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POSITIONING FOR A NEW MARKET REGIME

MIRABAUD - GLOBAL EMERGING MARKET BOND FUND

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Our positioning into the sell-off

From September last year the market was moving upwards and this lasted until the end of February. Throughout that period, the consensus, subsequently confirmed by the International Monetary Fund, was that there would be a pick-up in growth in 2020. They were forecasting 3% growth in 2019 and 3.2% growth in 2020. This primarily came from the reduction in tensions surrounding the US/China trade war. There was also an expectation that some Emerging Markets would pick up with a higher rate of growth.

Throughout this period we did relatively well. We had a deep carry value position in an environment where rates weren't doing anything and spreads were continuing to tighten gradually. In our view, our type of strategy performs best in this type of environment. As a result, throughout that time we outperformed the benchmark by 2%. Our game plan was that the recovery would continue in 2020 with an accrued rate of return of about 1% a quarter.

It's also important to remember that much of this can be achieved by off benchmark bonds. These give you a higher rate of carry and a higher degree of deep value relative to benchmark bonds. At the time, benchmark bonds were very expensive, with very high duration and very low yields. The onset of the Coronavirus meant we had to rethink our strategy. We saw a significant increase in spreads and a large correction across all segments of Emerging Market debt.

In February, we doubled our exposure to China in the domestic market. At the peak of the sell-off, we had 8% in Chinese domestic debt. It was better than cash because it gave us a larger return and it was a safe haven. In short, it's important to understand where we were coming from, the expectations for 2020, and our positioning.

Positioning the fund for a new market regime

As we entered the sell-off, it was all about positioning the fund to weather the market challenges. Consequently, the first thing we did was to move out of High Yield into Investment Grade credit, which was about 25% of the portfolio. From the end of February, we then increased this position incrementally, so that by the end of April Investment Grade credit accounted for around 50% of the Fund's portfolio.

We took this stance because in our view, Investment Grade credits are better positioned to withstand a sell-off than High Yield bonds. At the same time, we were also recycling out of credit risk into interest rate risk. Post the sell-off, spreads, even in Investment grade, remained relatively wide. However, we hope to gain duration when spreads normalise. It may take a number of months to normalise, but when they do, given the higher duration, it's likely they'll generate a higher return. Furthermore, our duration in the Fund has risen – it was about 3 years before we entered the crisis and now it is about 6.5 years (end-April 2020).

Secondly, we started increasing our exposure to Chinese local currency government bonds and quasi-sovereign bonds. Call rates were going down at that time and there was clear policy support. We increased the exposure from 3% at the end of February to 8% on the 21 March. This then fell to 7.5% by the end of March and was down to 5% at the end of April because we felt we needed to recycle some of that safe haven positioning. We also reduced our frontier exposure by almost half – it now represents 11% of the Fund.

Finally, as a theme, we have looked at structural strength from a geographical point of view. For example, we increased our exposure to Asia. Their net domestic savings position is strong, as is their external position. Their policy support also remains in place. We have therefore increased our exposure in Asia from 15% to 25% of the Fund.

Our current exposure to oil and gas

We have a 30% exposure to oil producing countries. Optically, it looks very high, but the devil is in the detail. We have a significant exposure to corporates that are not in the oil sector. For instance, we have exposure in Russia, UAE and Saudi Arabia in sectors like utilities, real estate, supermarkets and financials. They are in oil producing countries, but they have nothing to do with oil exposure itself. Our true exposure is about 25%, of which 19% is in names such as Qatar, Kuwait, Russia and the UAE. We believe that these are strong names that may withstand the current crisis. However, we believe it will take time for their spreads to normalise. Furthermore, the majority of these positions (19%) are in Investment Grade.

Outlook for local versus hard currency

The context is very important. Emerging Markets had been in a very positive cycle between 2016 and 2020. During these four years of upswing in growth, total return in both local and hard currency was approximately 18%. Local did better in 2017 and the beginning of 2018. At the beginning of 2020, however, they were pretty much the same.

During the sell-off in March, hard currency did worse and local currency was muted. Looking at the returns over the year to date (ending April 2020) there is now only a 1% difference. Both local (JP Morgan GBI EM Broad Diversified) and hard currency indices (JP Morgan EMBI Global Composite) are around minus 12%.[1] We believe that if the US Federal Reserve had not intervened, hard currency could have suffered more. This is similar to what we saw in 2008, when local currency did better than hard currency. Furthermore, it is also possible that local currency will do better than hard currency this year - but it's unlikely we will see significant differences given the intervention of the US Federal Reserve.

If local and hard currency benchmarks provide similar returns, we still believe that investors should have exposure to both because one is more liquid than the other. However, our local currency position has changed. Our exposure to smaller frontier markets has been sold. We now have China instead. Mexico and Russia currently have the highest real rates and have the biggest exposure in local currency.

Our largest risk positions

Our biggest exposure is to Russia, which is currently 11% - with 6.25% in roubles (the Mexican peso and the Russia rouble have the highest real rates). Furthermore, Russia is a strong economy (current account surplus and GDP ahead of Western economies, such as the UK and US[2]) and has strong official reserves (ranked 4 by all countries).[3]

Our credit exposure is to the government of Mexico at 7.15% - 6.25% is in local currency and has a lot of built in risk premium. Mexico is a very liquid market and remains our highest exposure in terms of single credit.

[1] Source: Bloomberg and Mirabaud Asset Management, end-April 2020 [2] Source: IMF.org, May 2020 [3] Based on 24 April 2020 data, trading economics.

Our largest single corporate exposure is 1.75% in a Mexican banking group. From a sector perspective, Financials is the largest at 12% of the Fund.

Opportunity Knocks?

We see the greatest opportunities in the normalisation of credit. When that happens, spreads should come in 50 to 100 points. Investment grade spreads are currently at 300 bps in Emerging Market Sovereign debt. Six weeks ago we were at 150 bps. This gives you a measure of where you can go from here.

The market is geared towards having a permanent search for yield. This won't disappear. We believe that when normalisation happens, investment grade bonds that are yielding 4% will potentially be yielding less than 3%. When that happens, the higher the duration we have, the more return we can aim to generate.

The second source of return is local currency. The central banks are cutting interest rates and the rate of inflation is very moderate. Once the equity flow comes back, and Emerging Market equities start performing again, there is the potential to push currencies upwards. In our view, local currencies are currently 25 to 30% undervalued.

Turning to the Fund's position in off-benchmark bonds, these have suffered the most because of less frequency in trading and lower liquidity. As a result, their prices have been marked down without looking at the underlying fundamentals. If there is a broad economic and market recovery, these have the potential to do well.

In closing, we think it's most important to focus on those that have the ability to weather the crisis and then to recover quickly. We think frontier markets have the highest degree of uncertainty and, as a result, we are significantly decreasing our exposure to them. It will take time, but spreads will eventually normalise, domestic debt will continue to go down, currencies will correct some of the under-valuations and distressed debt will recover. These are all significant ingredients that will allow us to help recover the underperformance.

Historical Performance

Net Annual Performance %	2016	2017	2018	2019	YTD 2020
Mirabaud - Global Emerging Market Bond Fund I cap USD*	-	0.86	-4.70	12.92	-18.25
50%JPM GBI-EM Broad Diversified / 50% JPM EMBI Global USD	-	1.75	-4.57	13.35	-12.23

Source: Mirabaud Asset Management as of 31/03/2020. **Past performance is not indicative or a guarantee of future returns. Indices are not available for direct investment.** Incepted 20/10/2017.

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