

EM Investment Grade Sovereign Hard Currency Debt in Central Bank Portfolios

Dr. Massimiliano Castelli, Head of Global Sovereign Markets Strategy & Advice
Shamaila Khan, Head of Global Emerging Markets and Asia-Pacific Fixed Income
Philipp Salman, Global Sovereign Markets Strategy & Advice
Sangram Jadhav, Global Emerging Markets Fixed Income

The framework for managing reserves by central banks has generally focused on achieving three key objectives: capital protection, liquidity and return. Optimizing along these parameters inevitably involves making trade-offs.

Traditionally, capital protection and liquidity have been the two dominant objectives with risk-adjusted returns ranking lower. The era of ultralow interest rates and subdued volatility that prevailed after the Global Financial Crisis prompted reserve managers to broaden their investable universe to generate higher returns and to protect their capital in real terms (see Figure 1). Many diversified away from fixed income into listed equity to take advantage of low volatility and negative correlation with government bonds.

However, we are now entering a new regime that might be marked by higher interest rates, more volatile business cycles and positive stock-bond correlations.

This shift will require a rethink of asset allocation and diversification concepts among central banks. In the new investment regime, fixed income is likely to play a crucial

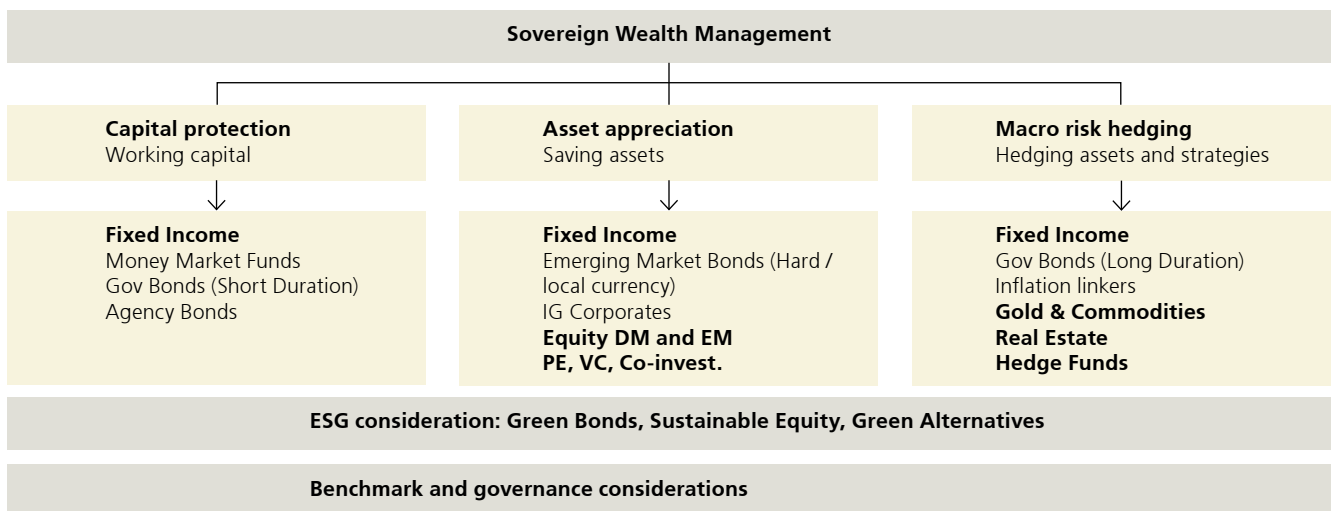
role not only in terms of capital protection, but also as a source of income.

It is an asset class that can strike a balance between the different constraints that central banks are subject to, while also making a significant contribution to protecting their reserves in real terms: emerging market (EM) investment grade sovereign debt in hard currency.

