

Emerging markets debt

The **unexpected** rules



Macro review: the unexpected rules

The unexpected once again happened in Q4 2016 with Mr. Trump winning the presidential election in the US. Moreover, the Republican Party retained a majority in the lower house and re-captured the Senate. This was a significant shock to markets, which had priced in the opposite outcome based on the information provided by most political pundits and surveyors. US fixed income and equity markets reacted violently to the presidential elections result. Equity markets rallied 6.3% as measured by the Dow Jones index US treasury 10-year yields rose 62 basis points (bps) and the US dollar appreciated more than 4.5% since the election on 8 November versus other leading currencies.

Emerging markets asset prices weakened briefly after the election but have stabilized more recently, albeit at a weaker level in rates and currencies space in particular. In credit space, sovereign spreads (JP Morgan EMBI Global Diversified) ended up unchanged in Q4 at 340bps after widening some 50bps just after the election. In contrast, corporate spreads, as measured by the JP Morgan CEMBI Diversified index, tightened almost 40bps in Q4 to 325bps. Although excess returns were positive, total returns were negative in Q4 reflecting the sell-off in US treasuries. In the currencies and rates space, the JP Morgan GBI-EM Global Diversified index showed highly negative returns in Q4, driven mostly by weaker currencies but also by higher rates (60bps widening).

For the year as a whole, 2016 was a surprisingly good year for emerging markets, all the more so when put in the context of the highly uncertain global macroeconomic and political environment. All emerging markets asset classes showed a total return close to 10% in US dollar terms. Sovereign and corporate spreads tightened 76bps and 127bps, respectively, based on the corresponding JP Morgan indices. Emerging markets currencies did not contribute meaningfully to 2016 returns as they appreciated sharply in Q1 before depreciating sharply again in Q4, against the US dollar. Emerging markets rates tighten 30bps during the year to 6.8% as the Q4 sell-off could not fully undo the rally of the first three quarters of the year, based on the JP Morgan GBI-EM Global Diversified index.

Q4 2016

	Total return	Spread return	UST return
JPM EMBI Global Div.	-4.02%	0.49%	-4.49%
JPM CEMBI Diversified	-1.42%	1.86%	-3.22%

	Total return	Currency return	Local return
JPM GBI-EM Glob. Div.	-6.09%	-4.76%	-1.40%
JP Morgan ELMI+	-3.59%	-4.36%	0.80%

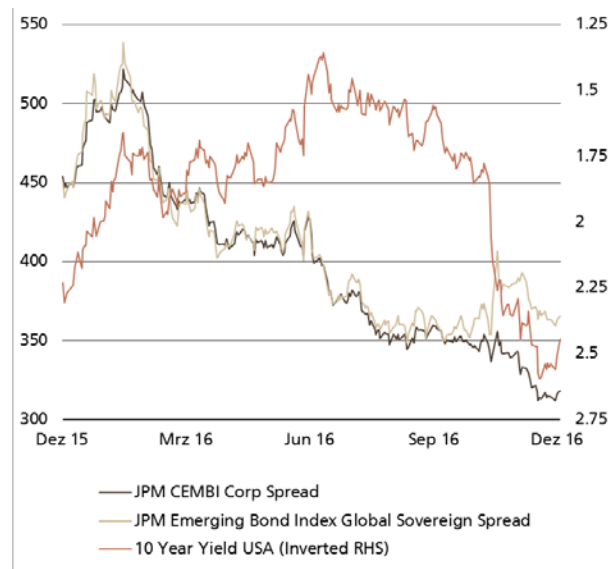
Year 2016

	Total return	Spread return	UST return
JPM EMBI Global Div.	10.15%	9.45%	0.65%
JPM CEMBI Diversified	10.43%	9.30%	1.03%

	Total return	Currency return	Local return
JPM GBI-EM Glob. Div.	9.94%	0.54%	9.35%
JP Morgan ELMI+	3.54%	-0.55%	4.11%

JPM = JP Morgan
UST = US treasury
Source: Bloomberg
Data as of end-December 2016

Spreads exhibited high volatility towards the end of the year



Source: Bloomberg
Data as of end-December 2016

Macro outlook: what to expect in 2017

As we start the year 2017, global economic activity is on a recovery path and market expectations have improved markedly in important centers, most noticeably in the US. Emerging markets countries have made further progress addressing their structural and macroeconomic fragilities and are starting to feel the benefits of a more stable commodity price environment.

