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EM Fixed Income: Paying the price of higher growth upfront

Emerging markets fixed income | UBS Asset Management

Q1 2021:
EM hit by higher US Treasury yields

- Emerging markets fixed income (EM FI) delivered negative total returns in Q1, reflecting the sizable sell-off in US Treasury (UST) yields and stronger US dollar.
- EM assets were hit by the negative price effect (higher US yields) as markets expect very high growth in coming quarters that could ignite global inflation.
- We expect EM assets to benefit from the highly positive income effect in coming quarters, including higher global growth, trade and commodity prices.
- The risks to our constructive view stem from pandemic dynamics and a further sell-off in UST yields.

EM FI showed negative total returns across all asset classes in Q1 2021, despite relatively constructive spread behavior. Sovereign (corporate) credit spreads as measured by the EMBIGD[1] (CEMBID[2]) widened (tightened) by 3 bps (22 bps) in Q1 to 354 bps (289 bps) generating a 0.73% (1.98%) spread return (inclusive of carry). However, the massive 77-83 bps widening in US Treasury (UST) yields in Q1 detracted from total credit returns.

Local yields (as measured by the GBIEMGD[3]) widened by 78 bps mirroring the sell-off in UST yields to 4.99%, generating a return of -3.19% in Q1. Emerging market currencies sold off 3.61% against the US dollar in Q1, reflecting idiosyncratic factors and broad US dollar strength. In all, the local index returned -6.68% in Q1 and 2021.

1Q 2021 returns

US dollar debt	Total return	Spread return	US treasury return
JP Morgan EMBI Global Diversified	-4.54%	0.73%	-5.23%
JP Morgan CEMBI Diversified	-0.99%	1.98%	-2.92%

Local currency debt	Total return	Currency return	Local debt return
JP Morgan GBI-EM Global Diversified	-6.68%	-3.61%	-3.19%
JP Morgan ELMI+	-2.57%	-3.00%	0.45%

JPM = JP Morgan.
EMBI = Emerging Markets Bond Index.
CEMBI = Corporate Emerging Markets Bond Index.
GBI-EM = Government Bond Index – Emerging Markets.
ELMI = Emerging Local Markets Index.
Source: Data as of March 31, 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

From inflows to outflows and back

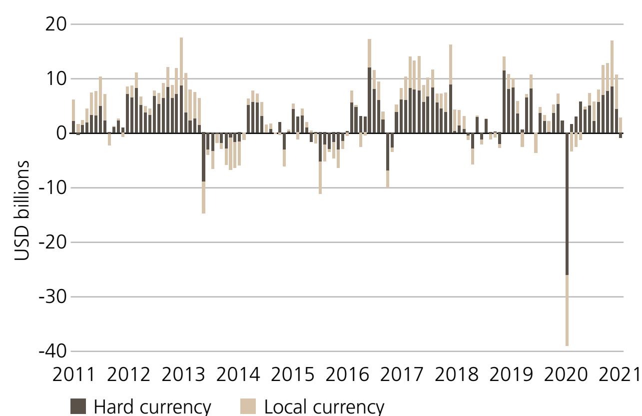
According to the latest J.P. Morgan survey, EM FI attracted USD 29 billion of new investments in Q1, after recording USD 30.5 billion of inflows in Q4 2020. Sovereign and corporate credit saw inflows of USD 11.6 billion in Q1 adding to the USD 19 billion inflow in Q4, while local EM (currency and rates) saw inflows of USD 17.4 billion in Q1 from a USD 11.5 billion inflow in Q4 2020.

Robust debt issuance continued in Q1, particularly by IG credits. Sovereign and corporate issuance in Q1 2021 reached USD 69.2 billion and USD 163 billion, respectively. Amortization and coupon payments reached USD 34.4 billion for sovereigns and USD 91.5 billion for corporates.

US to drive recovery in global activity in H1

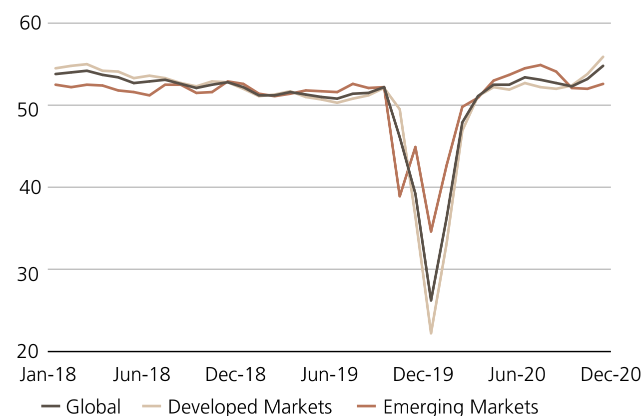
Purchasing manager indices (composite PMIs) suggest that global economic activity recovered further in Q1. However, the recovery was far from homogeneous. US economic activity is recovering at a very strong pace on the back of fiscal and monetary stimulus and record easy financial conditions. The Eurozone's composite PMI indicates that economic activity is also on the upswing, albeit at a slower pace than in the US. China and EM PMIs show more stable behavior in Q1 and thus are lagging the US and the Eurozone.

Incoming flows remain in Q1 (USD billion)



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

Global PMIs further recovery in Q1



Source: Macrobond, UBS Asset Management. As of 31 March 2021. A level above 50 indicates economic improvement.

Financial conditions remained at record easy levels in the US during Q1, in spite of the sell-off in UST yields and a somewhat stronger US dollar. This was because corporate spreads and equity markets rallied in Q1 offsetting the negative impact. The easing of financial conditions in the US stands out relative to what is observed in other regions.

