

We aren't out of the woods yet

Emerging markets fixed income – Q3 2022
UBS Asset Management



Emerging Markets Fixed Income

Q3 2022 review and Q4 2022 outlook

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The views expressed are a general guide to the views of UBS Asset Management's Emerging Market Fixed Income team as of 5 October 2022.

Market overview

Emerging markets feel the impact of developed markets policy mistakes

- Emerging markets fixed income delivered negative total returns in Q3, mostly in response to developed market (DM) policy mistakes and reversals.
- EM spreads tightened on cheap valuations and lack of supply, but rates and particularly currencies (EMFX) sold off, reflecting significantly higher global rates and a stronger US dollar.
- EM asset performance during the fourth quarter of 2022 is likely to be influenced by global factors, including DM monetary policy and global inflation and growth dynamics.

Emerging markets fixed income (EMFI) showed negative total returns across most asset classes during the third quarter of 2022. Sovereign EM credit spreads, as measured by the EMBIGD Index¹, widened by 17 bps while EM corporate credit spreads, as measured by the CEMBI Index², tightened by a slim 2 bps in Q3 to 559 bps and 374 bps, respectively, generating a 0.37% and 0.42% spread return (inclusive of carry). The US Treasury (UST) yield curve sold off aggressively while flattening further, with 2-year, 10-year and 30-year yields selling off 133 bps, 82 bps and 59 bps, respectively. The US

Treasury (UST) yield moves fully explain the negative total credit return performance of EMFI because of the duration impact that UST yields have on USD denominated EM bonds.

Local EM fixed income returns (as measured by the GBIEMGD Index³) were also negatively impacted by significantly higher global rates and a stronger USD. The high carry of local EM bonds was able to offset the widening in rates, at the end generating a positive total return of 0.62%. However, the significant strengthening of the US dollar had a detrimental impact on emerging market currencies, which returned -5.31% in Q3. In all, the local index returned -4.73% in Q3.

Most of the negative returns occurred in September, reflecting a newfound hawkishness in DM central banks as inflation prints surprised on the upside. These actions and data releases reversed the rally of July and August, which had been led by dovish DM central bank statements in June and July (more on this below). By mid-September, global DM markets – including equities, US dollar, UST yields and financial conditions – had sold off back to mid-June levels.

Q3 2022 returns⁴

	Total return	Spread return	US Treasury return
JP Morgan EMBI Global Diversified	-4.57%	0.37%	-4.92%
JP Morgan CEMBI Diversified	-2.66%	0.42%	-3.06%

	Total return	Currency return	Local debt return
JP Morgan GBI-EM Global Diversified	-4.73%	-5.31%	0.62%
JP Morgan ELMI+	-3.97%	-5.36%	1.47%

Source: Data as of 30 September 2022. Bloomberg Finance.

Past performance is not a reliable indicator of future results.

1 As measured by the JP Morgan Emerging Market Bond Index Global Diversified index.

2 As measured by the The JP Morgan Corporate Emerging Markets Bond Index Global Diversified index.

3 As measured by the JP Morgan Global Bond Index - Emerging Markets Global Diversified

4 EMBI = Emerging Markets Bond Index. CEMBI = Corporate Emerging Markets Bond Index. GBI-EM = Government Bond Index – Emerging Markets. ELMI = Emerging Local Markets Index. The table shows total returns of US dollar and local currency debt plus their return components. The US dollar debt return components: Spread return results from the yield difference between emerging markets debt and US treasuries and from spread movements. US treasury return results from US treasury yield movements. Local currency debt return components: Local debt return results from yield movements and coupons of the underlying bonds in local currency. Currency return results from exchange rate movements.

Outflows and negative issuance: supporting spreads near term

According to the latest J.P. Morgan survey, emerging markets fixed income saw outflows of USD 19.9 billion in Q3, after recording USD 35.4 billion of outflow in Q2 2022. Sovereign and corporate credit saw outflows of USD 9.9 billion in Q3, compared to the USD 15.0 billion outflow in Q2, while local emerging markets (currency and rates) saw outflows of USD 10.0 billion in Q3 after seeing outflows of USD 20.4 billion in Q2.

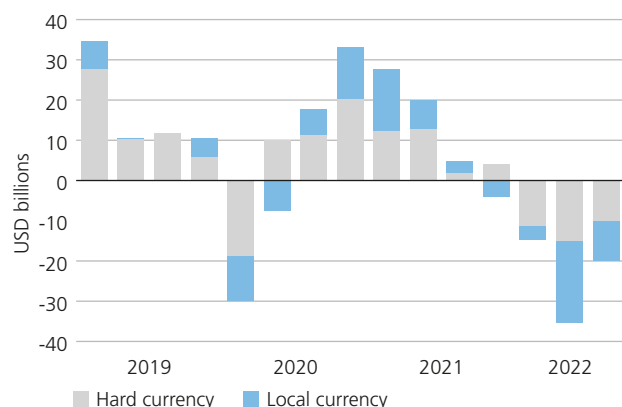
Emerging markets debt issuance further slowed in Q3, while supply continued to be led by investment grade credits. According to Bank of America, sovereign and corporate issuance in Q3 2022 reached USD 9.3 billion and USD 29.1 billion, respectively. Amortization and coupon payments reached USD 28.2 billion for sovereigns and USD 94.6 billion for corporates, leading to net negative supply in Q3 2022 of USD 84.4bn.

The Fed and the summer roller-coaster in asset prices

In our Q2 EM Quarterly, we argued that DM central banks were following cues from markets and explained why that strategy was likely to generate more financial volatility. We left that chapter with the Federal Reserve (Fed) hiking rates 75 bps to 1.75% on June 15th, as markets had already fully priced in such hike, followed by statements that were interpreted as dovish by market participants. On July 27th, the Fed hiked rates by 75 bps once again to 2.5%. Although the statements reaffirmed the Fed's commitment to reduce inflation to 2%, market participants focused on the dovish parts of chairman Powell's comments in the Q&A session: 1) that the fed funds rate at 2.5% was already in neutral territory, 2) that another 75 bps hike was not certain in the future, and 3) that "data-dependency" (read take hints from markets as opposed to a strong commitment to lower inflation regardless of the fallout) was their preferred strategy.

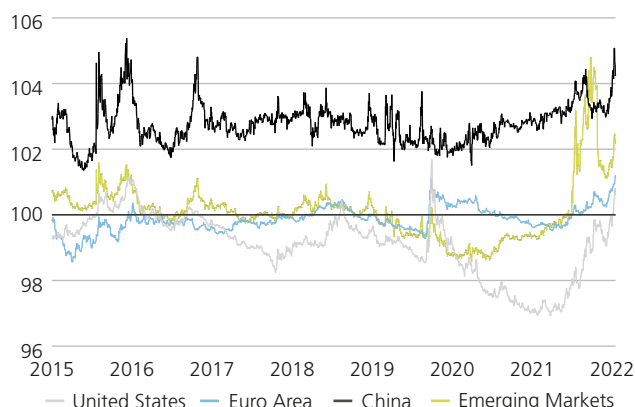
Markets responded in kind and proceeded to rally strongly during the summer months, undoing most of the tightening of financial conditions that had occurred until June: US Treasury yields on the 10-year bond rallied from 3.50% in mid-June to 2.50% in early August. Equity markets rallied 17% from mid-June to mid-August. That proved to be a mistake by the Fed in an already long list of missteps following its initially accurate policy response to the pandemic in 2020. We reckon that this mistake will end up forcing the Fed to hike more and to keep rates at that higher level for longer, pushing the economy into recession to tame inflation.

