EM assets rising amid high volatility and dispersion in 2019

Special feature: Top 10 charts for 2019

EM
Investment strategy:
What the year ahead will bring

Focus:
US sanctions: Another wall of worry to climb

Economy:
Mexico vs. Brazil: Stock vs. Flow

Equities:
Stuck in the Middle

Credit:
Tactically constructive, structurally cautious

Currencies:
Some stabilization, but no all-clear
## Contents

### Investing in emerging markets

**Editors-in-Chief**
Alejo Czerwonko  
Michael Bolliger

**Project management**
Brennan Azevedo

**Editors**
Abe De Ramos

**Editorial deadline**
20 November 2018

**Desktop Publishing**
Srinivas Addugula*  

**Contact**
wmrfeedback@ubs.com

---

### Editorial
Will 2019 be a year of living less dangerously? ............................................. 3

### Global investment views
............................................................................... 4

### Top 10 Charts for 2019
Figures illustrating the outlook for EM and the key countries we follow ...... 5

### Emerging market investment strategy
What the year ahead will bring ................................................................. 9

### Focus
US sanctions: Another wall of worry to climb ............................................ 12

### Economy
Mexico vs. Brazil: Stock vs. Flow............................................................ 13

### Equities
Stuck in the middle ............................................................................... 14

### USD bonds strategy
Tactically constructive, structurally cautious ........................................... 15

### Currencies
Stabilization, but uncertainties still cloud the outlook................................. 16

### Key events in 2019
................................................................................. 17

### Emerging markets publications
...................................................................................... 18

---

### 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

Will 2019 be a year of living less dangerously?

As we approach the end of 2018, the sources of volatility that have afflicted financial markets all year still prevail – namely the continued removal of monetary stimulus by the US Federal Reserve and other major central banks, the prospect of further escalation of the trade dispute between the US and China, and uncertainty in Europe around the specifics of Brexit and the Italian budget. Yet, though some of these sources of volatility are likely to stay through next year, there have been some important changes in the backdrop that help balance the investment outlook.

First, corporate earnings reports in the US for 3Q18 were very robust, posting double-digit year-on-year growth rates. And while guidance for next year was more muted (single-digit growth), the recent market correction, combined with the earnings performance, has rendered valuations more attractive. This led us to recently increase our tactical overweight recommendation on global equities in the portfolio.

Second, with the US midterm elections behind us, the market may focus more on fundamental economic and corporate performance and less on political uncertainty. At the margin, the new setup in Washington should produce more checks and balances in the US political process. We don’t expect significant policy shifts out of the new bipartisan Congress, other than a lower probability of another round of tax cuts by the Trump administration, which in any case was not priced in by the market.

Third, while we envision the recent improvement in communication between China and the US to ultimately lead to a framework of negotiations, rather than a “deal,” it is good news that a dialogue between the two is taking place again. Against a backdrop of very low market expectations on the resolution of the trade and investment issues between the two countries, any positive development at the end-November G20 meetings in Argentina would likely be a positive catalyst for markets.

In emerging markets, it is worth noting how concerns around the fragile links such as Turkey, Argentina, and to a lesser extent South Africa and Indonesia, have not translated into contagion during the summer months. Investors rightly recognized differences across emerging markets, and the fact that many have been pursuing prudent monetary and fiscal responses to a more challenging global environment.

As we peer into 2019, we see the following as necessary conditions for emerging markets’ resilience to turn into performance: a stable or moderately weaker US dollar, the peaking of expectations around US policy rates, evidence of traction in China’s reflationary efforts, a bottoming-out of emerging markets’ economic cycle, and the continuation of their prudent macroeconomic policies. The likelihood of these conditions being met is growing as we go into 2019. On the risk side, a significant slowdown in global growth is key to watch, as well as a more severe confidence crisis in Europe which could lead to further US dollar strength and therefore weigh on emerging market assets. For now, our tactical overweight in hard-currency sovereign bonds gives us exposure to emerging markets while we monitor the drivers for a more favorable alignment. There is no denying, however, that volatility will likely be a core feature of asset markets in 2019.

This being our “year ahead” issue, our team has selected 10 charts that illustrate our outlook for emerging markets as a whole and the main countries we follow. In the Strategy section, we discuss our preferences and recommended positioning within emerging markets for 2019. The Economy section discusses the impact of US sanctions, while the Focus section makes a side-by-side comparison of Mexico and Brazil, where the two just-elected, antiestablishment governments are choosing very different paths to tackle their country’s challenges. We also include a calendar of key 2019 events across developed and emerging markets at the end of the report.

We hope you enjoy this publication and find it useful in your investment strategy.
Global investment views

Asset allocation
Global equities fell about 7% in October, representing one of the worst-performing months for the asset class since the global financial crisis. Still, global leading indicators, especially for the service sector, point to robust economic growth. The US labor market remains robust and US earnings delivered slightly more than 25% year-over-year growth in the third quarter. This will slow in 2019 as the year-over-year lift from corporate tax cuts rolls off, but we continue to expect US earnings growth to be positive at 4%. In Europe, we look for mid-single-digit growth, and in the emerging markets 8%. Against this benign fundamental backdrop, we recently increased our tactical overweight to global equities versus government bonds – a position we had reduced in the summer.

Equities
Volatility picked up in October with US, emerging market, Eurozone, and Japanese equities falling 6–9%. The defensive Swiss market held up better. Global leading indicators continue to signal robust economic growth. In the 3Q earnings season, US companies delivered slightly more than 25% earnings growth. And as earnings improved globally, valuations became more attractive. We keep our preference for Canadian stocks over Australian equities due to more compelling valuations. Earnings dynamics are also stronger in Canada than in Australia.

