# Emerging markets debt

## Low volatility environment nurtures returns

UBS Asset Management l July 2017

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## Low volatility environment nurtures returns

Emerging markets delivered strong returns during the second quarter of 2017. Under very lax global financial conditions, positive, albeit subdued momentum in global economic activity combined with the moderate pace of global monetary tightening supported asset prices further. Delays in expected reforms and weaker data in the US kept both US treasury yields and the US dollar on a weakening path until late in the quarter. In Europe, economic activity indicators and confidence remain elevated while inflation is kept in check.

Furthermore, emerging markets reacted favorably to the reduction in quantitative easing by the European Central Bank (ECB) in April and the rate hike by the US Federal Reserve in June. Concomitantly, potential shocks from elections in the second quarter did not materialize (France, Turkey, Mexico), while other geopolitical risks remained contained (Middle East, North Korea). All the aforementioned factors supported low and stable volatility during the second quarter, an environment conducive for carry trades and allocations to riskier asset classes.

* 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.

**Second quarter 2017 returns***

| US dollar debt | Total return | Spread return | US treasury return |
|---|---|---|---|
| JPM EMBI Global Div. | 2.24% | 1.09% | 1.14% |
| JPM CEMBI Diversified | 1.96% | 1.03% | 0.92% |

| Local currency debt | Total return | Currency return | Local debt return |
|---|---|---|---|
| JPM GBI-EM Glob. Div. | 3.62% | 1.22% | 2.38% |
| JPM ELMI+ | 1.93% | 1.02% | 0.89% |

**2017 year-to-date returns***

| US dollar debt | Total return | Spread return | US treasury return |
|---|---|---|---|
| JPM EMBI Global Div. | 6.19% | 4.35% | 1.77% |
| JPM CEMBI Diversified | 5.13% | 3.53% | 1.54% |

| Local currency debt | Total return | Currency return | Local debt return |
|---|---|---|---|
| JPM GBI-EM Glob. Div. | 10.36% | 4.42% | 5.69% |
| JPM ELMI+ | 7.21% | 5.16% | 1.95% |

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
Data as of 30 June 2017
Source: Bloomberg Finance

## Macro outlook: constructive but more cautious

We have a constructive view on emerging markets based on positive growth dynamics and reform impetus. However, we perceive signs of fatigue, particularly on what so far has been a pretty benign external environment.

The US administration appears to have reached an impasse in terms of reforms, which could change growth expectations for the worse, thus increasing the probability of subdued growth for longer under full employment. On the positive side, the US administration is no longer pressing to implement potentially detrimental trade measures.

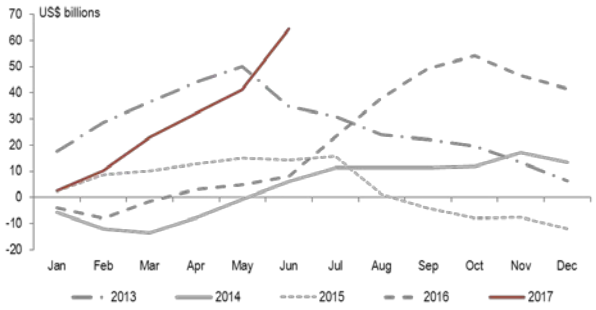
In Europe, growth continues to pick up both in the periphery as well as in the center, while confidence remains high after positive election results in France. Both the ECB and the Fed are communicating to the market that more tightening is on its way. Despite these announcements, rates in the developed world continued to trade in a range during the second quarter.

In Asia, Japan's zero 10-year yield policy was enough to keep the yen trading in a tight range. China continued to maneuver to gradually address excessive credit expansion and still high leverage, while keeping growth in line with the pre-announced target. Nonetheless, tighter monetary conditions could trigger a slowdown in Chinese (and global) growth in late 2017 and early 2018.

## Unusually low volatility and capital flows support emerging markets

Overall, global financial conditions remained benign and supportive of capital inflows to emerging markets during the second quarter.

