

EM fixed income: As good as it gets?

Emerging markets fixed income | UBS Asset Management



Q4 2020: Another strong performance period

- Emerging markets fixed income (EM FI) had a strong Q4, reflecting record easy global financial conditions and lower post US election uncertainty that trumped the new pandemic wave.
- EM investment grade (IG) spreads are at pre-pandemic levels. EM high yield (HY) spreads are 100 bps wider than pre-pandemic levels, but lower capacity-to-pay warrant those higher risk premiums.
- EM rates are at record lows in most countries and offer little value while most EM currencies are still fundamentally undervalued.
- Returns in Q1 2021 will likely continue to reflect global factors, including the pace and size of stimulus in developed economies and pandemic developments.

EM FI showed positive returns across all asset classes in Q4 2020. Sovereign (corporate) credit spreads as measured by the EMBIGD¹ (CEMBID²) tightened by an impressive 81 bps (67 bps) in Q4 to 352 bps (326 bps) generating a 7.36% (5.10%) spread return. With this result, the full year spread return in sovereigns (corporates) recovered to -2.94% (1.20%), an extremely benign result given the array of shocks that impacted EM FI in 2020. US Treasury (UST) yields widened around 20 bps in Q4, detracting from total credit returns.

Local yields (as measured by the GBIEMGD³) tightened by 26 bps to 4.22%, generating a return of 2.95% in Q4. The long awaited rally in emerging market currencies finally arrived in Q4: EM currencies strengthened an impressive 6.67% against the USD in Q4. In all, the local index returned 9.62% and 2.69% in Q4 and 2020, respectively. The 2020 returns in rates and currencies reached 8.37% and -5.23%, respectively.

Q4 2020 returns

US dollar debt	Total return	Spread return	US treasury return
JP Morgan EMBI Global Diversified	5.80%	7.36%	-1.46%
JP Morgan CEMBI Diversified	4.29%	5.10%	-0.77%

Local currency debt	Total return	Currency return	Local debt return
JP Morgan GBI-EM Global Diversified	9.62%	6.67%	2.76%
JP Morgan ELMI+	5.97%	5.43%	0.51%

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 31 December 2020. Bloomberg Finance.

2020 returns

US dollar debt	Total return	Spread return	US treasury return
JP Morgan EMBI Global Diversified	5.26%	-2.94%	8.44%
JP Morgan CEMBI Diversified	7.35%	1.20%	6.08%

Local currency debt	Total return	Currency return	Local debt return
JP Morgan GBI-EM Global Diversified	2.69%	-5.23%	8.37%
JP Morgan ELMI+	1.73%	-1.14%	2.91%

- * 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.

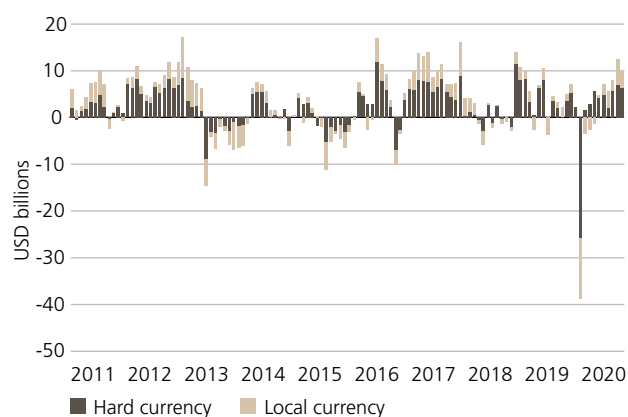
1 JP Morgan Emerging Markets Bond Index Global Diversified
 2 JP Morgan Corporate Emerging Markets Bond Index Diversified
 3 JP Morgan Global Bond Index Emerging Markets Global Diversified

Very strong inflows in Q4 2020

According to the latest J.P. Morgan survey⁴, EM FI attracted USD 30.5 billion in new investments in Q4 2020, after recording USD 17.5 billion of inflows in Q3. Sovereign and corporate credit saw inflows of USD 19 billion in Q4 adding to the USD 11.3 billion inflow in Q3, while local EM (currency and rates) saw inflows of USD 11.5 billion in Q4 from a USD 6.3 billion inflow in Q3.

Robust debt issuance continued in Q4, particularly by IG credits. According to Bank of America⁴, Sovereign and corporate issuance in Q4 2020 reached USD 52.6 billion and USD 98.6 billion (mostly from China), respectively, a continuation from Q3. Amortization and coupon payments reached USD 22.4 billion for sovereigns and USD 76.5 billion for corporates.

Better inflows in Q4 (USD billion)



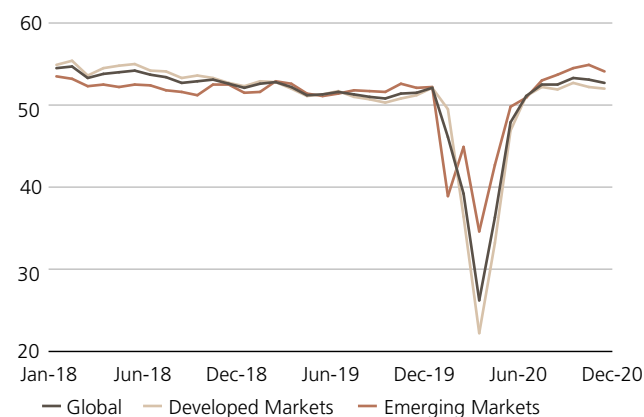
Source: JP Morgan, UBS Asset Management. As of 30 December, 2020