Bonds
We hold an overweight on emerging market (EM) hard-currency sovereign bonds. EM fundamentals and the bonds’ attractive yield of 6.9% support the position. We are also overweight 10-year US Treasuries, as we think this part of the curve has largely priced in the rate-hiking cycle, the carry is attractive, and this position will help offset equity risk in the rest of the portfolio. We also believe the Bank of Japan will allow 10-year Japanese government bond yields to move further upwards as inflation picks up, and that 2-year Italian bond yields will fall as markets realize that Italy has a low probability of defaulting over the coming years.

Foreign exchange
Within our FX strategy, we are overweight the Japanese yen (JPY) versus the Taiwan dollar (TWD). The long JPY position should benefit from either rising Japanese inflation prompting the Bank of Japan to allow yields to move further upwards, or a downturn in global financial markets creating demand for the JPY’s safe-haven function. Meanwhile, Taiwan is exposed to risks arising from US trade policy disputes.
EM growth: Not yet the time to get excited about growth

After a year full of headlines on emerging markets, it’s important to take a step back and look at fundamental drivers again. Historically, the attractiveness of emerging market assets is highly dependent on economic growth. This year, emerging economies have started to slow – a trend we expect to continue in 2019 (we forecast GDP growth of 4.8% versus 5.1% in 2018). Growth rates in emerging markets are still higher than in advanced economies, mainly thanks to Asia, but the differential is set to narrow further. A closer look at regions and individual countries, however, shows important differences across markets.

Although somewhat lower than this year, growth in Asia is set to remain the highest in 2019, lifted by India (7.3%) and China (6%). Latin America should accelerate from subdued levels, mainly due to Brazil as political uncertainties fade and investments pick up. The CEEMEA region remains fragmented: Turkey will likely move into recession due to the shock to private sector balance sheets and sentiment, as well as tighter liquidity conditions. On the other hand, South Africa may accelerate again after the recession earlier this year. After solid growth in recent quarters, Central and Eastern Europe will likely see lower growth in 2019.

Investors therefore have to differentiate growth prospects between individual emerging economies, but we think it’s not yet the time to get excited about overall growth. Uncertainties are high around key factors like tensions between the US and its trading partners, a further tightening of financial conditions, and the impact of commodity prices. In this environment, a tactical investment approach will remain key.

– Jonas David

China: Slowing down to a “new normal”

We expect GDP growth to moderate to 6.5% in 2018 from 6.9% in 2017 on slower investment and consumption, before further moderating to 6% in 2019 on rising trade tensions. Investment has grown at a record low pace in 2018, and the trend will likely continue but with the cushion of fiscal support on infrastructure. Retail sales should continue to slow down as consumers look to downgrade rather than upgrade, with consumer staples more resilient than consumer discretionary. Export growth should slow notably starting 2019 as more US tariffs kick in. Inflation has been mild at 2.2% in 2018 and should remain stable around 2% in 2019. Policy easing should continue to shield against internal and external headwinds. Stable monetary policy provides ample liquidity, with the expectation of another 100–200bps of cuts in bank reserve requirement ratios in 6–12 months. We see fiscal policy focusing on supporting infrastructure projects.

Sino-US relations are entering a “new normal” marked by a long-lasting war beyond trade, with cycles of talk-fight-talk. The second-round effects of US tariffs should be closely monitored. The trade spat is likely to splinter supply chains. The US should benefit from core high technology and innovation output, and China from its vast skilled labor, superior infrastructure, and high degree of industrialization. The rest of the world will capitalize on both for their own interests.

– Yifan Hu
Brazil: A more robust recovery ahead

After close to three years of recession between 2014 and 2016, the Brazilian economy has moderately recovered, but recent growth rates have stood far below potential. As a result, the country’s GDP is almost 5% below where it could be if the recession had not taken place. To be sure, like other emerging markets, Brazil will face external headwinds in the year ahead, but these are manageable in our view considering that the country’s external accounts are balanced. If, as we expect, the incoming government continues to take policy steps in the right direction, growth in Brazil could experience a substantial acceleration. Importantly, Brazil’s banking system has deleveraged relative to emerging market peers. Today, banks’ balance sheets are in good shape and enjoying historically low levels of nonperforming loans (especially on the consumer side). This is important for banks’ ability to further extend credit and add fuel to the recovery. In this favorable context, we see several opportunities in Brazilian stocks and bonds.

– Ronaldo Patah and Alejo Czerwonko

Mexico: López Obrador and MORENA in control

The July election represented a tectonic shift in Mexico’s political landscape. According to our estimates, the now ruling, left-leaning MORENA party and its allies control 340 seats in the Lower House (68%) and 76 in the Senate (59%), i.e. a qualified majority in the former and just eight seats short of one in the latter. President-elect López Obrador’s party can continue to gain support in Congress without any formal electoral process taking place, as small parties and members of the larger parties that emerged weaker from the election, such as PRI, PAN, and PRD, have incentives to join MORENA to guarantee their survival. MORENA’s legislative agenda has so far proven market-unfriendly and uncertainty-inducing, as recent proposals to reduce banking sector fees and impose restrictions in the mining sector illustrate. Congress could also shake up the political status quo for the long term, by approving public referendums as a constitutionally valid way of enforcing changes in the future, or reshaping the composition of country’s central bank board. In this new political environment, our outlook on Mexican macro dynamic and assets prices remains cautious.