Exhibit 1: Another negative quarterly flow (US \$bn)



Source: JP Morgan, UBS Asset Management, as of 30 September 2022

Exhibit 2: Financial conditions roller coaster



Source: Goldman Sachs, Bloomberg Finance, UBS Asset Management. As of 30 September, 2022

Markets took further comfort on favorable stable inflation figures in June-July, but the summer rally came to a halt following a hawkish statement from chairman Powell at Jackson Hole and a stubborn inflation print in August. On 21 September, the Fed hiked rates by another 75 bps to 3.25% and Federal Open Market Committee (FOMC) members, in the so-called dot chart, indicated they expected much higher terminal rates. While the Fed reasserted its data-dependency strategy, the message was unmistakable hawkish. Markets responded by selling off: equities dropped while US Treasury rates sold off strongly. As a result, by the end of September, financial conditions had just tightened back to levels observed in early June. Much more tightening is required to credibly lower inflation to 2%.

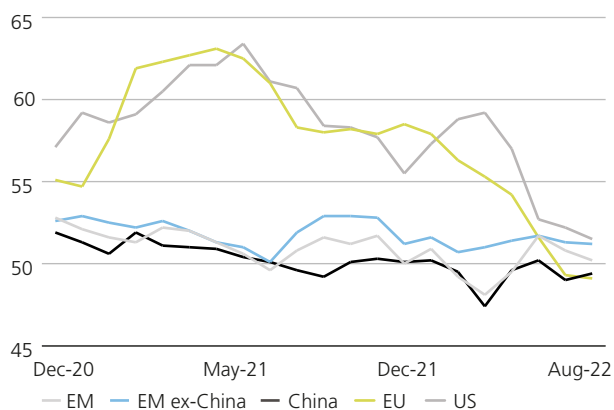
Tighter financial conditions and lower global growth are headwinds for EM

As we start the last quarter of the year, DM central banks continue tightening monetary policy even as growth is starting to slow down. In our view, the Fed has regained credibility after their recent actions and statements on their fight against inflation in a backdrop of still robust labor markets, even with signs of slowdown in many sectors.

We believe lowering inflation to 2% will take a lot more tightening of financial conditions going forward, and on the policy side, real policy rates (as measured by nominal rates vs. inflation as opposed to the real rates implied by financial markets) will have to be in positive territory for some time to have the required contractionary impact on domestic demand. This suggests policy rates at least 150-200 bps higher than current levels. Also, the European Central Bank (ECB) seems determined to tame inflation despite clear signs of lower growth amid the Russian-induced energy crisis. However, China's stimulus has not been strong enough to reverse the weakness in domestic demand.

As a result, EM is facing the negative price effect of higher global rates as DM central banks continue to fight inflation, while starting to feel the negative income effect from lower global growth. EM continues to be a high beta trade on global growth and is unlikely to perform well in an environment in which global growth is slowing down. The good news is that global inflation appears to be peaking, and DM central banks may not have to hike as much as markets are pricing in, more so if developed market economies go into recession as we expect to happen in Q1 2023. The most recent volatility in UK financial markets only adds to the sense that policy makers in DM are not on top of their economies.

Exhibit 3: Global PMIs: pointing down everywhere



Source: Macrobond, UBS Asset Management, as of 30 September 2022.

China not coming to the rescue this time around

China's economic growth continues to disappoint on weak domestic demand and strict COVID-19 driven lock-downs. At this stage, there is little visibility about any new fiscal or monetary package that could provide support to economic activity. There will likely be more clarity after President Xi is reappointed, as expected, at the 20th Communist Party congress that starts on October 16th. For example, there are tentative signs that COVID-19 restrictions will be eased in Q4, which on its own could generate better sentiment and support the recovery. All in all, it appears that China will experience cyclically lower-than-expected growth in 2022, perhaps as low as 2.5%-3%. As we have argued in the past, China is solidly a medium-income country with adverse demographics that has reached a degree of development that suggests lower growth in the medium-to-long term. We reckon that, as it was the case with Japan and Korea in the past, China's annual growth will stabilize at around 3% over the next decade.

Weak cyclical growth in China is likely to be detrimental to EM as China is one of the three most important pillars driving global trade and growth (the other two being the US and the eurozone) and a large consumer of commodities. In the absence of China's recovery to counteract a recession in the US and the eurozone, EM external and fiscal dynamics could weaken on lower commodity prices and export volumes.

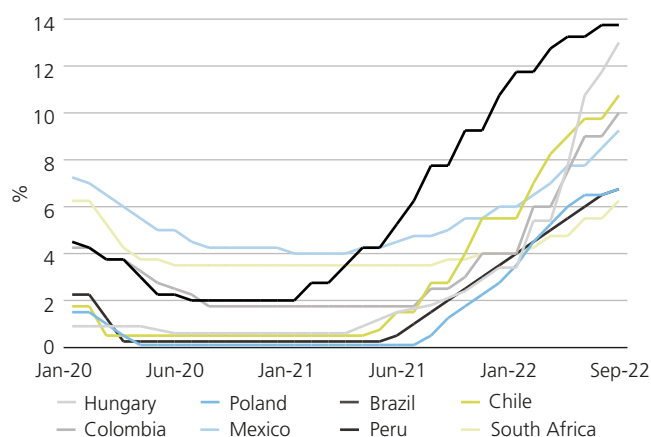
Putin: doubling down on a losing bet

The Russian invasion of Ukraine continues to backfire on Putin. China and India as well as other countries that initially either backed Russia or remained neutral, have started to express misgivings about the conflict. In the battlefield, Putin's army has suffered setbacks as well, as the Ukrainian army recovers some territories. In response, Putin has called referendums on the occupied territories to annex them to Russia and once again is threatening the world with the use of tactical nuclear weapons. It is clear to us that Putin is feeling cornered which we believe makes him far more dangerous. The West is likely to impose further sanctions on Russia after the most recent rounds of Russian activity. On the economic front, Putin continues to hold Europe hostage over energy, forcing governments in the eurozone to implement price controls, and quantitative restrictions ahead of the winter months. As a result, Europe is headed into recession in an environment where inflation is running at decades-high levels.

We remain defensive in Q4

EM asset prices behaved extremely well in Q3 considering the volatile global financial backdrop and uncertain macroeconomic environment. Global factors have been, and are likely to, remain the dominant force driving EM returns in Q4. For example, global equities as a proxy for risk appetite and an indication of growth strength (through earnings dynamics) continue to drive EM asset prices in general.