**Capital inflows to emerging markets**




Source: JP Morgan "Weekly flow monitor", 28 June 2017

Developed market central banks are tightening at a measured pace although growth is picking up while labor markets are tightening, particularly in the US, in an environment of still negative inflation-adjusted policy rates. Ample global liquidity – owed to the developed market central banks – has soothed markets, offsetting the potential impact of (geo)political and other shocks around the world, and persistently keeping volatility at unusually low levels:

**Volatility index comparison**


JP Morgan Global FX Volatility Index:
7.4% as of 30.06.17

Merrill Lynch Option Volatility Estimate MOVE Index:
52.2 implied volatility, annualized in basis points, as of 30.06.17

Chicago Board Options Exchange SPX Volatility Index:
10.6% as of 30.06.17

JP Morgan Emerging Market Volatility Index (EM-VXY):
7.5% as of 30.06.17

Data as of 30 June 2017
Source: Bloomberg Finance

Developed market central banks are now communicating that quantitative easing is likely to slowly but surely become quantitative tightening in the future, particularly in the US. We believe that this shift in developed market central bank policy could be enough to promote a gradual normalization of volatility measures in the second half of 2017 and beyond.

In contrast, commodity prices were less supportive to emerging markets during the second quarter. The CRY Index – a broad measure of commodity prices – declined by 6% during the quarter and almost 10% year to date, even if recovering from a local minimum in the third week of June. Oil prices declined by 11%, reflecting a sharp recovery in rig count and shale oil production in the US since the oil price stabilization at around USD 45-50 per barrel registered earlier in the year.

The velocity of the supply recovery was surprising and explains most of the more recent weakness in oil prices. Iron ore prices collapsed by 29% during the second quarter – possibly reflecting the People's Bank of China's tightening and expectation of lower domestic demand in the second half of the year. Other metal prices remained soft during most of the quarter before recovering in the second half of June. Soft commodities fared better with wheat and soybean prices recovering further. We expect commodity prices to trade in a range for the next couple of quarters, although potentially weaker demand from China could impact the metals complex further. Shale oil producers in the US could act as a stabilizing price force, given their flexibility to increase / reduce production when faced with higher / lower prices.

Macroeconomic conditions in emerging markets are improving, albeit not on a straight line and definitively not without political noise. In Mexico, ahead of the Presidential elections in 2018, state elections brought political risk to the fore again. In Brazil and South Africa, the lingering political crisis continues to imperil the adoption of necessary reforms. In Argentina, the results of the congressional elections in October could either accelerate or delay further measures needed. In contrast, with the referendum behind it, Turkey is now better positioned to focus on improving its economic performance. We continue to monitor geopolitical risks (Middle East and North Korea), policy risks (US reforms and global monetary policy), and political risks (ongoing crises in Brazil, South Africa, and others), watching out for any potential catalyst that would derail the current low volatility environment and upset carry trades in emerging markets.

All in all, we remain cautiously positive for emerging markets debt. Carry trades in credit (both sovereign and corporate) should continue to benefit as long as global financial conditions remain lax and volatility subdued. Foreign exchange trades should continue to be driven by idiosyncratic factors but also by changes in major currency pairs (USD/EUR) and commodity prices. We find most value in the rates of the major high-yielding countries.

# Review and outlook by asset class segment

### Sovereign credit: geopolitical risk vs. solid fundamentals

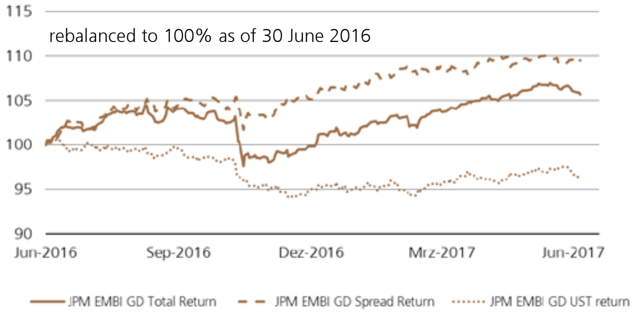
Sovereign credit posted a 2.2% return in the second quarter: 1.1% from carry and spread tightening, and 1.1% from US treasuries (all data measured by the JP Morgan EMBI Global Diversified index; also see graphs to the right). Most emerging markets posted positive total returns with high yield countries driving performance, sovereign bonds outperforming quasi-sovereign bonds, and high yield bonds outperforming investment grade bonds.