– Alejo Czerwonko

LatAm: Fragile and uneven improvement

The year ahead for LatAm from a macroeconomic perspective can be best described as one of fragile and uneven improvement. We do envision an acceleration in aggregate GDP growth in the region in 2019, but the headline number masks large discrepancies under the hood. The only meaningful source of faster economic activity expected for next year is Brazil, which we think can grow twice as fast as in 2018. Colombia’s expected acceleration will be milder, with a year-over-year expansion of slightly over 3%. Argentina will contribute to aggregate numbers by merely contracting at a slower pace, while Chile and Peru will likely maintain a respectable growth rate near 4%. Mexico’s potential 2.2% growth next year faces downside risks. Importantly, LatAm countries and governments continue to live beyond their means, therefore exhibiting twin fiscal and current account deficits which need to be financed at least partly externally. In the context of shifting global liquidity conditions, this reality leaves the region more exposed to changes in the external environment than others in the emerging world.

– Alejo Czerwonko
Russia: Robust fundamentals provide cushion against external pressure

The lingering risks of further US sanctions against Russia will remain a key headwind for Russian assets next year. Russia’s fundamentals remain robust, however, which is likely to cushion the economy from external pressure. The country has solid public finances, with a fiscal surplus and low indebtedness. Its external position is sound as well: Russia is a net external creditor and holds USD 462bn of international reserves. We expect oil prices to recover after the recent sell-off. This should benefit exporters like Russia and support its current account balance; we expect a surplus upwards of USD 100bn this year and next (around 6% of GDP). We are neutral on Russia across asset classes and closely monitor geopolitics, oil prices, business cycle dynamics, and reforms.

– Tatiana Boroditskaya

Turkey: Walking on a thin line

Turkish assets have remained highly volatile this year. Since the failed coup in July 2016 the country has gone through various crisis episodes. Those were driven by major political and geopolitical developments, including snap elections, a constitutional referendum in 2017 and growing tensions with the West; rising macroeconomic imbalances, fueled by a pro-cyclical macro policy mix; and multiple credit rating downgrades. The momentum has improved of late thanks to more orthodox policy measures, favorable current account dynamics, and improving US-Turkey relations, but Turkey continues to walk on a thin line. With inflation above 20% y/y and a fast-decelerating economy, reining in price increases and maintaining lira stability while avoiding a deep economic recession won’t be an easy task for policymakers given tightening external liquidity conditions, municipal elections scheduled for 31 March and lingering geopolitical tensions. Credit is our asset class of choice.

– Jérôme Audran

South Africa: Weak growth, twin deficits, and the need for reforms in a critical year

After the recession in 1H18, we expect the South African economy to grow a mere 0.5% this year, followed by an acceleration to 1.5% in 2019. Some recent reform efforts are positive and the investment outlook should improve. Meanwhile, inflation should trend higher in the coming months but remain within the official target of 3–6% next year. Still, risks are skewed toward policy rate hikes than any cuts, in our view.

At the same time, the persistent current account and budget deficits as well as high unemployment rate require further structural reforms. In our view, policymakers will continue a reform-oriented agenda, but progress takes time – more than initially expected – and the upcoming general elections imply further uncertainties. While the exact date has yet to be decided, the election should take place no later than August 2019. As politicians move into pre-election mode, we might see further delays in the reform progress and renewed leadership fights. In this environment, South Africa’s financial markets will likely experience further bouts of volatility. For now, we keep a neutral positioning across asset classes given the lack of clear catalysts.

– Jonas David
GCC: Reform momentum intact, but mind the steps

Gulf Cooperation Council (GCC) countries have continued to issue Eurobonds and liberalize their capital markets this year, enlarging the investable universe for foreign investors. GCC bonds and stocks have also outperformed thanks to rising GDP growth (on the verge of reaching 2.4% this year, following a contraction in 2017), narrowing fiscal deficits (Saudi’s is down 85% year-on-year in 3Q18, for example), higher energy prices (the average Brent price is up 31% from a year ago), and continued reforms (e.g., 5% VAT introduced in the UAE and Saudi Arabia). We see room for further outperformance given far-from-stretched valuations, our bullish view on oil after the sell-off, the ongoing cyclical rebound, and new economic measures. The defensive nature of most GCC bonds is another interesting feature for investors, while GCC stocks may also benefit from long-term trends such as favorable demographics, ongoing urbanization, and economic diversification. Key factors to watch are fiscal consolidation, oil prices, and geopolitics.

– Jérôme Audran and Tilmann Kolb

CEE: Life after the peak is still good

Gone are the days of 4%+ real GDP growth in Central and Eastern Europe, but we don’t expect growth rates to fall off a cliff – they should hover at or above 3% in 2019. Upward pressure on prices should hold up given tight labor markets in the region, moving inflation rates closer to respective targets. In this environment, we expect the Czech National Bank to continue its hiking cycle, an important reason for our long position on the koruna. Its Polish and Hungarian counterparts are likely waiting for the ECB to move first, however. Romania’s economy showed signs of overheating amid pro-cyclical fiscal stimulus. We monitor if and how the government will reduce the budget deficit, and express our cautious view with an underweight in our credit model portfolio. The main risks to the region are softer European growth and adverse dynamics around the Italian budget, Brexit, and potential auto tariffs. Also, disputes with the EU over the rule of law, migration, and funding are likely to continue.

– Jérôme Audran and Tilmann Kolb
Emerging market investment strategy

What the year ahead will bring

With the new year just around the corner, we want to provide an outlook of what 2019 might bring for emerging market investors. In a nutshell, we think the topics that kept us busy this year will remain highly relevant in 2019. We expect emerging market assets to drift higher in the quarters ahead amid high volatility and significant dispersion within asset classes. The distinction between fundamental trends and sentiment-driven corrections will be key. Investors will have to be agile, disciplined, and selective.

