We walk the thinnest line

Emerging market debt strategy

Q3 2019

IN BRIEF

- We expect continued solid returns for emerging market debt (EMD) over the next six to 12 months, driven by healthy fundamentals, a supportive net issuance level and attractive valuations. Our base case scenario is a 10.9% dollar return for hard currency in 2019, or 6.2% for the next 12 months. For local currency, our models suggest a base case of around 6.2% for the year, or around 7% over the next 12 months.
- Our core scenario for EMD returns assumes a soft landing for the end of the US economic cycle, including two interest rate cuts. The growing threat of a trade war between the US and China increases the risk of a US recession, which would negatively impact global growth and our returns expectations. However, we observe that a US reflation scenario would negatively impact EMD returns, largely due to expected dollar strength.
- We have reduced our estimates for emerging market (EM) growth, including China. However, we believe the heavy stimulus from the Chinese government will offset much of the negative effect of increased tariffs. At the same time, increased social and infrastructure spending could improve Chinese competitiveness through improved transport and manufacturing infrastructure.
- The current environment of slower growth is likely to ease inflationary pressures and allow EM countries more flexibility in their monetary policies. We also think the US dollar is trading slightly rich on a trade weighted basis, but that this strength could fade in the second half of 2019, which would be positive for EMD.

MARKET OVERVIEW: OUR BASE CASE IS THE BEST CASE

After a torrid first quarter, we expect continued solid returns for EMD over the next six to 12 months, making the asset class something of an outlier in global markets. In light of solid fundamentals, a supportive net issuance level and an attractive valuation, our base case scenario is a 10.9% dollar return for hard currency in 2019, or 6.2% for the next 12 months. For local currency, our models suggest a base case of around 6.2% for the year, or around 7% over the next 12 months.

However, both the sources of, and risks to EMD performance may vary substantially for the remainder of the year. These include: 1) the late stage of the economic cycle in the US, where our base case is a soft landing; 2) the increasing threat of a trade war between the US and China and the potential impact on growth rates and dollar strength; 3) specific issues facing a number of emerging market countries, namely Argentina, Brazil and Turkey.

The biggest changes to our scenarios impact our assessment of risks to returns, rather than the risks themselves. Away from our core case, the outlook for returns erodes. We continue to favour external credit and domestic duration, but we will look to add selected EM currencies as Federal Reserve easing nears.

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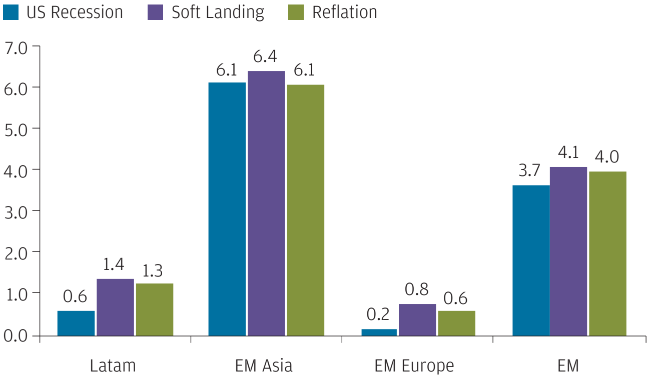
ADJUSTING OUR FORECASTS FOR A SLOWING GLOBAL ECONOMY

At our second quarter meeting, we made a number of adjustments to our expectations related to global growth. These adjustments resulted in a downward revision to our broad EM growth estimate from 4.4% to 4.1%, and a reduction in the EM growth premium over developed markets from 2.6% to 2.3%. Consistent with a late-cycle US economy, we see stable but slowing growth across all regions, especially in Latin America and emerging Europe. An actual US recession would most negatively impact our growth forecast for Latin America and then China, but would be less visible in emerging Asia (**Exhibit 1**).

The outlook for EMD returns is weaker in both US recession and reflation scenarios

EXHIBIT 1: EM REAL GDP GROWTH EXPECTATIONS



Source: J.P. Morgan Asset Management, as of 30 June 2019.

Forecasts are not a reliable indicator of current or future results.

