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Emerging markets fixed income | UBS Asset Management

Emerging Markets Fixed Income
Q3 2021 review and outlook

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The views expressed are a general guide to the views of UBS Asset Management as of October 2021.

Summary

- Emerging market fixed income delivered negative total returns across most asset classes in the third quarter of 2021.
- Overall, emerging market economic growth is still lagging that of developed markets.
- Inflation in Asia remains well contained. However, the rest of the emerging market sector has experienced higher inflation, forcing central banks to hike rates, in some cases strongly.
- Debt issuance continued to be robust over the quarter, particularly from investment grade credits.
- Developments in the US and China are likely to be the most important global factors influencing the performance of emerging market asset prices in the final quarter of 2021.
  - In China, the tighter regulatory stance on the real estate sector could end up affecting growth more than markets are envisaging during the fourth quarter and could impact demand for commodities and risk appetite in general.
  - In the US, the pace and extent of the tapering of its bond purchase program, and the likely path of any future interest rate rises, is likely to weigh on emerging market fixed income assets.

Economic overview

A summer of slower growth and higher inflation

Global economic activity slowed down in the summer months after a strong first half of the year. Purchasing manager indices (as reflected by composite PMIs, see Chart 1) indicate that global economic activity in the third quarter was still expanding in developed markets, but at a slower pace than previously recorded. By contrast, emerging markets are recovering far more slowly. In China's case, PMIs have been in contractionary territory since August, on the back of stricter pandemic lockdowns, stringent regulatory measures in several sectors of the economy and slowing credit expansion. Overall, developed market growth is still outpacing emerging market growth.

Regarding the impact of the pandemic, UBS's economists haven't found evidence that the pandemic is derailing the global recovery. In fact, vaccination rates continue to improve across emerging and developed markets and the most current estimates indicate that the world is past the latest summer wave driven by the Delta variant.

Global inflation continued to edge higher in developed and emerging markets (ex-Asia), reflecting to a large extent reopening 'pains' including supply constraints. In developed markets, higher inflation also reflects how successful central banks have been at implementing policies geared towards increasing inflation and inflation expectations above long-term targets. In emerging markets, it also reflects imported food and energy inflation, as well as the impact of currency depreciation on tradable goods.

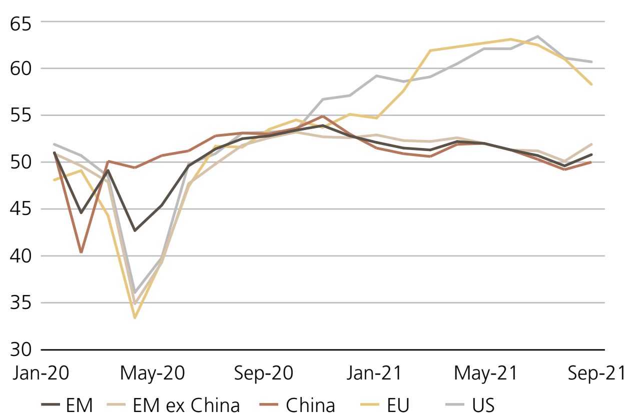
Inflation in Asia, including China, India, Indonesia, Malaysia, and South Korea remains well contained and, in most cases, at a very low level. However, the rest of the emerging market sector has experienced higher inflation, forcing central banks to hike rates, in some cases strongly.

Tighter monetary policy all around

In terms of **monetary policy**, Russia, Brazil and Mexico proved to be the most pro-active central banks in their efforts to tame inflation surges. Brazil's central bank hiked rates an additional 200 bps in Q3 to 6.5% as headline (core) inflation touched 9.7% (6.1%) in August, up from 4.5% (2.8%) at the beginning of the year.

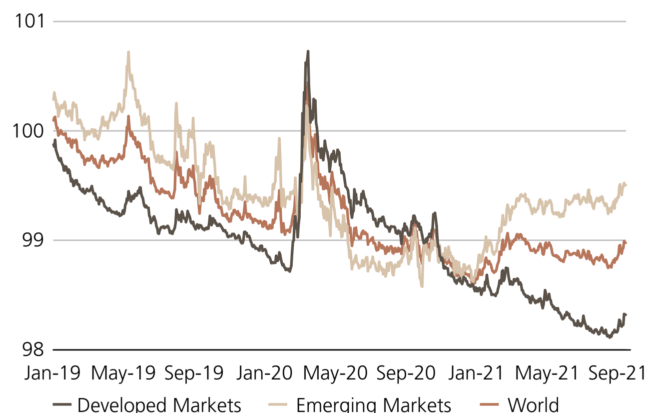
Russia's central bank hiked rates an additional 125 bps in Q3 to 6.75% as headline (core) inflation rose to 6.7% (7.1%) in August, up from 4.9% (4.2%) at the beginning of the year. Similarly, Mexico's central bank hiked rates 50bps to 4.5% during the summer as headline (core) inflation increased from 3.2% (3.8%) at the beginning of the year to 5.6%(4.8%) in August.