2019 will likely keep emerging market investors busy. Below we list what we consider to be the most important topics to monitor next year.

1. The Fed leads the way
Rising US interest rates have been the most important driver of emerging market assets in 2018 and will likely keep a top spot on investors’ radar in 2019. We expect US economic growth to slow to 2.4% from 2.8% this year, but labor market conditions are tight and upside risks to inflation linger. Countries that rely on foreign funding will have to either tighten their belts further or have strong reasons to attract capital, such as reforms or solid growth prospects. Vulnerabilities appear highest in Argentina, India, Indonesia, the Philippines, South Africa, and Turkey. That said, after significant underperformance in 2018, some assets have room to outperform in 2019. In our credit model portfolio, we remain overweight Argentina, Indonesia, and Turkey.

2. The US-China trade dispute
Slowing Chinese growth due to weaker domestic demand and declining exports to the US have had negative implications for Asia and the rest of the emerging markets, given China’s role as an engine of growth. The trade conflict will possibly linger for longer and could involve disagreement about other matters that might have negative consequences for global growth.

However, trade diversion could make winners out of other countries that have a similar export mix. Producers of agricultural goods in Argentina and Brazil are already benefiting from Chinese tariffs on US soybeans, and the production of auto parts, a target of US tariffs, could be shifted to Japan, Korea, or Mexico. A longer and deeper conflict could see a growing shift in foreign direct investments; in this case, markets in Southeast Asia or Latin America might benefit as manufacturing destinations owing to geographical proximity and competitive labor costs.

---

Tactical asset allocation deviations from benchmark*

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Underweight</th>
<th>Neutral</th>
<th>Overweight</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EM equities total</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EM Asia</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EM LatAm</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EM EMEA</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Bonds in USD</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EM sovereign bonds (USD)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EM sovereign bonds IG (USD)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EM sovereign bonds HY (USD)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EM corporate bonds (USD)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EM corporate bonds IG (USD)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EM corporate bonds HY (USD)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Local currencies</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EM currencies / money market</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EM government bonds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EM inflation-linked bonds</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Most Preferred**
- China
- Indonesia ( neger)
- South Korea

**Least Preferred**
- Taiwan
- Malaysia
- Philippines
- Corporate bonds (index-level)
- Investment grade sovereigns
- Asian bonds
- TWD ( neger)

---

* 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 15 November 2018. Green/Red arrows indicate new upgrades/downgrades. Grey up/down arrows indicate increase/reduction to existing positions.
Emerging market investment strategy

We have a constructive view on selected bonds from Argentina and Brazil. We also see several opportunities in Brazilian stocks.

3. China’s policy response
Unlike in previous crises, the Chinese policy response to weakening domestic growth is more muted, focusing on measures to spur consumption via tax cuts instead of large infrastructure investments. We don’t expect Chinese policymakers to announce a large stimulus program in 2019. Countries dependent on China will thus have to cope with fewer positive spillovers and lower global growth more generally. How well they will manage this challenge remains to be seen, but those willing to progress with reforms are more likely to do well. Argentina, Brazil, Egypt, South Africa, Thailand, Vietnam, and of course China are interesting markets to monitor.

4. Walk the thin line between reflation and reforms
2018 was a busy year, with important elections in a number of countries. 2019 won’t bring much relief in this regard, with general elections scheduled in South Africa, India, Indonesia, and Thailand, among others. The challenge for incumbent parties will be to walk the thin line between reﬂating the economy ahead of elections and showing commitment to reforms to avoid pressure on local assets.

The new governments in Mexico and Brazil will face similar challenges. In Brazil, President-elect Jair Bolsonaro has so far catered to the market’s taste, but pushing the social security reform through a fragmented Congress will be his key challenge in 2019, in our view. On the other hand, Mexico’s President-elect Andrés Manuel López Obrador might face growing pressure from financial markets as he continues to fulﬁl unorthodox campaign promises.

5. US foreign policy and the geopolitical pressure points
The US administration imposed or increased sanctions against several emerging countries in 2018. Geopolitical tensions are unlikely to disappear in 2019. Russia will likely remain in the limelight as possible new sanctions could hit Russian assets; North Korea is likely to remain a geopolitical hotspot; and the situation in the Middle East will likely remain volatile. We advise investors to keep a close eye on these developments. That being said, geopolitical headlines are often of temporary relevance and bouts of underperformance can present buying opportunities for investors with a medium- to longer-term investment horizon. In this context, we advise looking for opportunities in sovereign bonds from Gulf Cooperation Council nations.

Our expectations for 2019: A short outlook for asset classes

Currencies: Over our six-month investment horizon, we expect a ﬂat to slightly positive total return for emerging market currencies. In the near term, we think the case for a stronger US dollar remains intact. But once investors focus more on the US twin deﬁcits, it may enable some appreciation in emerging market currencies due to their cheap valuations and improved carry after recent policy rate hikes. For a sustained rally, we look for a broad-based improvement in economic momentum, which seems unlikely for now. Hence, we prefer a neutral allocation to the asset class. Main downside risks include a sharp rise in global yields, softer global growth, and escalating trade conﬂicts.
Emerging market investment strategy

**Credit:** We have a positive return outlook for a diversified basket of emerging market bonds and favor a moderate risk-on allocation as we enter 2019. Challenging external conditions and headwinds from decelerating global growth mean more volatility, but current valuations already discount some of the risk, and the interest rate carry has increased by 150bps, to 6.8%. Credit fundamentals should remain resilient thanks to higher cash buffers, a lower dependency on foreign funding, and the more competitive valuation of most currencies. We think these factors should limit the downside. Risks to our view include a meaningful rise in US interest rates, a strong slowdown in global growth, a slump in commodity prices, and rising geopolitical tensions.