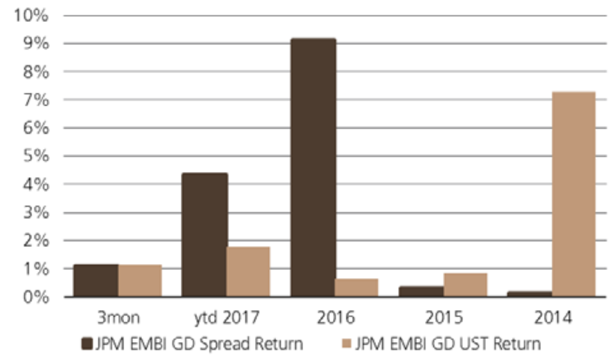
Africa and Latin America were the top performers closely followed by Europe. Asia underperformed but generated positive returns. The Middle East was not able to add any returns in the second quarter due to the increasing tensions Qatar faced with Saudi Arabia and the United Arab Emirates, which led to heightened risk and spread widening in Middle East bonds. In Venezuela, where political uncertainty and civil unrest escalated further, the government continued to service debt. A USD 2.2 billion debt payment made in April caused a significant spread rally, resulting in an outsized positive return of 9.94%. In Brazil, in contrast, assets experienced an adverse shock in early May due to heightened political uncertainty involved with President Temer's administration, which made markets believe that expected reforms might be deferred. In Turkey too, assets were impacted by political noise, but they finally outperformed after the narrow passage of the April referendum granting President Erdogan more executive power and looser reins to implement reforms.

As to credit ratings, South Africa was downgraded to "speculative grade" by Moody's following the political shake-up seen at the end of March. El Salvador was downgraded to "selective default" by Standard & Poor's after the government had missed payments related to pension liabilities. Trinidad and Tobago was downgraded to "speculative grade" by Moody's due to deteriorating fundamental data and further undermined growth prospects.

**Large inflows tightened spreads and drove returns**

The graphs below show the total return of JPM 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. US treasury return results from US treasury yield movements.




Data as of 30 June 2017
Source: JP Morgan, UBS Asset Management

In the first half of 2017, flows into emerging markets debt reached a new record at USD 64.3 billion*, easily surpassing the previous 2013 high mark. Such large inflow compares favorably against the USD 22.3 billion* in total sovereign gross issuance during the same period. The solid reception of new issuances reflects stability of demand amidst low risk aversion and the ongoing search for yield.

For the remainder of the year, we see current spread levels as fairly valued and expect range trading in the foreseeable future.

However, there are some important factors that could significantly alter the landscape:
– policy surprises by the US and the EU
– surprises to global growth expectations including in China
– lingering geopolitical risks

The first of the aforementioned factors could have a more positive impact on emerging economies due to more measured trade policies. It could also mean less support for growth in the US, a softer path for rate hikes, and lower US treasury yields. The other two factors could be strong enough to increase volatility and spreads. Even if such events might not directly be related to emerging countries, investors' confidence could decline as risk aversion increases.

* Source: JP Morgan

### Corporate credit: the search for yield continues

In the second quarter, emerging markets corporates posted positive total returns in line with the carry on offer, a function of little spread movement and relatively stable US treasury yields. While emerging markets corporates underperformed emerging markets sovereigns slightly – due in part to the longer duration and carry of the latter – they matched the return of quasi-sovereign credit during the quarter. A tilt toward lower credit quality benefited performance, albeit to a much lower degree than in previous quarters.

From an industries perspective (also see left-hand graph below), metals and mining names stumbled after a solid run as base metal prices fell. Financial and industrial names underperformed as well. Oil and gas credits proved resilient to falling oil prices as some names – namely those focused on refining activities, as opposed to exploration – benefited from lower input costs. Utilities names outperformed, especially in Chile, while technology, media and telecom names in Jamaica and Mexico also returned into positive territory.

In terms of regional performance (also see right-hand graph below), while Latin America and Africa outperformed the broader index, APAC and the Middle East underperformed and Eastern European names were flat. Corporate bonds in Argentina, Jamaica and Ukraine significantly outperformed, while Brazil and investment grade APAC, including China and Hong Kong, underperformed.

