EMERGING MARKET FIXED INCOME

2022 OUTLOOK

White Paper

For Professional Investors in Switzerland or Professional Investors as defined by the relevant laws

UBP

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Key points

- *Global growth is weakening but EM growth remains above long-term trend while fundamentals and governance remain strong.*
- *Inflation risk in EM to be mitigated by the stabilisation of food and energy prices as well as supply chain normalisation.*
- *EM central banks have moved rapidly and early in the cycle to hike interest rates, which should anchor inflation expectations in 2022 and help stabilise EM currencies.*
- *Stimulus from H2 2021 is likely to be supportive of Chinese growth in 2022, after authorities took advantage of the post-Covid recovery phase to implement reforms. The Government is likely to use policy levers to manage any key risk to the economy.*
- *Historical and relative valuations in EM fixed income offers compelling arguments for a strategic allocation.*

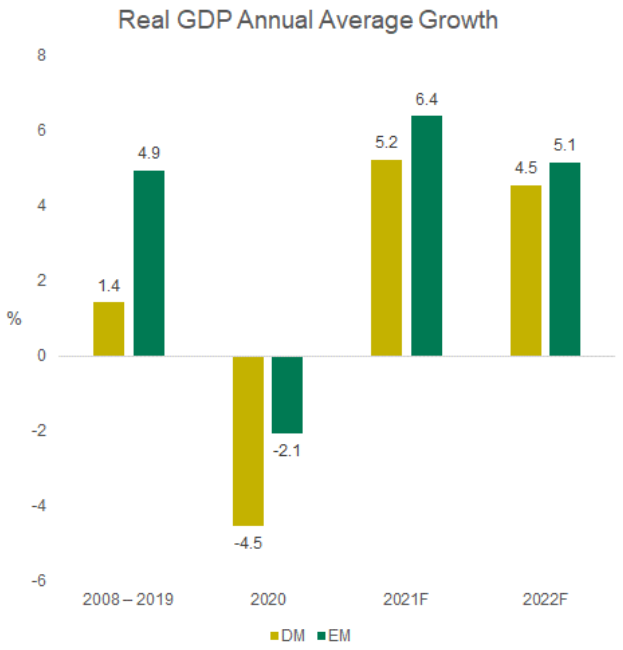
In this paper, we will discuss the outlook for emerging market (EM) fixed income in 2022 and the key themes investors are likely to focus on at the beginning of this year. A waning global growth momentum, rising inflation and tightening monetary policies are clear headwinds. China's economic restructuring is also likely to impact EM and global growth negatively in the short-term. However, historically attractive valuation and strong fundamentals mean EM debt should remain the asset class of choice for fixed income asset allocators in 2022.

A waning growth momentum, but strong fundamentals and institutions in emerging markets

As the rebound weakens, global real GDP growth is expected to be lower in 2022 than in 2021. However, forecasts by the International Monetary Fund (IMF) still predict a real GDP growth of +5.1% for EM in 2022, versus a long-term trend of +4.9% (2008-2019).

The main reason for the slow-down in growth is primarily due to the base effect, caused by the rebound in 2021. We note however that slower Developed Markets (DM) growth, structural changes in the Chinese growth model and the withdrawal of monetary and fiscal support are likely to cause additional drags on growth in 2022.

Tailwinds will include the gradual re-opening of EM and pick-up in domestic demand as vaccination campaigns extend to additional countries, particularly in some of the high growth Frontier markets. Concerns remain over the Omicron variant, and countries exposed to supply chain restrictions or facing lengthy lockdowns. So far though, the variant has displayed a high contagion, but a low mortality rate. Such characteristics could potentially lead to higher natural immunity and add to the growth impetus in 2022.



Sources: IMF World Economic Outlook, October 2021

While EM and DM are projected to grow broadly at the same rate in 2022, EM projections are heavily skewed towards China, where growth is expected to remain subdued until the impact of policy support kicks in. The housing slowdown and strict health regulations in place have placed significant constraints on domestic growth over the last few months, but should sentiment improve, a pick-up in domestic consumption is likely for 2022. Frontier markets are forecasted to have higher than average growth levels as vaccination rates improve and offer attractive investment opportunities in this context.

Overall, EM have shown resilience across the Covid crisis and continue to display some strong fundamentals. EM current accounts have improved considerably throughout the crisis, as strong commodity prices led to additional revenues for commodity-exporting countries. A strong US Dollar environment including against emerging market currencies, have also helped shore up EM current accounts in this instance.

