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EM Fixed Income: The Fed holds the key

Emerging markets fixed income | UBS Asset Management

A little sunshine after the storm

- Emerging economies (EM) are struggling to recover from the pandemic and are lagging the recovery of developed markets (DM). Most of EM will be in recession in 2020.

- Emerging markets fixed income (EM FI) has reacted positively to the global policy response and is following global factors.

- The lack of inflationary pressures has allowed EM central banks to ease monetary policy. We expect rates to come down more and yield curves to steepen.

- Even after the rally in Q2, valuations remain attractive. If global risk appetite remains elevated, EM FI could rally further in Q3.

EM FI returns staged a fierce comeback during Q2 2020 after the plunge in Q1, reflecting the impact of aggressive global monetary easing. In fact, the policy response by major central banks and governments around the world (predominantly by the US Fed and Treasury) was unprecedented and provided a strong signal of their commitment to reduce tail risks in financial markets.

Sovereign (corporate) credit spreads as measured by the EMBIGD (CEMBID) tightened 152bps (121bps) in Q2 to 474bps (426bps) generating an outsized 12.37% (11.45%) spread return. However, such returns were not enough to make up for the large negative returns in sovereign (-21.57%) and corporate (-15.78%) spreads in Q1. US Treasury (UST) yields remained extremely stable during Q2, and their contribution to total credit returns was minimal.

Local yields (as measured by the GBIEMGD) tightened by an impressive 85bps to 4.51%, generating a return of 5.90% in Q2. Emerging market currencies rallied 3.92% against the USD in Q2, after the 14.30% selloff in Q1. In all, the local index returned 9.82% in Q2 from -15.20% in Q1.

2Q 2020 returns

US dollar debt	Total return	Spread return	US treasury return
JP Morgan EMBI Global Diversified	12.26%	12.37%	-0.10%
JP Morgan CEMBI Diversified	11.47%	11.45%	0.02%

Local currency debt	Total return	Currency return	Local debt return
JP Morgan GBI-EM Global Diversified	9.82%	3.92%	5.67%
JP Morgan ELMI+	3.42%	2.52%	0.88%

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 June 30, 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

A V-shape recovery in asset prices in Q2

The array of financial support programs announced and implemented around the world were successful in avoiding a further deterioration in expectations as well as containing tail risks in financial markets. None of the programs announced by developed central banks included direct purchases of EM assets, but the positive impact of those programs on confidence and risk appetite had a very beneficial impact on EM asset prices. This is because after the COVID-19 shock, EM asset prices have been closely reacting to global factors – including equity and credit markets, volatility, rates, currencies and commodities – rather than to idiosyncratic factors (with the notable exception of EM rates).

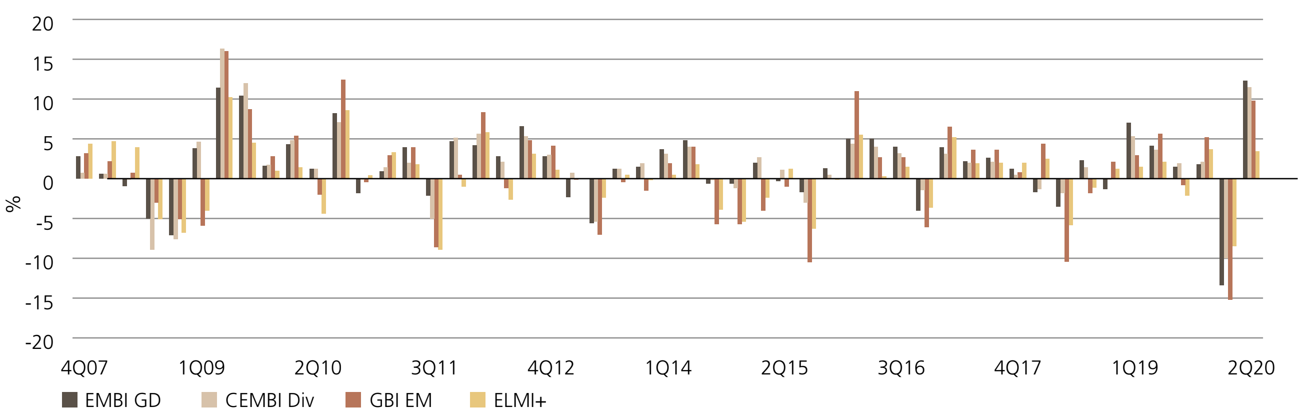
Equity markets, particularly in the US, staged one of the most pronounced quarterly rallies in recent memory, which together with lower volatility and stable UST yields set the stage for a benign risk-taking environment in EM.

The Fed announcement of a program directed at buying short duration US investment grade (IG) bond funds – designed to stabilize financing costs for the corporate sector – added to the perceived value in credit, including in EM. EM IG names benefitted the most as IG funds usually allocate to EM IG names to lock in higher spreads.

