Emerging Markets Update

January 2019

Overview

The outlook for emerging markets in early 2019 represents something of a contrast to that of a year ago. There are several factors which we feel will influence the performance of EM assets as markets look ahead to a year of potentially slower growth and a less certain path for US interest rates.

Early 2018	Early 2019
"Synchronous Global Growth"	"Synchronous Global Slowdown"
EM Central Banks tightening bias	EM Central Banks holding pat
Fed bias towards tightening	Fed bias less clear
China tightening	China "stealth-stimulus"
Plentiful EM bond issuance	Slower EM issuance
Commodity Strength	Commodity weakness (but rising)
Aggressive US stance towards China (trade war)	More conciliatory tone from US towards China

USD - Fed hiking cycle, quantitative tightening and global growth

In 2018, the future path of US interest rates was a factor in negative EM performance as market pricing for higher rates and a stronger US Dollar ("USD") saw many EM assets struggle. Countries with large proportions of USD denominated debt came under pressure, with Turkey and Argentina in particular experiencing significant volatility. Performance improved in late 2018 as the upward pressure on the dollar dissipated and the market began to price a more dovish Federal Reserve. While this dovishness goes hand-in-hand with a softer outlook for global growth, in the near term the prospect of a weaker USD can be more important for the valuation of EM assets.

The USD strength of 2018, which caught many investors off guard, appears more balanced now with risks potentially pointing to a weaker USD in the short term at least. In addition, widening of spreads in EM hard currency bonds and higher yields makes EM a more interesting proposition vs 2018.

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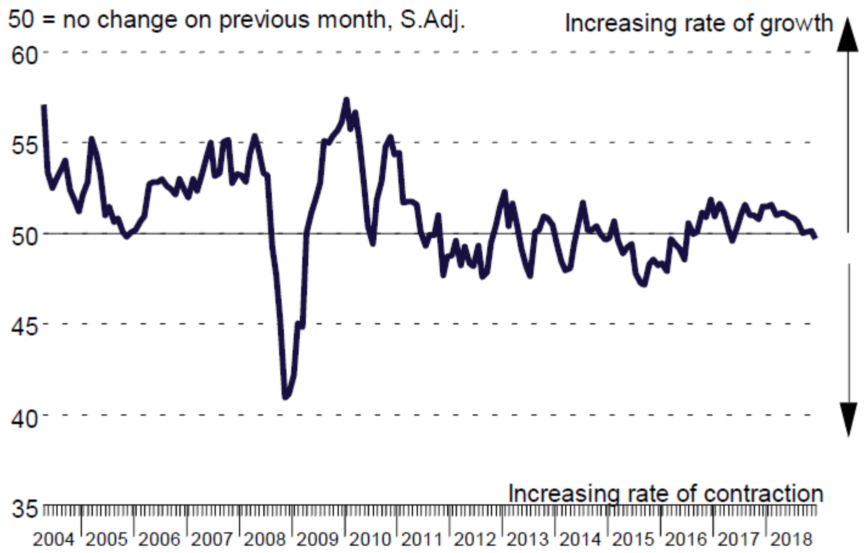
Risks however, do remain on the horizon, with the impact of the Federal Reserve's Quantitative Tightening policy not likely to be supportive for risk assets, while a slowdown in global growth can hurt EM economies should it become more severe.

China – growth fears, domestic demand & policy easing

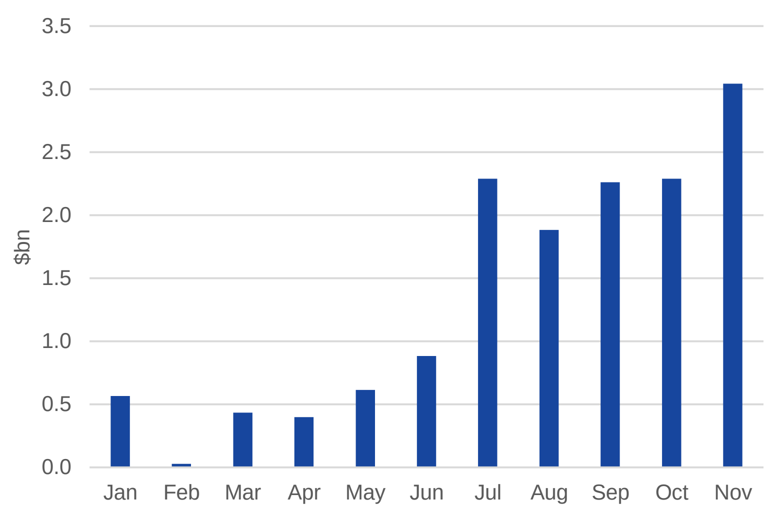
China's rate of GDP growth has been slowing due to uncertainty over US-China trade tensions and a drop-off in domestic demand. China manufacturing PMI fell below 50 in December, signalling the first contraction since May '17. China has implemented numerous policy easing measures, including targeted RRR cuts, tax cuts and liquidity injections. It is yet to be seen if these measures can offset the rising levels of local corporate defaults, brought about by high levels of local corporate indebtedness and less capital being allocated to weaker entities.

