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October 2017

Emerging markets debt

The song remains the same

UBS Asset Management

The song remains the same

As it was the case in the first half of the year, emerging markets delivered strong returns during the third quarter of 2017, reflecting the effects of the sweet spot of low inflation and synchronized economic recovery globally, which makes the ongoing global monetary policy tightening cycle less threatening for riskier carry trades. Low and declining volatility during the quarter further supported carry trades in an environment in which yields and spreads continued to decline further.

Tighter spreads and lower yields could not deter record inflow into the asset class in all its flavors: credit, rates and currencies. According to JP Morgan, flows into emerging markets in the third quarter amounted to USD 27.4bn. Year-to-date inflow amounted to a record high of USD 91.7bn. Emerging markets are no doubt quite popular again with cross-over and dedicated investors alike.

Delays in expected reforms and lack of inflationary pressures in the US kept both US treasury yields and the US dollar on a weakening path until late in the third quarter of 2017. In Europe, economic activity indicators and confidence remain elevated, while inflation is kept in check. Furthermore, the tone of the European Central Bank (ECB) grew more dovish as the quarter progressed on lack of inflationary pressures.

The quarter was not free of geopolitical and policy-driven events: the North Korea threat re-emerged repeatedly, but proved to be transient. In Germany, Chancellor Merkel was re-elected to a fourth term, albeit with a lower-than-expected margin. Furthermore, the right-wing populist party *AfD* surprised by gaining enough votes to enter the *Bundestag*.
In the US, renewed Republican attempts to repeal and replace *Obamacare* failed, while the Fed made clear hawkish noises at their mid-September meeting and started their well-advertised and gradual quantitative tightening.

Third quarter 2017 returns

The table below shows total returns of US dollar and local currency debt plus their return components, as follows:

US dollar debt return components
– spread return, resulting from the yield difference between emerging markets debt and US treasuries and from spread movements
– US treasury return, resulting from US treasury yield movements

Local currency debt return components
– local debt return, resulting from yield movements and from coupons of the underlying bonds in local currency
– currency return, resulting from exchange rate movements

US dollar debt	Total return	Spread return	US treasury return
JPM EMBI Global Div.	2.63%	2.44%	0.19%
JPM CEMBI Diversified	2.07%	1.83%	0.24%

Local currency debt	Total return	Currency return	Local debt return
JPM GBI-EM Glob. Div.	3.55%	1.31%	2.21%
JPM ELMI+	2.00%	0.99%	1.01%

2017 year-to-date returns*

US dollar debt	Total return	Spread return	US treasury return
JPM EMBI Global Div.	8.99%	5.62%	1.96%
JPM CEMBI Diversified	7.31%	5.43%	1.78%

Local currency debt	Total return	Currency return	Local debt return
JPM GBI-EM Glob. Div.	14.28%	5.78%	8.02%
JPM ELMI+	9.35%	6.19%	2.98%

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
Data as of 30 September 2017
Source: Bloomberg Finance

Macro outlook: what might go wrong?

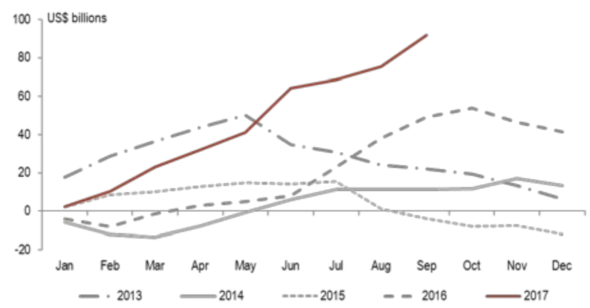
The performance of emerging markets in the fourth quarter of 2017 will depend far more on a benign external environment detached of policy shocks and volatility. It is only in such a benign environment that carry trades are likely to continue their performance trend seen so far this year.

Our baseline scenario is one of more subdued returns in an environment characterized by increasing volatility and relatively more crowded positions. Fundamentally, we still have a constructive view on emerging markets based on positive growth dynamics and reform impetus. However, there are global policy-driven risks with the potential to derail what has been an exceptional year so far.

In the US, the administration's efforts to get a tax reform approved (most likely in the first quarter of 2018) has re-ignited the so-called reflation trade: higher US treasury yields and a stronger US dollar. On the trade front, the US administration is now in the midst of re-negotiating NAFTA with contentious negotiations on several fronts. Finally, the Fed has become more vocal about their intentions to increase rates in December this year, while the latest dots indicate that three hikes are possible in 2018 – far more than what the market is pricing in. Additionally, the ECB is about to embark on another wave of tapering.

