PORTFOLIO INSIGHTS

Q1 2021: Happy New Year

Emerging market debt strategy

Q1 2021

IN BRIEF

- In our view, emerging market growth, led by China, could reach 6.7% in 2021. A backdrop of easy global monetary policy further supports the case for emerging market assets broadly, with risks to the upside.
- We believe local currency assets present the best opportunity. Supported by valuation, sensitivity to emerging market currencies and historically wide yield premiums over Treasuries, the outlook for emerging market local currency is only very rarely this appealing.
- Improving economic activity levels are a tailwind for hard currency sovereign debt, but as the sector approaches the five-year average spread over Treasuries, we worry that it increasingly discounts expectations that may prove unsustainable. As such, we are seeking defensive positioning and continue with a portfolio beta below one.
- Emerging market corporates, which also benefit from increased activity, currently have attractive valuations and improving fundamentals. With low interest rates in the developed markets, emerging market corporates are also likely to see a pick-up in crossover flows. Our base case strategy is to maintain a high-yield bias, looking for opportunities to add cyclicals to play the expected fundamental recovery.

A SIMPLE AND POSITIVE OUTLOOK

Rarely is the outlook for emerging markets both simple and positive. At our most recent quarterly meeting, we identified evidence that not only supports the positive stance we carried into the meeting, but also led us to a more constructive positioning. In our view, emerging market growth, led by China, should surge in 2021 – easily eclipsing the US and European recoveries in the process. We expect this acceleration to support the case for emerging market assets, improving the outlook for emerging market corporates, where we find curve risk attractively priced, as well as for hard currency sovereign bonds through improving activity levels. Yet we find the case for local currency assets ultimately strongest of all. Supported by valuation, sensitivity to emerging market currencies and historically wide yield premiums over Treasuries, the outlook for emerging market local currency is only very rarely this appealing.

In our previous quarterly, we identified the central challenge for policymakers in coming quarters to be the timing of a reduction in stimulus – in effect, handing the business end of economic growth back to the private sector. Ultimately, the timing of this decision is critical: left too late, it will create sustained inflation, while to cut early risks a double-dip recession for the affected country.

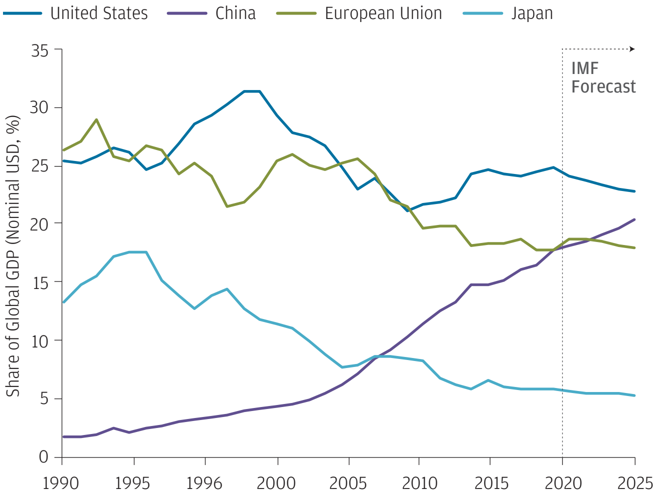
AUTHOR

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

Against a backdrop of non-existent inflation in the developed world, China has unleashed a stimulus equivalent in scale to its response to the global financial crisis in 2008-2009. Seeking a sustained economic recovery, the Chinese have also introduced a new domestic strategy that aims to simultaneously reaccelerate and rebalance the economy. The result is a powerful, balanced recovery in Chinese and Asian activity levels. In our base case, we expect China to rapidly recover off a low base, with growth improving from 2.3% currently to 8.2% in 2021 (**EXHIBIT 1**). The shift in development priorities flagged by the new "dual circulation strategy" should transmit to the broader emerging market complex through commodity and component demand.

China is leading global growth and its share of global GDP is now larger than the EU's

EXHIBIT 1: SHARE OF GLOBAL GDP (NOMINAL USD, %)



Source: J.P. Morgan Asset Management, IMF, Data as of December 2020.

