UBS

Global Research

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EM Cross Asset Strategy: Outlook 2015
Slow motion commotion

Emerging Markets

Global

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"Any idiot can face a crisis, it's day to day living that wears you out": A Chekov

The good news is that EM has no external liability trigger for a blow up. The bad news is that EM doesn't seem to have a plan B for growth. This swamp-land of muddle-through investing is much trickier to negotiate than either a full blown crisis or a bull market. The salient point, on balance, is that EM's growth alpha over DM is not about to improve next year, and EM's cost of capital may go up, thanks to modest savings rates and likely higher US yields. 2015 should not see a string of EM blow ups, but it will likely bring low returns similar to, or modestly worse than, a thus far underwhelming 2014. Top trades on page 4.

Overview of EM asset calls: Equity over debt, low returns overall

EM fixed income will likely present a low bar for EM equities to cross next year. Driven by losses in Treasuries and gains in the USD, we think both local currency and hard currency debt will give 0-2% returns in 2015. We expect total returns in the range of 5-7% for EM equities. EM currencies will likely sell off by 3-4% against the USD, but by less against the EUR. Our present tactical recommendation is to be overweight EM credit relative to EM equities. Over a longer, 1 year horizon, as US rates rise and spreads widen out, equities ought to do modestly better than debt. (Page 23)

Will looser ECB and BoJ make up for Fed tightening?

We find that the US is the bigger driver of asset trends and flows in EM. In addition, the bulk of EM external liabilities are written in USDs. Even if the ECB and Bank of Japan ease further, they will likely not be able to compensate for rises in US rates. As we've noted before, at an aggregate level EM's growth is modestly more correlated with China and Europe, while its cost of capital is driven more by the US. That worked well in 2005, but is an unfortunate juncture to be at today. (Page 35)

EM equities: Valuations in line with averages, growth reality isn't

EM growth will likely come in slightly weaker in 2015, and the spread of EM growth over DM, now at nearly 15 year lows, isn't likely to improve either. In this context EM earnings are likely to disappoint a remarkably stubborn consensus again. We expect total returns in the range of 5-7%. Mexico, Korea, Taiwan are amongst our preferred markets, and we remain cautious on S Africa, Indonesia and Brazil. We think industrials, telecoms and IT outperform materials, energy and consumer staples. (Page 58)

EM debt and FX: What's EM done with the borrowed time?

Amidst low rates and volatility this year, EM got a window of calm to fix its deficits, push up its savings rates and control leverage. Some, like India have done a decent job, while others like Turkey, Brazil and South Africa haven't. If US rates rise again next year, as we think they will, these markets can come under pressure. We don't expect the degree of underperformance seen in 2013, but we think the local currency benchmark will likely give flat returns in USD terms. USDEM is likely to rise by 4% on GBI weighted basis. Hedging debt in EUR can help achieve 3% total returns. We see sovereign spreads widening by 30 bps and corporates by 50 bps. Total return for corporates is likely to be near 1%, while sovereigns should give us up to 2%. (Pages 49, 75, 85)

Upside and downside risks in 2015

The biggest upside risk for EM assets is oil prices continuing their slide. The channels through which this can help are a) stronger global growth, b) monetary policy in DM staying loose for longer c) stronger trade through lower transport costs and a stronger DM consumer d) lower trade and fiscal imbalances in parts of EM. Other upside risks are a revival in Europe's credit multiplier, US spending becoming more EM friendly, the list of reformist EM countries expanding, and a resolution of the Russian situation.

Contents

We would like to thank **Mickael Sabet, Rohan Agrawal, Jayasankar Mallisetty, Manish Singh and Girish Gupta,** employees of Cognizant Group, for their contribution in preparing this report. Cognizant staff provide reasearch support services to UBS.

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"Glory days

Well they'll pass you by, glory days

In the wink of a young girl's eye, glory days

Glory days"

Bruce Springsteen

Top cross asset trades for 2015

(1) Long Taiwan v Indonesia equities. Long TWDIDR.

(2) Long USD against SGD and THB

(3) Long MYR v NZD

(4) Receive Korea 5y5y vs US 5y5y

(5) Long India local debt vs Turkey. Long INRTRY

(6) Long 10y Mbonos v Italian BTPs. Short EURMXN

(7) Long USDHUF

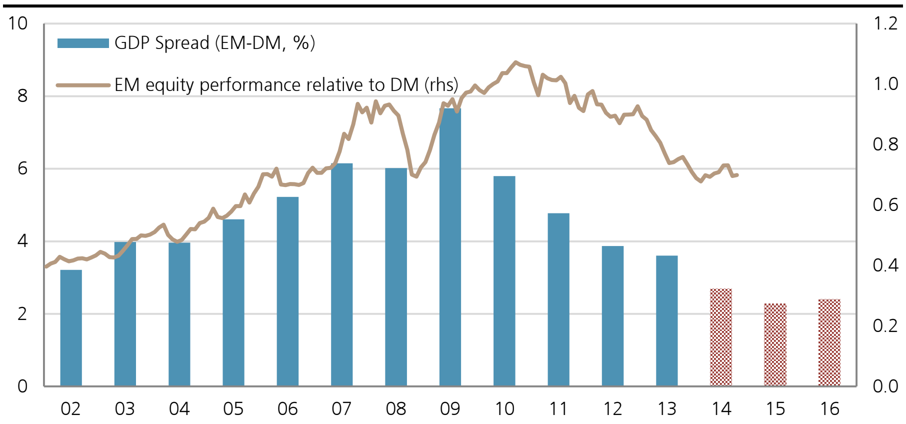
(8) Long Turkey CDS v Indonesia CDS.

(9) Receive Jan 17s v Short equities in Brazil

(10) Long Mexico equities vs South Africa. Long MXNZAR.

Pictures that tell the story

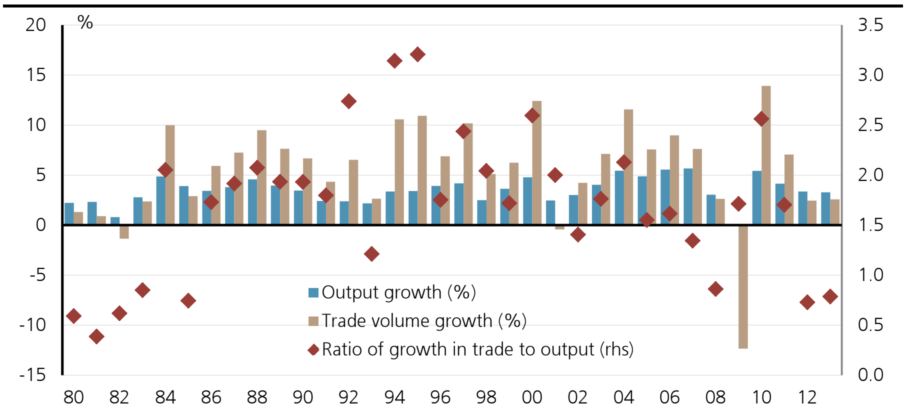
Figure 1: EM vs. DM GDP growth and EM vs DM equity performance



Source: Datastream, Haver, Bloomberg, UBS

Based on UBS growth forecasts, the alpha of EM growth over DM is unlikely to pick up in 2015. Equities are responding in tandem.

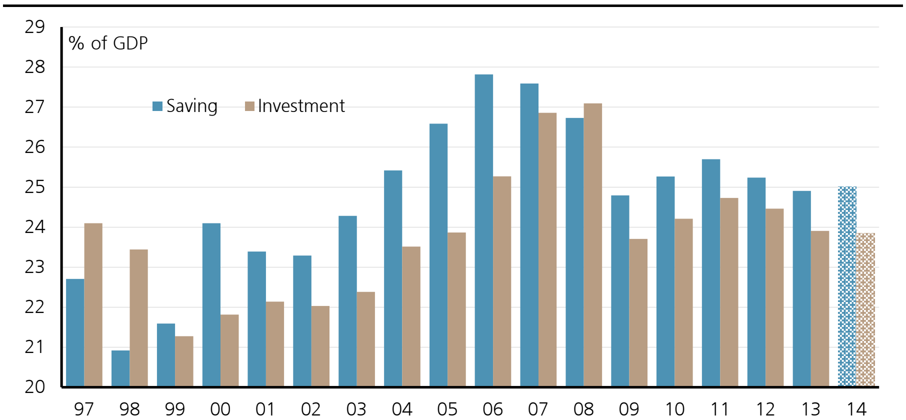
Figure 2: Global GDP and trade growth



Source: Haver, UBS

We think the multiplier of global trade to global growth has shifted lower. This has 3 main consequences a) weaker EM earnings growth, b) more depreciation in EM currencies, and c) over time, deterioration in EM fiscal balances

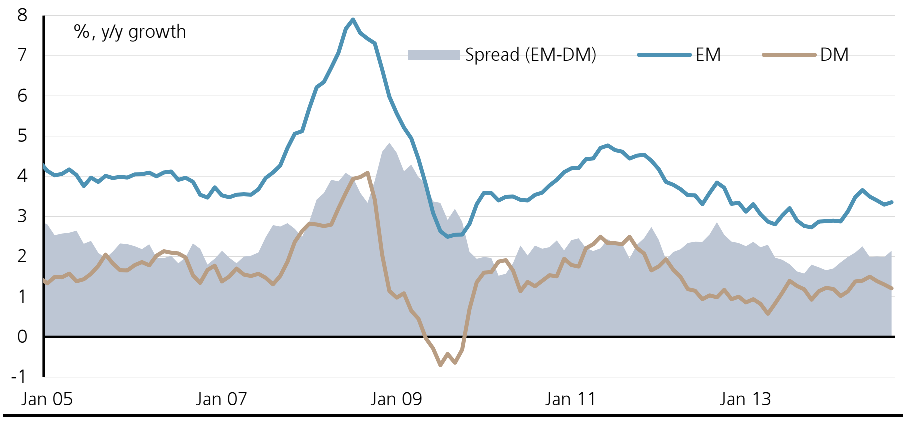
Figure 3: EM Savings and Investment (% of GDP), un-weighted average of EM



Source: Haver, UBS. Dotted bars represent IMF forecasts for 2014

The EM 'savings glut' has always been more of NE Asia story. At an aggregate EM level, savings and investment rates peaked with global imbalances around 2007, and in many countries like Brazil, South Africa and Turkey, they are now dangerously low.

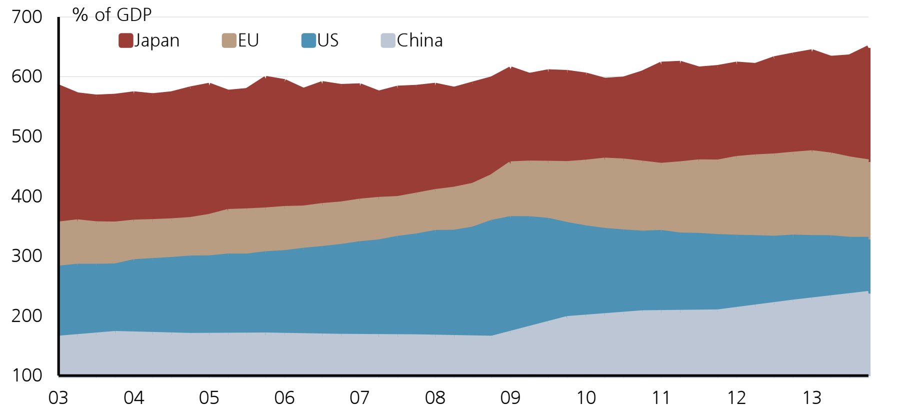
Figure 4: EM and DM inflation (y/y 6m trimmed mean)



Source: Haver, UBS

One of the big positives for EM today is well behaved inflation. We expect this will remain the case through 2015. The big decline in headline inflation lies in the 3-6 months immediately ahead; it should flatten out subsequently.

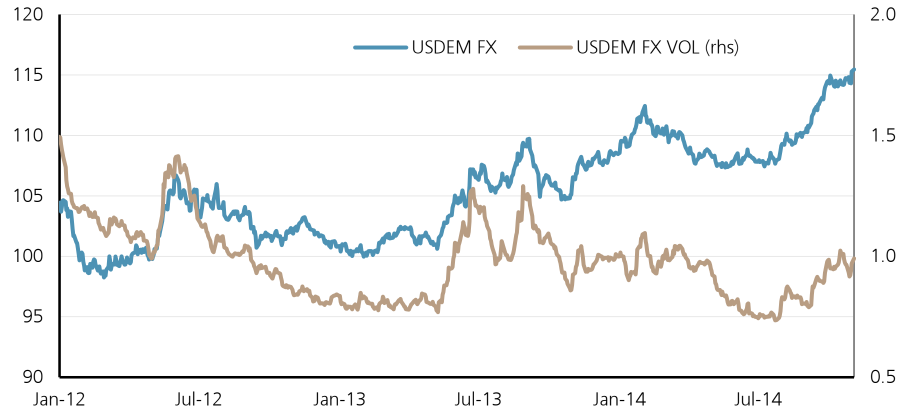
Figure 5: The debt mountain range: Total debt per country (% of GDP)



Source: Haver, CEIC, UBS

US is the only major region where debt to GDP has been coming off over the last few years. This also means that this is the region most able to cope with higher rates. A stronger US is a mixed blessing for EM.

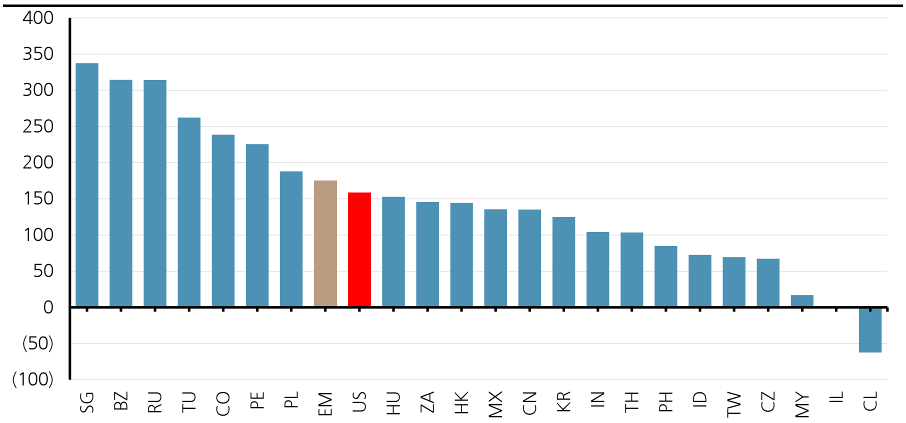
Figure 6: USD EM and USD EM volatility



Source: Bloomberg, UBS

EM currencies depreciated this year, for the most part in an environment of low volatility. Loose global monetary policy supresses risk premia and volatility, but fundamentals take EM currencies weaker. We think this divergence will be resolved by volatility rising. In 2015 we see USDEM rising by 3% on an MSCI EM weighted basis, and by 4% on a GBI weighted basis.

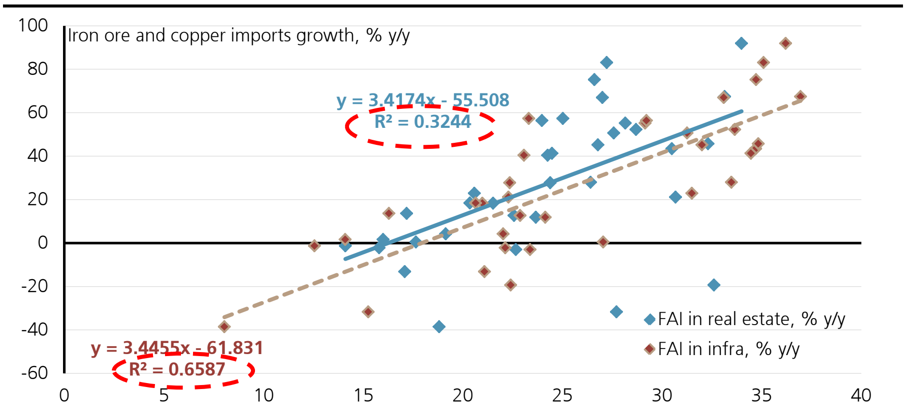
Figure 7: Change in 10y real yields since pre taper tantrum (April 2013)



Source: Bloomberg, Haver, UBS. EM represents GBI weighted. * denotes nominal yields deflated by 24m average CPI.

EM's real rates have increased since 2013, but not much more than in the US. EM spreads against the US are now in line with their median since 2010. That's exactly what it says on the tin – middle of the road, not too good to resist. Based on our view of a stronger USD and losses in duration, we think the EM local currency benchmark will give flat returns in 2015.

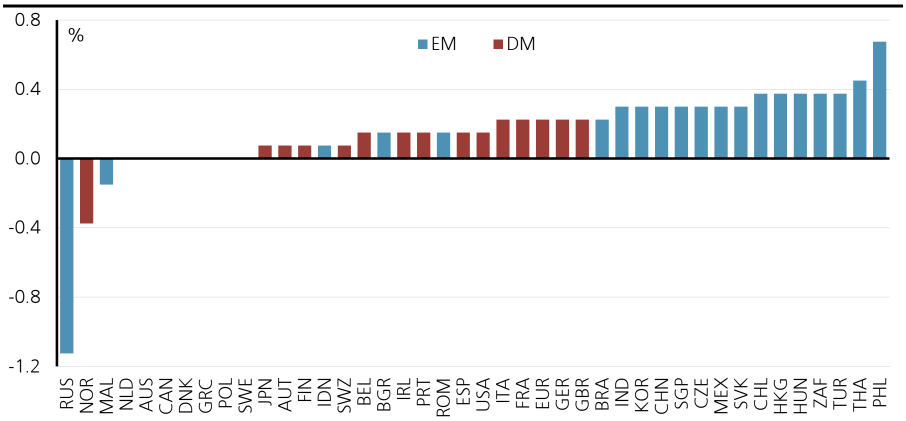
Figure 8: China: imports of iron and copper ore regressed on real estate and infrastructure investment



Source: Haver, UBS

Commodity import growth in China should come lower as China's growth model shifts away from investment to consumption. This chart shows that even within investment it is real estate spending, not infrastructure investment, that explains imports of iron and copper ore (look at the R squares). We expect real estate investment to remain weak. Commodities are unlikely to become a tailwind for EM, except, perhaps, oil.

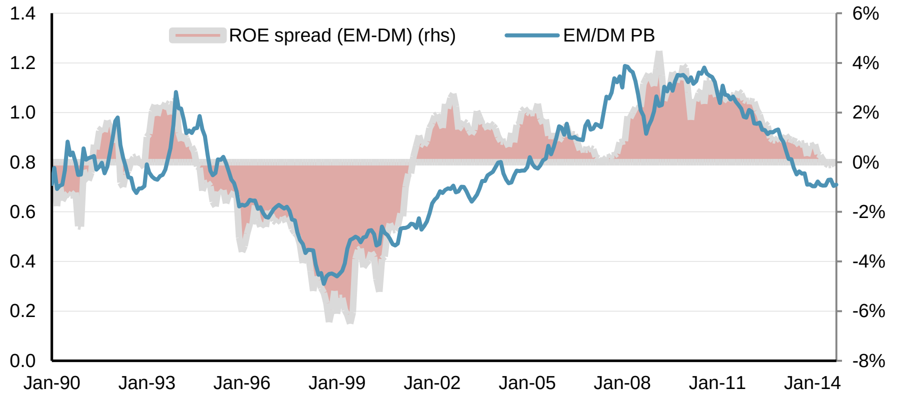
Figure 9: Impact on GDP after one year of \$15 decline in the price of oil



Source: OEF , UBS estimates This is a chart Andy Cates' report "Oiling the wheels", 29 Oct 2014

The biggest upside risk for EM assets is oil prices going lower. Other than lower inflation, the channels through which this can help are a) stronger global growth, b) monetary policy in the DM being able to stay looser c) stronger international trade through lower transport costs and stronger DM consumer d) lower trade and fiscal imbalances in parts of EM

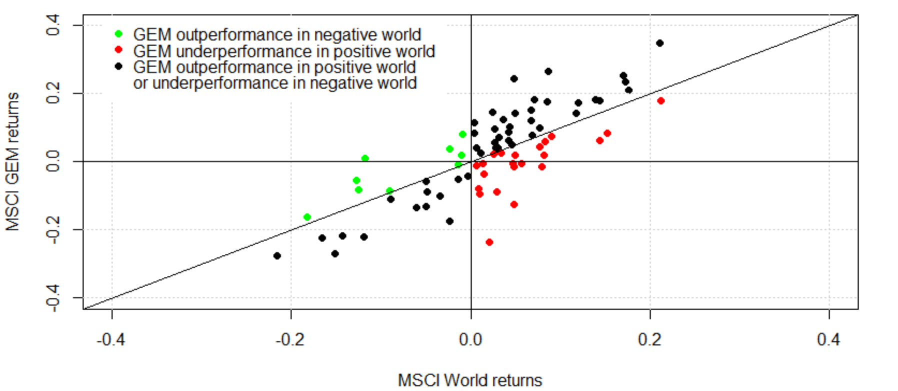
Figure 10: Trends in EM and DM relative equity valuations and relative ROE



Source: MSCI Datastream, UBS

EM equities have de-rated tremendously against DM but we don't think they've taken a step out of place. The de-rating must be seen in the context of decline in EM RoE relative to DM. We don't see EM stocks outperforming DM stocks next year. We expect 5-7% total returns in MSCI EM in 2015.

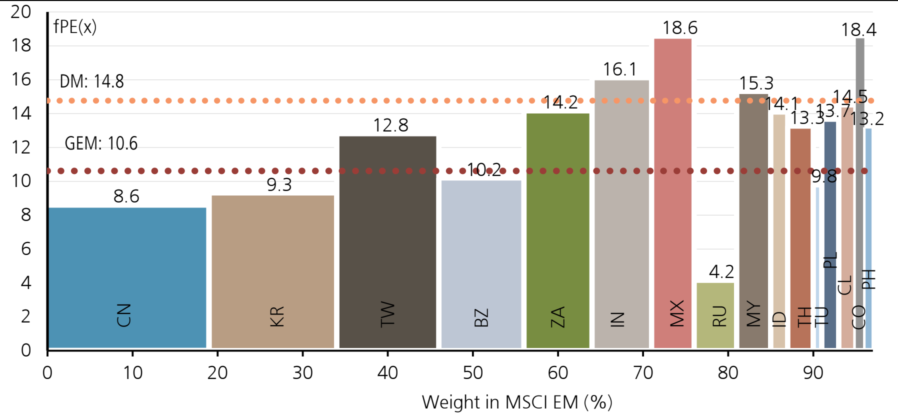
Figure 11: What happens if DM stocks fall: EM v DM quarterly returns since '96



Source: MSCI, DataStream, UBS

The black dots show periods when EM has outperformed in a world of positive DM returns, or vice versa- this is what one would expect from a high beta asset. The coloured dots show quarters of unexpected performance: Green dots show periods of EM outperformance in a world of negative DM returns, Red dots show EM underperformance in a world of positive DM returns. More evidence of red than green; an unfortunate asymmetry.

Figure 12: Country 12M Fwd P/E relative to MSCI EM and MSCI DM[1]



Source: MSCI Datastream, UBS

GEM is at roughly 10.6x forward earnings assuming earnings forecasts are correct, which they seldom are. More likely GEM is around 10.8x, which is in line with long term averages. There only a few markets which are cheap relative to the EM average – Russia, China, Korea, and, if you look under a microscope, Brazil.

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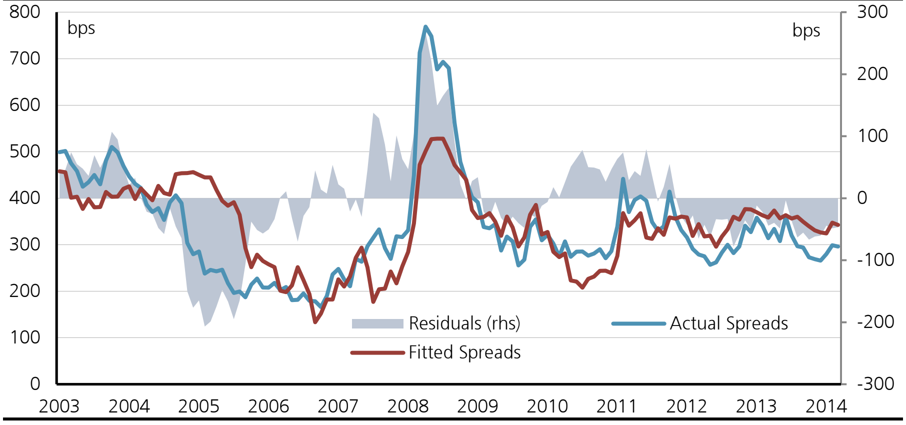
[1] Width of a bar in Figure 12 is proportional to its weight in the MSCI EM benchmark

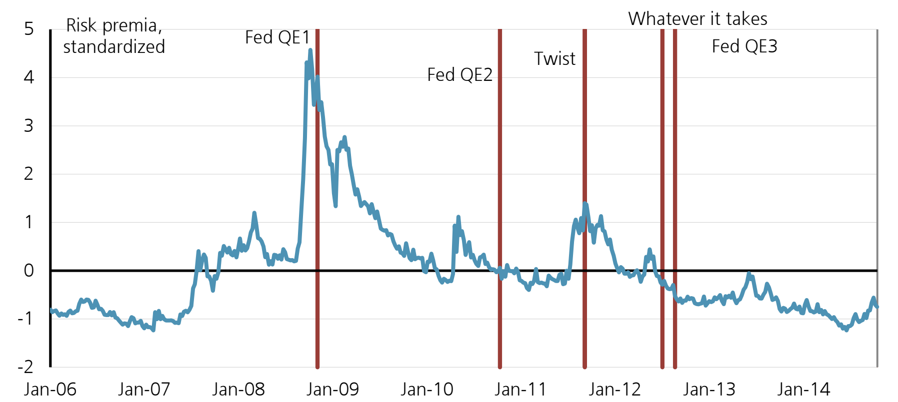
Figure 13: EMBI spread Model: Suggests spreads trade too tight by 50-75bps



Source: UBS

With EM macro balance sheets worsening slowly and commodity prices falling, the fair value of EM credit spreads is moving higher. Assuming risk appetite worsens from today's levels to the median of its long term distribution, sovereign spreads ought to rise by 75 bps. That move needn't be accomplished in one year though. We see sovereign spreads rising 30 bps in 2015.

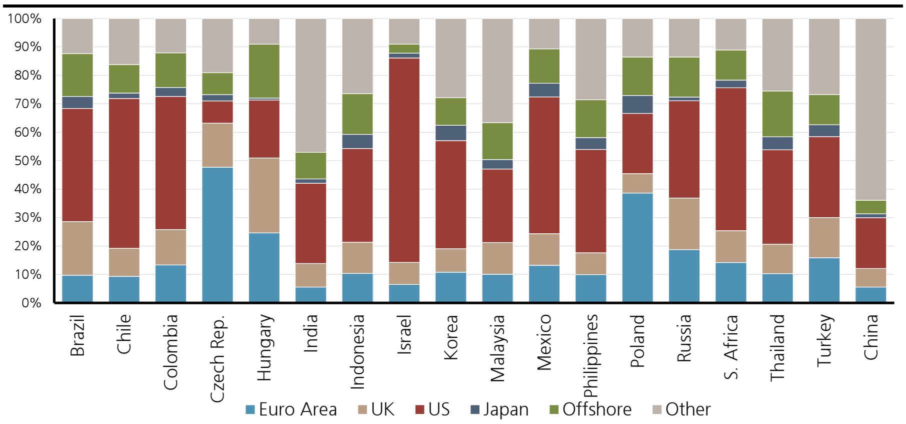
Figure 14: Evolution of risk premia: First principal component of risk measures[2]



Source: Haver, UBS

At the time of writing risk appetite is not as strong as it was in the middle of year, but in the context of its long term history, risk premia are still very low.

Figure 15: Who is responsible for inflows into EM: Holders of EM liabilities



Source: IMF CPIS, UBS

In this note we've dedicated a chapter to whether looser BoJ and ECB will make up for Fed tightening. We look at this issue from several dimensions. One amongst them is who the big investors in EM assets are. This chart shows that for most countries US investors are bigger than Japanese and Euro area investors.

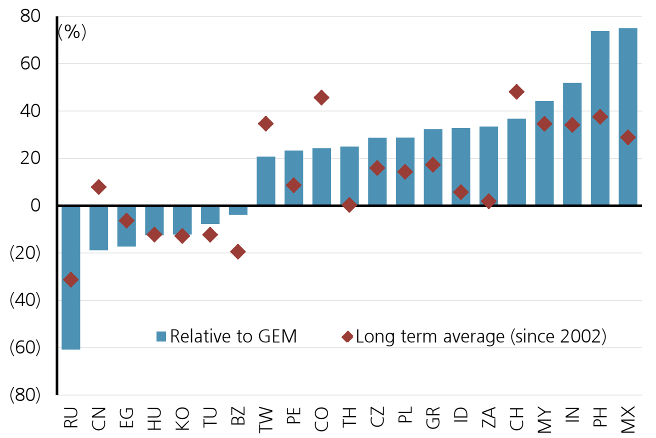
[2] The first principal component of US HY, EU HY spreads, MOVE Index, VIX, VDAX indices, AUDJPY, EURJPY and USDJPY 3M implied vol, US and EU 3m TED spreads

Top trades for 2015

Overweight Taiwan v Indonesia equities. Long TWDIDR

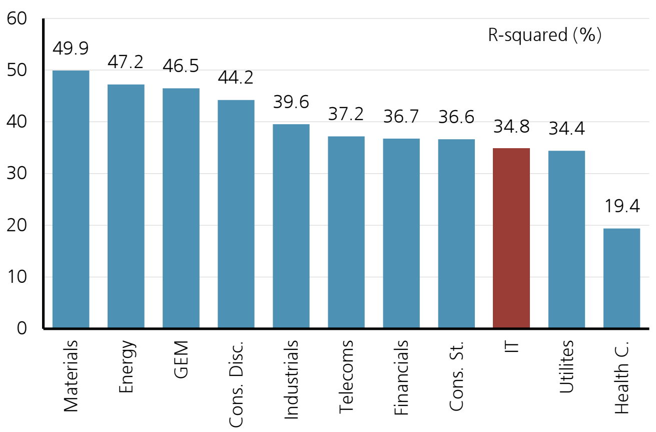
Since the crisis ASEAN markets have enjoyed a strong outperformance relative to GEM as investors have placed a hefty premium for domestic demand. While these economies are slowing, (with the exception of Thailand, which is likely to pick from a very low base) growth here will still be stronger than the rest of the world. There are two factors that have changed, however. First, the valuations are now very different than were in 2009. These markets do trade more expensive than the GEM average usually, but current valuations relative to GEM are way in excess of where they have been the past. Second, in most of these economies the quality of earnings has remained questionable as it has come on the back of a strong credit growth, which likely takes away from future earnings growth. In Indonesia, we have two added complications- the vulnerability of the bond market and currency to higher volatility in US yields, and the potential hit to earnings from a China investment slowdown through commodities. The trailing 12 month growth has been superior in Taiwan at 12.1%, and the market now expects a lower 8.3% earnings upside in 2015. In Indonesia the market is expecting earnings to pick up to nearly 12% in 2015 after the 12 month trailing growth has been only 7.8%. We think this will be a high bar to achieve within the context of a slowing Asia.

Figure 16: Forward PE relative to GEM: Latest and long-term average of this ratio



Source: IBES Datastream, UBS

Figure 17: Rsq* of GEM sectors to commodities



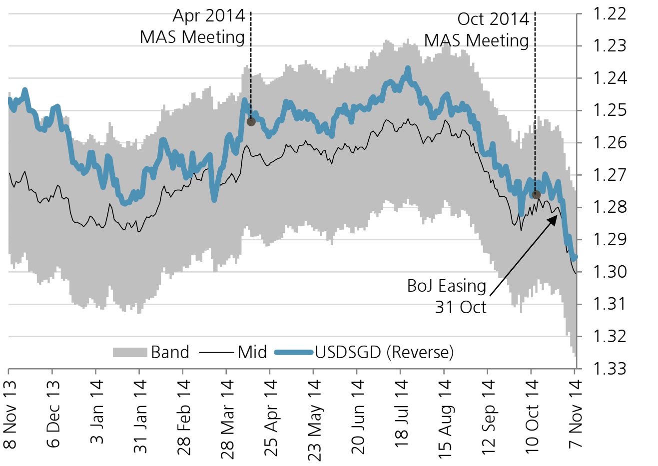
Source: Bloomberg, Datastream, UBS *Calculated on monthly returns in MSCI EM sectors and Bloomberg Commodity index

Valuations in Taiwan are clearly less demanding. On a 12m forward PE basis the premium of Taiwan over GEM is half of what it has been historically (Figure 16). The market has the disadvantage of being disproportionately exposed to one sector (IT) but this is an exposure that we do think makes sense; it has high sensitivity to the US business spending cycle and less so to commodities (Figure 17). While the USD will likely appreciate against the TWD along with other Asian currencies, we think the risks of volatility here are much lower than that in Indonesia.

Long USD against SGD and THB

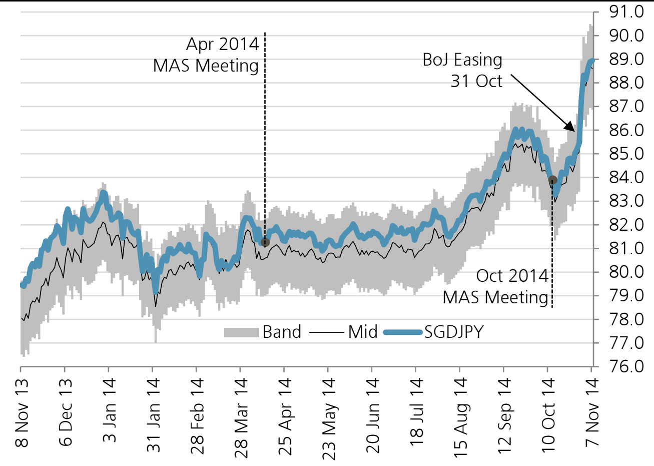
We enter 2015 tactically long USD/SGD, but believe this trade also makes sense for medium term investors. On a NEER basis, we estimate the SGD is still 0.3% stronger than the MAS NEER mid-point. Future SGD weakness may not be as rapid as that seen in late October / early November, but with no cost of carry, the SGD remains a 'cheap' vehicle through which to express views on weakening growth in China, rising US rates, and Singapore's maturing credit cycle. Our ASEAN economist Ed Teather is growing increasingly concerned that previously favourable feedback loops between credit, employment, property prices, household net worth and domestic demand may turn more vicious (see here for details).

Figure 18: Implied NEER band in USDSGD Terms



Source: Bloomberg, UBS

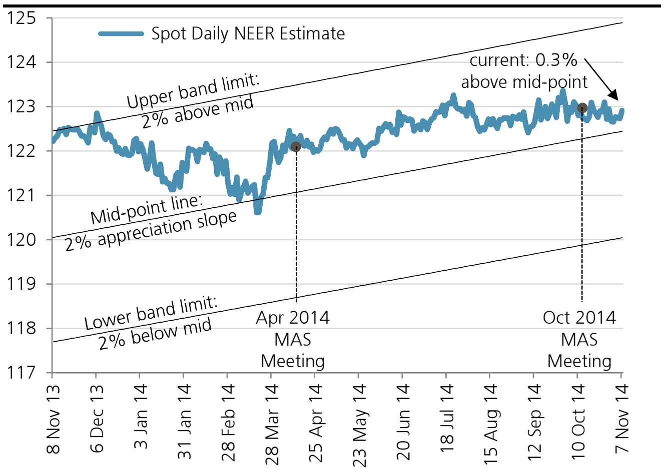
Figure 19: Implied NEER band in SGDJPY Terms



Source: Bloomberg, UBS

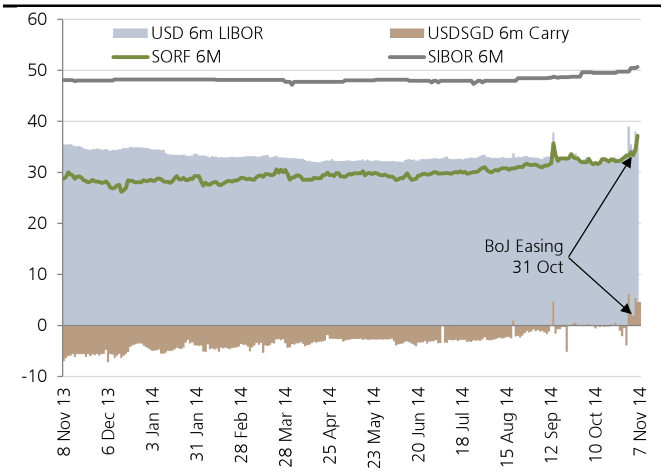
We expect additional SGD weakness against the NEER basket next year as a maturing credit cycle and cooling property market begin to dampen consumption and employment. We believe there is a high chance for an MAS NEER policy change in October 2015. In addition to headwinds from falling asset prices, we expect higher money market rates to put additional pressure on balance sheets.

Figure 20: Estimated MAS NEER policy band history



Source: Bloomberg, UBS

Figure 21: SOR Fixing, USD LIBOR and USDSGD carry (bps)

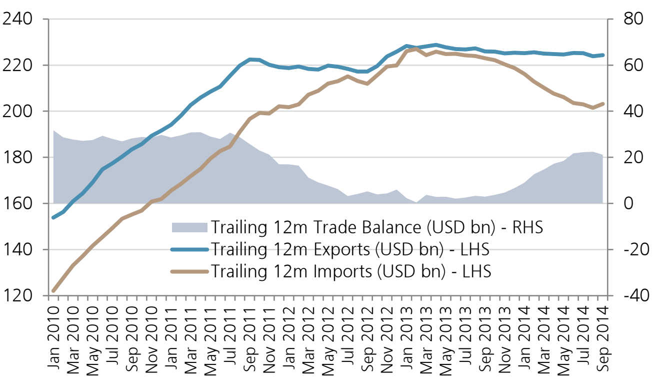


Source: Bloomberg, UBS

In addition to headwinds from falling asset prices, we expect higher money market rates to put additional pressure on balance sheets. Most mortgages are floating rate, and the benchmark Singapore Swap Offer Rate (SOR) fixing has already moved slightly higher as USDSGD has risen. The cash flow and discount rate implications for Singapore will likely be a drag on employment and the property market directly.

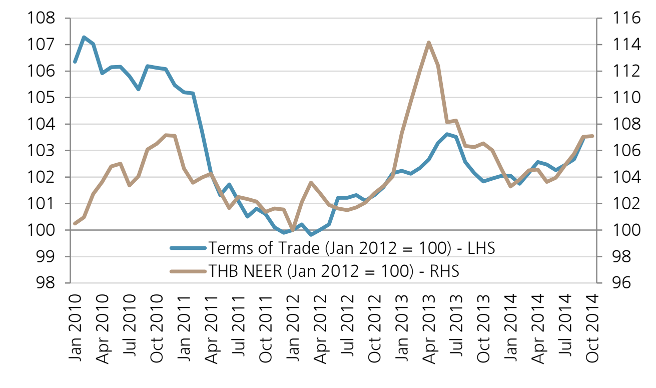
We look to add long USDTHB to our existing long USDSGD position. We think that THB is overvalued and is due for a correction, even if Thai growth from pent-up demand recovers. The cost of carry (1.8% annual implied carry) is higher than the zero-carry USDSGD position but is still low among Southeast Asian peers.

Figure 22: Thailand twelve month trade balance (USD bn)



Source: Haver, UBS

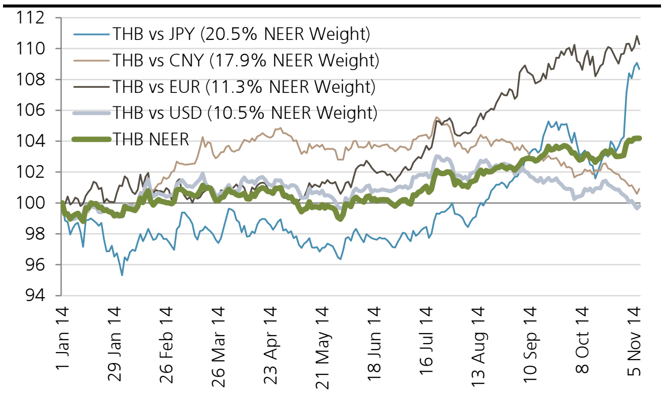
Figure 23: THB NEER and terms of trade



Source: Haver, BIS, Bloomberg, UBS

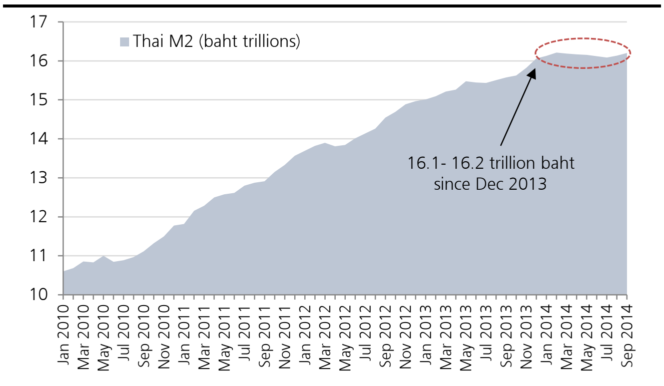
Thailand's recent trade surpluses are driven by weak imports since street protests began in November 2013. As such, an expected rise in consumption on pent-up demand will pull the trade balance back towards breakeven and potentially tilt the current account back into deficit, which should weaken baht. Strong baht likely contributed to lacklustre export growth since 2012, before political turmoil began. The terms of trade and THB NEER have been steadily rising as export growth slows. Year-to-date, baht is still 4% stronger than the BIS NEER basket and around 10% stronger against euro and yen. Bank of Thailand has not cut rates since January and money supply has not grown since December 2013. If the recovery continues to prove elusive, we think the central bank will have to change its conservative stance, potentially weakening baht. Therefore, we think a case for weaker baht can be made for an economic recovery as well as for continued economic weakness.

Figure 24: THB against major trading partners and NEER



Source: Haver, BIS, Bloomberg, UBS

Figure 25: Thai M2 money supply (baht trillions)



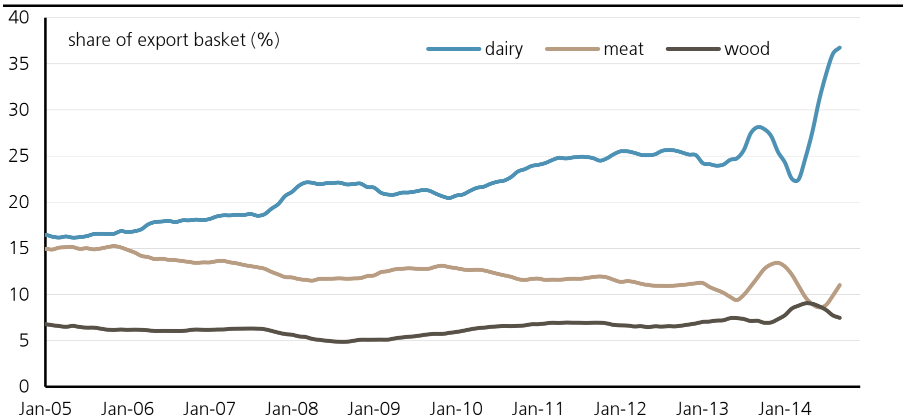
Source: Bloomberg, UBS

Long MYR vs NZD

Four rate hikes into a tightening campaign, and the RBNZ has taken a breather sooner than guidance indicated. The tightening bias remains, but it is implied now rather than explicit. So the key driver of NZD strength during the first half 2014 has faded, and the central bank is looking increasingly hesitant about the timing of its next move. In many ways a pause is justified. House price inflation has cooled - thanks in part to the introduction of macroprudential measures - and inflationary pressure more generally has been brought to heel too, recently coming in at just +1.0% y/y. The general decline in inflation is hardly unique to New Zealand, but rapidly falling milk prices this year (-50% y/y) have added a local element to this global theme.

The currency's downtrend against the US dollar is now well entrenched, helped on its way by a sudden blast of RBNZ FX intervention in August, but we think there is more weakness ahead. Milk remains New Zealand's largest export and, with US dollar-denominated commodity prices still falling virtually across the board, the scope for a strong rebound in milk prices seems limited. That's bad news for the terms of trade, and the hit to exports means the current account deficit is likely to widen sharply from here.

Figure 26: Top 3 Components of NZ's Export Basket



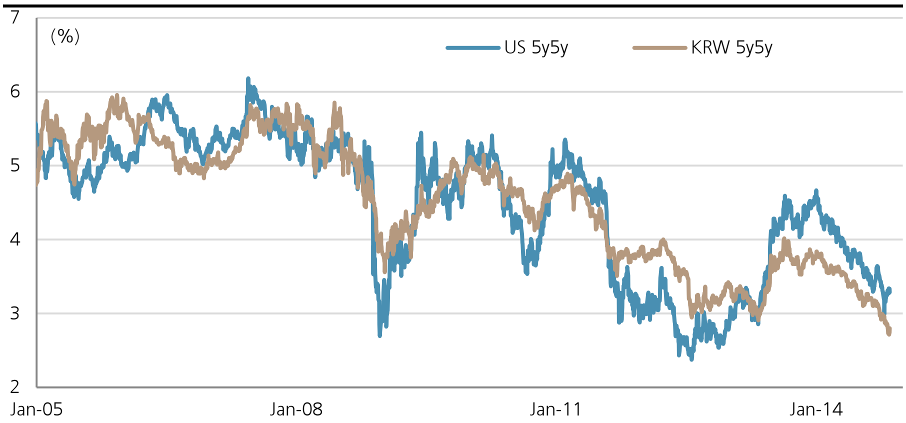
Source: Haver

Contrast that with Malaysia which still boasts a current account surplus (5.9% of GDP as of Q2-2014, 12m rolling), a rising share of which could be invested domestically as the EPF gets closer to the ceiling of its foreign asset allocation ceiling. Meanwhile with subsidy rationalisation continuing and the implementation of a Goods and Services Tax scheduled for April, the central bank is likely to push back against further potential setbacks to inflation expectations if the MYR sells off further. Worried about heavy foreign positioning in Malaysian bonds? Caution is certainly warranted here given foreigners hold c.46% of conventional MGS outstanding. But overseas investors are even more engaged in New Zealand where foreign holdings account for 66% of the NZGB market. If bonds selloff globally, or if FX hedges are applied, NZD is likely to suffer at least as much as MYR.

