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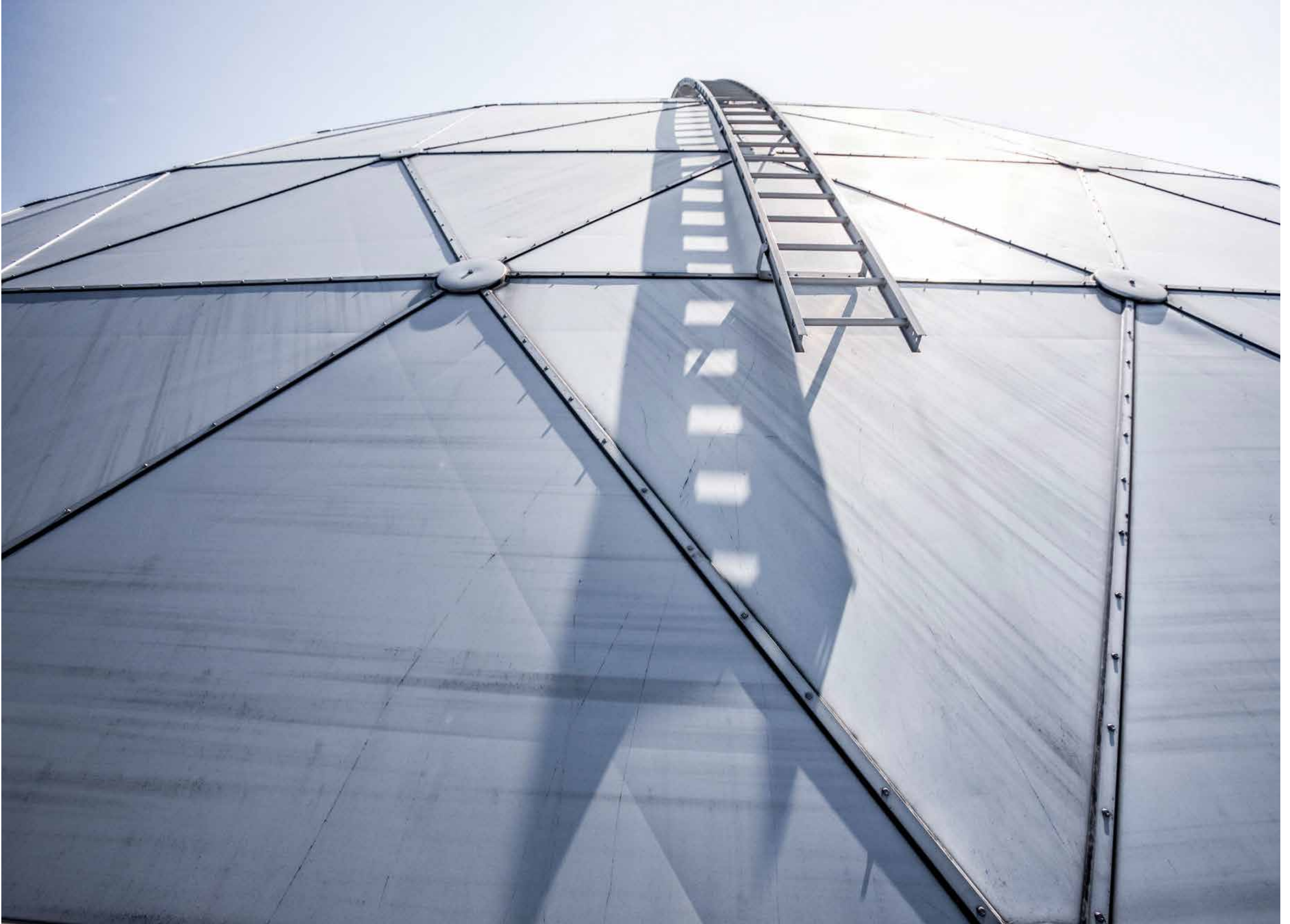
The post-pandemic recovery takes shape

Emerging markets fixed income | UBS Asset Management



Q2 2021:
Good performance on lower US treasury yields

- Emerging markets fixed income (EM FI) delivered positive total returns in Q2, reflecting a more stable external environment.

- Sovereign and corporate spreads remained broadly stable, but high yield sovereign spreads tightened significantly while EM currencies (EMFX) rallied reflecting stronger commodity prices.

- The risks to our constructive view stem from pandemic dynamics and a renewed sell-off in UST yields.

- A rally in US Treasury (UST) yields on relatively softer labor markets data in April and May and a weaker USD supported EM returns.

EM FI showed positive total returns across all asset classes in Q2 2021. Sovereign (corporate) credit spreads as measured by the EMBIGD[1] (CEMBID[2]) tightened (widened) by 14 bps (5 bps) in Q2 to 340 bps (302 bps) generating a 1.80% (0.88%) spread return (inclusive of carry). The 18-32 bps rally in UST yields in Q2 added to total credit returns.

Local yields (as measured by the GBIEMGD[3]) tightened 1 bps in spite of the UST rally, reflecting the impact of tighter monetary policy in EM, and returned 1.43% on high carry. Higher monetary policy rates and a weaker USD supported EMFX in Q2, which returned 2.11% against the US dollar in Q2. In all, the local index returned 3.54% in Q2.

Q2 2021 returns

US dollar debt	Total return	Spread return	US treasury return
JP Morgan EMBI Global Diversified	4.06%	1.80%	2.22%
JP Morgan CEMBI Diversified	2.12%	0.88%	1.23%

Local currency debt	Total return	Currency return	Local debt return
JP Morgan GBI-EM Global Diversified	3.54%	2.11%	1.40%
JP Morgan ELMI+	2.02%	1.35%	0.66%

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 June 30, 2021. Bloomberg Finance.
Past performance is not a guide to future results.

