Q4 2022: Recession vs. Inflation

Emerging Market Debt Quarterly Strategy

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In brief

- Markets have entered a price discovery period as central banks exit accommodative monetary policies. We have also entered a period of mild US exceptionalism, amid a recession in Europe and a slower-than-expected Chinese recovery. The result is a structurally higher volatility environment.
- We see inflation as less of a directional concern in 2023, although the standard of living debate has now moved fully into focus. We expect financial conditions to continue to tighten in the near term, with quantitative tightening a contributing factor.
- Against this backdrop, emerging markets are showing resilience: growth is holding up, and corporate fundamentals are strong. Our base case scenario for the remainder of 2022 is a soft landing, where emerging markets achieve a 3% growth premium over developed markets, with Chinese growth at 3%.
- Based on our soft landing scenario, we continue to favor EM local rates over hard currency credits as our preferred exposure.

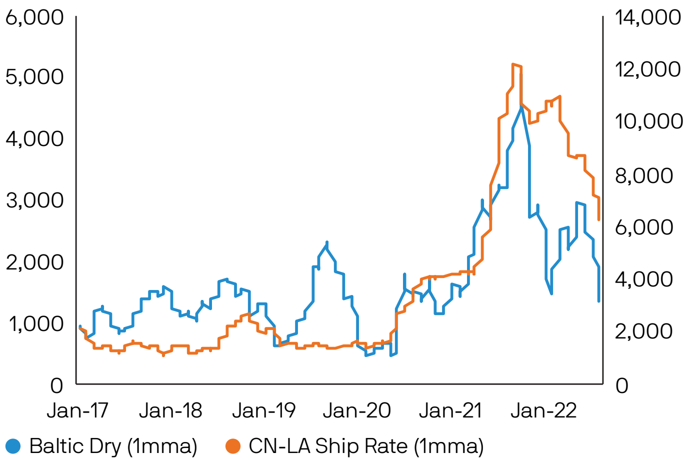
The global backdrop: Tighter financial conditions to continue

The global economic backdrop remains finely balanced as far as emerging markets are concerned. We see the probability of a US recession rising in the second half of 2023, which would likely mean a global recession, although we think the downturn might be mild and resemble 2001 rather than 2009. Our soft landing base case scenario for emerging markets does include a deeper European recessionary event in the first half of 2023, although a European downturn should be a more contained event globally. By comparison, we see Chinese growth accelerating in 2023.

We expect US inflation to roll over in the coming quarter. The evidence of easing from manufacturing channels and commodity prices suggests US inflation has already peaked (**Exhibit 1**). We note that US gasoline prices have fallen materially beneath the USD 4.30/gallon level, below which the commodity contributes to deflation. Core goods prices remain high but appear to be rolling over.

Higher frequency data reinforces the easing trend in economic activity

Exhibit 1: Baltic Dry and China-Los Angeles Shipping Rate



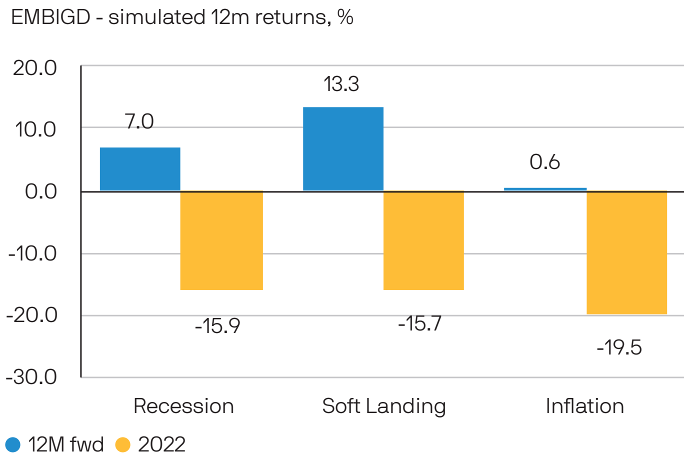
Source: Bloomberg, J.P. Morgan Asset Management; data as of September 2022.

