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Q2 2022: Attempted soft landing

Emerging Market Debt Quarterly Strategy

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In brief

- We are changing our expected base case scenario from reflation to a soft landing. The greatest risks to our view come from uncertainty around the global economic recovery from the pandemic and the ongoing conflict in Ukraine.
- We forecast emerging market growth of 4.5% this year, some 50 basis points (bps) less than we forecast in December. We see emerging market/developed market growth alpha averaging around 1% for 2022 and becoming more visible in the second half of the year.
- Our base case expectation for hard currency sovereign bond (JPMorgan – EMBI) returns is -1.8% in 2022, while we expect a 6.8% return for emerging market local currency (JPMorgan – GBI EM GD) over the same period, implying that we expect positive return for the rest of the year.
- We think local markets are cheap, for both bonds and currencies, and that the available carry is also attractively priced.
- We think post-peak corporate fundamentals remain strong, while valuations have generally returned to more normal, less demanding levels. Technicals could deteriorate due to outflows in light of the geopolitical backdrop.
- Emerging market hard currency spreads are at rarely seen levels. We see value at BBB and below, where selectivity matters. We see room for re-engagement despite a complex backdrop.

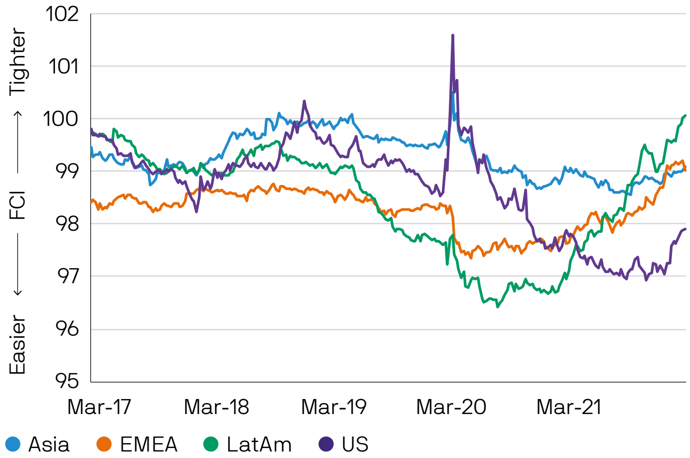
Emerging market debt outlook

Against the backdrop of worsening conflict in Ukraine, our global fixed income team gathered to contemplate the outlook for the next two quarters. In our view, the recovery ahead will be supportive of emerging market assets, though two near-term sources of uncertainty—the pandemic and the Ukraine crisis—will need to be resolved before the recovery becomes visible.

We think the pandemic is the more manageable of these uncertainties, while the impact of the conflict between Russia and Ukraine on growth, inflation and policy normalisation appears less well understood. For now, we think the Ukraine crisis plays out in tighter financial conditions caused by higher energy prices and higher prices for wheat and other agricultural products (**Exhibit 1**).

Higher energy prices from geopolitical uncertainty are resulting in tighter financial conditions

Exhibit 1: Index of financial conditions across major regions



Source: Bloomberg, J.P. Morgan Asset Management, Goldman Sachs. Data as of 4 March 2022. EMEA indices exclude Turkey and Russia. Indices include all other countries in the J.P. Morgan GBI-EM GD. Ex-ante reflects one-year forward inflation expectations. Financial conditions index tracks equities, credit, interest rates and FX.

We are changing our base case growth expectation from reflation to a soft landing, though we accept that this outcome is challenged by uncertainty over where we are in the economic cycle, which has been interrupted by the pandemic. We also expect the outcome of the Ukraine crisis to play a role in the calculus.

We are approaching a point in the recovery where the superior long-term growth rate of emerging markets should become more visible, to the benefit of emerging market assets. We observe that when emerging market growth exceeds that of the developed world, emerging market spreads have historically compressed, though we caveat the current instance given post-pandemic micro dynamics and prevalent geopolitical uncertainty.

US growth losing momentum

Among other macroeconomic factors that could affect emerging markets, we see growth losing momentum in the US. This does not mean that the US economy is likely to tip into a recession; on our models, that is a low probability in the near term. Instead, we see slower growth consistent with a late-cycle US economy that is trending towards a recession sometime in the future. Rising oil prices may bring this timing forward; we note a linkage between US recessions and changes in oil prices, as rising fuel prices can tighten monetary conditions. In our view, an oil price move to $147 per barrel would have the equivalent impact of a 100bps increase in the Fed Funds rate.