Global activity stabilized amidst a new pandemic wave

Global economic activity stabilized in Q4 as countries across the world re-opened as the impact of the pandemic subsided during the southern hemisphere spring. PMIs (Purchasing Managers Indices – a measure of economic activity) in developed markets (DM) recovered to pre-pandemic levels in Q4 but started pointing downwards later in the quarter. A better post-election outcome in the US and very positive news on the vaccine front lifted animal spirits and contributed to the recovery. PMIs and other economic indicators showed signals of a slowdown in economic activity in December, however. First, the smaller-than-expected US fiscal stimulus came too late to have an impact in Q4, and second the pandemic across Europe and the US picked up strongly once again forcing new lockdowns. PMIs in EM recovered further driven by China and southern hemisphere countries where better weather allowed them to ease lockdowns.

The US and global equity markets rallied strongly in Q4, particularly after the US elections in early November, while UST yields sold off on stronger economic activity. The US dollar index (DXY), depreciated 4.5% in Q4 while commodity prices recovered strongly across the board. This positive global backdrop largely explained the tightening in EM credit, rates and EM currencies during Q4.

Global PMIs appeared to have peaked in Q4



Source: Macrobond, UBS Asset Management. As of 31 December 2020. A level above 50 indicates economic improvement.

COVID-19 remains a significant risk

The third wave of the pandemic has been quite severe and some countries locked down again. This probably dented the recovery of global economic activity in Q4, but with the advent of highly effective vaccines, markets were more than willing to look through the new pandemic wave. In fact, markets were probably correct: with the vaccines available and ready to deploy it should be a matter of time before the pandemic is behind us and the world goes back to some resemblance of normalcy. The vaccines should be highly beneficial for the recovery of EM because lockdowns didn't have the expected results as they couldn't be enforced.

During Q4 financial markets benefitted from several positive factors that more than offset the worsening of the pandemic and other shocks in Q4. First and foremost, the combination of lax monetary policies, low and relatively stable DM yields and recovery in asset prices resulted in record easy financial conditions across DM and EM. Second, the post-election political environment in the US was better than expected, in spite of the several issues that arose. Third, after weeks of discussions a USD 900 billion (5% of GDP) second fiscal stimulus package was approved in December. Fourth, the Fed and other DM central banks double down on their resolve to keep rates at extremely low levels or, until inflation hits their inflation targets. Fifth, news on the vaccines was extremely positive in terms of their effectiveness, safety and availability.

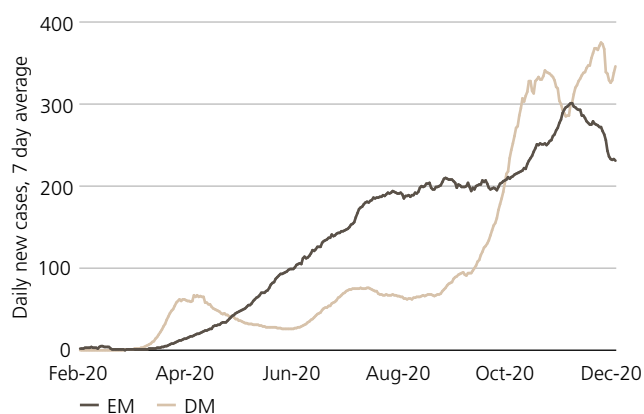
EM riding the blue-wave

The Democratic Party won the Presidency, the Senate and kept its majority in the House of Representatives. Such combination will give President-elect Biden room to undo many of the policies implemented by President Trump. He is likely to increase regulations and revive and strengthen the Affordable Care Act (Obamacare) by expanding access to Medicaid for low income households and adding a public option for others.

His signature policy is likely to be on the environment (100% clean energy with net-zero emissions no later than 2050). He is also likely to back an additional fiscal stimulus package, including broad employment compensation schemes and a bail out of several states under severe financial stress due to the pandemic. He has committed to hike tax rates on corporations (to 28% from 21%) and implement a 15% minimum tax on book income, restore the 39.6% income tax rate on high income individuals, tax investment income as ordinary income for individuals earning USD 1 million or more a year and impose a wealth tax.

On the external front, he is likely to be less confrontational with trading partners – including China (although he is likely to have a tougher stance than in the past), repair relations with the World Health Organization (WHO) and World Trade Organization (WTO), and rejoin the Paris Agreement.

COVID-19 remains a significant risk
(Daily new confirmed cases, in thousands)



Source: Our World in Data, UBS Asset Management. As of 31 December 2020.

Under this scenario, we would expect a strong rebound of economic activity in 2021-22. We would also expect that such fiscal-driven expansion could increase inflation expectations, weaken the US dollar and pressure UST yields upwards while steepening the UST yield curve as markets start pricing in Fed rate hikes as soon as mid-2022.

EM credit and rates will likely do well under the President-elect Biden administration in 2021, as income effects (higher growth) more than offset price effects (higher UST yields). Longer term however, higher UST yields have historically been detrimental for EM credit spreads and EM rates, particularly when those higher yields reflect higher inflation expectations and start pricing in rate hikes.

EM currencies will likely do better in a weaker US dollar environment, as long as UST yields sell off in an orderly fashion. An abrupt sell off in UST yields could drag most EM asset prices down. On the one hand, historical spreads have failed to compress enough to offset the negative impact of abrupt UST yields sell offs while the US dollar has tended to appreciate in those instances, weakening EM currencies.

