Delayed, not derailed

Emerging market debt strategy

Q4 2021

IN BRIEF

- Our base case expectation for emerging market growth looks for 6.8% in 2021 and 5.5% in 2022, a 1.4% premium over developed markets, which is lower than normal due to current robust growth in developed economies.
- At our quarterly meeting, we reduced our base case "global reflation" expectation to a 50% probability, while we now expect greater tail risks, reflecting the uncertainty around the global economy's direction of travel.
- We expect a 4.4% return for emerging market hard currency sovereigns and a 7.2% return for their local currency equivalents over the next 12 months, though we think these returns will be back-end loaded.
- Overall, we are shifting from a beta to an alpha approach, seeking a greater contribution from selection than allocation. In a more fully valued world, we want to focus on rolling down curves, adding selected higher-yielding issuers chosen for quality and gaining exposure to currencies of resilient local economies benefiting from credible policymaking.
- For our base case scenario, we favour selected high yield credit, payers in rates and relative value in currencies, while seeking to add receivers on dips. In our inflation scenario, we would seek to reduce portfolio betas, while moving short on currencies and paying rates. Should a headwind emerge, we would seek to lengthen duration while remaining engaged with selected risk assets.

AUTHOR

Pierre-Yves Bareau
Head of Emerging Market Debt, J.P. Morgan Asset Management

CAUTIOUS OPTIMISM

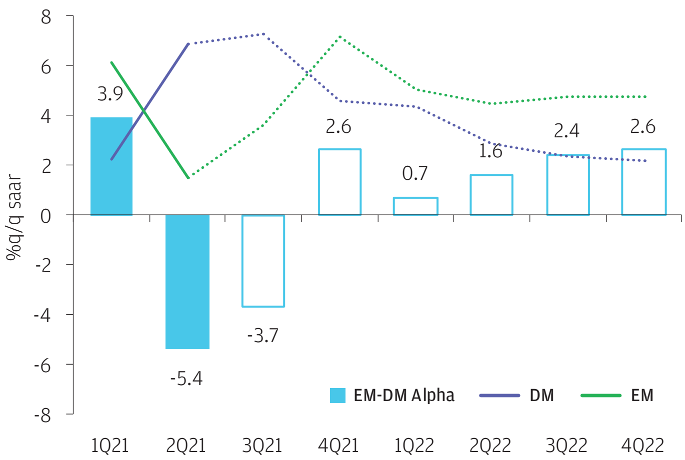
Lingering Covid friction continues to dampen growth in the emerging markets, delaying a visible reflation. In the coming quarters, we see a more benign growth outlook forming, albeit one that could be challenged by bouts of higher core yields. The pandemic's dynamics constrain our conviction, as variants continue to threaten growth with incremental potential lockdowns. We see a stronger outlook for local currency assets in most scenarios, though this depends on a continued recovery in both Europe and the emerging world.

Of the major economies, China offers the clearest growth signal. Our base case expects China's economy to grow 8.4% in 2021, though risks skew to the downside given the potential for further lockdowns. The Chinese government's recent public policy has emphasised long-term priorities over near-term cyclical considerations in a challenging external environment. China's goal of a more sustainable, less risky and less speculative economy is not entirely without an impact on growth. However, we think China is more likely to adopt forceful and effective fiscal measures than aggressively ease monetary policy. For this reason, we think the Chinese rates rally is largely done, though the RMB continues to offer good carry in the near term. While credit spreads appear compelling, managed deleveraging may have a mixed impact on Chinese corporates; we see headwinds in real estate, technology and coal, while local government financing vehicles (LGFV) also face challenges. The Chinese government continues to support the economy in other areas, such as banks, autos, gas utilities and infrastructure, which continues to provide a positive macro backdrop for commodities.

Our base case growth expectation for emerging markets as a whole is 6.8% in 2021 and 5.5% in 2022. We think economic recovery will continue, though the potential for setbacks is real. While we have robust expectations for emerging market growth, our emerging market growth alpha measure estimates only a 1.4% premium over developed markets in 2021 and 2022, largely due to strong developed market growth (**EXHIBIT 1**). Our largest downside risk remains a Delta variant shock that drives wider-than-expected lockdowns, where we see emerging markets hit harder in Asia and less in Europe, the Middle East and Africa.

Emerging market growth is set to rise back above developed markets in 2022.

EXHIBIT 1: EMERGING MARKETS VS. DEVELOPED MARKETS GDP GROWTH



Source: J.P. Morgan Asset Management; data as of 3 September 2021.