Valuation-wise, emerging markets credit appears to be fairly valued. In our view, spreads are likely to remain in a relatively wide range centered about a slight tightening trend. As it was the case in 2016, duration management will be of paramount importance. We might see a 25bps tightening in spreads in 2017. Currencies and rates will be far more dependent on idiosyncratic factors and the impact of US policies.

The year 2017 will likely be dominated by the policies the new administration in the US may undertake and by further divergence in global monetary policies, particularly between the US, Japan and Europe. Our baseline scenario for 2017 includes higher rates in the US and a stronger US dollar but more of the same in Europe and Japan: quantitative easing and negative rates.

With currently available information, it is difficult to assess the potential impact of president-elect Trump policies on emerging markets. We understand that there are three main dimensions to president-elect Trump's proposals*:

On the fiscal front: a tax reform – including corporate and personal tax simplification, lower tax rates, broader base, etc.; an infrastructure investment plan; and a tax amnesty for corporate cash abroad estimated at USD 2.6 trillion.

* Sources:
<https://www.donaldjtrump.com/positions>
<http://abetterway.speaker.gov/>

On the international front: a trade reform – including the potential renegotiation of existing free trade agreements (NAFTA among others), potential action on countries deemed as dumping goods on the US and, immigration reform.

On the structural reform front: deregulation initiatives on the energy, health care and financial sector, among others, and reforms to the education and welfare system.

We lack specific details on any of the aforementioned initiatives and reforms but such an ambitious agenda is likely to be a multi-annual process. Furthermore, the final impact on emerging markets will depend on the type of fiscal reform president-elect Trump may choose – his own version as per the campaign or the more fiscally sustainable house republicans version* – and on how aggressive he decides to be on trade policies.

The best-case scenario for emerging markets includes a long-term sustainable fiscal and deregulation reform that generates a boost to US growth together with a measured trade policy. In this scenario, emerging markets growth could experience a faster and stronger recovery on the back of stronger US growth. The worst-case scenario for emerging markets includes an aggressive trade policy together with delayed deregulation and a longer term unsustainable fiscal policy that could be detrimental for emerging markets growth and external accounts. This is because such a scenario would likely depress international trade while failing to boost US growth.

Which emerging markets countries are likely to benefit or suffer under President Trump?

We believe that Mexico and China are likely to suffer the most were President-elect Trump to follow on his campaign promises to toughen the US international trade positions. President-elect Trump has said he will revise or even repeal the NAFTA, with a concomitant increase in tariffs and other potential restrictions on Mexico.

Around 80% of Mexico's exports are sold in the US.** Disruptions to that flow of trade will have a detrimental impact on Mexico's growth and inflation, and could further weaken Mexico's fiscal an external accounts. Expectations of changes to the current trade agreement are already having an impact on credit, currencies and rates in Mexico. Several Central American countries closely linked to Mexico's export sector are likely to suffer as well.

China is also likely to be affected were President-elect Trump to name it a currency manipulator and impose countervailing measures for unfair trade practices. In his campaign, Mr. Trump has threatened to impose a 45% tariff on Chinese imports. In such a scenario, almost 20% of Chinese exports sold in the US will be affected. China will suffer most of the impact but other Asian countries closely linked to China's tradable sector will also suffer.

* Sources:
<https://www.donaldjtrump.com/positions>
<http://abetterway.speaker.gov/>

** Source: <http://www.trademap.org>

In contrast, Russia is one country that could benefit from a more favorable geopolitical environment and better relations with the US. It is possible that in an effort to "reset" the relations with Russia the US may reduce or even eliminate economic and financial sanctions imposed after the Crimea annexation. Certain metal exporters – Peru and Chile, among others – could benefit from the massive infrastructure program advertised by Mr. Trump during his campaign.

The impact of a Trump Presidency on emerging markets asset prices

Financial markets seem to be pricing in a significant pick-up in growth and inflation on the back of fiscal expansion and deregulation in the US in 2017 and beyond. After the recent hike in December, markets are expecting at least two 25bps hikes in 2017. Furthermore, business sentiment improved quite dramatically on the back of expectations of market friendly policies.

