

EM fixed income: Shifting to a lower gear

Emerging markets fixed income | UBS Asset Management



It was a good, good summer

- Emerging markets fixed income (EM FI) had a good Q3, although election uncertainty in the US started impacting on it in September. We expect uncertainty to pick up in Q4 on volatile developed markets (DM) politics and the risk of a second COVID-19 wave of infections.
- Most emerging markets (EM) continued to struggle to control the pandemic and are running out of space for monetary and fiscal stimulus. However, China continues to recover, providing support to EM.
- EM capacity-to-pay has deteriorated after the pandemic. Although we don't envision systemic defaults, we believe the asset class warrants a higher risk premium in the future.

EM FI showed positive returns in credit and rates, but the fundamental cheapness in EM currencies was not enough to offset larger headwinds coming from a stronger USD in September. Returns in Q3 were less volatile, after the outsized negative and positive returns in Q1 and Q2, respectively.

Sovereign (corporate) credit spreads as measured by the EMBIGD¹ (CEMBID²) tightened 42 bps (33 bps) in Q3 to 432 bps (393 bps) generating a 2.59% (2.59%) spread return. With this result, the year-to-date spread return in sovereigns (corporates) recovered to -9.59% (-3.71%). US Treasury (UST) yields remained extremely stable during Q3, and their contribution to total credit returns was minimal.

Local yields (as measured by the GBIEMGD³) tightened marginally by 3 bps to 4.48%, generating a return of 0.87% in Q3. Emerging market currencies sold off 0.24% against the USD in Q3, reflecting the strengthening of the USD in September. In all, the local index returned 0.61% and 6.32% in Q3 and year-to-date, respectively. The year-to-date returns in rates and currencies as at the end of Q3 stand at 5.46% and -11.2%, respectively.

3Q 2020 returns

US dollar debt	Total return	Spread return	US treasury return
JP Morgan EMBI Global Diversified	2.32%	2.59%	-0.26%
JP Morgan CEMBI Diversified	2.63%	2.59%	0.04%

Local currency debt	Total return	Currency return	Local debt return
JP Morgan GBI-EM Global Diversified	0.61%	-0.24%	0.87%
JP Morgan ELMI+	1.42%	0.85%	0.57%

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 30 September 2020. 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.

- 1 Emerging Markets Bond Index Global Diversified
- 2 Corporate Emerging Markets Bond Index Diversified
- 3 Global Bond Index Emerging Markets Global Diversified

September showed us what may come next

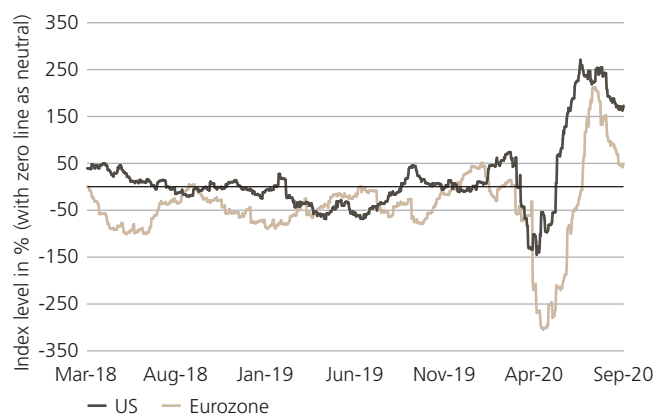
The third quarter showed a strong recovery in economic activity across the world, after the sharp worldwide drop in Q2, in part reflecting the array of monetary and fiscal stimulus that helped offset the persistent negative impact of the pandemic in the US and EM in particular.

However, high frequency data indicates that the pace of the recovery started to slow down as the summer came to an end. This reflected in part, the lack of additional fiscal stimulus (mainly in the US) but also the uncertainty surrounding the timing and effectiveness of the vaccine ahead of a potential second wave of infections, which seems to be reappearing in some countries in Europe. Most EM continue to struggle with the pandemic.

US and global equity markets rallied in Q3 but sold off in September, while UST remained remarkably stable throughout the quarter. The US dollar index (DXY), depreciated strongly in July, before stalling and reverting some of the losses in September, as Europe's recovery stalled. Commodity prices continued to recover, in some cases strongly (industrial and precious metals), but oil prices stalled.

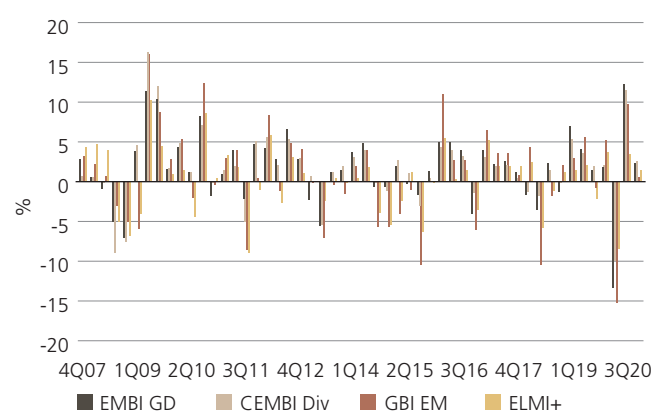
This global backdrop largely explained the tightening in EM credit, the stability in EM rates and the less than stellar behavior of EM currencies during Q3.

