Macro Monthly

For global professional / qualified / institutional clients and investors and US retail clients and investors.

UBS Asset Management | Economic insights and asset class attractiveness
July 2018

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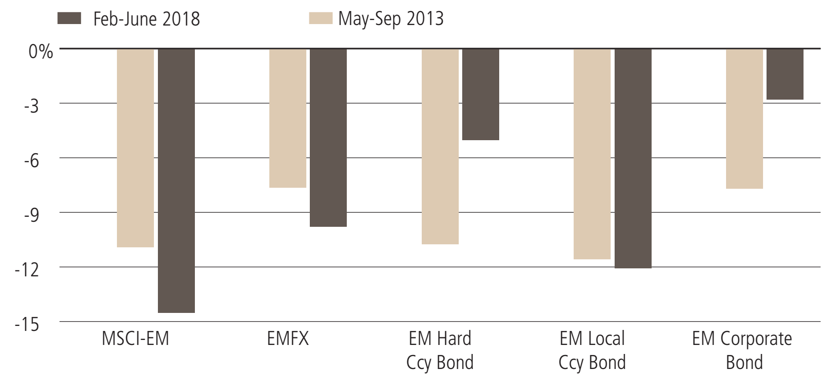
EM sell-off: Is the worst over?

Highlights

– Emerging market asset classes have experienced a broad-based sell-off across regions and asset classes, similar in severity to the Taper Tantrum in 2013.
– In contrast to the first half of the decade, we do not see this as the start of a prolonged period of EM underperformance.
– Improved fundamentals, a more growth-supportive China and more attractive valuations suggest to us that for investors with a longer-term investment horizon, emerging market assets offer good diversification and return potential.
– Still, heightened trade tensions and a Fed set on tightening further present meaningful risks, suggesting that emerging markets are likely to remain volatile in the near term.

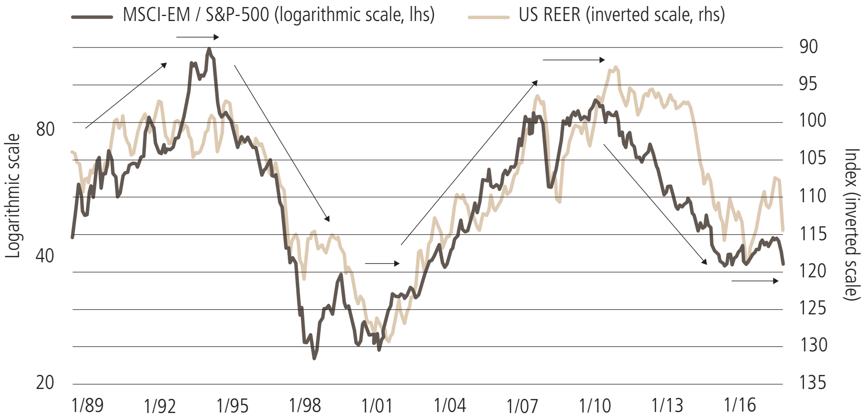
After a very strong 2016-2017, emerging market asset classes have struggled in the first half of this year. The weakness has been broad-based across regions and asset classes. Exhibit 1 shows how performance since early February has been comparable, and in some cases worse, than that during the Fed's "Taper Tantrum" of May to September 2013. It is worth noting that the Taper Tantrum was a particularly severe sell-off that took place within an extended period of EM underperformance from 2011 to early 2016 (Exhibit 2). The question now is if this sharp sell-off is just the beginning of another prolonged period of EM weakness or if it represents a buying opportunity. In this Macro Monthly we examine what has driven the recent turn in EM performance, how the current EM backdrop compares to that in the first half of the decade, and where we stand on EM asset classes from here. It is of course important to note that emerging markets span a very broad set of countries and asset classes with idiosyncratic opportunities and risks. For the sake of simplicity, we describe simply our thinking on the broad 'beta' characteristics of emerging markets. But our specific 'alpha' positioning in EM fixed income and currencies is much more nuanced than described in these pages.

Exhibit 1: Recent performance across EM asset classes compared to Taper Tantrum



Sources: UBS Asset Management, JP Morgan, Bloomberg. Data as of June 27, 2018.

Exhibit 2: Long cycles in EM vs. US stocks and US dollar real effective exchange rate



Sources: UBS Asset Management, Bloomberg. Data as of June 27, 2018.