The US dollar index (DXY), which had remained strong (appreciated) after the COVID-19 shock, started depreciating in mid-May, helping EM currencies to outperform in the process. Historically, EM currencies have failed to rally absent strong risk appetite and a weaker DXY. EM rates were the only asset class that rallied mostly on EM driven fundamentals, although stability in UST yields provided the required support. EM central banks have been implementing their own version of quantitative easing (QE) and have continued to cut rates to record lows in many cases.

Such expansionary monetary policy was justified by the significant output gaps generated by the pandemic (most emerging economies will be in recession in 2020), the absence of inflationary pressures and the evident lack of depreciation-to-inflation pass-through.

EM FI quarterly returns – strong Q2 across most segments



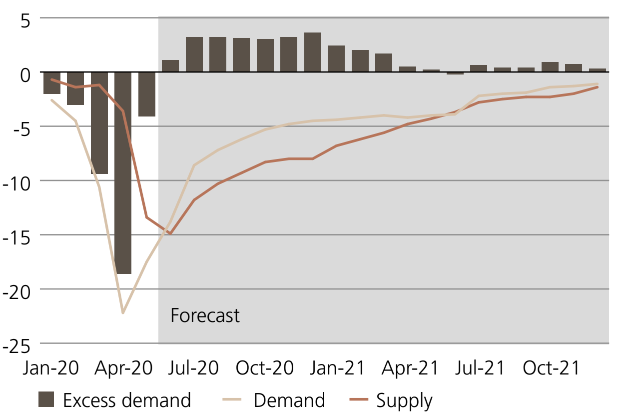
Source: JP Morgan, UBS Asset Management. As of June 30, 2020.

Oil prices: Inventory overhang

Oil markets have rebounded dramatically following the price war in the middle of the pandemic in March-April this year. On 20th April, the May WTI future contract closed at -$36.7 a barrel exposing significant imbalances and storage capacity constraints in oil markets. The excess supply of crude oil in April alone reached 18.6mbdp, the largest imbalance on record, raising questions on whether the existing physical storage capacity was enough to absorb such a large shock. The collapse in oil prices led to an unprecedented 13.4 mbpd reduction in oil supply in May. OPEC+ (OPEC + Russia) cut 7.3 mbpd (vs. a 9.7mbd agreed quota) while non-OPEC+ countries cut an additional 6.1mbpd (US production alone declined 2.1mbpd). These production cuts, together with increased demand from newly open economies, restored balance in the oil markets in late May. As a result, oil prices recovered to $35-40 a barrel.

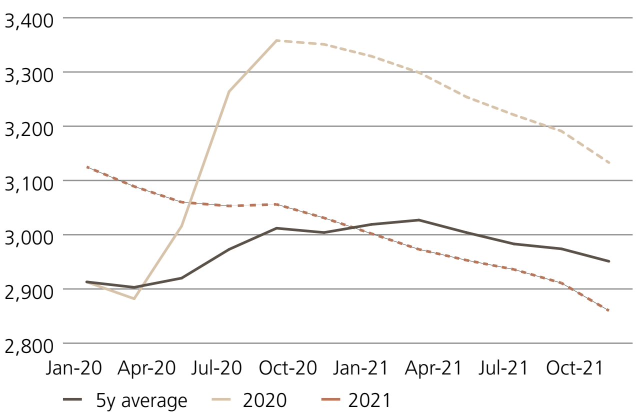
Still, a shock of this magnitude left a wound in oil markets that will take a long time to heal. The inventory overhang remains significant and will likely take at least until end-2021 to return to pre-pandemic levels. This estimate can be considered optimistic as it does not account for additional pandemic waves and assumes that OPEC+ countries will continue to curb oil production throughout this period. Overall, the oil supply and demand outlook remains highly uncertain, with the inventory overhang and production increases from non-OPEC countries likely to cap the recovery of oil prices in the short to medium term. As such, it is unlikely that oil prices will rise significantly, while episodes of sharp price drops cannot be discarded. *(Thiago Carlos)*

Oil supply and demand vs year end 2019 (mbpd)



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

OECD commercial oil inventories (mb)



Source: EIA, Macrobond. Note: Dotted lines represent EIA forecasts.

Small inflows in Q2 2020

EM FI attracted USD 4.7 billion in new investments in Q2, after a record USD 29.8 billion outflows in Q1. Sovereign and corporate credit saw inflows of USD 10.7 billion in Q2 from USD 17.9 billion outflow in Q1, while local EM (currency and rates) had an outflow of USD 6.0 billion in Q2 from a USD 10.8 billion outflow in Q1[4].

Debt issuance recovered strongly in Q2, particularly by IG credits. Sovereign and corporate issuance in Q2 2020 reached USD 100.4 billion and USD 121.5 billion (mostly from China), respectively, a strong recovery from Q1. Amortization and coupon payments reached USD 84.7 billion for corporates and USD 47.6 billion for sovereigns.

