

Emerging Debt Local Currency Strategy

Quarterly Newsletter (EUR)

Market review

Over the quarter, the market saw pressure in the face of a rapid rise in US Treasury yields, particularly following the US Federal Reserve's comments about plans to phase out quantitative easing. Emerging market local currency bonds weakened by 7% in the second quarter, with some small recovery seen in the last few days. Mexico was down 9%, given its closer correlation with US Treasuries and recent disappointing growth numbers, including a 1.7% drop in industrial production for the most recent monthly data. Brazil was down over 10%, with most of this coming from currency weakness, while bond prices were impacted by a rate hike of 50bps. Brazil intervened to support the currency, given inflation fears such as the removal of the IOF tax on foreign investors. Hungary was one of the few bright spots where the market was positive, supported by stronger-than-expected industrial production at 2.9% year-on-year, and rates were cut by 25bps. Poland was down close to 3%, with the central bank cutting rates by 25bps. Russia was down 6% as growth remains soft, particularly from lower oil prices.

Asia was down considerably, led by a -17% return from the Philippines following position unwinding after the credit rating upgrade and a recent 5.9% fall in exports. Indonesia was down over 10% after the policy rate was raised in June. Malaysian manufacturing rose by 4.2%, much better than expected.

Performance analysis

During the quarter, performance was broadly in line with the benchmark on a gross basis despite very active portfolio decisions. Although being underweight emerging currencies strongly contributed to performance in May and June, this was offset by being overweight local rates, which detracted. A significant underweight to the Russian rouble contributed to performance as this was one of the worst-hit currencies; however, an overweight to local rates in anticipation of potential monetary policy easing detracted from performance. There were some similarities in Brazil and Mexico, where underweight positions in these currencies contributed, but overweights in local rates for both at the start of the period detracted. The underweight Turkish lira position contributed to performance, but again the small overweight

Performance¹

Annualised %	Q2	YTD	1yr	3yr	5yr	Since inception ²	
Pictet Emerging Local Currency Debt Composite	-8.19	-6.01	-1.15	3.92	12.37	10.11	
JP Morgan GBI-EM Global Diversified	-8.17	-5.83	-1.08	3.95	10.90	8.87	
Relative performance	-0.02	-0.18	-0.07	-0.03	1.47	1.24	
Calendar years %	2012	2011	2010	2009	2008	2007	2006 ³
Pictet Emerging Local Currency Debt Composite	14.70	2.94	22.45	21.14	3.91	5.45	7.91
JP Morgan GBI-EM Global Diversified	15.00	1.53	23.72	18.18	-0.31	5.84	6.15
Relative performance	-0.30	1.41	-1.27	2.96	4.22	-0.39	1.76

¹Pictet Emerging Local Currency Debt Composite for pooled portfolios, gross of fees in EUR, 30.06.2013. ²Inception date 31.07.2006. ³Partial year since 31.07.2006. Benchmark JP Morgan GBI-EM Broad Diversified to March 2007.

For professional investors only

Risk statistics 5yr annualised in %

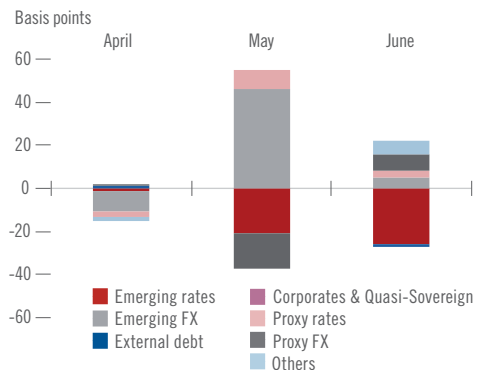
	Pictet Emerging Local Currency Debt Composite	JP Morgan GBI-EM Global Diversified
Standard deviation	9.14	9.50
Ex-post Tracking Error	1.53	—
Information ratio	0.86	—
Beta	0.95	—

Emerging currency exposure net exposure in %

	Rep A/C	JP Morgan GBI-EM Global Diversified
Mexico New Peso	12.6	10.1
South Africa Rand	11.4	10.2
Malaysia Ringgit	10.2	10.2
Poland Zloty	10.0	10.0
Turkey New Lira	9.8	9.8
Brazil Real	8.7	9.9
US Dollar	8.3	0.0
Russia New Rouble	7.9	10.1
Indonesia Rupiah	7.8	8.7
Thai Baht	7.0	7.0
Hungary Forint	5.0	5.5
Colombia Peso	3.5	3.4
Nigeria Naira	2.6	1.8
Peru New Sole	1.7	1.7
New Romanian Leu	1.0	1.0
Philippines Peso	0.5	0.5
Chile Peso	-0.5	0.1
China Renminbi	-2.2	0.0
Euro	-5.2	0.0

Currency positions are taken from the Pictet-Emerging Local Currency Debt fund, which is included in the composite. Off benchmark currencies excluded if <1% exposure.

