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EM Fixed Income: unprecedented shocks

Emerging markets fixed income | UBS Asset Management

A quarter to forget

- Emerging economies were battered by unprecedented shocks in Q1 2020, setting new record lows in economic activity, commodity prices, financial flows and asset returns.

- Most emerging markets (EM) have limited fiscal space to confront these shocks. We expect real exchange rates and domestic demand to weaken further and bear the brunt of the required adjustment.

- We expect higher defaults in EM. The unprecedented global policy response and further support from multilaterals agencies and China could help avoid a systemic crisis, however.

- Valuations have cheapened to 2008 levels. Extreme valuations offer a significant opportunity for long-term horizon investors willing to accept near-term volatility.

Emerging markets fixed income (EM FI) returns plunged during Q1 2020, reflecting the impact of several global shocks of unparalleled magnitude and speed in March. The year started on a positive tone, with global assets – including EM – making new record highs on continued global expansion expectations. In fact, on its January 2020 update to the World Economic Outlook (WEO), the International Monetary Fund (IMF) forecasted global growth to pick up to 3.3% in 2020 from 2.9% in 2019, comfortably above the 2.5% level considered to indicate a global recession.

In March, everything changed: A record downward global supply-demand cycle erupted with unprecedented speed. A localized epidemic in Wuhan, China turned global, compelling the World Health Organization (WHO) to declare a global pandemic on March 11th. As the novel coronavirus strain spread across the world, one country after another locked down and quarantined their populations, generating a sudden stop in economic activity across the world.

To make a bad situation worse, on March 6th, OPEC+ failed to reach a largely expected production cut agreement in the face of a COVID-19-induced collapse in oil demand, sending oil prices on a downward spiral.

The policy response by major central banks and governments around the world (predominantly by the US Federal Reserve and Treasury) was equally unprecedented. Their response provided a strong signal of their commitment to do whatever it takes to alleviate the impact of the shocks on economic activity and reduce tail risks in financial markets.

Sovereign (corporate) credit spreads as measured by the EMBIGD[1] (CEMBIBD[2]) widened 336bps (240bps) in Q1 (most of it in March) to 645bps (556bps) generating a dismal -21.57% (-15.78%) spread return. In contrast, local yields (as measured by the GBIEMGD[3]) widened by only 14bps to 5.53%, generating a return of -1.05%. Emerging market currencies sold off 14.30% against the USD in Q1. In all, the local index returned -15.20% in Q1.

1Q 2020 returns

US dollar debt	Total return	Spread return	US treasury return
JP Morgan EMBI Global Diversified	-13.38%	-21.57%	10.45%
JP Morgan CEMBI Diversified	-10.02%	-15.78%	6.84%

Local currency debt	Total return	Currency return	Local debt return
JP Morgan GBI-EM Global Diversified	-15.21%	-14.30%	-1.05%
JP Morgan ELMI+	-8.48%	-9.31%	0.91%

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 March 31, 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

It is darkest before the dawn

It is now clear that the world will likely be in a deep recession in 2020 on the back of the aforementioned global shocks. As we write this report, the impact of COVID-19 is far from over as the disease is still spreading across the world and most countries around the world remain virtually closed for business. While the situation looks gloomy in Q2, there are reasons to be optimistic in the second half of the year (H2).

First and foremost, the pandemic's dynamic is such, that by mid-year it is likely to be largely gone, giving countries around the world time to better prepare for the next episode including equipment, treatments, herd immunity and a vaccine. In fact, China has largely left behind the impact of the virus, while the most severely affected countries in Europe (Italy and Spain) are now experiencing drops in the number of newly infected patients.

The US is likely to peak sometime around mid–April, according to the government. China is gradually reopening its economy and other countries will likely follow a protracted approach to re-opening their economies to lower the odds of a relapse.

Second, the policy response across the (mainly developed) world is likely to help reduce the impact of the pandemic in Q2, although it is unlikely to stimulate growth until well into the second half of the year. The monetary measures and stimulus provided by major central banks have flooded global markets with liquidity, helping avoid major disruptions in crucial segments of the market and payments system. By providing direct payments to households and loans to companies, the fiscal stimulus will help alleviate the impact of the shock in Q2.

