Investing in emerging markets

A monthly guide to investing in emerging market financial assets
February 2019

In policymakers we trust

Equities:
Strong start, but stay selective

Credit:
A solid start to the year

Currencies:
Global cues, local diversity

Focus:
Mexico vs Brazil: Diverging policy outlooks and investment implications

Economy:
China - Stimulus building amid weak economic data

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Important disclosure
Please note there may be changes to our house view and tactical asset allocation strategies prior to the next edition of Investing in Emerging Markets. For all updated views, please refer to the latest UBS House View.

* An employee of Cognizant Group. Cognizant staff provides support services to UBS.
After a roller-coaster December, 2019 started short on good news. The US government was rolling into its longest shutdown in its history, fears of a severe global economic slowdown were increasing, China’s data was failing to improve, commodity prices remained weak, and the market leadership of the technology sector had lost momentum.

And yet financial markets started to rally. Through the third week of January, the S&P 500 jumped more than 5% and the leading ETF for emerging market equities rose 8%. Within EM equities, Latin America surged 11%, EMEA 8%, and Asia 6%. The US dollar weakened marginally, allowing for a strong performance for EM currencies, as well as a solid 57bps decline in average hard-currency sovereign bond spreads.

Policy to draw the line between slowdown and recession
Among the important factors for the better tone of markets in January is investors’ belief, despite ample evidence of a deceleration in global growth, that policymakers stand ready to prevent the slowdown from reaching critical levels. Put in other words, January has been a display of optimism that policymakers will not make a grave mistake.

In the US, Federal Reserve Chair Jerome Powell has reemphasized that Fed decision-making will remain data-dependent, and the markets have moved to price in less than one rate hike this year even though the Fed “dot plot” still points to 2 hikes in 2019. In Europe, ECB President Mario Draghi has so far maintained plans to end quantitative easing this summer, though he has recently pointed out that the risk to the EU outlook is shifting to the downside, potentially opening the door for a more flexible calendar of stimulus withdrawal.

Meanwhile, though we expect trade negotiations between China and the US to be protracted and even volatile at times, both sides have shown intention to prevent further escalation—surely due in part to the realization that their sanctions against each other have already created some economic damage. Similarly, Chinese authorities have been stepping up their fiscal, monetary, and credit efforts to engineer a soft landing of their economy.

Investors therefore seem to have acted upon the belief that authorities in the world’s key economies will draw a line between a tolerable slowdown and a recession. Of course, this confidence can be shaken by a worse-than-expected decay in incoming data, or if policymakers negatively surprise the markets. Confidence can thus strengthen and weaken, giving rise to market volatility. But we believe that, while limited, policymakers still have the wherewithal to prevent the worst outcomes.

Against this backdrop, it is reasonable to expect a moderation of investment returns and an increase in underlying volatility relative to the last few years. The appropriate investment strategy for the late stage of the economic cycle is to hold a diversified portfolio, not just across equities and bonds, but also across geographies and the liquidity spectrum, i.e., hedge funds, real estate, private equity, and other investments that seek valuation dislocations and the assets best suited for this moment in the cycle.

A “Gold(ish)locks” environment could arise in 2019
If we are correct in our base case assumption that the world slows but skirts a recession, this could be good news for EM assets. First, most emerging economies saw a slowdown before developed economies did and are now stabilizing. And as we discuss in the Economy section, China is likely to see better prints in the second half of the year. So while global growth is slowing, the relative growth gap is likely to widen in favor of emerging markets. Second, the moderation of growth in the US, combined with a more dovish path of US interest rates, would likely lead to a stable to weaker USD, a factor that has historically supported EM assets. Finally, the majority of emerging economies have maintained prudent macro policies. Even some of the more risky outliers, such as Argentina and Turkey, have acted responsibly.

The ongoing turmoil in Venezuela is in fact society’s reaction to a failed economic model and holds the promise of change. It should be noted that the small size of the Venezuelan market means a significant impact on the region, let alone the world, is unlikely. Also, the country’s assets are too small a weight in bond and equity benchmarks, and they have long been regarded as highly speculative. However, were the crisis to deep-
en and extend, it could further erode the country’s ability to produce oil, and worsen the humanitarian consequences of Venezuelans’ migration to neighboring countries.