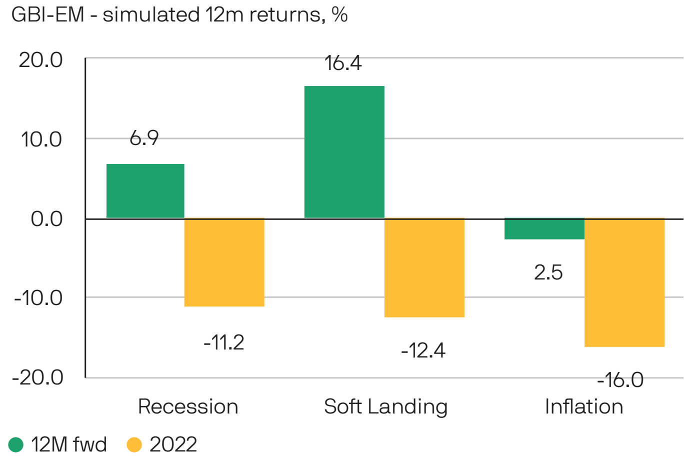
Core inflation may be stickier, due to the contribution from shelter and wages. US labour markets remain extremely tight, with unemployment very low. As a result, wage growth continues to increase. Nevertheless, we expect both the core personal consumption expenditure (PCE) index and the consumer price index (CPI) to decline to month-on-month levels of between 0.3% and 0.4% into the first half of 2023.

Given our base case for moderating inflation and a soft landing, our assumptions suggest the JPMorgan GBI – EM index could deliver returns of 16.4% on a 12-month forward basis, with hard currency sovereign returns (JPMorgan EMBIGD) of 13.3% over the same period (**Exhibit 2**). A recession scenario would deliver milder results, with both hard and local currency assets returning around 7% according to our simulations (all returns in US dollar terms).

Our base case expects economic weakness to be front loaded, while our inflation scenario is the most challenging

Exhibit 2: Simulated Return Analysis Based on Economic Scenarios





Source: J.P. Morgan Asset Management; data as of September 2022. Scenarios reflect simulations based on assumptions, not forecasts.

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Rising Treasury yields and a stronger dollar

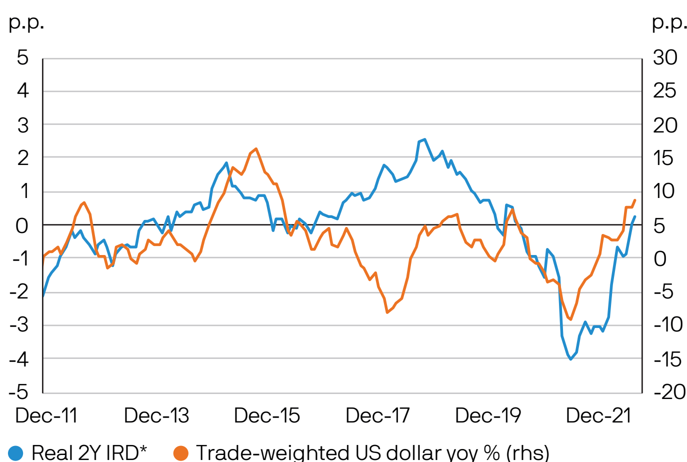
Despite easing inflation pressures and an already substantial tightening in US financial conditions year to date, we think the Federal Reserve (the Fed) will continue to apply pressure to cool the economy. Lower inflation, in turn, will help lift the real Fed Funds rate. We note that a 4% terminal rate would leave the real policy rate at 1.25%-1.5% by the end of 2023. That level would be consistent with levels we saw in 2018, though insufficient for prior cycles. Quantitative tightening remains in play and will become more relevant when we reach terminal rates.

We expect rising yields and tighter monetary policy in Europe to put further upward pressure on US yields. Our base case soft landing scenario looks for the US 10-year Treasury yield to rise by the third quarter of 2023. However, a recession scenario – our bear case – would see the US 10-year yield fall to 2.7%, from a third-quarter 2022 high of 3.38%. Our inflation scenario, on the other hand, sees US 10-year yields reaching 4%.

Against this backdrop, we think trade-weighted US dollar strength can continue in the near term. On a trade-weighted basis, the dollar has continued to strengthen in the third quarter, and we think this is likely to continue at least until a Chinese recovery becomes more visible. The European Central Bank's (ECB's) reaction to inflation may also pull interest rate differentials to a more neutral level, potentially cooling the dollar (**Exhibit 3**).

European Central Bank action has the potential to dent real US interest rates and cool the dollar

Exhibit 3: US Dollar vs. Real Interest Rates



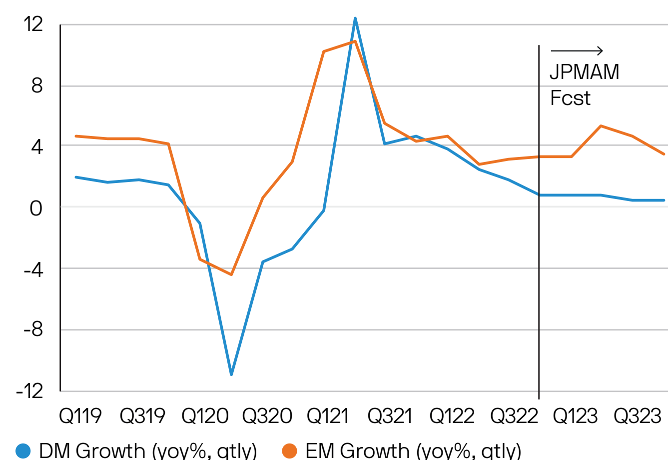
Source: Bloomberg, J.P. Morgan Asset Management; data as of August 2022. IRD*: US – Eurozone and Japan real interest rates.

