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Trade accord in focus for 3Q

Emerging markets fixed income | UBS Asset Management

A carry environment for EM FI in 2Q

- Dovish Central Banks rescued 2Q returns from trade uncertainty and geopolitical risks
- EM FI credit and rates rallied on lower UST yields, FX remained subdued due to stable USD
- Returns in 3Q will remain highly dependent on systemic global factors: Growth, Trade and Geopolitical risk

Emerging markets fixed income (EM FI) returns remained strong in 2Q, albeit at a more subdued level than in 1Q. Sovereign and corporate credit spreads ended relatively unchanged in the quarter after selling off in May and rallying in June as central banks in Europe and the US turned decisively dovish.

2Q 2019 returns

	Total return	Spread return	UST return
JP Morgan EMBI Global diversified	4.08%	0.77%	3.30%
JP Morgan CEMBI diversified	3.61%	1.11%	2.50%

	Total return	FX return	Local return
JP Morgan GBI-EM Global diversified	5.64%	1.45%	4.18%
JP Morgan ELMI+	2.07%	0.53%	1.53%

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 28 June 2019. Bloomberg Finance.

The tables show total returns of US dollar and local currency debt plus their return components, as explained below:
- US dollar debt return components: Spread return results from the yield difference between emerging markets debt and US treasuries and from spread movements. US treasury return results from US treasury yield movements.
- Local currency debt return components: Local debt return results from yield movements and coupons of the underlying bonds in local currency. Currency return results from exchange rate movements.

In fact, most of the return in 2Q in EM credit was due to the significant rally in developed rates. Local rates, on the other hand, rallied in tandem with developed rates but EMFX remained unchanged against the USD, as a reflection of the stability in the USD versus the Euro in particular. It was only late in the quarter that the USD weakened somewhat on a dovish Federal Reserve.

By the end of June, sovereign (corporate) spreads as measured by the EMBIGD[1] (CEMBIBD[2]) were at similar levels that at the end of the previous quarter. Local yields (as measured by the GBIEMGD) tightened 48 bps, in spite of a further strong sell off in Argentinean rates, while EMFX remained unchanged against the USD in 2Q.

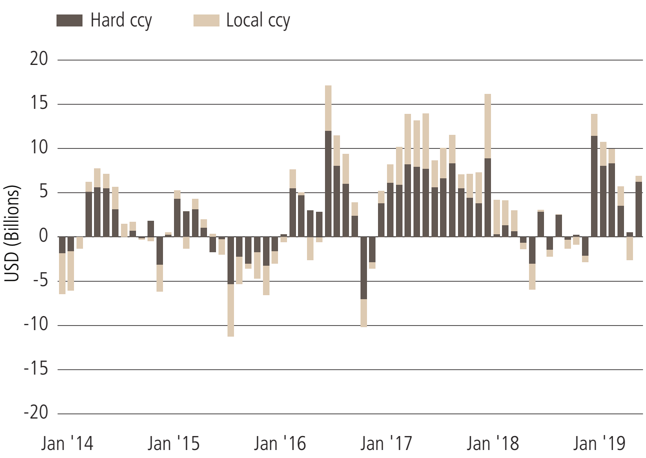
Strong inflows into EM FI in 2Q
As it was the case in 1Q, further developed market (DM) central bank dovishness – particularly since early June – resulted in additional inflows into EM FI, albeit at a slower pace than the record inflows experienced in 1Q, and with outflows in May due to trade war concerns.

EM FI attracted a solid USD 10.5 billion in 2Q (from USD 34.7 billion in 1Q). Sovereign and corporate credit saw inflows of USD 10.2 billion. Local EM (FX and rates) attracted USD 0.3 billion.[3]

Issuance from sovereign and corporate names reached USD 27.7 billion and USD 136 billion is 2Q, respectively, lower than it is usually the case.

Amortization and coupon payments were substantial, reaching USD 25.5 billion for sovereigns and USD 90.6 billion for Corporates. As a result, the technical backdrop – in credit in particular – was very supportive of the asset class in 2Q.

Monthly EM FI flows (USD bn)



Source: JP Morgan, UBS Asset Management. As of 26 June 2019.