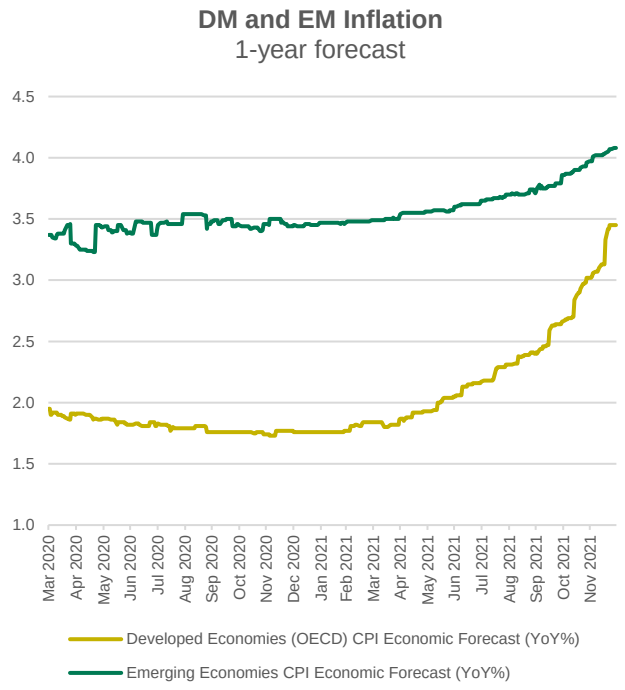
EM also illustrated disciplined fiscal approaches during the crisis, with debt increasing to a much lesser extent than that of DM. The quick tightening monetary stance implemented by several Central Banks across EM in 2021, such as Brazil and Mexico, also highlighted their experience in managing inflation risk and mitigating the impact on their economies.

From a governance perspective, reforms across EM institutions in the last decades have resulted in higher resilience against systemic risk. A higher focus on financial market stability, independent central banks decision-making and exchange rate flexibility are now the norm, rather than exceptions in EM. We believe that those institutions remain in place to deliver on their growth mandate once the Covid induced volatility subsides. Some exceptions exist such as

Turkey, and we also have concerns with the political shifts in a few Latin American countries, but those issues are unlikely to turn into systemic risks for EM.

Inflation risk to be mitigated by the stabilisation of food and energy prices as well as supply chain normalisation.

The impact of the recent surge in price levels has been felt more acutely in DM than in EM. As per the chart below, inflation expectations rose strongly in 2021 in DM. We believe that the factors responsible for inflation are likely to be remain under control for 2022. While near-term inflation risks might be skewed to the upside given the global nature of this phenomenon, the resolution of supply chain issues and abating pressures from food and energy prices should help ease inflation in EM.



Sources: UBP, Bloomberg, 29 December 2021

Food prices account for a much larger percentage of the basket used to calculate inflation in EM than in DM. Estimates suggest almost a quarter of EM's inflation basket to be in food on average, compared to a mean of 10-15% in DM. Accounting for the inflationary base effect of 2021, we do not expect material food price increases in 2022, which should temper inflationary pressures in EM.

In addition, rising energy prices should not be particularly hurtful on average to EM. Price control mechanism on commodities are in place in several EM, and a large portion of those countries tend to be commodity exporters, thereby benefitting from improving trade balances. We remain mindful of fiscal pressures on issuers subsidising commodities, but on balance rising energy prices have tended not to cause major inflationary issues in EM.

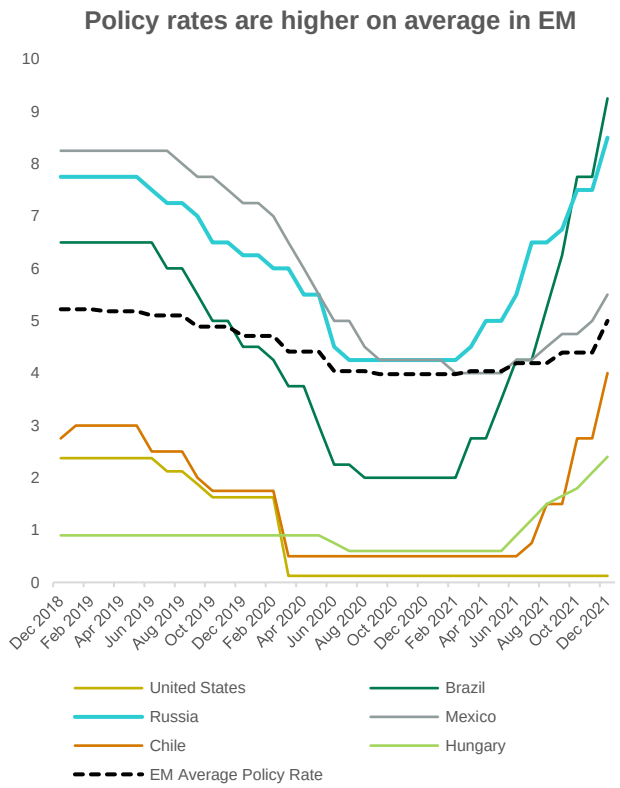
Supply chain issues have disrupted economic activity in several countries during the pandemic, and the impact of the omicron variant on economic activity in 2022 is still to be ascertained. Overall, supply bottlenecks are easing, and logistics should improve in 2022. As a result, we believe that imported inflation is likely to gradually subdue.