Surprise indices no longer up



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

Positive Q3 returns across most segments



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

Better inflows in Q3 2020

EM FI attracted USD 17.25 billion in new investments in Q3, after recording USD 2.52 billion of inflows in Q2. Sovereign and corporate credit saw inflows of USD 10.77 billion in Q3 adding to the USD 10.06 billion inflow in Q2, while local EM (currency and rates) saw inflows of USD 6.48 billion in Q3 from a USD 7.52 billion outflow in Q2.

Robust debt issuance continued in Q3, particularly by IG credits. Sovereign and corporate issuance in Q3 2020 reached USD 31.8 billion and USD 139.25 billion (mostly from China), respectively, a continuation from Q2. Amortization and coupon payments reached USD 93 billion for corporates and USD 21.4 billion for sovereigns.

Developed markets to drive Q4 returns in EM

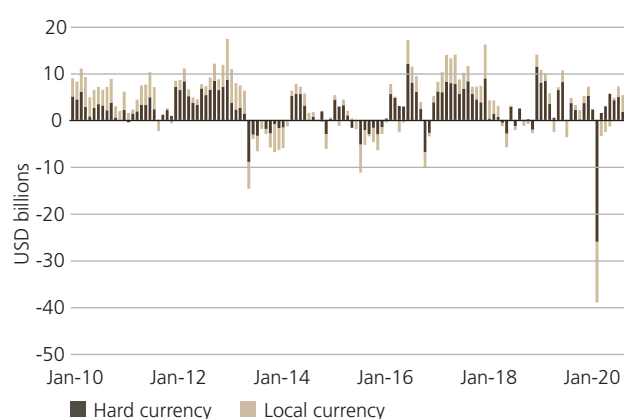
A scenario of heightened political and policy uncertainty is likely to influence returns in main asset classes in the US –including equity markets, UST and USD. Additionally, as a result, the uncertainty is likely to influence what may happen to returns in EM credit, rates and currencies during Q4. Elections in the US are likely to keep uncertainty high and could adversely impact risk appetite in Q4. This is because the probability of a contested election that could drag on for weeks, if not months, is not negligible.

The democratic candidate former vice-president Biden has a substantial lead in the national polls over the incumbent Republican President Trump, but Biden's lead in battleground states – which could determine how many of the required 270 Electoral College votes each of the candidates will get – is much smaller and subject to change in coming weeks. Furthermore, President Trump alleges that mail-in voting is vulnerable to voting fraud, and has left open the possibility of legally challenging the results if he loses, a process that could end up at the Supreme Court and take several weeks.

Although negotiations are ongoing, the adverse political environment could delay the approval of a second fiscal stimulus package (CARES II) until 2021. Democrats advocate for a USD 2.2 trillion (10% of GDP) stimulus package with broad employment protections and state bailouts. Republicans are in favor of a smaller USD 1.5 trillion (7% of GDP) fiscal stimulus package with different priorities. In the absence of further fiscal stimulus, growth in the US in Q4 is likely to be lower than previously anticipated.

In other parts of the world, Europe is slowing down and facing a second wave of the pandemic, while Brexit issues are coming back to the fore. However, the current positive economic dynamic in China is likely to provide some support to commodity prices and external demand in Q4, benefiting other EM. Furthermore, we do not expect setbacks or further escalations in the US-China trade relations in Q4.

Better inflows in Q3 (USD billion)



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

The pandemic continues to affect EM

EM continues to struggle in containing the pandemic and several countries are still imposing mobility restrictions. This dynamic has had a detrimental impact on growth and the fiscal account in EM.

Lockdowns didn't have the expected results because they couldn't be enforced, as EM governments can't provide the sort of financial assistance that would be required to keep vast portions of the population at home. Some countries like Brazil are starting to experience a slow reduction in the number of cases and deaths, but other countries like India, are still struggling to turn the curve around.

Early evidence of a second wave in Europe and certain spots in the US could dent the outlook for Q4 further. Regarding the vaccine, there are many promising frontrunners but none of them have yet reached the finish line. Markets appear to have internalized that the vaccine will not be broadly available until well into 2021. However, a successful completion of phase 3 trials by one or more vaccine candidates may buoy the markets by the end of the year.

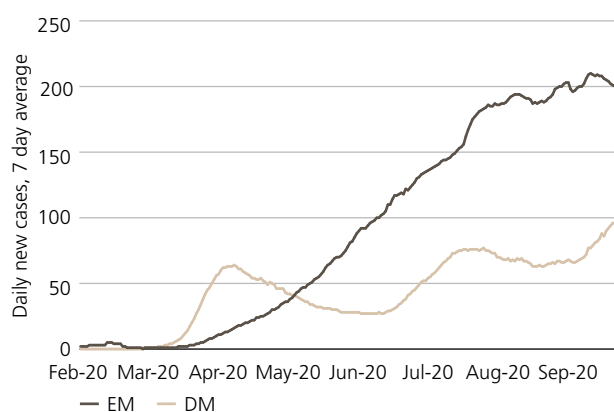
EM under the next US administration

The post-election dynamics in the US will have a profound impact on EM asset prices in the last two months of the year and beyond. Barring the adverse contested election scenario argued earlier, a Biden or Trump administration will follow distinctively divergent economic and foreign relations policy paths once they take office on 20 January 2021, provided that they win enough support in the house/senate.

Under both scenarios, we expect a fiscal stimulus of as low as 5% of GDP (republican) and as high as 15% of GDP (democratic) to be approved in Q1 2021. Under both scenarios we would expect the US economy to recover further, but at different speeds and with different inflation expectations, UST and USD outcomes. In both scenarios, we expect the US stance vis-a-vis China to continue to be tough, although styles will be vastly different.