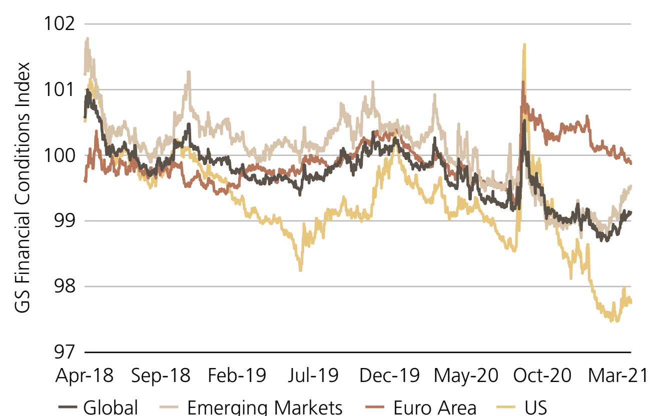
The pandemic continued to generate havoc in several countries in both in DM and EM, forcing several countries to lock down again in an effort to slow the spread of the virus. In EM, Latin America and Brazil in particular have been unable to control the pandemic. Even Chile, which had a very efficient vaccination effort, had to lock down as the virus started spreading once again.

In other EM countries, India's contagion rate is re-accelerating, but Asia in general is doing a lot better. Most DM countries appeared to have been able to stabilize the rate of contagion.

Vaccination efforts have been most successful in Israel (almost 58% of the population received a first shot as the time of writing), UK (46%), Chile (35%) and the US (almost 30%). Most countries are in the low teens with large EM lagging behind: Brazil (8.4%), Mexico (5.1%), Russia (4.2%) and India (4%).

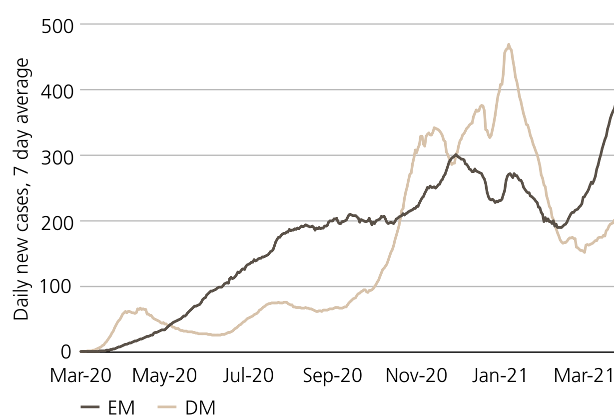
Besides pandemic dynamics, financial markets responded to several policy developments in DM during Q1. Most notable was the new USD 1.9 trillion (9% of GDP) fiscal stimulus approved in the US, which comes less than 3 months after a USD 0.9 trillion (c. 4.5% of GDP) fiscal stimulus approved in December 2020. Additionally, DM central banks continued with the implementation of their respective expansive quantitative easing (QE) programs and in the case of the US, the Fed clarified that they will no longer follow inflation expectations but keep rates at current record low levels until they see actual inflation rise above 2% on a sustainable basis. In all, DM fiscal and monetary policies were expansionary in Q1.

Financial conditions: easiest level on record in the US



Source: Goldmand Sachs, Bloomberg,UBS Asset Management.
As of 31 March 2021

EM is in the worst of the pandemic
(Daily new confirmed COVID-19 cases, in thousands)

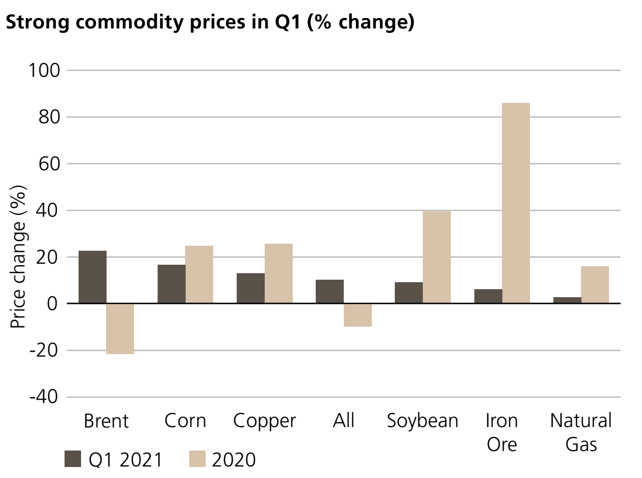


Source: Our World in Data, UBS Asset Management. As of 31 March 2021.

China's economic activity continued to recover in Q1 according to the latest composite PMIs. Our economists expect year-on-year growth of almost 20% in Q1 due to a low base effect, but a much smaller, albeit positive sequential growth. In its late-March meeting, the National People's Congress (NPC) called for less hawkish and supportive macroeconomic policies in 2021. The NPC also approved the 14th Five-Year Plan in March, which notably did not set a real GDP target as in past plans, but set an above 7% annual growth rate for research and development (R&D) spending and an increase of 4-5% in the urbanization rate to 65%. The plan emphasizes domestic demand, innovation, infrastructure development, carbon controls and further structural reforms.

The recovery of global economic activity had a positive impact on global trade volumes and commodity prices. Global trade volume has a more than proportional sensitivity to global growth. Hence, the recovery in growth in Q1 had an important impact on global trade volume. The price of oil increased by more than 20% in Q1 reflecting demand recovery and supply constraints. Similarly, copper, iron-ore and soybean prices all had strong increases in Q1. These positive developments helped many EM commodity exporters.

Strong commodity prices in Q1 (% change)



Source: Bloomberg, UBS Asset Management. As of 31 March 2021.
Note: All commodities is represented by the CRB Index.
Past performance is not a guide to future results.

Higher growth follows higher yields?

The US Treasury sell-off had a detrimental impact on EM returns in Q1. The sell-off reflected expectations of higher-than-previously-expected growth in 2021 on the back of a larger-than-expected fiscal package and the renewed commitment from the Fed not to hike rates until inflation is above 2% for an extended period of time. Additionally, inflation expectations adjusted upwards.

