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EM Fixed Income: remarkably unexpected

Emerging markets fixed income | UBS Asset Management

Surprising strong returns in 2019

- EM credit showed mid double digit returns in 2019, reflecting a sizable compression of spreads and the UST rally.
- EM rates delivered strong double digit returns as EM central banks eased aggressively on lower growth and inflation.
- EM FX disappointed as the headwinds from a stubbornly strong USD prove to be too strong. EM FX is fundamentally undervalued.

Emerging markets fixed income (EM FI) returns ended 2019 on a very strong note, reflecting better economic activity in DM and China, a more optimistic tone on US-China trade negotiations, and the significant impact of easier DM central bank announcements and policies. If there is a lesson to be learned from 2019 market dynamics, it surely is to never fight the Fed: More money (QE) at a lower cost (rate cuts) certainly can neutralize and even revert substantial headwinds.

Sovereign (Corporate) credit spreads as measured by the EMBIGD[1] (CEMBIBD[2]) tightened an impressive 47 bps (32 bps) in 4Q (most of it in December) generating an equally impressive 3.16% (2.59%) spread return. In contrast, local yields (as measured by the GBIEMGD[3]) finished 4Q unchanged, generating a carry return of 1.56%. However, the behavior of the constituents of the local benchmark was far from homogeneous. A strong rally in yields in volatile credits, including Argentina and Turkey, was offset by the selloff in European yields. EMFX rallied 3.58% against the USD in 4Q, almost fully offsetting the weakness in 3Q. In all, the local index returned an impressive 5.20% in 4Q.

4Q 2019 returns

US dollar debt	Total return	Spread return	US treasury return
JP Morgan EMBI Global Diversified	1.81%	3.16%	-1.30%
JP Morgan CEMBI Diversified	2.09%	2.59%	-0.48%

Local currency debt	Total return	Currency return	Local debt return
JP Morgan GBI-EM Global Diversified	5.20%	3.58%	1.56%
JP Morgan ELMI+	3.73%	2.75%	0.95%

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.
Source: Data as of Decemver 31, 2019. Bloomberg Finance.

2019 returns

US dollar debt	Total return	Spread return	US treasury return
JP Morgan EMBI Global Diversified	15.04%	7.51%	7.00%
JP Morgan CEMBI Diversified	13.55%	7.62%	5.51%

Local currency debt	Total return	Currency return	Local debt return
JP Morgan GBI-EM Global Diversified	13.47%	1.00%	12.34%
JP Morgan ELMI+	5.20%	0.14%	5.05%

* 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.

1 Emerging Markets Bond Index Global Diversified
2 Corporate Emerging Markets Bond Index Diversified
3 Global Bond Index Emerging Markets Global Diversified

Declining political uncertainty in 4Q helped

A significant reduction in political uncertainty in DM and EM also helped risk taking in 2019, particularly in 4Q. In the UK, Boris Johnson's conservative party won the snap parliamentary elections by a surprising landslide –setting the tone for Brexit in 1Q 2020. In the US, the house of representatives voted to impeach President Trump on strictly partisan lines. The consensus is that he will be cleared by the Senate, once again on strictly partisan lines. Polls indicate that impeachment has not affected President Trump's popularity and that he remains competitive against Democratic candidates in the November 2020 election.

In EM, Argentina's elections delivered the expected victory of opposition candidate Fernandez, but also an unexpectedly strong showing by the ousted pro-market government coalition in congress. The new government will have to negotiate with the opposition, which may reduce their appetite for broadly advertised anti-market reforms. So far they have shown remarkable restrain, prompting a strong rally in all Argentine asset prices. In Bolivia, President Morales was ousted by massive popular protests after the OAS found he had rigged the October elections results. In Lebanon, Hassan Diab was elected PM after months of negotiations and protests. Whether he will be able to form a government and implement the needed reforms is still unknown at this juncture, but if he does, Lebanon could be one of the best if not the best performer in 2020. Chile, Colombia and Ecuador experienced popular protests for different reasons, but most of them reflect deep discontent with the lack of growth and opportunities since commodity prices collapsed in mid-2014. By December most protests had subsided.

