EM Fixed Income: weathering global uncertainty

Emerging markets fixed income | UBS Asset Management
UST rally to the rescue in 3Q

- Emerging markets (EM) are in the middle of a cyclical slowdown driven by adverse global factors, including uncertainty in global trade policies.

- With a few exceptions, EM don’t have room to implement counter cyclical fiscal policies, and are relying on expansionary monetary policies instead.

- Credit, rates and FX will continue to be driven by global factors. Spreads (particularly in the investment grade (IG) space) and rates could benefit further from lower and declining rates in developed markets (DM), such as US Treasuries (UST). EMFX is unlikely to rally unless USD weakens.

- The upside risk to this view is a clear and definitive resolution to the trade conflict between the US and China. In that scenario, rates will sell off, FX will appreciate and IG spreads lag while high yield (HY) spreads rally.

Emerging markets fixed income (EM FI) returns remained strong in 3Q, albeit at a more subdued level than in 2Q. Sovereign and corporate credit spreads ended relatively unchanged in the quarter after selling off in August and rallying in July and September, closely following dynamics in the UST markets, and the sell-off in Argentinean spreads in August.

As was the case in 2Q, most of the returns in EM credit during 3Q were due to the significant rally in rates in developed market (DM). Local rates, on the other hand, rallied in tandem with developed rates but EMFX weakened, as a reflection of the continued strength of the USD, particularly versus the Euro.

By the end of September, sovereign (corporate) spreads as measured by the EMBIGD1 (CEMBIBD2) were 9bps (8bps) tighter (wider) that at the end of the previous quarter. Local yields (as measured by the GBIEMGD) tightened and additional 48 bps in the quarter (in spite of a further strong sell off in Argentinean rates) replicating the same dynamics of 2Q, while EMFX weakened 4.14% against the USD in 3Q.

3Q 2019 returns

<table>
<thead>
<tr>
<th>Total return</th>
<th>Spread return</th>
<th>UST return</th>
</tr>
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<tbody>
<tr>
<td>JP Morgan EMBI Global Diversified</td>
<td>1.50%</td>
<td>-1.09%</td>
</tr>
<tr>
<td>JP Morgan CEMBI Diversified</td>
<td>1.91%</td>
<td>0.20%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total return</th>
<th>FX return</th>
<th>Local return</th>
</tr>
</thead>
<tbody>
<tr>
<td>JP Morgan GBI-EM Global Diversified</td>
<td>-0.79%</td>
<td>-4.14%</td>
</tr>
<tr>
<td>JP Morgan ELMI+</td>
<td>-2.08%</td>
<td>-3.30%</td>
</tr>
</tbody>
</table>

JPM = JP Morgan.
EMBI = Emerging Markets Bond Index.
CEMBI = Corporate Emerging Markets Bond Index.
ELMI = Emerging Local Markets Index.
Source: Data as of September 30th, 2019. Bloomberg Finance.

* The tables show total returns of US dollar and local currency debt plus their return components, as explained below:
  - US dollar debt return components: Spread return results from the yield difference between emerging markets debt and US treasuries and from spread movements. US treasury return results from US treasury yield movements.
  - Local currency debt return components: Local debt return results from yield movements and coupons of the underlying bonds in local currency. Currency return results from exchange rate movements.

1 Emerging Markets Bond Index Global Diversified
2 Corporate Emerging Markets Bond Index Broad Diversified
EM FI: strong inflows in 3Q

As was the case in 2Q, further central bank dovishness drove additional inflows into EM FI, albeit at a slower pace than the record inflows experienced in 1Q, and with outflows in August due to trade war concerns.

EM FI attracted a solid USD10.9 billion in 3Q (from USD10.6 billion in 2Q). Sovereign and corporate credit saw inflows of USD11.1 billion. Local EM (FX and rates) had an outflow of USD0.2 billion³.