However, the Fed kept its QE program unchanged at USD 120bn/month with USD 80bn/month allocated to UST and didn't provide guidance on additional operations to control longer term yields. Given the higher expected supply of UST bonds to finance a double digit fiscal deficit in 2021, markets promptly adjusted yields upwards along the yield curve.

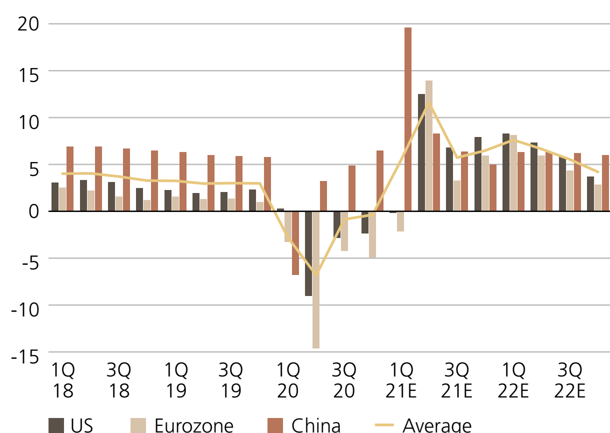
Furthermore, the 5-year/5-year USD Overnight Index Swap, a usual bellwether of medium term rates expectations, sold off 100 bps in Q1 and got close to the Fed's median longer-run policy rate projection or 'dot' currently at 2.5%[4]. After the massive selloff in Q1, it is plausible that UST yields may have found a new range in the near term.

If UST yields stabilize at around 1.75% in the 10-year and 2.5% in the 30-year (Bloomberg, March 2021), 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). In this scenario, we would expect EM asset prices to perform a lot better than in Q1. The main risk in Q2 is that inflation in the US and globally is likely to increase substantially on base effects. If markets are unable to see this as a temporary inflation boost, yields could start selling off once again.

On the global activity side, we are very constructive in Q2, absent a resurgence of the pandemic. We expect systemic countries/regions to recover strongly on a sequential basis (US, Europe and China) and on an annual basis (US and Eurozone). Year-on-year the US is expected to grow at 12.5%, China at 8.3% and Europe at 13.9% in Q2. This implies that 60% of the most important countries/regions in the world, those that drive global consumption and trade are expected to have robust growth in Q2.

This is a very powerful tailwind that is likely to strongly improve EM external and fiscal fundamentals. We expect most EM (with the possible exception of India) to lag DM and China in the recovery in Q2, but we also expect these divergencies to diminish as DM growth rates slow down to more sustainable levels and EM growth rates recover further in H2 2021 and 2022.

US, Europe and China GDP growth (% y/y)



Source: Haver, CEIC, National Statistics, UBS forecasts. As of 31 March 2021.

4 Source: Federal Reserve FOMC meeting, 17 March 2021.

The International Monetary Fund (IMF) is bullish on global growth

IMF WEO real GDP growth Projections (%)

	2020	2021E	2022E
World output	**-3.3**	**6.0**	**4.4**
Advanced economies	**-4.7**	**5.1**	**3.6**
United States	-3.5	6.4	3.5
Euro area	-6.6	4.4	3.8
Japan	-4.8	3.3	2.5
United Kingdom	-9.9	5.3	5.1
Canada	-5.4	5.0	4.7
Other advanced economies	-2.1	4.4	3.4
Emerging Markets	**-2.2**	**6.7**	**5.0**
Emerging Asia	-1.0	8.6	6.0
China	2.3	8.4	5.6
India	-8.0	12.5	6.9
ASEAN-5	-3.4	4.9	6.1
Emerging Europe	-2.0	4.4	3.9
Russia	-3.1	3.8	3.8
Latin America and the Caribbean	-7.0	4.6	3.1
Brazil	-4.1	3.7	2.6
Mexico	-8.2	5.0	3.0
Middle East and Central Asia	-2.9	3.7	3.8
Saudi Arabia	-4.1	2.9	4.0
Sub-Saharan Africa	-1.9	3.4	4.0
Nigeria	-1.8	2.5	2.3
South Africa	-7.0	3.1	2.0

Note: For India, data and forecasts are presented on a fiscal year basis, with FY 2020/2021 starting in April 2020. For the April 2021 WEO, India's growth projections are -7.1 percent in 2020 and 11.3 percent in 2021 based on calendar year.
Source: IMF WEO June Update. UBS Asset Management. As of June 30 2020.

SDR allocations: Manna from heaven?

In their efforts to further assist member countries in the wake of the global pandemic, the IMF is discussing a proposal to increase the allocation of Special Drawing Rights[5] (SDR) across members with the objective of boosting members' international reserves and helping them cope with the aftermaths of COVID-19. The latest proposal will have the IMF increase SDR allocations by USD 650 billion (the last USD 250 billion increase occurred in 2009 after the Global Financial Crisis). Each country will get a portion of this allocation according to its quota at the IMF. Countries can then exchange SDR for the currency of their choice (usually US dollars) and use it for international transactions (pay for imports, debt service, etc.) In effect, an increase in an SDR allocation provides liquidity in a reserve currency to countries that lack a reserve currency at a minimal cost (currently 0.05% interest rate).