Global growth may come under further pressure as a more protectionist paradigm replaces the previous global consensus on free trade. In the second quarter, rhetoric between China and the US intensified and the tension from goods to services. However, the effects of a trade war are as diverse as the emerging markets themselves.

Chinese stimulus designed to pivot growth towards domestic sources may result in a demand-driven increase in basic commodity prices, which could be a boon to Latin American countries that produce those commodities. Pointed domestically, China's core competitive advantages may ultimately make it a stronger, more competitive destination for investment. Trade wars don't alter end demand; instead they frustrate supply, which in turn creates opportunities for alternatives.

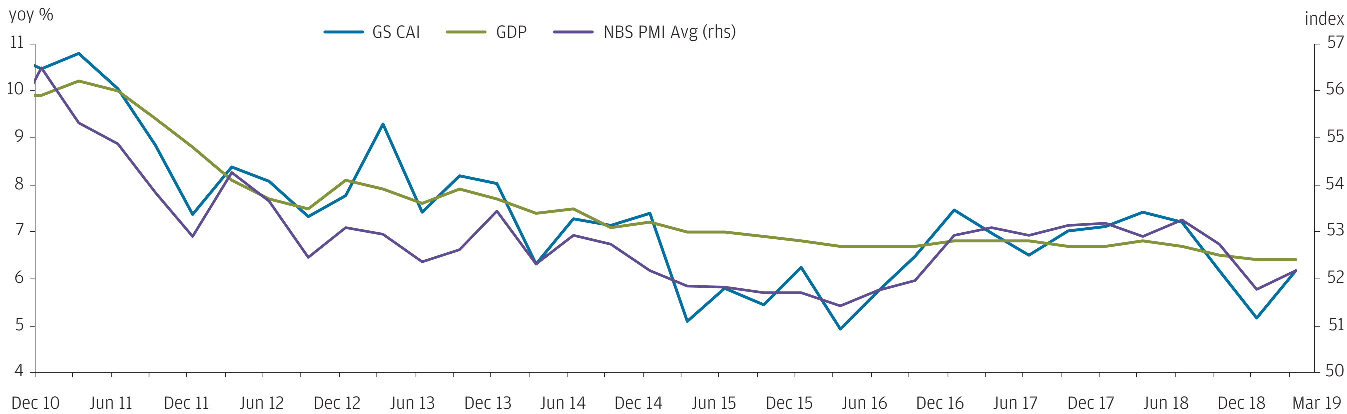
TRADE TENSIONS ARE REFLECTED IN LOWER CHINESE GROWTH EXPECTATIONS

We have reduced our Chinese growth expectations to about 6.2% for 2019, reflecting the negative impact of a trade war (**Exhibit 2**). This base case estimate assumes a 50% chance of tariff escalation as relations with Washington deteriorate. A trade war could result in factory relocations, job losses and supply chain breakdowns, all of which cost growth.

In response, we think the Chinese authorities could make heavy use of domestic credit subsidies as they seek to offset slowing export volumes. This "policy put" may reflect in increasing social and infrastructure spending, eventually improving Chinese domestic competitiveness through improved transport and manufacturing infrastructure.

The trade war is negatively impacting Chinese growth

EXHIBIT 2: CHINA: ACTIVITY INDICATORS



Source: J.P. Morgan Asset Management as of 30 June 2019.

GS CAI = Goldman Sachs Chinese Activity Indicator

NBS PMI = National Bureau of Statistic of China, Purchasing Manufacturer's index

The stimulus may protect Chinese domestic growth, but its wider impact on emerging countries is likely to be more muted and diverse. We think a diverted supply chain will help countries like Indonesia, India and the Philippines, possibly at the expense of South Korea, Singapore and Malaysia. We believe the yuan may weaken to around 7.00, with further downside possible in a "cold war" trade scenario.

Against this backdrop, EMD investors need to navigate between a slowing global growth outlook and easier domestic monetary policy. Crucially, a slowing global economy generates both less inflationary pressure and lower core yields, granting many emerging market countries additional monetary policy space. The ability to cut rates, especially at a time when the US dollar's strength may be moderating, could improve liquidity conditions in local economies, which is good for debt servicing.