Caixin China Manufacturing PMI



Source: IHS Markit, Caixin

China local corp bond defaults (2018)



Source: Bloomberg

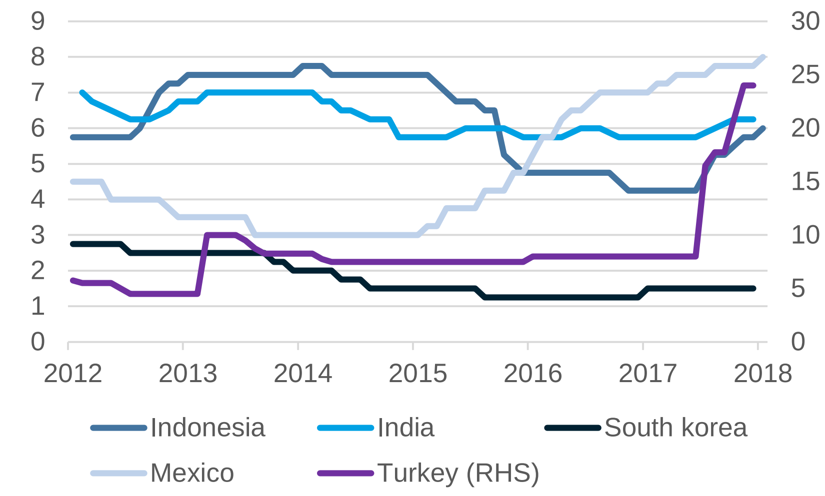
Negotiations with the US on trade are ongoing with a more positive tone from Chinese trade officials of late. However, sentiment is one thing and actions another, judging by the still unresolved case of Huawei's CFO, who was arrested on behalf of US authorities in Canada. It will be interesting to see if the scarcer liquidity and the power struggle with the US will see any moderation in the "One Belt One Road" initiative, and the associated impact it may have on its other partners in EM.

EM Central Banks – hiking cycles set to slow or stop

Several EM central banks hiked rates in 2018 in response to the negative impact (surging inflation, capital outflows) of a stronger USD on their domestic economies. Nations with large stocks of USD denominated debt like Turkey and Argentina suffered the most. With the global economy set to moderate in 2019, and in the absence of a flight to liquidity in a stronger dollar scenario, this cycle of rate hikes may be less likely to continue.

This has been evident recently in more dovish Central Bank meetings in large EM nations (e.g. India, Indonesia, South Africa, Turkey). This more dovish policy setting, combined with a potentially softer outlook for the USD, could see EM local currency bonds perform well. Performance as measured by the Bloomberg Barclays EM Local Currency Government index struggled in 2018 before recovering somewhat towards the end of the year.

Rate trajectory of major EM nations



Source: Bloomberg

Populism – Set to continue being a source of volatility in EM

Brazil and Mexico elected populist leaders in 2018 from different ends of the political spectrum. In Brazil the right-leaning Bolsonaro has taken control with a promise to clean up corruption that has plagued Brazil. His first real policy test will be on delivering pension reform.

Barclays EM Local Currency Government TR Index Unhedged USD

Source: Bloomberg

Brazilian assets have started the year strongly as optimism for Bolsonaro's presidency abounds. In Mexico the left-leaning Andres Manuel Lopez Obrador, or AMLO, had a difficult start to his tenure as the cancellation of construction of a new airport in Mexico city led to concerns among investors. Sentiment around Mexico and AMLO appears to have improved, demonstrated by Mexico's new 10 year bond which attracted over $8bn of demand for a $2bn issue in January.

India goes to the polls this year with voters facing the choice of incumbent Modi of the BJP or Rahul Ghandi of the Congress Party. The BJP has already hinted towards a more expansionary economic policy and is less fixated on keeping India's fiscal deficit at 3.3% of GDP*.

