, the worst performance came from Venezuela, whose bonds lost 33.2% as US sanctions took their toll. Zambia also underperformed (-5.9%) as the economic situation continues to deteriorate, and the government is still unwilling to tighten its fiscal policy.

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Performance Review

- Over the quarter, the fund returned 2.57% net of fees. Gross of fees, the fund was up 2.84%, vs. 4.08% for the JP Morgan EMBI Global Diversified Index.
- The main source of underperformance was our issuer/issue credit selection, due notably to our overweight in some of the higher yielding, riskier, countries. The contribution of our FX positions was marginally positive, while our duration and curve positioning was neutral.
- At a country level, the worst performance came from Argentina and Zambia, where the economic situation continues to deteriorate (though over the longer term, we believe this to be well priced in at current yield levels). In Argentina, our overweight in Provinces was partcularly costly, as, despite their sounder fiscal profile, bonds underperformed due to their lower liquidity. Our overweight in Venezuela also detracted from performance after trading was limited by US sanctions.
- In contrast, the best performance came from our selection in Romania, where we favoured an off-benchmark, euro-denominated bond. Our selection in Russia (including off-benchmark corporate bonds) also outperformed.
- On the FX side, the fund benefited primarily from its exposure to Russian Ruble and South African rand. Our exposure to the Colombian peso, however, proved costly.
- YTD, the fund is up 10.36% net of fees, and 10.93% gross of fees, vs. 11.25% for the JP Morgan EMBI Global Diversified index.

Portfolio Activity

- Over the period, we have reduced our beta and spread duration, but maintained our overweght in high yield vs. investment grade bonds.
- We also bought protection via CDS on China and Malaysia, as a hedge against the risk of spread widening in case the US-China trade war escalated.
- We reduced our exposure to Africa and the Middle East in favour of Emerging Europe.
- In Africa, we sold our exposure to Angola and Senegal. We also reduced risks in Zambia: while we believe that the bonds are trading below their estimated recovery value, the economy continues to deteriorate, and there are little signs that the government is able to tackle its dire fiscal situation.
- In the Middle East, we reduced our holdings in Lebanon and Oman, but bought exposure to Iraq.
- In Europe, we increased exposure in Russia, (sovereign and a Metals & Mining corporate) as well as in Ukraine. We took some profit on Romania bonds in EUR.
- In Latin America, we reduced our overweight in Argentina (sovereign and provinces) as volatility remains high. We increased our underweight in Panama, where valuations appear unattractive. Finally, we sold holdings in Suriname. In contrast, we increased exposure to Uruguay (local bonds) and to Guatemala.
- In Asia, we sold our holdings in Pakistan and Malaysia (quasi-sovereign), but added to Sri Lanka.

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Outlook

- After a strong first half of the year, we expect the summer to be more range-trading. The global and EM economic climate has improved. And the Fed seems willing to act pre-emptively, cutting before a recession has hit the US and addressing any fears that it might be behind the curve.
- That said, a lot of good news has now been digested by the market. Moreover the ECB meeting on July 25 and the Fed meeting on July 31 are unlikely to deliver more than already priced in. Rate futures markets are pricing in some chance of an ECB 10bps cut and a 75% change of a 25bps cut from the Fed (and 25% chance of a 50bps cut).
- We thus think the environment will remain generally supportive for EM but given the fast recent gains, a period of consolidation seems appropriate first, before further drop in yields.
- In particular, Emerging Market bonds should attract investors due to the low yield environment, a light political agenda and an increasing gap between EM and DM growth.
- At a regional level, we favour Africa and Latin America at the expense of Asia and the Middle East.
- At a country level, our largest cash overweight positions are Nigeria, Russia and Côte d’Ivoire.
- In contrast, our largest underweights are Mexico, Saudi Arabia and China.

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