Exhibit 4: EM policy rates: Still in tightening mode



Source: UBS Asset Management, Bloomberg Finance, as of 30 September 2022.

The USD continues to be highly negatively correlated with EMFX returns, while US Treasury yields continue to be highly negatively correlated with rates and spread returns. We believe this will continue to be the case in Q4 as DM central banks continue to hike rates and tighten financial conditions to reduce inflation even as their economies slow down and head toward recession, likely by Q1 2023 if not before then.

Volatile yields and equity markets in DM are likely to permeate into EM asset returns in Q4. We expect DM equity markets to weaken further on slowing growth and earnings and higher rates. We expect UST yields to remain volatile but edging higher at the margin, reflecting the give and take between inflation and growth. We expect the USD to remain strong and strengthen further on higher relative growth and tighter monetary policy versus other DMs.

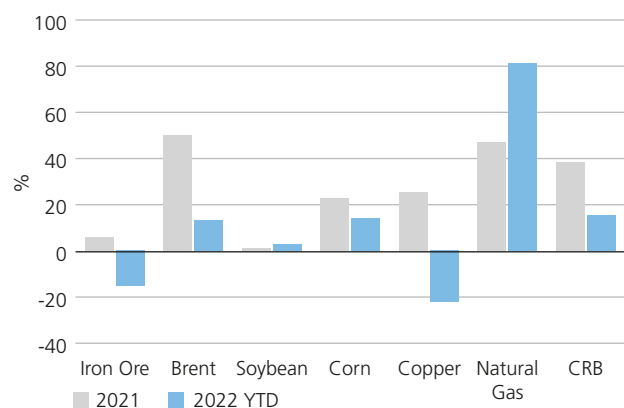
These global dynamics are likely to exert a significant influence over EM asset returns in Q4 and for this reason we remain defensive across sub-asset classes: credit, rates, and FX. We expect EM spreads to behave in tandem with

US investment grade (IG) and high yield (HY) spreads and to widen on higher and volatile rates (IG) and bouts of risk aversion (HY) as markets digest lower growth which would bring with it lower commodity prices and lower trade volumes. As it was the case in Q3, spreads could be supported by a lack of supply and net repayments, but at some point, low access to capital markets could become a problem for weaker sovereign and corporate credits.

We believe higher DM rates will push most EM rates even higher, as EM follow DM central banks in their tightening cycle, as they fight their own battles against inflation and try to avoid excessive weakness in their currencies. Finally, a strong USD will continue to exert negative pressure on EMFX. We note however, that EMFX has done much better than ex-USD DM currencies so far in 2022, the reason being more proactive EM central banks. We believe that will continue to be the case in Q4.

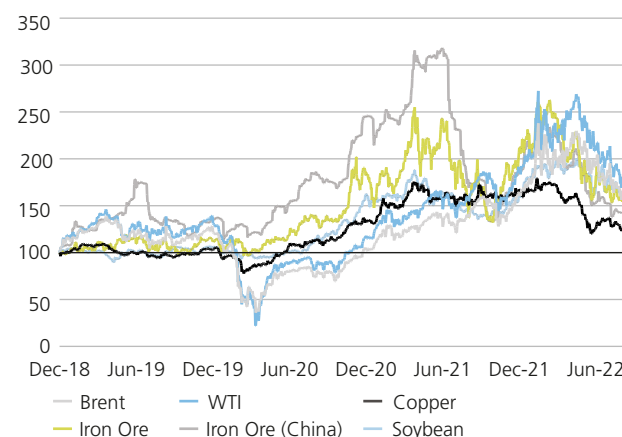
(Federico Kaune)

Exhibit 5: Commodities price change 2021 vs 2022 YTD (%)



Source: Bloomberg Finance, UBS Asset Management. As of 30 September, 2022.

Exhibit 6: Commodity Prices since 2018



Source: Bloomberg, UBS Asset Management, as of 31 March 2022. Index rebased to 100 as of end December 2018

Sovereign debt

Spreads continue widening

Sovereign credit posted a -4.57% total return in Q3 2022 (measured by the JP Morgan EMBIGD Index). Spreads widened by 17 bps to 559 bps, generating a 0.37% spread return inclusive of carry. The significant widening in US Treasury yields detracted from total returns.

Investment grade widened only 2 bps to 196 bps in Q3. As it was the case in Q2, this was a remarkable performance given the variety and size of the global shocks facing the asset class. Lack of supply and a net repayment of bonded debt supported debt prices. At 196 bps, we believe investment grade spreads remain close to fair value when measured relative to historical levels and relative to US IG.

High yield spreads also benefitted from lack of supply, but most importantly from the massive Fed-induced rally in the summer months. Nonetheless, HY spreads widened by 26 bps to 991 bps in Q3, most of it in the later part of September (92 bps). Favorable valuations – following the severe widening of spreads in Q2, which made EM HY even cheaper relative to historical levels and to competing asset classes, including US HY – also helped. Wide HY spreads are partially justified by potentially higher default rates (more below).

Spreads in high yielding South Saharan Africa (SSA) widened the most (53 bps) to 1027 bps in Q3, which together with the impact of wider US yields resulted in a total return of -3.76%. Oil exporter Ghana continued to underperform on weak financial policies and an increased probability that a debt restructuring may be required to re-establish debt sustainability. Ghana spreads are now trading at clearly distressed levels (2456 bps over US Treasuries). Ethiopia's spreads also widened significantly (828 bps) on increased violence and political instability stemming from longstanding ethnic tensions and weakening macroeconomic fundamentals. Defaulted Zambia's bonds dropped to less than 50c from 70c in June on a proposal to restructure external debt that was more draconian than markets expected.

Asia, usually a defensive region, experienced the second largest spread widening in Q3. Pakistan and Sri-Lanka explained all the spread widening. Sri Lanka's ongoing political crisis, weaker macroeconomic fundamentals, and protracted negotiations on a bail-out program with the IMF resulted in a further drop of its bond prices to 25c from 40c in June, a level that is better aligned with Sri Lanka's capacity to pay in the medium term. Pakistan, which was already experiencing financial distress as it negotiated a new program with the IMF, suffered catastrophic floods affecting two-thirds of the country during the summer. As a result, bond prices dropped to 35c in September from 65c in June. We now believe that Pakistan is likely to restructure its external debt with recovery values that are in line with current market prices.

Latin America spreads widened 19 bps to 525 bps in Q3, resulting in a total return of -5.29% on account of the longer duration of their bonds relative to other regions. Argentina (-12.33%) and Ecuador (-30.38%) explained most of the widening on political and macroeconomic policy uncertainty in both countries. In contrast, Central American countries did much better and many of them rallied strongly. El Salvador successfully bought back USD133 million of the USD800 million 2023 bond and USD432 million out of the USD800 million 2025 bond, partially financed with a USD200 million loan from the Central American Bank for Economic Integration and its USD275 million SDR allocation at the IMF. Although seen as successful by markets, President Bukele's strategy is not without risks as El Salvador will require access to markets to avoid payment difficulties in 2023, given the low level of international reserves and high external financing requirements.

