# EMD QUARTERLY

MIRABAUD 1819 Asset Management

THE MIRABAUD - GLOBAL EMERGING MARKET BOND FUND TAKES AN UNCONSTRAINED, FLEXIBLE APPROACH TO INVESTING IN SOVEREIGN AND CORPORATE BONDS DENOMINATED IN BOTH HARD AND LOCAL CURRENCY. IT AIMS TO CAPTURE SOME OF THE BEST OPPORTUNITIES WITH A SUPERIOR RISK-ADJUSTED RETURN OVER THE LONG RUN.

BY DAN MORENO, PORTFOLIO MANAGER OF THE MIRABAUD – GLOBAL EMERGING MARKET BOND FUND

## AT A GLANCE

- Three distinctly different periods during the quarter – July and September saw positive returns in both Sovereign Hard and Local currency bonds. August finished the month much lower, especially in Local currency.
- Overall, fund returns for the quarter were close to flat at -0.10% (I Cap USD share class*).
- Continued weakness in Turkey and Argentina has opened up compelling opportunities, which we have selectively taken advantage of.
- In Turkey, policy response has stabilised markets significantly. We have added short dated hard currency bank & quasi-sovereign bonds as well as government local currency.
- In Argentina, we have added to the energy sector (USD) and floating rate notes in peso.
- During the summer, the fund significantly reduced its positioning in Russian hard currency bonds as the risk of further sanctions remain elevated. We have also applied a temporary currency hedge.
- Duration over the period edged up slightly higher and it now stands at 3.62*.
- Yield to maturity has extended from 8.25% at the end of June to 9.30% at the end of September*.

## ONE QUARTER: THREE VERY DISTINCTIVE MONTHS

It has been a challenging, volatile quarter for Emerging Markets, weighed down by increasing trade tensions between the US and China, contagion worries following the extreme volatility in Turkey & Argentina, as well as light summer liquidity. However, it is important to keep in mind that the structural case and fundamental backdrop for Emerging Market debt remains largely supportive as growth remains resilient. The recent market environment also emphasises the importance of taking a blended, flexible approach to this asset class.

Despite the volatility across Emerging Markets, the fund ended the quarter broadly flat (-0.10% I Cap USD share class*). During the quarter, Emerging Market sovereign indices ended + 2.33% for Hard Currency (*JPM EMBI Global Composite*) and -1.6% for Local currency (*JPM GBI EM Board Diversified Index*). This, however, masks three distinctly different periods during the quarter – July and September saw positive returns in Sovereign Hard and Local currency bonds. August finished the month much lower, especially in Local currency, following the loss of confidence in both Turkey and Argentina, leading to FX volatility that reached levels above those of previous crisis in 2008 and 2001. Furthermore, Russia was also impacted by the weakness in the Ruble following the ongoing concerns of further sanctions. In stark contrast, during the month of September, Emerging Market debt traded on a positive tone on the back of a strong policy response in Turkey, high oil prices and stronger currencies.

During volatile markets such as this, it's also important to remember that generating returns from this asset class through a flexible approach is just one important component. How you get there also matters. We take a risk-based approach to controlling volatility and throughout this period, it remained close to 5% (90-day average).

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# THE ARGENTINIAN AND TURKISH QUESTION

The recent challenges across both Turkey and Argentina have had a big influence on sentiment across Emerging Market countries, driving concerns about possible contagion, especially Turkey, given the size of this market.

## TURKEY: TURNING THE CORNER

From a fundamental point of view, we believe that Turkey is the stronger market relative to Argentina. Firstly, Turkey is approaching the US$1 trillion economy by size – it has the world's 17th-largest nominal GDP. It has a young and dynamic population with a large domestic market, a track record of fiscal discipline, relatively low levels of indebtedness (government to GDP stands at 28%) and a maturing local currency market, making it less susceptible to the strength of the US dollar than is generally perceived. The political risk in Turkey has also greatly diminished following the presidential election in July. The newly implemented presidential system translates into agile policy making despite Erdogan's somewhat unorthodox rhetoric. During September, the Turkish central bank's recent policy response, in raising interest rates by 625bp, was a good demonstration of their independence and restored some credibility in the market. Finally, the newly appointed finance minister also unveiled a reasonably pragmatic new economic plan. All this resulted in a more stable currency and during September, the Turkish Lira was the best performing, rising +9.88% against the US dollar. Furthermore, the rebound in Turkish assets has been significant, particularly on the hard currency side, where credit spreads have tightened back to levels of early August, with Financials leading the move.