Receive Korea 5y5y vs US 5y5y

The outlook for Korean growth and inflation remains subdued, and the Bank of Korea knows it. We think the 50 bp of rate cuts administered since August are not enough to re-energise an economy already saddled with high household debt, and another cut will be needed next year. Meanwhile sovereign buying of Korean bonds continues, adding to downside pressure on KRW yields. The US leg of this trade insulates us against a climate of rising US rates as the Fed inches towards policy normalisation. We entered this trade on October 13th at a spread of -29bp, with an initial target of -70 bp but we think it still has some juice left in it, and we aim to hold it into 2015. For a fresh trade entered today, the roll down costs 1.25 bp per quarter.

Figure 27: KRW 5y5y and US 5y5y



Source: Bloomberg, UBS

Long India local debt vs Turkey. Long INRTRY

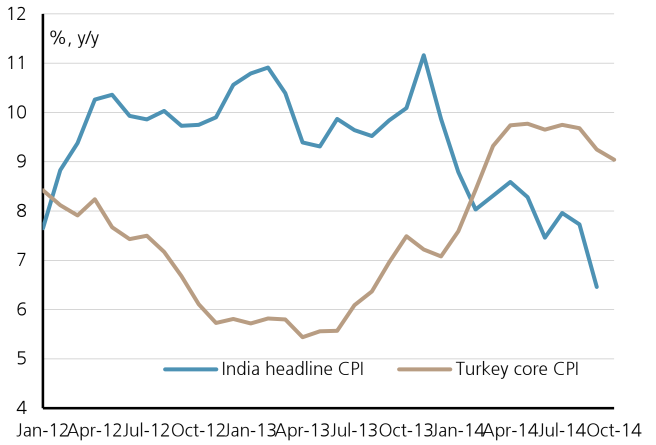
Despite Turkey's exceptionally low savings rate, dwindling primary surpluses ahead of next year's election, and weak track record of inflation targeting, 10y real yields continue to trade significantly below the GBI-EM average, and indeed below their average historical discount. The yield curve is relatively flat, implying that the CBT has been successful in communicating to markets that current inflation overshoots are primarily due to food prices and the lagged impact of TRY depreciation which is unlikely to be repeated. We believe the CBT and markets are engaged in a somewhat dubious equilibrium, whereby the CBT is reluctant to raise rates until long term yields rise, while markets are reluctant to punish the back end believing that the CBT's inflation targeting mandate will ultimately come through. This equilibrium is a fragile one, in our view, that may be tested by rising US rates. Though inflation has almost certainly peaked in Turkey, CBT's dovish policy stance, complacency on the 2015 inflation target and absence of meaningful policy reform (that seems likely to persist into the July 2015 parliamentary elections and likely constitutional amendments thereafter) should limit the ability of the back end to go much lower, in our view.

At broadly similar yield levels, we see Indian bonds, supported by commitment to tighter and better targeted fiscal policy and a more hawkish central bank, as far better supported than Turkey's (note that foreign quotas for long-dated Indian bonds are fully utilised and that different withholding tax rates apply to interest income earned from Indian Government Securities, depending on investor type

and country of origin). Disinflation continues to be the main component to our outlook on lower Indian yields, with fiscal consolidation as additional upside. RBI monetary stance, government policies and lower oil prices should bring headline CPI in close to RBI's de facto 6.0% target within two years. The signs are positive – September's CPI reading of 6.46% is near target, but it's still too soon to declare victory. RBI will take a cautious approach before easing policy and monetary policy will lag inflation readings. As such, our view on India bonds is not a short-term bet on rate cuts; rather it is a medium-term view on lower inflation, supported by a credible central bank and coordinated government policy.

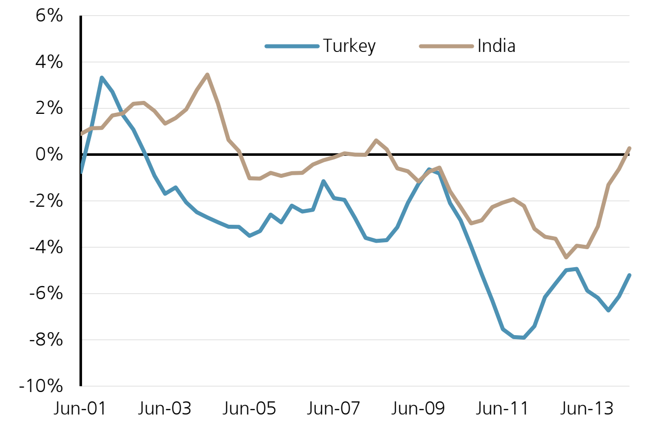
Fiscally the signals have been positive, though the market awaits further details. More concrete action towards budget consolidation, specifically fuel subsidy reductions, would be necessary. India's fiscal position has been a historical credit weakness (India has high government debt to GDP among similarly rated peers). The recent upgrade in outlook by S&P (from negative to stable) brings its rating in-line with other agencies, taking India to stable outlook across all three low-BBB ratings, making India an attractive case in EM BBBs.

Figure 28: Inflation, % y/y: India vs. Turkey



Source: Haver

Figure 29: Basic balances (% GDP). Who's improving?



Source: Haver

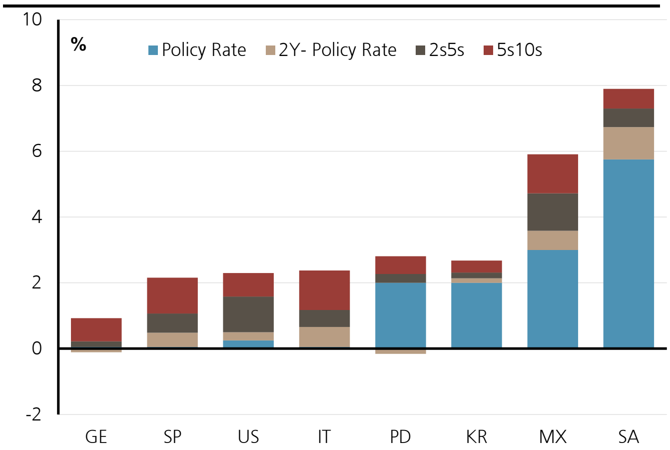
Long 10y Mbonos vs Italian BTPs. Short EURMXN

Mexico is likely to begin 2015 with a very attractive growth inflation mix. Manufacturing exports are doing well, private investment is improving, the disappointing impact of public investment will turn around in H1 ahead of the midterm elections. 2015 is the year where actual inflows from the energy and telecom reforms begin enter. Meanwhile inflation is likely to fall sharply from 4.3% currently to 3.4% in 2015. This is on account of base effects (after this year's tax reform), lower gasoline prices and softer food prices. Our Latam chief economist, **Rafael de la Fuente** doesn't expect Banxico to move before the Fed. If and when Fed and Banxico do move, we think the very steep gradient of the Mexican curve, and a healthy cushion against US yields will limit the move on the 10y part of the curve.

In 2013 Mexican yields much more aggressively than US yields did but that was because the UST move was unexpected and violent. Interestingly, Mbonos retain that yield premium that they built up last year – at about 360 bps higher than US

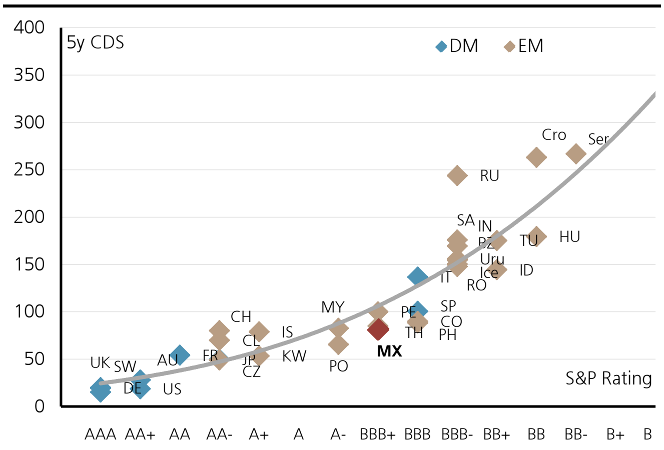
yields, the spread of Mexican 10y bonos trades right in line with the median of long term distribution.

Figure 30: Gradient decomposition in key bond markets



Source: Bloomberg, UBS

Figure 31: Credit rating & spreads: MX lower risk than IT



Source: Bloomberg, S&P, UBS

Against the MBonos position we recommend investors in global bond portfolios hold an underweight position in Italian bonds. While Mexican spreads are wider by 100 bps against USTs since just before the taper tantrum, Italian spreads over US have converged by 250 bps through this time. The most common push back from investors on a negative view on BTPs is the potential for ECB buying. At UBS, while we do expect the central bank will slowly expand its balance sheet by EUR 1 trl , we don't believe this will involve open ended buying of government bonds. Both asset allocation and European strategy teams at UBS believe that the peripheral rally doesn't have much further to run. **Justin Knight**, UBS' European rates strategist believes that for now Italian spreads against the Bund can remain in a 135-185 bps range. However, beyond the middle of next year Justin expects the bond spreads in the European periphery, including Italy, to widen out as concerns about debt sustainability return. In 2016 Italy may become the first peripheral country to be subject to the debt reduction clause of the Fiscal Compact. We will also watch what signals we get from Italian politics at the regional elections in March.

Briefly drilling down into the details of this the Mbonos v BTPs trade, we find that using both trailing and expected inflation, Mexico provides a better real yield than Italy. Also, in Italy this real yield constitutes credit risk. The CDS spread on Italy is much wider than in Mexico, but is not it is not out of sync with credit ratings. We don't see any change in credit ratings in Mexico next year, but we do see downside risks for Italy. Netting out inflation and credit risk (though these are not mutually exclusive) Mexico has much more left on the table than does Italy. This is today. As we said, the trajectory of public debt implies much higher risks for Italy in the future.

We express this trade unhedged for the currency. We see the MXN as very modestly undervalued. Meanwhile the EUR remains the key tool of transmission of looser monetary policy for the EUR. Note that today positioning in MXN is probably at its cleanest level in 6 months.

Long USDHUF

We retain a long USD/HUF recommendation in 2015, a trade that gives investors a high beta exposure to continued EURUSD downside and/or stalling gains in peripheral European fixed income, while encapsulating some interesting localised themes in Hungary.

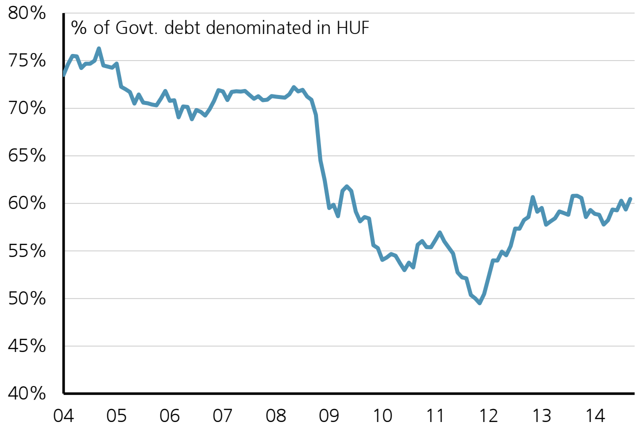
First, the carry on long USD/HUF positions has declined to 1% annualised, down from nearly 5% in 2012 as the NBH has eased policy aggressively. This decline in carry offered to FX investors has taken place despite Hungary's public debt and external debt/GDP metrics remaining more comparable with EM's high yielders. As inflation is set to accelerate next year as the impact of large utility price cuts fall out of the base effect, real policy rates are set to turn negative. It will be interesting to see how quickly the NBH, which has clearly taken on a more dovish disposition in recent years, is prepared to tighten policy, especially if growth in the Euro area remains weak. The NBH has signalled that it will preserve policy rates at 2.1% until the end of 2015. We think that faced between raising rates or allowing the currency to weaken, policy makers would lean towards the latter (more on this below).

Second, our economists expect growth to weaken from around 3.1% this year to 2.2% in 2015 as certain one-off impacts subside and fiscal policy is unable to loosen further (without putting Hungary in jeopardy of rejoining the EC's Excessive Deficit Procedure).

Third, the current account surplus is showing signs of peaking, at a time when there has been no clear evidence that the private sector (especially banks) are willing to start levering up anew, a legacy of high taxation and significant policy uncertainties.

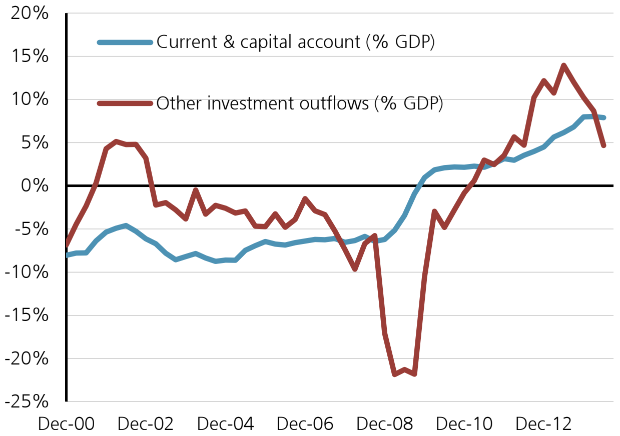
Most importantly, however, our concern for the HUF stems from a likely declining sensitivity among the public and household sectors to a weaker currency. The government's recent decision to go ahead with the conversion of the entire FX retail mortgage stock into HUF will make household balance sheets far less sensitive to future FX depreciation. Meanwhile as the government issues more in local currency debt, it will also become less vulnerable to a weaker HUF (particularly after the December 31 public debt fix, which is used for the calculation of the public debt stock).

Figure 32: Government financing is increasing denominated in local currency



Source: Haver, UBS

Figure 33: Hungary BoP - deleveraging continues to compromise support for the HUF



Source: Haver, UBS

Long Turkey CDS v Indonesia CDS

We continue to see a strong fundamental rationale for this trade and carry it over from last year.

In Turkey, while all asset classes have enjoyed some respite following the emergency rate hike at the beginning of the year, macro vulnerabilities remain significant. Core inflation remains extremely far from the central bank's inflation target, at a time when the currency remains vulnerable, yet the CBT has shown reluctance to tighten any further. Turkey is also much more vulnerable than EM peers to FX depreciation, as a result of the sizable FX mismatches in the corporate sector, which are not fully hedged out, in our view. The high level of short-term external debt (relative to reserves) keeps the economy highly procylical to capital flows. Should the end of Fed QE start translating into less flows into EM, Turkey would find itself in a particularly vulnerable position. In the medium term, a key macro issue we feel remains underappreciated is that of a potentially large credit misallocation issue (see here). Since 2011, credit to GDP has risen from 48% to 67%/GDP, whereas private investment has fallen from 23% to 19%GDP. We believe this may reflect borrowing to service existing debt (as oppose to fuelling investment), and may reflect Turkey's leverage tipping point arriving sooner than most expect.

Along with the these structural issues, parliamentary elections in Q2-15, uncertainty around the succession of economic personnel, and continued geopolitical risks also skewed risk / reward towards further weakness, in our view.

In Indonesia, while we accept that reform momentum is likely to be slower than pre-election euphoria might have suggested, we still expect fuel subsidy reform by Q1-2015, that is likely to alleviate rating agencies' concerns on fiscal vulnerabilities. The central bank has been more successful in containing core inflation.

We enter this trade at a -35bps spread. This trade has returned +90bps this year.

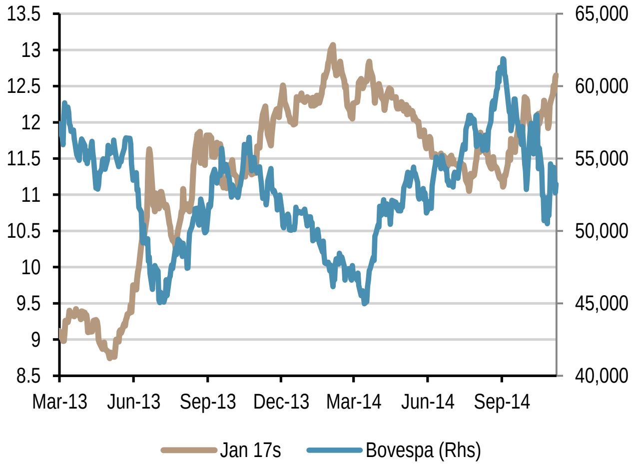
Receive Jan 17s v Short equities in Brazil

Brazil faces a tough year in 2015. Inflation will be high and growth will not recover. The Central Bank has started a new hiking cycle which the market is generously pricing in, 185bps in 12m. Our Brazil economists think the CB will stop at 125bps to get the Selic rate to 12.50%.[3] This is reasonable given expected inflation and especially considering that the economy is not starting out from an overheated state. We think the government wants to show resolve to combat inflation, but it also does not want to worsen the ongoing economic contraction. The slowing demand and widening output gap should get help the CB's efforts. Falling oil prices will temper the domestic fuel price increases needed.

Regardless of the composition of the next economic team, growth will not appear magically. Policies are going to be contractionary and equities negative. UBS forecasts GDP to grow 0.6% in 2015 on account of slowing investment and consumption. But risks to growth will also come from the looming energy and water crisis due to extended droughts. The government has already recognized that it will not meet the required fiscal targets necessary to keep public debt on a stable path. Our economists built into base case for 2015 outlook a one-notch credit downgrade (i.e., not lose investment grade, yet). Brazil will be negatively affected by falling commodity prices which also hits an important chunk of the index. All told, we think that many in the market are likely to be disappointed again by the 'new' economic policies which we expect to continue a gradualist approach. Additionally, Brazil's equities are not cheap to its own history and we see little reason for them to attract investors before it cheapens more. Hence we think there is the risk that Bovespa tests 2014 lows.

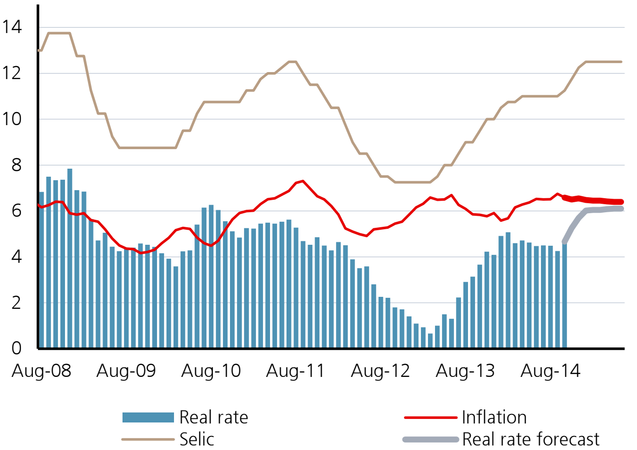
We think the DI curve will remain slightly inverted and we see the belly remaining roughly anchored as the front end adjusts to the hiking cycle. At 12.65% we like the risks, which would be mitigated by equities selling off. We also premise our expectations that USDBRL will continue to follow a BCB managed depreciation path, which at the moment forwards are slightly overstating in our view.

Figure 34:Brazil : Jan 17's vs Bovespa



Source: Bloomberg and UBS

Figure 35: Real policy rate rising to contractionary levels



Source: Haver Bloomberg and UBS

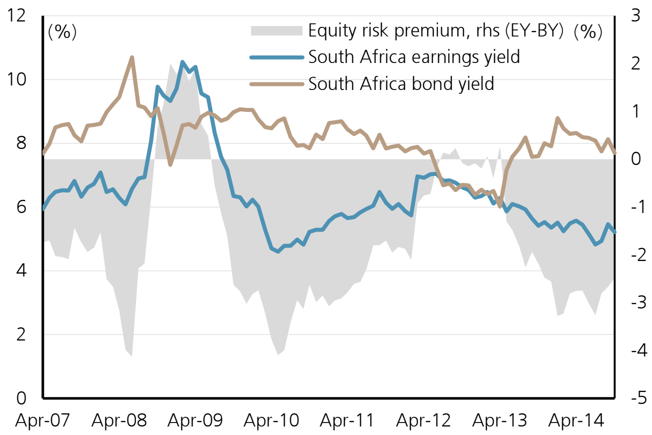
[3] UBS's Latin America Economic Outlook 2012-16.

Long Mexico equities vs South Africa. Long MXNZAR

The gist of this trade is being long a market where earnings are the variable that responds more to an improving US economy compared to another where the cost of capital does the responding to a healthier US.

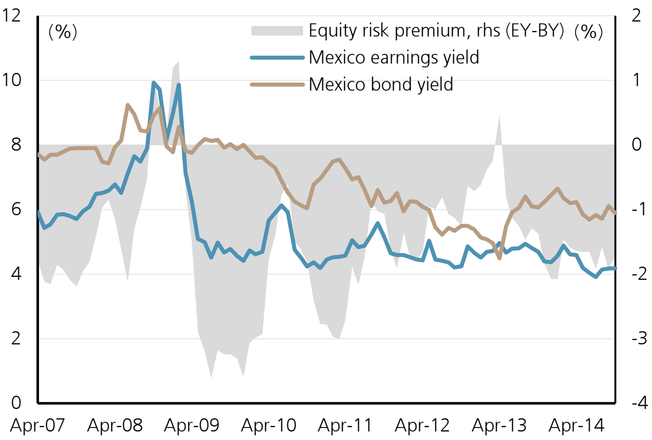
South Africa's earning exposure is to Africa, Europe, China, and of course to South Africa itself, more than it is to the US. These are regions that are likely to see very modest improvements in growth (China is in fact going to slow). By contrast we expect both US and Mexican growth to improve strongly over the next two years. As US growth improves both Mexican and South African rates are likely to push higher, but owing to the much lower savings rate in South Africa, the risk of volatility in the currency and rates is high in South Africa.

Figure 36: S Africa earnings yield, bond yield and spread



Source: MSCI Datastream, Bloomberg, UBS

Figure 37: Mexico earnings yield, bond yield and spread



Source: MSCI Datastream, Bloomberg, UBS

This is a trade we are carrying over form our top trades in 2013. This trade did well for us, but largely because of the FX gains in MXN relative ZAR. On the stock markets itself Mexico returned only 2.5% higher than South Africa (some of which would also be compromised by a higher dividend yield in South Africa). The trailing 12m earnings growth is close to zero in S Africa but is -6% in Mexico. But now as the Mexican economy is clearly picking up domestically and exports too are improving, one should expect a decent earnings turnaround. To be fair, the market does already believe this will happen, and has paid a higher multiple for it. On some measures Mexico is now the most expensive GEM. We certainly don't like this market as a standalone from a valuation perspective, but note that South Africa is not much further behind.

In both countries individually debt ought to be the preferred asset class, but a simple proxy for the equity risk premium (earnings yield minus bond yield) is more negative for South Africa than it is for Mexico (Figure 36 and Figure 37).

Overview of EM Asset Calls for 2015

Overview of EM asset calls for 2015

Bhanu Baweja

Since the crisis we have characterised EM as having reasonably strong macro balance sheets but very weak macro income statements.

EM doesn't have the fodder a crisis breeds upon- large funding liabilities

EM balance sheet strength derived from their aggressive deleveraging and build-up of FX reserves post their own crises between 1997 and 2003. Although EM balance sheets have deteriorated considerably since, it is primarily because internal leverage has increased. Given that most of EM debt has been refinanced away from hard currency to local currency, and that EM still has considerable hard currency reserves, a big external EM crisis is unlikely. An EM blow up typically feeds on external funding liabilities, and EM doesn't have too many.

But the EM growth machine is creaking badly. It will take more than a regular service to get it back on the road

Equally though, EM just doesn't seem to have a plan B to resurrect its growth. Exports remain depressingly weak not just because of weak global growth, but also, we believe, because the multiplier of global trade to global growth has flattened out after rising for 20 years. For a good while after the crisis, this weakness in the external sector was camouflaged by strong credit and wage growth in EM. But currency markets are in silent rebellion now, and it is unlikely that this model can continue without flaring things up. This may mean that fiscal pumping is the next gear to be engaged. Even so, without strong reform it's not clear where the genesis of the next growth surge in EM will come from.

The swampland of 'muddle through'

So the answer is reform. But what drives reform? Well, in all honesty, a crisis does. Sometimes strong growth does the job. Very rarely is reform attempted in swampland of 'muddle through growth'. Welcome to EM's Catch 22.

No trigger for a blow up. No ideas for growth

This is a serious problem. Not just because this will mean today's issue festers for much longer, but also, and we are very practical people, because it is just very difficult to trade successfully while one is this swampland. Should one pay the carry and buy volatility in every asset class, looking for that blow up. Er… no, developed central banks stand ready to add more liquidity, and what will make EM blow? China owes money to itself, you recall, not to hedge funds registered in Cayman Islands. Well then, should one sell developed market assets and get long EM. Uhhm… no again!. Investors come to EM, first and foremost for growth, not for protection from high volatility, and growth is where EM has completely and utterly run out of ideas.

This doesn't end well, but we all know that

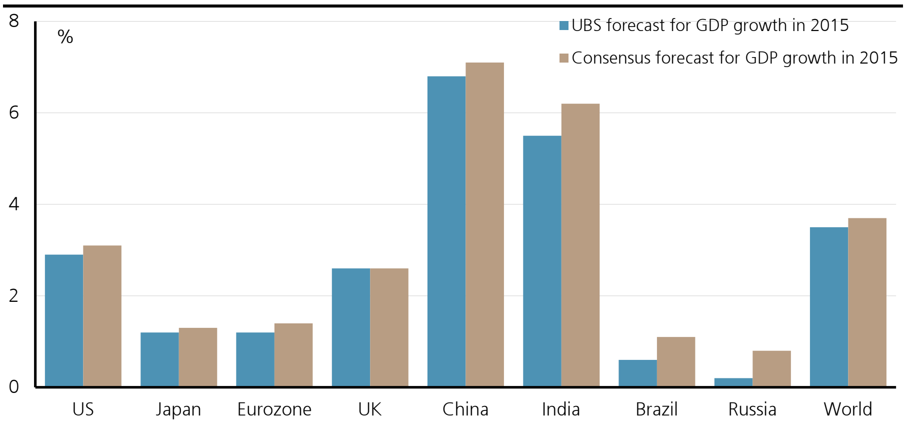
Over time bad income statements do contaminate balance sheets as well. Over time the global risk free rate should also rise. Both these developments point to what most of us already know- that this story doesn't end well. 2015 will very likely be much more challenging for EM than 2014. Even if we don't see huge blow ups, there will be plenty of low intensity conflicts. Beta isn't going to help EM assets much; this is where all of us need to look for pure alpha. A tough proposition, no doubt, and we are as nervous as you. Here is our best shot at it.

- 2014 is turning out to an under-whelming year for EM assets. 2015 will likely not be much better.
- Within the context of very low returns overall we think EM equities will outperform EM debt.
- Given headwinds from a likely duration selloff and a strong USD, we expect local currency debt benchmarks to deliver flat returns next year. Hard currency sovereign debt should deliver 1-2% returns. Sovereign spreads will likely widen by 30 bps and corporate spreads by up to 50 bps.
- EM equities will likely deliver 5-7% total returns all which will be made up for by EM earnings. We expect EM earnings to be sub consensus again in 2015, and come in at around 7%. Were it not for micro improvements at a company level and lower oil prices EM earnings would likely be even lower.
- EM FX is likely to lose 3% against the USD on an MSCI weighted basis, and about 4% on a GBI weighted basis

Modestly stronger DM growth

We start with our macro base case. UBS global economists **Larry Hatheway** and **Andy Cates** expect global growth to accelerate modestly from 3.3% in 2014 to 3.5% in 2015. The US and UK are expected to remain the clear leaders, posting 2.9% and 2.6% 2015 growth (Figure 38). Loose monetary policy, low inflation and only modestly tighter fiscal will likely support steady growth of 1.2% in the Eurozone. Japan will grow modestly at 1.1%. Overall growth in advanced economies will pick up from 1.9% this year to 2.3% in 2015, they believe.

Figure 38: UBS growth forecasts and consensus



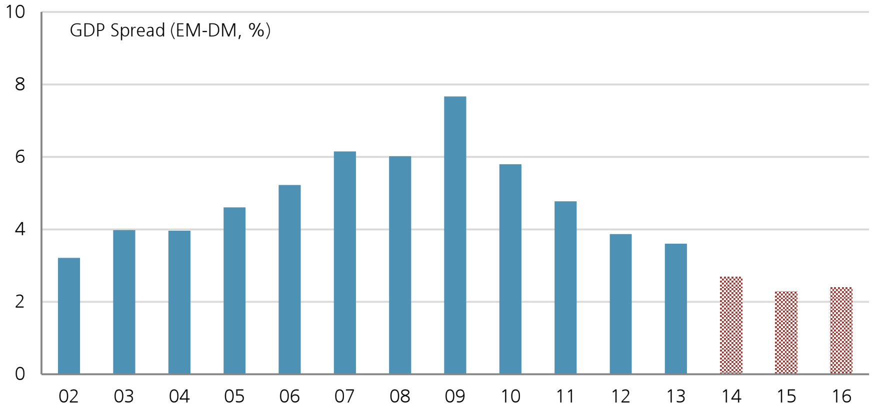
Source: UBS

Modestly weaker EM growth

EM economies are seen growing at a modestly slower pace of 5% in 2015[4] compared with 5.2% in 2014. Chinese growth slips to 6.8% next year and further to 6.5% in 2016. LatAm and EMEA are likely to grow modestly stronger after a very challenging 2014, but will not push the needle higher for EM as a whole.

[4] These growth numbers use new PPP weights (from the IMF) to aggregate individual country GDP into regional and global averages. Using these new weights the trajectory of global growth has been pushed up relative to that seen under the old weightings.

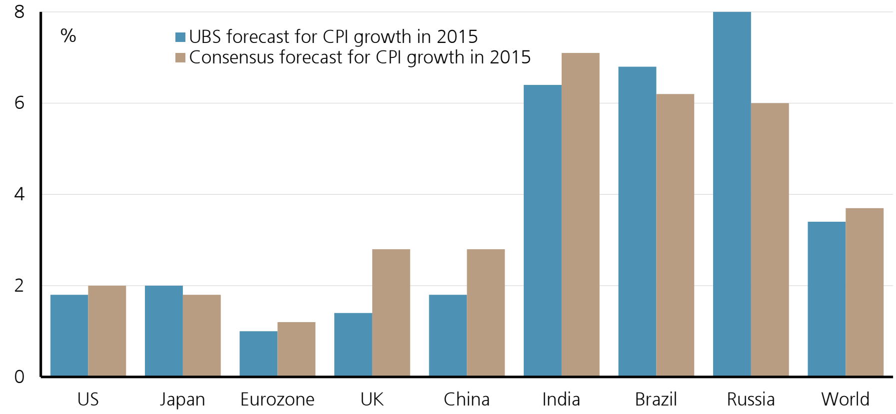
Figure 39: EM growth spread over DM: Alpha of EM GDP down to 2002 levels



Source: Haver, Bloomberg, UBS

The growth spread between EM and DM is likely to come lower next year. An unusual degree of decoupling between developed and developing economies characterise UBS' global growth forecasts for 2015 and 2016 (Figure 39). This de-coupling reflects the uneven global recovery, characterised by domestic demand autonomy in the United States, a clear slowdown in China and other parts of the emerging complex and the ongoing cyclical, structural and policy impediments to strong growth in Europe and Japan. Moreover, global trade growth will also remain subdued relative to global GDP growth for cyclical and structural reasons[5].

Figure 40: UBS inflation forecasts and consensus

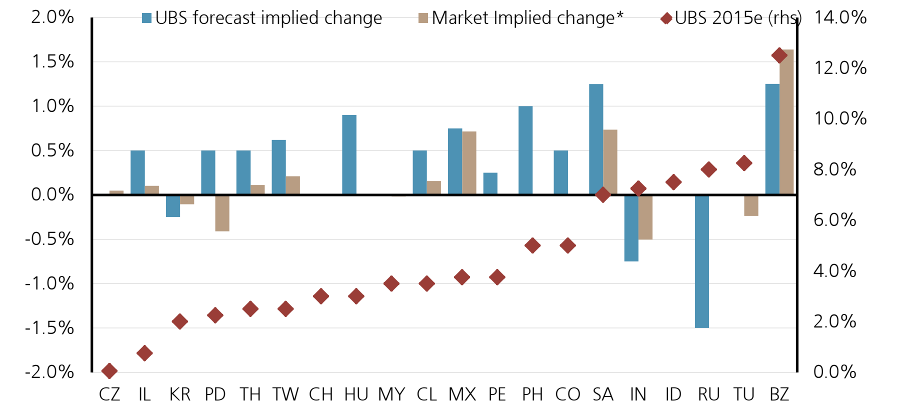


Source: UBS

UBS' 2015 growth base case is modestly below the global consensus. This is also so for UBS's inflation forecasts wherein our economists expect US inflation to rise to 1.8% and, importantly for Eurozone inflation to move higher from the zone implying deflation threat to 1.1% (Figure 40).

[5] See Video: Structural elements of the slowdown in global trade

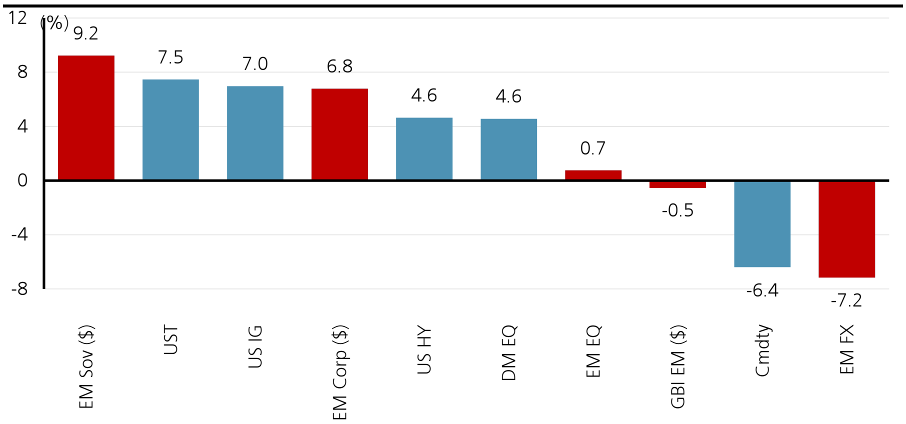
Figure 41: UBS interest rate forecasts for 2015 vs what the market is implying



Source: Bloomberg, UBS, *over next 12 month

UBS' US economist **Maury Harris** expects the Fed to raise rates by 125 bps next year. The 10y rate is likely to push towards 3.50% by the end of 2015, a parallel (and large) shift higher in the US yield curve. The 10 y bund is seen ending 2015 at 1.9%. The difference in the front end interest rate differentials between the US and the rest of the world will push EUR and JPY weaker against the USD to 1.20 and 115 respectively.

Figure 42: Year to date performance across EM and DM asset classes



Source: Bloomberg, DataStream, UBS. Pricing as of 07-Nov-14

Fixed income: A year to keep ambitions low

Local currency debt: Yet again, FX will spoil the show

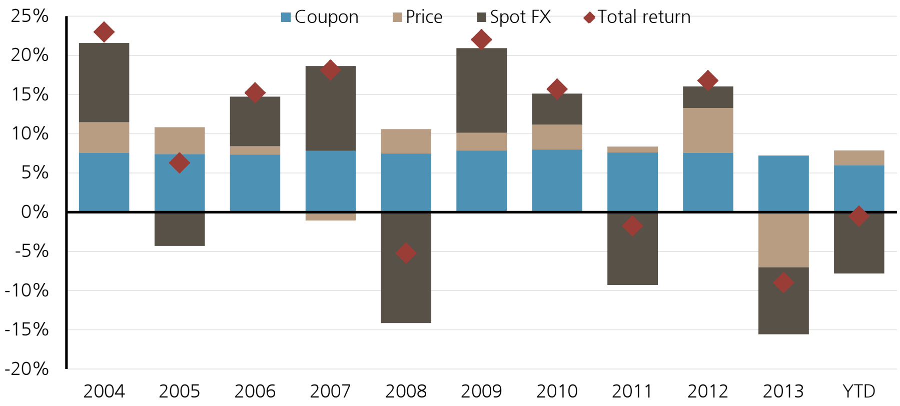
EM debt hasn't been able to capitalise on a big rally in US yields

After the high rates and high volatility environment of 2013, this year's UST rally should have been a great environment for EM rates. However, in USD terms EM local currency bond yields have managed only modest returns, and have once again underperformed US Treasuries.

Currencies are always the big swing factor in local yields

That local EM bonds underperformed USTs both as UST yields went up (2013) and as they came down (2014) will be a bit disconcerting for EM investors. What hurt EM local yields, of course, is what we have always stated is the swing factor in driving performance – currencies. With the exception of 2005, there are almost no years in the last decade where GBI has managed to post positive returns in an environment of negative spot returns in EM currencies (Figure 44).

Figure 43: EM Local currency bonds: total return decomposition



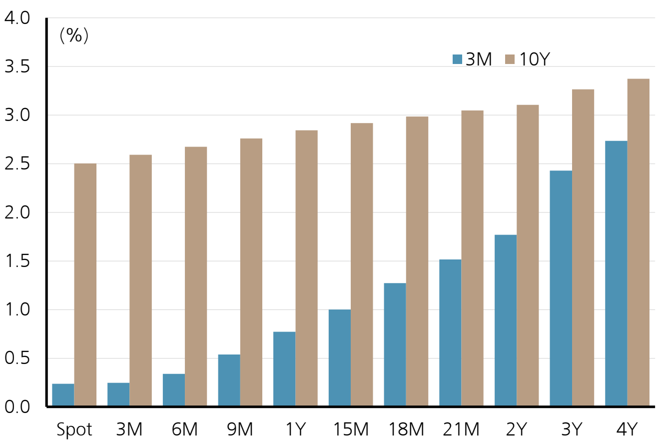
Source: DataStream, UBS

In 2015, we expect that US yields will replace Bunds in the driver's seat. The Interest rate forward market is priced for a measured 50 bps rise at the very front end, and a 30 bps increase for the 10 year note through 2015. UBS expects US yields to rise an above consensus 100-125 bps in a near parallel fashion across the curve.

In our view, EM currencies will likely provide negative alpha once again in 2015. As we have argued consistently for the last two years, in a world where the multiplier of global trade to global output is lower, EM currencies need to move more to evoke the same responses from the current account as they did earlier.

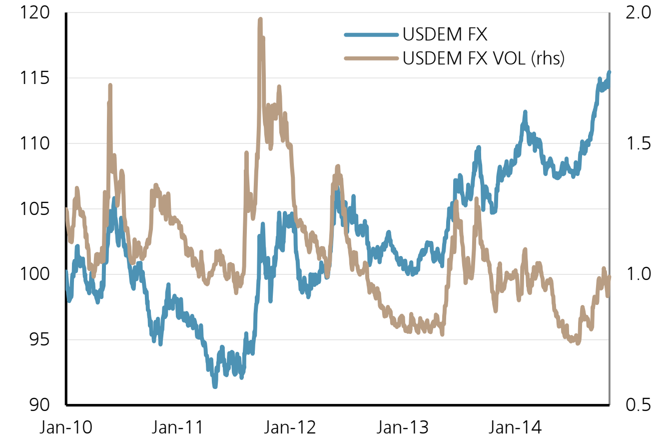
On a GBI weighted basis we expect USD EM to go up by about 4% next year

Figure 44: US 3m and 10y yields in the forward space



Source: Bloomberg, UBS

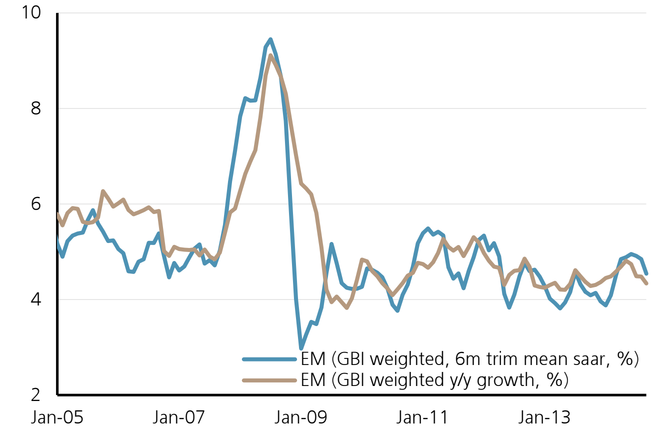
Figure 45: USDEMFX and USDEM FX vol (since 2010)



Source: Bloomberg, UBS

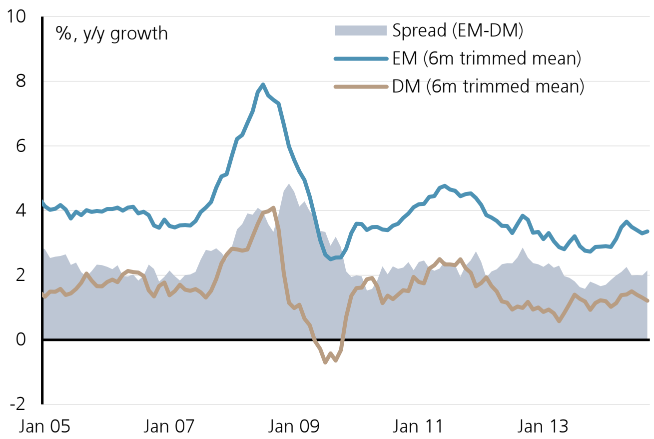
What has been notable about this year's move in EM currencies is that they have sold off despite the low volatility environment (Figure 45). It will not be surprising at all to see volatility pick up somewhat as front end rates rise in the US. Over and above weak growth fundamentals, this will likely provide another headwind for EM FX. On a GBI weighted basis we expect USD EM to go up by about 4% next year.

Figure 46: EM inflation: 6m trimmed mean and y/y growth (GBI weighted)



Source: Haver, UBS

Figure 47: EM v DM inflation (y/y 6m trimmed mean)

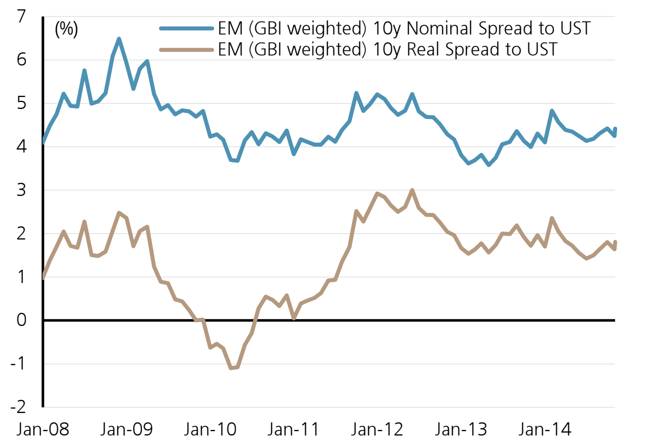


Source: Haver, UBS

What about duration itself? We think EM 5-7 year rates can sell off by close to 50 bps on a GBI weighted basis next year. Based on UBS' above consensus US rates call, this is quite a generous forecast for EM. We think the good news for EM assets; none more so than EM fixed income, is that EM inflation is set to remain quite benign in the coming quarters (Figure 46 and Figure 47). At the time of writing, EM headline inflation is under pressure from sharply lower commodity prices. The inertia in this trend will carry y/y numbers lower for the coming quarter or two, but even beyond that we don't see a big rise in inflation.

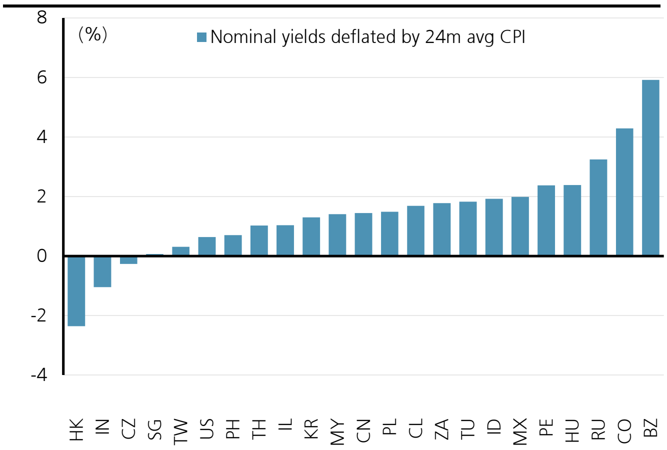
EM inflation staying low will be a positive influence but US rates won't help

Figure 48: EM nominal and real spreads against UST



Source: Bloomberg, Haver, UBS. Real yields are Nominal yields deflated by 24m avg CPI

Figure 49: EM real 10Y rates (adjusted for 2Y trailing CPI)



Source: Bloomberg, Haver, UBS

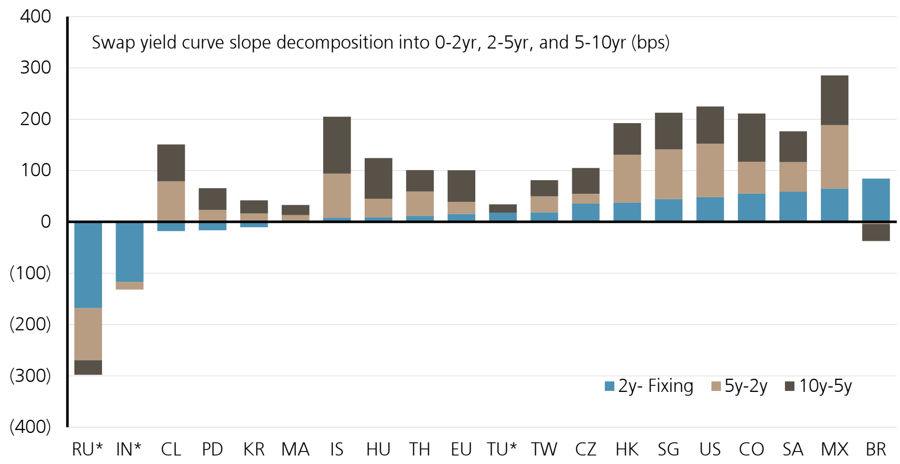
In nominal terms EM rates had moved well higher than UST yields in 2013, and have come lower only modestly more than US yields in 2014, so the spread against US has increased (Figure 48). In real terms the spread against the US is broadly unchanged over the last two years. The environment of low inflation probably means that even as both US and EM rates rise, EM yields don't need to rise much more than US yields. The risks to this view are that EM fiscal and current account deficits worsen significantly from here and that EM policy-makers make mistakes in how they tackle a stronger USD. As a base case we think the benchmark is likely to lose nearly 2% from duration losses next year.