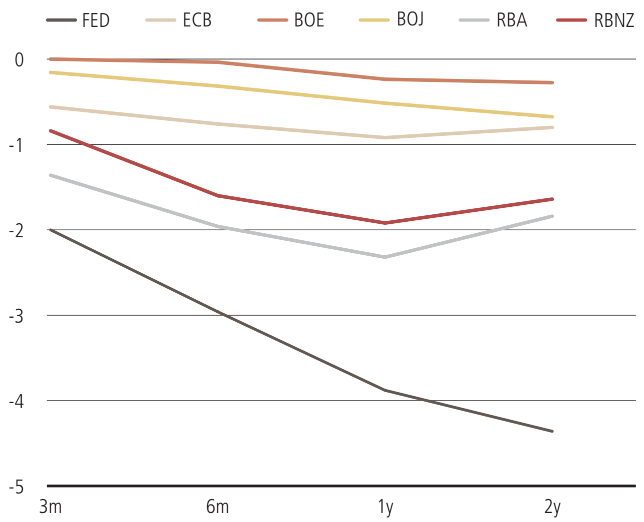
Dovish central banks delivered more than expected
As May came to an end, markets started pricing in rate cuts in the US and UST yields collapsed, reflecting lower than expected growth and inflation dynamics. The Fed kept rates unchanged on 19 June, but issued a dovish statement and revised forecasts.

Taken together, markets interpreted the statement as confirmation that the next move will be a rate cut. By the end of June, markets were pricing in 50bps of cuts with 100% probability in 3Q 2019.

The ECB left rates unchanged at its June 6th meeting, but the tone of its communiques became unequivocally dovish as the month progressed.

On 18 June ECB President Mario Draghi offered a speech that was interpreted by markets as a renewed commitment by the ECB to do "whatever it takes" to stabilize lower inflation and growth dynamics in the Euro zone. He committed to be flexible and implement additional stimulus, including amending forward guidance, lowering rates and implementing further asset purchases in case inflation failed to strengthen.

Number of implied 25bps cuts



Source: Bloomberg, UBS Asset Management. As of 28 June 2019.

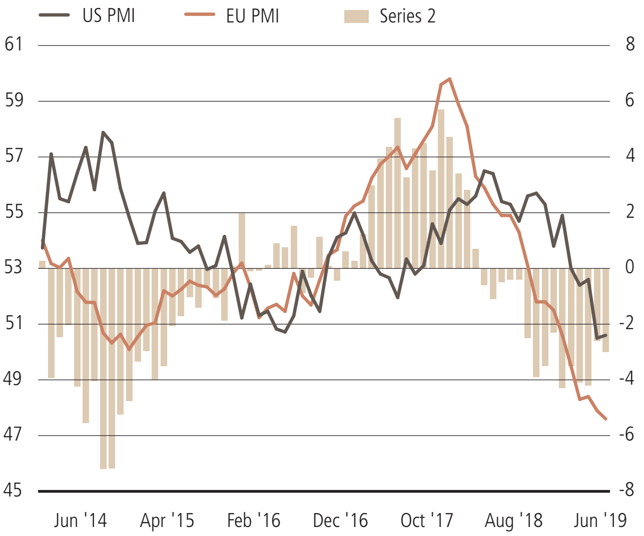
Finally, the BOJ remained consistent in their policy aimed at keeping a very accommodative monetary stance, including keeping the yield curve control policy (nominal 10 yr. JGB yield target at 0%, and monetary policy rate at -0.1%) and QE target unchanged (at ¥80 trillion a year).

Taken together, dovish central banks turned even more dovish, generating aggressive rallies in rates and equity markets and supporting riskier asset classes in 2Q.

[1] Emerging Markets Bond Index Global Diversified.
[2] Corporate Emerging Markets Bond Index Broad Diversified.
[3] Flows data as of 26 June 2019.

Global growth and inflation have dropped
Economic data showed that growth and inflation in the world continued to soften in 2Q. Purchasing Managers' Indexes (PMIs) in the developed world continue to show softer readings in Europe and a decisively lower reading in the US. PMIs in China also soften in 2Q after a fleeting recovery in March. Citing worse global conditions for trade the International Monetary Fund lowered its global growth forecasts for 70% of the global economy in 2019 and emphasized that risks were on the downside absent a resolution of pending trade disputes.

Developed PMI: Going down together now



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

Inflation in the US as measured by the Personal Consumption Expenditures (PCE) price index declined back to 1.5% in mid-2019, after touching 2% a year earlier. Core inflation in the Eurozone has remained stuck in a 0.8%–1.2% range for the past three years. Both central banks have failed to ignite inflation to their respective 2% targets.

Lingering trade disputes still a risk
China and the US failed to reach an agreement on their trade disputes in 2Q. Quite the opposite, trade negotiations stopped and both parties threatened to escalate the dispute.