This month, our global asset allocation team took tactical profits in an overweight position in USD-denominated EM sovereign bonds, but maintained a medium-term recommendation to hold exposure to the asset class. Our global team also maintained an overweight in emerging market equities. Details of our intra EM allocation are spelled out in the Strategy section of this report.

Staying with the theme of Latin America, our Focus section discusses the real-time sociopolitical “experiment” taking place in Brazil and Mexico. The new and popular governments of Jair Bolsonaro in Brazil and Andres Manuel Lopez Obrador (AMLO) in Mexico were elected to solve similar social demands for an end to widespread corruption and crime. Yet the two governments are tackling these issues in diametrically opposite ways. Bolsonaro seeks a government that is lighter on the economy but powerful on the rule of law. AMLO, on the other hand, is trying to increase government influence on the economy and dismantle so-called “neoliberal reforms” of the past, but he has also said that violence is not solved with more violence, given that many are led to crime out of economic need and lack of opportunities. Dare to issue a forecast of who will be more successful?

As is customary, we also include our deeper dive into equities, bonds, and currencies, as well as changes to our credit model portfolio in this report.

We hope you find this monthly pleasant to read and useful to your investment objectives.

Sincerely,

Mark Haefele
Chief Investment Officer

Jorge Mariscal
Emerging Markets Chief Investment Officer
Global investment views

Asset allocation
After sharply repricing in December, risk assets have rebounded this year on the back of more dovish Fed rhetoric, the announcement of further China policy stimulus, and signs of progress on US-China trade talks. While the economic backdrop has weakened, the strong US labor market and China stimulus are among factors that should help support growth in the months ahead. We keep our overweight position in global equities, but reduce risk exposure by trimming our overweight position in emerging market (EM) sovereign debt. For investors who are able to, we recommend considering a protective hedge against a portion of equity exposure.

Equities
Equity markets have shown signs of a recovery after reaching a trough in late December. We remain constructive based on our expectation for a stabilization in economic data after last year’s deceleration in global growth momentum. Within our equity strategy, we keep our preference for EM equities over Swiss equities, based on attractive valuations, the expectation for Chinese stimulus measures to start feeding into the macro data, and potential further weakness in the dollar after the Fed’s shift in tone. Furthermore, we stick to our Canada overweight versus Australian equities. Valuations look attractive, in particular given the favorable earnings dynamics and our forecast for a rise in the oil price. Lastly, we add an overweight in Canadian equities over Swiss equities, also on valuations grounds.

Bonds
We reduced our overweight to EM sovereign bonds in USD (EMBIGD) against US government debt. The near-term risk-return outlook has diminished as spreads have tightened toward our target level, while leading indicators suggest EM growth momentum has softened. We continue to hold an overweight in longer-duration US Treasuries. If our assessment of the economic cycle is wrong and a recession begins sooner than expected, this position could provide even greater protection against equity risk.

Foreign exchange
In our FX strategy we add an overweight in the Norwegian krone against the Swiss franc given diverging economic momentum and central bank policies. We expect Norges Bank to continue to hike rates, while the Swiss National Bank should wait for the European Central Bank to eye a first hike. We are overweight the Canadian dollar against the Australian dollar. Higher oil prices and better economic growth should allow the Bank of Canada to hike rates. In Australia, numerous challenges including falling house prices and curtailed bank lending should keep rates on hold until 2020. We see longer-term appreciation potential in the yen.
Emerging market investment strategy

A tale of two parts

After a weak 2018, emerging market (EM) assets have returned with a bang. Four weeks into the new year, the major asset classes have delivered positive returns: equities almost 5%, US dollar bonds a solid 2.5%, and local-currency bonds 2%. One reason for this performance is the fading strength of the US dollar, which depreciated by 1% against a basket of emerging market currencies over the same period. Across asset classes, CEEMEA and Latin America performed decisively out of Asia.