Emerging market growth alpha is set to normalise

For emerging markets, we think the global economic backdrop will lead to a gradual normalisation in the EM-DM growth alpha, which measures the difference between emerging market (EM) growth and developed market (DM) growth (**Exhibit 4**). Helped by resilience in Asia and supported by an expected improvement in Latin American growth in the second half of 2023, the EM-DM growth alpha should reach 2% in 2023 – a level that is more consistent with the historical average.

EM-DM growth alpha should normalise gradually heading into 2023

Exhibit 4: EM-DM Growth Alpha



Source: Bloomberg, J.P. Morgan Asset Management; data as of September 2022. Forecasts are not a reliable indicator of future results.

We think emerging markets will do better in a recession or soft landing, and worst in an inflation scenario. Our analysis of US recessions since 1996 suggests that the EM-DM growth alpha could actually be most positive against a backdrop of global recession, which gives us some confidence in emerging market fundamentals. In a deeper recession, we think the EM-DM growth alpha could be as high as 3.5%, falling to just 2.6% in an inflationary scenario.

However, variations in emerging market growth sensitivity will become more apparent, both because of tightening liquidity conditions and the developed market slowdown. We think the most resilient emerging market economies are those that are both linked to Asia and largely closed – for example Brazil, Chile, Indonesia and India. More open economies appear more vulnerable to changing conditions – for example, those in central and eastern Europe, and Mexico.

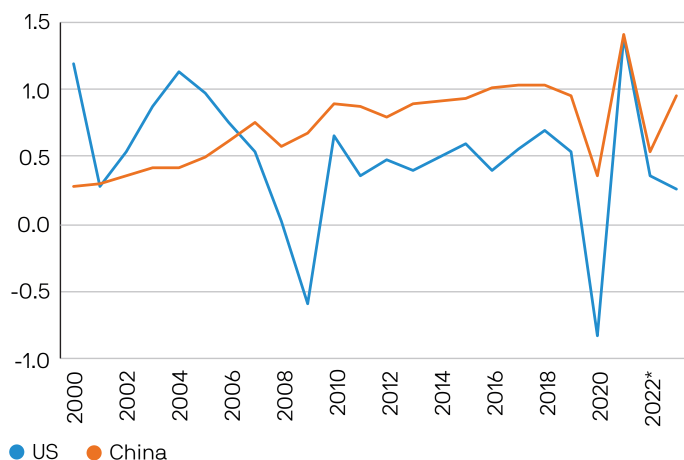
China: Improving growth but lingering tensions

The outlook for China remains key for emerging markets. We see stable local Chinese rates, improving growth and some tail risk protection, though valuations are stretched. We expect the renminbi to trend weaker. In the credit space, we prefer shorter-dated investment grade credit, especially state-owned enterprises. In high yield, we see selected opportunities with manageable near-term risk.

2023 should see a growth improvement, with the October party congress a key catalyst. Following this year's more subdued performance, we expect to see Chinese growth recover from 3% in 2022, potentially reaching 5% in coming quarters, with China's contribution to global GDP rising again (**Exhibit 5**). This view is contingent on the outcome of the upcoming party conference, a potential end to the zero Covid policy (which may not occur until March), and policy responses to the real estate stresses that currently impair consumer confidence and consumption.

Emerging markets have already seen decent outflows

Exhibit 5: Contribution to Global Growth Using Consensus GDP



Source: IIF, IMF, Bloomberg; data as of September 2022.
2022*: forecast.

Fiscal support takes the strain

China would be expected to continue to favour new economy sectors and infrastructure with its policy response. With this in mind, China has recently implemented both fiscal and credit measures to prevent a fiscal cliff in the coming quarter. Modest monetary easing is also in place to accommodate funding requirements and re-leveraging, and monetary policy appears ample to manage systemic risks.

While we see rates anchored to support growth in the coming quarter, a gradual acceleration of inflation, along with a focus on targeted fiscal measures and a material rates differential with the US could all help to limit potential rallies. We expect to see the renminbi weaken against the dollar in the coming quarter, with the currency moving more gradually within the China Foreign Exchange Trade System (CFETS) basket.

One concern has been the banking system, where profitability is being negatively impacted by a property market downturn. However, we see limited risk from the ongoing challenges in real estate and believe the system remains solvent and capable of normal operations. While declining returns on assets may be a problem for some smaller rural and city banks, the larger, more systemic institutions are less likely to be impacted.