We're expecting losses of 2% to the benchmark from duration selloff

The carry and roll that accrues from investing in local currency bonds will just about compensate for the losses from FX and duration next year, we feel. Indeed, the risks in our mind are skewed towards this carry not being enough to make up for the losses on duration and FX, and the local currency benchmark delivering negative returns.

We see the local currency benchmark delivering flat returns in 2015

Figure 50: Yield curves gradients: Not too many steep curves out there



Source: Bloomberg, UBS * represents based on local currency bonds

On a positive note, we do feel that investors can make positive returns in local currency EM bonds by hedging away their FX risks in the EUR or the JPY. In our view, it will considerably mitigate the currency losses, and for some markets like India, Mexico and Malaysia, being hedged in the EUR will likely mean that FX returns are positive.

Hedging FX risk in EUR should allow positive returns of up to 3%

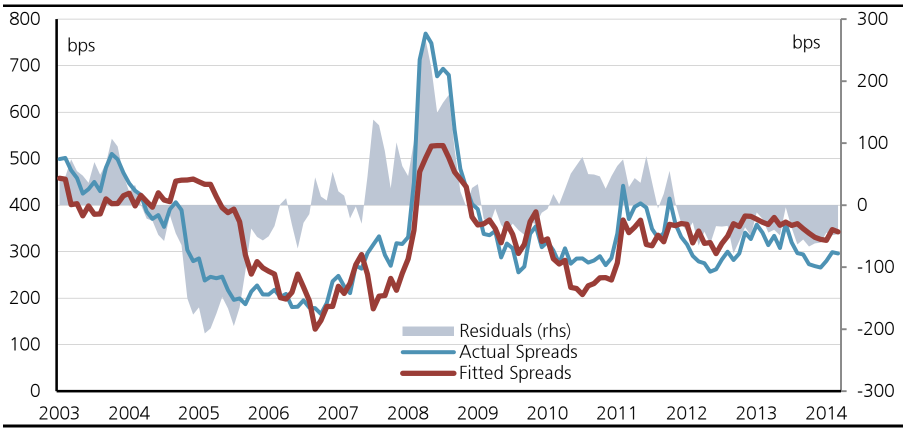
Hard currency debt: Where next for the rock star?

We have called hard currency EM debt the rock star of EM assets as it has consistently provided not just better Sharpe ratios, but also better total returns. This year is a case in point, but to be fair all the returns have accrued from lower US rates; EM spreads have provided small negative returns.

EM credit benchmarks have higher duration (7) than the local currency benchmark (4.8). Based on our view on US rates next year, we expect the duration component will be losing around 350 bps for the sovereign benchmark. As it is lower duration the corporate benchmark is likely to lose only 250 bps from the move higher in US rates. However, as we will argue later, other considerations keep us overweight EM sovereigns relative to corporates next year.

Duration losses will likely take away 350 bps for EM sovereigns next year

Figure 51: EMBI GD spread model: actual and fitted spreads since 2003



Source: Datastream, Haver, UBS

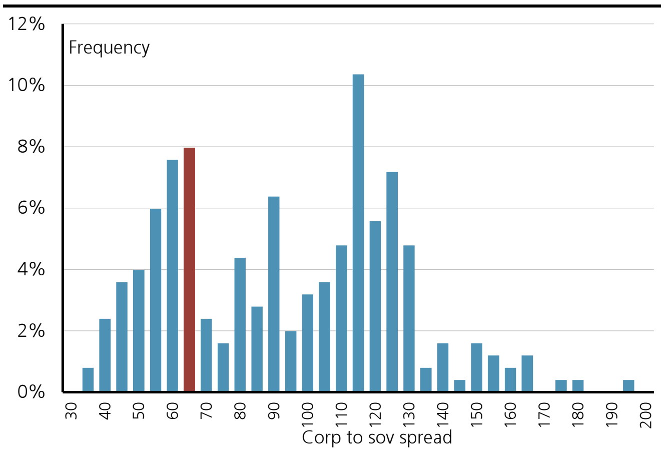
Fair value of EMBI GD is wider at around 375, we think, but the journey to fair value may not be accomplished in one year.

How will spreads themselves do next year? We base our fair value model on EM sovereign spread on three variables: a) fundamental macro balance sheet risk score of EM countries (EMBI weighted), b) commodity prices and c) a global measure of risk appetite. For details of this model see Where next for the rock star of EM assets?. Assuming that over time the risk appetite in the global economy is likely to go towards the median of its long term distribution, we see the fair value of EMBI spreads around 375 bps. However, it is fair to say that in this world of excess liquidity, risk appetite will regress to its median level only very slowly. Assuming it takes 3 years for rates to head towards their neutral levels, we believe it is over such a time frame that risk appetite will head towards the median of its distribution. The slow 3 year march in EMBI spreads towards their fair value still gives us a widening of about 30 bps in EMBI GD next year.

Hard currency sovereigns will likely provide 0-1% returns in 2015.

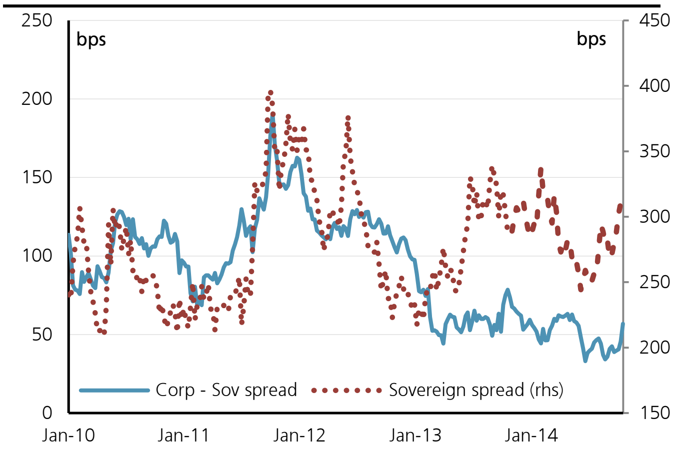
Similar to local currency debt, coupon of just under 6.5% remains the only force contributing positively to total return next year. Based on this math we forecast modest total returns in EM sovereign credit of 1% next year.

Figure 52: Distribution of EM corporate to sovereign



Source: Bloomberg, UBS

Figure 53: Corporates spreads to sovereign: not reacting lately to where sovereign spreads are headed *



Source: Bloomberg, UBS. *Looking at Bloomberg proprietary indices for consistency.

What about EM corporates relative to sovereigns? Typically the EM corporate credit spread is fairly closely linked with the direction of where EMBI is headed, but interestingly this has not been the case in the most recent quarters (Figure 52 and Figure 53). Even as EMBI has widened out since the taper tantrum of last year, the

CEMBI v EMBI spreads have remained well behaved at a very low percentile of their 5 year distribution. This very likely indicates that more and more investors have come into the corporate credit space looking for slightly higher yields.

We think corporate spreads will widen by 20-30 bps more than sovereigns next year. Liquidity is a key consideration for us in 2015.

Can this resistance to wider EMBI spreads continue into next year for EM corporates? On balance, we don't believe it can. Not only can risk appetite and EMBI spreads correct closer to their respective median and fair value next year, for us one of the prime considerations heading into 2015 is to remain in the most liquid of trades. As US rates rise, it is very possible that volatility also gets impacted, and as it does the liquidity premium goes up quickly. And this is where we have grave concerns.

Big bifurcation in primary and secondary credit markets

As we have pointed out in Low Volatility: Underpinnings and Cracks there is a strong bifurcation in liquidity in the primary and secondary credit markets. While primary deals are met with enthusiasm and strong bid to covers from investors, regulation and light street inventory have these issues being traded in an illiquid fashion in the secondary market. Lack of volumes supresses volatility presently but amplifies at a later point once a trigger for volatility is established. Higher rates could be one such trigger to dislocate the more illiquid corporate space in EM.

Figure 54: Regression of spreads on commodities, Dollar and S&P500: summary

Against		Beta	R squared
DXY	EM Sovereign spreads	8.99	42%
	EM Corporate spreads	9.67	39%
BCOM	EM Sovereign spreads	-4.34	32%
	EM Corporate spreads	-5.14	35%
S&P500	EM Sovereign spreads	-5.13	43%
	EM Corporate spreads	-6.46	54%

Source: Bloomberg, UBS

Lastly, when we run basic regressions of sovereign and corporate spreads on the USD and commodities, we have found that over time corporate spreads are more sensitive to these than are sovereign spreads (Figure 54).

Fixed income will pose a low bar for EM equities to cross

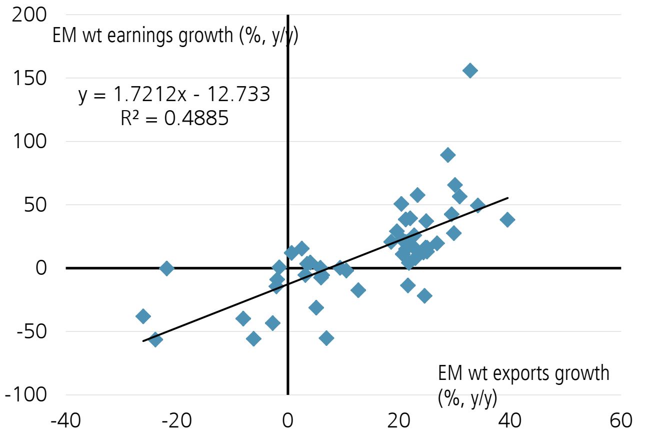
All in all we believe that EM fixed income will next year provide a very a low bar for EM equities to beat. That's just as well, because we don't believe EM equities are likely to light up the town in 2015.

EM Equities: Single digit total returns in 2015

EM will once again deliver sub consensus earnings of 5-7% next year

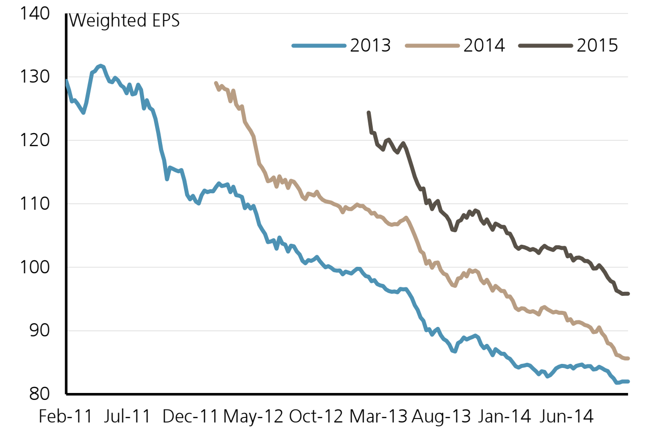
2014 will be the fifth year where earnings will not be met, and based on what we know of consensus for next year, 2015 will be the sixth (Figure 56). Based on a) our non-consensus call on global trade (Figure 55) (we think it stays weak even if global growth improves modestly), b) our call for a stronger USD and higher UST yields, c) modestly weaker commodity prices and d) our view that EM growth is likely to fall modestly at a time of global growth improving, we think that EM earnings are likely to come in at 5-7% next year against a consensus of 11-12%.

Figure 55: EM exports and EM earnings



Source: Haver, MSCI, IBES and UBS

Figure 56: Revisions of 2013, 2014 and 2015 earnings

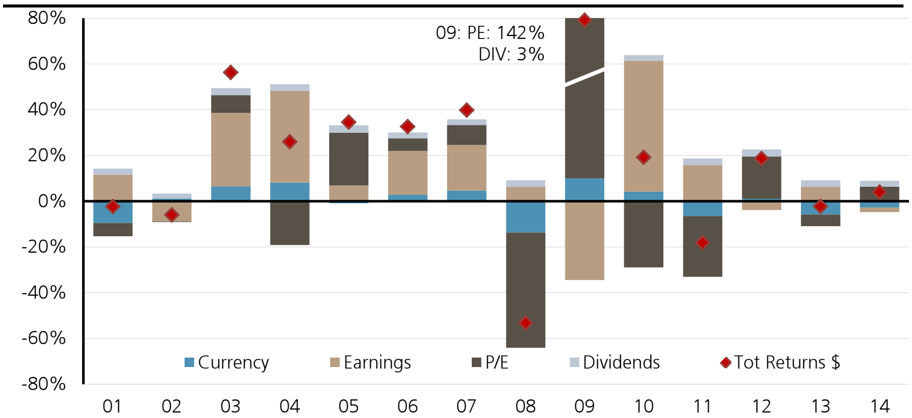


Source: IBES Datastream, UBS

Typically EM currencies don't form a large part of the total return in EM stocks (Figure 57) but next year we think they could provide a headwind of up to 3% especially as next year we expect currencies in the heavy weight region, Asia, to selloff (including the RMB). The strong depreciation of EM currencies over the last 3 years (which has come despite quantitative easing from the Fed, BoJ and promise from the ECB) has meant that on a decade long view, EM currencies have made no positive alpha for a USD based equity investor (Figure 58)

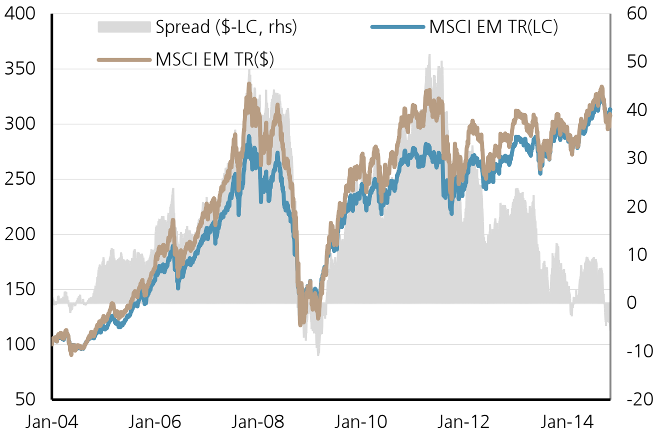
USD based investors will likely lose up to 3% on an MSCI weighted basis in EM currencies next year

Figure 57: EM equities: total return attribution



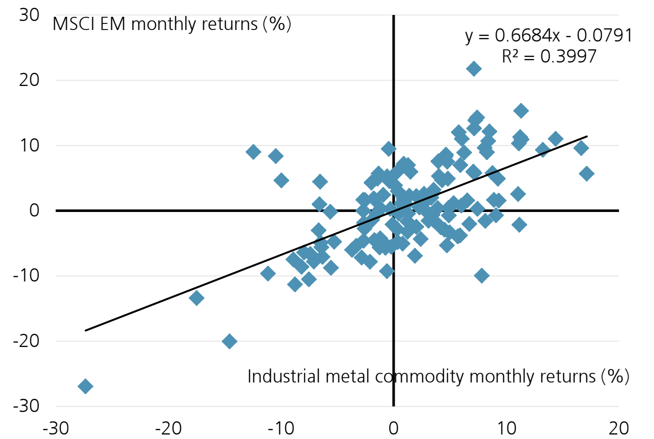
Source: DataStream, UBS

Figure 58: MSCI EM: 10y performance in local and USD total returns: A decade's gains from currency now gone



Source: DataStream, UBS

Figure 59: MSCI EM v. Industrial metals monthly returns

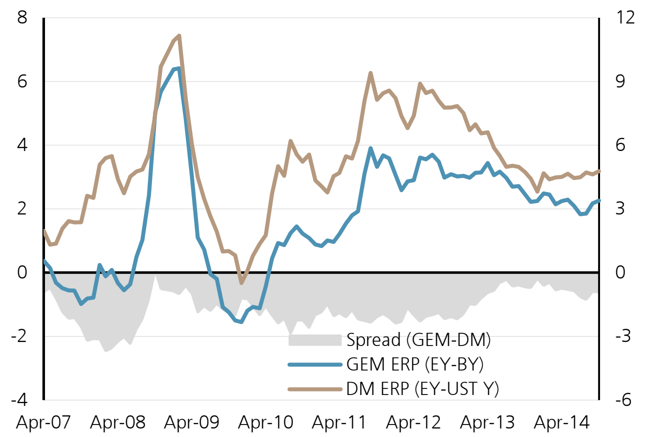


Source: Bloomberg, DataStream, UBS

At around 10.8x forward earnings (assuming the more realistic earnings growth of around 5-7%) EM valuations are trading close to long term averages. For us this doesn't in itself make a case for EM rerating. We do believe that based on EM macro and earnings fundamentals that even a long term average multiple could be a tad generous- we are hardly living in an 'average' EM time.

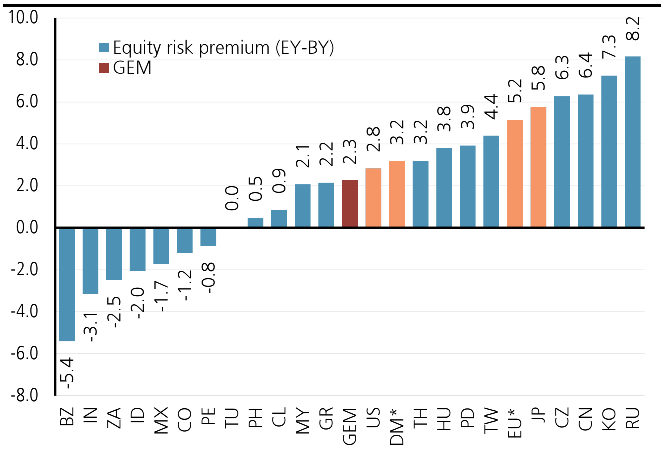
There will likely be little rerating of EM multiples

Figure 60: EM and DM equity risk premium proxy



Source: Haver, Bloomberg, DataStream, UBS. *DM ERP is based on MSCI World and UST, *EU ERP is based on MSCI EUROPE and GERMAN BUNDS and *GEM ERP is based on MSCI EM and wt. average of Sovereigns

Figure 61: EM and DM equity risk premium proxy



Source: Haver, Bloomberg, DataStream, UBS. *DM ERP is based on MSCI World and UST, *EU ERP is based on MSCI EUROPE and GERMAN BUNDS and *GEM ERP is based on MSCI EM and wt. average of Sovereigns

Overall we don't see the EM equity risk premium as excessive both in the absolute and also relative to developed markets (Figure 60 and Figure 61). We are assuming no rerating of EM stocks next year. Including dividend yield we look for a total return of around 6-7% from EM in USD terms and around 10% in local currency terms next year. Given how low the fixed income gains are likely to be, EM equities will likely outperform EM debt both on a total return and Sharpe Ratio basis next year.

EM equities will likely yield close to 6-7% total return in 2015

This said, we don't feel confident at all that 2015 will be the year when EM stock markets break the jinx and outperform DM markets comfortably. The alpha of EM's growth over DM isn't likely to increase next year, and this has historically been the main driver of capital flows into EM and relative performance of EM assets.

EM stocks are unlikely to outperform DM

Can looser ECB and BoJ make up for a tighter Fed?

Can looser ECB and BoJ make up for a tighter Fed[6]?

Bhanu Baweja / Manik Narain

- We asses this difficult question from five perspectives. 1. How much will ECB easing shrink risk premia incrementally? 2. Which DM assets have a bigger influence on EM assets? 3. Which DM economy dominates flows into EM? 4. Can European yields keep US yields in check? 5. Which currencies are EM liabilities listed in?

- QE works through bringing real rates and risk premia lower. Risk premia are already at pretty low percentiles of long term distributions.

- Both correlation and causality analysis point to the US, not European or Japanese assets as being the main driver of EM assets.

- Based on individual country BoP data and IMF's CPIS data we confirm that US investors account for the majority of EM portfolio liabilities. Importantly, there is also very little evidence of European investors having increased their investments into EM when rates come off.

- Statistical evidence tends to prove that European rates going lower could well keep a cap on US back-end rates. However, qualitatively we disagree: the US has de-levered much more than Europe, and this means the American economy could very well handle higher back-end rates. We think the US-German spread can go even wider.

- The vast majority of EM debt is denominated in US dollars. This implies that a higher US cost of borrowing and a stronger USD will have a larger pernicious impact on EM debt profiles than lower rates and a weaker currency in Europe or Japan will be beneficial

Amongst the questions that we keep getting from investors is whether the force of BoJ and (potential) ECB easing can compensate EM assets for the expected tightening from the Fed. We find there are a lot of 'gut' based answers, but little that's evidence based. To be fair, it is tough even to build a framework for this enquiry in logical or scientific terms, let alone give a clear answer. In this note we try to give our most considered views on the topic.

We assess this issue from 5 different perspectives

(1) How much further can ECB/BoJ actions compress rates and risk premia?

(2) Is EM risk driven by US risk or European and Japanese risk?

(3) How big are US investors compared to European /Japanese investors in EM?

(4) Will low rates in Japan/ Europe keep a lid on US back end rates as well?

(5) Which currencies are EM liabilities denominated in?

[6] We would like to thank Mickael Sabet and Jayasanker Mallisetty for their very useful contributions to this note.

As we look to answer these questions, we will not debate the actual likelihood of further easing from the BoJ and the ECB. For what it's worth UBS' base case view is that we will get further easing from the BoJ and, that there will be no large scale QE from the ECB. For the purposes of this note we will ignore this, and take as a given the idea that the BoJ and the ECB are going to ease next year, as the Fed moves in the opposite direction. We focus our attention in just trying to answer how EM assets will do in the situation where we get this monetary policy divergence between the US and Europe/Japan.

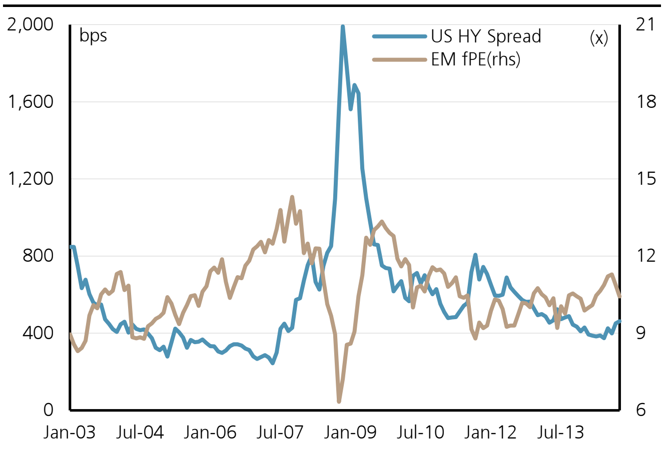
For the purpose of this note, we will assume both the BoJ and ECB will ease next year

1. How much further can ECB /BoJ actions compress rates and risk premia

First up, let us assess the question of how much incremental juice easing from the BoJ and ECB can provide to asset markets in general.

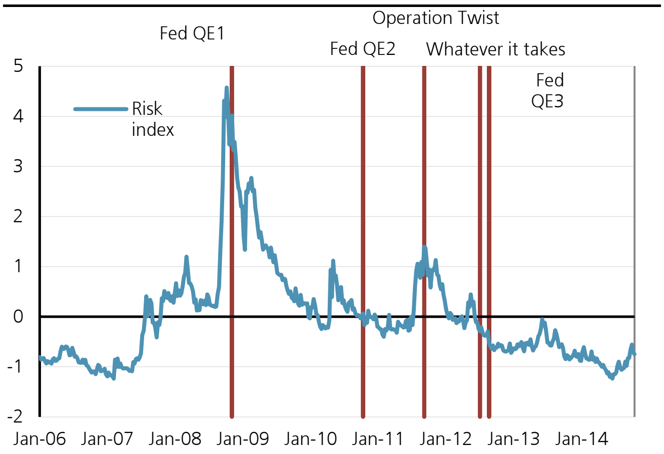
In our view the purpose of QE (as opposed to regular monetary policy) is to a) bring down the 'whole' term structure, so that the price of credit is low, 'and' b) supress risk premia, particularly in the credit markets so that credit multiplier is not impaired.

Figure 62: US HY spreads and MSCI EM forward P/E ratio



Source: Bloomberg, DataStream, UBS

Figure 63: Monetary policy in the US and Euro Area and risk index[7]: Can we expect much more



Source: Bloomberg, UBS

How a vintage of quantitative easing from the Fed, ECB or BoJ has done has depended less on how aggressive the actual easing was, but more on the rate and risk circumstances in which that easing was introduced. The most effective batch of QE was QE1 from the Fed (Figure 62 and Figure 63), coming as it did when the financial world was in near ruins. Risk premia screamed tighter, and the markets shot higher. 'Relatively' speaking QE3 had a smaller impact on the markets. In Europe, Draghi's 'Whatever it Takes' commitment in London, in July 2012, had a huge impact, again, coming as it did when a dark cloud hung above the European project. The reader will recall that Dr Draghi didn't spend a penny; his intervention was not large, it was only perceived as providing an anchor amidst chaos.

Timing and quality of QE measures have mattered at least as much – if not more – than quantity

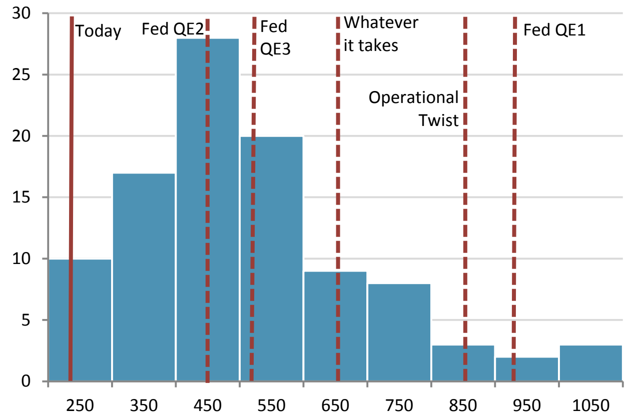
[7] We define the risk index as the first principal component of US HY and EU HY spreads, bond volatility (MOVE Index), VIX and VDAX indices, -AUDJPY, EURJPY and USDJPY 3M implied vol, US and EU 3m TED spreads

Today, in contrast to those troublesome times, there is no chaos in the market In Figure 64 and Figure 65 we show the actual levels of European high yield spreads and European forward P/E respectively on the X axis and the ex post relative frequency of that level being realised on the Y axis.

Risk premia are unlikely to tighten considerably further given their current levels

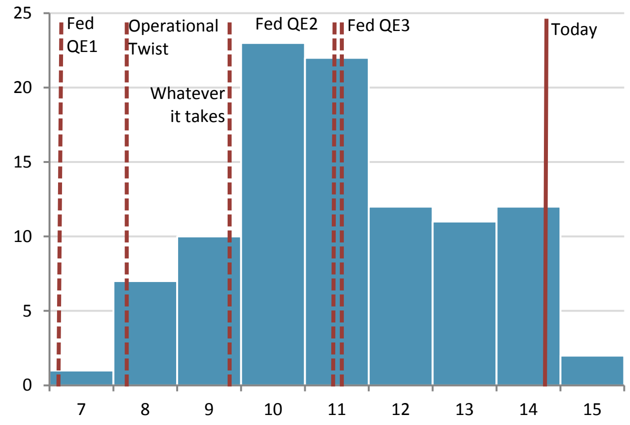
Sure, risk premia can tighten further somewhat if ECB intervenes in sovereign and credit markets very aggressively (though investors often forget that it may take much wider risk premia to get ECB to intervene in the first place), but simply by virtue of the levels they are already at, we find it difficult to see them tightening considerably more. The distributions take values since Aug-2005.

Figure 64: Distribution of European Xover spread



Source: Bloomberg, UBS. Data since Aug-05

Figure 65: Distribution of Euro Stoxx 50 forward P/E



Source: Bloomberg, UBS. Data since Aug-05

2. Are EM assets driven by US assets or European and Japanese assets?

Not an easy one to pin down. The answer can easily depend on the asset class and time frame under consideration.

We start with a straightforward approach and look at correlations between EM and DM in different asset classes

Let's start by looking at a correlation matrix of returns in (local currency terms) of different assets in EM on one hand, and (respectively) US, Europe and Japan counterparts on the other. This may be a simple approach but there's nothing very wrong with it. The tables below (Figure 66 to Figure 68) are based on monthly returns or bps change data since 2003.

The results do show that for equities (MSCI EM), local rates (GBI), and credit (EMBI) EM returns are more closely correlated with their US counterparts than they are with those in Europe (although in the case of equities, both US and Europe have equally high correlation with EM assets). We also observe that Japanese assets have even lower correlation with EM assets, particularly in rates.

Figure 66: Equity markets: correlation matrix between EM and DM

	MSCI EM	S&P 500	Euro Stoxx 50	Nikkei 225
MSCI EM	1.00	0.78	0. 78	0.69
S&P 500	0.78	1.00	0.89	0.70
Euro Stoxx 50	0.78	0.89	1.00	0.68
Nikkei 225	0.69	0.70	0.68	1.00

Source: Bloomberg, Haver, UBS

In equities, EM shows a lower correlation with Japan than it does with the US and Europe

Figure 67: Rates: correlation matrix between EM and DM

	GBI EM	US Treasuries	German Bund	Japan Government Bond
GBI EM	1.00	0.36	0.29	0.14
US Treasuries	0.36	1.00	0.73	0.47
German Bund	0.29	0.73	1.00	0.44
Japan Government Bond	0.14	0.47	0.44	1.00

Source: Bloomberg, Haver, UBS

In rates, the correlation is higher with the US than it is with Europe or Japan

Figure 68: Credit: correlation matrix between EM and DM

	EMBI	USHY	EUHY
EMBI	1.00	0.77	0.38
USHY	0.77	1.00	0.34
EUHY	0.38	0.34	1.00

Source: Bloomberg, Haver, UBS

In credit, the US is leading the show once again

But correlation is not causation, so we must dig deeper.

But correlation is not causation, we hear you say, and you are right!

We then conducted tests using Granger Causality (Figure 69), a time series technique, which sets a reasonably high bar to determine causation. The details are available in the appendix but the intuition of the process is trying to determine causality by seeing if a variable, Y (MSCI EM monthly returns, for instance), can be better predicted by using the histories of 'both' its owned lagged values and that of another variable, X (say S&P 500 lagged monthly returns), than it can using only the lagged values of the variable itself.

If this is the case, and if the opposite is not true (otherwise the two variables would not be exogenous) then one can say that X Granger causes Y (X > Y for short).

We ran this test on daily returns starting in 2005 for equities and local rates, and on all the available data within this range in credit. We used 3 lags of the EM variable and 3 lags of the DM variable.

The results clearly point to US equities Granger causing EM equities. The tests for European or Japanese equities driving EM equities are accepted at a 95% confidence level. (Recall that correlations also showed a strong relationship between EM and European stocks.) However, for Europe and Japan equities our tests show the relationship with EM equities being bi-directional, i.e. there is feedback between Europe and EM, which isn't compatible with true causation.

Figure 69: Granger causality test results (p-values)

	X > Y	US	Europe	Japan
Equities	DM > EM	0.00	0.00	0.00
	EM > DM	0.06	0.00	0.00
Rates	DM > EM	0.00	0.07	0.09
	EM > DM	0.33	0.33	0.70
Credit*	DM > EM	0.00	0.00	.
	EM > DM	0.38	0.00	.

Source: Bloomberg, UBS. The null of this test is (H_0): X does not Granger-cause Y. We used daily data since 2005, except for US HY where the data starts in Feb-09.

Granger causality tests confirm our call that US assets are in the driver's seat when it comes to movements in EM assets

We found exactly the same results in credit – US HY does Granger cause EMBI spreads but European HY spreads don't in a unidirectional way.

EM's cost of capital is driven by the trend in US yields, not European or Japanese yields

Importantly, in local rates US yields do Granger cause GBI local EM yields but Europe and Japan don't. This, combined with finding on credit is a crucial result. This does suggest that EM's cost of capital is driven by US fixed income, not quite by European or Japanese fixed income

Looser monetary policy in Europe or Japan is unlikely to compensate for Fed tightening

So, both at a level of correlation and causation it is reasonably clear that when we regard movements in EM assets at an aggregate level, it is US assets that are in the driver's seat, not quite European or Japanese assets. Looser monetary policy elsewhere may therefore not be able to neutralise the impact of Fed tightening.

What readers may find interesting is that when testing for Granger causality on US and German yields, it was clear that US yields do Granger cause Bunds. This is an important result in the context of Fed vs ECB question, we feel. We will investigate the relationship between US and GE yields from another angle later in this note.

3. How big are US investors compared to European /Japanese investors in EM?

Which investor dominates flows into EM?

If the previous issue was difficult to pin down, this one is even closer to an art than a science. The premise of this question is that incrementally looser liquidity in an economy is likely to push investors of that economy into risk assets, including risk assets abroad, including, in turn, into EM assets. Higher rates, by contrast, will mean a higher opportunity cost of moving abroad, keeping folks invested at home.

This question tries to answer at a level of 'flows' what the previous question tried to answer in terms of 'price' – who drives EM?

We look at this issue from two angles: a) what proportion of portfolio outflows from US, Japan and Germany (which, owing to data constraints, we use as proxy for Europe) head towards EM (Figure 70), and we cross check this with b) which DM countries do EM economies get their portfolio capital from (Figure 71). We use individual country BoP data[8] and the IMF CPIS database to answer these questions.

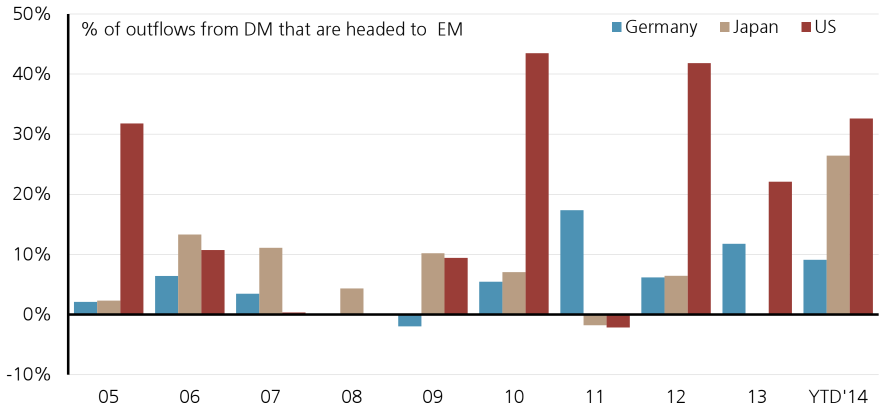
[8]As of 2014 most major economies are changing their BoP methodology from BMP5 to BPM6. Unfortunately the two methodologies are not comparable. Where the entire history of BPM6 data is not available (Japan), in order to assess 2014 data in the context of history, we have not compared actual JPY amounts, but the ratio of flows to one country/region/ asset class as a proportion of total flows. We think these ratios should be comparable over time despite the change in methodology.

From the BoP data of Japan[9], Germany and the US (Figure 70) we learn that Japanese and German investors have invested smaller proportions of their portfolio capital in EM than US investors. The definition of EM in this chart is based on the data provided by each economy can be very modestly different.

US investors have significantly increased the proportion of their portfolio assets headed to emerging markets from roughly 15% pre-crisis to nearly 35% since then. Also there is no steady preference visible for any one EM asset class from US investors; over time they have bought broadly equal amounts in debt and equities. German and Japanese investors have, as an average, allocated from 7 to 15% of their annual portfolio flows between 2005 and 2013 to emerging markets. Japanese investors, in particular have, till 2013, shown a very clear preference for debt assets (both in EM and DM). From a developed country perspective then, the US shows the highest propensity to invest in EM.

Of the US, Germany and Japan, US investors have been most keen to head for EM

Figure 70: Proportion of respective DM country flows headed into EM



Source: Haver, UBS. YTD'14 flows represents data till Aug-14 for Japan and Jun-14 for US and Germany

Japanese and German investors have invested smaller proportions of their portfolio capital in EM than US investors

Perhaps it is more relevant to assess this question from EM country perspective – what proportion of their portfolio liabilities (funds coming into EM) have they sourced from each developed market or region respectively. For this we turn to the IMF's CPIS database, which can be thought of as being similar to like the input-output matrix of global portfolio flows[10].

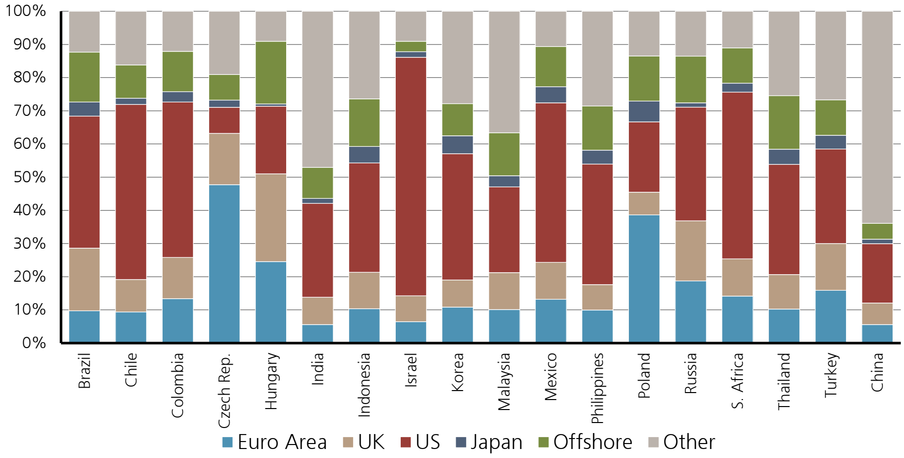
Based on this database, we know the stock of assets a particular country's investors hold in any EM country. The holdings as of end 2013 are shown in Figure 71. Foreign investor patterns do differ by country, but broadly it can be seen that in many cases US investors together account for roughly as much as the sum of European and Japanese investors put together.

In most EM countries, US investors account for the majority of portfolio investment liabilities

[9] The Japan BoP data is somewhat of a minefield. It shows a very large portion of outflows headed to centres with offshore funds like Cayman Islands. We stay agnostic about these flows and don't count them into EM flows. To this extent it is possible that Japanese investment into EM is modestly understated in this analysis.

[10] This database is better than the BoP databases of the individual countries, but only slightly. The problem again is that a large portion of the money is going into offshore centres like Cayman Islands and Luxembourg. In this analysis we have accounted explicitly for the money coming from offshore centres, and have been agnostic about who the ultimate investor may have been. The other big assumption we have to make is that domicile of funds does represent the residence of those flows as well. That may be a heroic assumption sometimes.

Figure 71: Holders of EM portfolio investment liabilities as of December 2013



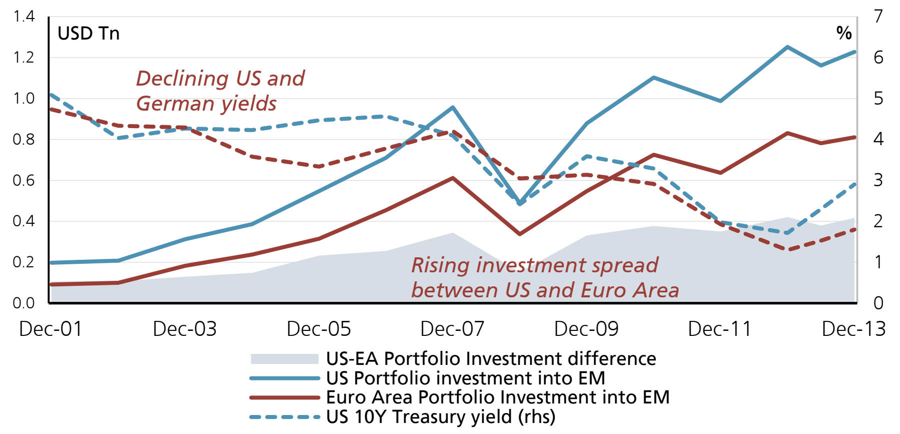
Source: IMF Coordinated Portfolio Investment Survey (CPIS), UBS

Now thanks to CPIS data, we can also assess how the stock of EM portfolio liabilities held by DM has evolved since 2001 (Figure 72). With decreasing yields both in the US and core Euro Area, have the two major holders of EM portfolio liabilities increased their investments in the same way? Looking at the chart below, the answer is clearly no. Despite US Treasury and German Bund yields both declining over the past 12 years, the difference in holdings of EM portfolio liabilities between the US and the Euro Area was multiplied by four (from about USD 100bn to 400bn). Also, the investment trends from Euro area don't seem to be very sensitive to the yields on the bunds. One may say that US flows into EM have in fact been more sensitive to declining yields at home.

European investment into EM does not seem to be sensitive to bund yields. US investment in to EM seems more sensitive to US yields

What we learn from this is that the Bund yields falling (or even staying low) may not impact European investment into EM by in a big way…

Figure 72: US and Euro Area investment into EM in a falling yield context



Source: IMF CPIS, Haver, UBS

Despite US Treasury and German Bund yields both declining over the past 12 years, the difference in holdings of EM liabilities between the US and the Euro Area has been multiplied by four

But this is all data till end-2013. Can we make any sensible comment about trends so far in 2014, and what they may suggest about the future?

Q1 and Q2 US and German data don't show any marked changes from historic norms, but the data on Japanese investments abroad does suggest a shift from historic propensities. Monthly data available till August points to a significant increase in the proportion headed to EM from 5-7% to nearly 30% of their flows (Figure 70). The other respect in which the data has made from a real break from the past is that equities have become quite a large part of Japan's overseas purchases. Region-wise, the big rise in the pick-up in flows to EM is headed towards Asia, particularly for markets like China, Korea and ASEAN. South Africa and Mexico have been the other big gainers.

Interesting new development of higher EM flows from Japan- they seem to like Asian equities. It's too early to call this the beginning a new trend

We need to treat Japanese data with some caution given the shift in methodology and the large tax haven categories without clear country destinations, but year-to-date numbers do tentatively point to a big tilt towards EM. It really is too early to tell if this will be sustained, and Japanese flows can compensate fully a potential decline in US flows, but there is some hope here. Watch this space.

4. Will ECB/BoJ actions keep a limit on US rates themselves[11]?

We now look at the important issue of whether globalisation of financial markets will mean that still easier monetary policy in Europe and Japan will 'effectively' counteract any hikes from the Fed by keeping a cap on back end rates in the US.

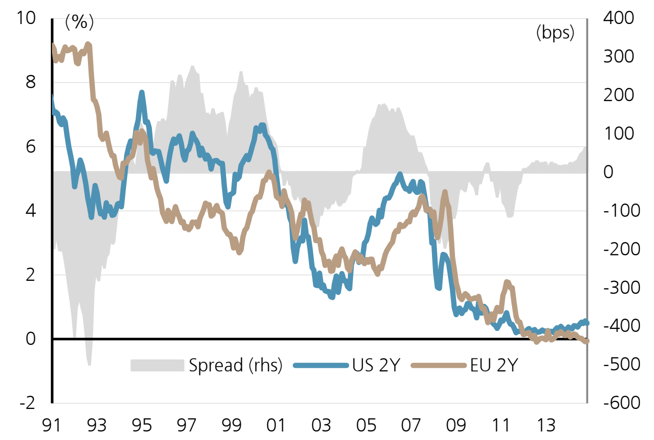
We test this statistically (Figure 73 to Figure 75) by asking whether the spread between US and Japanese rates, and US and European rates is in fact stationary. That is, whether that spread has stable and constant mean and variance; in simple terms, whether that spread mean reverts. We tested this for both 2y and 10y rate spreads between US and Europe and US and Japan.

We test for stationarity in the US yield spread against Bund and Japanese yields.

2y spreads were not stationary, not between US and Europe, and not between US and Japan. So, no matter how closely correlated global economic cycles have become, front end rates can often times move in different directions for long periods. Indeed, that is exactly what UBS economists expect will happen next year. So no luck here, but what about 10y rates? Can the gravity of bund and JGB yields keep US rates from going into orbit?

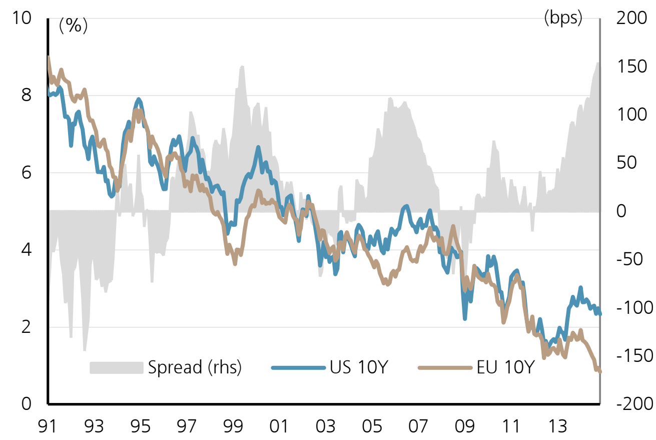
[11] Our asset allocation team headed by Stephane Deo had also found, similar to us, that over a long period US yields Granger cause Bunds. In section 4 we are approaching the relationship between US yields and Bunds from the slightly different perspective of spread stationarity.

Figure 73: US and EU 2Y yields and spread



Source: Bloomberg, UBS

Figure 74: US and EU 10Y yields and spread



Source: Bloomberg, UBS

Figure 75: Results of ADF stationarity test

	US-GERMANY		US-JAPAN	
	2Y	10Y	2Y	10Y
Test statistic	-1.53	-2.00	-0.76	-0.65

Source: Bloomberg, Haver, UBS. The critical value of the test is -1.95 at a 95% confidence level. A value smaller than this critical value indicates the absence of a unit root, and therefore mean-reversion

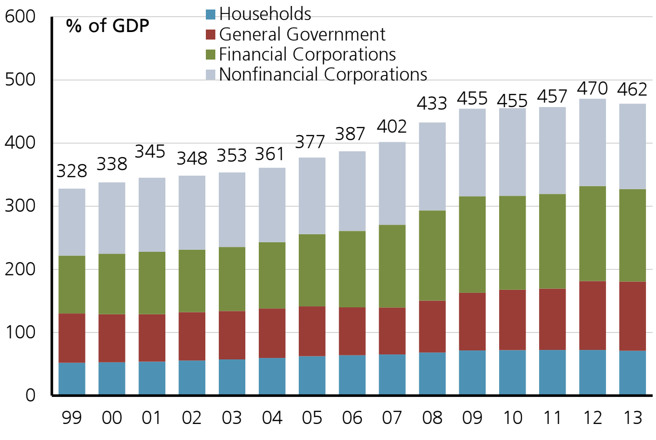
The US-German 10Y spread shows mean-reversion characteristics

Aha, finally some good news, well, sort of. While the US – Japan 10y spread is not mean reverting or stationary, we do find that the US-Bund 10y spread does satisfy the Augmented Dickey Fuller (ADF) test for stationarity.