Global markets are walking on sunshine

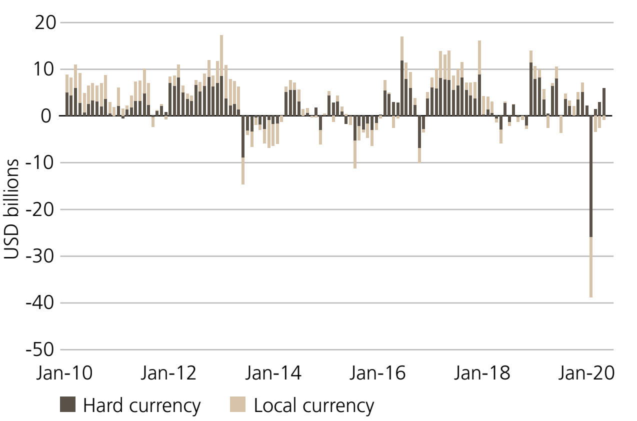
It has rarely been the case that asset prices and economic / earnings fundamentals diverge to such an extreme as is the case today. On the economic front, the world economy will be in recession in 2020 and the recovery is unlikely to be V-shaped. Earnings projections on the other hand, are hard to predict. The only certainty is how uncertain the path of the expected upcoming recovery is.

The latest global growth projections by the International Monetary Fund (IMF) indicate that much. The IMF projects that global growth will be -4.9% in 2020 (1.9% below their already bearish projection in April), and expects a shallower 5.4% recovery in 2021. This growth path will leave the level of end-2021 world GDP 6.5% below the IMF projections of February 2020. The US is expected to contract 8% in 2020 and to recover 4.5% in 2021. That is hardly a V-shaped recovery as simple arithmetic indicates that growth would have to be at least 12% in 2021 to be at the same level as pre COVID-19 projections by the end of that year. The same goes for developed Europe and Asia.

The path for emerging economies looks more varied. On the most optimistic extreme, China is expected to show growth in 2020 in this updated projection, and to recover strongly (8.2%) in 2021. Even with this optimistic growth path, China's GDP level will still be around 3% below pre COVID19 projections by year end 2021. On the most pessimistic extreme, Brazil, Mexico and South Africa could see their GDP levels, 10% below pre COVID19 projections by year end 2021.

4 Flows data as of June 30, 2020

Small inflows in 2Q (USD billion)



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

IMF WEO real GDP growth Projections (%)

	2018	2019	2020F	2021F
World output	**3.6**	**2.9**	**-4.9**	**5.4**
Advanced economies	**2.2**	**1.7**	**-8.0**	**4.8**
United States	2.9	2.3	-8.0	4.5
Euro area	1.9	1.3	-10.2	6.0
Germany	1.5	0.6	-7.8	5.4
France	1.8	1.5	-12.5	7.3
Italy	0.8	0.3	-12.8	6.3
Spain	2.4	2.0	-12.8	6.3
Japan	0.3	0.7	-5.8	2.4
United Kingdom	1.3	1.4	-10.2	6.3
Canada	2.0	1.7	-8.4	4.9
Other advanced economies	2.7	1.7	-4.8	4.2
Emerging Mkt & Developing Economies	**4.5**	**3.7**	**-3.0**	**5.9**
Emerging and Developing Asia	6.3	5.5	-0.8	7.4
China	6.7	6.1	1.0	8.2
India	6.1	4.2	-4.5	6.0
ASEAN-5	5.3	4.9	-2.0	6.2
Emerging and Developing Europe	3.2	2.1	-5.8	4.3
Russia	2.5	1.3	-6.6	4.1
Latin America and the Caribbean	1.1	0.1	-9.4	3.7
Brazil	1.3	1.1	-9.1	3.6
Mexico	2.2	-0.3	-10.5	3.3
Middle East and Central Asia	1.8	1.0	-4.7	3.3
Saudi Arabia	2.4	0.3	-6.8	3.1
Sub-Saharan Africa	3.2	3.1	-3.2	3.4
Nigeria	1.9	2.2	-5.4	2.6
South Africa	0.8	0.2	-8.0	3.5
Low-Income Developing Countries	5.1	5.2	-1.0	5.2

Source: IMF WEO June Update. UBS Asset Management. As of June 30 2020.

Bubble makers or visionary policy makers?

There are at least three reasons why asset prices have reacted so positively after the pandemic erupted in Q1. First, the policy response by developed central banks and governments was unprecedented, in that it all but eliminated tail risks from financial markets, while assuring them that there were entire asset classes that were likely to perform well given the provided support. Second, markets looked through the first wave of the pandemic and found comfort in unproven optimistic pandemic paths. Third, markets chose to believe in the most favorable of outcomes for the vaccine against COVID-19.

