THE DRIVE YOU DEMAND

UBAM - EMERGING MARKET DEBT OPPORTUNITIES

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, reducing risks of a sharp slowdown in the global economy.
- The Fed reaffirmed its position of pausing interest rate cuts via its chairman's testimony in front of the US Congress. Although it comforted markets, it also sent the sign that the Fed would be also ready to resume its rate cuts if it is 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 provides 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 will 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 place to the Central Bank, hence using foreign exchange reserves to service its 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.

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.

- 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 will lead to further widening of the country’s fiscal deficit.
- Overall, EM local bonds performed strongly (+5.2% in USD terms, thanks to the strong performance of EM currencies against the dollar (+3.6%). EM hard currency bonds continued to perform well too, with EM corporate bonds (+2.1%) outperforming sovereign bonds (+1.8%).
- Among EM sovereign bonds, the best-performing countries were Argentina (+20.8%), Gabon (+7.8%) and Angola (+6.2%).
- In contrast, the worst performance came from Lebanon (-29.4% - due to violent protests against corruption and the government’s decision to increase taxes). Suriname (-10.1% due to the country’s difficulties in refinancing its debt in international markets) and Ecuador (-5.3% - continued political protests) also underperformed.
- Similarly, among EM corporates, 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%), followed by Kazakhstan (-0.6%) and Thailand (-0.1%).

Performance Review

- The fund returned 1.99% net of fees over the quarter, and -2.29% gross of fees. As an indication, the performance of the index was up 1.53%.
- Performance attribution shows that the fund benefited from its credit selection, while its duration positioning proved costly. The contribution of our FX positions was marginally positive. Overall, our selection in sovereign and quasi-sovereign issuers contributed positively over the period, while allocation to corporates proved costly.
- In hard currency, at a country level, the best contributors were our holdings in Argentina, which rebounded strongly, zero exposure to Lebanon and Ecuador, and overweight in Kazakhstan.
- In contrast, our holdings in Ghana corporate proved costly after 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. Our selection in Mexico and South Africa also contributed negatively.
- In terms of local rates and currencies, the fund benefited from its positions in TRL, IDR and PLN, but suffered from its exposure to UYU and BRL.
- YTD, the fund returned 10.20% net of fees and 11.53% gross of fees. As an indication, the performance of the index was up 14.92%. The fund suffered from its credit allocation, duration positioning and FX exposure. At a country level, the best performance came from our allocation to Romania EUR-denominated bonds, as well as from our zero exposure to Lebanon, allocation in China (favouring quasi-sovereign) and overweight and selection in Kenya. In contrast, our worst performance came from our overweight in Argentina, allocation to corporate in Ghana, underweight in Ukraine, and overweight in Zambia. In FX, the worst performance came from our positions in UYU, TRL and COP. The fund, however, benefited from its exposure to RUB, IDR and PLN.

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Portfolio Activity

- During the quarter, we increased our allocation to corporates at the expense of quasi-sovereign and sovereign issuers.
- We increased holdings in Africa, Latin America and the Middle East, at the expense of Asia and Europe.
- In Africa, we increased our allocation to South Africa (corporates – Industrials, Metals & Mining), as well as to other sub-Saharan countries adding both sovereigns (Cote d'Ivoire, Senegal, Nigeria, Kenya) and corporates (Ghana – Oil & Gas). In contrast, we sold our exposure to regional development banks and to Tunisia.
- In Latin America, we increased our exposure to Chilean corporates (TMT, Pulp & Paper, Utilities), taking advantage of the wider spreads resulting from political protests. We also added to our holdings in Colombia (both sovereign and corporates – Oil & Gas, TMT) and in Brazil (quasi-sovereign - Oil & Gas, corporates - Consumer). In contrast, we reduced our exposure to Panama (sovereign) and Mexico (sovereign and quasi-sovereign - Utilities). We also closed our short exposure to BRL.
- In the Middle East, we added Qatar (sovereign) and the UAE corporates (Infrastructure), at the expense of Iraq.
- In Asia, we reduced our exposure to quasi-sovereigns in China (Oil & Gas, Utilities, Financials) and Korea (Financials). In contrast, we increased our exposure to corporates in India (Oil & Gas, Metals & Mining, TMT). In Indonesia, we increased exposure to euro-denominated sovereign bonds, as well as to IDR.
- In Europe, we sold our allocation to sovereign issuers (Russia, Serbia, Croatia) and reduced Kazakhstan. In contrast, we added some long position in PLN, in Belarus (sovereign) and in Russian corporates (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 market exposure, as well as our allocation to some EM currencies and commodity-linked issuers (specifically metal miners and producers). However, after the strong rally experienced in 2019, we will need to be increasingly selective
- At a regional level, we favour Latin America and Asia. Our largest country exposures are in Indonesia (sovereign, quasi-sovereign, FX), Colombia (sovereign, corporate), India (corporate) and Argentina (sovereign, provinces).
- In FX, we have a net long exposure of 2.7%, with long positions in IDR, PLN and UYU and a short exposure to TRY.

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