Our base case scenario of gradual, moderate global economic recovery and easy global monetary policy create a benign backdrop for emerging market assets. Risks here bias to the positive, with the global pandemic playing most of the arbiter. Approvals of vaccines in November greatly cheered markets, moving the debate towards the efficacy of their distribution. Contingent on successful implementation, emerging market growth should begin to reaccelerate in the second quarter of 2021, reaching 6.7% for the full year. Chinese import demand, long a key driver of Asian growth, is now broadening with new policies. This supports the case for an improving emerging market current account, liquidity conditions and activity levels – taking the probability of a more positive rebound scenario upward with it. We expect this recovery to be led by Asia, with more idiosyncratic Latin America lagging.

As a rising tide returns to flood a harbour, the focus shifts to more specific questions of buoyancy. Specific countries in the emerging markets may therefore confront divergent policy sustainability outcomes against a backdrop of improving global growth. A generally supportive backdrop reduces our expectations for sovereign defaults in 2021; it also brings higher growth and less liquidity stress. However, a benevolent backdrop magnifies country differentiation, in particular around historically weaker countries now experiencing increased fiscal commitments due to the pandemic. We prefer Mexico, Indonesia and Russia among core countries, and elsewhere we like Belarus, Cote d'Ivoire, Nigeria, Egypt and Ukraine. We are less positive on Turkey, Jordan and Sri Lanka, while we see Brazil and South Africa at inflection points.

Our positive case for the asset class should not surprise: a voracious Chinese demand recovery that is driving emerging market exports plays the foreground to a supportive global backdrop. In places, markets have swiftly discounted policy support and subsequent recovery, but not all. In emerging markets, even after a solid second half of 2020, we continue to see value. In our base case scenario, the J.P. Morgan EMBI Global (hard currency sovereign) could return around 6%, and the J.P. Morgan GBI EM could post 9.8% for full year 2021.

In our view, the strongest opportunity presents in emerging market local currency debt, where positive beta characteristics align with a substantial yield premium at time of writing. While many voices are calling for a weaker dollar, we note that this is not required for a successful investment in local currency debt. With it, the possibility exists for a substantial return. Lower volatility globally and developed market yield compression continue to support emerging market local debt, where higher yields often attract crossover flows. But it also reflects a potential risk around policy tightening should the Federal Reserve stop suppressing volatility.

LOCAL CURRENCY DEBT: ATTRACTIVE PERFORMANCE OUTLOOK

We see three key drivers aligning to create an attractive performance vector for emerging market local currency debt. With the Chinese recovery powering an improving export picture, we think the outlook for emerging market currencies most closely resembles what happened after the global slowdowns in 2001 (dot com crash) and 2009 (developed market banking crisis). If so, the likely performance pathway triggered by a softening US dollar is a strengthening of emerging market currencies as their economies accelerate. In turn, this supports the case for the higher-yielding currencies over lower-yielding ones, as stronger valuation support could lead to further strengthening, we think.

Furthermore, the current valuation premium for emerging market local currency debt over equivalent US Treasuries has rarely been higher. We see these features attracting inflows, and indeed note the active compression of this premium as we write (**EXHIBIT 2**). The reality is that emerging market local currency bonds are an increasingly important part of the global aggregate bond complex, as they combine both income and the potential for capital appreciation.

While we do not view the potential for higher core rates to be a threat to the current opportunity, we remain mindful of the potential of higher rates to disrupt. Although global inflation remains substantially in remission, with the world returning to work, we see optimism returning and with it the potential for rising pressures in the medium term. We see this as a transitional period for many emerging market central banks.

A key arena for local currency investors in the coming quarters is Asian currency exposure to China. An immediate impact of China's policies to balance the economy – and US trade restrictions – is an increase in the complexity of Asian trade. The expected increase in demand for technology inputs to meet China's quest for technology self-sufficiency will likely boost currencies in countries such as India, Korea and Taiwan.

