Navigating recession risk

Emerging market debt strategy

Q4 2019

IN BRIEF

- We emerged with a cautious near-term view from our latest quarterly strategy meeting in early September. In our base case scenario, the global economy is expected to narrowly avoid recession and continue to grow, albeit much more slowly.
- As developed market growth slows, some emerging market central banks have room to cut interest rates. We expect them to work hard to protect growth, helping to prevent the global economy slipping into recession. However, we do not believe that emerging markets can fully decouple from the slowdown in the developed world.
- Given the uncertainty over near-term economic outcomes, we favour high quality external credit and local duration. Select currencies may offer tactical opportunities, although we expect the US dollar to remain strong in the current environment.
- We continue to favour credits with positive stories and are content to receive local rates where we see attractive yields and scope for policy easing.

EMERGING MARKET GROWTH PREMIUM SET TO RISE

Against a backdrop of rising economic risk, we expect emerging market growth to increase from 4.2% to 4.4% in 2020. In our view, improving growth prospects in Latin America and Europe should offset the continued slowdown in China. While trade wars are leading to an adjustment in Chinese policy priorities, the effect of slowing exports is also reflected in greater levels of slack in the Chinese economy, which is putting stress on the financial system.

With the market expecting a slowdown in both the US and the broader developed world, the emerging market growth premium should increase (**Exhibit 1**). We think emerging markets are unlikely to fully decouple from the US cycle, but they are likely to narrowly avoid a recession, supported by higher real rates, which provide the scope for some central banks to cut rates more quickly. While emerging markets do not offer economic homogeneity, those emerging market central banks with the space to ease policy could tip the balance away from a global recession.

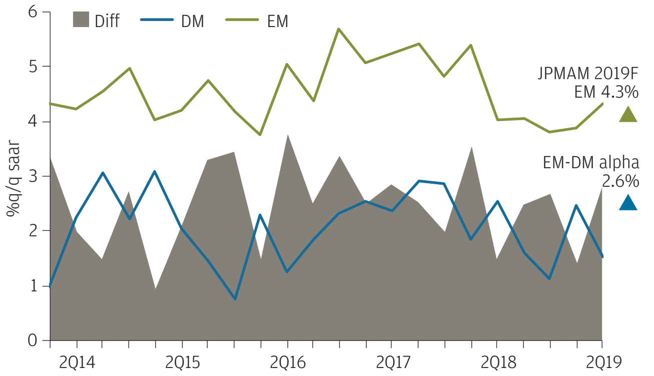
AUTHOR

Pierre-Yves Bareau
Head of Emerging Market Debt,
J.P. Morgan Asset Management

J.P.Morgan
Asset Management

The difference between emerging market and developed market GDP has widened again as developed market growth has slowed

EXHIBIT 1: REAL GDP GROWTH, % QUARTER ON QUARTER (SEASONALLY ADJUSTED ANNUAL RATE)



Source: J.P. Morgan Asset Management, J.P. Morgan, Bloomberg; data as of 3 September 2019. Data for second-quarter 2019 is estimated for Argentina.

The higher real rates offered by some emerging market countries, coupled with moderating demand from the developed world, should result in lower inflationary pressure across emerging markets. Unless currencies weaken materially, we think this relatively benign inflationary outlook will continue to support the emerging market local currency carry argument, which could augment further should the US dollar eventually weaken. Our base case continues to look for US dollar strength, however.

ESCALATING TRADE TENSIONS REMAIN A KEY RISK

Rising trade tensions between the US and China are the reason for the largest revision to our expectations: a downward adjustment to Chinese growth to 5.7%, from 6.1%. At this level, Chinese labour force participation rates may begin to decline, possibly reflecting a rise in unemployment. We expect Chinese policymakers to be vigilant in response, although we worry that policy support may not be sufficient to offset the slowdown.

We do not expect the Chinese authorities to float the Chinese currency, although we think it is possible that the renminbi is allowed to weaken to 7.3 vs. the US dollar. In turn, the effectiveness of any policy response may test China's strategy at the negotiating table.

