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Cross currents bring risks and opportunities in Q1 2022

Emerging markets fixed income
UBS Asset Management

Emerging Markets Fixed Income
Q4 2021 review and Q1 2022 outlook

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The views expressed are a general guide to the views of UBS Asset Management as of December 2021.

Market overview

Q4 2021: Further negative performance on Omicron

- Emerging markets fixed income (EM FI) delivered negative total returns in Q4, mainly reflecting the latest pandemic wave.
- As in Q3, spreads widened driven by high yield spreads while EM currencies (EMFX) sold off reflecting a strong USD; rates widened on higher EM inflation.
- EM asset performance in Q1 2022 will largely depend on pandemic developments and global policy responses.

EM FI showed negative total returns across all asset classes in Q4 2021. Sovereign (corporate) credit spreads as measured by the EMBIGD[1] (CEMBID[2]) widened by 12 bps (3 bps) in Q4 to 369 bps (302 bps) generating a -0.55% (-0.53%) spread return (inclusive of carry). The US Treasury (UST) yield curve flattened with the 2Y (10Y) selling off 15bps (2bps) and the 30-year rallying 14 bps. These US Treasury (UST) yield moves detracted slightly from total credit return performance, particularly in the shorter duration CEMBID. Most of the negative returns occurred in November when the first signs of Omicron, a highly contagious new COVID-19 variant, appeared in South Africa and affected risk taking. The full year spread return in sovereigns (corporates) reached 1.60% (2.40%), an extremely benign result given the array of shocks that impacted EM FI in 2021. The significant sell off in UST yields in 2021detracted from total credit returns.

Q4 2021 returns[3]

	Total return	Spread return	US treasury return
JP Morgan EMBI Global Diversified	-0.44%	-0.37%	-0.07%
JP Morgan CEMBI Diversified	-0.67%	-0.53%	-0.15%

	Total return	Currency return	Local debt return
JP Morgan GBI-EM Global Diversified	-2.53%	-1.68%	-0.88%
JP Morgan ELMI+	-0.95%	-1.70%	0.77%

Source: Data as of December 31, 2021. Bloomberg Finance.
Past performance is not a guide to future results.

2021 returns[3]

	Total return	Spread return	US treasury return
JP Morgan EMBI Global Diversified	-1.80%	1.60%	-3.34%
JP Morgan CEMBI Diversified	0.49%	2.40%	-1.86%

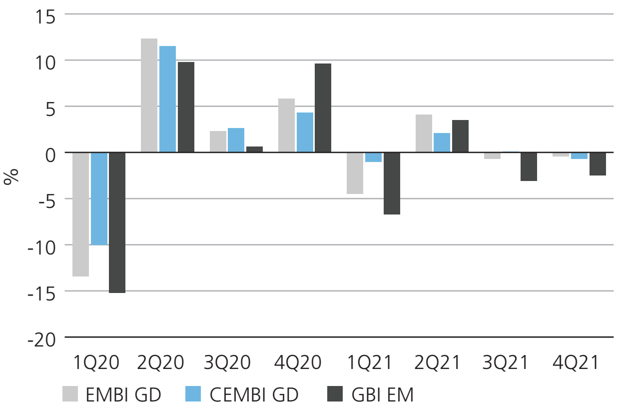
	Total return	Currency return	Local debt return
JP Morgan GBI-EM Global Diversified	-8.75%	-6.00%	-2.92%
JP Morgan ELMI+	-3.09%	-5.58%	2.64%

Source: Data as of December 31, 2021. Bloomberg Finance.
Past performance is not a guide to 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 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.

Continuing with the trend in Q3, local yields (as measured by the GBIEMGD[4]) widened 42 bps in Q4, reflecting the impact of higher inflation and tighter monetary policy in EM, and returned -0.88% inclusive of carry. Higher monetary policy rates could not offset the impact of a stronger USD and as a result EMFX sold off 1.68% in Q4. In all, the local index returned -2.53% in Q4. For the full year, local rates widened 150 bps returning -2.92% inclusive of carry, while EMFX returned -6.00%. Overall, the local index returned -8.75% in 2021.

Exhibit 1: Quarterly returns



Source: Data as of December 31, 2021. Bloomberg Finance.
Past performance is not a guide to future results.

4 As measured by the JP Morgan GBI-EM Global Diversified index

Seasonal slowdown in flows and issuance

According to the latest J.P. Morgan survey, EM FI attracted USD 0.3 billion of new investments in Q4, after recording USD 4.7 billion of inflows in Q3 2021. Sovereign and corporate credit saw inflows of USD 4.2 billion in Q4 adding to the USD 1.8 billion inflow in Q3, while local EM (currency and rates) saw outflows of USD 3.9 billion in Q4 after seeing inflows of USD 2.9 billion inflow in Q3 2021.

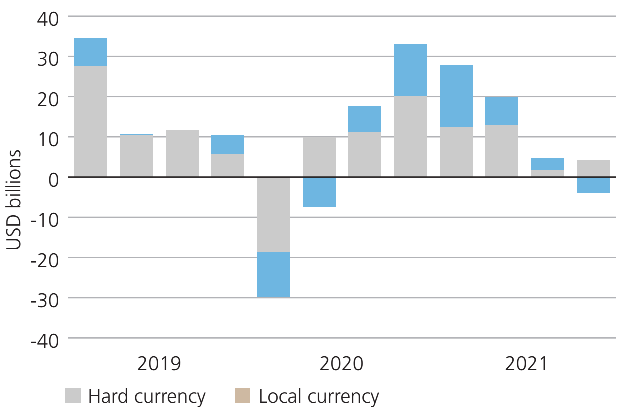
Emerging markets debt issuance slowed in Q4, while supply continued to be led by investment grade (IG) credits. Sovereign and corporate issuance in Q4 2021 reached USD 33.5 billion and USD 122.6 billion, respectively. Amortization and coupon payments reached USD 28.3 billion for sovereigns and USD 106.4 billion for corporates.

2021 high growth almost everywhere

Overall, DM growth is still outpacing EM growth. Regarding the impact of the pandemic, the new highly contagious Omicron variant had a severe impact on markets when it appeared in November, but subsequent findings - mild symptoms and high vaccine effectiveness - suggest that its impact on global economic activity should be slightly negative but not likely to derail the global recovery.

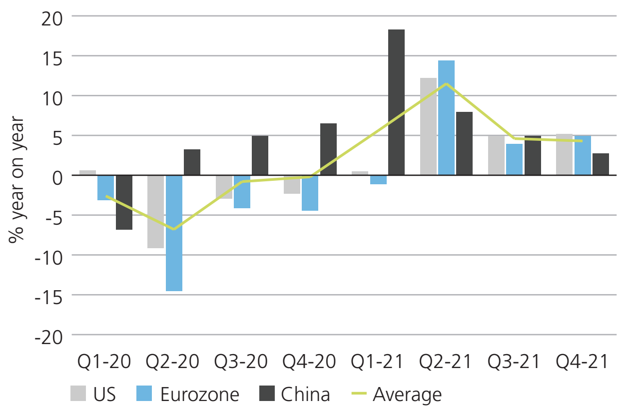
On a broader perspective, DM real GDP growth rates in 2021 were the highest in several decades. At the expected 5.9% in 2021, US growth was the highest since 1986. At the expected 5.1%, Eurozone growth was the highest ever recorded since its formation. With such results, these two main world centers grew faster than the majority of EM, except for China (8%) and India (9.3%), among the large EM countries.

