In brief

• Our baseline view remains that the US economy will continue to cool, eventually entering a recession towards the end of the year. We think a sequential downturn is beginning, which will impact both the developed and emerging world. As a result, we expect emerging market (EM) growth alpha to increase to 2% as the year unfolds, powered by economic resilience in EM countries.

• While residual uncertainty remains around the Federal Reserve’s (the Fed’s) terminal rate, we believe we are near the end of the tightening cycle, which should lower rate volatility. We also expect inflation to cool faster in emerging markets than it does in the developed world, with EM inflation expected to be around 5% by year end.

• Reflecting this core view in our positioning has led us to remain constructive on duration, with a bias towards quality in our security selection.

• Our central scenario looks for emerging market debt returns in the region of 7%-8% for the remainder of the year. Our preferred positioning focus is on the EM local rates opportunity, which should perform well if the US economy – and US dollar – weaken in response to the Fed’s tightening.

Macro outlook: EM growth to remain resilient while the disinflationary trend should continue

A key theme for us this quarter is around the impact of a delayed recession on risk assets, combined with the potential for emerging market (EM) country differentiation. In recent months, EM fundamentals have shown signs of normalisation to pre-pandemic levels, while growth resilience has challenged the near-term recession narrative.

As a house, we expect the US to enter a recession in the fourth quarter of this year, setting up the potential for a period of more elevated EM growth relative to developed market (DM) growth. As a result, we expect EM growth alpha to hit 2% as the year unfolds on the back of EM GDP growth of 4% for 2023.
Emerging market growth is expected to remain resilient despite a slowdown in the developed world

Exhibit 1: EM growth vs. DM growth

J.P. Morgan Asset Management forecast


We also expect EM inflation to fall faster than DM inflation, with the overall annual EM inflation rate ending the year around 5%. Global supply chain normalisation, lower commodities and weaker Chinese producer prices have combined to broaden the disinflation trend we observed last quarter. Against this backdrop, the dollar appears overvalued, but not extremely so. With the US markets pricing in a large rate cutting cycle, there is a risk of outflows from dollar assets. The upcoming US Treasury rebuild could exacerbate tighter financial conditions and negatively impact risk assets.

Inflation now looks to have peaked in all EM regions

Exhibit 2: Regional EM inflation rates, % year on year

Source: J.P. Morgan Asset Management; data as of June 2023. Inflation country list: Asia (China, India, Indonesia, Thailand, Malaysia, Korea), EMEA – Europe, Middle East and Africa (Poland, South Africa, Romania, Hungary, Czech Republic, Israel, Egypt) LatAm – Latin America (Brazil, Mexico, Colombia, Chile, Peru).

China: Pressure on policymakers could spark renminbi depreciation

We have left our 2023 Chinese growth forecast unchanged compared to last quarter, at 5.5%, though we note that evolving challenges are impacting market sentiment, with softer economic readings in April and May causing a reduction in consensus growth expectations. Among the main challenges are softer real estate demand, a slowdown in household consumption and the recent growth in youth unemployment.

In previous years, real estate has been an important engine of Chinese growth. Today, however, the real estate driver has become more sluggish, with property developers reducing the area of land under construction. Overall real estate funding has halved from 60% of China’s total social financing to 30%.

Reopening optimism in China has reversed

Exhibit 3: US and China economic surprise indices

Source: J.P. Morgan Asset Management, Citi, Bloomberg; data as of June 2023.

On the household side, meanwhile, spending on real estate has also fallen materially – from 25% to 10% of total social funding. Survey data from the People’s Bank of China points to an increase in savings and a resistance to incremental consumption. Intertwined with this issue is a high level of youth unemployment in China, which points both to a weaker services recovery and a sluggish rate of post-pandemic enterprise repair.

We think China’s policymakers will not accept sluggish growth. We have already begun to see a response through a monetary policy adjustment, with China moving to reduce deposit rates to stimulate both consumption and investment spending. The resulting interest rate differential with the US could lead to a 5%-7% depreciation of the renminbi against the US dollar. Our baseline expectation looks for CNYUSD to reach 7.15.

