Q1 2023: From resiliency to reopening

Emerging Market Debt Quarterly Strategy

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In brief

China's reopening and the end of US tightening should support emerging market assets in 2023.

- We see a soft landing or mild recession sustaining a better risk backdrop for emerging market debt in 2023.
- In our view, potentially sticky inflation is a risk that could lead to negative returns, bringing additional hikes and "US exceptionalism" concerns. We think a deeper recession would hurt emerging market assets, but a decline in core yields would offset wider spreads and cheaper EMFX (emerging market foreign exchange), leading to positive returns with carry.
- **Macro:** We are positive on Latin America but are less optimistic about economies linked to the European Union (EU). In Asia, we expect a growth recovery supported by a potential Chinese reopening. We see China's economic reopening playing out through the currency and local rates, while emerging markets will benefit from demand shifts in supply chains, technology imports, commodities, services and tourism. Differentiation across emerging market countries will vary by sensitivity to these macro developments, while slowing developed market economies should offset some of the positive impact of Chinese reopening.
- **Local currency**: Inflation in the emerging markets is peaking, and thus we maintain a receiver bias. We favour high real yield countries and those where central banks have room to cut or react dovishly to US Treasury accommodation. EMFX also has room to perform well. Our sticky inflation scenario warrants some hedges and relative value trades.
- **Hard currency**: Lower rate volatility will be more supportive of emerging market hard currency debt, but value has become more concentrated in weaker credit names. We continue to favour a core overweight in BB-rated bonds, with selective and tactical opportunities in lower-quality names.

Strategy and positioning

At present, we have a quality credit bias in our portfolios. Looking across the full opportunity set, we like emerging market local assets, as well as sovereign and corporate credit. In general, we have an upward bias in quality but are comfortable using our research capability to access opportunities elsewhere. Where we see improving fundamentals, we are happy to take selected views in EMFX and more risky credits, which leaves our portfolios positively engaged with risk. Geographically, we prefer Latin America to lower-yielding Asia and expect a weaker European economy to challenge EU-sensitive emerging market countries. We hedge our riskier positions with CNY exposure, core rates and steepeners.

We prefer long duration positioning in markets where inflation is peaking and fiscal policy is tight enough to support returns. In this area, we remain positive on Mexico, South Africa, the Czech Republic, Romania and Peru, among others. We hedge our exposures in places where inflation is either sticky or rising, and where we see strong bond supply, such as in China, Poland and Hungary.

We favour a long EMFX bias in our portfolios, ideally accessed through carry. We like Indonesia, Mexico, Brazil, Romania and Peru in this context. A second theme within our EMFX exposure is around countries with positive balance of payments momentum, including Thailand, Korea and South Africa. We fund these positions against the CNY and USD.

In credit, we like EMBI (Emerging Markets Bond Index) beta, and see value in rotations within BB and B buckets. We maintain an up-in-quality bias to positions and a willingness to engage in new issues, which we expect to proliferate in the new year. Among issuers, we continue to like both Pemex and Oman.

In the corporate world, we see headwinds to fundamentals but believe that companies have sufficient buffers to endure these challenges. Differentiation within credits remains key; we focus on bottom-up stories and avoid issuers with weaker balance sheets and smaller players with less liquid bonds. With this approach, we find pockets of value across both investment grade and high yield bonds.

The companies above are shown for illustrative purposes only. Their inclusion should not be interpreted as a recommendation to buy or sell.

Key views on our positioning

We believe peak-inflation and soft-landing scenarios support emerging market assets. We see the EU heading towards a mild recession and expect that sub-par US growth may turn into recession later in 2023. In addition, we see growth across emerging markets ex-China slowing while China is likely to reopen in the first half of 2023. Core consumer price index inflation in the US has likely peaked but the path ahead appears uncertain, in our view.

Higher terminal rates in the US are a key risk to monitor. While both headline and core goods inflation are slowing, pressures remain from wages and core services. If US activity and core inflation remain resilient we may see higher-than-expected terminal interest rates and prolonged pressure on emerging market asset prices in the first half of 2023.

