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Blooming in winter?

Emerging markets fixed income I UBS Asset Management

A rollercoaster of returns in Q3

- Credit recovered but local debt sold off further in Q3 on high FX and rates volatility
- High political uncertainty and poor policy responses mainly in Turkey and Argentina drove returns

Emerging markets fixed income (EMFI) delivered mixed returns during Q3 2018. High political and geopolitical uncertainty in large countries and poor policy responses to financial pressures particularly in Turkey and Argentina, caused wild gyrations in credit, FX and rates amidst continued outflows from the asset class for most of the quarter.

Q3 2018 returns

	Total return	Spread return	UST return
JP Morgan EMBI Global diversified	2.30%	3.02%	-0.70%
JP Morgan CEMBI diversified	1.44%	1.74%	-0.30%

	Total return	FX return	Local return
JP Morgan GBI-EM Global diversified	-1.83%	-2.06%	0.24%
JP Morgan ELMI+	-1.11%	-2.25%	1.13%

Year-to-date 2018 returns

	Total return	Spread return	UST return
JP Morgan EMBI Global diversified	-3.04%	-0.83%	-2.25%
JP Morgan CEMBI diversified	-1.66%	-1.37%	-0.30%

	Total return	FX return	Local return
JP Morgan GBI-EM Global diversified	-8.15%	-8.36%	0.24%
JP Morgan ELMI+	-4.48%	-5.58%	1.16%

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 September 31, 2018. 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.

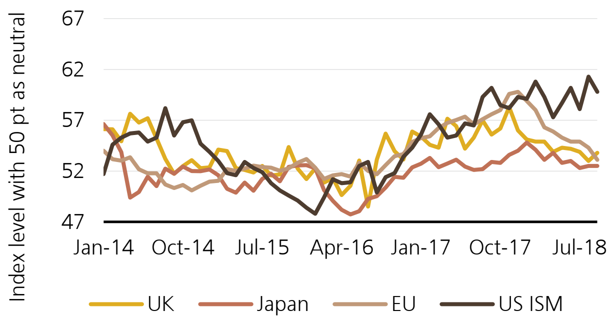
Sovereign (corporate) credit spreads tightened 34 (11) basis points (bps) to 335 (321) bps over US Treasury yields. Sovereign (corporate) credit returned 2.3% (1.4%) on account of tighter spreads as the UST curve continued to widen (20bps). Local emerging market assets continue to perform markedly worse than credit, delivering a -1.8% return in Q3.

However EM debt experienced a return rollercoaster during Q3, as did UST yields. The quarter started on a positive note with strong returns in all asset classes in July, after a poor Q2 and June in particular. Local debt returned 1.9% while sovereign (corporate) credit spreads tightened 42 (25) basis points producing a 2.6% (1.5%) return in the July. However the situation in August took a turn for the worse on the back of sharply worsening conditions in Argentina and Turkey, surprisingly negative polls in Brazil, treats of sanctions in Russia and discussions on potential land grabs in South Africa. As a result local debt sold off dramatically, returning -6.1% in August, with Argentina and Turkey returning -35% and Brazil, Russia and South Africa -11%. Sovereign (corporate) spreads widened 43 (34) bps in August, more than offsetting the tightening of July but delivered only -1.7% (-1%) returns as UST yields rallied. September delivered positive returns in all asset classes once again as the situation in most countries improved at the margin.

Unsynchronized growth in a de-globalized world

Global growth has decelerated from the very strong numbers in Q4 2017 and Q1 2018. Furthermore growth divergences among developed countries have increased – the US is still going strong with Europe and Japan are stabilizing – while EM has slowed down. This is a feature of the current juncture that will affect emerging market economies and drive returns going forward.

PMIs show a diverging global growth



Source: Macrobond, October 2, 2018

Furthermore, inflation in the US has normalized and is increasing everywhere else, compliments of higher oil prices. This situation calls for further normalization of rates in the US and, at some point, normalization in developed Europe and Asia. However, the notable divergence in global monetary stances will continue to be a feature of the current juncture affecting USD and UST levels. In an environment in which the US continues to report strong growth figures – compliments of sustainable supply side effects brought about by lower corporate tax rates and de-regulation but also by possible unsustainable demand-side fiscal impulse – into early 2020, when most effects die down, we expect USD to strengthen but UST to trade in a well-behaved range in the next 3 months.