From resilience to differentiation
Should this policy reaction prove insufficient, we expect the Chinese government to reach for additional levers. A large fiscal response is constrained by complex local government financing and a high debt-to-GDP ratio, but some incremental infrastructure investment could follow. An additional incremental step would be to use industrial policy to encourage private sector confidence. We do not expect policymakers to accept growth below 5% and think this could be a trigger for a more meaningful response. This summer’s Politburo meeting could offer clues to the next steps.

We think EM assets outside China continue to offer a more appealing exposure to Chinese growth than dedicated China assets. In our view, China’s investment grade assets remain fully valued, while high yielding Chinese credits look more moderately priced. That said, we are happy to add risk selectively, with an emphasis on quality fundamentals and operational momentum. For example, in the real estate sector we are currently finding value in higher quality state-owned enterprises (SOEs), given they are benefiting from a compelling contracted sales trend, have the ability to access the onshore bond market, and have good liquidity coverage ratios. We are wary of lower quality credit exposure at present, given material unpriced default risk.

Positioning for softer growth

We see emerging markets enjoying a higher level of macro certainty than their DM peers, even with softening Chinese growth expectations. The higher levels of EM growth alpha that we expect and the potential for EM rate cuts should provide further support. We expect third-quarter data to challenge an investor consensus that has largely ignored EM quality in favour of more defensive assets in developed markets. As a result, we expect to move from a period characterised by more frequent surprises towards one defined by a less volatile glide path.

In this environment, we think it is key that core portfolios position for softening growth, with a bias towards longer duration assets and EM local currency debt, and up-in-quality credit exposure. In our base case scenario for softer growth, EM local currency debt is expected to produce a full-year return of 13.7%, with returns of 8.1% coming in the second half of the year.

We expect the second half of 2023 to reward security, sector and country selection, as country and issuer differentiation becomes more apparent against a backdrop of slowing economic momentum. Emerging markets are not a homogenous set of countries, so we expect some divergence in public policy response, especially for those countries expecting elections. At present, higher quality EM sovereign debt is perhaps not as expensive as spreads indicate, given lower default rates, higher levels of recovery, and relatively clean positioning. A further boost comes in the form of ratings upgrades, which we think can outperform momentum.

At current levels, EM sovereign spreads may represent value

**Exhibit 4: Historical EM sovereign returns for given spread levels**

<table>
<thead>
<tr>
<th>EMBIG Div Spread Range (bps)</th>
<th>1 year return</th>
<th>2 year return</th>
<th>3 year return</th>
</tr>
</thead>
<tbody>
<tr>
<td>200-300</td>
<td>3%</td>
<td>5%</td>
<td>9%</td>
</tr>
<tr>
<td>300-400</td>
<td>12%</td>
<td>13%</td>
<td>17%</td>
</tr>
<tr>
<td>400-500</td>
<td>19%</td>
<td>18%</td>
<td>30%</td>
</tr>
<tr>
<td>500+</td>
<td>49%</td>
<td>31%</td>
<td>16%</td>
</tr>
</tbody>
</table>

Selectivity matters

Downside risk is ever present, especially from a possible macroeconomic shock, such as disruption to commodity suppliers, tourism, and remittances. In our view, it is likely that these potential shocks will be less severe than those seen during the Covid pandemic. In the sovereign space, we see only a handful of countries facing external financing stress – even without market access through 2024. The International Monetary Fund remains active in the emerging markets arena, which can help weaker issuers.

Nonetheless, we think country and issuer selection matters. This quarter, we like the case for quality improvers, such as Costa Rica, Paraguay, Oman, Bahrain, Indonesia and Morocco, while we remain more sceptical towards those countries with weaker policy momentum, such as Argentina, Egypt, Malaysia, Hungary and Georgia. Some countries will weather a recession shock better than others: we think UAE, Thailand and Indonesia benefit here, while El Salvador, Dominican Republic and Angola are examples of countries that are less positively exposed.

Monetary policy supports the case for some of the larger emerging markets, such as Mexico, Brazil and Peru, while Poland and China face more challenging positions. Overall, our preferred countries this quarter are Mexico, Indonesia, and the UAE, while we think Hungary, Egypt and Colombia will face headwinds.

Our baseline scenario is for cooling DM growth EM resilience and a greater EM growth alpha.

Source: J.P. Morgan Asset Management; data as of June 2023. Opinions, estimates, forecasts, projections and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. There can be no guarantee they will be met.
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