The sun also rises

Emerging market debt strategy

Q1 2022

IN BRIEF

- Emerging market debt may face a challenging environment early in 2022, given the US dollar is likely to be supported by policy normalisation. Overall, however, we forecast a positive year, and expect emerging markets to achieve a 5.0% growth rate in 2022, helped mostly by the impact of economic reopening.
- Of the three component asset classes that make up the emerging markets debt complex, we are most constructive on local currency assets despite a challenging 2021. We expect the local currency space to be supported by a return to more synchronised policymaking, reflecting easier financial conditions across emerging markets.
- Within emerging market corporates, we don't think the first quarter will be good for risk assets, and are therefore focusing on more bottom-up, idiosyncratic opportunities. We are concerned about refinancing risk, especially in Chinese high yield, where there are substantial refinancing walls present early in the year.
- In our view, emerging market hard currency debt offers an opportunity for patient, long-term investors. We see very little of the momentum trades that used to attract shorter-term flows. Instead, market participants are watching closely to see if the crossover investor continues to move more deeply into higher yielding segments.

A GAME OF TWO HALVES?

As 2021 drew to a close, our emerging market debt team gathered to look ahead to the coming quarter and year. Our meeting coincided with the discovery of the first cases of the Omicron variant in Europe. We thus begin with a note of caution: we have chosen to view the new variant as a surge rather than a negative paradigm shift. Hence, we think Omicron may delay, rather than derail, the global reflation that was previously underway. Already, the present scale of post pandemic dynamics limits our conviction, as stimulus in the US and elsewhere remains a key distortion. Were we to see a larger Covid event unfolding globally, our bear case expectations may prove more probable.

Broadly, we see the new year unfolding almost as the old one ended, with inflationary pressures rising in the early weeks as logistics systems struggle to fill vacancies and move goods in the developed world. Yet inflationary pressure is not limited to developed economies. In some emerging markets, expansionist fiscal policies are also increasing domestic inflation. For the first time in decades, we have emerging market (EM) central banks breaking with the Federal Reserve (the Fed) to fight domestic inflationary pressures. Within the rates space, investors may be able to capture a rising inflation trade early on, through paid positions. As we reach peak inflation, we think the EM rates sell-off may halt temporarily, giving us an opportunity to reduce exposure.

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We forecast the global recovery to continue next year, with supply disruptions only really easing gradually in the first half of the year. We believe that the Fed will see both its inflation and unemployment mandates met by the end of the tapering period, which may occur as early as June 2022, resulting in higher core yields. We also expect pricing pressure in the US to peak in the first quarter, followed by a gradual decline in inflation, as we see evidence of supply bottlenecks easing across the US logistics system. Hence, we think US Treasuries may reach 2.25% late in the first quarter, but then fall back to 1.5%-1.75% by year-end. In this environment, the US dollar should be well supported.

As a result, emerging markets face a challenging environment in the first half of 2022, as investors look to price in a period of policy normalisation. As the year plays through, we think emerging market growth rates will steadily draw ahead of their mature market peers, while we expect inflation to cool to 4.5%.

