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Bye bye globalization, hello stagflation

Emerging markets fixed income – Q1 2022
UBS Asset Management

Emerging Markets Fixed Income
Q1 2022 review and Q2 2022 outlook

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The views expressed are a general guide to the views of UBS Asset Management as of 6 April 2022.

Market overview

Q1 2022: War and inflation flummoxed risk assets

- Emerging markets fixed income (EM FI) delivered negative total returns in Q1, mostly reflecting the Russian invasion of Ukraine and higher global inflation.
- EM spreads widened, driven by high yield spreads, while rates sold off, but currencies (EMFX) benefitted from tighter monetary policy and strong commodity prices.
- EM asset performance in Q2 2022 is likely to continue to be influenced by geopolitics and the policy responses from behind-the-curve developed market central banks to high inflation.

EM FI showed negative total returns across most asset classes in Q1 2022. Sovereign (corporate) credit spreads as measured by the EMBIGD[1] (CEMBID[2]) widened by 31 bps (15 bps) in Q1 to 400 bps (317 bps) generating a -4.52% (-5.56%) spread return (inclusive of carry). The US Treasury (UST) yield curve sold off aggressively while flattening further, with the 2Y, 10Y and 30Y yields selling off 160 bps, 83 bps and 54 bps respectively. These UST yield moves detracted significantly from total credit return performance.

Most of the negative returns occurred in February, reflecting Russia's invasion of Ukraine and the sanctions that followed. Russia had a significant 3.4% weight in the EMBIGD (4.5% CEMBIGD) at the beginning of the year, and the violent drop in bonds prices (generically from around par to around 20c) greatly affected overall performance. Russia has now been dropped from all indices.

Q1 2022 returns[3]

	Total return	Spread return	US treasury return
JP Morgan EMBI Global Diversified	-10.02%	-4.52%	-5.76%
JP Morgan CEMBI Diversified	-9.27%	-5.56%	-3.92%

	Total return	Currency return	Local debt return
JP Morgan GBI-EM Global Diversified	-6.46%	1.42%	-7.77%
JP Morgan ELMI+	-5.53%	0.05%	-5.58%

Source: Data as of 31 March 2022. Bloomberg Finance.
Past performance is not a reliable indicator of future results.

1 As measured by the JP Morgan Emerging Market Bond Index Global Diversified index.
2 As measured by the The JP Morgan Corporate Emerging Markets Bond Index Global Diversified index.
3 EMBI = Emerging Markets Bond Index. CEMBI = Corporate Emerging Markets Bond Index. GBI-EM = Government Bond Index – Emerging Markets. ELMI = Emerging Local Markets Index. The table shows total returns of US dollar and local currency debt plus their return components. The US dollar debt return components: Spread return results from the yield difference between emerging markets debt and US treasuries and from spread movements. US treasury return results from US treasury yield movements. Local currency debt return components: Local debt return results from yield movements and coupons of the underlying bonds in local currency. Currency return results from exchange rate movements.

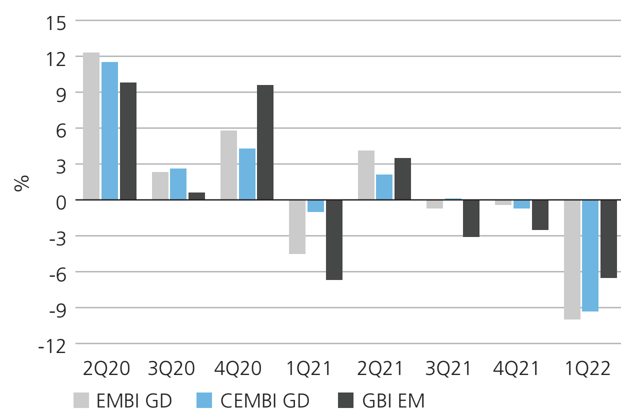
Continuing with the trend in Q4, local yields (as measured by the GBIEMGD[4]) widened 52 bps in Q1, reflecting the impact of higher inflation and tighter monetary policy in EM, and the severe impact from the Russia's invasion of Ukraine (Russia had a 7.8% weight on the GBIEMGD index at the beginning of the year and local Russian bonds dropped from around par to 5c in Q1). As a result, EM rates returned -7.77% inclusive of carry. Higher monetary policy rates in EM and higher commodity prices provided support to EMFX which returned 1.42% in Q1. In all, the local index returned -6.46% in Q1.

Outflows met with net negative issuance

According to the latest J.P. Morgan survey, EM FI saw outflows of USD 14.1 bn in Q1, after recording USD 0.2bn of inflows in Q4 2021. Sovereign and corporate credit saw outflows of USD 11.9bn in Q1, a reversal from the USD 4.2bn inflow in Q4, while local EM (currency and rates) saw outflows of USD 2.1bn in Q1 after seeing outflows of USD 4.0bn in Q4 2021.

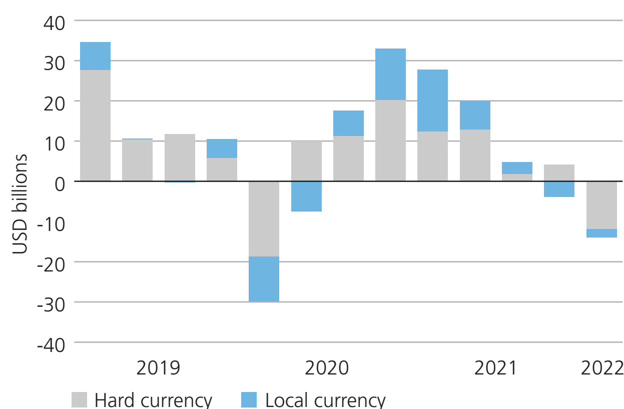
Emerging markets debt issuance slowed in Q1, while supply continued to be led by investment grade (IG) credits. Sovereign and corporate issuance in Q1 2022 reached USD 40.0bn and USD 95.7bn, respectively. Amortization and coupon payments reached USD 42.8bn for sovereigns and USD 98.6bn for corporates leading to net negative supply in Q1 2022.

Exhibit 1: Quarterly returns



Source: Data as of 31 March 2022. Bloomberg Finance.
Past performance is not a reliable indicator of future results.

Exhibit 2: Outflows at the start 2022



Source: JP Morgan, UBS Asset Management, as of 31 March 2022.

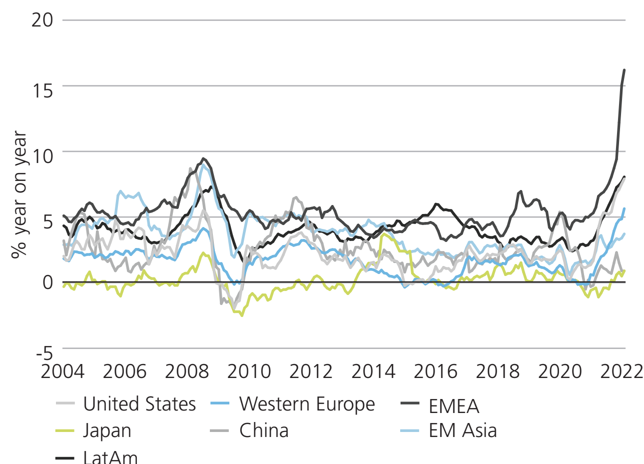
4 As measured by the JP Morgan GBI-EM Global Diversified index.

Higher inflation everywhere

Inflation increased further around the world on higher food and energy inflation and dovish DM central banks. The Russian invasion of Ukraine exacerbated these shocks, and inflation prints in Q1 were higher than expected almost everywhere (exceptions include China and Japan among the systemically important countries). Russia and Ukraine account for around 25% of the global trade of grains, while Russia produces 11%/21% of the oil /gas in the world. New COVID-19 waves, in China in particular, forced new lockdowns, probably disrupting global supply chains and adding to inflationary pressures in Q1. In all, global inflation reached levels not seen since the 1970s in developed markets. EMEA inflation was impacted by a significant increase in CEE4 inflation, but most notably by a jump in Turkey's inflation to almost 55% in Q1 2022 from around 25% in Q4 2021 on account of highly heterodox monetary policies. So far, Japan and China have remained isolated from the global inflationary shock.