Dedicated emerging market investors will remember that 2018 also started strongly, but things quickly turned for the worse amid an onrush of global and idiosyncratic headwinds. For now, we don’t expect history to repeat itself given a range of supportive factors: a less hawkish global monetary policy outlook; more stimulus out of China; easing US-Sino tensions; more appealing valuations following last year’s sell-off; a potential rebound in energy prices; and waning US dollar strength vis-à-vis better valuations of emerging market currencies. While these factors have fueled the current rally, they are not fully priced in just yet, in our view. We maintain an overweight allocation to emerging market assets in our global portfolios.

But this is no reason to rest easy. The medium- to longer-term outlook is clouded by external and domestic risks. Globally, economic growth is set to soften, funding conditions to tighten, and political uncertainty to remain in the headlines. For China, its tensions with the US over trade imbalance, intellectual property, and domestic market access, among others, are compounding the more local challenge of achieving sufficient growth while reducing debt in the economy and maintaining a stable currency. Meanwhile, other large economies are in the midst of a political transition (Mexico, Brazil) or will hold potentially transformative elections (Argentina, India, Indonesia, South Africa, Thailand, Turkey). This warrants a gradual shift toward a more cautious positioning, in our view.

There are also various risks to our near-term outlook for emerging market assets. First, the global business cycle could turn sour more quickly and forcefully than we expect. If this happens, growth assets like stocks would suffer most, but bonds and currencies would also be vulnerable despite their more benign valuations.

Second, we think the market expectations for the Federal Reserve are too dovish and will need to be repriced. This would happen as fears of a global recession subside, which would be a

Tactical asset allocation deviations from benchmark*

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<tr>
<th>Equities</th>
<th>Underweight</th>
<th>Neutral</th>
<th>Overweight</th>
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<td>EM equities total</td>
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<td>Bonds in USD</td>
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<td>EM sovereign bonds (USD)</td>
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<td>EM corporate bonds HY (USD)</td>
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<td>Local currency / money market</td>
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<td>EM currencies / money market</td>
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<td>EM government bonds</td>
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<td>EM inflation-linked bonds</td>
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</table>

Most Preferred
- China
- South Korea

Least Preferred
- Taiwan
- Malaysia
- Corporate bonds (index-level)
- Investment grade sovereigns
- Sovereign bonds (index-level)
- High yield sovereigns
- Asian corporate high yield
- GCC sovereign and quasisovereign bonds
- Select LatAm corporates
- RUB (₽)
- BRL-denominated government bonds (Г)

*Source: UBS, as of 24 January 2019. Green/Red arrows indicate new upgrades/downgrades. Grey up/down arrows indicate increase/reduction to existing positions.

* Please note that the bar charts show total portfolio preferences. Thus, it can be interpreted as the recommended deviation from the relevant portfolio benchmark for any given asset class and sub-asset class. These charts were formulated at the Emerging Markets Investment Committee. These preferences are designed for global investors. For models that are tailored to US investors, please see our flagship publication, UBS House View.
boost to emerging market assets. However, a spike in US inflation amid a weak or deteriorating global macro backdrop could add renewed pressure.

Third, markets are wary about the effectiveness of Chinese stimulus measures. So far, Beijing has done less than it did during previous downturns, and measures appear more targeted toward small and medium-sized businesses and the lower to middle income population. Moreover, the corporate tax cuts might have a limited multiplier effect as companies are likely to save rather than spend most of the tax cut in light of the economic slowdown and persistent uncertainties. This would then reduce the positive spillover to other emerging markets.

Finally, we have to monitor the implication of tighter global liquidity conditions on overly levered companies, for example in the US or China, or selected sovereigns, whether in developed or emerging markets.

Where we invest
The current environment requires investors in both emerging and developed markets to stay agile, selective, and disciplined. In our portfolios, we remain positioned for further upside in the near term, but we start to gradually take profit. Specifically:

- **Global asset allocation:** Following their substantial rally, we take some profit on our overweight in emerging market sovereigns bonds, which remain a significant part of our portfolios. We maintain an overweight to emerging market equities versus Swiss equities. While their upside potential is more limited after the recent rally, emerging market equity valuations and earnings growth prospects still look attractive.

