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FIXED INCOME INVESTMENT STRATEGY

THE CASE FOR CREDIT – HIGH QUALITY AND HIGHER RETURNS



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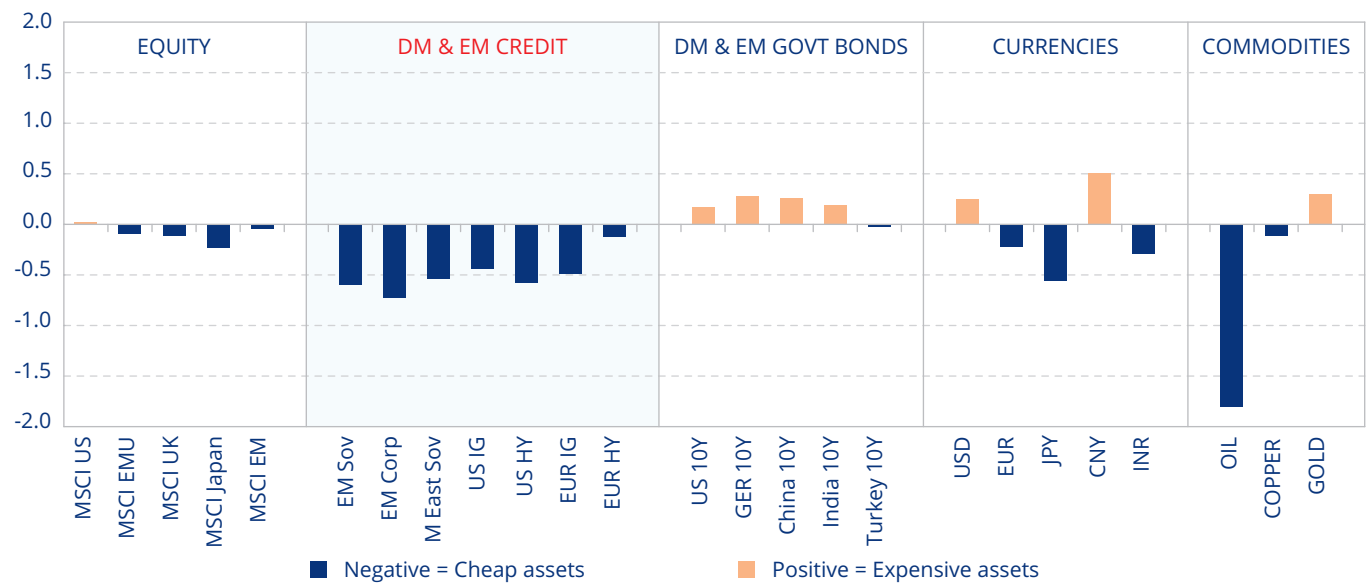
We hold the view that conditions are right to invest in credit* to reap positive returns without running abnormally high risks. The FED's direct support, with bond purchases on the primary and secondary market, extending to highest quality HY credit, has put a floor under Developed Market (DM) bonds.

* The term 'credit' in this report refers to emerging market sovereign debt and any type of corporate bond

VALUATIONS

Valuations-wise the recent crash has seen marked improvements across the asset class, which compares favourably with others on a medium-to-long term basis (Fig. 1) being now the most undervalued.

FIG. 1: Credit is the most undervalued asset class
The chart illustrates deviations from long-term average of forward P/Es, credit spreads, real bond yields, real commodity prices and real effective exchange rates. Positive (negative) horizontal lines show standard deviation bands of richness (cheapness).



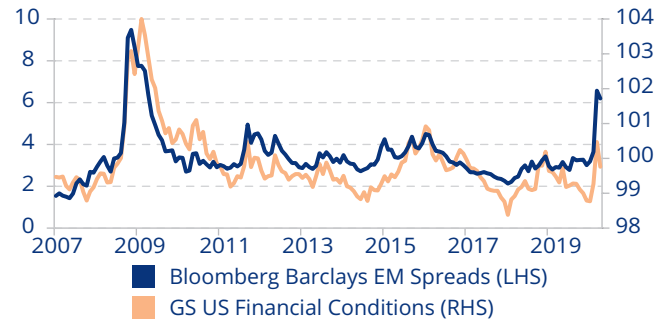
Source: JPM Research



USD LIQUIDITY CYCLE

At a global level, the main driver of credit spreads is USD liquidity, whose cycle is driven by the US Federal Reserve (Fig. 2). As the US Financial Conditions Index rises, which means conditions tighten, EM spreads widen till liquidity is re-established and spreads tighten again. The huge liquidity injections via QE4, the direct Fed backstop to US credit alongside fiscal packages and other facilities are bringing US liquidity back to normal and will soon see a feed-through to EM bonds. In the absence of Fed support, the destiny of EM bonds would have been pretty dire.