There are several reasons to believe that inflation will remain elevated for some time not only because of the most recent commodity shocks, but also because of the large monetary/ fiscal impulse by developed markets during the pandemic and beyond, structural changes in labor markets, deglobalization and higher government intervention.

Exhibit 3: Global inflation by region



Source: UBS Asset Management, Macrobond, BLS, NBS, as of February 2022.

The hawks are awakening after a long nap

As result of the inflation pressures, DM central banks started to become more hawkish in their statements and actions.

The Fed started the year on a dovish tilt, with Fed funds at 0-0.25% and still printing money through QE, although inflation was already running at 7% by end Q4 2021. On March 16th the Fed hiked by a timid 25 bps while indicating that QT wasn't necessarily forthcoming anytime soon. The decision was the more puzzling because board members' inflation projections stood at 4.3%/2.7% by end-2022/23 respectively (above the historical 2% inflation target), but the dots representing board members forecasts of Fed fund rates stood at 1.75%/2.75% by end-2022/23, implying several quarters of negative real monetary policy rates. This hardly constituted a credible tightening to lower inflation and inflation expectations, more so when one year Michigan inflation expectations stood at 5.4% in March, the highest since Q1 1982 (other market-based indicators also point towards decades high inflation expectations).

As the quarter progressed, FOMC members started to issue increasingly hawkish statements, prompted perhaps by the impact of the war on food/energy inflation. Such statements

included faster hikes (50 bps instead of 25 bps per meeting) and clearer statements about QT. Markets quickly adopted such views and are now pricing in 50 bps hikes per meeting in the next two meetings and a total of six hikes with a cumulative 212.5 bps in hikes. If these expectations are realized, Fed funds will be around 2.5% by end-2022, still below expected inflation. Furthermore UST two year yields (closely associated with monetary policy expectations) sold 160 bps off to around 2.4% in Q1, while the curve flattened and almost inverted. Clearly, the Fed still has strong credibility with the markets.

The European Central Bank (ECB) also started the year dovish as well, but surprised markets with a more hawkish posture in late March as it announced a faster tapering of asset purchases than the one outlined in December 2021. The ECB now expects "to conclude net asset purchases under the APP in (Q3)." However, the ECB still prefers to have maximum flexibility, optionality and gradualism, as it also pushed away rate hikes from "shortly after" to "some time after" the end of QE. Markets are pricing in 60 bps worth of hikes in H2-2022. Clearly there are other concerns taking precedence over inflation, including the impact of the Russian invasion and sanctions on growth expectations, given inflation in the Eurozone is running at 7.5% in March, the highest level ever since its formation.

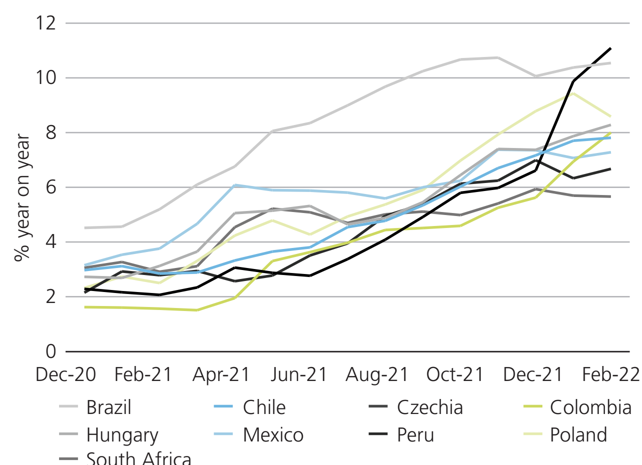
The Bank of Japan (BoJ) kept its extremely accommodative monetary policy stance unchanged at the March 18th meeting and kept its policy-balance rates at -0.10% and the 10 year JGB yield target at 0% +/-0.25% under the yield curve control policy. The guidelines for asset purchases remained unchanged as well. In their own words: "The Bank will continue with Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control, aiming to achieve the price stability target of two percent, as long as it is necessary." The BoJ considers that inflation is driven by higher commodity prices and that Ukraine uncertainties warrant a cautious stance. Inflation in Japan is now at 0.9% and could reach the target by 2H 2022.

EM Central Banks are far more advanced in the tightening cycle

Central banks in emerging markets started to tighten before developed markets as a response to substantial inflationary pressures from imported inflation (food and energy even before the war) and the depreciation of their currencies in 2021. Because of their pro-active stance, they are far ahead in their fight against inflation. However, the recent commodity shocks brought about by the Russian invasion are likely to require further hikes to contain inflation expectations and second round effects.

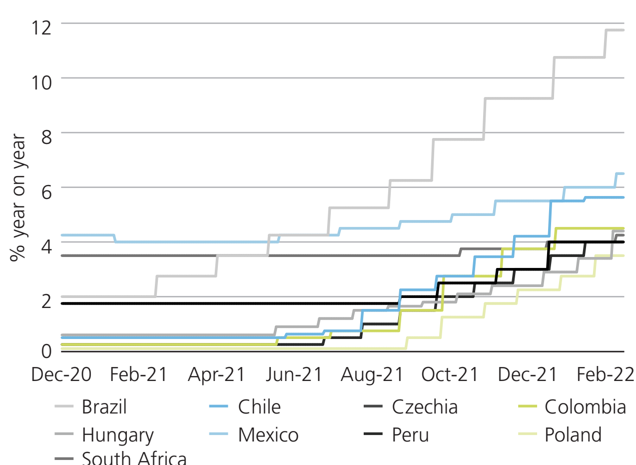
At one extreme, Brazil hiked rates 975 bps to 11.75% (with inflation running at 10.5% in March). Such hikes should have been enough if not for the most recent shocks. Currently markets are pricing in an additional 100 bps hike to 12.75% in the next three months to a very restrictive stance on year-end expected inflation of 6.5% by Q4 2022. Although extreme,

Exhibit 4: EM headline inflation



Source: Macrobond, UBS Asset Management, as of 31 March 2022.

Exhibit 5: EM policy rates



Source: UBS Asset Management, Macrobond, BCB, CNB, MNB, BANXICO, BCRP, NBP, SARB, as of March 2022.

this is the direction most EM central banks are pursuing with very few exceptions. One of those exceptions is Turkey, whose CB has decided to confront very high inflation by lowering interest rates and imposing other distortionary measures instead.

At other extreme, China's PBOC is in an enviable position as inflation continues to be well behaved and so far, immune to global inflationary shocks. While most central banks are tightening monetary policy to fight higher inflation while growth is low or coming down, the PBOC should be able to ease financial policies to provide some impulse to subdued economic activity without worrying about inflation. Markets are expecting such easing besides other measures to address the weakness in the real estate sector and possibly from the most recent COVID-19 induced lockdowns.

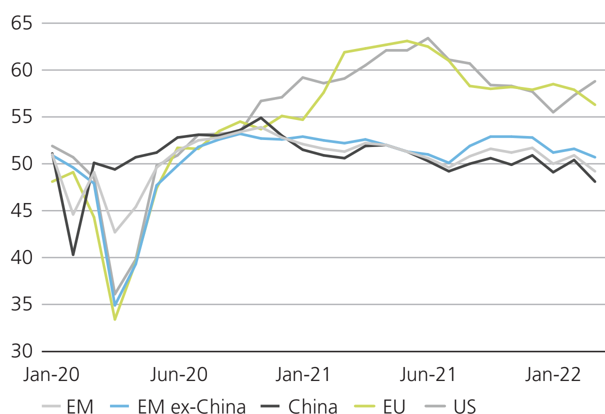
Low growth, high inflation = stagflation

While inflation is going up, economic activity is coming down. PMIs and surveys in DM and China indicate that much. Most recent official forecasts on real GDP growth in 2022, confirmed the trend. On the one hand, tighter monetary policy, and a negative fiscal impulse – following the hyper-expansions of 2020-21 – would negatively affect growth. On the other hand, new Covid waves (now in China), ongoing supply constraints, and more importantly the negative impact of falling real incomes (compliments of very high inflation rates) will affect private sector consumption. Usually, high oil prices have the same impact as a tax on global consumption, now it is not only oil going up but also food. Another factor affecting growth prospects is the low level of sentiment indicators in the Eurozone and the US, which have predictive power on growth six months hence.