Asset Class Review 2023

2023 has been a rollercoaster for global markets, including fixed income. From a “Goldilocks” scenario in January, markets moved quickly to a “No Landing” narrative in February; expectations for interest rate hikes’ shoot up to 6%. In Spring, the US mid-sized banks’ crisis shook markets and suddenly interest rate cuts were priced in for summer. However, in the following months, fears of a broadening of the financial crisis subsided quickly and economic resilience and persistent inflationary pressure pushed markets back to a higher-for-longer narrative. US 10-Y rates rose to above 5% in October, the highest level since before the Great Financial Crisis.

Figure 1: Framework for managing central bank reserves



Source: UBS AM as of January 2024

In the last two months of the year, however, growing evidence of inflation falling towards target, more dovish communication by central bankers and hopes of rates cuts in the first half of 2024 led to a rally in the bond market. As a result, the global government bond market did not suffer a third year of negative returns, something that would have been almost unprecedented in the post-war period.

Emerging market sovereigns bonds also performed well. EM investment grade government bonds delivered a return of 7.1%, almost 2% above advanced economies' government bonds. EM High yield Sovereigns generated returns above 15%.

Figure 2: Government Bond Market, 2023 Returns

Asset Classes	Return
Advanced Economies Global Government Bonds 1–3 Years ¹	4.5%
Advanced Economies Global Government Bonds ¹	5.3%
Emerging Economies Sovereign Bonds ²	11.1%
Emerging Economies Sovereign Investment Grade Bonds ²	7.1%
Emerging Economies Sovereign High-Yield Bonds ²	15.4%

1 Sample portfolio that tracks the performance of typical central bank short-term and long-term government bond portfolios that follow the average currency composition of global FX reserves as reported by IMF COFER data.

2 JP Morgan EMBI Global Diversified indices.

Source: UBS Asset Management, Bloomberg, as of January 2024.

Asset class outlook

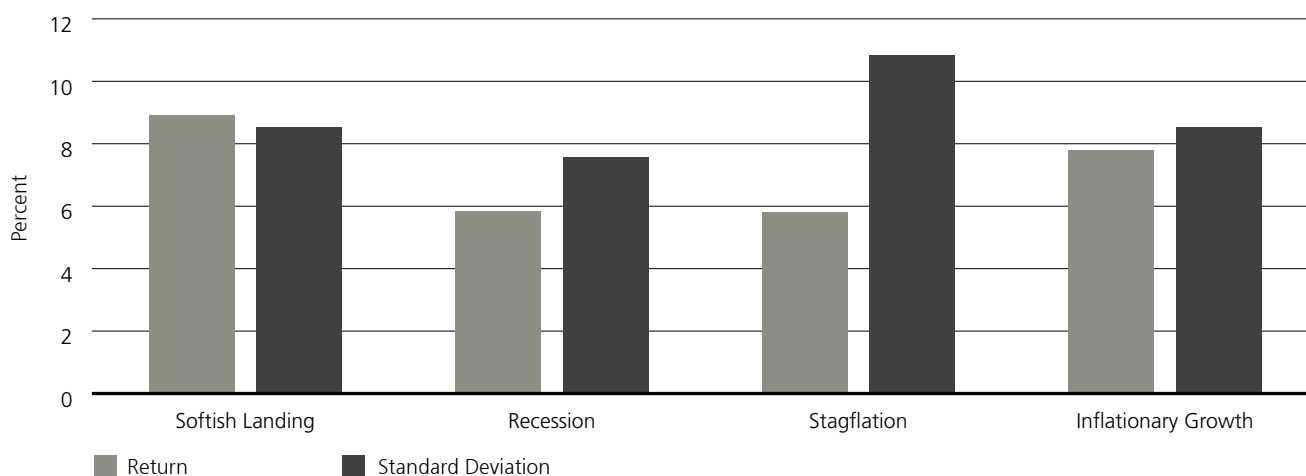
The shift from the lower-for-longer regime that prevailed since the early 2010s to higher-for-longer following the COVID crisis has led to a dramatic increase in the expected returns of fixed income assets. Given its traditionally low volatility when compared to listed equity, fixed income assets have become relatively more attractive in risk-adjusted terms. This provides reserve managers with an excellent opportunity to potentially generate adequate returns relative to previous investment regimes.

