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Dovish central banks to the rescue

Emerging markets fixed income | UBS Asset Management

By: Emerging Markets Fixed Income team

A very strong start to the year for EM FI

- In 1Q 2019 EM FI rallied on cheap valuations
- Global CB dovishness and benign expectations on trade supported EM FI
- Returns in 2Q are likely to be more subdued but still compelling in our benign scenario

Emerging markets fixed income (EM FI) saw strong performance during 1Q. Sovereign and corporate credit delivered positive returns reflecting a significant tightening of spreads and a significant rally in UST yields. Local EM also delivered positive returns as FX and yields rallied almost everywhere.

By end March, sovereign (corporate) spreads as measured by the EMBIGD (CEMBID) had tightened 64 (33) bps undoing almost all of the widening experienced in 4Q 2018. Local yields (as measured by the GBIEMGD) tightened 29 bps, in spite of a significant sell off in Argentina and Turkey, while EMFX strengthened marginally against the USD in 1Q.

1Q 2019 returns

	Total return	Spread return	UST return
JP Morgan EMBI Global diversified	6.95%	4.56%	2.39%
JP Morgan CEMBI diversified	5.34%	3.55%	1.79%
	Total return	**FX Return**	**Local return**
JP Morgan GBI-EM Global diversified	2.92%	0.26%	2.66%
JP Morgan ELMI+	1.48%	0.26%	1.22%

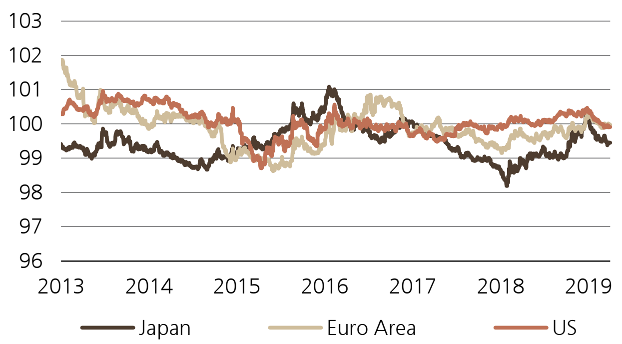
Note: JPM = JP Morgan. EMBI = Emerging Markets Bond Index. CEMBI = Corporate Emerging Markets Bond Index. GBI-EM = Government Bond Index – Emerging Markets. ELMI = Emerging Local Markets Index.
Source: Data as of March 31st, 2019. Bloomberg Finance.
* The tables show total returns of US dollar and local 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.

Dovish global monetary policies helped

During 1Q the FED made a 180° turn on its communicated intentions to continue normalizing monetary conditions. Such change was driven in part by the market reaction to the December 19, 2018 hike and the tightening of financial conditions that ensued, but also to early signs that US economic activity was softening. On March 20th the FED opted to not hike rates, lowered its own expectations of future rate hikes to one hike in 2020, and announced it was reducing quantitative tightening in May and ending it altogether in September. As the quarter progressed, markets stopped pricing hikes in 2019. Furthermore, the UST yield curve inverted, bringing back fears that a recession was near.

The ECB, which had not hiked rates in December 2018, announced it was ending QE, while expressing concerns about downside risks to growth. As economic activity softened further, on March 7th the ECB announced a comprehensive package of very accommodative financial policies, including a new wave of Targeted Longer-Term Refinancing Operations (TLTRO III), a change in rate guidance (no hikes until December 2019 from sometime in the summer earlier), and a new set of downbeat growth and inflation forecasts for 2019. Finally, the BOJ was consistent in keeping their very accommodative monetary stance throughout the first quarter, including keeping the yield curve control policy (nominal 10 yr. JGB yield target at 0%, and monetary policy rate at -0.1%) and QE target unchanged (at ¥80 trillion a year).

