EuroHedge

African alpha

BY **HUGH LEASK**

Enko Capital Management is positioning for success in the continent's post-shock environment

It's been a tumultuous decade for Africa's economies. The burgeoning momentum of the early 2000s – a legacy of the debt forgiveness programmes of the 1990s – later gave way to a deceleration in growth triggered by the 2008 financial crisis. By 2016, the continent's commodities-based economies were reeling from the collapse in global oil prices two years earlier, while the fallout from the Arab Spring revolutions that swept through north Africa earlier in the decade continued.

But for Alain Nkontchou, co-founder, managing partner and chief investment officer at Enko Capital Management in London, this "post-shock environment" offered considerable investment opportunities for his Enko Africa Debt Fund as it prepared for launch.

Rolled out in October 2016 with $150m, the strategy – which today manages $213m – is designed to capitalise on opportunities and inefficiencies arising from macro shocks, market dislocations and volatility events impacting Africa's $513bn debt market (excluding South Africa).

"We're essentially doing macro relative value on African markets," says Nkontchou, who before establishing Enko had been a managing director within JP Morgan and later in Credit Suisse's proprietary trading unit, focusing on global macro trading since 2005.

The fund trades listed sovereign and corporate bonds in an investment universe where sovereign debt accounts for 94% of the market, with the remaining $30bn being corporate. This dominance of local currency-denominated sovereign debt is reflected in Enko's investment portfolio, with roughly three-quarters of the risk exposure invested in government issuance, while the remainder is split across corporates, supra-nationals and banks.

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ENKO CAPITAL MANAGEMENT

- Offices in London and Johannesburg
- $276m in firm-wide assets under management; $213m in Enko Africa Debt Fund
- 11 investment professionals: 4 in London, 7 in Johannesburg

dollar or Eurobond or a developed domestic market, that rules out that country," he explains of the strategy.

Restructuring and rebuilding

Having launched in the final quarter of 2016, the Enko Africa Debt Fund scored an eye-catching gain of 16.2% in 2017. Performance was driven predominantly by positions in Zambia, Nigeria, Ghana, Angola and Egypt, where economies had been restructuring and rebuilding amidst their post-shock, balance-of-payments problems, Nkontchou explains.

Though African growth has been squeezed recently by the Arab Spring and oil's decline, some issues go back to the global financial crisis. Though Africa was not directly linked to the underlying credit issues that sparked the 2008 crash, the continent ultimately underperformed other regions, as investors took flight from peripheral markets globally.

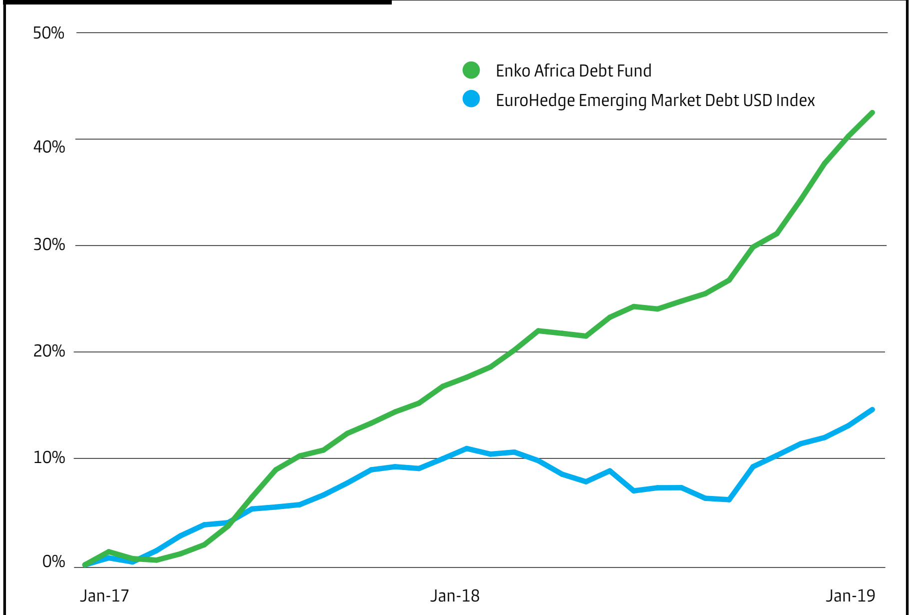
"If you don't have an economic growth model that allows you to be able to absorb such capital outflows, then you typically face a challenging time from a current account and balance of payments perspective, ultimately with currency and inflation repercussions," he says.