The US undoubtedly benefits from the fact that the USD is a reserve currency around the world. Otherwise it would be difficult to explain how with money supply growing at 20-40% the USD continues to be on the stronger side. It is obvious that markets are looking at the relative stance of the US economy vis-à-vis other developed countries and deciding that it is still the best in such a lackluster group.

Markets have clearly noticed that the Fed and other DM and certain EM central banks will likely keep rates as low as possible for as long as possible. Markets have also internalized that further interventions in financial markets such as yield curve controls and even negative policy rates are often part of the tool kit nowadays. As long as this is the case, valuation will be artificially high and disconnected from fundamentals.

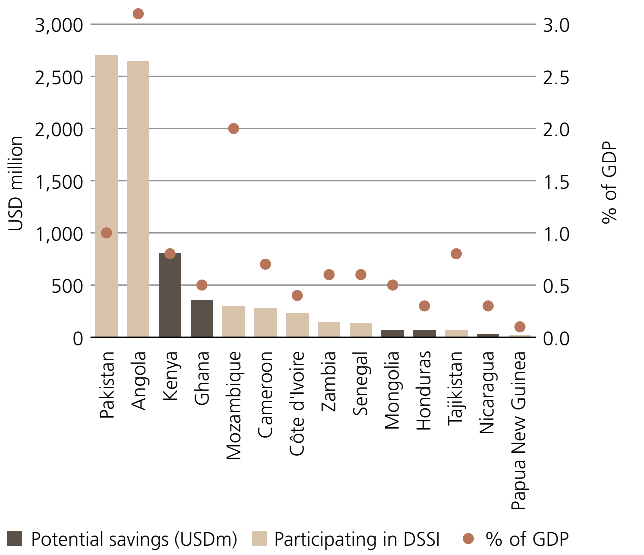
On the fiscal front, DM and EM countries that were already running high fiscal deficits are now running even higher fiscal deficits while accumulating higher debt loads. Whether fiscal restraint and high growth rates globally will materialize in coming years to contain the deterioration of public sector accounts, is again uncertain. There is, however another possible path and one that has been used often by emerging economies in the past: financial repression with higher inflation rates as a way to liquefy debts. Markets are assigning a very low probability to such a path.

Debt standstill for low income countries

As it became evident in March that many low income countries (LICs) would face the global pandemic with significant funding gaps, multilateral organizations were quick to respond. The IMF provided grant-based debt relief to 29 of the IMF's poorest members and is responding to more than 100 countries' requests for emergency financial assistance. In April, the G20 agreed to temporarily suspend debt service payments on existing bilateral loans to 77 LICs that requested forbearance. As of today 39 countries signed MoUs with Paris Club creditors under the Debt Service Suspension Initiative (DSSI). With 40 among the 77 DSSI-eligible countries coming from Africa, China has been under spotlight as it is widely thought of as Africa's single largest creditor. However, as a non-Paris Club member, China has taken a bilateral approach in its negotiations with affected countries, including debt restructuring. For some countries heavily indebted to China, such as Angola, Pakistan and Zambia, China's participation in this initiative makes a significant difference. For many, additional negotiation with China may happen to extend debt relief or re-profile the debt beyond 2020. For example, China agreed to grant Angola a three-year moratorium on interest payments and installments on its $21.7 billion debt.

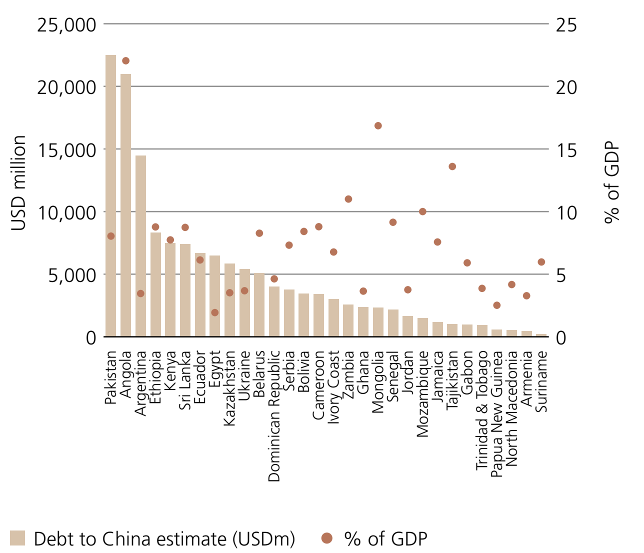
There have been calls for private sector participation on comparable terms. Some proposals have been made earlier such as creating a special purpose vehicle to exchange commercial debt for new concessional paper backed by a multilateral bank, similar to the Brady bonds, but they have not yet gained traction. The Institute of International Finance, a US-based financial services association that has historically served the London Club – the commercial counterpart to the Paris Club – has suggested that the private sector participation be on a voluntary basis with a case-by-case approach. Similarly, the newly-formed Africa Private Creditor Working Group, composed of a group of 25 private creditors representing $9 trillion in AUM, has rejected a "one-size-fits-all" solution, which may end up increasing the countries' cost of capital. So far, the commercial creditors' approach has disappointed those who advocate a stronger role. While the swift action by the official sector has created some breathing space for LICs, it is yet unclear whether there will be large-scale debt forgiveness from China or a blanket standstill from the private sector. *(Yuni Kim)*

Potential savings under the DSSI



Source: World Bank, UBS Asset Management. As of June 30, 2020.