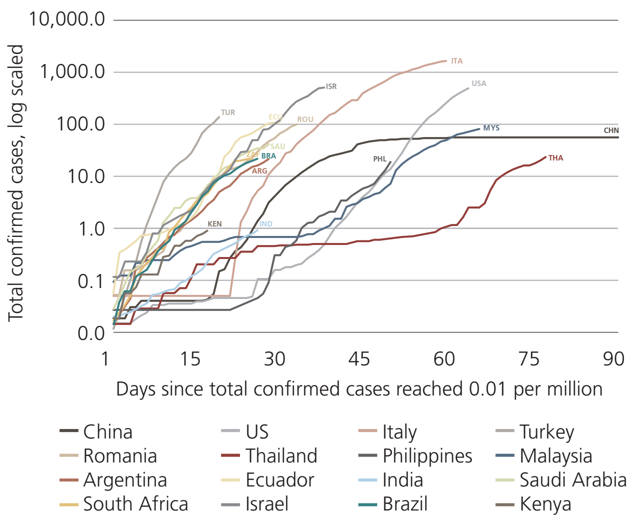
Whether the world will experience a V, U or L recovery in H2 will depend on the degree of damage inflicted on the corporate sector (including small, medium and large companies), and on the speed at which supply chains can be reestablished across the world.

Record outflows in Q1 2020

EM flows turned highly negative in Q1 as the global shocks generated a wave of risk aversion in financial markets. EM FI experienced USD 28.7 billion outflows in Q1, the largest on record. Sovereign and corporate credit saw outflows of USD 17.9 billion while local EM (currency and rates) had an outflow of USD 10.8 billion[4].

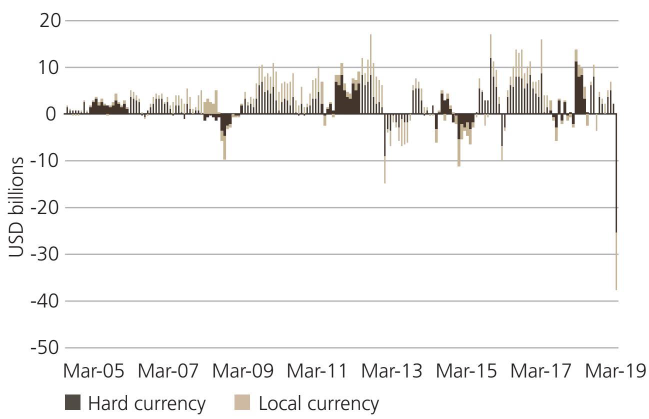
Debt issuance came to a virtual halt in March, with only highly rated names able to tap international capital markets. Sovereign and corporate) issuance in Q1 2020 reached USD45.2 billion and USD 133 billion (mostly from China), respectively, a record low as demand for EM debt collapse to 2009 levels in March. Amortization and coupon payments reached USD 69.1 billion for corporates and USD 36.5 billion for sovereigns.

COVID-19: some are turning the corner



Source: Our World in Data, UBS Asset Management. As of March 31, 2020.

Record outflows in 1Q (USD billion)



Source: JP Morgan, UBS Asset Management. As of March 31, 2020

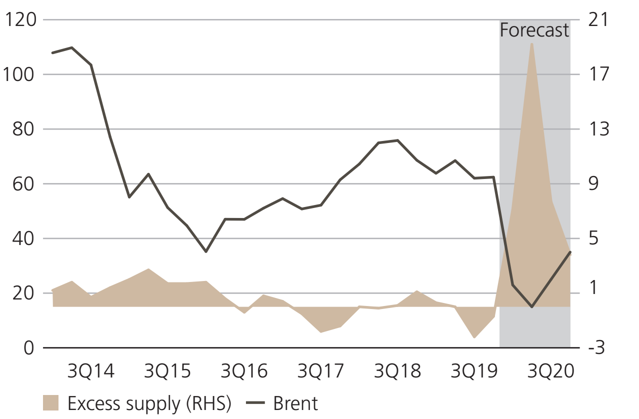
4 Flows data as of March 31, 2020

Oil prices: at the bottom of the barrel

As financial markets were on a tailspin in the midst of enduring one of the most severe shocks in decades, OPEC+ (OPEC and Russia) surprised everyone when they could not agree to cut oil production further in the face of collapsing demand. Moreover, OPEC+ decided to eliminate the existing 2.1mbpd production limit. OPEC+ members – particularly Saudi Arabia and Russia– want the US to be part of any global agreement to cut production. In their view, the US – now the largest producer of oil thanks to the shale revolution – has to commit to production cuts as well in order to stabilize oil markets. Oil sector experts reckon that the excess supply of oil is now close to 20mbpd, mainly explained by the collapse in oil demand. Furthermore, they forecast that the excess supply measured in mbpd will remain in mid-single digits in H2 2020 unless significant cuts are agreed upon. As we write this report, OPEC+ and the US have not been able to reach an agreement.