A third feature that may affect returns going forward is the potential impact of US-driven protectionism on the world economy. Although the NAFTA dispute has come to an apparent end with what we believe to be an unequivocally worse treaty for Canada and Mexico (assuming Congress ratifies the new USMCA) and no reprieve on aluminum and steel tariffs, the confrontations between the US and China on the trade front are far from resolved. During Q3 the US upped the ante by imposing tariffs on additional USD 200 billion of Chinese exports to the US. With this latest measure, about 50% of Chinese exports to the US are now subject to higher tariffs. The world took this development with surprising calm because the tariff was only 10% as opposed to the widely advertised 25% and also because of China's measured response. However, the trade dispute between the US and China is far from over and has the potential to disrupt global growth and trade in 2019 if it escalates further into a trade war. The US has indicated that it is prepared to increase tariffs to 25% on the USD 200 billion in early 2019, absent a resolution to its demands. Furthermore, it appears that the US is prepared to impose such tariffs on all Chinese exports to the US if China does not agree to address the US demands. Whether this is just a negotiating tactic or a decision is yet to be seen.

China to the rescue

Our economists estimate that the impact of a 25% tariff on all Chinese exports to the US could be as high as 1pp on growth annually. The impact of the current protectionist measures by the US is around half that already. China responded to the US tariffs with a variety of tools. First it let the exchange rate depreciate by almost 10% vs the USD in 2018, mitigating the impact of the tariff. It has also aggressively started to reverse financial tightening in place during H1 2018 through a variety of monetary and fiscal channels. These measures are directed to incentivize domestic demand to indirectly offset the negative impact of US protectionism on China's economic activity.

Although expansionary fiscal and monetary policies in China mean re-leveraging the economy, these policies will likely have a positive impact on Chinese and global credit growth – given the importance of China in global credit creation – and trickle down to the rest of the world, supporting global growth and commodity prices in 2018 and 2019.

Midsummer blues

August witnessed the implosion of Argentina's ill-designed USD 50bn IMF-sponsored adjustment program approved in late June. The program was designed to 'shock and awe' investors with its sheer size but failed to impress as the expected fiscal adjustment – a hallmark of IMF programs in the past – was largely absent. Instead, investors perceived that the program lacked the necessary nominal anchors to stabilize inflationary expectations and left too much for markets to refinance. It was only in late September that the authorities and the IMF came up with a redesigned program that included meaningful fiscal adjustment and a better designed monetary strategy.

Turkey fell victim to its high external vulnerabilities and poor policies amidst political confrontation with the US that included sanctions. These events damaged market confidence in the ability of the country to refinance its large stock of short term debt. Furthermore, the government kept interest rates unchanged for too long amidst currency pressure. The pressure abated when the central bank rates increased by 650bps and the government announced a multiannual program to address the countries fiscal situation.

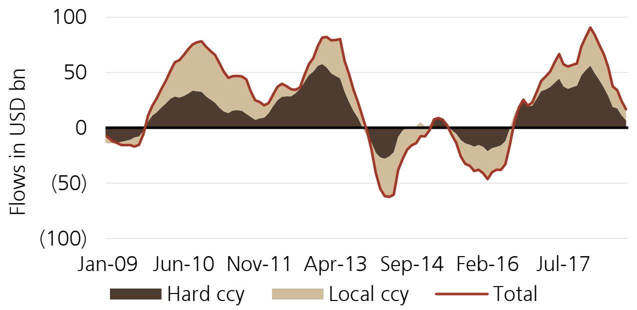
In Brazil, mid-August polls showed for the first time that former President Lula's Workers Party could be back in government after the October elections. Such realization ignited a violent reaction in markets that were expecting a contest dominated by market-friendly candidates. Brazilian markets continued mired in political uncertainty with asset prices reacting to polls for the remainder of the quarter.

