J.P.Morgan
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THE FUTURE OF FIXED INCOME

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Finding the EM nuances

Emerging market debt is underpinned by a solid fundamental backdrop, but the local index is at all-time tights. A differentiated approach seems warranted.

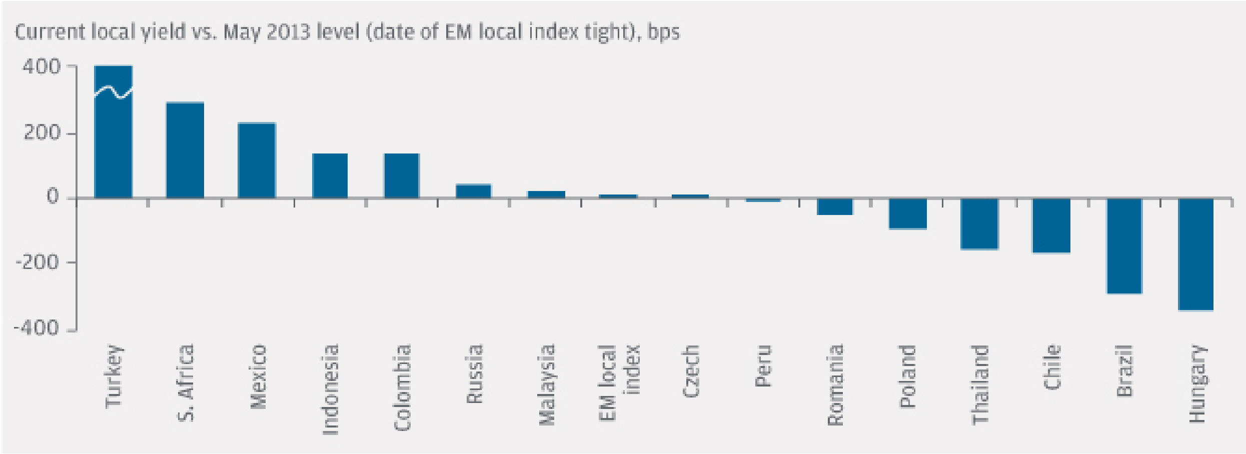
Fundamentals:

Geopolitical risk remains heightened in specific emerging market (EM) countries—including the threat of a coup in Ecuador, social unrest in Hong Kong, and potential repercussions from military action by Turkey. The overall macro picture for emerging markets is still supportive, though, especially for local rates. The International Monetary Fund's semi-annual World Economic Outlook signalled further downside risks to growth, driven by trade concerns; in particular, China's growth was downgraded to below the critical 6% level for 2020. However, for the EM complex overall, growth is expected to pick up again in 2020 to a solid 4.6%. Also supportive is the expected outperformance of emerging vs. developed market growth, which is forecast to increase from 2.2% in 2019 to 2.9% in 2020. Meanwhile, monetary policy is increasingly accommodative: EM central banks have cut rates 44 times in 2019 (to the end of September), and another three central banks (Korea, Chile and Russia) are meeting over the next two weeks, with further rate cuts expected.

Quantitative valuations:

The EM local index hit an all-time low in yield of 5.15% on 9 October, breaching the previous low reached in May 2013. However, the underlying composition of the index is very different now. Certain countries, such as Hungary, Brazil and Chile, are trading even tighter than their 2013 levels. Other countries are meaningfully wider. Mexico is 216 basis points (bps) above its May 2013 level and Indonesia is 130 bps higher, suggesting compelling valuation opportunities given both countries offer attractive yields in excess of inflation and the central banks are cutting rates. However, high yields in themselves don't justify investment: Turkey, for instance, is yielding nearly 10% above its May 2013 level, which is arguably warranted by domestic concerns. To fully realise the yield opportunities in EM local, investors need to invest on an unhedged basis, meaning currency risk is a key consideration. EM currencies typically bring with them meaningful volatility, though they have lagged the broader market this year and are therefore already pricing in much of this risk. Stability in the Chinese renminbi, which is included in the "Phase 1" trade talk discussion, could help keep a cap on overall EM currency volatility. (All data to 15 October).

Select emerging market countries still offer attractive local yields



Source: J.P. Morgan, J.P. Morgan Asset Management; data as of 15 October 2019. EM local index = JPMorgan GBI-EM Global Diversified. EM local index tight = 9 May 2013.

Technicals:

The technical backdrop is mixed. On the demand front, September's tentative inflows have reversed month to date, with October outflows totalling USD 1.2 billion across EM debt funds. For the EM local market specifically, outflows have persisted all year, and now stand at USD 7 billion year to date. This is evidence of investor caution about stepping out on the EM risk spectrum, but it also means investor positioning (particularly in EM currencies) is light, which could help to propel further yield compression if demand picks up. The broader technical driver of the search for yield in a pervasively negative yield environment is also likely to benefit EM debt overall. (All data to 14 October).

What does this mean for fixed income investors?

The case for EM debt, particularly EM local, is nuanced. While the overall index does not appear to offer value compared to historical levels, individual countries within the EM complex are trading wider than they have previously, so a selective approach can still uncover opportunities. China's economy is clearly expected to bear the brunt of the persistent trade tensions, but with the rest of the EM complex forecast to generate increasingly strong growth vs. developed markets and investors still under-invested in the asset class, the local rates trade in select countries should have further room to perform.

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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