As a result, oil prices collapsed 50% so far in 2020 to around $30 a barrel from $60 a barrel in December 2019. Most oil exporters in emerging economies require oil prices that are well above current levels. Major emerging economies' public sector budgets in 2020 assume higher oil prices than is currently the case.

Oil markets are in massive excess supply



Source: OPEC 3/2020 bulletin, Rystad energy report 4/2020, UBS Asset Management.

Oil: sensitivity and break-even

	Impact of $10bbls decline (% of GDP)		Breakeven oil price	
	External	Fiscal	External	Fiscal
Oil exporters	-2.6	-2.3		
Kuwait	-7.8	-6.1	41	54
Qatar	-7.2	-4.3	60	45
Oman	-6.3	-5.9	77	85
Iraq	-6.0	-7.7	62	61
Azerbaijan	-5.4	-2.9	60	48
Saudi Arabia	-4.6	-4.0	47	74
Bahrain	-4.3	-2.5	79	103
Gabon	-3.3	-1.1	48	78
Angola	-2.9	-1.6	71	73
UAE	-2.8	-2.8	45	61
Kazakhstan	-1.9	-1.4	81	65
Nigeria	-1.6	-1.0	68	115
Russia	-0.9	-1.1	40	51
Ecuador	-0.9	-0.7	80	95
Colombia	-0.6	-0.4	133	117
Ghana	-0.4	-0.3	153	223

Source: Bank of America, Barclays, Goldman Sachs, JP Morgan, UBS Asset Management.

3 Flows data as of December 31, 2019

Emerging economies: triple whammy

Emerging economies have been facing massive negative shocks so far in 2020:

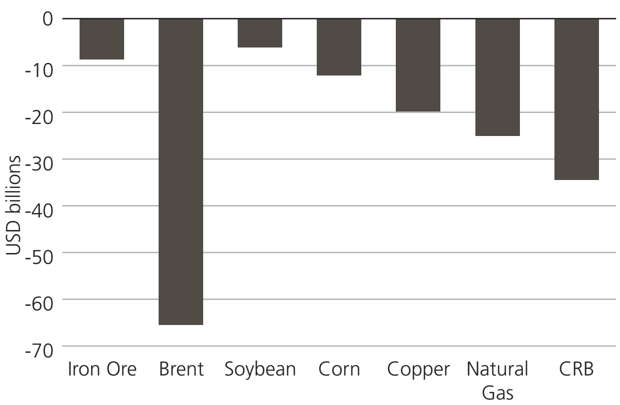
a) Sharply lower global growth,
b) Sharply lower commodity prices, and
c) Sharply higher capital/financial outflows.

These shocks are unlikely to dissipate in Q2 and will only slowly revert in H2 2020.

Most emerging economies have less fiscal space than in the 2008 great financial crisis, as they have accumulated more debt in the past decade. As a result, very few countries with strong public sector balance sheets will be able to implement meaningful fiscal stimulus. Among them: Qatar (13% of GDP), Singapore (12%) and Peru (7.5%).

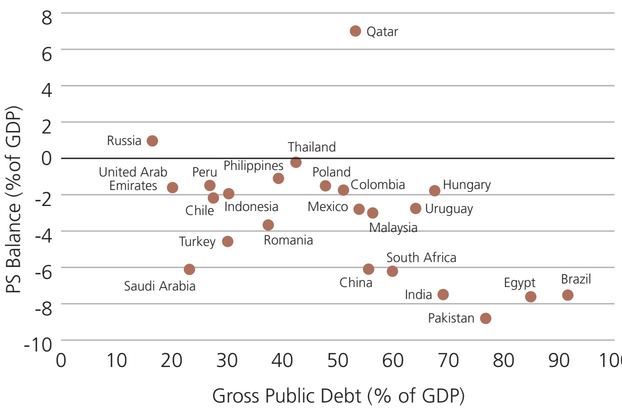
Monetary stimulus – which has largely followed the developed world – will also be limited by the risk of sharp depreciation of their exchange rates. As a result we expect emerging economies' growth to slow down considerably in Q2, not only because of the lockdowns, but also because of the (temporary) lack of demand for their exports in the world economy.