President Trump is likely to continue with his current policies. Domestically he is likely to continue with de-regulation and marginally lower taxes and an overall pro-market macroeconomic strategy. Externally, he is likely to continue to confront China on trade, forced technological transfer and geo-political issues. Pro-market policies could help further advance the cycle of creative destruction that supports the productivity boost that usually follows recessions. A measured and targeted fiscal impulse could limit a further deterioration of the US fiscal and debt dynamics, while partially offsetting the negative impact that protectionist policies would continue to have on growth.

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



Source: Our World in Data, UBS Asset Management. As of 30 September 2020.

Under this scenario we would expect a stronger USD, contained inflation expectations and a gradual increase in UST yields as the Fed delays rate hikes well into the end of the next administration.

Former vice-president Biden is likely 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 a large 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 also committed to hike tax rates on corporations (to 28% from 21%) and high income individuals (USD 4 trillion in revenue in the next 10 years). 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.

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 USD, and pressure UST yields upwards while steepening the UST yield curve as markets start pricing in FED hikes as soon as mid-2022.

Polls indicate that vice president Biden has a higher probability of winning the election. Polls also indicate that vice president Biden has a higher probability of a blue wave (winning both houses) than Trump a red wave. If Biden/Trump wins the election but not the senate, we could expect four years of gridlock. If Biden wins both houses, the market reaction could be negative on impact, as markets will price in more government intervention in the economy.

Interestingly, EM credit and rates could do well under both scenarios (assuming Biden proves to be a moderate) in 2021, as income effects (higher/lower growth) partially offset price effects (lower/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 inflations expectations and start pricing in rate hikes. EM currencies should do better in the weaker USD scenario, as long as UST yields remain relatively stable.

Weaker fundamentals, higher risk premiums

The pandemic had a devastating effect on the finances of public and private companies and Governments in emerging markets. Many of them experienced a collapse in their (tax/sales) revenues, a sharp increase in their leverage and a diminished capacity to service their obligations. Several issuers defaulted or restructured their external and domestic obligations under different schemes.

The poorest countries got International Monetary Fund (IMF) grant-based debt relief, or joined the Debt Service Suspension Initiative (DSSI) under the Paris Club umbrella. Others defaulted (Lebanon) and renegotiated (or are renegotiating) their debt obligations (Argentina, Belize, Ecuador, Suriname, Zambia). Those that had access to capital markets have done active liability management to extend maturities and clean up the front end of their bonded debt curves. So far in 2020, 6.4% of

the sovereigns in the asset class have defaulted or restructured their external debts (see section below on "**EM sovereign defaults to set a new record high in 2020**" for more details). Sovereigns have experienced 71 rating downgrades (vs 8 upgrades) reflecting their overall weaker fundamental stance (see section below on "**EM ratings on a downward path**" for more details).

We are far from a systemic debt crisis, but weaker fundamentals warrant lower ratings and higher risk premiums in credit (spreads) and also steeper domestic yield curves in rates (see section below on "**Inflation in the time of a pandemic**" for more details). As such, we believe that we are unlikely to converge to the tight pre COVID-19 spread levels any time soon.

We expect a volatile Q4 in EM asset prices

Back in July we argued that spreads and rates offered value and could rally further in a calm environment with continued Fed support. We clearly got what we asked for, particularly in credit. We start Q4 after a significant rally since the pandemic struck earlier this year. Sovereign (corporate) spreads have tightened around 200 bps (150 bps) while rates have rallied almost 100 bps since the end of Q1. However, sovereign (corporate) spreads are still 140 bps (90 bps) wider than in December 2019, reflecting concerns about the fundamental strength of EM. EM rates have rallied 75 bps during the same period, reflecting the heavy usage of monetary policy in the absence of inflationary pressures and the presence of large output gaps. EM currencies have continued to struggle as it is the natural adjustment valve to external macroeconomic imbalance in EM.

We acknowledge that EM fundamentals have suffered with the pandemic, but we also believe that, at current levels, spreads offer value. We believe that sovereign and corporate spreads could compress another 50-75 bps in a nurturing risk-on environment in the next few quarters. However, we expect spreads to remain stuck in a range in the near term and until uncertainty subsides. Rates have generated most of what they could and in many cases are too low to be interesting. Curves are steep in many cases but 10 -year bonds with high nominal and real yields, are reflecting higher risk premiums stemming from weaker fiscal stances and larger domestic issuance. As such there are idiosyncratic opportunities around but not as a whole.

EM currencies started the year fundamentally undervalued and remain undervalued. There are many cross currents and headwinds affecting EM currencies, including the need for weaker exchange rates to adjust balance of payments imbalances, the reduction in policy rates across EM until recently, which sharply reduced the carry and high volatility. EM currencies will only rally as they did in July, in a risk-on environment in which USD is weakening. However, Q4 is unlikely to be a nurturing risk-on environment. *(Federico Kaune)*