Spreads in the Middle East and North Africa (MENA) tightened marginally by 5 bps to 384 bps but generated a negative total return (inclusive of the impact of UST yields) of -3.30%. As it was the case in Q2, spreads in Gulf Cooperation Countries remained well behaved as they benefited from solid fundamentals and high energy prices, offsetting widening

of spreads in Lebanon, and Egypt. Lebanon is still mired in a deep crisis, while Egypt is trying to stabilize its economy post-pandemic with a potential depreciation of the currency likely in the cards. In contrast, Tunisia's tourism sector recovered during the summer and the government made further progress with the IMF. As a result, Tunisian spreads tightened a hefty 237 bps in Q3.

Finally, Eastern European spreads tightened 34 bps to 732 bps as the Russian invasion of Ukraine stalled and Ukraine regained some territories, promoting a rally in Ukrainian bond prices and pulling several other countries with it. In all, the total return in Eastern Europe (inclusive of the impact of wider UST yields) was -3.52%, with Ukraine bonds down -28%.

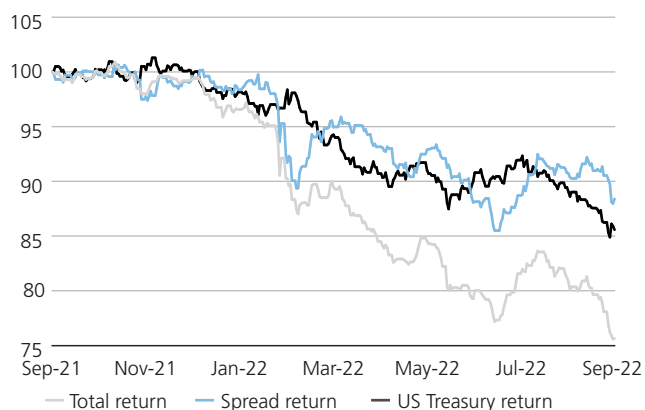
As in Q4, we believe emerging market sovereign debt will continue to be subject to the volatility of US Treasury yields and risks emanating from the decisions of DM central banks.

As we start Q4, it is not only higher and volatile DM rates that could affect EM credit, but also the slowdown in economic activity in Europe and the US and the prospects of a global recession in early 2023. At 559 bps over US Treasuries, EM spreads screen cheap on different metrics: relative to their fundamental capacity to pay (despite some countries being at risk of default), their historical levels and relative to competing asset classes (US IG and US HY in particular). However, as we have been saying throughout the year, we doubt such value will be realized in the current global environment characterized by high financial volatility and deep macroeconomic uncertainty.

(Federico Kaune)

Exhibit 7: Sovereign credit returns by component

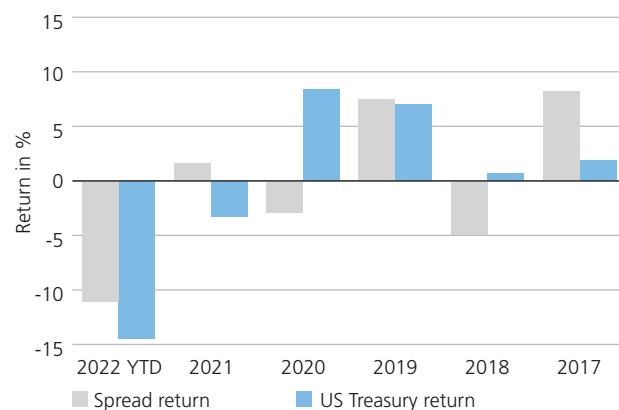
Rebalanced to 100 as of 30 September, 2021



Source: JP Morgan, Bloomberg Finance. As of 30 September, 2022.

Past performance is not a guide to future results.

Exhibit 8: Sovereign credit yearly returns over past 5 years



Source: JP Morgan, Bloomberg Finance. As of 30 September, 2022.

Past performance is not a guide to future results.

Corporate debt

Uncertainty into year end

EM corporate credit returns were negative in Q3 2022, resulting in returns of -2.66% (measured by the JP Morgan CEMBI Diversified Index). Corporate credit spreads widened by 2 bps in Q3 2022 resulting in a spread return of 0.42% while Treasury rate movements detracted -3.06%.

In Q3 2022 corporate bonds in Macau (7.46%), Argentina (2.53%), and Jamaica (1.52%) provided the best returns while the largest underperformers were Ghana (-11.44%), Ukraine (-10.96%) and Malaysia (-5.90%),

As in previous quarters, most sectors provided negative returns in Q3 2022 with the only flat performance from Consumer (-0.02%). The other top performing sectors were Financial (-2.00%), Diversified (-2.07%) and Infrastructure (-2.12%), while the worst performing sectors were Real Estate (-6.44%), Pulp and Paper (-6.36%) and Transport (-5.52%). In Q3 Europe was the only region to provide positive returns (0.62%), while all other regions reflected negative returns: Africa (-1.72%), Middle East (-1.65%), Asia (-3.16%), and Latin America (-3.68%).

The first half of 2022 provided many negative global shocks, and while risk sentiment rebounded to start Q3, that sentiment did not last as the Fed continued with its restrictive economic policy, hiking their target rate twice by 75 bps reaching a level of 3.25%, the highest target rate since 2008. Hawkish press

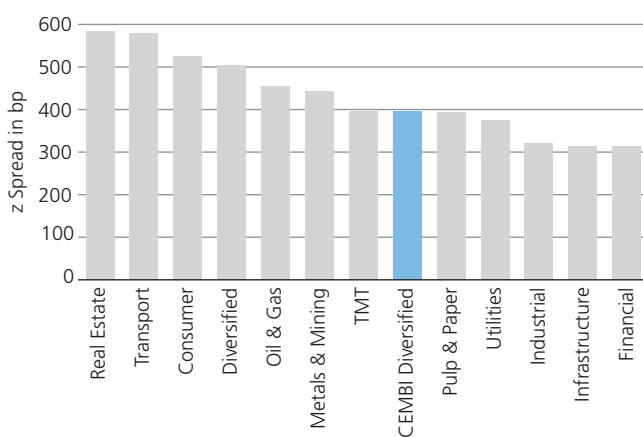
conferences that followed the Fed's annual Jackson Hole meetings pushed rates higher, and pricing in additional rate hikes of 100 bps – 150 bps and further increasing the likelihood of a US recession in the coming year.

While US politicians announced an end to the COVID-19 pandemic, China continued with its zero-COVID-19 policy and lockdowns resulting in lower growth forecasts for China.

Financials: Higher interest rates are broadly supportive for net interest margin (NIM) expansion benefiting financials with faster asset repricing. A slowdown in growth leads us to prefer large high-quality franchises that have solid capital and liquidity buffers and conservative underwriting standards.