Given this backdrop, we expect emerging market inflation to remain uncomfortably elevated, though the moment of peak pressure may not be far away. We see US inflation softening after the reopening supply disruptions, though we expect the easing of inflation to be gradual. We think a first-quarter 2022 decline in inflation is possible in the emerging world, accounting for commodity prices and base effects. How policymakers choose to respond will play an important role in generating returns for investors, especially as we expect US interest rates to rise in the fourth quarter of 2021.

We think emerging market differentiation may favour those countries with more policy space, while exporters will increasingly benefit from improving global growth momentum. Although emerging markets are recovering quickly from the pandemic, we see spending adjusting more gradually, elevating debt levels and increasing pressure on central banks. We expect support from the International Monetary Fund – and the politics associated with that support – to also play a role in market outcomes. On this basis, we think Ukraine, Mexico, Russia and Indonesia offer interesting opportunities, while Brazil, Chile and Turkey face challenges.

In the medium term, growth seems less secure. Emerging market economies that are more open are also more vulnerable to changes in growth expectations and trade flows. While we see global manufacturing experiencing positive trend growth, we also see Chinese factory demand normalising, suggesting we are past the cyclical peak. While we remain positive on commodity demand, the market for goods may yet slow, especially as central bankers shift their focus towards fighting inflation through more hawkish policy.

As a result, we see a mixed performance outlook. As US tapering looms, we see emerging markets better positioned than in 2013, with fewer aggregate vulnerabilities. Hence, we think the outlook for emerging market returns remains positive; we expect a 4.4% return for hard currency sovereigns and 7.2% for their local currency equivalents over the next 12 months, though we think these returns will be back-end loaded. Uncertainty around policy normalisation will also overhang the asset class, especially in local currency, where we expect inflation to remain challenging in 4Q 2021. Higher-yielding countries with improving growth momentum should outperform. In the hard currency space, we remain cautious towards single B credits and other weaker high yield offerings.

LOCAL CURRENCY: LEANING IN

Emerging market local currency appears well positioned to offer investors exposure to the central bank normalisation theme currently playing out around the world. As the world moves past peak US exceptionalism and the global economy continues to unlock from the pandemic, we expect recovering European, Asian and other emerging markets should see positive returns, aided in part by attractive valuations, which is unusual for a liquid asset class.

Our core approach to the opportunity looks for a gradual increase in US Treasury yields, while inflation remains persistent and elevated. In our base case, we want to maintain exposure to currencies whose central banks enjoy policy flexibility and who have maintained credibility in the pandemic, while also carrying a small positive beta to local rates. We see two principle risks to the local currency opportunity: the first is a new Delta wave that delays a meaningful recovery while increasing pressure on central banks trying to offset the resulting fiscal expansion; the second risk is a sharp sell-off in US Treasuries that causes a shock.

For local currencies, high growth and fading trade momentum creates a mixed backdrop. Supply chain disruption and stalling commodity momentum have negatively impacted trade, resulting in a currency market with little direction. This is not automatically negative for performance; inventory restocking and steady Chinese demand can potentially provide market direction. Emerging market account surpluses may be drawn down and the speed of this erosion may well attract attention, though we caution against excessive concern given that the drawdown can be supportive in many scenarios. For example, while pro-cyclical fiscal policies can dampen local currency returns, we think improvement in terms of trade can help strengthen emerging market currencies. In our view, it is sensible to remain cautious around currencies in the Andean region, the Philippines and India; we view currencies in Russia, Hungary, Israel, and Malaysia as positively positioned. We will watch the speed of normalisation carefully.

China's apparent slowdown plays a substantial role in the level of economic activity we see in the emerging markets. The results of China's dual circulation strategy are becoming more visible; though export volumes in emerging markets continue to correlate with China, those relationships are becoming less clear. Where China clearly imports – Australia, Korea and Malaysia, for example – the relationship remains clear, while import substitution increases vulnerability elsewhere. This slowdown also suggests that emerging market inflation may be peaking, though reopening means mean that growth can continue to surprise positively. With emerging markets offering positive real rates, there is increasing potential for selected currencies to perform well.

Central to this thesis is our view that we see a move in core rates. How – and which – emerging markets respond is a function of domestic inflation. We see a linkage between local rates and Treasury yields that depends on domestic inflation: in an environment where Treasury yields are rising, stronger countries tend to outperform, although the link varies depending both on the degree of openness in an economy and the composition of exports. For example, Russian rates are more insulated than Brazilian rates. This reaction function matters because emerging market central banks have been busy raising rates, and are expected to continue doing so for a considerable time. We see mid-cycle tightening as the most positive phase for emerging market currencies. In positioning for normalisation, we are seeking to be long emerging market currencies with a small bias towards more credible central banks. In rates, we remain quite short domestic duration through our Treasury and CE3 exposures.

