Emerging Markets Fixed Income

January, 2018

How much longer can it run?

UBS Asset Management
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How much longer can it run?

Emerging markets (EM) delivered strong returns during the last quarter of 2017 and regaled investors with double digit returns for a second year in a row in credit as well as in FX and rates. The synchronized recovery of global economic activity with stable inflation, supportive commodity prices and a thoughtful and well communicated global monetary policy tightening by developed markets' central banks kept volatility and developed rates well anchored in a relatively narrow range, thus allowing for riskier carry trades to flourish well beyond expectations. Improvements in emerging economies' fundamentals helped mitigate the negative impact of sporadic bouts of uncertainty brought about by geo-political and domestic shocks in several regions and countries.

Just like the best ultra-marathon runners, EM stamina and resistance endured through the 4Q of 2017. All sub-asset classes delivered positive returns. Sovereign and corporate spreads remained largely stable while local yields widened marginally in 4Q2017. However, spreads and yields tightened substantially for the full year. Sovereign spreads (JP Morgan EMBI GD) tightened 56bps to 285bps over US Treasuries while corporate spreads (JP Morgan CEMBI D) rallied 39bps to 287bps. Local yields (JPM GBI-EM GD) declined 0.63% to 6.14% and EM currencies strengthened by 5.87% vs the USD (JP Morgan ELMI). As a result, credit generated outsized excess returns in 2017 - similar to those in 2016 -, but it was local returns (including local rates and currencies) that robbed the spotlight.

Benign global financial conditions and a low volatility environment fostered record inflows into the asset class in all its flavors: credit, rates and currencies. According to JP Morgan, flows into emerging markets in the fourth quarter amounted to USD 18.2bn while inflows in 2017 reached a record high of USD 112.8bn. Such large inflows allowed sovereigns and corporates alike to take further advantage of the low interest rate environment and to issue a record amount of bonds in 2017.

Against most expectations, the US government delivered a tax reform with significant tax cuts mainly for the corporate sector and continued with its deregulation push in various sectors of the economy. The Fed hiked rates three times during the year generating a significant curve flattening that kept the long-end well anchored. In Europe, economic activity indicators and confidence improved amidst low and stable inflation and a relatively dovish central bank.

In a symbolically significant showing of strength for President Xi, China's 19th party congress enshrined his name and ideas in the party constitution: "Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era". The Turkish government found itself fighting on several fronts including with Europe and the US. In South Africa, President Zuma left the ANC election severely weakened and possibly on his way out. In Brazil, the much awaited pension reform died in the hands of an ineffective political class.

The quarter was not free of geo-political events: the North Korea threat reemerged repeatedly, but proved to be transient. Geo-political risk in the Middle East increased dramatically in 4Q while the proxy confrontations between Iran and Saudi Arabia continued to affect several countries in the region (Lebanon was the most affected this time around). However, the intensity of these confrontations declined with the help of the US and France as the year drew to an end.

Fourth quarter 2017 returns

US dollar debt	Total return	Spread return	US treasury return
JPM EMBI Global Div.	1.16%	1.22%	-0.06%
JPM CEMBI Diversified	0.54%	0.69%	-0.15%

Local currency debt	Total return	Currency return	Local debt return
JPM GBI-EM Glob. Div.	0.82%	0.00%	0.82%
JPM ELMI+	2.00%	0.99%	1.00%

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%

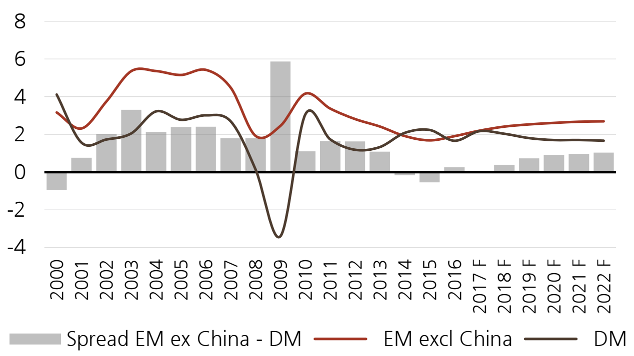
Local currency debt	Total return	Currency return	Local debt return
JPM GBI-EM Glob. Div.	15.21%	5.78%	8.91%
JPM ELMI+	11.54%	7.24%	4.01%

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 December 2017. 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.

