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Opportunities in uncertain times

Emerging markets fixed income | UBS Asset Management

No lift off for EM FI in 4Q

- In 4Q 2018 credit sold-off on lower oil prices, but local debt rallied as Argentina and Turkey recovered
- 2018 wasn't kind to EM FI, but the weakness offers compelling value
- Such value could be realized if the global backdrop stabilizes in 2019

Emerging markets fixed income (EM FI) delivered mixed returns during Q4 2018. Sovereign and corporate credit delivered negative returns reflecting a significant widening of spreads, only partially compensated by the rally in UST yields. However, local EM delivered positive returns as lower yields offset weaker FX almost everywhere.

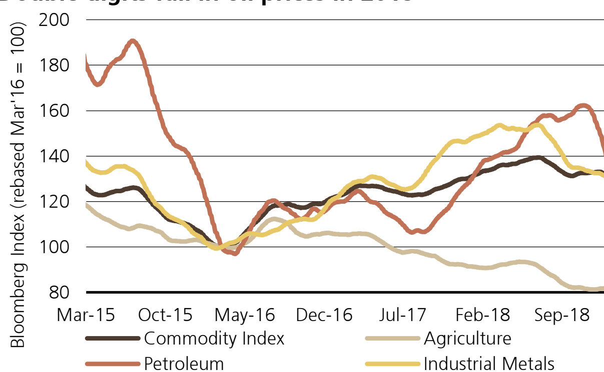
By December, sovereign (corporate) spreads as measured by the EMBIGD (CEMBID) had widened 80 (45) bps reaching a record high for the year at 415 (366) bps. In contrast, local yields (as measured by the GBIEMGD) tightened 17 bps, driven by a significant rally in Argentina and Turkey (partially reversing the large sell-off in 3Q) but EMFX weakened 0.8% against the USD in 4Q 2018.

Lower oil prices dampen the quarter

The abrupt and sizable drop in oil prices in 4Q negatively affected several oil exporters –particularly in Africa and Latin America- generating a significant spread widening ranging between 100-200 bps and weakened their currencies. The sustainability of the significant recovery of oil prices in the first three quarters of 2018 rested on several factors that did not pan out as expected.

First and more importantly, the US government surprised markets with its announcement not to impose sanctions on countries importing oil from Iran. Second, Russia and Saudi Arabia released information that showed they were producing oil at record levels. Third, oil shale producers took full advantage of higher oil prices and lower marginal costs to pump up oil production in the US. Finally, expectations of softer global growth -driven by trade war concerns- weighed on markets. Low oil prices pose a risk to many EM oil exporters that have oil break-even prices for their fiscal/external accounts that are much higher than current prices.

Double digits fall in oil prices in 2018



Source: Bloomberg, Macrobond, UBS Asset Management. As of December 31st, 2018

Disappointing global backdrop in 4Q 2018

The trade disputes between China and the US continued to shape risk appetite in 4Q. The bilateral talks at the G20 meetings in Buenos Aires, Argentina in late November, saw China and the US agree to extend discussions for an additional three months before imposing further tariffs on each other.

The announcement had little impact on risk appetite, however, as the market turned its attention to the significant tightening of financial conditions in the US driven by the widening of US IG and HY spreads and the sharp fall in the stock market. Lower oil prices impacted several companies in the energy sector but slowdown in earnings growth brought about by the impact of trade wars was a significant contributor, as almost half the S&P earnings come from overseas. Additionally, economic activity and other surveys started to show more clearly that global growth was slowing down across the globe.

Q4 2018 returns

	Total return	Spread return	UST return
JP Morgan EMBI Global diversified	-1.26%	-4.10%	2.97%
JP Morgan CEMBI diversified	-0.06%	-2.41%	2.41%

	Total return	FX return	Local return
JP Morgan GBI-EM Global diversified	2.11%	-0.80%	2.93%
JP Morgan ELMI+	1.20%	-0.13%	1.34%

2018 returns

	Total return	Spread return	UST return
JP Morgan EMBI Global diversified	-4.26%	-4.89%	0.66%
JP Morgan CEMBI diversified	-1.72%	-2.89%	1.20%

	Total return	FX return	Local return
JP Morgan GBI-EM Global diversified	-6.21%	-9.10%	3.18%
JP Morgan ELMI+	-3.33%	-7.50%	4.51%

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 December 31, 2018. Bloomberg Finance.