Importantly, EM have considerable experience dealing with inflation, and have been proactive in raising interest rates in 2021.

A no-tantrum tapering? Why emerging markets are better prepared this time around.

Back in 2013, EM suffered from a sudden withdrawal of foreign capital flows as the Fed announced its tapering programme. EM - and in particularly what was referred to as the Fragile 5 (Brazil, India, Indonesia, South Africa, and Turkey) – suffered significant underperformance as their currencies depreciated. Local debt investors faced further losses as EM central banks hiked interest rates rapidly.

We believe that 2022 is unlikely to provide a repeat of such a scenario. Although the Fed has recognised the inflationary threat, they remain focused on job creation and are unlikely to aggressively tighten their monetary policy. Previous experience should also prove useful to the Fed to adequately manage communication to market participants. Given the current context, there is a non-negligible risk that the current monetary guidance of the Fed changes over the course of 2022. Investors would be wise to remember that at the beginning of 2021, most market participants expected a weaker US Dollar and 10-year US Treasury yields significantly above 2%. The Fed's monetary stance will remain guided by economic data in 2022, and they are likely to adapt monetary policy as required.



Sources: UBP, Bloomberg, 29 December 2021

While the market's attention has been on the Fed, EM central banks have focused on inflation-targeting to drive monetary policy. As a result, EM central banks have moved early in the cycle to hike interest rates. While this has meant poor bond performance in 2021, appropriate monetary policy management should anchor inflation expectations in 2022 and help stabilise EM currencies. Importantly, EM central banks' proactiveness in raising interest rates should now ensure ample capacity to loosen monetary policy if required.

Additionally, EM current accounts should be more resilient to capital outflows this time around. EM have seen increasing current account levels for the last three years, and most regions maintain robust levels. The IMF however forecasts a moderate deterioration in 2022, with EM current accounts moving from $391bn to $308bn, whilst DM current accounts should also trend lower, from $246bn to $200bn.

Data from JP Morgan suggests that flows to EM fixed income in H2 2021 have been broadly flat, after an initial surge of foreign capital in H1 2021. The study, which tracks data from investors in Europe, US and Japan suggests inflows of $50.6bn in 2021. This is certainly a positive rebound from the $23.3bn of inflows of 2020, but still far from the inflows of $116bn and $67bn recorded in 2017 and 2019 respectively. We expect investors to come back into the asset class in 2022 and provide technical support, after tactically delaying allocations in 2020 and 2021.

China to rebound from policy-induced slowdown in 2022

China faced strong headwinds to growth in 2021, partly due to the pandemic but also because of the property crisis which has seen several issuers in the Chinese real estate sector default. January 2022 is likely to be a critical month as several issuers are due to refinance their bonds, in what could prove to be a tense market that set the tone for sentiment in 2022. However, with the latest data suggesting supportive measures by the Chinese government, we expect a gradual easing of the short-term liquidity pressure on Chinese property developers in 2022. We believe that this may improve the market situation as developers are able to demonstrate access to liquidity to service their debts.

Over the course of 2022, we expect policies to remain accommodative and growth to improve relative to H2 2021 - in what is likely to be a politically sensitive year for the Chinese government. China's 20th Party Congress is scheduled to take place in the second half of the year. Growth remains a key priority for the Chinese authorities, but additional objectives such as de-carbonisation and common prosperity will also be clear focus areas.

2021 offered an ideal opportunity for the Chinese government to implement several reforms across key sectors such as manufacturing and real estate ahead of the congress. Several of those reforms have caused a drag on growth in 2021, but ultimately remain consistent with the government's long-term objectives.

The short-term pain may be politically astute, given modest growth expectations for 2021 and China's inability to meet its growth target in recent years. Having taken advantage of the post Covid recovery phase to implement reforms, we now expect the Chinese authorities to carefully use policy levers to manage any key risk to economic growth in 2022. Chinese growth is likely to be lower than in previous decades because of those reforms, but should rebound meaningfully from the low levels of H2 2021.

Geopolitical risk in 2022 will require careful positioning

Political risk in Latin America is likely to continue to be at the forefront of investors' minds in 2022. National elections in Brazil and Colombia will be closely monitored by investors, as will the on-going protests in Chile and Peru where new governments were recently elected.

In Asia, the Philippines will also be going into election year in 2022, with President Rodrigo Duterte set to leave his seat.

