Investing in emerging markets

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

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Chief Investment Office GWM
Investment Research

On a balancing act

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UBS

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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*.

Editorial

On a balancing act

Mark Haefele
Global Chief
Investment Officer

Jorge Mariscal
Head of
EM Investment Office

Welcome to the April edition of our monthly *Investing in Emerging Markets*. Despite good absolute returns in the first quarter of the year, emerging market equities underperformed US and global counterparts. Developing economies continue to tread a fine line that requires a balancing act where, on one hand, the prospects of extended central bank liquidity provide tailwinds, and on the other the specter of a global recession weighs on investors' minds.

In addition, elections in India, Turkey, South Africa, Thailand, and Argentina, among others, as well as a contentious social security reform approval process in Brazil are providing some homegrown uncertainty. We discuss the latest political developments in detail in the **Electoral Monitor** section of this report.

While maintaining a pro-risk stance, our Global Investment Committee partially took down equity risk in global portfolios this month to account for the solid performance of global equity markets year-to-date, and a more symmetric balance of upside versus downside risks. A continuation of the strong first-quarter performance of global equities may have to wait for a clearer picture on global economic growth and its impact on policy.

We still recommend an overweight allocation in equities, however, as well as an overweight position in dollar-denominated emerging market sovereign bonds. This is predicated on our base-case assumption that the US and European economies may continue to cool off in 2019 but avoid a recession. This puts the Federal Reserve at, or close to, the end of its hiking cycle; the European Central Bank has already conveyed to the markets the prolongation of its stimulus programs.

With a low-for-longer environment in global bond yields, and a more constructive attitude on trade by the US and China, global growth will be a key focus of the markets. For emerging markets to perform on a more sustainable basis—and for the world to be on a better economic footing—the dynamics in China need to work in their favor. The latest data releases there point to a lower rate of deceleration, but they have failed to convincingly demonstrate a bottom of the cycle. We believe that policy lags and a gradual approach to stimulus are reasons for the delayed stabilization in the data, but we keep a high level of conviction that a soft landing will materialize in the second half of 2019. Chinese equities, one of the best-performing equity markets this year, have only partially discounted these expectations. Within emerging markets we maintain an overweight in Chinese equities, and explore this theme in more detail in the **Equities** section of this report.

Latin America is one region where economic indicators have been more positive. However, the aggregates mask two realities: optimism about Brazil and concerns about Mexico. In our **Focus** section this month we dive deep into the first 100 days of the presidency of Andrés Manuel López Obrador; the balance of his term, we regret to say, should be far from reassuring to the markets.

In our **Economy** section, we focus on Turkey's weak economic performance, as well as on the broader political dynamics in the region comprising Central and Eastern Europe, the Middle East,and Africa. As is customary, our **Investment Strategy** section provides our portfolio positioning views, while our **Equities, Currency,** and **Credit** sections highlight specific trade recommendations.

As always, we hope you find this reading enjoyable and productive for your investment objectives.

Mark Haefele
Chief Investment Officer

Jorge Mariscal
Emerging Markets Chief Investment Officer

Global investment views

Asset allocation
The dovish shift in the Fed's and ECB's policy outlook since the beginning of the year has fueled a considerable rally in global equity markets. Meanwhile, economic data has remained mixed recently and we are still waiting for confirmation that global economic growth is stabilizing. While this remains our base case, we note that a lot of the positive factors have been fully priced into the market, and near-term risks to company earnings as well as geopolitical threats persist. In the US TAA, we have closed our overweight in emerging market (EM) equities. Our overall allocation remains mildly "risk-on" with an overweight to US All-cap equities and an overweight in emerging market sovereign bonds. We are still holding long duration US Treasuries to hedge against possible downside risk scenarios.

Bonds
We continue to hold an overweight to US long-duration Treasuries, which should help protect the portfolio against unanticipated equity market weakness. We also maintain our overweight to emerging market dollar-denominated sovereign bonds as they continue to have strong credit fundamentals and attractive yields. The rally in credit spreads so far this year has left much of the market at fair or slightly expensive levels, and we don't see further attractive risk-return opportunities at this time.

Equities
Our base case calls for stabilization of economic growth near trend, marginally tighter monetary policy, and no further trade conflict escalation. Against this backdrop, we took down portfolio risk by closing our overweight to emerging market (EM) equities. We remain overweight US all-cap equities, with a size and style agnostic view. In our global all-equity portfolio, we closed our overweight to Canadian vs. Australian equities. Canadian economic growth came almost to a standstill in 4Q18 and the relative case vs. Australia has faded. We maintain our underweight to Swiss equities, which are among the world's most expensive, and see better value in Canadian stocks given their more cyclical exposure and cheaper valuations.

Foreign exchange
Within our FX strategy, we are closing the overweight in the Canadian dollar against the Australian dollar and taking profits, as the case for economic divergence between the countries has diminished. In particular, recent downside surprises in Canadian growth data forced the central bank to adopt a more cautious stance. We are still overweight the Norwegian krone against the Swiss franc on the back of diverging economic momentum and central bank policies. We expect Norway to buck the recent global trend of monetary policy and continue to hike rates. Meanwhile, the Swiss National Bank should wait for the ECB to hike first, which is very unlikely to happen before 1Q20.

Emerging market investment strategy

Michael Bolliger
Head of EM Asset Allocation

Cloudy with a chance of sunshine

I tend to have some of my best skiing days when the weather is cloudy with a chance of sunshine. These days, a bright sky is a matter of luck, though I often get fresh snow and uncrowded slopes. The flipside is that visibility tends to be poor, which requires careful planning. On such days, I prefer to ski on lower altitudes where trees and bushes provide contours, and also I make a fallback plan in case the weather deteriorates. Looking at our emerging market investment strategy, I see many similarities to my skiing adventures.

It doesn't always pay off to wait for clear skies

Investors brave enough to stick to their emerging market exposure during the stormy last days of 2018 got rewarded for their tenacity. Performance has been surprisingly strong so far in 2019. The search for interest rate carry has resulted in a 5.5% return on a USD-denominated portfolio of emerging market sovereign and corporate bonds. Stocks are up 9%, driven mainly by heavyweights China (up 15%), Russia (up 15%), and Brazil (up 8%). And local bond markets benefited from stronger currencies in addition to an attractive interest rate carry.

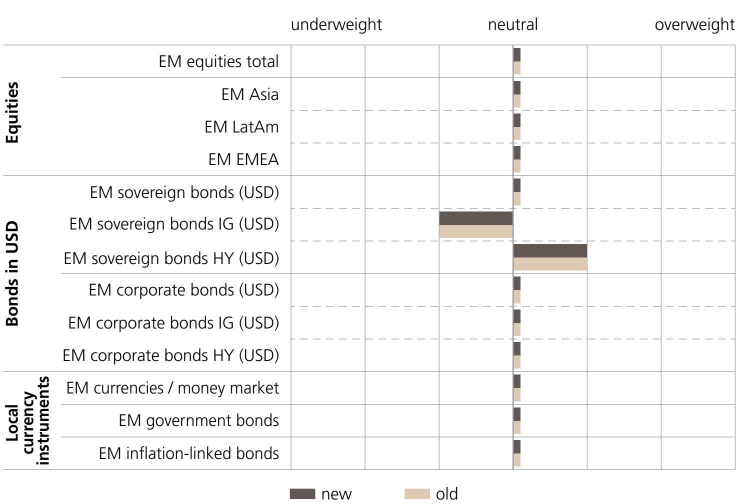
Interestingly, this impressive recovery occurred amid poor visibility. For this rally to continue, economic fundamentals and growth dynamics must improve.