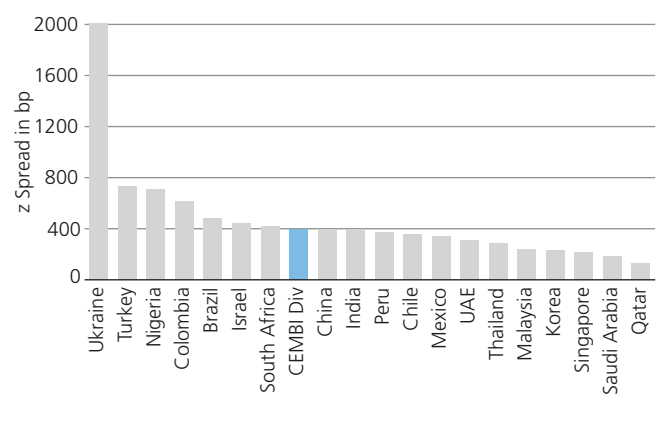
TMT (technology, media & telecom): This sector has a domestic-oriented nature as consumption of mobile, internet and TV subscription services remained resilient and decoupled from Russian war in Ukraine war. We believe the long-term investment case for TMT remains intact, on the back of stronger demand for telecom services surged post pandemic, with increases in mobile and fixed broadband traffic, a supportive demographic outlook for EM as well as comparatively lower penetration rates relative to developed economies. While the backdrop remains supportive, this is reflected in prices, and we see limited upside in TMT.

Exhibit 9: Emerging market corporate spreads by sector



Source: JP Morgan. Index shown is the JP Morgan CEMBI Global Diversified index, as of 30 September 2022. The z-spread, also known as the zero-volatility spread or the static spread, measures the spread over the benchmark zero coupon swap curve.

Exhibit 10: Emerging market corporate spreads by country



Source: JP Morgan. Index shown is the JP Morgan CEMBI Global Diversified index, as of 30 September 2022. The z-spread, also known as the zero-volatility spread or the static spread, measures the spread over the benchmark zero coupon swap curve.

Oil & Gas: Russia's war in Ukraine disrupted traditional supply of Oil & Gas. The sector will face headwinds due to a slowdown in economic activity, but the longer-term outlook remains positive given structural underinvestment in favor of energy alternatives (such as, biofuels, solar, wind).

Consumer: Within the consumer sector we are defensive cyclical names. We prefer packaged food, beverages and household products while remaining selective given higher costs of raw materials.

Metals & Mining: This sector was disrupted by Russia's war in Ukraine. The post-COVID-19 economic recovery and green transition have improved the outlook/demand for most base

metals. While our outlook for Metals & Mining remains broadly positive, growth risks and the slow economic recovery in China could continue to strain the outlook causing us to lower expectations.

We remain cautious going into Q4 as the risk environment remains challenged in both developed and emerging markets. We recommend avoiding credits with low to negative cash flow generation and tight liquidity buffers. While we see value in EM corporate credit it will be difficult for value to perform in Q4 and look for a better risk environment in 2023.

(David Michael)

Local currency debt

Fork in the road

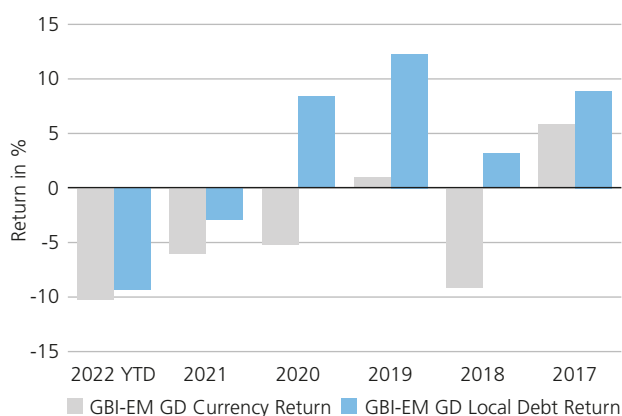
EM local debt (measured by JP Morgan GBI-EM Global Diversified index) lost -4.73% in Q3 bringing the year-to-date return to -18.57%. The loss was concentrated in weakening of the currencies (-5.31%), with local bond returns posting a small gain of 0.62% thanks to the high starting point for yields and significant dispersion in potential outcomes. The main driver of the losses was a hawkish pivot by the Fed, driving up the dollar, in addition to ongoing disruptions caused by the war in Ukraine and COVID-19 policies in China.

The outlook for Q4 2022 continues to hang in the balance of a hostile external environment partly offset by valuations. The impact of the pandemic has dissipated outside China, where the zero-COVID-19 policy has led to slow growth. Russia has escalated the war in Ukraine with the referenda in the occupied territories and a military draft. We believe Europe is likely to enter recession this winter after the surge of energy prices, and the US economy may finally yield to the aggressive Fed hikes. A fall in demand pulled back prices of commodities, including energy. However, many EM central banks have started hiking cycles earlier and are at or nearing a pause. The yield levels outside APAC are attractive by historical standards and the DXY (dollar) index is at the multi-decade high.

Latin American markets, except for Brazil, had a negative return in Q3. In Brazil, the central bank ended the hiking cycle at a very high rate after inflation had peaked. The market has come to terms with the likely win of Lula in the October presidential elections and the Brazilian currency is likely to be supported by positive external balances. We are cautious on rates in Mexico as the Central Bank is likely to pace the Fed, but the Mexican peso remains the beneficiary of prudent monetary and tight fiscal policy. We continue to avoid Colombia and Chile, where we believe the elections of left-leaning presidents, without legislative majorities, will lead to erratic policymaking. In addition, Chile and Peru's terms of trade are deteriorating with lower copper prices. On the other hand, the failure of the constitutional referendum in Chile should result in moderation of policies. We similarly expect constrained policymaking in Colombia and Brazil after the elections.

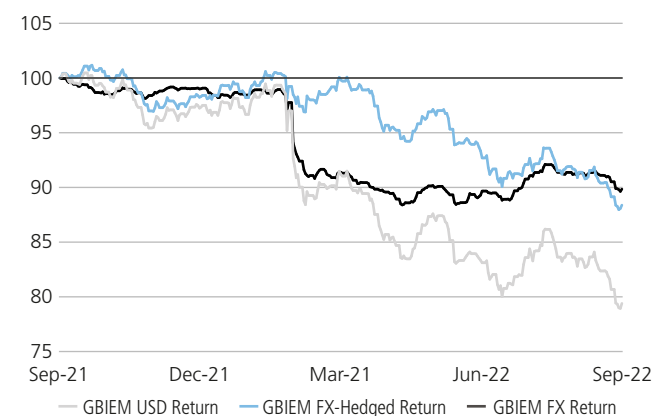
In EMEA, Russian assets were removed from indexes at the end of March, and due to sanctions are no longer investable. Turkey's government and central bank have lost control of inflation with little hope for a return to more orthodox policies. With inflation south of 80% per year, the central bank still cut interest rates twice. As the result of government controls,

Exhibit 11: EM local debt yearly returns over past 5 years



Source: JP Morgan, Bloomberg Finance. As of 30 September, 2022.
Past performance is not a guide to future results

Exhibit 12: EM local debt total returns
 (rebalanced to 100 at the start of the period)



Source: JP Morgan monitor. As of 30 September, 2022.
 The graph shows the total return of JP Morgan GBI-EM Global Diversified and its components, local debt return with FX hedged into US dollar 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.
Past performance is not a guide to future results.

the Turkish lira has partially stabilized, and bonds rallied dramatically. However, this low-volatility equilibrium is brittle and may suddenly unravel. Egypt devalued its currency in March as the shock of higher oil and food prices was severe and led to portfolio flight. The outlook for the Egyptian pound is uncertain as it remains overvalued, however, the base case scenario shifted to a gradual depreciation rather than additional one-off devaluation. South African growth and fiscal balance had improved earlier on significant improvement in terms of trade; however, we believe the best trade gains are behind us. In addition, political risks are creeping up ahead the ruling party's conference in December.

