

EM Cross Asset Strategy

Irrationality, illiquidity or inability?

Emerging Markets

Global

Is the recent selloff really that unjustified?

In a sense, what we are seeing in the markets now is the antithesis of what played out between March and July. Then, low volumes and a benign (growth-neutral) decline in US yields pushed volatility lower and this, in turn, enticed investors into chasing yield and risk. Now, with lower commodity prices and renewed disappointments in EM growth surprises acting as triggers, the same lack of volumes is exacerbating volatility. Amplifiers aside, at the root of the problem is EM's inability to find sources of growth. Since September we have preferred EM credit to EM equities. We maintain that stance.

Prices have moved a long way. Could we see a big turnaround in Jan?

Prices have adjusted a long way in EM, and that must change the risk reward of a negative call. Also with some liquidity coming back early next year, a positive spell is very possible. We are less bearish than we were, but we believe EM has more hurdles to cross yet. We don't expect a big rebound in exports or in hard commodities. Meanwhile, other volatility triggers in the form of higher US rates or possible weakness in European peripherals (with the exception of Greece) have really not been engaged so far. EM is thankfully carrying less baggage, but it hasn't fought off all its demons.

Equities: Ending the year at low prices, but average valuations

Earnings have fallen in sync with prices in EM equities and so valuations, at an aggregate level have not cheapened dramatically. We continue to like North Asia, India, Chile and Mexico over South Africa, Brazil and Indonesia. The latter set of markets constitutes those which will be hurt 'both' by higher US rates and weaker investment in China. Brazil has not reached our buy levels yet, but it has cheapened quickly; we will keep a close eye here. On balance we still prefer Brazilian fixed income to equities.

FX: Could the USD consensus be wrong in '15 as the rates consensus was in '14

Never say never in markets, but we think the strong USD theme is likely to be more robust than the previous consensus on selling Treasuries. First, the USD will likely rally both in the event of rate divergence between the US and the rest of the world and also in the event of much weaker than expected global growth forcing the Fed to keep rates low. Second, we feel that the long position on the USD is not as big as many suggest. Remember the USD selloff was a 10 year event through which many corporates borrowed aggressively in this currency, and many long term investors moved away from it. A 10y old carry trade isn't easily unwound. We see no reason to shift from our long USD vs. EM bias, even as we acknowledge that recent moves have likely been exacerbated by thin liquidity. More details on tactical trades inside.

Local rates: Value emerging

Post the recent selloff we like India, Malaysia and China duration, and think the risk premium in front end Mexico and back end Colombia rates is starting to look overdone. We also like Korea 5y5y receivers vs. the US, and Brazil Jan 17s.

Credit: Fading weakness in some oil producers

EM credit spreads are 140bps off their 2014 troughs, total ytd returns are now only 3.6%, from 10% in August. This asset class has more commodity exposure than any other benchmark. Oil exporters have led the move weaker, widening by around 180bps on average in H2 2014, whereas non-oil exporters are only 40-50bps wider. Going forward, we think sovereigns will continue to outperform corporates. Amongst oil producing sovereigns, we would look to fade the weakness in Mexico, Colombia and Kazakhstan before others. Non- economic variables are at work in Russia, but we think the Russian sovereign is now attractive for long term holders.

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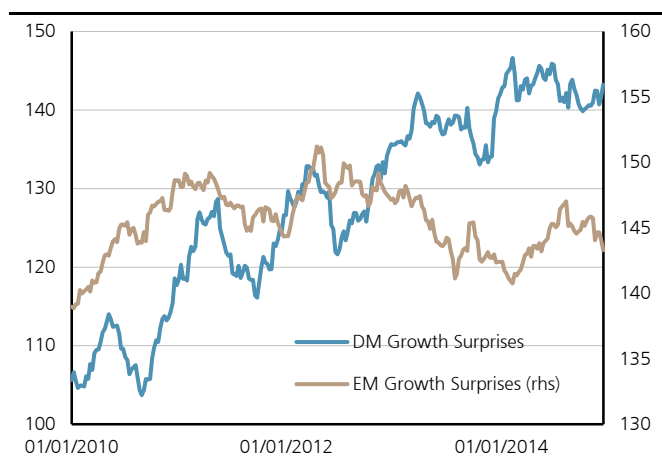
Sure, fundamentals haven't changed that much, but was it always about fundamentals?