* 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 JP Morgan Emerging Markets Bond Index Global Diversified
2 JP Morgan Corporate Emerging Markets Bond Index Diversified
3 JP Morgan Global Bond Index Emerging Markets Global Diversified

Strong inflows, strong issuance

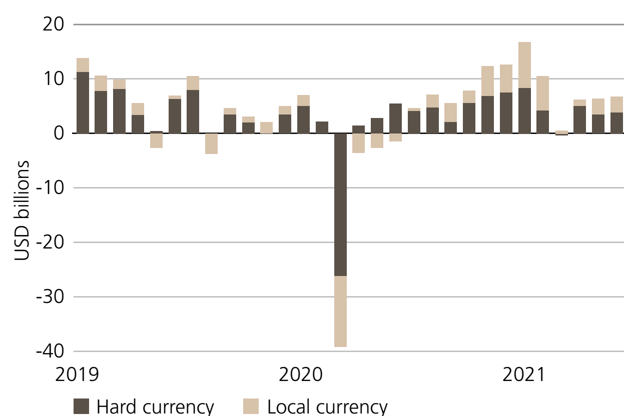
According to the latest J.P. Morgan survey, EM FI attracted USD 18.3 billion of new investments in Q2, after recording USD 29 billion of inflows in Q1 2021. Sovereign and corporate credit saw inflows of USD 13.5 billion in Q2 adding to the USD 11.6 billion inflow in Q1, while local EM (currency and rates) saw inflows of USD 4.8 billion in Q2 from a USD 17.4 billion inflow in Q1 2021.

Emerging markets continued with robust debt issuance in Q2, particularly by investment grade (IG) credits. Sovereign and corporate issuance in Q2 2021 reached USD 45.5 billion and USD 159.6 billion, respectively. Amortization and coupon payments reached USD 40.2 billion for sovereigns and USD 89.2 billion for corporates.

Divergent behaviors in DM and EM in Q2

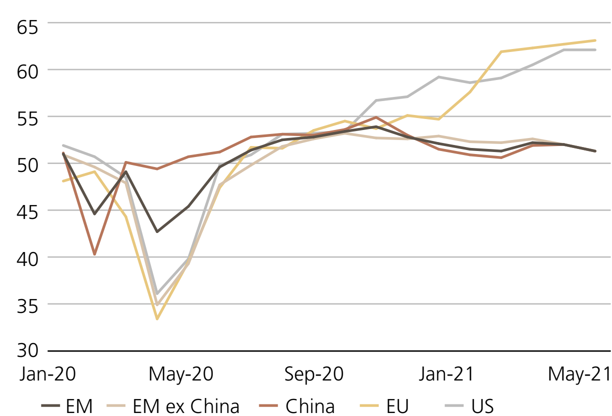
Purchasing manager indices (composite PMIs) suggest that global economic activity recovered further in Q2. However, the recovery was far from homogeneous. Economic activity in DM has outpaced that of EM after the pandemic erupted in March 2020. PMIs in the US and Europe are above 60 while PMIs in China and EM continued to show a stable, albeit expansionary behavior in Q2 and thus are lagging the US and the Eurozone.

Incoming flows remain robust in Q2 (USD billion)



Source: JP Morgan, UBS Asset Management. As of 30 June 2021

Global PMIs: DM outpacing EM



Source: Macrobond, UBS Asset Management. As of 30 June 2021.
A level above 50 indicates economic improvement.

A similar dynamic can be found in global financial conditions (FI): They are at record easy levels in developed markets (DM) but tightening at the margin in EM, particularly since the beginning of 2021.

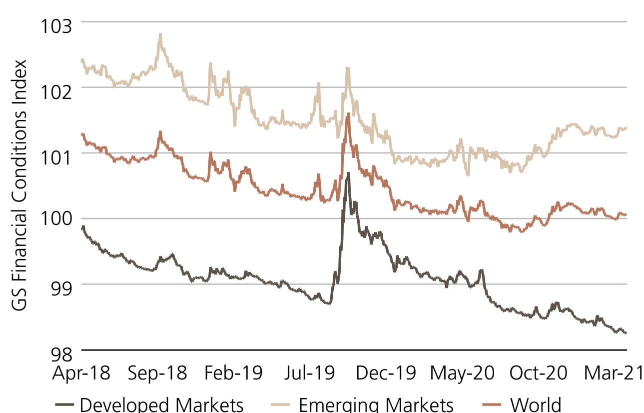
FI remained at record easy levels particularly in the US, where the rally in UST yields, equity markets and corporate spreads contributed. FI in Europe have eased but are still tighter than the level it had before the pandemic hit in March 2020. Financial conditions in EM are less tight in part due to higher rates and domestic yields, as central banks started to tighten monetary policies to contain growing inflation and inflation expectations.

The pandemic and the EM/DM growth differential

It is evident that the pandemic continues to affect EM more than DM, forcing several countries to lock down again in an effort to slow the spread of the virus. In DM, some European countries have imposed restrictions as the Delta variant proliferated rapidly. In EM, India, South Africa, Indonesia and to a lesser extend Latin America are still struggling to control the pandemic.

