Emerging markets fixed income

July, 2018

Air pockets and headwinds

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A rough quarter for EM FI

- EM fixed Income saw negative returns amid sizable outflows and low liquidity
- Worsening global conditions, rising political uncertainty and poor policy responses to blame

Emerging markets fixed income (EMFI) delivered negative returns during Q2 2018. Worsening global conditions, rising political uncertainty, and poor policy responses to financial pressures caused drops in asset prices amid limited liquidity and persistent outflows from the asset class.

Q2 2018 returns

US dollar debt	**Total return**	**Spread return**	**US treasury return**
JPM EMBI Global Div.	-3.54%	-3.53%	-0.02%
JPM CEMBI Diversified	-1.83%	-1.92%	0.09%

Local currency debt	**Total return**	**Currency return**	**Local debt return**
JPM GBI-EM Glob. Div.	-10.40%	-8.34%	-2.25%
JPM ELMI+	-5.77%	-6.72%	1.01%

2018 YTD returns

US dollar debt	Total return	Spread return	US treasury return
JPM EMBI Global Div.	-5.23%	-3.73%	-1.56%
JPM CEMBI Diversified	-3.06%	-2.20%	-0.88%

Local currency debt	Total return	Currency return	Local debt return
JPM GBI-EM Glob. Div.	-6.44%	-6.49%	0.05%
JPM ELMI+	-3.41%	-5.25%	1.94%

JPM = JP Morgan. EMBI = Emerging Markets Bond Index. CEMBI = Corporate Emerging Markets Bond Index. GBI-EM = Government Bond Index – Emerging Markets. ELMI = Emerging Local Markets Index.
Source: Data as of June 30, 2018. Bloomberg Finance.

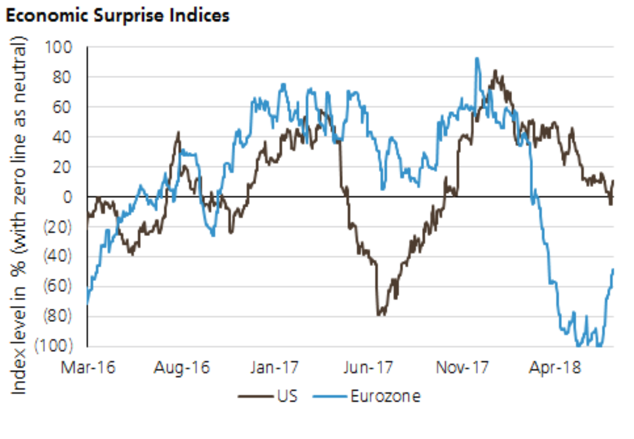
* The tables show total returns of US dollar and local currency debt plus their return components, as explained below:
- US dollar debt return components: Spread return results from the yield difference between emerging markets debt and US treasuries and from spread movements. US treasury return results 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.

As a result, sovereign (corporate) credit spreads widened 66 (40) basis points (bps) to 369 (332) bps over US Treasury yields. Sovereign (corporate) credit returned -3.5% (-1.8%) mostly on account of wider spreads rather than higher UST yields. At -10.4%, local EM assets performed markedly worse than credit.

Broad USD strength compounded the negative impact on FX, which returned -8.4% during the quarter. Argentina's peso weakened 30.2% against the USD while Brazil's real, South Africa's rand and Turkey's lira weakened more than 10% each. EM rates sold off 59 bps with Turkey and Argentina rates widening 418 and 271 bps, respectively.

Synchronized global growth story no longer in place

The positive global backdrop, which supported emerging economies and markets in 2016-17, seems to be faltering. Economic indicators show the synchronized global growth story is no longer in place with softer growth in Europe and some EM but strong growth in the US.

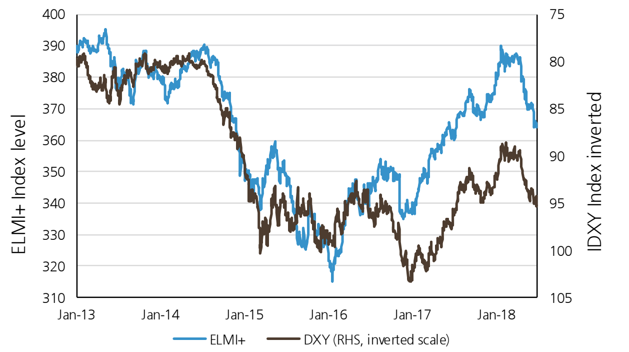


Source: Bloomberg as of June 30, 2018

The US Federal Reserve hiked the fed funds rate another 25bps in June, continuing its normalization strategy in the face of stronger growth, tighter labor markets and higher inflation. The European Central Bank (ECB) indicated that quantitative easing (QE) will end by the end of 2018, but the Bank of Japan (BOJ) remained committed to keeping 10yr yields close to 0%.