Rising oil prices may also lead inflation expectations higher. Thus, higher oil prices may raise concerns over stagflation, though the rise in inflation may be offset by a likely peak in Omicron-related inflationary pressures in the first quarter. The concern is that core inflation has both moved higher and broadened, which risks the possibility of a more sustained period of higher inflation. With consensus currently looking for a first-quarter peak, we see an upside risk to expectations at present. While we continue to look for core personal consumption expenditure (PCE), a measure of US inflation, to finish the year at 2%, we think labour market trends are important to watch, as wage inflation could spiral with negative consequences.

In our view, the Federal Reserve (Fed) needs to avoid tipping the US into a recession while bringing labour demand more into line with supply. With oil prices rising, we think the Fed may not raise rates as rapidly as some expect, given how late it is in the cycle. Instead, we think a more modest tightening is likely given the current geopolitical impact on commodity prices.

Should the conflict in Ukraine escalate further, we would expect to see higher commodity prices with negative implications for growth to follow. However, commodity prices could fall in the face of continued aggression, as alternative suppliers emerge to meet demand. For example, in the energy markets, that could mean Iranian oil supply coming back, or increased production from Opec.

In isolation, it is difficult to forecast a positive growth scenario if commodity prices rise from current levels. Equally, commodity prices could stabilise if there is a de-escalation in the situation in Ukraine and if additional supply was to come on line. Hence, we think it makes sense to consider the factors moving commodity prices, rather than simple commodity price action, when forming our investment strategy.

Chinese growth rates may slow

We forecast Chinese growth of 5.1% this year, reaching a low in the first quarter before recovering for the remainder of the year. At the end of last year, we saw a substantial change in the Chinese policy stance. At the beginning of 2021, Chinese policy focus was centred on deleveraging and regulatory action, which in turn elevated pressure on real estate. In 2022, the priorities appear to have shifted towards growth and stability. For this reason, we think policy easing will remain in place.

If growth slows, we think the government would respond, given the importance of the 20th Party Congress scheduled for next year. However, the drags on growth last year, such as Covid lockdowns, may fade in the coming quarter, while we expect greater fiscal support to be reflected in improving real credit growth, investment growth and technology upgrades. The consensus, meanwhile, continues to expect China's potential growth to slow, perhaps to a 5.5% trend rate.

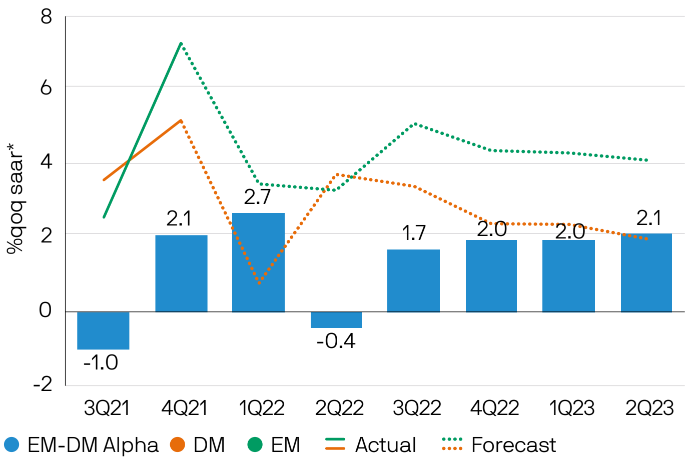
Though we see less contribution from pure labour, we see China's stock of capital playing a greater role in growth generation over time. Regardless, we think China will continue to be the largest contributor to global growth in future. In the near term, Chinese stimulus will continue to soften the periodic slowdowns, contributing to what we expect to be a stronger second half.

Emerging market growth expectations reduced

For emerging markets as a whole, we forecast growth of 4.5% this year, some 50bps less than we forecast in December. The main driver of growth remains the global reopening from pandemic restrictions but mark-to-market adjustments and the impact of the Ukraine crisis reduce our expectations. With these estimates, we see emerging market/developed market growth alpha averaging around 1% during the year, becoming more visible in the second half of the year (**Exhibit 2**).

Emerging market growth alpha should become more visible in the second half of the year

Exhibit 2: Emerging market/developed market growth alpha



Source: J.P. Morgan Asset Management. Data as of 1 March 2022.
*Quarter on quarter, seasonally-adjusted annualised rate.