Asset price volatility in Mexico, South Africa, India and Indonesia also picked up on diverse shocks and issues. Discussions of constitutional amendments to redistribute land in South Africa kept markets on their toes. Announcements and appointments by the newly elected government in Mexico also affected Mexican markets. Finally, Indonesia and Indian markets were also affected, prompting the government to announce further measures to address perceived and real vulnerabilities.

Outflows turn into inflows in late summer

After the severe sell off in August, market participants felt enticed to add risk on valuations and further policy initiatives. As a result outflows in June and August turned into inflows in late September. Still, overall Q3 2018 was a negative quarter for EM fixed income flows, with net outflows from EM of USD1billion (most of it in August) compared to USD 10.5 billion net outflows in Q2 2018, according to JP Morgan data. Investors mainly withdrew from hard currency strategies.

Cumulative 12m EM FI flows (USD bn)



Source: JP Morgan monitor, September 28, 2018

Winter is coming...but it could be mild

Global growth has stabilized above trend – compliments of the US, but it is likely to slow down in coming quarters. China is likely to show better activity numbers on expansionary policies, and trade news are likely to be mild in the remainder of the year. Furthermore, commodity prices are on the upswing on geopolitics and demand from China. All of these factors bode well for EM asset prices in Q4 2018.

Our prediction of heightened volatility in EM FI asset prices in Q3 proved right and we are keeping it for Q4, but with a more constructive bias as we believe emerging markets could benefit from temporarily better dynamics and news in Q4.

Q4 will be subjected to event risk emanating from several different directions. First, political events in the US (mid-term elections in early November) and in Europe (Italy) could affect developed asset prices (rates and FX) that could in turn derail or further help our slightly more constructive scenario. Also, second round elections in Brazil (October 28th) will likely keep volatility high in Q4. A positive outcome will further reinforce our constructive view but a negative one could derail sentiment towards EM, given the importance of Brazil in the asset class. Third, the new government in Mexico takes office on December 1st and it is yet unclear whether President elect Lopez Obrador will take a gradual or drastic approach in the implementation of his reform agenda.

Besides the aforementioned event risks, we believe more news will come from Argentina and Turkey in Q4 with the potential to once again disrupt markets. In Argentina, the above-mentioned adjustment is likely to stabilize inflation expectations and lower fiscal and current account deficits, but at a cost of a deep recession that could ignite social unrest and put into question the sustainability of the strategy. Turkey is also going through a deep recession, is further behind in the implementing of policies that could stabilize their macroeconomic situation, and could yet face geopolitical headwinds on its relationships with the west.

Finally, as we approach the end of the quarter, we expect US-China trade-related noise to increase. Whether this noise will set the stage for a better 2019 or a much worse one is still an open question. (Federico Kaune)

Sovereign credit spreads: Just clip the coupon ...

Sovereign credit posted a solid 2.3% return in Q3 2018, while YTD return have been kept still in negative with a disappointing -3.0% and in sharp contrast to the 10% return in 2017. Spread tightening by around 35bp contributed around 3% this quarter, while masking the high volatility during the reporting period. On the other hand, duration slightly detracted due to the increasing UST yields (-0.85%).

While the EM economic backdrop looks robust, geopolitical headwinds and trade protectionism still provide headwinds for emerging market bonds. In addition, a more desynchronized growth, tighter monetary conditions and some idiosyncratic issues within the emerging markets weigh on emerging market countries, despite the most recent positive return.

The dispersion between the regions was relatively low and all regions posted a positive return between 1.6% in Europe (with Turkey detracting around 90bp) and 4% in the Middle East. Despite the country specific issues in Argentina, Latin America contributed 2.1% during the quarter.

Middle East issuers, however, benefitted from a higher oil price as well as from JP Morgan's decision to change index methodology, which in fact leads to an inclusion of 5 more Middle East countries from January 2019 onwards. This might have helped in shifting the focus towards the region as well.