Commodity prices collapsed in Q1 2020



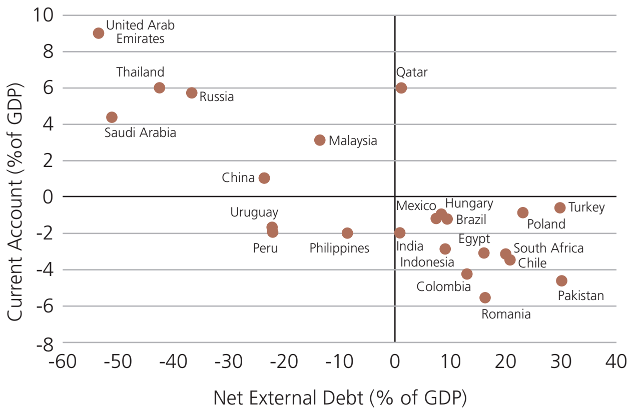
Source: Bloomberg, UBS Asset Management. As of March 31, 2020.

Public sector balance vs gross public debt



Source: IMF, Fitch, Macrobond, UBS Asset Management.
As of December 31, 2019.

Current account balance and net external debt



Source: IMF, Fitch, Macrobond, UBS Asset Management.
As of December 31, 2019.
Note: Net external debt: Net incurrence of liabilities - net acquisition of assets. The assets / liabilities include debt securities, such as bonds, notes and money market instruments, as well as loans, deposits, currency, trade credits and advances due to non-residents.

The macroeconomic dynamics in most emerging economies will include a combination of sharply lower domestic absorption and weaker real exchange rates in the face of limited capital inflows. The substantial drop in commodity prices – particularly oil – is an additional challenge to them. The macroeconomic performance of individual countries in H2 2020 and beyond will depend on their current initial conditions: level of international reserves, debt, current account and fiscal balances and their reliance on commodity exports.

Many emerging economies will have to rely heavily on multilateral (IMF, World Bank, regional development banks) and bilateral financing, until access to private capital markets improve. As an example, more than 80 countries have already requested IMF help so far in 2020 and more will likely knock at the IMF's door in coming months since the IMF currently has a lending capacity of around USD 1 trillion. Furthermore, bilateral creditors to emerging countries – either thru Official Development Assistance (ODA), Paris Club, or other otherwise (China), will most likely have to soften their terms and conditions and roll over debt maturities.

Nonetheless, some of the weakest sovereigns, that were able to access international capital markets in the past, will likely encounter payment difficulties in 2020. So far, four weak sovereigns have announced they will restructure (Argentina, Lebanon) or are analysing whether to restructure (Ecuador, Zambia) their bonded debt obligations. Some of them will likely require bilateral lenders (most importantly China in the case of Ecuador and Zambia) to re-profile debt service in 2020 and beyond. Argentina will almost definitely require the IMF to re-profile sizeable upcoming maturities in 2021-23.

Value in EM FI: big risks, big rewards

Back in December we argued that after the robust performance in 2019, EM FI markets could rally further only if everything went right, given the relatively stretched starting point valuation-wise. As per the litany of adverse shocks described above, not much has gone right for EM FI in Q1 and Q2 does not look that promising either.

We expect macroeconomic and asset price volatility and uncertainty to remain elevated in Q2 as markets get more clarity on the extent of the impact of the shocks on emerging economies and the likely shape of the recovery in world economic activity in H2 2020.

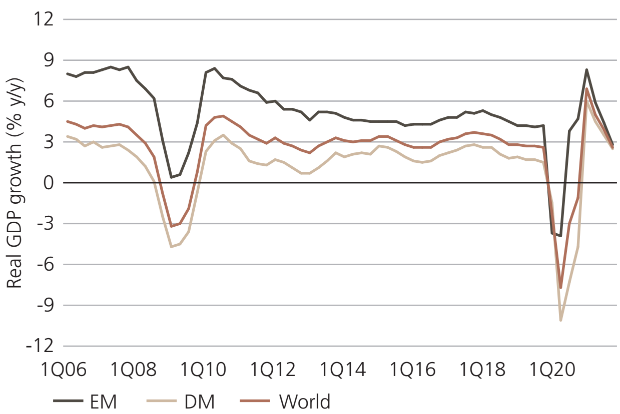
Although we are not in a position to pin down the exact inflection point, after which emerging asset prices will rally as they did after the severe dislocation in 1998 and 2008, we believe that emerging credit and currencies offer compelling value at current levels. Investors capable of withstanding high volatility and further sell-offs in coming weeks, but that have longer return horizons (5-10 years), could benefit from building positions at levels that could prove to be a once in a decade opportunity to lock-in outsized returns. *(Federico Kaune)*