For instance, a short-duration global government bond portfolio resembling the composition of global FX reserves – largely USD, plus euro, sterling and yen – is expected to generate an average annual return of around 4% in the next five years, according to our estimates. Between 2009-2021, the same portfolio generated a return of less than 1%. A similar portfolio but with long-duration holdings is expected to generate a return of around 5% over the same period; nearly 1% higher than in 2009-21.

Higher returns are also expected for spread assets. An investment grade corporate bond portfolio is expected to generate a return of around 6% over the next five years, 5% higher than in 2020.

Emerging market debt (EMD) in hard currency is also expected to generate robust returns. According to our estimates, in a softish landing scenario this asset class could generate an annual return of nearly 9%. This expected return is higher than listed equity but with a much lower level of volatility.

Figure 3: EMD expected returns and volatility across alternative scenarios



Source: UBS AM as of 4Q 2023

EMD's high return expectations also hold up across more pessimistic scenarios. The table on the previous page outlines the expected 5-year returns for EM hard currency debt under a number of different economic scenarios. The results show that even in the relatively downbeat recession and stagflation scenarios, nominal 5-year returns are expected to be relatively high when compared with historical returns.

For reserve managers, hard currency EMD could partly replace the return enhancement role played by listed equity with the advantage of lower volatility.

Robust risk-adjusted returns

Over the past decade, emerging market sovereign debt has approximately doubled in size from around USD 700 billion in the early 2010s to over USD 1.5 trillion at the end of 2023 according to data from Bank of America. Over half of this debt is rated investment-grade.

Through this period, emerging market economies have grown, on average, almost 2 percentage points higher than developed economies (see Figure 4). This growth has not been achieved solely through increased spending. Gross government debt is still under 60% of GDP (gross domestic product), while for advanced economies it has consistently exceeded 100%.

Growth prospects for EM countries such as Mexico, Brazil and Poland are likely to improve, led by a pick-up in near-shoring and friend-shoring activities and in foreign direct investments as businesses adjust their global supply chain strategies. This economic growth without a commensurate increase in debt implies that debt/GDP ratios for hard

currency EMD should continue to improve. Robust emerging market economic growth also implies a rise in the number of net creditor countries. Including the latest projection of the United Arab Emirates' international investment position, the total net foreign assets netted of foreign liabilities for investment grade sovereigns with the JP Morgan Globally Diversified Emerging Market Bond Index (EMBI) stands at USD 2.5 trillion.

Yields on investment grade EMD are still at what we consider attractive levels despite spreads gapping tighter especially into year-end 2023.