In 2017, divergence in global monetary policies is likely to increase further with Europe and Japan still in easing mode – negative rates and quantitative easing – and the US in a hiking cycle that could surprise to the upside if US economic activity and inflation pick up under the new administration. Our baseline scenario is that President-elect Trump policies are likely to generate a boost to growth and inflation and a further sell-off in rates and strength in the US dollar in 2017. We expect most emerging markets rates and currencies (versus the US dollar) to remain under pressure – except for those high yielders with a positive structural story. We also expect credit spreads to tighten marginally as the positive income effect of higher US growth offsets the negative price effect of higher rates on emerging markets over time. Interest duration management will be paramount to protect returns in this scenario.

Duration management will be paramount to protect returns

The sustainability of the expected recovery and US assets price dynamics beyond 2017 will hinge on the quality and sustainability of the policies the new administration will implement. In a scenario in which the Trump administration successfully implements a sustainable fiscal expansion and measured trade policies, we expect terminal Fed fund rates to increase to levels not seen since before the great financial crisis. US treasury yields could adjust accordingly reflecting the return of a positive term premium. In this scenario, we expect the US dollar to be the dominant world currency and we do not discard an appreciation event similar to that experienced in the first half of the 1980s.

Review and outlook by **asset class** segment

External debt: uncertainty keeps volatility high, but reviving global demand provides support

When taking a look at the spreads at the beginning and at the end of Q4, one could conclude that nothing happened. Spreads were nearly flat. However, this masked high volatility in the immediate aftermath of the 8 November election in the US, when spreads widened by around 50bps, reaching 380bps over US treasuries, before fully retracing to 330bps, as measured by the JP Morgan EMBI Global Diversified index.

This heightened volatility was driven by fears about the new political and economic path in the US and the corresponding global impact. Later, monetary policy in Europe as well as in the US became the focus for investors. The decision and the wording of the Fed communique led to a significant increase in US treasury yields and an appreciating US dollar.

Commodity prices, which are an important factor for many emerging markets countries, were broadly stable over Q4, which provided some additional support for the more exposed countries. The oil production cut agreed by OPEC was taken positively and helped move oil prices higher. We expect this agreement to support crude oil prices further in 2017. Higher oil prices should provide a relief to oil-producing countries, resulting in further spread tightening.

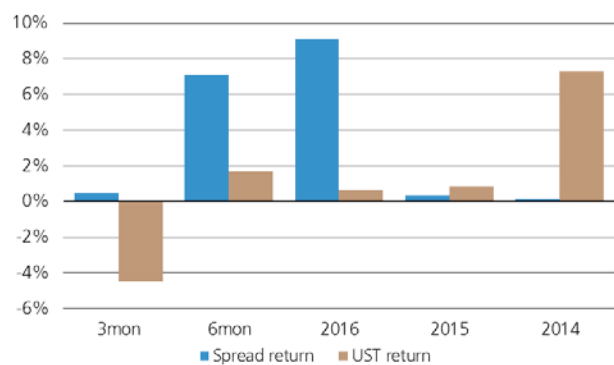
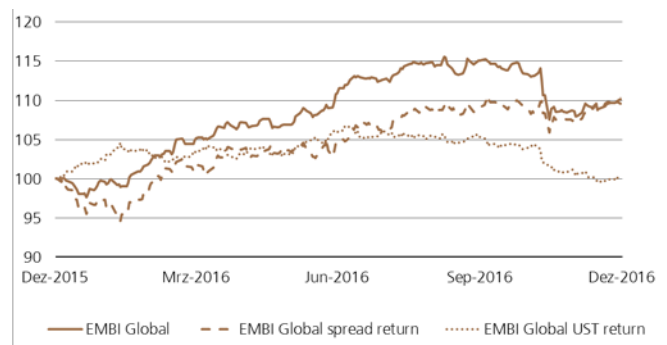
We remain constructive on emerging markets for the next 12 months and we expect moderately tighter spreads. Overall, political risk and economic adjustment seem to be manageable as the ongoing stabilization in commodity prices continues to lend its support. The most significant impact could come from potential economic as well as political measures that the new elected government in the US may adopt.