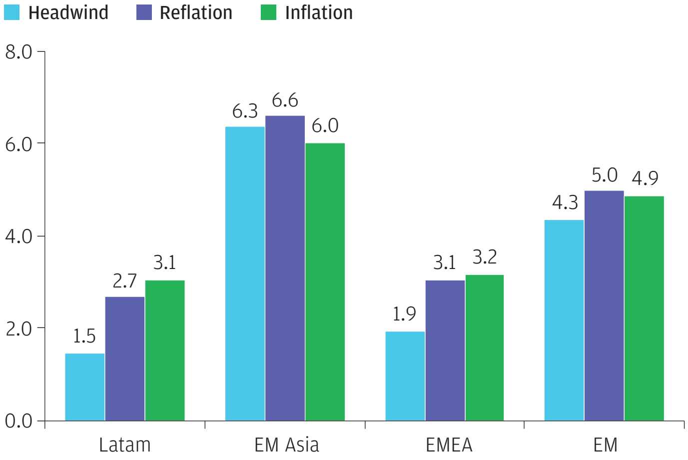
A POSITIVE OVERALL FORECAST

China plays an important role in our projections. We think that Chinese growth reaches a low in the first quarter of 2022, before beginning a recovery. We forecast 5.5% growth for the year as a whole for China. We continue to believe that the Chinese authorities wish to avoid a systemic liquidity crunch or property market collapse, and expect policymakers are most likely to use policy fine tuning rather than aggressive easing to achieve this outcome.

We think emerging markets should achieve a 5.0% growth rate in 2022, helped mostly by the impact of economic reopening (**EXHIBIT 1**). In our view, the gap between EM growth and developed market (DM) growth – the EM/DM growth alpha – should improve sequentially, becoming clearly observable in the second half the year. While EM inflation remains high, we predict inflation will begin to fade as the year unfolds, helped both by base effects and underlying pricing trends. With inflation moderating and growth improving, the second half of 2022 should differ in character from the first.

We expect EM growth to hit 5.0% in 2022 under our base "reflation" scenario

EXHIBIT 1: 2022 GDP GROWTH SCENARIOS (%, YEAR ON YEAR)



Source: International Monetary Fund, J.P. Morgan Asset Management; data as of 26 November 2021.

Not every EM country will align with this forecast, and for this reason we prefer quality over beta early in the year. We favour countries with ample policy space, where there is potential for supportive tailwinds from higher commodity prices and high vaccination rates. We see opportunities in South Africa and Chile, where value has been created, but remain structurally bearish on Turkey and Brazil.

Nevertheless, while emerging markets may face headwinds in the first quarter, we think the investment outlook for 2022 remains positive overall, thanks to our forecasted back-end loading from improving growth and policy normalisation. We forecast returns of 2.7% for hard currency sovereign debt (JPMorgan EMBI Global Diversified) and 4.4% for local currency sovereign debt (JPMorgan GBI EM Global Diversified).

In local currency, we see opportunities around a potential peak in inflation, where we would want to engage through selective payers and linkers, as well as via selected receiving opportunities. Tightening financial conditions should leave the US dollar well supported, which may challenge the emerging market beta, but would support selective engagement with EM currencies on a thematic basis, albeit funded away from the dollar.

Within the hard currency universe, valuations remain attractive and bouts of recovery are to be expected. That said, the backdrop is challenging and limited support remains in place for EM debt until US policy normalisation is better priced. With investment grade tightly priced, we aim to engage with selective alpha opportunities in the sector, while reducing exposure to high yield, which looks fully valued. Corporate fundamentals are strong, but are probably peaking. An accumulation of cash has reduced balance sheet efficiency while raising risks around potential deployment of that cash.

LOCAL CURRENCY: RELATIVE VALUE OPPORTUNITY

Of the three component asset classes that make up the emerging market debt complex, we are perhaps most constructive on local currency assets. Our optimism follows a challenging year and an even harder most recent quarter for EM local currency bonds. As of 29 November 2021, EM local currency had delivered a year-to-date FX (foreign exchange) return of -5.0%, a rates return of -3.4% and a carry return of 1.1% – all leading to a total return of -7.2% on the year. We think this performance reflects a period of desynchronised reflation, marked by tighter financial conditions in selected EM countries (**EXHIBIT 2**).

Desynchronised reflation has created tighter financial conditions in emerging markets.

EXHIBIT 2: EMERGING MARKETS FINANCIAL CONDITIONS INDEX (FCI)

Source: J.P. Morgan Asset Management; as of December 2021.

A potential feature of 2022 is a return to more synchronised policymaking, reflecting easier financial conditions across the space. A transitory period like this one requires investors to be tactical in their engagement, both in rates and FX. In rates, we see an opportunity to play the end of the hiking cycle in some markets, while in EM FX we think a stronger US dollar provides scope for engagement, with EM FX valuations moving back to previous lows.