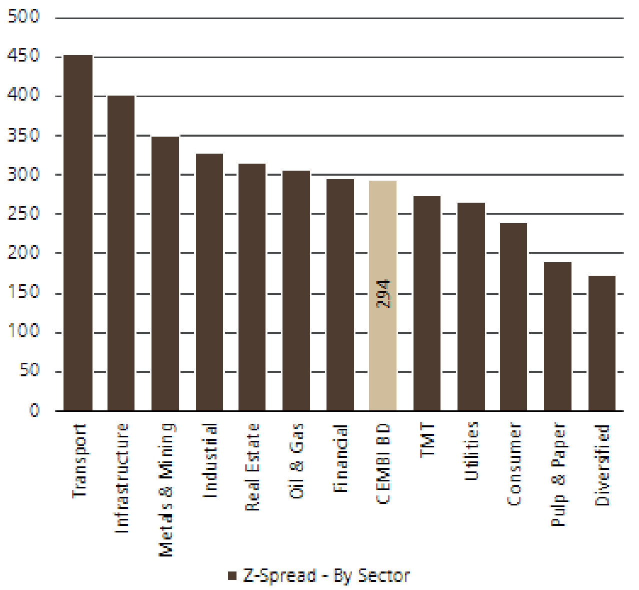
In our view, volatility may increase during the second half of the year, which calls for a more cautious positioning. Corporate fundamentals will continue to reflect the improvement in global growth prospects with better leverage metrics and profitability probably leading to fewer downgrades and defaults in 2017. According to Standard & Poor's estimates, emerging markets high yield corporate defaults are expected to decrease to 3% in 2017 from nearly 5% in 2016.

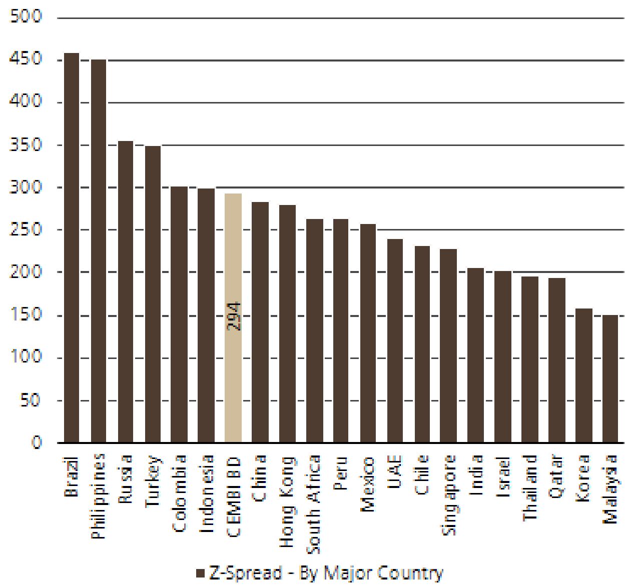
Valuations have become even less attractive during an impressive year of total returns. The quarters ahead will require nimble stock picking, as opposed to taking more general beta exposure to the index. Technicals should remain supportive as the continuing search for yield argues in favor of emerging markets debt. On the supply side, net new corporate issuance is expected to be manageable in an environment of increasing maturities in 2017 and beyond. We continue to see value in higher yielding subordinated debt of high-quality bank issuers in Turkey and Brazil, Latin America quasi-sovereign oil and gas names, as well as Jamaican and Mexican corporates.

In the current environment, we have been able to uncover a few special situations in distressed credit, and we aim to take advantage of more of these opportunities. Exposures to the lower-beta countries in APAC are less attractive given their lower carry. But as they have outperformance potential in a higher volatility environment, we tend to reduce our underweight to places like Korea and Singapore accordingly. Lower economic activity and still high leverage metrics in China argue for continued caution. However, we keep our positive stance toward the systemically important state-owned enterprises in China, especially energy-related and systemically important financial institutions.

**Z-spreads**

The z-spread – also known as the zero-volatility spread or the static spread – measures the spread that the investor will receive over the entire treasury spot rate curve.




Data as of 10 July 2017
Source: Bloomberg Finance

**Local debt: the carry environment persists**

Emerging markets local bonds performed respectably in the second quarter: The JP Morgan GBI-EM Global Diversified index returned 3.6% with local currency returns accounting for 2.4%. Such performance came on the heels of a great year start, but hides high country and regional dispersion. Local emerging markets benefitted from rising equity prices, range-bound US treasury yields, and a weaker US dollar. The best performers were in the euro-related CE4 markets Poland, Hungary, Czech Republic, Slovak Republic, helped by the euro rally following the French elections. Outside these core markets, the best performers were Turkey and Mexico, both benefitting from lower political risk and relatively cheap valuations.