Debt to China, estimate



Source: Horn, Reinhart and Trebesch (2019). UBS Asset Management. As of June 30, 2020.

Most investors and financial analysts have become experts on pandemics and vaccines, we haven't. We observe the dynamics of the ongoing new waves in several states in the US and the delayed peaks in several emerging countries and wonder whether the optimistic pandemic paths are warranted. Also, we understand that historically vaccines have taken years to test for effectiveness and safety, yet markets are betting on a vaccine as soon as year end.

The question then is what would happen with asset prices if a new wave appears and there is no vaccine available, say by Q1 2021? What if COVID-19 becomes a cyclical feature like the flu? Should markets expect ever increasing policy accommodation or would they finally allow asset prices to reflect fundamentals rather than government-sponsored financial support? EM FI is at the riskiest side of the spectrum and will amplify one path or another with sheer force.

Value in EM? The Fed holds the key

Back in April we argued that although we were not in a position to pin down the exact inflection point, after which emerging asset prices will rally, we believed that emerging assets offered compelling value at those extreme cheap levels.

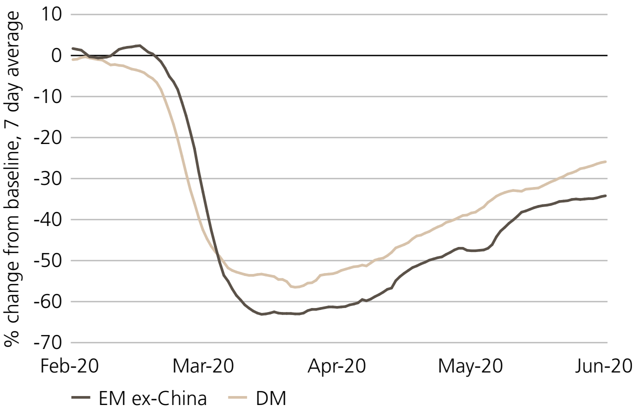
We also argued that long-horizon investors capable of withstanding high volatility could benefit from those cheap valuations and lock-in outsized returns. Q2 delivered very high returns indeed. The question now is whether we should expect a further rally after the recent recovery.

There is little argument against the assertion that at current spreads levels, credit still offers value and that EM currencies are fundamentally cheap. Even rates could rally another 50 bps in a calm environment, even if to new record lows.

As we argued above, EM asset prices are following global factors. If the Fed support increases as new shocks arise in Q3 –including but not limited to trade confrontations, election uncertainty, new pandemic waves, vaccine delays and so on-, EM FI can offer value. This is because EM FI will thrive in an environment where risk appetite is high and volatility low, something that Fed policies have achieved quite successfully.

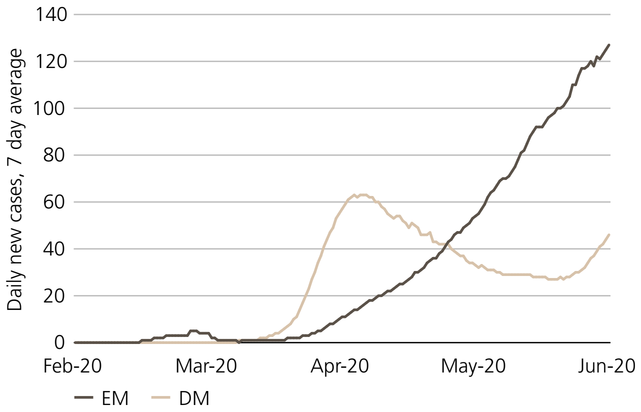
Furthermore, EM FI will likely perform quite well in an environment where UST yields are stable and the DXY index depreciates in an orderly manner. *(Federico Kaune)*

Google Transit Index: slow way back



Source: Google, UBS Asset Management. As of June 27, 2020

COVID19: all going up again
(Daily new confirmed cases, in thousands)



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

Sovereign debt: strong come back, more needed

Sovereign credit posted a 12.26% total return in Q2 2020 (measured as EMBIGD). Spreads tightened 152bps, generating a -12.27% spread return. US Treasury yields remained roughly unchanged in Q2.

IG spreads tightened 111 bps and high yield (HY) spreads an impressive 245 bps in Q2. As a result, EM IG (HY) sovereigns returned 9.06% (16.57%) in Q2 2020.