In EM, growth is also likely to be underwhelming in 2022. Among the big ones, the Chinese authorities are struggling to turn around its economy, despite indications from the leadership that macroeconomic stimulus may be warranted, besides specific measures to alleviate the downturn in the real estate and tech sectors. We expect Q1 growth in China to be disappointing at around 3-4%. In the absence of a turnabout in the general policy stance, it will be difficult for China to reach its stated growth target of around 5.5% in 2022. The rest of EM is also struggling to recover amidst tighter policies to combat higher inflation. Back in October 2021, the IMF expected global growth to reach 4.9% in 2022 from 5.9% in 2020. In January 2021, the IMF reduced the estimate to 4.4% on tighter monetary policies and lower fiscal impulse. We expect global growth expectations to be reduced further to around 3.8% for 2022, when the new April report is published at the time of the annual meetings in Washington DC, on account of the Russian invasion and further inflationary pressures.

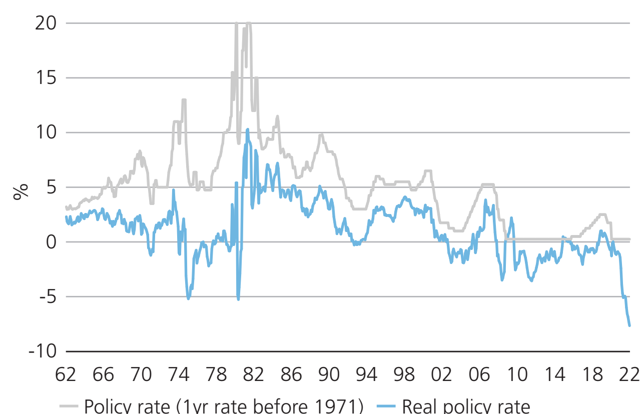
The main risk down the road for growth is inflation and the policies required to bring it under control, particularly in DM. Monetary policy rates in real terms are highly negative and would need to make up a lot of room in a relatively short period of time. If past experience is of any guidance, a recession may be the only way to bring inflation under control, given the policy mistakes of the recent past.

Exhibit 6: Global PMIs



Source: Macrobond, UBS Asset Management, as of 31 March 2022.

Exhibit 7: The Fed is behind the curve



Source: Macrobond, NBER, UBS Asset Management, as of 31 March 2022.

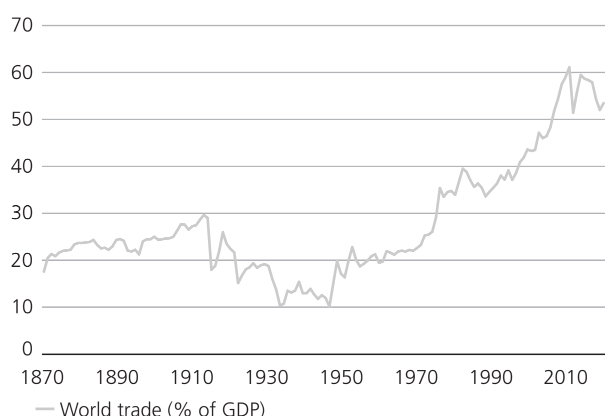
De-globalization: A reality or a risk?

Is the most recent globalization episode coming to an end? Has the pandemic and increased geopolitical risks given it the last stroke? By several accounts globalization peaked a decade or more ago and has been in decline. A simple measure such as global trade/ global GDP reached its zenith in 2008 at an impressive 60% from 10% in 1945 and has been declining ever since. Another measure like the average level of tariffs in the world reached its nadir last decade and has been slowly rising since the US imposed tariffs on China. The current globalization episode came to be around the collapse of the Soviet Union (1989-1991), continued with the creation of the WTO (1994) and the accession of China to it (2001).[5]

It seems to us that recent events - including the imposition on tariffs by the US on Chinese goods in late 2018, recent sanctions and spats between these two countries - indicate that we are rather facing the return of global blocks like the cold war days. The Russian invasion of Ukraine together with the uncommitted position taken by China, has further pulled apart Russia and China from the West. Furthermore, the West and China would likely have the difficult issue of Taiwan to tackle at some point. This issue is not going away and is already one of the main sources of geopolitical risk globally. Would China and Russia together with several EM countries now dependent of China become allies and form a new front? Would China invade Taiwan and further antagonize the West? These events would certainly erode globalization further and could change the global order for decades to come.

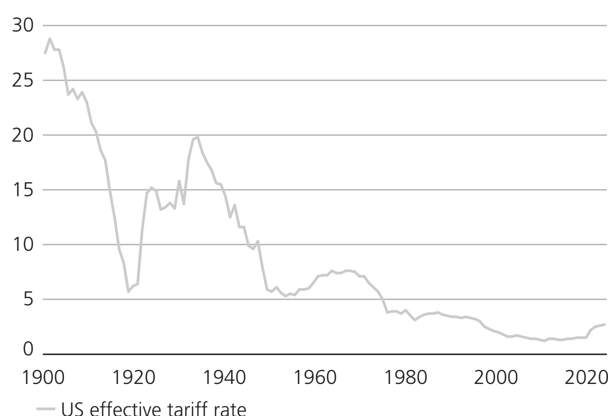
One of the most immediate consequences of de-globalization is higher inflation. This is because this last globalization wave came with extremely efficient but vulnerable inventory technology highly dependent on reliable global supply and trade partners. This technology lowered global costs and had and deflationary impact globally. The pandemic and growing geopolitical risks are changing the technology back to a more costly, inefficient but more reliable (absent trusted suppliers and traders). The current supply bottlenecks are subsiding but are unlikely to disappear if new geopolitical risks keep arising.

Exhibit 8: The current globalization wave has ended



Source: PWT, Our World in Data, UBS Asset Management, as of 31 March 2022.

Exhibit 9: First steps toward a multipolar world



Source: Source: UBS Asset Management, Goldman Sachs, USITC, as of 31 March 2022.

[5] The World Economic Forum argues that the 3rd wave of globalization that started in 1989 came to an end with the GFC in 2008 and that we are now in the 4th wave, a globalization order dominated by the US and China in the digital age. According to the WEF, the first globalization wave happened on the back of the industrial revolution in the 19th century until the beginning of WWI. The second from the end of WWII to around 1989 although the soviet block was excluded and China was not integrated to the world economy.

Uncertainty and volatility likely to remain elevated

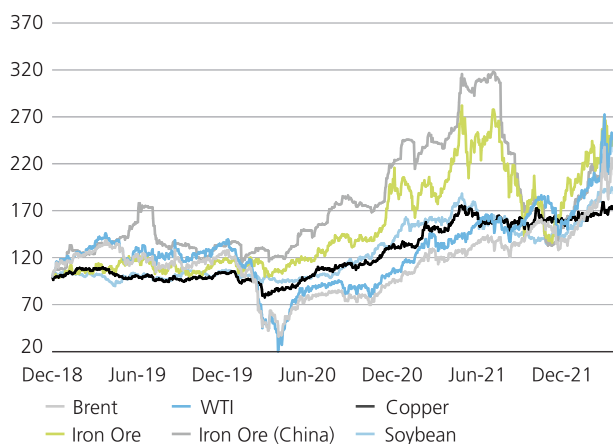
Uncertainty and volatility are likely to remain elevated in Q2 on account of COVID, the war in Russian-Ukraine and tighter policies in DM. We can't rule out another severe widening of UST yields as markets remember that high inflation can co-exist with lower growth, particularly if inflation prints continue to surprise on the upside, which we expect will be the case. In this context we would remain short interest rate duration.

