J.P.Morgan
Asset Management

THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

21 March 2019

All stars aligned for emerging markets?

Dovish central banks, strong fundamentals and an improved outlook for China suggest that all stars are aligned for emerging markets. How long can the year-to-date rally continue?

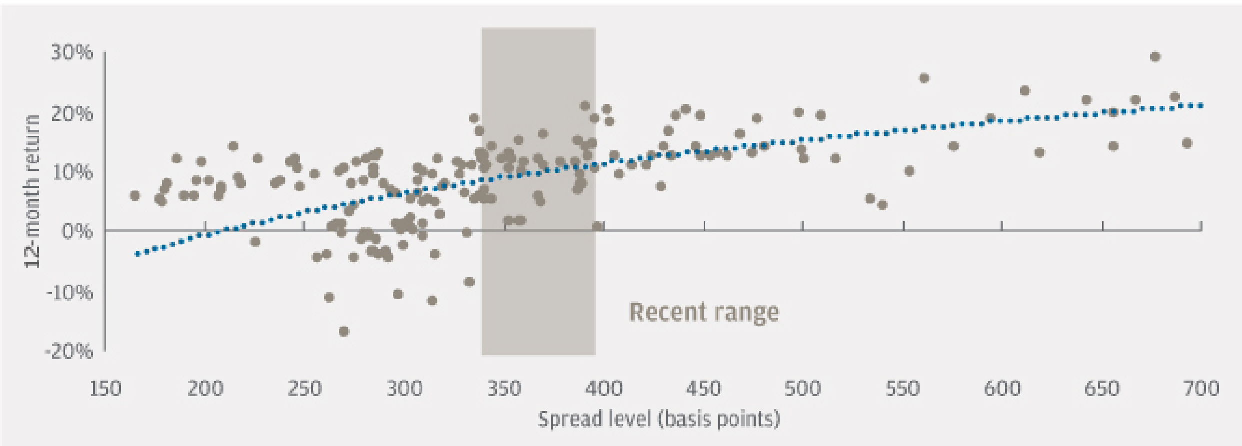
Fundamentals:

The recent dovish tone from the Federal Reserve (the Fed) and European Central Bank has provided a substantial tailwind for emerging markets so far this year. However, other factors have also helped boost emerging market (EM) performance. China, which contributes around 40% to EM GDP, has benefited from increased policy stimulus and substantial progress in trade talks with the US. As a result, we now expect Chinese GDP growth of approximately 6.3% in 2019. Combined EM growth is still expected to slow from 4.6% in 2018 to 4.4% in 2019, but the growth differential between emerging markets and developed markets should actually widen according to our forecasts. Meanwhile, EM corporate fundamentals continue to improve. Although revenue growth may have peaked, disciplined capital expenditure has helped leverage fall to the lowest levels in the past six years. Nonetheless, some risks continue to lurk in the background. If growth fails to rebound in Europe and China, for example, or if the Fed reverses its dovish stance—or even if the upcoming US election campaign favours less market-friendly candidates—risk sentiment could change quite quickly.

Quantitative valuations:

The positive fundamental backdrop has continued to boost EM debt performance into March. Hard-currency sovereigns and corporates have returned 6.26% and 4.61% respectively since the start of the year (as of 19 March). While some investors may think this rally is overdone, spreads for both sectors have so far only retraced about 55% of the spread widening experienced in 2018. Furthermore, EM sovereigns have historically always delivered positive returns over the next 12 month period when spreads have traded around the current level of 340 – 350 basis points. Local currency EM sovereigns have also delivered a positive return this year (+4.45% in US dollar terms) and are yet to recoup last year's -6.21% return. Also, the factors that helped support US dollar strength in 2018 are fading and should therefore provide a tailwind for EM currencies.

EM sovereigns have delivered positive returns over the next 12 months from current spread levels



Source: J.P. Morgan Asset Management; data as of 28 February 2019.

Technicals:

Across most of the risk asset classes, we continue to see ample investor demand this year. According to our in-house fund flow monitor, the combined EM debt fund universe received over $16 billion of inflows in 2019 (as of 19 March), with almost half of the inflows coming into the hard-currency sovereign space. Although these inflows have already surpassed the $13 billion that flowed out of EM debt in the second half of last year, we think further inflows are likely given the positive market environment. The current strength of investor demand is illustrated by a recent Eurobond issuance in Ghana, where the total order book was around $20 billion, although the country's Ministry of Finance was looking to issue only $3 billion.

What does this mean for fixed income investors?

Although global growth has been slowing, the fundamental backdrop remains broadly supportive for EM debt. Investors will need to keep a close eye on central banks for any signs of a reversal to their current dovish policy stance, and on economic data to ensure that EM growth is picking up as anticipated. In the meantime, investors can take advantage of some attractive carry opportunities while also looking to extract value from selective EM corporates and sovereigns that have lagged behind in the year-to-date rally.

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