Eastern Europe appears to have its own issues with populist leaders:

- Hungary - Orban clashing with the EU on immigration
- Poland - Ruling Law & Justice Party have been reprimanded by the EU over, ironically, respecting the democratic rule of law

* Reuters, January 2019

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EM fund flows and technicals

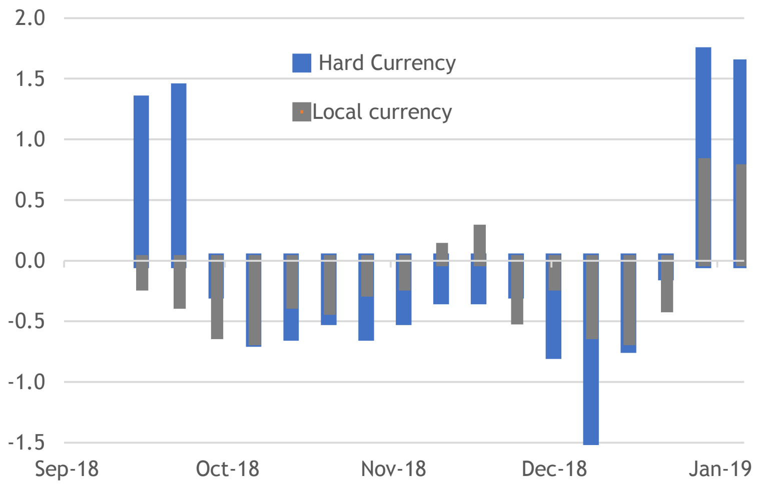
EM bond fund flows have turned positive in the first few weeks of 2019, after several consecutive weeks of outflows, boosting asset prices. However, we think this year could see more volatility.

One source of vol is the concept of EM "tourists", or non-EM dedicated investors who allocate into EM when it looks cheap compared to US credit and allocate away from EM when US credit is cheaper. An above-average level of volatility could also manifest itself due to:-

- More mixed global economic data
- Monthly "live" Fed Meetings
- Greater prevalence of EM Bond ETFs and Algo driven accounts

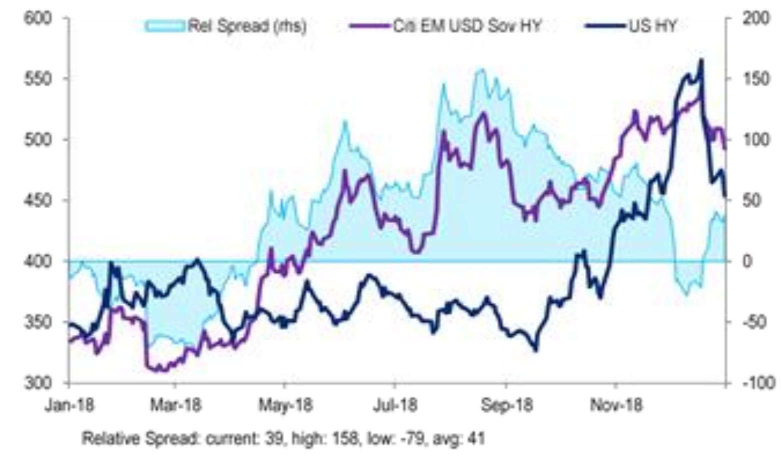
Volatile periods in markets present our fund with the opportunity to buy high quality EM bonds at attractive levels.

Recent EM Bond Fund Flows



Source: Citi Research

US HY Spreads vs EM HY Spreads



Source: Citi Research

EM Hard Currency spreads correlation to US credit spreads

Analysis of data going back to 2007 shows that EM hard currency spreads are correlated to US credit spreads. This relationship held up in 2018 in Investment Grade. In EM HY, the relationship was more volatile as the sharp fall in oil prices in December saw US HY trade cheap to EM temporarily. The spread is currently around the average level although the range was quite wide, trading from -79bp to +158bp in 2018. **Towards the end of 2018, our models indicated a strong short term positive signal on US HY, however we feel spreads could re-trace higher, as seen in 2016 when US HY spreads peaked around 870bps vs 540bps in December.**

Fund Positioning

EMFX and EM local currency bonds behave in a similar way, with the latter typically overshooting FX due to differences in liquidity. We have been more constructive on EM FX and local since the end of August 2018 and started to add selectively to local currency risk in Q4 last year, which has proved to be beneficial.