These macroeconomic dynamics helped strengthen the USD and higher UST yields in Q2. The USD Index (DXY) appreciated 5% while UST10yr yields widened 14bps to 2.86% in Q2. However, the 37bps sell-off in UST yields to 3.11% from April to mid-May contributed to negative sentiment towards EM that the subsequent rally could not undo.

ELMI+ vs DXY indices



Source: Bloomberg, UBS as of June 30, 2018

Trade and political uncertainty take their toll

Aggressive global trade postures kept markets on their toes, with preliminary data already showing slower trade volumes.. Additionally, commodity prices – with the exception of oil - weakened in Q2. China reacted to trade pressure wars by letting the currency depreciate beyond what markets were expecting, thus bringing an extra layer of market uncertainty. At the time of writing, the US administration had announced it will impose higher tariffs on an additional $200bn of Chinese exports. If the US proceeds with this decision, more than 50% of Chinese exports to the US will face significantly higher tariffs.

Higher political uncertainty following the Italian election paled in comparison to that leading up to Turkey's Presidential election and the Brexit-like result of the Malaysian election. Additionally, Mexico elected Mr. Lopez Obrador to the Presidency by a landslide on a promise to change the economic model. Only Colombia delivered a clear, market-friendly result. In Brazil, there's no clarity on the outcome of the October election since a large share of the population remains undecided.

2Q18 EM Interest rate changes

Increases (ppt)		Cuts (ppt)	
Argentina	12.75	Azerbaijan	-3.00
Turkey	9.75	Ghana	-1.00
Indonesia	1.00	Mozambique	-1.00
Tunisia	1.00	Kazakhstan	-0.50
Pakistan	0.50	Colombia	-0.25
Philippines	0.50	Serbia	-0.25
Bahrain	0.25		
India	0.25		
Mexico	0.25		
Romania	0.25		
Saudi Arabia	0.25		
UAE	0.25		

Source: Macrobond, Bloomberg, UBS as of June 29, 2018

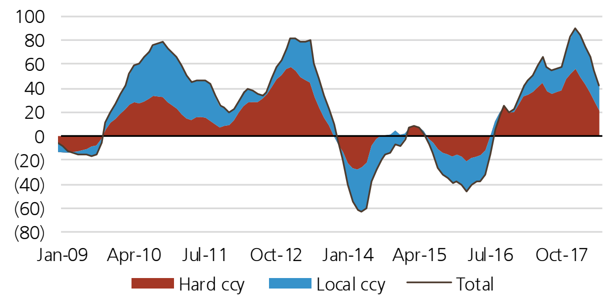
Poor quality policy responses from several EM central banks to global shocks further dented confidence in the asset class during Q2. Argentina and Turkey currencies, rates, and spreads were particularly affected by these shocks, as was Brazil's and several others. When faced with speculative outflows, central banks resisted hiking rates more aggressively and some (Argentina, Brazil) resorted to ineffectual FX intervention strategies. Still, several EM central banks have started to hike rates.

A negative feedback loop

Returns turned more negative and risk appetite worsened as Q2 progressed. Outflows ensued amidst low liquidity, causing severe dislocations across asset prices. With no clear catalyst to shift expectations, markets entered a negative feedback loop where cheaper valuation sparked outflows, which subsequently lowered assets prices further.

Q2 2018 was a negative quarter for EM fixed income flows, with outflows from EM of USD 6.0bn (most of it in June) compared to inflows of USD 12.4 bn in Q1 2018, according to JP Morgan data. Investors mainly withdrew from hard currency strategies.

Cumulative 12m EM FI Flows (US$bn)



Source: JP Morgan as of June 30, 2018

EMFI, which had been a popular investment destination, seems to be falling out of favor among the global investor community. After attracting some USD100bn inflows since early 2016, with USD 65bn in hard currency debt, EM FI has seen USD 8bn of outflows since February, mostly from hard currency mandates (EPFR).

EMFI was able to retain a significant portion of the inflows it received amidst negative returns MTD, QTD and YTD. Outflows were driven by higher global uncertainty on trade disputes and growth, but most importantly by a far more volatile domestic political environment in several countries.