- **EM equities:** We maintain our style preference for value sectors (financials, materials, energy, telecoms) over growth sectors (tech, consumer discretionary, staples) given their more attractive valuations, resilience to rising rates, and earnings trends. In our bottom-up selection, we like financial and energy firms with solid dividend yields in Russia. In South Africa, we prefer food to apparel retailers, and cheap growth stocks in the communication services and materials sectors to those in the insurance and telco sectors, which face slower growth. We are avoiding Turkey due to earnings risks and Poland because of its expensive valuation. In Brazil, we favor a balanced selection of high-quality domestic cyclical names (financials, consumer discretionary, industrials) that should benefit from a pickup in economic growth, as well as some cheap domestic defensives (consumer staples, healthcare, telecom) that offer about 5% dividend yield.

- **EM FX and rates:** Given that a number of emerging market central banks hiked their policy rates in recent months, inflationary pressure remains contained, and the Fed is coming closer to signaling that US interest rates have reached a neutral level, we see opportunities in higher-yielding currencies like the Russian ruble (against EUR and USD) and local-currency Brazilian government bonds. Russia’s prudent monetary policy and solid current account surplus support the ruble’s outlook and should cushion it against potential external pressures, while we expect growth to accelerate in Brazil and President Jair Bolsonaro’s social security reform efforts to bear fruit.
Focus

Mexico vs Brazil: Diverging policy outlooks and investment implications

In the last edition of this publication in 2018, we featured a piece titled “Mexico vs. Brazil: Stock vs. Flow,” distinguishing the noticeable differences between the two countries’ economic starting points (the “stock”) and the likely policy paths they will take moving forward (the “flow”). A few weeks hence, with greater clarity on the policy paths newly installed Presidents Jair Bolsonaro and Andres Manuel Lopez Obrador (AMLO) intend to pursue, we describe our baseline scenario across key “flow” areas for both countries and conclude that investors will find more rewarding opportunities in Brazil than in Mexico in 2019.

The table below summarizes our baseline scenario across a number of important policy areas. We assess the risks to this central scenario to be roughly balanced for Brazil, but still tilted to the downside for Mexico.

Brazilian assets have undeniably moved to price the country’s more promising outlook in recent weeks. We nonetheless think there is further upside potential in select assets should our baseline scenario materialize. On fixed income, we have moved Brazil’s USD bonds to neutral from overweight in our emerging market credit portfolio as sovereign spreads are trading near their highest level relative to high yield peers in four years. We are, however, keeping our view that attractive opportunities in the quasi-sovereign space still exist. Select BRL-denominated bonds also look attractive. While domestic government bond yields have declined in recent months, those of medium-term maturities still look decent to us. When it comes to equities, we remain positive for the medium term on the back of a still reasonable valuation multiple of 12.6x P/E. We prefer a balanced selection of high-quality domestic cyclical names (financials, consumer discretionary, industrials) as well as some cheap domestic defensively (consumer staples, healthcare, telecom). We avoid the heavyweights of the commodity complex (energy and materials), which has been the best-performing sector this year.

On the other hand, we remain cautious on Mexican assets and continue to recommend that investors take advantage of periods of strength, such as the one experienced year-to-date, as opportunities to reduce positions across assets. We hold a short-term recommendation to short the Mexican peso versus the US dollar.

