UBAM – EMERGING MARKETS FRONTIER BOND

Quarterly Comment

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

Market Comment

- After the sharp collapse in risk assets in March, triggered by the COVID-19 pandemic, the second quarter saw a strong rally. This was supported by the series of massive monetary and fiscal packages put in place by DM and EM central banks and government authorities to cushion the effects of the lockdowns on the world economy. Indeed, while these measures will not prevent a global recession, estimated at -4.9% by the IMF, market participants saw them as a sign that a worse outcome would be avoided.
- Also, as the quarter advanced, there were signs that the pandemic was receding, with lockdowns being gradually eased in several countries, which led to a pick-up in economic activity, notably in China.
- US treasury yields continued to come down, especially at the short-end of the curve, on the back of quantitative easing, but with much reduced volatility: 2-year US Treasury rates were down by -10 bps to 0.15% while 10-year rates fell by -1 bps to 0.66%.
- Commodities rebounded, with the CRB index up by over 13%. Oil prices had their best quarter in 30 years after the OPEC+ finally reached an agreement to cut production by 9.7 million barrels per day starting May 1 – agreement which was extended early June to the month of July (-9.6 bbl/day). Some weakness was felt late June as new cases of the virus appeared in some countries, raising fears that this could trigger a return of lockdowns. But this was compensated by a reduction in US crude stockpiles later in the month. Overall, Brent prices jumped by 81%, ending the quarter over $41/bbl, while WTI almost doubled to $39/bbl. Metal prices also shot up, with silver and iron ore rising by 30%, copper +22% and gold +13%.
- In EM bond markets, this better tone helped liquidity to come back gradually, outflows to stop and the primary market to reopen.
- Frontier markets outperformed (up by 20%) benefiting from investors' rising risk appetite in May and June, the bonds' high carry. Also, progress made in discussions of a potential private sector participation in debt relief, which were still prevalent in April, weighing on distressed bonds, receded in the last two months of the period.
- At a regional level, the best performance came from Africa (+34%) and the Middle East (+20%). In contrast, Latin America (+8%) and Europe (+12%) underperformed.

- There was a lot of dispersion in performance, with the best-performing country, Angola, returning +119%, while Suriname was the worst performer, with bonds down -32%.
- Other strong performers included Gabon (+46%), Zambia (+41%) as well as Tajikistan (+40%) and Nigeria (+38%). In contrast, other underperformers included Belize (-22%) and Barbados (-6%).
- During the quarter, the main news flow was around distressed credits. Shortly after we launched, Zambia announced that they had hired advisors to “help implement a liability management of its external debt” but maintained their talks with the IMF. Bonds fell on the news to the low 30s, but eventually recovered to trade more in line with our recovery estimate ($40-60). By the end of June, a bond holder group was formed, reportedly with a blocking stake in all three outstanding bonds.
- In April, the G20 announced near term debt relief for 76 so-called “IDA” (International Development Association) low income countries. Combined with the IMF support (up to USD 1tn pledged), this was positive sign, as it would contribute to meeting the 2020 financing needs of these countries. However, this announcement was combined with a call by the G20 for private creditors to also participate in alleviating these low-income sovereign debt burden, which set jitters into the market. Our belief was that the participation of private creditors would eventually not be pursued as not all IDA countries issue in the international bond market, hence the debt relief from private creditors would be limited but the long-term negative impact (with likely higher borrowing costs in the future) could be detrimental. Mid May, the Africa Private Creditor Working Group was created, with views in line with ours. By the end of the June, the option of a generalised debt relief program by private bondholders had declined, helping distressed debt to recover.
- Over the quarter, several countries sought debt relief from the G20, including Pakistan, Ethiopia, Senegal and Ivory Coast. None of them required the participation of private creditors in the debt relief effort. Kenya, Tajikistan and Guatemala, on their side, were among the many countries to get financial assistance from the IMF.
- The first details of Argentina’s bond restructuring proposal were revealed by the government mid-April, but the initial plan was rapidly rejected by the large bondholder groups. Negotiations continued throughout the quarter, creating volatility as progress remained slow. But expectations that a deal would eventually be reached helped prices rebound from their lows.

  Late June, Angola was reported to have agreed a debt moratorium with Chinese official and bank lenders. This, combined with rising oil prices, trigger a strong rally in the country’s bonds.

Performance Review

- The fund was launched on March 31. Over the quarter, AUMs grew from USD 62.4 mln at inception to USD 110.7 mln on June 30.
- Over the period, the fund returned 16.21% net of fees, and 16.40% gross of fees.
- The fund benefited primarily form its credit selection (spread effect + carry spread).
- 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 Nigeria, Paraguay, Sri Lanka, Gabon and Guatemala.
- In contrast, our exposure to El Salvador and Lebanon detracted from performance.

Portfolio Activity

- At inception, despite the market being still very volatile and liquidity poor, we were able to invest the fund fairly rapidly, though taking into account the very large bif-offer spreads. For instance, as the market was stong on day 1, we only invested the fund up to 65%, After three days of trading, however, the fund was already invested at about 86%, and well diversified across 24 countries and 24 frontier issuers (23 sovereign, 1 quasi-sovereign).
- Late April, we participated in two new issues (Guatemala and Paraguay). We also added Angola, which traded below our projected recovery value.
- In May, we locked in partial profit in Ecuador, after bond prices rallied by close to 30%. We kept some small exposure as we believed there was some upside left, though limited. We also took partial profit in Argentina later in the month. We still believed short term recovery could be higher, but the uncertainty around the debt restructuring negotiations remains high, which convinced us to reduce risk.
- We increased our exposure to Sri Lanka, at prices below $50, where we believed bonds offered some value.
- In June, we sold part of our exposure in Iraq and Pakistan, both at prices above $90 as, at such levels, we saw better risk-reward opportunities elsewhere. We also further reduced holdings in Ecuador and took some profit in Sri Lanka. In exchange, we bought Dominican Republic (long-end) and participated in the new issue of Honduras.
- We took profit on Angola, after the announcement of the debt moratorium with Chinese creditors. Bonds are now trading above their expected recovery value, while the country’s credit fundamentals remain weak. Instead, we added Ukraine GDP warrants, which we considered still undervalued.
- We added Belarus late June as the country lagged the rest of the market in the rebound, offering an attractive opportunity. Given the country’s weak fundamentals, however, we only bought a small allocation of about 1%.
- At the end of the quarter, the fund was fully invested, across 26 countries and 27 issuers (26 sovereign, 1 quasi-sovereign).

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

- Volatility has come down and liquidity has improved but the impact of the pandemic-induced lockdowns on global growth is sharper than initially expected. Over the medium-term, we see as a positive the forceful reaction of public authorities around the world. Many EM central banks have decided to cut rates while some governments have also announced fiscal measures. The US Federal Reserve’s Quantitative Easing will put pressure on the US Dollar, which in turn will continue to reflate financial assets and commodities.
- While the world is entering a global recession, EM economies are expected to fare better than DM thanks to the earlier rebound of Asia, as well as to the vast diversity of EM economies. We thus expect the gap in economic activity between EM and DM to widen again, which should contribute to attract further capital flows towards EM.
- Already, inflows into EM bonds have picked up again and supported the better tone in the market experienced since early April. Primary markets have reopened allowing many sovereign and corporate issuers, both IG and HY, to refinance.
- Still, the economic slowdown has a negative impact on issuers’ creditworthiness, leading to a rise in the number of rating downgrades and for some even, default. Issuer selection remains thus of paramount importance.
- We are thus favouring countries with high yield but relatively low debt servicing or where the current yield levels are underestimating the potential recovery value in case of default.

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

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