Given the relatively uncertain global political and economic environment and technical headwinds from large outflows, current emerging markets spreads seem now only fairly valued. After all, most of the recent spread compression has been driven by external and technical factors, changes in risk appetite and search for yield instead of improvements in economic fundamentals. Even in an environment in which the growth differential between emerging and developed markets remains low, emerging markets countries could benefit from a reviving global demand and, as a consequence, increasing exports of goods and commodities. Additionally, fiscal adjustments should lead to a more solid financial framework in many emerging markets countries. The fiscal stance is crucial for many emerging markets countries as it weighs on the country's vulnerability as well as on the growth outlook. After several years without any meaningful reforms, emerging markets countries realized that they can only turnaround their economic path with broad and strong structural reforms.

Overall, we expect a global economic recovery in 2017/2018 – supported by further accommodative monetary policies, particularly in Europe and Japan – and higher growth in the US. This global policy framework together with more stable commodity prices could generate a moderate spread tightening in emerging markets. Aggressive protectionist measures in the US could reduce the positive impact of higher global growth on emerging markets.

In this context, we prefer higher yielding US dollar debt exposure, where we see higher spread compression potential.

Return disaggregation shows the real sources of return



UST = US treasury
Source: JP Morgan, UBS Asset Management
Data as of end-December 2016, rebalanced to 100 as of end-December 2015

Local debt: the North-South rotation

The narrative for global markets has changed almost overnight after the US presidential election with significant implications for emerging markets local debt. Higher US rates and growth, deflation, potential trade frictions and higher commodity prices are pulling currencies, as well as rates, in opposite directions with emerging winners and losers. The winners – the South – are countries that are more leveraged to growth and deflation and the losers – the North – are the ones more sensitive to rising interest rates and the strengthening US dollar. Even though uncertainties are abound on the Trump administration economic and trade policies, the general trends for a stronger US dollar and higher US rates looks set to continue in Q1 of 2017.

Higher US dollar and US treasury trend will create headwinds for both local-currency and net currency return. Local-currency returns will likely be positive after accounting for carry, while the net currency contribution could be negative at the index level. In our base-case scenario, higher-yielding components of the index, concentrated in Latin America and EMEA, will outperform low-yielders situated predominantly in the APAC region. Thus we favor relative-value positioning with a net long US dollar exposure and moderate duration risk: It will be hard to avoid additional bouts of volatility especially if the current relatively sanguine consensus on the US trade policies proves to be overly optimistic.

Potentially protectionist trade policies by the Trump administration will continue to weigh down on the Mexican peso as well as countries with substantial trade surpluses with the US including China. Trade issues notwithstanding, higher US rates will encourage additional capital outflows from China, leading to gradual depreciation of the Chinese renminbi and other APAC currencies against the US dollar.

On the positive side, higher commodity prices, and particularly the oil price, are welcome news for commodity exporters. The outlook for commodities is positive for Q1 following the pick-up of demand from China and the restriction of supply by oil-producing countries. Even though the sustainability of Chinese growth and commodity demand is a medium-term concern, it is unlikely to come to the fore in the first half of the year. Among large markets, Russia has emerged as an important beneficiary from a run-up of oil prices, the likely cyclical recovery this year, and a potential for easing of economic sanctions.

Despite the global reflation theme, disinflation stories are alive and well in a number of key emerging markets countries including Brazil, Argentina, Colombia, Russia, and India. These are the countries where, barring flaring up of political risks, interest rates have scope to move significantly lower. Political risk remains an important factor, and in many cases will generate market volatility, but could provide better entry points. As a result, we continue to favor long duration positions particularly in Brazil and Russia.

In Latin America, Brazil continues to be the most promising even after the huge rally year to date. Political risk stemming from the "Car Wash" investigation is acute and headlines have caused significant market volatility in Q4 2016. Nevertheless, the new administration has been adept passing critical macro-stability legislation. With rapidly falling inflation and still very weak economy, the central bank has cut rates twice in 2016, and is likely to accelerate the pace of rate cuts in 2017.