These views inform our return expectations for emerging market debt. Clarity on Ukraine implications combined with an emerging market macro recovery and higher carry should support returns. Our base case expectations for hard currency sovereign bonds (JPMorgan – EMBI) looks for a -1.8% return in 2022, while we expect a 6.8% return for emerging market local currency (JPMorgan – GBI EM GD) over the same period[1]. These views imply positive returns in the second quarter. In the near term, we may continue to see residual headwinds to emerging market performance, but we expect emerging market hard currency spreads to return to around 400bps by year end, with a little US dollar weakness and emerging market local rates compression helping local currency returns.

Regionally, we think policy room, oil prices and politics will play a role in both Latin American and central and eastern European performance. We like commodity exporters and countries that benefit from the Russia-Ukraine conflict, for example South Africa and Brazil. In local currency, our strategy seeks to play the inflationary peak, while in currencies, we look for emerging market foreign exchange (EMFX) exposures funded away from the US dollar. In hard currency, we think spreads are attractive, but see only bouts of recovery rather than a steady pathway.

Emerging market local currency: The sweet spot

We think local markets are cheap, for both bonds and currencies. We also think the available carry is attractively priced, with positioning quite clean, helped by limited foreign holdings.

We are approaching the end of the hiking cycle for many emerging market central banks. In our view, this is normally the sweet spot for being long local currency assets. We think the end of this cycle will be driven by slowing inflation, resulting in an attractive carry. As a result, we like carry currencies and commodity currencies, both of which we believe will benefit from the current environment.

We want to gradually add emerging market rates from countries where central banks have been ahead of the curve, starting with high yielding countries, and balance these trades against a US Treasury short or developed market short position. This sweet spot does depend, however, on inflation peaking and Chinese stimulus. In addition, geopolitical uncertainty and Fed tightening, even if it is delayed, are potential negatives.

[1] Forecasts are not a reliable indicator of future performance

We see several themes in the market, starting with emerging market central bank inflation carry, which we think we can receive in Mexican bonos and Czech rates. On the other side, we want to play the curve in those countries that are still early in the hiking cycle, such as India, Romania and Turkey. On the currency side of this theme, we like the high carry-to-volatility currencies, for example in Mexico, Brazil and even Chile.

Another theme for us is commodities, where we see Chile, Malaysia, Brazil and Indonesia potentially benefiting; for example, currencies such as the Brazilian real, Indonesian rupiah and Chilean peso all offer positive beta to commodities. In the more idiosyncratic space, we see South Africa as a winner, though we are more sceptical on the outlook for Colombia given the upcoming election. We plan to continue our strategy of using FX options and other hedges to manage downside in a period that could prove volatile.

Emerging market corporates: Steady margins, strong profitability

We expect emerging market corporate fundamentals to continue to improve at a marginal pace, which leaves us in a strong position overall. We think fundamentals may begin to deteriorate from the current record levels of strength, though this is not a concern in the short term. We think stressed sectors, such as Chinese real estate and those hit by the Russia-Ukraine conflict, will continue to be challenged, though outside those areas fundamentals look strong.

Quantitatively, we see the corporates space becoming more appealing after a long period of being somewhat expensive. With the exceptions of Russia and Ukraine, valuations have returned to more normal, less demanding levels. We see technicals deteriorating due to likely outflows in light of the geopolitical backdrop.

We think baseline fundamentals likely peaked in 2021, but should remain strong in 2022. Even from an earnings perspective, the strong growth in EBITDA (earnings before interest, taxes, depreciation and amortisation) that we saw in 2021 more than offset the weakness of the prior two years. Growth momentum may slow in 2022, but overall we are looking for strong corporate earnings.

We also think that margin pressure may impact the real estate, consumer, and technology, media and telecommunications (TMT) sectors, though overall we think that EBITDA margins will be flat for emerging market corporates given higher commodity prices. While we do not see margin pressure as a near-term risk, we are monitoring it over the medium term. Finally, corporate leverage may increase this year, as it is not efficient for corporates to be underleveraged at present, but we do not see emerging market corporates facing issues around interest cover, even if rates were to rise from current levels.

This backdrop does not mean that all corporate bonds in emerging markets are a buy. We continue to see Russian, Ukrainian and Chinese real estate names as sources of risk, as those issuers are running with low cash levels and face market access issues. While we think emerging market corporate default rates are likely to remain very low, it is possible that current tensions produce some negative outcomes among weaker, more exposed names. Higher oil prices will help some issuers, but likely not all, as very high oil prices also bring demand destruction. A key takeaway from our analysts this quarter is that in a growth slowdown, or an environment of negative growth, emerging market corporate EBITDA will be in a strong position.