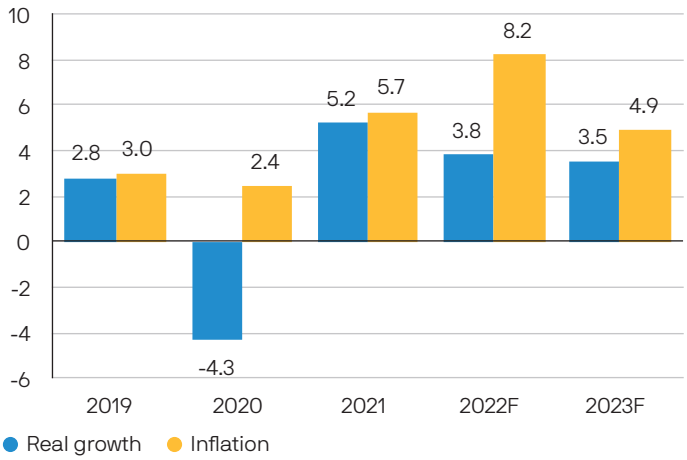
We expect emerging market – developed market (EM-DM) growth alpha to improve above 2% as developed market growth slows. Emerging market growth likely remains around 3.7% in 2023 as Asia recovers while Europe, the Middle East and Africa (EMEA) slows. The key driver of higher emerging market alpha is China , offset by potential challenges due to economic linkages with developed markets, higher interest rates and a fading post-pandemic cyclical boost.

We think China's pivot is now clear. Economic reopening, diminishing pressure on the real estate sector and regulatory relief in other areas point to a clear growth re-acceleration in 2023. We expect China's GDP to grow 4.5% vs. 3.0% in 2022. In the near term, we think the reopening will be bumpy due to a spike in Covid cases. Eventually, China's reopening should be visible in increased demand for commodities, services, tourism and technology – all of which will help emerging market export activity.

Emerging market resilience is real: we think most emerging market countries will see lower growth next year but also lower inflation (**Exhibit 1**), narrower deficits and stable to declining debt levels. Higher interest rates will not derail gradual debt consolidation, in our view. Differentiation remains a key theme: while Chinese reopening may help commodity exporters and other regional partners, we think some of the benefits may be eroded by a more complex developed markets growth backdrop. We see excessive leverage as more of a China story and not a broad-based problem across the emerging markets. We suspect a selection bias will remain for higher quality names in emerging markets.

Growth and inflation are expected to slow across the emerging markets but remain above 2019 levels

Exhibit 1: Real GDP growth and inflation across emerging markets, %



Source: J.P. Morgan Asset Management, December 2022

Our views on key issues in emerging markets

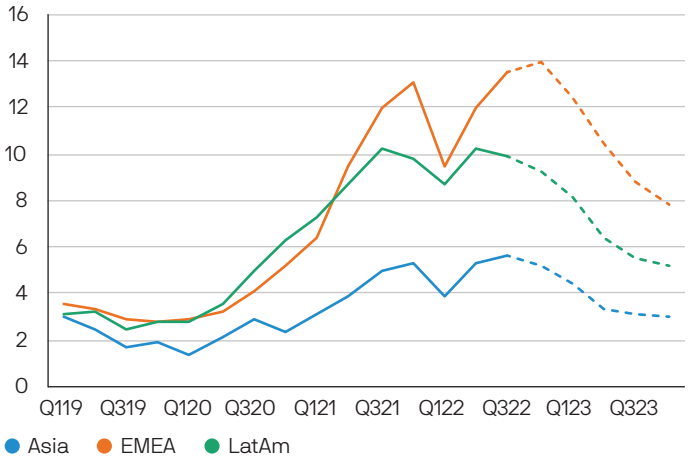
Macro: Landing where and how?

In our base case scenario, we look for China to reopen in 2023. We also expect the US to outperform the EU. This raises questions with implications for asset allocation around inflation and the Federal Reserve's (Fed's) response.

We believe peak inflation concerns are behind us (**Exhibit 2**), especially for headline levels, given lower commodity prices vs. a year ago and supply chain normalisation that has followed the end of the pandemic. We expect US core consumer price index (CPI) inflation to decline to around 3% by the end of 2023, with discrepancies between inflation for goods (collapsing) and services (sticky). Within emerging markets, we also think inflation has peaked and that growth remains below potential. That said, the emerging market disinflation pathway is idiosyncratic and we have greater concern for EU-linked countries.

Emerging market inflation is past the peak, but varies by region

Exhibit 2: Emerging market regional consumer price inflation



Source: J.P. Morgan Asset Management and Bloomberg, December 2022.

We expect the Fed's response will depend on activity and labour market developments, likely limiting excessive loosening of financial conditions. As a result, we think conditions remain tighter for longer.

What do higher US rates for longer mean for emerging market assets? We see increased credit risks with higher interest payments. For most emerging market sovereigns, these conditions will not derail a gradual debt consolidation. In our experience, change generally matters more than levels for risk assets – but we offer caution as real yields are now at the highest level in 12 years. The resulting "bonds are back" momentum may provide some support for emerging market debt, though the hurdle for carry trades is higher than in previous periods.