Attribution in USD



Attribution is taken from the Pictet-Emerging Local Currency Debt fund, which is included in the composite.

All data presented as at 30.06.2013 in EUR, (apart from attribution data which is in USD)

Source: Pictet

local rates – which we took off in June – detracted. A neutral currency position and small overweight local bonds in the Philippines detracted as the market suffered the worst of position unwinding in June. Retaining an underweight currency and local rates position in Indonesia contributed significantly, as this was one of the worst performers in the market. An underweight local rates in Malaysia also contributed, as did our active management of the South African rand exposure.

Portfolio activity

We progressively increased the underweight to emerging currencies over the quarter before reducing the underweight in the last few days of June when we started to see a minor recovery. In local rates, we reduced the overweight duration to a more neutral position as we entered June given the pressure on local bonds and lack of clarity on a potential recovery in the short term. In Brazil, we moved from an overweight duration to a neutral position given the potential for further rate hikes. We also moved to an underweight position in the Brazilian real of around 1% as slow growth, concerns over inflation and the recent demonstrations point to potential further weakness. The significant Russian rouble underweight was reduced once the market started to stabilise, but weak growth and soft commodity prices continue to be headwinds. In Russian rates, we reduced the overweight duration to a neutral position as the potential for a rate cut is diminishing. It was a similar story in Mexico, where a rate cut is likely to be off the table for now and we moved to neutral duration while going from an underweight peso position to a small overweight at the end of June to benefit from potential retracement. In Asia, we retained an underweight to Indonesian rates and underweight rupiah from the end of May while moving from an underweight Philippines peso position to a more neutral position in June.

Market outlook

The outlook for the asset class has seen some changes recently for the short and medium term, while the long-term case for the asset class in terms of diversification and yield

remains largely intact. The continued theme of a stronger US dollar, possible tapering of quantitative easing leading to upward trending US Treasury yields and flat-lining commodity prices is putting pressure on emerging market currencies and now local rates. Although rising yields may not be one way and are likely to be a long-term process, we believe this trend is unlikely to change in the near term. This is translating into lower return prospects for the asset class. Emerging currencies may see some benefit from the so-called ‘great rotation’ into equities and other high-return assets, but this looks less certain in the near term. Although underlying fundamentals in emerging markets remain generally unchanged, there is increasing differentiation from Brazil being in a rate hiking cycle to Russia potentially looking to cut rates and South Africa struggling to stimulate growth paired with a volatile currency. This means that looking at regions, rather than countries in isolation, is becoming less relevant.

Portfolio strategy

We see the stronger US dollar making emerging currencies more vulnerable and expect this theme to continue. As a result, we are likely to remain underweight emerging currencies. Some currencies have been hit badly over the past couple months, such as the South African rand, and we may want to take tactical advantage of potential retracement. The Turkish lira is another currency which could see a snap back if the current turmoil is resolved. Local rates is a more challenging decision, and we are not currently expecting a rapid bounce back given the overall direction of global yields. However, there are potential opportunities of seeing yield curve compression if emerging central banks resume interest rate cuts, given that growth remains mixed in a number of countries. Monetary policy in Russia and Mexico are examples of countries to watch. However, we remain very aware of global political and economic risks as markets remain highly sensitive and the situation still cannot be described as ‘normal’. As a result, increased idiosyncrasies will lead to more relative value type opportunities for active managers.

Emerging interest rate exposure duration in years

	Rep A/C	JP Morgan GBI-EM Global Diversified
South Africa Rand	0.64	0.63
Mexico New Peso	0.61	0.61
Indonesia Rupiah	0.53	0.61
Malaysia Ringgit	0.51	0.52
Russia New Rouble	0.43	0.42
Poland Zloty	0.42	0.41
Thai Baht	0.36	0.36
Turkey New Lira	0.33	0.34
Brazil Real	0.28	0.28
Hungary Forint	0.19	0.20
US Dollar	0.17	0.00
Colombia Peso	0.16	0.14
Philippines Peso	0.14	0.05
Peru New Sole	0.14	0.13
Singapore Dollar	0.13	0.00
Nigeria Naira	0.06	0.06
New Romanian Leu	0.02	0.03

Weighted modified duration positions are taken from the Pictet-Emerging Local Currency Debt fund, which is included in the composite. Off benchmark countries excluded if <0.1 value duration.

Strategy information

Strategy inception	31.07.2006
Strategy assets	EUR 12.3 bn
Objective	To outperform the JP Morgan GBI-EM Global Diversified index by 1-3% per annum, gross of fees
Investment team	Simon Lue-Fong Orlena Yee Mary-Thérèse Barton Wee-Ming Ting Philippe Petit

All data presented as at 30.06.2013 in EUR, (apart from attribution data which is in USD)

Source: Pictet

Pictet Asset Management

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