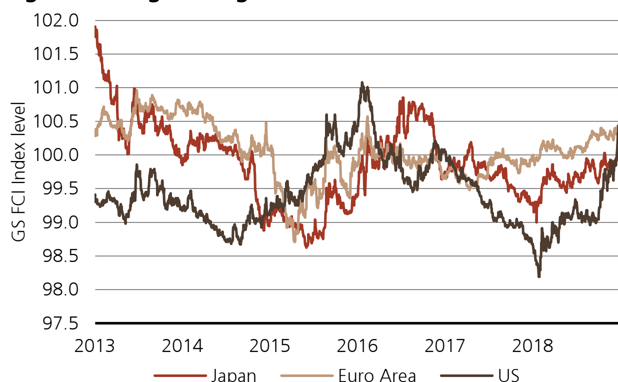
* The tables show total returns of US dollar and local currency debt plus their return components, as explained below:
- US dollar debt return components: Spread return results from the yield difference between emerging markets debt and US treasuries and from spread movements. US treasury return results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

In light of these developments, markets began to doubt the Fed's commitment to normalize rates which, in some instances were instigated by dovish speeches from some FOMC members. In the end, the Fed hiked rates by 25bps in

December to 2.5%, focusing on tight labor markets, and above target/trend inflation and growth. The hike immediately drew criticism from the White House, which in turn further tightened financial conditions via an additional drop in equity markets.

Market participants are right to be worried by these developments, as political meddling with central bank independence (rare in DM but unfortunately more common in EM) has brought with it devastating consequences in several countries most notably Argentina in 2017/18, Turkey in 2018 and Brazil in 2013.

Significant tightening of financial conditions in the US

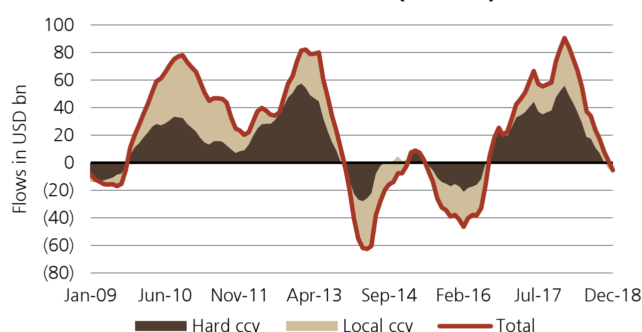


Source: Goldman Sachs, UBS Asset Management. As of December 31st, 2018

No help from flows in 4Q 2018

In-line with the negative flow dynamics of the 2Q and 3Q, 4Q also delivered net outflows from all asset classes. Past negative returns and the increased uncertainty from trade wars and the drop in oil prices drove outflows from EM FI. In all, net retail outflows from EM FI in 2018 reached 5.4 billion or 2% of invested assets according to JPM data.

Cumulative 12m EM FI retail flows (USD bn)



Source: JP Morgan, UBS Asset Management. As of December 13th, 2018

Political uncertainty remains

Brazil's asset prices rallied after the victory of right-wing candidate Jair Bolsonaro. Markets are optimistic about his intentions to implement much needed reforms to revert the significant deterioration of the public sector debt dynamics in the past five years. Brazil requires a reform to its pension system (for long-term sustainability) as well as significant fiscal adjustment worth 3-4% of GDP in the immediate term. President Bolsonaro has appointed a high quality cabinet but lacks support in congress, where his party holds about 10% of the seats.

In contrast Mexico's asset prices sold-off reflecting the new interventionist-nationalist paradigm sponsored by President Lopez Obrador (AMLO). AMLO won on a promise to lead a government free of corruption and to dismantle 25 years of "neo-liberal" policies. Before taking office he had already called and won two referendums (with minimal participation from the electorate) to stop the construction of a new airport in Mexico city (which generated a 20% drop in the price of the airport bonds issued in international capital markets in 2016 and 2017) and to approve several initiatives that, if fully implemented, could cost 1.5-2.0% of GDP in 2019 alone. The recently approved 2019 budget seems reasonable as was the recent central bank rate hike, but implementation risk (absent in the past) will be key.