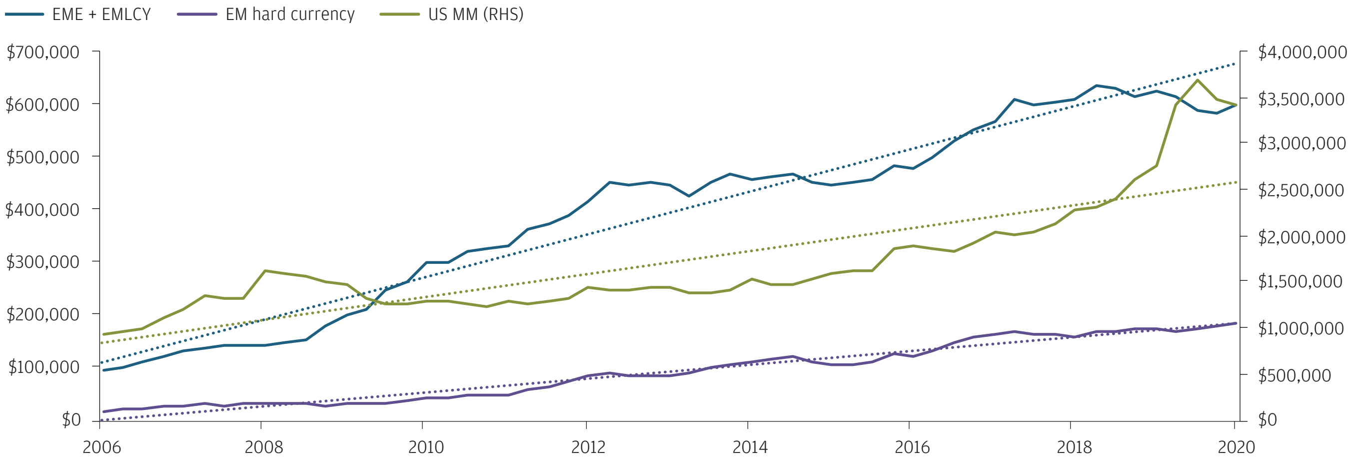
HARD CURRENCY DEBT: SELECTIVE SUPPORT

An improving risk outlook, assisted by an accommodative Fed, should continue to support investor engagement with emerging market hard currency assets. With overall levels of net issuance not expected to increase substantially over 2019 levels, we think it probable that initially, inflows into the asset class will help technicals win over fundamentals. Investors may come to focus on fundamental deterioration after a period of spread compression helped by relative valuations. We expect that country differentiation will be largely driven in the period by the ability (and willingness) to adjust policy to a normalising world, a choice that may force leaders to choose between domestic and financial/market priorities. We note that the market remains both quick to judge and unwilling to tolerate names showing weakness.

There is a risk that investors push valuations to indefensible levels as they seek income at any price – an outcome already seen in many investment grade names. As emerging market sovereign hard currency debt approaches the five-year average spread over Treasuries, we worry that valuations increasingly discount expectations that may prove unsustainable. With valuations demanding in places, downside considerations will need to be more actively considered. We believe emerging market investment grade exposure is well-supported, trading inside its five-year median spread over US investment grade debt, while emerging market high yield continues to offer more than a standard deviation of value over equivalent US high yield. As such, we are seeking defensive positioning and continue with a portfolio beta below one. We are content to selectively play idiosyncratic stories, but remain shy of weaker stories offering higher yields. In our view, it may be wise to selectively run with the crowds rather than risk an accumulation of less liquid exposures.

Local currency bonds could see strong inflows as investors rotate out of more defensive assets

EXHIBIT 2: ASSETS ALLOCATED TO EM LOCAL CURRENCY DEBT, EM HARD CURRENCY DEBT AND US TREASURIES



Source: J.P. Morgan Investment Management; data as of 7 December 2020.

EMERGING MARKET CORPORATES: AN IMPROVING PICTURE

With the stronger outlook for economic activity, we see an improving picture for emerging market corporate bonds. Of the three major asset classes that compose the emerging markets debt universe, corporates were by far the most exposed to the slowdown in economic activity that defined the year. Despite this, credit metric deterioration was manageable —and far better than the market feared earlier in the year. As economic activity returns, we think it likely that corporates see a strong broad-based rebound in earnings and metrics in the coming year.

