UNION BANCAIRE PRIVÉE

EM FIXED INCOME

Current Strategy | August 2019

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws.

Our views for the coming months

We see a range trading environment for EM, supported by Fed monetary easing and likely easing by other major developed and EM central banks. This should offset President Trumps' latest threaten to impose new tariffs on China to push trade negotiations forward.

We have a **neutral strategic bias on spread duration** as valuations across sovereign and corporate hard currency are fair. We are open to adding to spread duration on setbacks, particularly in the HY part of the credit market. We also have a **neutral strategic bias on interest duration**, albeit looking for tactical short duration opportunities given the protracted Fed rate cuts priced in and some tentative signs of growth stabilising in the US.

We have a **neutral bias on EM FX** as currencies. A weaker global growth environment and generalised rate cuts will make it hard for now generalized dollar weakness/EM FX appreciation. But we are comfortable in being long select pockets of FX carry especially where we have high confidence in low spot fx volatility. Nigerian Naira and Uruguayan peso continue to fit this description.

Risk environment

President Trump's latest tariff threat may prompt some temporary spikes in market volatility, but the forward-date on the threat (10% tariff on remaining Chinese un-tariffed goods effective from 1 September) suggests a negotiating tactic. Even if there is no progress in trade talks and the tariff hike goes into effect, global monetary policy will likely become looser in response.

Global monetary easing is rooted in softer global inflation and less helpfully, from lower GDP growth. But we should stress that we are facing lower growth and not a recession. This is important because it means, blips notwithstanding, flows on a multi-month basis to EM should remain firm. The IMF recently revised down its global growth forecasts 10bps for this year and 2020, to 3.20% and 3.50% respectively. This is not worrisome level as it compares to the post GFC average of 3.4%. The IMF might revise growth forecasts down again if the latest tariff threat is delivered, but probably not much (Citibank research, for example, estimates that a global growth impact of -20bps assuming no policy response).

Monetary easing is also become widespread in EM with more central banks have joined the ranks of rate cutters, leveraging off the lower domestic inflation and the backdrop of Fed easing to take action. This can help overall EM debt markets by lowering domestic currency funding costs and attracting some foreign buying of domestic currency bonds.

The upshot of monetary easing is a large global stock of negative yielding bonds in Developed Markets (DM), supporting bond portfolio flows into EM. Currently around 25% of the global aggregate bond index or USD 13.9tn in market value is negative yielding. This compares to 15%/USD 8.2tn at the beginning of this year and is biased, we think, to grow as central banks around the world take their cues from Fed monetary easing. The ECB, for example, has given strong hints of cutting and restarting QE in the coming months. Greek 10 year bond yields are at 2%, a historic low, which shows that it is not just IG in DM that are low yielding.

The reason that we are not more bullish for the general risk environment is that a decent amount of good news has been priced into global market, notably Fed interest rate cuts and looming ECB action. Investors are generally coming round to this view and cross market performance in July was more mixed compared to the across-the-board rally in June (in global fixed income for example, the global aggregate index fell 0.5% in July).

Commodity prices should have dipped moderately in July (-1%) but unlikely to fall significantly from here given supply constraints in some key markets (oil and copper). Also slightly improved recent industrial activity and PMI indicators out of China and the US should alleviate concerns of a further significant demand falls for industrial metals.

EM Fundamentals

EM growth fundamentals echo the global trend with a slowdown led by China and Mexico. Importantly there is very little chance of an EM recession and in our base-case scenario there should still be a healthy GDP gap between EM and DM. According to IMF forecasts, the gap between EM and DM GDP growth should be around 2.2 percentage points in 2019 (similar to last year) and 3.0 percentage points in 2020. The positive gap should continue to be a pull factor for EM capital flows, dovetailing with the push factor from low global yields.