EM credit and rates at pre-pandemic levels, EM currencies offer value

Back in September we acknowledged that EM fundamentals have suffered with the pandemic, but we also said that spreads offered value at those levels and expected 50-75 bps compression in the next few quarters. Sovereign (corporate) spreads tightened 81 bps (67 bps) in Q4 alone. We believe that EM spreads have fully converged to fair value; one compatible with weaker macroeconomic fundamentals. EM rates are also at record lows in many instances. However, record easy global financial conditions, expectation of lower-for-longer policy rates and additional fiscal stimulus coupled with strong inflows into the asset class could generate further spread/rates compression in Q1 2021, perhaps back to end-2019 levels, 50 bps below current levels. EM currencies can offer better opportunities, particularly in a weaker US dollar environment. *(Federico Kaune)*

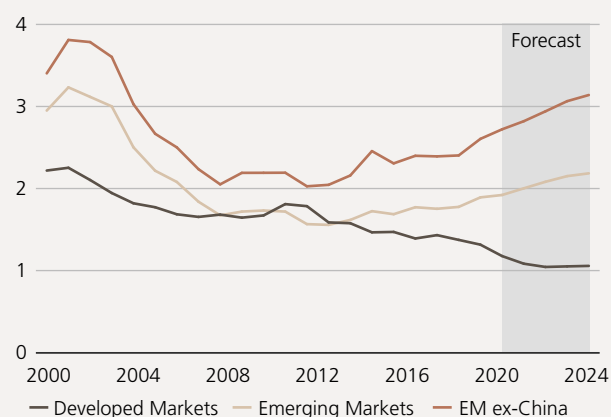
Debt matters: the bitter reality of pandemic-related cost for EM

Ultra-low interest rates are likely to limit the costs of fiscal stimulus in advanced economies, but the bitter reality in emerging markets is that more debt doesn't come for free. Since the Global Financial Crisis (GFC) gross debt has increased by 27 percentage points of GDP in both, DM and EM, to 125% and 65%, respectively, but the interest burden has followed opposite paths. In DM the cost of debt is expected to reach new lows in the coming years (1% of GDP in 2021 from 1.8% of GDP in 2011), in EM (excluding China) the cost is expected to increase to 3.1% of GDP by 2025, from 2.2% of GDP in 2011, a level only seen in the early 2000s. To make matters worse, this is all happening in an environment of slowing potential GDP growth in EM, in part due to less favorable demographics, which makes the arithmetic of debt sustainability more challenging.

Even if we assume that the fiscal accounts will improve as tax revenues pick up on the back of higher growth, a large fiscal effort is likely to be required to keep debt/GDP from

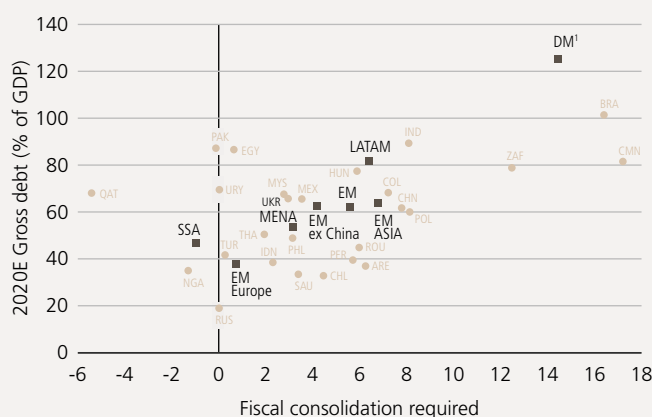
increasing further. Many highly indebted economies are facing a fragile equilibrium that could be easily derailed if another economic shock materializes. Latin America is a relevant example: it is the most indebted region in EM, (debt to GDP has increased by 11 percentage points to 81.5% in 2020), it has the lowest GDP growth potential (2.5%) in EM (4.5%), and the second highest interest rates behind sub-Saharan Africa. Thus, it's inevitable for the region to face a prolonged period of fiscal consolidation and reforms to increase its potential growth and reduce its debt burden. This is particularly true for Brazil, Argentina and Ecuador that have high debt levels and have struggled to grow in the past few decades, but Colombia also requires a tough fiscal effort to reduce debt levels and avoid losing its IG rating. In other regions, South Africa, India, Oman and Romania will certainly struggle to correct their fiscal accounts in the post-pandemic era. The unprecedented 2020 fiscal stimulus comes with a cost and will have to be followed by a remarkable fiscal consolidation in most emerging economies. *(Thiago Carlos)*

Interest expenditure (% of GDP)



Source: IMF and UBS Asset Management. Date as of 31 December 2020.

2020E Gross debt vs fiscal consolidation required (% GDP)



Source: IMF and UBS Asset Management. Date as of 31 December 2020.

1 For DM it was calculated the fiscal consolidation required to bring the Gross debt to 90% in 10 years.

Immunizing EM: impact versus feasibility

The pandemic has caused the world economy to veer off course in 2020. The IMF forecasts indicate that by the end of 2021 the economies of most countries in the world would be smaller than in the absence of a global pandemic, with most EM (excluding China and newly industrialized economies) lagging DM in the recovery. The pandemic has left the biggest gaps in growth forecasts in countries like Mexico, Peru, Dominican Republic, Philippines and India – and the vaccines may help boost economic activity in those countries, eventually reducing these gaps. Investors may find it useful to differentiate amongst the varying degrees of impact and feasibility across countries because the paths to mass immunization will prove to be more difficult for some than others.