Chart 1: Global PMIs: Emerging markets lagging developed markets in terms of global economic activity



Source: Macrobond, UBS Asset Management.
As of September 2021

Chart 2: Financial conditions tighten over the third quarter



Source: Goldman Sachs, Bloomberg, and UBS Asset Management.
As of 30 September 2021

Central eastern European countries, including Hungary and Poland, have been far more reluctant to hike rates in spite of inflation touching levels not seen in many years. In Hungary, headline inflation has increased from 2.7% at the beginning of the year to 4.9% in August, but the central bank hiked rates only 75 bps to 1.65% in Q3 on a stable core inflation of around 3.3% so far in 2021.

Poland's central bank kept rates unchanged at 0.1%, although inflation has more than doubled from 2.5% in December 2020 to 5.5% in August 2021. As in Hungary, Poland's core inflation has remained stable at around 3.8% in 2021.

In contrast, China's central bank has been pumping liquidity into the financial system while Indonesia has continued implementing quantitative easing. China's central bank has been proactively providing liquidity to the financial system to avoid a further deterioration of financial conditions in the face of severe pressure coming from the real estate sector.

In **developed markets**, the US Federal Reserve became more hawkish during the summer, reflecting an inflation rate that is running above target and an unemployment rate that continues to drop on the back of strong and lively labor markets. At their late September meeting, the Fed's rate-setting committee gave the clearest indication yet that it was ready to start tapering bond purchases in Q4, ending in mid-2022. Furthermore, half the members saw at least one hike in 2022, up from a minority in the previous meeting. Fed chair Powel emphasized that a tapering decision does not imply interest rate hikes, which are driven purely by inflation/ unemployment dynamics.

In early September, the **European Central Bank** announced a recalibration of its Pandemic Emergency Purchase Programme (PEPP) purchases in Q4, which should be between the Q1 level and the higher Q2-Q3 levels. This "moderately lower" pace of PEPP purchases relative to Q2-Q3 reflects the ECB reaction function outlined in March, which takes into consideration financial conditions and inflation dynamics. Financial conditions eased and the inflation forecast increased during the summer, but the ECB sees higher inflation as transitory. ECB President Lagarde remained non-committal to ending PEPP purchases anytime soon.

Trend focus: supply side disruptions

Transitory pains could leave more lasting scars

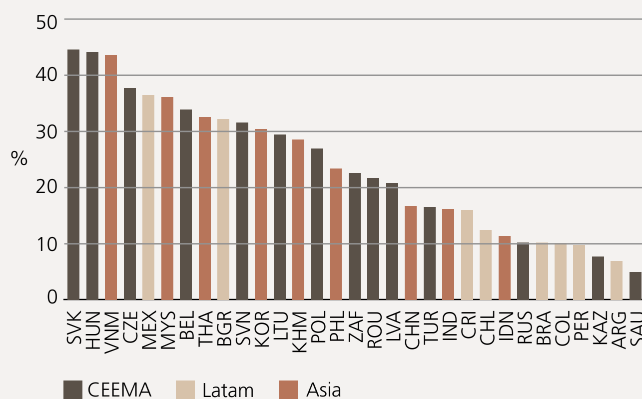
From port congestions in America's west coast to power outages in China and panic buying of petrol in the UK, the recent headlines indicate that global supply is struggling to catch up with rapidly rising demand as economies reopen and inventories remain depleted. COVID-induced factory shutdowns in Asia and a slow adjustment to strong tech demand drove the materials shortage and long delivery delays. Further fuelled by soaring commodity prices, shipping costs and a shortage of labour, supply chain issues are expected to continue to impact the growth and inflation outlook.

Over the next year the fiscal impulse is likely to decline, excess savings will be eventually drawn down and the spending pattern will probably shift from goods to more services, which should ease the severe demand and supply imbalances. On the supply side, higher vaccination rates in Asian manufacturing hubs means COVID-induced shutdowns are less likely to happen again, and long delivery times start to ease in many parts of the world. However, a swift return to normality is not likely to be easy. After soft growth in Q3, consumer demand is likely to remain strong in the short term, especially in the US and Europe and firms will restock inventories ahead of the holiday season. On the supply side, recent power outages in China are likely to add further pressure to input prices and delivery globally. The backlogs in shipping may take months to unwind. As a result, the global manufacturing sector is likely to continue to face headwinds for some time from rising input costs, lingering supply chain and logistical disruptions possibly leading to lower production, lower earnings potential and downward revision in capex and profit.

Manufacturing-oriented emerging market countries face headwinds from the current challenges which could slow the recovery momentum. Mexico's manufacturing sector, tightly integrated in North American supply chains, contracted in September as its automotive sector was hit by supply chain disruptions and rising transportation costs. Other Latam exporters are less integrated in the global value chains (see Figure 1) and are therefore somewhat shielded from the current supply challenges, although continued disruptions could possibly dampen demand for commodities. Manufacturers in ASEAN countries have started to recover from COVID-related disruptions, but due to their heavy reliance on imported inputs from China, they now face additional supply risks from the current power curbs on Chinese industries. In Central and Eastern Europe, where the tight labour market was already generating inflationary pressures prior to the pandemic, current supply-chain bottlenecks, rising energy prices and strong consumer demand are likely to require faster monetary tightening.