Watch critical developments carefully

Global growth will depend a lot on Chinese policy decisions. This is especially true for Europe, Asia, and the rest of the emerging markets that rely heavily on Chinese demand. Recent data, although distorted by the calendar effect of the Chinese New Year, continued to soften and surprised on the downside. Some green shoots exist, but it seems stimulus measures have not yet fully found their way into the economy.

The recently concluded National People's Congress provided important insights into China's likely policy stance in 2019. Premier Li Keqiang reiterated that the country will not resort to the "flood-like" stimulus measures seen in the past. Instead, policymakers will use a measured and targeted approach to address downward pressures on the economy while stabilizing debt levels and keeping the rise in total social financing in line with GDP growth.

Tactical asset allocation deviations from benchmark*



Most Preferred	Least Preferred
• China	• Malaysia
• High yield sovereigns • Asian corporate high yield • GCC sovereign and quasisovereign bonds • Select LatAm corporates	• Investment grade sovereigns

EM FX Views	
	• Long BRL vs. short MXN • Long NOK vs. short CZK**

**Short-term recommendation (1–2 months)

Source: UBS, as of 21 March 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*.

Emerging market investment strategy

This means the Chinese economy will expand less this year, and which may affect other emerging countries given limited prospects of spillover effects from Beijing's stimulus measures. But Li also confirmed the government's commitment to achieve GDP growth around 6–6.5%. We therefore think stimulus taps will remain open and be enough to stabilize the economic slowdown.

If the macro picture does stabilize or even brightens up a bit, additional support for emerging market assets seems plausible, especially for the more growth-sensitive asset classes like equities and currencies, and in the most open economies such as North Asia and Eastern Europe.

Lingering risks demand a fallback plan
Yet, uncertainties are high and several risks need watching closely. Global growth momentum has been slowing across regions. Trade talks between the US and China are progressing, but a full resolution that includes the protection of intellectual property rights and market access for US companies is still some way off. Moreover, US tariffs on European cars are a low-probability, high-impact event that would hit the small, open economies of Central and Eastern Europe particularly hard, besides its impact on market sentiment which would hurt all emerging market assets.

Improving liquidity conditions have been a major driver of the current market rally and may continue to support markets going forward, especially as US Federal Reserve reaffirmed a more dovish stance in its last policy meeting. While we don't expect further US interest rate hikes this year, we still need to keep an eye out on US inflation. Any repricing of Fed policy expectations may hurt emerging market currencies and bonds the most, especially where the rally has run too far too fast.

And let's not forget the volatility likely to arise with a busy political calendar, with elections in Turkey, Ukraine, South Africa, Argentina, and India, and new governments in place in Brazil and Mexico.

Where we invest: Stay at lower altitudes
We keep an overweight allocation in emerging market equities in our global portfolios. Current valuations are only slightly above their long-term average, and we expect decent earnings growth in the high single-digits to support the market.

Asia remains the most interesting area for emerging market equity investors. We maintain a constructive view on local stock markets but combine it with a collar strategy, i.e., we use options to give up some of the upside but gain protection on the downside. Within this region, we maintain an overweight allocation to China, funded with an underweight to Hong Kong.

We maintain our style preference for value sectors (financials, materials, energy, telecoms) over their growth peers (technology, consumer), given their more attractive valuations and earnings trends.

Easing global liquidity conditions have triggered a revival of investment strategies seeking interest rate carry. We only partly share the euphoria in emerging market fixed income, noting that more USD-denominated bonds start to look expensive. Although most of the bonds are underpinned by sound fundamentals, we think current valuations can only be justified if the global economy avoids a recession and growth recovers.

Still, we retain our overweight on sovereign credit due to strong technical factors and a still-supportive backdrop in our global strategies, but with a reduced beta exposure. Among high yield markets, we still like Argentina, Turkey, Oman, and a selection of African sovereigns. That said, the bottom-up selection is crucial.

Having a fallback plan also means that investors should take profit in a timely manner. This month, we closed our long position in the Russian ruble following its significant appreciation against the US dollar. Fundamentals remain supportive of the ruble, but we prefer to wait for better entry levels.

The Brazilian real is also interesting and offers exposure to domestic reform. However, we prefer to be long the real versus the Mexican peso due to a more favorable risk-reward, in our view.

Finally, we remain long the Norwegian krone versus the Czech koruna over a short-term horizon. The krone should benefit from rising oil prices and tighter policy conditions in Norway, whereas the koruna is among the assets most strongly exposed to the risks of US auto tariffs and weaker manufacturing activity in Europe.

Focus

Mexico: Taking stock of AMLO's first 100 days

Although it may seem like Andrés Manuel López Obrador (AMLO) took office a long time ago, his presidency has barely crossed the 100-day mark. In this piece we present the key takeaways of his presidency so far and focus on what to expect for the rest of the year.

Gabriela Soni, CFA
Strategist

Alejo Czerwonko, Ph.D.
Strategist

By now Mexico watchers have had the opportunity to digest the drastic change in policy path Mexico has experienced since AMLO's electoral victory last July. Quite interestingly, a large gap in perception has developed between investors and the local population regarding the outlook for the country. While the former remain by-and-large cautious, the lion's share of the locals envision a more promising scenario.

To gauge the optimism of the Mexican voter, one should look no further than to consumer confidence and presidential approval ratings, both of which stand at historical highs (see Fig. 1). We note, however, that this positivity hasn't so far translated into spending, as reflected by so-far uninspiring company earnings results. We are actually projecting a relatively poor 1Q GDP reading on the back of a variety of factors, including a prolonged period of fuel shortages, the blockage of freight railroads, and labor strikes in the state of Tamaulipas.

Investors are far less impressed. Over the last few months, members of AMLO's coalition introduced several controversial proposals to Congress that shook up the markets. The recommendations included imposing new rules in the mining sector and modifying Article 35 of the Constitution to grant more freedom to hold referendums. Crucially, increased concerns about Pemex's financial health on the back of poor energy sector policies have led to negative credit rating pressure on Mexico. It is highly likely that the government will be forced to take additional measures to rescue Pemex, which would undermine fiscal policy credibility. Last week's announcement that the government will draw USD 7bn from the country's rainy-day fund to support the company constitutes a one-off move and fails to address the key structural issue, i.e., the poor overall strategic direction of the energy sector. Pemex's oil output has undergone a 14-year decline, and underinvestment in exploration and production will translate into further deterioration.

Overall, we think the softening investor sentiment is justified and envision a gradual but steady worsening of macro policies, accompanied by a more challenging micro and regulatory environment, all of which will over time weigh on the country's growth and inflation outlook. Potential negative headlines around the US–Mexico–Canada Agreement (USMCA) ratification cannot be ruled out either as the US presidential race picks up speed.

We therefore remain cautious on Mexican assets. We recommend buying the Brazilian real against the Mexican peso as political dynamics point to a divergence in their respective performance, and expect economic momentum to favor the real later in the year.

Although we are neutral on Mexican equities, we see downside risk to the high-double-digit consensus earnings growth expectation. We prefer stocks with non-Mexican exposure and dollarized revenues. We also favor yield-paying companies (industrial FIBRAs) and consumer companies.

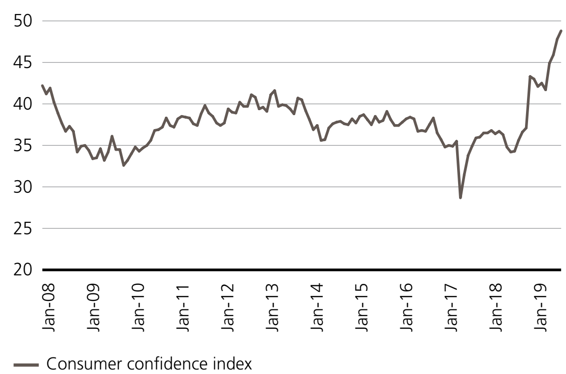
Finally, in emerging market credit we maintain an overall neutral stance on Mexico.