Offsetting strong fundamentals are more normalised valuations and likely declining technicals, although a potential shift in investor risk perception might lead valuations to more attractive levels. With the J.P. Morgan Broad Diversified Core Index (CEMBI) trading around 400bps over Treasuries, some parts of the market have started to look cheap, but adjusted for the current geopolitical situation, we see a more modest valuation opportunity. Within the corporate bond universe, high yield continues to offer more value than more tightly priced investment grade.

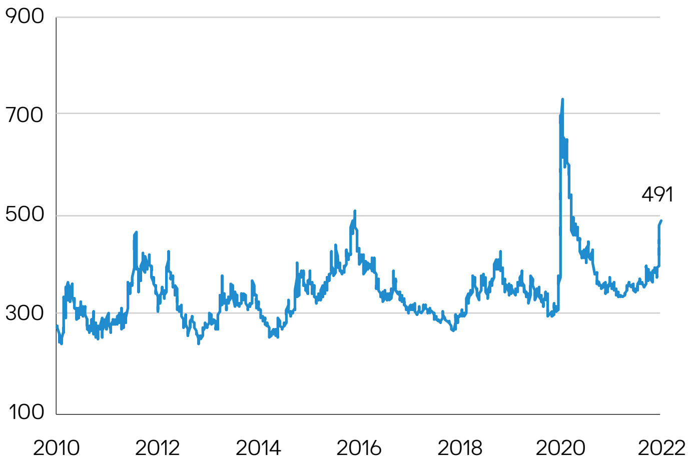
Emerging market hard currency: What price value?

Is emerging market hard currency debt at an inflection point? While Russia's invasion of Ukraine has elevated spreads, there remains a deeper question around the scalability of the asset class. In addition, emerging markets face a busy political schedule into the end of the year. With institutional participation increasing over the last few years, a rocky road ahead could test commitment and raise the probability of outflows. Yet there is value in emerging market hard currency debt, with Russia, Belarus and Ukraine accounting for 120bps of the spread widening seen year to date. Adjusting for this widening, we are increasing our spread target for the year to 425bps-450bps.

Emerging market spreads are currently at rarely seen levels (**Exhibit 3**). In our experience, the extreme circumstances that lead to elevated spreads tend to be long lasting events. Hence, we think a scenario exists where the index will adapt, and the market may find renewed appetite for risk at these levels.

Emerging market spreads are currently at rarely seen levels

Exhibit 3: EMBIGD ex-Russia spread (bps)



Source: J.P. Morgan Asset Management, Bloomberg.
Data as of 7 March 2022.

While investment grade valuations have backed up with recent events, the more idiosyncratic end of the high yield market has cheapened, with some bonds trading at levels not seen since 2015. Both BB rated and B rated names continue to look more crowded, though we remain engaged, prefering issuers without large funding needs. With rates likely to go higher, the longer ends of some curves look more appealing, as do those names with positive oil sensitivity. Though crowded, we continue to like issuers such as the Dominican Republic, while we are more pessimistic on Pakistan.

What happens to a benchmark index is material to any strategy that follows it. How the index provider therefore chooses to reflect the ongoing Russian event will play a role in determining valuation ranges and thus return targets. In the past, the index provider has chosen to maintain defaulted bonds in the indices; if it does something similar here, managers would have to maintain a watchful eye for a potential rally in impacted bonds.

Conclusion: Base case soft landing

While markets work through the current uncertain period, we think the conflict in Ukraine will impact but not derail the present macro momentum. We caveat that this view is predicated on a short, regional conflict. While sanctions impact our base case via energy price increases and tightening financial conditions, the reopening of economies post Omicron will continue, helped by supply bottlenecks easing.

We expect to see a gradual Fed liftoff, leading to an increase in Treasury yields. For these reasons, we are shifting our base case from a reflation scenario to a soft landing, as we see global growth recovering in the second quarter, albeit at a slower pace. This backdrop should allow emerging market growth alpha to recover into the end of the year.

While an atypical US recovery will challenge forecasts, we look for inflation to peak in the second quarter. We continue expect five 25bps rate increases from the Fed, with quantitative tapering (QT) beginning in July. We see real core yields tracking trend growth, leading US 10-year Treasury yields to close the year around 2.4%. We think inflation may lead to excess premiums in some curves, creating opportunities for paid positions, while elsewhere, opportunities to receive rates are more appealing.

Against this backdrop, we think the US dollar may strengthen on geopolitical concerns, before softening later in the year. We continue to like emerging market currency beta, but think exposure is best achieved away from pure US dollar funding. As with last quarter, a yield cushion should help emerging market debt, especially where central bank policy is credible.

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