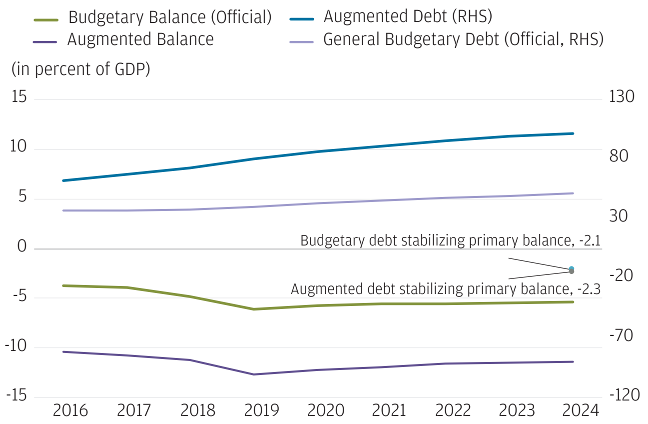
We think it likely that the Chinese economy slows down into 2020, before recovering later in the year as the impact of the policy response is felt. A key risk to this forecast is any broadening of the trade war, particularly if there is an attempt to draw other countries and blocs into the debate—for example, the European Union and Japan.

We also think Chinese policymakers will continue with the same or similar methods to support the economy through the period, using liquidity easing and credit support, while they may also move to consolidate some of the weaker segments of the banking system. In our view, risks to the Chinese banking system remain manageable at this juncture, as the large banks have enough surplus capital to cover many more severe potential strains.

Expectations that China and the US might reach a trade deal appear optimistic, given that some outcomes desired by the US are considered non-negotiable by China. For example, the US would like to see a more open Chinese economy, while the role of the Chinese military in the economy remains a key concern. We think the Chinese response will be a continued conversation, as a more vigorous response may create more challenging outcomes. The result could be an interim agreement, though we do not expect a full resolution in the near term. Therefore, an export-oriented Chinese economy now faces a sustained slowdown of exports, which in turn creates domestic issues around unemployment and potential challenges to the banking system.

Chinese augmented public debt is already at 80% of GDP and is projected to rise to over 100% in the next five years

EXHIBIT 2: CHINA DEBT LEVELS AND BUDGET BALANCE



Source: International Monetary Fund Fiscal Monitor April 2019.

China's increasing leverage is another visible symptom of the trade war, as the country's augmented public debt has reached 80% of GDP and appears on track to push through 100% over the next five years (**Exhibit 2**). The International Monetary Fund's (IMF's) measures suggest that Chinese reserves are currently adequate, though the trend is clearly negative.

This trajectory presents a policy constraint, especially as trade negotiations move forward. We think the most likely range of outcomes is for the renminbi to trade between 7.05 and 7.30 vs. the US dollar, but more negative economic outcomes could see the currency weaken as low as the 7.70 level.

EMERGING MARKET GROWTH SHOULD REMAIN RESILIENT

Diversity remains a key feature of the emerging markets story. While the trade war challenges China, many emerging market countries continue to offer investors relatively higher real rates than their developed market peers. Combined with less indebted sovereigns and positive local growth, central banks in emerging markets remain well positioned to manage cyclical risk using traditional methods. We note an increase in the number of countries recently reducing rates—a factor that could potentially provide some resilience to emerging market growth.

This is not to say that all emerging markets offer a positive story. Over the last three months since our last emerging market debt strategy report, Argentina's voters dealt President Macri a setback at the ballot box in August's primary round, resulting in a disorderly market drawdown that crushed the peso and hammered the value of Argentina's hard currency sovereign bonds.

Although discussions with the IMF around a potential debt haircut have now moved into the foreground, we think more pain is likely in the near term. Only weeks ago, Argentina was a consensus overweight; now investors worry that the currency's weakness further challenges the country's already tight servicing conditions. Given Argentina's issues are idiosyncratic and that the market has a weight of less than 3% in the sovereign benchmark, we don't think the current crisis presents the sort of systematic risk that could generate widespread contagion in the event of a default.

