Emerging Markets Fixed Income

April, 2018

Volatility rises, opportunities emerge

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Higher volatility dents returns

- Volatility has increased and has taken some toll on returns
- Fundamentals are robust enough to anchor current valuations

Emerging markets (EM) delivered mixed returns during Q1 2018. On the one hand, credit – sovereign and corporate debt – suffered the impact of the UST selloff and heightened volatility, delivering negative quarterly returns for the first time in five quarters. On the other hand, rates and FX debt showed robust positive returns as high-yielding local bonds rallied on better macroeconomic fundamentals and lesser political uncertainty in several countries.

Markets took marginally higher inflation releases in the US as early signs of broader inflationary pressures, generating a substantial sell off in UST yields. Furthermore, after a great start in January, US equity markets sold off sharply and volatility – which have been absent since the US election – shot up to levels last seen in mid-2015 after the surprising devaluation of the yuan and subsequent Chinese stock market sell off.

Volatility in equity and fixed income markets remained elevated for the remainder of Q1 2018, bringing an end to the supportive low-volatility environment that, until January 2018, had allowed carry trades to flourish well beyond expectations.

Furthermore, repatriation flows brought about by US tax reforms further pressured spreads in EM and other credit classes as US investors liquidated their offshore holdings and brought them back home. Repatriation also generated dislocations in short-term funding costs across the world, further denting appetite for EM credit.

In January, the initial 25bps compression of EM sovereign spreads fully compensated for the selloff in UST yields. However, EM credit could not withstand the combination of higher UST yields, higher volatility and technical pressures brought by repatriation and sold off 45bps in February and March.

The performance in local EM was markedly different to that in credit. Broad USD weakness in January boosted EM FX returns by 3.5%, but higher volatility and risk aversion brought EM FX down 1.5% in the remainder of the quarter. High-yielding local bonds – particularly in Brazil, Mexico, Russia and South Africa – further contributed to positive returns in Q1 2018.

Broadly benign global financial conditions and a low volatility environment fostered record inflows into the asset class in January. However flow dynamics changed drastically with subdued inflows in February and March.

In all, Q1 2018 was a positive quarter for EM fixed income flows. According to JP Morgan, flows into emerging markets in Q1 2018 amounted to USD 20.9 billion (most of it in January) compared to USD 22.9 billion in Q1 2017. Investors allocated in equal measure to hard and local currency strategies.

Another factor that may have dented investors' appetite in Q1 2018 was the decision of the United States to impose trade protectionist measures against China.

On January 22 the US imposed a one-year 30% (20%) tariff on solar cells (washing machines). On March 8 the US followed with a 25% (10%) tariff on steel (aluminum). On March 23 the US imposed a 25% tariff on USD 50-60 billion of Chinese exports as retaliation for "China's unfair and harmful acquisition of US technology" and with an aim at reducing the trade deficit with China by USD 100 billion.

China announced tit-for-tat measures shortly after. At the time of writing, the US administration had escalated the confrontation further by hinting of tariffs on another USD 100 billion of China exports.

Q1 2018 returns

US dollar debt	**Total return**	**Spread return**	**US Treasury return**
JPM EMBI Global Div.	-1.74%	-0.21%	-1.53%
JPM CEMBI Diversified	-1.25%	-0.27%	-0.98%
Local currency debt	**Total return**	**Currency return**	**Local debt return**
JPM GBI-EM Glob. Div.	4.42%	2.12%	2.30%
JPM ELMI+	2.51%	1.58%	0.93%

Calendar year 2017 returns

US dollar debt	**Total return**	**Spread return**	**US Treasury return**
JPM EMBI Global Div.	10.26%	8.20%	1.90%
JPM CEMBI Diversified	7.89%	6.16%	1.63%
Local currency debt	**Total return**	**Currency return**	**Local debt return**
JPM GBI-EM Glob. Div.	15.21%	5.78%	8.91%
JPM ELMI+	11.54%	7.24%	4.01%

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 31 March 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.