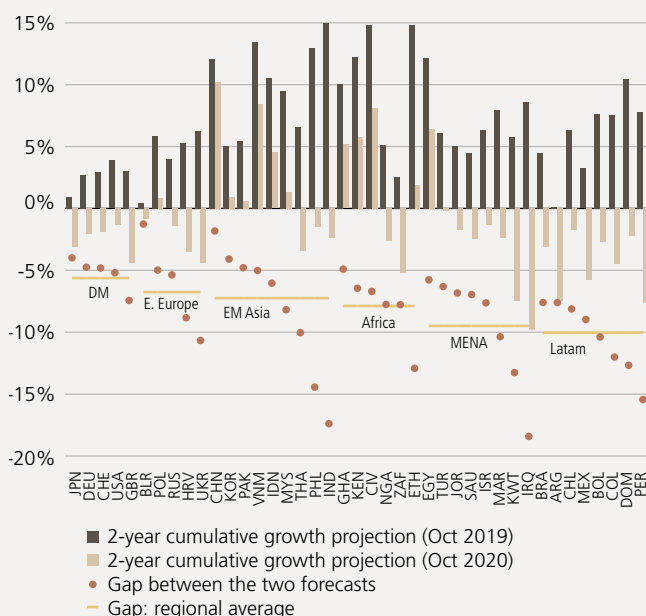
Will the vaccines – which exceeded expectations in both efficacy and timing – help reduce the gap in the growth forecasts? For most of EM the positive effect from the vaccine rollout would come first and foremost from a supportive external environment, as the vaccine availability and distribution in EM is likely to lag behind DM. As immunization campaigns take off in several EM, the direct impact on economic activity will vary across countries, depending on factors like the relative success in having contained the virus, the degree of stringency in social distancing measures and demographics.

At a regional level, the potential impact of mass vaccination is the greatest in Latin America because most of the countries were hit particularly hard. The greatest impact on economic

activity is expected in Argentina, Peru, and Bolivia, which imposed severe lockdowns. On the other hand, China, South Korea, and Vietnam, which contained the virus without prolonged lockdowns, should experience a smaller boost from vaccination. Similarly in sub-Saharan Africa, due to the relatively fewer number of confirmed cases and fatalities, less stringent mobility measures and more favorable demographic profiles, the vaccines' potential economic impact would be relatively small.

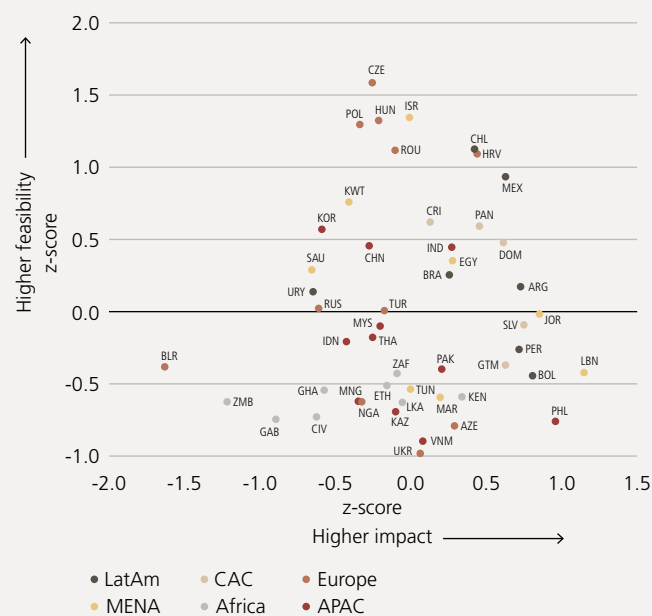
In EM, another important issue to consider besides the potential economic impact of vaccines is feasibility. Access, distribution bottlenecks, and confidence in the vaccines matter. DM countries that managed to secure sufficient doses of approved vaccines ahead of others started vaccinations in December 2020. EM countries, including many in Sub-Saharan Africa that rely entirely on Covax (a multilateral mechanism for pooled procurement of vaccines) are unlikely to begin vaccination until late 2021. The quality of healthcare infrastructure plays a role too. Strong healthcare systems (Israel, Uruguay, EU, and the Gulf countries) allow for speedier facilitation of public health campaigns. EM populations appear more likely to trust the safety and effectiveness of a vaccine than DM, but low levels of trust in countries like South Korea, Russia, and Ukraine could hamper vaccination efforts. Countries that did not procure vaccines developed in Europe or the US and rely on vaccines that have so far lacked data transparency, are more likely to suffer from vaccine hesitancy. (Yuni Kim)

How the pandemic hit '20-'21 growth forecasts



Source: IMF and UBS Asset Management. Date as of 31 December 2020.

Mass vaccination across EM: impact vs. feasibility



Source: Duke University, Our World in Data, Oxford University, World Bank, World Health Organization, World Tourism Organization, Wellcome, UBS Asset Management. As of 30 September 2020.

Note: The impact of mass vaccination on economic activity in country and its feasibility in implementing the vaccination campaign was assessed by considering various factors. Mass vaccination is considered to be more impactful in countries with higher COVID-19 burden, more stringent mobility measures, and higher share of vulnerable population, proxied by the number of confirmed COVID-19 cases per million, the Oxford Stringency Index, and the share of population aged 65 and higher, respectively. In terms of economic activity, the impact would be the most immediately reflected in those with high shares of domestic demand and/or high dependency on tourism. The implementation of mass vaccination is considered more feasible in countries that have secured adequate supply of approved vaccines (in terms of percentage of population) and where people have higher confidence in vaccines' effectiveness and safety (measured using surveys from the Vaccine Confidence Project). In addition, having adequate healthcare capacity, proxied by government health spending per capita (PPP), plays a significant role in carrying out public health campaigns. The "impact" and "feasibility" scores use the averaged Z-scores of these measures.