The main risk to our cautious view call is a "risk on" episode, which would strengthen the peso and increase investor appetite for cheap Mexican equities. Another risk is AMLO being more pragmatic and fiscally responsible than we anticipate.

Figure 1

Consumer confidence at record high

Consumer confidence index



Source: INEGI, UBS, as of March 2019.

Economy

Turkey and South Africa: Economies and politics revisited

The upcoming elections in Turkey (31 March) and South Africa (8 May) may trigger further market moves, but investors should remain focused on the economic fundamentals. Ultimately, election outcomes reduce uncertainty and allow investors to concentrate on policy measures and their implementation. Turkey's local elections will gauge the support for the ruling AK Party following the difficulties the economy has experienced since autumn. In South Africa, reform implementation is closely linked to voter support for the African National Congress (ANC) and its reform-oriented leadership.

Tilmann Kolb
Analyst

Jonas David, CFA
Analyst

Turkey: Local elections with economy in recession
Following last June's general election, the Turkish economy faced significant headwinds, including high inflation, a strong economic slowdown, and rising unemployment. Accordingly, the voting for mayors and councillors will serve as an important measure of support for the AK Party of President Recep Tayyip Erdogan. In the last local balloting in 2014, some 43% of voters supported the party. Whether it can meet or exceed this threshold, particularly in the larger cities, will be worth watching.

For investors, the period after the election will be very important. With no new elections until 2023, Turkish policymakers have an opportunity to focus on implementing economic measures and reforms to reduce vulnerabilities. Although they have made progress in stabilizing markets in recent months, we think the risks of renewed setbacks linger.

South Africa: General election amid soft growth and structural obstacles
South Africans will elect the National Assembly, which will later decide on the country's president. The ruling ANC party looks likely to retain a majority, and incumbent President Cyril Ramaphosa appears set to stay in office. But the magnitude of victory will determine the support for the president's reform plans as well as his ability to unite different party factions.

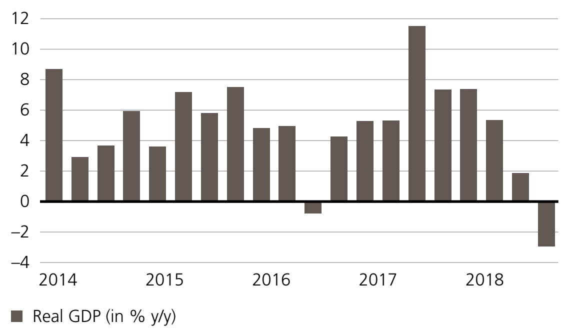
Infrequent polling shows the ANC retaining an absolute majority. Our base case assumes the ANC garnering majority support, but Ramaphosa' s standing would be harmed if the ANC's share of the final votes fell well below the 62% it achieved in the last general election, as this could limit the room for reform implementation.

The main opposition parties—the Democratic Alliance and Economic Freedom Fighters—are polling around 10–20%. Apart from the uncertainty in the political outlook, the focus on ANC unity may delay reforms ahead of and in the wake of the election, and populist headlines may trigger market volatility. In this context, the reaction of rating agencies, especially Moody's, is important. Moody's still assigns an investment grade rating to local South African debt, and a downgrade remains a risk. A policy focus on tackling structural challenges, fighting corruption, and boosting job creation would support South African assets, but we await more tangible progress before considering whether to take a more optimistic stance.

Figure 1

Strong economic slowdown in Turkey

Turkey's real GDP growth (in %, y/y)

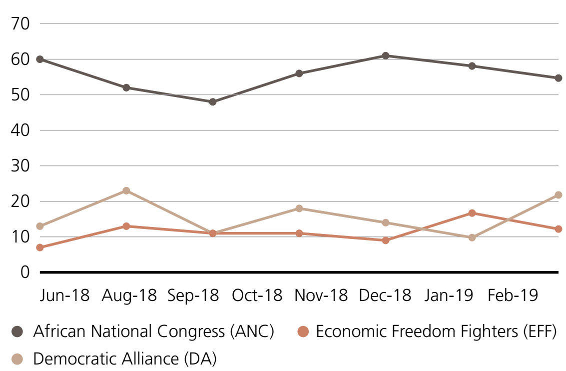


Source: Reuters, UBS, as of 18 March 2019.

Figure 2

ANC has a significant lead

Voting intentions for different parties in South Africa's general election (in %, based on opinion polls)



Source: Wikipedia (based on collection of various third-party opinion polls), UBS, as of 18 March 2019.

Equities

Earnings growth provides support in the longer term

Emerging market equities have done well in the last month, supported by a stable US dollar, progress in US-China trade talks, more accommodative Chinese policy, and expectations of a rebound in China's economy in 2Q19. Year-to-date, the MSCI Emerging Markets Index is up more than 10%, but the rally may slow from here as idiosyncratic risks are rising in India, Brazil, Mexico, South Africa, and Russia. This month we therefore reduce the size of our equity overweight in global portfolios by closing our overweight to emerging market equities. At 11.9x 12-month-forward P/E, valuations are more attractive than the developed market benchmark's 15.5x P/E, offering a 23% discount, yet we remain cautious in the near term as the emerging market valuations are at a small premium to their own 10-year average. We expect decent earnings growth of 7–8% for 2019, however, which should provide support in the longer term especially if the US-China trade conflict is resolved credibly and the Chinese economy recovers.

Jorge Mariscal
Head of
EM Investment Office

Xingchen Yu
Strategist

Beware the political noise

South Africa remains vulnerable to the outcome of the national elections, expected in May (see Economy section). Other risks include potential new sanctions against Russia; slower economic growth and political instability in the Eurozone, affecting Central and Eastern Europe; and potential policy missteps ahead of the municipal elections in Turkey. In Brazil, we expect the social security reform to be approved, promising close to BRL 700bn in savings for the next 10 years. For Mexico, S&P lowered its rating outlook on the sovereign bonds to negative, concerned about the new government's energy policy and a slowdown in GDP growth.

Prefer value over growth

Since January, value stocks have underperformed growth by close to 1%. We attribute this to a short-term technical rally in the tech and consumer sectors, helped by expectations of a US-China trade truce, lower interest rate expectations, and a rotation out of energy. Within emerging market equities, we maintain our style preference for major value sectors (financials, materials, energy) over their growth peers (tech, consumer) given the fundamental drivers, attractive valuations, better earnings growth, and higher oil and commodity prices.

Country and sector positioning

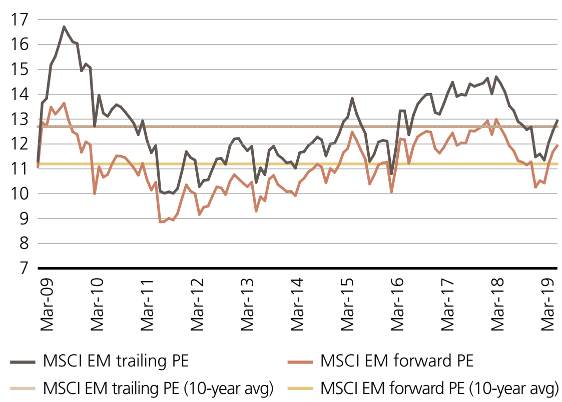
Within our country strategy, we remain positive on China given better policy support, progress on trade talks, and more sources of financing. That said, we recommend locking in some profit on onshore equities as we think valuations are ahead of fundamentals. We remain negative on Malaysia given its negative earnings momentum. We remain cautiously neutral on Latin America and CEEMEA due to earnings and political risks, and we prefer a selective exposure.