Exhibit 2: Inflows for USD debt, outflows for local debt in Q4 (USD billion)



Source: JP Morgan, UBS Asset Management. As of 31 December 2021

Exhibit 3: Real GDP growth US, Europe and China (% y/y)



Source: UBS IB, UBS Asset Management. As of 31 December 2021

2021 was also the year of inflation rebound

Developed market policymakers, particularly the Fed, ECB, and Bank of Japan, spent 2010s trying to steer inflation higher and warning about the dangers of "secular stagnation." As the saying goes, 'be careful what you wish for'. The best indicator of the inflation pressure or the lack thereof is probably a wide basket of commodities, for example, Bloomberg Commodity Index. It fell 58% from April 2011 to January 2016 and then remained broadly unchanged until COVID-19 hit in early 2020 after which a big rally began.

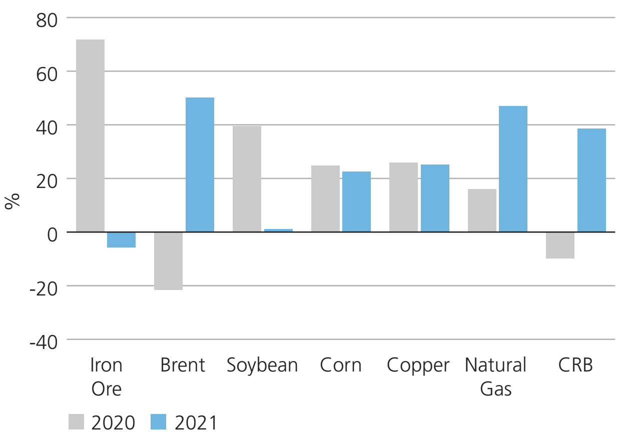
While the index was unchanged in 4Q2021, there was a big variation in the 4Q performance of individual commodity prices. Nickel and coffee futures gained more than 14%, while natural gas futures lost more than 30%. Most importantly, however, 2021 was the best year for the Bloomberg Commodity Index since 1979.

Given this massive increase in commodity prices it is probably not surprising that DM average inflation, which ended 2020 at 0.3%, close to all-time lows, was at 4.1% by November and is likely to end 2021 at the highest level since 1991. The increase was led by the US followed by Spain and Ireland while 2021 inflation remained below 2% in Japan and Switzerland.

Central banks in the developed world have already started to respond to these inflation prints. While the average G10 policy rate was 0.04% – the lowest level in history – in December 2020, one year later it had increased to 0.15% due to 4Q hikes by the UK, Norway, and New Zealand. Moreover, G4 central banks have across the board began to reduce their asset purchases.

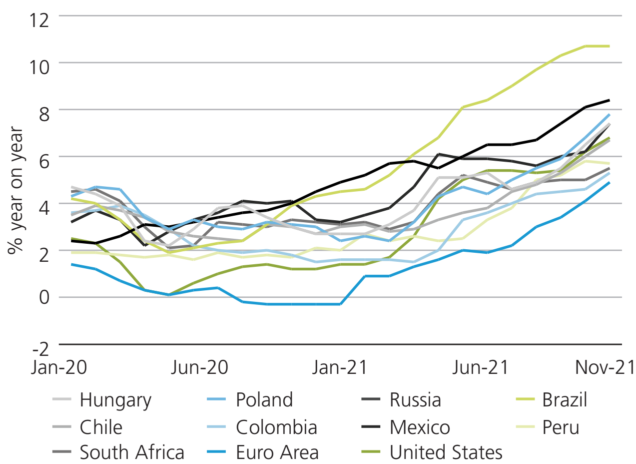
Emerging markets followed the same pattern as developed markets. The average EM inflation ended 2020 at 2.5%, close to its all-time low 1.9% in May 2020, had increased to 5% by 3Q2021, and by November 2021 had reached 5.9%, the fastest increase in prices in 13 years. By November, the headline inflation was above 20% in Turkey, above 10% in Brazil, around 8% in Russia and Poland, and around 7.4% in Hungary and Mexico.

Exhibit 4: 2021 Commodities price changes (%)



Source: Bloomberg, UBS Asset Management. As of 31 December 2021

Exhibit 5: Monthly CPI Inflation (yoy)



Source: Bloomberg, UBS Asset Management. As of 31 December 2021

The big difference between EM and DM is that EM central banks don't have the luxury of waiting to shoot until they see the whites of inflation's eyes. The average EM policy rate fell below 2% for the first time ever in August 2020 but by December 2020 it has already been increased 50bps to 2.4% and the pace continued in 2021. By September 2021 the average policy rate was 2.9% and by year end it was 3.5%.

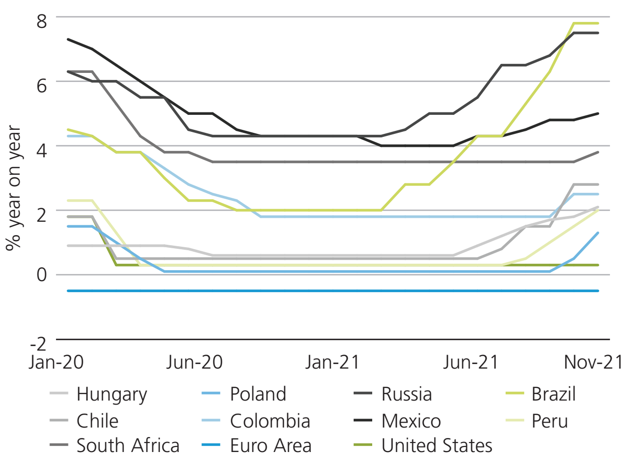
The most aggressive hikers in 4Q2021 were Brazil and Czech Republic by 300bps each, Chile by 250bps, Russia by 175bps, and Poland by 165bps. In Turkey, President Erdogan doubled down on an economic path predicated on lowering inflation by lowering interest rates 400bps in Q4. The Central Bank cut rates as inflation was increasing generating a run on the Lira. The Lira depreciated 85% before the Treasury committed to guaranteeing the value of Lira deposits. In all the Lira depreciated a massive 50% in Q4 and inflation printed 36.1% in 2021.