Can emerging market growth decouple from a developed market slowdown? We think emerging market growth should remain at around 3.7% in 2023 as Asia recovers while EMEA slows. EM-DM growth alpha is expected to improve to levels above 2% as developed market growth slows. Key to the delinking thesis is that emerging market sensitivity to slower growth in the US and EU is differentiated. We see risk to open and EU-linked economies, while Asia should benefit from China's reopening. That said, excessive leverage is more of an issue for China rather than a broad-based problem across the space.

So how might the story play out? We see several potential scenarios. Our central scenario includes a soft landing or mild recession, either of which we believe will have similar implications for emerging market debt. In this scenario, we look for the Fed to remain on hold amid declining inflation, supporting lower volatility and outperformance of emerging market assets. Our second scenario considers a deeper recession, reflecting current or future tightening beyond levels the market expects. This could lead to a period of weaker returns, albeit a decline in core yields would offset wider spreads and cheaper FX for both positive returns with carry. Sticky US wages and inflation remain the most challenging of our scenarios for emerging markets, requiring additional hikes, though potentially at a more gradual place.

Emerging market resilience: Normalisation to continue

Median fundamentals continue to normalise following the pandemic and food/energy price shocks, with metrics generally returning towards, but not yet at, 2019 levels.

We see opportunities for commodity exporters and China-linked stories to benefit in 2023 but continue to favour higher-quality names across our portfolios, as many countries may see marginally slower growth as higher local rates, EU linkages and the post-pandemic boosts fade. China's reopening could benefit commodity exporters and regional partners at the margin, but developed market slowdowns may offset some of the benefits and ultimately favour quality exporters. Tourism remains an important source of export revenue and is recovering broadly post the pandemic. Remittances have proven to be less cyclical, meaning that the impact of a recession may be more moderate than some fear.

Higher rates for longer – and the associated recession risk – still favours quality credits despite the potential for some relief at the margin. We see ratings being more balanced and have lowered our default expectations for 2023. In general, we see sovereign default risks concentrated in smaller countries (**Exhibit 3**) where they are better priced. With commodity prices off their recent highs, we see less acute pressure on some twin deficit countries, and in some places, we see countries benefiting from adjustments. While concessionary lending remains critical, external financing needs are generally lower in 2023.

Over the last few years, the emerging market central bank response to inflation has been to move early and vigorously. Now we see developed market central banks catching up while emerging market central banks hold rates. This leaves higher real rates concentrated in Latin America, where lower inflation is needed to turn early hikers into early cutters. Overall, South Africa, Mexico, Oman, Angola and the United Arab Emirates (UAE) look well positioned in this scenario. In contrast, central and eastern European countries, Ghana, El Salvador, and Colombia seem less well placed.

China: Stronger growth and less policy uncertainty in 2023

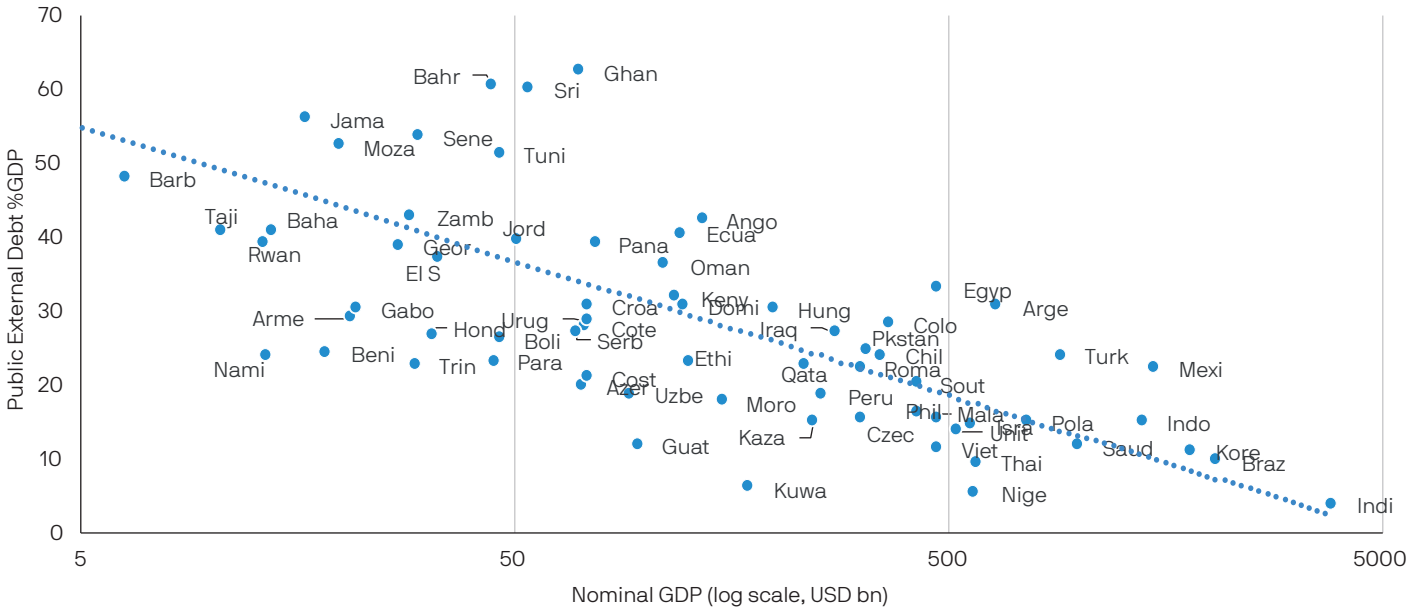
We forecast choppy near-term growth for China but maintain a more constructive 2023 outlook on gradual economic reopening. Following the recovery in the third quarter of 2022, the fourth quarter is once again negatively impacted by restrictions on mobility and likely leads to weak GDP growth of roughly 3% for 2022. China is already calibrating its Covid control guidelines, which will allow a more sustainable growth re-acceleration, particularly after the National Party Congress, scheduled for March 2023. We expect the reopening to boost 2023 GDP growth to around 4.5%.