Within Asia, we still like internet, financial, and consumer discretionary names coupled with some high-dividend-yield stocks. In Brazil, we favor high-quality domestic cyclical names (financials, consumer discretionary, industrials) that should benefit from a pickup in economic growth, and cheap domestic defensives that offer about 5% dividend yield. In Mexico, we prefer defensive names with non-Mexican exposure to protect against foreign-exchange volatility, slowing domestic growth, and higher political risk (consumer staples, utilities, and materials). We also favor interest-rate-sensitive stocks with high dividend yields.

Figure 1

Use caution in the near term given the valuations and the negative momentum

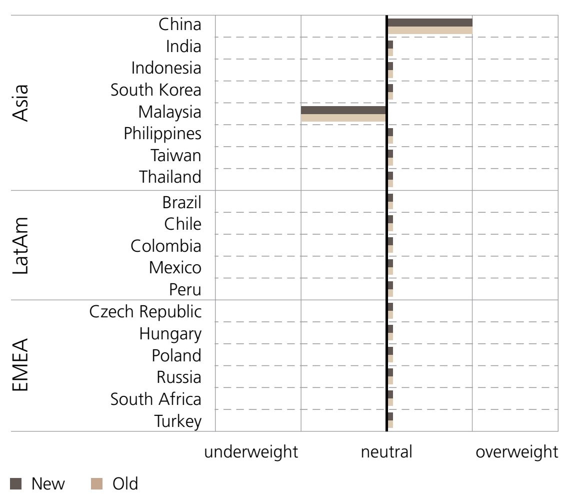
Trailing and forward P/Es of MSCI EM and their 10-year averages



Source: UBS, Bloomberg, DataStream, as of March 2019.

Figure 2

Emerging markets country preferences



Note: All positions are relative to MSCI EM.
Source: UBS, as of 22 March 2019.

USD bonds strategy

Spread rally takes a breather; we hold onto our selection

The 60-basis-point narrowing of emerging market bond spreads has been driven by a dovish global monetary policy outlook, progress in US-China trade talks, rising energy prices, Chinese stimulus measures, and benign technical factors. Although the spread rally has stalled in recent weeks, the ongoing decline in US rates boosted this year's returns to 5.5%. We are cautiously optimistic about the near term, but are also mindful of lingering global macro and political risks.

Jérôme Audran, CFA, FRM, Analyst

Michael Bolliger
Head of EM Asset Allocation

Valuations are less appealing; focus on bottom-up criteria
Emerging market sovereign and corporate bonds are trading at 355 and 320 basis points, respectively, slightly below our six-month targets. We are not concerned about the near-term fundamental outlook, but expect default rates on high yield corporate bonds to increase from 1% to 2–3% by year-end due to softer global growth and an export slowdown. Tighter global liquidity conditions could also increase default rates if major central banks turn more hawkish, but this is not our base case scenario.

We caution against getting pessimistic at this point. First, a default rate of 2–3% is in line with the long-term average. Second, historical evidence suggests that the pass-through at an asset class level takes around 18 months to unfold. Investors should have enough time to benefit from attractive opportunities based on a thorough bottom-up selection.

All eyes on China
Global growth dynamics will depend crucially on China. Recent Chinese economic data, though distorted by calendar effects from the Lunar New Year, have softened and disappointed. And given the country's trade links to the rest of the world, weaker growth has spread more widely, especially to Europe, North Asia, and other emerging countries.

China's annual National People's Congress provided important insights into the policy stance investors should expect this year. Premier Li Keqiang emphasized that the government will not resort to the "flood-like" stimulus measures of the past but instead pursue a measured and targeted approach to address the slowdown. Emerging countries could suffer if Chinese stimulus measures don't spill over to them. But Li also confirmed the government's commitment to achieving GDP growth of around 6–6.5%.

Investment implications
We expect more Chinese policy easing, which should ultimately stabilize growth in the months ahead. So the Chinese bond market remains interesting, especially in sectors exposed to ongoing stimulus measures, such as financials and real estate. Outside China, investors should stay selective and favor issuers, such as Argentina, Oman, and Turkey, that trade at discounts to similarly rated peers, or those from countries and sectors that benefit from favorable growth prospects or reform measures. Examples include selected issuers in Brazil, South Africa, Egypt, Côte d'Ivoire, Kenya, and Indonesia.

We are keeping a slight risk-on stance in our emerging market credit allocation due to tentative signs of stabilizing global growth. But risks remain tilted to the downside given the uncertainties provoked by slower growth, the unresolved US-China trade dispute, a fragile political environment in Europe, and the policy outlook of major central banks.

Table 1

Most and least preferred credit market segments

	Theme/Sector
Most Preferred	China BBBs / high yield
	African bond basket
	Gulf credits
	Turkish sovereign and banks
	Argentina
	Indonesia
	Select commodity producers
Least Preferred	Russia
	India
	Central and Eastern Europe
	Other underweights (Israel, Macau, Malaysia, Singapore)

Source: UBS, as of March 2019.

USD bonds bottom-up insights

EM debt at all-time highs but less risky

Although emerging market debt is at all-time highs, most of this debt is in local currency, which adds to the resilience of emerging economies.

Jérôme Audran, CFA, FRM, Analyst

Michael Bolliger
Head of EM Asset Allocation

Low interest rates following the global financial crisis have encouraged a sharp increase in borrowing from emerging markets. Government and private sector debt levels are at all-time highs, reaching 51% and 157% of aggregate emerging market GDP in 2018, respectively. But a few key factors make emerging economies more resilient to external shocks and shifts in sentiment.

First, the vast majority of their borrowing is in local currency: 85% for government debt and 93% for private sector debt. Second, external debt as a percentage of GDP remains moderate at 30%, below the peak of 39% in 1998. Finally, many of the larger emerging economies have stronger external accounts, with improved current account balances and higher foreign-exchange reserves. For these reasons, we see long-term value in sovereign bonds in USD and hold a longer-term overweight these assets in our global portfolios.

On the corporate side, Chinese borrowers played a significant role in the rise in emerging market debt post-crisis. Corporate debt in China has risen to 158% of GDP, and default risks are rising. But the level of defaults should remain contained given our expectation for still-resilient GDP growth of 6.1% thanks to stimulus measures and low interest rates. Stripping out China, corporate debt in emerging markets has only modestly increased since the crisis, and has actually fallen over the last two years.

Overall, we expect lower but resilient emerging market growth this year, broadly stable credit fundamentals, and below-average corporate default rates.

Investors have to assess risks carefully. One way we do this is through the Vulnerability Scorecard in our note "Time to look at the details: A primer on emerging market debt." Covering more than 70 emerging economies, the scorecard identifies potential fault lines, including countries with highly indebted corporates (China in particular), potentially unsustainable government debt trajectories (Brazil, South Africa, India, among others), and exposure to external funding risks (e.g., Argentina, Ukraine, Turkey, most frontier markets, and weak oil-dependent sovereigns).

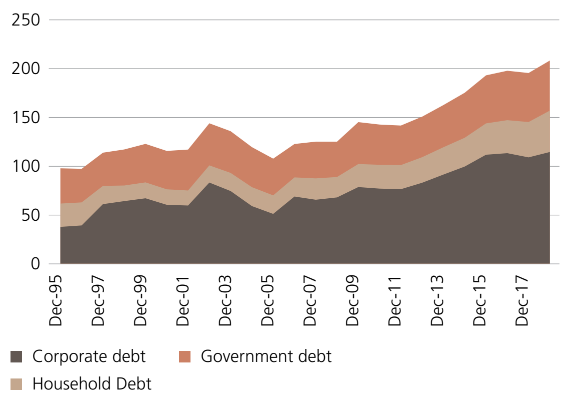
Beyond quantitative metrics, debt sustainability in emerging markets should be assessed qualitatively to take into account global factors such as the US dollar, US monetary policy, US Treasury yields, and protectionism, as well as domestic factors such as politics and prospects for reform. This year, a number of developing countries will hold elections, among them Thailand, Indonesia, India, South Africa, and Argentina.