Argentina's asset prices had very mixed behaviors. Rates and FX rallied –reflecting the efficacy of the new found central bank monetary orthodoxy- while spreads widened to record highs -reflecting the significant drop in economic activity and its consequences on the popularity of the reformist government ahead of elections in October 2019.

Turkey backtracked from its predisposition for lax monetary policies (instigated by the government) in the face of adverse inflationary dynamics and hiked rates by 625 bps in September, prompting a rally in credit, rates and FX.

There is value in EM FI

Overall 2018 wasn't kind to EM Fixed Income. After two years of positive double-digit returns, all asset classes –including sovereign and corporate credit, rates and FX- delivered negative returns. Sovereign (corporate) spreads widened by 130bps (80bps) to 415 (366) bps in 2018. Sovereign credit is now yielding close to 7% with HY at 9% and IG at 5%. Corporate credit yields are similar to those of sovereign credit but with two years less duration.

EM rates and FX also widened/weakened in 2018. Local yields widened 32bps to 6.46% in the year while currencies weakened circa 9% against the USD. Several high yielding currencies now trade significantly cheaper to fair value. Yields on 10 year local bonds in the largest and more systemically important countries –Mexico, Brazil, South Africa, Russia, Indonesia- now trade at around 9%, with several others trading at much higher levels (Turkey at 16% and Argentina at 22%). In contrast Asia trades close to 5% on average.

EM credit, rates and FX have widened/weakened enough to offer compelling value, provided that the global backdrop including growth, trade and commodity prices stabilize.

2019: Not too cold, not too hot

We start the year with a more constructive stance on the potential for EM FI to generate positive returns in 2019. Our more optimistic views are based on the following main pillars:

1) Trade wars subside: No additional tariffs
2) DM growth resynchronizes: US slows, Europe stable
3) Commodity prices recover and stabilize

We believe there are enough incentives for both the US and China to reach an agreement. Firstly, China is feeling the brunt of the impact on its economy as exports to the US have started to contract severely and economic activity is slowing down. Secondly, the US is also feeling the effects on the stock market as almost half its earning are generated outside the US. Thirdly, the US has shown willingness to negotiate by delaying the

increase of tariffs on $200 billion worth of Chinese imports while they negotiate. Fourthly, China has committed to resume imports of US soybeans and reduce tariffs on auto from 40% to 15%. Although it is still unclear whether China will be willing to address the demands raised by the US –including the opening of domestic markets to external competition-, we believe the incentives are powerful enough to reach an agreement.

There is increasing evidence that global growth and trade are decelerating in part due to the initial impact of higher tariffs already in place in the US and China and the uncertainty generated by the potential escalation of detrimental protectionism in 2019. It appears that even in a scenario absent of additional tariff increases, US growth is likely to slow down due to the delayed impact of a) eight 25bps Fed rate hikes, b) quantitative tightening and, c) significant tightening of financial conditions. On the other hand it is plausible that Eurozone growth will benefit from the drop in oil prices and less political uncertainty (Italy). If we are right, we expect the Fed to hike rates only two more times in 2019 (frontloaded) if at all, while Europe to hike marginally. We also envisage UST yields remaining contained within a narrow range (10 year at 3% +/- 25bps) from 2.75% currently. In contrast we expect bund yields to rise further (10 year at 1% +/- 50bps) from 0.25% currently. In this scenario we expect the USD to depreciate against the EUR to 1.2 +/- 5%.

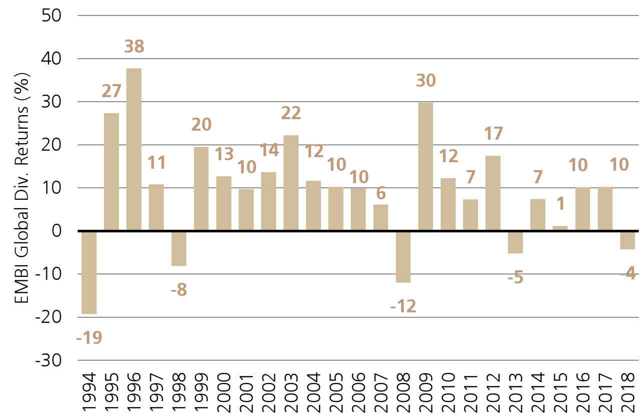
Regarding commodity prices, we understand that fundamentals in diverse markets are in general supportive. Supply excesses in oil markets are likely to be addressed via production cuts by OPEC and non-OPEC members alike and by lower production in US shale as current prices are at or below break-even levels. The violent drop in oil prices more recently has responded to concerns about demand (as growth declines on trade wars) and a stronger USD. If we are right and the trade wars subside, fear of a further slowdown in global growth will abate and demand for commodities –including energy and non-energy- will stabilize and could recover 15%-30% in 2019 relative to the end-2018 levels.