At the country level, the outlook is non-homogenous. A group of EM central banks have broken with the Fed by stepping into their hiking cycles. We expect this group to grow further, as other EM central banks hike rates in response to rising inflation. In both large and small countries, policy formation is not always coordinated and here we see fiscal policy in some markets adding to domestic inflationary pressures. An analysis of fiscal policy shows countries such as India, Chile and Colombia all adding fuel to their present inflationary fires. In places, central banks can use FX appreciation to tighten financial conditions and thus fight inflation, for example in central Europe, Russia, Israel and South Korea.

Our core conviction remains that US Treasury yields continue to rise, leading to a more volatile dollar. For this reason, we focus on identifying relative value opportunities in EM FX, while gradually positioning for EM/DM spread compression. While we see weakening fundamentals in emerging markets amid tighter financial conditions, we also see both valuations and technicals as supportive. In our view, these conditions should favour currencies from countries benefiting from strong external balances.

Within rates, we think our current short duration bias likely positions us well, though we expect to find some EM rates appealing should inflation roll over later in the first half. We also think there is an appeal to maintaining exposures that offer less correlation to core rates, examples of which include frontier markets and inflation-linked bonds.

A key point: for the first time in many quarters, we see strong signals that EM local currency valuations are reaching historically cheap levels vs. hard currency EM assets. This signal comes at a time when we find it difficult to be long EM FX given tightening financial conditions, but difficult to be short because of valuation. As a result, local currency bonds provide a relative value opportunity, based on external balances and the capacity to use FX as a monetary policy tool. We see rates as an evolving situation, in which we want to remain short US Treasuries, seeking exposure through spread trades. Much will depend on the technical backdrop as the quarter unfolds, where we maintain a constructive view.

EM CORPORATES: FOCUS ON HIGH YIELD

As fundamental investors in emerging market credit, we view the first quarter as one which is unlikely to be good for risk assets, and even less appealing for those seeking to create alpha from market risk. Hence, our focus in the period is on more bottom-up, idiosyncratic opportunities, with the likely outcome that we gradually reduce risk. While our biggest concern remains around Chinese real estate, we otherwise expect leverage and cash flow to remain stable throughout the year. We think it very likely that credit fundamentals, while highly rated, have peaked in the previous period, and are likely to deteriorate in coming quarters. We project 28% growth in EM corporate EBITDA (earnings before interest, taxes, debt and amortisation) in 2021 (**EXHIBIT 3A**), with stable cash flow generation in 2022 as well. We think EBITDA margins will be very strong in 2021, and a little weaker in 2022. We also expect leverage to reach lows not seen since 2016 while interest cover reaches historical highs (**EXHIBIT 3B**).

Capital discipline is an increasing risk in the EM corporate arena. An accumulation of cash has resulted in corporates deploying less efficient balance sheets. How this is resolved introduces new risks around potential acquisition activity, dividends and share buybacks. A key risk for us in the first quarter is around refinancing risk, especially in Chinese high yield, where there are substantial refinancing walls present early in the year. For this reason, we think that default rates in EM corporates will remain elevated, with China and Argentina most at risk. With EverGrande, we saw a 4.2% default rate in 2021; we currently forecast a 3.7% default rate in 2022. We think around two thirds of these defaults will come from China, with Latin America a major contributor to the remainder.