2019: Remarkably unexpected

2019 was a pretty remarkable year in that it defied conventional wisdom and most forecasts. The Fed switched from rapid rate hiking in 2018 to rapid rate cutting in 2019, despite a very modest growth slowdown in the US (2.9% in 2018 and 2.3% in 2019), a continued drop in the unemployment rate, and a slight drop in inflation (core PCE from 2.0% in 2018 to 1.6% in 2019). UST yields rallied 75bps, global equities had one of their best years, USD remained strong and US credit spreads rallied to historical lows. All of this in spite of IMF lamenting doom and gloom in global growth on the back of the trade war.

EM FI also had an outstanding 2019. Sovereign (Corporate) credit spreads tightened by a notable 125 bps (59 bps) in 2019 in line with local yields. EM FX appreciated by only 1.00% versus the USD, reflecting the unexpected strength of the USD in 2019. The return from the sovereign (corporate) spread rally reached 7.51% (7.62%) in 2019, which coupled with the significant UST rally generated a total return of 15.04% (13.55%) in 2019. These unexpectedly high returns were the second best of the past decade. However, the spread rally in 2019 was just enough to offset the spread sell off in 2018; we are back to December 2017 spread levels.

The local index generated a total return of 13.47% in 2019: 12.34% from rates and 1.00% from FX. The FX index as measured by the ELMI+ (EM FX and carry) returned 5.20% in 2019, in spite of the strong USD. At 12.46%, the RUB was the best performing EM currency despite the headwind from ongoing sanctions. Thailand was a close second at 8.61% despite very low yields and growth. The distant third was MXN at 3.82%. All of these were largely unexpected.

EM FI: Inflows won't stop

As was the case in 3Q, low global yields attracted additional inflows into EM FI. EM FI attracted a solid USD 11.8 billion in 4Q (from USD 11.6 billion in 3Q). Sovereign and corporate credit saw inflows of USD 7 billion. Local EM (FX and rates) had an inflow of USD 4.8 billion[3].

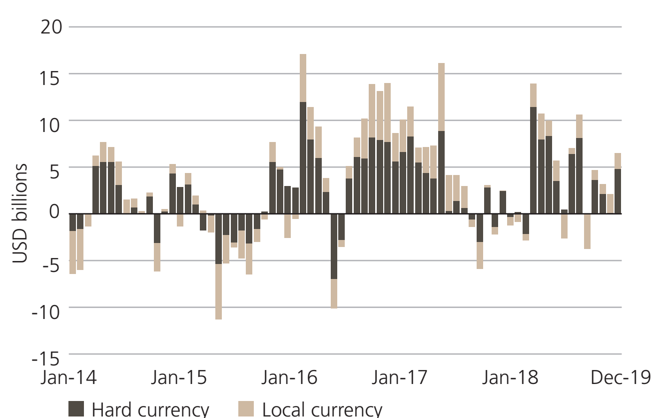
Issuance from sovereign and corporate names reached USD 35.7 billion and USD 108 billion (mainly Chinese names) in 4Q, respectively, higher than usual but similar to Q3, because issuers took advantage of lower yields. Amortization and coupon payments reached USD 61.3 billion for corporates and USD 21.5 billion for sovereigns.

2020: A delicate equilibrium

Can EM FI markets rally further after the robust performance in 2019? We think yes, but only if everything goes right, given the relatively stretched starting point valuation-wise. Most likely, we are looking at a carry environment without much price appreciation potential in 2020, particularly in credit and rates.