Additionally, we believe that global shocks - including a potential escalation in the war, a new global COVID wave and/or a correction in (expensive) US equity markets could have a negative impact on risk taking and hence on riskier asset classes like EM FI. On the positive side, we expect commodities to remain well supported despite lower growth because of the war and structural underinvestment as well as supply in several commodity markets.

We would express the above views by under investing in commodity importers and countries located in Eastern Europe and central Asia, which are likely to be affected by the Russia-Ukraine conflict, and over investing in commodity exporters not in Eastern Europe. We identify value in Latin America, Africa and the Middle East.

(Federico Kaune)

Exhibit 10: Commodity Prices have strong support (Index = 100 as of end Dec'18)



Source: Bloomberg, UBS Asset Management, as of 31 March 2022.

Sovereign debt

The Russian invasion hits returns

Sovereign credit posted a -10.02% total return in Q1 2022 (measured by the JP Morgan EMBIGD Index). Spreads widened 31 bps to 400 bps, generating a -4.52% spread return. This figure is counterintuitive given 7.5 year spread duration of the index. The explanation is that spreads changes and spread returns were distorted by the expulsion of Russian and Belarusian securities from the index at a price of zero on 31 March. The expulsion of Russia and Belarus resulted in a spread tightening of around 40 bps on 31 March. Had Russia and Belarus remained in the index until the end of the quarter, spreads would have widened by 71 bps instead of the officially reported 31 bps, while spread returns would have been 60 bps higher than the officially reported in Q1; a more intuitive result. A significant widening in US Treasury yields detracted from performance. Nearby Gianandrea explains the full impact of the invasion of Russia on EM benchmarks.

Investment grade (IG) spreads widened 7 bps officially to 155 bps in Q1 (62 bps to 211 bps, inclusive of Russia/ Belarus.) High yield (HY) spreads widened by 45 bps officially to 684 bps in Q1 (71 bps to 710 bps, inclusive of Russia/Belarus). At 155 bps, IG spreads are close to fair value. However, the spread widening in HY makes HY even cheaper relative to its own history and to competing asset classes including US HY.

Interestingly, spreads in Latin America (LATAM) and South Saharan Africa (SSA) remained stable in Q1. Spreads in the Middle East and North Africa (MENA) tightened 9 bps, despite the significant widening of spreads in Pakistan in Q1. Asia spreads widened 30 bps on account of Sri Lanka among others. Eastern Europe spreads widened 236 bps on account of Russia, Ukraine, Belarus, and Georgia among others. Despite no change in spreads, LATAM showed a total return of -5.69% while SSA showed a total return of -4.08%, reflecting the selloff in UST yields. MENA returned -4.09% and Asia -6.61%. Eastern Europe returned -31.68% in Q1.

In Latin America, only Ecuador (0.47%), Costa Rica (1.25%) and Venezuela (56.60%) showed positive returns. Venezuelan bond prices benefited from alleged discussions with the US administration about potential resumption of oil trade to compensate for the ban on Russian oil. All in all Venezuelan bonds increased from around 6c to around 9c.

In MENA, Pakistan returned -18.67% on political turmoil surrounding the potential non confidence vote on PM Khan, who had lost the backing of the military. Tunisia returned -10.10% as the president closed congress amidst a deteriorating political situation. In contrast Lebanon returned 16.22% on hopes of a monitoring IMF staff level agreement before the elections.

In SSA, all countries with exception of Angola (3.62%) and Mozambique (3.60%) showed negative returns. Angola benefited from higher oil prices and improved macroeconomic fundamentals and Mozambique secured a staff-level agreement with the IMF that should help it with financing and reforms. In Asia, Kazakhstan (-15.20%) and Tajikistan (-12.35%) showed highly negative returns because of the Russian invasion, reflecting their close economic and trade links with Russia. China Hight yield bonds -including in the real estate sector- continue to implode.

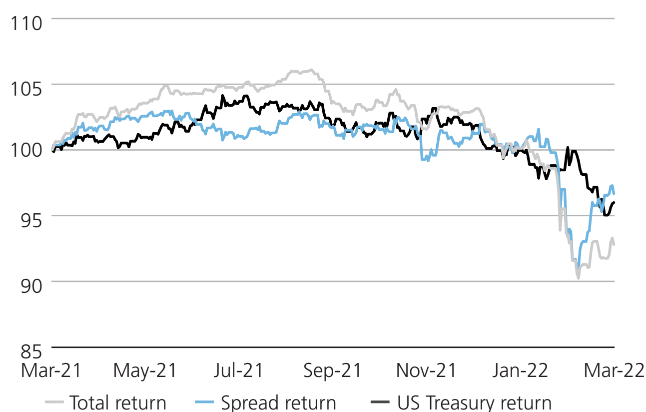
Finally Eastern Europe suffered the direct impact of the Russian invasion of the Ukraine. Ukraine returned -51.36% and Russian and Belarus -76.57% and -84.39%, respectively. The CEE4 countries' bonds were down between 2.7% (Poland) and 7.97% (Romania). Poland has received more than two million Ukrainian refugees, but it is expected to get financial help from the EU.

We believe EM sovereign debt will be subjected to the volatility of UST yields and risks emanating from developments in DM policies. We believe that DM central banks are behind the curve in their fight against inflation and this poses risks to markets including EM. At 400 bps over UST spreads are compelling in a low volatility regime but could widen further in the current high volatility regime. However, we find opportunities primarily in commodity exporters not directly affected by the Russian invasion. This is because we believe commodity prices including energy, metals and agricultural will remain well supported, benefiting countries that export them.

Countries with higher quality policies in Africa, Latin America and the Middle East offer such opportunities. China high yield has disappointed in the past six months on account of the lack of policy response by the authorities. It could still generate outsized returns in Q2, provided a change in the direction of macroeconomic and sectoral policies.

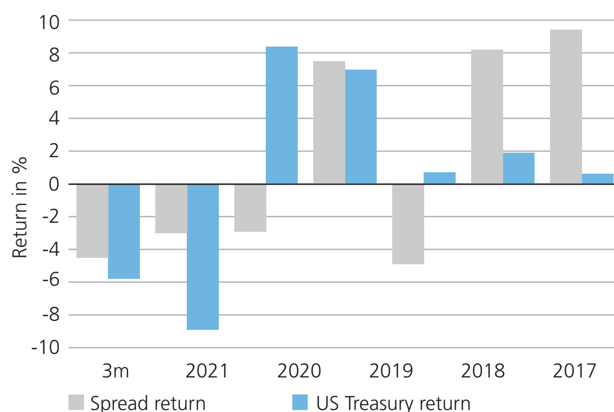
(Federico Kaune)

Exhibit 11: Emerging market sovereign debt: hit by Russia's invasion



Source: JP Morgan, as of 31 March 2022. Rebalanced to 100 from 31 December 2020. Index shown is the JP Morgan Emerging Market Bond Index Global Diversified (EMBIGD).

Exhibit 12: Emerging market sovereign debt returns over the past 5 years



Source: JP Morgan, as of 31 March 2022. Index shown is the JP Morgan Emerging Market Bond Index Global Diversified (EMBIGD).

Corporate debt

Multiple shocks sour returns, cloudy outlook

EM corporate credit returns were rocked by negative headlines in Q1 2022, resulting in negative returns of -9.27% (measured as JP Morgan CEMBI Diversified Index). Corporate credit spreads widened by 15 bps in Q1 2022. Total returns from carry / spread detracted -5.56% while Treasury detracted -3.92%.

In Q1 2022 corporate bonds in Argentina (5.91%), Ghana (3.06%), and Turkey (0.44%) provided the largest positive returns while the largest underperformers were Russia (-68.98%), Ukraine (-53.50%), Kazakhstan (-14.80%), Thailand (-8.95%), and Poland (-8.64%).