Why was the period of 2016 to 2017 so good for EM? At its most basic level, EM is highly levered to global growth, and the synchronized global upswing over this period underpinned outperformance across the EM universe, from commodity producers to manufacturers. Related, the USD peaked during this period, as investors in US assets sought higher returns in emerging markets which had become meaningfully undervalued over the first half of the decade. Low developed market inflation and only slowly rising bond yields provided easy financial conditions for emerging markets, and overall market volatility was low; EM FX and fixed income traditionally outperform in low volatility markets, as the carry (interest rate differential to US short term rates) to volatility ratios are attractive.

This period of EM outperformance came to an abrupt halt during the volatility spike across markets in early February this year. Investors had to re-assess their perceptions of risk-return in EM amid a generally higher volatility environment for all asset classes. EM had withstood accelerating rise in yields following the passage of US tax reform because perceptions of *global*, not just US growth coming into 2018 were so strong. But the softening of growth outside the US not only lowered growth expectations on an absolute level, but contributed to broad dollar strength which disrupted EM performance across asset classes. Suddenly economies with large external deficits like Argentina or Turkey seemed particularly vulnerable to a US Federal Reserve emboldened to tighten rates further. Contagion spread to other economies as the dollar gained momentum and President Trump began to push forward more earnestly with a protectionist agenda. Local political uncertainty in Mexico, Brazil and Turkey certainly did not help.

Amid this perfect storm, EM asset classes have repriced. Before addressing whether or not these largely exogenous factors will continue, it is worthwhile examining how overall EM fundamentals stand relative to the first half of this decade, a period of prolonged EM weakness. Exhibit 3 shows how measurements of EM vulnerability stand today versus where they were ahead of the 2013 Taper Tantrum. Current account positions, which track the overall dependence on foreign funding, have risen for most countries and meaningfully in some of the recently more vulnerable countries like South Africa, Brazil and India. External debt to GDP has risen, which is concerning, although this is somewhat offset by generally growing FX reserve coverage of short term external debt. Government balances are more of a mixed bag. While some countries, particularly Argentina and Turkey, stand out for worsening vulnerability, overall most emerging markets seem in a better place than five years ago.

Exhibit 3: Indicators of external and fiscal balances and their evolution since pre-"Taper Tantrum"

	CA % of GDP			Ext Debt % of GDP			FX Reserves % of ST Ext. Debt			Primary Balance % of GDP		
	Q1 2013	Q1 2018	Diff	Q1 2013	Q1 2018	Diff	Q1 2013	Q1 2018	Diff	Q1 2013	Q1 2018	Diff
Argentina	-0.7	-4.8	-4.1	26.3	36.6	10.3	107.2	101.7	-5.6	–	-3.7	–
Brazil	-3.3	-0.4	2.9	19.0	26.7	7.7	736.2	728.7	-7.5	-1.5	-7.0	-5.5
Chile	-4.3	-1.0	3.3	46.1	65.5	19.3	215.6	221.3	5.7	0.3	-2.6	-2.9
China	2.6	0.9	-1.7	–	14.0	–	–	285.7	–	6.8	6.6	-0.2
Colombia	-3.5	-3.1	0.4	21.8	39.6	17.7	334.3	373.3	39.0	-1.1	-2.6	-1.5
Czech Republic	-1.9	0.4	2.3	59.8	94.3	34.6	165.6	152.4	-13.2	-1.5	-0.1	1.4
Hungary	2.6	2.9	0.3	95.1	63.7	-31.5	189.8	200.0	10.2	-2.4	-4.9	-2.5
India	-4.8	-1.9	2.9	22.4	20.5	-1.9	302.0	419.1	117.1	-5.1	-4.1	1.0
Indonesia	-3.0	-2.0	0.9	27.6	34.7	7.1	230.3	265.8	35.5	-1.8	-2.4	-0.6
Israel	1.9	2.6	0.7	37.2	25.4	-11.8	203.7	341.1	137.4	-4.2	-1.9	2.3
Korea	5.1	4.5	-0.6	32.9	27.3	-5.6	265.0	335.8	70.8	1.1	1.3	0.2
Malaysia	4.8	3.7	-1.2	62.6	69.0	6.4	138.5	98.4	-40.2	-5.2	-3.0	2.1
Mexico	-1.8	-1.3	0.5	30.0	37.9	8.0	205.7	333.3	127.5	-2.0	-1.0	1.0
Peru	-3.8	-1.3	2.5	29.5	31.4	1.8	664.7	733.0	68.3	1.4	-3.1	-4.5
Philippines	4.2	-0.6	-4.8	22.8	23.3	0.6	857.9	571.4	-286.4	-2.5	-2.6	-0.2
Poland	-2.8	0.1	2.9	71.8	72.0	0.2	252.3	224.3	-28.1	-2.0	-1.1	0.9
Russia	2.5	2.2	-0.3	31.2	32.6	1.4	621.5	840.2	218.7	0.0	-1.4	-1.4
South Africa	-5.6	-2.5	3.1	36.0	49.6	13.6	204.2	154.2	-50.0	-3.8	-3.4	0.3
Taiwan	8.9	14.4	5.5	28.1	33.0	4.9	321.5	254.7	-66.8	2.7	2.1	-0.5
Thailand	-1.4	10.6	12.0	34.0	32.7	-1.3	346.7	364.9	18.2	-1.8	-3.4	-1.6
Turkey	-5.3	-6.3	-1.0	39.2	53.4	14.2	109.0	91.5	-17.5	-1.4	-1.6	-0.2
EM Average	-0.5	0.8	1.3	38.7	42.1	4.8	323.6	337.6	16.7	-1.2	-1.9	-0.6