At face value this suggests that if ECB acts to keep core European rates low (or indeed that they stay low on their own), that the US back end should not be able to move aggressively higher; they should stay contained so that the spread against the bund mean reverts instead of exploding higher.

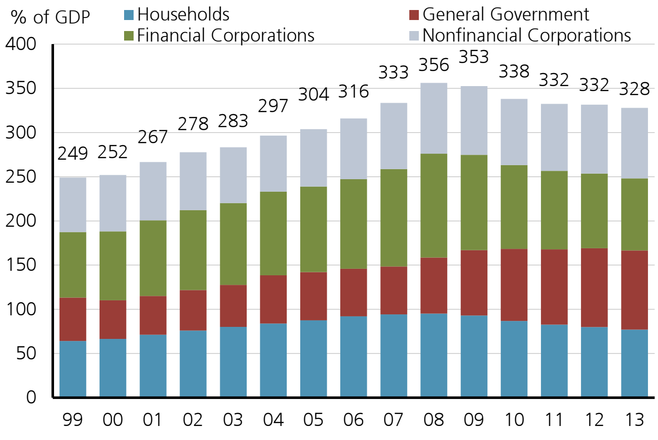
While that does bring a much needed favourable conclusion for EM assets, indeed for global assets, there is an important caveat that we think must be pointed out. What a statistical test for stationarity, which concerns itself just with the levels of rates, doesn't take into account is how the leverage in the respective economies is evolving (Figure 76 to Figure 79). When we look at the overall debt to GDP profiles of different parts of the world we notice one key fact – in pretty much all major regions in the world, leverage has been rising to flat, except, that is, for the US. In our mind dissimilar credit to GDP trajectories, which obviously are not picked up in the stationarity tests, mitigate the test results somewhat. Here we are using the qualitative macro understanding of debt trajectories and leverage to overrule what the econometric results are telling us.

Figure 76: Eurozone: total debt to GDP: Flattening



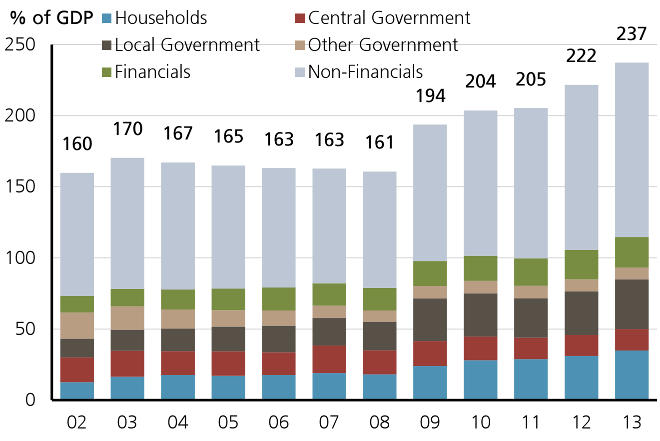
Source: Haver, UBS

Figure 77: US: total debt to GDP: Falling



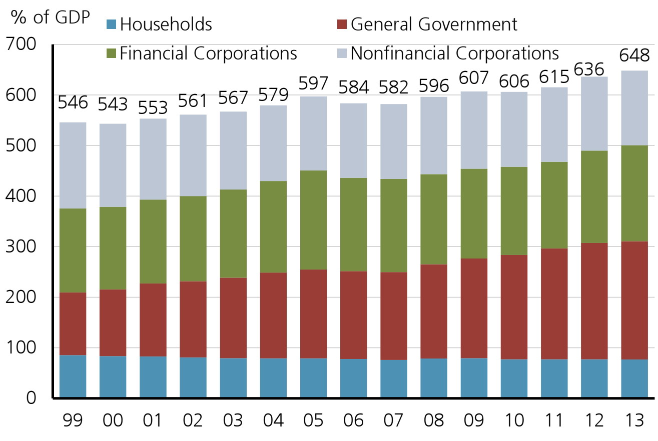
Source: Haver, UBS

Figure 78: China: total debt to GDP: Rising



Source: Haver, CEIC, UBS

Figure 79: Japan: total debt to GDP: Rising



Source: Haver, CEIC, UBS

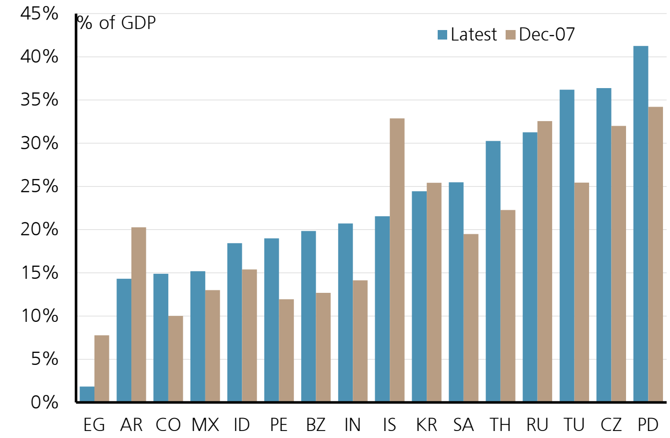
The statistical evidence may be misleading: we think the US-German spread can get wider

Unlike Europe, the US, which is now encumbered by lower debt as a proportion of output, is better able to handle higher back end rates. Historical statistical relationships may not apply in light of this divergence in leverage trajectories. We don't think the Japanese and German back ends will indefinitely be able to keep US back end rates down. The UST-Bund 10y spread is already at levels not seen since the late 1980s, and we think it can get wider.

Which currencies are EM liabilities listed in?

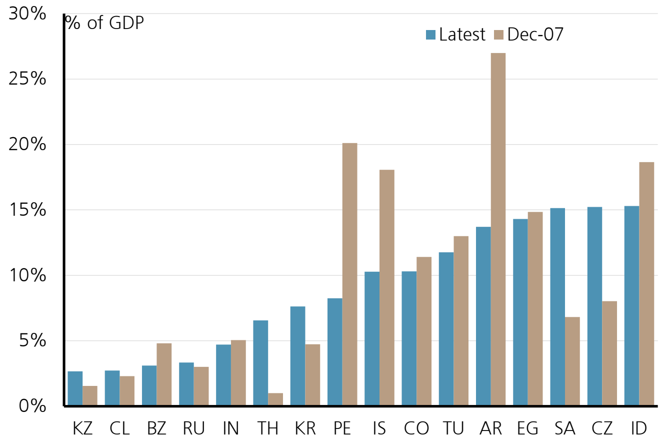
Lastly, we tackle what is perhaps the least nuanced (thank God!), but the very important issue of the currency and rates denomination of EM liabilities. We know that at a sovereign level EM external debt been has been falling relative to the FX reserves and GDP. However, corporate debt levels have been rising aggressively (Figure 80 and Figure 81).

Figure 80: Private debt as % of GDP



Source: Haver, UBS

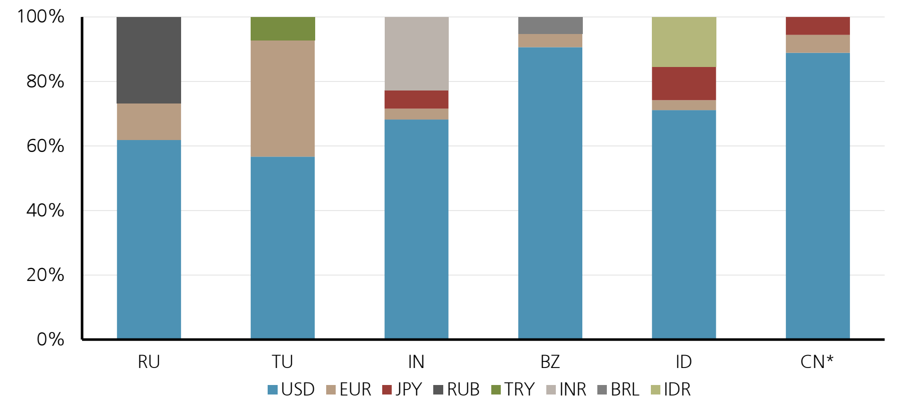
Figure 81: Public Debt as % of GDP



Source: Haver,UBS

When we break down the total external debt of different EM countries by currency denomination (Figure 82) it becomes clear very quickly that the vast majority of EM external liabilities are in USD securities or USD loans. EUR-listed securities did increase early on in the 2000s but have not exploded higher since, and overall make up for no more than 20-30% of overall liabilities. JPY listed external debt is even smaller at 0-3% of total EM liabilities.

Figure 82: EM external debt by country and currency



Source: Haver, UBS * represents registered external debt, which is about 2/3 of overall external debt

The vast majority of EM external liabilities are denominated in USD

This implies that a higher US cost of borrowing and a stronger USD will have a much greater pernicious impact on EM debt profiles than lower rates and a weaker currency in Europe or Japan will be beneficial.

When it comes to cost of borrowing and currency strength, the US is again more important to EM than Europe or Japan

Conclusion

We set out to see whether, from an EM investor's perspective, looser monetary policy from ECB and BoJ can compensate for higher rates from the Fed.

There's no way to dodge it or duck it, as US rates rise, the environment for EM rates will become more challenging even if ECB and BoJ are staying put for a good while longer.

We had investigated 5 aspects of this question.

First, on the levels of risk premia themselves, we found the incremental gains from further easing, should they occur at current market levels, would be limited. The real news here would be what happens to risk premia as US rates rise.

Second we investigated whether EM assets are driven by US and European assets. We found that both in terms of correlation and causation, US assets dominated in terms of impact on EM. US rates drive EM's cost of capital. This is a particularly important finding because we find that EM growth cycles, by contrast, are slightly better correlated with Europe (see EM By the Numbers: How does EM fare in the US- Europe growth tug). That is not a happy combination.

Third, we found that US's dominance was also a pattern in terms of flows, with one notable if nascent exception – the trend of Japanese flows year to date.

Fourth, in studying whether US rates can be kept in check in a steady range above Bunds, we found some statistical support for the proposition, but qualitative sense keeps us from implicitly accepting the numbers.

Lastly, there was little doubt in which way EM's fortunes would lean if the currency and rates their external liabilities were mainly denominated in were to rise.

Based on the parameters of our enquiry we struggle to see how Japan and European easing will compensate for higher US rates, which, no doubt, will also entail a stronger USD. There's no way to dodge it or duck it, as US rates rise, the environment for EM rates will become more challenging even if ECB and BoJ are staying put for a good while longer.

Appendix: Granger Causality

We run a series of Granger causality tests between EM and DM on different asset classes, in order to check statistically which of the US, Europe or Japan (if any) could Granger-cause EM returns. Our analysis is based on:

- The S&P500, Euro Stoxx 50, Nikkei 225 and MSCI EM price indices in the equities space, looking at daily returns starting in 2005
- The US, German and Japanese 10Y government yields, as well as GBI EM yields in the rates space, with daily differences starting in 2005
- US HY and European Xover spreads in the credit space, since 2005. Due to the lack of clean data, we base our analysis on daily differences from February 2009 for US HY. We test for causality against EMBI spreads.

In econometric theory, Granger causality tests must be undertaken on stationary time series only. As we're looking at daily returns/differences, these conditions are likely to be satisfied. We nevertheless run Augmented Dickey Fuller tests and verify that our series are indeed stationary. The results from our Granger causality tests are given below.

Figure 83: Granger causality test results (p-values)

	X > Y	US	Europe	Japan
Equities	DM > EM	0.00	0.00	0.00
	EM > DM	0.06	0.00	0.00
Rates	DM > EM	0.00	0.07	0.09
	EM > DM	0.33	0.33	0.70
Credit	DM > EM	0.00	0.00	.
	EM > DM	0.38	0.00	.

Source: Bloomberg, UBS. The null of this test is (H_0): X does not Granger-cause Y. We used daily data since 2005, except for US HY where the data starts in Feb-09.

The US Granger-causes EM in the Equity, Rates and Credit spaces

To formally check whether X Granger-causes Y (X > Y), we follow the standard procedure of checking in both directions, i.e. whether X > Y and/or Y > X. Looking at the results with a 95% confidence level (i.e. p-values lower than 5pc) it seems like the only one-way Granger-causal relations go from the US to EM in the equities, rates and credit spaces. In other cases, either the relationship is bi-directional – which indicates back and forth information feedback – or we do not find any relationship at all.

Now although this analysis tends to support our view that the US is the most important factor to watch when it comes to EM asset returns, we are also aware that Granger-causality is only one partial way of looking at the broader issue of causality which is usually a very hot topic among economists.

EM Rates: A life more ordinary

EM Rates: A life more ordinary

Manik Narain / Bhanu Baweja / Patrick Lamaa

- Weaker currencies continued to badly compromise returns in EM local rates in 2014. Our analysis finds that FX is typically a highly significant driver of EM bond yields, making it extremely difficult for investors to hedge away FX risks in general (see page 51). We expect both currencies and rates to act as a drag in 2015, and are forecasting flat returns for the GBI-EM benchmark.
- Further declines in oil prices are a key upside risk to the asset class, and can help contain the move higher in global bond yields as the Fed tightens. However, we don't foresee a rerun of 2012: EM valuations, developed world monetary policy, and EM's credit profile are significantly different. We think investors will find better levels to take positive risk in this asset class.
- Trades: Receive 10y Mexico v pay 10y Italian BTPs, receive Korea v pay US 5y5y, long 10y bonds in India vs. Turkey, long Brazil Jan 17s vs. Bovespa

EM rates: what really drives this asset class?

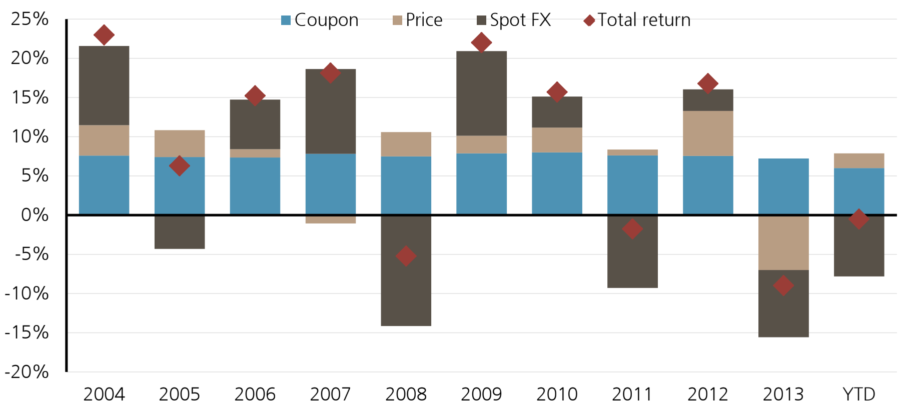
Awkward reality #1: EM rates have recently underperformed UST returns in both states of the world

Having provided stellar returns between 2009 and 2012, EM local markets have found the past two years much tougher going, returning -9% and -0.5% respectively. That the asset class has underperformed UST returns both as US yields rose (2013) and as they came lower (2014) will be a bit disconcerting for EM investors. This is an awkward reality that the asset class faces as we head into 2015, a year in which external headwinds are only likely to grow stronger: UBS expects UST yields to rise and the fixed income rally in Europe to prove much more subdued.

Currencies remain a critical swing factor for this asset class

A key reason behind the weak performance of EM local rates has been currencies. We have previously highlighted that there have been very few instances in the past decade of the GBI-EM benchmark posting positive returns (for USD based investors) during years when currencies have weakened in spot terms (Figure 84). Movement in EM yields (i.e. price returns) have typically not been a dominant determinant of total returns.

Figure 84: GBI-EM returns decomposed into Price, Coupon and FX contributions



Source: DataStream, UBS

Can't investors just hedge away currency risks?

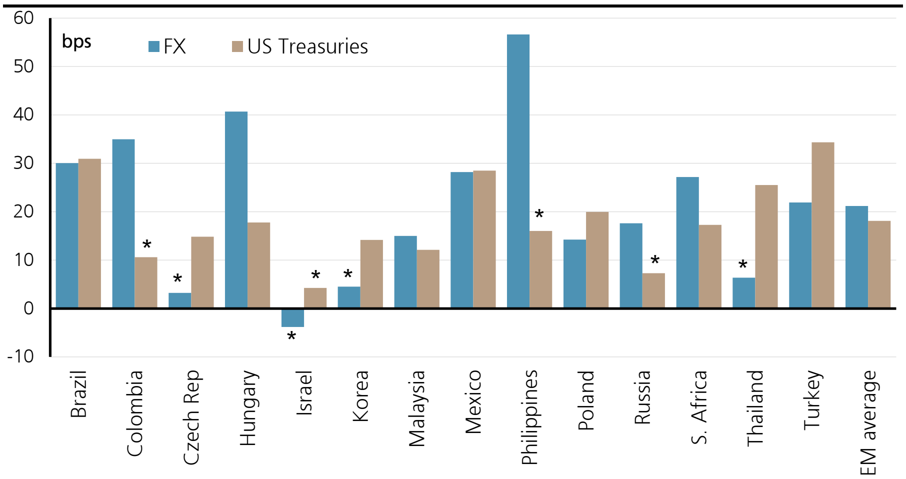
Awkward reality #2: FX hedging elegant in theory, tough in practice

If the big drag on EM local rates has been the currency, can't investors simply hedge these risks away? Two factors make this hard to do.

First, it's expensive: GBI-EM weighted 10y yields on aggregate fall from 6.6% to 1.6% net of FX hedging costs.

Second, we have found that currencies very often directly infect local yields themselves. In Figure 85 below we present the results from econometric regressions where we attempted to decompose the key drivers of EM 10y yields between local currencies, US Treasuries, and inflation. We found currencies to be a statistically significant variable across the clear majority of EM local markets (low beta developed markets such as Israel and the Czech Republic being the principal exceptions). In essence, if one sees the weakness in EM FX as chronic rather than temporary, hedging is unlikely to work at an aggregate level. This is partly due to the composition of the GBI-EM index, where fundamentally vulnerable markets such as South Africa, Turkey, Brazil and Indonesia for example constitute nearly 40% of the index. In these markets, currency depreciation typically contaminates inflation expectations quicker than in developed markets.

Figure 85: Contributions to local 10Y rate changes (bps) from a 5% depreciation in local FX and a 50bp rise in 10Y US Treasury yields



Source: Haver, UBS. * denotes when regression coefficients are not statistically significant at a 90% confidence level. Regressions were run after controlling for oil prices and/or local CPI inflation

Despite the FX drag, couldn't this be 2012 all over again?

Couldn't EM rates offset the negative contribution from currencies in 2015?

While currencies seem likely to remain a drag for USD based investors in 2015, could we not see strong yield declines making a large positive contribution to total returns, as was the case in 2012?

Couldn't benign oil prices, accommodative monetary policy in Europe and Japan, and/or attractive local market valuations provide a strong offset to the drag from weaker currencies? After all there is little statistical evidence to show that US Treasuries are more dominant than European rates in affecting EM local bond yields.

We attempt to gain insight into these difficult issues through two distinct questions:

(1) How well are EM local markets placed today to replicate their strong performance in 2012? Are valuations attractive enough to shield the asset class from a move higher in US Treasury yields?

(2) How should we think about the key upside risks – lower oil prices and further policy accommodation from the BoJ and ECB – in an EM rates context?

Comparisons with 2012

We think 2012 was an exceptional year for EM rates that bears more differences than similarities with the state of play today, for the following reasons:

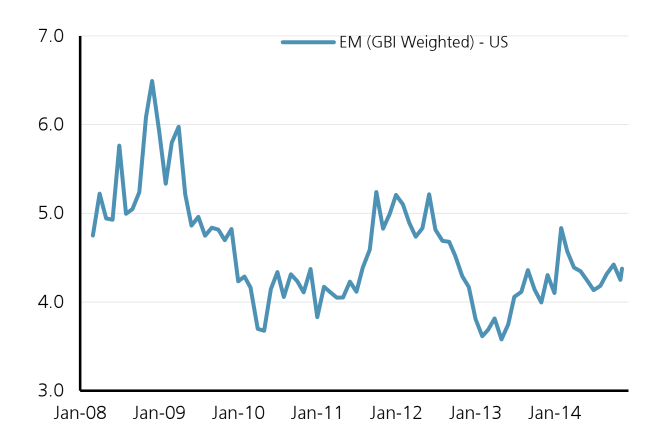
We expect core market monetary policy to be significantly different from 2012

- **Developed world easing:** 2012 was marked by powerful monetary easing by both the Fed and ECB, epitomised by Draghi's "whatever it takes" speech in July, followed by QE3 in September and a further expansion of Fed bond buying in December. Accordingly US 10y real yields declined from -12bps to -75bps, while peripheral European debt spreads contracted enormously (e.g. Italian spreads fell by 250bps). P/E ratios on European stocks rose from 9.3 to 11.7 as markets re-rated on the promise of reduced European break-up fears; today the P/E ratio stands close to decade highs at 14. UBS economics and strategy expect neither the same level of monetary support from the Fed or ECB in 2015 - indeed US 10y rates are seen rising significantly, while the rerating of European equity and fixed income markets is very likely at a mature phase.

Spreads to US Treasuries are more compact today

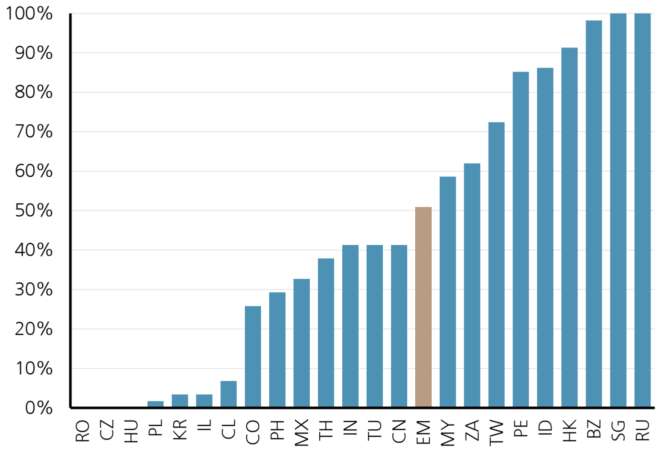
- On average we found nominal **EM spreads to USTs** to be around 520 bps at end of 2011 vs. around 436bps today (Figure 86). We find that spreads are pretty much exactly in the middle of their ranges since 2010 (Figure 87), hardly a level that promises a big re-rating in 2015. In real terms, we estimate EM yields were around 3% over USTs in January 2012 compared to about 1.85% today. In real terms the adjustment in EM rates since the 'taper tantrum' has been only marginally greater than that seen in the US (Figure 88 and Figure 89).

Figure 86: EM 10y (nominal) spreads to USTs: based on constant GBI weights



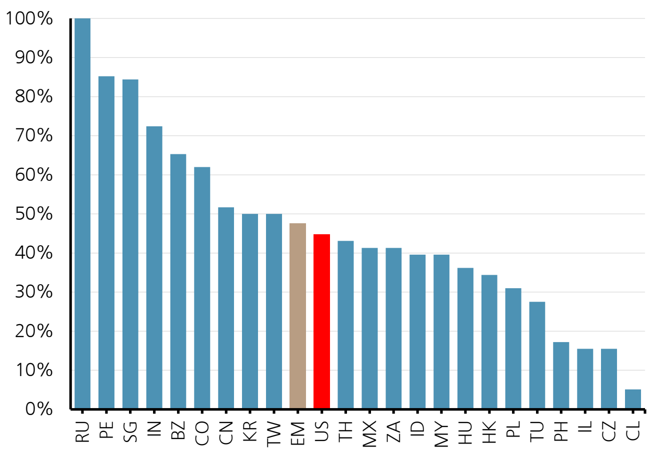
Source: Bloomberg, Haver, UBS estimates

Figure 87: 10y (nominal) spreads to USTs: percentile since 2010



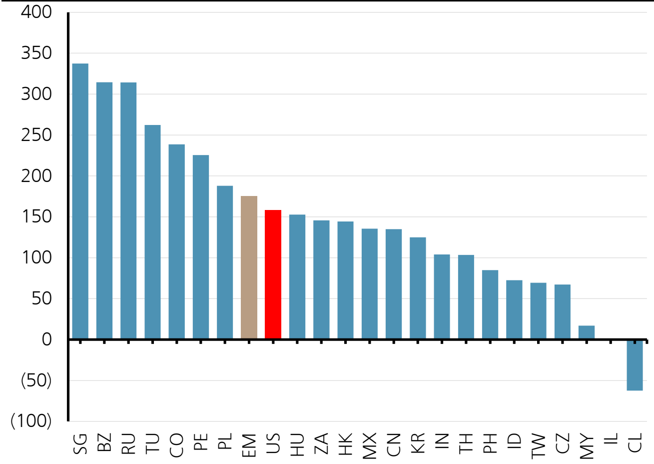
Source: Bloomberg, Haver, UBS estimates. EM series is GBI-weighted, constant weights

Figure 88: EM and US 10y (real) yields: percentile since 2010



Source: Bloomberg, Haver, UBS estimates. Real yields calculated by using 2y trailing y/y CPI to deflate nominal yields

Figure 89: Change in 10y real yields since April 2013 (pre taper tantrum), bps

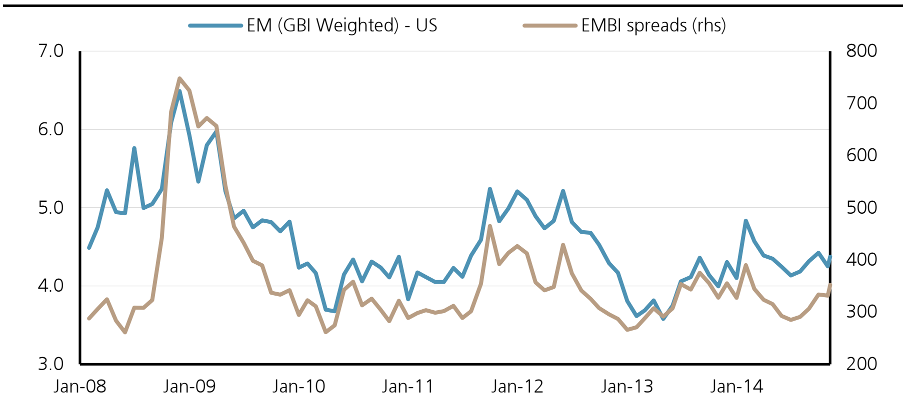


Source: Bloomberg, Haver, UBS estimates. Real yields calculated by using 2y trailing y/y CPI to deflate nominal yields

- A crucial ingredient necessary for EM to see a sustained compression in bond yields relative to the US is an improving **credit profile**. We have found that GBI EM spreads to USTs are quite closely correlated with EMBI spreads (Figure 90). As discussed in the credit chapter of this publication, though, with balance sheets worsening and spreads tighter today than in 2012, the case for further support from EM credit is not a strong one in our view.

EM's credit profile is no longer improving

Figure 90: EM 10y spreads to USTs vs EMBI spreads



Source: Bloomberg, UBS

Aren't lower oil prices big supports for GBI EM?

Lower oil prices are a key upside risk for EM local markets…

No doubt, the biggest support for EM local rates in 2015, however, is likely to come from EM inflation. There a few offsetting factors that we think investors should bear in mind, however.

…but they aren't falling in a vacuum. We think gold prices are sending an important signal, too

First, oil prices are not coming down in a vacuum. There is a generalised decline in commodity prices, which signals weaker growth and tighter financial conditions (even if not tighter monetary conditions). The impact of this on EM duration

depending on how solid the credit profile of the country in question is, but it is almost always negative for EMFX.

Second, in many EM countries, core inflation momentum isn't declining despite weak growth. Headline inflation can come off, but authorities are unlikely to respond unless services and core inflation come off.

Pass-through from lower international prices isn't automatic

Third, the pass-through from easing international USD oil prices to consumers in EM is likely to be tempered by recent local currency depreciation against the USD. The margins of fuel suppliers is another important swing variable: many of these have been affected negatively in recent years by high unit labour costs and an inability to fully pass-through higher costs to consumers through regulated price hikes

And what about the ECB and BoJ?

That's a great question, and one that we have taken some pains to answer. It's best to turn to the chapter: "ECB, BoJ, or Fed. Who drives EM?" of this publication for a detailed discussion, but in short we find that US investors, and US risk premia, typically have the dominant impact on EM assets.

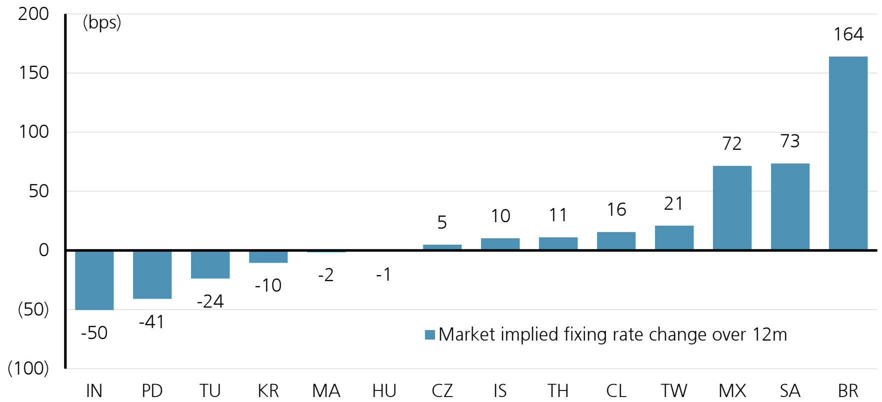
Opportunities at the front end? A quick overview of UBS' inflation and monetary policy calls for 2015

Opportunities at the front end look limited

At an aggregate EM level, UBS economists are only forecasting monetary easing in 3 out of 20 major EM economies next year: India, Korea and Russia (the latter expected late in the year, contingent on much lower FX volatility). On a GBI-weighted basis, EM inflation is expected to remain broadly flat at 4.3% (year-end basis), as acceleration in CEE and ASEAN inflation is expected to largely offset moderation in Latam, India, Turkey, and South Africa.

This benign inflation profile already looks priced into front end rates in EM, in our view. Outside of Brazil, Russia, South Africa, and Mexico, markets are currently pricing in less monetary tightening in EM than in the US next year. Against this backdrop receiver positions at the front end of most EM curves are likely to only make sense for the very tactical investor.

Figure 91: What's priced in over the next 12m



Source: Bloomberg, UBS

Concluding thoughts and trades

We forecast flat returns for the EM local currency benchmark in 2015

Overall 2015 looks likely to be another challenging year for EM local markets. While lower oil prices clearly support EM disinflation, valuations do not presently look robust enough in our view to provide insulation from further currency depreciation, rising US Treasury yields and potentially higher global risk premia. We expect EM currencies to weaken by 4% on a GBI-weighted basis, and expect a 40bp rise in local yields, generating flat returns for 2015.

In our view the ideal local debt investments in EM for 2015 should be based on the following factors to help navigate a challenging external environment:

- Solid real yields, or at least the promise of a significantly improved real yield outlook as central bank credibility increases
- A stable/improving credit profile
- Ability to FX hedge cheaply
- Decent liquidity

A screening tool

Mexico, India, Brazil and Korea are our favoured local debt markets for 2015

We try to systematise some of these criteria in Figure 92 overleaf. We present an ordinal ranking of EM debt attractiveness (excluding currency considerations) and find Mexico to be top of the pile, owing to its steep yield curve, relatively high yields net of FX hedging costs, deep liquidity, and decent real yield.

Korea, a market where our economists have warned of structurally declining inflation rates ahead and where policy is likely to remain expansionary in 2015, should be a relative outperformer as UST yields rise.

We also believe that India, supported by structurally improving inflation-targeting credibility, tighter fiscal policy and a more balanced currency valuation, should remain a structurally attractive local rates market in 2015. Lower oil prices, while not part of UBS' base case scenario for 2015, would be an added advantage.

Our favourite rates trades for 2015:

- Receive 10y Mexico v pay 10y Italian BTPS
- Receive Korea v pay US 5y5y
- Long 10y bonds in India vs. Turkey
- Long Brazil Jan 17ss vs. Bovespa

Figure 92: An ordinal ranking of valuation in EM duration (lower scores = greater value)

	10y yield - 2y avg CPI - 5y CDS	10y yield - 12m FX hedging cost	Real yield (percentile of range since 2010)	2s10s level* (bps)	2s10s* (percentile of range since 2010)	Liquidity (rank)	Nominal spread over USTs (percentile of range since 2010)	
	35%	10%	15%	10%	5%	15%	10%	
Mexico	1.2	3.6	37%	232	77%	2	40%	5.0
Brazil	4.8	2.3	56%	-4	17%	6	99%	6.2
Colombia	3.1	2.6	63%	159	42%	21	43%	6.9
Korea	0.8	2.4	58%	64	50%	1	0%	7.4
Singapore	0.0	2.3	81%	181	47%	4	99%	8.5
Taiwan	0.1	2.5	51%	104	88%	9	66%	10.0
Hungary	0.7	2.4	46%	97	65%	16	0%	10.1
Poland	0.9	1.0	30%	81	25%	10	0%	10.7
Malaysia	0.4	1.7	40%	37	1%	11	64%	10.8
Indonesia	0.4	1.1	46%	64	5%	13	85%	10.9
China	0.3	1.2	54%	40	25%	7	40%	11.1
S Africa	0.3	1.5	35%	102	1%	5	53%	11.1
Russia	0.3	-0.7	98%	-24	0%	15	100%	11.2
Chile	0.9	1.4	4%	122	77%	19	3%	11.6
HK	-2.6	1.9	33%	154	43%	3	91%	12.2
Thailand	0.2	1.3	42%	104	63%	14	37%	12.6
Israel	0.3	2.7	11%	199	61%	18	0%	13.0
India	-2.7	2.6	86%	-9	25%	8	41%	13.0
Philippines	-0.5	3.4	21%	127	18%	20	24%	14.7
Turkey	-1.1	0.1	26%	25	32%	12	45%	16.3
Czech R	-0.7	1.0	19%	76	0%	17	0%	17.8

Source: Haver, Bloomberg, UBS.
* Due to data limitations, 3m bill yield used as 2y rate for India, 2y swaps instead of bonds used for Israel and S. Africa
SBI CDS used to proxy India sovereign CDS. 5y CDS data for HK, Taiwan and Singapore taken as United States CDS
Real yields are calculated by deflating nominals with 24m avg CPI

Regional rate outlooks

EMEA: (Manik Narain / Patrick Lamaa)

The outlook for EMEA rates is likely to be marked by idiosyncrasies as cross-currents from US rates, ECB policy and diverging inflation patterns all take effect. Valuations in CEEMEA have become stretched after the recent powerful rally, in our view, with Polish 10y rates now trading a mere 35bps above US Treasuries and markets pricing no chance of a rate increase in Hungary over the next two years, for example. If our economists' view on the ECB holds correct - no sovereign quantitative easing programme in the absence of a notable increase in risk premium – these valuations will likely prove hard to sustain. We believe **paying Hungary 12x15 FRAs**, or positioning for **a steeper 1s5s IRS curve in Poland** offers an attractive risk/reward. We wait for better levels to going long South Africa government bonds, and maintain a **cautious view on Turkey** (having been paid relative to Israel in 2014) in light of much lower yields than the EM average, a weakening fiscal anchor, an unconvincing anti-inflation commitment and rising uncertainty around key economic personnel. Finally, while OFZ's in Russia have weakened substantially, we feel a more powerful monetary policy response to RUB depreciation is still needed to anchor bond market confidence.

Latam: (Gustavo Arteta)

In 2015 Latam rates should feel the pressure from US tightening but timing and extent of moves will respond to different stages in respective cycles. Brazil has restarted a tightening cycle but DIs are pricing more risks. We think the curve will remain slightly inverted and like receiving the belly. Mexico has a very steep curve owing to low policy rates and strong growth expectations. This market shows up as among the most attractive in EM on our metrics, and we see room for outperformance relative to most. We recommend buying MBONOs vs. Italian BTPs. We see little value in Chile duration where continuingly rising inflation and slowing economy has market guessing the next policy move. Colombia offers high real rates and CB is well placed to react to UST if need, but the currency moves may not be your friend.

Asia: (Gareth Berry / Maximillian Lin)

Our view on Asian duration is mildly positive relative to EM as a whole. We are most bullish on duration in India as RBI and government policies gradually bring inflation lower in pursuit of the de facto 6% CPI target. China and Korea face similar dynamics as policymakers grapple with slowing growth; for China we think incremental measures will continue as policymakers avoid large-scale stimulus and targeted measures prove insufficient to revive rapid growth. In Korea, we don't anticipate any Abenomics-style stimulus. BoK looks to pause for now but may still face pressure to continue cuts in the absence of structural reforms.

We remain cautious on Indonesian duration due to existing long positioning and extremely high expectations for reform. We view Malaysia more favourably; the central bank will likely see through inflation from fuel subsidies, but high foreign positioning still makes Malaysian duration vulnerable. In Thailand, we are slightly conflicted; the expected bounce-back in growth has proved elusive; if demand recovers rates should sell off, but thus far the data has been weak.

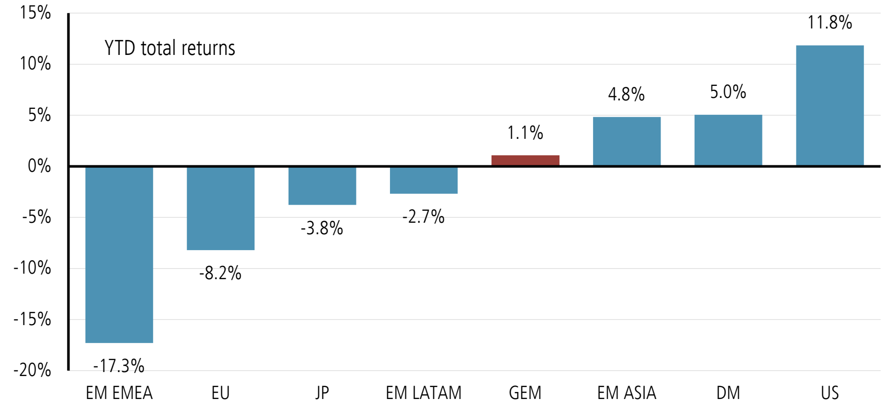
EM Equities: Is EM the never-land of earnings?

Is EM the never-never-land of earnings?

Bhanu Baweja / Geoff Dennis

- The EM growth model is seeing structural shifts and yet analysts have systematically over-predicted earnings in EM. Earnings should improve next year to 5-7%, that too only because low oil prices and inflation will help. However, the consensus, at just below 12%, is likely once again too high.
- We think total returns for EM equities will also be in the range of 5-7% next year. Based on a declining growth alpha against DM, it is difficult to see EM equities outperforming DM equities.
- FX typically plays a small part in total returns, but next year it may provide a bigger headwind to EM equities than usual. This is because we expect the heavyweight Asian currencies to depreciate modestly from current levels.
- EM's valuation story is best told not at an aggregate, but at a sector level. On this view there are a few instances of notable undervaluation relative to DM, but only in deep cyclicals, which will struggle to recover if growth doesn't.
- Going into next year we like Mexico, Korea, Taiwan, and are negative on South Africa, Indonesia. Thailand too is getting expensive quickly. Turkey will face headwinds again if US rates do begin to rise. Within sectors we find the risk reward relatively more attractive for Industrials, IT and Telecoms.
- Positives for EM equities are few but they do exist. First, lower inflation, which has historically led to better equity returns with a 6m lag. A supply driven decline in oil will help margins. Second, there are scattered signs that companies are becoming conscious both on labour and capital spend, helping free cash flow. Also they are singing a more shareholder friendly tone (though not for the first time). Third, European growth can improve and US spending can become more EM friendly. All these present upside risks to our view.

Figure 93: YTD performance of key regions in EM and DM



Source: MSCI, Datastream, UBS

EM's been an all-terrain underperformer

At the time of writing EM equities are lined up for another year of underwhelming returns. The fact that this has come despite a very strong rally in US Treasuries, a fall in which was blamed for 2013's bad performance, is a matter of some concern. Equally, EM stocks have already underperformed DM stocks by 46% on a

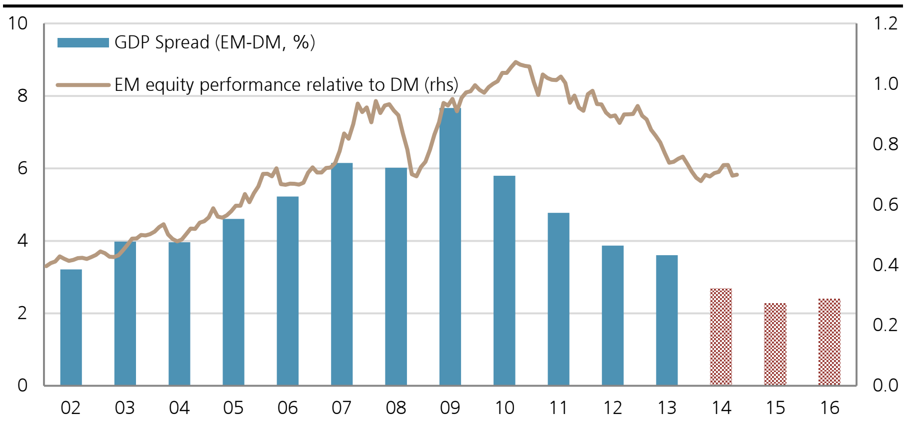
5 year view, and 30% lower on a 2 year view. Things are not great, but prices have gone a long way. Where next for EM equities?

Same old-same old is a powerful drug

The notion of mean reversion exerts an immensely powerful pull on investors' and analysts' minds. It's an idea that is innocent until proven guilty. Many successful quant models are based on this elegant idea of a move back to a stable equilibrium post a 'temporary' shock. The burden of proof is squarely on anyone who dares to say 'this time it's different' – words that have, not infrequently, ended careers. Mean reversion[12] says it's time to buy EM for a big swing higher, both in the absolute, and also relative DM.

Mean reversion says what is has said for a while- that it is time to buy EM against DM Are there new reasons to believe it now?

Figure 94: EM- DM growth spread & EM-DM equity performance:



Source: Haver, Bloomberg, UBS.

Yet, we resist its pull.

We are not looking for a quick reversion to the mean[13] of this EM-DM growth spread. Indeed, as we have argued before, it is very likely that the spell between 2003-2007, the honeymoon period for EM assets, was the exception, rather than the rule.

The patterns of global trade activity, EM leverage and limited reform will constrain earnings.

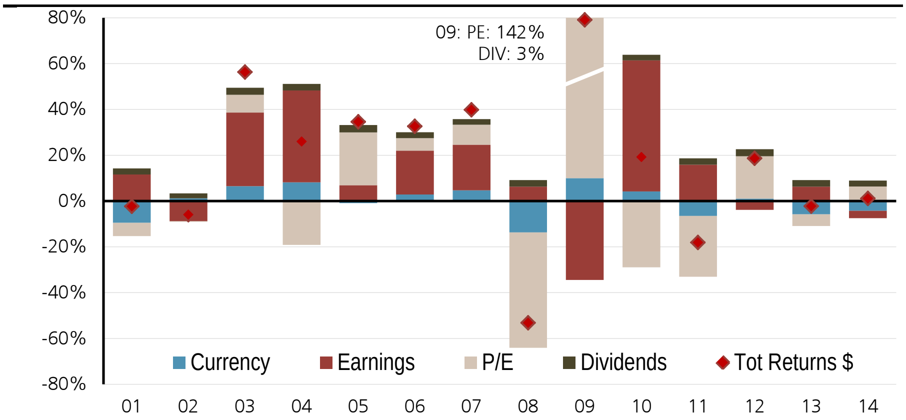
Arguing for a big rebound in EM stocks, we feel, we would be running completely on faith. It would be siding with the perceived properties of mean reversion against the evidence currently at hand. Yes, the evidence changes as time goes by, but if it does, we will change our mind. The risk of wrongly assuming as a base case that the EM growth model will return to its 10y mean is larger than missing a potential market bottom, we think.

Running on faith

[12] What many folks arguing for a mean reversion to pre-crisis growth /earnings/returns ignore, of course, is that if you really wanted to consider mean reversion over long haul period, say 35 years or more, then things look considerably less rosy for EM

[13] This idea of mean reversion, powerful as it conceptually, doesn't actually stack up to statistical scrutiny in EM. On both a long term (2002 till present) and near term (2010 till present) the spread of the total return between EM and DM equities is not stationary. That is, it goes through long spells of exploding in one direction rather than mean reverting

Figure 95: Total return attribution in MSCI EM: Where are the earnings?



Source: MSCI Datastream, UBS. 2014 denotes YTD data

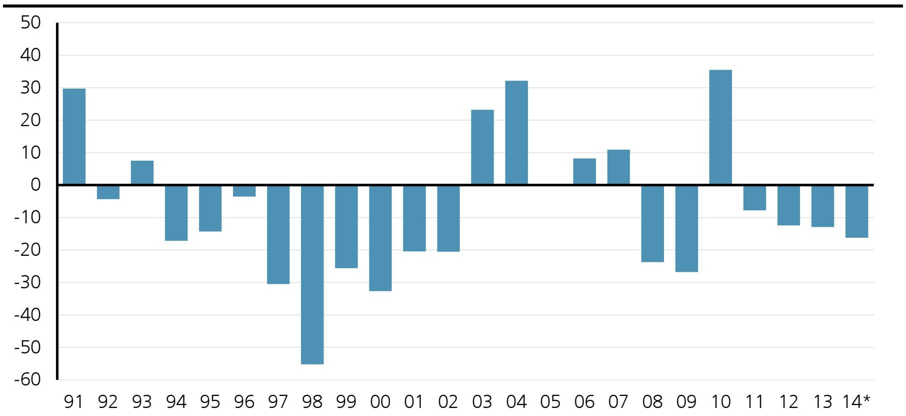
When we choose not to learn

We have a big argument with the street's systematically bullish earnings forecasts. 2014 was the fourth year running when earnings estimates were too high. Aren't things due to turn around after 4 long years? Sure, they could, but we had heard the same thing for about 3 long years.