Geopolitics and elections in Q4: Not good

China-US and Russia-Ukraine-US relations made the news in Q4. In October President Biden's statements put into questions four decades of "strategic ambiguity" US policy towards Taiwan. China was quick to react and warned that China would be "compelled to take resolute measures" should Beijing be provoked by "separatist forces" in Taiwan. Relation between the two countries remain frigid, more so after the US confirmed they will diplomatically boycott the winter Olympics in Beijing. Also, during Q4, Russia started a second buildup of military forces at the Ukraine border. Russia wants the west to provide "legally binding security guarantees" that Ukraine will not be part of NATO. The US and European allies were quick to react and warned Russia that an invasion of Ukraine would carry severe economic sanctions. The situation in the Russia-Ukraine border remains fluid.

In Chile, radical left candidate Boric won the runoff by a significant margin (56%-44%) against radical right candidate Katz. President-elect Boric, a 35-year-old former student protest organizer, has promised to dismantle Chile's economic model put in place by a group of University of Chicago trained Chilean economists in the early 1980s -the so-called Chicago boys. The economic model generated the highest growth rates and the lowest poverty levels in Latin America in the past 40 years.

Exhibit 6: EM central banks are hiking rates



Source: Bloomberg, UBS Asset Management. As of 31 December 2021

Exhibit 7: 2022 EM election calendar

February	Costa Rica General
March	South Korea Presidential Colombia Parliamentary
April	Costa Rica Presidential Serbia General Hungary General
May	Colombia Presidential Philippines General Lebanon Parliamentary
July	India Presidential
August	Kenya General Angola General
Fall	China 7th Plenum and 20th Party Congress
October	Brazil General
December	Tunisia Parliamentary

Source: UBS Asset Management. As of 31 December 2021

China: Easier policies in Q4

China's growth slowed down to below 3% year-on-year in Q4 2021 on the back of the severe slowdown in the property sector. Acknowledging the impact of the slowdown in the property sector on the broader economy, the Central Economic Work Conference (CEWC) that took place on 8th-10th December, sent a clear easing signal for macro policies and the property sector.

Policymakers announced policy stimulus measures in Q4 to confront the impact of the severe slowdown in the property sector on the broader economy and avoid a property sector-led hard-landing. On the fiscal policy side, the government continued to direct local governments to frontload bond issuance and speed up infrastructure spending, while reducing the tax burden to support the economy. On the monetary policy side, the PBoC delivered an across-the-board RRR cut, a targeted relending rate cut and a LPR cut. These measures are likely to gradually stabilize the property sector in coming quarters.

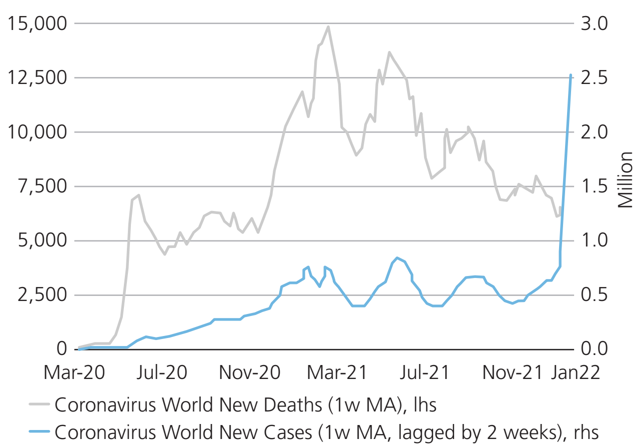
The government stepped away from more direct measures to support the property sector and reaffirmed their view that housing is for living and not for speculation. As such, the property sector experienced a further downturn in Q4 with several private sector developers defaulting on their domestic and external obligations.

2022: A year of high but declining growth and inflation in DM

We start 2022 with what is likely to be a temporary negative impact of Omicron on global growth, and concerns about global inflation and the likely policy response from DM central banks. Consensus forecasts for 2022 suggest that the US and Eurozone will grow at an annual rate of about 4%, while inflation will be around 2.5-3.5%. Furthermore, the path of both growth and inflation is a declining one. Growth in both regions would be below 3% by end 2022 while inflation will below 2.5%in the US and 1.5% in the Eurozone, or closer to long terms averages.

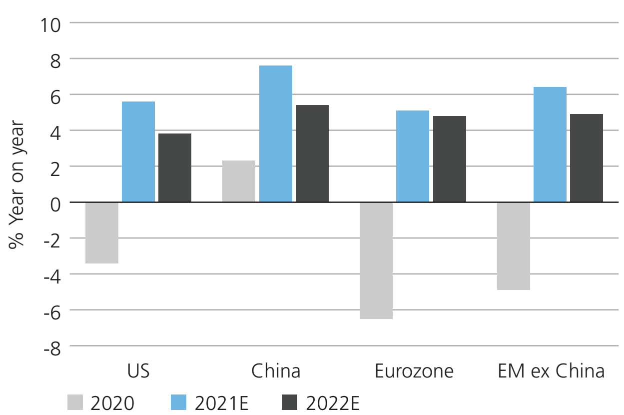
In all, private and official economic forecasts indicate that inflation in the US and Europe peaked in Q4 2021, was temporary albeit longer in nature, and will be back to close to long term averages by the end of 2022. They also indicate that the US and the Eurozone will be growing fast (albeit at a declining pace) and way above potential in 2022. To keep perspective, the US and the Eurozone represent about 40% of the world's GDP, more than enough to compensate for lower growth in China (15%).

Exhibit 8: World covid infections and deaths



Source: Macrobond, UBS Asset Management. As of 31 December 2021

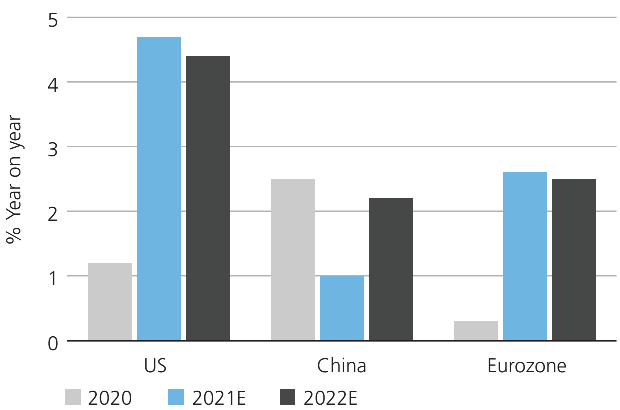
Exhibit 9: High but declining growth in 2022 (yoy)



Source: UBS IB, UBS Asset Management. As of 31 December 2021

Yet, the necessary and healthy reduction of DM central bank's unprecedented monetary stimulus, has the markets in turmoil as we start the year. FOMC December minutes indicated that the Fed may be willing to engage in quantitative tightening (QT) if inflation fails to come down, besides hiking rates. Markets are now (probably correctly) pricing in three 25 bps hikes in 2022. The ECB has also made hawkish statements, stating that they are prepared to withdraw stimulus and hike rates if inflation remains high, yet markets are pricing in a meager 12.5% hike to less-negative rates in 2022. Nonetheless, this is a welcomed change of stance from both major DM central banks, as monetary expansion without concerns on fiscal budget constraints can't go unchecked for long without inflation picking up. The most urgent task for DM central banks is to cut the potential inflation-wage spiral that could follow if inflation expectations remain high.