Financial conditions eased in 1Q 2019

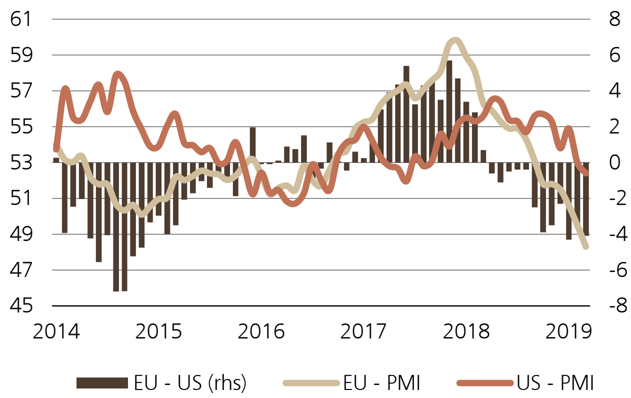


Source: Macrobond, UBS Asset Management. As of March 31st, 2019

Lower global growth and policy uncertainty had a negative impact later in the quarter

Economic data continued to soften as the first quarter advanced with some indicators taking a turn for the worse as 1Q came to an end. Softer economic activity figures overwhelmed the positive impact of easier monetary conditions and bouts of risk aversion ensued as markets grew increasingly fearful that the probability of a recession was growing.

European PMI: Still declining faster than in the US



Source: Macrobond, UBS Asset Management. As of April 1st, 2019

The uncertainty surrounding Brexit and the trade deals between the US and China, and Europe contributed further to the negative sentiment. The heated discussions and uncertainties surrounding Brexit weighted on European assets and the Euro, which in turn affected risk taking globally. This is because a 'no deal' Brexit would have a detrimental impact on European growth, potentially shaving up to 1% from growth in 2019-20. Another source of uncertainty that weighted on Europe was the potential imposition of tariffs by the US on auto imports from Europe, on national security grounds under section 232 of the Trade Expansion Act. Trade negotiations between China and the US continued throughout 1Q with some progress, but no concrete announcements. The US imposed deadline for reaching an agreement was extended into April but further delays are likely.

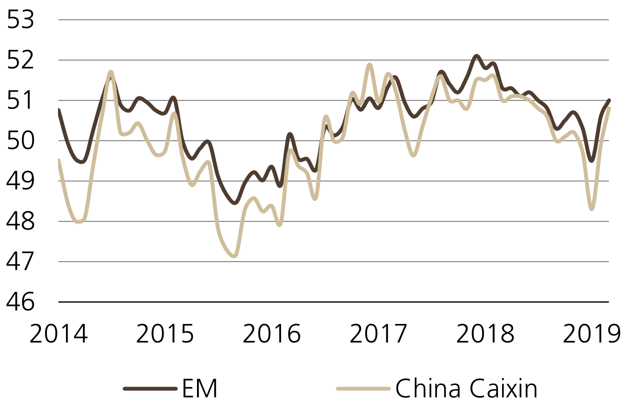
China stimulus starting to bite

China's growth momentum weakened further in 1Q. Weaker sentiment affected domestic demand, while the distortion generated by the imposition of tariffs by the US affected exports. It was with this softer growth background that the National People's Congress (NPC) announced several counter cyclical financial policies aimed at supporting economic activity in 2019.

Firstly, the NPC set the 2019 growth target at 6-6.5% from 6.5% in 2018. Second, the NPC announced an expansionary fiscal stance worth around 1.8% of GDP (augmented fiscal deficit) according to our economists, including corporate tax cuts worth 2ppts of GDP, a 3ppts cut in manufacturing VAT and, a 3-4ppts cut in corporate social security contributions. Furthermore, local governments will see their bond issuance limit increased by RMB 800bn in 2019. Third, the NPC called for ensuring adequate and ample liquidity and lowering borrowing costs, which will most likely be achieved with a further cut in reserve requirements (~200 bps) to ensure credit growth of around 11-12% from 9.5% in 2018.

These measures are substantial in magnitude (although smaller than the 2009-11 and 2015-16 stimulus) and could help stabilize and then boost growth in 2H provided that the trade impasse with the US is resolved in an amicable manner.

China and EM PMIs finally turning up



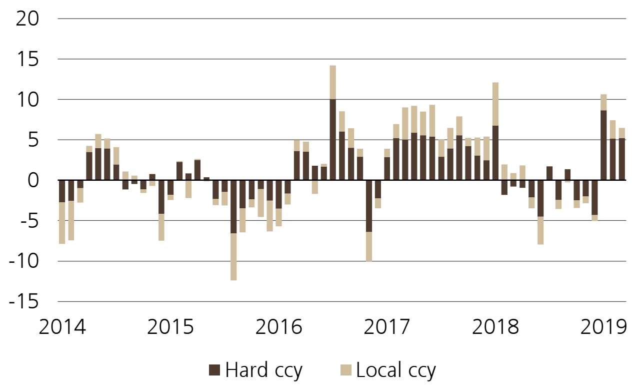
Source: Macrobond, UBS Asset Management. As of April 1st, 2019