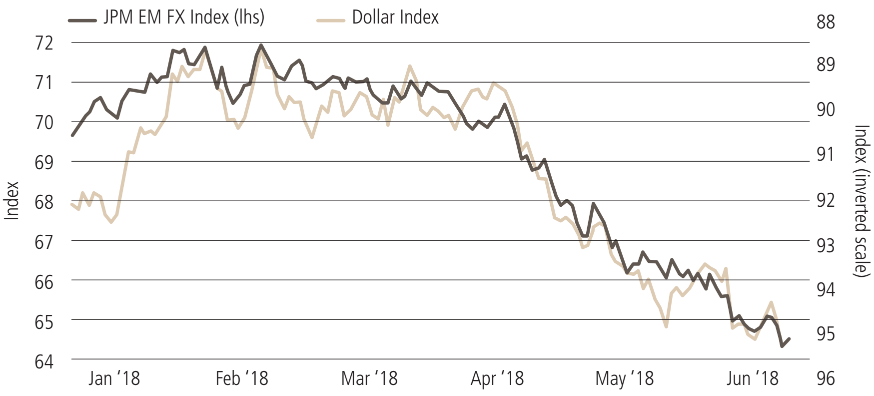
Sources: UBS Asset Management, Goldman Sachs. Data as of June 27, 2018.

The Importance of the USD

Typically the fortunes of emerging markets are very closely tied to the performance of the USD. This is not just because returns are often in local currency, but because many emerging market corporates are dependent on USD denominated debt; so USD strength against local currencies signifies a meaningful tightening of financial conditions. Moreover, the IMF has found that since a large portion of international trade is denominated in dollars, a 1% USD appreciation predicts a 0.6%–0.8% decline in the volume of global trade within a year (IMF WP 17/239).

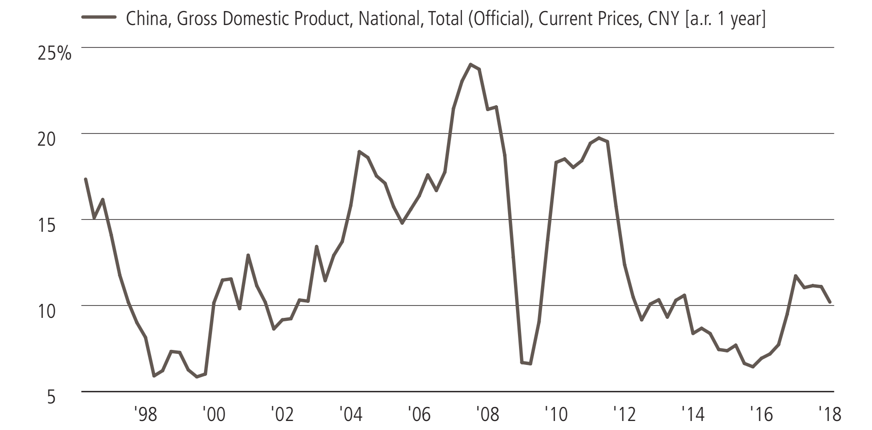
Distinguishing between recent EM pressures and those of the Taper Tantrum, dollar dynamics are quite interesting. During the Taper Tantrum, an index of emerging market currencies fell nearly 8%. In contrast, the dollar index, which is heavily weighted toward the euro and JPY along with a few other developed market currencies, actually weakened by 2% versus these currencies over the same time period. But in the most recent period of emerging market stress, the developed market currency focused dollar index and emerging market FX have almost traded exactly in line. In other words, the current emerging market weakness appears to be more of a strong dollar story than a fundamentally weak EM story, at least compared to the Taper Tantrum. This may suggest that as long as the broad USD can stabilize, then EM pressures should subside. So if broad ex-US growth can show some improvement, then emerging markets should be able to rebound.

