Q2 2023: Balancing Reopening and Resiliency

Emerging Market Debt Quarterly Strategy

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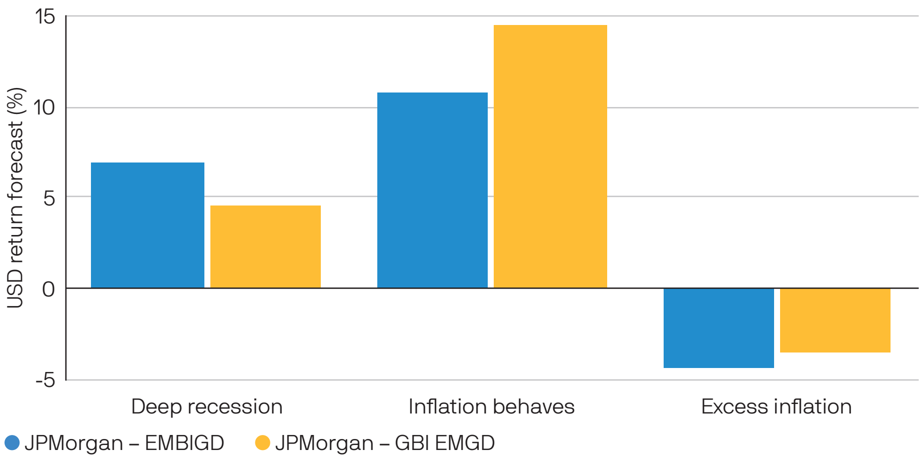
In brief

- China's reopening and better-than-expected global demand should anchor emerging market (EM) growth around 4%, meaning EM-DM alpha could continue to print above 2%. However, upside to developed market (DM) growth needs to be monitored for its potential impact on stickier inflation trends.
- Disinflation could be the dominant trend in the coming quarter. We see supply chains, commodities and the Chinese Producer Price Index (PPI) all working to alleviate inflationary pressures both globally and within the emerging markets. The US plays a key role here, with stronger core services and labour data causing uncertainty. We have higher confidence around EM disinflation, given weaker growth, tighter monetary policy and softer labour markets.
- We assign a 45% probability to our central scenario, but that probability is declining. Our central scenario expects inflation to behave, lower volatility and a pause in the Federal Reserve (Fed)'s interest rate hikes. Tails are getting fatter: We see a 20% probability of a deeper recession, and the probability of a higher terminal rate at 35% — and rising. The latter would imply a negative return for EM debt.

We have simulated returns based on carry and our assumptions for US Treasury yields, the US dollar, emerging market spreads and local sovereign yields under our scenarios:

Exhibit 1: Return simulations for our scenarios



Source: J.P. Morgan Asset Management, data as of March 2023. Simulated returns based on current pricing and targets. "JPMorgan EMBIGD" refers to the J.P. Morgan Emerging Market Bond Index – Global Diversified, "JPMorgan-GBIEMGD" refers to the J.P. Morgan Global Bond Index Emerging Markets Global Diversified. **Forecasts are not a reliable indicator of future results.**

Outlook: Declining inflation and lower core yield volatility should favour EM debt

In our view, a global recession has been delayed but not avoided. We do not see this view fully priced into all markets, however. Instead, we see developed markets pricing in a perfect landing, while emerging markets appear to discount higher levels of recession risk. We look for EM GDP growth of about 4% in 2023, meaning that EM-DM growth alpha should continue to improve over and above the 2% level. This growth alpha comes despite upward revision to our developed markets growth expectations. In this arena, our largest upward revision to growth expectations comes from the European Union (EU), with upside versus consensus in both the EU and US. However, rapid tightening keeps DM recession more elevated into the second half of 2023.

In emerging markets, inflation has begun to fade from the market's focus. We continue to see disinflationary trends building in both the developed and emerging markets. Strength in the US labour market keeps some uncertainty around the Fed's likely terminal rate. While a substantial adjustment has been priced, we think a pivot in Fed policy is not imminent. Watching global supply indicators, commodities and China's PPI has led us to expect a continued disinflation trend. We see EM disinflation reflecting in tighter monetary policies and weaker growth. Timing of EM central bank policy loosening may soon be a focus for the market.