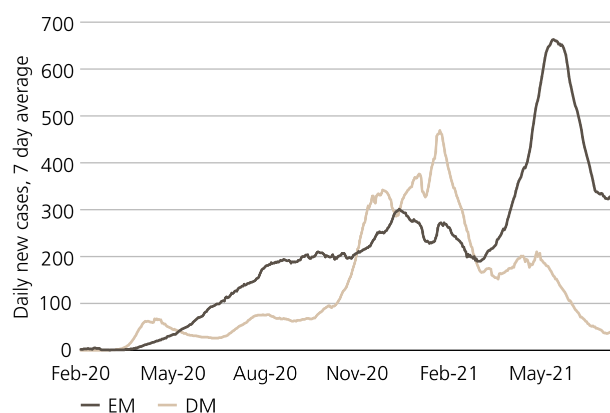
Our global vaccination tracker indicates that 27% of the global population has been vaccinated as of June 30th, with a run rate of about 10% per month aided by a larger supply of vaccines. At this rate most of the global population will be vaccinated in 2021. As of the end of June, between 40-50% of the population in DM has been vaccinated. In EM, vaccination rates go from as high as 77% (UAE) to as low as 1.9% in Vietnam and 2.6% in South Africa. The vaccination rates among large and systemic EM countries, goes from 11.9% in India (13.7% in Russia) to as high as 43.2% in China. Brazil and Mexico are at 23.9% and 17.5%, respectively.

Financial conditions: record easy level in DM



Source: Goldman Sachs, Bloomberg, and UBS Asset Management. As of 30 June 2021

The pandemic is slowly subsiding in EM (Daily new confirmed COVID-19 cases, in thousands)



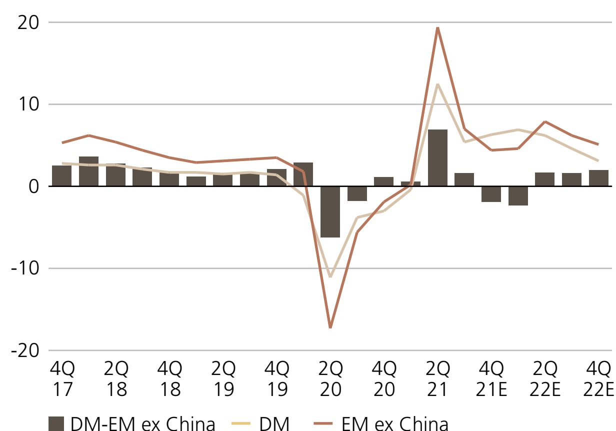
Source: Our World in Data, UBS Asset Management. As of 30 June 2021.

One topic of interest has been the negative EM-DM real GDP growth spread in the past few quarters, particularly excluding China, which continues to grow at very high rates. It is evident that the pandemic affected EM far more than DM and that EM did not have the infrastructure to tackle the health crisis that ensued or the fiscal/monetary space available to DM to tackle the macroeconomic impact of the pandemic. Furthermore, it is also evident that the vaccination efforts in EM have lagged DM, and that several EM countries are still vulnerable to new variants. Hence, we expect EM growth to lag DM growth in 2021 and only to recover slowly in 2022 and beyond, as DM growth rates converge down to potential (1.5%-2.0%) and EM growth rates converge up to potential (4.0%-5.0%).

The reopening and higher global inflation

Financial markets responded with uncharacteristic foresight to the high inflation prints across the world in Q2. Inflation in the US touched 5% in May (the highest in 12 years) but most of it was attributed to one off price increases reflecting temporary supply bottlenecks as the economy reopens. Furthermore, labor markets recovered at a slower than expected pace –although the underlying dynamics remain very robust. Finally the Fed surprised markets with a relatively hawkish stance in the mid-June meeting including talk of tapering and an upward move in rate expectations by its members. Market views seem to be guided by the Fed's expectation of lower longer-term inflation and rates. In fact, 1y1y swap rate jumped 15 bps to 35 bps after the FOMC in mid-June while 5y5y swap rate rallied 40 bps to 1.70%. This is indicative of markets expecting hikes earlier but with a lower terminal rate.

EM lagging DM growth after the pandemic



Source: Macrobond, UBS Asset Management. As of 30 June 2021

In EM, inflation has made a forceful comeback. Besides bottlenecks affecting the global economy and EM as well, the rapid rise in commodity prices, including food, has contributed to the higher inflation prints in EM. Headline Inflation in Brazil and Russia has increased to 8% and 6%, respectively from 2% right before the pandemic started. Malaysia, Mexico, South Africa and CEE countries show the same dynamics. The central banks in Russia and Brazil have reacted strongly to the inflation threat, hiking policy rates by 125 bps and 225bps since the beginning of the year, respectively. Other central banks in EM have been less reactive to higher inflation but have stopped cutting rates, and are now in pause or about to start a hiking cycle.

China is involved in its own growth and inflation dynamics, which are different than those in other EM. Economic activity continued to recover in Q2 according to the latest composite PMIs, but there is a clear softening trend in those figures. Inflation on the other hand remains well behaved. Hence, the Central Bank is in no hurry to change its monetary stance but cut reserve requirement 50bps recently and could cut rates in H2. In the midst of all the post-pandemic policies, local yields have remained uncorrelated to global rates, providing interesting opportunities for diversification.

On the brink of a new commodity super cycle?

The policy stimulus from governments and central banks, particularly in DM, together with their newfound purpose to reduce income inequality through income redistributing policies are likely to have a long lasting positive impact on global demand and the demand for commodities. Globalization and the incorporation of China to the global scene were in part responsible for the commodity super cycle 20 years ago. Income redistribution and the revival of national middle classes could be the new impulse behind higher commodity prices this time around. This sort of protracted demand growth as opposed to a cyclical recovery coupled with underinvestment in the commodity sector (due to relatively low expected returns on investment) could result in higher commodity prices for years to come. Under this new paradigm, commodity prices are less likely to be determined by China's demand as it was the case in the past couple of decades, but by the newly-acquired purchasing power of rising middle classes around the world.

