Investing in emerging markets

Bonds
Time to be more selective

Equities
Fundamentals in the driver’s seat

Currencies
How to position into the last quarter

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Important disclosure
Please note there may be changes to our house view and tactical asset al-
location 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.
Welcome to the October issue of our Investing in Emerging Markets flagship. As temperatures start to cool down and daylight shortens in the northern hemisphere, so too have the markets entered a period of consolidation – a cool-off period after a torrid first eight months.

The US Federal Reserve’s confirmation of its intention to work its way back to normal monetary policy, both via rate hikes and a gradual reduction of its balance sheet, is one factor to take into account. Another is the robust pace of economic recovery in the Eurozone, which increases the likelihood of the European Central Bank tapering its quantitative easing program in the months ahead. In short, we expect monetary conditions to be tighter in the coming months than they have been in the recent past. Much of this has been priced in, but markets have enjoyed unprecedented liquidity for the last 10 years and may be jittery at times, as they adjust to a new regime. After calling for a weaker US dollar against the euro for most of this year, our FX team now believes the exchange rate is likely to be range-bound in the months ahead. A weaker USD worked to ease financial conditions in the US, the world’s largest financial market.

Finally, while valuations in global equity markets are not expensive relative to interest rates and inflation, it is likely that after their recent rally, future returns may be more subdued than in the recent past. In view of the above factors, we are this month reducing our overweight in global equities by one-third, and adding that exposure to US government bonds. It must be made clear that we still believe equities offer the best absolute returns at this point in the investment cycle, relative to bonds and other assets. Furthermore, we believe equity performance can withstand the normalization of global monetary policy if flanked by robust global growth. However, it is possible that returns may become more muted, in line with earnings growth, and stemming more from sector, country, and security selection (alpha) and less from overall market exposure (beta).

In our emerging market portfolio, we also remain pro-risk with overweights in both equities versus hard currency corporate bonds, and high yield sovereign bonds versus investment grade peers. Emerging markets are less advanced in the business cycle with countries like Russia and Brazil coming out of recession, and China and India reaping the long-term benefits of structural reforms. We go deeper into where emerging markets are at this point in the cycle in the Investment Strategy section of this report.

As always, we hope you enjoy this monthly and find it productive for your investment decisions.

Mark Haefele
Global Chief Investment Officer
Jorge Mariscal
Emerging Markets Chief Investment Officer

For markets it may be autumn, but not fall
Global investment views

Asset allocation
Risk assets remain supported by solid business cycle trends, and were resilient despite a number of key threats, including tensions around North Korea, Hurricane Irma and the US debt ceiling debate. We believe that the global economy remains in mid-cycle and the probability of recession over the coming six months is low. However, after the strong performance of global equities this year, we are reducing our overweight in global equities against US government bonds and taking some profits. Earnings growth is expected to remain the key driver leading equities higher. Within our FX strategy, we are lowering our preference for the Canadian dollar against the Australian dollar. The Fed announced it will begin the process of reducing the size of its balance sheet in October. We expect the ECB in October to announce an exit from its quantitative easing program next year, and the Fed to raise rates once more later this year, still leaving monetary policy broadly accommodative.

Equities
Within Europe, we maintain our overweight in Eurozone versus UK equities. Due to their cyclical sector exposure, Eurozone companies particularly are benefiting from the global pick-up in economic activity this year. While the rapid rise of the euro has been a concern for investors, this advance did not continue in September. On the other hand, the British pound strengthened significantly after the Bank of England signaled an interest rate hike in the coming months. This put pressure on export-oriented UK stocks. We maintain an overweight position on global equities against US government bonds.

Bonds
We think equities provide better risk-adjusted returns than credit at this stage of the business cycle. We don’t see much upside from credit given current valuations. We believe the US Fed will hike rates more quickly than the market is pricing, as labor market slack has been substantially used up and financial conditions are relatively easy. Consequently, we expect short-term yields to rise as the market adjusts to a more realistic pace of Fed rate hikes.

Foreign exchange
Within our FX strategy, our Canadian dollar overweight against the Australian dollar (AUD) has performed well, so we are reducing the position to take some profits. We still think further upside remains, so we are not exiting the position entirely. The Bank of Canada (BoC) surprised markets this month by increasing its policy rate by 25bps to 1%. We expect the BoC to continue to raise rates over the coming months given robust economic growth. Higher US Treasury yields and moderating Chinese activity should pressure the AUD, and we don’t expect the Reserve Bank of Australia to raise rates until later next year. We remain overweight the Swedish krona against the Swiss franc. We expect Sweden’s Riksbank to become more hawkish in the coming months due to strong growth and firming inflation.
Emerging market investment strategy

Where are we in the emerging markets cycle?