All sectors provided negative returns in Q1 2022. The best performing sectors were Diversified (-3.86%), Infrastructure (-4.32%) and Transport (-4.82%), while the worst performing sectors were Metals & Mining (-20.74%), Oil & Gas (-15.81%), and Industrial (-10.75%). All regions reflected negative returns with Europe (-47.93%), followed by Asia (-5.76%), Latin America (-4.51%), Middle East (-4.10%) and Africa (-3.59%).

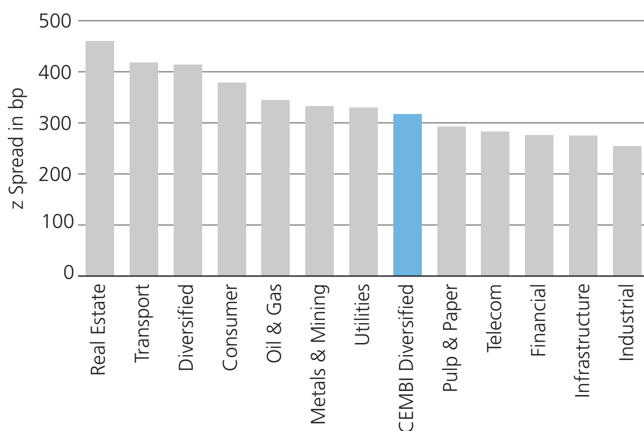
In the first quarter of this year EM corporate returns were negatively impacted by multiple shocks. For the first time in multiple quarters risk sentiment was not driven by COVID-19 headlines, but instead Russia's war in Ukraine, the concern of conflict spilling into other countries, and the impact on inflation, primarily through higher oil and gas prices as well as agricultural products. The increased inflation expectations applied more pressure on interest rates moving forward interest rate hikes and increasing pace of hikes primarily from the US.

While China continued reversing tightening policies from the last year, the damage inflicted on confidence to the real estate sector will be difficult to reverse. Without direct intervention in the property market, liquidity conditions for property developers will continue to deteriorate. Latam and Africa corporates were beneficiaries of asset allocation shifts away from commodity importers and the geopolitical turmoil in Europe.

Financials: Bank fundamentals continue improving as loan growth is expected keep pace with riding GDP. Furthermore, higher interest rates are broadly supportive for NIM expansion benefiting financials with faster asset repricing. Fundamentally, we continue to prefer large high-quality franchises that have solid capital and liquidity buffers and conservative underwriting standards. We favor subordinated Tier 2 bonds and subordinated AT1 bonds of these high-quality franchises over senior notes.

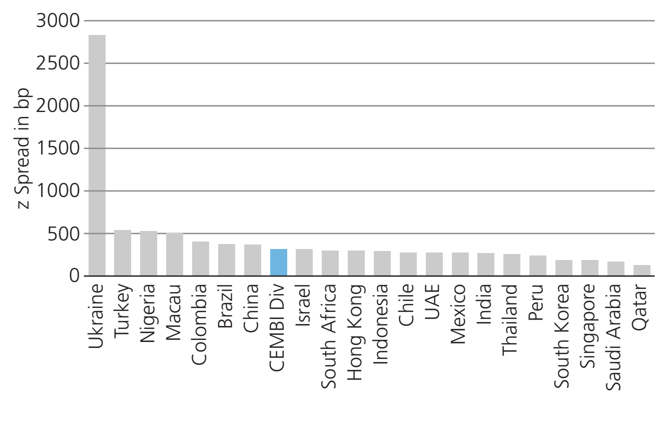
TMT (technology, media & telecom): This sector has a domestic-oriented nature as consumption of mobile, internet and TV subscription services remained resilient and decoupled from Russia/Ukraine war. The long-term investment case for TMT remains largely intact, on the back of stronger demand for telecom services surged post pandemic, with increases in

Exhibit 13: Emerging market corporate spreads by sector



Source: JP Morgan. Index shown is the JP Morgan CEMBI Global Diversified index, as of 31 March 2022. The z-spread, also known as the zero-volatility spread or the static spread, measures the spread over the benchmark zero coupon swap curve.

Exhibit 14: Emerging market corporate spreads by country



Source: JP Morgan. Index shown is the JP Morgan CEMBI Global Diversified index, as of 31 March 2022. The z-spread, also known as the zero-volatility spread or the static spread, measures the spread over the benchmark zero coupon swap curve.

mobile and fixed broadband traffic, a supportive demographic outlook for EM as well as comparatively lower penetration rates relative to developed economies. While the backdrop remains supportive, this is reflected in prices, and we see limited upside in TMT bonds.

Oil & Gas: Oil was already supported by low inventories amidst a severe supply crunch of natural gas. Russia's war in Ukraine further impacted supply or both Oil & Gas. We remain positively positioned on the sector to capture additional spread tightening while longer term we are cautious as integrated producers prioritize energy transitions to biofuels, solar, wind and battery charging stations.

Consumer: Within the consumer sector we continue rotating out from the more defensive components of this segment, packaged food, beverages and household products into consumer discretionary names. However, we prefer to remain selective given higher raw materials.

Metals & Mining: Another sector disrupted by Russia's war in Ukraine. The post COVID economic recovery and green transition have improved the outlook/demand for most base metals. While our outlook for Metals & Mining remains broadly positive, growing risks from Russia and the slow economic recovery in China could prove to be a strain on returns causing us to cautiously lower our expectations.
As we highlighted in previous quarters, EM issuers continue with robust liability management. This trend has continued over the last quarters as issuers take advantage of market liquidity and relatively low interest rate environment.

We remain cautious on credits with low to negative cash flow generation and tight liquidity buffers. The weakest corporations tend to be in the most exposed sectors including transport, industrials, travel and leisure, oil and gas, and real-estate. We prefer commodity exporters and short duration high yield over investment grade, while tactically managing interest rate duration. From a valuation perspective China real estate remains attractive. While we expect volatility in this sector to remain high, and liquidity to remain tight, this will provide both risks and opportunities in coming quarters.

(David Michael)

Local currency debt

The aftermath of the shocks

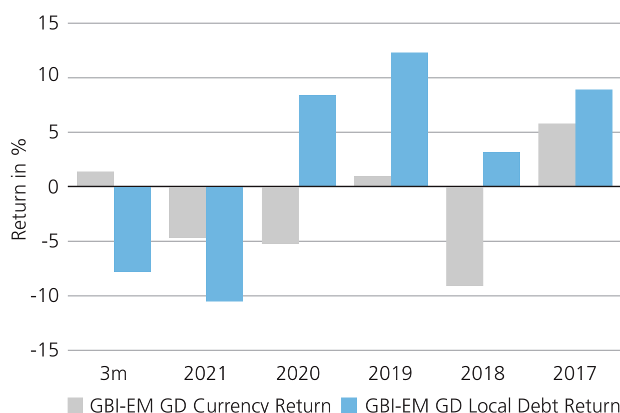
EM local debt (measured by JP Morgan GBI-EM Global Diversified index) lost 6.46% in Q1. The loss was concentrated in local currency performance -7.77%, while FX returns were surprisingly positive 1.52% thanks to a rally in commodity-sensitive currencies. Two shocks drove the negative returns – the Russian invasion of Ukraine, and the acceleration of global inflation that has resulted in a significant repricing of both UST and EM monetary policy trajectory. The rise in commodity prices and the distance to the military conflict benefited commodity exporters, particularly in Latin America, while EE underperformed.

The outlook for Q2 2022 is unsurprisingly cloudy. Despite the persistent COVID waves, the impact of the pandemic is gradually dissipating outside China, where the zero-covid policy is being put to a test. The war in Ukraine remains in the active phase. Even though the hope is for a de-escalation in Q2, more sinister scenarios cannot be ruled out. The growth is bound to decelerate in Europe, China and the US reducing demand, but commodities are well supported because of mounting supply constraints. This lends support for commodity currencies, even though upside is being reduced after the sharp rally in Q1. The FOMC has started the hiking cycle, which is expected to pick-up steam in the coming months. Nevertheless, many EM central banks have started earlier and are near the end of the hiking cycle, and the yield levels for high yielders are attractive by historical standards.