Inflation in the time of a pandemic

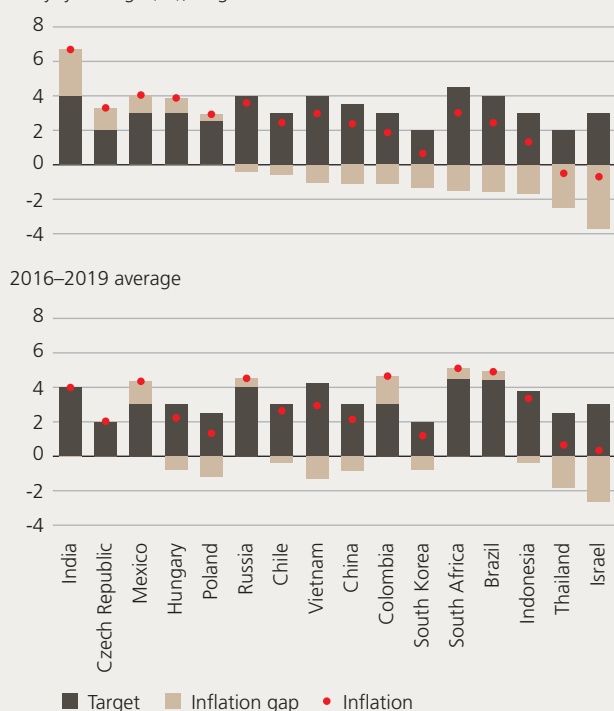
The COVID-19 pandemic has led to both demand and supply shocks. In most EMs, the disinflationary effects of lower demand and commodities prices offset the inflationary impact of currency depreciation. Currently, more EMs have negative inflation gaps than before (see chart 1), and in some countries like Malaysia, Israel and Thailand there is a greater risk of deflation. However, supply chain disruptions and other idiosyncratic shocks played a role in pushing inflation higher in other countries. Central Europe, Mexico and India saw inflation climb above target, often accelerating more than what markets expected (chart 2), contributing to a steepening of the yield curves in July/August. In Mexico and India, the sharp increase in food prices – the largest contributor in the CPI – was driven by supply-side disruptions. While these shocks are expected to fade away, other drivers of inflation are potentially sticky. Firms with market power may have contributed to higher inflation in Mexico relative to other

countries that have experienced similar currency depreciations. In Hungary and Poland, higher inflation was driven by more broad-based price increases, possibly reflecting the overheated economy prior to the pandemic. This suggests that CEE inflation could remain sticky.

Despite the temporary nature of supply-side factors, higher inflation has led markets to expect a pause or an end of the easing cycles. The National Bank of Hungary surprisingly hiked the 1-week deposit rate, sending a strong signal that it is going to prevent the escalation of inflationary risks, while India is widely expected to hold the rate in the next meeting. Going forward, while there are some strong arguments in favor of low EM inflation, country-specific factors that influence inflation dynamics are likely to be an important part of EM rate expectations. *(Yuni Kim)*

Chart 1: Inflation gaps

CPI yoy average (%), Aug 2020



Source: UBS Asset Management, Bloomberg, Macrobond, August 2020.

Chart 2: Inflation surprises

Actual headline CPI (YoY) - median Bloomberg forecast (bps)

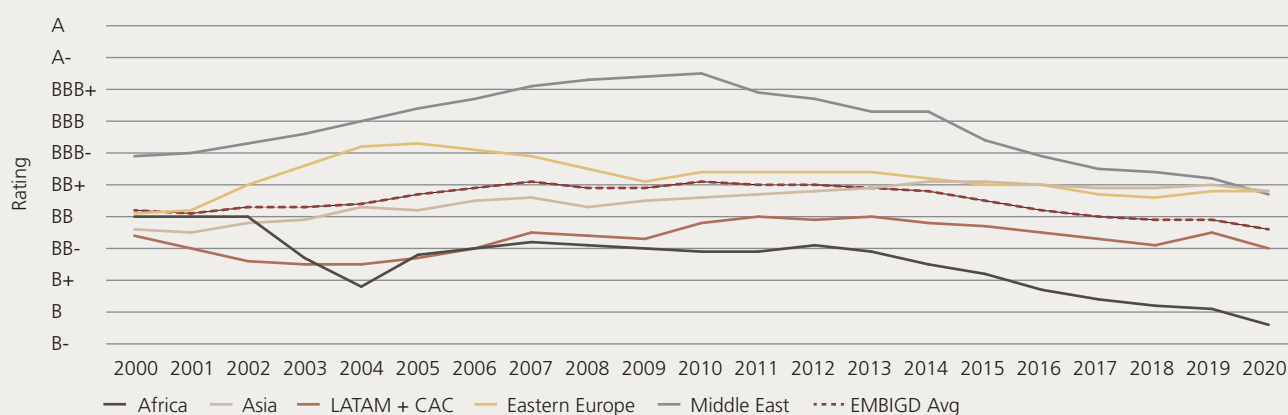
	INR	CZK	HUF	PLN	MXN	RUB	ZAR	IND	BRL	THB	MYR	ILS
March	1	-10	30	20	-12	-20	-10	4	-6	1	-10	10
April		10	-30	0	1	0	0	-9	-6	-179	-130	20
May		30	-10	-10	-14	0	-10	-1	9	-23	-10	-40
June	79	40	0	50	11	0	0	12	-4	151	-10	0
July	67	30	70	-10	0	0	20	-17	1	51	0	10
August	-21	0	0	-10	1	10		-8	0	0	-10	-20

EM ratings on a downward path after COVID-19

The commodity super cycle that started with China's opening and its acceptance into the WTO generated a significant improvement in credit quality of EM sovereigns during 2000-2012. During this period, the average rating improved to BB+ from BB, with a small and temporary setback during the Global Financial Crisis in 2008-2009. Credit quality deteriorated with more force starting in 2014, as declining oil and metal prices impacted fiscal and external accounts while increasing indebtedness. Regionally, we observed an outperformance of Middle East ratings until 2012, which however led to a quicker deterioration as oil prices fell and regional tensions rose. We also note a steady improvement of Asia, due to the lower exposure to commodities, stable social/political landscape, and because China's high growth benefited many countries in the region via supply chain channels.