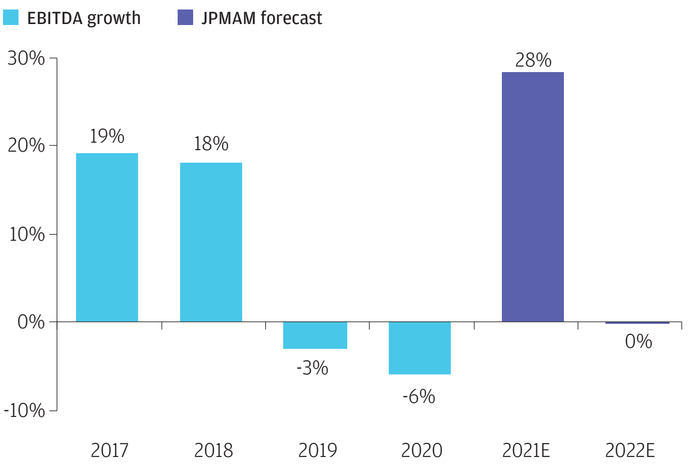
Valuations remain challenging. JPMorgan CEMBI is trading at the lower end of its 2018-2019 range, and has recently returned to its tightest levels. Duration-adjusted EM investment grade corporates still look attractive vs. equivalent DM peers, though both are trading tight vs. historical ranges. This feature overshadows high yield spreads, which have widened 50-80 basis points (bps) since the end of the summer. China is not the sole source of the widening; we also see weakness in Turkey, Brazil and Ukraine, and elsewhere.

While we expect inflows into EM corporate debt to be relatively muted, we also see relatively modest financing needs, with only the Middle East showing an increase in financing needs. We expect Asia, Latin America and Europe all to post negative financing needs. In our view, this should leave the market near a technical balance. Where things potentially get complex is around the financing needs of corporates in more challenged countries. For example, we note that the Turkish banks currently maintain ample liquidity, but were we to see an increase in investor interest in the space, they might be among the first to come back to the market.

We expect to remain focused on high yield, where we plan to search for more idiosyncratic issuers. In Asian high yield, we think commodities and infrastructure, as well as subordinated debt issued by banks, will be attractive. In EMEA (Europe, the Middle East and Africa), we are focusing on financials and commodities, while in Latin America we take a more idiosyncratic approach.

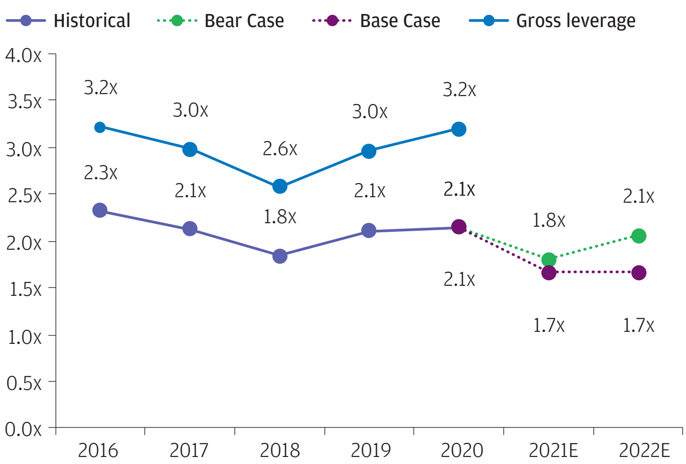
We expect further growth in earnings and low net leverage ratios for emerging market corporates.

EXHIBIT 3A: EBITDA GROWTH AND J.P. MORGAN FORECASTS



Source: J.P. Morgan Asset Management, data as of 30 November 2021. Includes 123 companies covering c.50% of CEMBI ex financials universe. The estimates are calculated after aggregating J.P. Morgan Asset Management analysts' EBITDA growth rate expectations. As of 30 November 2021.

EXHIBIT 3B: EMERGING MARKET CORPORATE LEVERAGE



Source: J.P. Morgan Asset Management; data as of 30 November 2021. Net Leverage includes post-IFRS adjustments starting financial year 2019 and onwards. Projected numbers assume most recent interest cost and net debt. *Recent indicates Q2 2021 data if available, else FY2020 or Q1 2021 data if not available. Bear case scenario assumes 25% lower commodities prices.