Diversification and selectivity remain important. We see value in China BBB rated bonds on the back of ongoing policy stimulus; a basket of African bonds on specific reform stories and expected cyclical recovery; Gulf credits due to ongoing reforms and rising oil prices; more volatile high yield markets like Turkey and Argentina where we think yields are attractive; select commodity producers; and Indonesian bonds.

Figure 1

EM debt levels at all-time highs

EM debt as a percentage of GDP

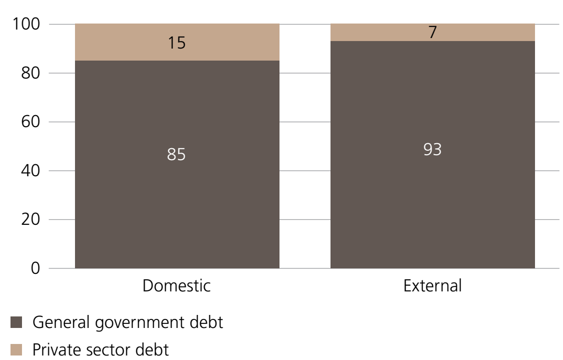


Source: UBS, JPMorgan, as of March 2019.

Figure 2

EM debt is overwhelmingly domestic

Share of EM domestic and external debt (in % of total)



Source: UBS, JPMorgan, as of March 2019.

Currencies

Single currency picks still the way to go

Emerging market currencies seem to largely reflect the improved backdrop for global monetary policy and have trended broadly sideways over the past weeks. Developments around global growth, yields, trade, and geopolitics can boost or weigh on the asset class. For the upside potential to be sustained, global dynamics would have to improve or economic data in emerging markets would need to rebound. We advise positions in single currencies and relative value trades.

Tilmann Kolb, CFA
Analyst

Jonas David, CFA
Analyst

Emerging market currencies trended sideways amid volatility over the past weeks. While improved global investor sentiment amid more dovish central banks makes for a more favorable backdrop, we think country-specific drivers are increasingly important. The global growth outlook and monetary policy, trade disputes, commodity prices, and geopolitics will drive the asset class's performance.

An agreement over trade between the US and China or a resolution to the Brexit impasse could lead to another leg higher for emerging market currencies. Within emerging markets, an uptick in economic activity or progress on structural reforms would help currencies rally further from still-undemanding long-term valuations. But signs for a pick-up so far are sporadic and mixed with still-weak data. In this regard, Chinese stimulus efforts and their impact on other economies and commodity prices will be important to monitor.

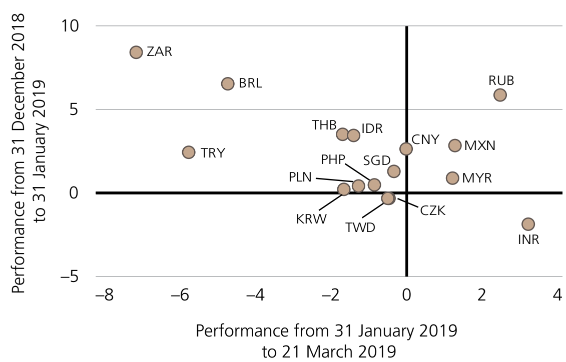
While the Federal Reserve has cemented its dovish stance, other risks linger, with the US and China haggling over more than just trade balances, and with Eurozone economic data still surprising to the downside. Should the Eurozone continue to disappoint, Central and Eastern European currencies like the Polish zloty and Czech koruna would likely suffer, as they are closely intertwined to the wider European economy and because Polish and Czech monetary policymakers take their cue from the European Central Bank. A weak European economy would also not serve other emerging market currencies well, since the Eurozone is an important export market for countries such as China and Turkey. Apart from global dynamics, individual emerging markets also face local political risks.

Against this backdrop, we advise focusing on single currencies' specifics instead of considering broad asset class exposure. We recently opened a new recommendation to buy the Brazilian real against the Mexican peso. We think political dynamics point to a divergence in the performance of these Latin American currencies. Brazil remains focused on President Jair Bolsonaro's plan to reform the social security system, aiming for ambitious savings with his initial version. By contrast, we expect more market-unfriendly policy proposals from Mexican President Andrés Manuel López Obrador and his party. We also expect economic momentum to favor the real later in the year. Meanwhile, we took profit on our recommendation to buy the Russian ruble against the US dollar after the ruble's strong recent performance.

Figure 1

Rally in January, setbacks in February

Spot performances for different periods (in %)

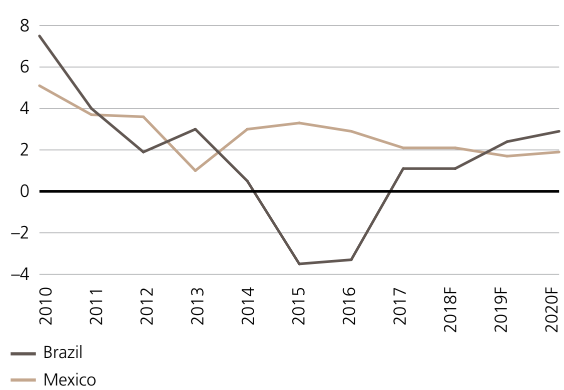


Source: Bloomberg, UBS, as of 21 March 2019.

Figure 2

Brazil's economy expected to accelerate and outgrow Mexico's

Real GDP growht (in %, y/y)



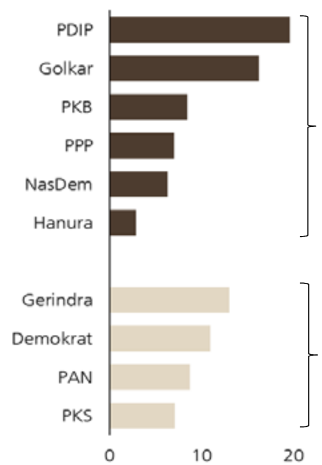
Source: UBS IB, UBS, as of 21 March 2019.

Indonesia

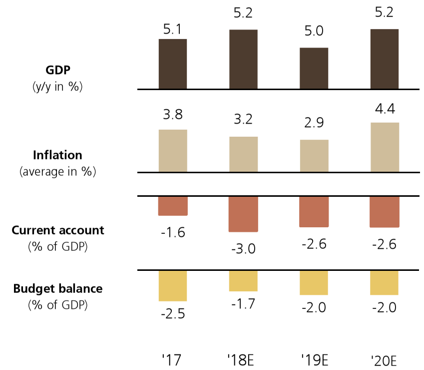
What's at stake?

17 April – General elections. For the first time, voting for the president and the People's Consultative Assembly will take place on the same day. The presidential contest will be a rematch of 2014: Joko Widodo, the current president, will once again face off with Prabowo Subianto in a two-horse race.

Current composition of House of Representatives
In % of legislature seats



Economic & policy backdrop



Economic growth: After four years of a gradual uptrend, economic growth is likely to moderate this year to be in line with the average growth since Jokowi took office in 2014. While we do not expect a slump in investment spending, it is likely to moderate as well due to tighter financial conditions. That said, government and household consumption is likely to provide an offset. Tax collection has been strong and has funded the government's populist measures.