Central Europe suffered the brunt of the Russian war in Ukraine, outside the combatants. The volatility in CE rates has been extremely high. The outlook will depend on the path of the conflict and the degree of the recession in Europe. Inflation is still high pressured by high energy prices, influx of refugees from Ukraine and earlier stimulus and recovery from COVID-19. Central banks, however, have raised rates and the yield curves have partially adjusted. Even though Czech and Hungarian central banks have announced the end of the hiking cycle, and Poland may do so soon, we continue to see upside risk to bond yields in the region as additional shocks are likely.

The APAC outlook has deteriorated significantly given the slowdown in China, the hawkish Fed, and the strong dollar. We believe the zero-COVID-19 policy in China and stress in the real estate sector will not bode well for China growth in Q4. As we predicted in "[What's ahead for the Chinese yuan \(CNY\)](#)" on June 10, the CNY has weakened sharply and is vulnerable to the increase in US rates against easier domestic monetary policy. In addition, still high oil prices affect both growth and the trade balance negatively for commodity importers such as India and Korea. Thailand and other ASEAN countries will likely continue to see few Chinese tourists despite the easing of lockdowns. On the other hand, commodity exporters such as Malaysia and Indonesia have benefitted from higher export prices. However, inflation is gradually increasing, putting pressure on bonds across the region, and we are cautious on regional bond markets based on valuations. A big and decisive unknown, however, is the timing of the expected relaxation of the zero-COVID-19 policy in China, potentially following the Communist Party congress in October.

(Igor Arsenin)

DM central banks and EM fixed income: It is always darkest before the dawn

On September 13, 2022, Bloomberg consensus expectations for US August headline and core inflation were 8.1% y/y and 6.1%, respectively. Instead, they came in higher at 8.3% and 6.3%. In response, the S&P-500 equity market index fell more than 4%, the JP Morgan EMFX index fell more than 1%, and the EMBI GD and GBI-EM GD 0.9%. US inflation and, consequently, US central bank policies can have powerful impact on both DM and EM asset prices. Therefore, it is worth asking what the future path of US inflation may be and what are the implications for both DM central banks and EM fixed income. To address this question, we analyzed the components of the US Core Consumer Price Index separately, derived implied US core inflation quarter by quarter, and tried to forecast how the US Federal Reserve Bank would react to these numbers. We assume here that the Fed will not react to temporary fluctuations in food and energy prices. We looked at three main components of core CPI: Shelter CPI, services ex shelter CPI, and core goods CPI.

In August, the largest component of US core CPI was shelter CPI with the weight of 42%. Not only has it the largest weight, but it also contributed the most to August core inflation: 2.6% out of 6.3% core inflation came from shelter inflation, and the increase in its contribution was the largest as well. However, the largest component in shelter CPI corresponds to house prices which are approximated by

Owners' Equivalent Rent (OER), an implicit rent that owner occupants would have to pay if they were renting their homes. What this methodology does is that it both smooths fluctuations in housing prices and creates a lag of several quarters between realized housing prices and when they show up in CPI. Given this lag, we expect both the OER and shelter inflation to peak in Q4 of this year and then gradually decline as higher mortgage rates reduce housing activity and prices. Similarly, to shelter inflation, there is a several quarter lag between core services ex shelter inflation and Employment Cost Index service sector compensation growth. That suggests core services ex shelter inflation will peak in the first quarter of the next year. Finally, core goods inflation appeared to peak in February 2022 at 12.4% and was 7% in August. We assume the decline will continue at a similar pace as the global supply chain bottlenecks are being cleared. The results are presented in the table below: US core inflation will likely peak in Q4 of this year at 6.5% and will then decline, at first gradually and then faster until it falls below 3% in Q1 of 2024. It will likely catch up with the target inflation of 2% in Q2 of 2024. Core inflation that far away from the target means that the Fed will likely have to hike aggressively this year. We expect that September's 75 bps hike will be followed by 75 bps in November, 50 bps in December, and 25 bps in February 2023. Once inflation has peaked, the Fed can pause, and we assume this becomes evident in Q2 of 2024. However, the Fed

Exhibit 13: UBS AM Forecasts: possible future path for US core inflation, its components, and the nominal and real Fed funds target rates

Date	Shelter Inflation	Core Services ex Shelter Inflation	Core Goods Inflation	Shelter Contribution	Core Services ex Shelter Contribution	Core Goods Contribution	Core Inflation	Fed Funds Target Rate	Real Fed Funds Target Rate
Jun-22	5.61	5.33	7.12	2.32	1.74	1.87	5.92	1.75	-4.17
Sep-22	6.25	5.90	7.00	2.59	1.91	1.84	6.33	3.25	-3.08
Dec-22	6.50	6.95	5.90	2.70	2.16	1.61	6.48	4.50	-1.98
Mar-23	6.25	8.00	4.80	2.59	2.49	1.32	6.40	4.75	-1.65
Jun-23	5.45	7.23	3.70	2.26	2.26	1.01	5.53	4.75	-0.78
Sep-23	4.65	6.47	2.60	1.93	2.02	0.71	4.66	4.75	0.09
Dec-23	3.85	5.70	1.50	1.60	1.78	0.41	3.79	4.75	0.96
Mar-24	3.05	4.93	0.40	1.27	1.54	0.11	2.92	4.50	1.58
Jun-24	2.25	4.17	-0.70	0.94	1.30	-0.19	2.04	3.00	0.96
Sep-24	1.45	3.40	-0.40	0.60	1.06	-0.11	1.55	1.50	-0.05
Dec-24	0.65	2.63	0.00	0.27	0.82	0.00	1.09	0.25	-0.84

Source: UBS Asset Management, Macrobond, and Bloomberg. Date as of 28 September 2022

Note: June figures are realized. September 2022 – December 2024 are potential realizations based on: (i) core goods trend, (ii) lagged relationship between shelter inflation and housing prices, and (iii) lagged relationship between core services ex shelter inflation and employment total costs.

cannot cut until the core inflation at least begins with a digit of '2.' That likely postpones the first cut until Q1 of 2024 but once cuts begin, we believe they can be very fast.