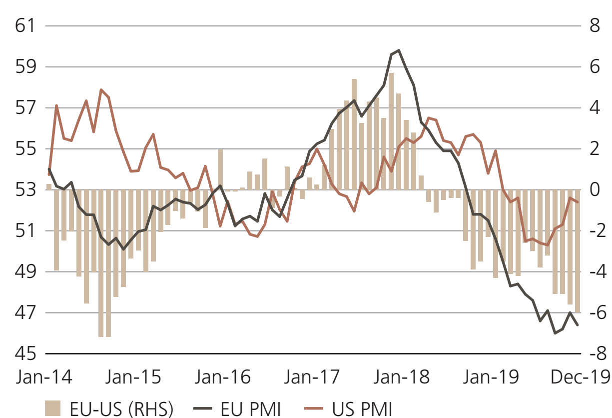
First, global macroeconomic dynamics point towards a year of subdued global growth but not a recession, with muted global inflation pressures. These fundamental dynamics coupled with our expectation of unchanged rates in DM, suggest to us that DM yields should remain relatively stable if not lower. Such an environment is likely to support carry trades in EM FI.

Strong inflows in 4Q (USD billion)



Source: JP Morgan, UBS Asset Management. As of December 31, 2019

A slight recovery in DM PMIs in late 2019



Source: Macrobond, UBS Asset Management. As of December 2019

3 Flows data as of December 31, 2019

Second, commodity prices continue to be supportive of emerging economies' external and fiscal accounts, helping offset the negative impact of lower global trade volumes. As long as this continues to be the case, emerging economies would not be forced to adjust their fiscal or monetary stances. This should support the overall capacity-to-pay of the vast majority of emerging economies that are commodity exporters.

Third, it appears that the US and China have reached a near truce on their protracted trade conflict. If this calmer trade environment persists, global trade volumes may stabilize and even start recovering in 2020, further helping emerging economies.

Fourth, the stock of negative yielding bonds stood at a high USD 11 trillion as of end 2019, down from 15 trillion earlier in the year. Positive and relatively high yields in EM have attracted financial flows into the asset class, helping finance EM external imbalances. These positive flow dynamics are likely to continue in 2020.

However, valuations are not as compelling as they were a year ago, reflecting the significant rally in most markets in 2019. The thinner cushion offered by current valuations may not be enough to shield markets from the risks leering on the horizon.

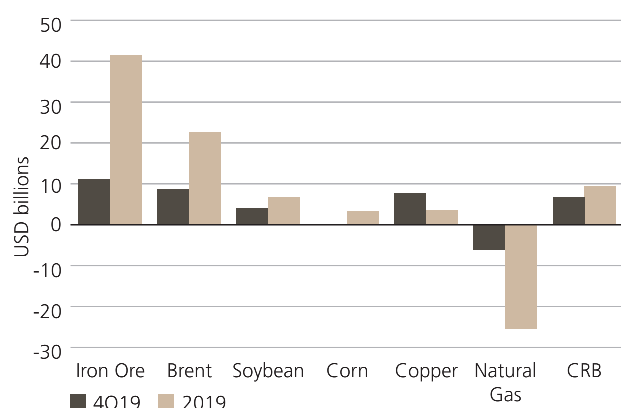
Geopolitical risks with potential to disrupt markets - most notable oil markets - abound (Iran is the latest example). DM politics, particularly US elections, could also be a significant source of market volatility in 2020. We are concerned about the impact that a correction in DM equity markets could have on EM asset prices through the risk aversion channel.

Furthermore, central bank policies overwhelmed equity fundamentals in 2019, particularly in the US. This is likely to change in 2020 as the tailwinds from expansionary Fed policies fade later in the year, and underwhelming fundamentals take over. This could be detrimental for riskier asset classes, which thrive when global risk appetite is high.

In summary, we expect 1Q20 to be good for EM credit and FX and more neutral for rates as trade tensions decline amidst dovish policies. We expect large inflows into EM FI to continue, given the backdrop of low/negative global yields. EM sovereign credit yields around 5%, which compares favorably with other markets. Overall we expect a further compression of spreads, driven by inflows. EM local rates are unlikely to rally further, but should continue to earn the carry (5.2%). EMFX offers interesting opportunities on a fundamental valuation basis after a year of scant returns against the USD. If the USD remains strong, it will be difficult for EMFX to reduce its undervaluation relative to the USD.