HARD CURRENCY SOVEREIGNS: QUESTIONS REMAIN

2021 has turned into the year of the crossover investor in emerging market hard currency sovereign debt. This feature is visible in tighter investment grade spreads and a steady flow of demand into higher quality BB and B names in the space. As a result, we see the hard currency sovereign debt arena as more of a market of stocks than a stock market, with the relative value argument (compared to DM peers) still in place. There is a key question, however, hanging over the continued relative appeal of hard currency sovereigns to the crossover investor and the EM investor: at what level, and when, do we expect to see the flow of funds into the space both broaden and deepen?

We see valuations as broadly supportive, with EMBI spreads near 400bps, though we do not see catalysts in place for a substantial range breakout in the first half of the coming year. For emerging market debt investors, investment grade bonds look rich compared to history, while more idiosyncratic higher yield credits offer more fair valuations. As a result, the hard currency space is becoming harder to generalise, and therefore more challenging to manage, with half of the space anchored much more by valuations than the other half.

The space also faces many concerns, from the impact of Covid, to policy normalisation, to a slowdown in China and an increase in core rate volatility. These concerns now offset the benefits of extraordinary policy support, historically low core yields, and attractive relative valuations versus developed market peers that had supported a positive stance at the beginning of 2021.

What comes next is key to whether valuations offer opportunity. While the present backdrop has worked well so far, conditions may begin to deteriorate, especially as idiosyncratic EM risks proliferate and the potential risk from the Fed becomes more tangible. Not so long ago, we recall thinking that the stars were aligning for hard currency debt to enjoy a period of stronger returns, though now we find the space harder to forecast, as it has become more dependent on the external backdrop.

Our strategy sees us continue with a beta above 1. However, we have begun to step back from some tighter credits, taking profits where we think we are no longer fully compensated for risk. Many of these disposals have happened in single-B rated names or at the long end of flatter curves. An area where we do see potential performance opportunities is in some of the more idiosyncratic countries, such as Ukraine and Iraq. Taken together, we think it is reasonable to expect a 2%-4% return in the space over the next 12 months[1], with risk to the downside from the Fed falling behind inflation. We see potential upside from a return to a gradual normalisation, though this would predicate on lower Treasury yields.

In our view, EM hard currency debt offers an opportunity for patient, long-term investors. We see very little of the quick momentum that used to attract shorter-term flows. Instead, market participants are watching closely to see if the crossover investor continues to move more deeply into higher yielding segments.

[1] 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.

BASE CASE MACRO SCENARIOS AND FORECASTS

At our quarterly strategy meeting, we updated the probabilities that we assign to our main macro scenarios (**EXHIBIT 4**).

Our base case scenario remains reflation, but the risk of an inflationary outcome has increased since our last quarterly strategy meeting.

EXHIBIT 4: MACRO SCENARIOS – STRATEGY/ASSET ALLOCATIONS – INVESTMENT THEMES

	Scenario	Headwind	Base Case Reflation	Inflation
MACRO	Probability	20	45	35
	Growth	Further setbacks from COVID & supply disruptions	EM growth & EM-DM alpha sequentially improving	Recovery faster than expected
	Inflation	Inflation concerns ease only partially	Peaking, gradually declining in 2022	Inflation persistently above target
	Financial Conditions	Somewhat easier	Moving tighter	Faster policy normalization
	Policy Room	Modestly more room	Differentiation in policy sustainability	Less room
	Commodities	Weaker	Stronger oil & metals (ex iron ore)	Stronger
STRATEGY	Beta	Long duration	Favour idiosyncratic Credits Underweight duration	Short Beta
	Sector view	From Credit to Duration Engaged but selective risk assets (HY credit & EMFX)	Favour HY credit Selective receivers vs USTRV in EMFX	Short EMFX, HY credit Pay rates

Themes for 2022
EMD cheap & under-owned, focus on Macro to unleash opportunities
Global growth to recover sequentially, but headwinds from tighter FCI
China structural growth moderating, but within strategic policy framework
Emphasise bottom-up selection in credit
Peaking inflation, gradually reduce duration shorts
Risks: Inflation, COVID relapse, equity correction, China Risk Usage: Medium

Source: J.P. Morgan Asset Management; as of December 2021.

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