THE DRIVE YOU DEMAND

EM FIXED INCOME: STRONG FUNDAMENTALS TO HELP OVERCOME RECENT MARKET VOLATILITY

22 February 2018

A technical sell-off

Since the beginning of the year, investors' concerns over a return of inflation have come back to the fore and triggered a sharp sell-off in US Treasury bonds. Investors were initially unfazed, as this move reflected solid US growth prospects. The S&P 500 reached a new high on 26 January, despite a rise in the US 10-year Treasury yield of 25 bp since the end of 2017. EM fixed-income markets also resisted well thanks notably to strong inflows into both EM hard currency and local currency bonds: spreads tightened to compensate for the rise in rates and EM currencies continued to appreciate against the USD.

The increase in rate volatility, combined with higher-than-expected US wage inflation, eventually took their toll and triggered a risk-off sentiment. This resulted in a sharp sell-off in equity markets and a contagion to all risk assets. In less than a month since 26 January, US 10-year yields have risen by another 29 bp to 2.93%, the S&P 500 and the EuroStoxx 50 6.0% and commodities futures 3.1%, on average.

Emerging market (EM) fixed-income instruments were also affected. The main reasons behind the sell-off were external to the asset class and largely based on technical factors. Most investors were long on risk assets already, including EM debt and EM equities. As investors sought to reduce risk, the most liquid assets suffered the most. EM sovereign hard currency bonds (-2.63% since 26 January, with spreads up 17 bp to 281 bp) were penalised by their longer duration and by outflows from ETFs, as well as from a high level of issuance since the beginning of the year.

The absence of "hot money" and ETFs, as well as their shorter interest rate durations and wider spreads, helped EM corporate bonds to resist better (-1.21%, with spreads up by only 1 bp in the period to 241 bp). EM credit thus outperformed EM sovereign and US credit, both in the investment-grade and high-yield segments.

The depreciation of EM local currencies against the USD stayed relatively contained (-1.08%) as inflows into EM local bonds and equities remained well supported.

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21/02/2018	Since 25/01/2018 Return (%)	Spreads (change,bps)	YTD Return (%)	Spreads (change,bps)
EM Corporate IG	-1.31%	158 (-2)	-1.41%	158 (-19)
EM Sovereign IG	-2.61%	151 (+9)	-2.90%	151 (-1)
US IG (Developed)	-2.10%	115 (+7)	-2.83%	115 (-2)
EM Corporate HY	-1.08%	350 (-1)	-0.56%	350 (-26)
EM Sovereign HY	-2.66%	413 (+23)	-1.92%	413 (-6)
US HY (Developed)	-1.25%	385 (+19)	-0.30%	385 (-15)

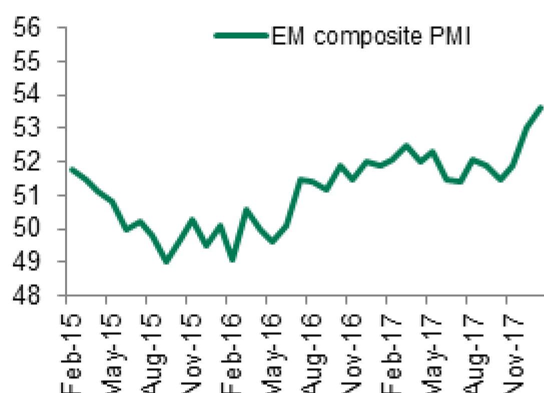
Source(s): Bloomberg Finance L.P., JP Morgan as at 21.02.2018
Past performance is not a guide to current or future returns

Positive fundamentals should overcome technicals

In the absence of a substantial rise in inflation well above current expectations, we would expect US Treasury rates to be close to their highs for the year. As a result, while volatility is likely to remain high in the coming weeks, after months of being extremely low, we believe that EM fixed-income markets should be well supported in the medium term. Current levels in EMFI are thus creating attractive investment opportunities as fundamentals help overcome technicals.