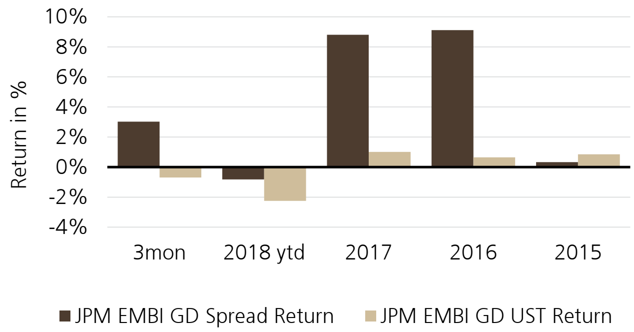
Commodities offered little support in Q3 2018. Though oil prices were around USD 5 higher at the end of the quarter than at the start, many commodity prices saw at best stable or slightly declining prices.

Further intensifying trade tensions between the US and China added some risk aversion in general making the economic outlook for EM countries somewhat more cloudy. New investments and higher spending announced by the Chinese government might help in terms of supporting the economic activity, but will also lead to a renewed increase in leverage in China.

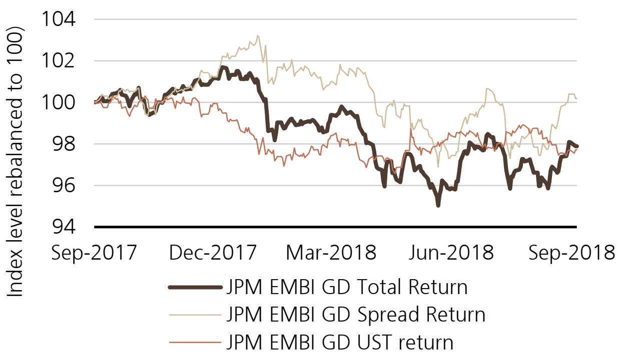
Additional announced tariffs will add further burdens on both sides and might end up with a lower-than-expected GDP growth in the US as well. How the Fed will react further in terms of planned rate hikes remains to be seen.

Upcoming elections in Brazil, handover in Mexico, increasing economic pressure in Argentina and upcoming US midterm elections will likely keep uncertainty and resulting volatility high. However, after a negative year-to-date return and some more expected support from commodities, at least some of the EM countries should post positive return. Single issuers and country specific developments may offer attractive investment opportunities and could add a solid return until year end. (Uta Fehm)

Sovereign Debt: Q3 posted high volatility on both sources of return
(rebalanced to 100 as of September 31, 2017)



Source: JP Morgan monitor, September 28, 2018



Source: JP Morgan monitor, September 28, 2018

Emerging market corporate bonds posted positive returns in Q3 2018: Risks continue to be politically driven

In Q3 2018, emerging markets corporates (measured as JP Morgan CEMBI diversified) provided positive returns of 1.44% vs -1.66% ytd. Corporate credit spreads tightened by 20bps this quarter providing approximately 1.74% of the 1.44% quarterly return. As US rates continued to rise, spreads tightened, and High Yield credits outperformed High Grade.

Similar to sovereign, most regions posted positive returns in Q3 2018. Europe was the only region with a negative return, all driven by Turkey spread widening.

Corporate bonds in Tanzania, Ghana, Jamaica, Ukraine, Nigeria, Oman, and Indonesia provided the largest positive returns while the only countries posting negative returns were Turkey (-2.70%), Zambia (-0.48%), and Russia (-0.14%).

From an industry perspective, all sectors provided positive total returns and the only sector to have negative spread returns was Financials, primarily driven by a weak performance of Turkish banks.

In the third quarter we saw a reprieve from political headlines, allowing emerging market credit to provide a modest recovery from the negative price action realized in the first two quarters of the year.

Corporate fundamentals continue to reflect improving growth prospects though they face headwinds from volatility in non-oil commodity sectors.

On the supply side, we expect net corporate issuance to increase, but to manageable levels, as supply form China has been lower than expected and is likely to remain low while political tensions between US and China trade remain. Value can be found in Africa, the Middle East, and issuers positively exposed to oil. On the other hand, caution is warranted in Turkey where we expect to see continued volatility, economic slowdown and stress on financial institutions and domestic oriented issuers.