Exhibit 10: Converging inflation in 2022 (yoy)



Source: Bloomberg, UBS Asset Management. As of 31 December 2021

China goes for stable economic growth in 2022

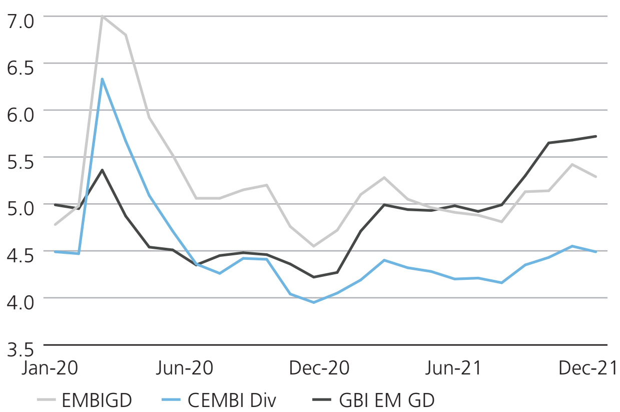
As per the CEWC statements in December, stable economic growth in 2022 and 'common prosperity', green development and new economy and innovation will continue to be the prominent themes for China's high-quality development strategy in the medium-term. The government will continue to support steady economic growth with lower social inequality.

We believe China could grow between 4-5% in 2022 in a recovering path from low growth in Q1 (below 3% due to property sector pressure) to higher growth in Q4 (above 5%). China has been able to keep inflation under control and contrary to the US and the Eurozone should be able to implement easier monetary and fiscal policies in 2022 in our view. Furthermore, China's fiscal policy in 2021 was very cautious, offering room for more fiscal expenditure in 2022. Overall, we expect more RRR cuts following the recent cut in December, no policy rate cut but lower actual funding cost (partly thanks to recent 5bp LPR cut), and a modest credit easing in H1 (we expect total social financing growth at 10-11% in 2022). We also expect a slightly higher headline deficit but more efficient and earlier use of fiscal funds, and a rebound in infrastructure investment in 2022. We expect more modest property easing to come, but don't expect a 2015-16 style aggressive stimulus. In addition, the CEWC called for a pragmatic push for decarbonization and common prosperity.

EM growth slow to recover on tight policies

EM growth (excluding China and India) is likely to remain relatively subdued for yet another year. This is because EM countries do not enjoy the benefit of having a reserve currency and thus can't implement DM like expansionary policies without hitting external and/or domestic budget constraints sooner rather than later. EM is going through a period of high inflation brought about by high world food and energy prices (unintended consequence of expansionary DM policies) together with the impact of weaker exchange rates on tradable goods inflation. Most EM central banks have turned hawkish and are hiking rates, while EM governments are no longer able to increase fiscal stimulus given their budgetary and financial constraints. Contractionary macroeconomic policies are likely to have a negative impact on EM growth in 2022.

Exhibit 11: Higher yields across EM asset classes



Source: Bloomberg Finance. As of 31 December 2021

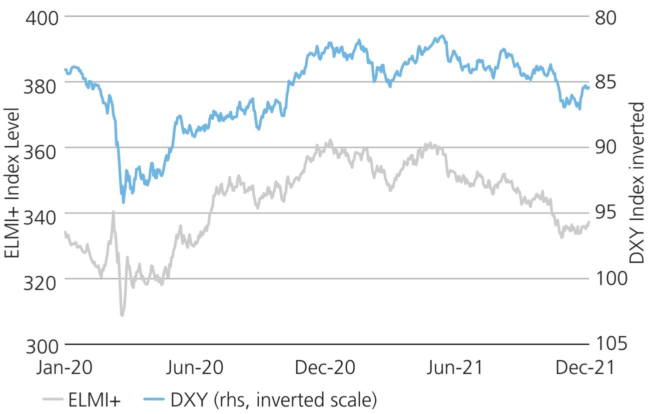
2022: Mostly a carry year for EM

We expect the main world economic centers to grow at a healthy pace in 2022, with lower/stable inflation (US, EU/China) as the year goes by. As growth in DM converges toward potential from above, growth in China should increase towards their medium-term goal of 5-6%. High (albeit declining) growth in DM and recovering growth in China should continue to support trade volumes and commodity prices in 2022. Furthermore, the impact of the pandemic is likely to be temporary, although it could generate some anguish in Q1. Finally, global supply chain bottlenecks are dissipating as per the latest figures. Global growth, global trade and commodity prices are amongst the most important global factors affecting EM economies and influencing EM asset prices (see Juha Seppala's analysis nearby), and we expect all off them to behave well in 2022.

The main risk is once again DM yields, but we believe the risk is much lower than it was at the beginning of 2021. Back then we argued that global macroeconomic fundamentals looked strong but that global DM yields were too low and could raise hurting total returns. UST10yr yields were close to 1.00% at the beginning of 2021 and are now at 1.75%. Mind you, DM inflation is a lot higher now and DM rates a lot more negative in real terms, but if consensus and official forecast are correct and inflation and growth declines toward 2.5% by the end of 2022, any potential UST yields sell off would likely be capped by these longer-term anchors. We expect UST10yr yields to trade in a wide range of 1.50% (growth scares) -2.25% (inflation scares) in 2022 with a central expectation of 2.00% by year-end. That is 25bps from current levels, or very manageable. However, there is a scenario where higher wage pressures keep inflation high as labor markets keep recovering, prompting the Fed to hike rates as soon as March 2022 and by more than the 75bps that markets are expecting. In that scenario, riskier asset markets could sell off significantly in H1, replicating the taper tantrum of 2013.

We expect 2022 to be mainly a carry year for EMFI, given the cross currents expressed above. This is not bad at all given the current low yield environment. Sovereign (corporate) credit yields 5.5% (5.0%); local debt yields 6% and EM FX has an implied yield of 8%. If UST yields remain in the 1.5%-2.25% range and spreads/rates remain unchanged then EM credit could end up returning a 4.5%-5.5%. However, there is ample scope for HY names to tighten in 2022, which would boost returns further. For example, China and Asia HY failed to deliver in Q4, but remain one of the most enticing opportunities in 2022. If China HY starts tightening in response to the measures announced and implemented by the authorities in December, this could have a positive influence not only in the whole Chinese complex, but also on Asia HY and EM HY in general.

Exhibit 12: USD: An important driver of EMFX



Source: Bloomberg Finance, UBS Asset Management.
As of 31 December 2021

Regarding local bonds, the Fed is likely to begin its hiking cycle this year but the EM high yielders such as Brazil, where the terminal rate may exceed 12%, and Russia, where it may reach 9%, have room to cut rates when their inflation peaks. Low-yielders, particularly countries which haven't even started hiking yet – for example, Asian countries such as India, Indonesia, Malaysia, Philippines, Thailand – may not be as lucky. As such, we believe that local bonds could offer enticing opportunities from Q2 onwards.