High global growth, inflation and lower yields: not sustainable

The US Treasury rally in Q2 had a stabilizing effect on EM asset prices in Q2. After the 80bps selloff in Q1, UST yields rallied 30bps in Q2. UST yields seem to have responded to softer labor markets in April-May and the perceived temporariness of the current inflationary shocks. Markets seem to be deriving comfort from indications of hawkishness by the Fed, which imply a need for lower terminal rates. Furthermore Fed inflation expectations are very well anchored at around 2.0%-2.6% and consensus forecast have headline/core at 3.5%/2.9% by end-2021 but down to 2.2%/2.1% by end 2023.

Having said that, the US economy is expected to grow well above potential for several years and unemployment is expected to drop to pre-pandemic levels by 2023. Currently, real yields along the curve are negative even at the lower long- term inflation rate of close to 2%. Fundamentals do not warrant negative real yields across the yield curve with inflation and growth running above target and potential, respectively.

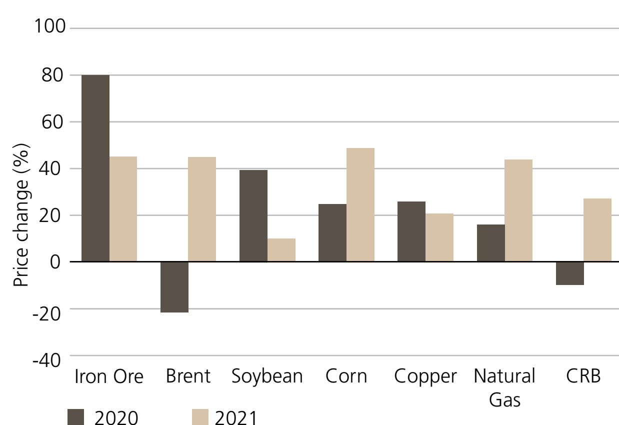
Hence, the distinct risk in our view is that after the rally in Q2 there will be renewed pressure on UST yields in Q3. High inflation prints, a further recovery of labor markets and Fed talk about tapering could impact the current situation during the summer time. Furthermore, our economists estimate that there are ample fiscal stimulus unspent resources that could be deployed if growth were to falter. Finally, most vaccines have proven to be effective against the variants seen so far, reducing the risk of COVID-19 going forward, making it less likely that a broad lockdown will be required once again. The risk is on delays in vaccinations across the world.

We are currently at the bottom of our broad 1.35%-1.95% range for UST 10 year, and our view is that it is likely that UST 10 year will be close to 1.75% by the end of the summer. If UST yields stabilize at around 1.75% in the 10-year and 2.5% in the 30-year, the negative impact of higher yields (price effect) would fade to make room for the positive impact of higher growth, trade and commodity prices (income effect) later in the year.

It could be an active summer for EM

As argued before, we believe there are pockets of value in HY credit and EMFX. However, for them to perform global factors have to behave favorably. Credit, including HY could be volatile in Q3 after the Q2 rally as the financial markets reflect perceived growth scares and inflation scares. EMFX will only realize its value if DM rates and USD remain stable, even in the presence of higher carry and stronger commodity prices. We believe that it is too early to jump into EM rates as inflation has yet to peak and central banks are far from finishing their hiking cycles. We are defensive duration as we start Q3. *(Federico Kaune)*

Strong commodity prices in Q2 (% change)



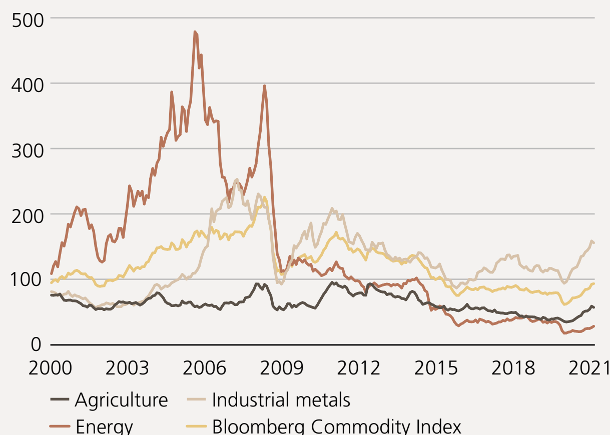
Source: Bloomberg, UBS Asset Management. As of 30 June 2021.
Note: All commodities are represented by the CRB Index.
Past performance is not a guide to future results.

A commodities super cycle and EM

Commodities from oil to metals to agricultural products are having a strong rally as the world economy recovers from the COVID-19 pandemic, supported by unprecedented policies (Figure 1). In addition to the current cyclical recovery and supply bottlenecks, there is a convincing narrative that we are entering a structural commodity boom, even a super cycle, driven by governments around the world pursuing policies designed to promote green energy, fight inequality, and restore supply chains as part of the post-pandemic recovery strategy, creating demand for commodities across different categories while supply is constrained by years long underinvestment.

Commodity prices are an important factor for EM assets as many are dependent on commodity exports. As a result, the likely improvements in fiscal and external accounts among commodity exporters are positive for energy dependent EM sovereign credits such as GCC[4], Russia, Colombia, Malaysia, and Nigeria as well as leading producers of industrial metals like South Africa, Chile, and Peru. While valuations may be already tight for sovereign names like Russia and Saudi Arabia, the ongoing commodity rally is critical for some high yielding names due to their higher external funding needs and can help reduce sovereign risk premium. Countries like Angola, Ecuador and Oman could see further tightening of spreads in a sustained rally.