In 2020, the global pandemic accelerated the deterioration in the average rating quality of EM sovereigns to the worst level in 20 years (BB/BB-). Most of the downgrades occurred in March/April, when the impact of the COVID-19 shock together with the implications of the lockdowns was at its peak. As a result EM sovereigns experienced: collapsing economic activity and trade, materially lower commodity prices, depreciating local currencies, declining FX reserves and remittances. Regionally, we highlight sharper deteriorations in Africa, due to the impact of lower commodity prices and trade on fundamentals and LATAM/Central America, due to large pandemic outbreaks, a decline in trade and remittances, and debt restructurings in Ecuador, Suriname and Belize. Overall, lower credit quality warrants caution on spread compression expectations. *(Gianandrea Heyer)*

Emerging sovereigns: ratings are falling



Source: Goldman Sachs, UBS Asset Management. As of 30 September 2020.

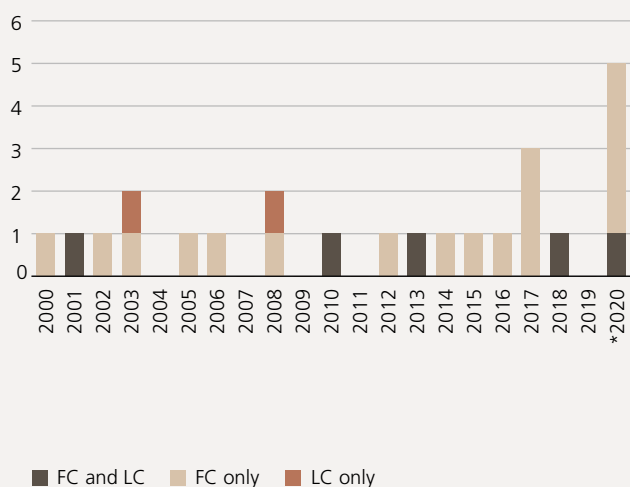
Note: Simple averages of countries and ratings from the three major rating agencies.

EM sovereign defaults to set a new record high in 2020

Sovereign defaults by large countries on foreign currency (FC)/ law bonds are historically rare. Over the past 20 years, excluding 2020, just 2 large issuers defaulted in FC bonds, i.e. Argentina (2001 and 2014) and Venezuela (2017). Among smaller issuers, sovereign defaults happened 14 other times, according to Moody's, but given their small size the impact in portfolios is not significant for diversified foreign investors. In 2020, the COVID-19 pandemic led to a record of 5 sovereign defaults (Lebanon, Ecuador, Argentina, Suriname and Belize – the last 2 were selective defaults) while there are twelve other countries with a high probability of default in the short-term with a rating of CCC+ or lower by at least one credit agency. Remarkably, the 2008/9 Global Financial Crisis triggered only one sovereign default (Ecuador) whereas in 2020 there has been a wave of defaults.

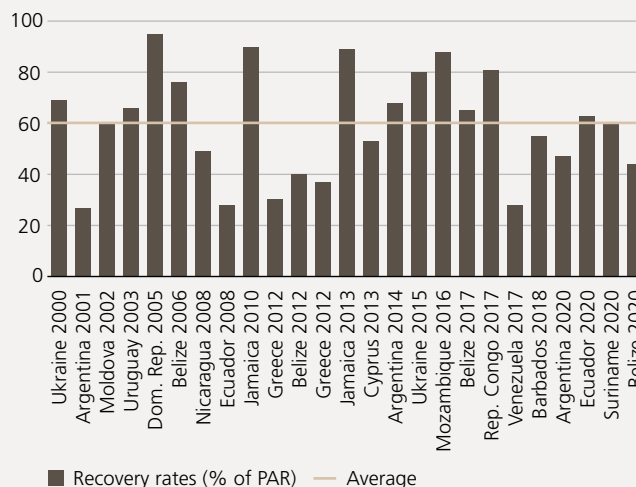
Although default events are an unpleasant surprise for investors, the recovery values (RV) for sovereigns have been relatively high, averaging \$58 per each \$100 per issuer in the last 20 years, according to Moody's. For instance, Ecuador and Argentina went through successful exchanges this year with average RV of \$63 and \$47, respectively. The restructuring of Lebanon bonds has yet to start and is likely to be a difficult and protracted endeavour. Lebanon needs a stable government and then it has to put forward a recovery plan with the help of donors and multilateral organizations. Even then RVs could be as low as in the Argentina 2001 restructuring. Zambia started a consent solicitation to request private participation on the debt moratorium proposed by the G-20 under the DSSI, which should be the first step to a broad based debt restructuring. However, politics will play a major role as the presidential election in 2021 could limit the government's fiscal efforts that would be required for an IMF program and a successful negotiation with creditors. We believe RV in Zambia Eurobonds could still be closer to the historical average \$50-60 range but negotiations won't be easy. *(Thiago Carlos)*

EM sovereign defaults by year



Source: Moody's, Bloomberg and UBS Asset Management.
Date as of 30 September 2020.
*Includes Argentina, Belize, Ecuador, Lebanon and Suriname debt restructuring.

