THE DRIVE YOU DEMAND

UBAM - EMERGING MARKET CORPORATE BOND

Quarterly Comment | Q4 2019

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

Market Comment

- Emerging Market bonds performed well over the quarter, thanks to improving trade discussion between the US and China and better than expected economic data, alleviating fears of a sharp slowdown in the global economy.
- The Fed reaffirmed its position of pausing interest rate cuts. Although this comforted markets, the Fed also sent signs that it would be ready to resume its rate cuts if necessary. The US Treasury curve steepened, with 2-year rates down 5 bps to 1.57% while 10-year rates rose by 25 bps to 1.92%.
- The improved market sentiment also supported commodities prices. The CRB index rose by about 7%, with Brent up 8.6% and copper up 8.0%. Precious metals underperformed, with gold up 3% only.
- Inflows into EM fixed income (hard and local currency) also picked up over the quarter, ending the year at USD 68.6 billion vs USD 18.7 billion in 2018. More specifically, inflows into hard currency bonds reached USD 56.7 billion vs. USD 9.2 billion in the previous year.
- At the end of the first phase of their negotiations, the United States and China agreed on a partial agreement in November. This provided for a reduction in punitive tariffs, more purchases of American goods by China from the agricultural, energy and commercial sectors, and clarification of certain issues regarding intellectual property. In return, the United States agreed to reduce the punitive tariffs on Chinese goods worth USD 120 billion from 15% to 7.5%.
- The quarter was marked by social protest across Latin America, often triggered by tariff hikes (gasoline price in Ecuador; subway tickets in Chile), leading to significant spread widening. The Chilean economy proved more resilient, however, thanks its robust fundamentals and solid institutions. So, while protests continued in the country in December, financial markets were able to stabilize and rebound.
- In Argentina, the opposition candidate, Alberto Fernandez won the presidential election with 48% of the vote in the first round in October. The new president took office on December 10 and announced his willingness to service its obligations in the short-term, while continuing to work on the debt reprofiling. To that end, the government decided to issue a new 10-year bond to be placed to the Central Bank, hence using foreign exchange reserves to service the country's dollar debt, a solution which, while helping in the short-term, could undermine the country's economic situation for the longer term by monetising the deficit and risking higher inflation. The new government also announced increased taxes on exporters (mainly on agricultural goods), greater flexibility on pensions, higher taxes on USD purchases, as well as a freeze on utility prices.

- The outlook for South Africa's rating was downgraded to negative by both Standard & Poor's and Moody's after the government announced further support to the ailing state-owned power company Eskom, which could lead to further deterioration in the country's fiscal balance.
- Despite higher US rates, EM corporate bonds performed well over the quarter (+2.09%), thanks to a spread tightening of 33 bps to 290 bps.
- High Yield bonds outperformed (+3.66%) as spreads tightened by 55 bps to 449 bps. Investment Grade bonds returned 1.06%, with spreads tightening by 20 bps to 187 bps.
- At a regional level, the best performance came from Emerging Europe (+3.0%) and the Middle East (+2.8%). In contrast, Africa (1.0%) and Asia (1.3%) underperformed.
- The best-performing countries were Argentina (+17.2%), Israel (+7.5%) and Zambia (+7.4%). In contrast, Ghana was the worst performing country (-8.3%) as Tullow Oil cut production forecasts for the fourth time in 12 months, revised down its reserve base and suspended dividends – all leading to the resignation of its CEO. Kazakhstan (-0.6%) and Thailand (-0.1%) also underperformed.
- At a sector level, the best performance came from the Consumer sector (+4.3%) and Real Estate (+2.6%). In contrast, Infrastructure (+1.1%) and Pulp & Paper (+1.5%) underperformed.

Performance Review

- The fund returned 1.65% net of fees over the quarter, and 1.94% gross of fees, compared to 2.09% for the index.
- Performance attribution shows that both credit selection and duration positioning contributed slightly negatively.
- Main contributors to relative performance, excluding duration effect which is managed at portfolio level:
    - Country-wise, the best performance came from our selection in Chile, underweight in the UAE and Korea, zero exposure to Qatar and overweight in Oman. In contrast, our underweight in Israel and Turkey, overweight in India and selection in Brazil proved costly.
    - Sector-wise, the fund benefited from its underweight and selection in Oil & Gas, and from its underweight in Financials. In contrast, our selection in the Consumer sector and overweight in Utilities and Industrials proved costly.
- YTD, the fund returned 12.58% net of fees, and 13.87% gross of fees, vs. 13.55% for the JP Morgan CEMBI Diversified Index. The outperformance was due to our issuer/issue selection, while our duration positioning proved marginally negative.
    - The best performance came from our selection in Chile, zero exposure in Jamaica, off-benchmark holdings in a euro-denominated bond in Romania, as well as from our selection in Hong Kong and Colombia. In contrast, the fund suffered from our underweight in Turkey and Israel, selection in China, and overweight in India.
    - At sector level, the best performance came from our underweight and selection in Financials and from selection in Utilities and Oil & Gas sectors. Our underweight in Consumer products, in contrast, proved costly.

Portfolio Activity

- Over the quarter, we increased our market exposure, favouring high yield over investment grade bonds.
- At a regional level, we added to holdings in Asia and Latin America at the expense of Emerging Europe and the Middle East.
- In Asia, we increased our exposure to India (Financials, Infrastructure) and Hong Kong (TMT, Real Estate). In contrast, we sold some of our holdings in China (Real Estate, Infrastructure).
- In Latin America, we took advantage of the wider spreads in Chile to increase our positions in Utilities, TMT and Pulp & Paper. We also added exposure to Peru (Utilities) and Brazil (Utilities, Consumer). In contrast, we reduced our positions in Mexico (Industrials, TMT) and Guatemala (TMT).
- In Europe, we reduced our positions in Kazakhstan (sovereign), the Czech Republic (Infrastructure) and Russia (Oil & Gas).
- In the Middle East, we reduced our positions in Israel (Utilities), Kuwait (Industrials), Oman (Utilities) and the UAE (sovereign)
- In Africa, we sold our exposure to Tunisia (sovereign) and to Supranationals (regional development bank) in favour of South Africa (Metals & Mining).

Outlook

- The global risk environment has improved to the benefit of EM, supported by the bottoming out of EM PMIs and the likely peaking of tariffs between the US and China. We think that this should improve the outlook for global manufacturing and in turn commodity prices (notably industrial metals). The floor on oil prices is probably higher now in the wake of the US/Iran attacks but the ceiling appears still capped by reactive US supply.
- We also see an improved technical backdrop for EM bonds. Flows to the asset class should remain solid on the back of a strong global investors' search for yield; less downside economic risks in EM and the recycling of large EM bond redemption and coupon payments due at the beginning of the year.
- We thus look to increase our beta and our allocation to commodity issuers (specifically metal miners and producers). However, after the strong rally experienced in 2019, we will need to be increasingly selective.
- At a country level, our largest overweights are in India, South Africa, Russia and Chile. Our largest underweights are in China, Korea, Qatar and Turkey.
- At a sector level, our main overweights are in Metals & Mining, TMT and Utilities. In contrast, our largest underweights are in Financials, Oil & Gas and Industrials.

All performance figures are given net of fees for the IC USD share – unless mentioned otherwise. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

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