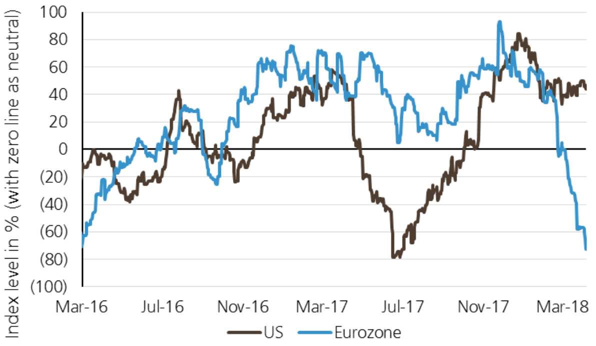
Political developments generated significant rallies in FX and rates in several countries. In South Africa, the resignation of President Zuma and appointment of Cyril Ramaphosa was well received by markets. In Mexico, the left-center candidate Lopez Obrador gained further backing in the polls with a new more market-friendly discourse. In Brazil, charges against former President Lula that may impede him from running in the October Presidential elections accompanied by very low inflation and a dovish central bank fueled a further rally in rates.

The quarter was not free of several interesting geo-political events. North Korea gave signs of its willingness to negotiate with the US, including on nuclear disarmament. Turkey's assets suffered as continued fighting at the Syrian border further antagonized the US and Europe. In Russia, newly re-elected President Putin faced the expulsion of dozens of his diplomats from the US, Canada and Europe for the poisoning of a former intelligence officer and other civilians in the UK in early March.

We are in higher volatility environment

Global macroeconomic conditions remain supportive for EM Fixed Income. Global growth has stabilized at a high level but there are sign of a cyclical soft patch in the near term as shown by negative surprise indicators in the US and Europe. China is slowing down and the US could yet overheat creating tail risks later in 2018. However, protectionist measures could dent the strength of the global recovery and its positive spillovers EM into H2 2018 and beyond.

Soft patch on the Citigroup Economic Surprise Index

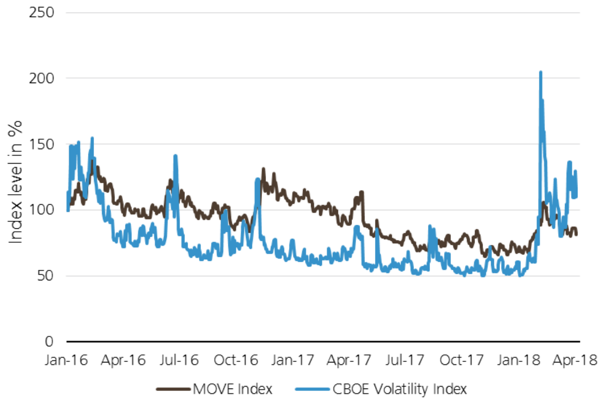


Source: Bloomberg, 31 March 2018.

Global financial conditions have changed for the worse at the margin. Many of the risk factors we spoke about in recent quarters have materialized: We are now in a higher volatility and rates environment that may warrant a higher compensation for risk in EM.

The poor performance in credit in Q1 2018 was driven by the surprisingly rapid normalization of UST yields, the correction in US equities and the one off impact of tax repatriation and portfolio liquidation by US corporates. These factors are likely to be less pronounced in Q2 2018. Steady increases in Fed Funds rates, however, will remain is a permanent headwind.

A higher volatility environment



Source: Bloomberg, 6 April 2018.
Note: rebased as of 12/31/2015 =100.

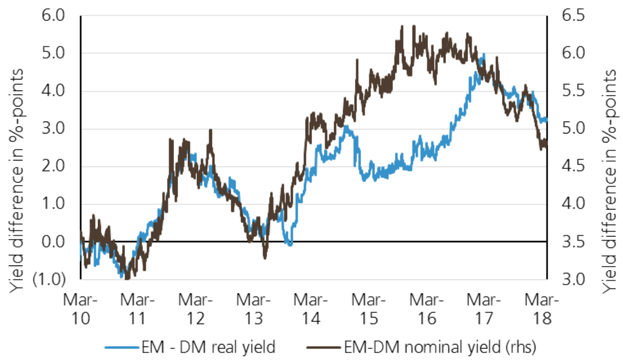
We expect credit spreads to trade in a range of +/- 10% around current levels (300bps) driven by global shocks rather than internal idiosyncratic developments.