Earnings forecasts say a thing or two about our industry

In Figure 96 below we assess how good a job the street has done in calling earnings. We have compared annual twelve month trailing earnings at time t with 12m forward earnings of analysts at t-1, that is, whether the earnings expectations were realised in actual earnings. As is clear, there are many more misses than beats in the data, and if one looks far enough the current pattern of earnings being missed year after year looks more like the norm than exception. We are all for optimism, but there's something to be said for an occasional visit to real town.

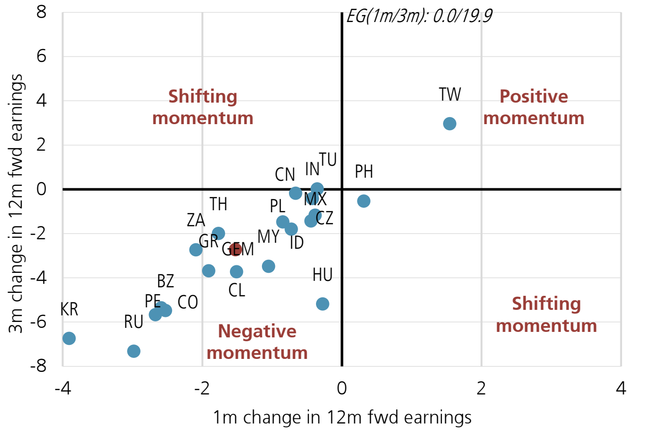
Figure 96: Theatre of the absurd: Realised earnings at t minus forecast earnings at t-1 (%). Negative is a year of miss, positive is a year of beat.



Source: MSCI Datastream, UBS *Data of 2014 is for 12m trailing y/y earnings till Oct

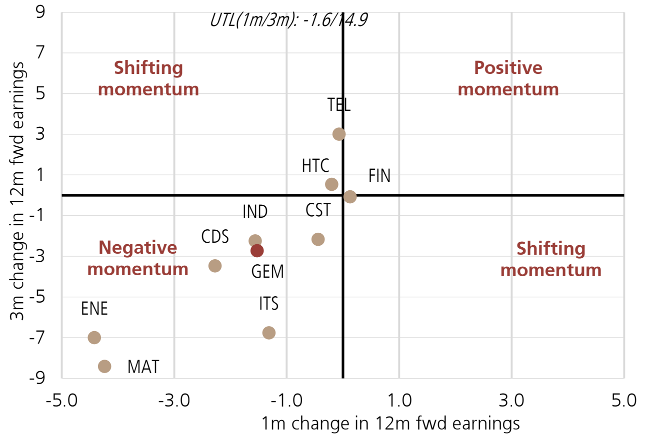
When we started this year we had forecasted 7% earnings growth, which stuck out as amongst the more bearish estimates on the street. It turns out that we will be lucky to hit 4% earnings growth for 2014, the stronger USD being one of key factors hurting earnings. The latest consensus numbers have earnings growing at just under 12% in 2015 and at 11% in 2016. This high level is where things stand after the numbers having been revised lower quickly (Figure 97).

Figure 97: 1m and 3m changes in 12m fwd. earnings estimates of MSCI EM countries



Source: IBES Datastream, UBS

Figure 98: 1m and 3m changes in 12m fwd. earnings estimates of MSCI EM sectors



Source: IBES Datastream, UBS

Based on strictly top down estimates we think a number of about 5-7% is much more appropriate for next year.

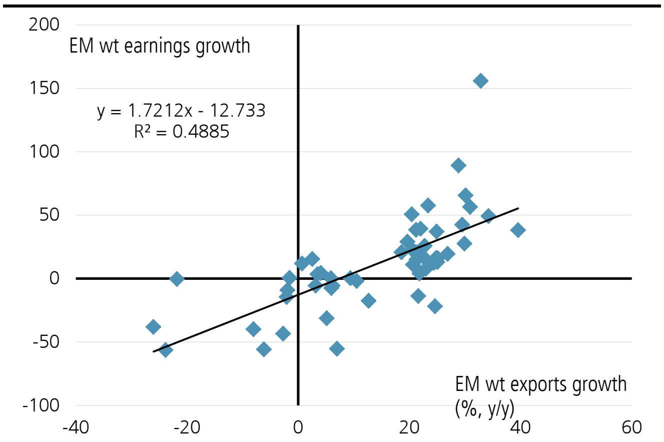
2015 should see 5- 7% earnings growth in EM. This number would have been lower had it not been for the oil price decline.

We base this on the view that EM exports, which have the closest fit with EM earnings amongst all macro variables, are likely to see another year of only moderate growth. We are growing more confident in our view that the relationship between global growth and global trade has loosened. Having written about this extensively, we will not go into great detail here, but we would refer the interested reader to EM Cross Asset Navigator: Is the trade slowdown structural or cyclical? Chinese real GDP growth rate has halved from 2015 and is falling fast, but not as fast as its imports. EM's balance sheets have much less room to expand, and EM's cost of capital is very likely due to rise as the Fed raises rates, loose ECB and BoJ notwithstanding (see dedicated chapter of this note).

Frankly, our macro numbers point to an even smaller growth rate for 2015 earnings, but we feel that these may not have incorporated some the micro improvements at an EM company level, and the big supply driven decline in oil prices, which should help EM margins. More on this topic later in this section.

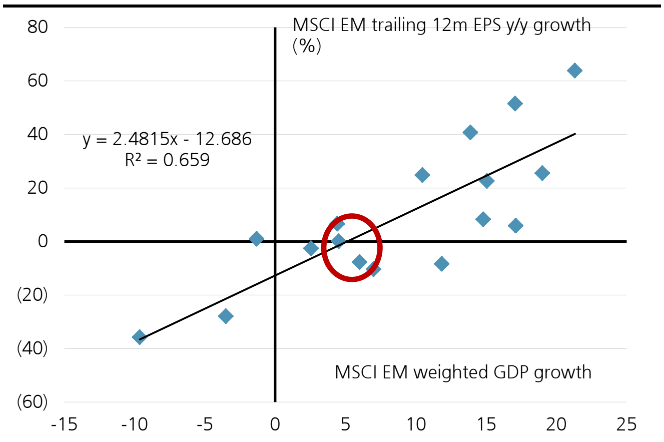
Our low earnings expectations for 2015 would have been lower still were it not for expectations of some company level reform and lower oil costs

Figure 99: EM earnings with EM exports growth : quarterly



Source: Haver, Datastream, UBS

Figure 100: EM earnings with EM USD GDP growth: Annual



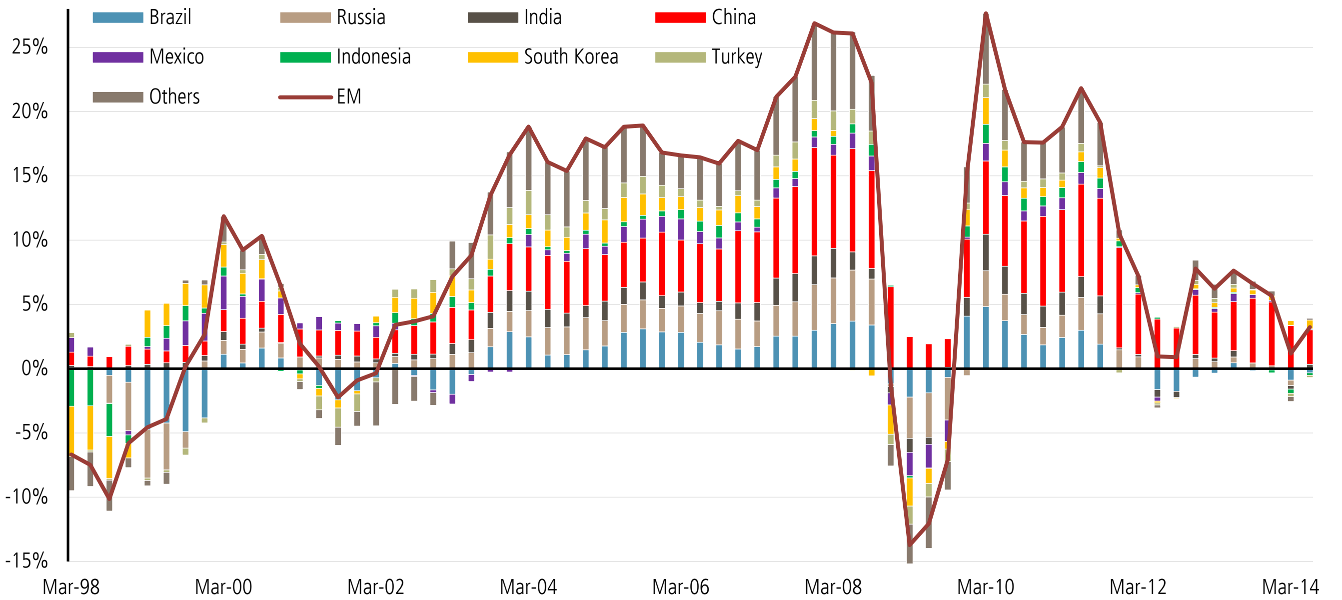
Source: Haver, Datastream, UBS

How cheap is EM then?

EM stocks are valued at 10.8x forward earnings which is in line with long term averages. Sure, that's not expensive; it's just what it says on the tin- average. But we have ask ourselves whether EM at an 'average' juncture relative to recent history. Figure 101 below doesn't suggest we are.

EM's valuations are broadly in line with long term average…

Figure 101: Contribution to EM USD GDP growth

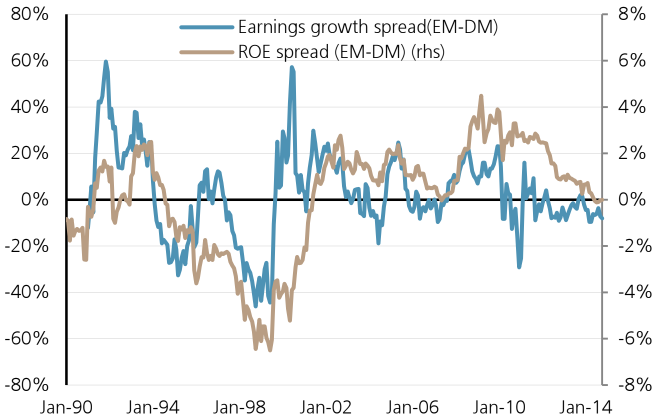


Source: Haver, UBS

USD terms EM GDP growth, having already slowed down substantially, is likely to slow further in 2015. This is likely both because we expect EM growth will fall modestly, and the USD will rally against EM currencies. Asia, the heavyweight region in MSCI EM, is pretty much the only place that has been contributing to nominal USD GDP growth in EM (Figure 101). Here too the numbers are likely to turn down next year as China slows and currencies depreciate. Based on a 10y history, 2015 will hardly be an average year for EM growth.

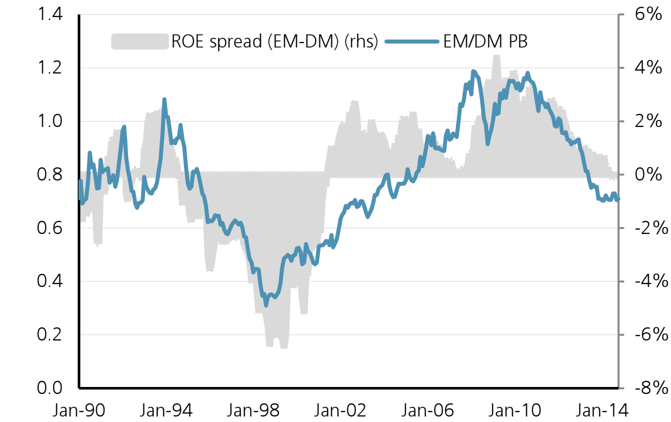
…but EM's growth is not. Based on annual USD GDP growth data for EM we see that earnings tend to go zero for USD GDP growth less than 5%

Figure 102: EM trailing earnings growth and ROE relative to DM: Spot anything out of the ordinary? We don't



Source: MSCI Datastream, UBS

Figure 103: EM v DM ROE spread vs EM v DM valuations: Spot anything out of the ordinary? We don't

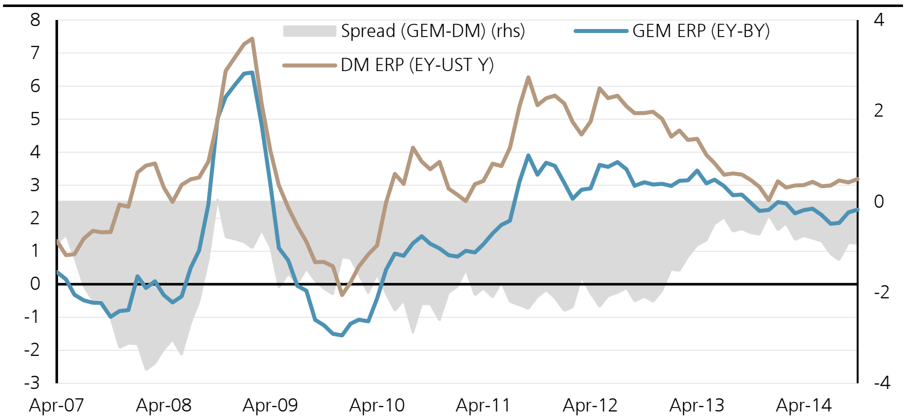


Source: MSCI Datastream, UBS

The de-rating of EM's multiples relative to those of DM has been exactly in line with the decline of EM's RoE relative to that of DM.

The usual comeback from investors to this line of reasoning is that we are missing the impact of loose monetary policy and risk premia on valuations, ie, they needn't trade in line with fundamentals. We are reminded about the slow but steady climb in developed market valuations. We have to say that we still don't see the argument for EM being increasingly cheap. Our view is simple (perhaps too simple): EM's earnings are weaker relative to DM, this leads to weaker RoE trend relative to DM. As Figure 102 and Figure 103 show, the de-rating of EM has been nothing if not in line with de-rating in EM RoE. Yes the spread between EM equity risk premium and DM equity risk premium (we are using a rough proxy here) has come in (Figure 104), but it is still below that in DM.

Figure 104: Proxy for Equity risk premium (Earnings yield - Bond yield) in EM and DM: The spread between EM and DM is lower but ERP is still higher in DM



Source: MSCI, IBES Datastream, Bloomberg, Haver, UBS

So, we expect largely flat multiples, and 5-7% earnings (although if earnings do rise more than expected, the market will almost certainly re-rate too). What about dividends and currencies?

FX is likely to provide negative return of up to 3% next year, taking away from total return nearly as much as dividends would contribute to it

We rethink returns from these sources are likely to broadly cancel out. Based on slightly better pay-out ratios we think EM's dividend yield is likely to be around 3%. Typically currencies contribute a small proportion of total returns in equities but next year we expect they will provide a stronger headwind than usual. This is so because we expect Asian currencies to weaken, including a slide in the RMB to 6.35 against the USD by end 2015. Given the region's weight in the index, and

further FX weakness in other markets like Russia, Brazil, South Africa and Turkey, we see FX taking away up to 3% from total return for USD based investors.

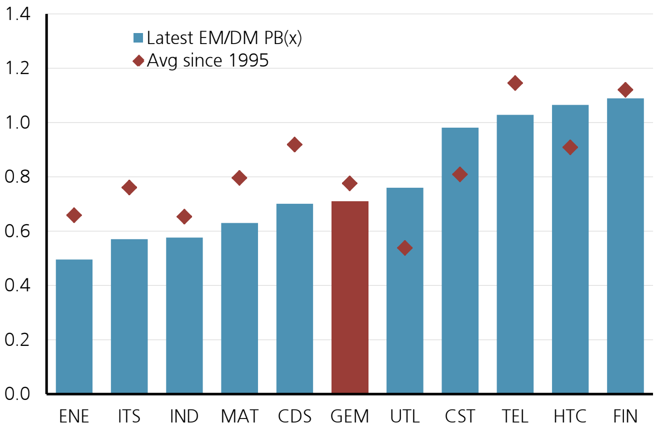
On this basis, we expect total returns next year to be largely in line with earnings at 5-7%

5-7% total returns in 2015

Where is EM really cheap?

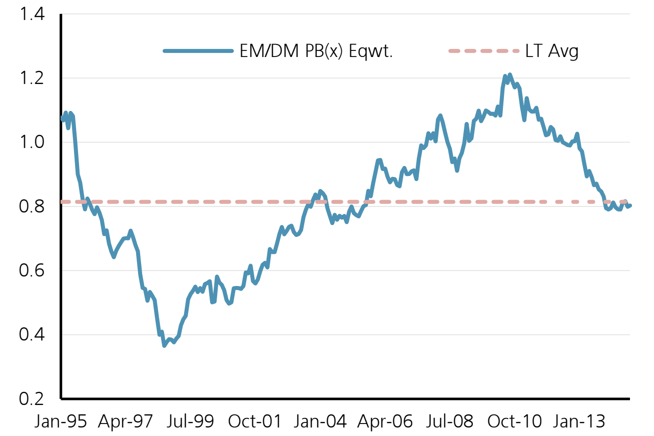
To the extent EM stocks have put up any performance in 2014 it is down to the defensive sectors in this market. The cyclicals in EM, particularly energy and materials have been beaten up a long way. Industrials have been broadly flat; it has only been IT that has done well. Where is EM cheap now?

Figure 105: EM sector valuations (P/B) relative to DM sector valuations: Today, and averages since 1995



Source: MSCI Datastream, UBS

Figure 106: EM V DM PB on a sector neutral basis (assuming equal weight per sector): In line with history



Source: MSCI Datastream, UBS

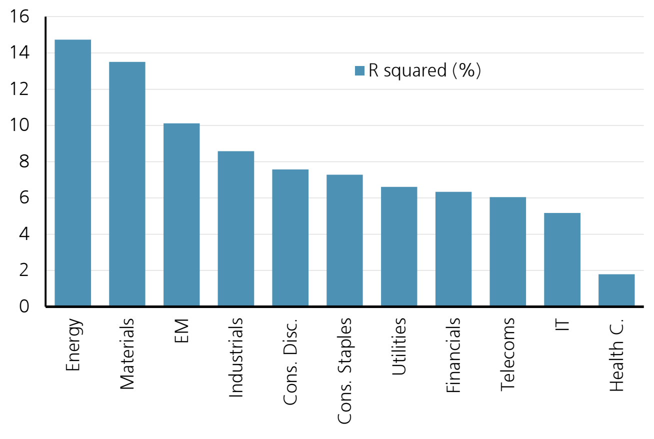
In Figure 105 we compare the price to book of each sector in EM with its counterpart in DM. We can see that 7 out of 10 sectors are cheaper than they are in DM (ratio of less than 1). We have also compared the current level of this EM v DM valuation ratio per sector to its long term average, which in our view is a more relevant comparison. We see quickly that consumer staples, healthcare and utilities are not cheap.

Expensive defensives have got more expensive (yes, that's been said before)

The defensive sectors in EM are not only not cheap, one can argue that the main drivers behind the strong performance of these sectors are now weakening. Strong employment, wage and credit growth have helped sectors such as consumer do well. Weakening overall economies and some pressure on currencies is now leading to some weakness in these variables. Not surprisingly, the contribution of consumption to overall EM growth, having held up strongly in the face of intense weakness in EM capital formation, is now weakening as well.

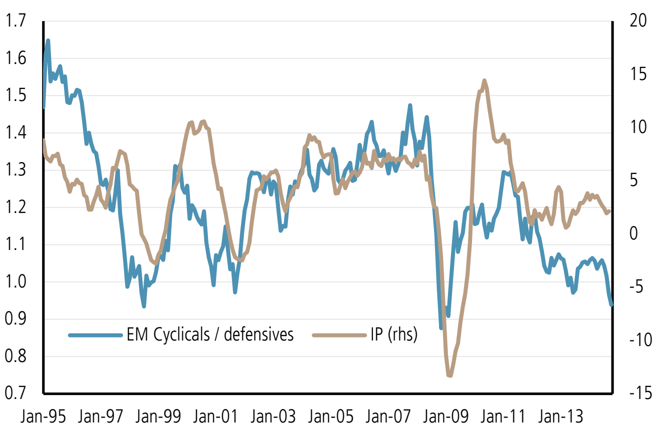
Certainly EM cyclicals look cheap relative to DM. This is in line with the weak EM growth profile, however (Figure 108). Also, the fate of energy and materials is tied inescapably to commodities (Figure 107).

Figure 107: R sq of different EM sectors with commodities



Source: MSCI Datastream, Haver, UBS. R squared are calculated using monthly returns of the Bloomberg Commodity index and MSCI EM sectors

Figure 108: EM industrial production vs cyclical/defensives



Source: Bloomberg, Haver, UBS

Industrials, IT and Telecom look more attractive than other sectors

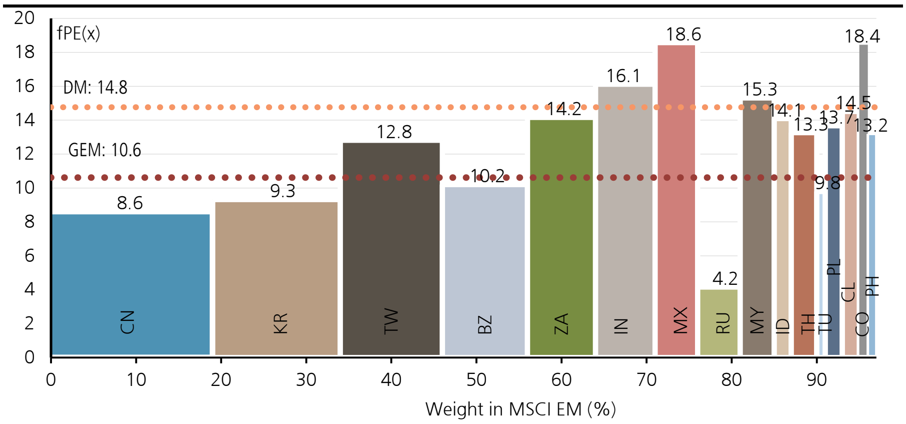
Amongst all sectors in EM, based on a) valuation profile relative to DM, and b) limited exposure to commodities and c) positive exposure to higher US investment spending telecoms, industrials and IT present the more attractive risk reward, in our view.

The reason EM does look quite cheap at a headline level is that in the sectors which have much higher weight in EM relative to DM, such as energy and materials, EM is well cheaper than DM. In Figure 106 we try to normalise for this by assigning a 10% weight to each GICS sector. Here EM is cheap relative to DM (ratio below 1) but the ratio is exactly in line with its history. Once again, valuation spread is at its average level, when growth spread isn't.

Korea, Mexico and Taiwan are over-weights for us

At a country level too, EM's valuation spread around its mean is quite high. There are 3 markets that are clearly cheap relative to the EM average: China, Korea (both of which are quite big and hence drag the average down), and Russia. In picking markets that one ought to be overweight in, one has to balance a) current valuations, b) earnings momentum, c) exposure to the right sectors/markets, d) vulnerability to higher USD and US rates and c) vulnerability to weaker Chinese investment and imports. In this regard we consider Taiwan, Korea and Mexico as relatively better placed.

Figure 109: EM country valuation: current fPE and GEM, DM averages. Width of column denotes weight of the market in the benchmark



Source: MSCI Datastream, UBS

Of these perhaps the most controversial is Korea, which has been a consistent disappointment on earnings. However we do feel that with at these valuations, and with exposure to the US investment cycle, it does present reasonable risk reward. We are not banking on a big change in the corporate governance environment; we'd consider shareholder friendly policies as a bonus.

Korea underperformance has been a tough one to swallow. We think this may be wrong time stop out of a long.

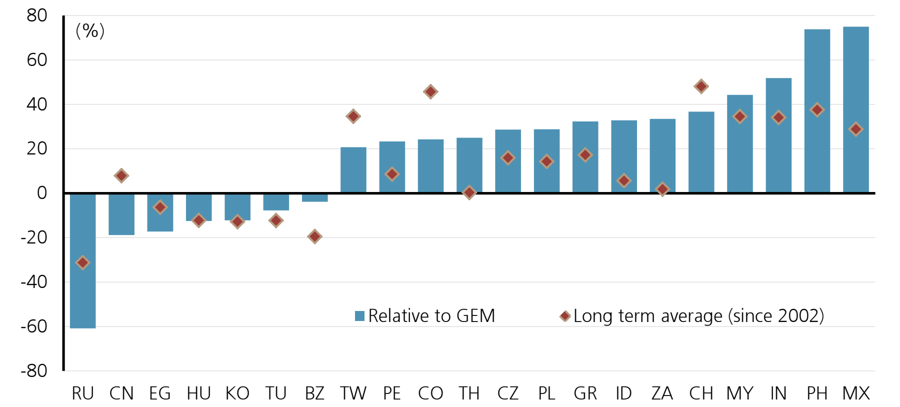
The markets that we are least constructive on are South Africa and Brazil. We lean more negatively on Thailand and, through a period of higher US rates, also on Turkey (although note that our equity strategy colleagues are presently overweight Turkey as a tactical trade).

South Africa, Indonesia Brazil and Thailand are our underweights.

China and India sit in the neutral space for us. Much as India has become quite expensive it is difficult to see it being sold on a relative basis. Hopes for lower rates and reforms are big positives for investors here. We have expressed a bullish view on India v Turkey in the debt and FX space rather than through equities.

India is expensive but investors will likely give it the benefit of doubt for a while longer

Figure 110: Current fPE relative to GEM, and long term average of this ratio



Source: IBES Datastream, UBS

What are the positives to hold out hope for

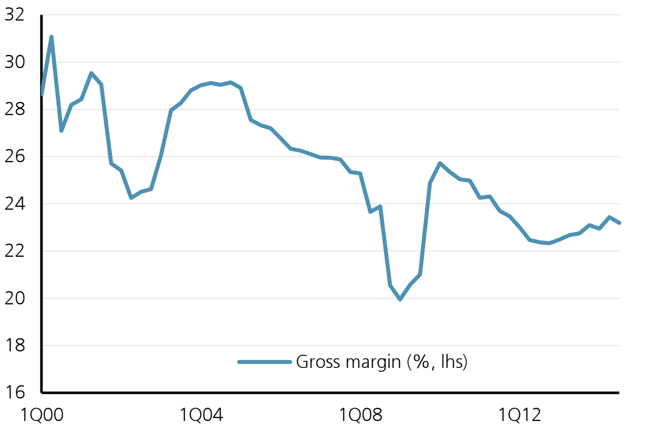
Oil lubricates the hope for better margins

First, we will be watching Q4 margins data (which will be available from January) very closely. We are keen to learn just how much of an impact lower energy costs or margins of industrials and other parts of MSCI EM. There are few historic data-points which help in working this out. Oil has very seldom fallen only for supply side reasons. It did fall in late H2 2006 amidst an era of strong growth, and subsequently EM margins did rise by 0.5-1%. We are hoping the same happens this time

There are few historic datapoints that help assess the impact of a supply driven decline in oil. H2 2006 may be one of them. We expect a 0.5-1% rise in % in margins

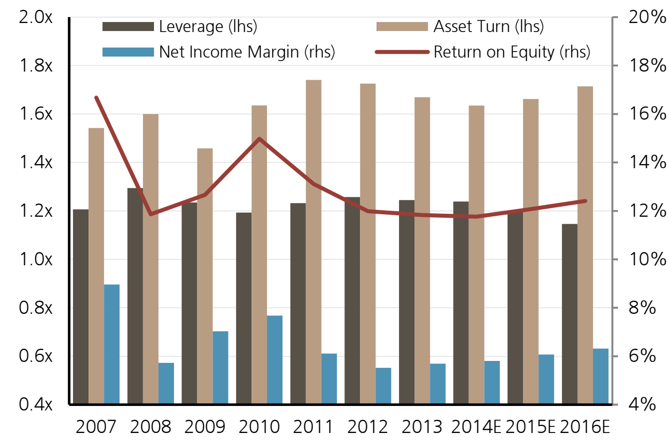
Beyond oil, one school of thought argues that EM companies have been made uncompetitive by the strong rise in wages, investment costs and commodities that earlier EM growth itself spawned. Now, as EM companies are limiting their investment, being more rational on wages/hiring, and, perhaps most importantly, as oil prices are coming off, EM margins, and EM RoEs can improve.

Figure 111: Gross margins for MSCI EM



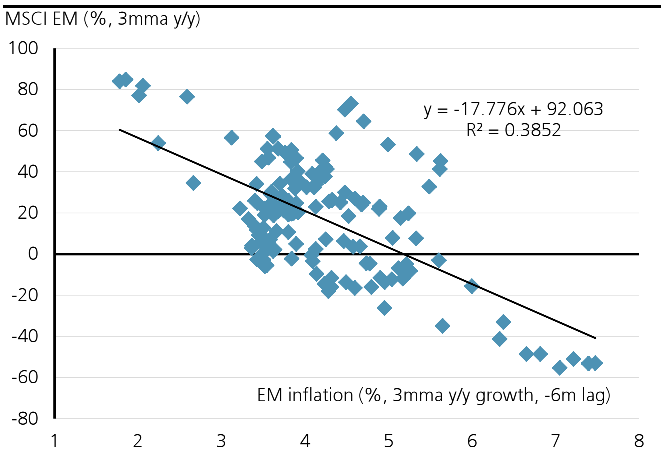
Source: Bloomberg, UBS

Figure 112: Du pont analysis of EM (ex-financials)



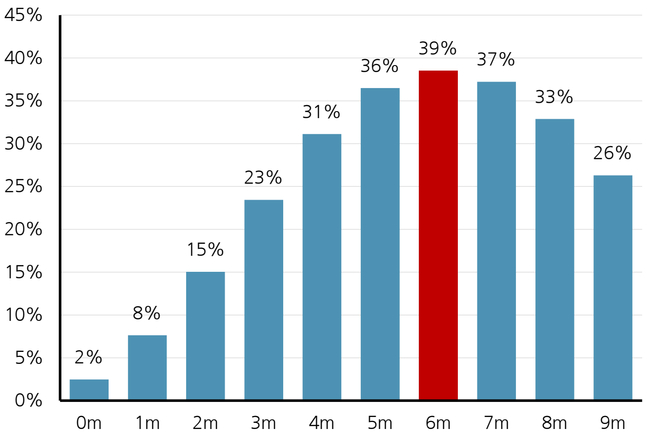
Source: GEM Inc., UBS

Figure 113: Smoothed MSCI EM performance y/y on 6m lagged smoothed y/y inflation



Source: Haver, IBES Datastream, Bloomberg, UBS

Figure 114: R squares between MSCI EM performance and EM MSCI weighted inflation at various lags of inflation



Source: Haver, IBES Datastream, Bloomberg, UBS

Low inflation

EM equities seem to react to inflation with a 6m lag

Even as we see the US raising rates (more than consensus expects) next year, low inflation globally, including in EM, will mean that EM central banks will not be in a big rush to push through aggressive rate hikes. In addition, EM central banks have (thankfully) mainly executed more conservative policies than their governments have espoused with the result that aggressive bond market volatility in EM has become a lower risk today. Lower headline (oil and food) and core inflation does over time help EM equities with a lag (Figure 113). Our models show maximum impact on GEM with a 6m lag (Figure 114).

The promise of shareholder friendly policies

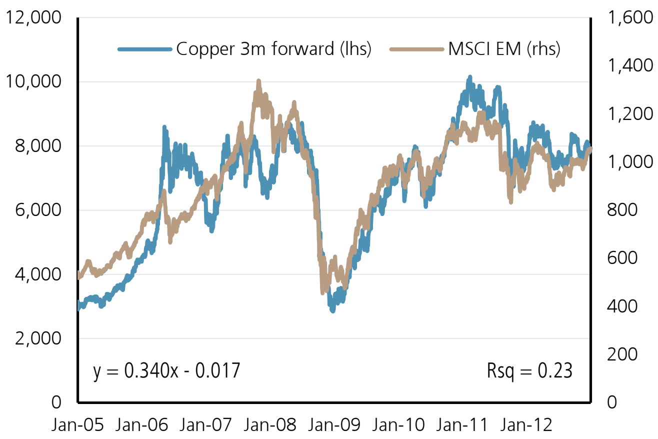
Corporate governance has been EM's bug bear for a long time. For just as long there has also been hope that this story will improve beyond markets like South Africa, Thailand and India, where corporate governance has been 'relatively' better compared to bigger markets like China, Korea, Brazil and Russia. There is no startling change to report at an aggregate level yet, but in all cases there have been stirrings of focus on shareholder returns. As companies are taking in the magnitude of the structural change in business environment, we think they are

becoming more focussed on costs. Governments in markets with large SoE footprints, such as China, and Korea, have expressed a desire to deregulate.

The relationship with commodities is weakening (a bit)

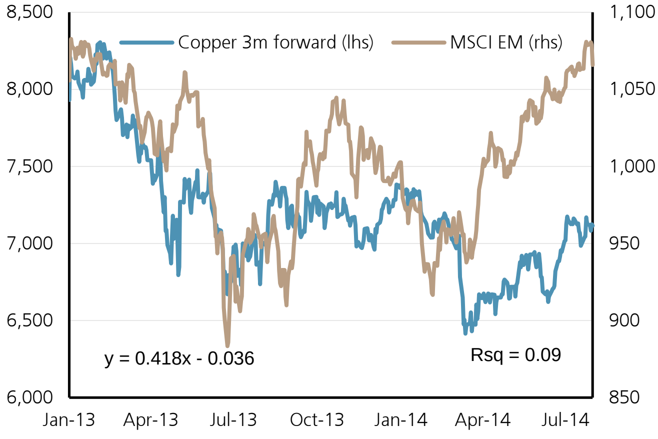
Over the last 10 years the relationship between EM stocks and commodities has been especially tight. That poses a not insignificant problem given UBS' views on China growth (particularly import growth) and the broader USD. Thankfully over the last two years the relationship has begun to loosen modestly. If we are honest this is very likely because strong credit growth supported domestically oriented defensive stocks. But it is an important change.

Figure 115: Copper vs. MSCI EM from 2005 to 2012



Source: Bloomberg, MSCI Datastream, UBS

Figure 116: Copper vs. MSCI EM TR from 2012 onwards

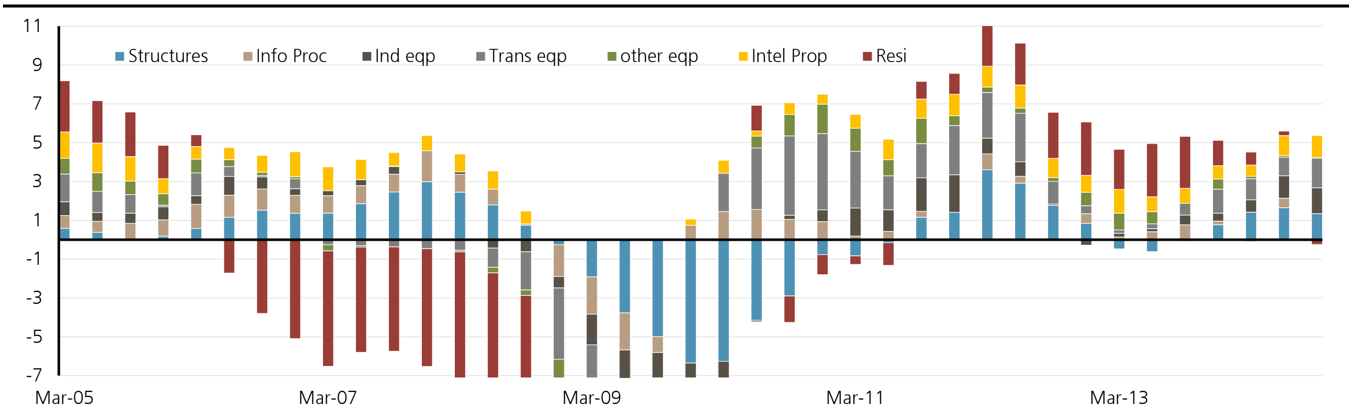


Source: Bloomberg, MSCI Datastream, UBS

And hey…growth may improve

Sure, global growth isn't stellar, but there are bright spots. US investment spending has picked up and US consumer spending is slowly getting better. The trouble for EM has been that investment spending on residential structures, and on information processing equipment- sectors that EM feeds into- have been quite weak. Similarly in consumer spending non-durable spending has been weak. But as the overall economy improves, these sectors can improve too. Should this come around, we can see a noticeable difference in EM exports and earnings

Figure 117: Growth in US investment spending by sectors



Source: Haver, UBS

What if DM stocks fall?

What if DM stocks fall?

Bhanu Baweja

In June 2014 we published a note Will EM gain if fully priced DM stocks fall? where we investigate the relationship between EM and DM equity returns.

- We study the relationship between quarterly total returns in MSCI World and MSCI EM over a 20 year period. We find little evidence of EM stocks posting positive total returns when global stocks fall. There is modestly more evidence of relative outperformance, but in aggregate EM underperformed more than 60% of the times when global stocks fell. EM's high 'beta' has unfortunately been less reliable in a positive world. Investors have suffered EM underperformance in a world of declining DM stocks more consistently than they have enjoyed EM outperformance when DM stocks rally.

- We split our sample into 4 periods: 1995-2002, 2003-2007, 2008-2009 and 2010 till today. We find that in the pre-2003 period, and since 2010, the performance of EM amidst different states of DM returns was heavily asymmetric – clear underperformance in a negative world, but less reliable positive returns in a positive world. The 2008-2009 period unsurprisingly shows extreme returns, but they are broadly symmetric. The only period in which returns are asymmetric positively is the 5 year boom period from 2003 to 2007, during which time Chinese growth averaged 11.25% and global growth averaged 4.8%, 1.2 standard deviations above its long term average.

1. Can 'cheap' EM benefit if fully priced DM stocks fall? Evidence from history

First up we investigate the relationship over time between MSCI EM and MSCI World. It's unsurprising that the relationship is a tight one with an adjusted R squared of 65% and a beta of 1.2 in the unconstrained sample.

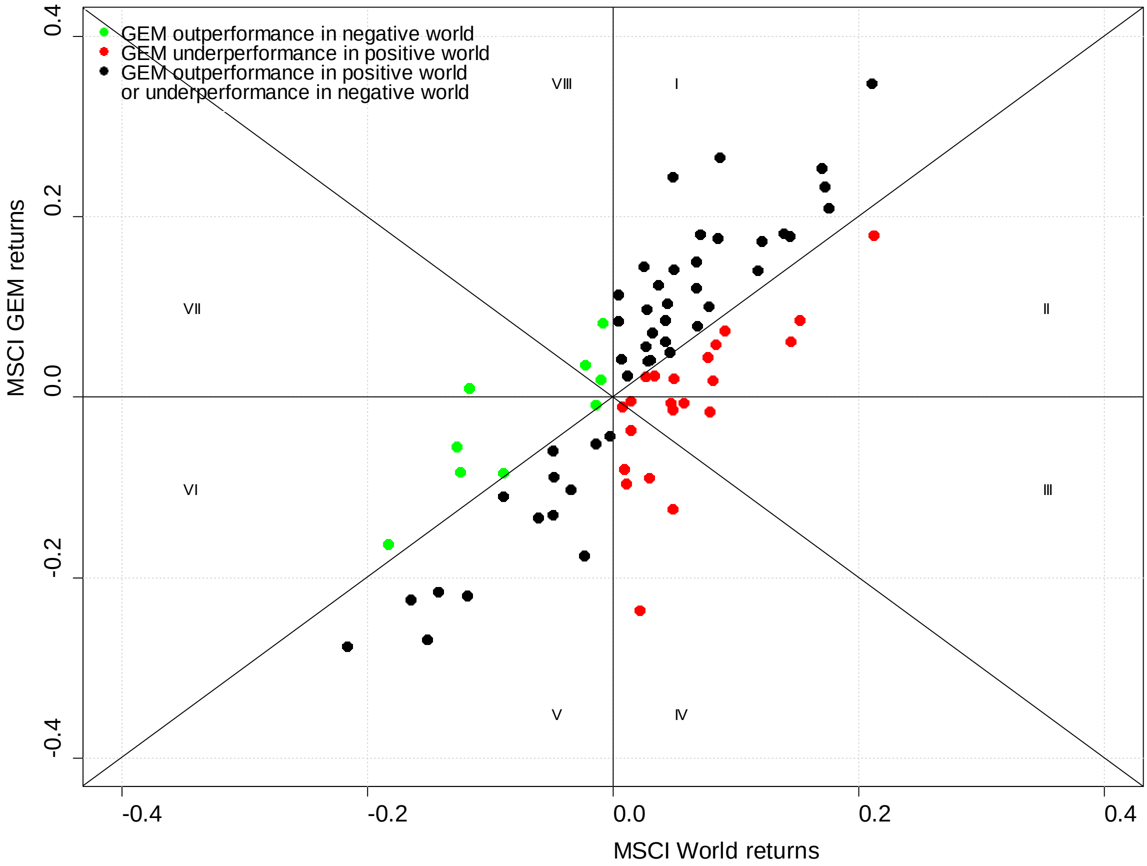
The 45 degree lines in the chart help identify period of absolute and relative performance

We now focus on the parts of the scatter in Figure 118 (identified by sections made by the two 45 degree lines), which help us define periods of absolute and relative out/underperformance of EM stocks vis a vis DM stocks. For example, section 1 houses the observations that indicate EM outperformance in a world of rising DM stocks and section II indicates positive absolute but negative relative EM performance over DM, and so on. For most of the last two decades global stocks have been rising, so the bulk of the observations sit on the right side of the y-axis.

Little evidence of positive EM out performance when global stocks fall, more evidence of EM underperformance when global stocks rise

But today we want to assess whether EM equities are able to post positive total returns when MSCI World total returns have been negative, and how this changes when we assess relative returns instead of absolute returns. **The periods of absolute positive performance by EM in world of falling global stocks (sections VII and VIII) are extremely rare- they comprise 5% of the total outcomes. This is a sobering fact for investors hoping to make positive returns from EM while DM stocks fall.**

Figure 118: MSCI EM vs MSCI world total returns since Q2-1995, % returns expressed in decimals.



Source: Datastream, UBS

Instead of studying reaction in GEM based on the whole sample space, we now limit our **sample only to the times when MSCI World has posted negative quarterly returns, so everything on the left side of the y-axis**, and in doing so we calculate the frequency of EM outperformance in a **conditional probability** sense.

As a proportion of all the times MSCI World returns have negative, absolute positive performance from GEM is seen only 17% of the time. In this constrained sample space, GEM relative outperformance– where GEM quarterly return is negative, but less so than MSCI World (section VI) – has been seen 22% of the time. **Together all observations of positive absolute return 'or' relative outperformance by EM account for 39% of all times when DM returns are negative. These observations are labelled in green in the scatter above.** So, in a negative beta world EM underperforms DM more than 6 times out of 10.

Green dots show quarters of absolute positive returns or relative outperformance by EM in the context of falling DM stocks

What's the big deal, you may ask? Isn't it well known that EM is a high beta asset class?

Sure it is, but here's the thing –there is less evidence of positive absolute or relative performance by EM when DM stocks are falling (green dots in sections VI, VII and VIII) than there is of EM underperforming in absolute or relative terms (red dots in sections II, III and IV) when DM stocks are rising.

Red dots show quarters of absolute negative or relative underperformance of EM in the context of rising DM stocks.

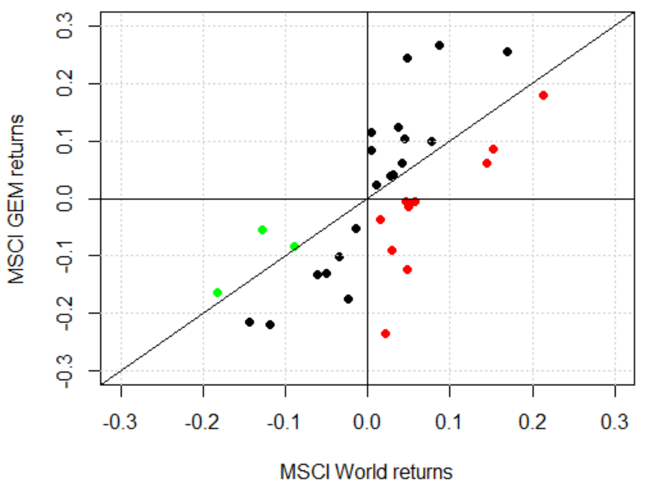
This is arguably down to the fact that we simply have more observations in the positive world. If we think in conditional (upon DM stock returns- positive or negative) probabilities then EM performance is broadly similar in the two states.

Tighter relationship between EM and DM stocks when the latter are falling

But take a close look at Figure 118 again. If we go beyond just the number of observations of over / underperformance and (in the spirit of maximum drawdown) look to establish the 'magnitude' of the hit or miss relative to the developed world, we find the relationship between global stocks and EM is tighter in the world of falling stocks, than it is in the world or rising stocks. **The R-squared between total returns in EM and DM stocks is 40% in a world of positive returns, stocks but rises to 50% in a world of declining DM stocks.**

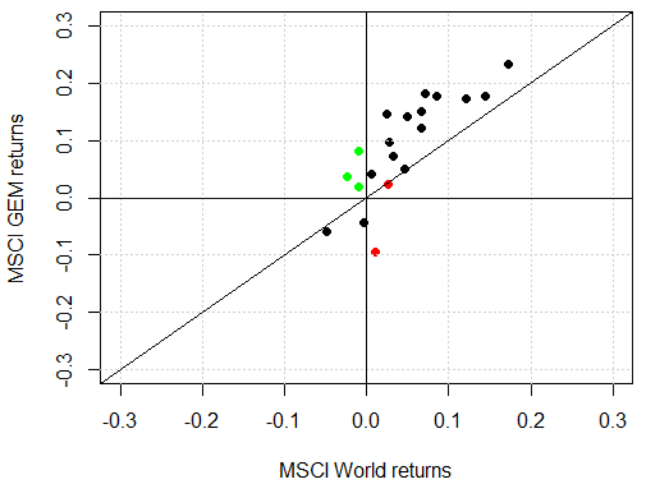
2. How has the relationship between EM and DM stock returns evolved over time?