Significant inflows into EM FI in 1Q

It is usually the case that a soft backdrop in global monetary conditions increases the appeal of high yielding asset classes, including EM. Thus, the newly found DM central bank dovishness resulted in an EM FI inflow bonanza in 1Q. EM FI attracted a solid $34.7 billion in 1Q. Sovereign and corporate credit saw inflows of $27.4 billion while local (FX and rates) attracted $7.3 billion.

Furthermore, issuance from sovereign and corporate names was lower than it is usually the case, while amortization and coupon payments were substantial. As a result, the technical backdrop - in credit in particular - was very supportive of the asset class in 1Q.

Monthly EM FI retail flows (USD bn)



Source: JP Morgan, UBS Asset Management. As of March 27th, 2019

Politics continue to plague EM

Argentina and Turkey were once again the main protagonists in an otherwise calmer quarter. Presidential elections in Nigeria and El Salvador proved to be uneventful. Local elections in Ecuador weakened President Moreno right after his government had agreed on an IMF program that includes tough fiscal commitments. The general elections in Thailand yielded no winners and will require alliances that could keep political uncertainty higher than normal for the next few weeks.

2019 Election Calendar

Date	Presidential	Parliamentary	Local
Apr-19	**Indonesia, Ukraine (runoff)**	**Indonesia, Israel**	-
May-19	**Panama, Lithuania**	**India, Philippines, South Africa, Panama**	**Philippines**
Jun-19	**Guatemala, Latvia**	**Guatemala**	-
Jul-19	-	-	-
Aug-19	-	-	-
Sep-19	-	-	-
Oct-19	**Argentina, Uruguay, Bolivia, Mozambique**	**Greece, Ukraine, Argentina, Uruguay, Bolivia, Mozambique**	**Argentina**
Nov-19	**Tunisia**	**Israel, Poland, Tunisia**	-
Dec-19	**Romania**	-	-

Source: UBS Asset Management, Eurasia, Wikipedia.
Note: Sub-Saharan Africa, Asia, Europe, Middle-East & North Africa, Latin America

Argentina's asset prices had very mixed behaviors in 1Q. Credit spreads, rates and FX rallied in January together with the rest of EM, only to sell off in February and March reflecting the significant drop in economic activity and its highly negative consequences on the popularity of the reformist government ahead of elections in October. In 1Q, Argentina USD denominated bonds returned 6.9% but local debt returned -10.5% as FX weakened 13.2% in March. The October election will continue to drive market volatility in Argentina as the outcome remains binary: Either the current administration wins and continues with the adjustment program or the opposition wins and all bets are off.

Turkey's asset prices were also impacted by the local elections on 30 March. Markets grew increasingly nervous about the potential election outcomes, while locals dollarized their portfolios further. As a result, the currency came under severe pressure ahead of the elections, forcing the central bank to take counter measures that lifted interbank rates as high as 1,200%. In the event, the AKP lost the mayoral race in Ankara and several Mediterranean cities and, at the time of writing, is behind the opposition candidate by a small margin in Istanbul. However, overall, the governing AKP party and their allies retained 51.5% of the popular vote, down 2ppts points from the 2018 election.

In contrast, markets remained calm ahead of the presidential elections in the Ukraine on March 31st. This was because it was expected that there were not going to be any winners in the first round and that pro-west and pro-IMF program candidates were going to make it to the second round on April 21st. In the event incumbent president Poroshenko and outsider candidate Zelenskiy made it to the runoff. The real test will come in October when a new parliament (Rada) will be elected.

Global dovishness helps EM valuations
EM FI asset prices rallied on DM central bank dovishness and on positive expectations on the resolution to the current world trade issues and China stimulus. If all of the above come to fruition, EM will benefit from the implied positive dynamics of a recovery in global growth and trade together with higher commodity prices.

In spite of the great rally in credit spreads during the 1Q, we believe there are still some idiosyncratic opportunities in credit. However we believe that most of the excess returns in 2Q will come from carry rather than from price appreciation. We also highlight that corporate spreads may offer interesting opportunities in 2Q as they lagged sovereign spreads so far this year.