Our view on China fundamentals is unchanged from a couple months ago: moderately cautious and anticipating a gradual slowdown as the burden US tariffs and precautionary action by global businesses (looking for alternative suppliers to China) continues to weigh on Chinese exports. Meanwhile, the high levels of Chinese non-government debt and regulatory efforts to strengthen the quality of the private sector loan book should contain new private sector investment. Chinese policy makers, in the face of the tariff threat, might loosen monetary policy again but generally Beijing is likely to stay away from aggressive monetary and fiscal stimulus, keeping the "powder dry" in case trade talks take a long lasting hit. The recent comment by the executive committee of the CPC in China against stimulating the housing market supports our view. Second quarter GDP in China was 6.3% (down from 6.4% in Q1) and likely to continue to creep lower, delivering a full year average of around 6.2%.

Elsewhere among major EMs, the fundamental developments are mixed. Brazil is surprising investors positively with the quick progress on substantive pension reforms – helpful for righting the fiscal position and encouraging the central bank to cut interest rates. While Turkey continues to worry us with the July sacking of the central bank governor and the large (425bps) rate cut by his successor soon after (25 July).

Corporate EM fundamentals are stable in our view, with some downward pressure on earnings growth offset by easier hard and local currency funding conditions. The helpful funding conditions cut across the ratings spectrum and together with good on average leverage fundamentals should keep be a strong cap on default rates in the HY portion of the market. Positively, default rates in EM HY are very low with BAML estimates of 0.67% for the 12-months to June 2019.

EM political risks for the months ahead seem limited to us. There are no major elections for the rest of the year with the exception of the presidential race in Argentina in October. Opinion polls have shown some improvement in support for president Macri although the race against the market-unfriendly opposition Alberto Fernandez/Cristina Fernandez Kirchner is still close.

EM Technicals and Valuations

Valuations are naturally less attractive after the July rally but there are still good pockets of value in HY and in EM currencies. The HY portion of the EMBIG div. for example is currently 535bps over UST and close to the 3y and 5y average and importantly is holding at a wide gap to US HY corporates (162bps above versus 117bps 3y and 101bp 5y average). The same is true for the HY portion of CEMBI div. at 449bps spread to worse (61bps above US HY corporates versus a 47bp 3y and 66bps 5y average).

Return Expectations

We expect around 5% for EM Corporate bonds (JP Morgan CEMBI Diversified) over the next 12 months (4% for the CEMBI Diversified IG index) with the main contribution still coming from carry. EM Sovereign bond returns (as measured by the JP Morgan EMBI Diversified index) should similarly be driven by carry and deliver around 5.6% returns.

Local markets GBI-EM returns should be around 5.5%. EM currencies have continued to creep upwards but in the absence of more generalised weakness of the USD – not clear that will be the case given monetary easing in both EM and US – most of the returns going forward should still be carry. We will be looking towards enhancing returns by avoiding the fundamentally most problematic currencies (TRY notably) with overweight's/off benchmark longs in select high yield/low volatility currencies such as the Nigerian Naira and the Uruguayan peso.

Global monetary policy – impact on EM

	- -	-	+	+ +
FED			Rates/QT pause Flows +ve	
ECB				Dovish support esp. CEE
BOJ				Long-term dovish driving flows
PBOC			Room for more cuts	

EM fundamentals view

	- -	-	+	+ +
China		Trade tensions meet stimulus		
Global EM		Moderate slowdown		
Major risks (TR)	Pressure on the central bank			

Commodities view

	- -	-	+	+ +
Oil		High US inventories		
Indus. Metals			Muted supply	
Precious Metals			Potential portfolio demand	

Source: UBP – 31.07.19

EM Indices[1]

30/7/19	Yield	Spread	Mod Dur
EM Sov	5.46%	330 bp	7.2
EM Sov IG	3.80%	156 bp	8.2
EM Sov HY	7.41%	533 bp	6.1
EM Corp	4.99%	253 bp	4.7
EM Corp IG	3.91%	162 bp	5.1
EM Corp HY	6.57%	488 bp	4.0
EM Local (USD terms)	5.52%		5.4

[1]EM Sov : JP Morgan EMBI Global Diversified
EM Corp : JP Morgan CEMBI Diversified
EM Local: JP Morgan GBI EM Global Diversified

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