Q4 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 fourth quarter was marked by investors' renewed optimism as the first vaccines were approved and started to be rolled out in several countries, and uncertainties linked to the US elections disappeared.
- With hopes that vaccines would open the way for a rebound in the global economy, the US treasury curve steepened. 2-year US Treasury rates were down -1 bp to 0.12% while 10-year rates up +23 bps to 0.91%.
- Commodities were also strong. The CRB index was up by 13.0%, thanks notably to the rally in metal prices (iron ore +35%, copper +16%, silver +14%). Oil prices also rebounded by over 20%, with Brent ending the year at 51.8 USD per barrel, a level not reached since end February. Gold underperformed however (+0.7%).
- Discussions around a potential G20 Debt Service Suspension Initiative (DSSI), which had been first brought up back in April, resurfaced at IMF meetings in October and initially weighed on frontier bond performance. The initiative was, however, not pursued, which helped the market to rebound.
- Over the quarter, frontier bonds, as measured by JP Morgan NexGEM index posted a very strong performance of 9.1%, thanks to a spread tightening of 136 bps to 596 bps.
- At a regional level, the best performance came from Africa (16.2%) and the Middle East (10.2%). In contrast, Asia (-4.7%) was the only region to post negative performance, being pulled down by Sri Lanka.
- At a country level, the best performance came from African countries and was led by Angola (+22.5%), followed by Ghana (+19.6%), Cote d'Ivoire (16.3%) and Nigeria (16.3%).
- **Angola** continued to perform strongly as well, with the bonds returning 21% over the quarter. The debt servicing relief was not Q4 news, but combined with the high carry still on offer, and the market coming to terms with resulting low default risk in the coming years, it continued to provide a tailwind. Even after the strong rally the previous two quarters, the country performed very well in the largely constructive risk environment.

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.

- **Cote d'Ivoire** had their much-anticipated Presidential election on October 31st. The lead-up to the election saw less noise than feared, and bonds performed strongly as the risks and concerns about potential violence dissipated. The main opposition candidates decided to boycott the election and called for nationwide protests that never amounted to much. Following the election, several steps have been taken by the government to attempt some reconciliation with the opposition. As one of the stronger macro stories in the markets, with political risk dissipating the bonds performed strongly, returning 28% on average over the quarter.
- In contrast, Sri Lanka lost over 13%, while Vietnam (1.3%), Suriname (1.5%), Zambia (2.5%), Georgia (2.6%) and Ethiopia (3.3%) also posted mediocre returns.
- **Sri Lanka** had rallied strongly in Q3, but significant doubts remain about their ability to finance themselves for 2021 in the face of their lack of commitment to a potential IMF programme. As the highest yielding name in the market, it was also an obvious choice to de-risk ahead of expected US election-related volatility. Indeed, the entirety of the negative performance in Sri Lanka came in October, ahead of the US election.
- **Zambian** Eurobonds also lagged following their official default. The Zambia 2024s were due to pay a coupon on October 14th, which was missed. This was accompanied with comments suggesting they did not intend to pay it during the 1-month grace period either. Bonds dropped more than 10% in October as a result. But as has been seen often before, they subsequently rallied as recovery value analysis by many market participants suggested there is some upside from the levels reached after the missed coupon.
- **Ethiopia** also underperformed in the fourth quarter, as violence erupted in the Tigray region. National elections were due in August, but electoral officials ruled that all voting would be delayed due to COVID-19. The Tigray region went ahead with elections, anyway, resulting in a new regional government led by the Tigray People's Liberation Front (TPLF). This government was not recognised by the federal government, exacerbating underlying tensions that had been in place since PM Abiy Ahmed took office. Following the elections, tensions continued to mount, culminating in the PM accusing the TPLF of attacking a federal military camp in the region. This caused the Federal Government to begin a military offensive against the regional government, sparking fears of a protracted civil war. Bonds sold off as a result. Federal forces eventually captured the capital of the region, according to PM Abiy Ahmed "marking the completion (of the) law enforcement action" and allowing bonds to recover their losses.