Emerging market assets continued to plow ahead over the past month despite jitters around the September FOMC meeting and geopolitical tensions around North Korea. With over 30% year-to-date gains in equities, 15% in local rates and close to 10% in sovereign credit and currencies, are we already in the late stage of the EM cycle?

The short answer is no. We think we are still mid-cycle, and here are five reasons why.

1. Growth: early to mid-cycle
One of the key drivers for asset performance is economic growth. This year, GDP growth in emerging markets is set to accelerate for the first time since 2010, with major economies such as Brazil and Russia putting recession behind. More important, the real GDP growth advantage of emerging economies over their developed peers is set to widen from a low of 2.1 percentage points in 2015 to 2.5 points this year and 3.3 points by 2021, according to IMF forecasts. This means the growth recovery in emerging markets is still in the early to mid-cycle.

2. Monetary policy: mid-cycle
Global liquidity conditions have been supportive of emerging market assets, and we are at an inflection point where global central banks are slowly closing the tap. A passive reduction in the Fed’s balance sheet next month and the expected tapering of the ECB’s quantitative easing program next year may pressure asset prices temporarily, especially if the Fed hikes the policy rate faster than expected. However, within emerging markets, real interest rates remain high, underpinning their resilience to higher rates in the US and Europe. Inflation also remains benign for most emerging economies, leaving room for several central banks to cut interest rates. Considering both external and domestic conditions, we categorize monetary policy conditions as mid-cycle.

3. Corporate profits: early to mid-cycle
Earnings for the MSCI Emerging Markets index have risen 18% year-to-date in US dollar terms, but are still 20% below 2011 levels. Similarly, return on equity has rebounded to 11% from 10% a year ago, but is still well below the 15% in 2011. Additional upside could come not only from solid top-line growth but also better profitability. Meanwhile, the earnings revision ratio has jumped from a deeply negative –40% last February to a moderate +8% currently, indicating analysts are starting to revise up their estimates. These factors all point to an early to mid-cycle stage in corporate earnings recovery, and we expect 6–10% profit growth in the next 12 months.

Tactical asset allocation deviations from benchmark*

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* 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.

Source: UBS, as of 21 September 2017. Green/Red arrows indicate new upgrades/downgrades. Grey up/down arrows indicate increase/reduction to existing positions.
4. Valuation: mid- to late cycle
This may be the most often cited argument for why we might be in late cycle. Valuations of emerging market assets are no longer attractive relative to their own history, but still compare favorably to developed market peers. Equities are trading at 14.4x 12-month-trailing earnings, above their 10-year average of 12.5x, but at a 21% discount to developed market stocks. Credit spreads are 60bps tighter than the 10-year average; by comparison, European high yield spreads are 350bps narrower. The real effective exchange rate (ELMI-weighted) on aggregate is in line with the 10-year average, and for EMEA and Latin America it is still around 8% below. This means despite their year-to-date gains, emerging market currencies remain competitive.

5. Fund flows/Positioning: mid-cycle
Emerging market equities have seen close to USD 50bn of inflows this year without a single month of outflows, but this recoups merely a third of the USD 150bn of outflows between 2013 and 2016. Even after adjusting for the valuation discount, global portfolio allocations to emerging market equities and bonds are in line with historical average, implying they are no longer underweight emerging markets, but the trade is not yet crowded.

Our positioning
Given the strong economic and corporate profit growth, benign liquidity conditions and not-so-stretched valuations and positioning, we think the emerging market cycle has further to run, and so we maintain a moderate pro-risk stance. In our dedicated emerging market portfolio, we remain overweight equities relative to corporate bonds to take advantage of the earnings rebound.

In equities, our most preferred markets are China, Indonesia, Thailand, Russia and Turkey. Our least preferred are Taiwan, Malaysia, the Philippines and South Africa. We expect value stocks to outperform their growth peers over the next 12 months given the recovering economic activity, higher commodity prices and attractive valuation discounts.