Reopening should continue support for EM macro fundamentals

We see median EM fundamentals continuing to normalise with metrics trending toward, but not yet reaching, 2019 levels. China's reopening from Covid lockdown has supported those countries linked to Chinese inputs: We find currency (FX) linkages are stronger and more direct than credit linkages. We see tourism's recovery broadening, while oil and commodity exporters remain supported.

Emerging countries' resilience continues and emerging markets have now passed the worst shocks, with more gradual improvements ahead. Resilience was driven by many factors, of which stronger fiscal performance was a key contributor. External financing stresses remain limited to select countries, especially as the market has reopened to some high yield issuers. As a result, we think the sovereign default rate in EM will be materially lower in 2023 vs. 2022, with more balanced rating actions.

We see EM monetary policy as a positive, as the EM hiking cycle is largely finished. Attractive real rates are concentrated in Latin America. We see Brazil, Mexico, Colombia, Chile and Peru as likely monetary policy winners.

Strategy: A soft landing remains our central scenario but the probability of a more bearish outcome increases

In our central scenario, we see a soft landing or mild recession globally, leading to 10% to 15% returns for EM debt. While this remains our most likely scenario, we also see its probability declining as risks around Fed policy remain elevated. A deeper developed market recession reflecting in lower core yields would offset cheaper FX and wider spreads for positive returns with carry. A higher US terminal interest rate is our most challenging scenario and is also one where we see an increasing probability following stronger DM labour data. In our view, emerging markets are unlikely to repeat 2022's negative returns, given that higher interest rate risk will be mitigated by disinflationary pressures and continuing recession risk.

As a result, our core asset allocation view is to rebuild long duration, expressed through EM local and sovereign debt and EM corporate credit. In all these areas, we want to engage with a bias for quality. With fatter tails now a more prominent feature in EM debt, we are seeking hedges, such as low voltality FX options and rate futures.

Our positioning carries these views forward into EM debt subsectors. In rates, we want to maintain a long duration into increasing deflation with limited growth upside, especially in Mexico, South Africa and some Central European countries. Carry creates a space for more idiosyncratic opportunities as well. In FX, we think carry has reached levels that are attractive enough that a long/short portfolio can be attractive. That said, we think diversified funding will be key in the coming quarter. We see FX shorting opportunities in China, Taiwan, Israel and Australia. In credit, we do not think higher for longer is a negative with JPMorgan-EMBI GD spreads at 420 basis points. We prefer BB quality for income and carry. While corporates are facing headwinds, we continue to see broad balance sheet strength with ample buffers, making differentiation and selection a key theme.

Our views on key issues in emerging markets

Fatter tails: What could a higher US terminal rate mean for emerging market returns?

Notable in this quarter's debate was the ascending credibility of our bear case scenario, which looks for further terminal rate repricing in the US. This view has gathered momentum as US employment and inflation data has recently surprised positively. While the market has been revising up the terminal rate expectation in recent weeks, rate volatility remains lower than last year following the Fed's downshift.

For investors in emerging markets, the core concern here is less around accelerating US momentum and more around a stronger-than-expected Fed reaction to that momentum. Higher growth for longer would be a positive for EM, given its positive growth differential. A sharp move from the Fed to cool the US economy might provoke a more challenging environment.

The risk of an increase in the US terminal rate has not gone unnoticed by the market. In the two charts below, we show that both EM sovereign risk (measured by EMBI spreads) and EMFX are increasingly negatively correlated with US data surprises – in effect, this means that US bad news is EM good news, and vice versa. A more exceptional US growth story could attract flows away from emerging markets and into the US, for example.

In our view, a strong increase in the terminal rate would be followed by a more rapid cooling in US economic conditions, and potentially a deeper recession to follow. Our discussion focused on the potential timings of these events. We also found some disagreement within our group over what this would mean for EM fundamentals, technicals and subsequent performance expectations.

In recent quarters, emerging markets have surprised investors positively with their resilience. We think this quality continues. For example, in 2023 we are looking for EM sovereign default rates to be lower than last year, even with an expected gradual consolidation unfolding.

In our view, a shallow US recession might produce performance headwinds insufficient to derail the EM investment case. Powered by China's reopening, EM's growth alpha over developed markets remains solid. That said, a cooling US economy might compress demand for EM exports. While a higher US terminal rate remains a challenging scenario, we think that 2022's negative returns are unlikely to repeat given EM's present disinflation trend.