In a sense, what we are seeing in the markets now is the antithesis of what played out between March and July. Then, low volumes and a benign (growth-neutral, positioning driven) decline in US yields pushed volatility lower and this in turn enticed investors into chasing yields and risk. But a few warning signs were already evident – European growth was failing to surpass already beaten down expectations, the variance of growth, inflation and stock price forecasts was coming lower, and there was a big polarisation of liquidity between the primary and secondary markets in the credit space - see [Macro-Strategy Key Issue: Low volatility: Underpinnings and cracks](#) for details. These low volumes in the market were suppressing volatility then, but more recently have begun to amplify it. Significant weakness in commodity prices and declining EM growth surprises have provided a trigger for higher volatility, and the liquidity premium in the market is very quickly on the rise. This is not an environment in which EM outperforms.

Why aren't lower core market rates helping EM anymore?

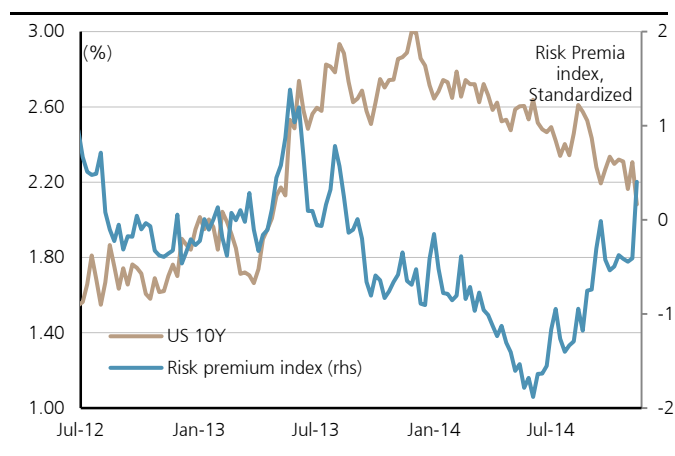
With apologies to regular readers, we would reiterate that the relationship between rates and volatility need not be stable. For the bulk of the last two years they have been positively correlated, but now volatility has risen even as developed market fixed income is rallying. Why has this happened? We think it's because the drivers of lower developed world rates has changed: from a largely positioning driven move in the early stages of the year, a weaker China, weaker commodity prices and weaker EM growth surprises are now playing a dominant role. The same weakness in commodity prices that is helping DM bonds rally has been a trigger for higher volatility in EM. For more on the relationship between rates and volatility see [Video: USD, Liquidity and Growth - 3 Key issues for EM](#).

Figure 1: EM and DM growth surprises



Source: Bloomberg, UBS

Figure 2: Risk premium index and US 10y yields: changing relationships



Source: Bloomberg, Datastream, UBS

The price has moved, so we are less bearish than we were, but we are not looking to fade weakness just yet. Why?

While volatility may not continue to surge from these levels, we are afraid to report that there really aren't many bright spots in EM growth even at this point. We will watch very closely how lower oil prices will help EM through the developed market consumer demanding more traded goods from EM, and through the EM consumer and (manufacturing) producers themselves finding their cash flow improved. But this room for optimism must be juxtaposed against a very lacklustre growth performance from Europe and China, EM's big export markets. Cyclical sectors in EM stock markets and trade data, which we are big fans of, is giving us little reason to get excited. We've argued that one of the lesser discussed issues in EM is the loosening link between global trade and global growth, and we stand by this view today. See the links below for details.

[EM Cross Asset Navigator: Is the trade slowdown cyclical or structural?](#)

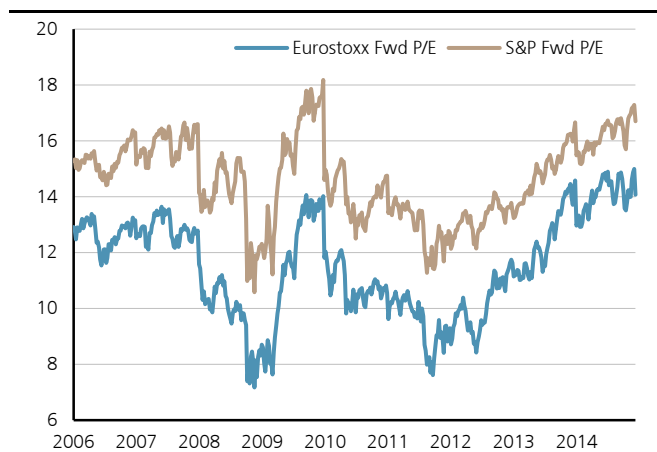
[EM Strategy Video "Structural elements of the trade slowdown"](#)

Second, don't expect a big reversal in commodity prices. Yes, we do agree they have moved far and fast, but based on our view on China (continued recession in property starts through 2015) and our constructive view on the dollar we retain a lacklustre outlook.