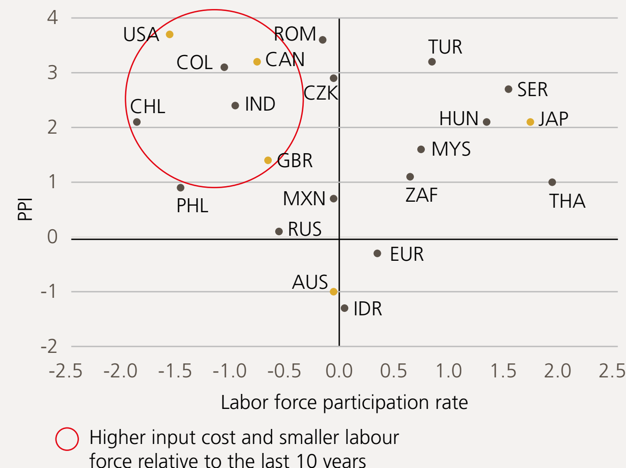
In addition to the frictions caused by the pandemic, the current demand-supply mismatch may reflect more structural changes: a more inelastic labour supply curve could mean a more permanent shift higher in wage growth, while a sharp rebound in energy demand, combined with decarbonization costs and years-long underinvestment in traditional energy sources could lead to a structural shift to higher energy and shipping costs going forward. Faced with a reduction in the labour force and higher input costs (see Figure 2) more persistent inflation dynamics could be felt in many parts of the world and a tightening of financial conditions may arrive sooner than some central banks currently expect. *(Yuni Kim)*

Figure 1: Import contents of export by country



Source: OECD 2021

Figure 2: Latest PPI and labour participation: z scores



Source: Macrobond, UBS Asset Management. 30 September 2021

Market overview

Negative performance amid economic cross currents

- Emerging market fixed income delivered negative total returns across most asset classes in the third quarter of 2021, reflecting several shocks.
- Spreads widened, driven mainly by high yield spreads while emerging market currencies sold off, reflecting a strong US dollar; rates widened amid higher rates of inflation in many emerging markets.
- In our view, the performance of emerging markets in the final quarter of the year will largely depend on developments in the US and China.

Emerging market fixed income delivered negative total returns across most asset classes in the third quarter of 2021 (see table). Sovereign[1] (corporate[2]) credit spreads widened by 17 bps (8 bps) in the third quarter to 357 bps (310 bps), generating a -0.55% (0.05%) spread return (inclusive of carry). US treasury yields rallied before selling off again over the quarter, ending the period almost unchanged but detracting slightly from total credit returns. Most of the negative returns occurred in September with the US Federal Reserve announcements on tapering and the deterioration of the property sector in China, which affected risk taking.

Local yields[3] widened 31 bps, reflecting the impact of higher inflation and tighter monetary policy in emerging markets, and returned -0.24% inclusive of carry. Higher monetary policy rates could not offset the impact of a stronger US dollar and as a result emerging market currencies sold off by 2.87% in Q3. In all, the local index returned -3.10% in Q3.

Q3 2021 returns[4]

	Total return	Spread return	US treasury return
JP Morgan EMBI Global Diversified	-0.70%	-0.55%	-0.15%
JP Morgan CEMBI Diversified	0.06%	0.05%	0.01%

	Total return	Currency return	Local debt return
JP Morgan GBI-EM Global Diversified	-3.10%	-2.87%	-0.24%
JP Morgan ELMI+	-1.57%	-2.29%	0.74%

Source: Data as of September 30, 2021. Bloomberg Finance.
Past performance is not a guide to future results.

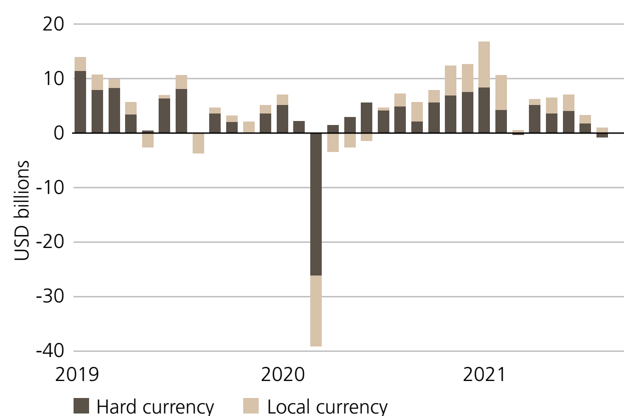
1 As measured by the JP Morgan Emerging Market Bond Index Global Diversified index
2 As measured by the The JP Morgan Corporate Emerging Markets Bond Index Global Diversified index
3 As measured by the JP Morgan GBI-EM Global Diversified index
4 EMBI = Emerging Markets Bond Index. CEMBI = Corporate Emerging 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.