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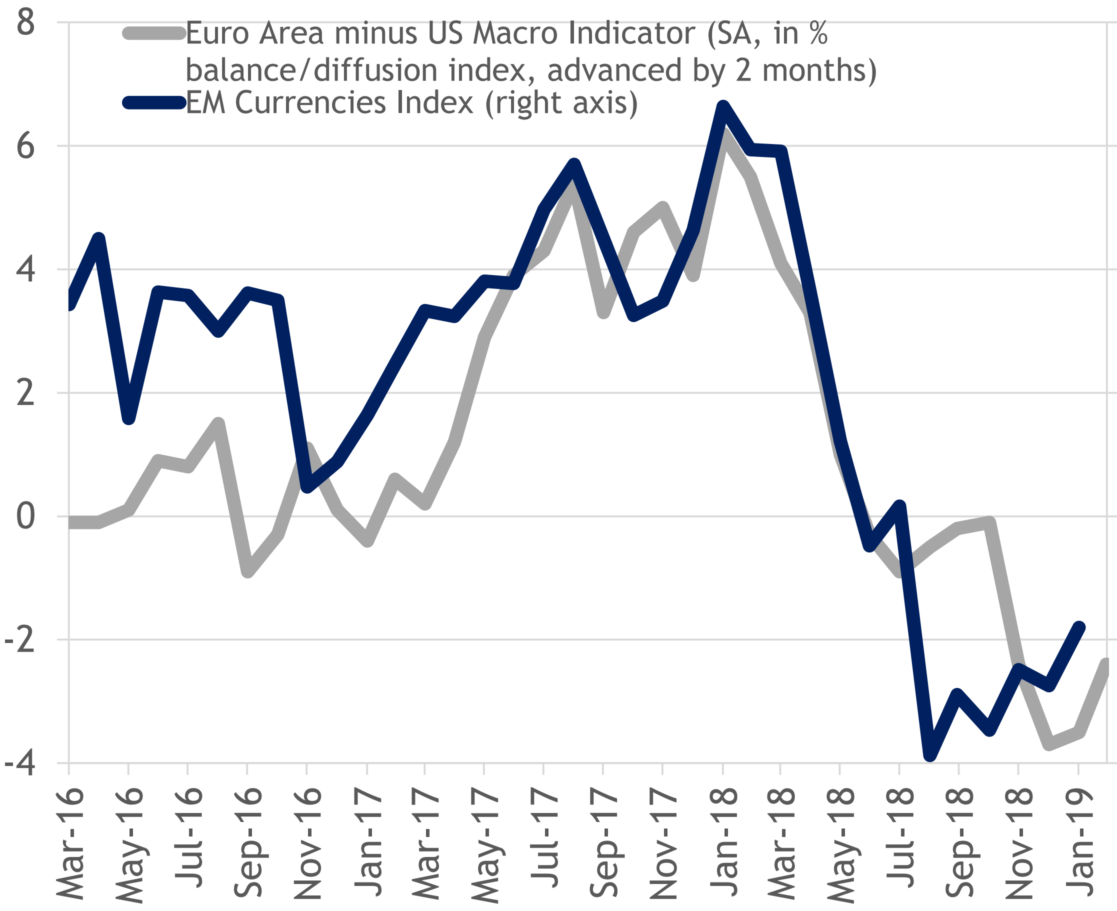
The rationale behind this was that in August 2018, the riskiest EM currencies (TRY, ARS and ZAR) became oversold with respect to what was justified by the macro context (chart below left).