Significant SDR allocation for some EM

	SDR allocation (USD bn)	Gross reserves (USD bn)	SDR allocation/ gross reserves
Zambia	1.34	1.20	111.09%
Suriname	0.18	0.58	30.13%
Bahrain	0.54	2.25	24.03%
Gabon	0.30	1.62	18.22%
Papua New Guinea	0.36	2.29	15.74%
Pakistan	2.78	18.25	15.21%
Sri Lanka	0.79	5.67	13.96%
Tajikistan	0.24	1.74	13.69%
Ethiopia	0.41	3.05	13.49%
Ecuador	0.95	7.13	13.37%
Ghana	1.01	7.65	13.18%
Jamaica	0.52	4.08	12.82%
El Salvador	0.39	3.08	12.73%
Belarus	0.93	7.47	12.47%
Barbados	0.13	1.05	12.33%
Namibia	0.26	2.17	12.03%
Argentina	4.36	39.41	11.05%
Belize	0.04	0.35	10.48%

Source: IMF and UBS Asset Management. As of 31 March 2021.

The quota of EM at the IMF is around 42%, therefore EM will receive around USD 275 billion of this allocation. This is a significant boost, particularly for low reserve / vulnerable economies, which could further improve EM prospects in H2. Those that approve of the allocation are thinking of the benefits of a quick way of helping all member countries without conditions. Those that oppose the allocation argue that the IMF has several programs to help countries in need and target them in exchange for better policies (conditionality). Be it as it may, it appears that even more cost-free money could be raining over the world in the months to come.

5 The SDR is a unit of account composed of a basket of 5 currencies: USD, Euro, Yuan, Yen and Pound Sterling. Its current value is 1USD = 0.67SDR. SDR are allocated to members according to their quota at the IMF.

Sovereign credit lagged and offers value

In January 2021 we argued that IG EM spreads had fully converged to fair value but that HY spreads offered valued even with weaker macroeconomic fundamentals. We also argued that because of record easy global financial conditions, expectation of lower-for-longer policy rates and additional fiscal stimulus coupled with strong inflows into the asset class, spreads could compress 25-50 bps from those levels.

Sovereign spreads remained broadly unchanged, resilient to the UST yields decompression despite its relative long duration of almost 8 years. On the other hand, 5-year duration corporate spreads tightened 30 bps, almost offsetting the impact of the UST selloff on total return. We believe there is value in sovereign spreads, which have lagged corporate spreads. We also believe that HY spreads are likely to benefit from higher growth, trade and commodity prices, but acknowledge that stability in UST yields could also generate further compression in IG spreads in Q2.

EM rates could do better than in Q1 if UST yields stabilize. EM currencies usually require all global factors to push in the same positive direction to rally, and are unlikely to perform in a stronger USD environment, which is likely to persist in Q2. *(Federico Kaune)*

Capital flows: can EM governments handle another tantrum?

Just one year after the violent sell-off in EM assets, EM investors' anticipation of strong US spill overs and recovery in EM were overtaken by a reminder of the 'Taper Tantrum' of 2013 as US long-term real yields rose sharply. Faced with a prospective tightening of global financial conditions, volatility in EM local yields increased in Q1.

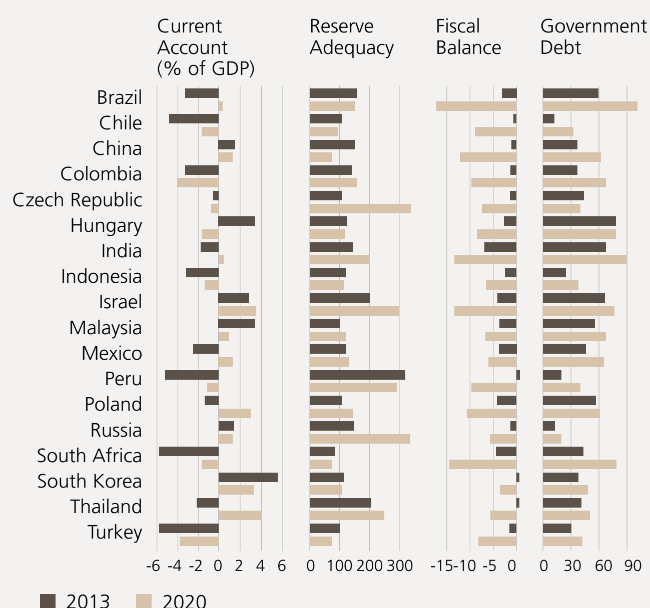
In terms of EM fundamentals, since 2013 the external positions of most EM have generally improved. Most of the 'Fragile Five' – Brazil, India, Indonesia, South Africa, and Turkey – have reduced their external imbalances and fundamentals suggest they are now less reliant on USD liquidity to fund their external funding needs. India in particular, which has built significant buffers in terms of official reserves, is in a much better place to withstand a currency shock than in 2013 when it saw the rupee fall by more than 15%. One exception is Turkey, whose external imbalances were exacerbated by recent policies.

Although EM at large have reduced external vulnerabilities, a tightening in global financial conditions is still concerning because of a surge of pandemic-related borrowing in EM. To finance deficits that are likely to remain wide, some governments are planning to issue even more domestic debt than they did last year, however their reliance on portfolio capital flows remain considerable for many, notably Mexico, Malaysia, Indonesia, South Africa, Central and Eastern Europe (CEE) and Russia due to the high share of foreign participation in local currency government bonds. Foreign capital inflows are needed to support large local debt issuance, estimated based on the local government debt issued in Q1 2021 and current levels of foreign participation, are compared to the year-to-date net capital flows to/from local government bonds in Chart 2 below. This indicates capital outflows in Indonesia, Mexico and Russia may put further pressure on bond yields.

With potentially less favorable global financial conditions, EM may face a reversal of capital flows through next few months. With lower foreign participation, governments may need to rely more on residents and central bank support. However, some EM central banks no longer have policy room amid rising inflation driven by commodity prices. As countries like Brazil, Russia and Philippines face persistent and higher inflation and market expectations of policy rate hikes, not all EM central banks may be able to continue to provide bond market support.