The above, is a "not too cold, not too hot" benign scenario for EM FI asset prices. As the fear of an escalation in protectionism subside, the fear of a significant slowdown in global trade and growth will also subside, supporting commodity prices. This is a supportive scenario for credit and could result in a significant rally in several countries. The USD/EUR envisaged weakness and relatively stable UST is also supportive for credit and EMFX and rates.

The risks to the above scenario are obvious. But the clearest one is the China-US trade war. If there is a further escalation in the trade war, global growth and trade will suffer even if China implements counter cyclical measures to reduce the impact of the negative external shock on domestic demand. This is because further fiscal expansion accompanied by easier monetary policy and a weaker currency could somewhat dampen the negative impact on China growth but it will not be effective in addressing the likely disruption to the global supply chain and investment. In this scenario, EM asset prices could suffer further downside.

Finally, valuations are also on the cheaper side in EM FI. If the constructive scenario materializes we could enjoy significant rallies in credit, rates and FX while collecting the high carry that these asset classes offer in the meantime. In particular, we expect credit to deliver carry plus 50bps tightening, which would imply close to 10% returns. We also expect EMFX to strengthen around 5% against the USD and together with carry deliver about the same return.

Twenty five years of sovereign returns



Source: JP Morgan, Bloomberg, UBS Asset Management. As of December 31st, 2018

In the 25 years of returns in sovereign credit, negative return years (1994, 98, 08, 13, 18) have always been followed by several years of positive returns as usually spreads blow up during the correction year. Although there is far more differentiation nowadays, high yielders –including Argentina and several African oil exporters- could be the ones that deliver the expected tightening.

2019 Election Calendar

Date	Presidential	Parliamentary	Local
Jan-19	-	-	-
Feb-19	Nigeria, El Salvador	Nigeria, Thailand	Ecuador
Mar-19	Ukraine, Slovakia, El Salvador (runoff)	-	Turkey
Apr-19	Indonesia	Indonesia, Israel	-
May-19	Panama, Lithuania	India, Philippines, South Africa, Panama	Philippines
Jun-19	Guatemala, Latvia	Guatemala	-
Jul-19	-	-	-
Aug-19	-	-	-
Sep-19	-	-	-
Oct-19	Argentina, Uruguay, Bolivia, Mozambique	Greece, Ukraine, Argentina, Uruguay, Bolivia, Mozambique	Argentina
Nov-19	Tunisia	Israel, Poland, Tunisia	-
Dec-19	Romania	-	-

Souce: UBS Asset Management, Eurasia, Wikipedia.
Note: **Sub-Saharan Africa**, **Asia**, **Europe**, **Middle-East & North Africa**, **Latin America**

Finally, a word of caution is warranted. Because of the risks to our baseline scenario, we would recommend starting the year with a positive bias, but add or reduce risk allocations to EM FI conditional on developments on global trade negotiations, which are likely to be resolved in some way in 1Q 2019. (Federico Kaune)

Sovereign debt: light at the end of the tunnel or just an oncoming train?

Sovereign credit posted a -1.26% return in Q4 2018 (measured as JP Morgan EMBI Global Diversified), while the full year posted a disappointing -4.26% for EM sovereign debt, in sharp contrast to the 10% return in 2017. Spreads widened 80 bps detracting 4.10% this quarter, while lower UST yields added 2.85% to the overall performance.

While the EM economic backdrop looks robust– with the exception of China –, geopolitical uncertainty and trade protectionism have been headwinds for emerging market investments. Even if the direct economic impact from trade tensions has been smaller than expected in summer, increasing risk aversion and lower investor confidence led to outflows and resulted in wider spreads in EM bonds.