While Argentina's troubles are idiosyncratic in nature, the remainder of the emerging market universe divides neatly into those whose fundamentals are improving (Brazil, Indonesia) and those for whom fundamentals are weakening (Mexico, South Africa). Our analysts have adjusted expectations upwards for a number of countries in our universe, including India (+0.07 to 6.5%), Brazil (+0.05% to 2.0%) and Turkey (+0.13% to 1.2%). With other adjustments, these revisions offset the negative revision to China, producing an overall 2020 growth expectation of 4.36%, a small improvement over 2019's 4.24%. We remain a little more pessimistic about 2019 growth than others, and are more conservative than the IMF's expectations.

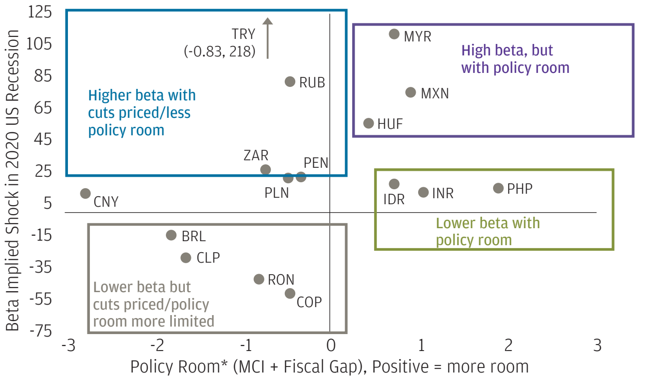
GLOBAL RECESSION SHOULD (JUST) BE AVOIDED

While our base case looks for the global economy to avoid recession, we think the probability of the world dipping into one remains sufficiently material for recession to form the bulk of our bear case scenario. We think the odds are shortening between the two outcomes, with a shallow US recession unlikely to trigger a global one. This narrow gap leaves the wider economy vulnerable to negative surprises or shocks. Hence, we are watching particularly closely for signs of stresses within the US financial system.

Our own and other bottom up forecasts see global growth dipping to levels approaching recession in the first quarter, suggesting the issue will become increasingly topical for investors. As part of our quarterly strategy meeting, our sovereign research analysed the impact of a US slowdown on the various emerging markets that we cover. We do not believe that the broader emerging market universe could fully decouple from a US slowdown, though we do think that countries will be impacted differently (**Exhibit 3**).

> "Emerging markets won't decouple from a US recession, but some have a relatively low sensitivity and several have policy space to respond"

EXHIBIT 3: SENSITIVITY TO US RECESSION AND POLICY ROOM



Source: J.P. Morgan Asset Management, Bloomberg, International Monetary Fund. *MCI is a weighted sum of each country's changes in real interest rate and real effective exchange rate (REER). TRY = Turkish lira, RUB = Russian ruble, ZAR = South African rand, PEN = Peruvian sol, PLN = Polish zloty, CNY = Chinese renminbi, BRL = Brazilian real, CLP = Chilean peso, RON = Romanian leu, COP = Colombian peso, MYR = Malaysian ringgit, MXN = Mexican peso, HUF = Hungarian forint, IDR = Indonesian rupiah, INR = Indian rupee, PHP = Philippine peso.

How a US recession would impact specific countries within emerging markets is a function of the size of the event, the degree of openness of the impacted countries and the linkages that connect them. The degree of dependency on external funding is an important element of the sensitivity equation, as countries that are more dependent on external funding tend to be more sensitive to a variation in capital cost.

In a recession, we think emerging market growth will be around 120 basis points less than our core scenario, which in turn effects countries in different ways. Diversity has always been a core strength of the emerging market asset class, and this diversity is reflected here in the distribution of potential outcomes. Brazil, and central and eastern European countries, appear more resilient than Mexico and Turkey, for example. Vulnerability to changing macro conditions may influence policymakers, and thus the market's view of their credibility.

WE EXPECT A 6%-8% RETURN IN 2020

Assuming our base case low growth scenario plays out, we are looking for a 6%-8% return from emerging market assets in 2020. Returns could drop to just 1%-4% in the event of a shallow global recession, a view predicated on relatively limited US financial stress (**Exhibit 4A** and **Exhibit 4B**).