We expect better Q2 2018 returns, with credit earning its carry on the back of more stable UST yields.

However, unless the global environment changes dramatically, we now expect returns in EM credit to be between 3-5% in 2018, after negative 1-2% returns in Q1 2018.

We expect high yielding EM rates to perform well as there are pockets of value in key countries including Argentina, Brazil, Mexico, Turkey, South Africa, Russia, Indonesia and India. However, the yield differential between EM and DM is shrinking and REER valuations are no longer cheap with a few exceptions. This should lead to a range-trading environment for EM currencies.

The gap between EM and DM real yields still looks attractive



Source: Bloomberg, 31 March 2018.

We believe that the weakening USD trend seen since the French election last year has further to go, including against the CNY. This is because a stronger CNY seems to be the revealed preference of the Chinese authorities, with capital controls firmly in place. A solid 4% return in Q1 2018 bodes well from EM local (rates/FX) to generate high single digit returns in 2018.

The main risks to our more subdued outlook include:

- The current soft patch in DM growth turns out to be more permanent
- Negative headlines from China – as it addresses past excesses in banking lending - could also be a source of volatility in months to come
- The current discussions and measures on international trade turn into an open trade war

(Federico Kaune)

Sovereign credit: Shifting into a new paradigm

- Spreads widened, mainly driven by external factors
- We expect mildly positive returns in Q2 2018

Sovereign credit posted a – 1.8% return in Q1 2018, in sharp contrast with the stellar 10% return in 2017. Spread widening detracted slightly from performance while the increase in UST yields had a major negative impact of around – 1.5%.

All regions posted negative returns, underlining that recent losses were not driven by idiosyncratic events and/or developments in single countries.

While the economic background in EM countries still looks robust, nearly all risk factors we highlighted during the course of 2017 materialized: increasing UST rates and yields in DM, increasing rhetoric and trade/tariff costs, which could make global trade more difficult. There are growing concerns that a spiral of tariffs could start having an impact on global growth soon.

Support from commodities was limited during the first weeks of the year as the broad commodity indices (CRB for example) were range bound. Crude oil prices (Brent) finished the quarter nearly unchanged as well at around USD 63.

Despite a very fragile situation in Venezuela, spreads of Venezuela bonds were supported by the increase in oil prices during March while also being supported by a payment made on the 2022 debt and talks about possibly accelerating some securities. In addition, a glim of hope for a new opposition candidate helped, making the country the best performing issuer in March as well as during Q1.

At the other end of the range was Argentina, detracting around 5.2% in Q1 2018. This underperformance was related to the large supply of bonds early in the year. Furthermore, the central bank unexpectedly cut interest rates for a second consecutive time early in the month. The surprise cut led some investors to be concerned that the country will not be as vigilant in its fight against inflation.

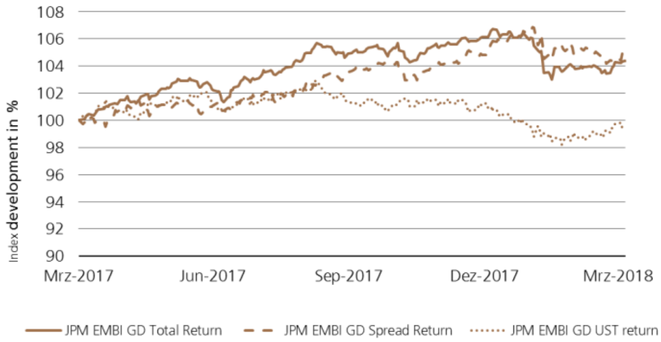
The Middle East, with close to a zero return in Q1 was the best performing region, supported by a solid performance of Lebanese government bonds, which recovered after the political situation calmed. Also, Iraq and Egypt performed well and contributed positively to the regional outperformance. Africa and Europe performed in line with the overall markets, while Latin America and Asia detracted most.

