BI SICAV Emerging Markets Corporate Debt I (USD)

BANKINVEST

Dear Investor

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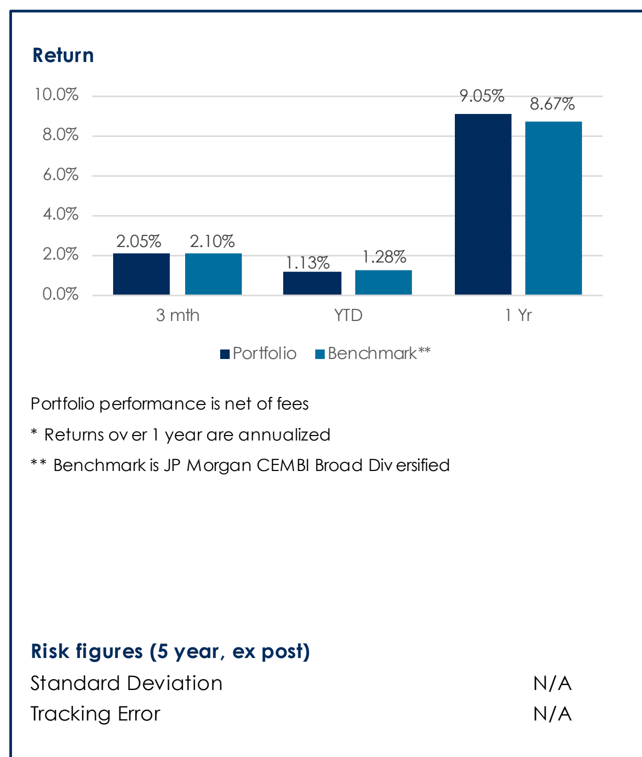
Summary

- Q2 was characterized by reversal of US rates and benign commodities leading to solid quarterly returns. Generally speaking, outperformers were long duration bonds as well as HY issuers with the energy sector performing best at a sectoral level. The benign market environment did have some pockets of volatility as select Latin American countries have chosen a more populist route.
- Inflation dynamics still appear to be transitory although latest signals from the US labor market has been mixed. EM central banks seem prepared and already have hiked rates. Chinese credit impulse has weakened and it will be interesting to see how this affects growth and commodity prices.
- EM corporate fundamentals appear robust and improving, but valuations have come a long way. In contrast to DM, EM spreads are however not at multi-year tights faciliting crossover interest



Calm markets and changing politics

While Q1 was characterized by rising US rates and commodity prices, Q2 saw a reversal of US rates and still benign commodity prices. This scenario led to favorable returns for EM corporates with quarterly returns of 2.1% (USD) created equally through spreads and rate moves with duration and HY bonds in the lead. The fund outperformed by 23 bp gross of fees.

While markets overall remained calm, the political front saw some rather big shifts in different pockets of EM. In Israel, long-standing PM Bibi Netanyahu's reign was upended though we expect little change to economic policies and are comfortable with our exposures. Not far away, Iran elected its new President Raisi who is described as a conservative hard-liner indicating very tough JPCOA negotiations ahead. In Latin America, Peru elected Mr. Castillo a hardcore leftist as its next President which does not bode well for economic policies. In Chile, the drafting of the new constitution by the constituent assembly requires attention and upcoming parliamentary and presidential elections could lead to more rumblings. Lastly, Colombia's new political cycle seems to be populist and the anticipated macroeconomic headwinds have already caused Fitch and S&P to downgrade the country into HY. We remain selectively exposed in these Latin American countries.

On the sanctions front Q2 saw mixed developments as Belarus got much attention post the Ryanair flight highjack and a series of personal and quasi-sovereigns got sanctioned. All this led the risk premium on Belarusian assets to spike. Almost simultaneously, new issues of Russian domestic government debt got sanctioned by the US although secondary trading remains exempt causing a muted reaction. Further, the US administration specified

that some of the China related company sanctions were modified meaning that some Chinese quasi-sovereigns were taken off the sanctions list. We anticipate that the era of sanctions will continue to create noise and volatility going forward in countries seen as adversaries of the West.

Is inflation transitory or has a new regime begun?

Global growth is expected to be 6% this year and reports of bottlenecks, rising commodity prices and wage inflation have caused many investors to fear whether inflation could derail the EM upswing and what the implications for monetary policies will be. In the US, revelations might appear at Jackson Hole by the end of August and as this could be a signal from QE to QT although the FED is aware that all risky asset valuations are dependent on them. Add to this recent house price inflation which further contributed to wealth-inequality, and it is not hard to see some politicians calling for normalization of rates before low rates become a political liability. Relatedly, higher taxation has become a global theme underscored by the recent G7 tax initiative indicating the direction of travel which undoubtedly means higher taxation to fund public debt and decrease inequality.

At the same time, inflation dynamics have or should be about to peak in most economies as base effects from the massive price declines begin to fade. That said, soaring input costs and delivery delays have started to pass through into consumer prices. However, key to the underlying inflation dynamics will be the performance of the US labor market, which has been mixed recently. EM central banks have not been caught off guard as many already started tightening policy stances in recent months. The combination of still improving growth, higher but likely transitory inflation has been a boon for EM credit metrics and the IMF already projected falling public debt/GDP many places. At the same time though, fiscal prudence is required as additional spending and populist initiatives could be hard to reverse as the cyclical tailwind fades.

Standalone fundamentals of EM corporates have been resilient, and we expect the rebound in commodity prices to enabling credit metrics to reach their lowest levels since 2011. This also reflects the prudent focus on deleveraging in recent years, and notably almost half of the rating downgrades over the past year were sovereign driven. Commodity credits stand to be the biggest beneficiaries from price reflation and reopening of economies and businesses.

Worth keeping an eye on is how growth dynamics are changing. Momentum in China looks to have peaked already and the growth is now slowing as the credit impulse weakens. We always anticipated Beijing to keep markets orderly into the 100th anniversary of the Communist Party of China (CPC) through its activism across asset classes. Nonetheless, China continues its economic transition, and we expect increasing uncertainty in the time ahead as Beijing cools down leverage and manage financial stability. Interestingly while CPC might be 100 years old, it has only been in charge 72 years, i.e. 2 years shorter than the Soviet Union which among others collapsed after glasnost (increased openness), which the CPC has zero tolerance for. This will bring headlines locally and internationally as the US administration has human rights and openness as high priorities.

Whereas fundamentals appear robust, valuations have come a long way. However, contrary to US HY and US IG corporate credit markets EM spreads are not at multi-year tights. Of course, index spread comparisons are a rather primitive tool as it does not account for compositional effects over time. However, it illustrates that in a still yield-starved world, EM credit seems set to continue to attract crossover investor interest which anecdotally remains the case. While considering the above framework and the recent pullback in US rates, we continue to prefer credit and the shorter end of the HY space with our traditional neutral position on duration. We suspect that credit selection will remain the main driver of alpha generation in the remainder of the year and maintain our tilt towards the better part of HY.

Kind regards,

Chresten Hagelund, Søren Bertelsen and Eduardo Ordoñez

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