Commodities: Outlook and historical impact on EM fundamentals

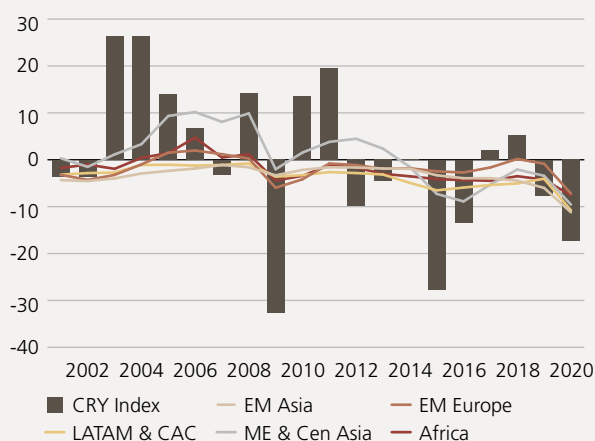
The outlook for commodities appears generally favorable. The COVID-19 vaccine is going to be introduced gradually in 2021, which should lead to a progressive reopening of the economy, recovering growth and to substantially increase the movement of people and things. At the same time, the US dollar weakness is likely to continue as the Fed should keep interest rates low for a while. Valuations are also generally attractive, as the CRY Commodity Index closed 2020 at the lowest level in 19 years.

Oil demand is likely to pick up gradually in 2021, with a full recovery by 2022. On the supply side we believe that OPEC decisions will remain crucial to determine production levels, while increases on Iranian production are now more likely under the Biden administration. Copper performed well in 2020, supported by recovering Chinese and global demand since April. These dynamics are likely to continue but at a more moderate pace due to increasing supply levels (pandemic related production disruptions are less likely to take place in 2021 on the back of the vaccine). Similarly, agricultural demand should benefit from the increase in mobility and commercial food consumption. On the supply side, while weather related disruptions have historically led to volatility in output, rising margins should increase supply. The outlook on gold prices is less optimistic, firstly due to valuations and secondly as US real yields are likely to rise

during 2021 due to the expected economic recovery on the back of the vaccine delivery and fiscal stimulus. Historically, increases in real yields have led to lower gold prices.

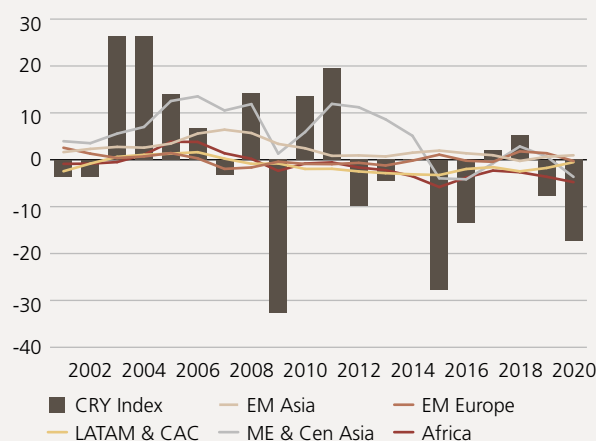
In general, to what extent do commodity prices affect EM countries? We analysed the historical impact of commodity prices on the fundamentals of EM countries, by correlating the CRY index with the fiscal and current account performances of countries in the five main regions in EM (Asia, Europe, Africa, Middle East, LATAM) over the past 20 years. Looking at the results, while both fundamentals correlate positively with commodity prices, we observe stronger correlation levels with fiscal results (0.49) rather than current account performance (0.36). Regionally, on the fiscal side, we highlight meaningful correlation levels (above 0.5) in LATAM, Middle East and Africa, suggesting that these regions' fiscal performance improves in years when commodities rise in price. On the current account side, results are more dispersed. While Middle East and Africa post significant positive correlations (0.6), Europe and Asia show low explanatory levels, as external accounts are generally less impacted by swings in commodity prices compared to other regions. Overall, if higher commodity prices do materialize in 2021, we should generally expect an improvement in fundamentals across the board, with a more pronounced amelioration in Middle Eastern and African countries' twin deficits among all regions. (*Gianandrea Heyer*)

Fiscal balance (% of GDP) and commodity prices in EM (YOY %), 2001-2020



Source: IMF and UBS Asset Management. Date as of 31 December 2020.

Current account (% of GDP) and commodity prices in EM (YOY %), 2001-2020



Source: IMF and UBS Asset Management. Date as of 31 December 2020.

Sovereign debt: Strong rally in high yield

Sovereign credit posted a strong 5.80% total return in Q4 2020 (measured by the JP Morgan EMBIGD Index). Spreads tightened an impressive 81 bps to 352 bps, generating a 7.36% spread return. US Treasury yields sold off roughly 20 bps in Q4, detracting from performance. IG spreads tightened 44 bps to 152 bps and high yield (HY) spreads 145 bps to 608 bps in Q4, continuing with the trend in Q3. As a result, EM IG (HY) sovereigns returned 2.96% (9.32%) in Q4 2020.