Third, other volatility triggers in the form of higher US rates or weakness in European peripherals have, with the exception of Greece, really not been engaged yet. Sure given weak inflation the Fed can potentially remain dovish for a good while longer (not UBS' base case view) but consider what is already priced in: Fed fund futures expect one rate hike and about a 70% chance of another rate hike next year. That's not much, not by a long shot, in our opinion (or the Fed's). At the back end, the UST 10 year rate, 10 years forward (that's for 18 Dec 2024), is priced at 2.8%. It would seem to us secular stagnation is already in the price. Growth, even if modest, would be the surprise.

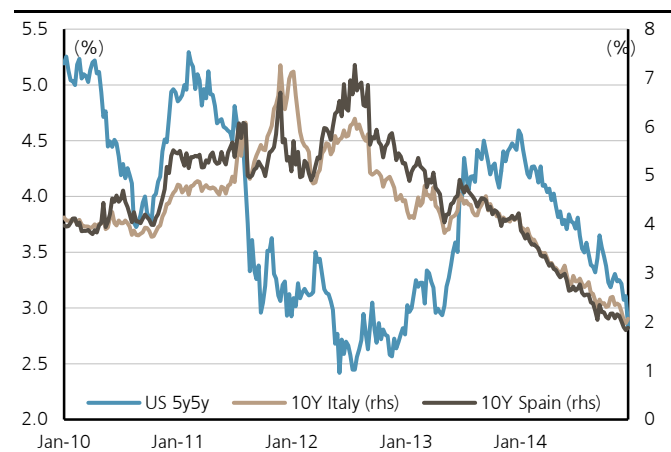
Lastly, we don't yet see signs of distress in EM assets to be compelled to buy on pure valuations, fundamentals notwithstanding. The only markets where we can spot signs of distress are Venezuela and Russia. Even in these markets positioning has not been cleared out, as best as we can tell. The rest of EM is weakening, but not in a vacuum. Weakness in export volumes and commodity prices are compromising earnings along with prices.

Figure 3: US and Europe forward P/E ratios



Source: Bloomberg, UBS

Figure 4: US 5y5y forward and Spain/Italy bond yields



Source: Bloomberg, UBS

Spots of weakness and (relative) strength: Equities

Going back to 1991, December has, on average, been the best month of the year for EM equities. This time the seasonals have not worked. EM equities have now fallen by over 8% in December, translating essentially a flat year-to-date performance at the end of November into a test of the February 2014 low. Year-to-date, EM is now underperforming DM 7.5% in total returns terms (ytd high of +4.2% in September).

What we remain invested in

- **China** and **India** still look the best opportunities to us in both Asia and in GEMs as a whole. China is very cheap still, if complicated (8.9x v. 12.3x);
- **Mexico** looks interesting as the peso has sold off significantly and is now very cheap, even if the equity market is not (17.6x v. 13.3x). However, the current scandal looks bad and further bad news may be forthcoming, including possible government resignations;
- **Taiwan** looks cheap (12.8x v. 14.4x) and is quite defensive;
- **Chile** now looks slightly cheap by its own expensive standards (15.2x v. 15.6x) and we remain Overweight;

Markets we're negative on, but less so given violent price moves

- **Russia.** The call is not about value (it is already very cheap indeed at 3.5x v. a long-term average of 7.2x) but about events, i.e. when and where do oil prices and the Ruble stop falling?
- **Brazil** is now below our pre-election 'Dilma victory' range of 48,000-50,000 on the Bovespa, but still slightly above our 'Buy level' of 45,000 at R\$2.75. However, as the market has moved lower in recent weeks, EPS forecasts have fallen also and the market is still expensive versus its long-term average (8.8x v. 8.5x). However, with foreign investor positioning still very light, Brazil is closing in on interesting levels to add;