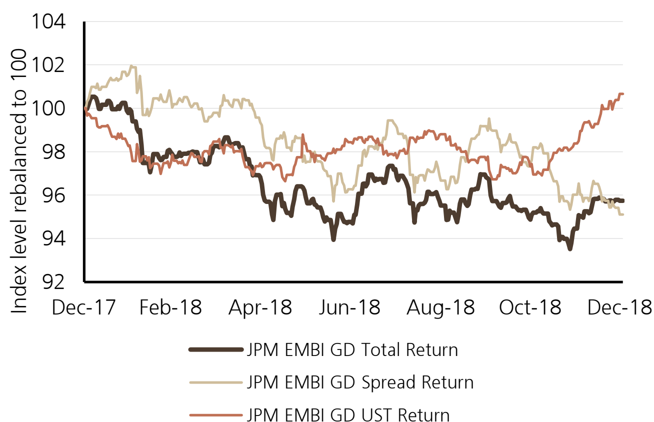
The dispersion of returns among regions was large. Asia and Europe delivered small positive retuns (0.2%), Latin America returned -1.86% and Africa and the Middle East returned -3.53% and -3.29%, respectively, driven mainly by lower oil prices. Overall, commodity and oil exporting countries were under pressure given lower oil prices. Looking into 2019, we expect the US economy to slow down and the European economy to grow slightly faster than in 2018. We also expect demand for commodities to stabilize at a high enough level to benefit EM exporting countries. On the other hand, commodity importing countries and smaller open economies in Asia may suffer from higher commodity prices and lower trade volume.

The G20 summit was unable to deliver concrete results, other than Presidents Trump and Xi agreeing to resume further talks in Q1 2019. We believe there are sufficient incentives to reach a resolution to the trade conflict but our conviction level is not high. Global and Asia growth hinges on the resolution of trade tensions.

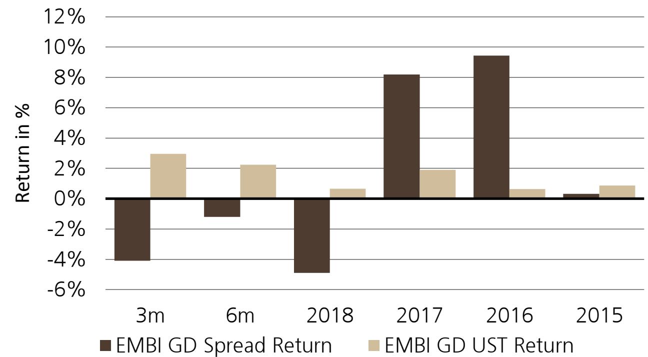
With the widening of spreads in Q4, EM USD debt is once again attractive, offering higher yields than local debt without EM FX exposure but longer duration. (Uta Fehm)

Sovereign debt: Q4 posted high volatility on both sources of return

(Rebalanced to 100 as of December 31, 2017)



Source: JP Morgan monitor, December 31, 2018



Source: JP Morgan monitor, December 31, 2018

Corporate debt: nimble security selection

In Q4 2018, emerging markets corporate credit (measured as JP Morgan CEMBI diversified) provided a flat return of -0.06% vs -1.72% for the whole year. Corporate credit spreads widened by 65 bps this quarter providing -2.41% of the -0.06% quarterly return. As US rate interest rate volatility increased, spreads widened and high grade credit outperformed high yield.

Similar to sovereign debt, in Q4 2018 regional performance varied based on credit quality and interest rate sensitivity. This was reflected in stronger performance from Europe and Asia with underperformances from Africa, Latin America, and the Middle-East.

Corporate bonds in Turkey (3.83%), Brazil (2.82%), Taiwan (2.33%), Tanzania (2.01%), and S Korea (1.64%) provided the largest positive returns while the largest negative returns stemmed from Kazakhstan (-10.22%), Jamaica (-5.41%), Ukraine (-4.62%), Oman (-3.63 %) and Ghana (-3.33%).

From an industry perspective, transport (2.45%), financials (1.11%) and diversified (0.99%) provided the largest positive returns while most negative returns came from infrastructure (-1.97%), consumer (1.38%), and metals & mining (-1.23%).

The fourth quarter continued to be fuelled by political headlines, from elections in Brazil, referendums in Mexico, continued tension in the Middle-East, and an announcement of trade negotiations between China and the US. These headlines were received with mixed reactions from emerging market credit leading to flattish returns over a volatile quarter.