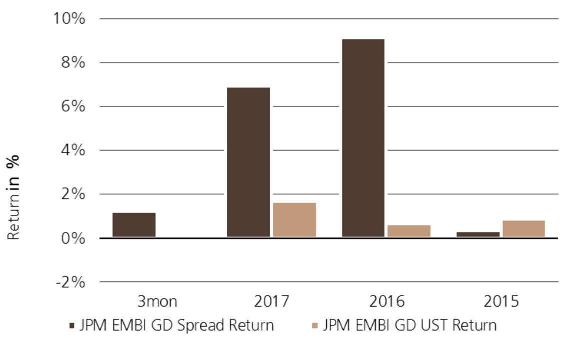
In Latin America, the impressive 11.6% return in Venezuelan bonds could not offset the negative returns in Argentina (-5.2%), Ecuador (-3.6%), Uruguay (-4.4%) and Chile (-2.8%). We also saw some spread widening in Asia, even in countries with solid fundamentals, but often with a higher correlation to the UST moves. Regional dispersion was relatively limited and several countries detracted around 2% in Q1 2018.

Despite this negative start, we still believe that growth in EM countries is robust enough to justify current spread levels. However, it is becoming increasingly difficult to identify reasons to be constructive because of the risk of an open trade war that could cloud the outlook for global growth (in particular in the US) and global trade. Even if such protectionist measures are not fully implemented, the heated rhetoric has increased uncertainty thus limiting the momentum for further spread compression.

We also acknowledge that spreads have moved to levels, which can be seen as adequate to the new range of UST yield (2.6%-3.0%). As long as UST yields remain in such a range, spreads are unlikely to break into a new level upwards or downwards. Thus, we expect EM spreads to trade in a +/-10% range at around 300bps in 2018. If we are right, and EM credit is able to gain the carry (coupon) in Q2, excess returns could be close to 1% in H1 2018. (Uta Fehm)

Sovereign debt: Most of the negative return was due to US Treasury moves





Source: Bloomberg Finance. Data as of March 31, 2018
Note: rebased as of 03/31/2017 =100

Corporate credit: The new normal

- Negative returns posted in Q1 2018
- Value opportunities in Brazil corporates, LatAm quasi-sovereigns and commodity-linked names

In Q1 2018, emerging markets corporates (measured as JP Morgan CEMBI diversified) posted negative returns primarily driven by widening treasury yields. Due to a shorter duration benchmark, this quarter, corporate returns outperformed sovereigns. High yield credits continued to outperform investment grade.

Similar to sovereign, all regions posted negative returns in Q1 2018.

Africa was the only region with a positive spread (carry) contribution to returns but it was not able to offset the move in US Treasuries.

Corporate bonds in Ghana, Bahrain, Tanzania, Kazakhstan, Jordan, Guatemala and Ukraine squeezed out positive returns while all other countries posted negative returns with the largest outlier(s) being Zambia (-4.83%) and Jamaica (-7.64%).

From an industry perspective, the transportation sector provided large enough spread returns to offset the negative US treasury contribution. All other industries posted negative returns.

After the increased US equity and US rate volatility in Q1, we return to a more normal volatility environment.

Corporate fundamentals will continue to reflect improving global growth likely leading to fewer downgrades.

After the increased US Equity and US rate volatility in Q1, we return to a more normal volatility environment. Corporate fundamentals should continue to reflect improving global growth prospects; with better leverage metrics and profitability likely leading to fewer downgrades.

Even with the increased volatility, valuations in Emerging Market corporate have returned to Q3 2017 levels.