Most of the positive total return in sovereigns was generated in May, reflecting the massive monetary and fiscal stimulus implemented in developed countries. During Q2, all regions generated highly positive total returns. Africa posted the highest returns at 25.95%, followed by the Middle East, 13.49%. Latin America returned 10.62%, while Eastern Europe returned 9.65%. Asia returned 8.52%, reflecting the higher quality/lower risk of its members.

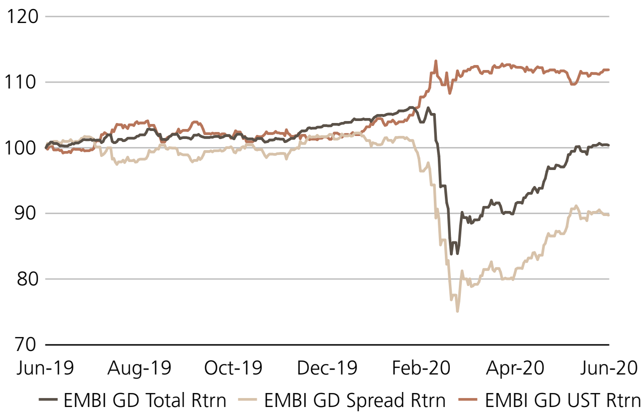
Vulnerable oil exporters in Africa and Latin America were the best performers in Q2, reflecting the recovery in oil prices and the strong global risk appetite that prevailed throughout the quarter. Angola returned 119.4% (After selling off 61.61% in Q1), Ecuador 40.11% even after requesting a delay in coupon payments on its bonded debt. Countries that are expected to default/restructure with low recovery values sold off, including Belize and Suriname.

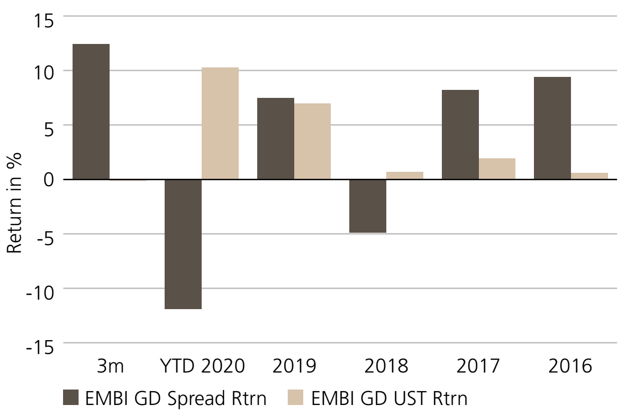
Argentina extended deadlines for its proposed restructuring several times and at the time of writing it is still negotiating with creditors that are demanding more than what the authorities are willing to give in NPV terms. Lebanon is nowhere near starting negotiations on their defaulted debt, while Zambia is still seeking advice on how to proceed.

At around 470bps for the EMBIGD, sovereign spreads are historically cheap. Whether this value is realized in Q3, will largely depend on how global factors behave. We note that the rally in oil exporters' asset prices, that followed the oil price rebound in Q2 2020, is probably over.

However, fears of widespread sovereign defaults have been mostly dissipated due to higher oil prices, multilaterals financial support and the G20 debt relief initiative. *(Federico Kaune)*

Sovereign debt: strong rebound
(Rebalanced to 100 as of June 30, 2020)





Source: JP Morgan monitor. As of June 30, 2020

Corporate debt: Valuations reflect upside

EM corporate credit posted robust Q2 2020 returns of 11.47% (measured as CEMBID). Corporate credit spreads tightened 159bps contributing to the sharp selloff seen in Q1 2020. Total returns were driven by credit spreads contributing 11.45% to Q2 returns while Treasury contributes 0.02%.

In Q2 2020 corporate bonds in Ghana (123.65%), South Africa (33.75%), Argentina (32.91%), Ukraine (27.88%), and Jamaica (22.55%) provided the best returns given their high spread/yield, while the largest underperformers were from low spread/yielding countries of Taiwan (2.43%), Poland (2.53%), South Korea (3.88%), Hong Kong (3.95%), and Singapore (4.95%).

The top preforming sectors were metals & mining (19.87%), pulp & paper (18.76%), and industrials (16.33%) while the largest underperforming sectors were transportation (-9.04%), diversified (7.26%), and financial (7.55%).

In Q2 2020 all regions provided positive returns. The best regions for total return were Africa and Latin America, while Asia lagged in both total return and spread return given the regions tighter spread and more defensive commodity importers. This closes out a quarter where all risk markets reflected a strong price recovery.