In early May, after a round of negotiations did not yield the expected results, the US administration imposed 25% tariffs on USD 200 billion worth of exports that had been subjected to a 10% tariffs previously. Furthermore the US imposed further measures to reduce technological transfer to China and included communication company Huawei in its "entity list" (blacklist) due to national security concerns. China retaliated by further closing its local cyber market to US competitors, among other measures. This uncertainty weighed on markets in April and particularly in May.

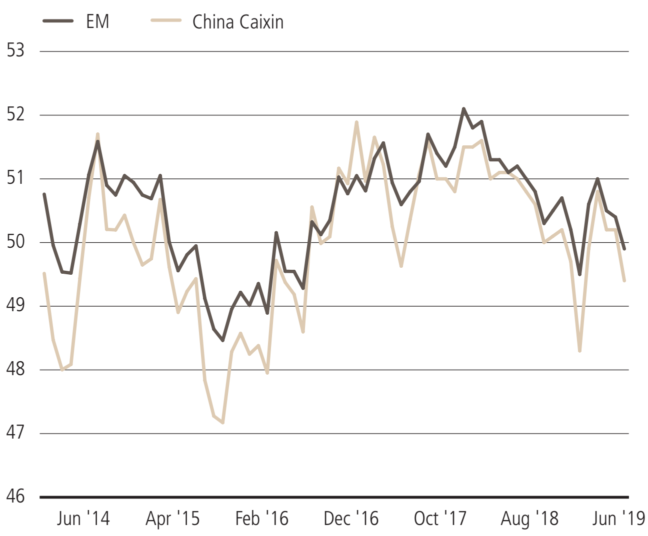
President Trump and President Xi met at the G20 meetings in Japan on 28-29 June, and reached a truce on the trade war, in spite of the significant differences between the involved parties. Overall, this is a positive outcome, given the alternatives, despite the lack of clarity on the issues and time-line.

Frustrated with what he describes as an illegal immigration crisis in the US southern border, on May 30th President Trump announced his intentions to levy an initial 5% tariff on all Mexican export to the US effective June 10th, and to further increase the tariff by 5% the first day of every month thereafter up to 25% in October 2019 absent swift and sufficient action by the Mexican government to stop the flux of illegal immigrants into the US. Mexico committed to adopt certain measures and President Trump backtracked from his threat. However, the US will reassess the situation in early September and decide whether further tariffs are warranted.

Whether the global economy starts recovering or decisively slows down depends, in good measure, on the successful de-escalation of trade disputes. In the worst case scenario, one in which negotiations between the US and China and Mexico fail, almost USD 1 trillion in US imports would be subjected to 25% tariffs by end 3Q2019.

Such a scenario would likely imply further lower global growth and would bode poorly for EM even if China implements stimulus measures to counter the negative impact of tariffs.

China and EM PMIs down again



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

Abundant idiosyncratic risks and opportunities in EM FI
As we come to the end of 2Q, Argentina and Turkey are once again the main protagonists this quarter. Argentina is in the midst of a heated election campaign for the presidency in October and asset prices are reacting to announced candidacies, political coalitions and polls, all of which are generating wild gyrations in asset prices. The election is happening with the backdrop of a deep economic recession with high inflation. If the winner turns out to be a market friendly one, Argentina could be one of the best trades in EM FI in 2019; the exact opposite is, unfortunately, also true.

Turkey's situation is getting more interesting on several fronts. On the domestic political front, the governing AKP party was successful in challenging the results of the local elections in Istanbul that gave the victory to the opposition CHP party by a slim 13,000 margin. New elections took place on 23 June, and Ekrem Imamoglu from the main opposition Republican People's Party won by an overwhelming 800,000 votes (9.3pp) margin. Whether President Erdogan reacts to such a crushing defeat with a new conciliatory posture or by doubling down on his assertiveness will shape the political landscape in Turkey in months and years to come.

On the external political front, President Erdogan is committed to acquiring Russian S-400 missiles in July, which could put Turkey on a collision course with the US and possibly NATO and result in sanctions under the Countering America's Adversaries Through Sanctions Act (CAATSA). However, at the G20 meetings, President Trump met President Erdogan and he seemed to defuse the issue of the S-400 missiles. The issue is far from resolved but it seems that Turkey could get some relief near term.

In Ukraine, outsider candidate Zelenzky won the presidency and swiftly called for snap parliamentary elections in July in an effort to secure a working majority. Markets have reacted enthusiastically to this election outcome as they perceive President Zelensky to be market friendly.

