ARISTEA SICAV

FIM GEM DEBT

INVESTOR LETTER – AUGUST 2022

The fund mainly invests in global EM and frontier debt markets. The strategy uses an unconstrained, high conviction approach to investing, with a framework that ensures high diversification while protecting against downside risk. Alpha generation is based on a bottom-up fundamental analysis of the EM issuers, enhanced with exposure to frontier opportunities. The portfolio manager has a long track record, having managed similar products for some of the largest global asset managers over the years. The sub-fund is dedicated to investors who intend to pursue capital growth in the medium to long term with medium to high volatility.

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In accordance with article 8 of EU regulation 2019/2088, the fund promotes environmental, social and governance characteristics in accordance with European regulation. Notably, the fund's investment process excludes companies having low practice or standards in these sectors, or those with a high long term sustainability risk.

The fund generated a +15bps return in August vs. benchmark of -74bps. As a result, net alpha ytd stands at +235bps.

August was the mirror image of July - a strong first half of the month and a weak second half, culminating with a leg down in risk assets following the Jackson Hole speech by Jay Powell.

In general, however, the EMD beta to global risk has held up better than expected, with EMD outperforming global credit and the S&P 500.

There are several themes playing out in EM at the moment, which we are trying to capitalize on:

1. Frontier credits continue under duress, even though the IMF is coming to the rescue.
2. The tightening cycle in "mainstream" EM economies (GBI constituents) looks well advanced and is showing signs of maturing.
3. Growth is holding up better than expected despite global recession fears.
4. External balances have deteriorated quite considerably, with the exception of a few oil exporters.
5. The news flow from China remains negative.

The strategy remains wary of frontier local, where macro and social pressures are building up, and markets are "breaking" on the back of terms of trade shocks and much tighter financing conditions. We express those views via a basket of USD longs vs. frontier currencies and by being very light frontier credits in external debt. We recognize the negative carry is a challenge, and thus the portfolio is running a large carry UW vs. benchmark, but we expect the returns from currency depreciation (and spread widening) to offset the carry loss. The Ghanian Cedi is a good example whereby the currency depreciation offset the carry loss by a factor of 3x, generating more than 30bps of alpha in the process.

As mentioned, the IMF is stepping up its efforts in the frontier space, which could provide a backstop for some of those challenged credits. Just last week, the Fund reached a staff level agreement on an extended fund facility with Sri Lanka, it concluded its seventh and eighth reviews of the Extended Arrangement for Pakistan, and it approved a new extended credit facility for Zambia. For now we think some of those actions may be a case of too little to late (Pakistan), already priced in by the market (Zambia), or too early for what's still pending (Sri Lanka), so not enough for us to jump on the bandwagon. It has become clear from Argentina, Ecuador and others that have entered into IMF programs that they are not the panacea they once seemed to be. With global liquidity tightening, program design and implementation leave too much uncertainty in most cases.

Meanwhile mainstream EM (GBI) continues their path of policy normalization, averaging 475bps of hikes since the start of this cycle vs. the 225bps done by the FED. Rate hikes have been very skewed towards Latin America and Eastern Europe (with Brazil and Hungary hiking by 11.75pc and 11.15pc respectively), while Asia has taken a much slower approach to rate normalization, with China actually easing policy. Our strategy has been generally voiding or/and shorting EM local duration throughout the year, on account of the high beta of EM rates to US yields and the need by EM central banks to take real rates to more acceptable (i.e., positive) levels. The latter has now been partly achieved in a few names, and thus we closed some of the payers we had in the portfolio in places such as Mexico and Poland, admittedly too early on the latter. Currently we are not long any mainstream local bonds as we remain cautious on US and ECB duration.

The macro backdrop in EM has been more resilient than expected, with close to 50% of the EM mainstream economies showing accelerating quarterly sequential growth in Q2 2022. Brazil, Indonesia, Colombia and the GCC economies among others have shown robust growth, while especially China, and some of the Eastern European economies are going the other way. Likewise, the PMI gap between EM and developed markets has now narrowed substantially in favour of EM.

At the same time, external balances have taken a turn for the worse on account of higher energy import prices or/and challenging export markets in China and Europe. The most vivid expression of that turn is Korea, a traditional surplus country, with the trade balance now running well into deficit. But it's not only Korea; the combined current account for the mainstream EM economies has dropped significantly. Bucking the trend, GCC trade surpluses are running at multi years highs.

This macro backdrop, combined with the normalization in EM rates, is somewhat favourable for EM currencies, but the missing element for sustained EMFX performance is the "push factor" coming from the dollar itself. As we highlighted in the July note, we still think the market is too aggressive on rate cuts for 2023, but on the terminal rate itself, 4pc as priced-in by futures begins to look like a reasonable number. As such we think the dollar still has some support left in the tank, but we recognize the balance of risks for the dollar is beginning to look more symmetric. For now, we continue to fund our EM FX positions in EUR or against low-yielding Asian currencies, and play EMFX more as an RV trade – long the positive carry/growth stories vs. UW the negative carry/deteriorating growth stories. One currency that stands out in our screens is the Indonesian Rupee, both in terms of growth and in terms of improving external balances, particularly as BI is finally getting on board with the tightening cycle. The Government just decided to hike fuel subsidies, which will likely add to headline inflation and spur additional tightening and support for the IDR.

In China the news flow continues to be negative, with the authorities trapped in a permanent on/off Covid lockdown policy, which weighs on the economy and growth. The double whammy of a weak economy and a weak JPY (and KRW) continues to put upward pressure on the CNH REER. In addition, capital outflows are persisting despite record high trade surpluses. As a result, we stay away from China credit, and remain UW CNH, which we also use as a funding currency.

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