Issuance from sovereign and corporate names reached USD37.6 billion and USD113.2 billion in 3Q, respectively, higher than usual because issuers took advantage of lower yields. Amortization and coupon payments were substantial for corporates, reaching USD70.3 billion, and within the seasonality for sovereign, reaching USD17.9 billion. As a result, the technical backdrop - particularly in credit - was supportive of the asset class in 3Q.

Dovish central banks continue delivering

The Federal Reserve (Fed) cut rates 25bps each in July and September, a move largely expected by markets. UST yields rallied further, reaching a minimum in early September to a level rarely seen in the past 10 years. UST yields sold off in the first half of September only to rally later on, reflecting better high frequency figures and an apparent US administration willingness to negotiate with China on the trade front. Markets are currently pricing in 25bps cuts in October and December, on the back of weaker US data and trade uncertainty.

In mid-September the ECB went back to quantitative easing, making an open ended commitment to buy €20bn per month starting in November. The ECB also lowered rates with a 10 bps cut to the deposit rate to -0.5%, as well as differentiating rates to mitigate the impact on banks, and improving TLTRO terms. Furthermore, the post-announcement statement was dovish and another 10bp cut is expected in December. Mario Draghi, President of the ECB, called for more pro-active fiscal policy from member countries that have fiscal space (i.e. Germany).

Source: JP Morgan, UBS Asset Management. As of September 30, 2019

3 Flows data as of September 25, 2019
Finally, the Bank of Japan (BOJ) remained consistent in their policy aimed at keeping an accommodative monetary stance, including keeping the yield curve control policy (nominal 10 yr. JGB yield target at around 0%, and monetary policy rate at -0.1%) and QE target unchanged (at ¥80 trillion a year). Nonetheless, 10yr JGB yields are now at around -0.2%, suggesting an easing bias by the BOJ.

Taken together, dovish central banks turned even more dovish in 3Q, generating aggressive rallies in EM rates and supporting riskier asset classes in the face of global trade uncertainty and geopolitical risks.

The world continues to slow down on trade uncertainty

Economic data showed that growth and inflation in the world continued to soften in 3Q. Purchasing Managers’ Indexes (PMIs) in the US have declined while in Europe they are stabilizing in decisively contractionary territory.

The global economy is suffering the impact of protracted uncertainty on global trade policies between the US and various parties. China and the rest of EM, as well as DM are now on a cyclical slowdown.

Not much has changed on the US-China trade war front in 3Q. Announcements of imminent deals have been followed by disappointments, further denting global confidence.

In July, the US announced a path for tariff increases for the rest of the year including a 15% tariff on an additional $110bn exports on September 1st, an increase of tariffs on the existing $250bn to 30% from 25% on October 1st (delayed for two weeks as goodwill gesture by the US in respect to the 70th anniversary of the Communist regime in China), and a 15% tariff on the last $160bn batch of Chinese exports to the US on December 15th. China has announced it will retaliate.

In mid-October, both parties are scheduled to meet for further negotiations. At this point it is impossible to predict what the outcome will be given their track record and more recent contradictory announcements.

Also, the WTO ruled in favor of the US on its trade dispute with Europe, authorizing the US to impose tariffs on up to $7.5bn worth of European exports annually in retaliation for illegal government aid to Airbus.

The potential consequences remain the same however: whether the global economy starts recovering or decisively slows down depends, in good measure, on the successful de-escalation of trade disputes.
Argentina the main protagonist again in 3Q

The third quarter brought about more surprises from Argentina, where the primary elections on August 11th favored Peronist party candidate Fernandez over President Macri by an unexpectedly large margin. Markets took the news badly and spreads, rates and the currency experienced a dramatic selloff on the expectation that Fernandez will win the Presidential elections on October 27th. As a result, the incipient virtuous cycle of declining inflation, recovering growth in the context of the ongoing fiscal adjustment was replaced by a negative feedback loop in which the speculative attack on the FX resulted in a significant loss of reserves, unanchored inflation expectation and renewed contraction of economic activity. Markets now expect Argentina to restructure its external debt sometime after the new administration takes office on December 10th.

