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FLEXIBLY POSITIONING THE MIRABAUD – GLOBAL EMERGING MARKET BOND FUND IN A CHALLENGING MARKET ENVIRONMENT

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Silver linings during unprecedented times

The Coronavirus continues to makes its presence felt across the world. But while this is a very worrying time for everyone, there are some silver linings in terms of the impact of the epidemic itself and its effect on emerging markets themselves. It's important in looking forward over the next two to three quarters to see how this will affect the overall universe in Emerging Markets and how the market is pricing this in.

The first silver lining in terms of the epidemic is that there is a very significant difference between advanced economies and Emerging Markets. Much of this is the result of demographics. If you look at the population pyramid in the US, Europe and Japan, the median average age is much higher, particularly in Europe and Japan - as the pandemic is much more severe for the elderly, it is placing an enormous strain on their healthcare systems.

Average age is important

If you look at China, the median age is 37 and the average in Emerging Market economies is 30. In Latin America, it's 28 and in Africa it's below 20.* As a result, there's a very significant difference in the population pyramid. This suggests that the impact of the virus on these countries will have a smaller effect on public services overall. The International Monetary Fund (IMF) recently released a chart that compared the bell curve of the virus between China, Europe and Emerging Markets and it's strikingly different. We expect the bell curve in Emerging Markets will look quite similar to what we saw in China - or even smaller, given that the median age is much younger.

Mind the gap

The supply and demand shock in the global economy has been very severe and will have a significant impact on the growth outlook. The IMF has yet to come out with its official forecasts, but they will be holding their spring meetings in mid-April. Some investment banks have already announced growth projections.

For Emerging Markets, it may be the first year since the 1980s when they could slip marginally into negative growth. A good reference point would be 2008, when they decelerated from almost 6% GDP growth in 2007 to 2.8%, so it wasn't actually negative. During the same period, In the developed world, growth went from – 0.2% to – 3.7%. We think this year we will see a similar increase in the gap. We believe that the difference in advanced economies will be quite large. We are potentially looking at a growth range of somewhere between – 5 and – 10%, an even greater gap than in 2008. This is having a significant impact on how countries are reacting.

*Source: ourworldindata.org

Quick reactions

In terms of market reaction, bad news was priced-in within four weeks, and a monetary and fiscal reaction occurred extremely quickly. There are a number of factors that explain this. We believe that one reason rests on the fact that the asset management industry, and financial markets overall, are a multiple of what they were in 2008 and, as a result, the impact of any external shock is going to be priced in much quicker. To add to this, liquidity in fixed income is very poor, which means that capital outflows and fund redemptions are very significant - there are no pricing mechanisms to adjust in a measured manner as they did in 2008. For Emerging Market debt, for example, in a matter of two weeks we experienced as much spread widening as we saw post Lehman in the following three months. The lack of liquidity is a primary factor in all this because intermediation is not taking place and banks can't take positions on their balance sheets. As a result, market making has become a significant challenge.

In terms of flows, we have already seen the highest monthly outflows from investment banks in both debt and equity since 2008 – even larger on a one month basis – with almost $85 billion dollars, the majority in debt, rather than equity, and most of it in hard currency.

Over the last decade, investors have significantly increased their positions in hard currency assets and this is an area where we have seen the biggest stress. Before the US Federal Reserve (Fed) intervened with quantitative easing and buying corporate debt, up to that point the Emerging Market Debt Global Diversified Index was at – 20% and the corresponding ETF EMD was at -25%. From the 16th March until the 19th of March the intervention in the corporate market in the US led to the direct purchasing of corporate grade ETFs, which led to an overall recovery in some segments of Investment Grade and that's why we had a rebound, although that was not the case with High Yield. As a result, we currently have the biggest differential between High Yield spreads and Investment Grade spreads in more than twenty years.

In Emerging Markets the majority of High Yield, both corporate and sovereign, are trading in the 900 to 1,000 point spread differential, whereas in the investment grade we have come down from 400 to 300. So that difference of almost 700 basis points is much larger than it was in 2008. The explanation behind this is that the Fed bought corporate debt investment grade for the first time and that had repercussions in the remaining segments of Emerging Market debt.

Thinking local

In this environment, local debt has performed relatively well and there are many reasons for this. For example, the average yield to maturity of the local debt index - J P Morgan GBIM - is currently about 5.5%, whereas in US dollars its 7%. This is the widest it's been in the last twenty years in favour of local debt. It's the first time we've seen a shock in Emerging Markets that translates into lower yields in local debt and higher yields in US dollar debt at the same time.

In the past, Emerging Market economies would respond by raising rates and trying to protect their currencies. That's not the case anymore. It's a reflection of the maturity of these markets that they are reacting to the crisis in a more orthodox way. Indeed, we have seen more than twenty Emerging Market countries cut rates and introduce fiscal stimulus measures and some have even introduced qualitative easing by purchasing bonds in their own government bond market. This hasn't happened before. So far we have seen this in South Africa, Poland and Turkey, for example. It indicates that local debt markets are in a very different place now than they were ten or twenty years ago.