After the shocking spread widening in Q1 2020, EM corporate bonds bounced off the March lows to a strong recovery in Q2. While the world was facing new and increasing economic uncertainty, global governments stepped up with unprecedented monetary and fiscal policy response. After the US Federal Reserve took decisive action in March by cutting overnight lending rates by 150bps, this quarter they began executing liquidity facilities and commercial paper and bond buying programs. The FED's action coupled with global fiscal spending packages injected massive amounts of liquidity into global risk markets. This liquidity translated into large inflows into US IG and US HY, as asset allocators wanted to follow the Fed. While these flows were not directly into emerging market corporates, the cross over demand helped support the recovery in emerging market corporate valuations.

As developed economies emerged from the lock downs, and economic data continued to improve, asset values also improved. Despite a recovery in risk markets, many uncertainties remain.

Financials: Bank fundamentals are likely to remain under pressure. Monetary policies introduced globally will reduce margins and profitability. Loan growth is expected to be slow or become negative while asset quality deteriorates. Risks are partially mitigated by the fact that since the global financial crisis (2007) EM banks have strengthened their capital positions, reduced leverage and generally maintain high levels of liquidity. 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 over deeply subordinated AT1 bonds even if current valuations appear cheap.

TMT (tech. & telecoms.): This is one of the more defensive sectors against the pandemic as consumption of mobile, internet and TV subscription services remain resilient during economic recessions. 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.

Oil & gas: Expectations are for a slow recovery through the rest of the year, with market consensus forecasting crude oil prices to bounce back from current levels of around $40 a barrel. Despite some signs of a demand pickup, we are sceptical about the oil-market recovery. This is due to the end of OPEC+ production cuts in July, poor OPEC+ compliance by some members, the potential changes in fuel consumption patterns, particularly in transport, the possibility of further COVID19 outbreaks, and the overhang of large inventories. We prefer to stay nimble and capture opportunities as they are presented.

Consumer: We prefer the most defensive segments that are considered first necessity such as packaged food, beverages and household product. We like exporters and companies with international operations in developed countries. On the other side, we expect that the consumer discretionary will continue to underperform from prolonged shelter-in-place, lockdowns and/or social distancing measures. This not only reduces store traffic, but also average ticket size and same-sales store (SSS), pressuring profitability. Hence, we prefer to stay away from non-food retailers and travel & leisure.

Metals & mining: We have a mixed outlook as metal commodity markets remain subject to a combination of softer consumer demand and temporary supply disruption, partly due to government-imposed lockdowns. Iron ore has been supported by improved Chinese demand coupled with temporary disruptions. We prefer low-cost and larger producers of iron ore, gold, silver, and to a lesser extent copper. We prefer to avoid zinc and lead producers as the outlook for these base metals is more challenging due to large surpluses.

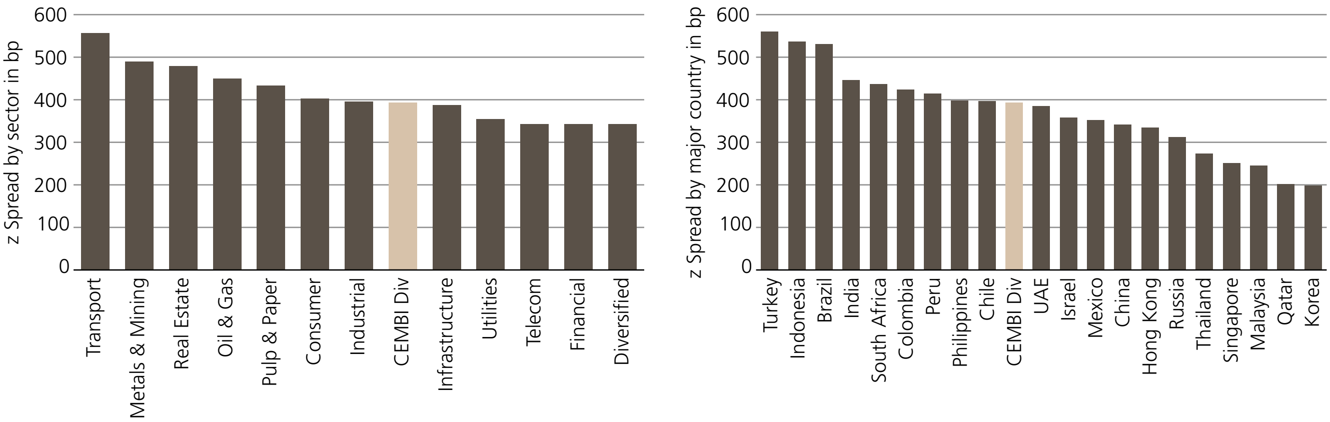
As we have been highlighting, EM issuers have successfully been executing liability management exercises over the past few years that have alleviated short term funding pressures.

As we highlighted in our last quarterly, due to the sharp decline in growth, demand, consumer confidence, and commodity prices we have seen an increase in distressed events (defaults/distressed exchanges), including a number of airlines filing for bankruptcy protection along with a hotel chain and retailers.