For the J.P. Morgan CEMBI, we think 2020's 14% compression in EBITDA[1] could be followed by 27% growth, with interest cover improving from 4.2x to 6.2x, based on our own calculations (**EXHIBIT 3**). We expect the majority of this improvement to be led by contributions from Asia, where the EBITDA recovery could be as high as 34% in 2021. The main risk to fundamentals globally is around the pandemic, as a disappointing vaccine outcome could easily slow growth again. At this time, we see a positive outlook for corporate fundamentals.

Encouragingly, corporate ratings have stabilised, and while outlooks expect marginal improvements in the credit backdrop, meaningful improvements should follow a visible recovery. The three ratings agencies have around two thirds of the universe on stable outlook, with the number of negative outlooks gradually receding. Hence, we think the risk of defaults probably tracks the relatively contained 2020 outlook, with potential for upside surprise if a high profile issuer avoids default.

Our optimism towards the space is clearly not universally shared, as valuations appear generally cheap versus history and other peer assets. With spreads near the top of the 300-350 range from 2018-2019, the market continues to discount the potential for further disappointment. This is especially notable in high yield, where we think the space may continue to outperform higher quality peers. Emerging market corporate spread risk is notably cheap versus US peers; investment grade duration-adjusted spreads have never been wider.

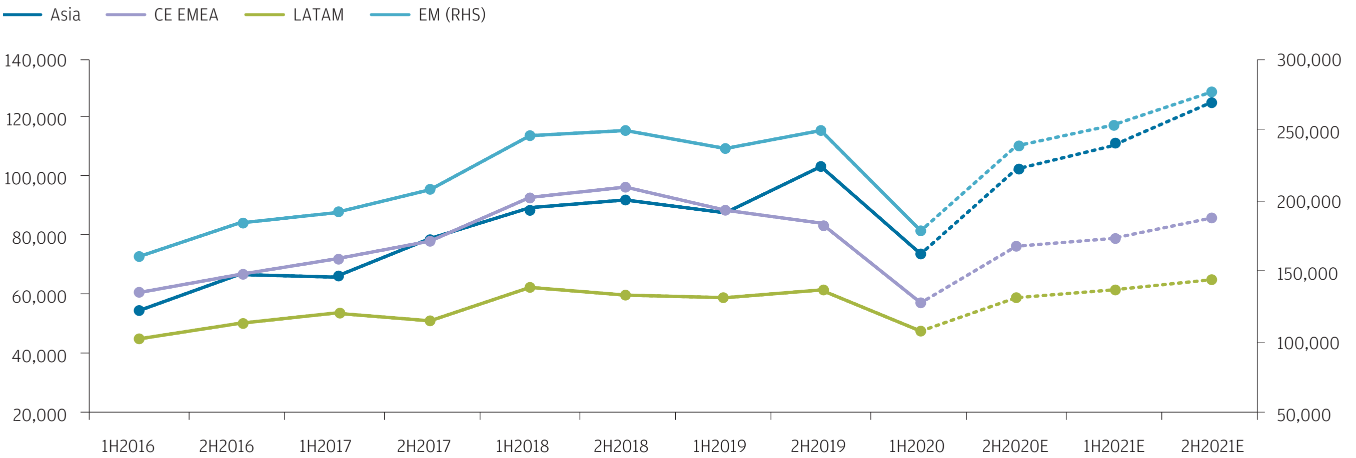
With valuations appealing and fundamentals improving, we think EM corporates are a secondary beneficiary of developed market central bank support, and therefore likely to see a steady pickup in crossover flows as investors become more comfortable with recovery. Encouragingly, the issuance calendars for 2021 are positioned to see net supply shrinkage outside of Asia, where the growth in issuance should be supported both locally and internationally. Taken together, the corporate opportunity should be snapped up, though we would hasten to add that the fastest money into an asset is commonly the quickest to leave, sometimes at the first sign of trouble.

Our base case strategy in corporates is to maintain a high-yield bias, looking for opportunities to add cyclicals to play the expected fundamental recovery. Were the more optimistic scenario to unfold, we would likely seek to be more aggressive in our positioning towards the cyclical trade.

[1] Earnings before interest, depreciation and amortisation.

