Pictet Asset Management | Q4 2013

For professional investors only

Emerging Debt Local Currency Strategy

Quarterly Newsletter (EUR)

Market review

The market leading index fell 1.5% in USD terms in the fourth quarter amid significant volatility: the index was up over 4% in early October given the Fed's decision not to go ahead with tapering in September and got a boost from solid Chinese growth of 7.8%. However, it then declined nearly 6% over the remainder of the quarter in the lead up to the Fed's December meeting when the start of tapering was announced. The Brazilian real was one of the worst affected currencies with two rate hikes to 10%, despite manageable inflation and slow growth expectations, in the light of growing concerns over monetary policy as well as the budget deficit which is now at 3.2%. Mexico passed its landmark energy reform bill and Moody's upgraded local sovereign bonds to 'A'. Indonesia performed well in October as investors were attracted by the highest yields in the region, but rapidly rising US treasury yields in early November contributed to a significant slide in the currency and bonds the rest of the quarter, given concerns over increased funding costs as the current account deficit approached 4% of GDP. Turkey, already one of the year's worst performers due to unfavourable fundamentals, saw a massive sell-off at the end of December in both the currency and bonds as a corruption scandal expanded into a government crisis. Eastern Europe was one of the few bright spots with Hungary, Poland and Romania all seeing positive returns.

Performance analysis

The strategy outperformed over the quarter (in gross terms), with the majority of performance coming from underweight emerging currency positions, while active local rates positions marginally detracted. The Brazilian r eal was one of the biggest contributors owing to a significant underweight as the currency was one of the worst performers, down over 6% in the quarter. However, a marginal overweight to Brazilian rates, which was implemented during the small window of opportunity when rates rallied at the end of September and into October, detracted slightly. An underweight to the Turkish lira also contributed strongly, particularly in December, when a government corruption scandal exacerbated the already unfavourable fundamental story sending the currency sharply down 8% for the quarter. An underweight to the South African rand, not helped by a continued decline in commodity prices, contributed as did an overweight to the Mexican peso where the currency was marginally positive.

Performance[1]

Annualised %	Q4	YTD	1yr	3yr	5yr	Since inception[2]
Pictet Emerging Local Currency Debt Composite	-3.16	-13.54	-13.54	0.70	8.66	8.18
JP Morgan GBI-EM Global Diversified	-3.27	-12.91	-12.91	0.55	8.25	7.11
Relative performance	0.11	-0.63	-0.63	0.15	0.41	1.07

Calendar years %	2013	2012	2011	2010	2009	2008	2007	2006[3]
Pictet Emerging Local Currency Debt Composite	-13.54	14.70	2.94	22.45	21.14	3.91	5.45	7.91
JP Morgan GBI-EM Global Diversified	-12.91	15.00	1.53	23.72	18.18	-0.31	5.84	6.15
Relative performance	-0.63	-0.3	1.41	-1.27	2.96	4.22	-0.39	1.76

[1]Pictet Emerging Local Currency Debt Composite for pooled portfolios, gross of fees in EUR, 31.12.2013. [2]Inception date 31.07.2006. [3]Partial year since 31.07.2006. Benchmark JP Morgan GBI-EM Broad Diversified to March 2007.

Risk statistics 5yr annualised in %

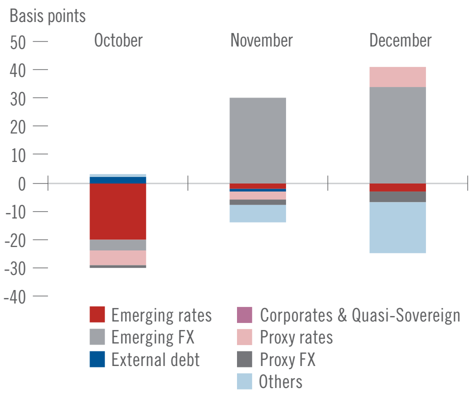
	Pictet Emerging Local Currency Debt Composite	JP Morgan GBI-EM Global Diversified
Standard deviation	9.20	9.33
Ex-post Tracking Error	1.12	—
Information ratio	0.34	—
Beta	0.98	—

Emerging currency exposure net exposure in %

	Rep A/C	JP Morgan GBI-EM Global Diversified
US Dollar	13.8	0.0
Mexico New Peso	10.4	10.0
Malaysia Ringgit	9.4	10.0
Poland Zloty	8.6	10.0
South Africa Rand	8.6	10.0
Turkey New Lira	8.3	9.5
Russia New Rouble	8.1	10.0
Thai Baht	7.9	8.0
Indonesia Rupiah	6.7	6.9
Hungary Forint	6.1	6.2
Brazil Real	5.6	10.0
Colombia Peso	3.4	3.4
Nigeria Naira	2.5	2.0
Peru New Sole	1.8	1.7
Philippines Peso	1.7	0.5
New Romanian Leu	1.5	1.5
China Renminbi	1.1	0.0
Chile Peso	0.2	0.1

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 31.12.2013 in EUR, (apart from attribution data which is in USD)

Source: Pictet Asset Management

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An underweight to Indonesian rates detracted in October when the bonds rebounded, but we made much of this back in November and December. An overweight to the Philippine peso detracted marginally while a small overweight to Philippine rates detracted where we had been taking profits over the past few months.