With very few exceptions (Argentina, Brazil, South Africa and Turkey) EM rates rallied across the board in 1Q, following the dovish global monetary stance and the significant rally in DM rates. There may be opportunities in the countries that lagged the rally because of idiosyncratic issues but generally speaking rates are at or close to fair value. Were DM rates to sell off on better economic data and/or resolution of uncertainties, EM rates could follow, detracting from performance in 2Q.

The performance of EM FX in 1Q was mixed and driven by idiosyncratic factors amidst a lack of sponsorship from the USD, which strengthened vs the Euro and on a trade weighted basis. EM FX is unlikely to rally significantly unless global risk appetite recovers and USD depreciates. If we are right and most of the current uncertainties are resolved in 2Q, then we expect FX to perform better but with high volatility driven by high event risk in DM and EM. If the situation in Argentina, Brazil, Turkey and South Africa improves, we could see significant rallies in their currencies in 2Q.

It is too cold in the world now
We started the year with a constructive stance based on cheap valuations across the board and a not-too-cold-not-too-hot baseline scenario when it comes to the global economy.

Our optimistic views were based on the following main pillars:

1. Trade wars subside
2. DM growth stabilizes
3. Commodity prices recover and stabilize

So far only the third condition has been satisfied, while we remain in wait and see mode on the first condition, and have gone in the opposite direction on the second condition.

Regarding the first condition, we still believe that there are enough incentives for both the US and China to reach an agreement given the macroeconomic and financial costs that both parties may endure in the case of an escalation. However, we also acknowledge that negotiations are likely to be tough and that further delays are possible.

Regarding the second condition, US growth slowed down as expected but European growth slowed down a lot faster than expected. European growth was affected mainly by China's slowdown but also by poor generalized sentiment, in part driven by ongoing discussions about Brexit. This growth dynamic has had a negative impact on the Euro, limiting the expected strengthening versus the USD in 1Q. A benign resolution to Brexit (soft Brexit) could change the Euro dynamic in 2Q, thus benefit EM FX.

Given the more recent global dynamics and DM central bank actions in 1Q, we now believe the FED, ECB and BOJ will not hike rates and/or tighten policies at least until 4Q. We also believe that duration management will be of more relevance after the recent rally in DM rates. This is because in a scenario in which (1) – (3) come to fruition; expectations of higher global growth in 2H will likely push rates higher.

The main risk to the above scenario continues to be a negative outcome to the China-US trade negotiations. This is because, as observed during the past few quarters, protectionism is likely to have a detrimental impact on global growth and trade. In this downward scenario, EM asset prices could fall further.

Finally, valuations in credit are no longer as compelling as was the case in 4Q 2018 as the rally has largely priced in a benign resolution of the ongoing trade conflicts. EM rates have already rallied quite substantially almost everywhere and could get negatively impacted if DM rates sell off. EM FX is unlikely to strengthen as an asset class until risk appetite improves and USD weakens. **(Federico Kaune)**.

Sovereign debt: What next after a strong start

Sovereign credit posted an impressive 6.95% return in 1Q (measured as JP Morgan EMBI Global Diversified), although most of the performance (4.4%) was added in January. February and March contributed as well, but increasing uncertainty and declining UST yields played a more prominent role than spread tightening. 10y UST yields declined by around 28bp while spreads tightened by 64bp in 1Q.

After a difficult close to 2018, investor's sentiment improved strongly in 2019. First, concerns that the FED was going to continue hiking rates subsided after Governor Powell's dovish statement and no hike in January. Second, optimism increased around key US-China trade talks in January although since then, progress has been limited and optimism is fading. Third, the overall more positive market tone boosted commodities, with oil prices up over 30% in 1Q, supporting the performance of commodity-exporting nations.

Flows into USD denominated debt (sovereign and corporate credit) were robust reaching over $27.4 billion, the strongest start into a year ever. Sovereign primary market remained healthy at $52.4 billion pricing in 1Q.