Turkey is likely to continue to be a cause of concern for markets, although limited foreign capital remains. We believe that continued economic mismanagement is likely to lead to the further depreciation in the Lira, given the precarity of their current account.

While a tail-risk, we continue to monitor the escalating tensions between Russia and Ukraine. Ongoing dialogue between the United States and Russia could help avoid escalation, and a potential agreement could lead to a significant repricing in Ukrainian bond prices.

Tempting EM debt valuations will attract investors once visibility improves

Flows to EM fixed income have been muted for the past six months as investors patiently wait for right time to deploy into risk assets. As always, timing will be difficult to ascertain given the complex transition phase we will likely face in 2022, but current valuations in EM fixed income make it an attractive point of entry for fixed income investors. Some segments of the EM fixed income market are likely to present better risk-return opportunities than others, given the background of declining global growth and Fed monetary policy tightening. Selectivity will be critical.

While 2021 was a challenging year for local currency debt, the asset class now offers attractive yields as EM central banks increased interest rates and yield curves steepened. Valuations are clearly compelling for local EM interest rates, and historical data suggests a third negative performance calendar year for local rates is unlikely in 2022. While the nominal yield on offer remain attractive, international investors are still likely to monitor the effectiveness of EM monetary policies in controlling inflation before committing capital to local debt markets.

Prospect for EM currencies remain more mixed however, and selectivity between regions will be key in 2022. Frontier currencies outperformed in 2021, but countries such as Mexico and Russia now offer similar yields in 2022 after aggressive interest rate hikes. Overall, we prefer to be funded in Euro rather than USD in 2022, due to the likely persistence

of low growth and accommodative monetary stance in the Eurozone.

In Asia, we would expect most currencies to appreciate versus the Chinese Renminbi in 2022 as China indicated it will be allowing more currency flexibility and will likely start easing interest rates, creating a monetary policy divergence with the rest of Asia. We also foresee some selective opportunities in laggard currencies such as the Thai Baht or the Singaporean Dollar, which stand to gain from a reopening of air travel. In CEEMEA, we would expect the Russian Ruble and Ukrainian Hryvna to rebound in 2022 if tensions de-escalate. The most challenged currencies are likely to be in Latin America, given the election risk in H1 2022.

EM hard currency debt on the other hand offers compelling arguments. Spreads have typically tightened during phases of interest rate hikes by the Fed. In addition, the asset class offers attractive valuation versus US and European fixed income alternatives, with room for further spread compression in 2022.

At the higher end of the credit quality spectrum, EM Corporate Investment Grade (IG) bonds (denominated in USD) offer a spread of around 170bps, compared to approximately 100bps for US and Euro IG. This segment of the asset class also provides lesser sensitivity to rising US interest rates, with a duration of 5.5 years (versus 8.1 years for US IG Credit). Our actively managed EM IG Corporate bond strategy offers exposure to a segment of the asset class which benefit from one of the highest Sharpe ratio in fixed income over the last 10 years at 0.95.

Investors unwilling to increase the duration of their exposure may want to consider short dated bonds. Our EM Corporate Short Duration bond strategy offers a yield of 4.6% with a duration of 2.8 years. With an average credit rating of BBB-, the strategy can provide attractive income or capital appreciation with limited interest rate and credit risk.

For investors looking to maximise yield and long-term performance, our Frontier bond fund strategy can offer significant opportunities for capital appreciation. We expect high yielding sovereign issuers to outperform lower yielding ones, given the historically wide gap in valuation, and expected rebound. Frontier markets offer attractive relative and historical valuation with spreads at 665bps. This is 150bps above their last five-year average spread level, and significantly higher than US High Yield, which offers a spread of 300bps over US Treasuries. Frontier markets have exhibited fewer defaults than US High Yield (2.2% versus 4.2% over the long-term) and higher recovery values (average recovery of a Frontier Sovereign bond is 63% and 41% for a US High Yield bond). As with EM local rates, 2021 saw the second consecutive year of negative price returns in Sovereign high yield bonds. We have yet to see 3 consecutive years of negative price returns in the history of the EM Sovereign indices. Given historically low default rates and limited liquidity risks going into 2022, we view this year as unlikely to break that mould. Thus, with a historically wide valuation gap, and potential for some price appreciation in our markets, we expect frontier markets to significantly outperform US High Yield in 2022.

Demand for Green, Social and Sustainable bonds is also driving EM Sovereigns and Corporates to increasingly use such instruments. Supranational issuers are also increasingly using fixed income instruments to fund their high ESG impact activities in several countries. We expect demand to remain strong for such securities as an increasing percentage of international investors adopt more sustainable practices. Our EM fixed income team has a keen focus on sustainability, managing ESG strategies across the EM fixed income spectrum. Please be on the lookout for more commentary on this subject from UBP, as we move through 2022.

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