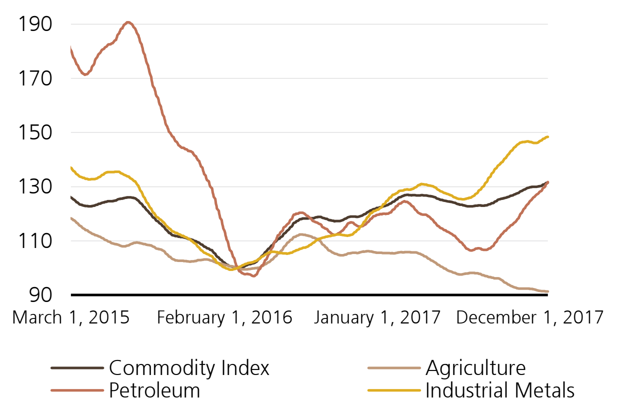
Macro outlook: What may stop the EM rally?

As we start 2018, the world economy appears to be in pretty good health - Growth is picking up further and inflation is well under control almost everywhere. Additionally, global fiscal and monetary policies remain supportive and global financial conditions remain accommodative. As a result, trade volumes are recovering further, commodity prices have found what appears to be solid support and emerging markets continue to enjoy outsized financial inflows. Furthermore, emerging economies have come a long way in adjusting to lower commodity prices and are starting to grow faster again. This is good news because emerging markets – by virtue of their small size and openness - are predominantly a high-beta play on global growth.

GDP growth rates: Convergence is making a come back



Commodity prices: Supportive at the margin



Index= 100 as of 1 March 2016
Source: UBS Asset Management, Macrobonds database as of 31 December 2017
Indices: Bloomberg Commodity index, Bloomberg Agricultural Subindex, Bloomberg Petroleum Subindex, Bloomberg Industrial Metals Subindex

Against this positive backdrop, credit valuations look stretched but we still believe there is value in high yielding domestic bonds and FX. As was the case in 2017, a favorable performance in emerging markets hinges on a benign external environment with low volatility and no policy shocks. It is only in such a benign environment that carry trades are likely to continue their performance trend seen in 2017. Besides the unforecastable geo-political shocks there are a few topics that will require attention in 2018.

Financial policies in the Developed Markets

In the US, the administration's successful approval of its tax reform in December 2017 together with several deregulation measures has the potential to re-ignite the so-called reflation trade: higher US treasury yields and a stronger US Dollar as the US economy accelerates further and inflation picks up. Although we believe growth could recover faster than markets expect, we also believe inflation is likely to remain well behaved for longer, compliments of the supply-side impact of the reforms, particularly on productivity. If this is the case, 2018 could be a year of robust growth, modest inflation and limited Fed action. However, if we are wrong and inflation picks up stronger and faster than expected, markets could reassess their views on the speed at which the Fed will hike rates in 2018. This would be detrimental to credit FX and rates in emerging markets. On the trade front, the US administration is once again reigniting its efforts to engage in contentious negotiations with China and Mexico (NAFTA).

While the ECB seems to be in a dovish mood it is also likely to implement yet another wave of tapering at the same time that the US is implementing a gradual quantitative tightening. In Japan, the BoJ is likely to let markets determine more freely the yields on the 10-30 year JGBs. In summary, developed market central banks are in the early stages of undoing one of the most unique monetary expansions in modern times, one that involved an unprecedented monetary quantitative expansion coupled with a negative nominal price for money in several parts of the world. We are skeptical that such transition will have no impact on global volatility or asset prices.

A busy Election Calendar in Emerging Markets

Elections in Emerging Markets in 2018 have the potential to keep political uncertainty higher than otherwise normal. This is because many countries could see a change in government and congress that would result in a very different mix and direction of macroeconomic policies, some of which may not be deemed to be market friendly. We are paying close attention to elections in Latin America because in several countries we could witness significant changes. In Mexico, Colombia and Costa Rica, left-wing candidates are leading the polls. In Brazil, it is still very uncertain who will even run but the outcomes could again be surprising. There is definitively more certainty about the result (good or bad) in Russia, Egypt and Malaysia. In Venezuela's case, it is not even clear whether elections will be held.