The quarter(s) ahead will continue to require nimble bond picking as opposed to 'beta' exposure. Technicals should remain supportive as many issuers pursue debt liability management and buy back their debt.

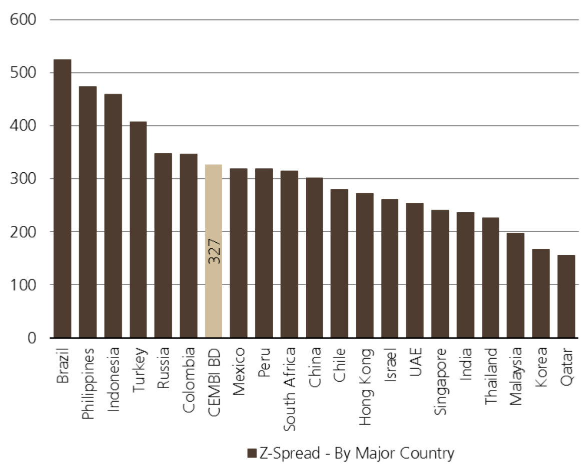
On the supply side, we expect net new corporate issuance to increase driven by China and the Middle East. There remains value in higher yielding debt linked to improving fundamentals.

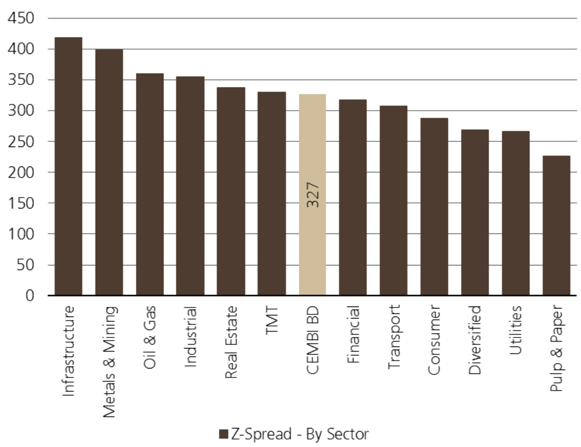
We believe value can be found in Brazil corporates, Latin American quasi-sovereign and commodity linked names. Exposures to lower spread and higher duration issuers are less attractive given their low carry, and are likely to underperform if hit with another round of increased rate volatility.

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: Tighter but still compelling – 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 March 31, 2018

Local debt: A range-trading environment

- Q1 2018: January rally drove impressive returns of 4.44%
- Countries with improving fundamentals likely to do well

EM local debt (GBI-EMGD) returned an impressive 4.44% in Q1 2018. Most of the rally happened in January, followed by a range-bound and more volatile trading pattern in February and March. The rally was interrupted by the spike in volatility and the aftershocks of the rapid increase in UST yields.

EM local markets have shown to be resilient, but, as long as volatility in global market remains elevated -as we expect- they are likely to remain range-bound.

The high-yielding members of the JPMorgan Government Bond Index-Emerging Markets (GBI-EMGD) index performed well, with the notable exception of Argentina and Turkey, which showed negative returns.

The best performers were South Africa and Mexico. In South Africa, the new President quickly reasserted power over the government in spite of his slim majority at the ANC conference in December. South Africa avoided a downgrade to sub-investment grade by Moody's and potential outflows from the local bond market. In the case of Mexico, NAFTA negotiations appeared to proceed more smoothly and markets have so far discounted the potential impact of Presidential elections in August.

The FOMC continues to push US interest rates higher eroding the carry advantage of EM currencies. With higher UST yields, valuations are no longer skewed in favor of local bonds. In addition, the market has taken in its stride the flare-up of the trade war with China, which could yet dent confidence.

As value is concentrated in higher-yielding current-account deficit countries with high sensitivity to global factors, navigating country-specific stories and trading the ranges will be crucial to performance in Q2, in our view.

Even with the continuing rally, several bond markets in countries with improving fundamentals are likely to do well, namely Brazil and South Africa. We also think that levels are attractive in more vulnerable Turkey and Argentina.