In Brazil, a larger-than-expected pension reform (worth 13ppts of GDP in savings in the next 10 years) was approved by congress in September, making a significant contribution to address Brazil’s long-term fiscal sustainability concerns.

Houthi militants in Yemen claimed responsibility for a drone attack on Saudi Arabia’s largest oil processing facility in Abqaiq which took down 5.7mbpd in oil production or about 5% of world daily output. Oil prices jumped 20% on impact but retreated as it became clear that output was going to be brought back in a matter of a few weeks, as was eventually the case.
Commodity prices well behaved in 2019

Commodity prices have behaved remarkably well so far in 2019 in face of the downward repricing of global growth and demand. In spite of broad weakness in 3Q, commodity prices are still up 2.4% year-to-date.

Lower demand for commodities - reflecting lower global growth - has been partially offset by negative supply shocks to oil (Iran, Saudi Arabia and Venezuela) and metal producers (Chile on copper and Brazil on Iron Ore). As long as commodity prices remain relatively stable at current levels, most EM economies will not be forced to tighten financial policies further in order to maintain macroeconomic stability and keep their debt-servicing capacity strong.

EM in the midst of opposing global forces

Emerging Markets are in the middle of two opposing global forces. On the one hand, global growth has slowed down as a consequence of global trade conflicts, particularly between the US and China. On the other hand, DM central banks have reversed course and are now easing monetary policy providing a cushion of global liquidity at a declining cost.

Lower growth would normally be bad news for EMD because of its negative impact on global trade volumes and commodity prices. Trade volumes have declined, but commodity prices have remained supportive reflecting negative supply shocks.

DM central banks are once again pumping liquidity at lower cost into the global economy. This is good news for EM because it allows sovereigns/quasi-sovereigns and corporates to roll over their debt and perform liability-management exercises at lower costs, thus improving their debt-service profiles. Moreover, in a world where roughly USD15 trillion worth of fixed income securities trade with negative yields, positive and relatively high yields in EM have attracted financial flows into the asset class, helping finance EM external imbalances.

Low global growth with low inflation and low rates should be constructive for EM credit as long as the world economy does not go into recession - a scenario that we do not envisage.

EM is in a cyclical slowdown driven by adverse global factors - in particular trade-related uncertainty. Fundamentally, several countries require structural reforms - including to their labor markets, tax systems and SOEs - to sustain higher growth rates in the future. Few (Brazil, Indonesia) are implementing them currently. Most large EM economies don’t have room to implement counter cyclical fiscal policy as their public debt load is already high. There are some exceptions in Asia, including China that is likely to use fiscal stimulus to counteract trade shocks if required.

Most EM countries will continue to rely on monetary policy in the face of low growth. We expect most major EM central banks to cut rates in our lower-for-longer baseline scenario. Brazil, Mexico, Turkey, South Africa, Russia and Indonesia are among the countries we would expect to continue to cut rates in coming quarters. The reason is that in most of these countries growth is low and inflationary pressures are well under control or declining.
In this low global growth environment, we believe that EM assets, including spreads, rates and FX will continue to be driven largely by global factors. Spreads (particularly in IG) and rates could benefit further from lower and declining rates in DM (UST) as it has been the case so far this year. EMFX will continue to struggle under the weight of a stronger USD in this scenario.

The upside risk to our lower growth view is two-fold. The first risk is a clear and sustainable resolution to the current global trade conflicts that could change global growth expectations for the better. The second risk is that faced with the clear risk of recession, Europe engages in fiscal stimulus at some point in 2020 joining China in its support of global growth. In these scenarios, we would expect DM rates to sell off on the expectation that global growth will pick up, with a potentially detrimental impact on IG EM credit and rates. In the near term, EMFX could benefit from higher global growth and a weaker USD in this scenario. (Federico Kaune)

Sovereign debt: Good IG, poor HY

Sovereign credit posted a 1.50% return in 3Q (measured as EMBIGD), with most of the performance (2.63%) driven by a further rally in UST yields. 10y UST yields dropped by 34bps to 1.61% while spreads tightened by just 9bps in 3Q, with IG spreads tightening 2bps and HY spreads widening 10bps. As a result, EM IG sovereigns returned 3.82%, in contrast with the negative -0.95% return from EM HY sovereigns.