> “Low growth remains the best scenario for performance while US reflation is the most challenging”

EXHIBIT 4A: JPMORGAN EMBI GLOBAL DIVERSIFIED SIMULATED 2020 RETURNS

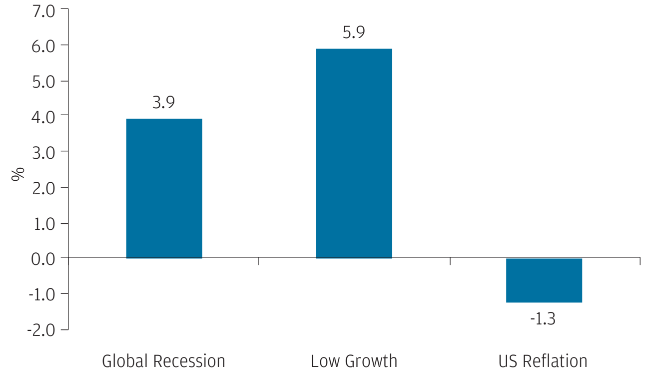
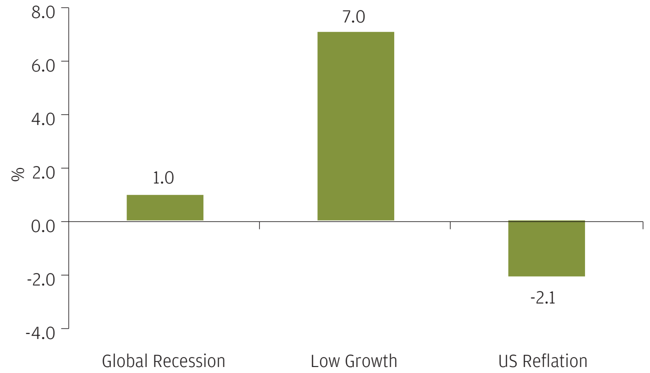


EXHIBIT 4B: JPMORGAN GBI-EM SIMULATED 2020 RETURNS



Source: J.P. Morgan Asset Management. GBI-EM = emerging market bond index.
Forecasts are not a reliable indicator of future performance.

In our low growth base case expectation for 2020, we are looking for 4.3% GDP growth for the emerging world, which is a 2.7 percentage point premium over the expected developed market growth rate. In the event of a global recession, we think emerging market growth would decelerate to 3.2%, representing a 2.5% growth premium over the developed world.

Were the US to reflate, we might see emerging market growth printing at 3.9%, though the growth premium would decline (**Exhibit 5**). Despite the trade war, we continue to see the fastest growth in Asia regardless of scenario, with Latin America and eastern Europe showing greater sensitivity to the global economic trend.

Emerging market growth should pick up by the second half of 2020 despite the slowdown in China

EXHIBIT 5: 2020 ECONOMIC SIMULATION SCENARIOS

In %	2019 Base	Global Recession	Low Growth	US Reflation	Prob. Weighted
EM Real GDP gr.	4.1	3.2	4.3	3.9	3.8
EM-DM gr. Alpha	2.5	2.5	2.7	1.9	2.6

Source: J.P. Morgan Asset Management. EM = emerging market. TWREER = trade-weighted real-effective exchange rate.

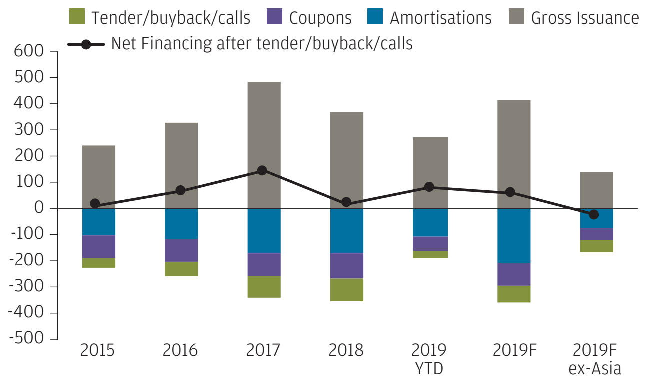
EMERGING MARKET DEBT SHOULD REMAIN WELL SUPPORTED

Limited supply should help the investment case for emerging market debt. We see a favourable combination of real yield matched against a manageable issuer schedule. Modest issuance requirements in 2020 and beyond should help support the asset class. In the sovereign space, we expect new issuance to remain flat for the year.

