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THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

25 July 2019

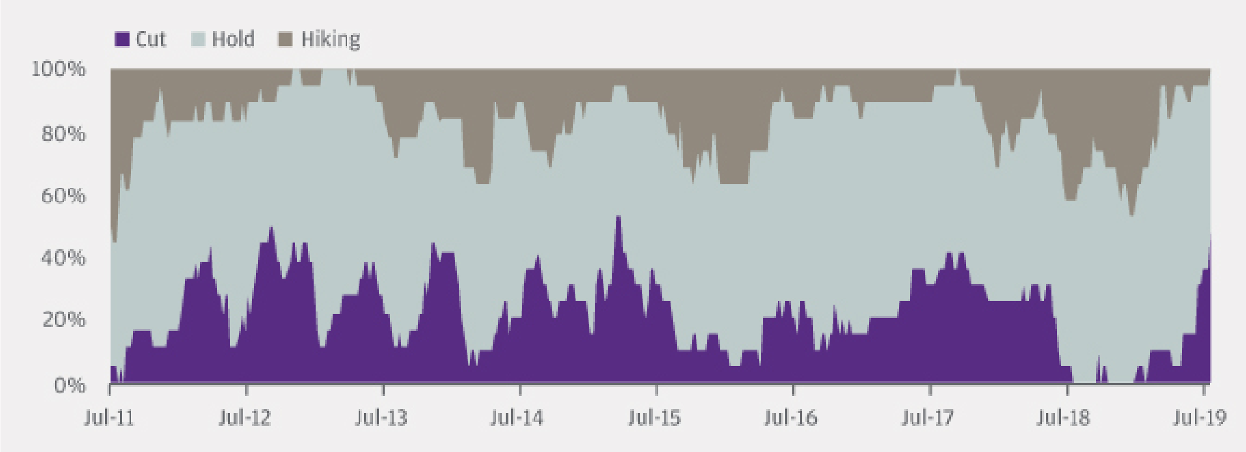
EMs easing into the summer

Emerging market (EM) central banks are following their developed market peers with easier monetary policy. What are the implications for EM debt?

Fundamentals:

By the end of July, we expect that more than half of EM central banks will have started to cut rates, with South Korea, South Africa and Indonesia among those delivering rate cuts recently. This reflects widely held views about the direction of global growth, and comes after the International Monetary Fund (IMF) revised down its growth outlook. At 4.1%, the IMF's forecast for 2019 EM GDP growth is 0.3% lower than the previous forecast in April, reflecting both global and local challenges. China has been impacted by trade, domestic demand in India is weaker, and many other markets are seeing softer growth data. We will be closely watching the July EM purchasing managers' indices, as well as the actions of the major developed market central banks, which will affect emerging markets. For example, expectations of more accommodative policy from the European Central Bank could prove beneficial for central European emerging markets, which have historically tended to outperform in the run up to announcements on quantitative easing.

Almost half of EM central banks have started to cut rates



Source: J.P. Morgan Asset Management; data as at 24 July 2019. Percentage of central banks cutting/hiking defined as the proportion of central banks that have enacted a change in the policy/funding rate of more than 20 basis points in the past 12 weeks.

Quantitative valuations:

Given the global grab for yield, quality comes at a price, and high-quality EM hard currency credit valuations no longer look attractive. Investment grade sovereign spreads are now only 22 basis points (bps) above their post-crisis tights, with the high-yielding segment of the index over 200 bps above. Given the fundamental backdrop, the higher risk associated with higher-yielding credit makes it difficult to justify moving down in quality. Local EM government duration could provide an opportunity, especially for countries where the yield curve is steeper: 10-year yields in South Africa, Peru and Brazil are all more than 150 bps higher than two-year yields, with cuts expected later this year. Real yields in these countries look attractive, especially compared with developed market sovereigns: the real yield on a South Africa 10-year bond is currently around 4.2%, compared to around 0.3% in the US. (All data as at 24 July 2019.)

Technicals:

Steady inflows to hard currency retail funds in recent months reflect modest demand for EM debt, although relatively low volumes (compared to developed market credit, for example) suggest that positioning is less likely to be stretched. EM local flows have lagged—possibly a reflection of caution around EM currencies, which have not performed strongly this year—so there could be room in investor portfolios for this part of the market, providing the fundamental picture does not deteriorate significantly. On the supply front, seasonally lower issuance should help, although August also tends to mean lower liquidity. Technicals will therefore depend on the absence of negative headlines.

What does this mean for fixed income investors?

Heightened risk and uncertainty on the macroeconomic front make it harder to justify owning riskier credit, whether in developed or emerging markets. With valuations challenging the higher-quality parts of the EM debt market, investors may look to the local markets. Should dovish policy responses succeed in stabilising global growth, EM local currency bonds with steeper curves and high real yields could offer selective opportunities.

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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