EM: 2020 monetary and fiscal stimulus

Country	Monetary Stimulus Rate cuts (bps)	Fiscal Stimulus % of GDP
Brazil	-75	2.5
Chile	-125	4.7
China	-10	2.5
India	-75	0.9
Indonesia	-50	2.4
Malaysia	-50	1.8
Mexico	-75	0.7
Russia	-25	0.3
Saudi Arabia	-125	2.7
South Africa	-125	0.2
South Korea	-50	0.8
Turkey	-225	1.7
Ukraine	-350	3.5
United Arab Emirates	-125	1.8

Source: UBS AG, Standard Chartered, IMF, UBS Asset Management. As of March 31, 2020.
Note: Monetary stimulus is YTD rates cuts.
Fiscal stimulus is announced impulse for 2020.

An optimistic but possible global growth view



Source: Macrobond, UBS Asset Management. As of March 31, 2020.

Sovereign debt: nowhere to hide

Sovereign credit posted a -13.38% total return in Q1 2020 (measured as EMBIGD). Spreads widened 336bps, generating a -21.57% spread return. US Treasury yields rallied massively, reflecting a bout of risk aversion in the world and added 10.45% to overall sovereign returns.

Investment grade (IG) spreads widened 187 bps and high yield (HY) spreads an impressive 591 bps in Q1. As a result, EM IG (HY) sovereigns returned -5.44% (-22.44%) in Q1 2020. Most of the negative total return in sovereigns was generated in March, reflecting the massive shocks that affected global financial markets. Sovereign spreads sold off starting in January, reflecting stretched valuations as we started the year. However, it was in March when spreads widened in an unprecedented manner.

During Q1, all regions generated highly negative total returns. Europe posted the highest returns at -7.24%, followed by Asia, 8.19%. The Middle East returned -13.44%, while Latin America returned -15.25%. Africa returned -24.94%, reflecting a significant sell-off in weak commodity exporters.

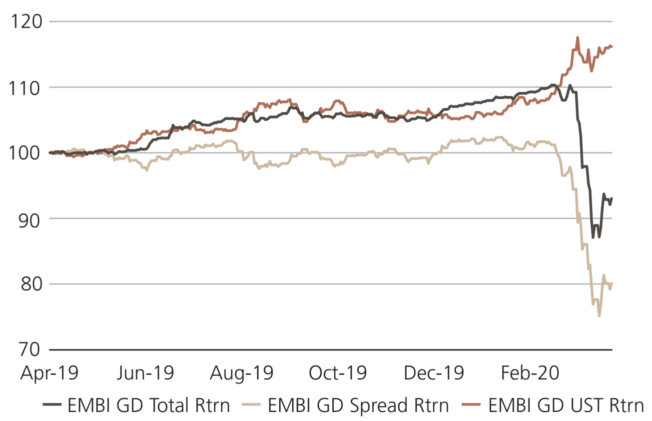
Lithuania (2.27%), China (1.98%) and Poland (1.93%) were the only countries that posted positive returns in Q1. These countries benefited the most from their high sensitivity to US Treasury yield movements, which more than offset the spread widening they experienced.

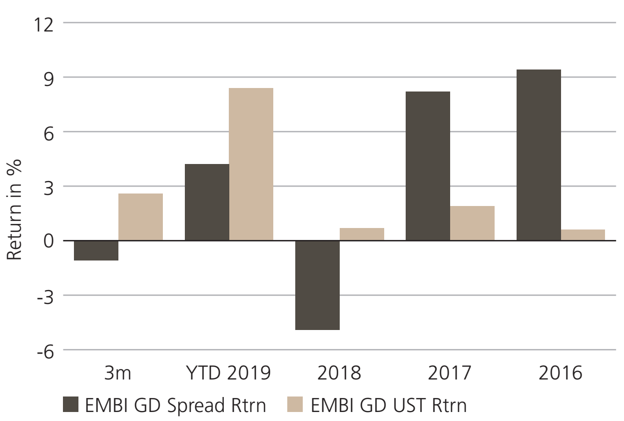
On the other hand, Ecuador (-67.04%), Angola (-62.61%), Lebanon (-61.5%) were the worst performers in Q1. Ecuador is suffering greatly from COVID-19; it derives most of its exports revenues from oil, and is a fully dollarized economy. It is now using the 30-day grace period on coupon payments and is likely to declare default sometime in April.