HARD CURRENCY: BETTER THE DEVIL YOU KNOW?

In last quarter's Emerging Market Debt Strategy paper, we proposed that emerging market hard currency sovereign debt was entering a more challenging period, with much of the easy return already priced in. Noting that the market offered attractive spreads from the top down, the team highlighted that closer inspection found value more elusive; thus we began to take profits and reduce risk in some less liquid, higher-yielding names. Fast forward a quarter and little has changed: spreads have moved in a narrow range, with the JPMorgan – EMBI Global Diversified Index grinding a little tighter.

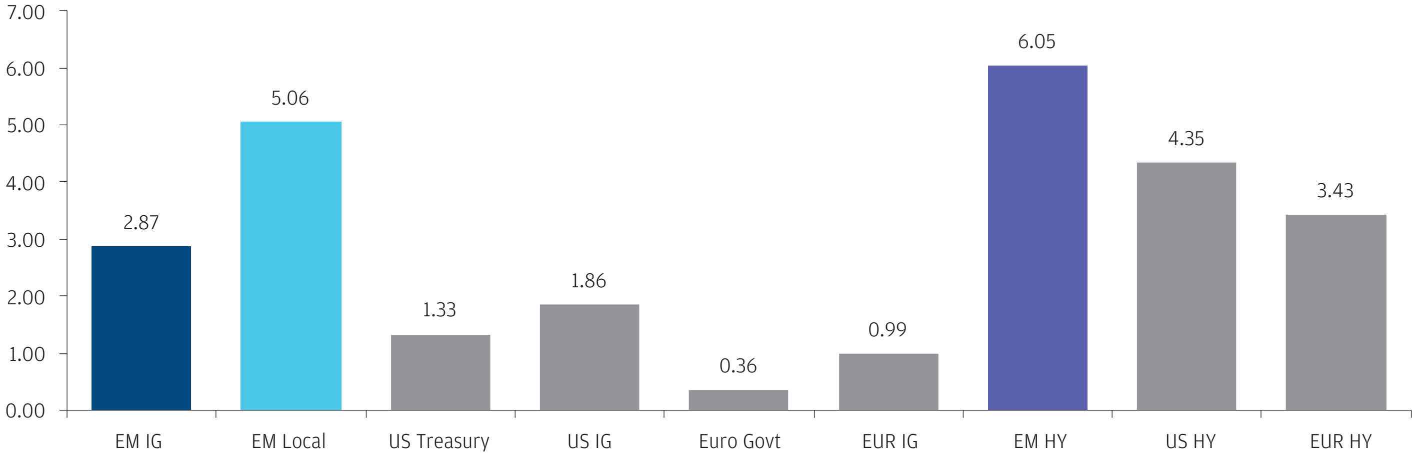
While in some places, emerging market debt appears ripe for patient, long-term money to find opportunities, performance across much of the asset class will depend on continued inflows from yield-hungry crossover investors. Since last quarter, the available premium in investment grade has shrunk under the weight of flows targeting investment grade bonds. Emerging market investment grade spreads have revisited tights not seen since the beginning of the pandemic, with over half of the investment grade issuance in the JPMorgan EMBI GD Index now trading tighter than pre-pandemic levels. The remaining 65% that trades wider is heavily weighted towards higher-yielding issuers.

The relative appeal of the income offered by emerging market high yield is obvious: it presents nearly all the opportunity in the space currently (**EXHIBIT 2**). Emerging market sovereigns currently outspread developed market peers by a factor of two in both the BB to BBB and B to BB ranges. But below the headlines, valuations in emerging market high yield are more idiosyncratic, with weaker fundamental stories, such as South Africa and Brazil, contributing heavily to the wide spreads. The question for investors is whether these stories can sustain their appeal to the marginal allocator as the investment grade premium reduces. With spreads at 344 basis points (bps) over Treasuries, the broader hard currency space offers a little more income than in June, when the post-crisis tight was 330bps. Investor perception of global risk becomes a key question: a more stable US Treasury market will encourage more crossover flows into the space, while more idiosyncratic issuer variance may reduce interest.