Regarding EMFX, value has been restored following the depreciations but more importantly the interest rates: Implied yields are now enticing and more in line with historical levels. For EMFX to unleash its potential, USD will have to depreciate, and UST will have to remain relatively stable. We prefer idiosyncratic stories on EMFX in Q1.
(Federico Kaune)

Global factors and EMFI in 2022:
It is all about carry

Emerging markets fixed income (EMFI) is a high-beta asset to global factors. However, global factors often move in opposite directions. To assess how important these opposing trends are likely to be, we develop a framework to forecast annual changes in EM sovereign spreads, EM local yields and EMFX, including annual changes in six global factors: DXY, global export volumes (GXV), Bloomberg commodity index (BCI), US HY spreads, UST10yr yield, and the average policy rate in HY EM (Brazil, Mexico, Russia, South Africa, India, and Indonesia). DXY, GXV and BCI explain 80% of EMFX variations (excluding Turkish lira). For EM sovereign spreads and EM local yields, we add a factor which captures an EM-specific risk appetite or risk aversion. Fortunately, we already have one from the previous paragraph: EMFX. EMFX and US HY spreads explain 86% of the variation in EM sovereign spreads. Finally, EMFX, UST10yr yield, and HY EM countries policy rate explain 78% of the variation in local EM yields. It is worth mentioning that in all regression equations for all three asset classes all coefficients have the correct signs and are statistically significant at the 1% level (as a matter of fact, the absolute values of t-statistics of all independent variables in every regression are above 5).

The next step is to up come with reasonable guestimates for the global drivers in 2022 (from the perspective of an EM investor) for bull, base, and bear cases. The Fed is expected to begin the hiking cycle in summer 2022 and hike 2-3 times in the second half of the year. Interestingly, in the previous hiking cycles which started in 2004 and 2015, the UST10y yield, DXY, and US HY spreads all increased prior to the beginning of the hiking cycle and then decreased (that is, the UST10y yield rallied, DXY sold off, and HY spreads tightened). We expect a similar pattern to play out in 2022 but so that the net result is that the DXY is unchanged while US HY spreads and the UST10y yields increase about 50bps. Similarly, we expect the HY EM central banks to continue hiking in the first half and, once inflation turns, some of them will be able to cut rates so that the net result is only 70bps increase in the policy rate from the current level. We do not have a strong view on commodity prices. Hence our base case is that the BCI does not change (random walk forecast). It is worth noting that both the DXY and BCI have already appreciated significantly in 2021 while the UST10y yield, and US HY spreads are arguably quite expensive. Finally, the bull and bear case provide reasonable deviations from the base case.

The results are presented in the table below: EMFX depreciates 2%, EM sovereign spreads widen by 9bps, and EM local yield increase by 29bps in 2022. However, it is worth remembering the quite attractive starting point: EMFX carry is 7.5%, EM sovereign spread is 369bps, and EM local yield is 5.7%. These more than compensate for the possible capital losses in the base case and limit possible losses in the bear case. Furthermore, the returns in the bull and bear cases are quite asymmetric. The total return gains in the bull case are many times larger than the total return losses in the bear case. For example, for EMFX the total return (inclusive of carry) in the bull case is +10.1% while it is -1.8% in the bear case and +5.7% in the base case. Nonetheless, 2022 is likely to be an alpha rather than a beta year for EMFI. This is because the Fed hiking cycle is going to hurt low-carry EM assets while high-yielders such as Brazil, where the policy rate may exceed 12% in the first half of 2022, have room to cut when inflation comes down. Double digit carry means there is a significant buffer compared to the US rates at 1% or even 3%.
(Juha Seppala)

Global drivers and EMFI in 2022

		2021	EM Bull Case (30%)		EM Bull Case (50%)		EM Bull Case (20%)		Probably-weighted	
		Level	Level	Change	Level	Change	Level	Change	Level	Change
Global Factors	USD	95.67	90.89	-5%	95.67	0%	100.45	5%	95.19	-0.50%
	Global Export Volume	338	372	10%	355	5%	304	-10%	349.8	3.50%
	Commodity Index	99.17	109.09	10%	99.17	0%	89.25	-10%	100.16	1.00%
	US HY OAS	283	250	-33	350	67	450	167	340	57
	US 10y	1.51	1.0	-51	2.0	49	2.5	99	1.80	29
	HY EM Policy Rate	5.75	6.0	25	6.5	75	7	125	6.45	70
EM Fixed Income	EMFX	52.57	53.92	2.57%	51.61	-1.83%	47.67	-9.32%	51.51	-2.01%
	EMBI GD	369	325	-44	381	12	450	82	378	9
	GBI-EM GD	5.72	5.20	-0.52	6.15	0.43	6.88	1.16	6.01	0.29

Source: UBS Asset Management, Macrobond, and Bloomberg. Date as of December 31, 2021.
Note: EMFX is JP Morgan's EM FX index, DXY is a US dollar spot index, GXV is a UBS 31-country proxy for global export volumes, and BCI is the Bloomberg commodity index; EMBI = g(EMFX,USHY), where EMBI is the JP Morgan's EMBI GD sovereign spread and USHY is Bloomberg-Barclays US high yield options adjusted spread; and GBI = h(EMFX,US10,PR), where GBI is the JP Morgan's GBI-EM GD yield, US10 is the UST 10yr yield, and PR is the average policy rate of Brazil, India, Indonesia, Mexico, Russia, and South Africa, Russia.

Fiscal in Focus:
Outlook for fiscal adjustments in EM

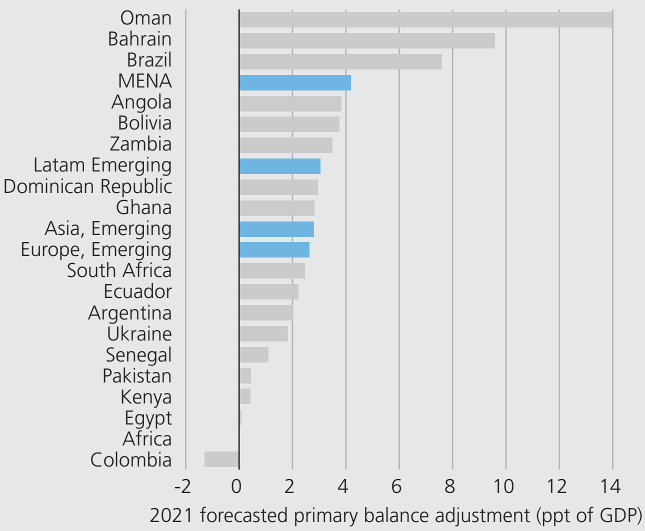
As countries recover from the pandemic after a record build-up in public debt, one of the factors that investors will be watching closely in 2022 will be how emerging markets successfully implement fiscal policy normalization. The last year's bounce-back allowed a cyclical recovery in fiscal revenue in EM, often supported by high commodity prices. In 2021 Latam (except Colombia and Chile), Sub-Saharan Africa and Eastern Europe saw modest improvement while Gulf Cooperation Council's (GCC) oil exporters and many commodity producers have seen significant improvements in their fiscal balances (see Figure 1).