Lebanon defaulted on a USD 1.2 billion principal payment on 9th March after Parliament unanimously voted to default, in spite of having USD 25 billion (60% of GDP) in usable reserves at the central bank. Zambia, has hired an advisor to help them design a strategy around external debt; their next coupon payment is due on 14th April. Angola is still on top of its debt obligations, and has not announced any intention to stop servicing debt as of now. Argentina presented its debt sustainability analysis in mid-March, a preliminary step before announcing its restructuring proposal to investors by mid-April this year.

At around 650bps for the EMBIGD, sovereign spreads are historically cheap. While it is difficult to predict the inflection point in the current juncture, we believe that current valuations are compelling and present a unique opportunity to lock-in cheap valuations particularly for long-term investors willing to withstand near-term volatility. *(Federico Kaune)*

Sovereign debt: historically cheap
(Rebalanced to 100 as of March 31, 2020)





Source: JP Morgan monitor. As of March 31, 2020

Corporate debt: global pandemic

EM corporate credit posted a negative Q1 2020 total return of -10.02% (as measured by JP Morgan CEMBI Diversified). Corporate credit spreads widened 283bps during this period. Total returns were pulled down by the selloff in credit spreads contributing -15.78% to Q1 returns while Treasury added 6.84%.

In Q1 2020 corporate bonds in Taiwan (1.72%), South Korea (-0.13%), Poland (-0.21%), Hong Kong (-1.48%), and China (-1.85%) provided the best total returns given their sensitivities to US Treasuries, while the largest underperformers were the high yielding of Ghana (-60.93%), Argentina (-30.42%), South Africa (-27.91%), Jamaica (-26.58%), and Kazakhstan (-23.01%).

The top performing sectors were Financial (-5.92%), Diversified (-6.72%) and Real Estate (-7.08%), while the largest underperforming sectors were Transportation (-37.93%), Metals & Mining (-17.61%), and Pulp & Paper (-15.16%).

In Q1 2020 all regions provided negative total returns. The best regions in terms of total return were Asia and the Middle East, while Africa lagged in both total returns and spread returns given the region's reliance on commodity exports relative to regional peers.

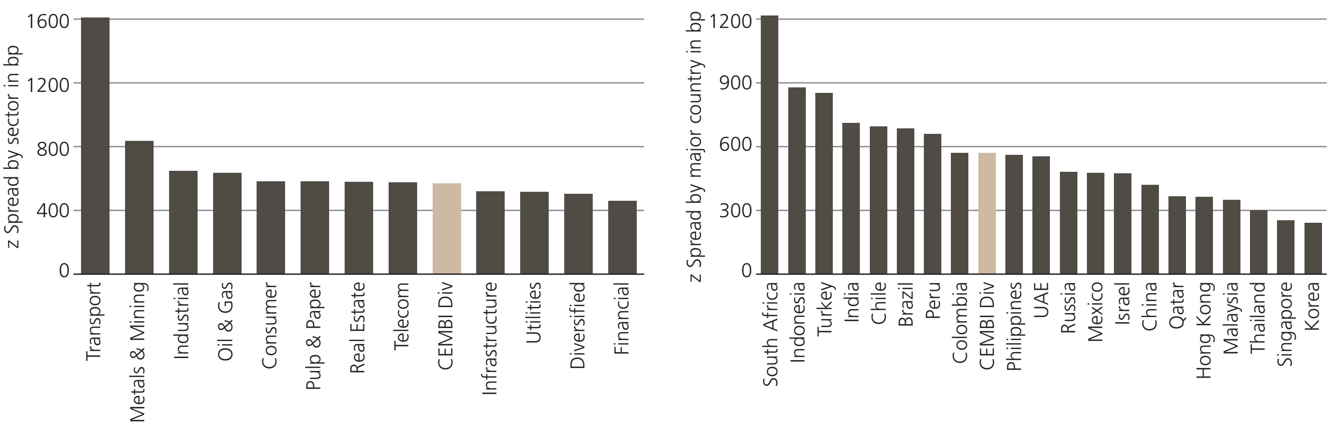
This closes out a difficult quarter for all risk markets including EM corporate credit.