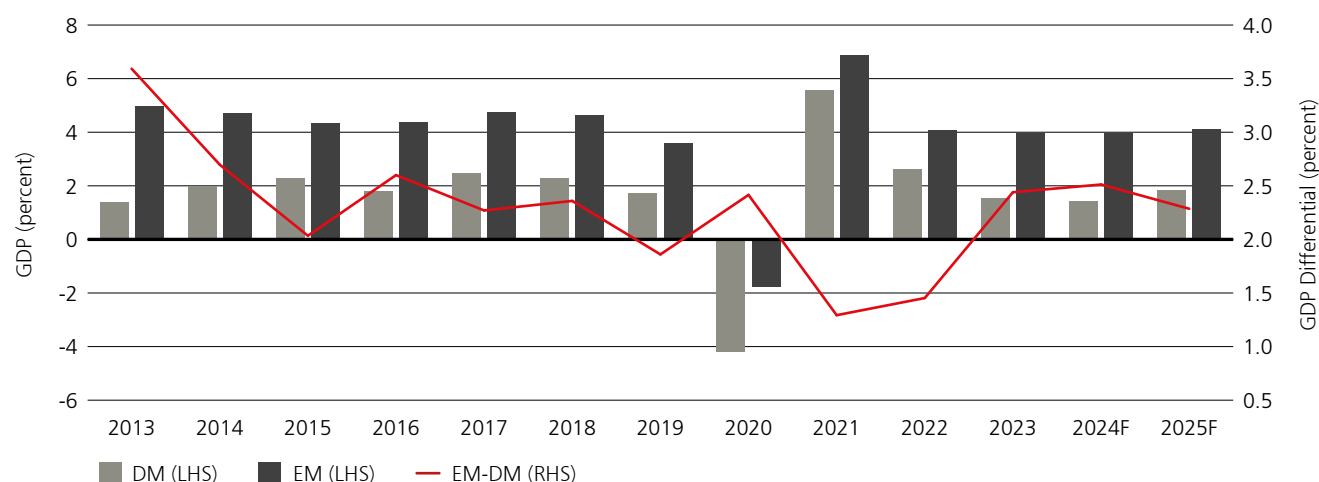
EM investment-grade sovereigns kick-started the primary market in 2024 and this supply was well absorbed given the backdrop of light investor positioning in the asset class. According to Morgan Stanley estimates, EM hard currency issuance is expected to increase on a year-on-year basis.

EM external debt net issuance is expected to be negative, which should create an upward pressure on existing bond prices. Thus, the asset class appears to be one of the few opportunities in fixed income to invest in growth at a reasonable price.

Balanced economic policies

Over the past 50 years, many countries in Latin America and other emerging markets experienced recurring high inflation coupled with economic and financial crises. Central banks in these countries developed hands-on experience dealing with inflationary regimes as well as financial instability. Certain countries adopted the inflation-targeting approach from developed markets that recognizes the key role of central bank monetary policies in determining the inflation rate.

Figure 4: EM-DM growth differential



Source: IMF and Macrobond Data as of October 2023

Controlling inflation has been one of the drivers of rapid economic growth and stability in output and employment in several emerging market economies. To stem inflation, many EM central banks started raising policy rates from as early as 2021, while DM central banks were still grappling with how best to respond. A case in point is the Brazilian Central Bank, which hiked rates at 12 consecutive policy meetings from a low of 2% in March 2021 to 13.75%. It decided to stop hiking only after inflation starting to trend lower.

Such actions have played a large part in elevating the credibility of emerging market sovereigns and the credit ratings not only for the sovereigns but also for the domestic companies that have been on an improving trajectory, as shown below. The inclusion of higher-rated Gulf Cooperation Countries (GCC) has further boosted the upward rating migration trend.

Return of and return on capital

Liquidity and return of capital continue to be the overriding objectives from a reserve management perspective, and these have often been prioritized at the expense of returns. When looking at the returns generated from underlying investments, it is perhaps helpful to look at the Sharpe ratio – i.e., how much excess return you receive for the volatility of holding a riskier asset and is an objective metric for risk-reward.

As shown below, the return profile for emerging market investment grade (IG) debt is significantly above that of sovereign debt issued by the US or other DM sovereigns – and even broad equity indices. While the EM IG Sharpe ratio is comparable to that of US IG, the returns are higher by 0.64% on an annualized basis. Investors with longer

investment horizons, such as central banks, who can ride through periodic bouts of volatility, should be well positioned to harvest this premium.

Figure 5: Sharpe ratios

Asset Class	Return	Risk	Sharpe
EMBI GD IG	5.10%	7.30%	0.70
US IG	4.46%	6.13%	0.73
US Treasuries	2.82%	4.49%	0.63
Global Treasuries	2.73%	6.94%	0.39
S&P-500	11.36%	17.35%	0.65
MSCI World	7.96%	17.20%	0.46