### Baseline scenario across key areas

<table>
<thead>
<tr>
<th>CIO assessment</th>
<th>Mexico</th>
<th>Brazil</th>
</tr>
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<tbody>
<tr>
<td><strong>Fiscal policy</strong></td>
<td>Gradual worsening of fiscal dynamics. AMLO’s cornerstone policy initiatives imply sizable spending increases, while his fiscal savings proposals will be much harder to realize. Despite Congress’s approval of a conservative budget last December, investors should brace for fiscal disappointments. These will likely only come gradually, as incoming administrations have historically found it difficult to execute budgets during their first year in office – something that should be particularly true for the current administration given the ongoing talent exodus from the public sector.</td>
<td>Economy Minister Paulo Guedes pledged to balance the budget in his first year in office, with the help of proceeds from privatizations. He described social security reform as the top government priority. Also, the fiscal plan contemplates using cash refunds from the National Development Bank (BNDES) and cutting the number of ministries to 20 from 37. Guedes also expects to save BRL 10bn by clamping down on illegal claims on social security benefits. A tax reform is also on the agenda with the aim of increasing efficiency in the tax system and raising government revenues.</td>
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<tr>
<td><strong>Monetary policy</strong></td>
<td>Banxico should remain largely independent and its current president in place. Further policy rate hikes are expected to take place in the next six months, followed by a pause at high rate levels. Tighter monetary policy will likely be pursued in response to the expected easier fiscal stance.</td>
<td>The BCB is expected to keep the policy rate accommodative in the coming months. As the economy gets traction, the central bank may need to hike rates by the end of the year, but the visibility on the exact timing is low. One of the government’s short-term priorities is to approve a reform that would give the BCB formal independence.</td>
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<tr>
<td><strong>Ease of doing business</strong></td>
<td>Worsening. Increased regulation and public sector involvement. Mining, banking, and energy particularly vulnerable to experiencing a less favorable regulatory environment.</td>
<td>Improving. The government has the explicit goal of simplifying the tax system, reducing the tax burden, opening the economy to international trade, and cutting red tape overall.</td>
</tr>
<tr>
<td><strong>Governing team</strong></td>
<td>By and large, AMLO’s cabinet members are well prepared and feature rich academic backgrounds. Many, however, lack public sector experience. Most important, AMLO is showing evidence of concentrating power into his own hands and failing to pursue expert advice before making important policy decisions.</td>
<td>The governing team is composed of three main groups: the economic team, which is very high in technical expertise with a Chicago School profile; the military, mostly focused on infrastructure; and the political coordinators, who were chosen based on their background and their leadership ability in Congress. There were no bargains with political parties for government posts.</td>
</tr>
<tr>
<td><strong>Privatization outlook</strong></td>
<td>AMLO’s government intends to pursue a stronger participation of the state in the economy. We expect little to no privatization action.</td>
<td>Privatization run at the core of Bolsonaro’s economic agenda. The Investment Partnership Program has been enhanced by the new government. Privatizations in railways, airports, ports, communications, and lottery are expected.</td>
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<tr>
<td><strong>SOE outlook</strong></td>
<td>Worsening. Government interference in state-owned enterprises (SOEs) increases and corporate governance weakens. Quasi-sovereigns are run by political appointees and employed as instruments of policy with limited focus on profitability. Energy-reform-related contracts signed to-date likely to remain, but further implementation unlikely.</td>
<td>A professional team has been chosen to lead SOEs. Political interference is to be avoided even in government-owned banks. Petrobras and Eletrobras have the mandate to sell every non-core business. BNDES is expected to shrink, and Banco do Brasil and Caixa will not be used as active instruments of public policy.</td>
</tr>
<tr>
<td><strong>Quality of institutions</strong></td>
<td>Worsening. Possible constitutional changes and abuse of “public consultation” tool.</td>
<td>Improving. Judge Sergio Moro, largely responsible for the Lava Jato investigations, became Justice Minister and has plans to improve the rule of law, reduce corruption, and fight organized crime.</td>
</tr>
<tr>
<td><strong>Credit ratings</strong></td>
<td>Worsening. Likely downgrades. Sovereign IG rating maintained in the next 12 to 18 months. SOEs should experience credit rating downgrades, but we expect them to remain IG-rated over the same period.</td>
<td>Improving. Upgrades likely in 2020 after final approval of the social security reform, opening the path for Brazil to possibly regain IG rating in the next two years.</td>
</tr>
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</table>

Source: UBS, as of 25 January 2019.
Economy
China - Stimulus building amid weak economic data

2018 challenged China with the effects of deleveraging efforts, a cyclical slowdown, and intensifying tensions in the relationship with the United States. This year started with a slew of weak data releases, which reverberated globally given China’s importance for the world economy. Against difficult conditions, policymakers are increasingly ramping up stimulus measures which should stabilize the Chinese economy, and thereby underpin global investor sentiment.

Worries around the world’s growth outlook and wobbly market conditions greeted the new year. Chinese data releases for December did little to brighten the mood: Manufacturing PMIs came in below 50, the level that marks the transition from expansion to contraction; and trade data surprised expectations significantly to the downside for both imports and export. 1Q19 trade data could be particularly weak due to front-loading before the threatened (and in the end adjourned) tariff increase by the US, and a strong base for comparison. The weakness in trade is reflected in other economies of the region as well, and with incomes in Asia being highly sensitive to export growth and being used as a funding source for machinery and equipment, corporate investment should hit a soft patch as well.