Sovereign spreads rallied in July before widening 34bps to 353bps in August reflecting a significant widening in HY names (particularly Argentina and Lebanon). Spreads tightened 16bps in September as DM central banks cut rates and renewed QE commitments (ECB). During 3Q, all regions but Latin America generated positive returns. Eastern Europe posted the highest returns once again at around 3%, followed by Asia (2.7%). The Middle East returned 2.4%, in spite of the large sell-off in Lebanon (-13.7%), while Africa returned 1.5%. Latin America returned -0.3%, reflecting a significant sell-off in Venezuela (-51%) and Argentina (-41.7%).

Argentina’s highly negative performance reflected the surprising outcome from the primary elections on August 11th that gave opposition Peronist candidate Fernandez a virtually unbeatable margin over reformist President Macri. The negative reaction of market participants generated a significant sell-off in asset prices that in turn weakened fundamentals as the central bank spent about 1/3 of the stock on international reserves and hiked rates several hundreds of bps in their attempt to stabilize the currency. Market participants now believe that candidate Fernandez (And even President Macri if he were to win) will have to restructure external debt.

Lebanon continued struggling with deposit outflows as the government and parliament continue to discuss measures to contain the deterioration of the economy. Efforts to reduce the fiscal deficit have now met a good reception from investors, because the recent effort is highly insufficient to stabilize the 150% debt-to-GDP ratio. Geopolitical issues in the region - particularly between Saudi Arabia and Iran - have also affected Lebanon.

Out of the 73 countries in the EMBIGD only eight had negative returns in 3Q, all of them high yielders and five of them weak oil exporters (Angola, Argentina, Ecuador, Tajikistan and Venezuela).
Venezuela’s weight in the main benchmarks continues to decline as it is been gradually phased out of them, due to sanctions and the ensuing collapse in trading volumes. The spread on the EMBIGD sovereign benchmark excluding Venezuela currently stands at around 317s, or 20bps lower than the headline figure.

At around 340bp for the EMBIGD, sovereign spreads seem to offer fair value and still attractive carry (5.2%) for a low yielding global environment. However, as we have said in past reports, a further spread tightening would require more clarity on the US-China trade issue.

In this context, we expect range-trading in USD sovereign debt, favouring a carry strategy in 4Q, as it was the case in 3Q and 2Q. Spread widening to around 400bp should trigger an increase in risk exposure. (Federico Kaune)

Corporate debt: A carry environment supported by dovish central banks

EM Corporate credit provided another quarter of strong returns of 1.91% in Q3 2019 (measured as JP Morgan CEMBI Diversified) providing positive returns in each month. Corporate credit spreads widened 6bps this quarter. Total returns were supported a rally in US interest rates contributing 1.7% to the quarterly return with carry providing for the remaining returns.

Corporate bonds in Turkey (4.91%), Zambia (4.78%), Ukraine (3.72%), Thailand (3.55%), and Mexico (3.30%) provided the largest positive returns while the largest underperformers stemmed from Argentina (-14.80%), Kazakhstan (-4.81%), Israel (0.30%), S Africa (0.67%) and China (1.34%).

From a sector perspective, Transport (3.11%), Infrastructure (3.04%) and Telecom (2.78%) provided the largest positive returns while the underperforming sectors were Consumer (0.94%), Real Estate (1.11%), and Utilities (1.13%).

After the strong rally in the first half of 2019, EM corporate bonds provided modest returns in Q3. The continued dovish mid-cycle adjustments from the US Federal Reserve provided a supportive backdrop for credit.
All regions provided positive total returns. The largest outperformers in total return was Europe and the Middle East with the Latin America lagging in both total returns and spread returns when compared to regional peers.

EM Corporate fundamentals continue to improve as reflected in lower leverage and strong earnings growth in most sectors and regions. We will need to monitor this given the decline in commodity prices coupled with IMF forecasting a slowdown in global growth.