Our base case scenario is for a steady recovery from the pandemic in both the developed and emerging world, with an improving export environment having a positive impact on emerging market hard currency returns despite a slowdown in China. We are looking for low- to mid-single-digit returns over the next 12 months, and that estimate increases with reopening. Conversely, a further pandemic slowdown could impair the story, especially with so much of the opportunity in higher-yielding segments. In our view, being selective makes sense. For this reason, we choose to focus on countries with clearer credit stories and catalysts, such as Ukraine, Egypt, Nigeria and Kenya. We are more sceptical of Bahrain, Oman, Turkey and El Salvador.

Emerging market debt continues to offer a yield premium to developed markets.

EXHIBIT 2: INVESTMENT GRADE AND HIGH YIELD BOND YIELDS (%)



Source: J.P. Morgan Asset Management, Bloomberg; data as of 7 September 2021. US Treasury = 10-year bond. US IG = JPM JULI 7-year. Eurozon Gvt = 7-year bond. EUR IG = JPM EU Corporate Bond 7-10 year. EM Local IG = weighted average of IG countries in JPM GBI-EM Global Diversfied Euro denominated bonds hedged to USD (3-month FX forward). Past performance is not a reliable indicator of current and future results.

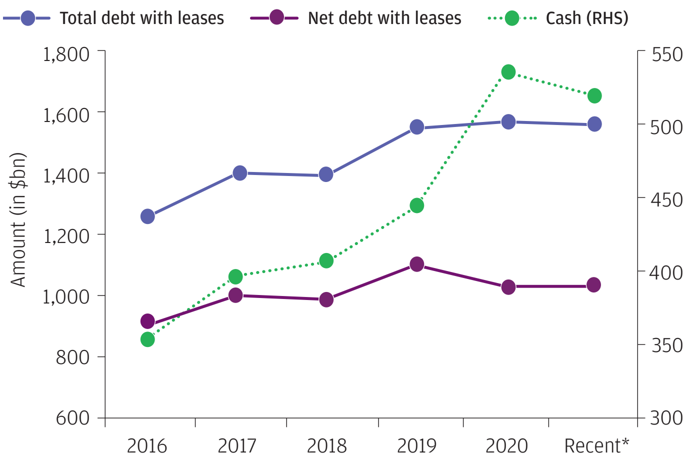
With the market polarised between higher quality and higher yield, we are reducing our portfolio beta, primarily by reducing risk in our single B sleeve, where we worry about the impact of potential slowdowns or shocks on weaker credits. We are closely watching our BB exposures, especially where levels are approaching our target prices.

EMERGING MARKET CORPORATES: ROBUST, AND PRICED ACCORDINGLY

In aggregate, emerging market corporate fundamentals have rarely been this robust. We expect strong full-year earnings, enabling leverage ratios to hit record lows. Emerging market corporate managements have generally been careful with their balance sheets and have put buffers in place, such as high cash levels, to withstand slowdowns (**EXHIBIT 3**). As a result, we see limited refinancing pressure outside of Chinese real estate, where government policy changes have impacted business models. More broadly, we see fewer systemic issues confronting corporates, with more challenged issuers tending to be more idiosyncratic.

Cash balances have increased significantly in recent years, suppressing leverage and boosting corporate balance sheets.

EXHIBIT 3: EMERGING MARKET CORPORATE CASH BALANCES



Source: J.P. Morgan Asset Management. Includes 126 companies covering c.55% of CEMBI ex financials universe. The estimates are calculated after aggregating JPMAM analysts' EBITDA growth rate expectations. *Recent indicates Q1 2021 data if available, else FY2020 data if Q1 2021 data is not available. Data as of 3 September 2021

We think the asset class will eclipse the pre-pandemic level of earnings before interest tax depreciation and amortisation (EBITDA) from 2019, while improvements in interest cover and declining leverage are evidence of further improvement in credit quality. This is all being reflected in credit ratings and leading to an improvement in the outlook for the asset class. We note that consensus default expectations have increased to 5.6%, but the bulk of this revision comes from Evergrande, the large Chinese property developer, and we see limited contagion risk. With access to markets and steady demand for incremental supply, we view default risk as manageable. Across emerging market corporates as a whole, we see risks in a potential commodity selloff, while the broader question of China also looms large.

Chinese policy changes that emphasise common prosperity and social equality have been important drivers of performance in credit markets in recent months. These changes focus on improving sustainability, reducing financial risks and containing leverage, while also containing monopoly power and enhancing oversight. We expect further regulatory changes to unfold next quarter, as a new regulatory reform law appears on track for introduction in the next three-to-six months. Not every company in China is impacted by this push, but a focus on common prosperity has put the government at cross purposes with a number of high profile Chinese companies.