For sovereign investors, we expect the bulk of new issuance to come from Africa and the states of the Gulf Cooperation Council. On the corporate side, the story is similar. We expect a modest level of new issuance in the period, although excluding Asia we expect the pool of corporate debt to fall by USD 29 billon through a combination of amortisations, tenders and coupons (**Exhibit 6**).

> “Corporate issuance should remain manageable, with net financing of USD 29 billion for the rest of the year”

EXHIBIT 6: CORPORATE NET FINANCING EXCLUDING ASIA



Source: J.P. Morgan Asset Management, Deutsche Bank, Barclays.

The demand side remains robust. Since the global financial crisis, the market’s need for income has helped support the emerging market debt asset class. We have now entered a new phase. The market’s interest in alternative sources of income is a function of what it can find in developed markets. The need for yield may lead investors towards the relatively high level of income that can still be found in emerging markets, supporting the asset class.

Within the emerging market space, investors have been more tactical. Tightening spreads in emerging market hard currency assets has led some investors to seek opportunities closer to home, while in local rates and currencies investor positioning has turned more constructive. In both cases, investors remain constructive.

HARD CURRENCY SOVEREIGNS: TIGHTER VALUATIONS, BUT OPPORTUNITY REMAINS.

Of the principle component asset classes in the emerging market debt space, hard currency sovereign debt has seen the largest inflows in recent quarters and remains the primary target of crossover investors seeking emerging market debt exposure. For this reason, the market has experienced broad support from a widening sponsorship. With a limited new issuance calendar, these inflows can challenge managers to find opportunities. In our view, the emerging market hard currency sovereign arena offers opportunities for those who, like us, prefer to not chase excessive momentum.

Our broad bias is to favour investment grade and selected BB rated issuers. We see opportunity in two strategic themes. First, we seek countries where we can tap into the curve flattening trend, and second, we want to identify select BB rated opportunities at the long end of the curve. In flatteners, we see an opportunity to benefit from sensitivity to both the US economy and US Treasury market. With 10-year single B rated securities trading near to record tight spreads, we want to access economic momentum through longer dated, less tightly priced bonds.

Outside outliers such as Argentina, sovereign fundamentals remain reasonably solid, meaning that inflows are focusing on yield optimisation. As a result, a tactical opportunity may exist in the investment grade segment of the market, which still offers both income and longer duration. At 175 basis points over Treasuries, investors could be forgiven for not seeing excessive value in the space.

Instead, we note that benchmark returns three months forward on a 175 basis point spread entry point can deliver a positive return, especially if Treasuries offer direction and high yield fundamentals begin to struggle into a downturn. We see signs of this in the market, as investors shy away from adding further single B exposure, while targeting value in A rated or better issuers.

EMERGING MARKET CORPORATES: AT THE MERCY OF THE MACRO?

Contextualising a weaker external environment into our expectations for emerging market corporates shows some industrial issuers entering the consolidation phase of the cycle. The result is a gradual upward trajectory for net leverage. Emerging market issuers continue to demonstrate good capital discipline, as they have largely restricted capital expansion in the face of flattening margin growth. At the headline level, earnings growth is likely to soften, though much of this move is attributable to a handful of larger issuers. Leverage has not reached dangerous territory.

The emerging market corporate space is not homogenous. In Asia, we see a maturity bulge forming on the horizon, with this year's USD 79 billion of maturing debt rising to USD 102 billion in 2020 and then USD 125 billion in 2021. Moody's believes that 39% of Asian corporates require market access, a space where 92 of 102 high yield issuers are Chinese. Were the trade war to restrict the access of Chinese corporates to the market, this maturity bubble could become problematic for issuers and investors alike, as it might increase the default rate to 2.3%—with the market-implied default rate going higher still.

Looking at valuations, the crucial question faced by investors is whether the current high yield premium over investment grade is a trap. With spreads rising above the one-year average, we think the market is becoming more aware of negative outcomes, with the risk burden predicated on macro outcomes and the trade war. The result is that valuations may attract flows from investors hunting for yield, with potential inflows creating a risk to the upside.

We want to bias positioning towards longer-dated investment grade names, preferring more defensive sectors. The pricing of default risk may create opportunities. Where macro risk is concerned, not every credit will default; hence a drawdown can unearth substantial value.