The EMBIGD index widened 61 bps in 2020, resulting in a 5.26% total return and a -2.94% spread return. The strong rally in UST yields added 8.2% to total return. Sovereign spreads started the year at 291 bps, widened 430 bps to 721 bps in March 23, 2020 and rallied back to 352 bps by end-2020. IG spreads have fully converged to end-2019 levels, while HY spreads are still 121 bps wider than at the end of 2019.

All the positive total return in sovereigns during Q4 was generated in November and December, particularly in November after the uncertainty surrounding the US election subsided and expectations of further fiscal stimulus increased.

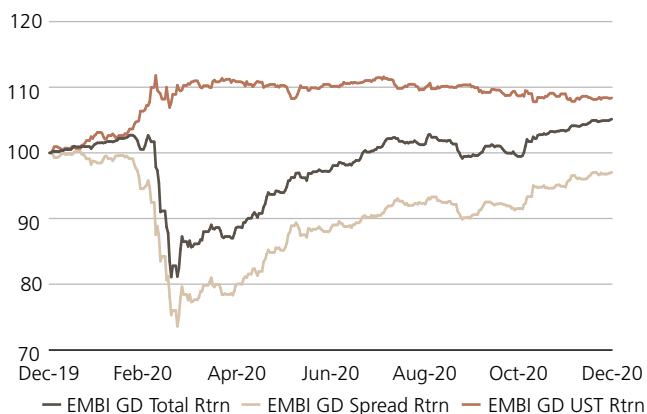
In response to the fading uncertainties, flows into EM FI funds increased substantially, driving prices up everywhere, but most notably on relatively illiquid high yielding bonds in Africa.

All regions generated positive total returns in Q4 as it was the case in Q3. Africa posted an outsized 14.31% return, relative to any other region. The African rally was broad: 10 out of the 12 African countries included in the EMBIG index rallied more than 10%, with Angola (22.49%) at the helm. On the other extreme, Zambia, which had recently defaulted on its external obligations, rallied 2.53%. Angola and other oil exporters – including Ghana and Nigeria – benefitted from the rally in oil prices of almost 20% and strong inflows into indexed funds.

Emerging Europe finished a distant second, posting a 6.61% total return. High-yielders including Ukraine (14.32%), Turkey (12.35%) and Belarus (10.88%) showed the strongest returns. Ukraine benefitted from ongoing discussions on a program with the International Monetary Fund (IMF), while Turkey started rallying once the central bank changed course and started tightening monetary policy, thus strengthening the currency.

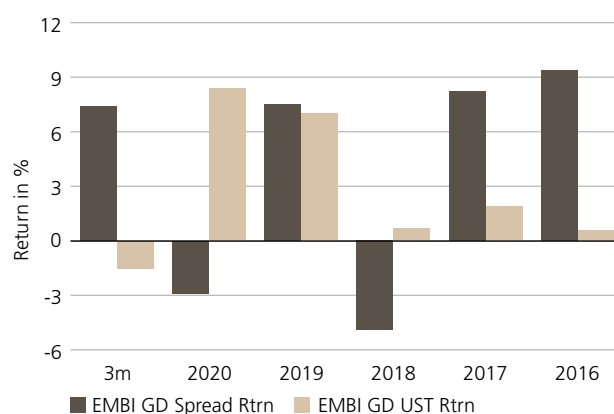
EM sovereign debt: ongoing rally in Q4

(Rebalanced to 100 as of 31 December 2019)



Source: JP Morgan monitor. As of 31 December 2020.

EM sovereign debt returns over the past 5 years



Latin America came third with a 6.00% total return. Dominican Republic, Mexico and Jamaica returned close to 13% each. On the other extreme, those countries that had recently restructured their external obligations lagged. Argentina (-2.83%) and Ecuador (-2.39%), underperformed in part because their new post-restructuring bonds lack carry as they pay close to zero coupons. This feature deters a large group of leveraged investors from allocating risk to these bonds. Argentina's underperformance was noticeable in that it followed negative performance in Q3. Clearly investors did not agree with the post-restructuring economic strategy presented by the government and are still waiting for a program with the IMF.

The Middle East returned 3.92%, led by high yielding Jordan (13.27%), Egypt (12.96%) and Oman (11.54%). Lebanon continued imploding, returning -21.89%, as the government has been unable to design, agree and implement an economic recovery program that donors and multilateral organizations could back. The mediocre returns of several IG oil exporters in the region reflected the negative impact of higher UST yields in Q4, as most of those bonds are long duration and low yielding, which makes them more sensitive to UST moves. Asia returned 1.13% in Q4. Tajikistan (8.23%) and Azerbaijan (7.06%) showed the highest returns. China was flat, reflecting

the negative impact of US sanctions on several government related companies that resulted in a significant spread widening in several IG bonds. At this juncture it is unclear whether the Biden administration will reverse those sanctions. Sri Lanka sold off 13.12% reflecting growing concerns on the country's ability to continue to service its bonded debt in 2021.

At around 350 bps for the EMBIGD, sovereign spreads have largely converged to their 10-year mean (344 bps), on strong inflows and despite their higher indebtedness and weaker capacity to pay after the pandemic.

At 150 bps, EM IG spreads have fully converged to pre-pandemic levels and are trading 50 bps wide to US IG, in line with historical levels. At 570 bps EM HY spreads (excluding credits in default) are 50 bps wider than their 10-year mean and pre-pandemic levels and 150 bps wider than US HY. Spreads could tighten 25-50 bps in the next few quarters in the current favorable risk-on global environment.