In credit, we overweight select high yield markets where the chances of structural reform remain intact and business cycle dynamics point toward acceleration. On the other hand, we remain underweight several investment grade markets where yields are severely compressed or business cycle dynamics look less favorable.

In currencies, we remain overweight select high yield currencies with sound fundamentals, including the Mexican peso, the Russian ruble and, as of this month, the Brazilian real, all funded by an equally weighted basket of US dollar and euro. Benign global conditions, an improving external balance and better growth-inflation dynamics should all support the real, in our view. We also overweight the Indonesian rupiah and the Indian rupee relative to the Singapore dollar. We expect the Turkish lira to further outperform the South African rand due to more favorable monetary policy, economic activity, and politics. In Central and Eastern Europe, we reaffirm our Hungarian forint underweight against the Polish zloty due to the National Bank of Hungary’s dovish monetary policy stance, but take profit on the short forint against long euro position.
Africa is often labeled the “final investment frontier.” It consists of countries whose indicators of social, economic and financial development are relatively low, which translates into more upside potential than anywhere else on the planet. But these same factors that substantiate this potential are also often viewed as challenges that make investing in the region an unjustifiably risky proposition for many.

This glass half-empty, half-full perception of the opportunities hinges on whether one believes the region can realize its significant potential. In our new white paper, *Africa – Cradle of Diversity*, we find that the answer to this question isn’t straightforward.

To start, the continent, home to more than 1 billion people, is heterogeneous. The dissimilarities among its countries are significant, and their paths to development vary greatly depending on their resource endowment and sociopolitical heritage. Oil-exporter Nigeria, for example, has a very different economy than Kenya, which relies more on tourism to generate foreign exchange.

For many of the continent’s small, open economies, especially those dependent on agriculture and natural resources, the fate of the world economy plays an important role in their development. But, ultimately, how each country confronts domestic and external challenges is in the hands of its leaders, entrepreneurs and consumers. The track record of many of these nations on growth and development is uneven but, on the whole, encouraging.

Indeed, Africa has numerous drivers that could sustain an average annual growth rate of 4%, based on IMF estimates. It has the world’s youngest and fastest-growing population and middle class – a major catalyst for sectors such as manufacturing, retail and finance. While primary commodities will likely remain a major source of revenue in several countries, their role in driving growth is diminishing.

But the region continues to face many challenges stemming from insufficient governance standards and reforms. Governments need to ensure the right policies are in place to harness the demographic dividend, ease infrastructure constraints, diversify export sectors and improve intra-regional trade.

For financial markets, Africa can be an attractive destination for investors willing and able to identify the opportunities offered by its favorable demographics and rising urbanization. For now, investability is best in credit, where many liquid instruments exist. For equities, South Africa remains the most important market, but investors can also look at indirect ways to build exposure. Currencies and local bond markets are niche areas, but can present interesting opportunities for risk-tolerant investors.

As many African countries will continue to grow at a faster pace than developed nations, so will the size and liquidity of their capital markets gain in relevance over time. But no matter which asset investors pick, risks tend to be higher than elsewhere, and exposure should be held in a diversified manner only.

For more of our economic and investment outlook for Africa – including a look at eight markets chosen for their size, investability and potential – refer to our white paper published 5 September.
Economy

All engines revving up at once

The years since the global financial crisis have been characterized by a mediocre and uncoordinated growth in world economies. Close to a decade out, it looks like 2017 is finally painting a rosier picture. GDP growth is rising across a broad range of economies and not just a few. Of all the countries for which the International Monetary Fund compiles economic data, 93% are on track for positive GDP growth this year, and 61% are growing at a faster pace than in the previous year (see Fig. 1). Global manufacturing purchasing managers’ indices (PMIs) are exhibiting a similar behavior. Not since 2011 have the PMI readings for the US, the Eurozone, China, and emerging markets been in expansion territory for 12 straight months at the same time (see Fig. 2).

The forward-looking nature of the PMI data supports our expectation that benign global macro conditions can persist over time. The synchronized nature of the global upswing also leads us to believe that the current economic recovery can be relatively resilient to shocks in any single country. For example, the global economy seems better prepared, at least from a cyclical standpoint, to digest the expected slowdown in China, which continues to rebalance from an investment-driven economy toward a consumption-driven one.