Exhibit 4: The dollar has risen evenly against EM and DM this year, unlike in 2013



Sources: UBS Asset Management, Bloomberg. Data as of June 27, 2018.

Exhibit 5: China's nominal GDP growth moderating, but well off 2015 lows



Sources: UBS Asset Management, Macrobond. Data as of June 27, 2018.

China

Another important comparison of the backdrop for EM now versus in the first half of the decade is the state of China's growth. After injecting significant stimulus into the economy following the Global Financial Crisis, China reined back fiscal and credit support for the economy. In 2015, China's nominal GDP growth fell as low as it did in the 2008 crisis and 2000 recession before the country eased policy late that year and in early 2016. Of course, China is the world's second largest economy, contributing somewhere between 25% to 30% of global GDP growth in recent years (World Bank). It is integral to global supply chains and commodity prices, and the collapse in China's nominal GDP growth amplified pressures across EM over this period. Now, China's growth momentum is again cooling as authorities de-risk the financial sector and address pollution. This managed slowdown has been well communicated and is set to be gradual, having learned the lessons from the sharp downturn several years ago. Moreover, China's recent cuts to its reserve requirements signal a bias towards liquidity provision and careful focus on the downside risks to growth. Having experienced something of a 'nominal hard landing' in 2015, China's more balanced approach to deleveraging should ease concerns that history is repeating itself.

Valuation

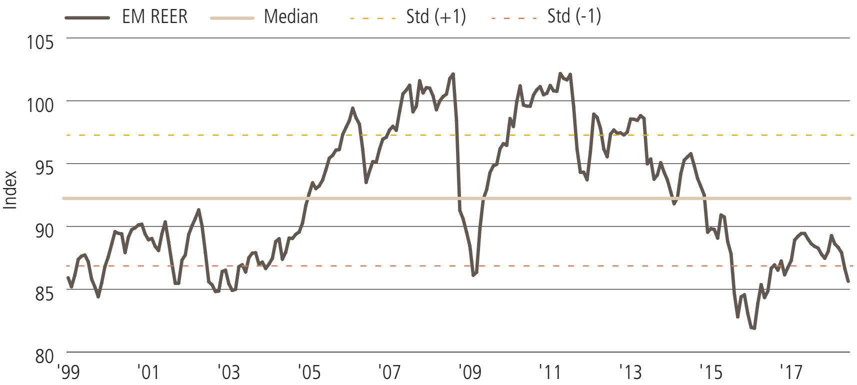
One additional consideration is valuation. A key measure of FX valuation is the real effective exchange rate (REER), or the trade-weighted exchange rate adjusted for inflation. The EM REER is currently more than one standard deviation below its historical average since 1999. Contrast this to 2011, when the REER was over one standard deviation higher than average. In fixed income, the spread between EM and US real yields has widened substantially, suggesting that investors are much better compensated for taking EM debt risk. This stands in contrast to the period just before the Taper Tantrum, when this spread was 0.5 standard deviation rich.

Significant risks remain

The above considerations suggest to us that the current sell-off is not the beginning of a prolonged period of EM weakness, and is dissimilar to the 2011–2016 period. Still, one must recognize that there are significant risks in the current environment. Unlike in the first half of the decade, when rates were firmly pinned at zero, the Fed tightening cycle is now well entrenched. As yields go higher, more vulnerable emerging markets are likely to feel pressure, especially if local central banks are unwilling to tighten and shore up their currencies. Moreover, the great experiment of quantitative easing is beginning to unwind. To the extent that central bank buying has pushed flows into emerging markets beyond what is justified by fundamentals, the unwinding of this liquidity support could reverse these flows.