Recovery rates (% of PAR)



Source: Moody's and UBS Asset Management.
Date as of 30 September 2020.
Note: Recovery measured as the average trading price in % of the par value of the bond at the time of the initial default event, 30-day post-default for missed payments or around the close of an exchange for distressed debt exchanges.

Sovereign debt: A good Q3

Sovereign credit posted a 2.32% total return in Q3 2020 (measured by the EMBIGD Index). Spreads tightened 42 bps, generating a 2.59% spread return. US Treasury yields remained roughly unchanged in Q3.

IG spreads tightened 21 bps to 196 bps and high yield (HY) spreads 79 bps to 753 bps in Q3, continuing with the trend in Q2. As a result, EM IG (HY) sovereigns returned 2.58% (1.99%) in Q3 2020.

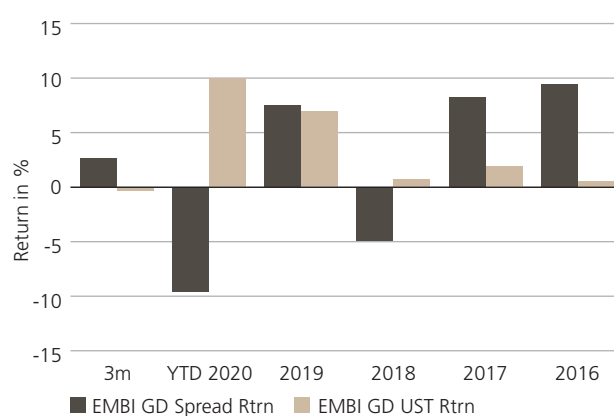
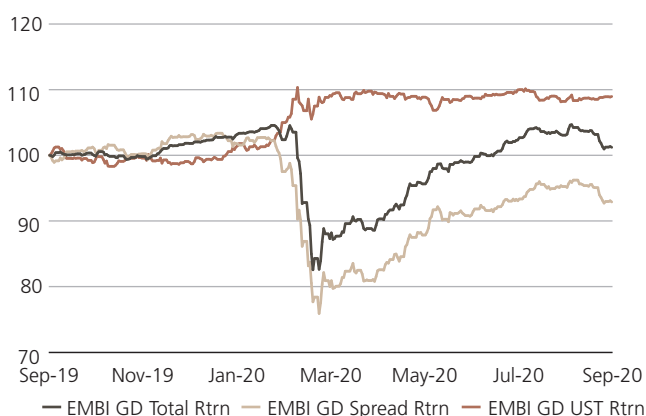
Most of the positive total return in sovereigns was generated in July, as global growth started rebounding strongly amidst large fiscal and monetary stimulus worldwide. In contrast, September showed negative returns in sovereigns, as spreads widened after the Fed announcement was taken as relatively hawkish by markets. During Q3, all regions generated positive total returns. Latin America posted the highest returns at (3.97%), followed by Asia (3.03%) and the Middle East (1.61%). Eastern Europe returned 0.71%, while Africa returned 0.42%.

Vulnerable oil exporters in Africa – including Angola and Ghana – suffered from lower oil prices. Zambia sold off 4.23% as it became clear that the sovereign will restructure its bonded debt. The government approached investors and requested a 6-month interest moratorium but investors rejected the proposal as it lacked a specific IMF sponsored financial program. Zambia bonds are trading at around 50 cents on the dollar, or close to where recovery value is likely to be.

Among the countries that finalized their debt restructuring, Ecuador was the best performer in the quarter (10.89%) as it successfully restructured with a relatively high recovery value (63 cents on the dollar) under the auspices of the IMF. Subsequent to the successful debt restructuring, the IMF approved a USD 6.5 billion EFF (Extended Fund Facility) program with the government of Ecuador.

In contrast, Argentina sold off (-0.76%) as it also finalized its debt restructuring with a relatively low recovery value (47 cents on the dollar) without a clear macroeconomic plan or IMF program. Moreover, two weeks after the exchange the central bank announced draconian capital controls including stringent limits for service of corporate external debt. Sovereign bond prices plummeted to the mid-30s in response.

Sovereign debt: ongoing rally in Q3
(Rebalanced to 100 as of 30 September 2019)



Source: JP Morgan monitor. As of 30 September 2020.

Suriname has yet to approach investors with a proposal on debt restructuring, although one is urgently needed given the lack of payment capacity and high leverage in the country. However, the government took an important step towards macroeconomic balance as it devalued its overvalued currency 87%. Bonds rallied 36.65% in response.

In Lebanon, the government headed by PM Adib collapsed, reflecting the inability of the political class to compromise on a short-term deal to form a technocratic government and implement urgent reforms. Hezbollah and Amal (Shia parties) opposed the deals, fearing they would weaken their political stances in the country. The international community and the IMF are unlikely to engage with Lebanon in current circumstances.

At around 430 bps for the EMBIGD, sovereign spreads remain historically cheap. Spreads could tighten an additional 50-75 bps in the next few quarters, in a favourable risk-on external environment.

However, we believe that spreads are not likely to go back to pre-pandemic levels (290bps) anytime soon. This is because weaker EM fundamentals warrant higher risk premiums. Furthermore, we believe that spreads are likely to be stuck in a range in the near term until political uncertainty in DM subsides. (*Federico Kaune*)

Corporate debt: Keep on keeping on

EM corporate credit posted positive Q3 2020 returns of 2.63% (as measured by JP Morgan CEMBI Diversified). Corporate credit spreads tightened 40 bps (spread to worst/STW) a continued recovery, though to a lesser extent than Q2 2020. Total returns were driven by credit spreads contributing 2.59% to Q3 returns while Treasury contributed 0.04%.