Latin America has been the main beneficiary of these trends. Six of the top seven performing currencies are in Latam (the one outside the region is also commodity-driven ZAR). In particular, the BRL rose over 20% this year. Even after the rally, think there is additional appreciation potential for Latam FX as currencies are still not expensive by historical standards, and interest rates have risen significantly, but the returns are likely to be more modest. Interest rates, however, could perform once it becomes clear that inflation is flattening out and central banks are close to ending the hiking cycle. These conditions are likely to have been achieved in Brazil. We are still cautious on rates in Mexico, Colombia and Chile. In the case of Mexico, the central bank has started behind the curve, while Chile, Colombia and Peru suffer from elevated political risk. We prefer Chile and Peru with known election outcome to Colombia where a sharp move to the left is the base-case scenario for the upcoming presidential election.

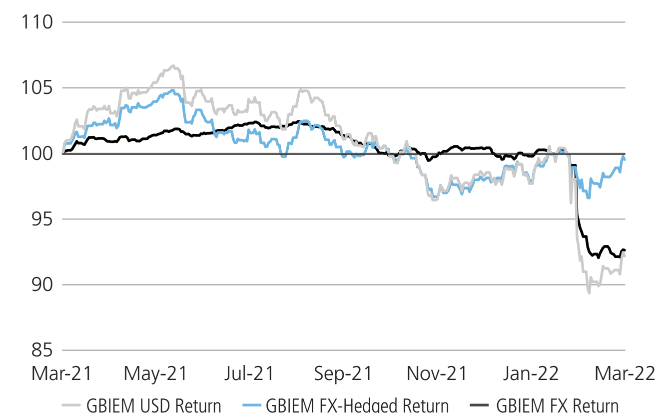
In EMEA, Russian assets have gone out of indices at the end of March and are no longer investable. Turkey's government and central bank have lost control of inflation and the currency has collapsed with little hope for a return to more orthodox policies. With inflation already north of 50%, the TRY is at risk of further sell-off. Turkey external position has been negatively affected by the drop in tourism and high oil prices. The currency, however, sold off and the price of hedging is high, creating a brittle equilibrium after sharp

Exhibit 15: Emerging market local currency returns: split between local debt and currency components



Source: JP Morgan monitor, as of 31 March 2022.

Exhibit 16: Currency returns: more sensitive to economic and political shocks



Source: JP Morgan, as of 31 March 2022. Rebalanced to 100 at the start of the period.

moves in December of last year. Egypt that entered the indices in Q1 devalued its currency in March as the shock of higher oil and food prices was severe and led to portfolio flight. The outlook for the pound is uncertain as it remains overvalued. The outlook for South African growth and fiscal balance has improved on sizeable gains in terms of trade and political support for the government, however, high dependency to China and low growth are the perennial risks.

Central Europe has suffered the brunt of the fallout from the Russian invasion of Ukraine outside the combatants. The volatility in CE currencies has been very high. The outlook will largely depend on the path of the conflict. Inflation had been very high even earlier, and the outlook continues to be negative due to supply constraints, influx of refugees from Ukraine and risk premium. Central banks, however, have accelerated rate-hike cycles and the yield curve have adjusted. We continue to see upside risk to bond yields in the region as long as the conflict continues.

The APAC outlook has deteriorate given the slowdown in China and rise in oil price. The recent lockdowns in large Chinese cities and stress in the real estate sector bode ill for China growth. The CNY is at an expensive level driven by widening trade surpluses, and the currency is vulnerable to higher rates in the US. In addition, higher oil prices will affect both growth and trade balance negatively for commodity importers such as India and Korea. Thailand and other ASEAN countries will continue to see few Chinese tourists despite easing of lockdowns. Commodity exporters – Malaysia and Indonesia – on the other hand will benefit from higher export prices. However, inflation is likely to gradually increase putting pressure on bonds across the region, ex China. As the result we are cautious on regional bond markets and neutral on the currencies.

(Igor Arsenin)

Inflation is here to stay

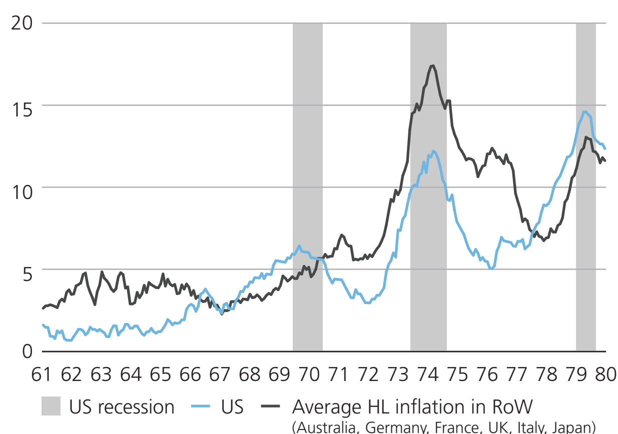
Q1 2022 brought very dramatic inflation prints around the world: 7.9% in the US, 7.4% in Germany, 16.2% in EMEA, 8.1% in LatAm, and 3.7% in EM Asia. The previous time the world experienced anything like this was in the 1970s. To understand what the current increase in inflation means for the future, we begin our investigation in 1965 when the US congress passed the Great Society programs Medicare, Medicaid, the Older Americans Act, and the Elementary and Secondary Education Acts. At the same time, the US became increasingly involved in the Vietnam war.

The key observation is that after US inflation began to rise, inflation in the rest of the world[6] (ROW) followed. This happened three times in the 1965-80 period, and in all episodes, US inflation led ROW inflation by three months. First in 1965-70; US inflation was consistently below 2% in the early 1960s but in 1965 it began to increase gradually reaching 6.4% in 1970. Second, in 1972-1974, particularly after the first oil shock in October 1973. Third in 1976-1980 when the US inflation reached 14.6% after the second oil shock associated with the Iranian Revolution in 1979. Our statistical analysis of global inflation suggests that inflation typically begins in the US, moves to Western Europe next, and then gets disseminated to different EM regions, while China and Japan remain largely unaffected. The above analysis suggests that to understand what will happen to EM inflation we need to understand what will happen to US inflation. We begin by trying to understand why US inflation has increased so much, so fast.

1970s vs Today

There are several similarities between the 1970s episode and today's: (i) Increased fiscal spending, then associated with the Great Society programs and now with Covid-19 support; (ii) monetary stimulus in a period of strong economic growth; (iii) energy shocks. The US keeps playing an outsize role in global inflation dynamics and while the speed at which US inflation increased was surprising, its rise should not have been. One of the strongest laws in macroeconomics is that prices go up if central banks print enough money – and in 2020 the world experienced an unprecedented monetary and fiscal expansion: central banks printed a lot of money and governments spent it. In the US, the M2 measure of money supply grew by 27% in 2021, higher than in the 1960s-70s. Moreover, US households' disposable income, which was already above 2014-19 levels, increased further due to government transfers. All this extra cash had to go somewhere. It couldn't go to services during the pandemic, it went to goods at the same time as manufacturers and shipping firms were expecting the opposite and had sharply reduced capacity. Moreover, Covid restrictions impacted labor markets leading to supply chain bottlenecks. There wasn't enough capacity to satisfy the massive increase in demand for goods and, when that happens, prices must rise. Higher inflation is in part due to these supply-chain bottlenecks and should come down once those issues are resolved. The invasion of Ukraine has impacted food and energy inflation further, but those pressures should also decline if/when the

Exhibit 17: That 70s show?



Source: Macrobond, NBER, UBS Asset Management, as of 31 March 2022.

Exhibit 18: When US inflation rises, the world follows

	US	W. Eur	EMEA	Japan	China	EM Asia	LatAm
US	1.00						
W. Eur	0.83	1.00					
EMEA	0.62	0.68	1.00				
Japan	0.15	0.02	0.06	1.00			
China	0.37	0.46	0.16	0.20	1.00		
EM Asia	0.43	0.62	0.29	0.09	0.32	1.00	
LatAm	0.40	0.37	0.59	0.32	0.14	0.29	1.00

Source: Macrobond, UBS Asset Management, as of 31 March 2022.