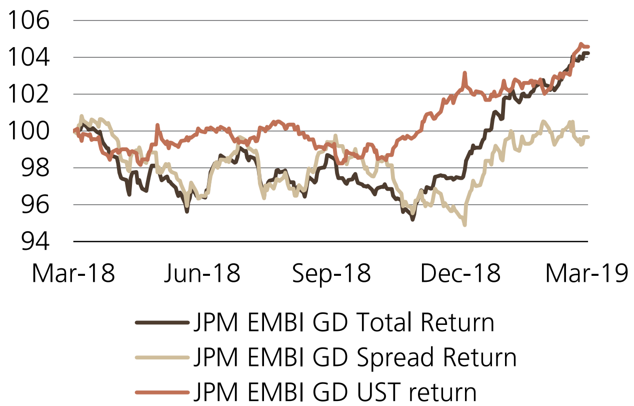
During 1Q, Africa posted the highest returns at around 9.6%, followed by Latin America (8.5%), Middle East (6.8%) and Asia (5.8%). Eastern Europe returned only 4.2%, limited by a slowing EU economy, ongoing concerns on additional sanctions (Russia) as well as idiosyncratic developments (Turkey).

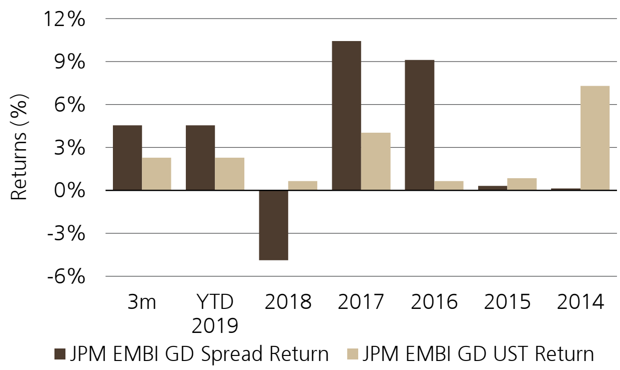
Nearly all countries contributed positively to performance. Only Mozambique (-8% due to the unaddressed economic weaknesses and mounting debt burden) and Turkey (-0.8% mainly triggered by economic and political volatility towards the end of 1Q) detracted from performance. Venezuela drove performance due to a glimmer of hope of political changes initiated by the opposition of the President of the National Assembly Juan Guaido against Maduro. With that, Venezuela posted an impressive 30% return in 1Q. Ecuador profited from a newly released IMF program and performed at 15.3%. Strong performance also came from African countries supported by stable metal prices (zinc, copper, iron ore) as well as oil-/gas prices. In that context, Kenya (+14.5%), Nigeria (+14.4%) and Angola (+13.5%) profited most.

At around 350bp for the EMBIGD, sovereign spreads seem to offer fair value and still attractive carry for a low yielding global environment. However, a further spread tightening would require more clarity on some of the existing uncertainties: US-China trade, global monetary policy, global – and in particular China – growth rates. In this context, we expect a range-trading in USD sovereign debt, favoring a carry strategy in 2Q. Spread widening to around 400bp should trigger an increase in risk exposure. **(Uta Fehm)**.

Sovereign debt: 1Q completely eliminated the negative performance

(Rebalanced to 100 as of March 31st, 2018)





Source: JP Morgan monitor, March 31st, 2019

Corporate debt: Valuations tighten as tailwinds ease

EM corporate credit provided robust 1Q returns of 5.34% (measured as JP Morgan CEMBI Diversified) providing positive returns in each month. Corporate credit spreads tightened by 40bp this quarter providing 3.55% of the 5.34% quarterly return backed by spread tightening from both high grade and high yield, while the US interest rate rally contributed 1.73% to the quarterly return.

Corporate bonds in Zambia (12.03%), Ukraine (10.21%), Indonesia (8.67%), Macau (8.24%), and Ghana (8.03%) provided the largest positive returns while the largest underperformers stemmed from Jamaica (-10.54%), Kazakhstan (1.74%), Turkey (1.79%), Jordan (1.81%), and Bahrain (2.35%).

From a sector perspective, real estate (8.58%), consumer (6.59%), and metals & mining (6.57%) provided the largest positive returns while the undeforming sectors were financial (3.84%), telecoms (4.79%), and diversified (5.07%).

After multiple rounds of market volatility last year, EM corporate credit began the year with very attractive valuations. This coupled with a switch in US Federal Reserve Policy (from hawkish to dovish) and increased optimism on trade negotiations between China and the US helped fuel the rally to start 2019. Similar to sovereign debt, during 1Q all regions provided positive total returns. The largest outperformers in total return were from Africa and Asia with Europe lagging in both total return and spread return. Corporate fundamentals continue to improve as reflected in lower leverage and earnings growth in most sectors and regions.