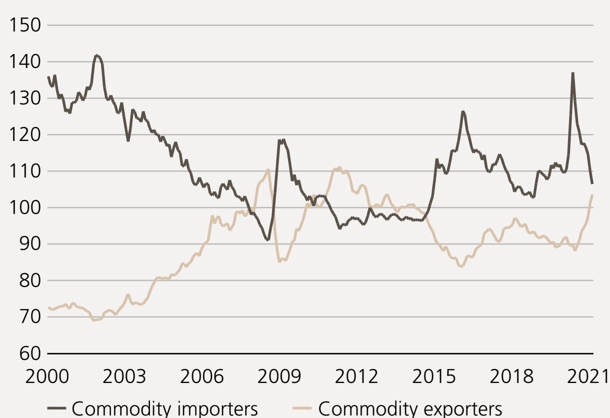
Figure 1 Commodity indexes



Source: Bloomberg and Macrobond

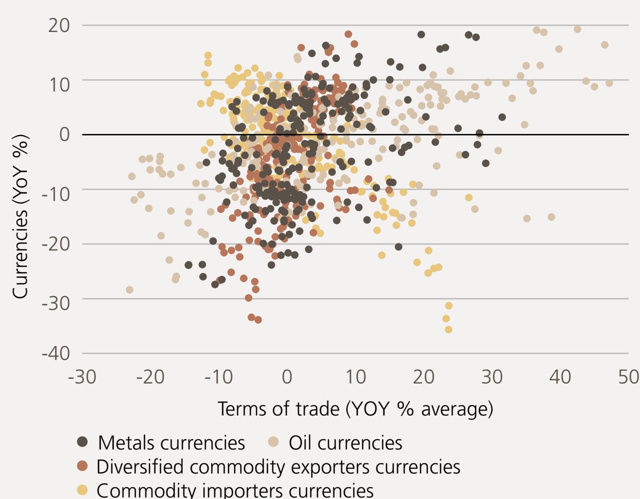
In FX, higher commodity prices tend to lead to higher terms of trade for net export countries (Figure 2) often leading to currency appreciation (Figure 3). Historically, ZAR, CLP and PEN together have been more responsive to changes in industrial metals prices than RUB, COP on average are to changes in oil prices. While less volatile, the terms of trade for Brazil, Indonesia, and Malaysia ("diversified commodity exporters") also show positive correlations with stronger BRL, IDR and MYR on average. However, despite the rising terms of

Figure 2 Terms of trade



Source: Bloomberg and Macrobond

Figure 3 Terms of trade vs. currencies



Source: Bloomberg and Macrobond

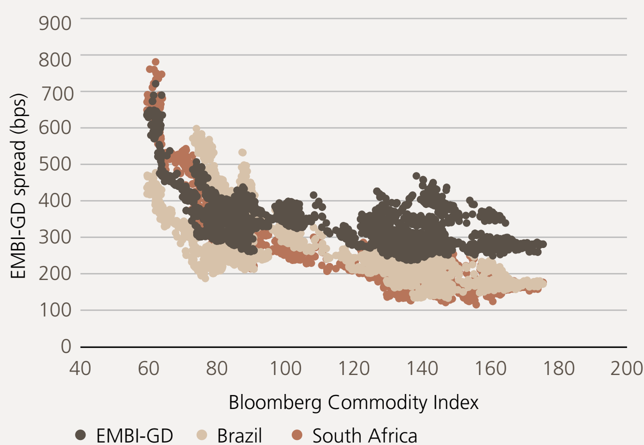
IMF terms of trade net export price indices are country-specific commodity price indices where individual commodities weighed (rolling weights) by ratio of net exports to GDP. Commodity exporters are Brazil, Chile, Colombia, Indonesia, Malaysia, Peru, Russia and South Africa. Commodity importers are Czech Republic, Hungary, India, Mexico, Poland, and South Korea.
Oil currencies refer to the Russia rouble (RUB), Colombian peso (COP); metal currencies refer to the South African rand (ZAR), Chilean peso (CLP), Peruvian sol (PEN); and diversified commodity exporter currencies are the Brazil real (BRL), Indonesia rupee (IDR) and Malaysia ringgit (MYR).

[4] Gulf Cooperation Council, is a regional, intergovernmental political and economic union that consist of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates

trade, recent performance of those currencies lagged in most of H1 2021 due to geopolitical tensions, COVID-19, domestic politics, and volatile US core rates. Going forward, the environment is positive for commodity currencies to perform well, however, it does not mean commodity importing currencies will underperform. While oil above $75/barrel will put pressure on external accounts of countries like India with large net oil trade deficits, the currencies of manufacturing hubs such as the Korean won and Taiwanese dollar have positive correlations with industrial metals when driven by global growth.

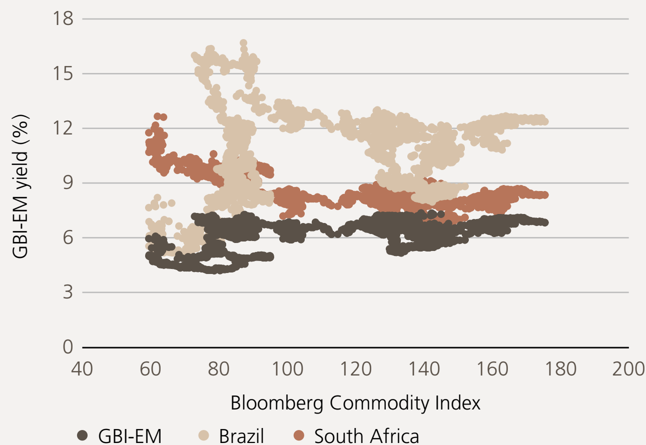
The relationship between commodity and EM local rates are not as straightforward (Figures 4 and 5) except for some high yielding countries with very large net oil trade surplus/deficit like Russia and India, as commodities affect local rates in multiple channels, often indirectly. Accounting for a large share of the CPI basket, energy and food prices feed into headline inflation and inflation expectations as they have in recent months, forcing several EM central banks to start a rate hiking cycle. However, the extent of commodity price pass-through varies by country because of idiosyncrasies in local demand conditions and government responses such as subsidies. Going forward, while higher commodity prices could reduce the credit risk premium in high yielders, the outlook for EM local rates will depend on multiple factors, namely the Fed, local demand conditions as well as central bank reaction function.
(Yuni Kim)

Figure 4 Sovereign credit spreads vs. commodity index



Source: IMF and UBS Asset Management. Date as of 30 June 2021.