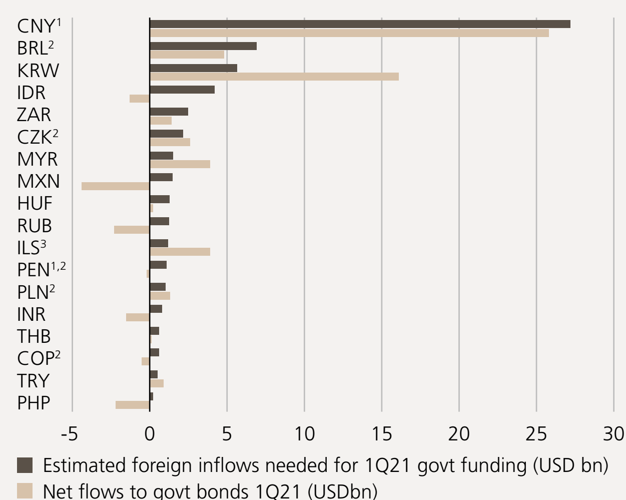
On the other hand, countries that can continue to pursue supportive monetary policy, including those that could continue unconventional QE to contain bond yields, such as central banks in Hungary, Poland and Romania that are further stepping up their government bond purchase programs, or able to diversify funding sources may be able to mitigate the upward pressures on local bond yields. With limited external vulnerabilities, most of EM is in a better place to avoid a repeat of the 2013 'Taper Tantrum'. However, continued high volatility in US rates is likely to be a headwind for those with limited fiscal and monetary policy room.
(Yuni Kim)

Chart 1: Externally more resilient, fiscally more fragile



Source: IMF and UBS Asset Management, all % of GDP, Reserve Adequacy % of metric, as of 5 April 2021.

Chart 2: Some rely more on foreign capital to fund fiscal needs



Note: Foreign inflows needed for 2021 Q1 government funding were estimated by using the local government debt issued in Q1 and year-end foreign share of local government bond holding.
1 Foreign inflows needed for 2021 Q1 government funding were estimated using planned issuance for 2021
2 Net flows to govt bonds up to February 2021
3 Net flows to govt bonds up to January 2021
Sources: Bloomberg, national sources, HSBC, VTB, Morgan Stanley, author's calculation

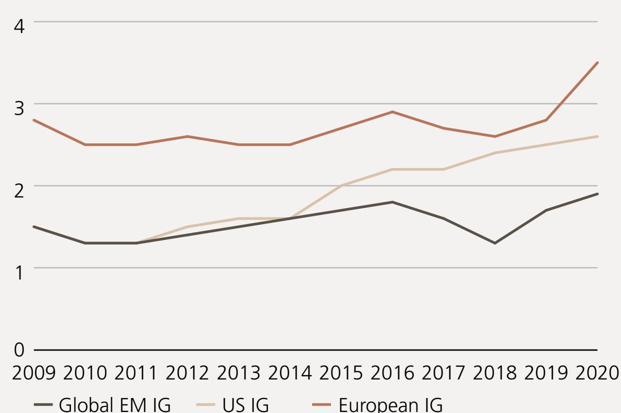
Emerging market corporate bonds have come of age as an asset class

Just a decade ago, investors deemed them to be mostly suitable for "off-benchmark" exposures in sovereign EM portfolios. Today, EM corporate bonds have grown nearly threefold into a USD 2.5 trillion asset class, twice the size of the US high yield (HY) market and also twice the size of the EM USD sovereign bond market. The asset class has amongst its ranks some of the largest and most recognized companies in the world issuing bonds. These include Industrial and Commercial Bank of China (ICBC), the largest bank in the world by assets with an asset base of USD 4.3 trillion[6], almost twice that of JP Morgan Chase, and Saudi ARAMCO, the largest oil producer in the world. Indeed, Baidu, Alibaba and Tencent, the internet behemoths, as well as Teva Pharmaceuticals, the largest manufacturer of generic drugs in the world all issue bonds in this market.

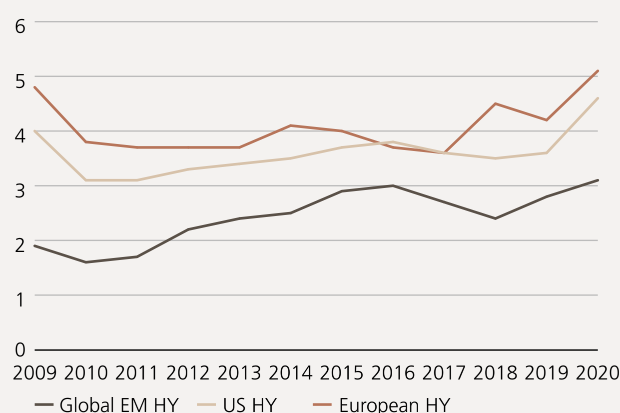
The appeal of EM corporate bonds as an asset class partly stems from the fact that they exhibit a rare trifecta of high average quality (BBB-), moderate duration (5.1 years) and above-market yields (4.1%)[7] relative to comparable asset classes. In early 2020 global credit spreads widened at an unprecedented pace as the impact of the COVID-19 pandemic roiled global markets. During this period, the JPM CEMBI Diversified Index, a proxy for EM USD corporate bonds returned -14.6%, compared to -20.4% for EM sovereign hard currency bonds, -20.9% for European High Yield and -21.4% for US High Yield[8] bonds. Impressively, EM corporate bonds held up almost as well as the -12.0% return[8] for US IG despite lacking the tailwind of direct bond purchases by the Fed which provided a backstop for US IG spreads. The first quarter of 2021 has brought with it a different kind of risk in the form of sharply rising interest rates. According to Bloomberg, 10-year US Treasury yields in Q1 jumped from 0.93% to 1.74% on a combination of an improved global growth outlook and rising inflation expectations. Due to its moderate duration profile and yield cushion, the EM corporate bond asset class generated a total return of -0.99%[9] compared to -4.54%[10] return for the longer-duration EM hard currency sovereign asset class and -4.65%[11] for US Investment grade bonds. Indeed, the only comparable major asset class to outperform EM corporates has been US HY with a +0.90%[12] return on the back of continued spread tightening.