In Brazil, a larger-than-expected pension reform is likely to be voted in congress sometime in 3Q, boding well for asset prices there. Mexico and South Africa will continue to struggle to stabilize their national energy champions (Pemex and Eskom) with credible rescue plans or risk further downgrades down the road. In addition, Mexico will have to deal with the permanent threat of tariffs or other sanctions – besides bearing the costs of providing for thousands of Central American migrants – related to the immigration issues in the US southern border.

In Venezuela, efforts to force a political transition failed in April. The standoff between the government and the opposition lingers while the humanitarian crisis worsens. So far, about four million Venezuelans have left their country escaping the economics and security crisis. The government is relying on the backing of Russia among others while the opposition has the backing of the US, EU and others.

2H 2019 Election calendar

Date	Presidential	Parliamentary	Local
Jul-19	—	Ukraine	—
Aug-19	Guatemala (run-off)	—	—
Sep-19	—	Israel	—
Oct-19	Argentina, Uruguay, Bolivia, Mozambique	Argentina, Uruguay, Bolivia, Mozambique, Tunisia	Argentina
Nov-19	Argentina (run-off), Uruguay (run-off), Tunisia	Poland	—
Dec-19	Romania	—	—

Sub-Saharan Africa: Mozambique; Europe: Poland, Romania, Ukraine; Middle-East & North Africa: Israel, Tunisia; Latin America: Argentina, Bolivia, Guatemala, Uruguay

CB dovishness is not enough, a trade resolution is needed
EM FI asset prices rallied on the back of DM central bank announcements to ease monetary policies as required to support economic activity and lift inflation and inflation expectations going forward. Such dovishness had a very powerful positive impact on risk appetite, favoring EM assets in all its forms and is likely to provide a cushion to EM assets for the remainder of the year.

However, dovishness in DM CB policies is a necessary but not a sufficient condition to for EM economies to thrive and for EM asset prices to deliver strong returns.

For EM economies to deliver higher and sustainable growth – a basic requirement for solid and sustainable returns – global trade volumes and commodity prices have to recover in a sustainable fashion. For that to happen trade wars have to subside and global growth has to stabilize.

Absent a resolution to the ongoing trade wars, dovish monetary policies will only be able to carry the world economy so far for so long. The outcome of the meeting between President Trump and President Xi at the G20 meetings could shape the behavior of EM asset prices in 2H 2019.

As expected, there was no resolution to the trade impasse between the US and China at the G20 meeting, but the outcome was on the positive side as Presidents Trump and XI agreed to re-engage in negotiations and delayed any further actions on tariffs.

Oil prices between supply shocks and lower growth
After reaching a high for the year in late April, oil prices had dropped about 20% by mid-June, all on account of lower global growth expectations and in spite of several negative supply shocks from Iran, Venezuela and others. A stronger USD trend in 2Q also had an impact on commodity prices including oil. Most recently, higher geopolitical uncertainty helped oil prices recover almost 10% to USD 65bbl (Brent).

Attacks on two oil tankers in the Gulf of Oman, at the entrance of the Strait of Hormuz, and other actions on smaller boats in the UAE port of Fujairah were behind the sharp increase in oil prices. OPEC is likely to keep current quotas unchanged as main oil producers – including Saudi Arabia and Russia – have an incentive (mainly fiscal) to keep oil prices above USD 60 on a sustainable basis. Oil at around USD 60-70 per barrel in the remaining of the year will be supportive of EM oil exporters.

EM still going but less upside after outsized YTD returns
We now believe that DM central banks will adopt easier monetary policies in 2H as required, which will likely continue to support riskier asset classes. However, for EM asset prices to continue to deliver as they have so far in 2019, trade concerns will have to be resolved.

So far in 2019, sovereign (corporate) credit has delivered 11.3% (9.1%) returns; roughly half of it due to spread compression of 69bps (36bps) with the other half explained by lower UST yields. Local debt has delivered 8.7% returns so far this year, of which 7.1% due to a 77bps rally in local rates (as measured by the GBI EMGD).

At 346 (330) bps over UST, sovereign (corporate) spreads are not particularly compelling, but it is possible for spreads to tighten further provided that countries like Argentina and Turkey rally from their unusually high levels. Most likely sovereign (corporate) credit will deliver excess returns in proportion to the carry it generates in 3Q.

In local debt, there is ample scope for rates to rally further in an environment in which DM central banks get even softer on monetary policy. For EM FX to rally, a weaker USD against other major currencies (particularly Euro) is a necessary condition.