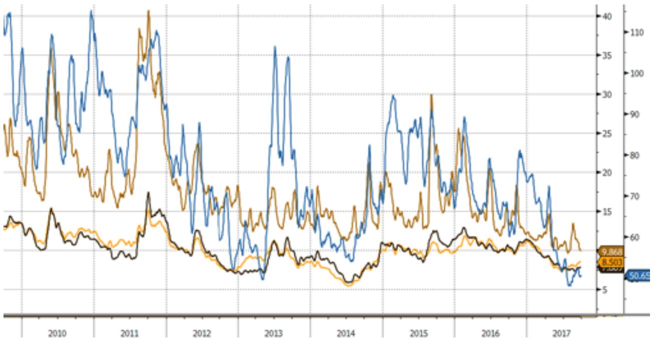
In summary, developed market central banks are in the early stages of undoing one of the most unique monetary expansions in modern times, one that involved an unprecedented monetary quantitative expansion coupled with a negative nominal price for money in several parts of the world. We are skeptical that such transition will have no impact on global volatility or asset prices. In contrast, we believe that the aforementioned global monetary trends call for a more nimble, discriminatory and opportunistic risk-taking approach as opposed to a long beta strategy. This is because these trends have the potential to make emerging markets currency positions far more difficult and volatile while shocking rates – particularly in low carry countries. In credit, spreads tightened so far and largely compensated for higher US treasury yields, but the starting point is already tight leaving credit vulnerable to further sell-offs.

Capital inflows to emerging markets



Source: JP Morgan "Weekly flow monitor", 28 September 2017

Volatility index comparison



- JP Morgan Global FX Volatility Index: 8.50% as of 30.09.17
- Merrill Lynch Option Volatility Estimate MOVE Index: 50.66 implied volatility, annualized in basis points, as of 30.09.17
- Chicago Board Options Exchange SPX Volatility Index: 9.87% as of 30.09.17
- JP Morgan Emerging Market Volatility Index (EM-VXY): 7.89% as of 30.09.17

Data as of 30 September 2017
Source: Bloomberg Finance

Review and outlook by asset class segment

Sovereign credit: solid fundamentals losing steam

Sovereign credit posted a 2.63% return in the third quarter of 2017: 2.44% from carry and spread tightening, and a meager 0.19% from US treasuries (all data measured by the JP Morgan EMBI Global Diversified index; also see graphs to the right). Most emerging markets posted positive total returns with high yield countries driving performance, sovereign bonds outperforming quasi-sovereign bonds, and high yield bonds outperforming investment grade bonds.

Top performer was Latin America ahead of Africa, which was closely followed by Europe. Asia and the Middle East underperformed but generated positive returns. While Latin America contributed strongly with a little more than 3%, Venezuela was the only country which detracted from overall performance in the third quarter. Political turmoil after the elections in July continued to escalate as tensions rose with the US government which imposed new restrictive sanctions on the country during the second half of the month. The Trump administration imposed sanctions prohibiting transacting in new bonds, stocks, or lending arrangements with both the Venezuelan government and the state-owned oil company, PDVSA. The restrictions are intended to further shut off access to capital markets for the country, but short at this point of a full embargo. At the end of the quarter, Venezuela traded at around 3100bp over US treasuries. The Middle East was the weakest performing region given heightened geopolitical risks – increased by tensions between Saudi-Arabia and its allies on the one hand and Qatar on the other hand.

As to credit ratings, the third quarter was relatively calm in terms of meaningful rating adjustments. While China was downgraded by S&P to A+, it is now in line with the other ratings from Moody's and Fitch. With the deterioration in Venezuela, S&P and Fitch took action and decreased the rating by one notch each, ending up with CCC- (S&P) and CC (Fitch).

Year to date in 2017, flows into emerging markets debt reached a new record high at USD 91.7bn* with around 2/3 invested in US dollar and 1/3 in local currencies. The solid reception of new issuances reflects stability of demand amidst low risk aversion and the ongoing search for yield.

Approaching the last quarter and year end, we are somewhat more cautious with regard to spread levels. Currently, the overall index JP Morgan EMBI Global Diversified should have priced in a lot of positive developments, while assumptions for 2017/18 already tightened by nearly 50bp to levels below 300 (as measured by JP Morgan EMBI Global Diversified).