Current account: The current account has yet to stabilize, but the monthly oil trade data has provided some relief. While the surprise trade surplus in February was likely driven by seasonal factors, we expect higher rates, government measures to curb imports, and a more prudent fiscal budget to drive a more sustainable improvement in the current account this year.

Inflation: Inflation remains manageable for now, with the latest reading below the mid-range of Bank Indonesia's 2.5–4.5% target. That said, we see a risk of a temporary spike should Brent oil prices trend higher and the government decide belatedly to increase fuel prices in 2H19. Based on our 12-month House View forecast of USD 75/bbl Brent, we estimate the government will need to raise administered fuel prices by around 30%, boosting average inflation to 4.1% by year-end from an estimated 3.2% last year. If oil prices decline below USD 50/bbl, the government will not need to raise fuel prices at all, we estimate.

Candidates & key trends

Joko Widodo (Jokowi): Born in 1961. Seventh and current president of Indonesia since 2014. A businessman by background, he was previously mayor of Surakarta and governor of Jakarta.

Prabowo Subianto: Born in 1951. Chairman of Great Indonesia Movement Party. A former army lieutenant general, Prabowo ran in the 2009 election for vice-president and in the 2014 election for president.

Polling/Social media trends (below):
The latest polls give Jokowi around a 20-point lead over Prabowo, far above the 3–4-point lead he had over him one month before the 2014 election. The rupiah and religious tensions remain key swing factors.

Timeline:
17 January – First presidential debate on law, human rights, corruption, and terrorism.

17 February – Second presidential debate on energy, food, natural resources, and environment.

17 March – Third presidential debate on education, healthcare, labor, and culture.

30 March – Fourth presidential debate on ideology, defense, security, and international relations.

Before 14 April – Fifth presidential debate on economy, social welfare, finance, investment, trade, and industry.

17 April – Presidential and Legislative election

Scenarios & implications

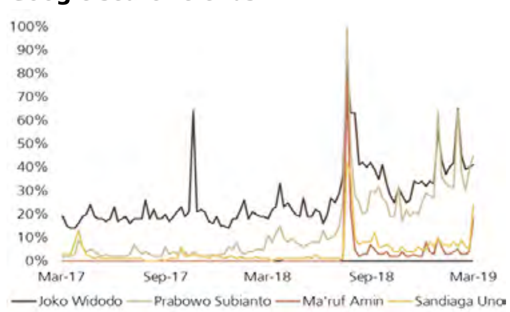
At present, we consider political risk as it relates to the domestic equity market to be manageable. Jokow leads the polls and controls a coalition that holds about 60% of the legislative seats. Jokowi's appointment of Ma'ruf Amin, a prominent Islamic scholar, as his running mate improves his standing among religious voters.

A win by Jokowi would likely be positive for sentiment as it represents continuity, usually favored by investors. Given that this would be his final five-year term, he may push for a bolder agenda, such as labor market reform, once he returned to office, and his government's focus would likely shift toward human-capital issues such as education and healthcare.

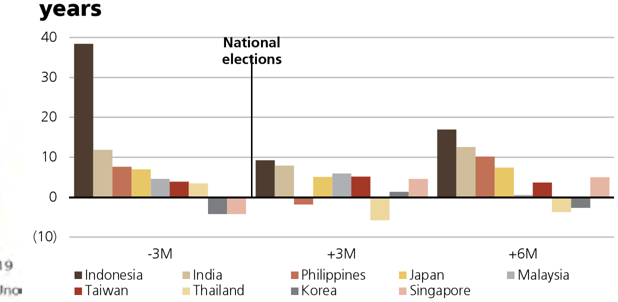
On the other hand, the momentum for infrastructure investment may taper, given that it accounts for a lower proportion overall government expenditure this year. The budget indicates the allocation is projected to decline to 17.2% this year, after rising from 8.7% in 2014 to 18.6% last year.

Victory by the opposition could raise uncertainty about some of the reforms Jokowi has started. Prabowo has promised an income tax cut, a higher minimum wage formula, the removal of land and building taxes for first-time home buyers, agricultural reform, and more support for entrepreneurs.

Google search trends



Equity performance during elections in past 25 years



Social media following

	Facebook likes	Twitter followers
Joko Widodo	8.9m	11m
Ma'ruf Amin	<0.1m	<0.1m
Prabowo Subianto	9.7m	3.7m
Sandiaga Uno	1.5m	1.2m

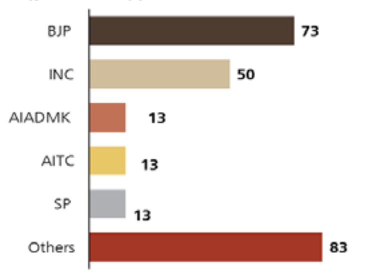
Source: Komisi Pemilihan Umum Indonesia, Google, UBS, as of March 2019

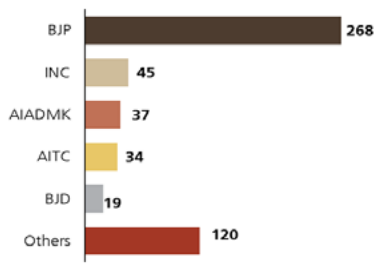
India

What's at stake?

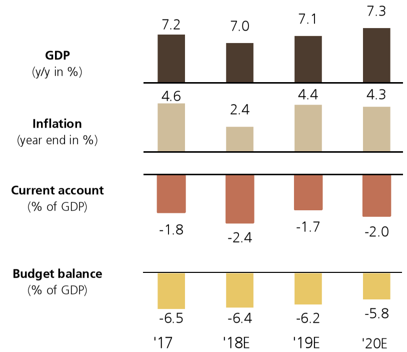
11 April to 19 May: General elections to be held in seven phases to constitute the 17th Lok Sabha. The 543 MPs will be elected from single-member constituencies using first-past-the-post voting. The president of India nominates an additional two members from the Anglo-Indian community

23 May: Declaration of election results





Economic & policy backdrop



Populism tends to gain traction leading up to elections, which can help boost consumption. A countrywide farm-loan waiver, for example, is one of Congress's promises in their campaign. The short-term effects of any fiscal or monetary measure would be stimulative and welcomed by the market initially. But once side-effects (such as inflation, pressure on government finances, current account deficits) kick in, investors would only be willing to pay lower valuation multiples.

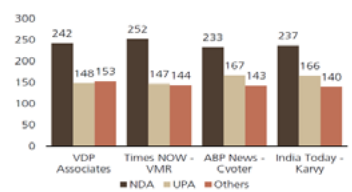
Candidates & key trends

Narendra Modi (BJP): Born in 1950. 14th and current prime minister of India. Led the BJP to a landslide victory in the 2014 general election.

Rahul Gandhi (INC): Born in 1970. President of the INC. In 2014, Gandhi led the INC to its worst electoral result in the party's history, winning only 44 seats compared to the 206 seats won in the 2009 general election.

Polling/Social media trends (below): Polls suggest the gap between Modi and Congress's Gandhi has decreased in recent quarters. Of course, voting intentions can shift in the coming weeks. Some observers claim the recent tensions with Pakistan, along with the military measures taken, might revive the Modi administration's fortunes. Similarly, measures in the budget to support the rural population could also be well received.

Lok Sabha seat distribution in different opinion polls



Scenarios & implications

The national-level elections have essentially only two players: the Bharatiya Janata Party (BJP) and the Indian National Congress (INC), which formed the previous government but in 2014 experienced a significant defeat (the BJP won six times as many seats as Congress did in the lower house, or Lok Sabha). The regional parties of various sizes group around the **BJP-led National Democratic Alliance (NDA)** or the **Congress-led United Progressive Alliance (UPA)**. But alliances are often fluid and can change over time, not least ahead of elections.