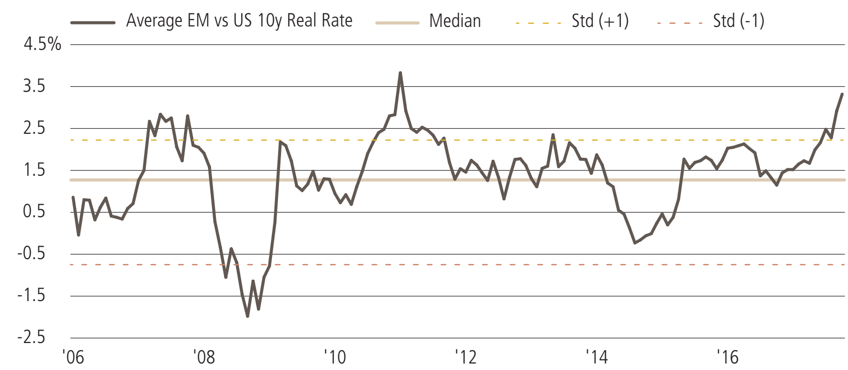
Heightened protectionism remains a major risk for emerging markets, which are highly levered to the global trade environment. While conflict over trade and technology is likely to be an ongoing feature of the US and China relationship, we think there is a high incentive to de-escalate current tensions in order not to risk too much disruption to economies and markets, especially ahead of the US midterm elections in November. There is likely to be a bumpy path towards a trade truce, which makes timing the adding of exposure to highly trade-sensitive EM a tricky endeavor. Finally, as discussed above, there are risks associated with China's deleveraging and rebalancing process. Credit growth has slowed sharply and recent economic data have weakened. China's policymakers have recently signaled some willingness to add liquidity and support domestic demand, which should add encouragement that the de-risking is being carefully managed. But a disorderly and sharp slowdown in China is one factor that could turn the recent cooling in EM into a more prolonged sell-off.

Exhibit 6: EM real effective exchange rate is at very low levels



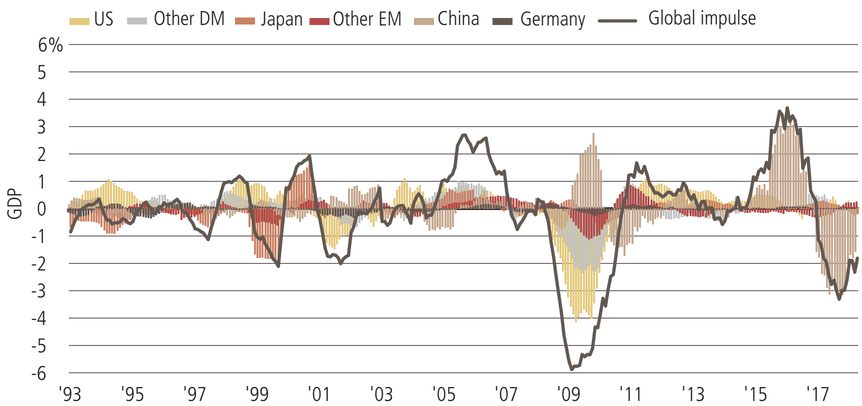
Sources: UBS Asset Management, Bloomberg. Data as of June 27, 2018.

Exhibit 7: Average EM vs. US 10y real rate is quite high



Sources: UBS Asset Management, Bloomberg. Data as of June 27, 2018.