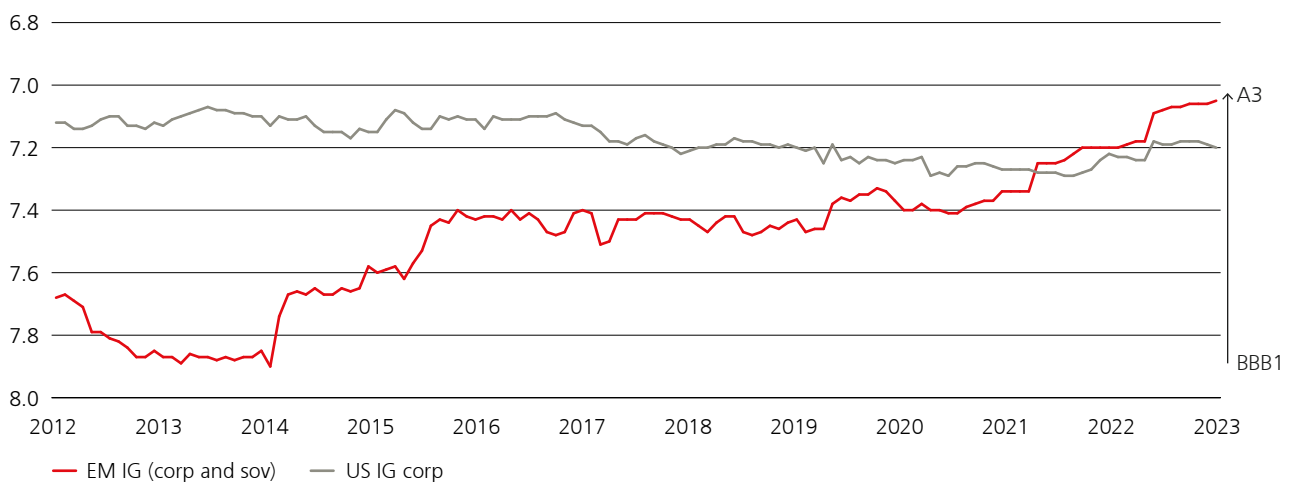
Source: UBS Asset Management, Bloomberg, 2003-2023

Expanding buyer base

Sovereign debt indices, unlike equity indices, are constrained at the country level, and 10% is the maximum permitted for a single country in the JP Morgan Emerging Market – Global Diversified Index. As of end-December 2023, Mexico has the largest weight in the index at 5%, while Saudi Arabia is at 4.8%

Historically, emerging market debt tended to be held by overseas portfolio investors. However, in certain regions such as the Middle East, local institutions are now part of the buyer base. They are effectively buying dollar-denominated debt issued by their home/sovereign country – a safe haven asset for them. This has had positive implications for bond spreads and volatility. Finally, asset allocators with longer-term investment horizons such as global insurance companies, pension

Figure 6: Improving credit ratings



Source: Bank of America, December 2023

funds and endowments are starting to recognize the benefits and raising their allocations to the investment grade segment of emerging market hard currency debt.

Spreads and liquidity

Bank failures, currency sell-offs and systemic corporate defaults have plagued emerging market countries in the past, causing their bonds to trade at a discount. However, spreads on EM IG sovereigns now move more in line with US investment grade corporates (see Figure 7).

In March 2023, when US regional banks such as SVB Group failed because of a mismatch in assets and liabilities, EM IG sovereigns held up relatively well. The percentage spread widening from end-February to mid-March 2023 for US IG was 31%, almost double EM IG's 16%.

Since January 2021, the share of single-A and above ratings has risen in both EMBI IG and US IG indices. However, the increase is much greater for EMBI IG. Single-A and higher rated countries now comprise 47% of the index, versus 39% in January 2021. For US IG the figures are 52% versus 49%. Spread compression to US IG has been achieved along with an increase in the quality of the underlying assets.

The flurry of Issuance In hard-currency issuance since the start of 2024 shows up in the relative underperformance of EM investment grade bonds relative to US IG. The drivers behind this include valuations due to moves in US treasuries, bond issuance relative to muted inflows and geopolitics. That differential is at one of the widest points since early-2022 and given it does not last for long, this is an opportune time to revisit allocations to the asset class.