Duration management will continue to be of upmost importance after the recent large move in DM rates. A resolution to the trade disputes could ignite expectations of higher global growth and lead to a selloff in DM rates. An escalation of the trade disputes could dent global growth expectations further and lead to a further rally in DM rates. In the first scenario we would expect spreads to tighten, but rates to widen and EM FX to do well. In the second scenario we would expect spreads to widen, rates to rally and EM FX to be more idiosyncratic. (Federico Kaune)

Sovereign debt: Buoyed by lower UST Yields
Sovereign credit posted a respectable 4.08% return in 2Q (measured as EMBIGD), with most of the performance (3.30%) driven by the significant rally in UST yields. 10y UST yields dropped by 40bps to 2.01% while spreads tightened by just 5bps in 2Q, with IG spreads tightening 8bps (mostly in Europe) while HY spreads widening 14bps.

Sovereign spreads remained largely stable in April before widening 33bps to 378bps in May as trade negotiations between the US and China failed. In June, dovish DM central banks ignited a rally in sovereign spreads that negated the May sell off.

During 2Q, all regions generated positive returns. Eastern Europe posted the highest returns at around 5.6%, followed by Africa (4.7%), Asia (3.8%) and the Middle East (3.7%). Latin America returned only 3.3%, limited by significant sell off in Venezuela, but also poor returns in Argentina (1.5%) and Mexico (2.7%).

Mexico's poor performance reflected increased pressure from the US on immigration issues and the threat to impose tariffs on all exports to the US. The immigration issue has not been fully resolved and tariffs or other sanctions are still possible at some point in 3Q. Such uncertainty is likely to weight on local sentiment, further affecting investment, consumption and ultimately economic growth in 2019.

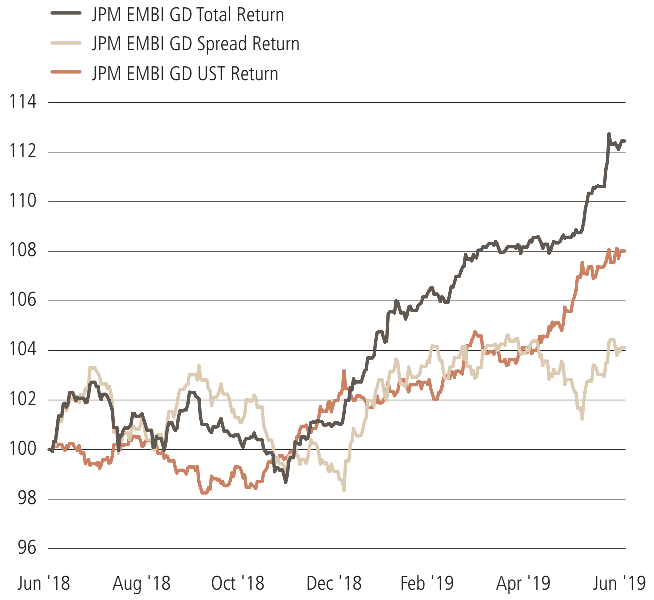
Furthermore, Pemex – the government owned oil company – is facing increased pressure from markets as it has yet to present a sustainable financial plan for 2019 and beyond. As a result, in June rating agencies downgraded both the sovereign (Fitch to BBB) and Pemex (Fitch to BB+ with negative outlook from BBB-and Moody's to caa1stand alone while keeping the overall rating at Baa3 but with negative outlook). Absent the announcement of strong measures in July, there is a distinct possibility that Pemex may be downgraded further.

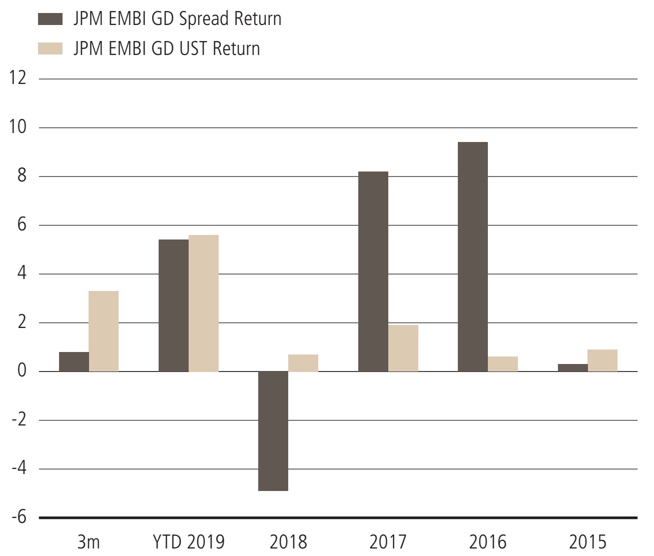
Nearly all countries contributed positively to performance. The main exception was Venezuela, which returned -33% due to the failed attempt to oust President Maduro. Interestingly, Venezuela may start to be gradually faced out off the main benchmarks starting in 3Q, due to sanctions and the ensued collapse in trading volumes. The spread on the EMBIGD sovereign benchmark excluding Venezuela currently stands at around 300bps, or 50bps lower than the headline figure.