**Equities:** Investors will need to wait for better macro indicators, especially from Asia, to turn more positive on emerging market equities. Until then, we expect the negative earnings momentum to continue and consensus earnings growth estimates of 11% for the next 12 months to fall. Valuation is more reasonable at close to 10.5x 12-month-forward P/E but not cheap enough to turn more constructive on equities. Relative to developed markets, however, emerging market equities are cheap, trading near a 30% discount.
Focus

US sanctions: Another wall of worry to climb

Sanctions as a policy tool have been playing a central role in modern diplomacy for years, allowing geopolitical powers to penalize countries they consider errant without having to pursue military confrontation. Although the US has increasingly used sanctions in recent years, President Donald Trump has upped the ante by resorting to such measures with unprecedented frequency. US sanctions are also becoming more unilateral in nature, that is, less coordinated with traditional allies. We see few reasons to expect a change in this trend under the current administration.

Developing countries are often the ones at the receiving end of the sanctions game, adding complexity to our job of formulating investment strategies in emerging markets. Sanctions are notoriously hard to price into assets once they are imposed. Although the expectation of sanctions can cause the potentially affected assets to underperform, much of the market impact occurs at the time of announcement. In our analysis of the last few years, we found that sanctions-related underperformance has been temporary, opening some buy-time of announcement. In our analysis of the last few years, we found that sanctions-related underperformance has been temporary, opening some buy-time of announcement. In our analysis of the last few years, we found that sanctions-related underperformance has been temporary, opening some buy-time of announcement.

Turkish assets suffered extreme volatility in 3Q18 as the imposition of US sanctions against two Turkish ministers – following a stand-off involving the fate of jailed American pastor Andrew Brunson – helped investors’ concerns about Turkey’s deteriorating economy and policy credibility. Brunson’s release and the subsequent removal of the US sanctions – coupled with some orthodox economic policy measures by Turkish authorities – were taken positively by the markets and helped stabilize Turkish assets. Although a number of issues remain unresolved, the removal of sanctions signaled an improvement in US-Turkey relations, something we think can be sustained into next year. In this context, we believe an overweight position on Turkey in our in credit model portfolio, expressed through carefully selected bonds, is justified.

Russian assets have gone through two bouts of sanctions-related volatility this year, triggered by the imposition of US sanctions in April, which had knock-on effects on global aluminum markets, and by the US Senate’s consideration of several draft sanctions bills ahead of the US midterm elections. On both occasions, Russian assets partially recovered after an initial sell-off. Some geopolitical risk premium remains justifiably priced in given the ongoing uncertainty. The Trump administration is expected to impose a second round of sanctions related to Russia’s alleged involvement in the attempted assassination of former spy Sergei Skripal in the UK. Meanwhile, US security agencies have 45 days to determine whether Russia had interfered during the midterms. But Senator Bob Corker, who sponsors a draft sanctions bill on derailing elections meddling, said the bill “would be missing the mark” as the elections appear not to have been targeted by Russian interference. We expect the issue of sanctions against Russia to be postponed until the New Year, when the newly elected Congress swears in. Partly due to lack of clarity on the sanctions front, we maintain a neutral stance on Russian assets in our strategy.

Venezuela: The Trump administration has adopted a considerably more aggressive stance toward Venezuela than his predecessors. In August 2017, the Trump White House imposed wide-ranging sanctions on US persons dealing with Venezuelan equity and debt securities. Most recently, on 1 November, the US Treasury targeted Venezuela’s domestic gold sector, and the US has reportedly considered turning up the heat and targeting its oil sector directly. Venezuela looks increasingly isolated as the right-leaning Bolsonaro-Pinera-Macri Southern Cone trident looks likely to increase cooperation with the Trump administration to make President Maduro’s life harder. A sudden regime change in Venezuela under current economic and geopolitical conditions cannot be ruled out. We recommend investors with the willingness and ability to tolerate losses to maintain a small exposure to Venezuela’s bonds in the context of a broadly diversified portfolio.

Iran: In November, the US reimposed sanctions on Iran but agreed to provide “significant reduction exemptions” to eight countries that import oil from the country, including India, China, South Korea, Taiwan, and Turkey, for six months. The oil market viewed this as a bearish development for oil prices, which declined to a three-month low on the news. The exemptions are positive for the importing countries as they allow for a smoother transition to other energy suppliers, while lower oil prices are also broadly supportive of emerging economies. The markets will monitor closely if further exemptions will be given after the current ones expire in 2Q19. Taking into account the recent oil price slump, we retain our view that reduced Iranian oil exports from US sanctions and healthy oil demand growth should tighten the oil market and lift crude prices into 2019.

Other countries to monitor: Saudi Arabia, North Korea.
Economy
Mexico vs. Brazil: Stock vs. Flow

Latin America’s economic heavyweights held presidential elections in the same year for the first time in history in 2018, both yielding outcomes that mark a stark departure from the status quo. In order to assess the economic and financial market outlook of Mexico and Brazil, it helps to distinguish the noticeable differences in their starting points (the “stock”) and the likely policy paths they will take moving forward (the “flow”).

