Pictet Asset Management | Q3 2014

For professional investors only

Emerging Debt Hard Currency Strategy

Quarterly Newsletter (EUR)

Market review

External debt posted a negative return of 0.6% in USD terms for the third quarter, with most weakness attributed to widening in spreads, although higher US Treasury yields were a detractor in September. This time, tighter-spread investment-grade countries were relatively flat overall while below-investment-grade countries posted a negative return of 1.6%. Brazil underperformed the market, with Moody's highlighting the country's deterioration in debt metrics and little sign of a return to potential growth in the near term. Despite the apparent ceasefire between Russia and Ukraine, Russia posted a negative return of 3.3% for the quarter. Costa Rica was downgraded by Moody's to Ba1, with the agency citing deteriorating fiscal metrics and failed efforts to implement tax reforms. In higher-yielding markets, Venezuela was down 16% following comments by a Harvard professor and former member of the political opposition that the country should default. President Maduro assured markets that the country would pay back every dollar it owed. S&P downgraded Venezuela to CCC+, citing a decline in FX reserves, recession and high inflation. Ukraine declined 9%. Argentina performed well, as a change in payment location or jurisdiction received Senate approval, although the situation remains messy and any solution is likely to be protracted and incremental.

Performance analysis

The strategy outperformed over the quarter, with September the highlight for outperformance. Selection in Russia, where the strategy remained significantly underweight quasi-sovereign bonds given the impact of sanctions, was positive for performance. Instrument selection in Brazil also contributed as a result of recent rating actions and the recent fall into recession. In higher-yielding markets, an underweight position in Argentina and selection focused on the longer-maturity bond contributed to performance. A defensive bias in Ukraine also contributed. However, Venezuela detracted as we had been overweight as a result of attractive valuations in our view. However, the country was downgraded and investor sentiment turned negative. In off-benchmark exposure to emerging market currencies, short positions in more vulnerable currencies were a strong contributor to performance. The short to the Brazilian real was a key outperformer as the currency sold off heavily as a result of the recession and the lead in the polls by President Dilma Rousseff, which was seen as negative by the market. The significant Russian rouble short also contributed because of our bearish view on the economy given the low oil prices and the impact of sanctions. A short to the South African rand also contributed while long exposure to the Chinese renminbi was a

Performance[1]

Annualised %	Q3	YTD	1yr	3yr	5yr	Since inception[2]
Pictet Emerging Debt Composite	8.41	17.65	17.02	10.19	11.10	12.72
JP Morgan EMBI Global Diversified (TRI)	7.75	17.83	17.53	10.14	11.23	9.03
Relative performance	0.66	-0.18	-0.51	0.05	-0.13	3.69

Calendar years %	2013	2012	2011	2010	2009	2008	2007	2006
Pictet Emerging Debt Composite	-9.19	16.02	12.26	17.40	26.33	0.62	-3.18	0.46
JP Morgan EMBI Global Diversified (TRI)	-9.34	15.63	10.94	20.04	25.76	-7.47	-4.26	-1.72
Relative performance	0.15	0.39	1.32	-2.64	0.57	8.09	1.08	2.18

[1]Pictet Emerging Debt Composite for pooled portfolios, gross of fees in EUR, 30.09.2014. [2]Inception date 30.11.1998. Benchmark 50% ELMI+ & 50% EMBI+ (TR) Index to 31.01.2002.

Risk statistics 5yr annualised in %

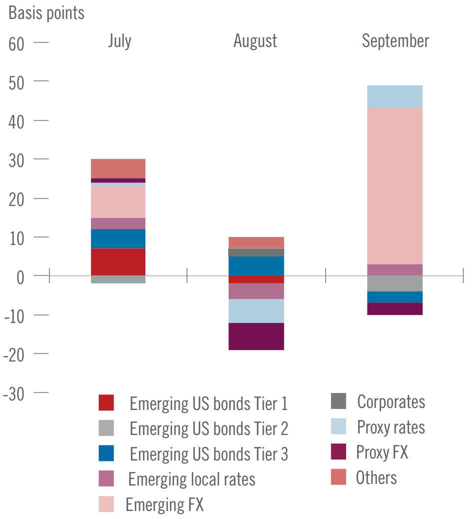
	Pictet Emerging Debt Composite	JP Morgan EMBI Global Diversified (TRI)
Standard deviation	9.50	9.36
Ex-post Tracking Error	1.35	—
Information ratio	-0.09	—
Beta	1.00	—

Top 10 country exposures for USD Bonds in %

	Rep A/C	JP Morgan EMBI Global Diversified (TRI)
Lebanon	5.5	3.3
Philippines	5.4	4.6
Indonesia	4.9	4.4
Turkey	4.2	4.6
Venezuela	3.8	2.9
Colombia	3.6	3.7
Hungary	3.3	3.5
Brazil	3.3	4.5
Mexico	2.8	4.5
South Africa	2.8	3.3
Off benchmark currency exposure	10.6	

Country positions are taken from the Pictet-Global Emerging Debt fund, which is included in the composite.