After robust spread tightening in Q4, EM corporate bonds carried that momentum into Q1 2020. Risk markets saw its share of headlines as US and Iran threatened war, US & China signed a Phase I trade deal, and Brexit became official. The headline that caused risk markets to reverse direction was the rapid spread of COVID-19 across the globe. Eventually quarantines became the standard response supressing economic activity. As COVID-19 spread globally, OPEC+ Russia failed to reach an expected agreement on cuts to oil production leading to large supply increases. The increased supply coupled with a collapse in demand due to global quarantines resulted in a large sell-off in oil markets. While thee quarantines are expected to alleviate immediate pressures on medical infrastructure, the decline in economic activity coupled with oil price declines was felt across risk markets impacting all sectors.

Financials: Banks fundamentals are likely to come under pressure. Monetary policies introduced globally will reduce margins and profitability. Cost of risk is expected to increase as asset quality deteriorates. Risks are partially mitigated by the fact that since the global financial crisis, 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.

Oil & gas: Given oversupply dynamics we prefer high quality, cost efficient names that have sizable liquidity buffers, strong balance sheets and the flexibility to postpone CAPEX spending and dividend payments to better absorb the negative impact

EM Corporate Spreads
Measured in bps as of March 31, 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 March 31, 2020

of a protracted oil price war. National oil companies credit profiles should start deteriorating quickly and negative rating actions should be expected, particularly PEMEX, whose rating seems to be inevitably downgraded to junk by Moody's as large cash shortfalls are expected if its crude oil basket continues trading in the teens for an extended period. Integrated oil companies, are relatively well positioned to navigate in the short term thanks to other profitable oil businesses (refinery and/or midstream) that will help to partly compensate shrinking revenue from upstream units.

Metals & mining: Lower oil prices should be supportive for metals and mining producers, however the balance of risks for metals are tilted to the downside from near-term demand pressures as COVID-19 spreads. Steel producers should be in a slightly better position than other base metals producers as steel demand could rebound more sharply vs base metals, given its importance and role in infrastructure and state-directed investments. Given the uncertain global economic backdrop and cyclical nature, we continue to prefer quality companies in this sector that have strong cash flow generation capacity, sizable liquidity buffers and defensive lowly levered balance sheets. Precious metal producers continue to look attractive given global demand for low-risk assets.

Lastly, many issuers successfully executed liability management exercises over the last few years alleviating funding pressures. As we highlighted in our last quarterly, we began seeing an increase in distressed events including defaults and restructurings in China. Given the sharp decline in global growth, decline in commodity prices and record outflows, these distressed events are likely to increase starting with weaker credits. In the month of March Stoneway Capital, an Argentina utility company and Digicel Group a Caribbean telecom company both defaulted on coupon payments and saw a restructuring announcement for DTEK Energy (Ukraine).

We expect credit events in EM corporates to increase, particularly in credits with low to negative cash flow generation and tight liquidity buffers. Sectors most exposed in this downturn are weaker institutions in transport, industrials, oil & gas, and telecom.

While current markets valuations and headlines reflect significant obstacles, the value opportunity for long term investors is compelling. We are witnessing an unprecedented global policy response targeted to first soften the sharp economic downturn and second provide stimulus for a strong recovery. Coupling the size and magnitude of global stimulus with cheap valuations, approaching 2008 levels, this creates a compelling argument for long term investors to build exposure to emerging market credit. *(David Michael)*

Local debt: currencies get cheaper on global shocks

EM local debt (measured by JP Morgan GBI-EM Global Diversified index) showed a -15.21% total return in Q1, cancelling out the return of the whole 2019. The Q1 2020 performance was entirely due to currency returns with rates widening only 14bps and returning -1.05%.