The outlook for the rest of the year is less certain because there are plenty of shocks (political and geo-political) that could ignite a broader market correction, undermining an otherwise calmer global macro environment. *(Federico Kaune)*

Supportive commodity prices (% change)



Source: Macrobond, UBS Asset Management. As of December 31, 2019

Sovereign debt: HY to the rescue

Sovereign credit posted a 1.81% return in 3Q (measured as EMBIGD), with spread compression generating a 3.16% return. UST yields sold off and detracted 1.3% from returns. IG spreads tightened 23bps and HY spreads an impressive 80bps in 4Q. As a result, EM IG (HY) sovereigns returned 1.17% (2.57%) in 4Q 2019. Most of the return in HY sovereigns was generated in December (3.65%), reflecting the recovery of stressed credit including Ecuador and Argentina.

Sovereign spreads rallied an impressive 47bps in 4Q. Spreads rallied in October, but sold off in November as Ecuador and Lebanon widened. Spreads had a strong rally in December as the situation in both of these countries improved and the new government in Argentina appeased markets.

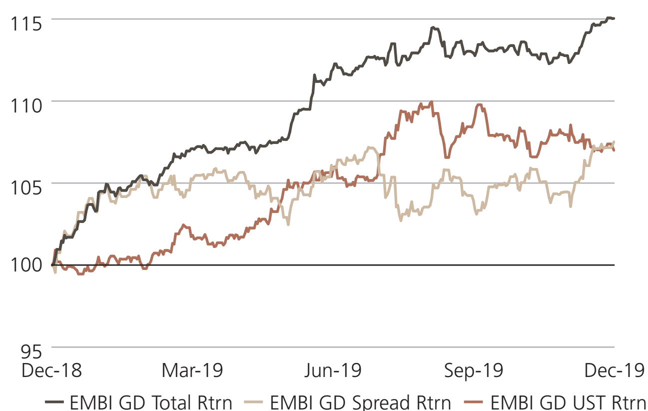
During 4Q, all regions but the Middle East generated positive returns. Africa posted the highest returns at around 3.54%, followed by Eastern Europe 2.94%. Latin America returned 2.24% in spite of the -5.28% return from Ecuador, while Asia returned 0.93%. The Middle East returned -0.49%, reflecting a significant sell-off in Lebanon of -29.38%.

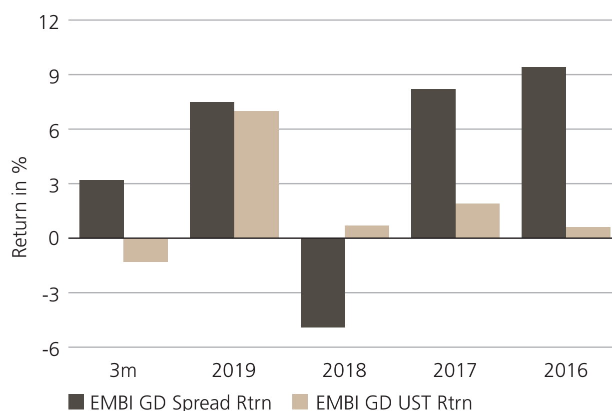
Argentina was the best performer in 4Q, returning 20.75% on the back of better-than-expected balance of payments figures and a conciliatory tone from the new administration that took office on December 11th. Additionally, the market-friendly opposition retained a surprisingly strong presence in congress, which will force the new Peronist government to the negotiation table to pass reforms. Bond prices are still in the mid-40s as market participants anticipate the government will restructure external debt sometime in 2H 2020. On the other hand, Lebanon was the worst performer in 4Q. Parliament could not elect a PM until December, and even then it was not clear that PM Diab was going to be able to form a cabinet of technocrats that could address the countries severe macroeconomic challenges while calming down protestors.