Argentina also posted a small negative return but with wild selloffs and rallies during the quarter due to the ongoing economic crisis and the uncertainty surrounding the upcoming Presidential elections in October. Surinam and Zambia were the other two credits that showed negative returns, reflecting idiosyncratic factors that affected their performance.

At around 350bp for the EMBIGD, sovereign spreads seem to offer fair value and still attractive carry for a low yielding global environment. However, as we said in our last report, a further spread tightening would require more clarity on the US-China trade issue. In this context, we expect range-trading in USD sovereign debt, favoring a carry strategy in 3Q, as it was the case in 2Q. Spread widening to around 400bp should trigger an increase in risk exposure. (Federico Kaune)

Sovereign debt: A carry trade with volatility
(Rebalanced to 100 as of 29 June 2018.)





Source: JP Morgan monitor, 28 June 2019.

Corporate debt: Follow the FED and carry on…

EM Corporate credit provided another quarter of strong returns of 3.61% in 2Q 2019 (measured as JP Morgan CEMBI Diversified) providing positive returns in each month. Corporate credit spreads tightened by 3bp in 2Q, providing 1.11% of carry supported by a rally in US interest rates contributing 2.50% to the quarterly return.

Corporate bonds in Ukraine (7.62%), Turkey (6.79%), Brazil (5.17%), Russia (4.90%), and Morocco (4.55%) provided the largest positive returns while the largest underperformers stemmed from Jamaica (-8.28%), Israel (1.12%), Guatemala (1.67%), Zambia (1.95%) and Philippines (2.33%).

From a sector perspective, Pulp & Paper (5.25%), Metals & Mining (4.33%) and Oil & Gas (4.05%) provided the largest positive returns while the undeforming sectors were Consumer (3.01%), Real Estate (3.12%), and Telecom (3.34%).

After strong spread tightening in the first quarter of 2019, EM corporate bonds provided modest spread returns in 2Q. This, coupled with a pivot in US Federal Reserve Policy, provided a strong backdrop for EM credit. Similar to sovereign debt, during 2Q 2019 all regions provided positive total returns. The largest outperformers in total return were Europe and Latin America with the Middle East lagging in both total return and spread return when compared to regional peers.

EM corporate fundamentals continue to improve as reflected in lower leverage and robust earnings growth in across most sectors and regions. A large positive lift came from Asia with the Chinese property sector driving strong results.

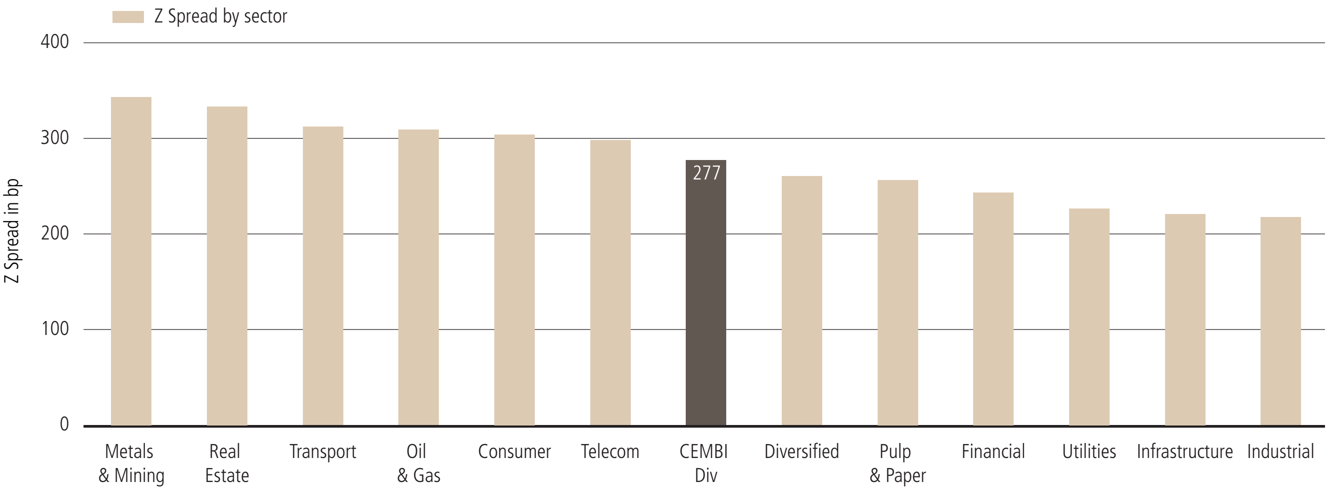
On the supply side, corporate issuers in Asia continued to take advantage of the positive market sentiment and were able to relieve external funding pressure that built over the last few years. For the remainder of 2019 we expect net corporate issuance to be negative (new issuance less coupons and amortizations) and supply will continue to be driven by refinancing over capex and M&A. The largest variables in the supply outlook continue to be issuance from China and the Middle-East.