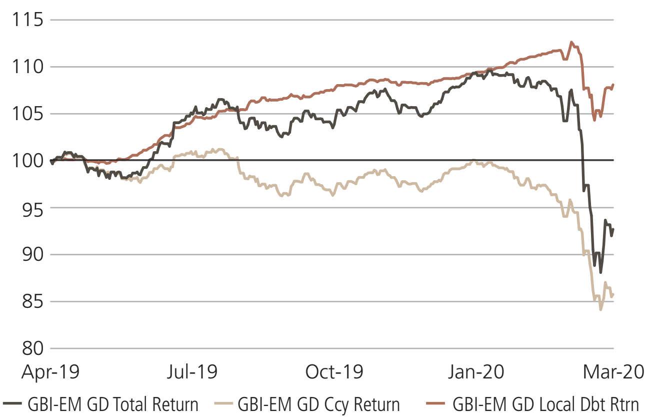
All the countries, with the exception of Argentina (1.83%) and China (1.77%), showed negative returns during Q1. South Africa showed the worst total return (-28.82%) as the currency weakened 21.71% against the USD and rates widened 170bps, reflecting deteriorating macroeconomic performance and ratings downgrades. Other commodity currencies – including RUB, BRL, MXN and COP weakened around 20%, reflecting the sharp drop in commodities prices. All central banks of the countries included in the GBIEMGD index, cut policy rates in Q1 as growth prospects deteriorated further. Local bonds spiked in Q1 with 10-year yields in certain mainstream countries – Brazil, Mexico, Russia, South Africa and Indonesia – widening 200-300bps in March before rallying back half that amount.

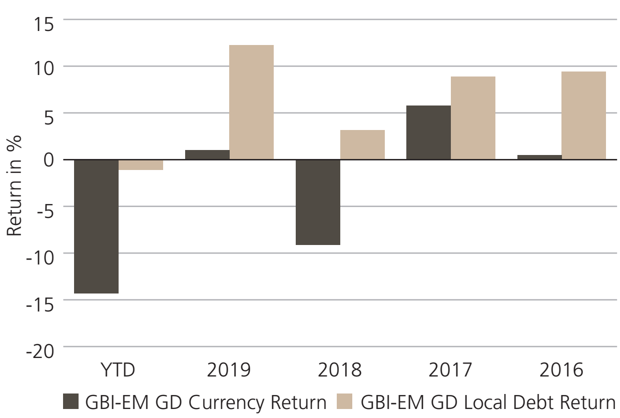
The outlook for Q2 remains uncertain and dependent on the evolution of the pandemic, the effectiveness of the policy responses, and on whether an agreement to stabilize oil prices is reached. We expect currencies to remain volatile in Q2 as it will continue to suffer (benefit) from deteriorating (improving) external conditions. Limited demand-pressures have helped contain the impact of currencies depreciation on inflation and inflation expectations so far, allowing central banks to cut rates. Policy rates are already at record lows in many countries, more so when adjusted for inflation. If external conditions fail to improve materially in Q2 it would be difficult for central banks in emerging economies to continue to cut rates without igniting capital outflows and further currency depreciation that could contaminate inflation expectations. Longer-term bond yields will respond with more sensitivity to risk aversion than to fundamentals in the near term.

Latin America is one of the most vulnerable regions in EM as it is heavily dependent on commodity exports and exhibits relatively weaker fundamentals, particularly on the fiscal front. Countries in this region will likely continue to rely on exchange rates to rebalance their external accounts. Mexico continues on a path of long term deterioration as state-owned enterprises continue to drag fiscal resources. Banxico has allowed the currency to depreciate heavily while continuing to cut rates. However, inflation has started to pick up, which could limit further cuts. Brazil continues to cut rates, which are now in negative territory in real terms, while the currency continues to depreciate. Chile and Colombia will trade with copper and oil, respectively. Peru's currency appears overvalued relative to its neighbours and also relative to lower commodity prices.

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 March 31, 2020

In EMEA, Russian bonds and currencies will continue to trade with oil amidst the lingering threat of sanctions from the west. It is worth mentioning that Russia’s Central Bank is one of the very few that has become more cautious, keeping rates unchanged in their last meeting. Moody's downgraded South Africa to junk in March. The economy remains weak and, as it is the case in Mexico, struggling state-owned enterprises are a drag on fiscal resources. Lower oil prices have limited the weakness of Turkish Lira in Q1. However, heterodox economic management could offset the benefit of lower oil prices going forward. Monetary policy rates are negative in real terms and 10-year yields have sold off 400bps but could sell off further. Central Europe was enjoying high growth rates and some insulation from broader EM weakness despite the slowdown in the Eurozone, but now looks vulnerable to the expected deep recession in the Eurozone.

Most APAC currencies are likely to remain well behaved in Q2, absent a relapse of COVID-19 as they come back to work. We expect CNYUSD to continue to trade in narrow range around 7 in Q2, and serve as an anchor to other currencies in the region. *(Federico Kaune)*

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