We evaluate four scenarios of government formation post-elections in May:

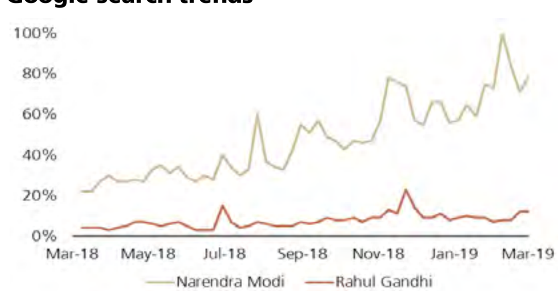
1) BJP with single-party majority. This is the status quo, so the party may be able to continue with its policies and reforms.

(2) BJP-led coalition (dependent on the number of allies). Policies and reforms could be similar to that in the first scenario, but tougher ones such as privatization may be put on the backburner. Investors would be more concerned over fiscal discipline in this scenario.

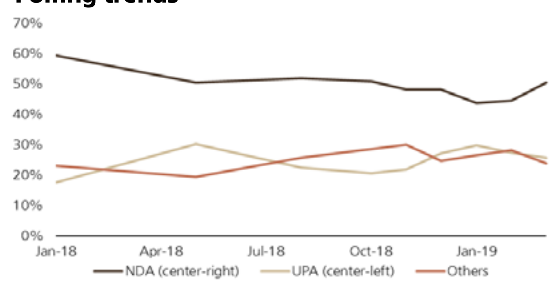
(3) Congress-led coalition, similar to 2004–2008 or possibly a weaker coalition. In this scenario, discussions around the goods and services tax may resurface and markets would have concerns about fiscal discipline.

(4) Third Front coalition of small regional parties, with a prime minister who is not as strong as in other scenarios. A Third Front government would raise questions about the direction of policy choices, although history suggests that broad macro policy will not dramtically change. In this scenario, political uncertainty would be elevated over concerns about policies and reforms.

Google search trends



Polling trends



Social media following

	Facebook likes	Twitter followers
Narendra Modi	43m	46.5m
Rahul Gandhi	2.4m	8.9m

Source: India – Election Commission, Lok Sabha, Rajya Sabha, Google, Times Now-VMR, Deccan Herald, ABP News-Cvoter, India Today-Karvy, VDP Associates, UBS, as of March 2019.

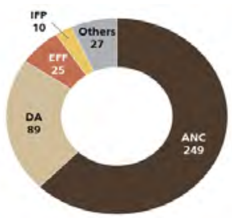
Emerging market electoral monitor

South Africa

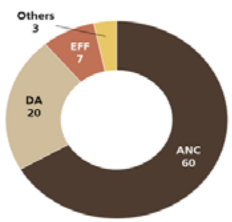
What's at stake?

8 May: National and provincial elections
– 400 deputies in National Assembly, proportional representation
– Provincial legislatures for all nine provinces, proportional representation

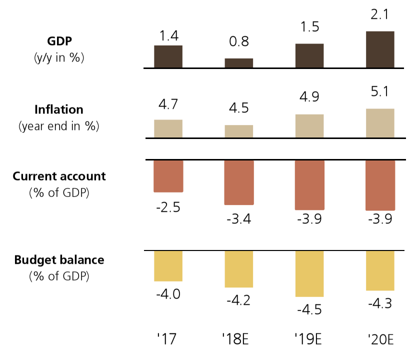
National Assembly current composition:



National Council of Provinces current composition:



Economic & policy backdrop



South Africa's economic expansion is broad-based, but still fragile. We expect a modest rise in GDP growth to 1–1.5% this year (from 0.5–1% in 2018), but structural obstacles and weak confidence keep the outlook lackluster and well below the levels needed to alleviate the country's severe unemployment and poverty levels.

Candidates & key trends

African National Congress (ANC): Led by incumbent President Cyril Ramaphosa, the ANC is the dominant post-apartheid party in South Africa. It combines different factions and ideologies but focuses on reforming South Africa and fighting corruption under Ramaphosa.

Democratic Alliance (DA): The Democratic Alliance represents the biggest opposition party and can be characterized as centrist/liberal. Its stronghold is in the Western Cape province, but it has made some progress in Gauteng province and looks to boost its voting share among the black population. The party is led by Mmusi Maimane.

Economic Freedom Fighters (EFF): The left-wing Economic Freedom Fighters was founded and is led by former ANC Youth League President Julius Malema. The party is in favor of wide-ranging nationalization of businesses and land. Its astute use of social media means it is often able to influence the political discourse more strongly than its polling share would suggest.

Polling/Social media trends (below):
So far, infrequent polling mostly shows the ANC reaching an absolute majority comfortably. While the topic of land expropriation without compensation has received significant attention by the media and from international investors, the state of the economy and labor market is more relevant for the general electorate.

Scenarios & implications

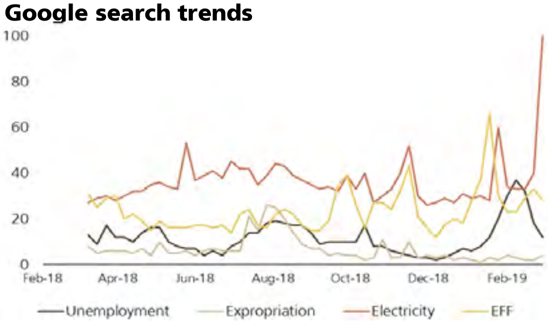
Base case:
The ruling ANC is likely to retain a majority and Ramaphosa looks set to stay in office, but the magnitude of victory will be important for the legitimacy of the president's reform plans and to see off factions still more aligned with former President Zuma. In our base case, we expect a strong enough vote share in the vicinity of 60% to allow Ramaphosa to continue his reform push.

A campaign focused on how to tackle structural challenges, fight corruption, and boost job creation might not only support South African assets, but also appeal to voters.

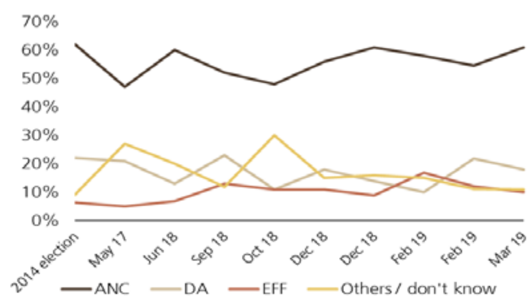
Reforms have seen delays so far, and public finances as well as the financial viability of state-owned enterprises are continuing to pose challenges. A strong mandate combined with speedy progress on improving growth and the fiscal outlook could lead to a rally in South African assets.

Alternative scenarios:
Ramaphosa's standing would likely be harmed if the ANC results were significantly below the 62.2% achieved in the last general election; internal ANC challenges with respect to the reform efforts, or further delays in reforms, would likely weigh on South African assets.

Google search trends



Polling trends



Social media following

	Facebook likes	Twitter followers
Cyril Ramaphosa	-	470k
Mmusi Maimane	259k	1m
Julius Malema	422k	2.3m

Source: Parliament of South Africa, Google, BNP Paribas, UBS, as of March 2019

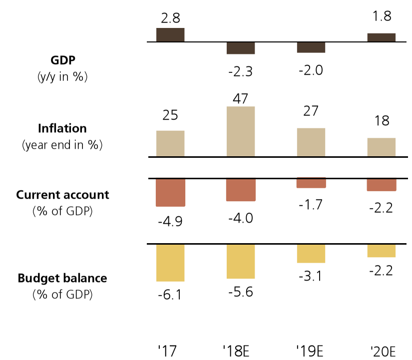
Argentina

What's at stake?

