PORTFOLIO INSIGHTS

Moving to overtake

Emerging market debt strategy

Q3 2021

IN BRIEF

- Last quarter, our base case expectation was for a period of gradual reflation, but as the global economy accelerates, our thoughts turn to new risks and sources of uncertainty. The withdrawal of US dollar liquidity implicit in tapering could produce diverse outcomes within the emerging markets, especially as valuations look relatively full in some segments.
- We expect country selection to be a more important driver of returns, particularly in light of diverging policies.
- China's shift from cyclical to strategic growth should mark a return to trend growth. We do not expect potential restrictions around some sectors that previously saw easy access to capital to contribute to a higher default rate.
- We are reducing our expectations for returns this quarter until we see clarity from the Federal Reserve. However, for the next 12 months, we remain positive on emerging market debt, which we think can deliver returns of around 6% for hard currency, though spreads in many areas suggest fair value.
- We retain our bias towards high yield over investment grade credit, which worked well last quarter, because we believe there is more value to capture.
- We are also more optimistic around the outlook for local currency, where we see a potential 6.5% return over the next 12 months from relative value opportunities in emerging market currencies, further enhanced by attractive local rates.

POST-PEAK ACCOMMODATION

With both speed and breadth, the US recovery has swept past the point of peak policy accommodation, surpassing our previous quarter's base case expectations and taking expectations of US exceptionalism with it. We may now have seen a peak in US exceptionalism, leaving emerging market growth rates poised to benefit from the growth trade. At last quarter's meeting, our base case expectation was for a period of gradual reflation, but as the global economy accelerates, our thoughts turn to new risks and sources of uncertainty, as well as other longer-term factors stemming from this more rapid recovery.

With the reopening of economies powering buoyant economic performances within the developed world, we note the possibility of more challenging financial conditions as the Federal Reserve (Fed) and other central banks unwind accommodative policy. The withdrawal of US dollar liquidity implicit in tapering could produce diverse outcomes within the emerging markets, especially as valuations look relatively full in some segments. We think country selection will matter more going forward as the breadth of emerging market diversity drives relative value opportunities.

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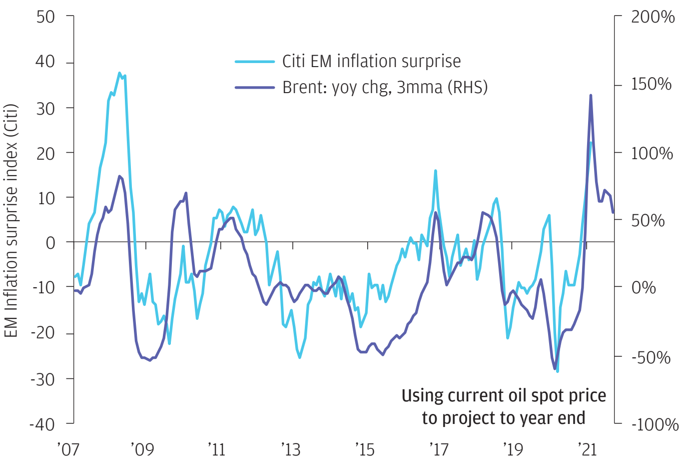
RECOVERY AND REFLATION

Our base case macro scenario remains anchored in reflation, which we think will continue as the cycle progresses. The risk of US exceptionalism has passed, though we see developed market policy changes as a potential source of uncertainly. Headwinds for emerging markets may be more front loaded into the summer while clarification of the Fed's thinking on tapering will likely be supportive for emerging markets into the second half of the year. Also, emerging market inflation may be about to peak, providing further support (**EXHIBIT 1**).

Inflation has risen and surprised to the upside, as we expected, but we are likely at a local peak

EXHIBIT 1: CITI EMERGING MARKET INFLATION SURPRISE INDEX



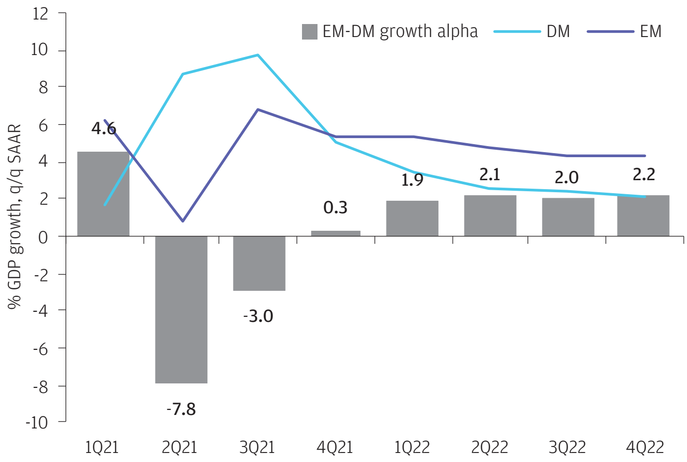
Source: Bloomberg, Citi, J.P. Morgan Asset Management. Yoy = year on year. 3mma = three-month moving average. Data as of June 2021.