In Q3 2020 corporate bonds in Brazil (6.02%), Egypt (5.90%), Chile (5.13%), Peru (4.79%), and South Africa (4.63%) provided the best total returns, while the largest underperformers were from Ghana (-16.55%), Kazakhstan (-8.40%), Argentina (-0.79%), Turkey (0.03%), and Thailand (0.74%).

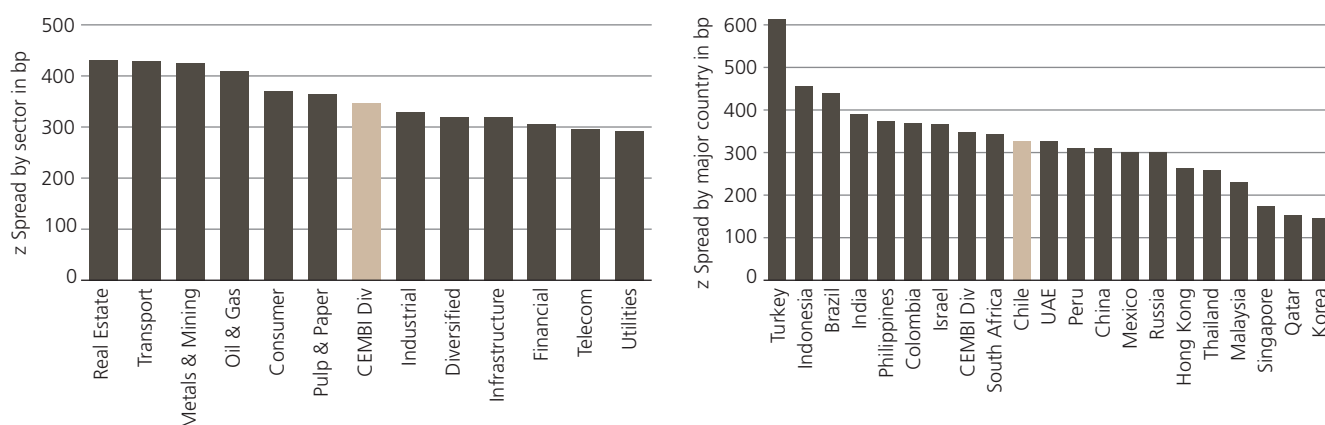
The top performing sectors were pulp & paper (7.34%), transport (5.52%), and infrastructure (5.26%) while the largest underperforming sectors were oil & gas (1.48%), telecom (2.07%), and consumer (2.16%). In Q3 2020 all regions provided positive returns. The best regions for total return were Latin America and the Middle East, while Europe lagged in total return. This closes out a quarter where risk markets continued to reflect modest price recovery.

Financials: Bank fundamentals are under pressure, but supportive forbearance measures have mitigated the risks of immediate and severe deterioration in asset quality, earnings and capital erosion. Loan growth was moderate, but supported by fiscal measures and government guarantees. Risks remain significant, but EM banks have strengthened capital positions, reduced leverage and increase liquidity since the Global Financial Crisis (2008/9). We prefer large high quality franchises that have solid capital and liquidity buffers and conservative underwriting standards. We prefer exposure to senior unsecured and subordinated tier 2 bonds, while remaining selective on deeply subordinated AT1 bonds.

TMT (tech. & telecoms.): This sector has been one of the more defensive sectors as consumption of mobile, internet and TV subscription services remained resilient during the pandemic. 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 outlook for EM as well as comparatively lower penetration rates relative to developed economies. We like TMTs that have strong fundamentals and low leverage. We also like tower operators given their strong contractual cash flows and defensive profiles.

EM corporate spreads: continued tightening

Measured in bps as of 30 September 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 30 September 2020.

Oil & Gas: The outlook for oil remains highly uncertain, on concerns over a second wave in the pandemic. OPEC expects global oil demand to increase 7% YOY to 96.9 million barrels per day (BPD) in 2021 from the 2020 forecast (90.2 million BPD vs IEA's 91.7 million BPD), but well below 2019's peak of over 100 million BPD. Despite signs of a demand pickup, we are sceptical about the oil-market recovery because China's demand is slowing down after its massive stock-piling, OPEC members are not consistently adhering to output cuts, and consumption is not recovering while inventories are still high. We prefer to stay nimble and capture opportunities as they are presented.

Consumer: We prefer the most defensive, first necessity sectors, such as packaged food, beverages and household products. We like exporters and companies with international operations in developed countries. We expect that consumer discretionary will continue to underperform because of reduces store traffic, and lower average ticket size and same-store sales (SSS). Hence, we prefer to stay away from non-food retailers and travel & leisure.

Metals & mining: The economic recovery in China has improved the outlook for iron ore, copper, aluminium, steel and zinc. Despite the positives, risks remain finely balanced, due to rising US/China tensions, oncoming supply and continued uncertainties over the pandemic. We prefer to remain defensive and maintain exposure to low-cost, lower levered, larger producers of iron ore, gold, silver, and to a lesser extent copper.