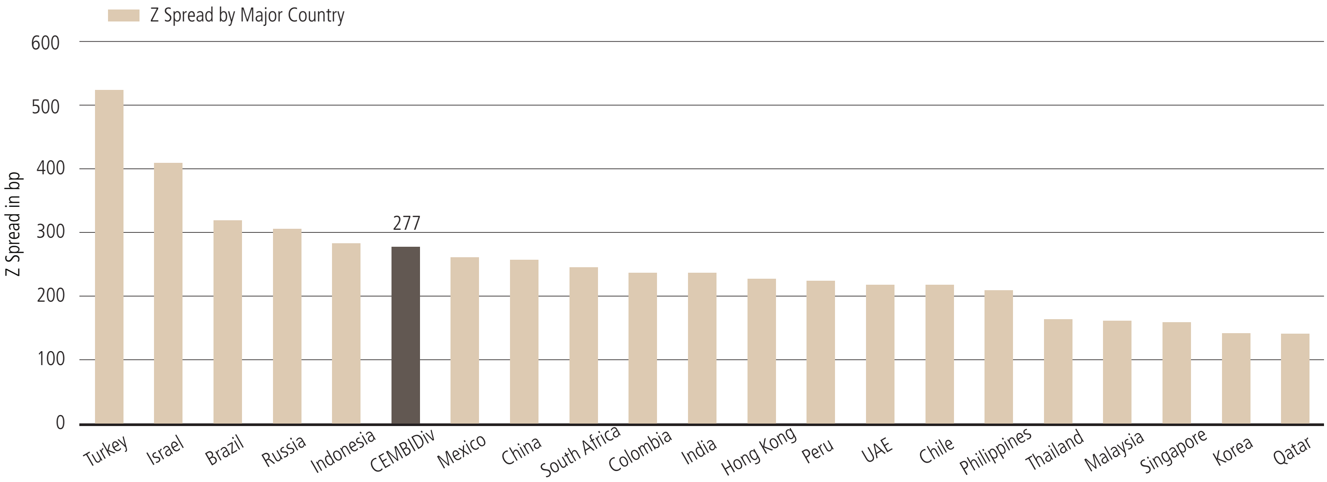
Value can be found in deleveraging high yield issuers, investment grade credit that has lagged the rally in US Treasury yields, as well as new issuance from Brazil and the Middle East. On the other hand, caution is warranted in Turkey where we expect to see continued volatility, economic slowdown and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

China companies continue to benefit from strong market demand, domestic stimulus, and policies measures direct toward the domestic economy. Chinese high yield has benefited greatly from this uplift, but given current valuations we see limited upside. Further, we keep our positive stance toward systemically important state-owned enterprises in China, and select Chinese property companies.

Risk appetite in emerging markets credit continues to be driven by global market conditions and local headlines. We continue to monitor trade negotiations between the US and China, positive expectations of Brazil's new reform agenda, Mexico's inconsistent messages to markets, Argentina's presidential elections, and Turkey's volatile politics. (David Michael)

Corporate Spreads: EM Politics and the FED (Measured in bps as of 28 June 2019)





(The z-spread – also known as the zero-volatility spread or the static spread – measures the spread over the benchmark zero coupon swap curve)
Source: JP Morgan monitor, 28 June 2019.

Local debt: Carry environment

EM local debt (measured by JP Morgan GBI-EM Global Diversified index) showed a 5.64% return bringing the total return so far in 2019 to impressive 8.72%. The positive performance in Q2 was predictably highly non-linear, with a drawdown in May on resumed trade tension and a recovery in June as global central banks signaled monetary policy easing.