FIG. 2: Bloomberg Barclays EM Option-Adjusted Spread versus Goldman Sachs US Financial Conditions Index



Source: Bloomberg

NOT ALL CREDITS ARE BORN EQUAL – STAY UP IN QUALITY

Although the tide of public interventions has lifted all boats, one must differentiate within credit and avoid excessive risk-taking related to the equity factor embedded in credit.

The table below illustrates the point with the beta to equities for different high-yielding sub-asset classes in credit.

FIG 3: Beta to equities, highest to lowest, and yield to worst for different sub-asset classes in credit

	LOWER QUALITY Higher Beta to Equities			HIGHER QUALITY Lower Beta to Equities				
	EMEA	US	GLOBAL	EM	US	US (IG)	EM	EM
	FINANCIAL SUBORDIN.	CCC & LOWER	CoCos	USD SOV & CORP	BB-B	PREFERRED PERPS	ASIA HY	ASIA USD SOV
Beta to Equity	61.8%	60.8%	49.4%	41.0%	33.3%	32.0%	28.7%	23.9%
Yield to Worst	7.29	17.97	5.78	6.63	7.38	4.39	10.34	4.56

Source: CIO-Office, Bloomberg

Main conclusions to be drawn from Fig 3:

- > One should avoid EM Financial Subordinate securities, under which we find AT1 perpetuals, US HY bonds CCC & Lower and CoCos and any kind of highly speculative credit, due to the current risky environment, or allocate small weights within a diversified portfolio.
- > EM credit overall, sovereign and corporate across all EM regions, has a pretty high beta to equities. This is due to high yielders with large twin deficits, for instance Turkey and Egypt, or commodity exporters, for instance Venezuela. The main message is that one should discriminate within the asset class which allows for very diverse exposure at a more granular level.
- > Preferred securities, though preferred perpetuals, bear relatively low equity risk amongst high yielder due to their higher quality (the index includes IG USD issuers in the US market; see below for details).
- > At the lower end of the risk spectrum EM Asia stands out, with a large difference between high-yielders and sovereign IG securities.

Details about the classification are given below. Risk of capital loss is highest at the top of the list and lowest at the bottom.

Subordinated financial securities

Benchmark: BofAML EMEA Subordinated Financial Emerging Markets Corporate Index. This includes all subordinated securities in hard currency by financial issuers in EM countries. In particular, it includes AT1 perpetuals and excludes CoCo.

US high-yielding corporate bonds CCC & lower

Benchmark: BofAML CCC & Lower US High Yield Index. This is the most speculative securities in US corp. HY.

Contingent capital debt (CoCo), both investment-grade and below

Benchmark: BofAML Contingent Capital Index.

EM hard-currency debt

Benchmark: Bloomberg Barclays EM USD Aggregate Index. It includes all sovereign and corporate EM debt. This is the SAA benchmark.

US high-yielding corporate bonds BB & B

Benchmark: BofA BB-B US High Yield Index. This is the higher quality securities in US corp. HY.

Perpetual preferred securities

Benchmark: BofAML Perpetual Preferred Securities Index. It includes fixed-rate US-dollar-denominated preferred investment-grade securities issued in the US market.

EM Asia high-yielding debt

Benchmark: Bloomberg Barclays EM Asia USD Credit High Yield. This is mostly a corporate debt index.

EM Asia sov. debt

Benchmark: J.P. Morgan EMBI Global Diversified Asia. This includes all Asian hard-currency sovereign debt.

OUR RECOMMENDATIONS FOR A HIGH-QUALITY BIAS IN FIXED INCOME

1. HIGHEST QUALITY GCC BONDS

This portfolio includes Investment Grade GCC bonds yielding at least 3% and rated by at least one major agency. We estimate for this portfolio a volatility of 3.9%, not markedly higher than the portfolio yield, versus benchmark volatility of 7.4%, the benchmark being the JPM MECI GCC Index TR.