Prior to the pandemic many of EM sovereigns already had high fiscal vulnerabilities. For the countries that had delayed carrying out necessary fiscal reforms, especially those below investment grade with high debt levels, 2022 would be critical to take their public finances back in order and re-build fiscal policy space as recovery slows and global financial conditions tighten. Countries like Pakistan, Ecuador and Costa Rica have received IMF support in pursuing structural fiscal reforms such as pension reforms, subsidy reforms, public employment, or wage reforms as the cyclical recovery alone would not be sufficient to see a return to pre-pandemic levels. However structural reforms remain politically and socially difficult to implement: a lack of political consensus on proposed fiscal reforms pose a significant risk to the planned fiscal path for countries like Ghana, Costa Rica and Sri Lanka although they are expected to continue to have a strong cyclical recovery, while upcoming elections (in case of Brazil, Colombia) or social tensions against new taxes (e.g. Dominican Republic) have prevented the governments from delivering long-term structural reforms. An economic slowdown in Brazil in 2022 could further increase the fiscal risks while a strong economic recovery in Dominican Republic and reforms in other areas have somewhat compensated for the failure to implement planned tax reforms.

In contrast, some EM sovereigns are expected to be supported by a strong cyclical recovery as well as better reform momentum – they are likely to maintain a tightening bias in 2022. Oman for example, has been supported not only by strong oil prices but also increased investor confidence as the government implement VAT and tackle reduce public wages, subsidies and defence spending. Similarly, Egypt is expected to continue its fiscal consolidation and reform agenda in 2022 however its large external financing needs could stand in the way.

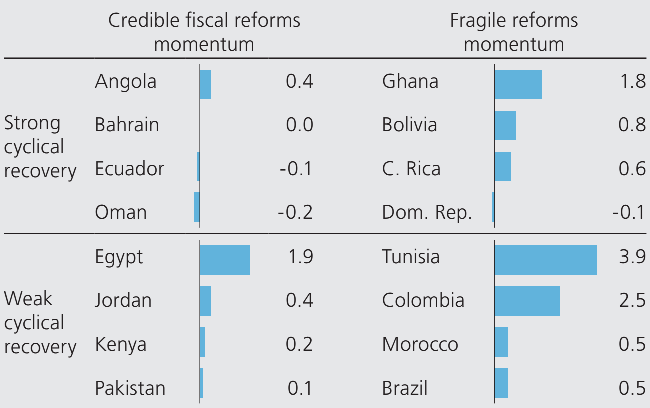
As such EM investors will focus on country-specific fiscal paths more closely and differentiate those with credible fiscal trajectories and effective structural fiscal reforms from those without (see Figure 2). It's noteworthy that for some countries, even with a strong cyclical recovery in fiscal balance, with fragile reforms momentum, their current spreads are wider by historical standards. As we progress into 2022 the ongoing pandemic, social demands, and political developments could change which category each country stands – those that can achieve credible fiscal reforms in the context of slowing growth and rising interest rates could see further spread tightening in 2022. *(Yuni Kim)*

Figure 1: Forecasted primary balance adjustments in 2021



Source: IMF, Macrobond, UBS Asset Management. Data as of 3 January 2022

Figure 2: Z-scores* of current spread over historical average in selected high-yielding EM sovereigns with debt levels above 60% of GDP



Source: Bloomberg, UBS Asset Management. Data as of 3 January 2022
*Z-score is defined as the difference between the current and the historical average spread of country-level index on EMBIGD divided by its standard deviation, calculated since 1/2012

Sovereign debt

Risk aversion hits returns

Sovereign credit posted a -0.44% total return in Q4 2021 (measured by the JP Morgan EMBIGD Index). Spreads widened 12 bps to 369 bps, generating a -0.37% spread return. US Treasury yields slightly detracted from performance.

Investment grade (IG) spreads tightened marginally, but high yield (HY) spreads widened by a significant 45 bps to 639 bps in Q4. As we have been arguing for a while, IG spreads have already converged to fair value, thus the small spread move is not surprising. However, the spread widening in HY makes HY even cheaper relative to its own history and to competing asset classes including US HY.

Performance was mixed across regions. South Saharan Africa and Europe showed double digit negative total returns, while the other regions had small positive total returns. Latin America had the highest returns (0.44%) followed the Middle East and North Africa (MENA) (0.40%) and Asia (0.29%).

In Latin America, IG credits including Uruguay (2.90%) and Mexico (2.34%) outperformed HY credits including Argentina (-1.26%) and Ecuador (-0.40%). Most of the negative action took place in November when risk aversion increased on Omicron and its potential impact on global growth and commodity prices collapsed (oil down 18% in November). The December recovery in commodity prices were not enough to turn around returns in HY names as the uncertainty surrounding Omicron lingered.

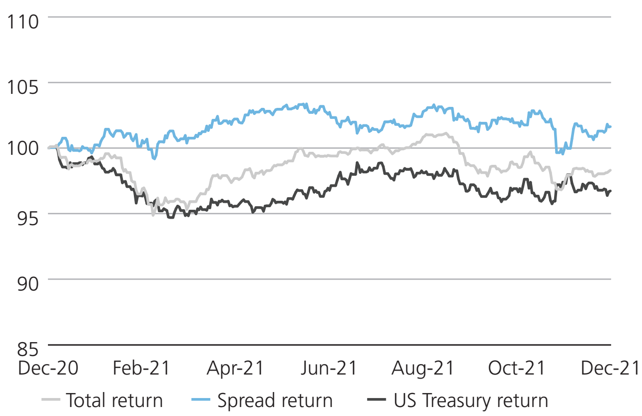
In MENA, Ethiopia returned -20% on political instability, while Lebanon also collapsed -39.14% on further failures to advance reforms. On the positive side, Oman returned 2.47% reflecting strong oil prices but also increased investor confidence as the government implement VAT and tackle reduce public wages, subsidies and defence spending. In Asia, Sri Lanka returned -13.97% on lower tourism (Omicron) and as international reserves declined to a minimum threshold level, putting in doubt their capacity to service debt in 2022. Furthermore, the authorities are resisting engaging with the IMF.

In Europe, Belarus continued its slow descent and returned -4.82% on further political issues and sanctions from the west. Ukraine showed a highly negative 9.91% total return as the border crisis with Russia took a turn for the worse. Russia total returns were -0.80% on the same issue and risk of sanctions.

Finally, in Africa, high yielding Ghana declined 8.59% on lower oil prices and general risk aversion.