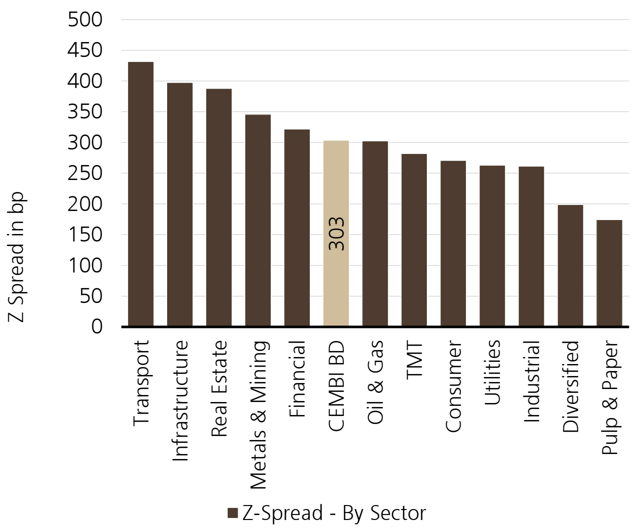
Lower economic activity and still-high leverage metrics in China argue for continued caution. However, we keep our positive stance toward systemically important state-owned enterprises in China, especially energy-related and financial institutions.

Risk appetite in emerging markets credit continued to be driven by headlines. We continue to monitor trade disputes and tariffs between US and China, Brazilian elections, continued stress in Argentina post an IMF bailout, additional sanctions on Russia and a deepening concern poor policy responses in Turkey.

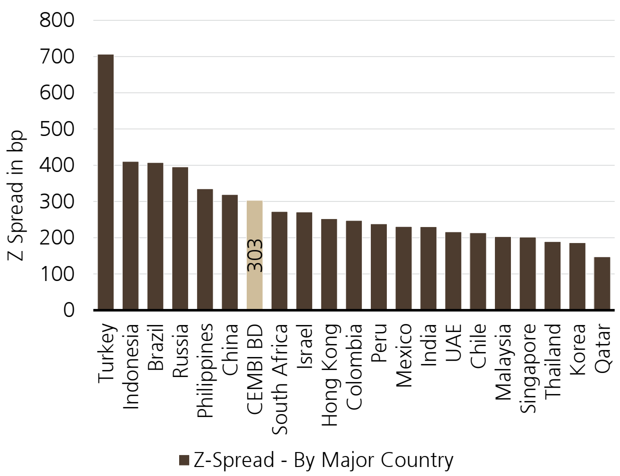
The quarter(s) ahead will continue to require nimble bond picking with tight beta management. (David Michael)

Spreads: Widening and more attractive again
measured in bps as of September 31, 2018

(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, October 02, 2018



Source: JP Morgan monitor, October 02, 2018

Local debt: Work in progress

Emerging markets local debt performance (measured as JP Morgan GBI-EM Global diversified) had another negative quarter – the index was down 1.83%, bringing the year-to-date return to -8.15%. The returns, however, were highly uneven, with Argentina and Turkey losing a whopping 35% and 27% respectively, and a number of countries posting positive returns. The path of the performance in the quarter was also uneven with a sharply negative August and strong July and September. Apart from some recovery in Turkey and Argentina and general positive price action, the second half of September also benefitted from a rally in Brazil.

Even though headwinds to EM local markets are still strong, levels look more attractive compared to the start of the year, while a number of idiosyncratic issues are being worked through:

- Political and macro tail risks have played out, albeit mostly in a negative way, but with a corresponding market adjustment.
- The elections in Mexico and the conclusion of NAFTA re-negotiations.
- Pricing in of more severe sanctions in Russia (still pending).
- The market meltdown and the emergence of more realistic and politically costly policies in Turkey and Argentina.
- In Brazil, October elections continue to remain the biggest source of uncertainty for EM, but Brazil asset prices are now more reflective of the risk compared to earlier in the year.

