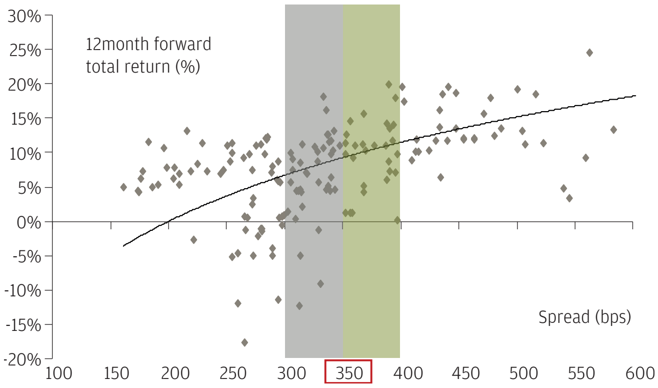
However, emerging markets are in a far stronger position than before the taper tantrum and therefore it's hard to see the rationale in the widening valuation gap between emerging and developed markets. Another explanation for this phenomenon is the fear factor – investors have enjoyed over two years of low volatility and high returns, and have trimmed their long-built overweight positions in emerging markets.

Significant and persistent outflows, as well as cleaner positioning across EMD asset classes, are evident in the data and have definitely helped to amplify the price correction. On the other hand, given a still relatively favourable environment for EM fundamentals, this selloff may offer an attractive entry-point for long-term investors (see **Exhibit 11**). Historically, EM sovereign bonds have returned 10% over 12 months at the current spread level of 370bp.

Furthermore, while the dispersion of return has been relatively wide at this spread level, it has been consistently positive. This lends support to our view investors who already have exposure to EM debt should continue holding their positions and that further spread widening would lead to attractive points of entry.

Total returns are projected to grow significantly as spreads widen

EXHIBIT 11: GLOBAL DIVERSIFIED HISTORICAL 12-MONTH FORWARD TOTAL RETURN PER SPREAD ENTRY POINT



Source: J.P.Morgan Asset Management, Data as at 31 May 2018. Historical returns calculated using monthly data from 31 December 2001 – 31 May 2018.

Past performance is not a reliable indicator of current and future results.

ROADMAP AND THEMES

Our strategy roadmap for the third quarter of 2018 is summarised in **Exhibit 12**. We did not make substantial changes in our outlook from the previous quarter's roadmap: our base case "reflation" scenario remains intact, with the same probability of 50% as the last quarter.

The only change in probabilities was that we added a 5% chance to the "external shock" scenario by reducing the "acceleration" scenario probability by the same amount. This change is based on the view that downside risks to global growth have marginally increased during the quarter as trade tensions rose, non-US growth data disappointed and global central banks ran a higher risk of making policy errors.

In our base case scenario, we expect global growth to be led by the US and remain at a healthy rate, although with downside risks for emerging markets as the tailwind of accommodative financial conditions created by global central banks fades.

Similarly to developed markets, emerging market inflation is expected to rise marginally from relatively low current levels, but this can be amplified if EMFX weakness becomes more pronounced and persistent. EM central bank policies will depend a lot on core yields and US dollar strength, but countries with higher external vulnerabilities that fail to adjust to rising pressures over the last few months may need to undergo some changes.

In terms of strategy, we are looking to start adding more risk to names that have been undeservingly punished in the market weakness since April. Although emerging market fundamentals remain, on aggregate, well-anchored, de-synchronisation in developed markets, particularly between the US and Europe, poses risks the EMD asset class.

More importantly, we need to monitor signs of a turnaround in technicals before starting to add risk as fundamentals and valuations are currently playing a secondary role in this market environment. Country and security differentiation should again be key as a more challenging external backdrop will continue to exert pressure on bonds at different levels.

On a sectoral level, we favour higher quality credit that is more defensive. We do not have a clear favourite between external EM credit and local-currency EM sovereigns due to different possible scenarios in developed markets and technicals. Given our expectation that the Federal Reserve will continue on its gradual monetary tightening path, we are still cautious on duration, but don't shy away from holding a barbell-like position through shorter duration corporates and cheap long-end sovereign bonds.

We consider reflation to be the most likely scenario, but are also planning for external shocks and acceleration

EXHIBIT 12: OUR STRATEGY ROADMAP

	Scenario	External shock	Base case: reflation	Acceleration
MACRO	Probability	20%	50%	30%
	Growth	Global growth falls back below trend	**US led growth, downside risks to EM alpha**	DM growth accelerates, output gaps close quicker
	Inflation	Global disinflation resume	**EM inflation has bottomed**	Inflation surprises highe
	Financial conditions	Central Banks are unable to tighten	**Less accommodative, head towards gradual tightening in H2**	Markets forced to reprice global tightening
	Policy space	Policy mistakes increase global uncertainty	**EM have built some policy space, but differentiation remains key**	US fiscal policy brings about overheating
	Commodities	Weaker	**Well supported**	Stronger
STRATEGY	Beta	Long duration, Investment grade	**Alpha over beta**	Short, wait for better re-entry point
	Sector View	From Credit to Duration Long rates Investment grade long-end	**Favour credit, up in quality Remain short duration Linkers over nominals in local Long EMFX vs a basket of funders**	Long USD, EMFX Pay rates Long commodity exporters

Themes
EM fundamentals remain anchored, but DM de-synchronisation poses risks.
Value has been created. Search for opportunities in names with solid fundamentals.
Watch technical signals for signs to start adding back risk.
Focus on alpha over beta: use episodes of volatility to build into favoured trades.
Risks: Inflation, policy mispricing/mistakes, trade wars & geopolitics, technicals and liquidity

Source: J.P.Morgan Asset Management. May 2018. Opinions, estimates, forecasts, projections and statements of financial market trends are based on market conditions at the date of the publication, constitute our judgment and are subject to change without notice. There can be no guarantee they will be met.

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