EMERGING MARKET DEBT QUARTERLY UPDATE: JULY 2018

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.

EMERGING MARKET DEBT (EMD) OVERVIEW AT A GLANCE

- Uncertainty across many fronts has had a significant impact on asset prices across Emerging Markets, namely emanating from political transition in a number of countries, particularly those that have macro vulnerabilities.
- The fundamentals for most Emerging Market economies, have not changed, despite recent market weakness and volatility in the region.
- The International Monetary Fund (IMF) announced in their July update that they are still expecting growth across Emerging Market (EM) economies to be 4.9% in 2018 and 5.1% for 2019. This compares with 2.4% for developed economies.
- Growth in China will continue to see a very modest slowdown (The IMF expects 6.6% in 2018 and 6.4% in 2019) and US protectionist policies won't have a large effect.
- Recent market weakness has opened up compelling opportunities across regions and segments of the EMD universe.
- Throughout the quarter, the fund's cash position has been fully deployed and maturing bonds have been re-invested at a much higher rate of return. As a result, both yield and duration are, at the time of writing, higher at 8.75% and 3.80 respectively.

DOWN BUT NOT OUT

The second quarter of 2018 remained challenging and Emerging Markets in general, including the debt market, experienced significant weakness, surpassing the market falls post the US presidential election two years ago. The recent weakness was on a similar magnitude to the declines experienced in Emerging Market debt during the Taper Tantrum of 2013.

The high degree of uncertainty emanated from the political transition in a number of countries, particularly those that have vulnerabilities, and other geo-political and economic factors:

Rising US interest rates: Rates in the US rose much higher, and more quickly, than the markets had anticipated as a result of rising inflationary pressures and a more assertive US Federal Reserve. Although US rates have steadily increased since September last year, the overall impact on Emerging Market bonds was rather muted until the end of the first quarter when other factors came into play.

In any case, it is important to highlight the fact that whereas US treasuries explain up to 80% of the returns of EM Investment grade bonds, this falls to 30% and below for EM High yield bonds, and the fund has very little exposure to the former segment (less than 10%).

Russian sanctions: Markets assumed the worst case scenario in April when the US introduced sanctions on some Russian entities. At first, it was difficult to gauge if they would be extended more broadly. However, when it became clear that they were limited in scope, this provided some level of support. Despite these risks, the fundamentals of Fixed Income in Russia continue to be very robust.

A combination of challenges in Latin America: A number of factors were at play here. In Mexico, the fear of an Andrés Manuel López Obrador victory ahead of the presidential election in June was overdone. In Brazil, uncertainty prior to the presidential election in October, alongside a national strike by truck drivers that paralysed the economy, weighted on market sentiment. And the collapse of investor confidence in Argentina ahead of the agreement with the IMF created uncertainty.

Finally, in Turkey, the presidential election created uncertainty, driving the market lower, as the country moved from a parliamentary democracy to a presidential democracy.

Despite the short term challenges, we believe that the right foundations remain in place across Emerging Markets to create strong investment, selective opportunities in Emerging Market debt.

FUNDAMENTALS REMAIN CONSTRUCTIVE

The majority of Emerging Market economies appear to be in a recovery phase post the commodity collapse in 2014/2015. This growth trajectory has not slowed down. For example, the International Monetary Fund is forecasting economic growth of 4.9% in 2018 and 5.1% in 2019 for the Emerging Market region, supported by the synchronised uptick in global growth. Furthermore, moderation of growth in China will be small, easing from 6.6% in 2018 to 6.4% in 2019 (IMF forecasts).

Average commodity prices also remain higher than 12 months ago, which creates a supportive backdrop for Emerging Markets. Finally, despite higher commodity prices and growth, inflationary pressures remain somewhat muted.

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HEAD OF EMERGING MARKET DEBT

Daniel joined Mirabaud Asset Management in 2017, bringing some twenty years of experience investing in Emerging Market debt.

CONCERNS ABOUT US DOLLAR STRENGTH AND ITS IMPACT ON EMERGING MARKETS APPEAR OVERBLOWN

During Q2, the US dollar strengthened an average of 5%. This scenario is possibly creating some short-term anxiety in the market because the perception is that a strengthening US dollar could put the brakes on Emerging Market growth. However, structural changes have meant that Emerging Market economies are less reliant on the US dollar than previously.

Also, it is important to remember that the US dollar remains overvalued around 15% based on the IMF's measure of US real effective exchange rate

In the context of higher global growth and stronger commodity prices, the valuation appears to be overstretched.

INVESTING FOR OPPORTUNITY

We remain committed to achieving an attractive rate of return relative to the risk that the Fund takes. The recent volatility in Emerging Markets has created pockets of value in local and hard currency debt, which the Fund has been quick to capitalise on. The Fund's average cash position of around 10% has been fully deployed. And given the portfolio's low maturity profile (60% of the portfolio is invested in bonds with a maturity of three years or under), we have utilised additional cash flow from bonds that matured in June and July to reinvest in opportunities at much cheaper valuations, meaning higher yields. This move has led to an increase in the Fund's duration from 3.2 to 3.8 years.

The market has also experienced some disproportionate selling in long-end bonds in the hard currency space. We have taken the opportunity to increase our positions in this area of the market and add new positions in the portfolio, especially those that are trading significantly below par, with no deterioration in the macro outlook.

RUSSIA

The Fund's largest overweight position continues to be Russia, although this has been trimmed in recent months because of maturing bonds, which have been reinvested in stronger opportunities elsewhere. The sanctions announced in April are political in nature and probably won't have a broader impact on the economy. The macro environment remains supportive.

ARGENTINA

The $50bn 'Stand-By Agreement' (SBA) agreement with the IMF, which is one of the largest given to any Emerging Market country, should ease financing concerns and provide some stability going forward. This means that the government should now have its financing needs covered and is not reliant on market conditions between now and the election in November 2019. The programme also sets new fiscal and inflation targets, aiming to reach primary balance by 2020 and an inflation rate of falling to 17% in 2019. As a result, there is a good chance that credit will recover. Against this backdrop, there are quite a few bonds offering a significant amount of value, particularly those denominated in Euro.

TURKEY

The market risk premium significantly overshot before the presidential election in June and represented the cheapest Emerging Market. Following the presidential election, the market has begun to settle and in the absence of further negative headlines, it is unlikely to experience further significant falls. Going forward, there are obvious questions surrounding the quality of policy making. However, in an EM context, overall debt levels are not high and there is a wide buffer at the disposal of the banking system to withstand challenging conditions. There are quite a few opportunities to buy short term bonds in both US Dollar and Euro. There may be further credit rating downgrades. However, we believe that these are already in the price and risk of default remains relatively low.

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