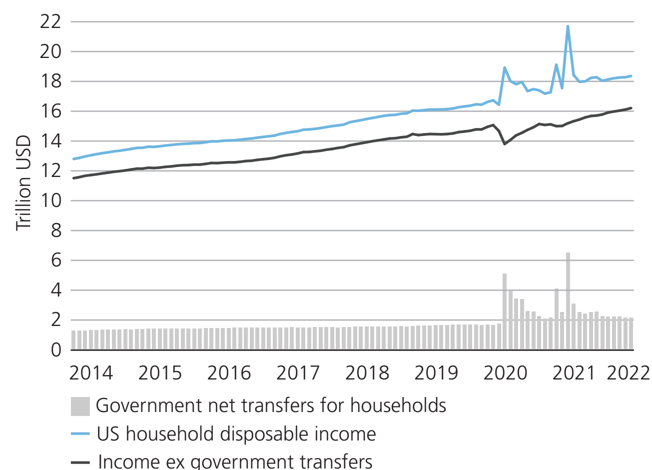
6 Represented by Australia, Germany, France, the UK, Italy, and Japan for which we have data available going back to the 60s and were more integrated to the world economy than the typical EM.

war is over. However, shelter and services inflation may be more persistent. After the GFC, fragile households' financial conditions reduce demand for housing, particularly from first-time homebuyers. This pent-up demand for shelter is likely to increase shelter inflation in coming years. Also, the demand for services will increase as the lockdowns end. The largest component of services is labor, and labor costs are rising due to minimal working age population growth.

Other changes in long-term trends suggests higher inflation in the future. The era of globalization is ending, while government intervention is on the rise. Both trends are likely to be inflationary. Regarding globalization, in 1945 global trade was 10% of GDP, by 2008 it was 61%, but has been declining ever since. Just-in-time supply chains with their emphasis on maximum efficiency and minimal costs came along with globalization, lowering global inflationary pressures. However, systems which are maximally efficient can be fragile. Even prior to the war in Ukraine, the Covid shock and the associated supply chain bottlenecks were forcing firms to increase their resilience by moving to "just-in-case" supply chains. This means multiple chains, lower efficiency, and higher costs. The war in Ukraine will further increase this pressure as firms will seek to insure themselves against geopolitical shocks. Furthermore, it is possible that the sanctions will lead to multiple trading blocs with minimal inter-bloc trade, further increasing costs. Regarding government intervention, fiscal stimulus increased in popularity after its "success" during the Covid crisis (the recession was exceptionally short and the recovery exceptionally fast). Also, defense spending is likely to increase after the Russian invasion of Ukraine while an aging population is likely to require more services and more government support. The last 400 years of UK history are indicative of what this means. UK's CPI in 1744 was the same as it was in 1600, but in the second half 18th century, the world entered a period of long and costly wars and UK's CPI increased by 135% from 1756 to 1815. After the Congress of Vienna in 1815, UK's CPI fell nearly 40% in the next 20 years. World War I led to another inflationary episode, followed by deflation after the war ended. But since 1939, the UK has had a persistent increase in the price level as the role of government increased. For the above reasons, we believe that US inflation is likely to remain elevated for years to come, pushing global inflation up with it. As in the 1970-80s', a damaging recession may be the only way to bring inflation down.

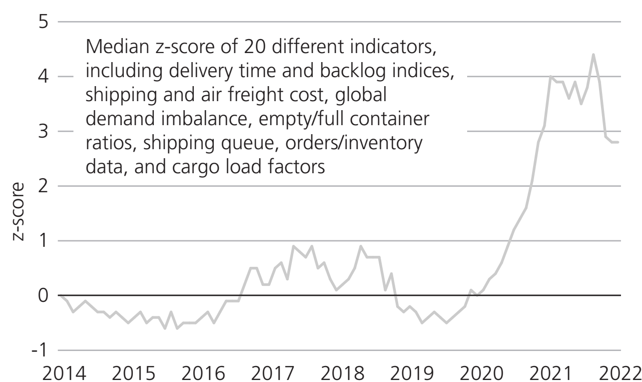
Juha Seppala

Exhibit 19: Unprecedented jump in US household income



Source: Macrobond, NBER, UBS Asset Management, as of 31 March 2022.

Exhibit 20: Supply chain bottlenecks improving



Source: UBS, as of 31 March 2022.

War in Ukraine: impact on Eastern Europe

Besides the direct implications of the conflict for Russia, Ukraine and Belarus, we analysed the collateral damage to peripheral countries in the Eastern Europe region which are members of the EMBIGD. Intuitively, countries with higher trade exposure to Russia should have underperformed more than countries with minimal linkages. Was this the case? In order to study this relationship, we used the share of Russia exports as percentage of total exports for each country in 2020 and compared it to their total return (spread+treasury) on JPMX between 10 February (when in our view markets started to price in the conflict's news flow) until 31 March 2022 (Q1 2022 quarter end).

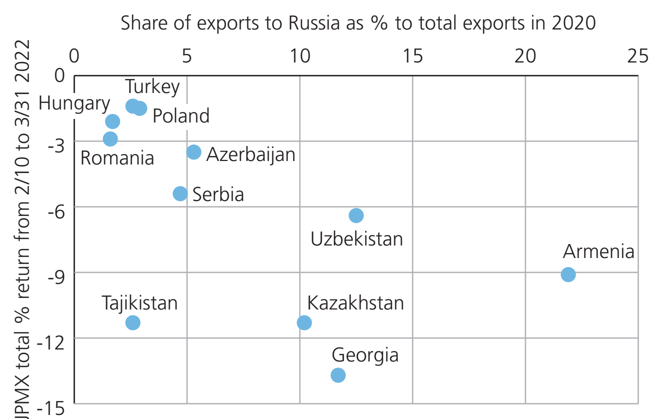
Results point to a generally negative correlation at -0.57. Looking in depth, we observe that countries with high trade exposure (Kazakhstan, Georgia and Armenia – all above 10% of total exports to Russia) have significantly underperformed, with total returns ranging between -9% and -14%. The exception to this group is Uzbekistan, which posted a smaller -6% loss despite 13% of their exports going to Russia. Similarly, we observed that countries with limited trade linkages with Russia (Turkey, Hungary, Romania, Poland, Azerbaijan and Serbia – all below five percent of total exports to Russia) have generally posted relatively smaller negative total returns ranging from -1% to -5%. The outlier in this group is Tajikistan, with a large negative total return of -11% in this period despite limited trade linkages (3% of total exports to Russia), although with a substantial remittance exposure to Russia (24% of Tajikistan's GDP in 2021).

EMBIGD regional spreads are mostly back to start of the year levels. At a global level beyond Eastern Europe, we analyzed the impact on the main regions in the EMBIGD (LATAM, Asia, Africa and Middle East) by studying the JPMX spread movement at regional level for the whole Q1 2022. Firstly, we observed that besides Eastern Europe (which materially widened by 535 to 859), Africa, Middle East and LATAM all closed the quarter practically flat compared to year end. Slightly deviating from this trend was Asia, which widened by 39 to 274. Secondly, we observed that within the quarter, spread volatility has varied among regions. In Asia, spreads have been proportionally most volatile, widening from 229 at the start of the year, to 324 on 8 March and back to 265 at quarter end. We observe a similar pattern, but with smaller magnitudes in Africa followed by LATAM, whereas the Middle East has been the least volatile by far, as spreads have been very stable through Q1 2022, always between 315 and 350.