Outflows occurred in an environment of scant liquidity and poor technical positions that exacerbated the negative impact on prices. In retrospect, we greatly underestimated the ability of some EM participants to absorb risk and provide liquidity to investors.

As a result, entire sovereign and corporate curves encountered deep air pockets generating severe dislocations across the asset class. In all, Q2 was a negative quarter for EM asset prices and negative sentiment prevented – in some cases - significant adjustment efforts from having any impact on prices (e.g. Argentina).

After the fallout: Is the only way up?

Although global macroeconomic conditions remain positive, they have deteriorated at the margin. Global growth is still high but it is no longer synchronized. The US is growing faster than Europe and several large EM countries and China are seeing secular slowdowns amid deleveraging policies.

Global trade tensions continue as a result of protectionist actions and announcements of further actions by the US and retaliation by the affected nations (China, Europe). Heightened protectionism will prevent EM from benefiting from the positive impact that global growth usually has on global trade, potentially requiring a further adjustment in relative prices and policies in EM.

Additionally, EM will also have to manage the impact of tighter global financial conditions amidst a more divergent policy stance among developed countries. Political uncertainty in several countries across EM brought about by upcoming elections (Brazil) or recent election results (Mexico and Turkey), will likely weigh on EM in Q3.

We believe that EM FI asset prices will remain volatile in Q3. That's because political uncertainty remains elevated in both the developed and developing world, as well as risk emanating from moves in USD, US Treasury yields and deepening trade wars.

In the developed world, we could see further political developments in Europe (Italy, Germany, UK) and the US. In the developing world, it is far from clear whether the policies sponsored by the newly elected Presidents of Turkey and Mexico will be market friendly.

Additionally, the uncertainty surrounding Brazil's presidential elections in October, will likely keep asset prices dependent on polls and political proposals.

At the beginning of Q2 we expected credit to earn the carry, rates to rally and FX to range-trade given stretched valuation. We were clearly too optimistic in our assessment.

Furthermore, there is no doubt that all of these factors have now become more enticing as valuations have improved.

However, the uncertainties described above and the positioning in the market could impede those cheaper valuations from realizing their full potential in Q3, absent a strong catalyst.

All in all, we are more nimble in our assessment of potential returns in EM in Q3. In spite of widening spreads and rates and the significant weakening in EM FX, we don't find these asset classes to be undervalued to the extent that it will make sense to have long beta positions.

In contrast, we favor idiosyncratic and tactical stories until we have more clarity on how the current political and macroeconomic uncertainties may get resolved.

The risks to our more cautious outlook include:

- Much improved global trade policies and a clear resolution of the pending disputes/discussions among NAFTA members and the US and Europe and China.
- Further clarity on the political/policy front in several EM countries (Argentina, Brazil, Mexico, Turkey) that could help attract flows and lift prices.
- Finally, a weaker USD and stable UST that could provide support to EM asset prices.

(Federico Kaune)

Sovereign credit spreads: Stabilizing at high levels – but no recovery yet

Sovereign credit posted a -3.5% return in Q2 2018, bringing YTD return to a disappointing -5.2% and in sharp contrast to the 10% return in 2017. Spread widening detracted severely from performance (-3.53%) while UST yields had no impact in Q2, while all regions posted negative returns.

While the EM economic backdrop looks robust, geopolitical headwinds and trade protectionism measures stopped many EM issuers from posting positive returns. Only Belize and Latvia posted positive performance in Q2 2018, while smaller Eastern European countries like Azerbaijan and Lithuania, but also China, posted returns close to zero.

However, the dispersion between the regions was relatively high and impacted by country-specific factors and developments. While EM Asia posted the lowest negative performance at around –90bp, Middle East (-690bp) and Africa (-578bp) suffered the most, given the severe spread widening in Lebanon and Zambia. However, Argentina and Ecuador also came under permanent pressure due to country - specific weaknesses and challenges.

Political factors, including escalating Middle East tensions, the electoral victory of Hezbollah, and post-election instability, impacted Lebanon (-13.1% total return in Q2 2018) . Zambia (-13.2% total return in Q2 2018) underperformed as the country's ability to come to terms on an IMF aid package was in question.

In Argentina (-11.5%), the central bank's delayed reactions to a run on the currency created noise and uncertainty. The central bank eventually hiked rates but it was too little too late and the pressure continued. The run on the currency contaminated USD denominated debt, as the low quality of the policy response eroded investors' confidence leading to a substantial spread widening. The USD 50bn IMF program failed to either allay investors' fears nor tighten spreads to pre-crisis levels.