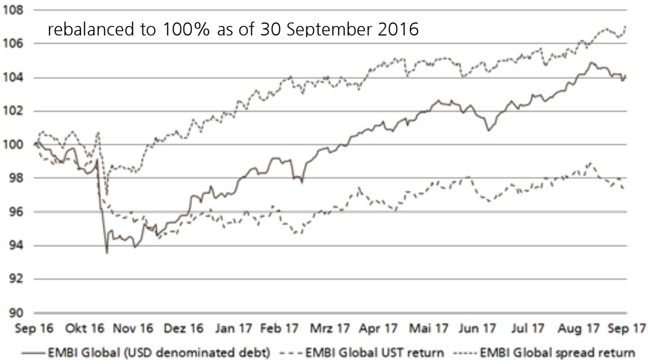
This positive contribution in 2017 year to date was mainly driven by the expected stronger economic recovery globally and further reforms in emerging market countries. While many of these delivered in terms of fiscal and political adjustments, global growth is increasing only marginally, still driven by growth in developed markets. Growth rates in emerging markets are stable at solid levels, but do not show any sign of a stronger momentum. Central banks globally are moving towards higher rates and yields. We do not expect any negative long term impact on spreads, but over time the supportive environment seen in the past is likely to disappear in our view.

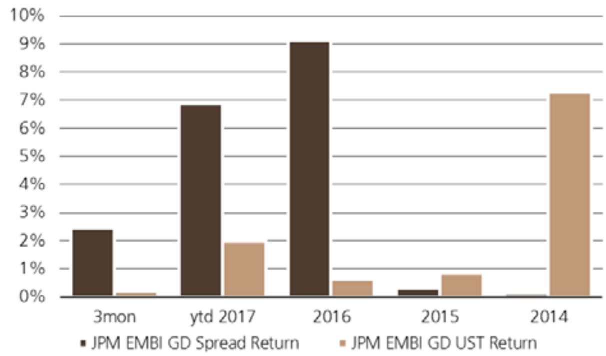
Even if we do not expect no further geopolitical escalation, we remain alert as some of the already existing conflicts could add higher volatility and selling waves in credit markets. Taking all these potential impacts and a somewhat more neutral technical picture into account, we tend to further reduce risk on a short term horizon, while our longer term outlook remains positive.

* Source: JP Morgan

Large inflows tightened spreads and drove returns

The graphs below show the total return of JP Morgan EMBI Global Diversified and its components, spread return and US treasury return. 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.





Data as of 30 September 2017
Source: JP Morgan, UBS Asset Management

However, there are some important factors that could significantly alter the landscape:
- policy surprises by the US and Eurozone
- surprises on GDP growth globally and in China in particular
- lingering geopolitical risks

The first of the aforementioned factors could have a more positive impact on emerging economies due to more measured trade policies. It could also mean less support for growth in the US, a softer path for rate hikes, and lower US treasury yields. The other two factors could be strong enough to increase volatility and spreads. Even if such events might not be directly related to emerging countries, investors' confidence could decline as risk aversion increases.

Corporate credit: unabated search for yield

In the third quarter of 2017, emerging markets corporates posted positive returns reflecting further spread tightening. However, they slightly underperformed emerging markets sovereigns, partly due to the latter's longer duration and carry. High yield credits handsomely outperformed investment grade.

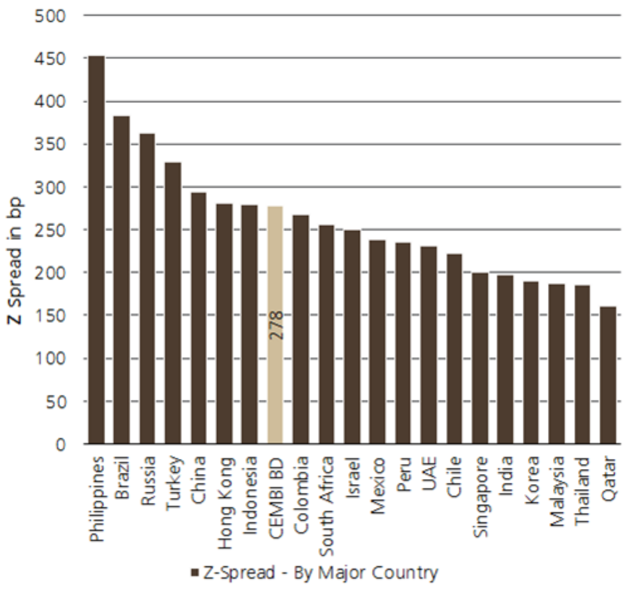
From a regional perspective, Latin America and Africa outperformed the broader index, whereas APAC and the Middle East underperformed, while Central Europe and Eastern Europe were flat. Corporate bonds in Ukraine, Iraq, Brazil and Jamaica significantly outperformed, while Azerbaijan, Israel and investment grade APAC – including Korea, China and Hong Kong – underperformed.