Weak inflows, strong issuance

According to the latest J.P. Morgan survey, emerging market fixed income attracted USD 3.6 billion of new investments in the third quarter, much lower than the USD 19.9 billion of inflows recorded the previous quarter. Sovereign and corporate credit saw inflows of USD 1.0 billion in the quarter added to the USD 12.9 billion inflow in Q2, while local emerging markets (currency and rates) saw inflows of USD 2.6 billion in Q3 down from a USD 7.0 billion inflow in Q2 2021.

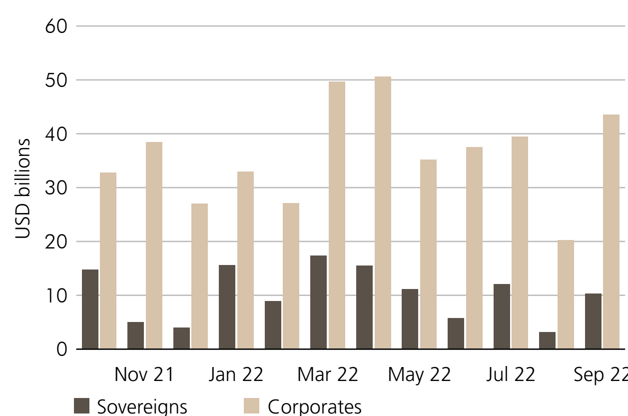
Nevertheless, emerging markets continued with robust debt issuance over the quarter, particularly from investment grade credits. Sovereign and corporate issuance in Q3 2021 reached USD 40.7 billion and USD 105.8 billion, respectively. Amortization and coupon payments reached USD 26.4 billion for sovereigns and USD 85.8 billion for corporates.

Chart 3: Small positive flows in Q3



Source: JP Morgan, UBS Asset Management. As of 30 September 2021

Chart 4: Emerging market external debt: projected amortization and coupon schedule



Source: JP Morgan. As at 30 September 2021.
Forward-looking cashflows are J.P. Morgan estimates

Country focus: China

The consequences of a tightening property market

In their effort to cool down the robust real estate market activity that fueled the post-pandemic economic rebound, the Chinese authorities started tightening regulations in late 2020 via the so-called "Three Red Lines" (limits on the liabilities/assets ratio, net gearing, and short-term debt cash coverage) on developers and the "two Red Lines" (limits on exposure to the property sector and mortgages) on banks (see illustration for more details). The impact of the tighter regulatory stance was a notable slowdown of activity in the sector and financial stress on highly leveraged developers. Evergrande, a large developer, experienced severe financial stress, threatening to affect the overall sector.

By late September the authorities started to intervene more actively to limit the impact of the downturn in the real estate sector on the economy. The central bank started injecting liquidity into the system while indicating their support for a healthy development of the real estate sector at their third-quarter monetary policy committee meeting.

Between September 17-29, the central bank injected RMB470bn (around $72.5bn) of liquidity via open market operations. Furthermore, central bank Governor Yi Gang urged 24 banks to support the healthy development of the property market - including providing funding to real estate developers and clearing the backlog of mortgages - while helping local governments stabilize the sector. In all, it appears that the government is ready to manage the situation without excessively relaxing its regulatory stance, thus avoiding moral hazard.

China's three red lines: re-rating phase for the property sector

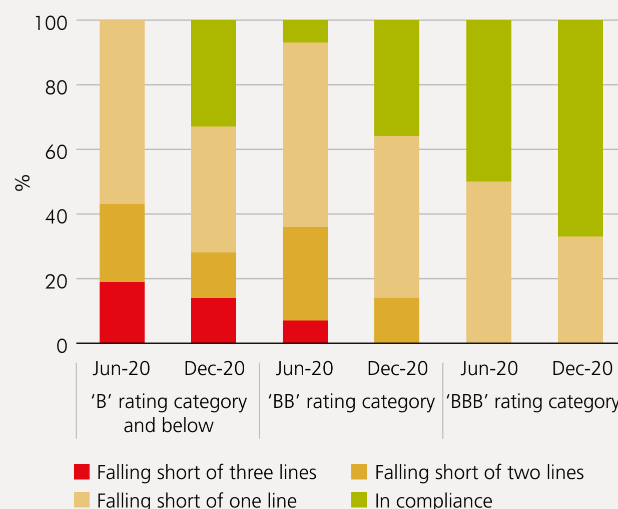
Three red lines: Why, and why now?

- Housing is socially and systemically important to the economy
- To control house prices: Housing is for living in, not speculating. Affordable for all
- Manage land markets: Developers bidding up land prices fuels higher housing costs
- Control household demand for housing: Tiered caps to banks' exposure to property loans and mortgage lending (Jan 2021)
- Three criteria:
  - Cash to short-term debt < 1x,
  - Asset-to-liability ratio of < 70%, and
  - Net-debt-to-equity > 100%

Color code	Number of red lines breached	Allowable annual growth in debt
Green	0	15%
Yellow	1	10%
Orange	2	5%
Red	3	0%

Source: UBS Asset Management

Rated Chinese developers' compliance with three red lines



Source: S&P Global Ratings, as of 2 April 2021
Data compiled based on rated Chinese developers who have released their annual results for Fiscal Year 2020.
Domestic perpetual bonds are treated as equity.
Percentage shown represents a portion of each rating category that falls short of the requirement.