Ecuador (-8.7%) underperformed because President Moreno took his time to both renew his economic cabinet and announce policies to stop further fiscal deterioration.

Commodities offered little support in Q2 2018. Though oil prices were around USD 10 higher at the end of the quarter than at the start, many commodity prices saw slight declines.

US sanctions against Iran, which stopped all imports, plus a drop in Venezuela's production capacity, put pressure on prices. OPEC responded with slightly higher production, thus outweighing the declining supply from Iran and Venezuela.

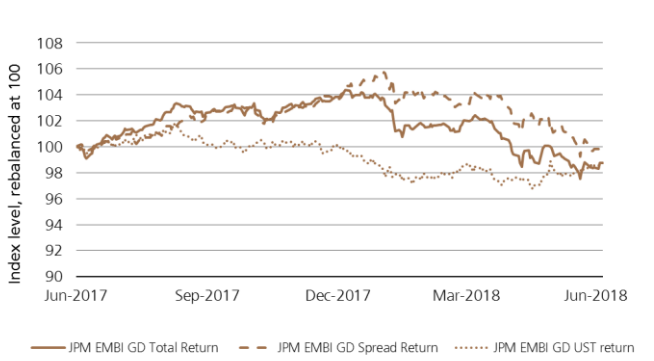
Despite this negative performance, we still believe that growth in EM countries is robust enough to avoid another economic slowdown.

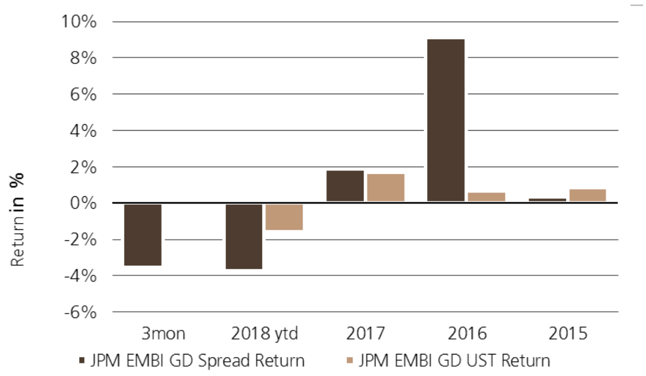
However, it is increasingly difficult to identify additional reasons to be more constructive as the risk of an open trade war clouds the outlook for global trade and growth.
Even if such protectionist measures don't materialize, trade rhetoric increases uncertainty and limits spread compression momentum. In addition, geopolitical risks remain dominant and are also impacting investors' confidence.

In that context, a nearly 3% UST yield for a 10y bond might look attractive and might require a higher risk premium than in the past. Recent spread widening, however, made USD debt more attractive and we are prepared to increase exposure as soon as we identify a positive catalyst.

(Uta Fehm)

Sovereign Debt: As UST yields were stable this time, spreads widened (rebalanced to 100 as of June 30, 2017)





Note: JPM EMBI GD UST Return at 3mon was -0.02%

Source: Bloomberg Finance. Data as of June 30, 2018

Corporate credit: Political risks driving volatility / returns

- Negative returns posted in Q2 2018
- Political risks increase value in LatAm, but risks still remain

In Q2 2018, EM corporates (measured as JP Morgan CEMBI diversified) posted negative returns primarily driven by a widening of credit spreads.

Due to a shorter duration benchmark, while corporate returns were negative, they outperformed sovereigns. As US rates stabilized and spreads widened, investment grade credits outperformed high yield.

Similar to sovereign, most regions posted negative returns in Q2 2018.

Middle East was the only region with a positive spread and positive total returns driven by strong contributions from Iraq, Israel, and to a lesser extent Jordan.

Corporate bonds in Zambia, Israel, Macau, Qatar, Egypt, Jordan, and Hungary squeezed out positive returns while all other countries posted negative returns with some of the largest being Argentina (-8.35%), Jamaica (-7.64%), Ukraine (-5.37%) & Turkey (5.03%).

From an industry perspective, all sectors provided negative spread and negative total returns. In Q2 2018, political

headlines overrode positive corporate fundamentals and further increased risk premium in EM corporate bonds.

EM faced increased political headwinds from protectionist rhetoric on trade and tariffs, coupled with elections in large EM countries including Malaysia, Lebanon, Colombia, Turkey and Mexico.