Out of the 73 countries in the EMBIGD only seven had negative returns in 4Q: Investment grade names including Chile (because of a rare wave of protests and violence) and Philippines (tight valuations), and high yielding names including Ecuador, Suriname, Zambia, Lebanon and Tajikistan.

At around 300bp for the EMBIGD, sovereign spreads seem to offer fair value and still attractive carry (4.90%) for a low yielding global environment. We believe that a strong search for yield could generate more than carry returns in 1Q20. However, the rest of 2020 is less certain. *(Federico Kaune)*

Sovereign debt: still going
(Rebalanced to 100 as of Dec 31, 2018)





Source: JP Morgan monitor, As of December 31, 2019

Corporate debt: credit differentiation over valuation

EM Corporate credit provided a strong Q4 2019 with 2.09% (measured as JP Morgan CEMBI Diversified). Corporate credit spreads tightened 33bps during this period. Total returns were supported by a rally in credit spreads contributing 2.59% to Q4 returns while Treasury detracted 0.48%.

This closes out a strong year of returns from EM Corporate credit of 13.55% (measured as JP Morgan CEMBI Diversified). This annual return was compensated by spread tightening of 68.5bps contributing 7.62% to the annual return while Treasury contributed 5.51% to full year 2019 returns.

In Q4 2019 Corporate bonds in Argentina (17.24%), Israel (7.54%), Zambia (7.45%), Jamaica (7.02%), and Oman (4.34%) provided the largest positive returns, while the largest underperformers were from Ghana (-8.31%), Kazakhstan (-0.62%), Thailand (-0.08%), Chile (-0.02%), and Malaysia (0.55%).

From a sector perspective, Consumer (4.26%), Real Estate (2.64%) and Transportation (2.40%) provided the highest positive returns, while Infrastructure (1.05%), Pulp & Paper (1.53%), and Financials (1.55%) underperformed most.

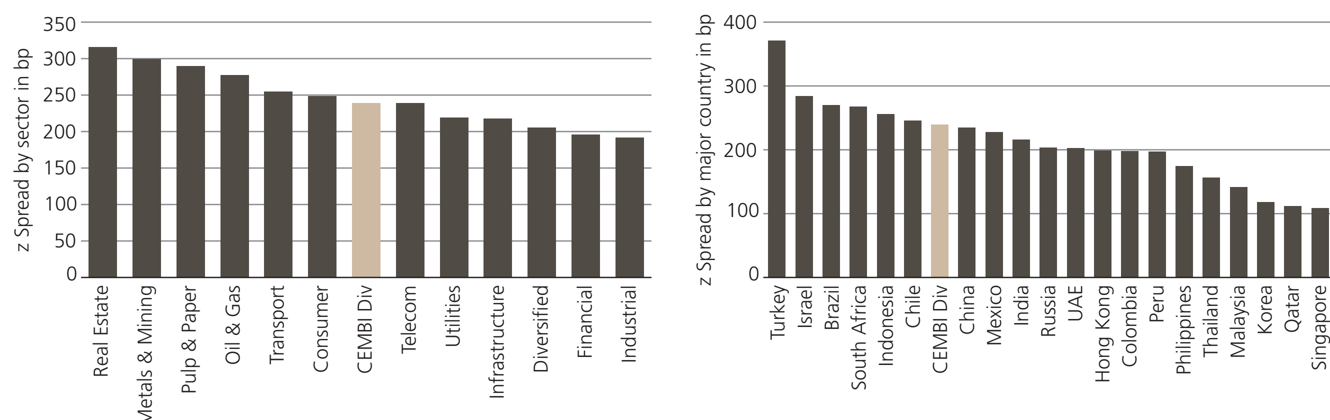
In Q4 2019 all regions provided positive total returns. The best regions in terms of total return were Europe and the Middle East, while Africa lagging in both total returns and spread returns when compared to regional peers.