Corporate fundamentals continue to improve as reflected in lower leverage and earnings growth from exporters fuelled from FX depreciation, though corporate credits continue to face headwinds from price volatility in oil and commodity related sectors.

On the supply side, we expect net corporate issuance in 2019 to see a slight increase over 2018 primarily driven by refinancing over capex and M&A. The largest variables in the supply outlook stems from a decline in issuance from China (as issuers increase lower cost onshore funding) offset by higher issuance from the Middle-East and Africa.

Value can be found in leveraging high yield issuers, investment grade credit that is beaten up from cross over flows, as well as new issuance from Africa and the Middle East and Brazil. On the other hand, caution is warranted in Turkey where we expect to see continued volatility, economic slowdown and stress on financial institutions and domestic oriented businesses.

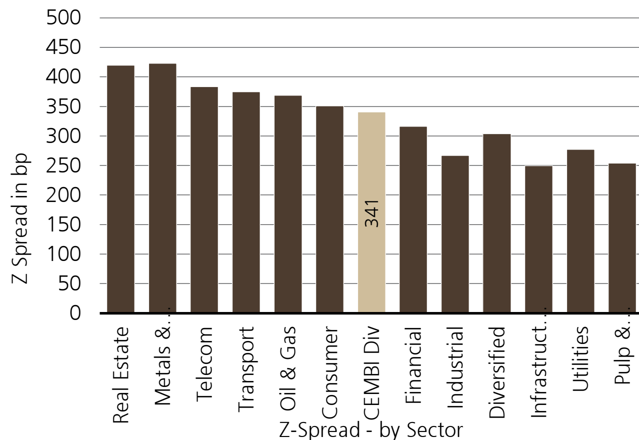
Lower economic activity and still-high leverage metrics in China argue for continued caution. However, we keep our positive stance toward systemically important state-owned enterprises in China, and select Chinese properties.

Risk appetite in emerging markets credit continues to be driven by headlines. We continue to monitor trade disputes and tariffs between US and China, Mexico's new referendum based governing model, stress in Argentina, further sanctions on Russia and a continued concern over poor policy responses in Turkey.

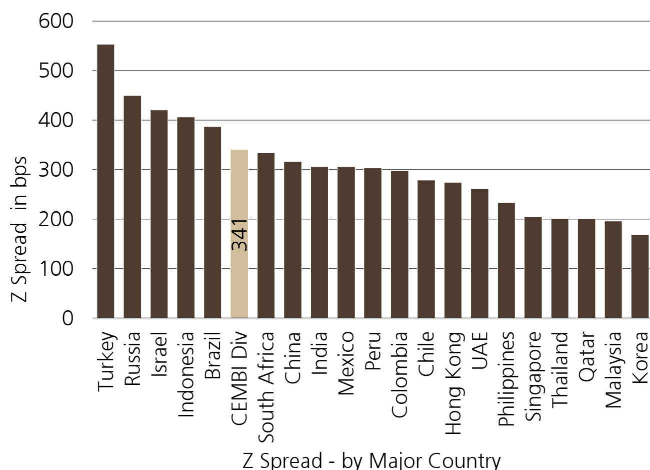
The quarter(s) ahead will continue to require nimble bond picking with a close eye on beta management. (David Michael)

Spreads: Widening and more attractive again
measured in bps as of December 31, 2018

(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: JP Morgan monitor, December 31, 2018



Source: JP Morgan monitor, December 31, 2018

Local debt: waiting for stability in global markets

EM local debt (measured by JP Morgan GBI-EM Global Diversified index) showed a 2.11% return in Q4 –bringing the year-to-date return to –6.21%. The positive performance in 4Q, however, was highly uneven, with Argentina, Brazil and Turkey showing double-digit positive returns, while several commodity sensitive countries –Colombia, Russia and Mexico- showing negative returns. Volatility also subsided, following the large draw-downs in May-June and then August. The positive performance in local markets was in sharp contrast with the sell-off in DM equities, credit and oil.