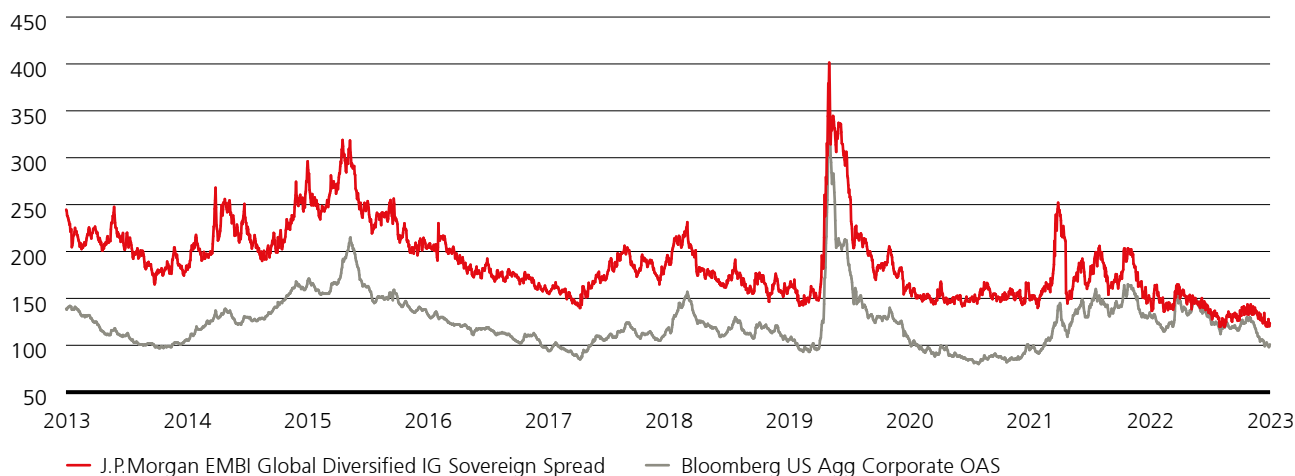
Prior to the Global Financial Crisis, bonds were predominantly traded by dealers and sell-side financial institutions. After Lehman Brothers filed for bankruptcy, banks had limited confidence in the ability of trading counterparties to honor their commitments. Given the nature of the trading ecosystem back then, it is perhaps unsurprising that liquidity in the bond markets dried up during that tumultuous period.

Post-crisis, regulators raised bank capital requirements and adopted other measures that reduced broker-dealers' ability and willingness to make markets in bonds. Electronic trading platforms stepped into this liquidity void and firms such as MarketAxess and TradeWeb now offer a diversified pool of liquidity, significant cost savings to institutional investors and greater trading efficiency. This is evident in the jump in market share for US high-grade corporate bond trading for MarketAxess from 9.4% in 2007 to over 21% in recent years.

Enhanced Multilateral Backstop

Countries are receiving unprecedented liquidity support from multilateral agencies and lenders. Through the Resilience and Sustainability Trust established in 2023, the IMF is playing an increasingly important role in helping countries with limited room in their budget to address long-term challenges. The IMF Board approved a proposal to increase members' quotas proportionally by 50%. The quotas, which take effect in 2024, will increase by USD 314 billion to a total of USD 941 billion. The proposal will impact the interest paid to the IMF as surcharges depend on the amount and duration that IMF credit has been outstanding.

Figure 7: EM IG versus US IG spreads



Source: Bloomberg, JP Morgan, Data as of end December 2023

The World Bank has proposed new steps to significantly boost its lending capacity. Specifically, it is increasing the guarantees provided by World Bank shareholders, raising hybrid capital from shareholder countries, and lifting the current roadblocks that hinder callable capital. Further, the World Bank is also fundraising for a new International Development Association (IDA) Crisis Facility which will strengthen its ability to help the neediest countries in challenging times.