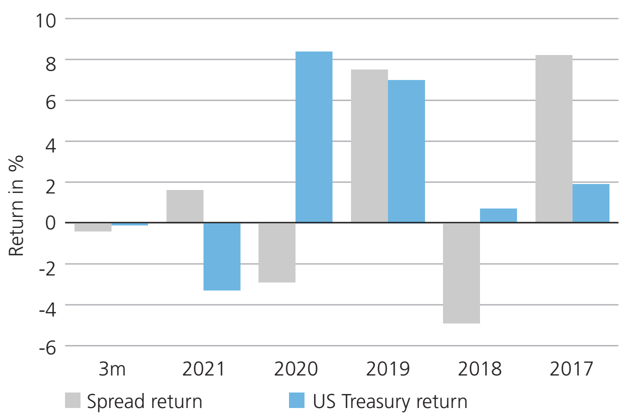
Similarly, to Q3, we reckon that at 369 bps for the EMBIGD, sovereign spreads trade close to their 10-year mean. At 150 bps, EM IG spreads are fair relative to its own history and to US IG and most likely will continue delivering mostly carry. EM HY spreads (excluding credits in default) have widened further and trade wide relative to its 10-year mean and 230 bps wider than US HY. After the selloff in HY spreads in Q3 and Q4, we wouldn't be surprised to see a 25-50 bps rally in 2021 on cheap relative valuations and strong commodity prices, if US Treasury yields remain well behaved.
(Federico Kaune)

Exhibit 13: Emerging market sovereign debt: hit by higher developed market yields



Source: JP Morgan. As of 31 December 2021. Rebalanced to 100 from 30 December, 2020. Index shown is the JP Morgan Emerging Market Bond Index Global Diversified (EMBIGD).

Exhibit 14: Emerging market sovereign debt returns over the past 5 years



Source: JP Morgan. As of 31 December 2021. Index shown is the JP Morgan Emerging Market Bond Index Global Diversified (EMBIGD).

Corporate debt

Soft Q4 caps off an uneventful year

EM corporate credit ended the year with negative returns of -0.67% in Q4 2021 (measured as JP Morgan CEMBI Diversified Index). This brings full year returns of 0.49% for 2021. Corporate credit spreads widened by 3bps in Q4 2021 bringing annual spread tightening to 9bps in 2021. Total returns in 2021 were supported by carry /spread returns contributing 2.40% while Treasury detracted 1.86%.

In Q4 2021 corporate bonds in Jamaica (1.40%), Zambia (1.18%), Peru (1.13%), Guatemala (0.77%), and Thailand (0.74%) provided the largest positive returns while the largest underperformers were Ukraine (-5.05%), Turkey (-3.57%), Poland (-3.46%), China (-3.24%), and Argentina (-3.06%).

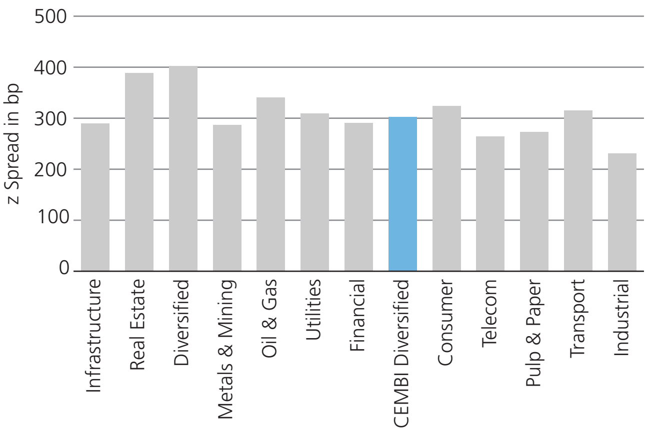
Sector returns were mixed in Q4 2021. The best performing sectors were Infrastructure (0.43%), Metals & Mining (0.39%) and Telecom (0.45%), while the lowest performing sectors were Real Estate (-4.51%), Transport (-1.36%), and Oil & Gas (-0.86%). In Q4 only the Middle East region provided positive returns while Europe (-2.34%), Latin America (-0.85%), Asia (-0.61%), and Africa (-0.05%) detracted from total returns.

Fourth quarter returns were driven by negative headlines. Continued supply chain disruptions, a second wave of COVID-19's Delta variant followed by the emergence of the highly contagious Omicron variant. This coupled with politically volatility: re-emergence of the Russia / Ukraine conflict, Turkey's government intervening in central bank policy, and the continuation of populist liberal governments being elected in Latin America. While China began reversing tightening policies from the last year, the damage inflicted on confidence to the real estate sector will be difficult to reverse. As the government slowed property sales, developers lost market access. This led to severely tight liquidity conditions.

Financials: Bank fundamentals continue improving as loan growth rises with EM growth. Furthermore, higher interest rates are broadly supportive for NIM expansion. Fundamentally, we continue to prefer large high-quality franchises that have solid capital and liquidity buffers and conservative underwriting standards. We favor subordinated Tier 2 bonds and subordinated AT1 bonds of these high-quality franchises over senior notes.

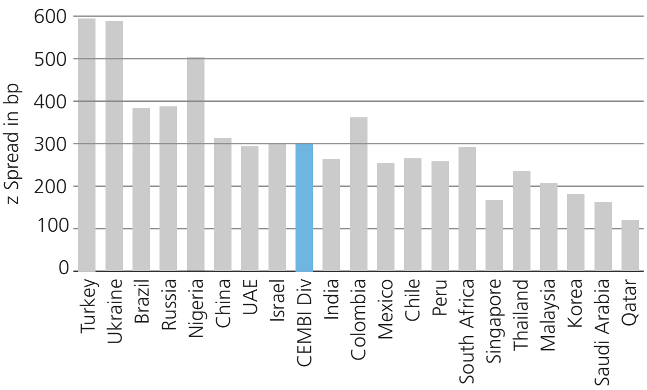
Technology, Media & Telecom (TMT): This sector was one of the more defensive sectors during the pandemic as consumption of mobile, internet and TV subscription services remained resilient. Moreover, demand for telecom services surged following lockdowns, with increases in mobile and fixed broadband traffic. The long-term investment case for TMT remains largely intact, on the back of 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 remain underweight TMT.

Exhibit 15: Emerging market corporate spreads by sector



Source: JP Morgan. Index shown is the JP Morgan CEMBI Global Diversified index, as of 31 December 2021. 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 16: Emerging market corporate spreads by country



Source: JP Morgan. Index shown is the JP Morgan CEMBI Global Diversified index, as of 31 December 2021. 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: Oil markets should remain underpinned by low inventory levels and the possibility of power sector fuel switching amidst a severe supply crunch of natural gas. We remain positively positioned on the sector to capture additional spread tightening while longer term we are cautious as integrated producers prioritize energy transitions to biofuels, solar, wind, & battery charging stations.

Consumer: Within the consumer sector we continue rotating out from the more defensive components of this segment, packaged food, beverages and household products into consumer discretionary names. However, we prefer to remain selective given higher costs of goods, slower growth and slower vaccine roll outs of EM vs DM.

Metals & Mining: The post COVID economic recovery and green transition have improved the outlook/demand for most base metals. The strong rally over 2021 in copper (+25%), aluminium (+41%), and zinc (+28%), which were supported by a weakening USD which has historically had an inverse relationship with metal prices. However, iron ore has been an outlier. After a very strong 1H21, the metal saw a reversal, giving back all 1H21 gains ending 2021 -36%. While our outlook for Metals & Mining remains broadly positive, growing supply side risks and continued tightening of economic conditions in China could prove to be a drain on returns causing us to cautiously lower our expectations. A reversal of policies in China would be a positive driver.