What are the implications for EM fixed income? The good news is that while EM fixed income is likely to have a bad Q4, if US inflation and the US policy rate in peak in Q1 2023 it should support EM fixed income. In the Q4 2021 [EM Fixed Income Quarterly](#) we showed how GBI-EM GD average yield is heavily influenced by the US 10-year rate (both have increased approximately 280 bps since January 2021) and EMFX by DXY (US dollar) index. Historically, since 1985, the US 10-year rate has peaked at the same level as the US policy rate when the hiking cycle is about to end. According to our table, which would mean a US 10-year rate in the 4.5% to 5% range or about 100 bps above the current levels. However, prior to 1985, the relationship was much looser. Clearly, the stagflationary scenario we wrote about in the Q1 2022 [EM Fixed Income Quarterly](#) would have very negative implications for all fixed income assets but we don't think that is the base case yet. In other words, while the GBI-EM GD average yield can widen about 100 bps more, we believe that should be the peak (again, assuming the path specified in our table is

realized), and we expect there will be room for a big rally once inflation begins to come down. Moreover, while we expect that US core inflation, at 6.3%, is close to its peak, the same is not likely true for Euro area core inflation at 4.3%. The energy price shock in Europe will spread out to the other components and the ECB has hiked only 125 bps so far in this hiking cycle while the Fed has hiked by 300 bps. This means while the Fed will likely be pausing in 2023, the ECB will probably have to continue to hike. This should create a floor to the EUR and, by implication, a ceiling to the DXY (EUR weight in DXY is 58%), hence supporting EMFX. As we wrote in the Q4 2021 EM Fixed Income Quarterly, EMFX captures EM-specific risk premium in EMBI GD spreads. Hence, if the US yields do not rise and EMFX stabilizes, EMBI GD will look very attractive to us, particularly in comparison to other credit instruments. To summarize, we expect a bad Q4 followed by much better 2023. This, of course, is under the assumption that the macro situation in Europe and China will not take a turn for worse next year.

(Juha Seppala)

EMBIGD country rating trends

A look at long term credit worthiness among EMBIGD countries

To assess how EM Sovereign credit worthiness has evolved over time, we analyzed the ratings of the current EMBIGD countries (70 as of today) at year end, between 2020 and 2021, together with September 2022 (current ratings). We use the mid-rating approach: with three credit ratings available (using S&P, Moody's and Fitch) we take the median of the three indexes. If only two are available we take the lowest rating. If only one is available, we use that one. In our calculations, we assign equal weights to all EMBIGD countries.

The downward trend in rating quality since 2012 continues, sharply accelerated by the pandemic

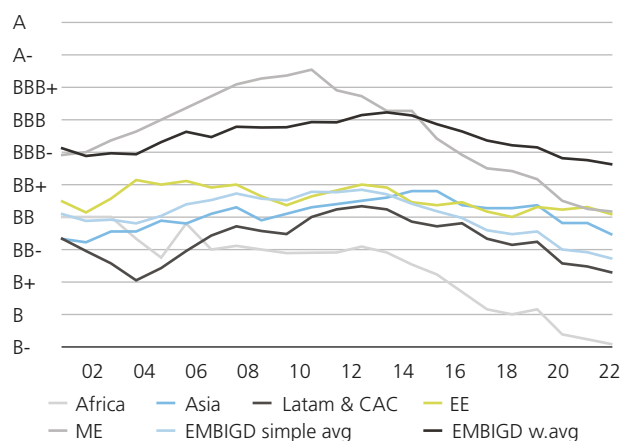
Overall, we observed two trends:

- 1) In the period 2003-2012, there was a general, albeit slow improvement of EMBIGD average credit quality from BB to BB+, supported by the commodity super cycle that boosted many EM countries' fundamentals, with a temporary setback during the Great Financial Crisis in 2008-2009.
- 2) A more rapid deterioration starting 2013, as declining oil and metal prices impacted fiscal and external accounts while increasing indebtedness and as the EM-DM growth differential faded, bringing the EMBIGD average rating back to the lower end of BB by 2019. The 2020 pandemic gave a sharp hit to fiscal, indebtedness and growth across

the board, thus accelerating the deterioration of credit quality, which continued in 2021 and in 2022 so far to BB- and approaching B+ level. We highlight that if we take a weighted average approach (taking today's EMBIGD weights), we observe a similar trend, but the average quality is three notches higher at BB+/BBB-. This is because most of the small and distressed countries now carry a smaller weight in the benchmark.

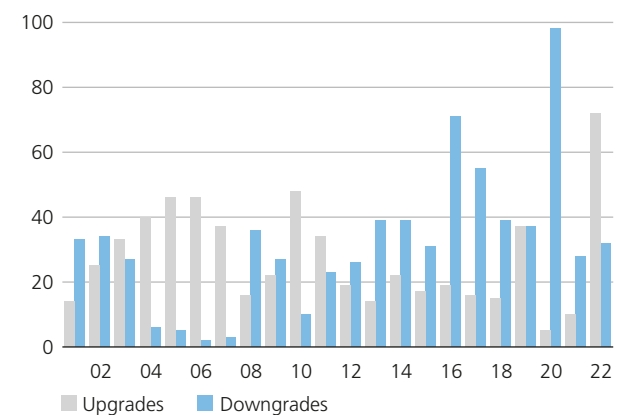
At a regional level, we observed an outperformance by the Middle East until 2010, which however led to a quicker deterioration as oil prices fell, regional tensions rose and as Lebanon defaulted in 2020. We also noted the steady improvement of Asia, due to the lower exposure to commodities, a more stable social/political landscape, and as China's growth benefited many countries in the region, despite a drop to the average in the last few years due to Maldives (CCC+) joining the EMBIGD in 2021 and as Sri Lanka defaulted in 2022. The resilience in the Eastern Europe rating should be taken with a grain of salt, due to the exclusion of Russia and Belarus because of the war in Ukraine, although downgrades in Ukraine and Turkey (both in 2022) were offset by upgrades in Kazakhstan (2021) and Croatia (2022). Particularly worrying is the deterioration of credit quality in Africa, which continues to be by far the weakest region on average at B-, due to higher political, structural and social issues than other regions, the Zambia default in 2020, and rising risks of a credit event in Ghana and Ethiopia.

Exhibit 14: EMBIGD ratings by region since 2000



Source: Bloomberg Finance, as of 30 September 2022

Exhibit 15: Combined downgrades/upgrades by cumulative notches per year, current EMBIGD countries since 2000



Source: Bloomberg Finance, as of 30 September 2022

A look at downgrades/upgrades by year: still way more downgrades than upgrades

Separately, we studied the combined notches of upgrades and downgrades in current EMBIGD countries by all three agencies per year. The pattern is similar, as post 2011 downgrades surpassed upgrades every year except 2019 (even). We note that after the shower of downgrades in 2020 due to the pandemic, we have recorded very few upgrades, highlighting the difficulties for most EM countries to recover. This trend is continuing in 2022 so far, where inflation, global challenges to energy and food security and rising geopolitical tensions continue to weigh on ratings.