Brazil’s elected president Jair Bolsonaro will inherit an economy with profound fiscal imbalances in need of repair, as well as a government that intervenes heavily in the economy and is mired in red tape that constrains productivity growth and private business activity. The picture from a “stock” perspective looks far from ideal. Given Bolsonaro’s policy agenda, however, the “flow” looks more promising. His is clearly a pro-business government that aims to cut and simplify the corporate tax system, accelerate the pace of privatizations, promote concessions and public-private partnerships, improve the functioning of regulatory agencies, open up the economy, and formalize the independence of the central bank, among other measures.

His government still has to define how it plans to address the pension reform, which is crucial to balancing the budget in the coming years. In a baseline scenario, we expect Bolsonaro’s government to be able to pass changes to Brazil’s social security system through Congress. A deep fix is unlikely, however, and risks of delays and outright failure exist given the politically complex nature of the task and the fragmentation of the Brazilian Congress.

The Mexican economy, on the other hand, enjoys a relatively healthy “stock.” True, deep-seated issues of corruption and poor public safety need to be addressed, but from a macro perspective its twin fiscal and current account deficits are small relative to the size of the economy, and its exposure to the US market remains a plus. President-elect Andres Manuel López Obrador’s policy agenda is, however, quite concerning to us and may walk the country down a treacherous path. Early warning signs came with the designation of political appointees, rather than qualified technocrats, to head key quasi-sovereign companies Pemex and CFE. Then came his announced intention to undo the education reform and eliminate, among others, the evaluation of teachers. Late October brought a “popular consultation” that ultimately led to the cancellation of the new Mexico City International Airport, a USD 13bn project that is already more than 30% completed.

Most recently López Obrador, who will take office on 1 December, announced plans to “validate” referendums through a constitutional reform as well as the intention to hold new public consultations on two railway projects, a new oil refinery, and six social programs on 24–25 November. The 2019 budget negotiations in December are the next big “flow” item to watch, as well as key nominations to the central bank’s board.

In light of these trends, we believe Brazil’s macroeconomic future looks brighter than Mexico’s. Asset prices tend to be more sensitive to unexpected changes in “flow” than to the preexisting “stock” conditions. Since we see greater room for Brazil to keep surprising to the upside and for Mexico to behave in opposite fashion, we are more constructive on the former’s assets than the latter’s. We express this view, for example, through our fixed income recommendations in the Emerging Markets Bonds List and credit model portfolio.
Emerging market equities will likely remain range-bound with relief rallies limited to technical bounces until positive turning points materialize. To turn bullish, we need to see a fundamental improvement in the US-China trade standoff, a growth pickup in emerging economies, and a weaker dollar. Until then, we remain neutral on equities as lingering headwinds such as US liquidity tightening, volatile commodity prices, and slower expected global growth will continue to keep the asset class under pressure.

Volatile and range-bound markets ahead
The MSCI Emerging Markets (EM) Index is down about 13% this year, underperforming MSCI World, the developed market benchmark, by 12%. P/E derating accounted for roughly 75% of this correction, currency weakness for the balance. After the October global equity sell-off, the trend started to reverse and MSCI EM has even outperformed MSCI World by 2% over the past month. Corrections are frequent in emerging markets. Since 1990, MSCI EM has corrected on average by 22% every 11 months. Following its 25% peak-to-through pullback since January, it is fair to expect some technical rebound, similar to the one seen in early November. However, these technical rallies are unlikely to be sustainable, in our view.

Catalysts needed to turn bullish are still missing
Going into 2019, we believe the risk-reward is still neutral on a 12-month-forward basis. Our base case sees no market growth, our bull case a rise of 14%, and our bear case a decline of 15%. We therefore do not think the time is right to enter the market as global headwinds continue to intensify. Valuations at 10.5x 12-month-forward P/E and 1.5x P/B are close to previous troughs (10x and 1.4x, respectively), but just below their long-term averages. Hence they are still vulnerable to further earnings and political risks. Consensus earnings estimates for 2019 have adjusted downward (by 5% over the past six months) but we believe they will continue to fall as our estimates are still about 5% below. Relative to MSCI World, MSCI EM seems cheap at close to 30% discount.

To turn bullish, we would need to see more stable growth in emerging economies, a positive trade deal between the US and China, and a weaker US dollar. We therefore stay tactically neutral on MSCI EM but continue to believe in emerging economies’ long-term story, as their growth differential with developed economies should reaccelerate in the next two years.

Our sector and country positioning
We continue to prefer value over growth sectors in emerging markets due to the more attractive valuation and earnings trends of value-heavy sectors (financials, materials, energy, telecoms) versus their growth counterparts (tech, consumer discretionary and staples).

Within our country strategy, we remain positive on China and South Korea as trade tensions seem priced into their shares. We stay negative on Taiwan, Malaysia, and the Philippines. We turn neutral on Thailand and positive on Indonesia. We remain neutral on EMEA and Latin America due to earnings and political risks.
After positive double-digit returns in 2017, emerging market bonds have posted negative returns around 3–4% this year, triggered mainly by rising US interest rates in 1H18. Since then, performance has been volatile and widely dispersed across countries and sectors. We maintain a positive return outlook for a diversified basket of emerging market bonds and favor a slight risk-on allocation. Challenging external conditions imply bouts of volatility in 2019 and require investment selectivity and agility.

We expect the environment to remain challenging for emerging market bonds next year. However, we expect positive returns of 2.5–4.5% in the next six months for an actively managed and well-diversified credit portfolio. Several drivers will shape the 2019 outlook and deserve close monitoring.

First, economic growth is likely to decelerate in both advanced and emerging economies. This is on the back of rising policy rates, lingering trade tensions, and slower demand from China.

Second, further Fed rate hikes and the likely tightening by the ECB in 2H19 will weigh on funding costs and liquidity. Default rates should remain low, but the rise in corporate debt may lead to future credit stress toward the end of the business cycle.