As we highlighted in previous quarters, EM HY issuers continue with robust liability management. This trend has continued over the last quarters as issuers take advantage of excess market liquidity and relatively low interest rates.

We remain cautious on credits with low to negative cash flow generation and tight liquidity buffers. The weakest corporations tend to be in the most exposed sectors including transport, industrials, travel and leisure, oil and gas, and real-estate. We continue to prefer high yield over investment grade, while tactically managing interest rate duration. From a valuation perspective China real estate remains attractive. We expect volatility in this sector to remain high, liquidity to remain tight which will provide both risks and opportunities. While we maintain a positive outlook for emerging market corporate credit, we start 2022 with a cautious outlook on US interest rates as volatility in interest rates will to impact risk sentiment and total returns.
(David Michael)

Local currency debt

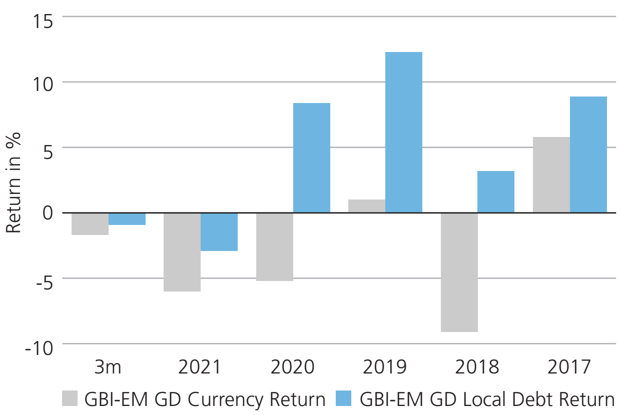
Value is rebuilt

EM local debt (measured by JP Morgan GBI-EM Global Diversified index) lost 2.53% in Q4 bringing 2021 return to minus 8.75%. Both local and currency returns were negative in the quarter. The bulk of the sell-off occurred in October-November as the USD rallied after the FED started tapering and the market brought forward the beginning of the rate hikes. A surge in inflation amid supply disruptions and a more a hawkish Fed outlook led a growing number of central banks to accelerate rate hikes. At the same time, regulatory tightening in China has quickly spread to large sectors of the economy reducing growth outlook. Finally, the emergence of the new Omicron variant added uncertainty in risk markets.

The outlook for Q1 2022 is still cloudy, even though the entry level into the asset class has become attractive for both FX and yields. Currencies are undervalued by historical standards, while advanced hiking cycles in many countries have restored yield support for currencies (particularly in Russia and Brazil). However, entering Q1, we are only cautiously optimistic on the market given that the continuing disruptions from the COVID-19 pandemic and persistent global inflation create unexpected political slipovers. Economic slowdown in China and the looming start of the rate hikes in the US are the main global headwinds for the beginning of the year.

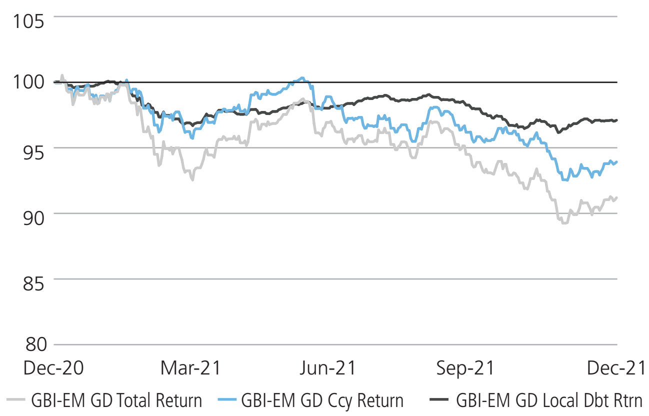
Latin America will tilt significantly to the left as the result of the recent and upcoming elections. Brazil is experiencing a combination of exhausted fiscal buffers, very high levels of inflation and difficult elections in October. Lack of confidence and inflation spike forced the central bank to embark on an aggressive rate-hike cycle. With better yield support and a positive terms-of-trade shock, we expect positive returns on the Brazilian real (BRL) carry. Bonds will likely perform well once inflation peaks, likely this quarter. Mexican fiscal and monetary policies have been conservative compared to peers and Banxico has hiked the policy rate; however, inflation continues to climb while the central bank is falling behind amid the leadership change. The Mexican peso (MXN) is expected to do well given economic ties to the US once headwinds form the US rates subside. The Colombian peso (COP) will continue to struggle, in our view, despite high oil prices, on twin deficits and ahead of the May presidential elections. The transition in Chile to the new left-wing government in March and the composition of the constitutional assembly bodes ill for investor sentiment in a medium and long-term horizon, but the Chilean peso (CLP) may perform well on post-election moderation. The Peruvian sol (PEN) may continue to lag as the result of more volatile and populist policies.

Exhibit 17: Emerging market local currency returns: split between local debt and currency components



Source: JP Morgan monitor. As of 31 December 2021.

Exhibit 18: Currency returns: more sensitive to economic and political shocks



Source: JP Morgan. As of 31 December 2021. Rebalanced to 100 at the start of the period.

In EMEA, Turkey's government and central bank have lost control of inflation and the currency has collapsed with little hope for a return of more orthodox policies. With inflation expected to reach 50% early in the year, the Turkish lira (TRY) is at risk for further devaluation. The outlook for South African growth and fiscal balance has improved amid the increase in commodity prices and strengthened political support for the government, however, high dependency to China, persistent COVID shocks, and high beta to global markets has led to volatility. Russian currency has suffered on increased tensions with the West over Ukraine. Government bonds have been undermined by persistent inflation but should do well once the CB ends the advanced hiking cycle, likely in Q1. The main risk in Russia remains geopolitical, while macro-economic indicators remain the bright spot.

Central Europe, as the rest of Europe, has been on a growth recovery path despite the COVID setbacks. Interest rates have started low by historical standards, while inflation surged leading to the significant sell-off in bond markets. The central banks have accelerated rate hikes, particularly in the Czech Republic, and yield support for the currencies has been gradually rebuilt. Hungary and Poland are expected to increase policy rates significantly in Q1 benefitting the zloty and forint.

The APAC outlook became less positive in the second half of 2021 after the region benefitted from better handling of the initial phase of the COVID-19 pandemic. The emergence of the more contagious Omicron variant will likely challenge the zero-tolerance policy in China. The expected slowdown in China growth and easing of fiscal and monetary policy bodes well for bonds, while the Chinese yuan renminbi (CNY) is likely to remain supported by ballooning trade balance. Bond yields increased but remain low in Korea, Malaysia and Thailand. Indonesian and Indian markets are likely to trade in-line with higher-beta EM.
(Igor Arsenin)

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