Emerging market performance during Q4 depends largely on the US and China

Developments in the US and China are likely to be the most important global factors influencing the performance of emerging market asset prices in the final quarter of 2021.

In the US, the likely beginning of the Fed tapering in November, the discussions on fiscal expenditure and taxes and issues surrounding the debt limit, will likely keep policy uncertainty relatively high, and could affect the path of US treasury yields and the US dollar, among other assets. Our baseline scenario is that growth is likely to remain strong in Europe and recover in the US after a soft summer. We expect the US Congress to approve the bi-partisan infrastructure bill soon and a smaller fiscal expenditure/tax package later in the quarter while avoiding issues with the debt limit. However, the process is not likely to be smooth and could keep financial volatility above normal.

In China, the tighter regulatory stance on the real estate sector could end up affecting growth by more than markets are envisaging during the fourth quarter and could impact demand for commodities and risk appetite in general. This is because the property sector could affect around 1/5 of GDP. We are encouraged by the recent action of the central bank, and we expect the authorities to seek to limit the impact of the downturn in the real estate sector through several actions. On the monetary policy side, those actions could include central bank directions to the financial system regarding their exposure and velocity of change of said exposure to the real estate sector, liquidity injections, reserve requirement ratios and interest rate cuts, among others. On the fiscal side, fiscal expansion in Q4 could help mitigate the impact of the downturn in the property sector.

China's high yield property sector

We believe that Chinese high yield real estate is the most exciting investment opportunity as we start the final quarter of 2021. Bond prices have been quick to reflect negative news and are now reflecting a continued stressed environment. Exposure to China's high yield real estate sector is not without risks, but we believe that at current levels, spreads may compensate for such risks under our baseline scenario of more active government direction and more gradual deleveraging. If we are right, and there is a shift in policy towards the property sector, given its large impact on Chinese growth, Chinese high yield could reverse its negative price action and have a positive influence not only in the whole Chinese complex, but also on Asian high yield and emerging markets.

We continue to prefer high yield over investment grade in global emerging market credit, on the back of strong commodity prices and global growth. We continue to find pockets of value in emerging market currencies. However, for currencies to perform, global factors will have to behave favorably, including the US dollar and US treasuries.

We believe that it is still too early to jump into emerging market rates as inflation has yet to peak and central banks are still hiking but we also believe that opportunities will appear in Q4. We are defensive duration as we start the fourth quarter but we are likely to reassess our stance if/when we approach the upper limit of our range (1.7% yield on the 10-year UST bond).

(Federico Kaune)

Sovereign debt

Giving back some gains

Sovereign credit posted a -0.70% total return in Q3 2021[5]. Spreads widened 17 bps to 357 bps, generating a -0.55% spread return. US Treasury yields sold off marginally, slightly detracting from performance.

Investment grade sovereign spreads widened marginally, while high yield sovereign spreads widened by 12 bps to 594 bps in Q3. As we argued in our last quarterly, investment grade spreads had already converged to fair value in our view, thus the small spread move is not surprising. Some high yield countries benefited from the IMF's SDR allocation[6], which was distributed in the summer to IMF members according to their quota.

Performance was mixed across regions. The Middle East and North Africa (MENA) region had the highest total return at 0.59%. Lebanon stood out as it rallied almost 33% on the formation of a new government, better prospects for reforms and their SDR allocation.

Emerging Europe returns were pretty flat (-0.07%). Belarus returned 3.74%. Spreads tightened 38 bps in Q3 after selling off by 150 bps in Q2 on the back of lighter-than-expected sanctions.

Asia returned -0.44%, with Sri Lanka selling off 3.73% in Q3 after the significant 7.97% rally in Q2. The widening occurred in spite of the SDR allocation that could help the country on the external liquidity front.

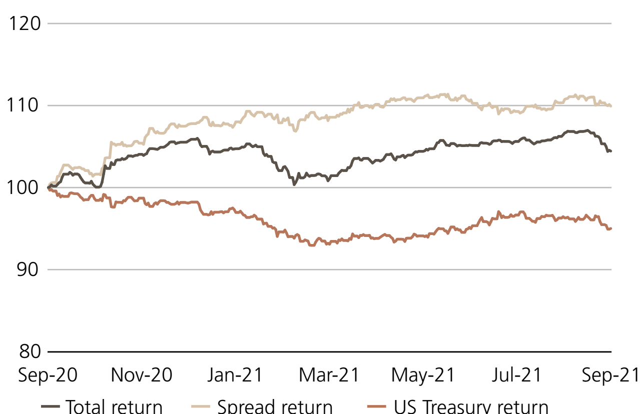
South Saharan Africa posted a negative return of -1.43%. The outlier was Zambia which rallied 21.57%, reflecting the impact of the SDR allocation on international reserves and the strong victory of the market-friendly candidate Hakainde Hichilema in the August presidential elections.