Third, global risks and market volatility will persist. The risks span within and across national borders, including trade tensions between the US and China, politics in Europe, sanctions risk against Russia, and rising populism worldwide. Social considerations should not be underestimated either, given ongoing fiscal consolidation, decelerating growth, and important elections in several countries.

Despite these headwinds, we see opportunities in emerging market credit, especially in selected high yield and sovereign bonds. The asset class still has a decent risk-reward, in our view, and positive surprises on the risks mentioned above offer additional upside given the level of bearishness in the market.

A key factor supporting our view is valuations. After this year’s sell-off, spreads are now back to long-term averages and close to the cheapest levels relative to US high yield corporates. In addition, the sharp rise in US Treasury yields has pushed emerging market bond yields higher, beyond the widening of credit spreads. Emerging market bond yields are now close to the highs last seen in 2010.

Finally, we expect macro and credit fundamentals to remain resilient on aggregate. Emerging economies have stronger external accounts compared to previous years, their currencies are competitively valued in our view, and growth is holding up well across regions. All this should underpin fundamentals in 2019. Fading risks in countries such as Turkey and Argentina and healthier corporate credit fundamentals (the current corporate default rate is 1.1%) may also provide downside protection in a more challenging backdrop.
Emerging market currencies traded roughly sideways over the past months. While long-term valuations remain attractive, fundamental conditions show little sign of broad-based improvement. Instead of "Emerging market currencies have stabilized on aggregate in recent months. But while valuations remain attractive in many cases, local economic fundamentals show little sign of a broad-based improvement."

Emerging market currencies on aggregate escaped the tumultuous weeks in global equity markets relatively unscathed, trending roughly sideways in a narrow range since mid-August. Over the past month, higher yielding Asian currencies such as the Indian rupee and Indonesian rupiah recouped some of their losses, and the Turkish lira extended its rebound. The Mexican peso stood out as the worst performer after the cancelation of the new Mexico City airport shook investor confidence in the incoming administration.

We think further negative developments can push EM currencies even lower against already cheap valuations. These include global developments such as the US-China trade tensions, Fed rate hikes, and potential hits to risk sentiment due to Italian budget and Brexit negotiations. But a resolution to these issues could also add vigor to markets, while locally the deluge of bad news has abated. Overall, while we think the risks are now more balanced than in the past months, we still don’t see the drivers in place for a sustainable recovery in emerging market currencies in the near term.

Heading into 2019, the direction of the US dollar will remain important for these currencies. We think the case for a stronger greenback in the near term remains intact based on the good performance of the US economy, the outlook for tighter US monetary policy, and the elevated yield in the USD money market. The outcome of the US midterm elections was in line with market expectations and shouldn’t lead to big shifts in policies. More infrastructure spending may be put on the agenda if agreement can be reached on funding; this could add to the already high US budget deficit. The potential for looser purse strings and a wider current account deficit later in 2019 should weigh on the US dollar, creating room for emerging market currencies to appreciate.

Real growth in emerging economies in 2019 is unlikely to exceed this year’s 4.7% (based on IMF data), and with trade tensions unresolved Asia may be headed for a rough start to the year. A broad-based improvement in growth momentum is necessary to sustainably push emerging market currencies higher, but we think this is unlikely for now. We therefore remain neutral on the asset class level, despite still attractive long-term valuations and local policy rate hikes in recent months.

In terms of individual currencies, we keep an overweight in the Czech koruna (CZK) against the euro (EUR), as we expect the koruna to get a boost from the Czech Republic’s tightening of monetary conditions. We also remain overweight the Singapore dollar (SGD) against the Taiwan dollar (TWD), as Sino-US trade tensions should hurt Taiwan more. Given the recent stabilization and improvement in the balance of risks, we close our long Mexican peso versus short African rand position, and our underweight in local-currency government bonds against their hard-currency peers.

**Figure 1**

EM currency preferences
Positioning over tactical investment horizon

<table>
<thead>
<tr>
<th>Currencies</th>
<th>underweight</th>
<th>neutral</th>
<th>overweight</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>LatAm</th>
<th>BRL</th>
<th>MXN</th>
</tr>
</thead>
<tbody>
<tr>
<td>EMU</td>
<td>CNY</td>
<td>HUF</td>
</tr>
<tr>
<td>INR</td>
<td>CZK</td>
<td></td>
</tr>
<tr>
<td>TRY</td>
<td>HUF</td>
<td></td>
</tr>
<tr>
<td>ZAR</td>
<td>TRY</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Asia</th>
<th>CNY</th>
<th>IDR</th>
</tr>
</thead>
<tbody>
<tr>
<td>EMEA</td>
<td>IDR</td>
<td>INR</td>
</tr>
<tr>
<td>KRW</td>
<td>KRW</td>
<td></td>
</tr>
<tr>
<td>MYR</td>
<td>MYR</td>
<td></td>
</tr>
<tr>
<td>PHP</td>
<td>HUF</td>
<td></td>
</tr>
<tr>
<td>SGD</td>
<td>SGD</td>
<td></td>
</tr>
<tr>
<td>THB</td>
<td>THB</td>
<td></td>
</tr>
<tr>
<td>TWD</td>
<td>TWD</td>
<td></td>
</tr>
<tr>
<td>USD</td>
<td>USD</td>
<td></td>
</tr>
<tr>
<td>EUR</td>
<td>EUR</td>
<td></td>
</tr>
</tbody>
</table>

Source: Bloomberg, UBS, as of 14 November 2018.