Attribution in USD



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

All data presented as at 30.09.2014 in EUR, (apart from attribution data which is in USD) Source: Pictet Asset Management

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positive as this was the only currency to post a positive return.

Portfolio activity

Over the quarter, we progressively reduced the marginal underweight to tighter spread markets in July as a result of the supportive environment of range-bound to lower US Treasury yields. Brazil duration was generally maintained at neutral, and we retained the underweights to China and Chile given tight valuations and the potential for US Treasury yields to move higher. While we were neutral to marginally underweight duration in Russia, we were heavily underweight quasisovereigns. In tier-two countries, which are just at or around investment-grade status, we increased the overweight, for example in Costa Rica where the country has performed well given that total public debt stock shrank on the back of a weaker colon. We retained the overweight to Indonesia given the positive political developments there. In higher-beta markets, we retained a tactical overweight, such as in the Dominican Republic, where growth has strengthened to 5.5% year on year and the government posted a small primary surplus. We remain selectively underweight in what we view as more vulnerable markets such as Serbia, Ukraine and Pakistan. In Argentina, we retained the underweight and defensive instrument selection. In off-benchmark positions, we increased the defensive position to currencies, but took profits towards the end of September, for example in the Russian rouble and Brazilian real.

Market outlook

The asset class fully recovered from the weakness seen last year, but it has lost momentum with weakness seen in September. As developed-market monetary stimulus moves towards normalisation, we expect to see more significant differentiation between markets, which is already becoming evident. While gradually improving global growth will be a positive for many emerging market countries, higher borrowing costs could be a negative for some. The potential for rangebound to steadily increasing US Treasury yields would be supportive and add to the argument that there is value given the spread level relative to other high-grade spread asset classes. However, a rapid and disorderly rise in yields could create downward pressure in the short term. On the whole, though, prudent fiscal and economic management will be recognised by investors over the long term. We still believe that many of the tightest-spread, investment-grade markets are likely to see weakness in line with US Treasuries. Meanwhile, high-yielding markets will trade more on their underlying fundamentals.

USD Bond duration in years

	Rep A/C	JP Morgan EMBI Global Diversified (TRI)
Indonesia	0.43	0.36
Mexico	0.40	0.41
Philippines	0.37	0.38
Colombia	0.36	0.32
Turkey	0.35	0.35
Brazil	0.33	0.32
Peru	0.29	0.29
Argentina	0.24	0.18
Panama	0.23	0.22
Uruguay	0.23	0.23
South Africa	0.23	0.22
Lebanon	0.21	0.16
Kazakhstan	0.21	0.20
Costa Rica	0.20	0.12
Hungary	0.20	0.22
Russia	0.19	0.24
Poland	0.18	0.18
Venezuela	0.18	0.14
China	0.16	0.25
Saudi Arabia	0.13	0.00
El Salvador	0.13	0.11
Chile	0.12	0.24
Croatia	0.12	0.13
Lithuania	0.11	0.09
Morocco	0.10	0.06
Dominican Republic	0.10	0.11
Ivory Coast	0.10	0.07

Weighted modified duration positions are taken from Pictet-Global Emerging Debt fund, which is included in the composite. Duration breakdown >0.10.

Portfolio strategy

We are likely to remain largely neutral duration overall, but with selective overweights and underweights by country and by security selection. If yields start rising in a meaningful way, we are prepared to react quickly and reduce duration as the trajectory for US Treasuries remains upwards in our view over the medium term. Moreover, we have not seen any real signs of a return of the traditional relationship between EM debt spreads and global growth. We will continue to look to take tactical advantage of some higher- yielding markets which trade more on their underlying fundamentals. For now, we are looking to take advantage of pockets of value around positive credit-rating events while being cautious on markets that have seen some deterioration, such as Russia and Venezuela. We will continue to look at actively using US Treasury futures as a less expensive, faster and more efficient way of managing the strategy's duration given changing market liquidity. We will also still look at emerging-currency opportunities as an off-benchmark strategy. We continue to remain cautious on taking corporate bond exposure and expect to have minimal exposure over the coming weeks.

Strategy information

Strategy inception	30.11.1998
Strategy assets	EUR 6.6 bn
Investment objective	To outperform the JP Morgan EMBI Global Diversified index by 1-3%per annum, gross of fees
Investment team	Simon Lue-Fong Mary-Therese Barton Wee-Ming Ting Philippe Petit Guido Chamoro

All data presented as at 30.09.2014 in EUR, (apart from attribution data which is in USD) Source: Pictet Asset Management

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