Investors appear to have taken notice of this asset class. For calendar year 2020, EM corporate bonds attracted the lion's share of inflows into emerging market retail bond funds with a haul of over USD 10 billion compared to just USD 3 billion in EM sovereigns and outflows of roughly USD 5 billion in EM local currency funds according to data from EPFR and JP Morgan. So far this year, EM corporates continue to lead the way in terms of retail bond fund flows to the region. Has the asset class gotten ahead of itself given this explosive growth? Empirical evidence suggests this is not the case. EM corporates have consistently maintained an average rating of investment grade over the past three years despite the broadening of the asset class. This contrasts with EM sovereign hard currency which is currently rated high yield and has toggled between IG and HY over that same period. Also, default rates were lower and recovery rates higher for EM corporates compared to US high yield, European high yield and EM sovereigns during a challenging 2020. Finally, as the below charts show, EM corporate borrowers remain the most conservative relative to both European and US issuers when looked at from a net leverage perspective. This asset class has proven it deserves all the attention it is receiving.
(Tony Appiah)

EM IG versus DM IG – Net leverage



EM HY versus DM HY – Net leverage



Source: J.P. Morgan, Bloomberg Finance L.P. 2020 incorporates partial 4Q20 earnings. As of February 2021.
Note: For EM, utilizing an evolving set of external bond issuers with debt outstanding and excluding 100%-quasis, financials, real estate, and defaulted companies

6 Source: S&P, as of 31 January 2020
7 Source: Bloomberg, JPM CEMBI Diversified Index, as of 31 January 2021
8 Source: Bloomberg, Morningstar Direct, as of 31 December 2020.
9 Source: Bloomberg, 31 March 2021, JP Morgan CEMBI Diversified Index
10 Source: Bloomberg, 31 March 2021, JP Morgan EMBI Global Diversified Index
11 Source: Bloomberg, 31 March 2021, Bloomberg Barclays US Corporate Bond Total Return Index
12 Source: Bloomberg, 31 March 2021, ICE BofA Merrill Lynch US High Yield Total Return Index

EM sovereign debt: Hit by DM yield

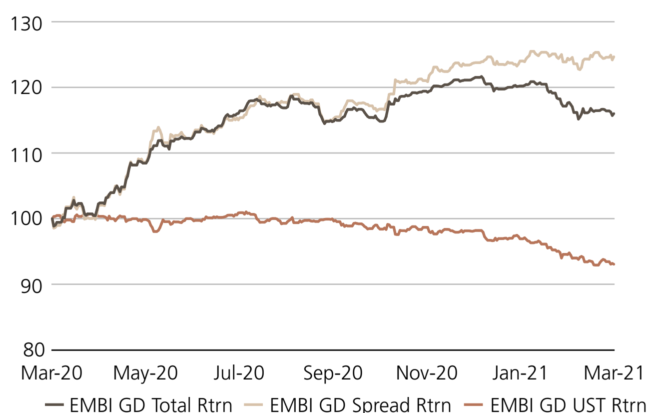
Sovereign credit posted a -4.54% total return in Q1 2021 (measured by the JP Morgan EMBIGD Index). Spreads widened 3 bps, generating a 0.73% spread return. US Treasury yields sold off an impressive 80 bps in Q1, greatly detracting from performance. IG spreads tightened 7 bps to 146 bps and high yield (HY) spreads widened 12 bps to 619 bps in Q1. Spreads proved to be resilient to the large sell-off in US Treasury yields experienced in Q1. The sovereign credit asset class delivered negative total returns every month in Q1 as UST 10-year yields sold off between 15 bps and 35 bps each month, while spreads remained close to unchanged.

All regions generated negative total returns in Q1. Latin America posted an outsized negative return of -6.65%, as high spread countries including Argentina, Belize and Ecuador sold off strongly. All other regions outperformed the benchmark.

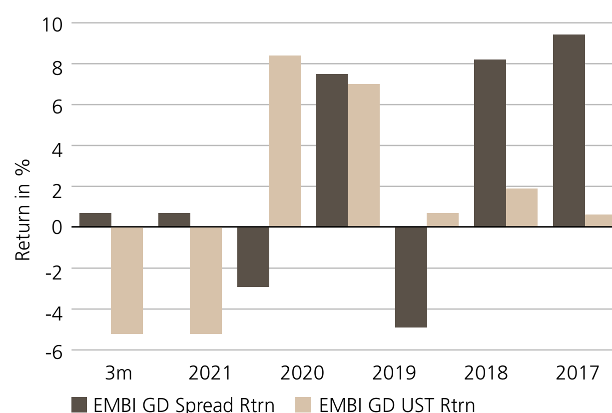
Argentina has been dragging negotiations with the IMF for several months reflecting the lack of internal political consensus in the governing coalition in an environment of lower reserves and growth. Argentina's restructured bonds pay 1/8% coupon per year, hence all the return or lack thereof comes from price variations. Prices dropped 15.14% in Q1. Ecuador is in the midst of a presidential election with a left-wing candidate whose main platform includes renegotiating the IMF program leading the polls.

As it is the case with Argentina, the recently restructured bonds in Ecuador pay such a small coupon that returns are explained by price variation. Ecuador bond prices dropped 13.13% in Q1. Belize requested yet another delay in the coupon payment of their only outstanding bond, which proceeded to drop 14.03%.

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 31 March 2021.
Past performance is not a guide to future results.