Portfolio activity

During the window of opportunity when rates rallied following the Fed's decision not to taper in September, we entered the fourth quarter marginally overweight duration. This was reduced to a neutral duration position by November in the lead up to the December taper decision. In emerging currencies, we maintained an underweight which was increased by the end of the quarter. In Brazil, we moved to a substantial underweight to the currency, where despite growth having picked up, expectations are that it will remain at around only 2% in 2014 while the central bank continues to be hawkish despite inflation just below 6%. The budget deficit recently increased and is unlikely to be addressed given the 2014 presidential election. In Brazilian rates, we moved to a neutral position in November. We retained an underweight to the Turkish lira given the focus by investors on current account deficit countries in the face of Fed tapering and higher borrowing costs while the uncertain political environment came to the fore. We actively managed an overweight to the Mexican peso which we believe is one of the better stories in emerging markets despite the relatively slow growth as the landmark energy reform bill is expected to give the economy a boost. We maintained an overweight Philippine peso as we still believe in the solid fundamental story including the recently achieved investment-grade status and a central bank on hold.

Market outlook

Tapering has started and global data is improving, but we believe caution should be maintained for now. One underlying reason for emerging market weakness has been the trend lower in exports since 2010. Now with expected stronger US and developed-market growth, emerging-market growth could move stronger as well. However, weakness has also been driven by a focus on idiosyncratic factors such as political risks in Turkey and poor investment as a share of GDP in Brazil and lack of structural reforms. The Fed pointed out that "asset purchases are not on a pre- set course", giving leeway to adjust the pace of tapering to counteract any disorderly rise in treasury yields which would lead to further outflows and weakness while each Fed decision will result in potentially different market reactions. At the same time, US interest rates are expected to remain low and many see scope for emerging market currencies to appreciate from their low valuations, even though we expect continued dispersion. We have already seen emerging currencies weaken since the start of tapering with even the Mexican peso down over 1% while the Turkish lira, Brazilian real and Thai baht were all down 2% or more. Tapering has occurred against a back-drop of continued outflows since May even though we still believe there is a long-term push factor from underweight institutional investors. When those inflows will return remains a big question.

Portfolio strategy

Given our view on the market outlook, we are taking a neutral to defensive position in local rates while taking a similar view on currencies, but on a highly selective basis. We like the fundamental story of the Mexican peso given the positive reforms and benefits from improving growth in the U.S., however it has one of the highest sensitivities to tapering and growth expectations may be overly optimistic. We like the Philippine peso given the excellent growth with monetary policy on hold, as well as the Chinese renminbi where we believe this market will open up faster than market consensus while being aware that growth could remain patchy. We are inclined to tactically manage currency underweights to markets with several of the following factors: a current account deficit, over-reliance on commodities, slow growth, lack of reforms or credible monetary policy and upcoming elections. Turkey, Indonesia and South Africa are key examples. Brazil is another market that could disappoint and with an upcoming presidential election, the budget deficit is unlikely to be addressed. While Russia is not facing elections or a deficit, slow growth and low inflation could mean a rate cut is increasingly likely. It is clear that the start of tapering has not been positive for local currency bonds, in particular the currency component, while bond yields have been creeping higher.

Emerging interest rate exposure duration in years

	Rep A/C	JP Morgan GBI-EM Global Diversified
South Africa Rand	0.61	0.62
Mexico New Peso	0.60	0.60
Malaysia Ringgit	0.48	0.49
Russia New Rouble	0.44	0.42
Indonesia Rupiah	0.43	0.46
Poland Zloty	0.39	0.38
Thai Baht	0.39	0.40
Turkey New Lira	0.34	0.34
Brazil Real	0.27	0.27
Hungary Forint	0.22	0.22
Colombia Peso	0.14	0.14
Peru New Sole	0.13	0.12
Philippines Peso	0.10	0.05
Singapore Dollar	0.10	0.00
Nigeria Naira	0.07	0.06
New Romanian Leu	0.04	0.05
Chile Peso	0.01	0.01

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 9.5 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-Therese Barton Wee-Ming Ting Philippe Petit Guido Chamorro

All data presented as at 31.12.2013 in EUR, (apart from attribution data which is in USD)

Source: Pictet Asset Management

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