- **CE3 and Greece** now look good value and benefit from lower oil prices. While political risk is high in Greece, the worst news – no President elected, new elections in early 2015 and a less 'bailout-friendly' government is elected – may now be priced in. The main political risk in Greece may now be to the upside;

Markets we remain negative on

- **South Africa** is still rich (13.9x v. 10.7x);
- **Indonesia** : High leverage, commodity exporter with high valuations and room for FX instability
- **Russia**: The Russian market needs the oil price and the Ruble to bottom out for a sustained rally to begin, in our view. MSCI Russia trades at just over 3x forward earnings (v. a long term average of 7.2x), but this is based on a consensus EPS forecast for 2015 of -1% - almost certainly far too high. Investors need to look for an 'event' trigger to buy Russia, not a 'valuation' trigger

Spots of weakness and strength: EM debt

EM fixed income has given back a large part of its year to date performance in recent weeks. EM hard currency debt is now up 5.1% in 2014 (from 10% at the end of November), while local currency debt is down 6.7% in dollar terms (from +0.2% at the start of the month). EM currencies have clearly been a drag, but local yields have also risen significantly as volatility has stirred – in local currency terms, the benchmark is now up 6.9% from 9.5% at the start of the month.

In local currency debt...

We have highlighted in the local rates chapter of our 2015 Outlook ([click here](#)) that, despite the promise of clearly improving inflation/fiscal profiles in most of EM as oil prices fall, investors should beware that weaker currencies often have a statistically significant impact in pushing local yields up, and hence FX weakness cannot merely be hedged away. This relationship between rates and FX weakened earlier this year as Bunds and USTs rallied and volatility was benign for the most part, but has clearly kicked in again as volatility has stirred. The principal exceptions to this finding are the more 'developed' EMs such as Korea, Israel, and the Czech Republic.

Keeping this historical correlation between rates and FX mind, and as the debate on the 'new normal' for EM real rates is likely to heat up as the Fed tightens in 2015, we believe investors should be highly selective in their choices of EM duration longs.

In general, we prefer markets that can be characterised by:

- a) A significant improvement in monetary policy or fiscal policy credibility e.g. credible expenditure-reduction plans, or pursuit of a lower inflation target,
- b) "DM-like" fixed income markets, where a weaker currency is unlikely to disturb bond markets and growth/inflation are likely to diverge from a

strengthening US

- c) Markets with historically high real yields and/or steep curves, such that investors should be able to gain exposure to local duration while hedging away FX risk

India 10y bonds remain our top pick in EM duration. The RBI's conservative stance towards policy easing, decelerating inflation momentum, fiscal consolidation and an improving basic balance keep us constructive. The significant negative carry on swaps, however, means that we would only express this view in bonds at current levels. We have been expressing this constructive view against an underweight in Turkish 10y bonds in recent months and, while we wouldn't add to this position at current levels, we do think it makes sense as a structural trade. In Asia we also feel that **Chinese, and to a lesser extent, Malaysian rates** also offer reasonable real rates and spreads to USTs. **We also remain received Korea 5y5y rates vs. the US.**

Next, we feel excessive risk premium is starting to get priced into **Latam rates markets**, specifically in **Mexico (front end)** and **Colombia (back end)**. We are also comfortable retaining our received recommendation in **Brazil Jan 17s vs. the Bovespa.**

By contrast, we find less value in the front end of South Africa and Hungary, and prefer not to engage in Indonesian or South African duration at these levels (despite the wider spreads to USTs, we don't believe the level of real interest rates in these markets are high enough at these levels to enter into receiver trades on a multi-week view).

In hard currency debt...

We think sovereigns will continue to outperform corporates, who are more vulnerable to the double whammy of lower oil prices & a stronger dollar.

Amongst oil producing sovereigns, which have underperformed in recent months, we would look to fade the weakness in Mexico, Colombia and Kazakhstan before others.

Russia 5y CDS at 550 bps, and Russia '42s at a USD price less than 80 are very tempting. We have waited for some stability in oil prices, and over the last two days this has been achieved. For investors that can get access to Russian assets, and have long term holding periods, we believe these are attractive levels to own Russian sovereign credit.