Figure 5 Local government yields vs. commodity index



Source: UBS Asset Management. Date as of 30 June 2021.

EM sovereign debt: High yielders shine

Sovereign credit posted a 4.06% total return in Q2 2021 (measured by the JP Morgan EMBIGD Index). Spreads tightened 14 bps to 340 bps, generating a 1.80% spread return. US Treasury yields rallied between 18 bps (2 year) and 32 bps (30 year) in Q2, adding to performance. Investment grade (IG) spreads widened 4 bps to 150 bps but high yield (HY) spreads tightened an impressive 37 bps to 582 bps in Q2.

As we argued in our last quarterly, IG spreads had already converged to fair value, thus the small spread move was not surprising. As a result, the rally in UST yields explained most of the 3.01% total return in IG sovereigns in Q2.

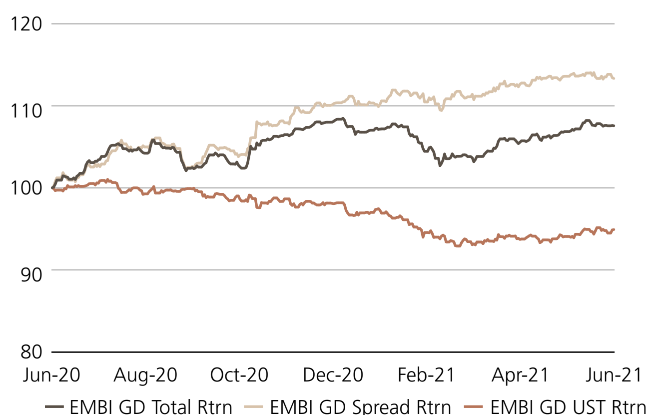
On the other hand, HY sovereign spreads offered value at the beginning of Q2, and converged further to fair value during the quarter. HY sovereigns showed a total return of 5.27% in Q2, of which 3.60% was due to the impressive compression in HY spreads.

All regions generated positive total returns in Q2. South Saharan Africa posted an outsized positive return of 5.90%, as high spread countries including Zambia (11.54%), Angola (10.51%) and Cameroon (10.42%) rallied strongly on a significant recovery of oil and copper prices and multilateral support.

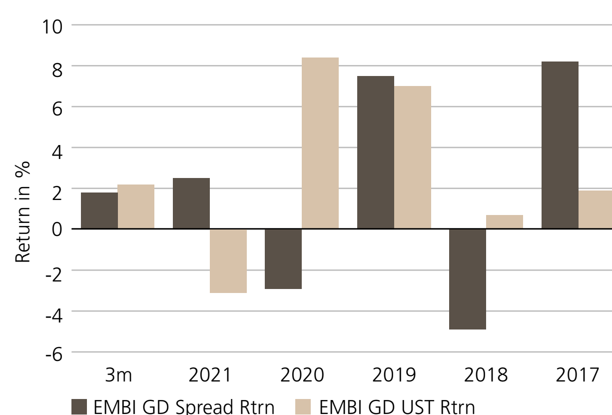
Latin America returned 4.63%, in part thanks to an outsized positive return from Ecuador (43.76% spread return), as other commodity exporters showed mid-single digit returns. Ecuador spreads tightened an impressive 425 bps to 776 bps on the back of the surprisingly positive presidential election results in Q2 where the market friendly candidate Guillermo Lasso won the election. Laggers included El Salvador (126 bps widening and -7.33% spread return) where President Bukele adopted certain anti-democratic actions that could strain relations with the IMF, and Peru (11bps widening and -0.8% spread return), where the results of the contested presidential elections gave a 0.25% margin to the radical left and largely unknown candidate Castillo. Spreads did not sell off more because as of time of writing the National Electoral Court hasn't yet declared Castillo's victory because of alleged election irregularities. If Castillo takes office, he is likely to call for a constitutional reform following Venezuela's example.

Emerging Europe returned 3.48%. Turkey returned 7.01% in total (5.60% spread return) as spreads compressed 73 bps to 469 bps as the new Central Bank governor committed to keep interest rates unchanged at 19% until inflation subsided and some tourists started to make a comeback to the main tourism attractions within Turkey. Ukraine returned

EM sovereign debt: Hit by higher DM yields
(Rebalanced to 100 as of 31 March, 2020)



EM sovereign debt returns over the past 5 years



Source: JP Morgan monitor, JP Morgan Emerging Markets Bond Index Global Diversified. As of 30 June 2021.
Past performance is not a guide to future results.

4.12% in total as the government made further progress on its reform agenda. On the other extreme, Belarus returned -3.33% in total (-4.28% spread return) as spreads widened 130 bps in Q2 on the back of further autocratic actions by the government of President Lukashenko.

The Middle East and North Africa (MENA) region returned 3.44%, as Lebanon and Tunisia bond prices recovered after selling off strongly in Q1. Finally Asia returned 2.98%, with Sri Lanka showing an outsized 7.97% total return as the government as able to secure certain liquidity lines that could help them withstand the structural weakness of the fiscal and external accounts until further needed reforms are forth coming.

At around 340 bps for the EMBIGD, sovereign spreads are close to their 10-year mean. After lagging in Q1, sovereign spreads rallied more than EM corporate spreads in Q2. However, IG sovereign spreads lagged IG US spreads while HY sovereign spreads rallied in tandem with US HY spreads in Q2.