Exhibit 8: China's credit impulse is rebounding but still negative



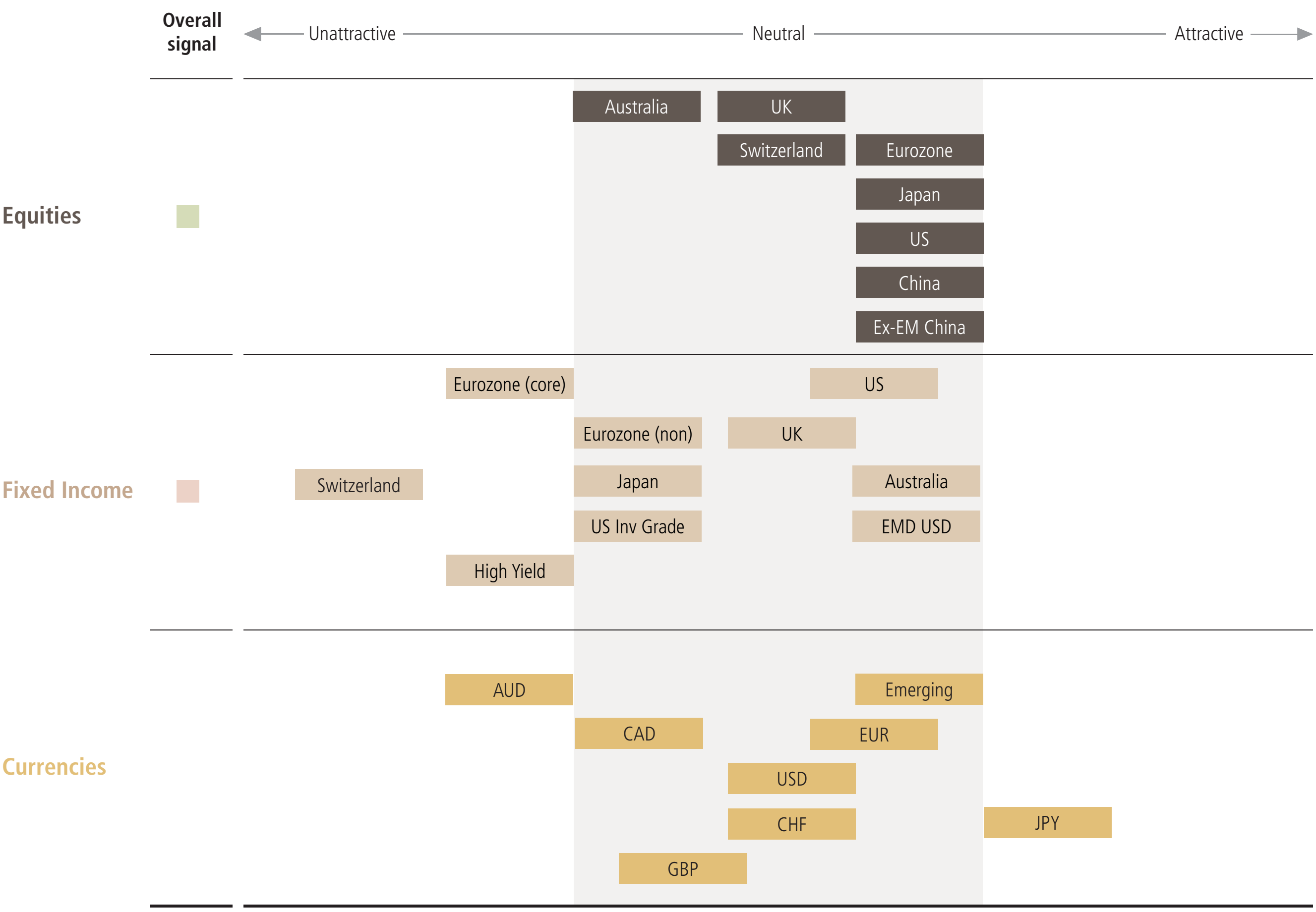
Sources: UBS Asset Management, Bloomberg. Data as of June 27, 2018.

The bottom line: Asset allocation

While we have revised down our expectations for EM equities and EM credit for 2018, we believe that emerging market asset classes offer attractive value for longer-term investors. If we are correct that global data outside the US is likely to stabilize, that should support EM asset classes both by boosting the economic outlook and limiting upward pressure on the USD. As evidence of this growth stabilization plays out, and assuming trade tensions cool as we expect EM investors will be rewarded, although volatility is likely to remain heightened in the near term. And we reiterate that there remain a number of idiosyncratic opportunities and risks in specific EM countries, which we continue to position for in our EM equity, fixed income and currency portfolios.

Asset class attractiveness

The chart below shows the views of our Asset Allocation team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of end-June 2018.



Source: UBS Asset Management Investment Solutions Asset Allocation team as at June 30, 2018. Views are provided on the basis of a 12-18 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change. For illustrative purposes only.