Figure 119: MSCI EM vs MSCI World returns: pre-2003: Not much outperformance



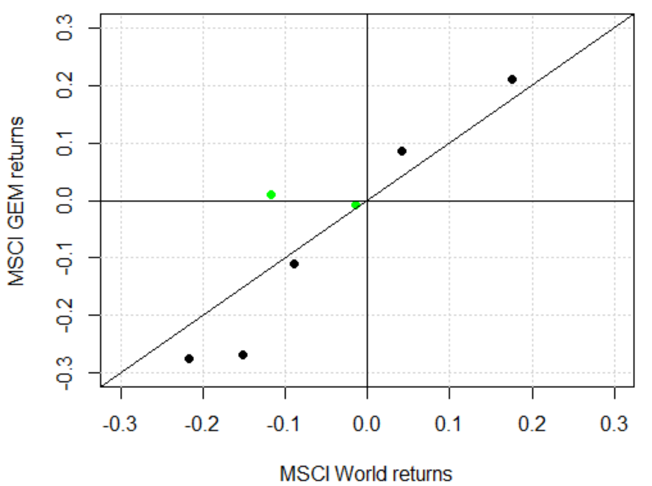
Source: Datastream, UBS

Figure 120: MSCI EM vs MSCI World returns: 2003 – 2007: Not much underperformance



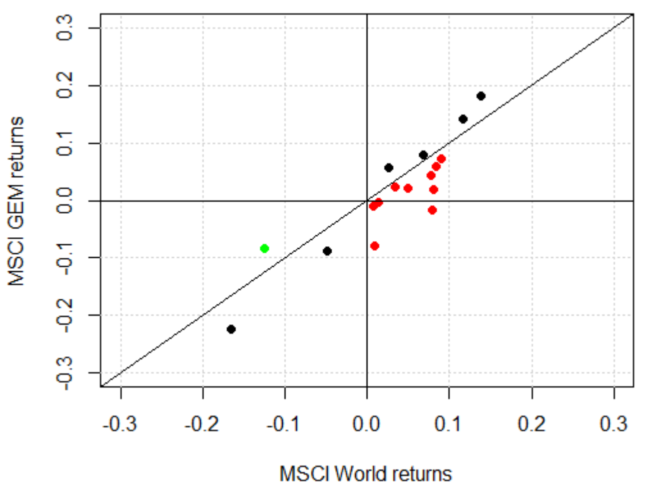
Source: Datastream, UBS

Figure 121: MSCI EM vs MSCI World returns: 2008 – 2009: Broadly symmetric



Source: Datastream, UBS

Figure 122: MSCI EM vs MSCI World returns: 2010-present: Not much outperformance at all



Source: Datastream, UBS

In Figure 119 to Figure 122 **green** dots indicate quarters of absolute or relative EM outperformance during times of declining DM stocks, and **red** dots indicate

quarters of absolute or relative EM underperformance during times of rising DM stocks.

Coming a full circle in asymmetry

We split our sample into 4 periods: pre 2003, 2003-2007 (the boom), 2008-2009 (crisis) and 2010 till today. We find that in the pre-2003 period and since 2010 there the performance of EM amidst different states of DM returns was heavily asymmetric- clear underperformance in a negative world, but less reliable positive returns in a positive world. The 2008-2009 sample of observations unsurprisingly shows extreme returns, but they are broadly symmetric. **The only period in which returns are asymmetric positively is the 5 year boom period from 2003 to 2007.** Most EM observers know this, but it's just useful to remind ourselves how strongly this 5 year period influences the analysis of EM time series.

EM FX: The myth of mean reversion

EM FX: The myth of mean reversion

Manik Narain / Bhanu Baweja

- EM currencies registered another weak performance against the USD this year, despite falling core bond yields and generally low volatility. Short EUR/EM held up better, but this strategy typically needs several benign external factors to fall in place simultaneously that can't be guaranteed for 2015 (See page 78)

- The good news is that we think further broad gains in the dollar could be slower in 2015, to the extent that front end yields in Europe can hardly fall any further. However, EM's own challenges – declining EM-DM growth spreads, weak global trade, falling savings rates and modest real rates - still leave EM currencies vulnerable as global liquidity turns less accommodative. The first stage of current account healing through import compression has simply not given way to stronger exports that would make us feel more confident about EM FX. We do not consider recent weakness to have moved the valuation needle sufficiently for most of the vulnerable markets (see page 79).

- We recommend investors buy the USD against low yielding SGD, THB and HUF, and go long MYR vs. the NZD. We are also positioned for INR outperformance vs. TRY, and MXN vs. the EUR in local debt.

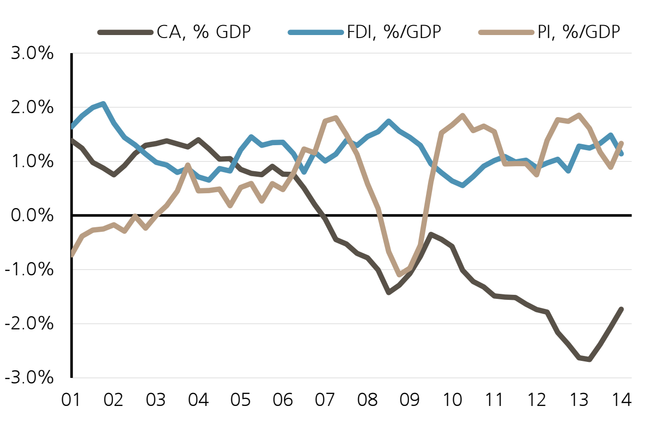
We continue to think of FX as the weakest link among EM assets

2014 was another disappointing year for EM currencies. Given the context of declining UST and Bund yields and, for the most part, low global volatility, EM currencies should have done much better. They haven't, we think because currency weakness is the key channel for EM to regain competitiveness in a world where structural forces are keeping trade volumes low. Combined with questions over EM's competitiveness given resilient unit labour costs and a levelling out of EM's share in global exports, EM currencies have been deprived of a crucial fuel for appreciation.

EM's growth model is directly pressuring its balance of payments configuration

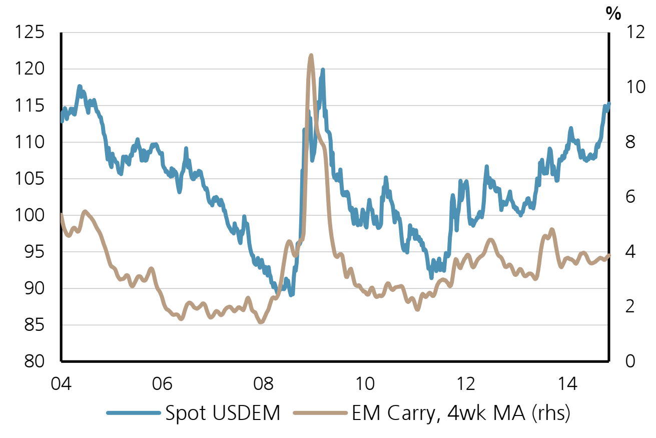
In our view EM's post crisis growth texture has fundamentally altered the valuation call on EM currencies. Over the last 5 years EM's growth engine has shifted from export growth to domestic credit growth and, more recently, to fiscal thrust. While this has kept headline growth rates from spiralling further downward, it has also meant that trade and current balances in many EMs have deteriorated significantly (Figure 123). Further, most of the incremental financing for these deficits has come from portfolio flows – especially debt – where investors are now sitting on a very indifferent return profile from 2013. Investors are not being provided extra carry to compensate for this deterioration in balance of payments structure (Figure 124).

Figure 123: Selected EM: Current account, net FDI flows, and portfolio investment, % GDP, 12m rolling



Source: UBS, Haver. Note: Chart shows data for 12 of more sensitive EM economies: Poland, Hungary, Russia, Romania, Turkey, South Africa, Mexico, Brazil, Colombia, India, Indonesia, Thailand

Figure 124: Little increase in forward premia despite persistent FX depreciation

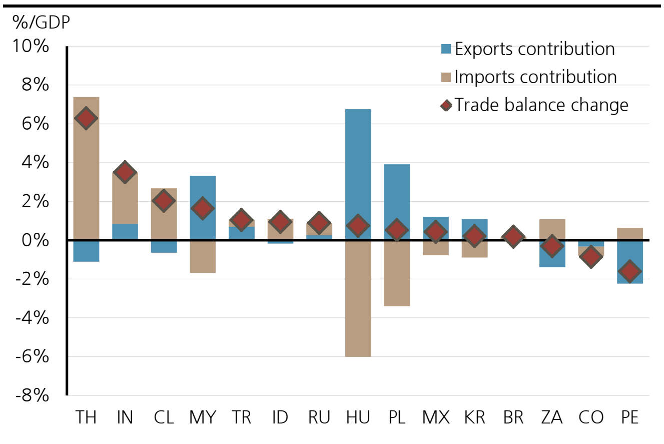


Source: Bloomberg, Haver

Investment stagnation and import compression isn't a sustainable recipe for external rebalancing

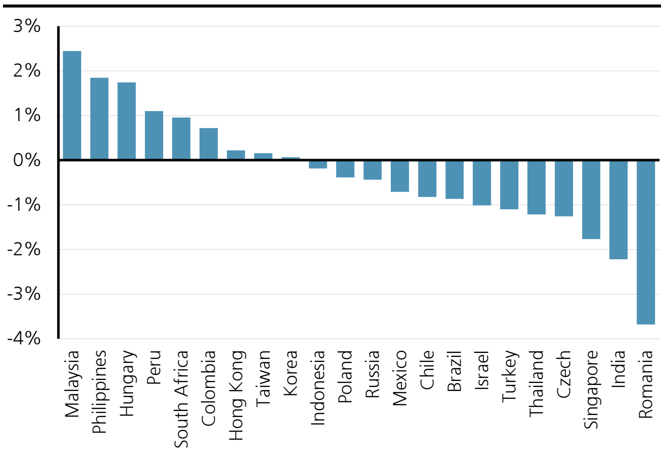
But current account deficits have begun to narrow, we hear you say. This is true, but the context of the improvement shouldn't be forgotten. Import compression has played a significant role in current account adjustment in 2013 and 2014 (Figure 125). This pattern of adjustment is understandable in the early stages, but ultimately savings rates and exports need to step up for the healing in imbalances sector to be cemented. To the extent that fixed asset investment in EM has clearly softened in the last few years (Figure 126), we fear that productive capacity and trend growth in EM is at risk of decelerating further if exports remain weak, an environment in which the outlook for EM currencies would only grow murkier.

Figure 125: 12m change in trade balance (%/GDP)



Source: Haver, UBS. Negative values in this chart denote negative contributions to the trade balance e.g. higher imports, or weaker exports

Figure 126: 2y change in fixed asset investment/GDP



Source: Haver, UBS

Surely EUR EM downside works just fine?

Didn't EM currencies fare pretty well against the EUR?

Many investors point out that in EUR or JPY terms, EM currencies really haven't had a bad year at all. This is certainly the case – by our calculations the EUR is about 3% weaker against a basket of 18 EM currencies so far this year -, and we ourselves believe that on a carry adjusted basis, and with long holding periods in

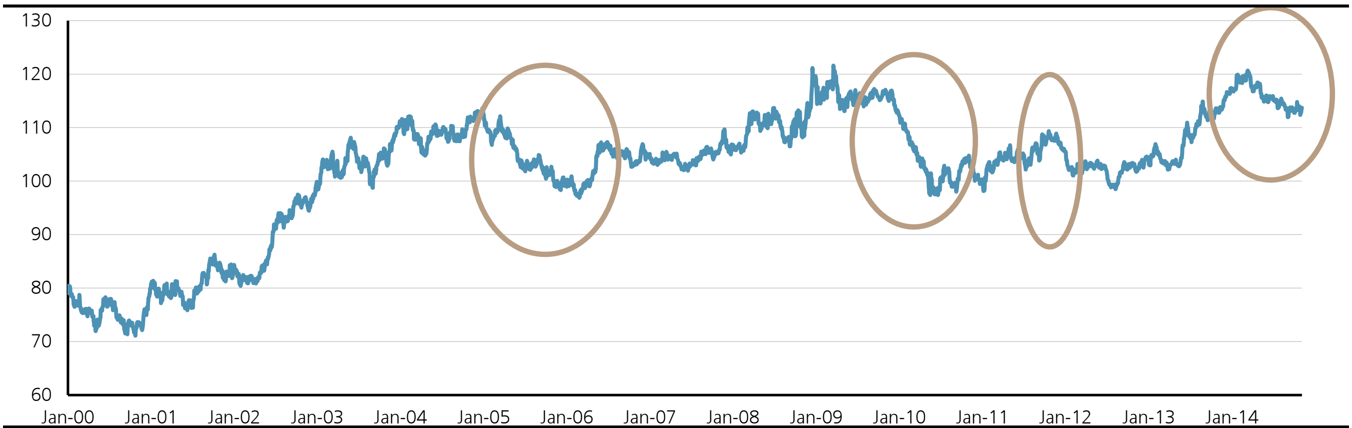
mind, some EM currencies such as the MXN and INR may do reasonably well against the EUR from here, too.

Several demanding conditions typically need to fall in place for short EUR/EM to prosper

But we would warn strongly against regarding this as a sustainable and generalised trend across EM. We would remind investors of how benign the global context has been for EM this year: declining US and European 10y bond yields, further compression in European peripheral debt spreads, rising global stocks, falling oil prices and benign US inflation, and very steady (7.4%) growth in China. This is the context in which short EUR/EM has prospered this year. Indeed we find that over the past decade a number of conditions have needed to fall in place simultaneously for short EM to work (Figure 127). These are a) higher US stocks, b) higher EM stocks and, perhaps most importantly, c) positive EM growth surprises d) tighter EM credit spreads.

We simply don't have confidence that these conditions will remain in place over the next 6-12 months. It is interesting, we think, that EM growth surprises have typically shown stronger correlation with European growth surprises than with US growth surprises. It is also worth remembering that as EM conducts more of its trade with Europe than the US, and with the bulk of its external debt denominated in US dollars, that a sustained weakening of the EUR and strengthening of the USD against EM is likely to introduce problems anew for EM.

Figure 127: Historical EUR-EM spot performance



Source: Bloomberg, UBS. Index comprised of 18 equally weighted currencies

Figure 128: Asset class performances during episodes of EUR/EM downside

	EUR/EM	EUR/USD	10y UST	US growth surprises	EU growth surprises	S&P 500	US HY (bps)	EM growth surprises	MSCI EM	SHCOMP	EMBI (bps)
Phase 1	-14.8%	-12.9%	27	-11.4%	n/a	6.6%	20.00	8.2%	47.3%	1.8%	-157
Phase 2	-16.7%	-17.9%	4	9.5%	4.6%	1.6%	-126.38	3.6%	2.7%	-19.1%	-18
Phase 3	-9.5%	-7.9%	-23	3.1%	-2.8%	21.0%	-261.10	1.8%	10.6%	-9.4%	-120
Phase 4	-7.2%	-6.6%	-19	3.3%	-13.3%	8.7%	-13.78	1.9%	16.3%	15.2%	-54

Source: Bloomberg, UBS. Phase 1: 29 Dec 2004-27 Feb 2006, Phase 2: 30 Nov 2009-21 Jun 2010, Phase 3: 23 Nov 2011-10 Aug 2012 and Phase 4: 13 Mar 2014-5 Sep 2014

An analysis of individual country returns over these periods yields disparate results, though we think a few conclusions can still be drawn.

MXN, MYR and KRW have traditionally performed best in periods of EUR/EM downside

First, we find that the consistently strongest returns in these periods have been posted by the MXN, KRW, MYR and TRY. The former three in particular are the more cyclical / fundamentally sound currencies in EM. At face value, this suggests that fundamentals generally stand out as a more important determinant of currency longs in these periods over pure carry, despite the stringent conditions that are generally required for short EUR/EM to work in.

The TRY sits oddly here, performing better than other high carry but fundamentally vulnerable currencies. We think this might have more to do with the timing of previous episodes of CBT tightening, particularly in late 2011 and again in early 2014. This is in contrast to CBT's approach today, where the central bank is confident in meeting its inflation targets and seems reluctant to tighten further unless and until the TRY shows clearer signs of underperformance.

Second, the PLN and HUF have been clear underperformers during episodes of EUR-EM downside, likely due to their direct exposure to weakening / underperforming growth in Europe.

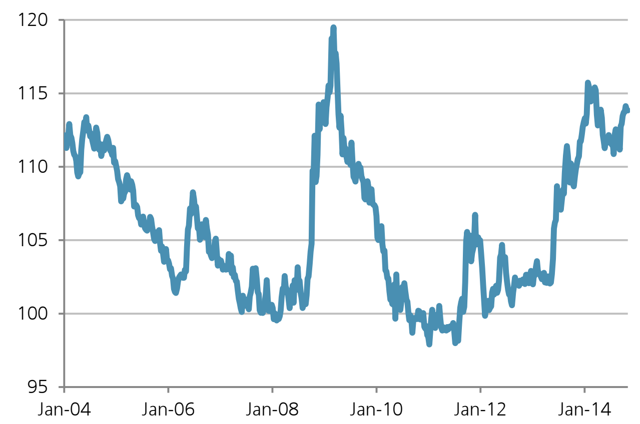
Haven't EM currencies depreciated enough?

Many EM real exchange rates are now at beaten up levels. Surely now's the time to be buying?

Ok, so the pressure on EM external sectors remains pretty strong, we get it - but haven't EM currencies simply depreciated too much already? After all, it's been three straight years of EM currency depreciation now (Figure 129). And a non-trivial number of EM currencies are now trading below their medium-term averages, even in real terms (Figure 130). Doesn't this mean EM currencies offer rather balanced, if not cheap, valuations now?

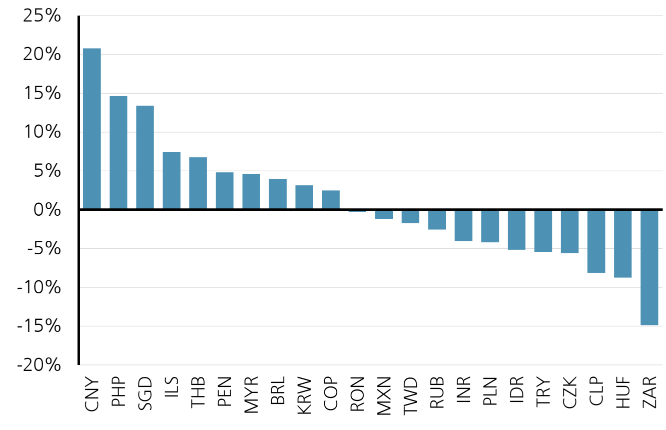
We have three difficulties with this line of reasoning.

Figure 129: EM FX spot index, equally weighted vs. EUR and USD



Source: Bloomberg, UBS estimates. Chart uses simple averages for 18 EM currencies

Figure 130: EM real effective exchange rates: deviations from 10y averages



Source: BIS, UBS

We find no statistical evidence of mean reversion in EM REERs

First, we find no statistical evidence of mean reversion in EM REERs, or indeed those for the USD, EUR or JPY for that matter. We note it is particularly dangerous to assume that EM currencies will soon experience mean reversion when one considers just how exceptional the period from 2002 to 2007 was for the global

economy, and especially EM (expanding globalisation, weak USD, declining US real yields, accelerating and investment-centric growth in China, etc.).

Unit labour cost adjusted REERs tell a very different story

Second, owing to data constraints, most investors use relative CPI inflation rates to deflate REERs in EM. However this is a measure that borders on irrelevancy for the purposes of gauging manufacturing competitiveness, especially in the current environment where declining food and energy prices are leading to widening gaps between CPI inflation and unit labour costs, a far more accurate gauge for these purposes. The latter is precisely where many emerging markets have been seeing significant growth in recent years as wages have proved sticky despite dwindling productivity. We find that unit labour cost based exchange rates in markets such as Brazil, Turkey, Indonesia and South Africa would hardly be cheap after a further 10% depreciation.

Exchange rates matter for less for exports than developed world demand

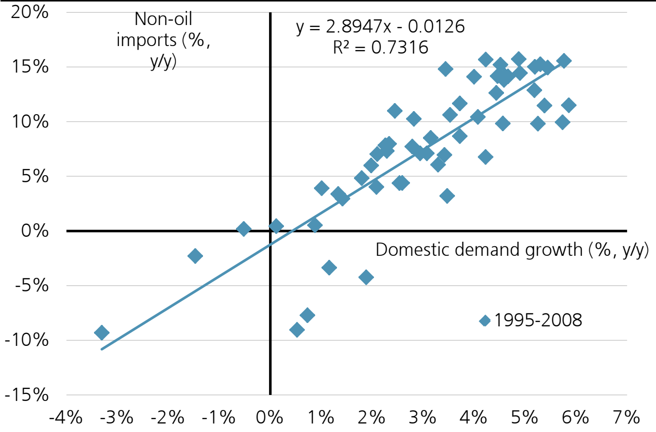
Third, as discussed earlier, the elasticity of exports with respect to the exchange rate is presently much weaker than in the past. This is likely to mean that currency depreciation elicits a considerably smaller response from exports than has traditionally been the case. More generally we find that, even over the long term, the influence of developed world demand on EM exports is about 5-6 times greater, and more statistically significant, than changes in EM REERs (Figure 131). This is precisely where the problem for EM currencies lies today.

Figure 131: Results from regressing EM exports growth (% y/y) on REER changes (% y/y) and G3 GDP growth (% y/y), Q1 2000 - Q2 2014

	REER		G3 GDP		Adj. R squared
China	-1.01	***	5.87	***	73%
Mexico	0.27		6.16	***	67%
South Africa	0.48	***	6.32	***	56%
Malaysia	-0.72	*	6.76	***	55%
Taiwan	0.46		7.06	***	52%
Russia	0.12		10.23	***	49%
Thailand	0.24		5.66	***	47%
Poland	0.21		6.13	***	46%
Korea	-0.04		6.54	***	46%
Philippines	0.39		5.75	***	45%
India	0.74		5.53	***	43%
Brazil	0.11		5.97	***	37%
Indonesia	0.22		6.70	***	36%
Colombia	0.56	*	4.96	***	34%
Turkey	-0.02		5.81	***	34%

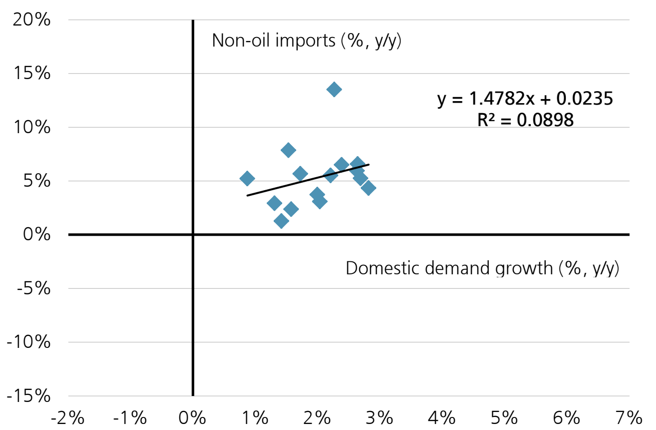
Source: Haver, UBS. The model was tested using multiple lags for EM REERs, with broadly unchanged results. ***, ** and * denote significant coefficients at 99.9%, 99% and 95% levels of statistical confidence resp.

Figure 132: Scatter chart of US domestic demand vs non-oil imports (1995-2008)



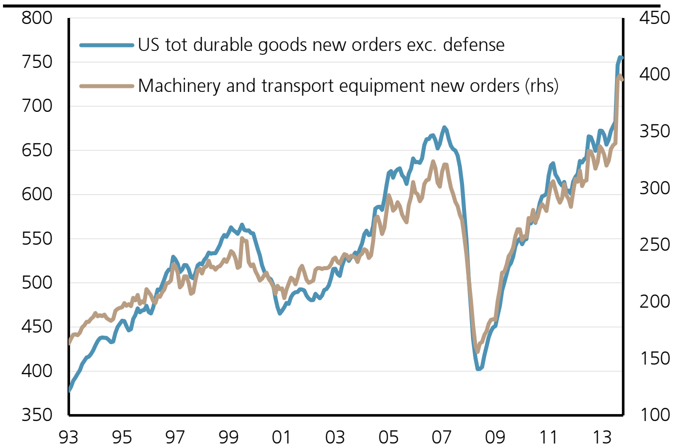
Source: Haver, UBS

Figure 133: Scatter chart of US domestic demand vs non-oil imports (2011-Sep'14)



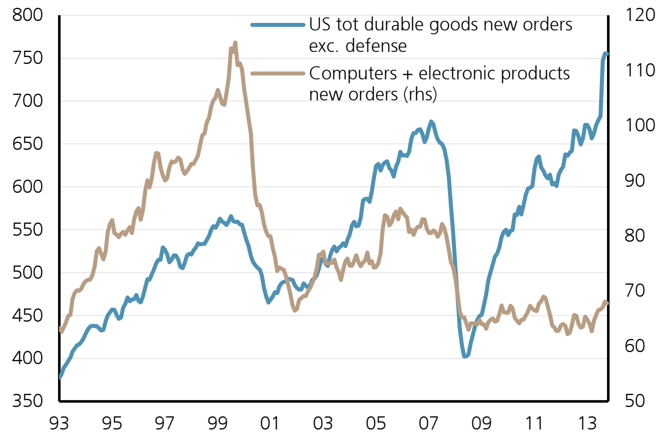
Source: Haver, UBS

Figure 134: US durable goods orders: total and machinery and transport sub-component, $mn



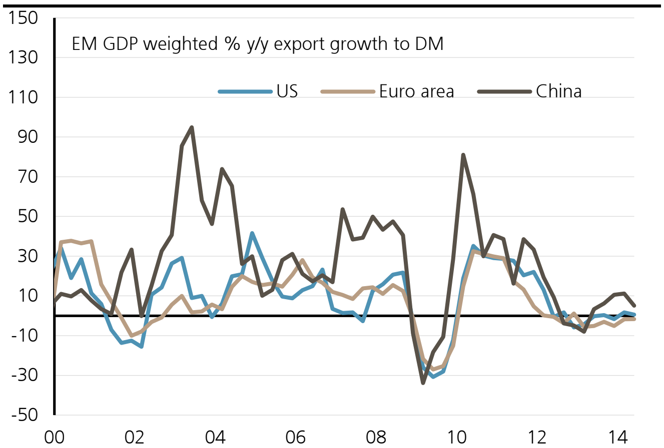
Source: Haver, UBS

Figure 135: US durable goods orders: total and computers, electronics sub-component, $mn



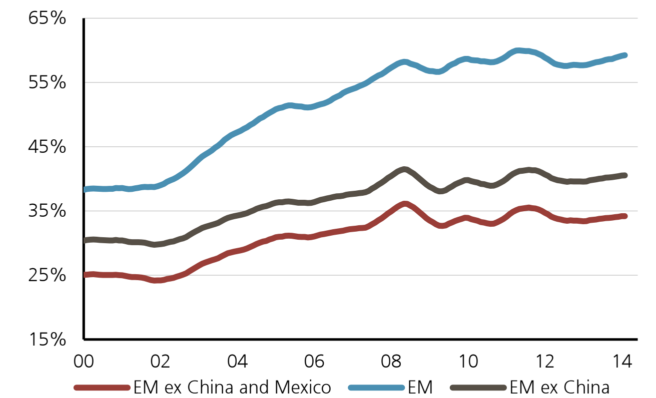
Source: Haver, UBS

Figure 136: EM exports growth by regional destination



Source: Haver, UBS

Figure 137: EM's share in US, European and Japanese imports, %, 12m rolling

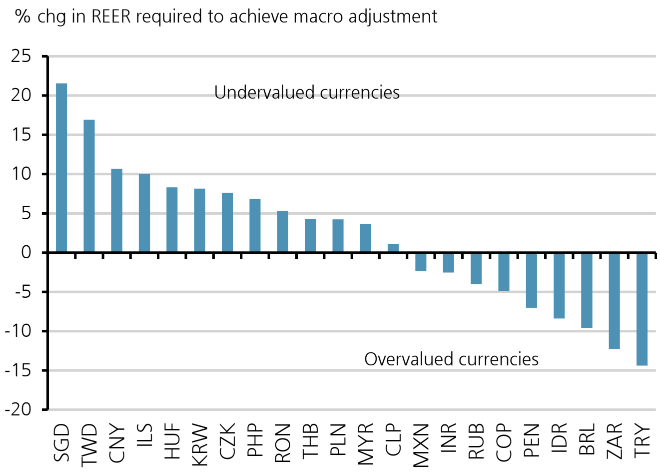


Source: Haver, UBS

Our fundamental equilibrium exchange rate (FEER) model for fair value in EM currencies picks up on this information and shows large parts of the EM universe as remaining over-valued (Figure 138). The currencies that show up as undervalued are precisely the ones that are most heavily managed. The case for a big appreciation to fair value in currencies in North Asia and the Middle East is probably as weak today as it has historically been. FX overvaluation is particularly problematic for local debt investors (Figure 140), an issue we explore in greater depth in the local rates chapter.

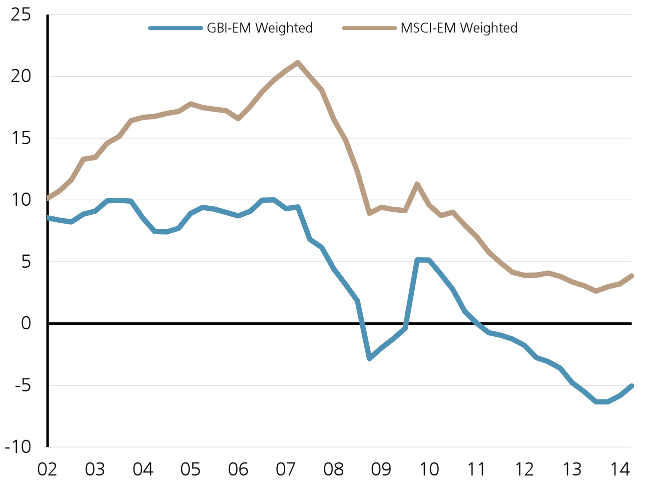
Our FEER model continues to show a large portion of EM currencies remaining overvalued

Figure 138: UBS FEER: Forward-looking estimates



Source: UBS estimates

Figure 139: Average valuation for EM currencies based on GBI-EM and MSCI-EM weights



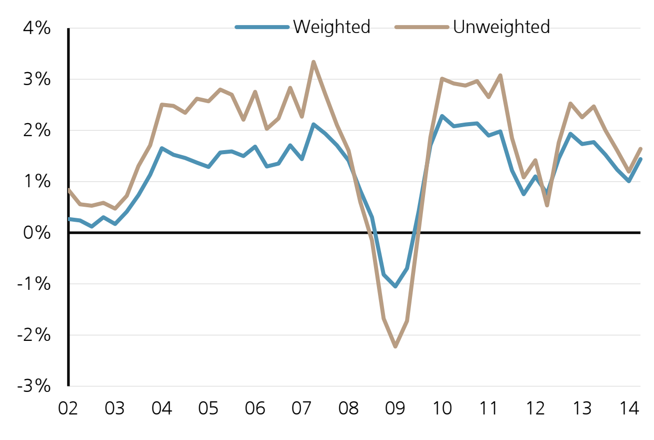
Source: UBS estimates

Isn't the market already beared up on EM?

What about positioning? Hasn't that been severely compromised by the weak performance of EM currencies, leaving room for a powerful relief rally? Sadly, we don't find this to be the case. Looking at EM official balance of payments data, we find at best a slowdown in the pace of inflows to EM in recent years (Figure 140 and Figure 141). While on the one hand this speaks to the resilience of portfolio investors in EM, supporting the view that these markets are attracting longer term, institutional investment, it doesn't change the fact that these investors are sitting long EM assets at a time when returns have generally proved underwhelming in recent years. IMF data also suggests that the bulk of flows more recently have flowed into EM debt, an asset class that is likely to be closely affected by the outlook for US Treasury yields.

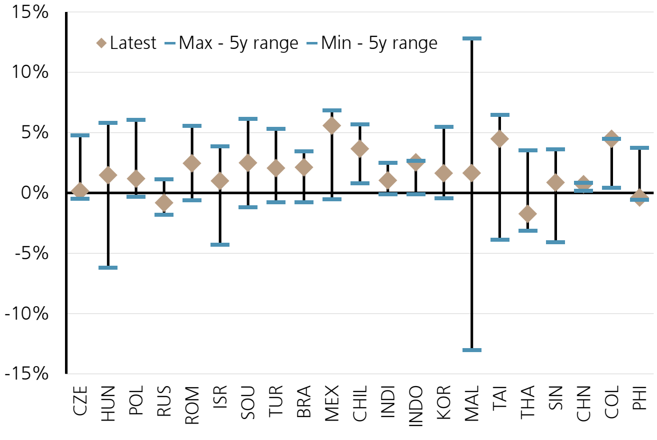
Despite indifferent returns, investors have retained faith in EM assets

Figure 140: Portfolio investment liabilities/GDP, 12m rolling, %



Source: Haver, UBS. Chart shows data for 20 EMs. Latest data; Q2 2014

Figure 141: Country breakdown of portfolio investment liabilities/GDP, 12m rolling, %



Source: Haver, UBS. Latest data; Q2 2014

Concluding thoughts

In 2013 it was US Treasuries, in 2014 it was the dollar. Might 2015 be a better year for EM currencies?

In our view 2015 is likely to be another highly challenging year for EM FX. Rising US rates in the context of weaker absolute and relative growth in EM, a structurally dampened export environment, and little room for a continued re-rating of the global risk environment make for no big winners in EM FX. Despite the persistent depreciation since 2011, the lack of positioning adjustment or increase in forward premia / volatility give little room for bargain hunters to express themselves in 2015. The first stage of external adjustment – weaker imports – has yet to give way to export growth that would make us feel more comfortable about this asset class.

EM FX is neither in deep value territory, nor suffering from exorbitant risk premia. We retain a long USD/EM bias

The good news is that with European front end rates at the zero bound, the pace at which the ECB can contribute to USD appreciation going forward will likely be slower. From here the US dollar is likely to motor on at a pace contingent on its own tightening trajectory. Lower oil prices and a modest acceleration in developed world growth should keep current account deficits in EM from expanding rapidly, though the bigger question surrounds the reliability of deficit financing as global liquidity conditions net tighten.

Trades

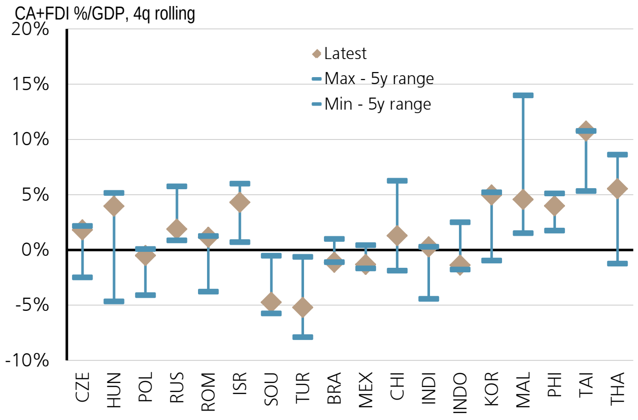
Our favourite FX trades for 2015

We recommend going long the USD vs. an equally-weighted basket of SGD and THB. As the EUR and JPY remain weak, and the Chinese economy is likely to decelerate further, we think we are still far from the late stages of currency depreciation even in these relatively robust economies. With European growth momentum likely to remain weak and local balance sheets becoming less sensitive to FX weakness, we also recommend buying **USD vs. HUF**. We also recommend buying the **MYR against the NZD.**

We think that the BRL, ZAR, TRY and IDR will also weaken significantly next year against the dollar, but in view of the carry we prefer to express this through relative value trades (**long INR vs. TRY in local debt, and long MXN vs. EUR in local debt as well**).

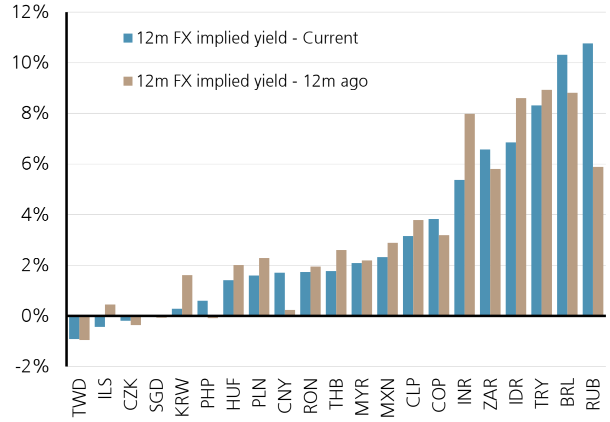
For more details on these trades, please refer to the trade summaries at the front of this publication.

Figure 142: Basic balances, 12m rolling, % GDP



Source: Haver, UBS

Figure 143: Carry available: today and 12m back



Source: Bloomberg, UBS

Credit: EM's aging rock star

EM's aging rock star

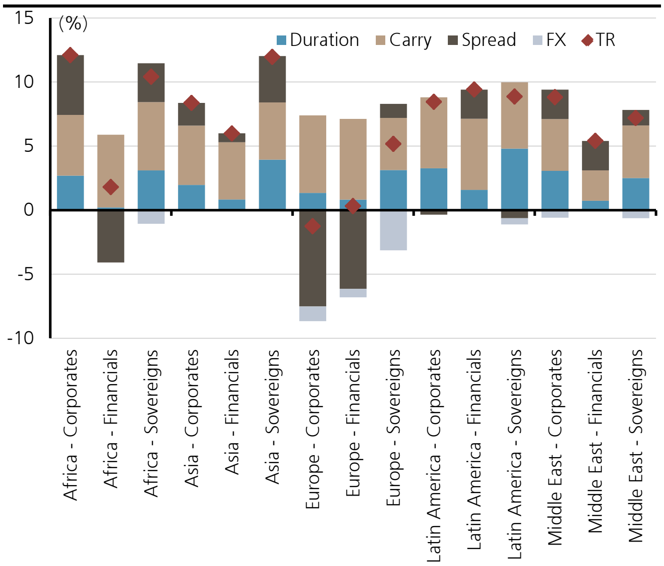
Patrick Lamaa / Edwin Chan / Kathleen Middlemiss / Sean Glickenhaus

- EMBIG-D has returned 9.5% YTD. Duration has been the main driver of returns with the US 10Y c.60bps tighter this year. Spreads have not contributed to total returns this year.
- We think both sovereign will post total returns of around 1-2%, with EMBIG-D spreads widening by around 30bps. The lower duration on corporates will be offset by slightly larger spread widening, at 50-60bps. Total returns there should come in at around 0-1%, in our view.
- The fundamental picture remains tricky for EM. Sluggish global trade, and the fall in oil & commodity prices should limit the scope for balance sheet improvements. We think we'll continue to see more downgrades than upgrades next year.
- In investment grade, we prefer Indonesia, Romania and Kazakhstan over Turkey and Brazil.
- In high yield, we think Hungary is expensive, Venezuela should continue to trade under pressure. In Argentina, we maintain a preference for the local law Bonar 17's.

Breakdown of 2014 performance & 2015 key calls

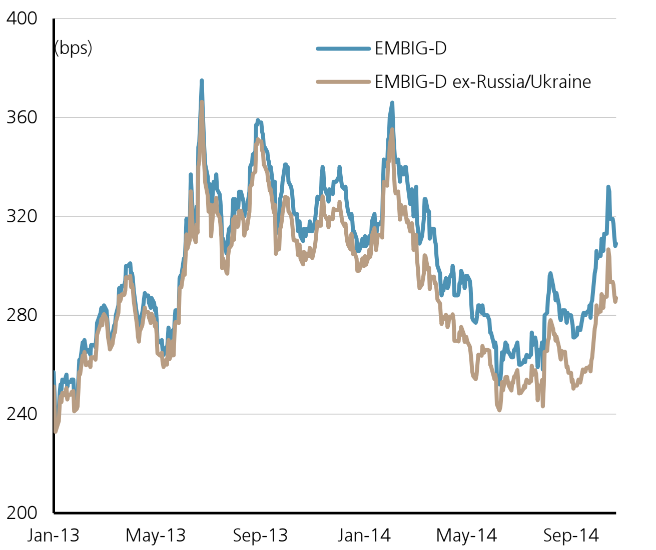
Hard currency debt has outperform virtually all other EM asset classes this year, buoyed by a strong rally in US treasuries (Over 5.1% in total return terms), and very low levels of volatility for much of the year, which has kept spreads well behaved.

Figure 144: EM Credit* total returns by region and sector



Source: Bloomberg, UBS Delta.*Total returns calculated from a database of around 2100 bonds.

Figure 145: EMBI Global diversified index spreads including and excluding* Russia & Ukraine



Source: Datastream, UBS Estimates. *Exclusion assumes no rebalancing of Russia and Ukraine weights in the index.

Total returns for the EMBIG-D benchmark stood at 9.33%. UST's and coupon accrual contributed 9.5% to performance, while spreads have deterred -0.3% from total performance, as a result of the modest spread widening in the second half of the year. The solid performance was pretty broad based across the index, with Venezuela, Russia and Ukraine the only countries posting negative total returns for the year. (In Figure 145, we plot EMBI-GD spreads including and excluding Russia & Ukraine)

Carry and treasuries have been the main drivers of return this year

In 2015, treasuries are unlikely to drive total returns the way they have this year. UBS economists see the 10y ending 2015 at 3.50%. While we do see downside risks to this forecast, even assuming a fairly dovish scenario, i.e. the 10y meeting its forwards, we would still expect at least 30-40bps widening by year end-2015 to 330-340bps (Figure 146). We also expect around 30bps of spread widening for sovereigns and 50-60bps for corporates. Carry (Coupon + roll) and spread compression are therefore likely to be the main drivers of returns next year. We advise investors to go down the credit curve, overweighting the BBB- rating bucket in IG. In high yield, we prefer Argentina to Ukraine and Venezuela. We also believe Hungary is expensive at current valuations. Due to the high proportion of commodity producers in EM high yield, and the uncertainty around commodity prices and the global trade backdrop, we believe selectivity will be key, as we are likely to see increased divergence in total returns.

We expect 1-2% total returns in EM sovereigns, 0-1% in EM corporates.

In IG, we prefer Romania, Kazakhstan and Indonesia over Turkey and Brazil. In high yield, we prefer Argentina to Ukraine and Venezuela.

Figure 146: EMBIG-D total returns based on spreads (columns) and UST's (rows)

	230	250	280	296	315	330	350
2.00	13.7%	12.2%	10.0%	**8.8%**	7.4%	6.3%	4.8%
2.15	12.5%	11.1%	8.9%	**7.7%**	6.3%	5.2%	3.8%
2.33	11.1%	9.7%	7.5%	**6.4%**	5.0%	3.9%	2.5%
2.50	9.8%	8.4%	6.2%	**5.1%**	3.7%	2.7%	1.2%
2.65	8.6%	7.2%	5.1%	**4.0%**	2.6%	1.6%	0.2%
2.80	7.5%	6.1%	4.0%	**2.9%**	1.5%	0.5%	-0.9%
2.95	6.3%	4.9%	2.9%	**1.8%**	0.4%	-0.6%	-2.0%
3.53	1.8%	0.5%	-1.5%	**-2.6%**	-3.8%	-4.8%	-6.1%

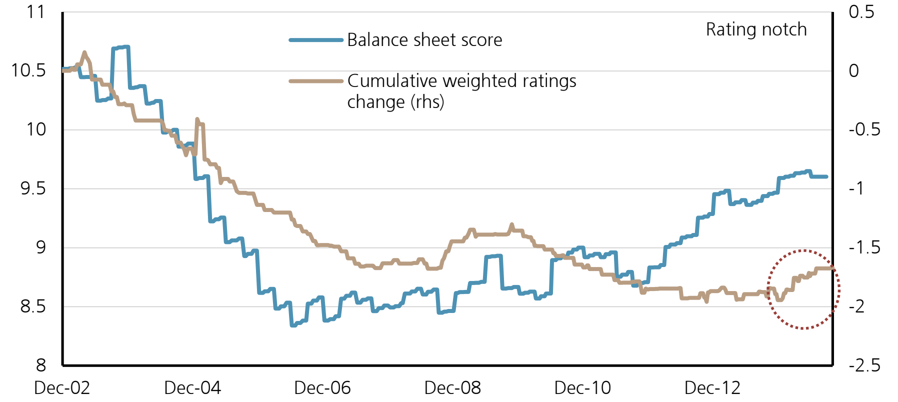
Source: Datastream, UBS

Fundamentals likely to cap gains

EM macro balance sheets have stabilized and modestly improved from last year's stretched levels. Current accounts have come in and EM central banks have rebuilt their FX reserves buffers. However, sluggish domestic demand and global trade growth globally have capped the much needed fundamental improvement this year. Aggregate average ratings have started catching up, with 9 net downgrades in EM sovereigns this year across the three main rating agencies. In Figure 147, we show the cumulative rating change of the EMBIG-D (assuming the latest weighs and ignoring index rebalancings) along with our EM macro balance sheet score[14].

[14] The balance sheet score aggregates current accounts, FDI inflows, private credit to GDP, external debt to GDP, public debt to GDP and short term debt to reserves for a cross section of EM's in the EMBIG-D index account for roughly 65% of the total composition. Click here for full report.

Figure 147: EM aggregated (EMBI-weighted) rating changes & balance sheet score

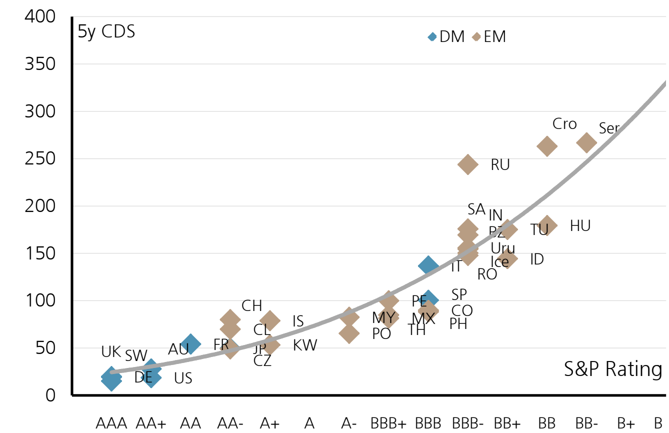


Source: Bloomberg, Haver, UBS.

