J.P.Morgan Asset Management

THE FUTURE OF FIXED INCOME

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What could spark an EM rebound?

What is the catalyst that could translate reasonable fundamentals and attractive valuations into an emerging market (EM) debt recovery?

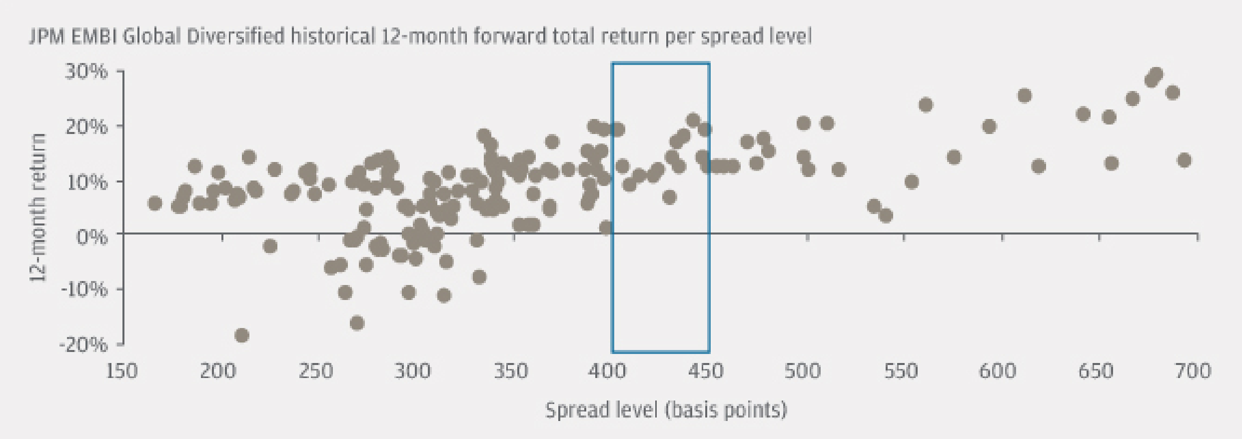
Fundamentals:

Recent data releases have been more constructive for the US than for emerging markets, although EM data is beginning to surprise to the upside more—suggesting potential positive momentum going forward. Two of the key external headwinds that have held back emerging markets this year—a strong US dollar and rising US rates—may also pose less of a challenge in 2019. We expect the Federal Reserve to continue raising rates at least through the middle of next year, though we are now three years into the rate hiking cycle and, as such, nearer the end than the beginning. While idiosyncratic risk could always flare up in specific countries, political risk across emerging markets overall is also likely to ease in 2019, with major elections in Mexico and Brazil out of the way. China remains the key risk for the space. Any potential agreement—and subsequent follow- or fall-through—between Donald Trump and Xi Jinping at the G20 summit on 30 November-1 December could have a meaningful impact on the future trade relationship between the US and China, and hence on the global economy. China's purchasing managers' indices will also be worth watching: October prints hovered around the critical 50 mark, so we will look to upcoming releases to confirm or refute the growth slowdown.

Quantitative valuations:

Valuations in EM hard currency sovereign debt now look unambiguously attractive, with the all-in yield of over 7% the highest since the aftermath of the financial crisis in 2009. It's also important to consider spreads, especially now that cash in the US has a meaningfully positive yield. On that measure, the sector has just breached the 400 basis point threshold—a level at which, historically, subsequent one-year returns have always been positive. Local and corporate sector valuations are more nuanced: most of the sell-off this year in the local market has been driven by the currency component, and the recent re-pricing in developed market credit has made EM corporates less attractive on a relative basis. Nevertheless, as we look ahead to 2019, we believe mid-to-high single-digit returns are possible across EM debt sectors. (All data as of 28 November.)

Spreads at 400 bps have historically been positive for forward-looking return prospects



Source: J.P. Morgan, J.P. Morgan Asset Management; data as of 30 September 2018. Historical returns calculated using monthly data from 31 December 2001 to 31 August 2018.

Technicals:

Prevailing technical dynamics are less rosy for emerging markets. The sector is suffering from very poor liquidity, partly due to seasonal factors. We are also seeing a backlog of supply materialise in increased new issuance, particularly for Chinese corporates, as onshore funding conditions have become more challenging. Flows may be signalling a shift in sentiment, though: while investors continue to redeem, outflows have been relatively muted in November. Particularly in the context of broader fixed income flows, which show developed market credit, aggregate and unconstrained funds experiencing meaningful outflows, the EM demand picture does not look too worrying. A potential risk is if recession fears increase and lead to capital flows out of the EM space; however, we do not expect this risk to materialise until closer to the end of the cycle.

What does this mean for fixed income investors?

2018 has been a challenging year for emerging markets, with the various sectors losing between 3% and 8% on a total return basis year to date. However, EM debt now appears well-placed for a rebound, underpinned by attractive valuations and reasonable fundamentals. Given challenging technicals, we are still cautious on the near-term outlook, though we remain constructive on the asset class over the next year. So what could spark the rebound? With China the biggest risk to the market currently, evidence that the country is managing its growth slowdown and able to defend against US tariffs could be one potential catalyst.

About the Bond Bulletin

Each week J.P. Morgan Asset Management's **Global Fixed Income, Currency and Commodities** group reviews key issues for bond investors through the lens of its common Fundamental, Quantitative Valuation and Technical (FQT) research framework.

Our common research language based on **Fundamental, Quantitative Valuation and Technical** analysis provides a framework for comparing research across fixed income sectors and allows for the global integration of investment ideas.

Fundamental factors include macroeconomic data (such as growth and inflation) as well as corporate health figures (such as default rates, earnings and leverage metrics)

Quantitative valuations is a measure of the extent to which a sector or security is rich or cheap (on both an absolute basis as well as versus history and relative to other sectors)

Technical factors are primarily supply and demand dynamics (issuance and flows), as well as investor positioning and momentum

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