We expect third quarter 2017 returns to be moderately positive given the less attractive starting point not only in emerging markets but also in other risk markets. In addition, a synchronized tapering by developed market central banks could create important headwinds while increasing volatility. However, the steady global growth backdrop, still very low developed market yields, and range-bound commodities are supportive.

Investors will probably continue to favor the high carry in emerging markets local bonds. We see the potential for significant yield compression in Brazil, Mexico, Russia, Turkey, and South Africa. In our view, Brazilian bonds after their large sell-off in May form a category of their own and offer the highest upside. Disinflation dynamics will be the key driver in many countries in the next few months. Disinflation is well underway in Brazil, Russia, Colombia, Indonesia and India, but risk premia have increased in Brazil and to some extent in Russia too. Inflation has likely peaked in Mexico, Turkey, and South Africa, offering high return potential for longer-dated bonds. Political risk is no doubt an important factor that could generate market volatility but at the same time could provide better entry points.

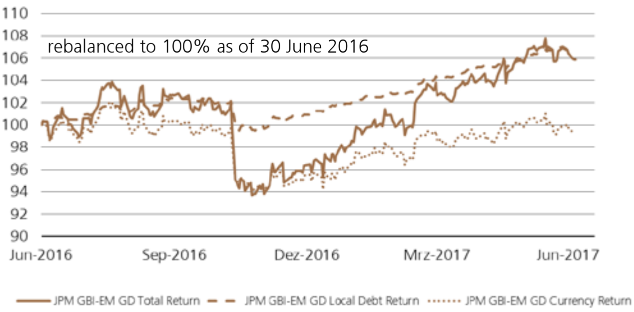
In Latin America, Brazil continues to be the most promising country after the yield curve steepening seen there in May. The "Car Wash" investigation has reached the President, which will probably undermine the reform agenda. Nevertheless, nascent economic recovery and sharply lower inflation allow for further aggressive rate cuts. The outlook for the Brazilian real is more neutral and will depend crucially on the resumption of growth and the passage of fiscal reforms. Similarly, Argentina is struggling to achieve sustainable growth, but the quality of the policy-making team and carry are high due to the hawkish central bank. Mexico's central bank indicated the end of the prolonged hiking cycle, opening the possibility for rate cuts next year.

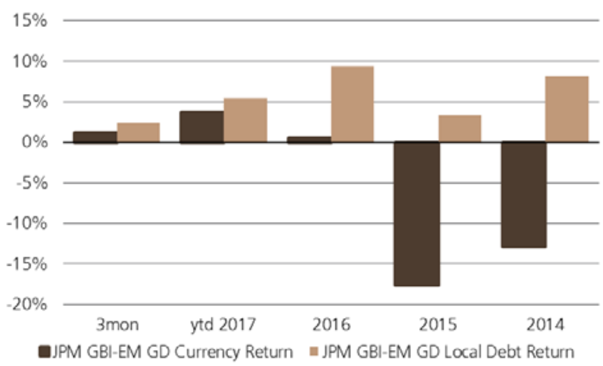
EMEA could be a swing factor in the third quarter of 2017 because political and economic fragility are on display in its larger economies Turkey and South Africa. Turkish bonds continue to depend on foreign inflows in the environment of higher developed market rates, while in South Africa, the dramatic flare-up of political risk has led to credit rating downgrades and a sell-off in the South African rand. South Africa's yield curve is steep and its central bank is likely to consider rate cuts this year still. The rand, however, is vulnerable to foreign investor outflows on additional rating downgrades. Russian bond markets have become less sensitive to oil price moves as long as these stay in a range. This should allow the central bank to continue its easing cycle this year and next.

In Asia, low-yielding currencies, which had been highly sensitive to the direction of the US dollar, recovered smartly since the "reflation" dollar trade stalled and China's outflows slowed down. Nevertheless, sentiment could easily change with a resumption of the US dollar rally or unfriendly US policies toward China or other high-surplus countries.

**Currency return is more sensitive to economic and political shocks**

The graphs below show the total return of JPM 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.




Data as of 30 June 2017
Source: JP Morgan, UBS Asset Management

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We draw on the best of our capabilities and insights to deliver the solution that is right for you.

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