Latin America lagged and returned -1.67% in Q3. Most large countries showed negative returns, including Brazil (-2.83%) where the ongoing discussions between their executive, the legislative and the judiciary increased not only political risk but also the risk of fiscal slippages. EL Salvador had an outsized negative return of -16.45%, as President Bukele became more confrontational with the IMF and the US government, while adopting Bitcoin as legal tender in the country.

At 357 bps, sovereign spreads are still trading close to their 10-year mean[7]. At 150 bps, in our view emerging market investment grade spreads are fair relative to their own history and versus US investment grade and most likely will continue delivering mostly carry. Emerging market high yield spreads (excluding credits in default) are still trading wide relative to their 10-year mean and 170 bps wider than US high yield. After the selloff in high yield spreads in Q3, we wouldn't be surprised to see a 25-50bps rally in Q4 on cheap relative valuations and strong commodity prices, if US Treasury yields remain well behaved.
(Federico Kaune)

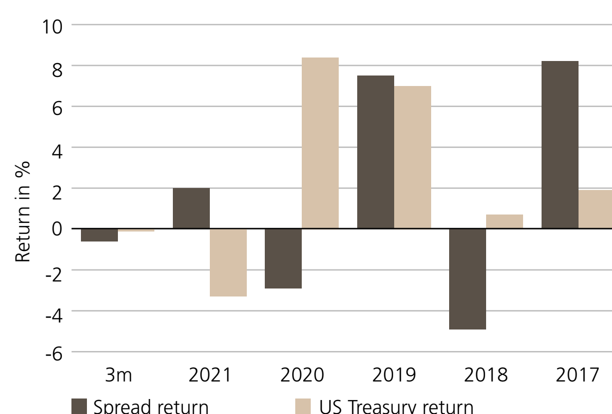
5 As measured by the JP Morgan EMBIGD Index
6 International Monetary Fund, Special Drawing Rights reserve of around $650 billion
7 As measured by the JP Morgan EMBIGD Index

Chart 5: Emerging market sovereign debt: hit by higher developed market yields



Source: JP Morgan. As of 30 September 2021. Rebalanced to 100 from 30 September, 2020. Index shown is the JP Morgan Emerging Market Bond Index Global Diversified (EMBIGD).

Chart 6: Emerging market sovereign debt returns over the past 5 years



Source: JP Morgan. As of 30 September 2021. Index shown is the JP Morgan Emerging Market Bond Index Global Diversified (EMBIGD).

Corporate debt

Mixed results

Emerging market corporate credit provided positive quarterly returns of 0.06% in Q3 2021[8].Corporate credit spreads widened by 5bps in Q3 2021. Total returns were supported by a tightening of investment grade credits, contributing 0.26% to Q3 returns. Spread returns contributed 0.05% while Treasury added 0.01%.

Returns were driven by a combination of supportive factors such as continued global growth recovery from COVID-19, the continued push of vaccine rollouts, and robust commodity demand. Partly offsetting the positive drivers were several negative factors: a slower pace of recovery due to the resurgence of COVID-19 (delta variant), policy tightening in China leading to lower domestic growth and lower commodity demand, and the US FOMC announcing plans for tapering. These factors combined for a volatile quarter with emerging market corporate credit squeezing out a small positive total return.

Most regions provided positive returns, led by Europe (0.74%), Africa (0.63%), Middle East (0.46%), Latin America (0.41%) while Asia (-0.61%) detracted from returns.

By county, corporate bonds issued by Argentina (4.30%), Egypt (1.84%), Jamaica (1.59%), Ghana (1.13%), and Nigeria (0.94%) provided the largest positive returns while the largest underperformers were Macau (-3.69%), China (-2.17%), Thailand (-0.81%), Morocco (-0.57%), and Brazil (-0.54%).

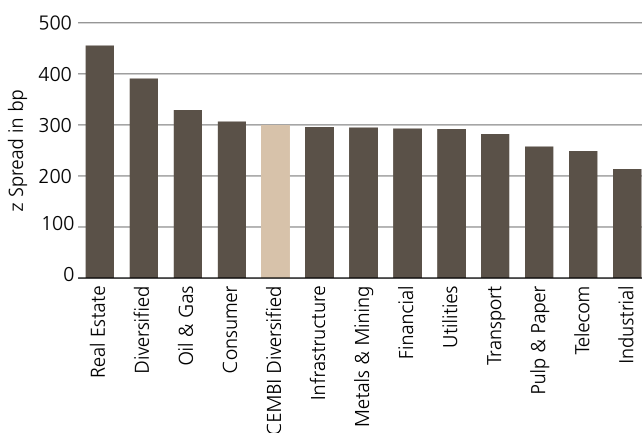
Sector returns were mixed. The best performing sectors were Utilities (0.71%), Financial (0.67%) and Infrastructure (0.45%), while the biggest detractors were Real Estate (-3.57%), Consumer (-0.85%), and Pulp & Paper (-0.51%).