We believe that reaching pre-pandemic spread levels (c. 300 bps) is possible due to strong demand for EM credit and ample global liquidity. This could happen even if weaker EM fundamentals warrant higher risk premiums. *(Federico Kaune)*

Corporate debt: Eyeing a post-pandemic recovery

EM corporate credit returned 4.29% in Q4 2020 (as measured by the JP Morgan CEMBI Index), 5.10% from the 67 bps spread compression and -0.77% from UST. EM corporate credit returned a strong 7.35% in 2020. This annual return was a combination of spreads widening by only 23 bps when combined with a carry, contributed 1.20% to the annual return, whereas Treasury contributed 6.08% to full year 2020 returns.

In Q4 all regions provided positive total returns. The largest outperformers were Africa and Latin America with Asia lagging in both total returns and spread returns. In Q4 2020 corporate bonds in Ghana (33.47%), Argentina (12.94%), Ukraine (10.94%), Zambia (9.97%) and Turkey (7.73%) provided the largest positive returns while the largest underperformers were again from low spread/yielding countries of Poland (0.45%), Korea (1.32%), Taiwan (1.44%), China (1.61%), and Qatar (1.77%). From a sector perspective, pulp & paper (7.80%), metals & mining (6.83%) and oil & gas (6.23%) provided the largest positive returns while the lowest returns were infrastructure (2.94%), financials (3.17%) and utilities (3.27%).

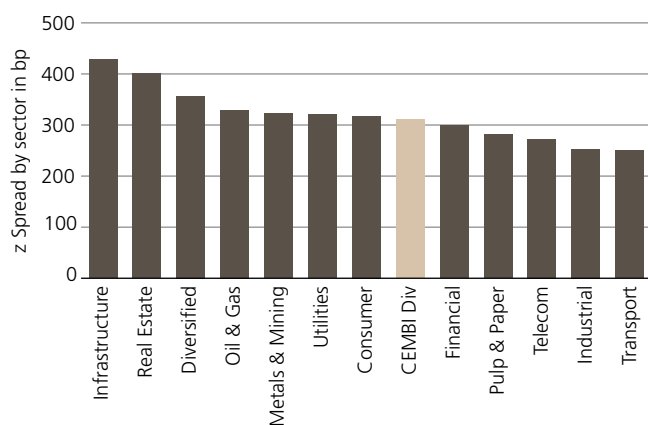
Financials: Supportive forbearance measures mitigated the deterioration in asset quality, earnings and capital erosion, but fundamentals are likely to remain under pressure in 2021. Loan growth should be moderate, supported by fiscal measures and government guarantees. Risks are contained at EM banks as they have strengthened capital positions, reduced leverage and generally maintain higher levels of liquidity since the GFC. Fundamentally, we continue to prefer large high quality franchises that have solid capital and liquidity buffers and conservative underwriting standards.

TMT (tech. & telecoms.): A defensive sector against the pandemic as consumption of mobile, internet and TV subscription services remained resilient. Moreover, demand for telecom services surged following the 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 in EM and comparatively lower penetration rates relative to developed economies.

Oil & gas: Despite some signs of a demand pickup, we remain cautious on the oil-market recovery. This is due to a slowdown in crude buying from China after its massive stockpiling, inconsistent adherence to OPEC's oil output cuts, the potential changes in fuel consumption patterns, particularly in transport, and continued overhang of inventories.

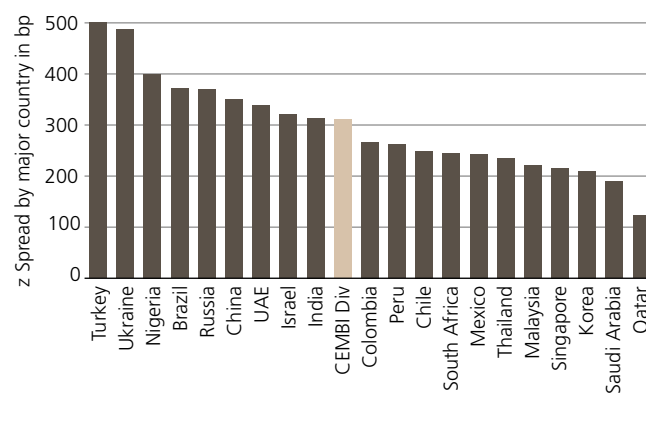
EM corporate spreads by sector

Measured in bps as of 31 December, 2020



EM corporate spreads by country

Measured in bps as of 31 December, 2020



The z-spread – also known as the zero-volatility spread or the static spread – measures the spread over the benchmark zero coupon swap curve. Source: JP Morgan monitor. As of 31 December 2020.

Consumer: Components of this segment considered first necessity such as packaged food, beverages and household products, particularly exporters and companies with international operations in developed countries are likely to benefit from the recovery. As we expected, consumer discretionary underperformed in most parts of the current pandemic due to periodic shelter-in-place, lockdowns and/or social distancing measures. This not only reduced store traffic, but also average ticket size and same-sales store (SSS). However, we prefer to stay nimble with non-food retailers and travel & leisure.

Metals & mining: The better than expected economic recovery in China has improved the outlook/demand for iron ore, copper, aluminium, steel and zinc. Risks remain finely balanced, on unknown US/China relationship, oncoming supply and continued uncertainties over the pandemic. We still prefer to maintain exposure to low-cost, lower-levered larger producers of iron ore, gold, silver, and copper.