ATTRACTIVE VALUATION	STRONG FUNDAMENTALS	LIQUIDITY ASSESSMENT
<ul style="list-style-type: none"> > The recent sell-off has resulted in very attractive valuation for these bonds > We stick strictly to A rated senior bonds 	<ul style="list-style-type: none"> > We stick to IG EM sovereigns or GREs > There is limited downside with these credits since the sovereigns have large FX reserves 	<ul style="list-style-type: none"> > We discarded all Domestic MTN, US Market and 144A securities > Minimum outstanding amount to be greater than USD 500mn

ISIN	ISSUER	COUPON	MATURITY	YTW	MOODY'S	S&P	COUNTRY	SECTOR	PAYMENT RANK
XS1800010693	ADCB	4.00	29.03.2023	3.02	NR	A	UAE	Financial	Sr Unsecured
XS1890684688	Sabic	4.00	10.10.2023	3.10	A1	A-	Saudi Arabia	Basic Materials	Sr Unsecured
XS1054250235	Saudi Electricity	4.00	08.04.2024	3.01	A2	A-	Saudi Arabia	Utilities	Sr Unsecured
XS2109396957	SAMBA	2.90	29.01.2027	3.48	A1	NR	Saudi Arabia	Financial	Sr Unsecured
XS1694217495	Saudi International Bond	3.63	04.03.2028	3.10	Aa2	AA	Saudi Arabia	Government	Sr Unsecured
XS1982113208	Saudi Aramco	3.50	16.04.2029	3.42	A1	A-	Saudi Arabia	Energy	Sr Unsecured

Source: Bloomberg



2. EM BONDS - AVOID FALLEN ANGELS

This portfolio includes investment grade bonds across the GCC and Asia yielding at least 4% and rated by at least one major agency. We estimate for this portfolio a volatility of 5.5% with a yield of 4.7%, versus benchmark volatility of 3.9% and a yield of 3.1%, the benchmark being the Bloomberg Barclays Asia IG Credit Index. Overall, the carry-to-volatility of 0.9 for the portfolio compares favourably with that of the benchmark of 0.79.

SECTOR SELECTION	CREDIT SELECTIONS	LIQUIDITY ASSESSMENT
<ul style="list-style-type: none"> > Stick to Government Related Agencies and Non-Cyclical sectors 	<ul style="list-style-type: none"> > Well-known names with strong sovereign support expectations > Jr Subordinated securities of banks rated at least BBB+ 	<ul style="list-style-type: none"> > We discarded all Domestic MTN, US Market and 144A securities > Minimum outstanding amount to be greater than USD 500mn

ISIN	ISSUER	COUPON	MATURITY	YTW	MOODY'S	S&P	COUNTRY	SECTOR	PAYMENT RANK
XS1936310371	Indian Oil Corp Ltd	4.75	16.01.2024	4.72	Baa2	NR	India	Energy	Sr Unsecured
XS1957412981	Almarai Sukuk Ltd	4.31	05.03.2024	3.62	Baa3	BBB-	KSA	Cons, Non-cycl	Sr Unsecured
XS1079848369	ONGC Videsh Ltd	4.63	15.07.2024	4.25	Baa2	BBB-	India	Energy	Sr Unsecured
XS1887479902	Aldar Sukuk Ltd	4.75	29.09.2025	4.03	Baa1	NR	UAE	Financial	Sr Unsecured
US71568QAC15	Perusahaan Listrik Negar	4.13	15.05.2027	4.20	Baa2	NR	Indonesia	Utilities	Sr Unsecured
XS1932866079	Oil India Ltd	5.13	04.02.2029	5.32	Baa2	NR	India	Energy	Sr Unsecured
US69370RAD98	PT Pertamina (Persero)	3.65	30.07.2029	4.31	Baa2	NR	Indonesia	Energy	Sr Unsecured
US30216KAE29	Export-Import BK India	3.25	15.01.2030	4.19	Baa2	BBB-	India	Government	Sr Unsecured
XS2122408854	DBS Group Holdings Ltd	3.30	PERP	4.76	Baa1	NR	Singapore	Financial	Jr Subordinated
XS1699845068	United Overseas Bank Ltd	3.88	PERP	4.45	Baa1	NR	Singapore	Financial	Jr Subordinated

Source: Bloomberg



3. EM HIGH YIELD SELECTION

The portfolio has a forecast volatility of 6.2% with a yield of 6.7%, with a high carry-to-volatility ratio.