At the same time, the government has launched an ambitious local finance initiative, allocating RMB 700 billion for special issuance “cross cyclical” projects. We think much of this theme will find its way into a 2022 National Party Conference on sustainability, which leaves us cautious around China's technology and real estate sectors. The introduction of a new regulation has already impacted cash flows and stressed credit metrics for Chinese real estate companies, especially for issuers such as Evergrande.

The crucial thing for investors to understand is that Chinese corporates are an issuer-specific, selection-led market. Regulatory change is likely to impact all sectors of the economy, but it will not necessarily impact each issuer with similar or equivalent severity. There are issuers with the ability to successfully navigate a way through this challenging period, but a critical question is whether we will be adequately compensated for the risks. Access is a further consideration; many of the names under pressure are the larger issuers, while the more defensive sectors are small and can be difficult to gain exposure to.

Valuations reflect this uncertain situation, which reduces the appeal of an otherwise strong story. While emerging market corporate high yield continues to offer a premium over investment grade bonds, the premium is only in line with historical averages. However, emerging market corporates do offer a material premium to developed market peers, especially in the investment grade sector – which also offers less leverage. This premium reinforces the appeal of emerging market corporates to the crossover investor, even if the space is not cheap relative to history.

While we favour higher-yielding instruments, we remain wary of exposure to Chinese high yield, where fundamentals remain challenged by regulatory change. So far, the spread spill-over to the rest of the emerging market universe remains contained, and we expect this to continue. We sometimes hear a narrative about China becoming less investable, but we expect the market will move past this concern so that investors are once again compensated fairly for the risks they are asked to take in both the technology and real estate sectors. That day may not be so far away.

CONCLUSION: BASE CASE REFLATION, WITH FATTER TAILS

At our quarterly meeting we updated the probabilities that we assign to our main macro scenarios (**EXHIBIT 4**). We reduced our base case "global reflation" expectation to a 50% probability, while we now expect greater tail risks, reflecting the current uncertainty around the global economy's direction of travel. In this distribution, our "growth headwind" scenario increases to a 20% probability from 10%, reflecting continued Covid challenges, while our "inflation" scenario increases to a 30% probability from 20%, given the potential for sustained inflation.

Without a clear roadmap to recovery, it is difficult to have a high level of conviction, especially towards the more richly valued markets. Increasingly, we are seeing price leadership from crossover flows, making the space vulnerable to potential outflows. We expect the emerging market growth premium to reach 140bps in 2022, though we acknowledge that this is low versus history, due to more robust developed market growth.

Looking across our markets, we see investors maintaining positions in investment grade bonds, likely reflecting the long-term structural impact of emerging market debt's greater index relevance; high yield bonds offer a sharp trade-off between quality and income. Against this backdrop, we see selected opportunities in those currencies supported by more credible local central banks, especially as a period of US exceptionalism gives way to a broader global recovery. That period of global recovery may derive some support from the global savings surplus that has accumulated through the pandemic.

We are more cautiously engaging with risk, using greater selectivity in higher yielding opportunities and disengaging from taking excessive risk. We are shifting from a beta to an alpha approach, seeking a greater contribution from security selection than asset allocation. In a more fully-valued world, we want to focus on rolling down curves, adding selected higher-yielding issuers chosen for quality and gaining exposure to currencies of resilient local economies that are benefiting from credible policymaking.

For our base case scenario, we favour selected high yield credit, payers in rates and relative value in currencies, while seeking to add receivers on dips. In our inflation scenario, we would seek to reduce portfolio betas, while moving short on currencies and paying rates. Should a headwind emerge, we would seek to lengthen duration while remaining engaged in selected risk assets. Though less certain of the pathway ahead, we believe that the combination of strong fundamentals, crossover appeal and strong technicals should lead to positive returns from emerging market debt in the medium term.

Our base case scenario remains reflation, but tail risks have increased since our last quarterly strategy meeting.

EXHIBIT 4: MACRO SCENARIO AND STRATEGY

	Scenario	Headwind	Base Case Reflation	Inflation
MACRO	Probability	20	50	30
	Growth	Further setback from COVID or China concerns	EM growth & EM-DM alpha bottoming cyclically	Recovery faster than expected
	Inflation	Inflation concerns ease only partially	Peaking, gradually declining in 2022	Inflation persistently above target
	Financial Conditions	Somewhat easier	Moving tighter	Faster policy normalization
	Policy Room	Modestly more room	Differentiation in policy sustainability	Less room
	Commodities	Weaker	Mixed performance	Stronger

Source: J.P. Morgan Asset Management; data as of 3 September 2021.

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