On the supply side, issuers in Asia continued to take advantage of the positive market sentiment and continued to relieve external funding pressure that built over the last few years. The remainder of 2019 we expect net corporate issuance to be negative (new issuance less coupons and amortizations) and supply will continue to be driven by refinancing over capex and M&A. This is positive for both fundamentals and market technicals.

Value can be found in deleveraging high grade issuers, select BB credits, as well as new issuance from Brazil and the Middle East. On the other hand, continued caution is warranted in Turkey where we expect to see continued volatility, economic slowdown and stress on financial institutions and domestic oriented businesses.

Caution is also warranted in Argentina where markets were shocked by the results of the Presidential Primary election forecasting a potential change in government. This election will continue to create volatile price action in Argentina assets through the 4th quarter.

Domestic oriented companies in China continue to benefit from strong market demand, stimulus, and policies measures directed toward the domestic economy. Chinese high yield issuers had benefited greatly from this uplift, but the tight valuations from Q2 have widened and we see pockets of value emerging. Further, we keep our positive stance toward systemically important state-owned enterprises in China, and select Chinese properties.

Risk appetite in emerging markets credit continues to be driven by global market conditions and political headlines. We continue to monitor trade negotiations between the US and China, increased violence in the middle east, the progress of Brazil’s reforms, Argentina’s presidential elections, and Turkey’s volatile politics. (David Michael)

Local debt: More of the same

EM local debt (measured by the JP Morgan GBI-EM Global Diversified index) showed a -0.79% return in 3Q bringing the total return in 2019 to a still solid 7.86%. The moderately performance in 3Q was entirely due to local returns (+3.49%), with spot currency moves bringing the returns into negative territory.

Argentina had yet another dismal quarter as primary elections showed a crushing lead of the opposition, and the government was forced to introduce capital controls and delay payment on short-term debt. Turkish assets had a positive quarter as inflation slowed allowing the new central bank governor to aggressively cut interest rates, differently than his predecessor.
The biggest contribution to the index returns, however, came from the rally in bonds across the board as EM central banks took the cue from the Fed and executed multiple rate cuts. Returns were magnified in the countries where local returns were not undermined by the currency returns: Indonesia, Mexico, Peru, Philippines and Thailand.

The outlook for 4Q is uncertain given a number of significant tension points – trade, global growth, political risks, and monetary policy. A disruption of oil supplies is an additional risk that that was not top of mind prior to the attacks on Saudi oil infrastructure.

However, lower US policy rates, lower global growth and the strong USD (given the relative outperformance of the US economy) point to a similar trend – likely positive but modest local returns and idiosyncratic and volatile EMFX.

In Latin America, we find Mexico at risk on fiscal/monetary policy as well as continuing trade uncertainty (the USMCA trade agreement yet to be ratified in the US Congress).

The Brazilian bonds had a spectacular rally on good prospects 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 that has become cheap to fundamentals.

In Argentina, local markets will largely depend on the ability of the new administration to come up with a credible recovery plan and convince creditors to restructure debt – each are a high order.

In EMEA, Turkey remains and important market to follow. Economic management has become more heterodox while the low-hanging returns due to cheap valuations are over, in our view. In addition, Turkey is at risk 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. Upside in bonds is limited by the risk of a downgrade by Moody’s and resulting index outflows from local markets. The sanction risk remains the key concern in Russia given the tensions in geopolitical hot spots.

Central Europe (CE) has been enjoying high growth rates and some insulation from border 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 correction.

APAC currencies continued to be volatile in Q3 in tandem with the CNY. This is likely to continue as the trade deal remains elusive and we see gradual depreciation of the CNY due to slower growth and capital outflows in the rest of APAC FX.

The main risks to the outlook are stemming from both positive and negative shocks – a breakthrough (or breakdown) in trade talks, the Fed policy amid high rate cut expectations and geopolitical risks. (Igor Arsenin)

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**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 September 30, 2019