LOCAL CURRENCY: ARE EMERGING MARKET CURRENCIES JUST A MIRROR OF A SUCCESSFUL DURATION TRADE?

In local currency, tactical opportunities don't always add up to strategic conviction. Currently, the market offers some tactical opportunity, but in sum we would prefer to remain in our defensive stance, where we are currently long duration. We will look to rotate into selected opportunities, but against a strengthening US dollar we remain cautious of an outright long on local currencies. That said, we remain tactically engaged in local currency beta where we think we will be well compensated for risk.

With the US dollar likely to remain well supported, we are looking to focus on differentiation among local rates, as we want to be positioned in countries that provide opportunity through fundamentals and policy. In our view, countries offering core rate stability, credible policy formation and scope to protect growth through policy implementation will offer the most appealing balance of risk and reward. While most emerging market countries maintain scope to cut rates, the most optimally positioned include Brazil, Russia and Mexico.

The risk to this position is currency weakness, as weakening currencies can complicate policy options for local central banks. How currencies behave in a downturn is both a function of vulnerability and export sensitivity. While many emerging market currencies have shown steady resilience, a number are entering territory consistent with policy risk. We see Brazil's real and the Chilean peso nearing these levels, with other currencies not drastically far behind.

Whether local currencies offer opportunity is a function of how much bad news is in the price. We continue to look to commodity prices for confirmation. Since the Federal Reserve's shift to a more dovish stance, we have seen a higher correlation between local currency performance and copper, which implies that an entry into an appealing growth trade may present itself in the near future.

CONCLUSION

In summary, we believe that the global economy will avoid a recession, but that it might get close. In our base case, the US narrowly avoids recession, though confidence will remain critical to that outcome. We expect the Federal Reserve to continue to reduce rates, probably cutting two-to-three times this year, with two more cuts to come in 2020.

We do not believe that emerging markets can fully decouple from the developed world, though central banks will work hard to protect growth through active monetary policy. On a trade-weighted basis, we think the US dollar may strengthen. With yields stable, we think a longer duration positioning is most appealing, although high yield offers some selective value. With the US dollar supported, we also think local currency bonds may offer tactical opportunities.

We see scope for strong inflows, helped by an increasing pool of negative yielding bonds and a relatively benign issuance forecast. However, we remain cautious in response to spread tightening. Overall, in our base case low growth scenario, we see selected opportunities and a shortage of issuance supporting mid-to-high single-digit returns for the coming 12 months.

EMD Investment Quarterly 4Q 2019

MACRO SCENARIO – STRATEGY/ASSET ALLOCATION – INVESTMENT THEMES

	Scenario	Shallow Recession	Base Case Low Growth	Reflation
MACRO	Probability	45%	50%	5%
MACRO	Growth	Global growth falls under 2.5%	Softer global growth EM-DM alpha flat	US growth re-accelerates
MACRO	Inflation	Global disinflation resumes	Benign inflation	Rising inflation
MACRO	Financial Conditions	Central Banks forced to ease aggressively; simultaneous DM fiscal stimulus	Central Banks easing; limited DM fiscal stimulus	Markets forced to price out global easing
MACRO	Policy Room	EM mitigate but cannot offset growth downside	EM using policy room	USD strength on Fed re-pricing brings EM tightening
MACRO	Commodities	Weaker	Range-bound with lower bias	Stronger
STRATEGY	Beta	Long duration, defensive riskier assets, conservative with liquidity	Long duration	USD strength on Fed re-pricing brings EM tightening
STRATEGY	Sector View	From Credit to Duration Long LY local rates IG long-end, short EMFX.	Long quality HY and local real rates Favour idiosyncratic stories in EMFX.	Gradually add EMFX Pay rates

Themes
Sub-trend EM growth. Supported by monetary easing, but watch for drag on vulnerable EM.
Beta: Strategic bias for quality credit and duration
Tactical: Adjust risk to capture re-pricings of policy stimulus vs headwinds with FX & rate beta.
Alpha theme: Favour EM with policy space and focus on positioning and liquidity (Dec).
Risks: China hard landing, policy errors, global recession **Risk Usage:** Medium

Source: J.P.Morgan Asset Management September 2019. 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. EM / DM = Emerging / Developed Markets..

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