Emerging markets should continue to benefit from this global growth phenomenon, as they tend to react strongly to changes in global aggregate demand. Within the region, for example, export growth has picked up to cruising speed in recent quarters. That said, much of this improvement owes to the recovery in commodity prices, so we need more evidence of improvement in domestic industrial production, investments, and private consumption to be truly certain that the emerging market growth cycle is broad-based.

To be sure, financial markets have taken note of these developments. Emerging market asset prices already reflect the positive backdrop to a good degree, in our view, so in the months ahead we are unlikely to see them perform as well as they have so far this year. But opportunities remain: Not all emerging economies are in the same stage of the business cycle; structural reform efforts in various countries should gradually support their respective growth outlooks; and, compared to developed market assets, emerging market ones still look relatively cheap.

Risks, of course, are as always present. China’s slowdown needs to be monitored, but as long as it happens in a controlled way, emerging markets should fare well. Global monetary policy is gradually tightening; the Fed last week announced a program to reduce the size of its balance sheet – a process that has no comparison in history. But we think policymakers are aware of the potential damage to growth if they tighten too much, too fast. Also, emerging markets have become more resilient to monetary-policy induced shocks over the past years, as their current account positions, currency valuations, and real interest have much improved. Finally, the tensions around North Korea remain a low-likelihood, big-impact tail risk in our view.

All in all, we think the environment is still conducive of moderate risk-taking in global and emerging market portfolios. The following pages of this report are full of ideas across emerging market equities, bonds and currencies we hope can help you take advantage of the current cycle.
We keep a moderate pro-risk stance in our dedicated emerging market strategy with an overweight in equities relative to corporate bonds. We expect 3–5% earnings growth in the next six months to be a key driver for further upside. Our most preferred markets are Russia, China, Indonesia, Thailand and Turkey. Our least preferred markets are Taiwan, Malaysia, the Philippines and South Africa.

Solid earnings growth
Despite some weakness in emerging market currencies ahead of September FOMC meeting and continued tension around North Korea, the MSCI Emerging Markets Index has delivered over 30% total return in US dollar terms so far this year. The index is trading at 14.4x 12-month-trailing P/E, and we expect further upside as the valuations are not stretched, in our view. Earnings have picked up 20% year-to-date in US dollar terms after five years of flat to negative growth, and we expect 3–5% earnings growth in the next six months.

Most and least preferred markets
In EMEA, we are overweight Russia and Turkey and underweight South Africa. In Russia, we expect improving growth-inflation dynamics to translate into greater earnings growth. The manufacturing PMI remains in expansion territory at 51.6 in August, and inflation continues on a downward trend at 3.3% for the same month. On 15 September, the Central Bank of Russia cut rates by 50bps as inflation stabilized. Turkish equities have fared well this year, and consensus expects close to 18% earnings growth in the next 12 months; we expect further rerating as the market is still attractively valued. Finally, South Africa is trading at expensive valuations amid low earnings growth and high political uncertainty.

In Asia, we like China for its attractive valuation, and Thailand and Indonesia for their strong earnings momentum and profitability. The outlook for China remains positive even though we do expect a rollover in nominal GDP growth, but this should be compensated by further margin improvement given the government plans for state-owned-enterprise reform. Policies have also remained supportive to ensure a smooth economic transition. We believe the earnings momentum will continue in 2018. Nevertheless, we think it is prudent to hedge our overweight China position with an underweight on MSCI Taiwan, where 2Q earnings releases were weak and the market lacks a near-term catalyst. We remain overweight on Indonesia and Thailand as both markets should benefit from upside potential in commodities and higher GDP growth. Meanwhile, we remain underweight on the Philippines and Malaysia as we believe market expectations are too optimistic given the rollover in macro momentum.

In LatAm, we remain neutral on Mexico as we believe the market is already pricing in a benign outcome for NAFTA negotiations as well as the good earnings momentum. In Brazil, despite the positive backdrop, valuations are not so attractive and uncertainty around politics will increase the volatility, in our view. For investors who would like to add exposure in the region, we recommend MSCI Argentina as growth-inflation dynamics are improving and we expect the index to outperform its benchmark MSCI Frontier or MSCI Emerging Markets.