While still remaining weak, Chinese December economic activity data like retail sales, industrial production, infrastructure investment and credit growth showed some signs of stabilization. In the coming months, the impact of earlier stimulus measures should further filter through the data, and policymakers at the Central Economic Work Conference (CEWC) in December pledged further policy easing and economic reforms in 2019 to counter the cyclical and structural headwinds. Monetary policy will be more accommodative to maintain ample liquidity, as evidenced by the latest reserve requirement ratio cut by the central bank and targeted medium-term lending facility easing. Fiscal policy will remain proactive with larger-scale tax cuts, as well as greater infrastructure investment support via an increased issuance of local government bonds. In a sign of accommodation to the US, Beijing also vowed broader market access for foreign companies, stronger intellectual property right protection, and fair competition between state-owned enterprises and private/foreign ones.

The clearer easing signals from the CEWC for 2019 should provide a policy put to cushion the economic slowdown, in our view; accordingly we expect stimulus measures to counterbalance the trade slowdown, and allow the economy to stabilize and growth to trend sideways in 2019.

To be sure, this rests on the assumption that we don’t see a renewed flare up in trade tensions and increase in tariffs. Negotiations between the US and China are ongoing, and some progress and positive messaging from both sides on the one hand, but still unresolved topics around intellectual property protection and market access on the other, argue for a continuation of talks in our view. The potential tariff increase on 1 March may therefore be postponed again. Should trade negotiations take a bad turn, the Chinese growth outlook would worsen considerably and likely trigger even more policy easing. On the flipside, should China and the US come to an agreement that includes the reduction of already implemented tariffs and China shows willingness to compromise on the outstanding issues, business and investor sentiment could receive a boost and trigger further upside for global risk assets.
Equities

Strong start, but stay selective

Following a strong start to the year due to dollar weakness, a pause in US Federal Reserve tightening and the easing of US-China trade tensions, market volatility is likely to remain high. The December PMI was disappointing, but China’s further fiscal and monetary easing should enable emerging market (EM) economic growth to stabilize. Valuations (11.3x 12 months-forward P/E) and earnings growth (7%) look attractive and should provide support. However in the near term we prefer to stay selective.

Volatility will remain

The MSCI EM Index has returned close 7% since the start of the year, mostly driven by P/E rerating and EM FX appreciation. This rally could turn tactical. A credible resolution to the US-China trade conflict is needed to underpin global growth and EM earnings momentum. Some EM countries are also vulnerable to idiosyncratic events, such as land reform and national elections in South Africa (expected in May), potential new sanctions against Russia, slower European economic growth and political instability that affects Poland and other CEE countries, and a deeper-than-expected recession and potential policy missteps ahead of the municipal elections in Turkey (March).

Prefer value over growth

We maintain our style preference for value sectors (financials, materials, energy, telecoms) over growth ones (tech, consumer discretionary and staples) in EM equities this year, given their more attractive valuations, resilience to rising rates and earnings trends.

Country and sectors positioning

Within our country strategy, we remain positive on China and South Korea as trade tensions seem priced into their shares. We stay negative on Taiwan and Malaysia. We are neutral on Thailand, Indonesia and the Philippines. We remain cautious on EMEA and Latin America due to earnings and political risks. In Brazil, we favor a balanced selection of high-quality domestic cyclical names (financials, consumer discretionary, industrials) that should benefit from a pickup in economic growth, as well as some cheap domestic defensives (consumer staples, healthcare, telecom) that offer about 5% dividend yield.

Corinne de Boursyty, CFA
USD bonds strategy
A solid start to the year

Emerging market (EM) bond spreads have tightened by 57 basis points for sovereigns and 29bps for corporates this year. Despite higher US interest rates, year-to-date returns are up 3.7% and 1.6%, respectively. The asset class benefited from a dovish shift in language by the US Federal Reserve, progress in US-China trade talks, expectations for more Chinese stimulus, rising energy prices, and light investor positioning after the slump in late 2018.