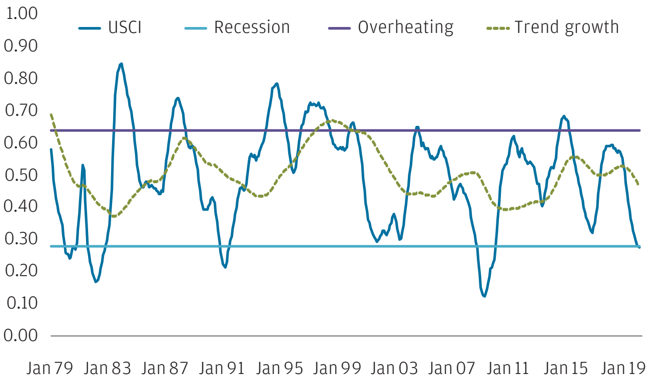
A US SOFT LANDING REMAINS OUR BASE CASE

Most EM countries are dependent on exports, which means their economic growth is influenced by that of larger countries. An early-cycle developed world pulls export demand higher, while a late-cycle one depresses it. The US is already in the late stage of the economic cycle and trade wars are escalating the debate around both the timing and depth of the US cyclical low.

We believe the current US slowdown appears to be a late-cycle feature, rather than the early stages of an imminent recession (**Exhibit 3**). As a result, we expect US growth to recover to a sub-2% pace for the balance of this year. Cyclical indicators are suggesting a soft landing but sentiment indicators reflect an increasingly pessimistic outlook among managers.

We believe US cyclical indicators are pointing to a soft landing

EXHIBIT 3: US CYCLICAL INDICATORS

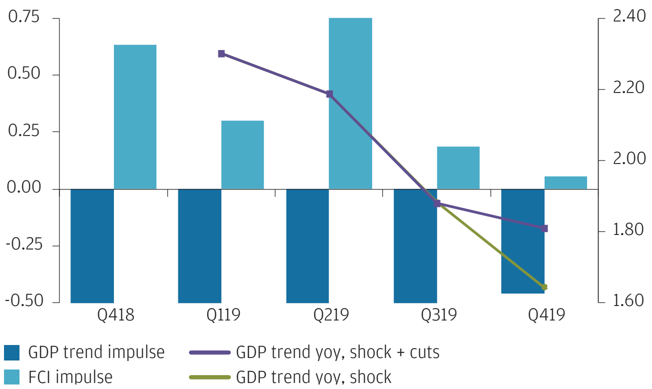


Source: J.P. Morgan Asset Management as of 30 June 2019.

By their nature, slowdowns are vulnerable to material shocks, and hence the risk of a stall is not negligible if trade wars intensify. The fear is real: Washington's escalating rhetoric with China has steadily tightened US financial conditions and slowed growth. According to simulations, a tariff on USD 200 billion in Chinese imports would further tighten US financial conditions by 0.48%, while slowing the overall economic growth rate by 0.38%—a meaningful level in the late stage of an economic cycle (**Exhibit 4**).

The trade war has already tightened US financial conditions and slowed economic growth

EXHIBIT 4: CHANGES TO US FINANCIAL CONDITIONS AND GDP GROWTH



Source: J.P. Morgan Asset Management as of 30 June 2019.

While further reductions to US economic growth are likely to have a negative impact on global growth estimates, it is possible that the vigorous Chinese stimulus in response to US tariffs may be sufficient to support global growth through a US cyclical low. On balance, we believe the increasing trade tensions are the biggest and most unpredictable source of risk for EMD investors.

A slowing US economy removes a positive performance tailwind from emerging markets, but we believe it will result in a net reduction in US and global inflationary pressure, which is positive for EM policymakers. We expect inflation from wage growth to moderate as US employment growth loses some momentum due to already high unemployment rates. While we believe higher tariffs translate into higher inflation, some of the effect is mitigated through tax relief, lightening the overall impact on the consumer.