Financials: Bank fundamentals are beginning to improve as loan growth rises alongside emerging market growth. Furthermore, higher interest rates are broadly supportive for NIM expansion. 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 & telecom): This sector was one of the more defensive sectors in the pandemic as consumption of mobile, internet and TV subscription services remained resilient. Moreover, demand for telecom services surged following lockdowns, with increases in mobile and fixed broadband traffic. The long-term investment case for TMT remains largely intact, on the back of a supportive demographic outlook for emerging markets as well as comparatively lower penetration rates relative to developed economies. While the backdrop remains supportive, we consider this to be reflected in prices and we remain underweight TMT relative to commodity-exposed sectors who continue to benefit from global economic recovery.

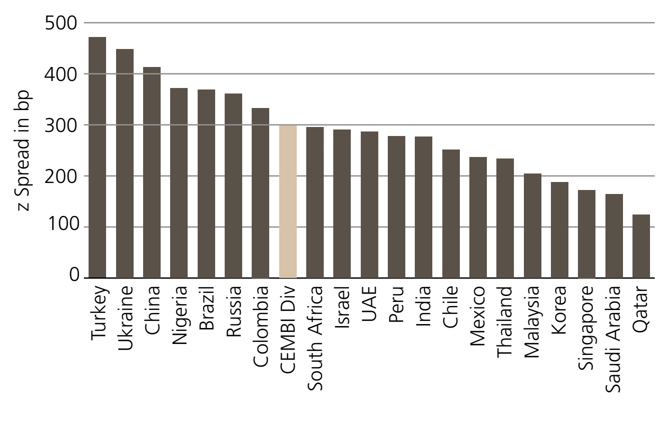
8 As measured as JP Morgan CEMBI Diversified Index

Chart 7: Emerging market corporate spreads by sector



Source: JP Morgan. Index shown is the JP Morgan CEMBI Global Diversified index, as of 30 Sep 2021. The z-spread, also known as the zero-volatility spread or the static spread, measures the spread over the benchmark zero coupon swap curve.

Chart 8: Emerging market corporate spreads by country



Source: JP Morgan. Index shown is the JP Morgan CEMBI Global Diversified index, as of 30 Sep 2021. The z-spread, also known as the zero-volatility spread or the static spread, measures the spread over the benchmark zero coupon swap curve.

Oil & Gas: Oil markets should remain underpinned by low inventory levels and the possibility of power sector fuel switching amidst a severe supply crunch of natural gas. Industrial demand continues to improve and OPEC+ will likely retain its intention to inject a further 400k bbl/d per month into the market through year-end. We remain positively positioned on the sector to capture any additional spread tightening in the short to medium term. In the longer term we are cautious as integrated producers prioritize energy transitions to biofuels, solar, wind, & 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 the slower growth and slower vaccine roll outs of emerging vs developed markets.

Metals and mining: The post COVID economic recovery and green transition have improved the outlook/demand for most base metals. The strong rally in copper, aluminium, steel and zinc, which were supported by a weakening US dollar which has historically had an inverse relationship with metal prices. However, iron ore has been an outlier. After a very strong first half of the year, the metal has seen a reversal in pricing, giving back ~45% of its gains in Q3 2021. A tightening of economic policies in China and lower steel demand from Chinese Real Estate were primary drivers adversely impacting prices. The slack was however partly offset by increased demand from US and Europe. While our outlook for Metals & Mining remains broadly positive, growing supply side risks and continued tightening of economic conditions in China could prove to be a drain on returns causing us to cautiously lower our expectations. A reversal of policies in China would be a positive driver.

As we highlighted in previous quarters, **emerging market high yield issuers** continue with robust liability management to reduce short-term funding. This trend has continued over the last quarters as issuers take advantage of market liquidity and low interest rates.

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. From a valuation perspective, several sectors in China have become more interesting, specifically Chinese Property. While we like valuations of the China property sector, we expect volatility to remain high which will provide opportunities to add exposure. While we maintain a broadly positive outlook for emerging market corporate credit, we are taking a more cautious stance as volatility in US interest rates will continue to impact sentiment toward fixed income assets. *(David Michael)*

Local currency debt

Overcoming headwinds

Emerging market local currency debt[9] lost 3.1% during Q3, bringing the year-to-date decline to -6.38%. Both local and currency returns were negative in the quarter, with currency bearing a larger share of the loss. Charts 9 and 10 show the total return of the JP Morgan GBI-EM Global Diversified and its components (local debt returns with currency hedged into US dollar and currency returns[10]).

The bulk of the sell-off occurred in September after US treasury yields jumped in response to the US Federal Reserve indicating that it would begin reducing its monthly bond purchases and that interest rates may rise at a faster-than-expected pace. A surge in inflation amid supply disruptions and a more hawkish Fed outlook led a growing number of central banks to raise interest rates. In a worrying development, regulatory tightening in China quickly spread to large sectors of the economy and began to weigh on global risk sentiment.