Country preferences in EM equities (relative to MSCI EM Index)

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<th>Region</th>
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Note: All positions are relative to the MSCI EM index. EM regional asset allocation shown is not part of the Global Tactical Asset Allocation (TAA).
Source: UBS, as of 21 September 2017

For further reading:
USD bonds strategy

Time to be more selective in emerging market credit

We expect the global environment to stay supportive of emerging market credit, despite a gradual rise in US interest rates, and given improving business and credit cycle dynamics. That said, we believe investors should start to more actively select their exposure as emerging economies are now somewhere between expansion and slowdown. Amid fair credit valuations on aggregate, we see pockets of opportunity within the asset class.

As we approach the last quarter of 2017, investors are wondering whether the benign global investment environment is sustainable. Not only emerging market credit has had a strong run this year; other asset classes such as global and emerging market equities have delivered double-digit returns. This has led many to believe that valuations have become stretched. Meanwhile, the Fed and other central banks are in the process of becoming less accommodative in their monetary policy – one of the main risks for the asset class.

We take these concerns seriously, but think that emerging market credit will continue to perform well in the next six to 12 months. Growth is picking up around the globe, and in a more synchronized manner than we have seen in recent years. Also, the gap between emerging and developed market growth is rising, and emerging markets on aggregate are lagging behind other regions such as the US that have reached more mature stages in the business cycle.

At this point of the cycle, emerging market credit historically has delivered attractive high-single-digit to double-digit returns. We therefore advise being exposed to the asset class. That said, now that we are past the recovery phase that fueled returns in recent months, active management and bond-picking have become more important. Returns are likely to be increasingly dispersed over time, so instead of simply being invested in the asset class, we think it is more important to choose the right credits. Furthermore, very high returns are likely in the recovery stage, but very low returns are also likely in the contraction stage. But passive investors, by definition, will neither make this switch from aggressive to defensive names during the onset of a recession, nor switch back into growth names once skies clear again. They therefore do not account for the business cycle in their allocation.

In sum, we think active management strategies can unlock the potential of diverging dynamics within emerging markets, and steer the allocation through the business cycle.
Benign global conditions, including the soft US dollar and accommodative monetary policy of the Fed and the ECB, support emerging market currencies. But rising expectation of a less accommodative policy stance may trigger setbacks. Although emerging markets are exposed to potential global headwinds, stronger fundamentals should make them more resilient compared to some years ago. We see several opportunities in markets with improving fundamentals and attractive interest rate carry, as well as in selected relative value trades.

Emerging market currencies have delivered strong total returns this year, but expected returns are lower in the coming months. Importantly, emerging markets are today in a better position than some years ago. Economic activity is stronger, interest rates are higher, and external balances have improved. A gradually less accommodative global monetary policy should therefore not derail emerging markets’ outlook, but some temporary setbacks are likely.

We reaffirm our preference for the Russian ruble and the Mexican peso, relative to an equally weighted basket of US dollar and euro. We use the same funding currencies for our newly initiated overweight position in the Brazilian real. In Asia, we keep our preference for the Indonesian rupiah and the Indian rupee, relative to the Singapore dollar. All these overweight positions are supported by improving fundamentals and an attractive interest rate carry amid benign global conditions. Also, we expect the Turkish lira to further outperform the South African rand due to more favorable monetary policy, economic activity and politics. In Central and Eastern Europe, we trim our underweight position on the Hungarian forint by closing it relative to the euro. We still expect the Polish zloty to outperform the forint due to the National Bank of Hungary’s dovish monetary policy stance.

The main risks to our view are weaker economic activity and a prolonged deterioration in investor sentiment. Sentiment might worsen due to upcoming moves by major central banks, uncertainty about the Trump administration’s policies, lower commodity prices, lingering concerns about China’s economic outlook, or geopolitical tensions.

A holistic approach to investing
In a recently published paper, we describe our holistic approach to investing in emerging market currencies. Starting with some real-life examples, we illustrate some of the obstacles that investors face in a world of imperfect foresight.

Therefore, the consideration of base- and risk-case scenarios is essential. Meanwhile, the needs of our clients differ based on their exposure to emerging market currencies, ranging from none or negligible levels to cases where the total wealth is highly dependent on a specific currency. Accordingly, investment objectives might differ and we outline a corresponding two-pillar framework, comprising investing and hedging advice. In our view, it serves clients with investment views according to their individual needs.

For further reading:
Emerging Markets publications

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

White Papers
Dissecting long-term trends in emerging market regions & countries

Africa
Cradle of Diversity

Russia
Back at Global Center Stage

Latin America
Beyond peak trade

Middle East
Prosperity beyond oil
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

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