UBAM – EMERGING MARKETS FRONTIER BOND

Quarterly Comment

For Professional Investors in Switzerland or Professional Investors as defined by the relevant laws.
The classification of the fund(s) as per the Sustainable Finance Disclosure Regulation (SFDR) is available on ubp.com or in the latest prospectus.

Market Comment

- US interest rates increased significantly over the quarter; 2-year US Treasuries were up 160bps to 2.33%, while 10-year US Treasuries rose by 83bps to 2.34% as the Fed delivered its first hike and the market priced more than 200bps of hikes until the end of the year.
- In terms of the risk environment, we downgraded our short-term expectations in Q1 2022, given Russia's invasion in Ukraine affecting the global supply chain, which was slowly recovering from the pandemic.
- Fears of rising interest rates kept investors away from fixed income in general over last quarter. The asset class saw outflows at -$14.1bn, according to data from JP Morgan. This follows up from weak flows of +$0.3bn in Q4 2021. In 2021, EM Fixed Income funds saw an inflow of $52.5bn.
- Rising US Treasury yields and widening credit spreads impacted returns in Q1 2022. Frontier Debt delivered a negative performance in this context, at -7.92% over the quarter according to the JP Morgan NEXGEM index. Spreads widened by 36bps, to 695bps over the quarter.

- At a regional level, the weakest returns were from the Europe (-25.83%) and Asia (-11.79%).
- At a country level, the best performance came from Angola (+3.62%), Mozambique (+3.22%) and Iraq (+2.78%).
- In contrast, countries that performed the worst were Pakistan (-18.67%), Georgia (-14.63%) and Armenia (-12.04%).

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 period, the fund returned -6.69% net of fees, as risk aversion due to the geopolitical situation and widening credit spreads impacted the performance of the fund in Q2 2022.
- Spread widening were the main contributors to negative returns in Q2 2022, at -4.09% (carry spread + spread effects). The high carry of the asset class mitigated the overall negative returns for the quarter, while duration contribution to performance was negative due to rising US Treasury yields.
- At a regional level, the best performance came from our holdings in Supranational issuers, which were resilient and only marginally detracted from absolute performance over Q2 2022. In contrast, Emerging Europe was the worst detractor from returns, given Russia's invasion in Ukraine.
- Country-wise, the largest contributors to performance were from our holdings in Russia (net short in FX), Guatemala and Angola.
- In contrast, our holdings in Belarus suffered the most. Ukraine followed closely behind, as our exposure was impacted by Russia-Ukraine conflict.

Portfolio Activity

- In Africa, we added our exposure to Cameroon, opened new position in Ghana and Mozambique, with the former trading inside our projected recovery value range. We also increased our exposure to Tunisia, while we removed our position in EGP local instruments.
- In Emerging Europe, we reduced our exposure to Ukraine over the quarter, ahead of the escalation. We also entered a short RUB FX position to hedge Belarus and Ukrainian holdings.
- In Latin America, we increased exposure to El Salvador while trimming exposure to Paraguay, Jamaica and Guatemala.
- We marginally reduced our exposure to EM local currencies, from 13.3% to 9.7%, over Q1 2022.

Outlook

- Inflation has risen to elevated levels globally and has impacted interest rates world-wide. Many EM Central banks have hiked early, starting a tightening cycle as soon as early 2021 in some cases. DM Central banks first read this inflation as transitory and have been reassessing their outlook. They now seem set for a quicker tightening of their interest rates.
- US rates have sold off significantly in Q1 2022 and remain a risk to be watched carefully going forward. The curve is now pricing a significant amount of tightening by end of 2022 (about 2.5% in rate hikes according to Fed Fund futures).
- The front end of US curve (up to 2 years) is now very steep, and yields start to be compelling in the asset class. We wouldn't expect a strong rally back in rates or spreads in the short term, but the increased carry should start to do its work in helping the asset class performance.
- In Q1 2022, about USD 15bln exited the asset class (mainly retail money). Despite the negative Q1 performance, but on the back of higher yields, we would expect investors to get attracted back in the asset class.
- The current yield pick-up that can be found in EM Sovereign bonds, when compared with other spread assets, is significant. Particularly in the HY segment, spreads to US high yield are at historically wide levels. At the index level, yields at end of March were 6.47% for the asset class, for 7.6 years of duration.
- Within EM sovereign debt, we continue to favour high yield bonds, which offer attractive carry. They also present a lower duration than investment grade bonds along with more spread cushion, thus insulating them from potential further rises in US rates. We thus expect high yielding sovereign issuers to continue to outperform lower yielding ones. Frontier markets offer attractive relative and historical valuation with spreads at 695bps. This is ~185bps above their last five-year average spread level, and significantly higher than US High Yield, which offers a spread of less than 400bps over US Treasuries. Frontier markets have exhibited fewer defaults than US High Yield (2.2% versus 4.2% over the long-term) and higher recovery values (average recovery of a Frontier Sovereign bond is 63% and 41% for a US High Yield bond). So when spread differentials get to the wider range, like today, there is an opportunity.
- At a country level, our largest positions remain in Africa, with Benin (9.1%), Ivory Coast (9.6%) and Nigeria (9.7%) accounting for the top 3 country exposures. We also count significant allocation in the Dominican Republic (6.2%).
- In EM local currencies, our largest exposures are DOP (3.6%), UGX (2.2%) and UZS (1.94%). The portfolio allocation to EM local currencies currently accounts for 9.7%.

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