An additional point to consider: EM is not homogenous, meaning differentiation remains a strong point in the space's favour. We see a number of countries well placed to benefit from the current macro backdrop. A common characteristic of this group is a stable or improving policy trajectory, such as in South Africa, Mexico and Indonesia. Less well-placed countries share weaker policy anchors and a higher probability of risk scenarios, such as Turkey, Brazil and Poland, we think.

With EM inflation peaking, we maintain a receiver bias towards our local currency exposure, preferring higher real yield countries and relative value trades. In hard currency, we want to be more selective around valuations, with a bias towards BB-rated sovereigns and select corporates.

Exhibit 2: Correlation of inverse EMBI GD spread vs. US data surprise changes (one-week lag, rolling 12 weeks)

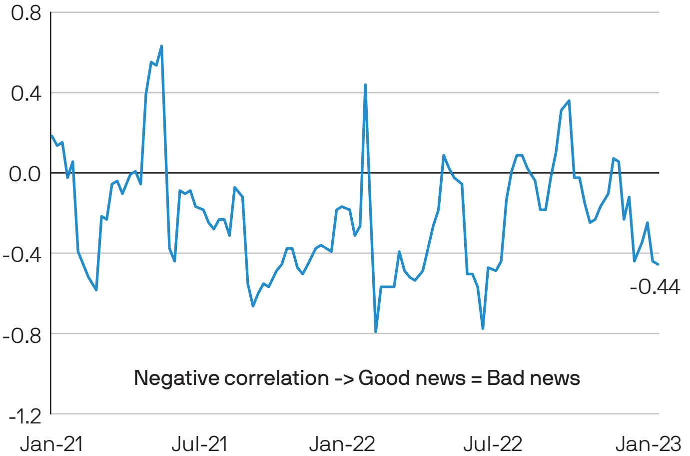
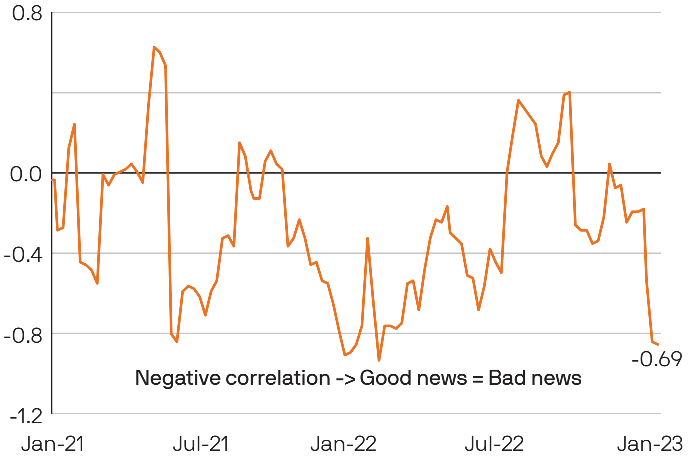


Exhibit 3: Correlation of EMFX vs. US data surprise changes (one-week lag, rolling 12 weeks)



Source: Bloomberg, Citi Surprise Indices, J.P. Morgan Asset Management, data as of February 2023.

Our views on key issues in emerging markets

China: Better growth, less spillover

A faster reopening should sustain a 5.0%+ growth outlook in China, in our view. Further, we believe that China's growth recovery may come with only a limited global inflationary impact. We note that China's authorities have recently announced "the end" of the Covid pandemic. Consistent with reopening elsewhere, we think China's GDP growth should accelerate rapidly. How quickly this pickup in demand translates into support for China's real estate sector is unclear: We think the pace of the housing sector recovery may lag China's recovery. Instead, we see the recovery being led by services consumption, supported by more anchored energy prices and a normalised supply chain. Collectively, these features should constrain the inflationary impact of China's reopening.

We think services consumption, manufacturing and infrastructure investment should support China's growth recovery in 2023. Reflecting the Covid narrative change, we think China's consumers should return in force, thus supporting both services and broader consumption. Some of this consumption may tap China's excessive savings base, while another driver could potentially be improving employment as pandemic conditions fade. We also expect investment in manufacturing capacity to continue, consistent with the government's focus on technological progress. We expect Chinese fiscal policy to be less expansionary but large enough to guarantee high-single-digit infrastructure investment growth in 2023.