Another important policy change announced recently is more explicit support to the real estate sector, pointing to some relief in 2023. While a net positive to the wider world, China's import growth should be far from extraordinary. For this reason, we see limited inflationary impact to the global economy, though this risk could increase in the event of a recession in the developed world.

We expect consumption to gradually replace fixed asset investment as the key driver of Chinese growth, while net exports may become a drag. We think Chinese policy makers will continue to favour infrastructure and manufacturing investments as policy responses to a near-term economic slowdown.

External debt vulnerability is primarily a concern for smaller countries

Exhibit 3: Public external debt as a % of GDP



Source: J.P. Morgan Asset Management, Bloomberg, December 2022.

We also expect this pattern to gradually change during 2023, as reopening and policy measures may start to sustain consumption growth, particularly in services. Domestic recovery could mean that net exports could drag GDP for the first time since 2018, a result of improving import volumes (linked to domestic demand re-acceleration) and stagnating exports (reflecting the global slowdown and the reshuffling of supply chains).

In our view, Chinese fiscal and credit support should abate in the second half of 2023 once the economy regains momentum. We think the augmented fiscal deficit likely reached a historical high in 2022. Targeted credit measures are also abundant, particularly favouring small and medium-sized enterprises, infrastructure, and technology upgrading. More recently banks were also guided to support real estate developers, which should offer some relief to that sector. However, fiscal support is expected to abate once the economy regains momentum, which will also likely limit the upside of this expected rebound.

Improving growth should eventually prompt the People's Bank of China (PBoC) to be less accommodative, and therefore we look for Chinese government bond (CGB) yields to drift higher next year. That said, the risk of overheating in China's economy is very low as some fiscal tightening will probably take place in the second half of 2023. We continue to expect the renminbi to underperform vs. a CFETS (China Foreign Exchange Trade System) basket as the slowdown in exports becomes increasingly evident, while the authorities will probably try to offset the impact of US sanctions/export controls on underlying supply chains.

EMD road map Q1 2023

EMD road map Q1 2023 Macro scenario – Strategy/Asset Allocation – Investment Themes

	Scenario	Deep Recession	Base Case Sub-trend	Sticky Inflation
Macro	Probability	20	65	15
	Growth	Slowing sharply	Sub-trend DM growth but EM-DM alpha improving	Holding up
	Inflation	Falling	Peaked and continues to decline in H1 '23	Inflation persistently above target
	Financial Conditions	Tighter first, easier later	Sideways	High for longer/Tighter
	Policy Room	Room to slow tightening	Differentiation in policy space	Less room
	Commodities	Increased volatility	Range-bound	Stronger
Strategy	Beta	Long duration	Long risk & duration	Short Beta Long cash
	Sector View	From Credit to Duration Engaged but selective risk assets (HY credit & EMFX)	Receive EM Rates EM Credit, remain selective EMFX, funded in USD/CNH	Short EMFX, HY credit Pay rates

Themes for 1H 2023
Macro headwinds turn to tailwinds, supportive for EMD
Focus shifting from inflation to growth ➔ long duration
China H123 reopening – more supportive for EM exporters than CNY/CGB
Local Rates offer high real yields & EMFX boost
Pockets of excess premium in EM Credit
Other Risks: (geo)politics Risk Usage: High & build hedges into Q1

Source: J.P.Morgan Asset Management December 2022.

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.

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