Impact on benchmark country weights: Lastly, country weights in the EMBIGD materially fluctuated in Q1 2022. The ongoing conflict had a deep negative impact on Russia, Ukraine and Belarus bonds, therefore diminishing their weight in the index over time. Russia and Belarus have proportionally lost the most representation during Q1 2022 (respectively from 3.34% to 0.83% and from 0.43% to 0.07% at 30 March), before being completely excluded from the EMBIGD by JPMorgan on 31 March. Ukraine's weight fell too, but relatively less from 2.30% to 1.16% over the same period. On the other hand, because of the above, the countries that have increased their EMBIGD representation the most during Q1 2022 are Turkey (+0.37% to 3.83%), Romania (+0.30% to 1.43%), Nigeria (+0.28% to 2.11%), Bahrain (+0.28% to 2.92%), Oman(+0.27% to 3.05%) and China (+0.21% to 4.72%).

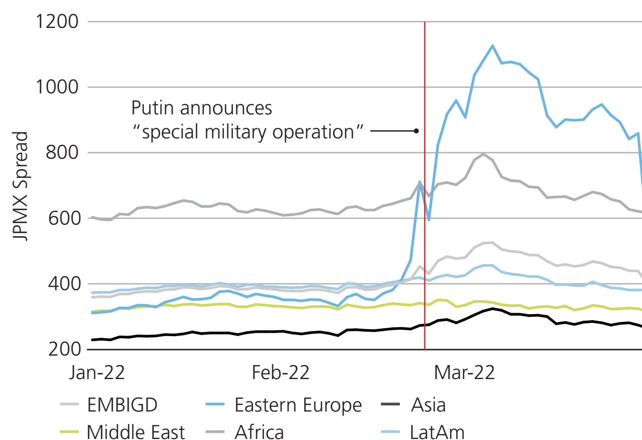
(Gianandrea Moccetti)

Exhibit 21: Share of Russia exports as a % of total exports and total return by country between 10 February 2022 and 31 March 2022



Source: Macrobond, NBER, UBS Asset Management, as of 31 March 2022.

Exhibit 22: Spread movement by EMBIGD region in Q1 2022



Source: UBS, as of 31 March 2022.

Russian debt: to pay or not to pay?

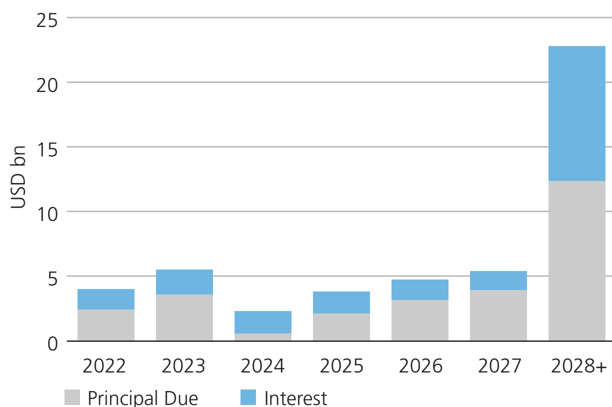
Investors in Russia are assessing the likelihood of a sovereign debt crisis as its invasion of Ukraine enters a second month. Swift and unprecedented sanctions by the West, including restrictions on transactions with the Central Bank of Russia (CBR) and the Finance Ministry, initially led investors to believe a Russian default was imminent. Russian 10y sovereign bonds fell to 20 cents on the dollar, five year CDS spreads touched 3,500bps, and credit rating agencies downgraded Russia sovereign debt to junk. The measures that Russia imposed to defend its financial system – including capital controls that block external debt payments and requiring issuers to service their Eurobond obligations in RUB – suggested that the sanctions were having an impact on the Kremlin's willingness to pay. However, in the last few weeks it surprised many by paying its obligations, leading investors to question how long it will have until it is unable to service its debts.

For the sovereign, current outstanding USD- or EUR-denominated external debt amounts close to USD 40bn and it faces USD 4.7bn of repayment until the year-end. The US sanctions restrict the Russian authorities from accessing USD- and EUR-denominated offshore assets, effectively freezing USD 300bn of USD 640bn total official reserves and reducing the available liquid resources. Although the CBR is the largest entity in terms of assets to ever be sanctioned by the US, a large portion of its reserves remain unfrozen. In addition, despite the partial oil embargo, the near historical high value of its oil exports, which contribute c. 40% of government revenues, also indicates that Russia has the technical capacity to pay. Against expectations, Russia in the last few weeks has demonstrated its willingness to pay and comply with the terms of the offerings – paying coupons in USD on the 2023s (USD 73mn), 2043s (USD 44mn), 2029s (USD 66mn), 2035s (USD 102mn) and finally the 2022s (USD 45mn) and its maturity (USD 2bn). (At the time of writing, the US Treasury has blocked the US paying agent banks from processing the latest funds, leaving Russia a 30-day grace period to make payments from its unfrozen reserves or face default.)

Similarly for Russian corporates, servicing their obligations has remained a steadfast priority for most issuers. Capacity is demonstrated by the strong fundamentals of most Russian issuers, which for the past decade have been fortifying their fundamental credit profiles, by improving efficiencies and reducing their reliance on wholesale international funding markets. However, capacity could become more of a concern in the medium to long term: most Russian corporates generate a significant share of their revenues from international operations that could begin to suffer as international clients refuse to buy Russian products and commodities, putting Russian corporates' willingness to continue servicing their debts to the test.

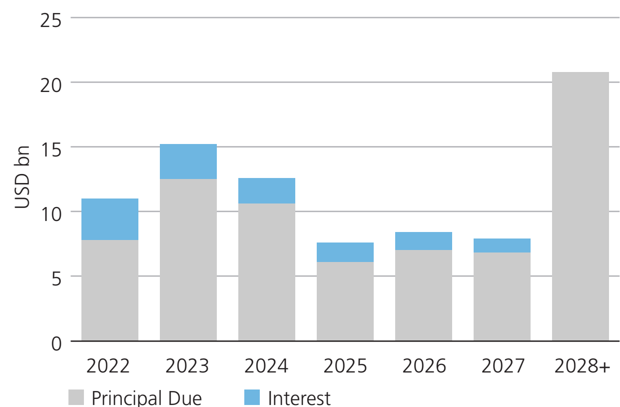
While the objective of Western sanctions has been to prevent Russia from benefitting from international capital markets, policymakers have also tried to avoid hurting Western financial institutions and investors. As a result, international investors have been allowed to receive debt service payments for a specified duration (90 days in the US). Russian companies have so far also been able to avoid Kremlin's countersanctions

Exhibit 23: Russian sovereign external debt repayment schedule



Source: Bloomberg, as at 31 March 2022.

Exhibit 24: Russian corporate external bonds repayment schedule



Source: Bloomberg, as at 31 March 2022.

and capital controls by requesting licenses from the CBR to continue servicing their debts in the original issuing currency. In the very near term, avoiding defaults is likely to depend on potential extensions of these licenses/exemptions. While the sanctions have not yet diminished most Russian corporates' capacity and willingness to pay (at least not as initially expected) in the short term, these are likely to eventually decrease as the war drags on for longer.

Sanctions are likely to have a more pronounced impact on Russian corporate debt, given that total outstanding Eurobonds amount to c. $105bn. While most companies remain unsanctioned and have continued making timely payments; these are now being blocked or frozen at the level of the paying agent banks. Fear of sanctions being breached as well as perceived reputational risks, are the driving forces behind these blocks, as many of the impacted Russian companies are controlled by shareholding Oligarchs that are also sanctioned individuals. For payments to be released to bondholders, companies are having to request 'licenses' or approvals from international regulators. Only four companies (EUCHEM, SUEK, CHMFRU and CHEPRU) and one state owned enterprise (RURAIL) have so far seen their blocked payment not being released and could likely be classified as technical defaults. The ongoing lack of clarity and uncertainty over the length of this conflict, as well as the possibility of sanctions being tightened further, is driving many of the financial intermediaries involved in the complex payment chains to perhaps become overly risk averse. As we begin to get more clarity, we may see operational and administrative conditions for Russian corporates begin to ease. However we also note that the longer the war drags on, the more negatively it is likely to weigh on issuers' capacity, willingness and ability to service their obligations.

(Yuni Kim, Will Riva)

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