We expect additional credit events in EM corporate credits and take a cautious approach to 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, & Telecoms. Performance in the upcoming months and quarters will rely on cautiously selecting corporates with strong credit fundamentals.

While we have seen a significant rally, current EM corporate valuations remain attractive. Coupled with the unprecedented and targeted global policy response, we should continue to see inflows to risky asset classes creating a compelling argument for long term investors to continue adding exposure to emerging market corporate credit. *(David Michael)*

EM Corporate Spreads
Measured in bps as of June 30, 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 June 30, 2020

Local debt: Rates preferred now, currencies have room to rally later in the year

EM local debt (measured as GBIEMGD) showed a 9.82% total return in Q2 reducing the loss so far in 2020 to a still impressive -6.89%. Q2 performance was due to the recovery from a dismal Q1, both in currencies and local bonds. Local returns were driven by the ability of EM central banks to cut interest rates and implement elements of QE without destabilizing their currencies. Yields curves, however, remain steep reflecting fiscal shortfalls and uncertain path to recovery.

The outlook for Q3 is moderately positive, conditional on the continued opening up of economies and avoiding a large second-wave of COVID19 infections. 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.

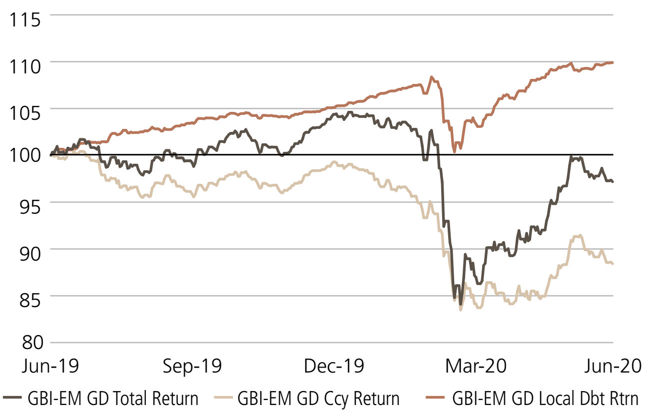
While the room to cut rates is now limited, an environment of falling inflation and the steep yield curves continues to favor duration extension. Currencies are cheap by historical measures. However, they have lost yield support, and with low pass-through to inflation, few central banks worry about under-valuation. As a result, investor flows are currently focused on hard-currency assets. We think EM currencies have potential to perform in Q3, but a solid performance would only be consistent with clear evidence that the pandemic is under control.

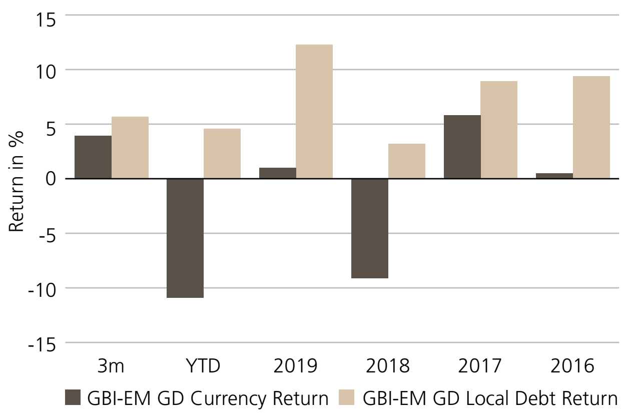
In Latin America, we believe the Mexican central bank to have the most ammunition to cut rates. The Brazilian central bank is at the end of the cutting cycle, but the yield curve has significant risk premium given the low inflation outlook. The Chilean rates market have little additional room for a rally, while the Colombian yield curve is steep and the central bank will likely cut rates again.

In EMEA, Turkey has continued with heterodox macro-economic policies leading to loss of reserves and high inflation. Turkish markets remain highly vulnerable to negative shocks. The outlook for South Africa's growth and fiscal balance remains bleak, but the country's large domestic asset base and improved political support for the government should allow assets to muddle through. Russian bonds and currency have performed well as oil prices recovered and the government maintained fiscal restraint. The risk has shifted to geopolitics once again. Central Europe has been relatively successful in handling COVID-19 and is likely to benefit from recovery in core Europe. Interest-rates however are historically low and there is limited value in the currencies.

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 June 30, 2020

Following a period of volatility earlier in the year, APAC currencies have recovered and the CNY has stabilized at around 7.0-7.1 range. Most APAC currencies have also rebounded showing limited losses for the year driven by better COVID-19 outcomes and the recovery in China. The Chinese central bank has been reluctant to ease aggressively, but stalling growth recovery and falling inflation is likely to bring lower rates. Central banks in Indonesia and Malaysia have room to cut rates. Yields are already very low, however, in Thailand and Korea.

The main risks to outlook stem from the uncertain nature of the global pandemic and the increase of political noise associated with the US November elections. *(Igor Arsenin)*