Emerging Europe returned -4.35% dragged down by political uncertainty in Turkey and sanctions risks in Russia. Turkey's President Erdogan proceeded to fire the Governor of the Central Bank after a surprising 200 bps interest rate hike in March, in spite of higher inflationary pressures. Markets sold off, as it is unclear how the new central bank Governor will bring 16% inflation under control without hiking rates further.

In mid-March US intelligence declassified a report that confirms Russian interference in the 2020 elections. Markets are staying away from Russia until they learn of the severity of sanctions the US may impose on Russia for its transgressions.

Africa returned -4.01% on Senegal's and Mozambique's sell-off, although Angola and Zambia (in default) had positive returns. Angola has benefited from cautious policies and higher oil prices, while Zambia has benefited from higher copper prices in spite of dubious policies.

The Middle East and North Africa (MENA) region returned -3.21%, dragged down by infighting in Ethiopia, weakening fundamentals in Morocco and crowded positioning in Egypt and Qatar. Defensive Asia returned -2.62% despite the negative price dynamics in some interest rate sensitive IG countries including Philippines and Kazakhstan.

At around 350 bps for the EMBIGD, sovereign spreads are close to their 10-year mean (344 bps). However, sovereign spreads have lagged corporate spreads and also US IG and HY in Q1.

At 146 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. But, at 574 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. Sovereign spreads could catch up with corporate spreads and tighten 25-50 bps in the next few months provided that US Treasury yields stabilize.

We believe that Q2 could be a quarter of transition between higher yields and higher growth. Once the positive effects from higher global growth, trade and commodity prices are reflected in EM fundamentals (including higher growth, improved balance of payment and shrinking fiscal deficits) we believe that pre-pandemic spread levels (ca. 300 bps) are possible later in 2021.
(Federico Kaune)

Corporate debt: Exceptional global growth

EM corporate credit provided negative quarterly returns of -0.99% in Q1 2021 (measured as JP Morgan CEMBI Diversified Index). Corporate credit spreads tightened 22 bps in Q1 2021. Total returns were supported by a rally in credit spreads contributing 1.98% to Q1 returns while Treasury detracted 2.92%.

In Q1 2021 corporate bonds in Ghana (15.60%), Oman (2.86%), Philippines (2.05%), UAE (1.69%), and Nigeria (1.18%) provided the largest positive returns while the largest underperformers were Mexico (-4.33%), Argentina (-3.95%), Kazakhstan (-3.60%), Thailand (-3.54%), and Colombia (-3.51%).

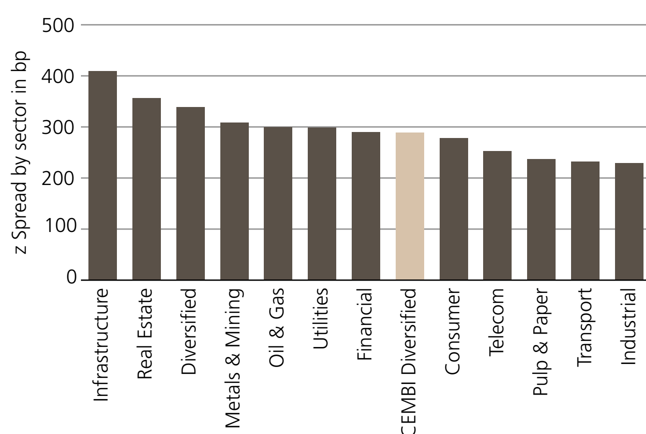
All sectors provided negative returns in Q1 2021. The best performing sectors were infrastructure (-0.07%), financials (-0.11%) and consumer (-0.47%), while the lowest returns were oil & gas (-2.95%), pulp & paper (-2.44%), and transport (-1.97%). Q1 2021 Africa was the only region to provide positive total returns (1.23%). The largest underperformers in total return were Latin America (-2.77%), Europe (-1.07%), and Asia (-0.60%).

Negative returns in the first quarter of 2021 were driven by increased expectation of exceptional US growth in H1 2021 on vaccine rollout, and more stimulus. The expectation of exceptional US growth fuelled concerns that short term inflation shocks may cause the US Federal Open Market Committee (FOMC)to bring forward rate hike projections. We continue to weigh a mix of strong economic rebound against rising US interest rates.

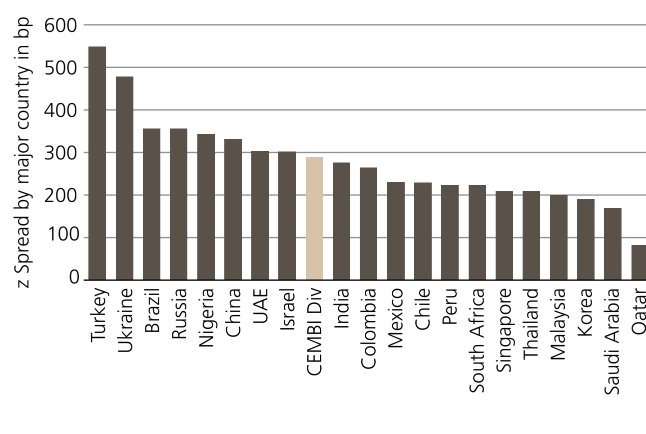
Financials: While supportive forbearance measures in 2020 mitigated some of the risks of immediate deterioration in asset quality and earnings, bank fundamentals are likely to begin improving in 2021 as loan growth rises with EM growth. Fundamentally, we continue to prefer large high quality franchises that have solid capital and liquidity buffers and conservative underwriting standards. We favor subordinated Tier 2 bonds and selective deeply subordinated AT1 bonds.

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 we tactically take profits on TMT and rotate into sectors more exposed to the global economic recovery.