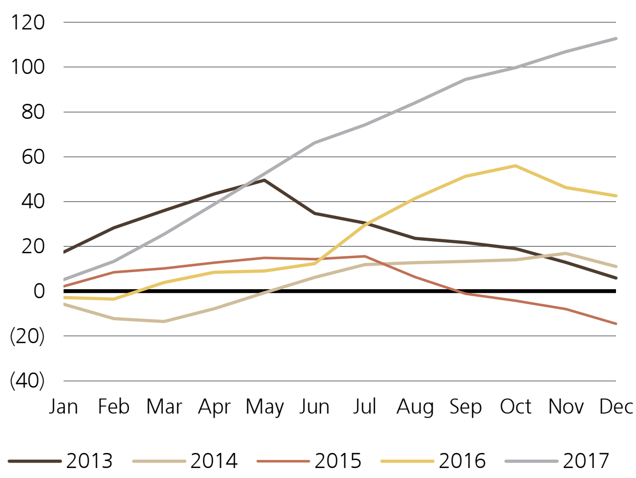
A busy election calendar in 2018

Date	Congress/Parliament	Presidential
January, 2018		Czech Rep
February, 2018	Costa Rica	Costa Rica
March, 2018	Colombia, El Salvador	Russia
April, 2018	Gabon, Hungary, Irap, Paraguay	Armenia, Paraguay
May, 2018	Lebanon	Colombia, Egypt
July, 2018	Mexico, Slovenia	Mexico
August, 2018	Malaysia	
September, 2018	Pakistan	Pakistan
October, 2018	Brazil, Latvia Cameroon	Azerbaijan, Brazil, Cameroon, Georgia
November, 2018	Thailand	Thailand
December, 2018		Venezuela?
TBD	Lybia	

Note: Africa, Asia, Europe, Middle-East, Latin America. Source: UBS, Eurasia, Wikipedia

The start of 2018 delivered a significant rally in credit spreads already, increasing further our valuation concerns. This recent action suggests a more nimble, discriminatory and opportunistic risk-taking approach near term, but not a defensive strategy as the overall global backdrop remains supportive. We find more value on high yielding domestic bonds and FX and would take political volatility or other shocks as an opportunity to add to such positions. (Federico Kaune)

Capital inflows to emerging markets: Record highs
(USD billion



Source: JP Morgan "Weekly flow monitor", 31 December 2017

Review and outlook by asset class segment

Sovereign credit: solid fundamentals but tight valuations

Sovereign credit posted a 1.2% return in the last quarter of 2017: 1.1% from carry and spread tightening, and a meager 0.1% from US Treasuries (all data measured by the JP Morgan EMBI GD index). Most emerging markets posted positive total returns with high yield countries like Mozambique, Angola and El Salvador driving performance. Sovereign bonds outperformed quasi-sovereign bonds, and high yield bonds outperformed investment grade bonds.

A continued increase in commodity prices, particularly crude oil and base metals (notably nickel, aluminum, and copper) was supportive of debt performance of such commodity-exporting nations. Crude oil prices (Brent) finished the quarter up17.7% hitting a year-to-date high at the close of the year and surpassing $65 per barrel for the first time in the calendar year resulting from a disruption in North Sea supplies and an explosion at a pipeline in Libya.

The top performer was Africa ahead of Europe, which was closely followed by Latin America. Asia, and in particular the Middle East, underperformed but generated positive returns as well. Africa performed strongly by more than 3%, driven by contributions from Zambia (5.1%), Mozambique (5.1%) and Angola (8.5%). Additionally, Angola's performance was supported by meeting a payment obligation early in the month avoiding a default. Eastern Europe profited on a broader and equal-weighted basis from a solid economic environment in Core Europe. However, major performance drivers included Armenia, Azerbaijan and Kazakhstan as well. Each of these countries is commodity rich and profited from stabilizing commodity prices as well as from an ongoing search for carry.

On the other end of the scale, Mexico underperformed again as the market focus is increasingly turning toward the presidential elections in 2018 while NAFTA renegotiations remain ongoing but are unlikely to be resolved soon or in favor of Mexico. Lebanon – as one of the detracting countries in the Middle East – was hit by political turmoil in which its prime minister surprisingly announced his resignation early in November while the country appears to be at the center of escalating tensions amongst other Middle Eastern nations. Political tensions between Gold Corporation Council (GCC) countries Saudi Arabia, UAE, Bahrain on the one side and Qatar, Kuwait and Oman on the other side as well as the ongoing dispute between Saudi Arabia and Iran are destabilizing the region politically and economically. Venezuela detracted the most with a negative 28% return in 4Q2017, as it finally missed payments on sovereign and state-owned oil company (PDVSA) debt in December. While bonds traded at default levels, they still traded with accrued interest awaiting further payments which were due in November (the Emerging Market Trading Association recommended to trade Venezuela bonds excluding accrued interest starting January 8th 2018).