At 150 bps, EM IG spreads have fully converged to pre-pandemic levels but are trading at around 70 bps wide to US IG, somewhat cheap compared to historical levels, thus IG sovereign spreads could do better provided that UST yields remain well behaved. EM HY spreads (excluding credits in default) rallied 42 bps in Q2 to 532 bps and are now 30 bps wider than their 10-year mean but 175 bps wider than US HY, as US HY continues to tighten. HY sovereign spreads could rally another 25-50bps on cheapness to US HY and strong commodity prices, provided that US Treasury yields remain stable.

We were expecting some stability in UST yields in Q2 after the severe selloff in Q1, but not the rally that ensued. This rally in UST yields erased the negative total returns in Q1. Fed communiques during the summer (Jackson Hole included) and the continued strength in US labor markets and high inflation could revert some of the Q2 UST yields rally in Q3. In this context we believe that UST duration management will be crucial to protect credit returns in Q3.
(Federico Kaune)

Corporate debt: search for value

EM corporate credit provided positive quarterly returns of 2.12% in Q2 2021 (measured as JP Morgan CEMBI Diversified Index). Corporate credit spreads widened by 6bps in Q2 2021. Total returns were supported by tightening in high yield credits contributing 2.63% to Q2 returns. Spread returns contributed 0.88% to Q2 while a rally in Treasury returns added 1.23%.

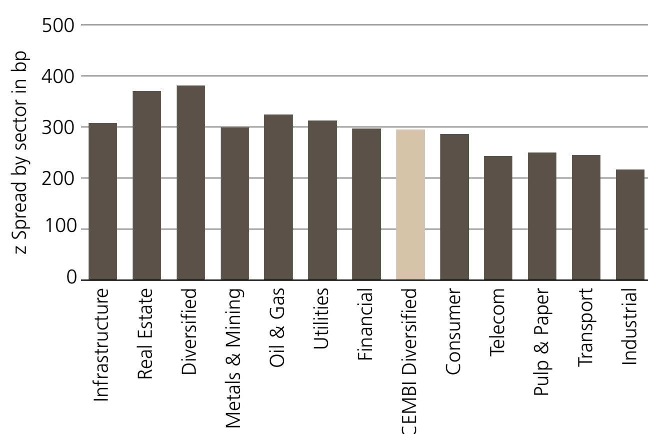
In Q2 2021 corporate bonds in Argentina (11.01%), Ghana (7.44%), Turkey (5.23%), Mexico (4.27%), and Thailand (4.26%) provided the largest positive returns while the largest underperformers were Peru (-0.50%), China (-0.17%), Colombia (0.40%), Chile (0.44%), and Poland (1.07%). All sectors provided positive returns in Q2 2021. The best performing sectors were Oil & Gas (4.26%), Transport (3.58%) and Pulp & Paper (3.57%), while the lowest returns were Real Estate (1.12%), Financial (1.29%), and Utilities (1.55%). Similarly in Q2 all regions provided positive returns lead by Europe (3.48%) and Africa (2.87%) while Latin America (2.67%), Middle East (1.88%) and Asia (1.44%) also contributed positive returns.

Positive returns in the second quarter of 2021 were driven by positive US re-opening and growth expectations, continued vaccine rollout, and stable US Treasury yields. While the expectation of exceptional US growth fuelled US rates to sell off in Q1, we saw stabilization and even rally in US rates following conflicting US economic data.

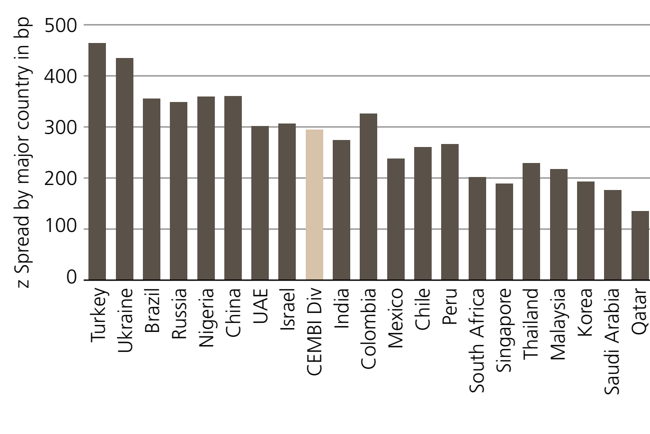
Financials: While supportive forbearance measures in 2020 mitigated some of the risks of immediate deterioration in asset quality and earnings, bank fundamentals are beginning to improve as loan growth rises with EM growth. Fundamentally, we continue to prefer large high quality franchises that have solid capital and liquidity buffers and conservative underwriting standards. We favor subordinated Tier 2 bonds and subordinated AT1 bonds over senior notes.

TMT (tech. & telecoms.): This sector was one of the more defensive sectors in 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 priced and we remain underweight TMT relative to commodity exposed sectors who continue to benefit from global economic recovery.

EM corporate spreads by sector
Measured in bps as of 30 June, 2021



EM corporate spreads by country
Measured in bps as of 30 June, 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.
Source: JP Morgan monitor, JP Morgan Corporate Emerging Markets Bond Index Diversified, as of 30 June 2021

Oil & gas: OPEC warned that that the longer term outlook for oil remains highly uncertain, demand has outpaced supply and supply shortages have been supportive for prices. Despite the demand pickup, we expect prices to be volatile while OPEC+ manages supply. We remain positively positioned to capture additional spread tightening given higher prices.

Consumer: Within the consumer sector we continue rotating from the more defensive components of this segment, packaged food, beverages and household products into consumer discretionary names that will benefit from reduced lockdowns and mandated isolation. However, we prefer to stay nimble given the slower vaccine roll outs of EM vs DM.