Therefore, even in a higher for longer environment emerging market sovereigns will be able to refinance at attractive rates. Lack of access to capital markets, a key vulnerability marker, is unlikely to be an issue in 2024.

Summary

The investment grade emerging market debt market reflects a healthy picture of strongly growing economies with relatively low levels of indebtedness and often combined with net creditor status. In dealing with inflationary regimes, EM countries were the first to raise interest rates and are now easing rates ahead of DM countries, which should be positive for EM debt yields. The IMF stands ready in its role as the lender of last resort with funds that can likely be used for refinancing of sovereign debt.

EM investment grade hard currency sovereign debt appears attractive on a risk/return basis when compared to other asset classes over different economic scenarios. We believe it should play an important role in central bank asset allocation considerations. Given the current uncertain backdrop, hard currency EMD can help strike the right balance between the objectives and constraints of central banks and help protect capital in real terms.

Disclaimer

For professional / qualified / institutional clients and investors.

This document does not replace portfolio and fund-specific materials. Commentary is at a macro or strategy level and is not with reference to any registered or other mutual funds.

Risks of sustainable investing

Consideration of environmental, social and governance (ESG) factors when selecting or recommending investments may reduce the investment universe for actively-managed strategies. When considering ESG factors, UBS AM may reduce exposure to certain investments or not make certain investments when it would otherwise have done so, which could adversely affect the performance of accounts.

Americas

The views expressed are a general guide to the views of UBS Asset Management as of February 2024. The information contained herein should not be considered a recommendation to purchase or sell securities or any particular strategy or fund. Commentary is at a macro level and is not with reference to any investment strategy, product or fund offered by UBS Asset Management. The information contained herein does not constitute investment research, has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith. All such information and opinions are subject to change without notice. Care has been taken to ensure its accuracy but no responsibility is accepted for any errors or omissions herein. A number of the comments in this document are based on current expectations and are considered "forward-looking statements." Actual future results, however, may prove to be different from expectations. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document was compiled, and any obligation to update or alter forward-looking statements as a result of new information, future events or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class or market generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund.

EMEA

The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith, but is not guaranteed as being accurate, nor is it a complete statement or summary of the securities, markets or developments referred to in the document. UBS AG and / or other members of the UBS Group may have a position in and may make a purchase and / or sale of any of the securities or other financial instruments mentioned in this document. Before investing in a product please read the latest prospectus carefully and thoroughly. Units of UBS funds mentioned herein may not be eligible for sale in all jurisdictions or to certain categories of investors and may not be offered, sold or delivered in the United States. The information mentioned herein is not intended to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Past performance is not a reliable indicator of future results. The performance shown does not take account of any commissions and costs charged when subscribing to and redeeming units. Commissions and costs have a negative impact on performance. If the currency of a financial product or financial service is different from your reference currency, the return can increase or decrease as a result of currency fluctuations. This information pays no regard to the specific or future investment objectives, financial or tax situation or particular needs of any specific recipient. The details and opinions contained in this document are provided by UBS without any guarantee or warranty and are for the recipient's personal use and information purposes only. This document may not be reproduced, redistributed or republished for any purpose without the written permission of UBS AG. This document contains statements that constitute "forward-looking statements", including, but not limited to, statements relating to our future business development. While these forward-looking statements represent our judgments and future expectations concerning the development of our business, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from our expectations.

UK

Issued in the UK by UBS Asset Management (UK) Ltd. Authorised and regulated by the Financial Conduct Authority.