Overall, we think that the declining credit quality across the board in EMBIGD should be considered when forming spread expectations. Looking forward, keeping in mind that rating actions usually occur with months of delay, we see upward rating potential from stable oil exporters, although in general we see risks more tilted to the downside due to 1) risks of weaker fiscal positions due to rising social needs on the back of high inflation 2) higher refinancing costs 3) persisting geopolitical risks, and 4) rising recession fears.

(Gianandrea Moccetti)

Chile's second attempt at constitutional reforms: implications for Chilean assets

Long considered the Switzerland of Latin America, Chile has led a neoliberal market-led economic model that was deemed beneficial for the country. So, when demonstrations against a small hike in subway fares ignited into widescale, violent protests in October 2019, Chilean observers noted that “it’s not about 30 pesos. It’s about 30 years,” referring to the three decades of market-friendly policies that brought prosperity and stability but also simmering public anger about rising inequality and lack of access to social services spanning decades. The severe social unrest and following political crisis resulted in a referendum to replace the hugely unpopular constitution written during the Pinochet era with a new charter that guaranteed more social rights – better education, healthcare, pension, and housing, – address inequality and protect the environment. It seemed inevitable that the country was shifting to the left: The new charter was going to be written by a Convention dominated by independent and left-leaning members; Chileans also elected as president a 35-year-old, far-left candidate Gabriel Boric who vowed to bury neoliberalism.

The outcome of a one-year process was a new charter under which Chile would be a pluri-national country, with the state having the ownership of mines; it abolished the Senate and created a separate judicial system for the indigenous population. Although most radical outcomes were eliminated in the end, this raised serious concerns among investors. With significant changes to the current economic model, the new system would have dented Chile’s potential growth and increased the fiscal deficit and debt burden.

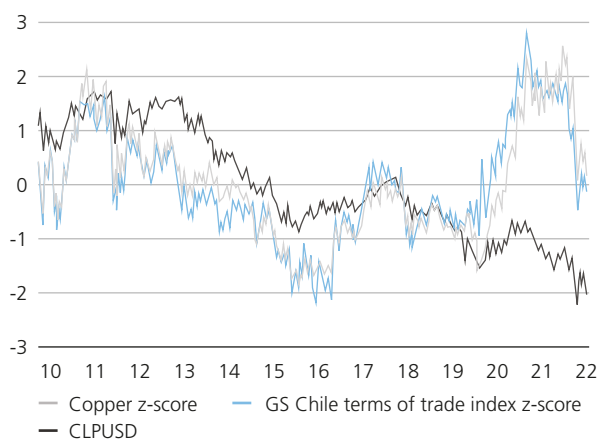
Chilean assets have underperformed during this political uncertainty

Since the severe social unrest and political crisis in 2019, Chilean financial assets have traded with a significant risk premium. The US dollar-Chilean peso (USD/CLP) exchange rate, which traded in line with copper prices and its terms of trade, decoupled from this trend and may have traded at a risk premium of around CLP200 at the weakest point, according to some estimates. Since the protests, there seems to have been a structural shift in the USD/CLP (see Figure 1), although it’s also likely affected by the US/China trade war and the pandemic. The local stock market was also considered to be trading at a discount of 15%-40%.⁵ Chile’s sovereign credit (A2/A/A- by Moody’s/S&P/Fitch, respectively) profile was downgraded from A1/A+/A during this period due to the weakening of public finances driven by spending pressures in the aftermath of the protests and the pandemic. As seen in Figure 2, in 2021 Chilean financial assets, especially local fixed income, underperformed its Latam peers and the rest of EM.

A second chance for Chile?

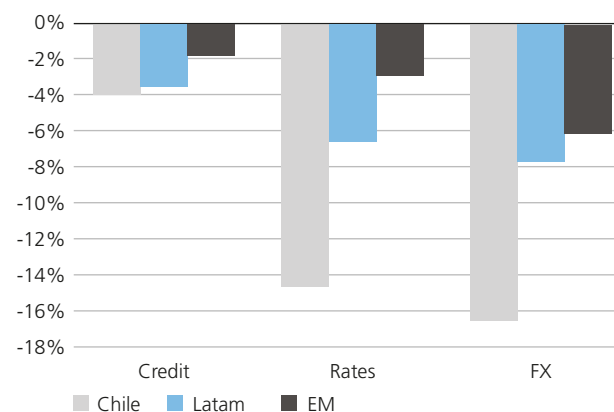
After a year of waiting for the Constitutional Convention to draft a new charter for Chile, and after almost three years since the eruption of protests, the population rejected the proposed charter in a popular referendum on September 4. The overwhelming rejection, which was unexpected, was seen as a sign that the population at large preferred more moderate changes, not an overhaul of the system. It is now expected that President Boric’s reform agenda that aligned with the rejected draft, especially in tax and pension, may need to be more gradual.

Exhibit 16: CLP decouples from copper and terms of trade



Source: Bloomberg, Goldman Sachs (Data as of September 2022)

Exhibit 17: Chilean assets underperformed Latam and EM in 2021



Source: Bloomberg, UBS (Data covers the 12 months of 2021)

⁵ Source: Credicorp Capital

We believe this is positive for the country's trajectory because it will now have a chance to reform in a broad political consensus. However, the overwhelming rejection of the new constitution has not resulted in a significant risk premium decompression in Chilean assets: the uncertainty remains as political parties discuss a new process to write a new charter that the population wants to accept. Still, we believe that the likelihood of an unsustainable fiscal trajectory has reduced significantly. The now-rejected draft would have made it possible for Congress to propose legislations with fiscal spending and given regional governments power to issue debt and own state-owned enterprises. Signs of moderation from the Boric administration is also seen positively.

Performance of the Chilean currency is likely to depend more on external factors. The depreciation of the CLP in early Q3 was unusually severe, reaching a record low of 1,045.80 to the dollar, driven by fears of a global recession and reduced demand for copper, especially from China, and assumptions of an aggressive rate hike by the Federal Reserve and its impact on a stronger dollar. After a short-lived post-referendum rally, the CLP continued its downward path. Because the CLP is

highly sensitive to global growth, China and copper prices, continued fears of a global recession would impact the CLP more than other EMFX. In the medium term, however, a recovery in copper prices due to its use in the green transition and a faster recovery in China would support the currency, along with a narrowing of Chile's record high current account deficit. We believe the referendum took some pressure off the central bank to intervene more, but with a weaker CLP, elevated inflation expectations and volatility from continued uncertainty, it may need to keep tightening monetary policy rate for the rest of the year.

As the country seeks a "new path forward," the constitutional debate is continuing and the uncertainty over a new process is likely to last at least for another year. People still appear to desire change and want the state play a bigger role in providing public services. Having learned from the experience, however, and having demonstrated where it collectively stands, Chile's next attempt at constitutional reforms is likely to be more representative and positive for the country.

(Yuni Kim)

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