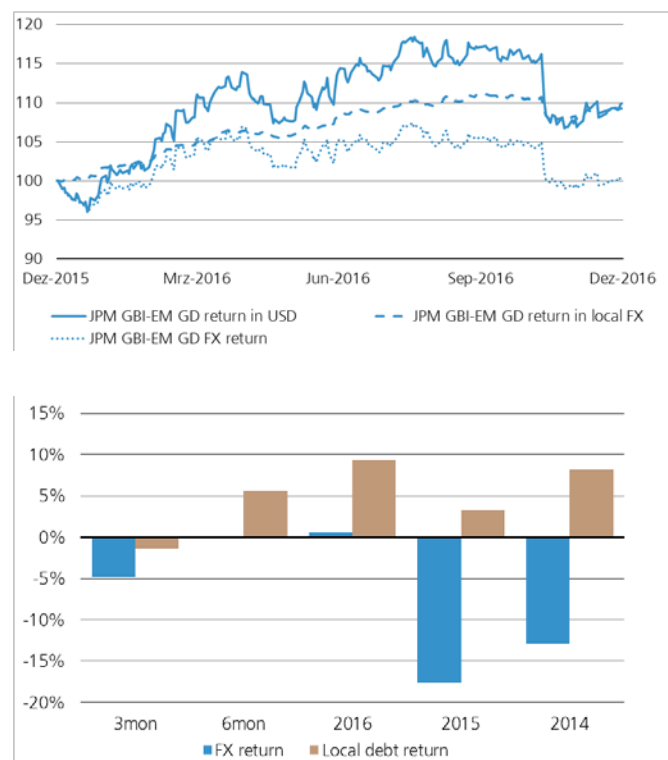
Mexican markets are suffering both from the uncertainty following the US election, higher rates amidst weakening growth and higher inflation. That is likely to translate into further weakness in the currency. Colombia has reached an important milestone passing peace treaty legislation and a fiscal reform. Falling inflation allowed the central bank to start an interest-rate cutting cycle earlier than expected. Argentine growth and politics are proving more challenging than envisioned earlier in the year. The market continues to give Macri the benefit of the doubt, but the next year will be challenging given mid-term elections, lack of growth and very large external financing needs.

The outlook for EMEA is also mixed. With the exception of Russia, political and economic fragility is on display in the larger regional economies: Turkey and South Africa. Turkish local markets continued to be distressed as government prioritizes growth over reducing external imbalances. The referendum on executive presidency slated for April could be a key turning point in Turkey with president's focus turning from securing political objectives to managing the economy. We believe credit spreads against US treasuries offer better value than the lira or local rates in Turkey in Q1. South African local markets may start exhibiting less volatility as the struggle within the ANC has reached a stalemate, and the December 2017 ANC leadership convention will provide a political anchor.

In the meantime, inflation is likely to fall this year allowing the SARB to cut rates.

Low-yielding currencies in Asia have been highly sensitive to the strength of the US dollar, and are likely to continue on the weakening trend. Despite high current account surpluses in NIEs (Korea, Taiwan, Singapore), capital outflows are driving the weakness of the currencies. In addition, the Chinese authorities have adopted a stable renminbi exchange-rate stance against the trade-weighted basket since July 2016, fuelling expectations of a weaker renminbi / US dollar exchange rate. The region, together with Mexico, is particularly vulnerable to more protectionist US trade policies setting the stage for further weakness. Indonesia and India are likely to be less affected by these headwinds and offer compensation of higher interest rates. Malaysia, on the other hand, is less likely to benefit from higher oil prices as political noise, and capital outflows persist.

Local currencies react more sensitive to economic and political weaknesses



Source: JP Morgan, UBS Asset Management
Data as of end-December 2016, rebalanced to 100 as of end-December 2015