"Typically, you don't have the traditional tools for countercyclical policy management in such an environment. In order to survive, you're almost obliged to lean further against your economy by tightening monetary conditions to both contain inflationary pressures and stabilise your exchange rate."

The 2014 oil collapse proved a stark demonstration of how economies dependent on higher commodity prices can be swept up in events beyond their control.

"Here, economic growth tends to be correlated to the broader commodity cycle, and such countries don't have much influence in the pricing of the goods that leads to their wealth creation," Nkontchou explains. "Also, when commodities prices are strong, you tend to be overinvested. When eventually commodity prices come down, you face shortfalls in terms of

PERFORMANCE: ENKO AFRICA DEBT FUND



Source: HFM database

income revenues, a widening budget deficit, balance of payments pressure, a weakening currency, and high inflation."

Such fragmentation would offer fertile ground for the fledgling fund. "If you can find a way to go through these crises and take advantage of that, it can be very rewarding," he says. "This is what we essentially did in 2016."

Delving deeper into the track record, the strategy's most successful bets have included Nigeria, where the central bank's exchange rate was misaligned, creating considerable currency tension, and Ghana, where, post-shock, an IMF programme post-election collided with high nominal interest rates.

"The bet for us in Nigeria was that we were in an unsustainable equilibrium and something had to give – either the currency would weaken sharply, alleviating rates pressure, or they would do whatever it takes from a policy rate perspective, but the Central Bank would need to be more bold," he says.

"We did very well on that point, because the bet was correct from the structural curve to the basis spread that we had on the foreign exchange. That was one of the low-hanging fruits that we had in the portfolio."

Profits amid pain

2018 was a torrid year for emerging markets, with economic upheaval in Turkey and Argentina leaving the overall market down between 4% and 9%. But Enko once again took profits amid the pain, gathering annual returns of 8.5% thanks to some conservative positioning on the macro and relative value spectrums. The performance duly propelled the fund to victory in the emerging markets category at the 2018 EuroHedge Awards.

Nkontchou says it was a "terrible" year for emerging markets. "When some countries are already going through challenging times, with the economic growth like we had in Brazil, Turkey, Argentina and the like, it risks swift capital outflows and rates spike up everywhere, and Africa was a part of that."

What set Enko apart, he believes, was its sustained focus on external macro factors. The strategy scored big last year with trades that were largely immune to a Fed change, or announcements of change, in monetary policy.

"We were proactive enough to not only continue making money within such an environment but also to take advantage of those market pressures that we had in the book," Nkontchou says. "Emerging markets currency weakness plus widening credit spreads were basically the themes that hurt quite a lot of people. In comparison to the market, we actually did much better."

The end of expansion

The fund has sustained its positive run into 2019, climbing 12.4% in the first six months of the year. Looking ahead to beyond the summer, Nkontchou explains that while internal country-specific developments remain integral to investment themes, it is the broader global macro backdrop that will likely prove more decisive in terms of maintaining the fund's momentum going forward.

The IMF's recent *Regional Economic Outlook* on the continent, *Recovery Amid Elevated Uncertainty*, observed how the global expansion is losing momentum, particularly in the continent's key trading partners, China and Europe. It also pointed to sharp swings in commodity prices, continued debt vulnerabilities, and high non-performing loans are weighing heavily on financial systems.

"What is really interesting for us is where policies are at this juncture," he says of 2019's midway point. "From a local perspective, we've had the shock, and those currencies have devalued. Now, what we are experiencing is a sort of mean reversion process."

Noting that many local markets remain dependent on commodities prices, Nkontchou says it is tough to be bullish on oil for the next five years. Yet in the absence of any sharp drop in commodity prices, those countries that have been able to build their reserves to decent levels and haven't sold everything forward "should be alright", he observes.