The surprising resilience of EM local markets in 4Q reflected the earlier correction as well as constructive developments including:

– Prospects of a truce in US/China trade frictions
– Pricing-in of more severe sanctions in Russia
– More realistic policies in Argentina and Turkey
– A market-friendly election outcome in Brazil
– Potential approval of the revised NAFTA in Mexico

In addition, we expect the Fed to hike rates twice and pause in H2 19 following the four rate hikes in 2018, leading to lower UST yields and weaker USD. This environment warrants a positive but cautious bias, in EM local markets for the beginning of 2019.

In Latin America, we find Mexico at risk on fiscal/monetary policy as well as trade uncertainty. The Brazilian yield curve has rallied substantially and appears fairly valued, but the currency is attractive given solid external accounts. Argentina's government has finally accepted the political price of a sharp macro-economic adjustment, but it remains at best a tactical long given the looming elections in October 2019. Commodity-linked Colombian Peso and Chilean Peso have suffered amid the meltdown in oil and copper, but are poised to do well if commodities recover.

In EMEA, Turkey remains the key market to watch. Following a collapse of the Turkish Lira, the government allowed higher interest rates and seems willing to tolerate lower growth. The currency has since recovered significantly and the yield curve is shaply inverted. We remain sceptical, however, that the government will be able to follow through once the political cost of the slowdown becomes higher. On the other hand, the stand-off between Turkey and the US has subsided and Turkey holds important leverage in Syria and the broader Middle East. In South Africa, the economy remains weak, but the key driver in 2019 will be Parliamentary elections, where we expect President Ramaphosa to consolidate his mandate. Finally, the prudent strategy in Russia is to first assess the severity of potential new sanctions, particularly given that the strength of external accounts is undermined by lower oil prices.

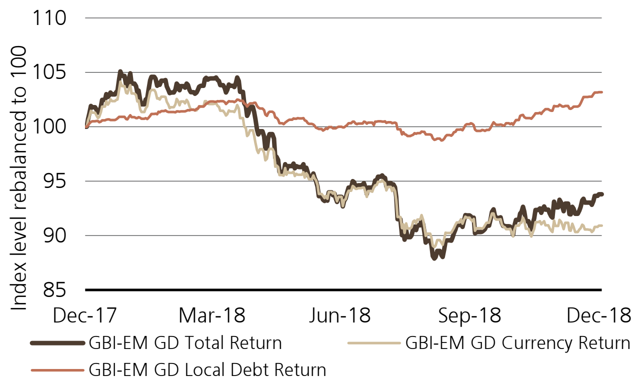
Central Europe has been enjoying high growth rates and some insulation from boarder EM weakness, despite the slowdown in the Eurozone. Tight labor markets, low policy rates and domestic-demand driven growth is a recipe for higher inflation and higher bond yields. With a weak starting point in the EUR, the regional currencies are at attractive levels, in our view, but will largely depend on the sentiment toward the EUR – growth and tail risks in Italy and Brexit.

Following a period of volatility, APAC currencies have been range-bound after the CNY stopped depreciating. However, the escalating trade war has affected sentiment, while valuations are not particularly attractive. That said, there appear to be pockets of value in high-yielders such as Indonesia, and the APAC currency block would greatly benefit from a potential settlement between China and the US on trade. India has benefited from low oil prices, but the general elections in April are likely to lead to volatility.

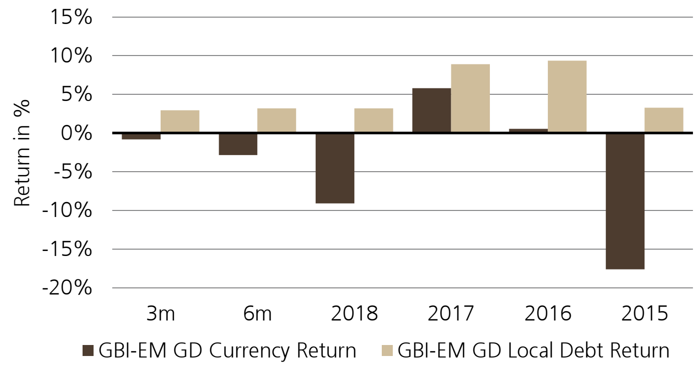
The main risks are now related to developed markets, unsettled China-US relations and political uncertainty in the US. (Igor Arsenin)

Currency returns: more sensitive to economic and political shocks (rebalanced to 100 as of December 31, 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 monitor, December 31, 2018



Source: JP Morgan monitor, December 31, 2018

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