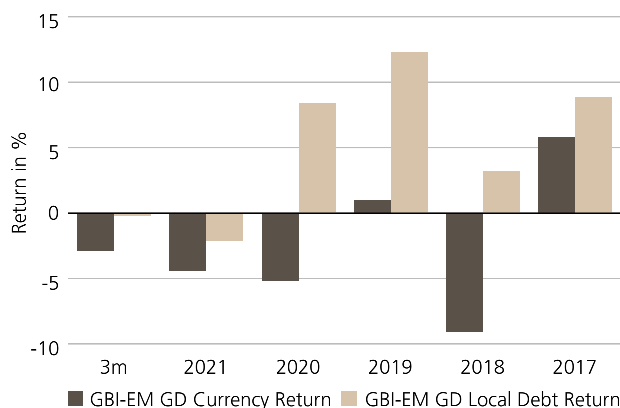
The outlook for Q4 2021 remains cloudy, even though we consider valuations to once again be attractive. A lot hinges on the timing of emerging market countries' catch-up to the US in the growth cycle. Better entry levels both for US Treasuries and the US dollar and the advances of the hiking cycles in many markets has restored yield support for currencies (particularly in Russia and Brazil). However, entering Q4, we are cautious on the market given the continuing disruptions from the COVID-19 pandemic which have led to global inflationary trends. The woes in China and the likely start of tapering in the US are the main global headwinds for Q4. The commodity picture has also become muddled: oil prices continue to rise on increased demand and OPEC+ tight supply policies, while lower demand from China has weighed on industrial commodities.

In **Latin America**, Brazil is experiencing a combination of ongoing disruption from the pandemic, exhausted fiscal buffers, very high level of inflation and difficult elections in 2022. Lack of confidence and an inflation spike forced the central bank to embark on an aggressive rate-hike cycle. With better yield support and a positive terms-of-trade shock, we expect the Brazilian Real and bonds to perform once inflation peaks, likely this quarter. Mexican fiscal and monetary policies have been conservative compared to peers and Banxico has hiked the policy rate; however, yields are not yet attractive on a spread to the US treasuries and inflation continues to climb. The Mexican Peso should do well given economic ties to the US once headwinds from US treasuries subside. We think the oil-propelled Colombian Peso could do well in Q4, while the performance of the Chilean Peso will depend on the outcome of critical November elections. The Peruvian Sol may continue to suffer as the result of more populist policies.

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

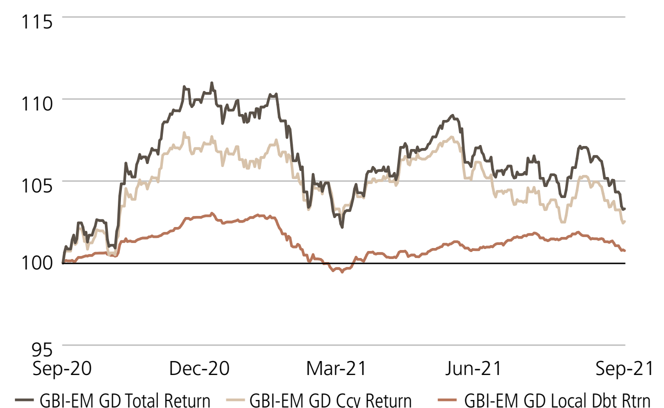
10 Local debt returns result from yield movements and coupons of the underlying bonds in local currency. Currency returns result from exchange rate movements and carry.

Chart 9: Emerging market local currency returns: split between local debt and currency components



Source: JP Morgan monitor. As of 30 September 2021.

Chart 10: Currency returns: more sensitive to economic and political shocks



Source: JP Morgan. As of 30 September 2021. Rebalanced to 100 at the start of the period.

In **Europe**, stabilization in Turkey was dealt a blow by the sacking of the respected central bank president. The central bank has prematurely started an easing cycle, and the currency is likely to continue to weaken over time. The outlook for South African growth and fiscal balance has improved on an increase in commodity prices and strengthened political support of the government. However, high dependency to China and high beta to global markets has led to volatility. The Russian currency has performed well as oil prices surged and the government maintained fiscal restraint. Government bonds have been undermined by persistent inflation but should do well once the central bank ends the advanced hiking cycle, likely in Q4. The main risk in Russia remains geopolitical.

Central Europe, along with the rest of Europe, has been on a recovery path as vaccination rates improved. Interest rates are low by historical standards, and inflation has surged, leading to a sell-off in bond markets, while currencies are largely following the Euro. While the Czech Republic and Poland have started the tightening cycle, the Hungarian central bank has kept interest rates very low. Romanian bonds suffered due to increased political noise. We continue to see low-yielding bonds in central Europe as unattractive.

In **Asia**, the outlook has become less positive. Having benefitted from better handling of the COVID-19 pandemic, many countries are lagging in vaccination; however, China has been rapidly catching up. The strong Renminbi and China's regulatory tightening bias weighs down on the outlook for the currency and the rest of APAC currencies. Bond yields increased but remain low in Korea and Thailand. Indonesian and Indian markets are likely to trade in-line with higher-beta emerging markets. *(Igor Arsenin)*

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