Consequently, the Fund has been adding exposure to selected top-tier Turkish short-term credits (one to three years), which in our opinion, at double digit yields, offer compelling value.

Going forward, the government will have to tackle the double whammy of lower growth and higher inflation although we expect both to stabilise throughout 2019. The current account has already started to deliver positive results posting a $2.59bn surplus in August, the first in 3 years.

## ARGENTINA: CAUTIOUS AND LONGER-TERM OUTLOOK DIFFICULT TO PREDICT

At the end of August, interest rates were raised to a record 60% and further increased in September to 65% as a result of the pressure following the "notebook" scandal in which a corruption web during the Kirchner era was unveiled and a number of high profile ex-government officials & corporate CEO's were arrested. In September, further funding uncertainty led the government to revise the agreement with the IMF and to increase its 'stand-by' programme by $7bn to $57.1bn, front loading disbursements for both 2018 and 2019 (as a reminder from our last quarter's comment, this is one of the largest packages given to any Emerging Market country). This revised programme also includes a shift in monetary policy that targets money-supply instead of inflation and a primary balance in 2019. This programme will impact growth, but it basically ring-fences against default for the next twelve months until the next election.

However, in comparison to Turkey, Argentina has long-standing weaknesses that makes it a much more vulnerable economy to external shocks. It's characterised by higher levels of government debt (Debt to GDP is currently standing at 50%) and more importantly, it is a highly 'dollarized' economy, which we believe is one of its biggest weaknesses. The banking system is largely underdeveloped and the lack of a deep and stable domestic debt market makes the economy entirely dependent on foreign capital flows, notwithstanding the fact that it becomes more susceptible to inflationary challenges. We are therefore more cautious on the longer-term opportunities in Argentina.

In the short-term, the market situation has created some pockets of deep value and we have been selectively adding to the energy sector and local floating rate notes. Despite the headwinds, commodity prices are holding up, which has been beneficial for the energy sector.

## WHERE NOW?

The current environment in Emerging Markets is still sensitive to the aggressive stance in the US to impose tariffs and/or sanctions to anyone that won't abide by their objectives. These types of policies are unlikely to yield any results, and despite the uncertainty surrounding the effects on the global economy, it will only accelerate integration elsewhere, which will improve the outlook for Emerging Markets.

We believe that whilst further escalation on trade remains a risk over the medium term, particularly for Asia, the bearish bias for Emerging Market as a whole has been reduced. A number of idiosyncratic issues have become less concerning, policy response has picked up and positioning is much cleaner. In the absence of a negative outcome in the second round of the Brazilian election, the stabilisation of Emerging Market Debt should continue in the final quarter of 2018.

In an important development for Gulf Cooperation Council (GCC) countries, JP Morgan announced that on 31 January 2019, sovereign and quasi-sovereign issuers from Saudi Arabia, Qatar, UAE, Bahrain and Kuwait will become eligible for inclusion in the family of EMBI indices. This is significant as it will represent 11.2% in both EMBIG & EMBIGD, and track over $100bn of outstanding bonds.

Looking into next year, we consider that political risk will once again become a focus in Nigeria, India and Argentina, all of which face general elections.

| **Yearly Performances** | **2015** | **2016** | **2017*** | **2018 YTD** |
|---|---|---|---|---|
| Mirabaud – Global Emerging Market Bond Fund I Cap.USD | - | - | 0.86% | -5.29% |
| Benchmark: JPM 50% EMBI Global – 50% GBI EM Broad Diversified | - | - | 1.75% | -5.42% |

**The Mirabaud – Global Emerging Markets Bond Fund I Cap USD inception date is 30/10/2017. Note: benchmark index is used for comparative purposes only. Indices are not available for direct investment.*

### IMPORTANT INFORMATION

All sources are from Bloomberg as at 28 September 2018, unless otherwise stated.

*Source: Mirabaud as at 28 September 2018. Returns illustrated are based on share class performance shown over the period, taking into account dividends, if any, but not subscription or redemption fees that might be levied.