After modest spread tightening in Q3, EM Corporate bonds finished off the year with robust Q4 returns. In their October meeting, the US Federal Reserve signalled they had completed their mid-cycle adjustment. While the adjustment provided a supportive backdrop for credit, the rally in spreads was amplified by positive trade headlines announcing a phase 1 trade deal between the US and China. Specific details of this trade deal are lacking and have yet to be confirmed by both parties.

EM Corporate fundamentals continue to improve as reflected in lower leverage and strong earnings growth in most sectors and regions. Earnings growth has been supported by a recovery in most commodity prices, low but stable global growth and access to easy financing and a low funding environment allowing many companies to reduce interest costs and extend their debt maturity profile.

On the supply side, issuance from Asia continued to dominate primary market supply. While 2019 supply relieved short-term funding pressures from Chinese property companies, they will continue to have large funding needs again in 2020. Outside of China, in 2020 we expect gross issuance to decline, while net issuance should reflect small funding needs. Supply estimates will continue to be driven by China and Middle East names, while refinancing over capex and M&A will be the key drivers for Latam and CEEMEA. This is positive for both fundamentals and market technicals.

EM Corporate Spreads
Measured in bps as of December 31, 2019



The z-spread – also known as the zero-volatility spread or the static spread – measures the spread over the benchmark zero coupon swap curve).
Source: JP Morgan monitor, As of December 31, 2019

Value can be found in deleveraging issuers (especially high yield), property / real estate names and primary supply. On the other hand, high grade spreads screen tight to sovereign peers.

We have seen an increase in distressed events in China, headlines on trade, the expectation of continued sanctions on Russia, Iran, Venezuela, and Turkey, along with geopolitical unrest in Hong Kong, Chile, Colombia, Ecuador, Lebanon and others. These events create an environment with increased volatility, uncertainty on policy responses and additional stress on weaker institutions.

In Argentina, we are monitoring sovereign debt restructuring negotiations and corporate issuers, specifically provinces and utilities, who face an uncertain regulatory environment, currency controls, and the potential pesification or re-negotiation of electricity generation, transmission and distribution contracts.

While we expect 2020 to start with the optimism we saw bring 2019 to a close, risk appetite and market volatility will continue to be driven by global central bank policy, previously mentioned headlines, idiosyncratic stories and the 2020 US Presidential election. *(David Michael)*

Local debt: More positive on currencies than rates

EM local debt (measured by JP Morgan GBI-EM Global Diversified index) showed a 5.20% return bringing the total return so far in 2019 to impressive 13.47%. The 2019 performance was entirely due to local returns – the interest rate rally – with FX return virtually flat. Argentina had yet another dismal quarter as the new government tightened capital controls and set to re-negotiate debt. Turkish assets had a positive quarter as inflation slowed allowing the central bank to aggressively cut interest rates, while high carry supported the lira despite political noise. A surprise underperformer was Chile, where the government scheduled a constitutional referendum after violent protests. Mexican bonds and the peso did well as the central bank began easing. Russia has benefited from rising oil prices. Overall, both local and FX returns were positive as the Fed cut rates and is expected to remain on hold throughout 2020.

The outlook for Q1 2020 is turning more positive for the currencies and ambiguous for yields. A number of significant problems – trade war, hard Brexit, and sharp China slowdown are in remission. Opec+ has managed to control supply and boost oil prices, and ongoing hostilities in the Middle East have not devolved into a larger war. The expected modest pickup in global growth, with major central banks on hold, bodes well for EM currencies. But the strength of the USD based on the outperformance of the US economy has been and will remain a limiting factor. On the other hand, the outlook for interest rates is at best neutral, with country-specific factors playing a more dominant role.