The positive performance in 2017 (10.3% measured by the JP Morgan EMBI GD) was mainly driven by stronger global economic recovery. Additionally, structural reforms in some of the emerging countries improved the economic and fiscal outlook for these countries further. However, emerging markets growth has been – so far – only gradually improving and global growth was dominated by the recovery in DM. This should change in 2018 as the economic outlook in emerging markets is solid and showing further signs of stronger momentum. While the Fed is moving further towards higher rates, we do not expect any significant negative impact on spreads in 2018.

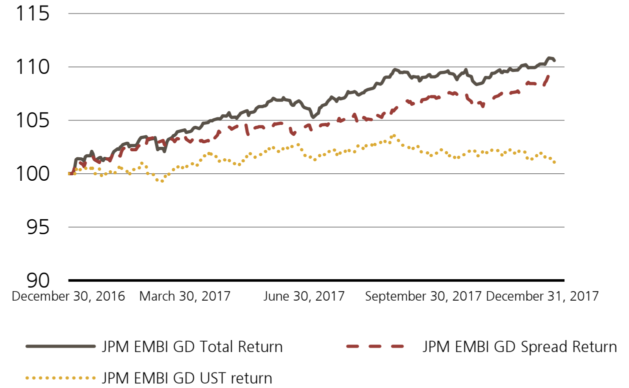
We are approaching 2018 with a solid and positive outlook for the economic environment in emerging markets. However, some political risks as well as already stretched valuations don't allow for major performance due to further spread tightening in our view. Even as we do not expect further geo-political escalation, we remain alert as some of the already existing conflicts could add higher volatility and selling waves in credit markets.

Taking each of these factors and a more neutral technical picture into account, we tend to keep the risk profile slightly above market levels, but have a strong focus on carry and opportunistic positions while expecting only minor spread tightening. (Uta Fehm)

Large inflows tightened spreads and drove returns

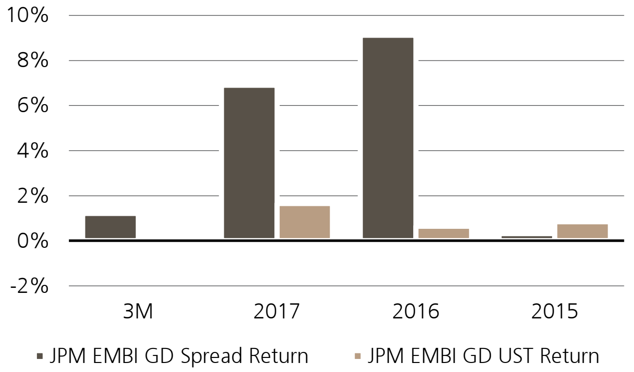
(The graphs below show the total return of JP Morgan EMBI Global Diversified and its components, spread return and US treasury return. Spread return results from the yield difference between emerging markets debt and US treasuries and from spread movements.)

Rebalanced to 100 as of 31 December 2016



Source: JP Morgan, UBS Asset Management. Data as of 31 December 2017

JP Morgan EMBI Global Div return composition



Source: JP Morgan, UBS Asset Management. Data as of 31 December 2017

Corporate credit: Resource intensive names deliver

In the fourth quarter of 2017, emerging markets corporates (measured as JP Morgan CEMBI diversified) posted positive returns reflecting further spread tightening. This quarter, corporates underperformed sovereigns. High yield credits continued to handsomely outperform investment grade.