APAC

This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in APAC. This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in your jurisdiction. No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of your jurisdiction. Using, copying, redistributing or republishing any part of this document without prior written permission from UBS Asset Management is prohibited. Any statements made regarding investment performance objectives, risk and/or return targets shall not constitute a representation or warranty that such objectives or expectations will be achieved or risks are fully disclosed. The information and opinions contained in this document is based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any misrepresentation, errors or omissions. All such information and opinions are subject to change without notice. A number of comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results may prove to be different from expectations and any unforeseen risk or event may arise in the future. The opinions expressed are a reflection of UBS Asset Management's judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed. You are advised to exercise caution in relation to this document. The information in this document does not constitute advice and does not take into consideration your investment objectives, legal, financial or tax situation or particular needs in any other respect. Investors should be aware that past performance of investment is not necessarily indicative of future performance. Potential for profit is accompanied by possibility of loss. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

Australia

This document is provided by UBS Asset Management (Australia) Ltd, ABN 31 003 146 290 and AFS License No. 222605.

China

The securities may not be offered or sold directly or indirectly in the People's Republic of China (the "PRC"). Neither this document or information contained or incorporated by reference herein relating to the securities, which have not been and will not be submitted to or approved/verified by or registered with the China Securities Regulatory Commission ("CSRC") or other relevant governmental authorities in the PRC pursuant to relevant laws and regulations, may be supplied to the public in the PRC or used in connection with any offer for the subscription or sale of the Securities in the PRC. The securities may only be offered or sold to the PRC investors that are authorized to engage in the purchase of Securities of the type being offered or sold. PRC investors are responsible for obtaining all relevant government regulatory approvals/licenses, verification and/or registrations themselves, including, but not limited to, any which may be required from the CSRC, the State Administration of Foreign Exchange and/or the China Banking Regulatory Commission, and complying with all relevant PRC regulations, including, but not limited to, all relevant foreign exchange regulations and/or foreign investment regulations.

Hong Kong

This document and its contents have not been reviewed by any regulatory authority in Hong Kong. No person may issue any invitation, advertisement or other document relating to the Interests whether in Hong Kong or elsewhere, which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the securities laws of Hong Kong) other than with respect to the Interests which are or are intended to be disposed of only to persons outside Hong Kong or only to "professional investors" within the meaning of the Securities and Futures Ordinance (Cap. 571) and the Securities and Futures (Professional Investor) Rules made thereunder.

Japan

This document is for informational purposes only and is not intended as an offer or a solicitation to buy or sell any specific financial products, or to provide any investment advisory/management services.

Korea

The securities may not be offered, sold and delivered directly or indirectly, or offered or sold to any person for re-offering or resale, directly or indirectly, in Korea or to any resident of Korea except pursuant to the applicable laws and regulations of Korea, including the Capital Market and Financial Investment Business Act and the Foreign Exchange Transaction Law of Korea, the presidential decrees and regulations thereunder and any other applicable laws, regulations or rules of Korea. UBS Asset Management has not been registered with the Financial Services Commission of Korea for a public offering in Korea nor has it been registered with the Financial Services Commission for distribution to non-qualified investors in Korea.

Malaysia

This document is sent to you, at your request, merely for information purposes only. No invitation or offer to subscribe or purchase securities is made by UBS Asset Management as the prior approval of the Securities Commission of Malaysia or other regulatory authorities of Malaysia have not been obtained. No prospectus has or will be filed or registered with the Securities Commission of Malaysia.

Singapore

This document has not been registered with the Monetary Authority of Singapore pursuant to the exemption under Section 304 of the SFA. Accordingly, this document may not be circulated or distributed, nor may the Securities be offered or sold, whether directly or indirectly, to any person in Singapore other than (i) to an institutional investor pursuant to Section 304 of the SFA.

Taiwan

This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in the Republic of China (R.O.C.). This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in the Republic of China (R.O.C.). No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of the Republic of China (R.O.C.).

Source for all data and charts (if not indicated otherwise): UBS Asset Management.

A summary of investor rights in English can be found online at: ubs.com/funds.

More explanations of financial terms can be found at: ubs.com/glossary

S-0224 NAMT-722

 [ubs.com/am-linkedin](https://www.ubs.com/am-linkedin)

For professional / qualified / institutional clients and investors.

[ubs.com/am](https://www.ubs.com/am)