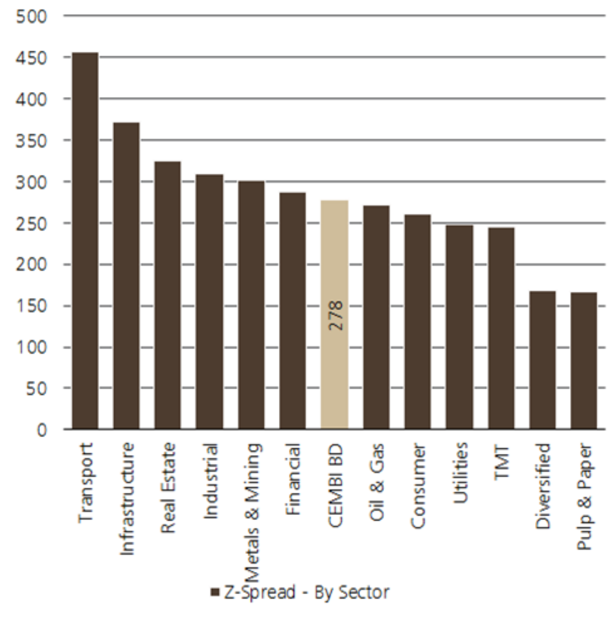
From an industry perspective, metals and mining names recovered strongly and in sympathy with higher base metal prices. Oil and gas credits also recovered with oil prices. Financial and industrial names underperformed.

We believe volatility could increase during the last quarter of 2017, which calls for a more cautious positioning. Corporate fundamentals will continue to reflect the improvement in global growth prospects; with better leverage metrics and profitability probably leading to fewer downgrades and defaults in 2017 (emerging markets corporate high yield defaults are expected to decrease to 3% in 2017 from nearly 5% in 2016, based on Standard & Poor's estimates).

Z-spreads

The z-spread – also known as the zero-volatility or static spread – measures the spread over the benchmark zero coupon swap curve.





Data as of 5 October 2017
Source: Bloomberg Finance

Valuations have become less attractive during three quarters of impressive total returns. The quarter ahead will require nimble stock picking as opposed to taking more general "beta" exposure to the index. Technicals should remain supportive as long as the search for yield continues. On the supply side, we expect net new corporate issuance to be manageable in an environment of increasing maturities in 2017 and beyond. There remains value in higher yielding subordinated debt of high-quality bank issuers in Turkey and Brazil, Latin American quasi-sovereign oil and gas names, as well as Jamaican and Mexican corporates. Exposures to lower beta countries in APAC are less attractive given their lower carry but will outperform in a higher volatility environment. Lower economic activity and still high leverage metrics in China argue for continued caution. However, we keep our positive stance toward systemically important state-owned enterprises in China, especially energy-related and financial institutions.

Local debt: a rougher ride

Emerging markets local debt performance was positive again in the third quarter of 2017: the JP Morgan GBI-EM Global Diversified index returned 3.6% with local currency returns accounting for 2.2%. Such performance came on the heels of a great year start and made the index reach its year-to-date peak at the beginning of September. In the first two months, the rally in local emerging markets was fueled by falling US treasury yields and a weakening US dollar. Among the best performers were the commodity-related markets Russia, Brazil, Chile, and Colombia, and – on the back of a stronger euro – the CE4 markets Poland, Hungary, as well as the Czech and Slovak Republics. In the second half of September, however, returns turned negative driven by the prospect of a more hawkish US monetary policy and the re-surfacing reflation trade. A stronger US dollar, sharply higher US treasury yields and increased volatility caused those local emerging markets to underperform which depend to a higher degree on portfolio inflows, particularly South Africa and Turkey.