On the supply side, corporate issuers in Asia took advantage of the positive market sentiment and were able to relieve some of the funding pressure that has led to concerns in previous years. For the rest of 2019 we expect net corporate issuance to be negative (new issuance less coupons and amortizations) and continue to be driven by refinancing over capex and M&A. The largest variables in the supply outlook continue to be issuance from China and the Middle-East.

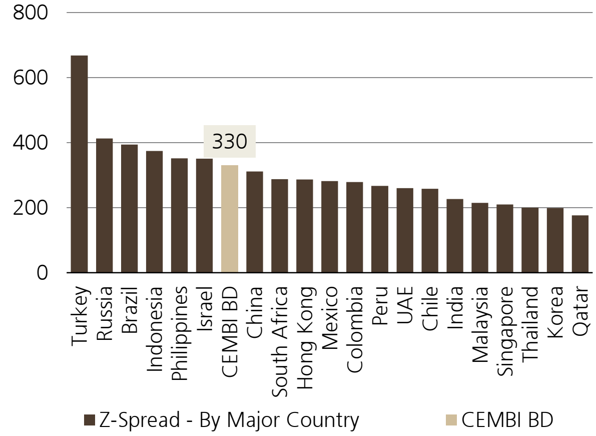
Value can be found in deleveraging high yield issuers, investment grade credit that has lagged the US Treasury rally, as well as new issuance. On the other hand, caution is warranted in Turkey where we expect to see continued volatility, economic slowdown, and stress on financial institutions and domestic oriented businesses.

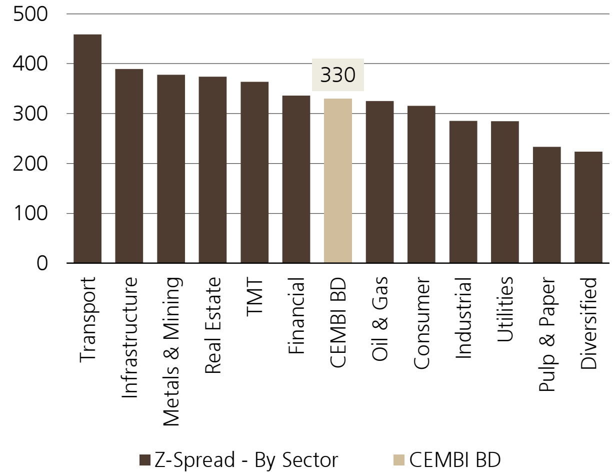
In China, the caution in 2018 due to a slowdown in economic activity and high leverage metrics now are benefiting from market access, stimulus, and policies measures direct toward the domestic market. Chinese real estate has benefited greatly from this uplift, but given current levels we see limited upside. Further, we keep our positive stance toward systemically important state-owned enterprises in China.

Risk appetite in emerging markets credit continues to be driven by headlines. We continue to monitor trade negotiations between the US and China, Mexico's inconsistent messages to the market, Argentina's political uncertainty in an election year, additional sanctions on Russia and political headlines in Turkey. **(David Michael)**

Corporate Spreads: Driven by politics

(Measured in bps as of March 31st, 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, March 31st, 2019

Local debt: heavy lift

EM local debt (measured by JP Morgan GBI-EM Global Diversified index) showed a 2.92% return in 1Q following a difficult 2018. The positive performance in 1Q was highly uneven, and the mirror image of the performance in Q4: Argentina and Turkey once again underperformed on rising political risk and incomplete macro adjustment.

Commodity-driven currencies shined with Chile, Colombia, Indonesia, Mexico, Peru and Russia performing well. Volatility has remained high, but without the series of large global draw-downs of 2018. The positive performance in local markets, concentrated in January, was helped by the recovery in DM equities and credit, while the rally in UST in March benefited local rates, but not currencies.

The outlook for 2Q depends on the interplay between the supportive global factors (with tail risks), and persistent political noise and/or fundamental imbalances in virtually all major EM countries. We expect the Fed to stay put this year and the US/European growth to rebalance, leading to bottoming out of UST yields and weaker USD. This environment warrants a positive, but cautious bias, in EM currencies and higher-yield rates for 2Q. Significant global tail risks remain largely related to further growth slowdown in China, Europe or the US.