What are the spots of significant weakness: FX

That the dollar will strengthen further next year is very likely the biggest consensus trade in markets today (though a flatter US curves, persistently low US wage growth, and a lower JPY vs. EM aren't far behind). Given how strongly the paid US rates consensus at this time last year subsequently suffered, many investors are understandably questioning whether the dollar could have already overshot. We believe that, though the pace of USD appreciation in 2015 will probably be slower (given zero front end rates in Europe, historically elevated Bund-UST spreads, and market positioning), the dollar's proclivity to appreciate both if the US economy

recovers stronger than anticipated, and also if it underwhelms, should mean that the long USD thesis is built on strong foundations. With the US showing global growth leadership, we think the volatility-inducing impact of weaker US growth should outweigh the volatility-suppressive impact of lower developed market rates.

We have long regarded FX as the weakest link in the EM asset spectrum, and we aren't looking for any EM currency to rally significantly against the USD. Much as the price has moved, the lack of improvement in EM exports or upward correction in US rates, and the contained movements in implied volatility (outside of Russia) and implied yields suggest that a strong dose of caution is warranted before fading the weakness in this asset class.

We also believe that long EM FX against the EUR and JPY has been a very popular trade this year and that higher volatility in recent weeks has only begun to trigger positioning adjustments. More broadly we are concerned that with front end yields in Europe now at the zero bound, the driver of EUR depreciation from these levels will likely be a) higher volatility in European stock/credit markets or b) a more hawkish US rates trajectory than expected, neither of which would bode well for EM FX (earlier in the year, rapidly declining European front end yields were the driver of EUR weakness). We have noted repeatedly in our research that short EUR vs. EM strategies typically require several benign conditions to fall in place (rising EM growth surprises, rising global stocks, rallying EM credit markets) which did characterise much of this year but can hardly be guaranteed for the months ahead.

We believe it continues to make sense to hold negative exposure to EM currencies in the markets which are vulnerable both to a backup in US yields and a further slowdown in Chinese construction. **This keeps us negative on the ZAR, IDR and BRL.** We also remain long the USD against low carry, cyclical EM currencies such as **SGD, THB and HUF** which we think provide exposure both to weak EM exports (and the loosening relationship between global growth and global trade, and to further JPY and EUR weakness against the USD.

We are relatively more optimistic on the INR and the MXN but recognise that positioning here can mean further short term weakness. We think tactical value may be emerging in the TRY as the central bank tightens liquidity settings and has signalled that state owned energy importers' FX demand is likely to be sated off market (which could in principle cover as much as 1/3 of the current account deficit). **We think long INR vs. ZAR, short CAD/MXN, and long TRY vs. HUF** are relative value trades that should make sense on a 1-2m timeframe.

Can the Russia rate move trigger the same positive EM response as Turkey's rate move did in Jan 2014?

Couldn't the CBR's much more aggressive defense of the RUB (having raised rates 750bps in the past week alone) represent a backstop for EM currencies, the way that the Central Bank of Turkey's emergency rate hike did back in late January? In our view, there are at least three important differences between now and then:

- (1) CBR's toolkit may be less effective in containing the problem at hand:**
Back in Dec 2013/Jan2014, market concerns towards Turkey had centred on the central bank's reluctance to raise rates in the face of rising political uncertainty ahead of key elections in March (local) and August (presidential). The current account deficit had approached a whopping 8%/GDP, real policy rates were in deeply negative terrain, credit growth was running at 25% y/y,

and the CBT's unorthodox monetary policy framework was winning it few admirers. These concerns were almost entirely dispelled on January 28 as the CBT raised interest rates aggressively and simplified the monetary policy framework in unison. By contrast, the drivers of RUB weakness in the current environment are in our view more complex and multi-faceted than what the CBR's toolkit can directly address. As explained here RUB weakness is in our view being driven by corporate demand for foreign assets as declining oil prices and international sanctions erode the domestic investment landscape. CBR tightening and greater coordination with exporters can help to curb speculative demand, an accelerant of RUB depreciation, and recent steps to discourage FX hoarding exporters can help, but do not strike at the drivers of RUB depreciation in the same way as the CBT's actions in January.

- (2) **Level of US and Euro (real) rates:** Back in January, EM assets were boosted by a largely healthy decline in US yields. The market was heavily paid in US rates and got caught off guard by a surprisingly shallow pick up in CPI and wage growth, and powerful rallies in European yields. This benign move in duration helped global stock and bond markets to rally in unison. Things have come a long way now, though, with Spanish and Italian bond yields below the US, and Bund yields nearly 150bps lower. The positive relationship between rates and vol that characterised the bulk of this year is now starting to loosen as the continued failure of EM growth to accelerate makes low volatility harder to sustain.
- (3) **Global stocks have re-rated in a decent fashion:** Since the end of January, US and European stock markets have re-rated by 8-12%, respectively. This should mean that further scope for risk assets to rally in sympathy with fixed income is harder to sustain, unless growth rebounds.