"We are just going to be muddling along in absence of any major external shock and have average rates of growth across the subcontinent, and that suffices for us. I think you can count on between 4% to 6% on average for the best cases on aggregate."

What may prove more crucial are the external macro factors, which draws in the still-unresolved US-China trade war, rising tensions among major oil exporters, the prevailing Federal Reserve interest rate movements, and the wider global economy.

"I don't remember a cut happening in an environment where recent growth didn't look alarming," Nkontchou says of the imminent rate cut. "We are not contracting, we are just growing slightly slower, as we've exhausted the positive impact from the tax cut when Trump came in."

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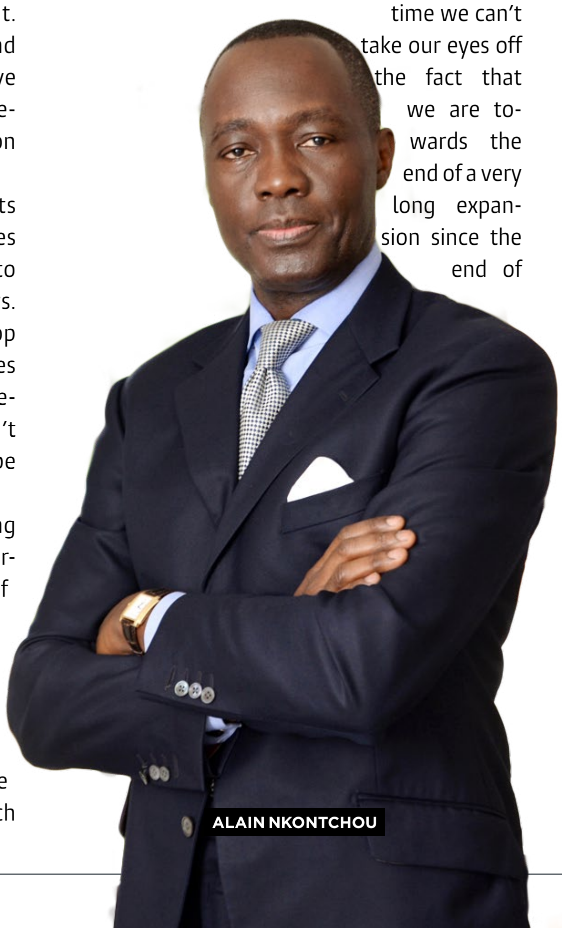
Easing monetary conditions will help cushion the major developed economies in the US, Europe and Japan, which should in turn be helpful for emerging markets. "But at the same time we can't take our eyes off the fact that we are towards the end of a very long expansion since the end of the global financial crisis. At the very least we should expect a cyclical downturn at some point."



ALAIN NKONTCHOU

Frontier alpha

Turning to the evolution of the fund, Nkontchou believes the strategy could grow to three or four times its current size without altering the investment approach significantly. The challenge today is persuading potential investors to look at the opportunities in Africa as a source of alpha.

"I started my career in 1989 and what is interesting is that I see the level of tenures and I see where we are today and I think, 'My god, what a journey'. It has been one whereby from a pure equity investment perspective, you've made decent money if you were just sitting tight. From a fixed income perspective, yes, in doing that process you have been helped by the central bank all along.

"We are now sitting almost at the low end of the interest rate distribution. Now the question is 'where do we go from here?' It's hard for me to believe that macro-based investing is dead. A lot of things have changed over time – you have more machines involved in trading, and we have reached an absolute low level of yield in a way that looks sustainable. But will the current environment be sustainable for the medium term? I think from that point of view, it's too early to say that active trading is actually dead per se."

As the fund's third anniversary approaches later in the year, its track record offers proof that alpha can be generated consistently in a region not unfamiliar with economic shocks.

"Investors are not necessarily coming to see us because they like Africa's macro-economic outlook – they are coming to see us because they like our performance. They look at our returns and say, 'I want some of that'," Nkontchou says.

"We are a frontier fund, and it's still a nascent market. But what we are happy with is that we believe we have found a way to create alpha within this market on a constant basis by doing things differently." ◘

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