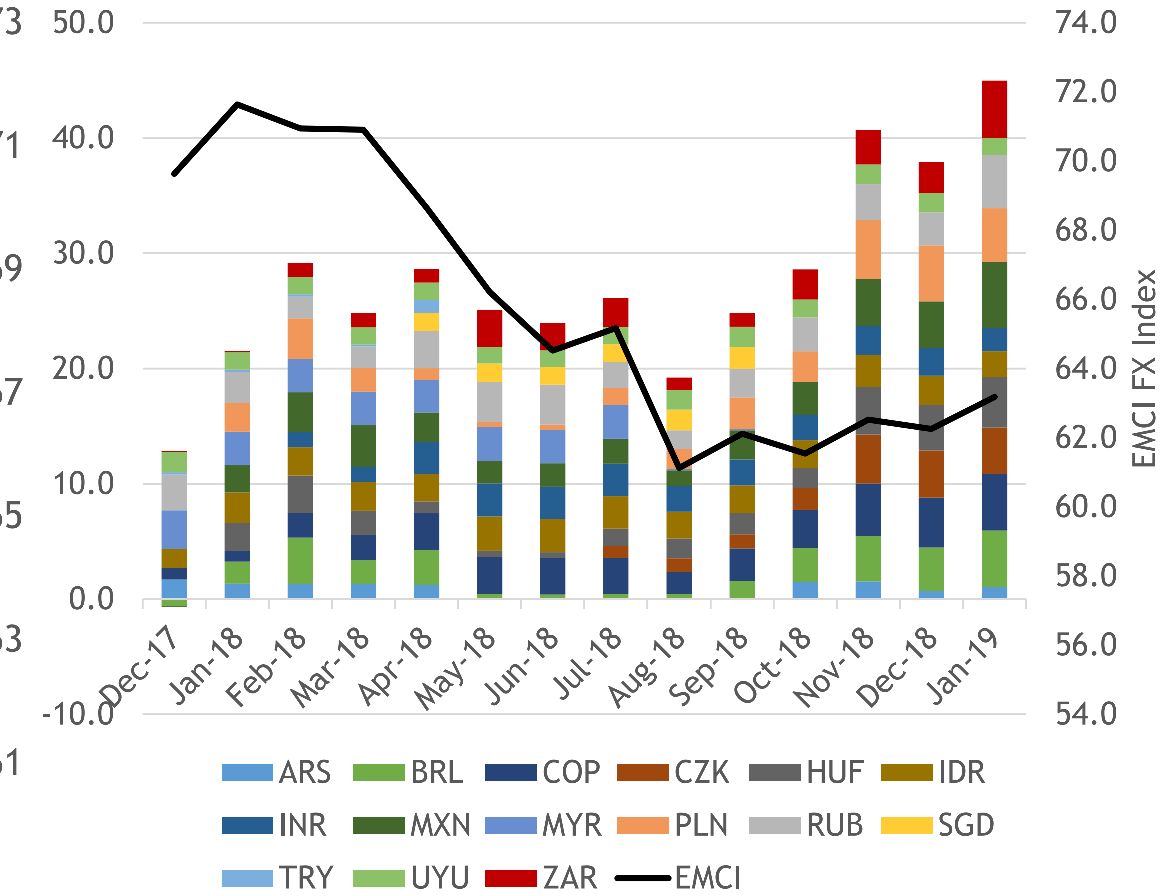
The chart (below right) shows the EM FX positioning of the fund throughout 2018, overlaid with the JP Morgan EM currency Index. **Our assessment of macro factors pointed to a stronger Dollar in 2018, our local currency exposure was kept low (10-25%) for most of 2018, then as EM currencies found a base, we increased exposure from August onwards.**

EMFX vs Macro Indicator (advanced by 2 mths)



Sources: Rubrics AM, Bloomberg

Fund FX Exposure



As alluded to earlier, we believe there may be some dollar depreciation later this quarter, ahead of which we may look to switch some liquid resources into EMFX and EM local exposure.

On the hard currency side, we re-iterate our view of the possibility of greater volatility in 2019 which will present better opportunities to initiate positions at more attractive spreads.

Rubrics EM Fund Summary

January 2019

- Non-benchmarked, total return investing
- Active Management
- Blended EM (Hard and Local Currency)
- Shorter duration bias
- Historical returns vs primary index:

	1 Year	3 Year	5 Year
Fund	-1.36%	8.07%	3.72%
Primary Index	-3.77%	4.47%	1.97%

Source: Rubrics AM

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IMPORTANT INFORMATION

January 2019

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Information Documents for Switzerland, the articles of association, the annual and semi-annual report in French, and further information can be obtained free of charge from the representative in Switzerland: Carnegie Fund Services S.A., 11, rue du Général-Dufour, CH-1204 Geneva, Switzerland, tel.: + 41 22 7051178, fax: + 41 22 7051179, web: www.carnegie-fund-services.ch. The Swiss paying agent is: Banque Cantonale de Genève, 17, quai de l'Ile, CH-1204 Geneva. The last share prices can be found on www.fundinfo.com. For the shares of the Funds distributed to non-qualified investors in and from Switzerland and for the shares of the Funds distributed to qualified investors in Switzerland, the place of performance is Geneva.

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