EM issuers have successfully executed liability management exercises over the past few years and this has alleviated short term funding pressures. This has been important for high yield issuers who did not have market access during this time of uncertainty. Also, the sharp decline in growth, demand, consumer confidence, and commodity prices has been reflected by an increase of distressed events (defaults / distressed exchanges), primarily within the airlines hotels and retailers sectors. While there was an increase in defaults, liability management exercises and ongoing central bank liquidity provided a much needed cushion, and allowed EM high yield issuers to keep corporate defaults contained.

We still 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, & telecom. Performance in the upcoming months and quarter will rely on a combination of beta management and selecting exposure to names with strong credit fundamentals. *(David Michael)*

Local debt: Front-loaded volatility

EM local debt (measured by JP Morgan GBI-EM Global Diversified Index) showed a 0.61% return in Q3 leaving the loss so far in 2020 to a still high -6.32%. Returns were higher through most of the quarter, but gave back gains in the last two weeks in September on rising global market volatility, looming US elections and second-waves of COVID-19 in Europe. Local returns were modestly positive driven by late interest-rate cuts cycles and idiosyncratic stories, while currencies responded to the strengthening of the USD.

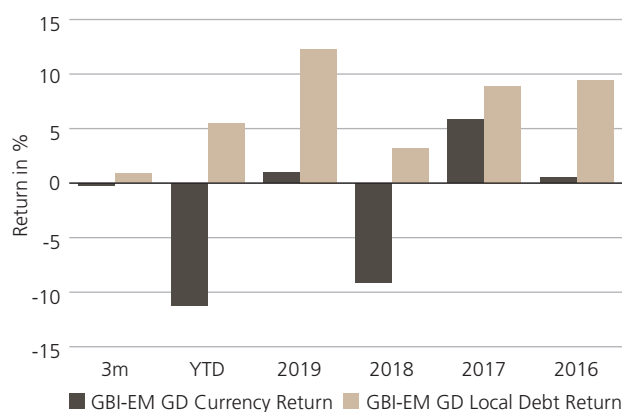
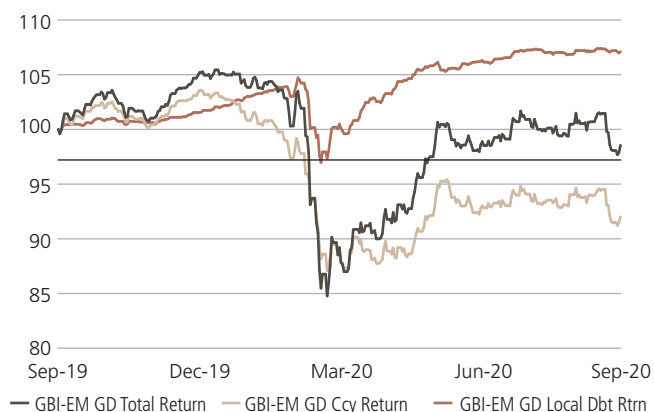
The outlook for Q4 2020 could be positive conditional on continuing opening up of economies and avoiding a large second-wave of COVID-19 infections as well as counting on the reduction of political risk post US November elections. Valuations are no longer distressed as at the end of Q1 and economic damage and uncertainties in the path of the pandemic are bound to create volatility in the markets. Even though room to cut rates is now limited, the environment of low inflation, large output gaps, and the steep yield curves continue to favor duration-extension. Currencies are cheap by historical measures. However, currencies have lost yield support

and with low pass-through to inflation, few central banks worry about under-valuation. As a result, investor flows were generally absent into the EM local markets. We think currencies have potential to perform in Q4, but sold performance would only be consistent with clear evidence that the pandemic is under control and vaccines are under way, together with weaker USD. The degree of fiscal deterioration and ability of countries to grow, cut expenditure, and tap sources of funding would become differentiation factors into 2021.

In Latin America, we find the Mexican central bank still has room for modest rate cuts. The Brazilian central bank is now on hold at a record-low Selic rate, but the yield curve has significant risk premium given the benign inflation outlook. The Chilean rates markets have little additional room for a rally while political risks are on the rise with constitutional referendum. Colombian yields performed well, and are likely to be range bound with central bank on hold. Commodity-dependent Andean currencies will respond to a resumption of global growth.

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

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



Source: JP Morgan monitor. As of 30 September 2020

In EMEA, Turkey continued with heterodox macro-economic policies leading to loss in reserves and high inflation. The market remains highly vulnerable to negative shocks, however, the central bank has begun steps to tighten monetary policy. The outlook for South Africa's (SA) growth and fiscal balance remains bleak, but the country's large domestic asset base and improved political support of the government will allow SA assets to muddle through. Russian bonds and currency have sold off on increasing risk of new sanctions, and are likely to remain cheap until the political risk drops.

Central Europe has been relatively successful in handling the COVID-19 and is likely to benefit from a recovery in core Europe. Interest-rates however are historically low and inflation pressures are building, which led to a first rate hike in Hungary. There is some value in the currencies vs the EUR.

Following a period of volatility earlier in the year, APAC currencies have recovered and the CNY rallied strongly based on enviable performance of China in stamping out the COVID-19 pandemic and resuming economic activity. Most APAC currencies have also rebounded showing limited losses for the year, driven by better COVID outcomes and the recovery in China. The Chinese central bank has been reluctant to ease aggressively, however, slowing growth recovery and falling inflation is likely to bring lower rates. The main risks to the outlook are stemming from the uncertain nature of the global pandemic and the increase of political noise associated with the US November elections. (Igor Arsenin)

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Americas

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EMEA

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