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, JP Morgan Corporate Emerging Markets Bond Index Diversified, as of 31 March 2021

Oil & gas: OPEC warned that that the outlook for Oil remains highly uncertain. Despite signs of a demand pickup, we expect prices to be range bound as supply continues to be managed by OPEC+. We prefer to tactically capture opportunities as they are presented.

Consumer: Within the consumer sector we are rotating from the more defensive components of this segment, packaged food, beverages and household products and move into consumer discretionary names that should benefit from exceptional global growth. However, we prefer to stay nimble within this sector given the different vaccine roll outs across EM.

Metals and mining: The better than expected economic recovery in China 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, such as unknown US/China relationship, upcoming supply and continued uncertainties over tightening of economic conditions in China.

As we highlighted in previous quarters, EM issuers continue liability management exercises and alleviate short term funding pressures. This trend has continued over the past quarters with issuers taking advantage of positive market sentiment and continued liability management exercises, taking advantage of low interest rates, while reducing 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 telecoms. We will tactically participate in these sectors given our positive growth outlook. Performance should rely on smart duration positioning and sector rotations.

Emerging market corporate credit entered 2021 with a shaky start thanks to an aggressive rise in US rates (US 10 -year +80 bps). We remain bullish on emerging market corporate credit given the improved return profile of US interest rates coupled with a continued economic rebound in 2021.
(David Michael)

EM local debt: On the brink of growth recovery

EM local debt (measured by JP Morgan GBI-EM Global Diversified Index) showed a drop of 6.68% in Q1 following a recovery in Q4 2020. The Q1 performance was due to a combination of rising yields globally and strengthening of the US dollar. Expectations of a balanced global recovery were dashed as the US pulled away from the rest of DM on the back of the faster vaccination program and large fiscal injections. New COVID-19 variants and lack of vaccine access left the rest of the world behind. As a result, rising UST yields and strengthening US dollar has forced a number of central banks to raise interest rates and yield curves steepened.

The outlook for H1 2021 is cloudy, but the outcome for H2 is likely to be positive for EM local markets. A lot hinges on the timing of first Europe, and then larger EM countries to catch up with the US in the growth cycle. The pre-requisites for such performance have been met, in our view: Better entry levels for both for the UST and US dollar; the start of the hiking cycles in important markets (Brazil, Russia, Turkey), and the end of the easing cycles in the rest, creating yield support for currencies; steep domestic yield curves; surging commodity prices and PMIs fuelling strong demand for EM exports. Entering Q2, we are cautious on the market given the still raging COVID pandemic and the propensity for the US to surprise positively and EM negatively. However, we will be looking for opportunities to re-engage.

In Latin America, Brazil is experiencing a combination of resurgent COVID-19 infection rates and exhausted fiscal buffers. Lack of confidence and an inflation spike forced the central bank to initiate a rate-hike cycle. With better yield support and a positive terms-of-trade shock, we think Brazilian real and then bonds could perform once the economy is on a recovery path. Mexican fiscal and monetary policies have been conservative compared to peers; however, yields are not yet attractive on a spread to the UST. The Mexican peso should do well given economic ties to the US. We think commodity currencies (Colombian peso and Chilean peso) are likely to do well in Q2, while the Peruvian sol may suffer from a change in government post elections.

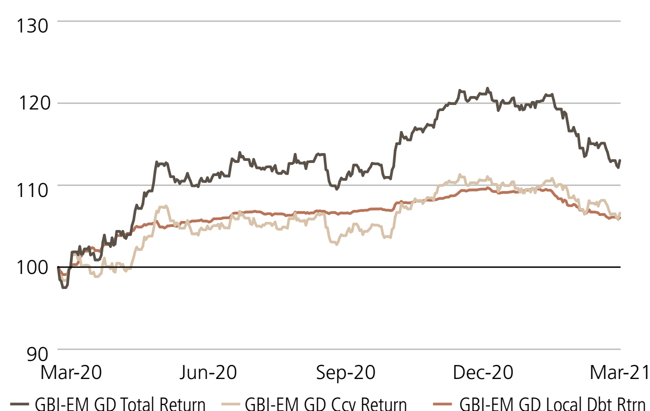
In EMEA, stabilization in Turkey was dealt a blow by dismissing the respected CB president. The outlook for South Africa growth and fiscal balance has improved with the increase in commodity prices and strengthened political support of the government, allowing South African assets to muddle through. Russian bonds and currency have underperformed even as oil prices recovered from the lows and government maintained fiscal restraint. The risk shifted again to geopolitics.

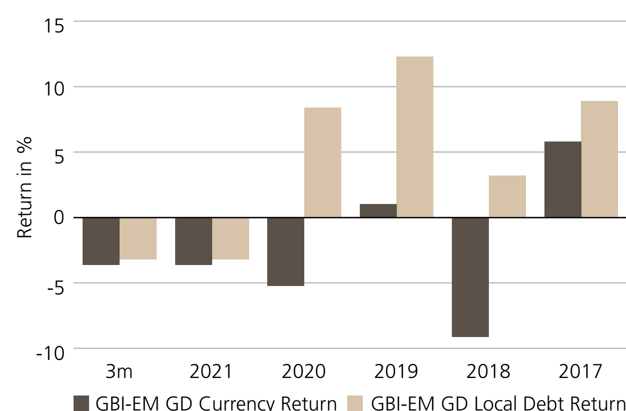
Central Europe, like the rest of Europe, has been suffering from a resurgent COVID19. Interest rates remain low by historical standards, and inflation is likely to pick up in a recovery phase, rendering bond markets unattractive.

The APAC outlook has become more nuanced. Having benefited from better handling of the COVID-19 pandemic, China and NIEs lag in vaccination. 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 still low in Korea and Thailand. Indonesian and India 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 31 March 2021. **Past performance is not a guide to future results.**

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