Corporate debt: yield enhancement with lower duration

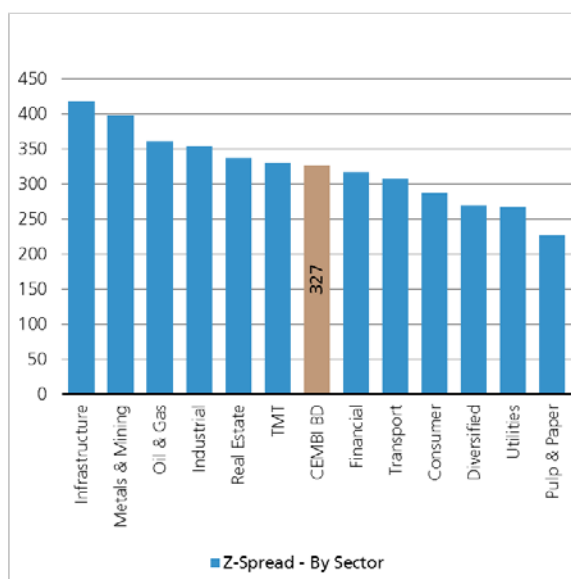
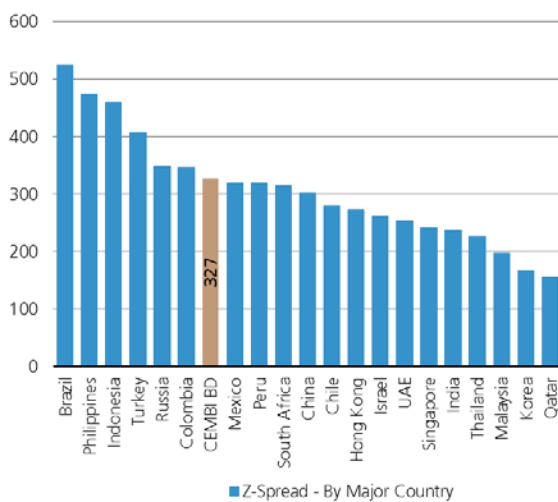
In Q4 2016, emerging markets corporates saw a negative total return, a function of higher US treasury yields offset by 38bps of spread tightening. Higher yielding corporates significantly outperformed investment grade names due to their lower durations and higher yield cushions.

Equity and credit market volatility measures declined but both developed and emerging markets currencies volatility increased substantially – along with US interest rate volatility – in the aftermath of the US presidential election results. Emerging markets corporates substantially outperformed emerging markets sovereigns and quasi-sovereign credit during Q4 in part due to their lower interest rate risk.

African names, Russia, Brazil and Kazakhstan were the outperforming regions and countries, while Israel, Mexico, and the higher quality APAC names (Korea, Hong Kong, Thailand, and Singapore) lagged. The Mexico sell-off proved overdone as the "Trump reflation" took hold and concerns over cross-border trade policy receded in December. Mexican credit staged an impressive recovery, outperforming all major countries but Colombia and Kazakhstan in the last four weeks of Q4.

Within emerging markets corporate credit, metals and mining names provided the only positive total return during Q4 (as of 20 December), fueled by a recovery in base metal prices (iron ore up nearly 50%, copper prices +13%, scrap steel up 13% as of 20 December). Financials outperformed while utilities underperformed – industrial names were broadly in line with the index. Oil and gas credits have had a very good year – second only to metals and mining – but during Q4, energy names did not fully reflect the +13% recovery in Brent oil prices, and finished the quarter broadly in line with the JP Morgan CEMBI Diversified index.

Corporate spread opportunities by major country and by sector
(in basis points)



Source: Bloomberg Plc.
Data as of end-December 2016

In 2017, the outlook for emerging markets corporates remains constructive but with growing uncertainty surrounding US policy and the continuation of global monetary policy accommodation. We expect volatility to increase in this environment and would expect to be positioned more defensively as a result. Corporate fundamentals will continue to reflect the improvement in global growth prospects, with better leverage metrics and profitability leading to fewer downgrades and defaults in 2017 (emerging markets corporate high yield defaults are expected to decrease to 3% in 2017 from nearly 5% in 2016, based on Standard & Poor's estimates).

Valuations have become less attractive during an impressive year of total returns – the year ahead will require nimble stock picking as opposed to taking more general "beta" bets on the index. Technicals should remain supportive as the search for yield, while less compelling with higher developed market sovereign rates, still argues in favor of emerging markets debt – but inflows to dedicated emerging markets bond funds have been waning. On the supply side, net new corporate issuance is expected to be manageable in an environment of increasing maturities – in 2017 and beyond.

There remains value in the subordinated debt of high quality bank issuers, Brazil and Mexico credit, and Turkish banks. Exposures to the lower beta countries in APAC are attractive in a higher volatility environment and we would look to reduce our underweight. Lower economic activity and still high leverage metrics in China argue for continued caution. We continue to favor the systemically important state-owned enterprises in China, especially energy-related ones.

Overall, the outlook for total returns in 2017 will depend on global growth and trade, US monetary policy and rates, and continued stability in commodity prices.

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