We expect more downgrades than upgrades next year

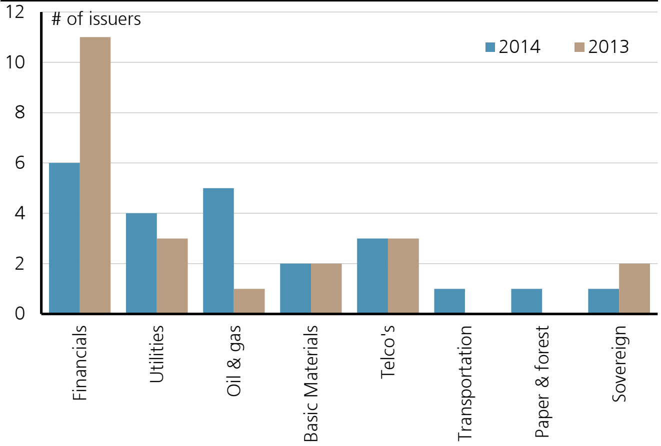
Brazil, Russia, South Africa and Turkey, together accounting for around 16% of the EMBIG-D index (roughly 30% of GBI-EM GD) are all on negative outlook and one downgrade away from being rated junk by at least one rating agency. Looking at Figure 148, we do not think that is fully reflected in the price (Russia being the exception), leaving risks skewed to the downside.

Figure 148: DM & EM 5y CDS spreads vs S&P ratings



Source: Bloomberg, S&P, UBS

Figure 149: EM potential fallen angels* (S&P ratings only)



Source: S&P Global Fixed Income Research. As of October 2014 & 2013. *Rating agencies define fallen angels as Investment grade issuers that get downgraded to Junk status.

IMF WEO 2015 forecasts suggest that while EM's fiscal impulse should remain contractionary, output will remain subdued and more importantly, its growth alpha over DM is forecast to sit at a 13 year low. What this means is that on an aggregate level, fundamentals should not drive EM outperformance in a meaningful way.

Still trading on the expensive side of fair value

In June-2014, we had introduced a model to gauge fair value in the EMBIG-D. The framework breaks down credit spreads into their fundamental drivers, namely; 1) Macro fundamentals (See also Figure 147) and 2) Commodity prices (namely

industrial metals). We also add our risk premium index (Figure 151) to the model, to take into account prevailing liquidity conditions and levels of risk appetite. We observe that since August 2012, EM spreads have seldom traded cheap relative to 'fair value'. This makes sense as DM central bank policy has specifically targeted risk premia.

Going forward, it is likely spreads will continue trading at the expensive end of the range, as the ECB and BoJ's easing stances should keep a lid on global risk premia, and help offset uncertainties around Fed normalization. This model currently puts spreads at 325bps (on EMBIG-D), a full 30bps above end-October levels. We shock all three of our explanatory variables to gauge 'fair value' in the year ahead:

-We assume our global risk appetite index backs up to the median of its post-crisis distribution

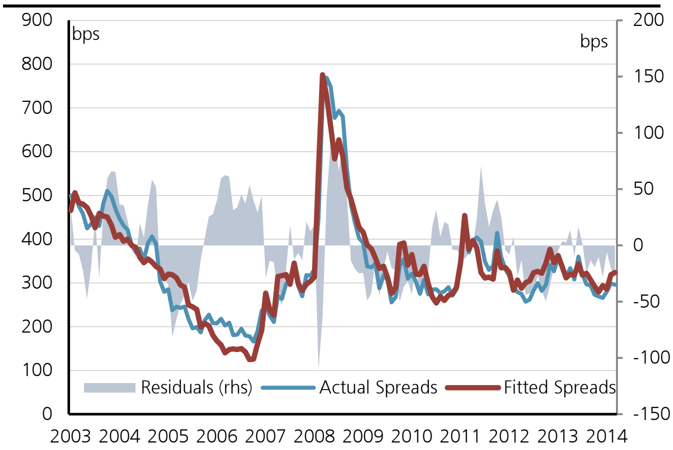
-We push our macro balance sheet risk score slightly weaker, in line with our view that leverage in EM will continue to go up.

-We assume industrial metals drift slightly weaker, by around 3.5%.

Credit spreads are still expensive, in our view

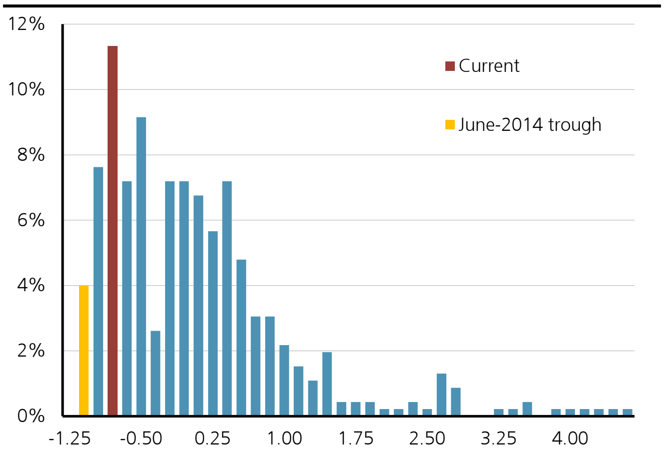
Under these assumptions, our model puts current EMBIG-D spreads fair value at 375bps, around 80bps wider from its end-October close. We do however recognize that given the search for yield and still high demand for fixed income, credit will likely trade below fair value for some time. We believe we're looking at a 30bps widening next year. Carry is likely to be the main driver of total return.

Figure 150: EMBIG-D actual and fitted spreads since 2003



Source: Datastream, Haver, UBS

Figure 151: Risk premium index histogram (since 2006) – Off the June 2014 lows, but still very subdued



Source: Datastream, Bloomberg, UBS

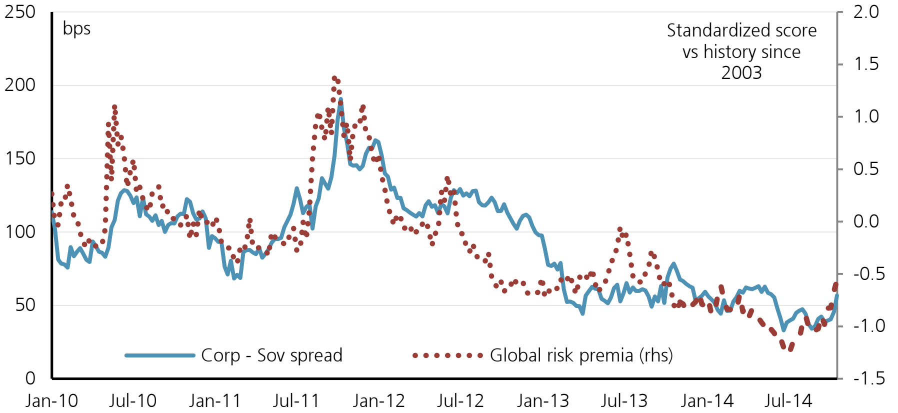
EM sovereigns over corporates

The spread of corporates to sovereigns should widen should risk premia rise; We prefer the latter for next year.

Duration is likely to shift from a headwind to a tailwind next year, as the Fed approaches normalizing policy. While that would argue in favour of a shift towards corporates to capitalize on the wider spread buffer, we would advise caution on that front; We believe Fed monetary policy cannot be disassociated from volatility completely, and we find (Figure 152) a solid relationship between our risk premia measure and the spread of corporates to sovereigns (Looking at Bloomberg indices). In total return terms and on an index level, it is likely the lower duration on corporates will be offset by higher spread losses, and so we would not expect

massively different returns from both asset classes next year. Our preference to sovereigns boils down to liquidity; the bifurcation between primary and secondary market liquidity (the former increasing while the latter decreasing[15]), as a result of DM central bank liquidity injections and declining dealer inventories, increases gap risk in this asset class.

Figure 152: Global risk premium index and the corporate to sovereign spread*



Source: Bloomberg, UBS. *We calculate this spread using the Bloomberg EM Sovereign and Corporate credit indices

Sovereign views – in a nutshell

In the sovereign space, Russia has been the story of 2014, widening up to 100bps (On the benchmark 2030's) as a result of the Ukraine conflict, the US/EU imposed sanctions and the loss of investor confidence. Russian credit is now trading very cheap to peers and, from a pure valuation perspective, is trading in line with BB rated credits such as Croatia & Serbia. We do not see a clear catalyst for spread compression as long as; 1) fighting is ongoing in eastern Ukraine, 2) oil prices remain weak, and 3) sanctions remain in place.

No catalyst for compression in Russia. Elsewhere in IG, we prefer Kazakhstan, Romania and Indonesia over Brazil and Turkey

Elsewhere in the IG space, we prefer to switch out of Turkey (where external vulnerabilities persist) and Brazil (where the growth outlook is poor due to lack of progress with structural reform agenda and fiscal deterioration lift the risks of credit downgrades) into Indonesia, Kazakhstan, and Romania. At the very long end of the curve (30y), these five credits trade at similar spreads.

In high yield, we see little value in Hungary, and prefer Argentina over Ukraine and Venezuela

In high yield, we think Hungary spreads are rich at current levels. The market seems to be fully pricing in an upgrade by rating agencies next year (currently (Ba1/BB/BB+ by Moody's/S&P/Fitch). We do not think this is a certainty given lingering fiscal issues (See chaper EM Reforms: Fact or Fiction?). Supply dynamics should however remain supportive of spreads as the government continues to reduce the FX public debt burden and switch towards more local issuance. In Ukraine, the situation remains challenging and we would remain underweight; UBS economists see it likely the $17bn IMF programme will have to be revised, with additional funding to come from other sources (as the IMF's exposure to Ukraine is already elevated). Additionally, Ukraine is on track to be in breach of the debt sustainability covenant of the 'bail-in' bonds issued to Russia in Fall 2013.

[15] See "Low Volatility: Underpinnings and Cracks" & "A Primer on Corporate Bond Liquidity"

Should Russia demand pre-payment (likely by Q1/2-2015), this could put further pressure on Ukraine's already stretched reserves.

In Latam, the outlook for Venezuela remains challenging, as it faces large redemptions and coupon payments which dwarf its estimated liquid reserves (around $2.5bn vs $20bn total reserves). That said, we don't see high risks of default, yet. Recently, the government has taken a few actions that help net dollar flow from Chinese loans and PDVSA. Continued drop in oil prices combined with more of the ongoing policy paralysis may be a bigger challenge. In Argentina, we wait for signs the Kirchner administration is willing to negotiate with holdout investors (after the RUFO clause expires next year), as opposed to postponing the issue till after the Oct-2015 presidential elections, before turning more constructive. In the meantime, we prefer the local law Bonar 17's.

Figure 153: Select EM estimated financing requirements for 2015

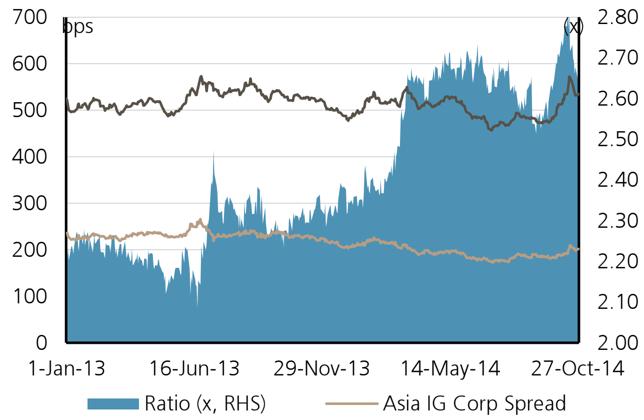
	Fiscal deficit (%/GDP)	Total financing needs (%/GDP)*	Hard currency redemptions (USD mn)	Hard currency redemptions (% Reserves)	Total outstanding debt (%/GDP)
Argentina	5.5	12.2	--	--	54.2
Brazil	3.1	15.2	2,146	1	65.6
Bulgaria	2.0	--	1,086	6	25.1
Chile	1.2	2.0	--	--	14.6
China	0.8	--	89	0	41.8
Colombia	1.3	4.1	1,423	3	33.1
Hungary	2.8	19.6	2,753	6	79.2
Indonesia	2.3	3.8	1,000	1	26.0
Latvia	0.7	--	228	8	35.3
Lithuania	1.7	--	1,550	20	39.5
Mexico	4.0	9.0	2,355	1	49.0
Pakistan	-0.4	30.6	--	--	29.1
Peru	0.1	2.1	278	0	19.2
Philippines	1.0	6.6	419	1	33.9
Poland	2.5	8.5	4,398	5	49.0
Romania	1.8	9.7	1,253	3	39.6
Russia	1.1	2.6	3,273	1	16.5
South Africa	5.1	12.4	--	--	50.8
Turkey	1.9	7.0	2,750	2	33.1
Ukraine	3.9	16.3	4,252	30	73.4
Venezuela	14.9	--	1,253	6	41.3

Source: IMF Fiscal Monitor October 2014, Bloomberg, Haver, UBS. *Total financing is defined as the fiscal deficit plus amortization needs (including local currency debt)

Corporate views – in a nutshell

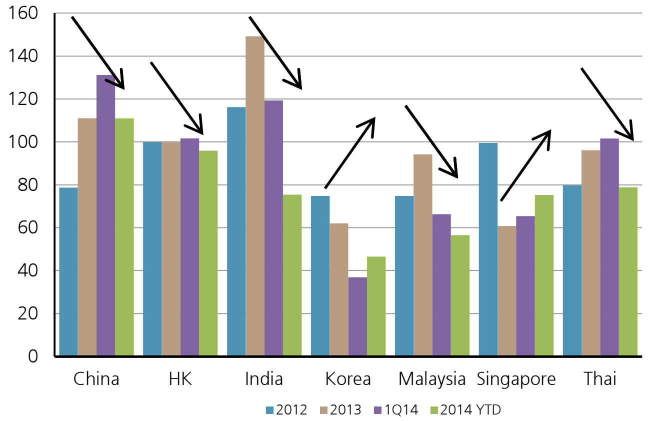
In Asia, the JACI index returned 8.1% YTD, driven by UST and carry as credit spreads stayed flattish, or even widened out in the case of HY. Asia sovereigns have generally been on stable trends in credit ratings, with a positive slant, for example, for India and Indonesia on reforms. This enabled the two to deliver outperformance in 2014. China, on the other hand, delivered mixed returns, and Asian premium for China corporates remained the highest, at 111bps at present, among Asian IG countries, pricing in, in our view, quite a bit of scepticism on growth and reforms. Our economists expect 6.8% real GDP growth for China in 2015 but do not expect a financial crisis in China.

Figure 154: Asia HY/IG ratio spiked in 2014



Source: UBS

Figure 155: Asian IG premium by country trending down



Source: UBS

We are looking to selectively moving down the credit curve to seek higher yield for return protection against rising UST yields. We see better opportunities in rotation and compression trades in China and Hong Kong, while valuations in Korea and Malaysia are generally more demanding. Credit spreads for China IG corporates did compress YTD, but this was counterbalanced by the underperformance in Chinese properties, the latter of which, in our view, have priced in higher inventory and corporate governance risks despite their generally comfortable financial and liquidity profiles. This should present opportunities for differentiation trades.

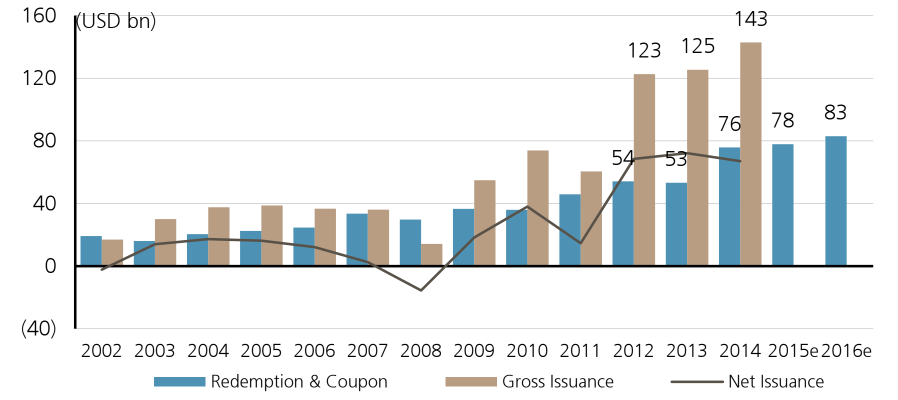
Fundamentals to deteriorate, albeit from a strong base

We are expecting Emerging EMEA and LatAm Issuers to continue to deteriorate, albeit from a strong base. CIS and Turkish Financials are seeing asset quality deterioration along with slower loan growth; not a good combination. UAE and Qatari financials appear to report resilient financials to date. We expect to see more debt restructuring for Ukrainian corporates given the ongoing domestic situation. In LatAm we generally expect fundamentals of issuers to deteriorate overall in FY15, and we believe there are likely to be more credit rating downgrades than upgrades. However, Brazilian food companies are likely to improve in FY15 due to strong growth from abroad and help from a weaker BRL with likely more credit rating upgrades than downgrades.

Issuance

Gross issuance in Asia has reached a new high to USD143bn YTD in 2014. China remains a key issuing segment accounting for 48% of YTD gross issuance, taking total China outstanding to USD187bn, or 31% of the Asian dollar bonds universe. Asian financials issuance also increased 92% yoy to USD53bn, with 23% being Basel III instruments including the first AT1s out of China. We expect these to remain key issuing segments in 2015. We expect gross issuance levels to remain lofty in 2015; however, coupons and redemption will remain high as the universe has grown. We expect them to reach USD78bn and USD83bn in 2015 and 2016 respectively.

Figure 156: Asia - Lofty gross issuance against high coupon and redemption



Source: UBS

Russian Corporates, the historical heavyweight in terms of primary issuance, takes a back seat

In the first ten months of 2014, Emerging EMEA Corporate issuers printed US$50 bn, down from US$96 bn for all of 2013. For next year, we are expecting similar issuance to this year. Within Emerging EMEA, the historical heavyweight behind issuance, namely Russian corporates, now have sanctions to contend with which severely limit certain issuers (mostly quasi-sovereigns) the ability to borrow from the popular international markets. Regardless, the Russian sovereign can weather issuer refinancing schedules for FY15 if necessary. In past years, Russia comprised ~50% of all Emerging EMEA corporate issuance. YTD, this has dropped to ~25%. In MENA & surrounding areas, we would expect 2015 similar issuance levels to this year: ~US$20 bn from GCC and ~US$10 bn from Turkey skewed towards the banks.

Strong, but slightly lower net issuance from LatAm Corporates

We expect lower, but still strong, total LatAm Corporate issuance in 2015. LatAm Corporate gross debt issuance reached cUS$85.7 bn in the first ten months of 2014 with about US$700 mn debt maturities for net issuance of US$85 bn. cUS$10 bn in LatAm Corporate Debt matures in November and December 2014 most of which has been re-financed already, in our view, bringing net issuance to US$75 bn. We expect about 5% lower net issuance for 2015, or about US$71 bn, excluding significant M&A deals which we expect would take at least a year to complete anyway. Around US$69 bn of local and external debt issued by LatAm corporates is maturing in 2015, according to Bloomberg, and we expect a significant portion of this to be re-financed. This would imply about US$140 bn in gross LatAm corporate debt issuance in FY15.

EM Reforms: Fact or Fiction?

EM Reforms: Fact or Fiction?

Gustavo Arteta / Manik Narain / Gareth Berry / Maximillian Lin / Patrick Lamaa

Where Asia stands

China: A marathon, not a sprint.

Next year, with the economic slowdown becoming more noticeable, we think priority will be given to growth-friendly measures and those considered comparatively easy to implement.

We expect reforms to include tax cuts for small companies, streamlining of government approval procedures, and more sectors being opened up to private firms. Infrastructure and social housing construction is likely to accelerate.

Streamlining approvals, and more de-regulation

On the fiscal side, a pilot project allowing 10 provinces/cities to issue local government bonds independently is likely to expand in scope and size.

Further liberalisation of deposit interest rates can be hoped for too, alongside greater exchange rate flexibility, and improved foreign access to onshore capital markets.

Excess capacity and rising financial leverage continues to plague the economy, but we think those issues will be tackled only gradually in the next couple of years. Overhaul of central-local fiscal relations, major tax changes, NPL restructuring, SOE rationalisation, as well as land and property reforms – all of these will eventually need to be addressed, but material progress in 2015 seems unlikely.

But put these on the back-burner

India: Huge progress on inflation credibility, beginnings of labour reform

The big change at the centre is slowly being reflected in the states. This will put pressure on other states to become reform minded as well

India made the most progress tacking inflation, with momentum beginning in other reform areas. For now the government is supportive of the RBI's stance; a formal adoption of inflation targeting into the RBI's mandate is another necessary step to further enhance central bank credibility and independence. Price stability and positive real rates should lead to higher domestic savings, improving India's ability to finance investment without foreign capital.

Labour market reforms are critically important too. Without this, India is at risk of missing its demographic dividend. Easing of restrictions on firing and hiring of employees announced in October in select states, are a positive step forward in addressing India's rigid labour markets. With the current reform minded ruling party increasingly gaining traction at a state level, especially in India's large industrialised states, investors can be hopeful that this reform will be pushed through, if only gradually.

Boosting formal employment will be the Government's main economic task

Easing of FDI and foreign investment restrictions should also spur job growth and plans to do so in the Insurance and Defence sectors have already been outlined.

The nationwide goods and services tax has been talked about for a while now (first introduced in 2008, with a 2011 deadline), and the current government has expressed a desire to pursue it has well. This may not be on the agenda in the very near term but should be put in place through 2015. This reform will help lubricate the local economy and help the government's revenues.

It's taken a while, but the GST is likely to be in place in the next 1-2 years

India's biggest immediate bottleneck has been the power and energy sector which is where the current government is working on regulatory and pricing certainty. This should help future investment in these industries, help industry produce, and dilute the dependence on imported energy.

Power sector bottlenecks are slowly being eased

Indonesia: Challenges in execution

Fuel subsidy reforms are positive to the current account, but implementation faces political headwinds

The President, Jokowi, shows strong reformist intention, but doesn't have large support in the parliament. One area of progress is subsidy reform; this is necessary for bring down the current account deficit, even if it does add to inflation in the near term.

Also, Indonesia's fiscal deficit, already running up to the mandated 3% market, will remain under pressure if fiscal revenue collections, which have lagged growth, don't improve. The government still believes it will be close to 2.4%, but only because expenditure has been lower than earlier believed.

The Jury still out on whether Indonesia wants to open up

One of the issues the markets are paying close attention to is whether the government will show willingness to stay open for business in sensitive sectors such as mining. At this point we have little new evidence that policy makers wants to open up aggressively.

The trade-off between the size or distribution of pie

The Indonesian economy and business environment needs issues of graft and bureaucracy to be addressed. Unequal distribution of income is also placing a constraint on medium term growth. In this context pursuing aggressive reform is likely to be an uphill battle.

Korea: Hoping to boost demand, not chasing supply side reform.

Lower your expectations – although very modest progress in two areas is still possible

Government policy has shielded small-to-medium (SME) enterprises from the full force of competitive pressures, and productivity enhancements are now desperately needed. The Finance Minister new economic policy focuses more on demand-side initiatives rather than structural reform[16].

Admittedly, tax incentives to encourage SMEs to upgrade equipment and automate processes are a hesitant step in the right direction, and a pledge to boost infrastructure will help too. Ultimately though, the parliamentary ratification process is sure to be tortuous and prolonged – at best.

Movable goal posts: annual year-end targets have been set to ensure steady progress towards greater stability

Household debt reforms in 2015 will be tentative too. Back in 2010, 99.5% of Korean mortgages were variable rate, and 93.6% of these were interest-only. This state of affairs ensured a permanent debt overhang, and created systemic risks. Since then, government policy has sought to encourage a migration into fixed-rate amortising mortgages instead[17] and the target is for these to represent 25% of mortgage books by end-2015 (up from 20% at end-2014). The structural soundness of household debt should improve, but slowly.

Philippines: Slight dilution in reform focus

Time is running out; politics proving to be a distraction – but the wheels of progress are already turning

With only 18 months left in President Acquino's term of office, the focus on reform agenda is being diluted. That said, major infrastructural bottlenecks are already being alleviated –numerous setbacks have delayed construction, but one

[16] http://english.mosf.go.kr/pre/view.do?bcd=N0001&seq=3653&bPage=4
[17] http://www.korea.net/Government/Briefing-Room/Press-Releases/view?articleId=2755

by one, these obstacles are being overcome. Also on the positive side, revenue collection is improving too thanks to a clampdown on tax non-compliance.

FDI still lagging behind Thailand, Indonesia, Malaysia

Acquino's efforts to stamp out corruption have been commendable, but more could be done to overhaul competition law so that multi-national corporates feel they can compete on a level playing field.

Decision not to join Trans-Pacific Partnership was a missed opportunity

We are watching FDI inflows as a litmus test for success here. The decision not to join negotiations on the Trans Pacific Partnership is a missed opportunity in our view – a constitutional restriction on foreign ownership in specific sectors was probably a key stumbling block here and we doubt this can be amended until 2016 at the earliest.

Malaysia: Fiscal reforms are advancing.

GST is a good policy, but keep an eye on which goods & services are excluded from GST; preferably, exclusions should be relatively few.

Fiscal consolidation remains the focus here – a sensible priority given foreign investors now hold 46% of the conventional MGS market. Subsidy rationalisation is already well underway with further reductions in fuel subsidies likely next year.

The forthcoming introduction of a Goods and Service tax in April will broaden the tax base too, helping to close the fiscal deficit over time. Strategic developmental priorities should become clearer when the next 5-year plan is published in May[18].

Where EMEA stands

South Africa: Glacial progress

Structural impediments continue to stifle South Africa's external competitiveness

The collective wage bargaining framework in key export sectors, continued supply constraints in electricity and infrastructure (particularly rail), and the strongly oligopolistic structure of South Africa's export industry – the top 5% of exporting firms account for 93% of exports - strain the ability/willingness to expand export volumes in response to a weaker currency, contribute to high unemployment and inhibit growth of SMEs and a competitive manufacturing sector. Uncertainties around issues such as land reform, increased resource nationalism, implementation of a national minimum wage, bilateral investment treaties, and economic empowerment policies continue to weigh on FDI and private sector employment. Recent progress on retirement reforms and e-tolling has been delayed by the ANC's increasingly fractured relations with COSATU.

Public investment programmes should help contain declines in trend growth. The wish-list for reforms is a long one

The government has shown greater resolve to contain fiscal deterioration by committing to, and indeed recently lowering, the primary expenditure ceiling, while hinting at tax hikes and (small scale) privatisation. However, coming against the backdrop of public debt/GDP estimates being consistently revised upward in recent years, and future growth estimates remaining on the optimistic side, this does not constitute a powerful reform effort, in our view. Greater progress is being made in rolling out public infrastructure investment, which should help to significantly reduce electricity constraints by 2017. A youth employment tax incentive and other elements of the National Development Plan should help to limit the decline in trend growth, though there is growing concern that the ANC's commitment to the latter is not sacrosanct. In our view South Africa should pursue amendments of the labour laws to reduce barriers to entry, increase incentives for competition, accelerate privatisation, and introduce secret voting ballots to reduce

[18] Previous plan available here: http://onlineapps.epu.gov.my/rmke10/rmke10_english.html

risks of strike action. We fear that with the 2016 municipal elections not too far away, reforms are likely to continue proceeding gradually.

Turkey: Desperate need for reform

Turkey has largely exhausted the limits of increasing private leverage

Turkey's low and declining savings rate has resulted in chronic, large current account deficits to finance growth, culminating in a relatively high sensitivity of growth to capital inflows and one of the largest net IIP deficits in emerging markets (c.54%/GDP.) While public finances are understandably seen as a strong point, high government spending to GDP by EM standards (c.39%/GDP vs 31% EM average), a strong focus on current expenditures and transfers, dwindling primary surpluses and rising contingent liabilities on infrastructure projects have contributed to imbalanced growth.

We are growing increasingly concerned by the disconnect between declining private investment/GDP despite rapid growth in private credit/GDP since 2011. We believe that in large part this may reflect borrowing to service existing debt (especially in FX), and 'leakage' into current expenditures (see here for details).

The weak inflation targeting track record of the past decade keeps the maturity structure of TRY deposits short-term, which in turn inhibits the ability of corporates to gain access to long-term financing in TRY and creates structural FX mismatches in the corporate sector (the sector's net short FX position has more than doubled since 2008 to -22%/GDP).

Despite recent progress, labour force participation remains low by EM standards. This is particularly true among women, where participation is around 30% vs. a 65% average for OECD nations. Labour market rigidities (relatively high minimum wages, employment protection, severance pay etc.) and educational standards need to be addressed more decisively.

There are rising expectations that Turkey will deliver reform after parliamentary elections in 2015

Details are thus far limited but the government has at least recognised the need to prioritise higher savings rates, increase energy efficiency and upgrade productivity. Implementation will be key, of course, and we are unlikely to see material progress made until after the June 2015 parliamentary elections.

Recent years have seen the introduction of a new commercial code, net patent laws, and new income legislation – all of which are steps in the right direction. Macro-prudential measures to restrain credit growth, especially for consumer loans, are helping limit systemic risks to asset quality.

The private pension system has seen strong growth in recent years, although the numbers involved remain small (around 4.5mn persons or 30bn TRY of assets) and clearly not large enough to prevent the overall savings rate from deteriorating.

While the government is budgeting a much stronger fiscal performance in 2015 (from an expected 0.4%/GDP this year to 1.2% in 2015), this forecast is based on a rather unlikely 5% GDP growth forecast, while the IMF has recently recommended that a 2%/GDP primary surplus is needed to make a material contribution to the savings rate. Efforts to broaden the tax base, reduce dependence on indirect taxation and sustain recent strong privatisation performance will also be key to make genuine progress in enacting reform.

Russia: Imbalanced growth model

Russia has made very little progress in diversifying away from commodities

Declining oil prices and economic sanctions that are effectively forcing deleveraging upon the banking and corporate sectors have harshly exposed Russia's imbalanced growth model and limited reform drive. Inadequate growth in export volumes despite the significant positive terms of trade shock, no tangible diversification in the export basket away from commodities (oil and gas constituted 2/3 of exports in 2013, up from 50% in 2012), and an unproductive makeup of fiscal spending (defence and social services now comprising the bulk of total expenditures), have all dented trend growth and in fact contributed to a faltering economic performance and structural capital flight well before this year's spike in regional uncertainties.

Besides geopolitical healing, business climate reforms are crucial

Russia-Ukraine political tensions, until resolved, will limit reform progress and extend the weight of the sanctions imposed by the West. Nonetheless, deep-rooted measures to improve the business environment and support small- and medium-sized enterprises, including tax reform could help to stall corporate desire to accumulate foreign assets that has exacerbated capital outflows. More effective measures to encourage "de-offshorisation" by Russian companies can slow the bleed in investment income outflows, an important driver of current account deterioration. Reversing recent state pressure on the private pension system could also increase market confidence in the government's reform drive.

Poland: Amongst EM's reform successes

Poland has made progress in liberalising labour markets, fiscal consolidation, and improving the business climate

In recent years the economy has grappled with several structural issues; namely, a decade of leverage accumulation, particularly in FX, a widening fiscal deficit and a business environment burdened with labour market rigidities and low participation.

In our view, policy makers have done a solid job in tackling many of these issues. The labour market has undergone reform; mobility has improved and access to around 250 regulated professions has been liberalized. Red tape has also been cut to help support business start-ups.

On the fiscal front, progress has made following the opening of an excessive deficit procedure by the European Commission in July 2009; public debt has fallen to 49%/GDP from 56%/GDP in 2013 as a result of pension reform. Fiscal consolidation has progressed as planned with the deficit expected to fall below 3%/GDP next year. The structural deficit is still below the Commission's medium-term objective however (at -2.5%/GDP for 2015 vs -1%/GDP recommended), but currently it’s a lesser concern.

Parliamentary elections introduce some uncertainty, however

A few issues remain however; further steps to boost labour participation, reduce administrative hurdles, and privatization, which has recently stalled. All could boost competition. Poland will be holding parliamentary elections in 2015 and as such, we expect the reform momentum to wane next year.

Hungary: Uncertainty hurts the business environment

FX and fiscal vulnerabilities remain in play in Hungary

The FX debt overhang is also a significant factor impairing the banking system from supporting growth, due to its high stock of NPL's (18% of loans). Hungary has one of the highest stocks of public debt in EM (around 77%/GDP) and while the budget deficit is below the -3%/GDP threshold mandated by the EU, the structural balance is in breach of the European Commission's medium term objective, or MTO (at -1.7%/GDP vs -2.7%/GDP forecast for 2014). The

government's footprint also remains large, in both absolute and relative terms, with government expenditures at around 50%/GDP

Hungary also struggles with competitiveness issues; the domestic value added content of exports is low compared to regional peers. Moreover, there is a present duality whereby only 5% of enterprises comprise 80% of the economy's total exports, while SME's are largely uninvolved in exports markets. Trend growth has fallen from about 3.5% to 2.5% according to the CB, but the IMF estimates it may be as low as 1%. The problems include high regulatory burden, weakening institutional framework, and frequent and unpredictable tax changes, says the IMF.

Competitiveness has been impacted by institutional and regulatory pressure

Policy makers in Hungary have undertaken several steps to address these structural challenges. The Treasury has cut down on hard currency debt issuance and is refinancing maturing FX debt in HUF. The government is also looking to completely phase out retail FX loans and resolve the NPL overhang on the banking system. On the fiscal front, policy makers have cut down on the unemployment benefits bill, through pension reforms and the public work schemes, however heavy vulnerabilities remain. We believe further steps to persuade markets and the MTO are needed, such as improve predictability for private sector, and reversing recent steps that have weakened institutions.

Where Latam stands

Mexico: Reform leader

Mexico passed reforms, now it needs to implement them. We are optimistic.

After years of frustration the three leading political parties reached an unprecedented Pact for Mexico. They agreed and have passed reforms in education, telecommunications, financial, fiscal, and energy, among other sectors. We remain optimistic that 2015 will begin to show the benefits of these reforms.

Mexico's seeks to boost its mundane potential growth rate by at least 0.5 pp (the government thinks much more)

The reforms seek to address key structural issues to boost trend growth which has been low (and below EM average for the past 20yrs). Investment rates as well as savings rates are EM average. Mexican total factor productivity has been close to zero for decades. There is a huge labor productivity gap between tradable and not tradable sectors. High underemployment, widespread informality and shallow financial penetration reflect structural deficiencies in the educational finance and regulatory frameworks.

Pemex let oil output fall to 2.5mll b/d from 3.4mll since 2006…

…private investment should help reverse the trend

The energy reform will allow private sector participation and should help reverse a decade-long decline in oil reserves and output. A series of investor rounds are expected to bring in more than $50bn in FDI. The first contracts may begin to be awarded from May to September. What could put these at risk is a deterioration of security issues which could complicate the political environment.

In July 2015 local elections could become more important than usual because of this, and cause delays in investment projects.

Colombia: Important progress

Colombia has made important structural advances in the past four years.

It adopted reforms to reduce labour market informality, improve infrastructure, reduce vulnerabilities via a new savings fund and distribution of oil and mining royalties, and also signed trade agreements to expand export markets and diversification. Debt and fiscal management has improved markedly, inflation targeting and a flexible exchange rate regime ease the impact of shocks.

Colombia has built solid fundamentals and investment to GDP has steadily climbed to 24%. However savings has stagnated around 21%. The difference was made up by FDI and increasingly by PI. Colombia has a diversified economy. It needs to diversify its exports (57% of exports are oil, and mining and commodities in total make up 70% of exports). The bottleneck lies in deficient transportation infrastructure. Red tape hinders execution of a massive (over USD25bn) infrastructure investment plan.

The potential growth rate can rise north of 4.5%

… It hinges on unblocking the infrastructure bottleneck

If Colombia can improve its infrastructure and reverse declining oil reserves, potential growth above 4.5% beckons. The left-overs of the armed guerrilla fighters remain a structural problem that impacts the business environment and major oil infrastructure, although we would become bullish when a peace agreement is reached. Governability issues could derail the pending reform agenda in labour, health and social security.

We have a constructive view on Colombia, despite some risks

Brazil: A clear laggard.

Low investment, low savings = low growth and dependence on external savings

Its reform momentum has been flat since the early-2000s. Potential GDP growth has fallen near 2.0%[19]. At 18% of GDP, investment barely replenishes the capital stock. A pitiful 14% GDP savings ratio leads to chronic dependence on foreign savings which increases its vulnerabilities. Recently it has even backtracked on previous macro stability gains as a result of discretionary policymaking and interventionism. The recent re-election of the Rousseff administration maintains some expectations about possible reforms, but we want to see to believe.

There much to do, but political and social constrains make damper reform hopes

Brazil needs reforms to reduce the weight of government and promote savings and investment. This includes a broad tax reform that makes the system simpler, more efficient, with economic stabilizers, and a lower corporate tax burden. Public sector reform is needed to improve expenditure efficiency; privatization and others would also help raise the savings rate and boost investment without exacerbating external vulnerabilities.

Brazil needs tax and public sector reform

More competition in domestic markets would increase efficiency

Brazil suffers severe infrastructure deficiencies in energy and transportation. The looming energy crisis is a case in point. Investment on this front is ongoing, but it is insufficient and riddled with hindrances that don't foster efficiency and effective private sector participation.

Energy and infrastructure bottlenecks are overwhelming the public sector – more private participation could help

Rising real wages and stagnant labour productivity compromise industrial competitiveness. Brazil is a large EM that can generate scale; however it is amongst the most closed economies to trade which inhibits competition and innovation.

Weak policy credibility is a structural problem. Falling credibility of the fiscal framework is leading to rising debt ratios which are putting Brazil's credit rating in peril. Public credit has overtaken private credit. Below market rates create distortions and lift contingent fiscal risks. All together these compromise the business environment.

Regulation and weak credibility in macro policymaking drags business environment

[19] Macro Keys Brazil: Why It Fails to Deliver on Potential, October 9, 2014

Chile's: Reforms may help social inclusion, less sure about growth.

Early pro-market reforms supported Chile's high grow rates, but a wide socio-economic gap remained.

Early and pioneering reforms allowed the country about two decades of investment to GDP at 26%, and potential GDP growth rates around of 4 to 5%. But Chile has seen few structural advances since 2007. Rising incomes have not been shared by all. Social pressure built up to push for income redistribution. In 2014 a new government responded with reforms in education, fiscal and labour sectors. However, the reforms are more distributive in nature. The tax reform will increase corporate taxes which are severely affecting business confidence and is likely to hurt Chile's relatively high investment ratios. So far, the reforms look like a textbook case of equity-growth trade-off. However, Chile still commands the highest credit rating in the region and we expect it to remain so. That said, the reforms are likely to lower Chile's potential growth rate.

…It's time to pay up

The Mining sector is getting old

We are not seeing enough export diversification

One of Chile's challenges is to deliver better social inclusion while keeping output growth high. Pressure on labour markets will rise as the size of the working-age population stagnates. Also, importantly, Chile needs to rebalance its economy to cope with the winding down of its very mature mining industry by diversifying its exports. We are not seeing clear reform proposals to address this, which could harm long term growth prospects. Unless this changes, fiscal accounts and exports are likely to suffer and the economy's historic soundness may be tested

China: Persistent Property Drag

China: Persistent property drag

Qi Chen / Mary Xia/ Gareth Berry

- China's GDP growth will slow further due to the ongoing property downturn. Additional infrastructure projects and improving exports due to the US recovery will be insufficient to offset the slowdown.

- The government will help mitigate the downturn, with employment and financial stability being major policy concerns. PBC will manage liquidity proactively and cut rates by 75bp by end 2015. Monetary easing is likely to help reduce financial distress, while doing little to boost investment.

- Money market rates will drop and we are in favor of a duration extension strategy. The capital account will likely slip into deficit, while a bulging trade surplus will reflect weak imports not strong exports. UBS economists expect modest CNY depreciation against USD over the course of the year.

- The central government starting to address the local government debt issue and PBC's proactive liquidity management will help reduce near term systematic risk. However, we expect overall leverage of the economy to rise further. More credit events in the private sector are likely.

Growth to slow further in 2015

GDP will slow further with property downturn as the main drag.

UBS economists expect China's economic growth to decelerate further in the next two years, even taking continuous policy support and US recovery into account. Our base case forecast for GDP growth is 6.8% in 2015 and 6.5% in 2016. The weakness lies mainly in the ongoing property downturn, which is expected to drag down domestic demand through softer construction, weaker heavy industry production and investment, and worse local government financial sustainability.

Structural, not cyclical property downturn

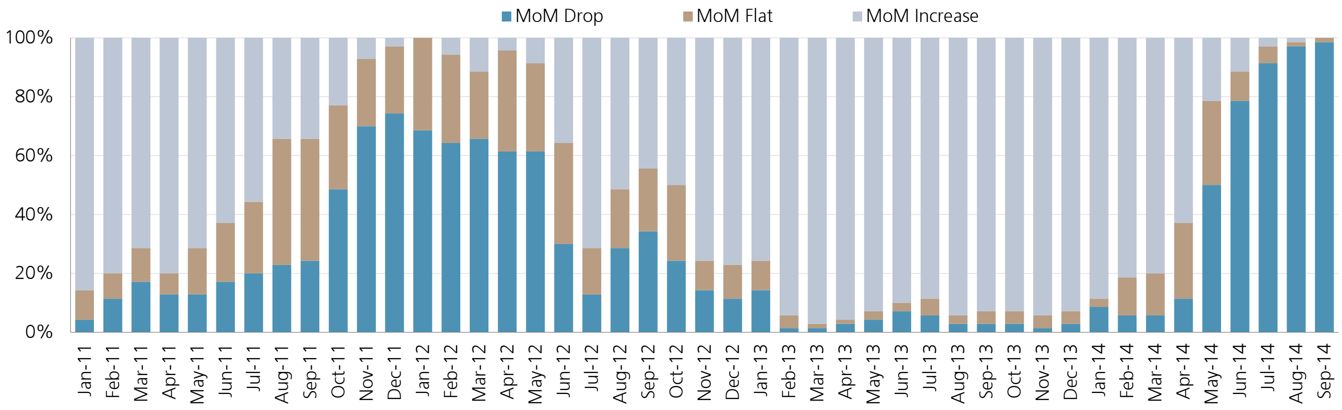
A structural property downturn can be mitigated but not reversed.

We believe the current property market weakness is not just another cyclical downturn; instead China's property sector has reached a structural turning point marked by oversupply and faltering investment demand. Even allowing for urbanization, we expect supply has outgrown underlying demand. Against this backdrop, we think the government can and will mitigate the pain of adjustment with gradual relaxing of previous property tightening policies and more credit support in the coming quarters, but it cannot reverse the downturn. Following an expected decline of about 10% this year, UBS expects new property starts to decline by a further 10-15% in 2015 before stabilizing in 2016. Overall construction activity, as measured by floor space under construction, is expected to slow to single digits in 2015 and marginally further in 2016.

Manufacturing investment will remain muted as negatively impacted by the property downturn and excess capacity.

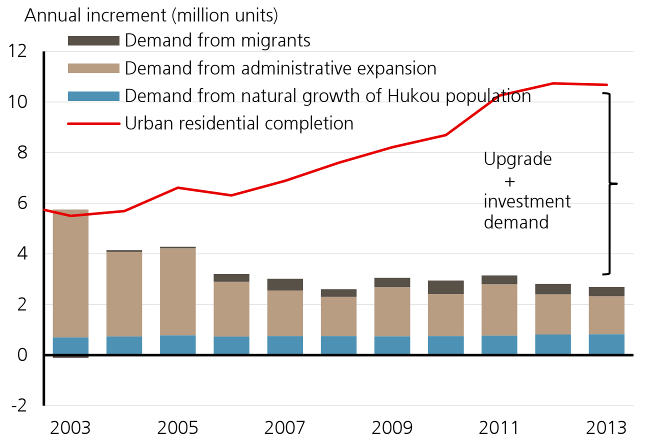
The deceleration of construction activity is expected to have an increasingly negative impact on other industries including metals, mining, construction materials, machinery, automobiles and household appliances. The deterioration in demand and cash flow in these industries will affect their investment as well. We expect manufacturing investment to remain muted due to the negative impact from the property downturn and the burden of excess capacity.

Figure 157: Distribution of MoM trends of property prices in 70 cities



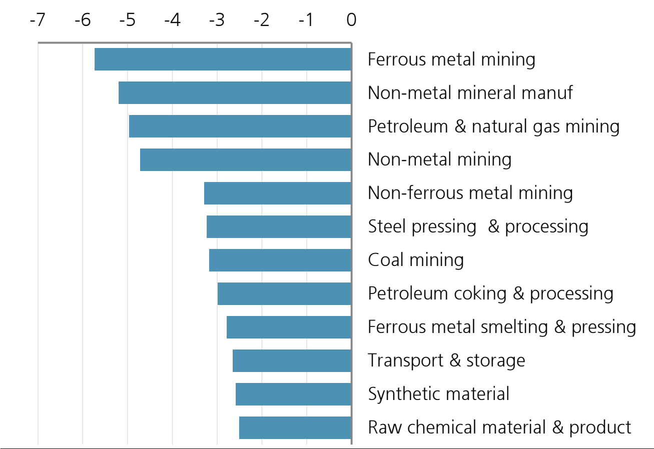
Source: CEIC, UBS

Figure 158: The supply-demand balance has changed



Source: CEIC, UBS estimates

Figure 159: Sensitivity test of property downturn (%)



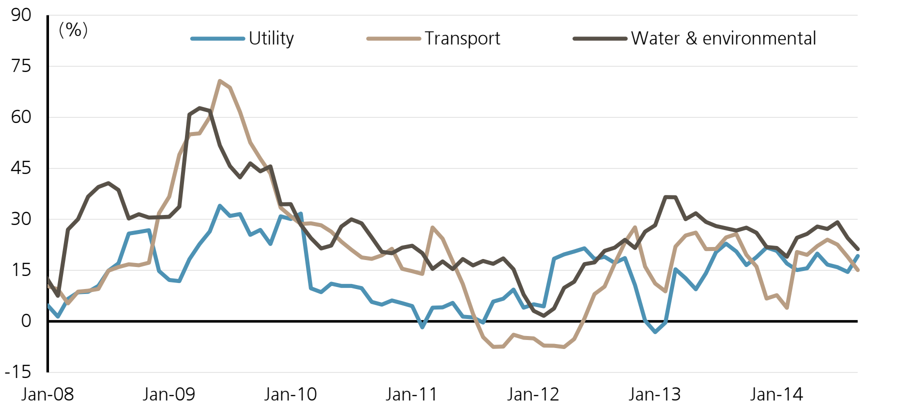
Note: Assuming a 10% drop in the growth of property and construction output.
Source: CEIC, UBS estimates

More infrastructure investment will be launched

We expect the government to launch additional infrastructure projects. However, we do not expect these will be enough to offset the slowdown, as 1) the contribution of infrastructure investment to FAI is relatively small compared to property and manufacturing investments; 2) there is limited room for infrastructure investment to grow, given infrastructure and social housing investments have already been heavily used and strong stimulus akin to 2008-2009 is unlikely due to the government's desire to avoid aggravating already-high financial leverage; 3) with the government starting to tighten local government budget constraints, and weaker land sales weighing on local governments' income growth, this will also limit local governments' ability to expand investments. Consequently, UBS expects real fixed investment will slow from 6.3% this year, to 5.6% and 5.3% in 2015 and 2016, respectively.