In Latin America, we find Mexico at risk on fiscal/monetary policy as well as trade uncertainty (the USMCA trade agreement yet to be ratified in Congress). The Brazilian assets have disappointed as the Bolsonaro administration relationship with Congress has deteriorated ahead of the needed fiscal reforms. We expect the administration to compromise and keep the legislative agenda in place. In Argentina, Macri's popularity is falling as the economy deteriorates and the presidential elections loom in October. Commodity-linked Peruvian and Chilean markets have performed well, and are poised to do well if commodities continue to rally.

In EMEA, Turkey remains the key market to watch. Following the collapse of the Turkish Lira last August, the government allowed higher interest rates and seems willing to tolerate lower growth. However, fiscal spending has increased ahead of the local elections at the end of March. Performance of Turkish bonds hinges on the government's ability to switch to prudent policies in the aftermath of the elections and avoid tensions with the US.

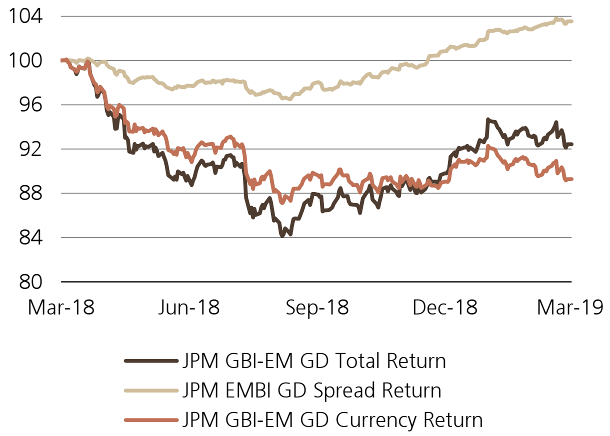
In South Africa, the economy remains weak and struggling SOEs are a continuing drag on fiscal resources, but the key driver for 2Q will be Parliamentary elections on 8 May, where we expect President Ramaphosa to consolidate his mandate. The conclusion of the Mueller investigation reduces the urgency for the US Congress to impose additional sanctions on Russia. However, the sanction risk remains due to US-Russia tensions in geopolitical hot spots, and ruble valuations are not particularly attractive.

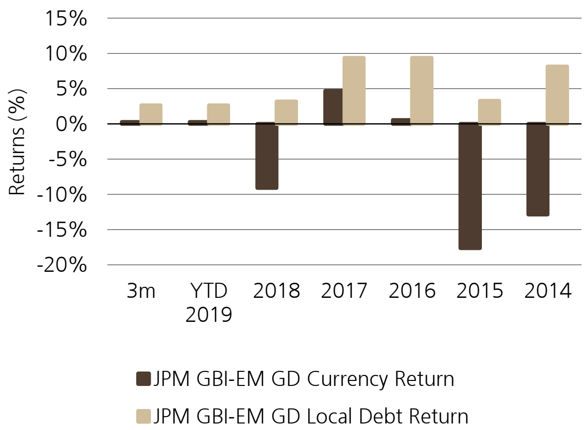
Central Europe has been enjoying high growth rates and some insulation from boarder EM weakness, despite the slowdown in the Eurozone. Tight labor markets, low policy rates and domestic-demand driven growth is a recipe for higher inflation and higher bond yields. With a weak starting point in the EUR, the regional currencies are at attractive levels, in our view, but will largely depend on the sentiment toward the EUR and the outlook for Brexit. CE3 interest rates have rallied in tandem with the D3 rates, and bonds look expensive to fundamentals. Following a period of volatility in 2018, APAC currencies have been range-bound after the CNY stopped depreciating.

However, the continuing trade negotiations have affected sentiment, while valuations are not particularly attractive. That said, there appears to be pockets of value in high-yielders such as Indonesia, and the APAC currency block would greatly benefit from a potential settlement between China and the US on trade. General elections in April could lead to volatility in India, while a re-election of Indonesia president and policy continuity is likely.

The main risks to the outlook are stemming from weak global growth and a flaring up of political risk in EM. **(Igor Arsenin)**.

Currency returns: more sensitive to economic and political shocks (rebalanced to 100 as of March 31st, 2018)
(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, March 31st, 2019

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