**Figure 2**

Many EM central banks turned more hawkish or hiked policy rates in recent months

EM central banks’ policy rates on aggregate and in regions (in %)

Source: Bloomberg, UBS, as of 14 November 2018.
### Key events in 2019

<table>
<thead>
<tr>
<th>Developed markets</th>
<th>Emerging markets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Nov-Dec</strong> US/China: President Trump meets with President Xi at G-20 meeting</td>
<td>Nov-Dec India: State elections</td>
</tr>
<tr>
<td><strong>Jan 2019</strong> US/China: US set to increase tariffs from 10% to 25% on 200bn USD of Chinese goods</td>
<td>01-Dec Mexico: AMLO Presidential inauguration</td>
</tr>
<tr>
<td><strong>Mar 2019</strong> US: Congress inauguration</td>
<td>06-Dec OPEC: Oil Market meeting</td>
</tr>
<tr>
<td><strong>May 2019</strong> US: Fed FOMC meeting</td>
<td><strong>15-Dec</strong> Mexico: 2019 budget</td>
</tr>
<tr>
<td><strong>Jun 2019</strong> US/China: US set to increase tariffs from 10% to 25% on 200bn USD of Chinese goods</td>
<td><strong>2019</strong> Kazakhstan: Presidential elections (possible)</td>
</tr>
<tr>
<td><strong>Jul 2019</strong> US: Fed FOMC meeting</td>
<td><strong>Dec 2019</strong> China: Central Economic conference</td>
</tr>
<tr>
<td><strong>Aug 2019</strong> US: Fed FOMC meeting</td>
<td><strong>Dec 2019</strong> China: Quarterly Politburo meeting</td>
</tr>
<tr>
<td><strong>Sep 2019</strong> US: Fed FOMC meeting</td>
<td><strong>2019</strong> Dec 26th: UBS GWM 35th ASEAN summit</td>
</tr>
<tr>
<td><strong>Oct 2019</strong> Switzerland: Parliamentary elections</td>
<td><strong>Dec 2019</strong> China: 35th ASEAN summit</td>
</tr>
<tr>
<td><strong>Nov 2019</strong> Switzerland: Last day of Mario Draghi’s term</td>
<td><strong>Dec 2019</strong> China: 35th ASEAN summit</td>
</tr>
<tr>
<td><strong>Dec 2019</strong> US: Fed FOMC meeting</td>
<td><strong>Dec 2019</strong> China: 35th ASEAN summit</td>
</tr>
</tbody>
</table>

---

**US:**
- **Nov/Dec** US: Fed FOMC meeting
- **Jan** US: Fed FOMC meeting
- **Mar** US: Fed FOMC meeting
- **Jun** US: Fed FOMC meeting
- **Sep** US: Fed FOMC meeting
- **Dec** US: Fed FOMC meeting

**EU:**
- **Jan** EU: ECB monetary policy meeting
- **Mar** EU: ECB monetary policy meeting
- **May** EU: ECB monetary policy meeting
- **Jun** EU: ECB General Council meeting
- **Jul** EU: ECB monetary policy meeting
- **Aug** EU: European Council meeting

**Switzerland:**
- **Dec** Switzerland: Parliamentary elections

---

**Japan:**
- **Apr** Japan: BoJ’s Outlook Report meetings
- **Jun** Japan: BoJ’s Outlook Report meetings
- **Jul** Japan: BoJ’s Outlook Report meetings
- **Aug** Japan: BoJ’s Outlook Report meetings

**US/China:**
- **Nov** US/China: President Trump meets with President Xi at G-20 meeting
- **Dec** US/China: US set to increase tariffs from 10% to 25% on 200bn USD of Chinese goods

**EU:**
- **Jan** EU: ECB monetary policy meeting
- **Mar** EU: ECB monetary policy meeting
- **Jun** EU: ECB General Council meeting
- **Sep** EU: ECB monetary policy meeting
- **Oct** EU: ECB monetary policy meeting

---

**Developed markets**

- **Nov/Dec** US/China: President Trump meets with President Xi at G-20 meeting
- **Jan 2019** US/China: US set to increase tariffs from 10% to 25% on 200bn USD of Chinese goods
- **Mar 2019** US: Congress inauguration
- **Apr 2019** US: Fed FOMC meeting
- **May 2019** US: Fed FOMC meeting
- **Jun 2019** US: Fed FOMC meeting
- **Jul 2019** US: Fed FOMC meeting
- **Aug 2019** US: Fed FOMC meeting
- **Sep 2019** US: Fed FOMC meeting
- **Oct 2019** US: Fed FOMC meeting
- **Nov 2019** US: Fed FOMC meeting
- **Dec 2019** US: Fed FOMC meeting

**Emerging markets**

- **Nov/Dec** India: State elections
- **Jan 2019** Mexico: AMLO Presidential inauguration
- **Mar 2019** India: Parliamentary elections (first round)
- **Apr 2019** India: Primary elections
- **May 2019** India: Parliamentary elections (second round, if needed)
- **Jun 2019** Argentina: Presidential and Congressional elections (third round)
- **Jul 2019** Mexico: Gubernatorial and local elections
- **Aug 2019** South Africa: Parliamentary elections (April/May possible)
- **Sep 2019** Colombia: Regional and local elections
- **Oct 2019** Brazil: Congress inauguration
- **Nov 2019** Australia: Federal elections
- **Dec 2019** China: Central Economic conference
Emerging Markets publications

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

White Papers
Economic, social and financial market changes over the last 20 years and investment implications
- Africa: Cradle of Diversity
- Russia: Back at Global Center Stage
- 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.