Additional infrastructure projects will be launched but not enough to offset the downturn.

Figure 160: Nominal growth of infrastructure investment (%, YoY, 3mma)



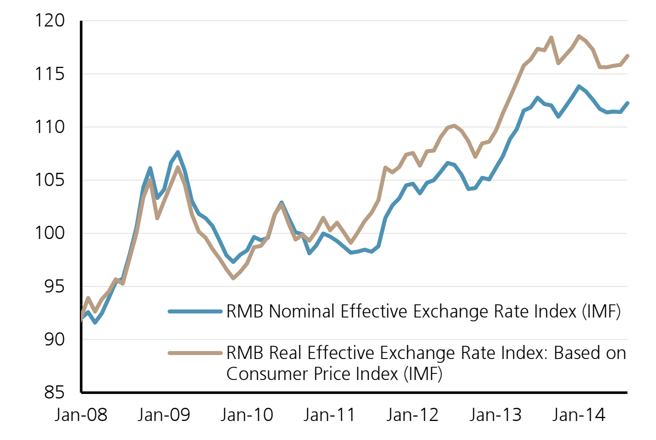
Source: CEIC, UBS estimate, data as of September 2014

Exports will improve, but competitiveness erodes

Export to improve on US recovery, but competitiveness erodes due to rising ULC and a currency appreciation.

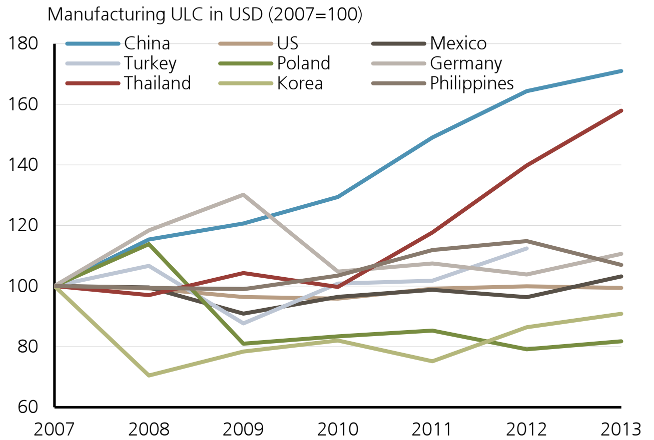
The continued recovery in advanced economies is expected to underpin China's external demand in the coming two years. UBS sees global economic growth accelerating modestly from 3.3% in 2014, to 3.5% in 2015, and 3.6% in 2016. However, import elasticity of demand from advanced economies seemed to have declined, and China's competitiveness has been eroded in some areas by the significant increase in unit labour costs and CNY appreciation in the past few years. Indeed, although we expect weaker CNY against USD in the coming two years (elaborated below), it will likely continue to appreciate in NEER terms. Therefore, we look for China's export growth to speed up only modestly to 8.5% in 2015. Imports, on the other hand, will continue to be constrained by sluggish domestic demand. As a result, we see net exports making a slight positive contribution to GDP growth in 2015 and 2016.

Figure 161: CNY NEER and REER appreciation



Source: CEIC, data as of August 2014

Figure 162: China's competitiveness has been eroded



Source: Haver, CEIC, UBS estimate, data as of 2013

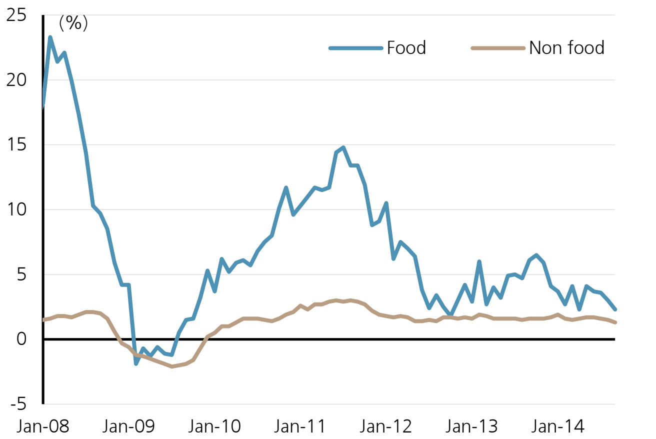
Inflationary pressures remain muted

Inflation will soften further despite modest support from higher food and utility prices.

The property-driven slowdown will bring disinflation pressure through various demand channels, weighing on prices of metals and mining products in particular. Excess capacity in the industrial sector is likely to be further exacerbated, which will depress industrial goods prices. Adjustment in the property and industrial sector is also expected to lead to slower wage growth. As a result, we expect CPI inflation

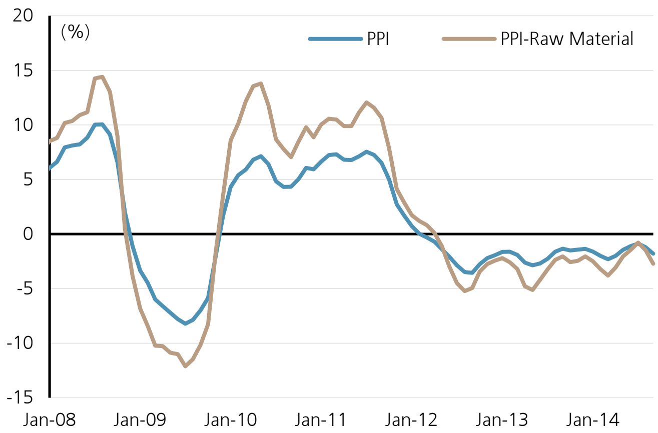
to soften to 1.8% in 2015 from an estimated 2.2% this year, despite modest support from higher food prices and upward adjustment in some utility prices. CPI inflation should pick up modestly to 2% in 2016 on the stabilization of commodity prices and higher food prices.

Figure 163: CPI (%, YoY)



Source: CEIC, data as of September 2014

Figure 164: PPI (%, YoY)



Source: CEIC, data as of September 2014

Monetary policies will ease further

Proactive liquidity management and rate cuts are expected

We think that the government is aware of the potential downside risks that a sharp economic slowdown could pose to both China's labour market and financial system. In light of this, despite still-resilient labour market conditions and the government's higher tolerance for property sector adjustment, which could facilitate a much-needed rebalancing in the economy, it is also in the government's interest to keep the adjustment process as smooth and as manageable as possible.

The government will help mitigate the pain of the economic slowdown.

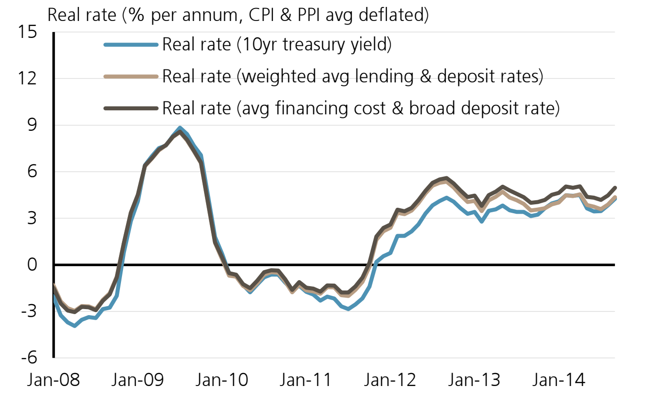
As such, in order to help safeguard financial stability and prevent the economy from a "hard landing", UBS expects the central bank will ensure ample liquidity in the financial system through various operations, including RRR cuts if necessary (in case of persistent large scale FX outflows for instance). More proactive liquidity management by the PBC is increasingly also necessary because of the changing external environment. We expect monetary policy divergence among major global central banks and the US Fed's interest rate hikes next year will lead to an increase in global yields, and more volatility in cross-border capital flows.

PBC will manage liquidity more proactively to ensure ample liquidity in the financial system.

We also expect the PBC to lower interest rates. Benchmark lending rates are to fall by up to 75 basis points by end 2015 to slow the pace of NPL formation, in the face of rising real interest rates. A cut in deposit rates is likely to be less steep, though. We expect the first rate cut to come at end-2014. Monetary easing can reduce financing costs and delay financial distress to some extent, but will be of little help in boosting investment, in our view.

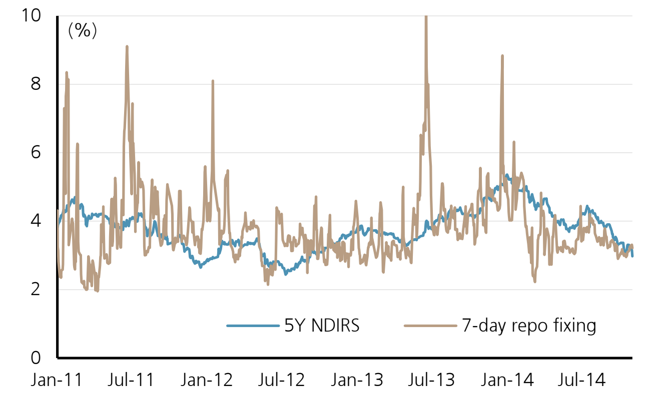
The central bank will also cut lending rates by 75bp by end 2015. Monetary easing aims to maintain financial stability instead of boosting investments.

Figure 165: China's real interest rate has increased



Source: CEIC, UBS estimates

Figure 166: 7-day fixing and 5s NDIRS



Source: Reuters, UBSS estimate, data as of November 4, 2014

Duration will be the main contributor to return

Money market rates will drop further and duration extension will be favoured.

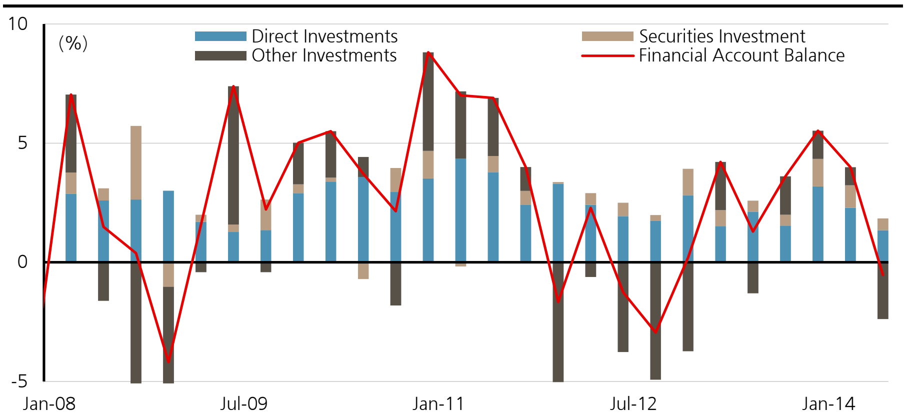
In light of the above, we expect money market liquidity will remain accommodative with PBC proactively managing liquidity conditions. Of course, there may be an unintended liquidity squeeze if the government tightens too much on shadow banking regulations and/or does not provide sufficient liquidity in the case of capital outflows. Therefore, there is the risk that money market rates could remain volatile. Taking 75bp interest rate cuts into account, we expect average 7-day repo fixing could slide further from 3.5% this year to 2.5% in 2015. We also think a receiver's position on the long-end of the NDIRS curve will continue to perform in 2015. Overall, with a gloomy growth outlook, monetary policies to ease further, and yield levels already lowered this year, we continue to like duration extension.

CNY to weaken against USD

Capital account will turn into deficit.

Although we forecast a continued increase in China's trade surplus, we expect the capital account to turn into deficit in 2015-2016. As interest rate differentials begin to narrow (PBC rate cuts vs. Fed rate hikes) in the next couple of years, carry-seeking inflows are expected to slow and unwind. Meanwhile, further capital account opening and changing relative asset prices at home and abroad could trigger capital outbound flows as household diversification needs grow.

Figure 167: China's financial account balance (% of GDP)



Source: BIS, Haver, CEIC, UBS estimates, data as of Q2 2014

However, the government's ambitions to push forward RMB internationalization, political pressure from major trading partners and PBC's concern for domestic financial stability will continue to underpin the CNY exchange rate as well. Therefore, on balance, UBS sees the CNY weakening only modestly against a strengthening USD, trading at 6.35 at end-2015, with increased two-way volatility.

A stable CNY is in the government's interest.

Financial risk still needs to be watched

Near term financial risk is reduced

The State Council's recently announced guidelines and budget law amendments have laid down new rules for local government bond issuance and debt management. The new framework paves the way for debt swaps and restructuring of existing local government debt, which should improve debt sustainability.

The government starts addressing the local government debt burden.

We believe PBC's proactive liquidity management and rate cuts will ensure sufficient liquidity in the face of more volatile capital flows and worsening cash flows in the real economy. It will also lower the debt service burden and reduce the pace of NPL formation. Thus, overall systematic risk in China's economy and financial system should decline.

PBC's proactive liquidity management is also helpful to financial stability.

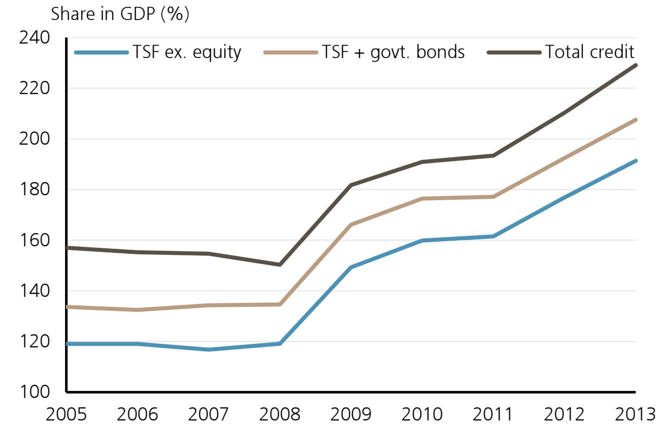
Concerns over shadow banking remain

With current policy supports helping to delay a de-leveraging of the economy, we expect overall leverage will rise further and the debt overhang will continue to accumulate, albeit at a slower pace. Moreover, rapid expansion of shadow banking as a result of regulatory arbitrage and disintermediation have raised the cost of credit and weakened the foundation of normal banking. Financial stability is vulnerable to a sharp property downturn, given that China's financial system has substantial exposure to property through bank loans, shadow banking credit, and the wide use of property or land as collateral.

We expect overall leverage of the economy will continue to rise.

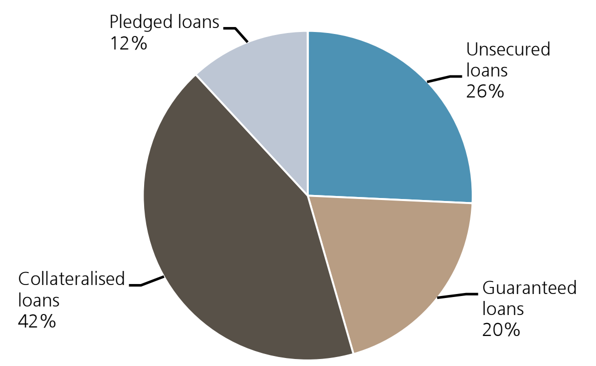
Financial stability is vulnerable to a sharp property downturn.

Figure 168: Rising leverage



Source: CEIC, UBS estimates, data as of 2013

Figure 169: H-share banks' loan breakdown by collateral type (%)



Source: Company information, UBS estimates, data as of 2013

.

Upside risks in 2015

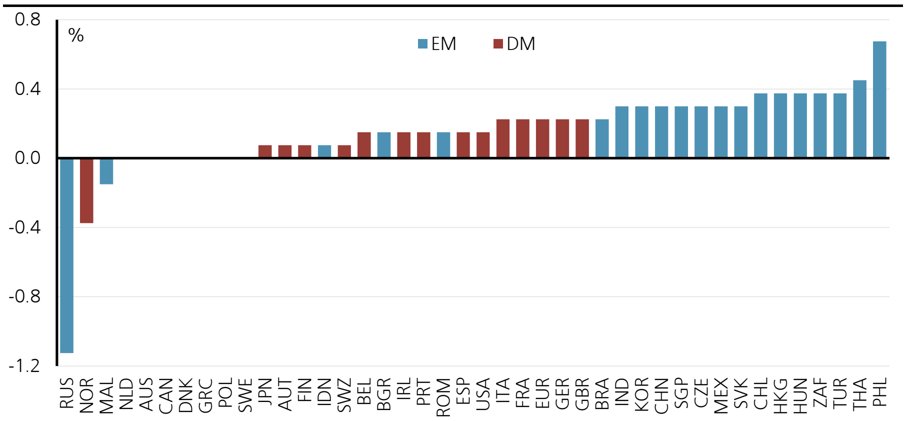
What are upside risks in 2015?

Bhanu Baweja / Manik Narain

(1) **Oil prices continue to slide lower due to supply side reasons**: The biggest upside risk for EM assets is oil prices going lower. The channels through which this can help are a) stronger global growth, b) monetary policy in the developed world being able to stay looser c) stronger international trade through lower transport costs and stronger DM consumer d) lower trade and fiscal imbalances in large parts of EM. Already low oil prices are leading to significant negative momentum in EM inflation. As we have detailed in the equities section, this usually does bring good news for EM assets with a 6m lag.

Lower energy prices may oil the wheels of the EM carriage

Figure 170: Impact on GDP after one year of $15 decline in the price of oil



Source: OEF , UBS estimates This is a chart from Andy Cates' report "Oiling the wheels", 29 Oct 2014

(2) **European Credit multiplier gains health, texture of US growth becomes more EM friendly**: There is no bigger consensus view in the market today than that of European growth remaining extremely weak for several years to come. Should the process of cleansing bank balance sheets through the AQR and depreciating the currency create room for European growth to surprise positively, EM would benefit greatly. In the US, it's possible that the recovery in investment demand broadens out from shale gas, heavy machinery and transportation equipment to sectors such as light manufacturing, electronic appliances, and electronics, which EM is better equipped to supply. We will continue to monitor the import propensity of US growth, the level of housing starts and the sub-components of durable goods orders closely in this context.

US growth may broaden; credit multiplier in Europe may revive

(3) **More EM countries (and companies) focus on reform**: As discussed in the chapter on EM Reforms: Fact or Fiction, perhaps the best remedy for EM to get ahead of the markets in this challenging global environment is to push up total factor productivity. The precise policy prescriptions for this will vary significantly by country, but in general accelerating privatisation, expanding tax bases, reforming land and labour laws, and improving the business climate to attract greater FDI can help to boost growth in a socially equitable manner. Mexico and India are the ones most investors would shortlist as the leaders of reform. This list needs to expand. Brazil, South Africa and Turkey would be welcome additions.

Reform is usually conducted in a background of distress or very strong growth. As Mexico shows, there can be exceptions to this rule

(4) **EM central bankers do the right thing when under pressure**. As the prospect of higher US rates looms large in 2015, the responses that EM central banks make to this changing global environment will have an important bearing on how local currencies perform. Real policy rates in EM, despite some recent tightening, remain well below pre-crisis years today. Rather than fight potential currency pressures through FX intervention (especially in cases where reserves buffer isn't strong) EM central banks ought to respond with higher rates that keep savings rate from declining further. Some countries like India, Malaysia, Colombia even Russia have conducted conservative monetary policy, which is encouraging. This is what FX and debt investors want to get long the asset class structurally. Equities will hurt near term but will likely follow up with a lag.

Focusing on rates, not on currencies, will help

(5) **US rates fail to rise, despite better growth**: While EM assets were unable to capitalise on the significant decline in 10y US Treasury yields this year, they were still forced to confront a much stronger USD as European front end yields tumbled. With European yields now hitting the zero bound, however, it's worth asking if EM assets would trade more favourably if US yields once again failed to take off in 2015.

Low global inflation and already low European yields may mean US rates and USD don't rise as aggressively as feared

(6) **Russian risks recede**: There's no denying that the biggest underweight in EM today in Russia. Representing a large part of EM benchmarks, a big improvement in the markets there would likely spill over into other markets too. This would take the form of a powerful response by the monetary authorities there to restore confidence in the RUB or, ideally, mending strained ties with Ukraine and the west to remove sanctions and thus reopen access to international credit markets.

Normalisation in Russia would not only bring a big market back into play, it will also help growth in Europe

Trade Monitor

Structural Trades

Year	Trade	Performance
2014[20]	Long MXN vs JPY (Closed Oct 13th)	6.35%
	Long USD vs HUF, RUB and ZAR (RUB leg closed Oct 31st)	12.2%
	Short AUD vs MYR	4.2%
	Buy Turkey CDS vs Indonesia CDS	90bps
	Long low duration bank credit vs bank equities in India	-24.5%
	Long fixed income in Israel vs Turkey (Closed Sep 12th)	200bps
	Receive Jan'15s in Brazil (Closed May 22nd)	45bps
	Long Mexico Equities vs South Africa Equities	8.24%
	Long Korea Equities vs Thailand Equities	-12.5%
	Long BBB against AA credit in China quasi sovereign credit (Closed May 16th)	0.7%
2013	Long MSCI China vs Copper	14.2%
	Prefer Fixed Income to stocks in India	-3.0%
	Short EUR vs SGD and PHP	-7.0%
	Long DEWA'20s vs Egypt'20s	9.2%
	Long Russia duration funded in EUR	-0.4%
	Long USD vs CZK	2.4%
	Long Mbonos vs UST	8.1%
	Receive Brazil Pre-DI Jan-15s	-4.5%
	Short AUD vs MXN	10.9%
	Long PDVSA 17Ns	2.3%
	Long RON vs HUF	8.3%
	Long BRL vs TRY	1.8%
2012	Sell EUR vs. EM basket of INR, BRL, TRY	5.6%
	2s5s NDIRS steepener in China	-45bps
	Long China high yield property credit	30.1%
	Receive INR NDOIS 2y1y	5bps
	Sell HGB vs. Sell Hungary CDS	-5.5%
	Buy CDX EM protection vs. US HY	120bps
	Long USDCZK	1.7%
	Long Mbonos38s hedged with 1y USDMXN fwd	12.9%
	Long MXN vs. CAD	6.7%
	Buy VENZ 22s basis	7.9%

[20] We measure total returns on these trades from 11/11/2013 to 08/11/2014. Because our recommendations span different asset classes, there isn't a single index to benchmark our trades on. For simplicity, we use the EMBI Global Diversified. During this period, our benchmark measure returned 9.8%. Past performance is not an indication of future results.

Tactical Trades

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						
Long USD vs ZAR	10.64	10-Jun-14			2.82%	0.01%
Long USD vs SGD	1.2710	13-Oct-14			1.43%	
CLOSED TACTICAL TRADES						
Short CLPCOP via 6m fwd,1% trail stop from 3.54, 5% target	USDCLP: 526.98	14-Jan-14	USDCLP: 561.00	22-Apr-14	6.70%	1.68%
	USDCOP: 1931.22		USDCOP: 1925.00			
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%
Indicative sum of ytd returns in 2014					**7.12% ****	

Source: UBS, Bloomberg — Market Pricing as of 1220 (07-Nov-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
Receive Korea 5y5y vs the US								**18**
	Rec 5y5y KRW IRS	bp		13-Oct-14	2.94		2.80	
	Pay 5y5y USD IRS	bp		13-Oct-14	3.23		3.26	
Long India fixed income vs Turkey (FX-unhedged)								**-4**
	Long Jul-24 IGB's	bp	9.87	12-Sep-14	8.50		8.21	
	Short Jul-24 TurkGB's	bp	10	12-Sep-14	8.96		8.63	
2s10s Flattener in CLP Camara swaps								**1**
	Rec 10y CLP Camara	bp	2.39	12-Sep-14	4.72		4.66	
	Pay 2y CLP Camara	bp	10	12-Sep-14	3.26		3.21	
Receive 5y5y PLN vs Pay 1y1y HUF								**15**
	Rec 5y5y PLN IRS	bp	2.38	29-Aug-14	3.39	13-Oct-14	3.07	33
	Pay 1y1y HUF IRS	bp	10	29-Aug-14	2.52	13-Oct-14	2.34	-18
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 1115 GMT on 07-Nov-14

Past performance is not an indication of future results

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FX & Macroeconomic Forecasts

Figure 171: Macro Economic Forecast

Real GDP growth (%)

	2011	2012	2013	2014E	2015E	2016E
China	9.3	7.7	7.7	7.3	6.8	6.5
Hong Kong	4.8	1.5	2.9	2.2	2.3	2.0
India	6.7	4.5	4.7	5.3	5.5	6.5
Indonesia	6.5	6.3	5.8	5.2	5.2	5.8
Malaysia	5.2	5.6	4.7	5.5	5.0	4.7
Philippines	3.7	6.8	7.2	6.5	6.0	5.8
Singapore	6.1	2.5	3.9	2.8	2.6	2.4
South Korea	3.7	2.3	3.0	3.4	2.9	3.1
Taiwan	4.2	1.5	2.1	4.0	3.3	2.7
Thailand	0.1	6.5	2.9	0.4	3.9	3.6
Argentina	8.6	0.9	2.9	-1.9	-2.5	3.0
Brazil	2.7	1.0	2.5	0.3	0.6	1.8
Chile	5.8	5.4	4.1	1.8	2.8	3.5
Colombia	6.6	4.0	4.7	4.8	4.2	4.0
Ecuador	na	na	na	na	na	na
Mexico	4.0	4.0	1.1	2.2	3.3	3.8
Peru	6.5	6.0	5.8	3.3	4.0	4.8
Venezuela	4.2	5.6	1.3	-3.0	-1.5	0.5
Czech Republic	1.8	-1.0	-0.9	2.7	2.2	2.4
Hungary	1.6	-1.7	1.1	3.1	2.2	2.4
Israel	4.6	3.4	3.3	2.5	3.0	3.2
Kazakhstan	7.5	5.0	5.9	4.5	4.8	5.0
Nigeria	4.9	4.3	5.4	7.0	7.0	6.5
Poland	4.5	1.9	1.6	3.2	3.3	3.3
Russia	4.3	3.4	1.3	0.5	0.2	1.0
South Africa	3.6	2.5	1.9	1.4	2.6	3.0
Turkey	8.8	2.1	4.1	3.0	3.2	3.7
Ukraine	5.2	0.3	0.0	-7.0	-2.0	2.5

CPI Inflation (%)

*	2011	2012	2013	2014E	2015E	2016E
China	5.4	2.6	2.6	2.2	1.8	2.0
Hong Kong	5.3	4.1	4.3	3.5	2.5	2.1
India	8.8	10.2	9.5	7.7	6.4	5.1
Indonesia	5.4	4.3	7.0	6.3	6.9	5.0
Malaysia	3.2	1.7	2.1	3.2	4.2	2.9
Philippines	4.7	3.2	2.9	4.2	4.5	4.0
Singapore	5.3	4.6	2.4	1.5	1.2	1.0
South Korea	4.0	2.2	1.3	1.7	2.2	1.6
Taiwan	1.4	1.9	0.8	1.5	1.2	1.0
Thailand	3.8	3.0	2.2	2.0	1.9	2.1
Argentina	9.5	10.8	10.9	26.0	30.0	25.0
Brazil	6.5	5.8	5.9	6.4	6.8	5.8
Chile	4.4	1.5	2.8	4.7	3.2	3.3
Colombia	3.7	2.4	1.9	3.3	3.0	3.0
Ecuador	na	na	na	na	na	na
Mexico	3.8	3.6	4.0	4.1	3.4	3.3
Peru	4.7	2.6	2.9	2.9	3.0	2.5
Venezuela	27.6	20.1	56.2	68.0	75.0	60.0
Czech Republic	2.4	2.4	1.4	0.8	1.8	2.0
Hungary	4.1	5.2	0.4	1.7	2.7	3.0
Israel	2.2	1.9	1.7	0.0	1.0	2.0
Kazakhstan	8.1	6.1	4.6	7.7	7.9	6.0
Nigeria	10.3	12.0	7.9	8.5	8.5	8.0
Poland	4.6	2.5	0.7	0.3	2.2	2.5
Russia	6.1	6.6	6.5	8.6	6.3	4.9
South Africa	6.1	5.6	5.4	6.3	5.9	5.5
Turkey	10.4	6.2	7.4	9.0	6.7	6.2
Ukraine	4.6	-0.2	-0.2	18.4	8.2	6.0

Total Public Debt (% of GDP)

	2011	2012	2013	2014E	2015E	2016E
China	15.6	15.2	15.5	na	na	na
Hong Kong	0.6	0.5	0.5	0.6	0.6	0.6
India	46.3	46.9	46.8	46.2	44.9	43.6
Indonesia	24.2	23.7	25.9	25.9	25.8	25.7
Malaysia	51.5	53.3	53.7	52.6	51.0	50.0
Philippines	51.0	51.5	49.2	47.3	45.5	44.2
Singapore	102.7	107.4	104.7	108.1	111.6	107.9
South Korea	30.2	30.9	32.5	35.3	36.9	38.3
Taiwan	48.0	48.8	48.8	48.8	48.2	47.2
Thailand	29.3	30.9	32.2	34.1	34.2	34.3
Argentina	32.2	32.7	34.0	36.6	43.7	45.4
Brazil	64.7	68.2	66.2	65.8	65.6	65.6
Chile	11.1	11.9	12.8	14.0	15.0	15.5
Colombia	35.5	33.7	35.7	37.7	39.7	41.6
Ecuador	na	na	na	na	na	na
Mexico	35.3	36.8	38.0	41.0	43.5	43.5
Peru	21.4	19.7	19.2	19.0	19.0	18.6
Venezuela	25.1	29.1	24.9	34.5	33.3	31.9
Czech Republic	41.4	46.2	46.0	45.5	45.0	44.0
Hungary	82.1	79.8	79.2	79.5	78.0	76.5
Israel	69.7	68.2	67.4	67.6	68.0	68.0
Kazakhstan	12.7	13.4	13.8	14.6	15.4	15.2
Nigeria	na	na	na	na	na	na
Poland	56.4	55.6	57.0	49.0	49.0	48.5
Russia	9.6	10.5	11.9	11.1	11.9	12.0
South Africa	38.5	40.4	42.4	48.2	49.2	50.0
Turkey	39.1	36.2	35.5	35.3	34.5	33.5
Ukraine	36.3	36.7	38.8	63.9	76.1	76.3

Primary Fiscal Balance (% of GDP)

	2011	2012	2013	2014E	2015E	2016E
China	-1.3	-1.0	na	na	na	na
Hong Kong	na	na	na	na	na	na
India	-3.0	-1.8	-1.2	-0.8	-0.3	na
Indonesia	0.1	-0.6	-1.0	-0.9	-0.7	na
Malaysia	-2.8	-2.4	-1.8	-1.5	-1.1	na
Philippines	0.8	0.7	1.4	0.6	0.4	na
Singapore	na	na	na	na	na	na
South Korea	2.5	2.4	1.9	1.9	1.9	na
Taiwan	16.8	16.5	16.0	15.5	15.3	na
Thailand	na	na	na	na	na	na
Argentina	0.2	-0.2	-0.7	-0.9	-1.8	-1.4
Brazil	3.1	2.4	1.9	0.7	1.0	1.3
Chile	1.8	1.1	0.0	-0.3	-1.3	-0.5
Colombia	-0.1	0.2	0.0	0.0	0.1	0.2
Ecuador	na	na	na	na	na	na
Mexico	-0.6	-0.8	-0.2	-1.6	-1.5	-0.8
Peru	2.0	2.3	1.5	1.5	0.8	0.6
Venezuela	-2.4	-2.2	-1.0	-0.5	-1.6	-2.4
Czech Republic	-2.1	-3.0	-0.3	-0.3	-0.9	-0.5
Hungary	8.6	2.0	1.8	1.1	1.4	1.5
Israel	0.3	-1.0	-0.3	-0.2	-0.6	0.0
Kazakhstan	6.3	5.6	4.4	7.0	3.0	2.6
Nigeria	na	na	na	na	na	na
Poland	-2.6	-1.2	-1.7	7.9	-0.4	0.1
Russia	1.1	0.5	0.1	1.1	0.3	-0.2
South Africa	-1.6	-2.4	-2.0	-2.1	-1.8	-0.7
Turkey	1.8	1.3	2.0	1.0	1.3	1.6
Ukraine	-0.8	-2.4	-2.3	-2.9	-0.3	0.0

Source: UBS. * Asia CPI forecast are year avg , rest are year-end

Figure 172: Macro Economic Forecast

Overall Fiscal Balance (% of GDP)	2011	2012	2013	2014E	2015E	2016E
China	-1.8	-1.5	-2.1	-2.1	na	na
Hong Kong	3.8	3.2	1.0	0.8	0.7	0.7
India	-5.7	-4.8	-4.5	-4.1	-3.6	-3.0
Indonesia	-1.1	-1.9	-2.5	-2.5	-2.3	-2.0
Malaysia	-4.8	-4.5	-3.9	-3.5	-3.0	-2.7
Philippines	-2.0	-2.3	-1.4	-1.9	-1.9	-2.3
Singapore	1.3	1.9	1.3	0.8	0.5	-0.8
South Korea	1.4	1.3	1.0	0.7	-0.1	-0.5
Taiwan	-2.2	-2.5	-1.4	-1.2	-1.0	-0.8
Thailand	-1.9	-2.9	-2.0	-2.7	-2.0	-2.0
Argentina	-1.3	-2.0	-1.9	-2.5	-3.6	-2.9
Brazil	-2.6	-2.5	-3.3	-4.5	-4.5	-4.2
Chile	1.5	0.5	-0.6	-0.9	-1.9	-1.0
Colombia	-2.8	-2.3	-2.2	-2.3	-2.2	-2.1
Ecuador	na	na	na	na	na	na
Mexico	-2.5	-2.6	-2.0	-3.6	-3.5	-2.8
Peru	1.0	1.3	0.5	0.5	-0.2	-0.3
Venezuela	-4.0	-4.9	-4.0	-4.4	-4.3	-4.3
Czech Republic	-3.3	-4.2	-1.5	-1.5	-2.0	-1.5
Hungary	4.3	-2.0	-2.2	-2.8	-2.5	-2.3
Israel	-2.7	-3.9	-3.2	-3.1	-3.5	-2.8
Kazakhstan	5.8	5.1	3.8	6.5	2.5	2.1
Nigeria	0.5	0.4	-2.3	-2.0	-2.5	-2.5
Poland	-5.0	-3.9	-4.3	5.5	-3.0	-2.5
Russia	0.8	-0.1	-0.5	0.5	-0.3	-0.8
South Africa	-4.4	-5.5	-5.5	-4.9	-4.3	-3.5
Turkey	-1.4	-2.1	-1.2	-1.8	-1.5	-1.2
Ukraine	-4.2	-6.6	-6.7	-10.6	-6.8	-5.0

Current Account (% of GDP)	2011	2012	2013	2014E	2015E	2016E
China	1.9	2.6	2.0	2.8	2.7	2.5
Hong Kong	5.6	1.6	1.8	1.9	2.4	2.1
India	-4.1	-4.7	-1.7	-1.6	-1.5	-0.7
Indonesia	0.2	-2.8	-3.4	-2.6	-1.9	-1.0
Malaysia	11.6	5.8	4.1	5.5	4.7	5.3
Philippines	3.2	2.8	3.5	2.7	2.5	2.3
Singapore	22.8	17.5	18.3	16.2	14.5	12.6
South Korea	1.5	4.2	6.1	6.3	5.7	5.5
Taiwan	9.0	10.6	11.7	12.7	11.8	11.8
Thailand	1.2	-0.4	-0.7	1.3	-0.3	-0.7
Argentina	-0.7	-0.2	-0.8	-0.9	-0.9	-0.9
Brazil	-2.1	-2.4	-3.7	-3.7	-3.4	-3.3
Chile	-1.3	-3.4	-3.5	-1.6	-1.6	-2.0
Colombia	-2.9	-3.2	-3.4	-4.1	-3.5	-3.4
Ecuador	na	na	na	na	na	na
Mexico	-1.2	-1.3	-2.1	-2.1	-2.6	-2.4
Peru	-1.8	-3.1	-4.4	-5.1	-3.5	-3.5
Venezuela	7.7	2.9	2.1	5.1	4.2	4.0
Czech Republic	-2.9	-2.4	-1.4	-0.3	-0.5	-0.6
Hungary	0.9	2.3	4.2	4.1	3.9	3.5
Israel	1.5	0.8	2.4	2.6	2.8	2.8
Kazakhstan	5.4	0.5	0.5	0.9	-0.9	-2.2
Nigeria	3.1	7.9	3.8	2.6	1.9	1.3
Poland	-5.2	-3.6	-1.4	-1.3	-1.5	-1.6
Russia	5.1	3.6	1.6	3.1	4.6	4.2
South Africa	-2.3	-5.2	-5.8	-5.9	-5.5	-5.3
Turkey	-9.7	-6.2	-7.9	-6.0	-6.3	-6.8
Ukraine	-6.1	-7.8	-8.8	-4.0	-2.2	-3.1

FX reserves (USD bn)	2011	2012	2013	2014E	2015E	2016E
China	3181.1	3311.6	3821.3	4119.6	4252.7	na
Hong Kong	285.4	317.4	311.2	na	na	na
India	260.1	259.7	276.4	278.7	279.7	na
Indonesia	110.1	112.8	99.4	99.4	99.4	na
Malaysia	133.6	139.7	134.9	129.9	127.9	na
Philippines	75.3	83.8	88.9	85.8	86.1	na
Singapore	238.2	259.3	273.1	273.1	273.1	na
South Korea	305.4	327.0	346.5	327.0	na	na
Taiwan	385.5	403.2	416.8	na	na	na
Thailand	175.1	181.6	167.2	167.2	167.2	na
Argentina	46.4	43.3	30.6	23.0	20.0	24.0
Brazil	352.0	373.1	375.8	376.7	376.3	375.3
Chile	42.0	41.6	41.1	48.6	55.2	64.4
Colombia	32.3	37.5	43.6	47.6	50.0	52.0
Ecuador	na	na	na	na	na	na
Mexico	142.5	163.5	176.5	182.8	192.1	193.2
Peru	48.9	64.0	65.7	64.5	66.0	68.0
Venezuela	29.9	29.9	21.5	22.0	21.5	22.5
Czech Republic	40.2	44.9	56.3	55.0	55.2	52.9
Hungary	48.9	44.7	49.6	41.3	30.0	25.3
Israel	74.9	75.9	81.8	79.3	81.2	na
Kazakhstan	29.3	28.3	24.7	28.0	28.0	26.0
Nigeria	32.8	44.3	43.6	39.0	35.0	35.0
Poland	98.0	109.0	106.4	100.0	100.8	96.6
Russia	454.0	486.6	469.6	370.0	350.0	350.0
South Africa	42.6	44.0	44.8	45.0	45.0	45.0
Turkey	90.6	120.6	132.7	135.0	130.0	130.0
Ukraine	30.4	22.7	18.8	10.0	16.2	20.0

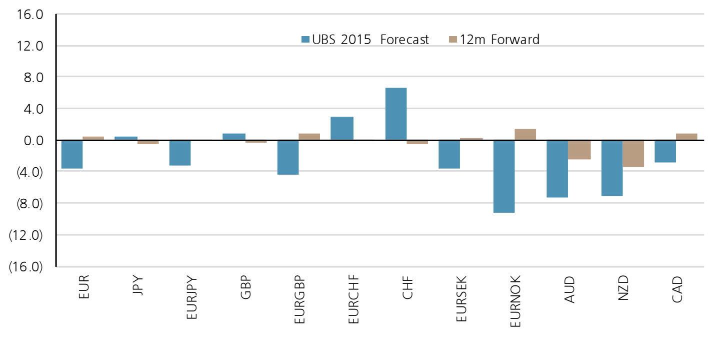
Year-end policy rate (%)	2011	2012	2013	2014E	2015E	2016E
China	3.50	3.00	3.00	3.00	3.00	3.00
Hong Kong	0.38	0.40	0.38	na	na	na
India	8.50	8.00	7.75	7.75	7.25	6.00
Indonesia	6.00	5.75	7.50	7.50	7.50	6.50
Malaysia	3.00	3.00	3.00	3.50	3.50	3.25
Philippines	4.50	3.50	3.50	4.00	5.00	5.50
Singapore	0.68	0.44	0.39	na	na	na
South Korea	3.25	2.75	2.50	na	na	na
Taiwan	1.88	1.88	1.88	na	na	na
Thailand	3.25	2.75	2.75	2.00	2.50	2.50
Argentina	na	na	na	na	na	na
Brazil	11.00	7.25	10.00	11.75	12.50	12.00
Chile	5.25	5.00	4.50	3.00	3.50	5.00
Colombia	4.75	4.25	3.25	4.50	5.00	5.50
Ecuador	na	na	na	na	na	na
Mexico	4.50	4.50	3.50	3.00	3.75	5.00
Peru	4.25	4.25	4.00	3.50	3.75	4.50
Venezuela	na	na	na	na	na	na
Czech Republic	0.75	0.05	0.05	0.05	0.05	0.05
Hungary	7.00	5.75	3.00	2.10	3.00	3.50
Israel	2.75	2.00	1.00	0.25	0.75	2.00
Kazakhstan	7.50	5.50	5.50	5.50	5.50	5.50
Nigeria	12.00	12.00	12.00	12.00	13.00	13.00
Poland	4.50	4.25	2.50	1.75	2.25	3.00
Russia	5.25	5.50	5.50	9.50	8.00	6.00
South Africa	5.50	5.28	5.00	6.00	7.00	8.00
Turkey	5.75	5.50	4.50	8.25	8.25	8.25
Ukraine	7.75	7.50	6.50	12.50	12.50	10.50

Source: UBS

Figure 173: FX Forecast*

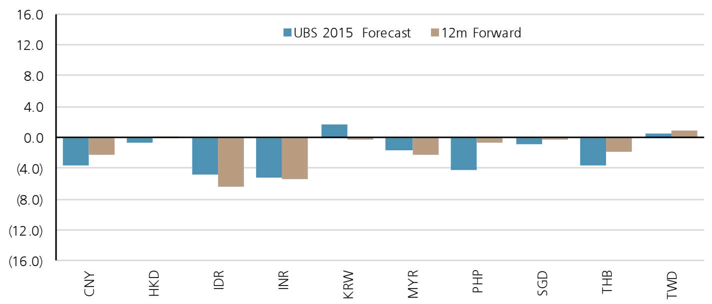
Majors

Spot At the Time of Forecast		12m Fwds	2015E
EURUSD	1.2455	1.2503	1.2000
USDJPY	114.60	114.00	115.00
EURJPY	142.73	142.5465	138.00
GBPUSD	1.5869	1.5811	1.6000
EURGBP	0.7848	0.7907	0.7500
EURCHF	1.2036	1.2015	1.2400
USDCHF	0.9662	0.9607	1.0300
EURSEK	9.2329	9.2538	8.9000
EURNOK	8.4911	8.6109	7.7000
AUDUSD	0.8637	0.8418	0.8000
NZDUSD	0.7754	0.7484	0.7200
USDCAD	1.1329	1.1429	1.1000



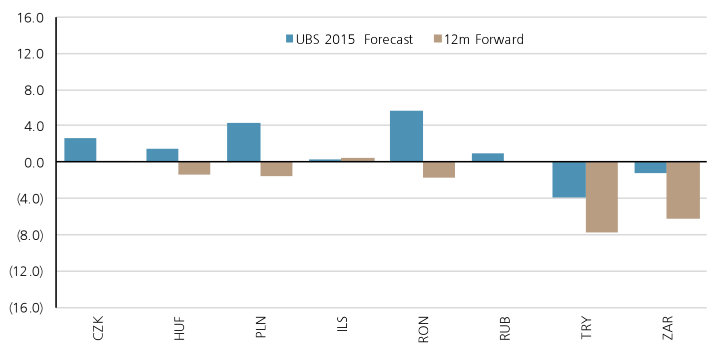
Emerging Asia

Spot At the Time of Forecast		12m Fwds	2015E
USDCNY	6.1224	6.2653	6.3500
USDHKD	7.7527	7.7521	7.8000
USDIDR	12178	13018	12800
USDINR	61.636	65.080	65.000
USDKRW	1093.4	1096.4	1075.0
USDMYR	3.3460	3.4220	3.4000
USDPHP	45.030	45.300	47.000
USDSGD	1.2889	1.2891	1.3000
USDTHB	32.787	33.430	34.000
USDTWD	30.645	30.364	30.500



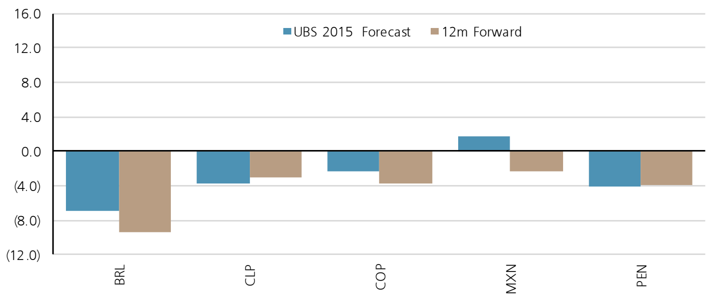
Emerging Europe

Spot At the Time of Forecast		12m Fwds	2015E
EURCZK	27.725	27.672	27.000
EURHUF	309.29	313.62	305.00
EURPLN	4.2280	4.2953	4.0500
USDILS	3.8101	3.7936	3.8000
EURRON	4.4353	4.5125	4.2000
USDRUB	46.723	n/a	46.240
USDTRY	2.2581	2.4460	2.3500
USDZAR	11.271	12.012	11.400



Emerging Americas

Spot At the Time of Forecast		12m Fwds	2015E
USDARS	8.5072	11.998	12.500
USDBRL	2.5587	2.8238	2.7500
USDCLP	587.85	606.08	610.00
USDCOP	2098.9	2180.0	2150.0
USDMXN	13.541	13.854	13.300
USDPEN	2.9275	3.0440	3.0500
USDVEF	6.2921	n/a	27.5600



Source: UBS, Bloomberg *As of Nov 09

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