Not surprisingly, high yield names outperformed investment grade bonds. The best performers include high yield names such as Venezuela, Argentina, Ecuador, Ivory Coast, Ukraine, and Nigeria. On the other hand, markets that underperformed include Lebanon following news of a potential bond restructuring, Romania due to deteriorating fiscal dynamics, Turkey due to renewed geopolitical tensions, and Oman following its downgrade to junk.

Our outlook is more positive for the near term than for the medium to long term. Supportive factors include a less hawkish global monetary policy outlook, more stimulus out of China, easing US-Sino tensions, more appealing EM credit valuations after the 4Q18 sell-off, seasonally positive cash flows for EM bonds, and further upside in the oil price.

For our positioning, this means that we maintain an overweight allocation to high yield issuers, but highlight once again that selectivity and agility are key.

We acknowledge various risks to our relatively benign outlook. First, the global business cycle could turn sour more quickly and forcefully than we expect, pushing EM bond spreads higher, especially in the high yield segment.

Second, current market expectations for the Fed are too dovish and will eventually require a repricing, in our view. Our base case is that this will happen amid easing global recession fears which should bode well for EM bonds. But a spike in US inflation amid weak or deteriorating macro data could result in significant pressure on bond spreads.

Third, the positioning of crossover investors is still heavy, particularly in Latin America. This could become a risk if these investors start to reduce exposure to lower-rated investment grade names, or if companies lose investment grade status.

Last, markets are wary of the effectiveness of Chinese stimulus measures. So far, authorities have done less than they did during previous downturns, and the measures appear more targeted toward domestic consumption. This reduces the spillover potential to other emerging markets.
The return of a little vigor to global markets has aided EM currencies in recent weeks. Yet, while long-term valuations remain favorable, fundamental conditions don’t point to a broad-based improvement in the outlook for them. With EM currencies susceptible to tighter global liquidity, growth and trade worries, and related investor sentiment, we expect only low positive total returns over a six-month horizon.

From worries to relief, but risks linger
Emerging market (EM) currencies gained more than 1.5% year-to-date in total return terms: More dovish communication from the Federal Reserve, moderating global growth worries and positive messages about US-China negotiations have boosted risks assets, including EM currencies. The asset class has recouped the losses of last summer, yet long-term valuations remain favorable. So a continuation of the currently benign global factors could lend further support.

But risks remain and limit the sustainability of the rally, in our view. The Fed’s interest rate path seems too dovishly priced, we think, and the US-China spat may see a resurgence of tensions. Also, economic data releases, specifically in China, have been weaker recently, keeping concerns about the outlook for the global economy in focus.

EM monetary policy: Few additional hikes expected, look for carry
Many EM central banks hiked their policy rates over in recent months, also given that currency weakness posed risks to the inflation outlook. With growth moderating in some EMs, and output gaps still persisting in others, local inflationary pressure should remain contained though. Somewhat lower oil prices compared to last year’s average should also provide some temporary relief for headline inflation. Accordingly, we expect EM central banks, on aggregate, to pause for the time being and abstain from further rate hikes.

That being said, current policy rate and money market levels are elevated, and with the Fed coming closer to and end of the hiking cycle, conditions for collecting carry have also improved, in our view. We see opportunities in selected higher-yielding currencies like the Russian ruble and BRL-denominated government bonds.

Further opportunities in EM FX
The effectiveness of Chinese stimulus will be important to monitor, and how Asian export-oriented economies cope with the cyclical slowdown. We advise overweighting the US dollar against a basket of North Asian currencies, consisting of the Chinese yuan, Taiwan dollar and Korean won.

EM politics will play its role, with elections scheduled in Turkey, Indonesia, India and South Africa in 1H19, and newly inaugurated administrations in Brazil and Mexico going to work. We think the Mexican peso, after having strengthened significantly, doesn’t reflect the risk of more populist policies being adopted in Mexico, and underweight it against the US dollar.

Finally, we are closing our overweight in the Czech koruna (CZK) against the euro (EUR). Soft data from the Eurozone and the Czech Republic reduces the likelihood of further Czech policy rate hikes in the near-term, we think, making the risk-reward profile of the position less appealing.
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Regional investment themes
Long term investments (LTIs)
Thematic investments with a 5yr+ investment horizon
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Appendix

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