Against this backdrop, we expect Chinese monetary policy to remain neutral, with a continued focus on targeted credit growth. We do not see China raising rates this year, while PBoC liquidity management will seek to maintain current funding rates. The structural policy change implemented in credit markets recently to support the real estate sector will play an important role in the recovery of the sector. We expect credit expansion will be close to nominal GDP expansion.

With growth re-acceleration on track, we continue to maintain a short bias towards both the Chinese yuan (CNY) and Chinese rates more generally. We see 3.1% as a structural target for CNY rates, though we raise geopolitical risk as a potential caveat to that level. China's move to deepen relations with Russia at this time reinforces geopolitical tension, elevating the risk of a trade war, in our view.

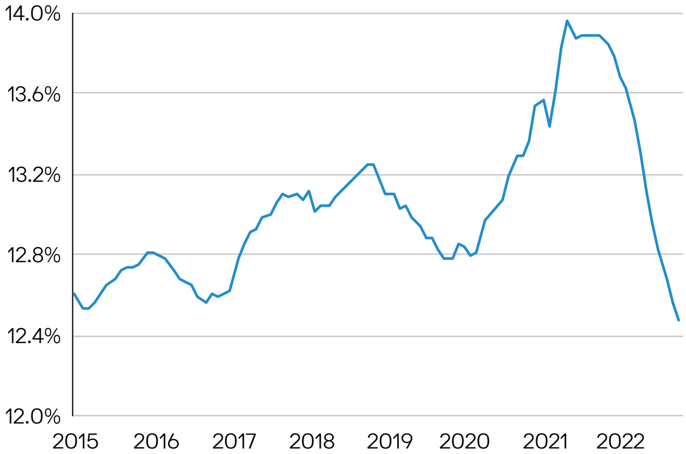
Exhibit 4: China GDP growth forecast

% Yoy	Q1	Q2	Q3	Q4	Annual
2022	4.8	0.4	3.9	2.8	3.0
2023 Base	**2.8**	**7.2**	**5.0**	**6.1**	**5.3**
2023 Bull	3.0	8.0	6.1	7.7	6.3
2023 Bear	2.0	5.6	2.9	3.6	3.6

Source: Bloomberg, J.P. Morgan Asset Management, data as of February 2023. Forecasts are not a reliable indicator of future results.

Faster reopening should sustain 5.0%+ growth in China...with limited inflationary impact.

Exhibit 5: China's share of global exports is declining (12 monthly moving average)



Source: Bloomberg, J.P. Morgan Asset Management, data as of February 2023.

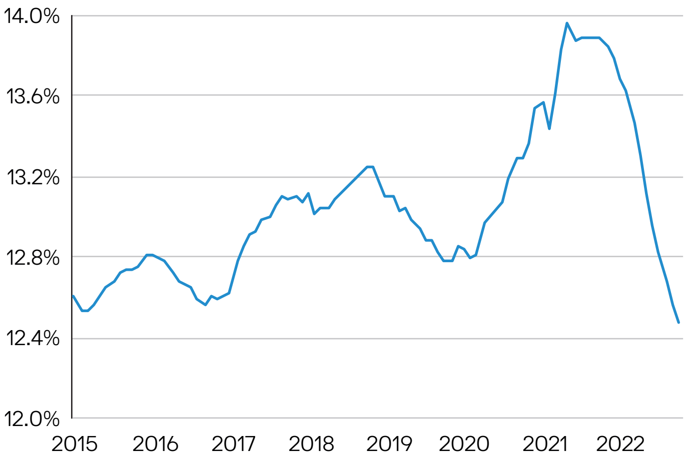
Asset class views

Emerging market local currency

After a period of elevated volatility and strong returns, we have seen a return to the year's starting position. An expensive US dollar and high real rates support our position. We remain positive and expect EM local currency debt to deliver a low-double-digit return for the remainder of year. Our strategy remains constructive, seeking to play disinflation through longer duration exposure in higher yielding markets, balanced with selective exposure in EMFX. In EMFX, we want to play elevated carry especially where currencies are supported by China linkage. We believe higher-for-longer rates are manageable but require monitoring.