INVESTMENT RATIONALE	CREDIT SELECTIONS	LIQUIDITY ASSESSMENT
<ul style="list-style-type: none"> > Look for players who enjoy some advantage in terms of their offering 	<ul style="list-style-type: none"> > Stick to Sovereigns, GREs and companies that are subsidiaries of strong IG entities from other countries 	<ul style="list-style-type: none"> > We discarded all Domestic MTN, US Market and 144A securities > Minimum outstanding amount to be greater than USD 350mn

ISIN	ISSUER	COUPON	MATURITY	YTW	MOODY'S	S&P	COUNTRY	SECTOR	PAYMENT RANK
XS0654493823	Indian Oil Corp Ltd	5.63	02.08.2021	4.55	Baa2	NR	India	Energy	Sr Unsecured
XS1505149325	KT Kira Sert Varlik	5.14	02.11.2021	5.55	NR	NR	Turkey	Financial	Sr Unsecured
XS1816199373	Hazine Mustesarligi VARL	5.80	21.02.2022	6.03	B1	NR	Turkey	Government	Sr Unsecured
US62828M2A84	Muthoot Finance Ltd	6.13	31.10.2022	11.22	NR	BB	India	Financial	1st lien
XS2079842485	Arab Republic of Egypt	4.55	20.11.2023	6.58	B2u	B	Egypt	Government	Sr Unsecured
XS2017807301	Bank Bahrain & Kuwait	5.50	09.07.2024	6.74	B2	NR	Bahrain	Financial	Sr Unsecured
XS1090889947	ABJA Investment Co	5.95	31.07.2024	8.61	NR	B+	India	Basic Materials	Sr Unsecured
XS1577950402	Coca-Cola Icecek AS	4.22	19.09.2024	4.64	B1	NR	Turkey	Cons, Non-cycl	Sr Unsecured
USL6401PAF01	Minerva Luxembourg SA	6.50	20.09.2026	7.53	NR	BB-	Luxembourg	Cons, Non-cycl	Sr Unsecured
XS2010037922	NBK Tier 1 Financing 2	4.50	PERP	5.81	Baa3	NR	UAE	Financial	Jr Subordinated

Source: Bloomberg



OUR TOP MUTUAL-FUND IDEAS

FUND	OBJECTIVE	YIELD	DURATION
PIMCO INVESTMENT GRADE CREDIT BOND FUND CREDIT QUALITY: A	The fund seeks to invest in investment grade corporate fixed income securities. Its average portfolio duration is three to seven years.	2.75%	6.62 Yrs
NC WEALTHY NATIONS BOND FUND CREDIT QUALITY: A-	The Fund's objective is to invest in a range of debt securities issued by governments, institutions and corporations in developed and developing markets who have a positive Net Foreign Asset position.	4.30%	6.84 Yrs
JUPITER JGF - DYNAMIC BOND FUND CREDIT QUALITY: BBB+	The objective of the Fund is to invest in opportunities across the credit spectrum. However, the fund is positioned defensively with a large part of the portfolio in Govt and DM Bonds.	3.57%	6.27 Yrs
PRINCIPAL SPECTRUM PREFERRED AND CAPITAL SECURITIES INCOME FUND CREDIT QUALITY: Baa2	This fund invests in preferred securities of US companies rated BBB or higher by S&P or Moody's Investor Service Inc.	5.02%	4.70 Yrs
FIDELITY FUNDS - ASIAN HIGH YIELD FUND CREDIT QUALITY: BB-	The Fund invests its assets primarily in debt securities issued by companies conducting the majority of their business in Asia and rated below investment grade	7.54%	2.90 Yrs



GIORGIO BORELLI
 Head of Asset Allocation and
 Quantitative Strategies
 Telephone: +971 4 609 3573
 Email: giorgiob@emiratesnbd.com



SATYAJIT SINGH, CFA
 Fixed Income Analyst
 Telephone: +971 4 609 3795
 Email: satyajitsi@emiratesnbd.com

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