Argentina had yet another bad quarter as polls show that opposition is ahead for the October Presidential elections. Turkish assets had a positive quarter as high carry and weak currency offset increased political risk. Russian assets continued to perform well as oil prices bounced and the timing and likelihood of sanctions became more muddled after the Mueller report. The biggest contribution to the index returns, however, came from the rally in bonds across the board following the re-pricing lower of the UST curve and pricing in of multiple rate cuts. Local returns were particularly large in Chile, Brazil, Peru, Russia and Turkey.

The outlook for 3Q is uncertain given a number of significant tension points – trade, global growth, political risks, and monetary policy. However, lower US policy rates and potential weakening of the USD against EUR and JPY is conducive to carry.

In Latin America, we find Mexico at risk on fiscal/monetary policy as well as continuing trade uncertainty (the USMCA trade agreement yet to be ratified in the US Congress). The Brazilian bonds had a spectacular rally on good prospects of the pension reform and expectations of rate cuts by the BCB. However, after the rally, the value is with the currency rather than bonds. In Argentina, the decision of former president to run as only vice-president, eliminated the tail risk of the new Kirchner presidency and supported the market. However, the outcome of the elections remains close to even and markets will no doubt be tested during the primary elections in August. Commodity-linked currencies – CLP and COP, among others – underperformed, and have room to catch-up in a muddle-through environment.

In EMEA, Turkey remains the key market to watch. The ruling AKP lost the re-run of Istanbul by a strong margin dealing a blow to President Erdogan. In addition, Turkey is risking US sanctions over the delivery of Russian weapons expected in July. Performance of Turkish bonds hinges on the government's ability to switch to prudent policies and avoid tensions with the US, which we think is unlikely. In South Africa, the economy remains weak and struggling SOEs are a continuing drag on fiscal resources. However, the comfortable win of the ANC in the Parliamentary elections in May consolidated the President's mandate, and SA bonds have plenty of room to catch up to global bond markets. The conclusion of the Mueller investigation reduces the urgency for the US Congress to impose additional sanctions on Russia. However, the sanction risk remains due to US-Russia tensions in geopolitical hot spots, while Russian Ruble valuations are very stretched.

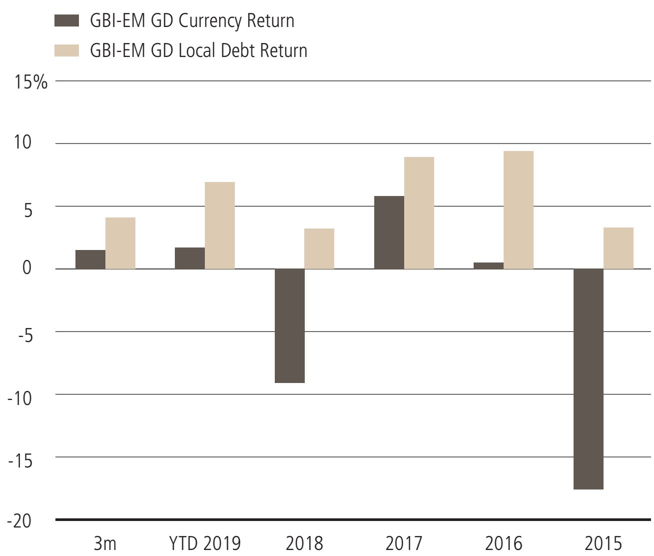
Central Europe has been enjoying high growth rates and some insulation from boarder EM weakness, despite the slowdown in the Eurozone. Tight labor markets, low policy rates and domestic-demand driven growth is a recipe for higher inflation. Following the large rally in yields in sympathy with global markets, CE bonds are vulnerable to a correction. At the same time, the nascent USD weakness bodes well for CE3 currencies.

Following a period of volatility in May, APAC currencies have partially recovered and the CNY stopped depreciating. However, the potential trade war escalation after the G20, or even a fragile truce, is negative for the region highly dependent on trade flows. We see gradual depreciation of the CNY due to slower growth and capital outflows, dragging down all regional currencies.

The main risks to the outlook are stemming from both positive and negative shocks – a breakdown of trade talks or inability of the Fed to validate rate cuts priced in the market (Igor Arsenin)

Currency returns: more sensitive to economic and political shocks

(Rebalanced to 100 as of 29 June 2018.) The graphs below show the total return of JP Morgan GBI-EM Global Diversified and its components, local debt returns 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, 28 June 2019.