Overall signal = Positive ◄—► Negative

Asset Class	Overall signal	UBS Asset Management's viewpoint
US Equities		– While the US economic cycle is mature, both consumer spending and corporate capital expenditure appear well supported by recent tax reform. The latter in particular gives grounds for optimism in future US productivity growth and in the sustainability of the cycle. – Stronger-than-expected corporate earnings growth, rising M&A and increasing capital returns to shareholders are likely to remain key supports in the coming months. Indeed, US equity valuations are now more attractive after recent profits growth has outpaced share price performance. More importantly in our view, US equities remain attractively valued relative to bonds despite the recent rise in yields. – We do not believe that rising bond yields are a de facto negative for equities. Nonetheless, with the range of potential growth, inflation and interest rate outcomes in the US broadening, a moderate increase in the volatility regime for all major US asset classes is likely.
Global (Ex-US) Equities		– In Europe, the increased risk premium prompted by recent political developments in peripheral Europe will likely constrain upside potential until more clarity emerges around the fiscal intentions of the new Italian government. Despite these short-term headwinds, our longer-term base case remains positive, supported by demand growth that is still above trend, and the potential support to earnings from re-gearing. – In Japan core inflation remains muted despite the closing of the output gap. This supports a very gradual adjustment of current loose monetary policy. After the recent stock market underperformance triggered by an appreciation in the JPY we view Japanese equities as moderately attractive.
Emerging markets (EM) Equities including China		– Emerging market equities have struggled in recent months in the face of a strengthening USD, rising USD funding rates and rising geopolitical risks. We do not dispute that the dollar factors present headwinds to EM countries with material external funding requirements, nor that within EM's broad universe there remain less favorable political and economic forces. But in aggregate fundamental conditions remain relatively robust: EM demand growth is strong, inflation low, and policy in aggregate still accommodative. – Our preferred EM region remains Asia; our least preferred Latin America. Concerns over debt sustainability in Brazil and upcoming elections in Brazil and Mexico will likely keep volatility high. Conversely, EM Asia continues to enjoy strong revenue growth and remains attractively valued compared to its own history. – We remain broadly positive on China. Any broadening of the current trade stand-off with the US is likely to hamper Chinese growth, but a gradual economic slowdown is already priced in and the Chinese authorities have already shown themselves willing to boost liquidity to help smooth the on-going economic transition. Chinese equities still trade at a PE discount to other markets and further market liberalization could prompt a rerating as international capital starts to flow into Chinese assets following the inclusion of onshore Chinese equities in MSCI's widely followed EM equity indices.
US Bonds		– US Treasury yields remain low by historical standards, but look attractive relative to most other developed government bond markets on an unhedged basis. In the absence of a material pick-up in inflation, yields are likely to remain range bound. Our overall assessment is neutral.
Global (Ex-US) Bonds		– In aggregate, we see global sovereign bonds outside of the US as unattractive. The ECB has committed to low rates into next year, so we see limited opportunity in Europe. – Swiss bonds continue to look very overvalued and in our view they have an increasingly asymmetric risk profile. The Swiss economy is relatively strong and we see Swiss bonds as vulnerable to attempts to normalize monetary policy by a Swiss National Bank increasingly concerned by the strength of the housing market. – Elsewhere we are more positive on Australian and Canadian duration on a relative basis. In our view, both economies are vulnerable to a housing market correction after very strong recent performance.
Investment Grade (IG) Corporate Debt		– Geopolitical turmoil and trade issues have spilled over into the credit markets, causing IG spreads to widen slightly in recent months. Although we do not believe that a sharp demand slowdown is imminent, we retain a neutral view on credit.
High Yield Bonds		– Current default rates in High Yield are very low by historical standards. Given the relatively positive economic backdrop, we do not expect any material pick-up in US corporate debt defaults in the near term. However, while spreads have widened in recent weeks, we do not yet view the risk/reward as attractive.
Emerging Markets Debt US dollar Local currency		– Spreads on EM debt relative to US treasuries have widened substantially in the face of higher geopolitical risks, a strengthening USD and higher USD funding rates—sparking particular fears for EM countries with large external funding requirements. Nonetheless, we see continued strong demand for EM debt's attractive real yield on a selective basis.
Currency		– With the Fed now alone among major central banks in pursuing a more aggressive tightening regime and the US benefiting from fiscal stimulus while growth elsewhere moderates, we see short-term support for the USD even if our medium-term view remains more negative. Over the medium to long term, we expect capital to flow from the US into earlier-cycle economies. Elsewhere, we continue to see strong valuation support for the JPY.

[1] Source: UBS Asset Management. As of June 30, 2018.

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