We expect emerging market corporates will see an earnings recovery in 2021

EXHIBIT 3: CORPORATE EBITDA ESTIMATES BY REGION (IN USD MILLIONS)



Source: J.P. Morgan Asset Management proprietary database. Total emerging market EBITDA includes 108 companies encompassing ~63% of the semi-annually reported CEMBI ex-financials universe. Data as of December 2020

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.

CONCLUSION: A RARE OPPORTUNITY

In our view, the case for emerging market debt has only rarely been this simple and this attractive. With China leading the world out of recession, activity levels globally appear set to increase – supported by generous developed market monetary policy and fiscal stimulus. If the central fear in engaging with emerging markets is a higher risk of default, then the space is showing its quality following the historic slowdown that saw the market lose confidence. For those that stepped into that risk, the resulting returns have been robust. We think the opportunity today is nearly as well-supported and continues to present an opportunity for the long-term investor.

The views contained herein are not to be taken as advice or a recommendation to buy or sell any investment in any jurisdiction, nor is it a commitment from J.P. Morgan Asset Management or any of its subsidiaries to participate in any of the transactions mentioned herein. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is considered to be accurate at the time of production. This material does not contain sufficient information to support an investment decision and it should not be relied upon by you in evaluating the merits of investing in any securities or products. In addition, users should make an independent assessment of the legal, regulatory, tax, credit and accounting implications and determine, together with their own financial professional, if any investment mentioned herein is believed to be appropriate to their personal goals. Investors should ensure that they obtain all available relevant information before making any investment. It should be noted that investment involves risks, the value of investments and the income from them may fluctuate in accordance with market conditions and taxation agreements and investors may not get back the full amount invested. Both past performance and yield are not a reliable indicator of current and future results. J.P. Morgan Asset Management is the brand for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide. To the extent permitted by applicable law, we may record telephone calls and monitor electronic communications to comply with our legal and regulatory obligations and internal policies. Personal data will be collected, stored and processed by J.P. Morgan Asset Management in accordance with our privacy policies at https://am.jpmorgan.com/global/privacy. This communication is issued by the following entities: In the United States, by J.P. Morgan Investment Management Inc. or J.P. Morgan Alternative Asset Management, Inc., both regulated by the Securities and Exchange Commission; in Latin America, for intended recipients' use only, by local J.P. Morgan entities, as the case may be; in Canada, for institutional clients' use only, by JPMorgan Asset Management (Canada) Inc., which is a registered Portfolio Manager and Exempt Market Dealer in all Canadian provinces and territories except the Yukon and is also registered as an Investment Fund Manager in British Columbia, Ontario, Quebec and Newfoundland and Labrador. In the United Kingdom, by JPMorgan Asset Management (UK) Limited, which is authorized and regulated by the Financial Conduct Authority; in other European jurisdictions, by JPMorgan Asset Management (Europe) S.à r.l. In Asia Pacific ("APAC"), by the following issuing entities and in the respective jurisdictions in which they are primarily regulated: JPMorgan Asset Management (Asia Pacific) Limited, or JPMorgan Funds (Asia) Limited, or JPMorgan Asset Management Real Assets (Asia) Limited, each of which is regulated by the Securities and Futures Commission of Hong Kong; JPMorgan Asset Management (Singapore) Limited (Co. Reg. No. 197601586K), this advertisement or publication has not been reviewed by the Monetary Authority of Singapore; JPMorgan Asset Management (Taiwan) Limited; JPMorgan Asset Management (Japan) Limited, which is a member of the Investment Trusts Association, Japan, the Japan Investment Advisers Association, Type II Financial Instruments Firms Association and the Japan Securities Dealers Association and is regulated by the Financial Services Agency (registration number "Kanto Local Finance Bureau (Financial Instruments Firm) No. 330"); in Australia, to wholesale clients only as defined in section 761A and 761G of the Corporations Act 2001 (Commonwealth), by JPMorgan Asset Management (Australia) Limited (ABN 55143832080) (AFSL 376919). [For all other markets in APAC, to intended recipients only]. For U.S. only: If you are a person with a disability and need additional support in viewing the material, please call us at 1-800-343-1113 for assistance. Copyright 2021 JPMorgan Chase & Co. All rights reserved..

LV–JPM53048 | 01/21 | Material ID: 0903c02a82adcd88

J.P.Morgan
Asset Management