Emerging markets local debt will probably face headwinds in the final quarter of 2017, and we expect significant dispersion of country returns versus the overall index. The prospect of higher interest rates in the US, the unveiling of the roadmap for the tapering of asset purchases by the ECB and the potential fiscal stimulus in the US are important hurdles. Volatility is likely to stay high as emerging markets local debt is adjusting to the new external environment. At the same time stronger economic activity, higher commodity prices and positive equity and credit markets – if sustained – provide an important medium-term anchor for local returns. In our view, countries with improving fundamentals, reasonable valuations and lower external vulnerability are likely to outperform. These include Argentina, Brazil, Russia and Indonesia. At the same time, following the recent sell-off and potential further price adjustments, entry levels will become attractive also in Mexico, South Africa and Turkey with elevated political risk and higher external vulnerabilities.

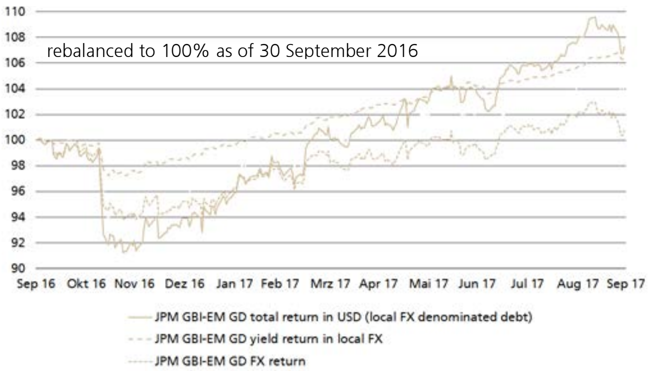
In Latin America, Brazil local debt continues to be attractive as the yield curve is very steep and the central bank is likely to cut interest rates in the fourth quarter of 2017. The Car Wash investigation has reached the President and undermined the reform agenda. However, the broad-based economic recovery is now evident, improving investor sentiment. With the end of the cutting cycle in sight, we expect future bond returns to stem largely from carry and roll-down rather than from yield contraction as seen in the third quarter. Our outlook for the Brazilian real is more neutral. It will depend on the passage of fiscal reforms and correlate to a higher degree with other emerging markets currencies, in our view. Similarly, Argentina is showing signs of more sustained growth after an uneven year start. A lot will depend on how the government will perform in the mid-term elections in October, but polls suggest that the outcome will be positive for the government. The central bank of Mexico indicated the end of the prolonged hiking cycle, opening the possibility for rate cuts next year, but NAFTA negotiations are a source of risk and political noise may pick up next year ahead of the presidential election.

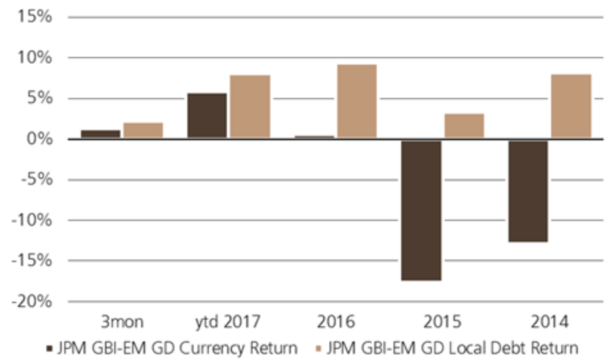
EMEA will be an important differentiator in the fourth quarter of 2017 because political and economic fragility is on display in the large regional economies: Turkey and South Africa. Turkey local debt continues to depend on foreign inflows in an environment of increasing interest rates in developed markets. The dramatic flare-up of political risk in South Africa led to credit-rating downgrades and a sell-off in the South African rand. The ANC conference in December will be the watershed moment for South Africa as either pro-market or more populist candidates will take control of the ruling party and eventually the presidency. However, the yield curve is steep, inflation is falling and the South African Reserve Bank cut the policy rate, creating value in the local curve. The rand is vulnerable to foreign investor outflows on additional rating downgrades and remains the main source of risk for local bonds. Russia local debt has become and will stay less sensitive to oil price movements provided these remain range-bound, allowing the central bank to continue their easing cycle into next year.

In Asia, low-yielding currencies were highly sensitive to the US dollar. They recovered smartly as the "reflation" dollar trade stalled and outflows from China slowed down. Nevertheless, the sentiment turned around by resumption of the dollar rally. Increased geopolitical risks with Korea added to ongoing tensions between the US and China on trade deficits.

Currency return: more sensitive to economic and political shocks

The graphs below show the total return of JP Morgan GBI-EM Global Diversified and its components: 1) local debt return, resulting from yield movements and coupons of the underlying bonds in local currency; 2) currency return, resulting from exchange rate movements





Data as of 30 September 2017
Source: JP Morgan, UBS Asset Management

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