We believe markets will be driven less by cyclical recovery in China and more by strategic issues. Chinese GDP growth should reach 8.8% in the current quarter as the economy moves past recovery. While a recovery in lagging sectors, such as consumption, should contribute to growth, we see potential headwinds from policy unwinding and some deleveraging. Our estimate of 7.2% GDP growth for emerging markets overall validates the idea that growth is recovering, despite uneven management of the pandemic among emerging market countries.

The unwinding of this lockdown could provide support for emerging market debt in the medium term. The growth differential between emerging markets and developed markets is a key driver of the relative appeal of emerging markets. Accelerating growth in both the US and Europe had compressed this relationship in recent quarters but we expect the growth differential to bottom out in the second quarter and then rise again in favour of the emerging markets as economies open up in the third quarter (**EXHIBIT 2**).

The differential between emerging market and developed market growth has bottomed and is now recovering

EXHIBIT 2: EMERGING MARKET VS. DEVELOPED MARKET GROWTH ALPHA, J.P. MORGAN FORECASTS



Source: Goldman Sachs, J.P. Morgan, Bloomberg, J.P. Morgan Asset Management. Q/q = quarter on quarter. SAAR = seasonally-adjusted annual rate. Data as of June 2021.

COUNTRY DIFFERENTIATION

Against this macro backdrop, country selection should play a greater role in successful asset allocation than it has in recent quarters. While monetary and fiscal policy adjustments are needed in many emerging market countries, a greater response is required in some countries more than others, which may create opportunities.

Emerging market policymakers have provided considerable support to their local economies over the last few quarters, but this support now constrains policy room for many. We believe front-end rates need to adjust, suggesting that rates on the back end of the curve may offer selective value. Such divergent policy outcomes should create additional opportunities in emerging market currencies this quarter. Differentiation in policy choices may diversify outcomes, with winners determined by exports and fiscal stance, while political headwinds for governments may be a key source of risk, especially in Latin America.

For China, the transition from cyclical to strategic growth is an opportunity. Chinese growth numbers in recent quarters have been inflated by low-base effects as the country recovers from the pandemic; the reality is that China is heading towards trend growth of 5.5%. We now expect areas that have lagged, such as the consumer and infrastructure sectors, to catch up and potentially lead as contributors to Chinese growth in the period. Real estate embodies the potential for an overshoot in growth, as evidenced by the state moving to increase regulation of the sector. We continue to monitor the Chinese economy for deleveraging and other signs of monetary tightening, which we do not see impacting the broader economy at this juncture.

EMERGING MARKET DEBT OUTLOOK

Our outlook remains supportive of both emerging markets generally and commodities. While there is a narrative in the market that a slowing China is bearish for commodities, we remain positive on the outlook for both. Geopolitical tension is a well-understood risk and could flare up, although currently we do not view the risk as sufficient to challenge our base case expectations.

The market's consensus appears split between those that are positive on China's growth trajectory, and those that are more concerned about a possible deceleration stemming from policy tightening. The bearish camp is focused on an apparently weakening credit impulse. We think the change is more in the denominator of the credit impulse calculation – nominal GDP growth – which has increased to 14% to 15%, meaning the formula shows credit growth collapsing. We therefore expect Chinese total credit growth to remain stable at 12% to 13%, suggesting that GDP growth is also likely to remain stable.

That said, we think the coming quarter may be more challenging, as investors react to potential US tapering against a backdrop of richer valuations in certain sectors. This sets up an environment conducive to outbreaks of repositioning volatility. As a result, we are reducing our expectations for returns this quarter until we see clarity from the Fed.

For the next 12 months, we remain positive on emerging market debt, which we think can deliver around 6% for hard currency, though spreads in many areas suggest fair value. We are continuing our bias towards high yield over investment grade credit, which worked well last quarter, because we believe there is more value to capture. We are more optimistic around the outlook for local currency, where we see a potential 6.5% return over the next 12 months from relative value opportunities in emerging market currencies, further enhanced by attractive local rates. Steeper local curves bring positive term premium, meaning investors are being paid well to take local risk.

ASSET CLASS VIEWS AND OUR PREFERRED TRADES

Much of the emerging market trade this quarter will be in the term premium, as the short end of the curve flattens and the long end starts to look appealing. Our preferred positioning relates to the challenge presented by front-end repricing in the US.