As we highlighted in previous quarters, EM issuers had prudently executed liability management exercises and alleviated short term funding pressures while lowering funding costs. We also highlighted that the sharp decline in growth, demand, and consumer confidence, would likely result in an increase of distressed events (defaults / distressed exchanges), primarily from airlines, hotels and retailers. While these events did materialize, it was not at the initially expected levels, as the prudent liability management exercises carried out by corporates over the previous few years, along with continued supportive central bank liquidity measures, reduced risks for most EM high yield issuers, enabling most corporates to weather the shocks of 2020.

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 & leisure, oil & gas and telecoms. We will tactically participate in these sectors given our positive outlook at the start of 2021. Performance in 2021 will likely rely on beta management, tactical duration positioning, while maintaining core exposure to names with strong fundamentals. While EM corporate credit has seen a significant rally from the March lows we remain bullish on EM credit given the roll out of COVID-19 vaccines and improvements in expectations of global growth and commodity demand. *(David Michael)*

Local debt: A weakening US dollar trend

EM local debt showed a 9.24% total return in Q4 (as measured by the JP Morgan GBIEMGD Index) turning performance from a sharp loss to a 2.69% return in 2020. The Q4 performance was largely due to a recovery in EM currencies (6.35%) rather than rates. Higher currency returns were a reflection of a general US dollar weakening trend post US elections in November. The prospect of ongoing fiscal and monetary stimuli in the US, less antagonistic US-China relations and the roll out of COVID-19 vaccines played a role. Flows into EM local funds, absent most of the year, also picked up strongly.

The outlook for Q1 2021 may continue to be positive for currencies and more balanced for rates. However, valuations are no longer distressed and the economic damage cause by the pandemic is bound to create volatility in the markets. Room to cut rates is now limited across EM, and interest rate hikes are possible in the second half of 2021. In our view, there are a few pockets of value in steep yield curves in more vulnerable markets such as South Africa. EM currencies have potential to perform well in Q1, but solid performance would only be consistent with clear evidence that the pandemic is under control. The degree of fiscal deterioration and ability of countries to grow, cut expenditure, and tap sources of funding would become a differentiation factor toward the middle of the year.

In Latin America, Mexico has some room to cut rates. Brazil has ended the cutting cycle, but the yield curve has a significant risk premium given the low inflation outlook as rate hikes are priced in to 2021. The Chilean rates markets have little additional room for a rally, and political noise will increase ahead of April elections. The Colombian yield curve is steep and the central bank will likely remain on hold. We think Brazilian real, Mexican peso and Colombian peso have room

to rally further, but are more neutral on Chilean peso and expect low volatility in Peruvian sol.

In EMEA, Turkey has sharply reversed course and pivoted to a more orthodox monetary policy after loss in reserves and high inflation, which supports the currency. The outlook for South Africa's growth and fiscal balance remains bleak, but the country's large domestic asset base and improved political support of the government should allow asset prices to muddle through. Russian bonds and currency have underperformed even as oil prices recovered from the lows and the government maintained fiscal restraint. The risk shifted again to geopolitics.

Central Europe has been marred by a resurgent COVID-19, and a political standoff with EU. However, it should benefit from a recovery in core Europe and the strength in the EURO. Interest-rates however are historically low and we believe there is limited value in bonds.

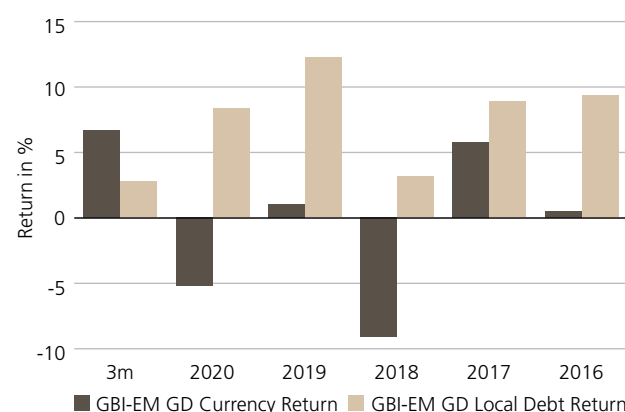
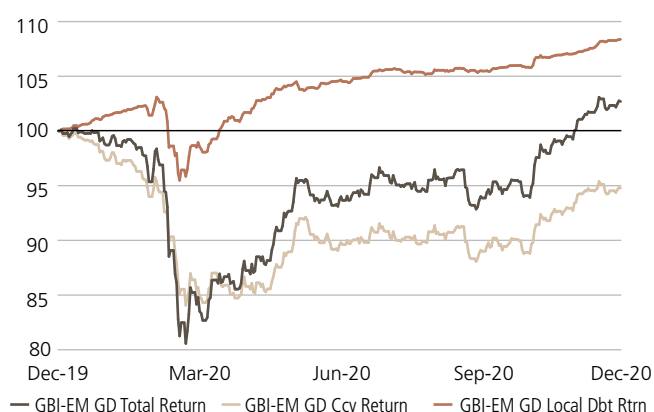
Following a period of volatility earlier in 2020, APAC currencies have recovered and the Chinese yuan has rallied from ~7.1 in June to ~6.60 by year end. Most APAC currencies also rebounded showing positive results for the year driven by better COVID-19 outcomes and the recovery in China. China's central bank has been reluctant to ease monetary policy given robust recovery creating yield support for the Chinese yuan. Most central banks in APAC have limited room to cut rates, in our view.

The main risks to the outlook are stemming from the uncertain nature of the global pandemic, geopolitical tensions, and lack of yield support for currencies in most markets. *(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 31 December 2020

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Americas

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EMEA

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