As we discussed in the introduction, higher rates in the US, asymmetrical global growth and the trade war with China continue to prevent investors from fully engaging with EM, and especially with EM local debt. As Brazil's election is in October, the main EM political event calendar will be over this year, and the macro-economic fundamentals and global factors will take over as the market driver.

In this environment we think that positions in individual markets is the right strategy in Q4.

In Latin America, we find Mexico at risk as the honeymoon of the new president is unlikely to last, particularly given that the NAFTA issue has settled (with only downside risk of legislative delays). The Brazilian yield curve remains steep even after the rally into the first round of the elections given the benign inflation and dovish central bank. The election outcome remains binary, even if the odds have tilted toward a market-friendly outcome. Argentina's government has finally accepted the political price of a sharp macro-economic adjustment. The recovery in assets has started, but by no means is a given as the economy falls into a recession and the election is one year away.

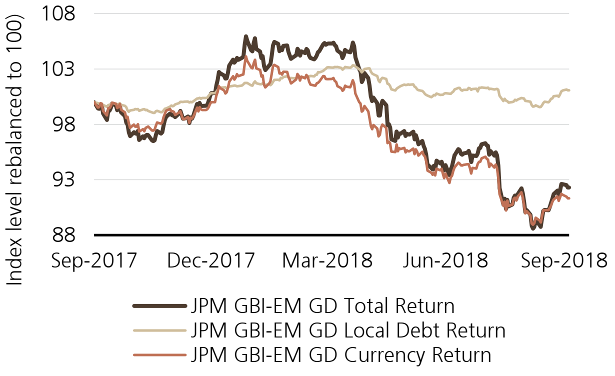
In EMEA, Turkey remains the key market to watch. Following a collapse of the Turkish Lira, the government allowed higher interest rates and seems to tolerate slowdown in growth. We remain sceptical, however, that they will be able to follow through once political cost of the slowdown becomes higher. Turkey's geopolitical ties to Iran and Russia are putting it at risk of sanctions, which it can ill afford. Russian bonds are under the risk of sanctions that are likely to include sovereign debt. In South Africa, general market sentiment and commodity prices are more of a driver than domestic politics. The country is likely to muddle through into next year elections, but the risks are to the downside: the country rating is still at risk to a downgrade to sub-IG by Moody's, which would lead to local bonds dropping out of IG indices. As a result, we recommend a relatively neutral stance in EM local debt, looking to fade beta-driven rallies and waiting for political resolution to engage in the market.

Central Europe is enjoying high growth rates and some insulation from boarder EM weakness given the (uneven) recovery in the Eurozone. Tight labor markets, low policy rates and domestic-demand driven growth is a recipe for higher infaltion and higher bond yields. With the weaker starting point in the EUR, the regional currencies are at attractive levels, in our view, but will largely depend on the sentiment toward the EUR – growth and tail risks in Italy, Turkey and Brexit.

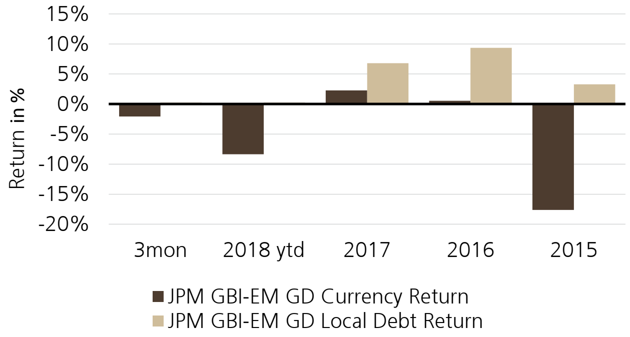
Following a period of stability, APAC currencies have been range-bound after the CNY stopped depreciating. However, the escalating trade war is affecting sentiment, while valuations are not particularly attractive. That said, there appear to be pockets of value in high-yielders such as India and Indonesia, and the APAC currency block would greately benefit from a potential settlement between China and the US on trade. (Igor Arsenin)

Currency returns: More sensitive to economic and political shocks (rebalanced to 100 as of September 31, 2017)

(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, September 28, 2018



Source: JP Morgan monitor, September 28, 2018

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