Corporate fundamentals should continue to reflect improving growth prospects and further recover from low commodity prices leading to better leverage metrics, profitability and fewer downgrades.

The quarter(s) ahead will continue to require nimble bond picking with tight beta management.

On the supply side, we expect net corporate issuance to increase but to manageable levels as supply form China has been lower than expected and is likely to remain low while political tensions between US and China trade remain.

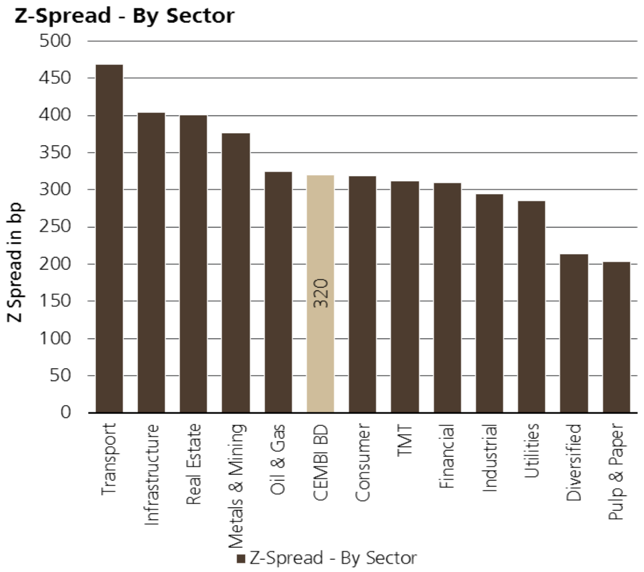
We believe value can be found in Argentina and Brazil corporates, commodity linked names, along with higher quality issuers who have underperformed in the recent volatility.

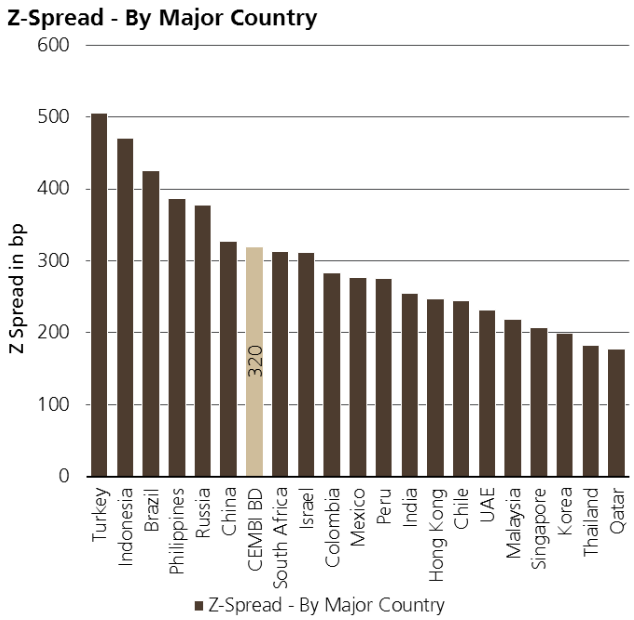
Lower economic activity and still high leverage metrics in China argue for continued caution. However, we keep our positive stance toward systemically important state-owned enterprises in China, especially energy-related and financial institutions.

(David Michael)

Spreads: Widening and more attractive again – measured in bps

(The z-spread – also known as the zero-volatility spread or the static spread – measures the spread over the benchmark zero coupon swap curve)





Source: Bloomberg Finance. Data as of July 03, 2018

Local debt: Stormy weather

EM local debt (EML) had a dismal quarter. The benchmark (JPM GBI-EMGD) fell 10.4%, which brought YTD returns to -6.44%.

Volatility in developed market equities in February began hitting performance but the relentless rise in Fed Funds rates, the stronger USD, and higher political risk in many key EM countries weighed on performance.

EML will most likely continue to struggle through Q3.

Rates have cheapened (the benchmark yield widened almost 60bps in Q2) but FX is still mixed, with most APAC currencies appreciated versus USD on the quarter, while the ARS declined by a whopping 30.2%, as BRL and TRY (both -10% in Q2) did.

Many central banks have been forced into rate hikes to defend their currency. Nevertheless, weaker fundamentals have cancelled out cheaper valuations.