Currently inflation expectations are hovering below mandate levels, leading consensus to look for rate cuts. We expect to see two cuts before the end of the year. If this happens, a US recession could peak as early as next year. It could also fuel speculation over near-term US dollar strength, given the tendency of the dollar to strengthen ahead of a recession, before softening in its early phases. We think the dollar is currently trading slightly rich on a trade weighted basis, but that this strength is likely to fade in the second half, which would be positive for EMD.

COUNTRY IDIOSYNCRASIES WILL CONTINUE IN THE SECOND HALF

Trade wars and US soft landings have dominated the discussion in emerging markets this quarter, but the reality of a diverse universe is that many of the countries continue to progress, often in more idiosyncratic ways. For investors, these countries offer both opportunity and risk.

Argentina: binary outcomes around an upcoming election

As recently as two years ago, the election of a reform-minded president Mauricio Macri led directly to a sustained recovery in Argentine sovereign bond prices. Since then, the government has made steady progress on reforms, the trade balance has swung positive and the current account balance is not far behind. These results have endeared Macri to bondholders, but at the same time proposals to reverse the reforms alienate them.

Macri is likely to face former president Cristina Fernandez Kirchner in the upcoming elections. Kirchner sharply disagrees with Macri's policy direction, and were she to prevail in local elections, we would expect a substantial change in Argentine fiscal policy. In our view, the outcome is binary: the re-election of Macri would likely bring continued real appreciation of the currency; if he loses, we see downside risk both to the currency and hard currency bond prices.

Brazil: Reforms on the way

High expectations for the Bolsonaro administration's reform agenda drove positive returns in Brazilian debt last quarter. Brazil's 80% debt/GDP level, which is also at a relatively high cost versus EM peers, underscores the need for reforms and presents a growing fiscal vulnerability.

At the centre of this debate is Brazil's social security spending. Because Brazilian finances are a constitutional commitment, the government cannot reduce spending without a 60% majority, meaning Bolsonaro is dependent on some backing from the opposition to pass reforms. As a result, the market is focusing on how much reform can be achieved.

We believe a result that saves more than BRL 600 billion over 10 years would help stabilise Brazilian fiscal dynamics, strengthen the currency and tighten credit default swap spreads. However, a reform that delivers less than BRL 500 billion in savings might have the opposite effect. We place a higher probability on the Bolsonaro government delivering on reforms, making us constructive on the country.

Turkey: What happens next?

Turkey has managed to confound allies and rally sceptics through a series of unusual policies and responses. Despite membership of Nato, Turkey has chosen to challenge its alliance with the US through a controversial defence equipment purchase, while an accommodative but poorly planned fiscal policy has widened the primary deficit.

To control the resulting inflation, Turkish policy makers have imposed a wide range of price controls across goods and services, interest rates and exchange rates—damaging the country's monetary policy transmission mechanism, as deposit and lending rates are capped below policy rates. Local banks are reporting a rapid dollarisation of the deposit base, threatening the stability of the banking system.

In the first quarter, the effects of these policy choices were cushioned by both fiscal and credit stimulus, while price controls muted the headline effects of inflation. However, we do not believe these results will be sustainable. Furthermore, Turkish imports have slowed and the country's currency reserves have begun to shrink. In our view, the outlook for the currency remains complex. We assign a low probability to a material shift in policy and instead believe the government will seek to muddle through, raising the risks of policy errors and a weaker currency.

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.

ASSET CLASS VIEWS: STRIDING THE NARROW PATH

Our base case assumption of a soft landing in the US, helped by two rate cuts this year, underpins our expectation for solid EMD returns over the remainder of the year. In light of the more demanding valuations we see elsewhere in the fixed income complex, EMD presents an attractive yield opportunity. However, our expectations work only within a narrow pathway: in both the US recession and US reflation scenarios, our return expectations for hard currency and local currency EMD are lower (**Exhibit 5**).