Metals and mining: The economic recovery has improved the outlook/demand for iron ore, copper, aluminium, steel and zinc, which were supported by a weakening USD, which has historically had an inverse relationship with metal prices. Despite the positives, risks remain balanced as tightening of economic policies in China has lowered growth/demand, has been offset by increased demand from US and to a lesser extent Europe. While our outlook remains positive, increasing supply and continued tightening of economic conditions in China has caused us to dampen expectations.

As we highlighted in previous quarters, EM issuers continue liability management exercises and alleviate short term funding pressures. This trend has continued over the last quarters with issuers taking advantage of positive market sentiment and continued liability management exercises, taking advantage of low interest rates to reduce overall funding costs.

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 tactically rotate exposure given our positive growth outlook. We continue to like corporate credit due to improving credit fundamentals, it's relatively low interest rate duration (around 4.5Y), and spread compensation (around 300bps), with an average rating around BB+. While we maintain a positive outlook for emerging market corporate credit, we take a more cautious stance relative to US interest as volatility will likely impact sentiment toward risk assets. *(David Michael)*

EM local debt: A bumpy road to recovery

EM local debt (measured by JP Morgan GBI-EM Global Diversified index) gained 3.38% in Q2 bringing YTD return to -3.38% after a sharp drop in Q1. The improvement in Q2 was driven by stability in UST yields and improvement in growth in Europe and many EM countries. However, new COVID-19 variants and the slow roll-out of vaccinations left most EU countries behind DM. A surge in headline inflation amid supply disruption and more a hawkish Fed outlook led a number of central banks raise interest rates and yield curves flattened.

The outlook for Q3 2021 remains cloudy, but the outcome for H2 is likely to be positive for EM local markets. A lot hinges on the timing of larger EM countries' catch-up to the US in the growth cycle. The pre-requisites for such performance have been met, in our view: Better entry levels both for UST and USD; the start of the hiking cycles in important markets (Brazil, Russia, Mexico), and the end of the easing cycles in the rest is creating yield support for currencies. Entering Q3, we are cautious on the market given the still raging COVID-19 pandemic, the propensity for the US to surprise positively and EM negatively. However, we recommend overweight EMFX positions and selective bond markets where valuation and monetary policy are supportive, but we are negative on duration in low yielders.

In Latin America, Brazil is experiencing a combination of still high COVID-19 rates, exhausted fiscal buffers, and difficult election in 2022. 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, the BRL is on a strengthening path, and we expect bonds will perform once inflation peaks, likely at the end of the quarter. Mexican fiscal and monetary policies have been conservative compared to peers and Banxico has hiked the policy rate; however, yields are not yet attractive on a spread to the UST. The MXN should do well given economic ties to the US. We think commodity currencies (COP, CLP) will do well in Q3, while PEN may continue to suffer from change in policies post elections.

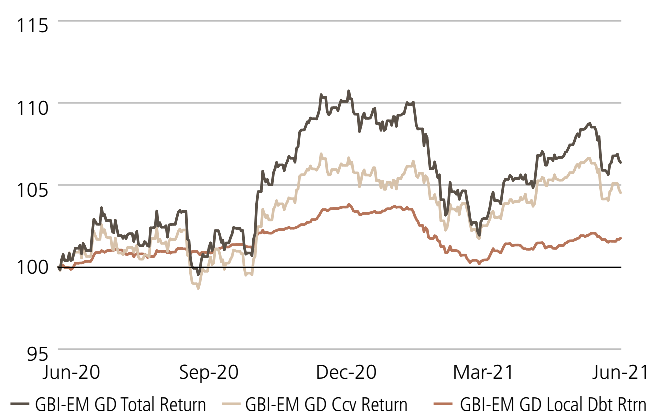
In EMEA, stabilization in Turkey was dealt a blow by the sacking of the respected CB president, while tourism remains depressed. The outlook for South Africa growth and fiscal balance has improved on increase in commodity prices and strengthened political support of the government, allowing SA assets to do well. Russian bonds and currency have underperformed even as oil prices recovered from the lows and government maintained fiscal restraint. The risk remains geopolitical. However, advanced rate-hike cycle bode well for the RUB and bonds.

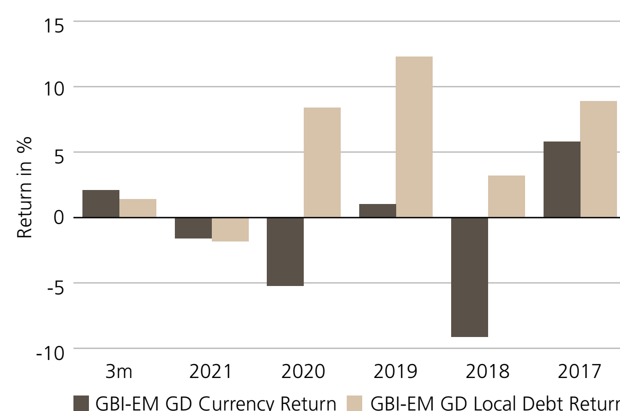
Central Europe, as the rest of Europe, has been on a recovery path as vaccination rates improved. Interest rates remain low by historical standards, and inflation is likely to pick up in a recovery phase, rendering bond markets unattractive, while currencies are largely following the EUR.

The APAC outlook has become less positive in our view. Having benefitted from better handling of the COVID-19 pandemic, many countries are lagging in vaccination; however China has been rapidly catching up. The strong CNY and China's regulatory tightening bias weighs down on the outlook for CNY and the rest of APAC currencies. Bond yields increased but remain low in Korea and Thailand. Indonesian and Indian markets are likely to trade in-line with higher-beta EM.
(Igor Arsenin)

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

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





Source: JP Morgan monitor. As of 30 June 2021. **Past performance is not a guide to future results.**

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