Political risk has increased across core EM. Electoral uncertainty in Brazil casts doubt on the fiscal stabilization program. Mexican populist Lopez Obrador had a clean sweep of congress with the most recent precedent of PRI rules in the tumultuous 80s and early 90s. Argentina's financial turmoil may undermine the government's position in 2019 elections. Turkey's Erdogan won executive presidency in the snap elections paving the way for an indefinite authoritarian rule. Russia continues its stand-off with the west, while South Africa struggles with the aftermath of years of economic malaise.

Second, the US Federal Reserve is poised to continue raising interest rates as the US economy expands above potential. Third, the trade war rhetoric is taking a toll on Chinese sentiment with authorities struggling to prop up financial markets.

In Latin America, Mexico is at risk once the newly elected President Andres Manuel Lopez Obrador's (AMLO's) honeymoon ends. Investors had plenty of time to prepare for the outcome of the election, but as positions are squared and hedges run their course, we foresee a path of deterioration.

Brazil's yield curve is steep given low inflation and a dovish central bank. We think BRL could weaken further, but the bonds could decouple, particularly in a reasonable election outcome.

Argentina is now at a cross-roads – if the government manages to stick to its fiscal targets and avoids giving in to political pressures as the economy slows, the Argentine peso (ARS) and bonds may prove attractive.

In EMEA, much will depend on whether Turkey's Erdogan supports tight fiscal and monetary policies. Russian bonds offer good value on a tight fiscal and monetary stance and high oil prices and production. Barring furrther sanctions, we beleive there is scope for a rally.

In South Africa, general market sentiment and commodity prices are more of a driver than domestic politics. The country is likely to muddle through into next year's elections.

Central Europe is enjoying high growth rates and some insulation from broarder EM weakness given the (uneven) recovery in the Eurozone. Tight labor markets, low policy rates, and domestic-demand driven growth is a recipe for higher inflation and higher bonds yields.

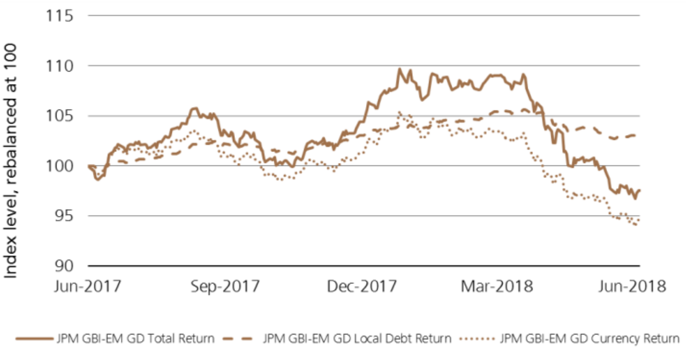
Following a period of stability, APAC currencies are on a weakening path led by the CNY. The escalating trade war has started to affect sentiment, while valuations are not particularly attractive. We believe that a basket in underweight positions to the region are warranted.

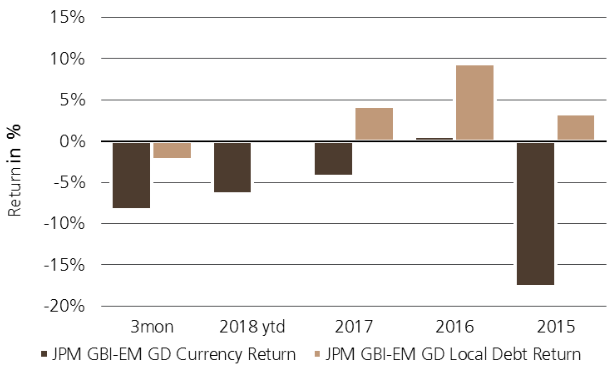
In this environment, modest and cautious positions may prove to be the right strategy for Q3. As monetary policy carries most of the burden of stabilizing the markets, investment flows are likely to remain jittery and tactical.

(Igor Arsenin)

Currency return: more sensitive to economic and political shocks (rebalanced to 100 as of 30 June 2017)

(The graphs below show the total return of JP Morgan GBI-EM Global Diversified and its components, local debt return with FX hedged into USD and currency returns. Local debt return results from yield movements and coupons of the underlying bonds in local currency. Currency return results from exchange rate movements and carry)





Source: JP Morgan, UBS Asset Management. Data as of June 30, 2018

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For more information please contact

Federico Kaune
Head of Emerging Markets Fixed Income
federico.kaune@ubs.com

Uta Fehm
Portfolio Manager Emerging Markets Debt
uta.fehm@ubs.com

www.ubs.com/am

UBS