EM FX Trade Monitor 2014

	SPOT AT ENTRY	DATE OF ENTRY	SPOT AT CLOSING	DATE OF CLOSING	PROFIT(+) / LOSS (-)	EMBI GD PERFORMANCE*
OPEN TACTICAL TRADES						
Sell ZAR vs INR	5.5925	01-Dec-14			2.20%	
Long USD vs SGD	1.2710	13-Oct-14			3.35%	-3.24%
Long USD vs ZAR	10.6420	10-Jun-14	11.1130	01-Dec-14	0.95%	0.76%
CLOSED TACTICAL TRADES						
Short CLPCOP via 6m fwd, 1% trail stop from 3.54, 5% target	USDCLP: 526.98 USDCOP: 1931.22	14-Jan-14	USDCLP: 561.00 USDCOP: 1925.00	22-Apr-14	6.70%	1.68%
Short AUD vs INR via 6m fwds (2.5% stop, 5% target)	55.0800	16-May-14	56.8800	02-Jul-14	-2.64%	1.57%
Long USDTRY via 3m fwds	1.9125	23-Jul-13	2.1660	31-Mar-14	-1.19%	3.42%
					9.37%	

Indicative sum of ytd returns in 2014

TOP STRUCTURAL TRADES FOR 2015

Long USD vs SGD and THB	USDSGD: 1.29 USDTHB: 32.83	10-Nov-14			1.74%	-3.83%
Long USD vs HUF	247.35	10-Nov-14			3.02%	-3.83%
Long MYR vs NZD	2.597	10-Nov-14			-3.53%	-3.83%
Indicative sum of ytd returns for 2015 top trades					1.27%	

Source: UBS, Bloomberg

Market Pricing as of 1230 GMT on 18-Dec-14

* The last column provides an indication of prevailing market conditions during the period the recommended trade was open. This measures the total return of the EMBI Global Diversified index.

Past performance is not an indication of future results

EM Rates Trade Monitor 2014

	P&L Units	Notional	Date of entry	Entry level	Date of closing	Current level	P&L
Long India fixed income vs Turkey (FX-unhedged)*							-35
Long Jul-24 IGB's	bp	9.87	12-Sep-14	8.50		7.93	
Short Jul-24 TurkGB's	bp	10	12-Sep-14	8.96		8.04	
2s10s Flattener in CLP Camara swaps							0
Rec 10y CLP Camara	bp	2.39	12-Sep-14	4.72		4.44	28
Pay 2y CLP Camara	bp	10	12-Sep-14	3.26		2.98	-28
Receive MXN TIIE 5y vs HUF IRS 5y							-24
Rec 5y MXN TIIE	bp	9.35	27-Nov-14	4.94	08-Dec-14	5.30	
Pay 5y HUF IRS	bp	10	27-Nov-14	2.32	08-Dec-14	2.44	
Receive Korea 5y5y vs the US							-20
Rec 5y5y KRW IRS	bp	10	13-Oct-14	2.94	12-Dec-14	2.73	21
Pay 5y5y USD IRS	bp	9.5	13-Oct-14	3.23	12-Dec-14	2.81	-41
Receive 5y5y PLN vs Pay 1y1y HUF							13
Rec 5y5y PLN IRS	bp	2.38	29-Aug-14	3.39	13-Oct-14	3.00	39
Pay 1y1y HUF IRS	bp	10	29-Aug-14	2.52	13-Oct-14	2.26	-26
Receive 5y ILS vs Pay 5y TRY-Xccy							200
Receive 5Y ILS IRS	bp	8.52	11-Nov-13	2.35	12-Sep-14	1.16	135
Pay 5y TRY X-CCY	bp	10	11-Nov-13	8.37	12-Sep-14	8.93	65

Source: UBS, Bloomberg, Datastream

Market Pricing as of 1230 GMT on 18-Dec-14

Past performance is not an indication of future results

*During that period, long INRTRY has returned (+1.10%) in spot terms

Final PnL (in bp) is calculated by dividing total PnL (In US\$) by the DV01 at initiation of the trade

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