Where next?

Looking forward, we think we are likely to see a similar experience to 2008. Local debt has held up better and could recover much faster relative to credit. We could see a big difference crystalizing in the summer or at the beginning of Q4, 2020. That happened in 2008 when local debt ended the year with a much lower drawdown than hard currency. This is also as a result of more foreign participation in hard currency.

We are still seeing forced selling. It will take a while to process because there is very little liquidity in the market and no marginal buyer of last resort in hard currencies.

We see yields in US Dollar going to much higher levels in local debt. Another silver lining is that inflation is also very low and the capacity to engage in fiscal measures is much larger now given that the net external position is much smaller. We calculate that ten years ago the net external positioning in Emerging Market Debt was about 10% of GDP, but now it is about 2%. At the same time, the asset base has grown much faster and the amount of reserves is much higher.

This doesn't apply to all Emerging Markets. You need to differentiate between the large Emerging Market economies (BRICS), the mid-sized economies and the low-income frontier markets. These three markets are very different. They have different needs and different levels of capacity to deal with the current situation. This means Emerging Market debt should not be viewed as one segment – and this is why you need complete flexibility in managing this asset class.

Our high conviction and flexible approach in action

The Mirabaud – Global Emerging Markets Bond Fund was designed to strike an equilibrium between liquidity and volatility. That's why it's important to have a balance between local debt and hard currency debt. This provides the Fund with a degree of liquidity that hard currencies do not have. This means we can make shifts much more quickly to ensure liquidity is still available.

We've doubled our position in China, three quarters of which is in local debt

By the time we saw the stresses in late February, we had already doubled our position in China. It remains the largest position in the Fund (10%), of which three quarters is in local debt. Chinese local debt has behaved as a safe haven, demonstrating for the third time in ten years that local Chinese government bonds are a safe haven. Consequently, China produced a positive contribution. We will keep this defensive position, so long as we don't see the world economy coming out of the current economic shock, most likely at the end of Q2 or the beginning of Q3 in 2020.

We've raised our positions in investment grade bonds

We have also significantly increased our positions in investment grade bonds. We used to have a lot of deep value, short-dated, high yield debt. These spreads have widened significantly, but because it's relatively short-dated debt, the price is still relatively high, so we were able to reduce this and go into long-dated investment grade bonds.

Over the next six months, we think the area that will bounce back is the long-dated investment grade area, so we are buying it. Going into this crisis, the level of duration in hard currency funds was very high and reached a peak of almost eight years in January. As a result, the reason why the performance of hard currency has been so negative, at least up until the Fed intervened, was because of this high duration, irrespective of credit rating. Many investment grade bonds in the 30 to 50 area dropped 20 to 30 points. As a result, we are buying in those areas with high ratings.

We are buying into Asia and high-grade Middle Eastern countries

We are buying in Asia and some of the high-grade Middle Eastern countries like the UEA and Qatar. In Asia, we are buying in the Philippines, and purchasing Chinese state entities. This enables us to be defensive if the economy takes longer to recover, while also having the capacity to bounce back when credit spreads normalise. We have increased duration significantly, from 3.5 years to 5.5 years, and aim to extend this to 6 years before the end of April 2020. This is a very significant shift in the portfolio. But the reason we can do this so quickly is because we have a very diversified and flexible portfolio, unlike Emerging Market debt strategies that engage in only one segment of the market.

We have funded this by using some short dated High Yield bonds, which have not moved much in terms of price, and we also exited a lot of carry trades we had in more exotic markets. We invested no more than 1% in each, but it all adds up. Examples include Ukraine, Ghana, Nigeria, Egypt and Uruguay – all of which we have now exited and taken profits. In the current situation, we think carry is not relevant anymore.

In local currency, we have a 90% weighting to the big economies, which will rebound the fastest

We continue to have 60% in hard currency, but we now have a much higher weighting in investment grade and long duration. In local debt, meanwhile, we have a 90% weighting to the big economies, which will rebound fastest from a currency perspective, have the lowest rates of inflation and the capacity to deal internally with this crisis without having to go the IMF. These include China, Indonesia, Russia, Mexico and Brazil. They all have liquidity and the capacity to bounce back faster than other countries.

It is important to note that we have not had to force-sell anything. Smaller economies that are more problematic have a degree of vulnerability to current commodity prices, especially Ecuador, Angola and other African nations. However, only 5% of our portfolio is currently exposed to vulnerable economies and we may see a recovery here as well. The IMF is in a position to provide US$50bn in support and it also has further fire power at its disposal. It's not clear whether the price of oil will continue to fall. If we see a stabilisation between US$ 30-40 then the average price for the entire year might not be that different from what the market was pricing in three weeks ago. If various agreements are put in place, the degree of stress in these smaller economics is likely to be reduced.

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