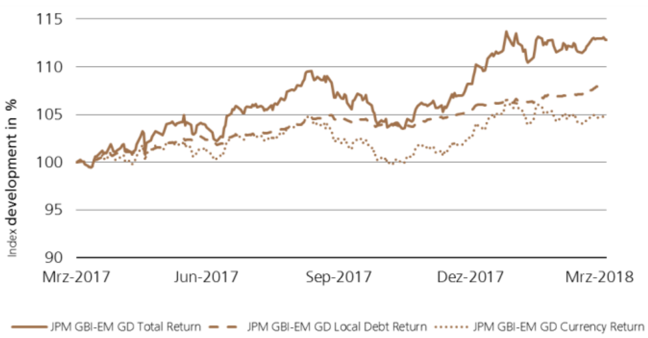
In Latin America, Brazil's yield curve is steep and the central bank is likely to cut interest rates once more in Q2, suggesting extending duration. We may turn more cautious as the election cycle heats up in Q3 ahead of the presidential election in October. Argentina is showing signs of higher growth after an uneven start. Further improvements depend on the credibility of the fiscal adjustment and the Central Bank disinflation commitment, which was dented by premature rate cuts and higher inflation targets. The outlook of Mexico continues to be binary ahead of the elections as more constructive NAFTA negotiations are priced in.

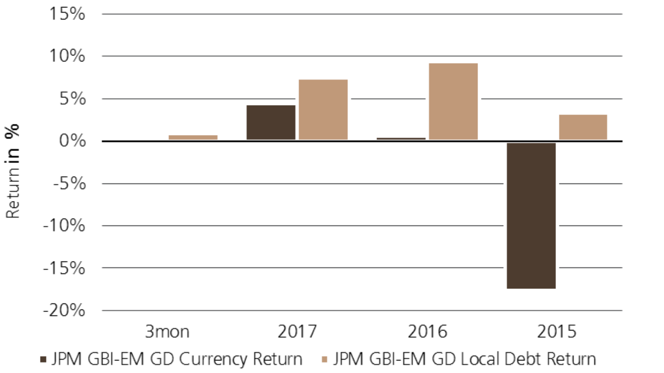
The focus on the EMEA region (Emerging Europe and Africa) will be on Turkey and South Africa. Bond returns in Czech Republic, Hungary, Poland and Romania (CE4) are likely to be modest as central banks are turning more hawkish in 2018. Turkey local debt continues to depend on foreign inflows in an environment of increasing interest rates in developed markets, but the meltdown of TRY and local bonds in the last few months provides attractive entry levels.

The election of a market-friendly president of the ANC has led to a dramatic rally in the ZAR. However, the yield curve is steep, inflation is falling and the Central Bank has resumed interest rate cuts. Russia's local debt has become less sensitive to oil price movements allowing the central bank to continue its rate-cut cycle.

Following the rally in 2017, Asian low-yielding currencies should be less volatile, in line with historical pattern, and anchored by the stability of the CNY. With solid growth, subdued inflation and generally large CA surpluses, fundamentals are in place for continuing good performance. CNY policy, the trade war, and central banks' response to currency pressures will be important differentiating factors. (Igor Arsenin)

Currency return: more sensitive to economic and political shocks





Source: Source: JP Morgan, UBS Asset Management. Data as of 31 March 2018. Note: rebased as of 03/31/2017 =100

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Our teams have distinct viewpoints and philosophies but they all share one goal: to provide you with access to the best ideas and superior investment performance.

A holistic perspective
The depth of our expertise and breadth of our capabilities allows us to have more insightful conversation with an active debate, all to help you make informed decisions.

Across markets
Our geographic reach means we can connect the parts of the investment world most relevant to you. That's what makes us different – we are on the ground locally with you and truly global.

Solutions-based thinking
We focus on finding the answers you need – and this defines the way we think. We draw on the best of our capabilities and insights to deliver the solution that is right for you.

Source for all data and charts (if not indicated otherwise): UBS Asset Management.

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