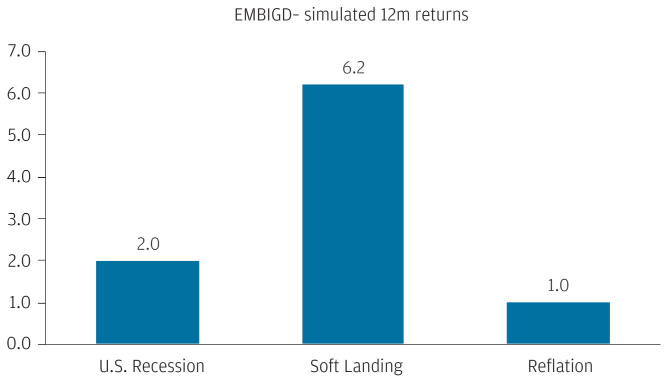
This dependency on a stable macroeconomic backdrop leaves our forecasts vulnerable to shocks, such as an escalating trade war. For example, should a more stable, or even softening dollar emerge as an outcome of policy response to a trade war, the effect on local currency EMD returns could be vigorous. Dollar cycles can be long, while local currency EMD is currently offering an attractive carry and appears under owned. Portfolio construction can also help reduce overall volatility by avoiding those markets where fundamentals appear to be softening.

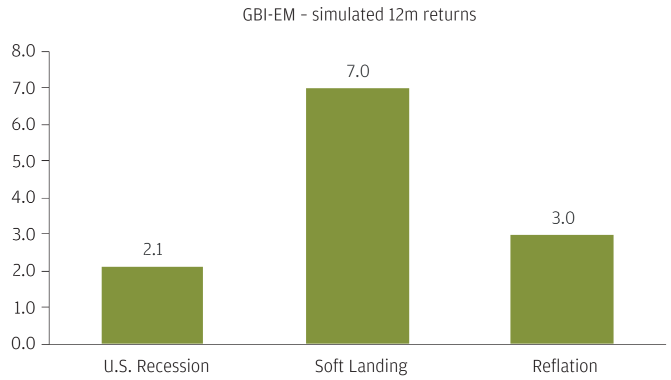
Within hard currency, we expect a 10.9% return for the coming year, or 6.2% for the remainder of the year. That said, the shift in tail risk sees a substantial degradation from our base case. Should a US recession unfold, we would expect to see hard currency EMD deliver a 6.7% return for 2019, or 2.0% for the remainder of the year. For local currency, we think the base case expectation for 2019 is 6.2%, falling to 0.8% in event of a US recession. The substantial fall in return expectations reflects the impact of a stronger dollar on local currency returns as early stage US recessions tend to see the dollar strengthen.

Our more positive case for the US - reflation - does not necessarily reflect in higher return expectations for hard currency EMD. In that regard, hard currency returns fall to 5.2%, or 1% for the remainder of the year. In local currency, a reflation scenario works out poorly as well, with the 2019 return falling to 0.3% and the return for the remainder of the year printing at 3.0%.

Our base case scenario of a soft landing for the US economy offers the best returns for EMD

EXHIBIT 5: EXPECTED RETURNS FOR HARD CURRENCY AND LOCAL CURRENCY





Source: J.P. Morgan Asset Management as of 30 June 2019.

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CONCLUSION

Emerging market debt has had a strong decade, resulting in a substantial broadening and deepening of the market. Notable for us during the de-risking in 2018 was a shift in investor behaviour: where previously investors might have cut emerging market weights to near or zero, we instead saw average allocations fall from 13% to 10%. This helped contain EM volatility, which in turn provided asset allocators with the confidence to re-invest in the first quarter of this year. We do not believe that investors have become overcommitted to the opaque charms of EMD so much as they have grown comfortable with the returns during a sustained period of relatively lower volatility.

In light of our base case scenario, we would view periodic volatility as an opportunity to add to positions. Ultimately, the factor that will play more forcefully in this phase of the cycle will be the policy flexibility enjoyed by local central banks, and the resulting impact on domestic growth that this can provide. In terms of their depth, diversity and complexity, today's emerging markets present a more competitive and investor-friendly destination than a decade ago. Historically, investors have been overcompensated for the risks taken in EMD. We think that this trend will continue and therefore view drawdowns as buying opportunities.

All date unless otherwise stated is sourced from J.P. Morgan Asset Management as at 30 June 2019.

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