Key alpha drivers: US rates, volatility, flows

Exhibit 6: Local rates are starting to reflect the transition to rate hike pauses



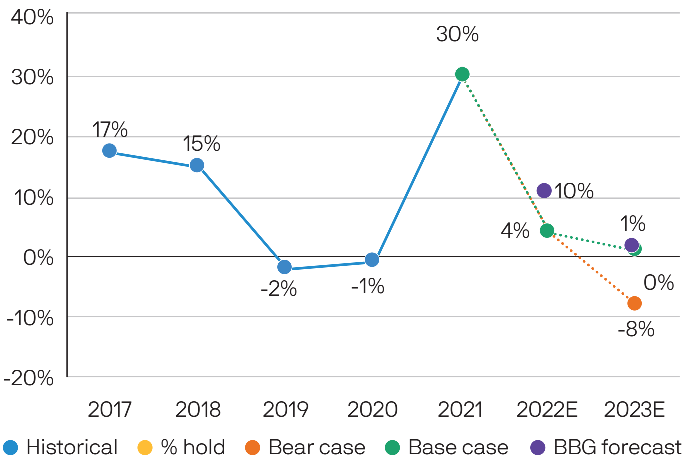
Source: Bloomberg, J.P. Morgan Asset Management, data as of February 2023.

Emerging market sovereign bonds

We sense that the current rally in EM sovereign bonds has seen valuations catch up with fundamentals. From here, we see the rally being challenged by higher US Treasury yields, despite positive returns supported by ample cash balances in investor portfolios. We think technicals are as positive as we have seen in a long time, with further catalysts to come. As investors adapt to higher real rates, we think the EM sovereign income story will continue to attract flows, which should help support performance. We see a fair value EMBI spread of around 420 basis points over Treasuries. We like Paraguay, Oman and Ivory Coast in BB-rated bonds.

Key alpha drivers: BB exposure, single B relative value.

Exhibit 7: EM EBITDA growth expected to slow



Source: J.P. Morgan Asset Management, data as of February 2023.

Emerging market corporate bonds

We think there is a case to trim beta in EM corporate bonds, initially in Latin America and then elsewhere. The market's soft landing expectations are perhaps strongest in this area, especially around commodity price expectations. Credit fundamentals remain strong, but corporate buffers may be tested by the coming slowdown, with all sectors impacted by tighter liquidity. Aggregate leverage remains low, though we expect the number of issuers with extended balance sheets to increase going forward. We see spreads hovering around historical averages, with pockets of value across regions. Absolute yields continue to support returns, however. We remain alert to outflow risk, and expect net supply to remain negative this year.

Key alpha drivers: Chinese growth, US rates, commodities

EMD road map Q2 2023

EMD road map Q2 2023 Macro scenario – Strategy/Asset Allocation – Investment Themes

	Scenario	Deep Recession	Base Case inflaton behaves	Excess inflation
Macro	Probability	20	45	35
	Growth	Slowing sharply	EM-DM growth alpha improvesDM growth holding up, but sub-trend	Resilient US and Rest of World growth
	Inflation	Falling	Peaking and continues to decline in 1H 2023	Inflation decline insufficient or rising again
	Financial Conditions	Tighter first, easier later	Bias for looser conditions	Tighter with higher macro volatility
	Policy Room	Room to slow tightening	EM tightening has been sufficientbut differentiated across countries	Less room
	Commodities	Weaker	Supported but range-bound	Increased volatility
Strategy	Beta	Long duration	Long carry & build duration	Short Beta Long cash
	Sector View	From Credit to Duration Cautious on risk assets (HY credit & EMFX)	Gradually receive EM Rates Selective in EM Credit Carry EMFX, USD neutral	Short EMFX, HY credit Pay rates

Themes for 1H 2023
China/EM-led growth supportive for EMD
Disinflation to support long duration
Favour belly local rates as EM central bank cycles turn
Maximise carry in EM FX and Credit
Other Risks: (geo)politics Risk Usage: Medium & maintain hedges

Source: J.P. Morgan Asset Management, data as of March 2023.

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.

Next steps

For more information, contact your J.P. Morgan Asset Management representative.

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