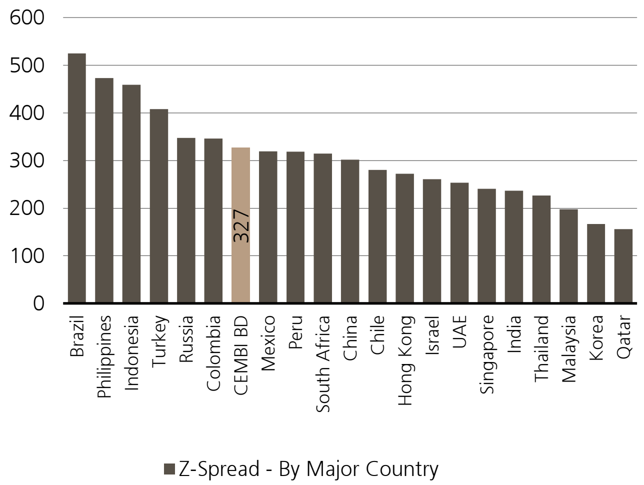
From a regional perspective, Africa, Latin America, and Europe outperformed the index mentioned above, whereas the Middle East and Asia underperformed. Corporate bonds in Ukraine, Latvia, Iraq, Tanzania and Jamaica significantly outperformed, while Israel, Bahrain, Taiwan and Investment Grade Asia (China, Hong Kong, Malaysia & Singapore) underperformed.

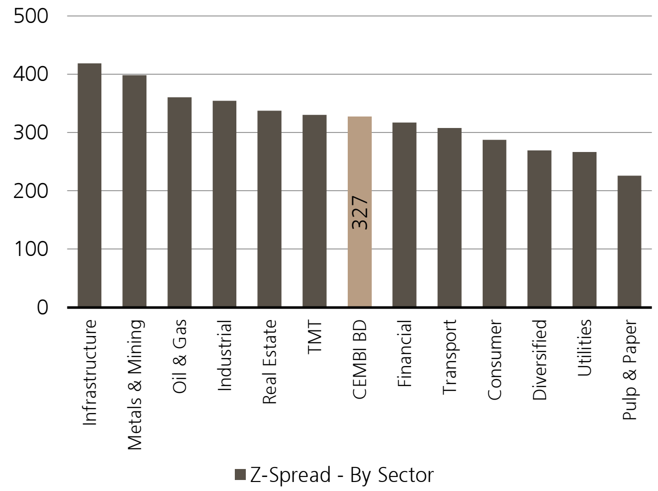
From an industry perspective, metals and mining along with oil and gas credits recovered strongly and in sympathy with higher commodity prices while consumer and transportation names underperformed.

We believe supply pressure and volatility could increase during the first quarter of 2018, which calls for a more cautious positioning. Corporate fundamentals will continue to reflect the improvement in global growth prospects; with better leverage metrics and profitability likely leading to fewer downgrades.

Spreads: Tighter but still compelling – measured in bp

(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 5 January 2018

Valuations have become less attractive during 2017 due to impressive total returns. The quarter(s) ahead will require nimble bond picking as opposed to taking more general "beta" exposure to the index. Technicals should remain supportive as long as the search for yield continues. On the supply side, we expect net new corporate issuance to increase in 2018 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 beta countries in APAC are less attractive given their low carry, but likely to outperform in a higher volatility environment. 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)

Local debt: Attractive valuation vs. cyclical headwinds

Emerging markets local debt performance (measured as JP Morgan GBI-EM Global diversified) was positive again in the fourth quarter (0.8%) bringing a second consecutive year of outsized returns (15.2% in 2017 and 9.9% in 2016). Even after a sizeable 5.4% drawdown between mid-September and mid-November, the index mentioned above almost fully recovered toward the year end in a positive global backdrop.

Most high-yielding members of the JP Morgan GBI-EM Global diversified index performed well, but some of the largest returns in 2017 came from unexpected quarters: Central Europe and APAC. The rally in the EUR in the middle of the year buoyed all EUR-related currencies, with Poland posting the highest individual country return of 25.97%. All APAC index components outperformed the benchmark in a post-US-election recovery. Finally, two of the highest-yielding members of the index, Argentina and Turkey, had mediocre returns due to political risk (Turkey) and persistent imbalances (Argentina).

As 2018 begins without familiar global dislocations, emerging markets returns should be positive but less spectacular. Emerging Markets local debt will continue to face headwinds in Q1 2018: likely higher US interest rates, tapering of asset purchases by the ECB and potential for trade disputes. At the same time stronger economic activity, higher commodity prices and positive equity and credit markets – if sustained – provide an important medium-term anchor. The differentiation will come from navigating political risk.