Throughout 2019, voters will elect the president, half of the representatives in the lower house, one-third of the senate, governors of 22 out of the country's 23 provinces, and the mayor of the City of Buenos Aires. Markets will focus on the outlook for the October presidential race.

Date	Election type	Where?
10-Mar-19	Gubernatorial - General	Neuquén
	Gubernatorial - General	Río Negro
12-May-19	Gubernatorial - General	Córdoba
19-May-19	Gubernatorial - General	La Pampa
2-Jun-19	Gubernatorial - General	San Juan
	Gubernatorial - General	Misiones
9-Jun-19	Gubernatorial - General	Entre Ríos
	Gubernatorial - General	Tucumán
	Gubernatorial - General	Jujuy
	Gubernatorial - General	Chubut
16-Jun-19	Gubernatorial - General	Santa Fe
	Gubernatorial - General	San Luis
11-Aug-19	**Presidential - Primary**	**National**
	Legislative - Primary	**National**
29-Sep-19	Gubernatorial - General	Mendoza
27-Oct-19	**Presidential - General**	**National**
	Legislative - General	**National**
	Gubernatorial - General	Buenos Aires
	Gubernatorial - General	Catamarca
	Gubernatorial - General	Formosa
	Gubernatorial - General	Santa Cruz
24-Nov-19	**Presidential - Runoff**	**National**
TBD	Gubernatorial - General	Caba
TBD	Gubernatorial - General	Chaco
TBD	Gubernatorial - General	La Rioja
TBD	Gubernatorial - General	Salta
TBD	Gubernatorial - General	Tierra del Fuego
Ongoing	**C. Kirchner's corruption trials**	**Federal courts**

Economic & policy backdrop



The macroeconomic stabilization plan in place since late 2018 seems to be working. The country's strict money base targets and foreign-exchange bands are leading to somewhat better behaved inflation and reduced exchange-rate volatility (conditions are still difficult as evidenced by the inflation prints and peso behavior in recent weeks). Fiscally, the government delivered its target primary deficit of 2.7% of GDP in 2018, and aims to achieve additional savings in 2019. We believe it will gradually approach, but remain short of, a primary fiscal balance this year. Economic activity seems to be bottoming out and is showing green shoots of growth. The primary sector will likely support overall activity as production stages a meaningful recovery from the depressed levels of 2018 due to drought conditions.

Candidates & key trends

Mauricio Macri: Current president and member of Cambiemos party. His voter support levels have been suffering since the mid-2018 currency crisis, but seem to be bottoming out.

Maria Eugenia Vidal: Current governor of the Province of Buenos Aires. Were Macri's polling numbers to worsen, she might step in as presidential candidate as she is among the most popular politicians in the country.

Cristina Fernandez de Kirchner: Former president and current senator for Buenos Aires Province. Despite widespread corruption allegations against her, she retains around 30% of voting intentions. It is widely believed she will run for president, and that there is a small chance she might negotiate an alternative path to guarantee legal protection against her family and herself.

Peronist candidates not aligned with Cristina Kirchner. Roberto Lavagna, former economy minister under Duhalde's administration; Juan Manuel Urtubery, current governor of Salta Province; Miguel Ángel Pichetto, senator for Río Negro province and leader of the Senate majority; Juan Schiaretti, governor of Córdoba. Despite clear differences among them, they all represent macroeconomic policy continuity.

Sergio Massa: Former chief-of-staff of Cristina Kirchner, former presidential candidate, and current congressman for Buenos Aires Province. He ran in the 2015 presidential race and came in third with 23% of the votes. He is ideologically ambiguous. We think he is closer in thinking to Kirchner than to the non-Kirchnerist Peronist candidates.

Libertarian economists: A number of libertarian economists intend to run, with Jose Luis Espert leading the pack. They enjoy limited voter support currently.

Scenarios & implications

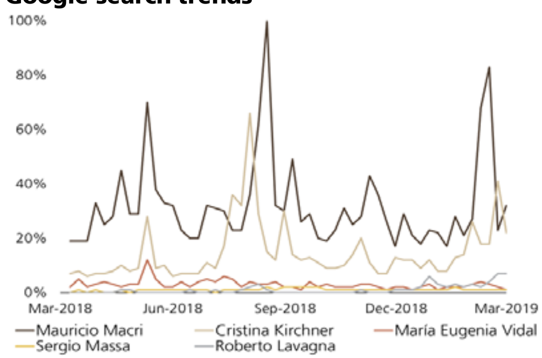
The outlook for the presidential race remains binary. It will result in either economic policy continuity—i.e., fiscal consolidation toward a primary fiscal surplus, tight monetary policy to rein in inflation, and a cooperative relationship with the IMF—or a return to the populist policies of the past.

Among the candidates we believe represent continuity, to varying degrees, are incumbent President Mauricio Macri, and most Peronist candidates not aligned with Cristina Kirchner. Kirchner and Sergio Massa would walk the country toward unfavorable policy paths.

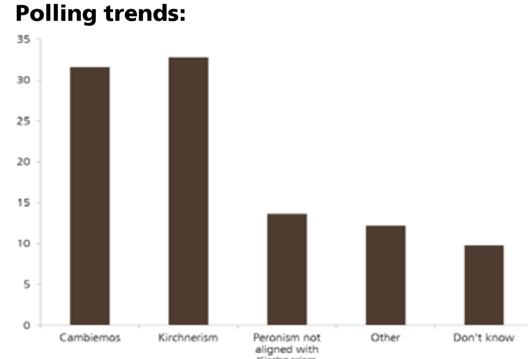
Given currently available information, and mindful of the potential changes in the political equation over the next few months, we work with a base case of policy continuity, to which we assign a 65–70% probability, for three main reasons: 1) the macroeconomic stabilization plan in place since late 2018 seems to be working; 2) external factors are likely to remain supportive; and 3) corruption investigations against Kirchner are likely to deepen.

We therefore see select opportunities in Argentine assets at this juncture. We warn investors against making too large of an allocation to the country, however. Our favorable view on Argentina's electoral outlook is far from guaranteed and the country's macroeconomic conditions will remain challenging post-elections no matter who wins.

Google search trends



Polling trends:

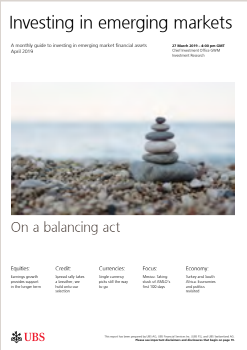


Social media following

	Facebook likes	Twitter followers
Mauricio Macri	4.4m	4.7m
Cristina Fernandez de Kirchner	2.4m	5.3m
María Eugenia Vidal	1.6m	1.4m
Sergio Massa	952k	1m
Roberto Lavagna	4.4k	137k

Source: Ministerio del Interior, Obras Publicas y Vivienda, La Nacion, Perfil, Synopsis Consultores, UBS, as of March 2019.

Emerging Markets publications



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Investing in emerging markets
Including investment views across asset classes and regions

White Papers

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Latin America
Beyond peak trade

Middle East
Prosperity beyond oil

Asset class publications

Equities
- EM Equity Monthly describing county preferences

Currencies
- EM FX Monthly including currency preferences
- FX one-pagers (BRL, MXN, RUB, ZAR, TRY, CEE3, APAC)

Regional investment themes

Long term investments (LTIs)
Thematic investments with a 5yr+ investment horizon

Appendix

Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-U.S. securities and illiquid investments.
- Managed Futures: There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- Real Estate: There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- Private Equity: There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- Foreign Exchange/Currency Risk: Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer's "home" currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.

Appendix

UBS Chief Investment Office's ("CIO") investment views are prepared and published by the Global Wealth Management business of UBS Switzerland AG (regulated by FINMA in Switzerland) or its affiliates ("UBS").

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