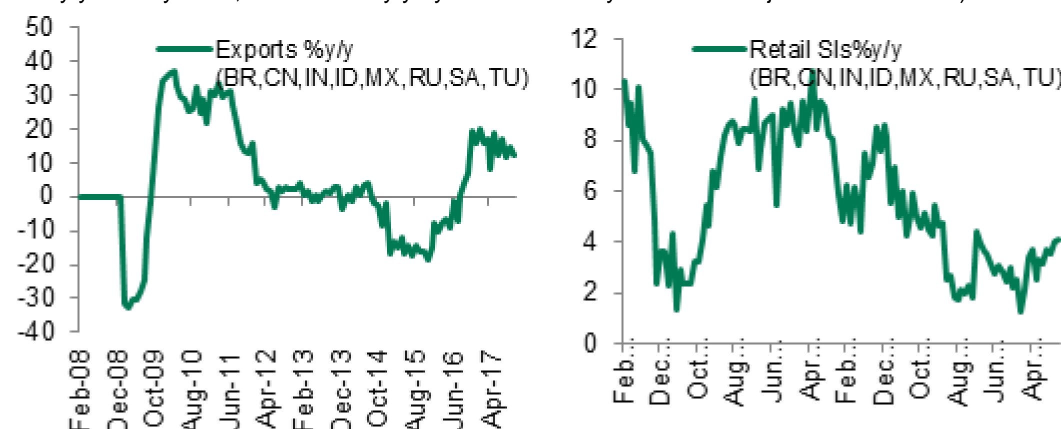
Indeed, **EM sovereign and corporate fundamentals are continuing to improve**. Indicators of EM growth dispersion are currently very low, pointing to a **synchronised growth recovery** across the majority of EM countries, as shown below:

- EM composite PMI reached 53.6 in January, vs. 51.4 six months ago.



Source(s): UBP, Bloomberg Finance L.P. as at 09.02.2018
Past performance is not a guide to current or future returns

- After the sharp acceleration in exports which started in late 2016, EM retail sales have now also picked up (from +1.3%, y/y in early 2017, to over +4% y/y by the end of the year for the major EM economies).



Source(s): UBP, Bloomberg Finance L.P. as at 09.02.2018
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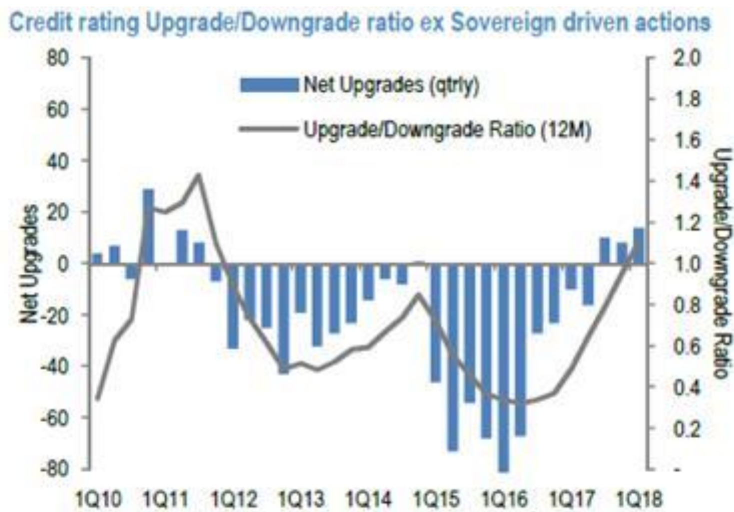
If anything, recent weeks have brought positive news in many countries:

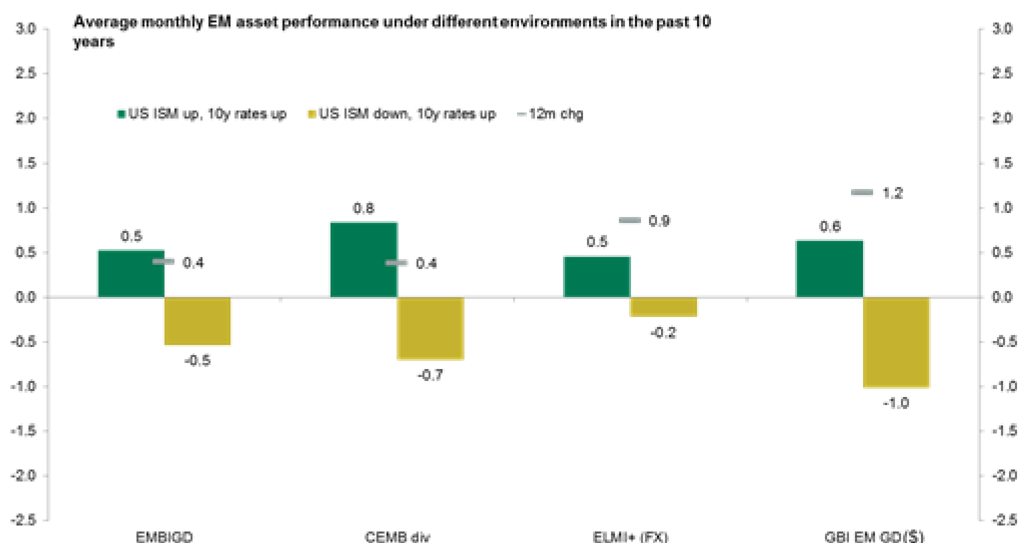
- in **Brazil**, former president Lula is unlikely to run in the upcoming presidential election next October, following the appeals court's decision to uphold his corruption conviction;
- in **China**, domestic demand continues to improve and imports are growing fast (+37% y/y in January), thus increasing demand for EM goods and commodities (exports to China represent 8% of total EM exports);
- in **Ecuador**, a recent referendum approved a constitutional change limiting the number of presidential terms to two. This will prevent leftist Rafael Correa from running in the next election;
- geopolitical tensions with **North Korea** appear to be cooling down, thanks in part to so-called "Olympic Diplomacy";
- fears of a major overhaul of the North America Free Trade Agreement (NAFTA), which would have been particularly negative for **Mexico**, are receding as negotiations appear to be progressing towards a more benign outcome;
- in **South Africa**, the ruling African National Congress (ANC) has pushed President Zuma, who is suspected of several corruption charges to resign.

Regarding **EM corporate issuers**, the latest reporting season is also showing predominantly positive developments in credit fundamentals. Rating changes have also been positive: so far this year, there were 35 upgrades vs. 26 downgrades for EM corporate issuers. Importantly, 14 of these downgrades were due only to S&P's downgrade of Brazil sovereign debt to BB-. The trailing 12-month upgrade/downgrade ratio (excluding sovereign-driven rating changes) has thus now reached 1.11x, its highest level since 2011. We would expect at least a stabilisation in this ratio for the next few quarters.



Source(s): JP Morgan, Bloomberg Finance L.P., S&P, Fitch, Moody's, as at 12.02.2018

Importantly, in the past, a rise in US rates has not necessarily translated in a sell-off in EM fixed-income asset classes. Indeed, quite the contrary is the case, as shown in the chart below: if such rise in rates is accompanied by strong US economic activity (as measured by the Institute for Supply Management (ISM) index), it often translates into positive performance.



Source(s): UBP, Bloomberg Finance L.P., as at 09.02.2018.
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After the recent sell-off, **technicals also improved**. Investors' positioning is less extreme, notably in FX markets where USD shorts have been significantly reduced. The investor base in EM fixed-income asset classes is more solid following the recent spike in ETF outflows. The large amount of issuance so far this year as issuers sought to anticipate the Fed's next rate hike means that financing needs for the remainder of the year should be easily manageable. Finally, valuations appear attractive compared with recent months: the yield on EM sovereign bonds (5.73%) and on EM corporate bonds (5.30%) are back to levels not seen since the beginning of 2017. EM FX should also perform well, as the growth differential between EM and DM is likely to rise further and portfolio and direct investment into EM assets should remain strong.

That said, idiosyncratic risks remain. For instance, the first round of elections in Costa Rica resulted in an outcome that was less market-friendly than expected; geopolitical tensions in the Middle East remain high; and amongst corporates issuers, Teva, an Israeli pharmaceutical company, lost its investment-grade status after both Moody's and Standard & Poor's downgraded it by two notches earlier this year to Ba2/BB.

Diversification thus remains particularly important to avoid any pitfalls. We expect, however, such risks to remain isolated and unlikely to disrupt the whole EM fixed-income asset class, which should benefit from the overall improvement in EM sovereign and corporate fundamentals.

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