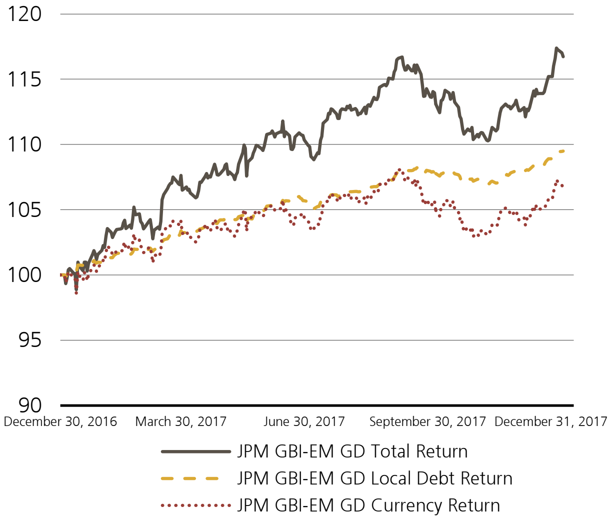
In our view, countries with improving fundamentals, lower external vulnerability and still sizeable risk premium are likely to outperform. These include Brazil, Russia and Indonesia. At the same time, following the recent sell-off, the entry levels are attractive in Turkey and Argentina. The outlook in South Africa and Mexico continue to be binary.

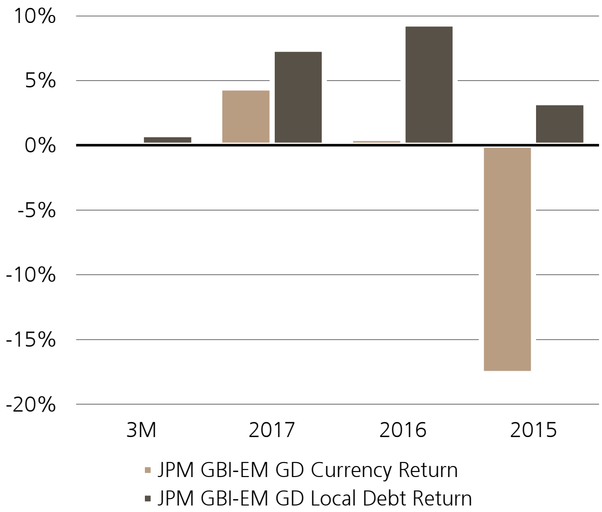
In Latin America, Brazil's yield curve is very steep and the central bank is likely to cut interest rates once more in Q1. With the end of the cutting cycle in sight, we expect future bond returns to stem largely from carry and roll-down rather than from massive yield contraction as seen previously. As the presidential election approaches, politics once again will be in the driver's seat starting in Q2 2018. Similarly, Argentina is showing signs of more sustained growth after an uneven start. A lot will depend on the credibility of economic policies and the commitment to disinflation. The outlook of Mexico is negative in Q1 with the potential for breakdown in the NAFTA negotiations and the prospect of electing a populist president.

EMEA will be important with the focus on Turkey and South Africa. The CE4 bond returns (CE4 countries are Czech Republic, Hungary, Poland and Slovak Republic) are likely to be modest as central banks turn increasingly 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 the market in 2H 2017 provides attractive entry levels. The election of a market-friendly president of the ANC has led to a dramatic rally in the SA rand, with little room for disappointment. However, the yield curve is steep, inflation is falling and the South African Reserve Bank could resume interest rate cuts, creating value in the local curve. Russia local debt has become less sensitive to oil price movements allowing the central bank to finish its rate-cut cycle.

Following the rally in 2017, Asian low-yielding currencies should be less volatile, in line with historical pattern. Interest rates will be under pressure as inflation is firming, growth is strong, and the Fed is raising interest rates. The high-yielding bonds in Indonesia and India will continue to benefit from the search for yield in the region and Malaysia Ringgit should benefit from still attractive levels and a reduction of political risk post-election. (Igor Arsenin)

Currency return: more sensitive to economic and political shocks (rebalanced to 100 as of 31 December 2016)
(The graphs below show the total return of JP Morgan GBI-EM Global Diversified and its components, local debt return and currency return. Local debt return results from yield movements and coupons of the underlying bonds in local currency. Currency return results from exchange rate movements)





Source: Source: JP Morgan, UBS Asset Management. Data as of 31 December 2017

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