Performance Review

- Over the quarter, AUMs continued to grow to USD 261 mln from USD 160mln on September 30.
- Over the period, the fund returned 11.57% net of feess.
- Performance came primarily from carry and spread tightening.
- At regional level, the best performance came from Africa and Latin America. In contrast Asia posted a negative return.
- Country-wise, the largest contributors to performance were Ivory Coast, Nigeria, Kenya and the Dominican Republic.
- In contrast, both Sri Lanka and Lebanon posted negative returns. Ethiopia, Iraq and Mongolia also underperforned in relative terms as these countries only provided modestly positive performance during the quarter.

- Since the inception of the fund on March 31, the fund has returned 32.65% net of fees, thanks to the sharp market rebound experienced after the pandemic-induced sell-off, which had occurred pre-launch. All regions contributed positively, with Africa and Latin America in the lead.
- At a country level, the best performance came from Nigeria, Ivory Coast, Paraguay, Guatemala and the Dominican Republic. Only two countries contributed negatively over the period: Lebanon and Ghana.

Portfolio Activity

- Over the period, we increased holdings in Africa at the expense of Asia and Latin America.
- In Africa, we increased Angola and Egypt (T-bills) at the expense of Ethiopia and Gabon. We also traded Zambia actively throughout the quarter. As a result, while Zambia was an underperformer, our fund returned average of 7% on Zambian Eurobonds during the quarter.
- In Latin America, we reduced holdings at the long end of Guatemala and Jamaica but added exposure in the Dominican Republic and El Salvador. In Argentina, we traded tactically the bonds of the Province of Rio Negro. Prices had fallen significantly below our projected recovery value. We managed to buy bonds early November at 42.56. Less than a month later, an official offer was made by the government that would put recovery value around 60 cents on the dollar (depending on your exit yield assumptions). We subsequently sold the bonds at 58.65.
- In Asia, we reduced exposure to Sri Lanka and to Tajikistan.
- Finally, we added exposure to Local Currency for the first time since the fund was launched. From a macro perspective, we have a benign view on the USD for 2021 and see the room for EM currencies to appreciate. Meanwhile, dollar yields available in several countries we like have become less compelling. In total, around 8% is now invested in local currency instruments (Dominican Republic, Egypt, Kazakhstan, Ukraine, and Uruguay).

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

- With the roll-out of vaccines globally and the sharper growth rebound expected in Emerging Markets vs. Developed Markets, we expect 2021 to be positive for emerging market and frontier bonds.
- While we may not see a repeat of the sharp rally seen since the March drawdown, we still see significant spread compression potential for the months ahead.
- Indeed, EM Frontier bond spreads are still considerably wider than where they were pre-COVID (by some 150+ basis points). Frontier spreads are also wider than their longer-term averages. This is in stark contrast to the valuations of most other financial assets. In particular, the spread between Frontier Markets and US High Yield has widened significantly. The Bloomberg Barclays US Corporate High Yield index ended 2020 with the lowest level of yield in its history, at 4.18%. In contrast, the JP Morgan Frontier Index, the NexGEM, ended 2020 yielding 6.84%, which is more than 100 bps above its historical low (5.75% in 2013). This means that Frontier bond markets yielded 2.66% more than US High Yield at year-end, in line with the pre-COVID widest level over the past 15 years (2.67% in February 2014).
- This valuation gap is combined with a global stock of negatively yielding debt which surpassed $18 trillion earlier in December. Investors' search for yield led to significant inflows into emerging debt markets in recent weeks, and we expect this to continue in 2021. This should benefit to frontier markets, one of the few fairly liquid asset classes with such high yield levels.
- Frontier bonds are also well positioned in the current environment as their wide spreads should provide a cushion against the potential negative impact of a rise in US interest rates, or a curve steepening, which could occur in response to positive growth or inflation expectations.

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

Disclaimer

Union Bancaire Privée, UBP SA Rue du Rhône 96-98 | P.O. Box 1320 | 1211 Geneva 1 | Switzerland **ubp@ubp.com** | **www.ubp.com**