In Latin America, we find Mexico on a path of long term deterioration of the fiscal accounts, but experiencing a short-term boost from the likely passage of USMCA and continuing rate cuts by Banxico. Brazilian bonds had a spectacular rally after the passage of the pension reform and aggressive cuts by the BCB. However, after the rally, there is little value in Brazilian rates, while the currency struggles to perform in the absence of growth. An improvement in growth should therefore be supportive for the BRL, which has become cheap to fundamentals. The Chilean markets are likely to bounce back from a significant sell-off, but the sharp deterioration of

the fiscal outlook will keep valuations cheap in the foreseeable future. Argentina's heterodox policies and capital controls will likely lead to high inflation and weak parallel FX market. Local bonds are subject to re-profiling by decree.

In EMEA, Turkey remains an important market to watch. Economic management has become heterodox while the low-hanging returns due to cheap valuations have been picked. In addition, Turkey is risking an escalation of US sanctions over the delivery of Russian weapons. In South Africa, the economy remains weak and struggling SOEs are a continuing drag on fiscal resources. Moreover, a downgrade by Moody's is a base case scenario for March. The sanction risk remains a key concern in Russia, however, higher oil prices and the expected fiscal and monetary easing should continue to boost bonds and the ruble.

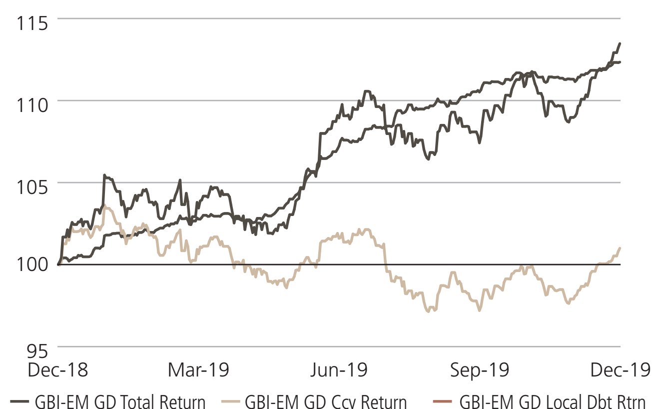
Central Europe has been enjoying high growth rates and some insulation from broader EM weakness despite the slowdown in the Eurozone. Following the large rally in yields in sympathy with global markets, CE bonds are vulnerable to a continuing correction.

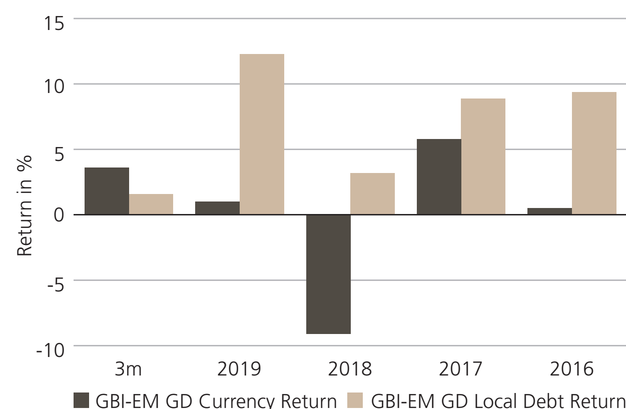
Following a period of volatility earlier in the year, APAC currencies have recovered and the CNYUSD has stabilized at around 7.0. Following more constructive negotiations on the trade deal, we expect the stability to continue in Q1. On a longer horizon, we a see gradual depreciation of the CNY due to slower growth and capital outflows, creating a headwind for regional local currencies, but keeping interest rates low.

The main risks to the outlook are stemming from frothy valuations in many markets, particularly in credit, and a steepening trend in the UST curve. Political risk dominates in many spots (Latam protests, Turkey and Russia sanctions, potential resumption of a trade war and Middle East hostilities), with the addition of the US elections in November 2020. *(Igor Arsenin)*

Currency returns: more sensitive to economic and political shocks
(rebalanced to 100 at the start of the period)

The graphs below show the total return of JP Morgan GBI-EM Global Diversified and its components, local debt return with FX hedged into USD and currency returns. Local debt return results from yield movements and coupons of the underlying bonds in local currency. Currency return results from exchange rate movements and carry





Source: JP Morgan monitor. As of December 31, 2019

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