In the past, tapering has been a challenge for emerging market investors, but this time it may be less pronounced for several reasons. For example, external positioning is stronger and more resilient than in past episodes, with wider inclusion of emerging markets in broad global indices attracting more long-term institutional investors, which may lead to less volatility. Also, the space is now less crowded, while we note less currency vulnerability this time as well, which should protect emerging market returns.

Opportunities in local currency and rates

We see opportunity this quarter in the local currency arena. With emerging market countries producing differentiated outcomes, and a variety of post-pandemic reopening pathways at work, we see an opportunity among those currencies where central banks have shown a willingness to hike. The other group is composed of countries where central bank credibility remains robust. We think the current low volatility environment should be supportive for a strategy that accesses a basket of currencies from countries including the Czech Republic, Hungary and Poland, as well as Korea, Chile and South Africa.

We note a second opportunity around local rates and inflation. Our idea is to play the differentiation in inflation trajectories within the space. We find some countries with high and rising inflation presenting opportunities, and we think the market has created value in some high-yielding local curves. Where inflation is soaring to higher levels, we want to pay rates; we want to receive in countries where inflation appears be offering relief – for example in Malaysia and Mexico. In addition, we see the market creating tactical opportunities to receive in Colombia, South Africa and Indonesia, where value has been created.

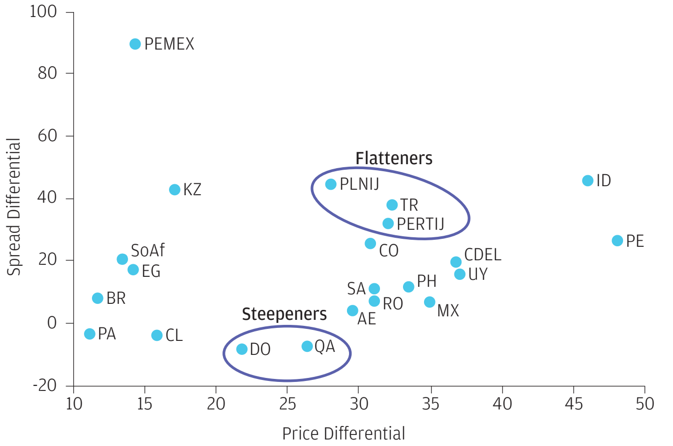
In combination, these ideas argue for a constructive exposure to the emerging market local currency complex. While less diverse in country composition than other emerging market debt sectors, it is also more liquid and well supported by domestic demand. The local currency space should therefore offer value for those investors who want to play a diminishing of US exceptionalism in their portfolios.

High yield in hard currency

Our third and final opportunity is around credit, which was our strongest idea in the previous quarter. Investment grade credit has seen a steady tightening in the period, commensurate with stronger fundamentals and increasing institutional participation. This leaves today's markets relatively tight, though higher yield opportunities continue to offer value. In our view, the most interesting arena in hard currency high yield are those issues which have seen widening in both spread and price after recent Treasury moves, a screen which shows some flattening countries offering hard currency value (**EXHIBIT 3**).

Value remains in emerging market sovereign high yield, but opportunities are becoming more selective

EXHIBIT 3: SPREAD/PRICE DIFFERENTIALS FOLLOWING US MOVES



Source: Bloomberg, J.P. Morgan Asset Management. Data as of 7 June 2021.

CONCLUSION

The first half of 2021 showed emerging market resilience towards a market looking for developed market economic recovery. In the face of a changing global economic backdrop, emerging market countries may need to adjust policy, following periods of substantial monetary and fiscal policy support. We think country differentiation will matter more in the coming quarters than it has in the previous period, as the market reacts to a rising cost of capital.

Populism is an issue to watch in many developing economies, especially those challenged by weaker growth outlooks. While this may lead to challenging policy choices for some, it may well reinforce the investment case for more credible emerging market policymakers. The resulting divergent policy options will reflect in relative value opportunities in both emerging market currencies and local rates, while investment grade credit remains tight versus historical averages.

China's shift from cyclical to strategic growth should mark a return to trend growth. China's efforts to return to a more balanced economic growth profile may lead to increasing restrictions around some sectors that previously saw easy access to capital. That said, we do not see these restrictions contributing to a higher default rate in the country.

As a whole, many portions of the emerging market debt universe feel fairly valued. How the Fed's policy evolves will greatly help clarify investor views and conviction over the coming quarter. We remain long-term positive on the asset class and view emerging markets' resilience as evidence of its ability to perform once its relative growth rate improves from this year's low.

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