We do, however, expect tensions with the US to remain elevated following the recent visit to Taiwan by Nancy Pelosi, the speaker of the US House of Representatives. It is possible some tariffs on low tech consumer goods could be reduced, but this will not reduce the pace of "friend-shoring" technology production. The recently passed US CHIPS act may also increase pressure on multinationals to relocate the production of "strategic" products away from China.

Emerging market resilience: Not every country is the same

While emerging markets have been broadly resilient to successive shocks, some remain more vulnerable than others. With median growth trending above 2019 levels, we expect emerging market debt and fiscal deficit levels to decline overall. While credit ratings have reflected these improving fundamentals, with several upward revisions in the most recent quarter, we expect credit rating adjustments to become more balanced.

Challenging external financial conditions render countries with larger external financing needs more vulnerable. Energy importers may enjoy some marginal relief next year, as commodities roll off their highs, although a decline in price does not help everyone equally. That said, we think the worst of the cycle's sovereign defaults are now behind us, with International Monetary Fund programmes more sufficient than necessary.

Most countries do not need a major fiscal adjustment

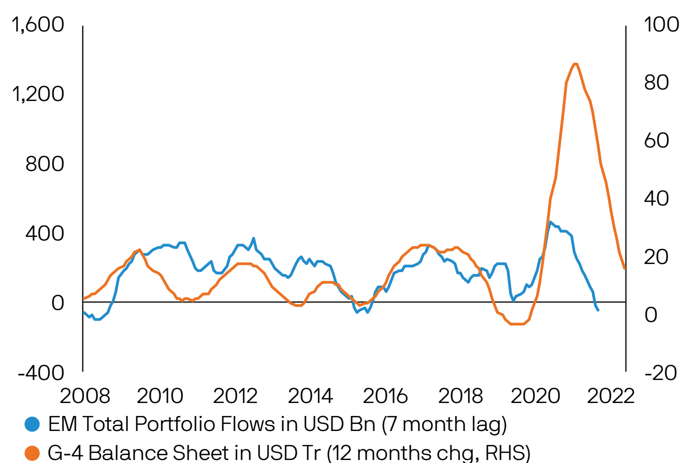
Some emerging markets will have to weigh monetary adjustment (quantitative tightening) against fiscal restructuring. We think larger monetary adjustments will be more challenging given the prevalent external conditions and could be more negative for local rates and currencies.

On the plus side, monetary space has been created versus developed market peers. Emerging markets have already seen decent portfolio outflows (**Exhibit 6**), suggesting a degree of tightening has been priced in, while most emerging markets are now looking for inflation to roll over. A recovery in tourism will also help some countries.

For us, the winners include South Africa, Mexico, Oman, Angola and the UAE. Those facing challenges include Turkey, central and eastern European countries, Ghana, Kenya, El Salvador, Egypt, and Colombia.

Emerging markets have already seen decent outflows

Exhibit 6: Emerging Market Portfolio Outflows



Source: IIF, IMF, Bloomberg; data as of September 2022.

Strategy and positioning

With a potential US recession looming, local rates remain our preferred asset class. We remain cautious on emerging market currency (EMFX), and are becoming more selective in credit, with a bias towards higher quality. We see selective opportunities in high yield credits.

Emerging market local currency

We are positioning our strategy for a coming US recession, though we remain mindful that inflation may be peaking. Hence, we begin the quarter in a defensive position but are beginning to turn more positive on duration in local rates, while continuing with a negative bias towards EMFX. Our preference is to be long dollar, though we see selected relative value opportunities.

- Local rates: We conclude that we have reached a pivot on receivers, where we recommend hedging potential volatility with developed market rates while waiting for confirmation. In addition, we want to play peak inflation names and the long end of high-quality investment grade names to protect against recession.
- EMFX: Directionality remains strong in the US dollar, given the challenging outlook for the euro and renmimbi. This creates a complex backdrop for EMFX more generally. Hence, we retain our long dollar bias, funded by shorts in lower yielding Asian and euro-linked currencies. We balance this view with tactical longs in the Brazilian real, Indonesian rupiah or Mexican peso.

Emerging market hard currency sovereign credit

We think sovereign fundamentals are sufficient to manage a mild recession. We see a positive technical position, with sentiment negative and positioning defensive. We think valuations have a floor, supported by crossover inflows that have been buying price weakness. We prefer cheaper high yield to more expensive investment grade, which we believe will be negatively impacted by rising US Treasury yields. Our intention is to be overweight BB names against single A, while using rallies to move closer to home. We prefer Iraq, Nigeria and Ivory Coast over Turkey, Egypt and Kenya.

Emerging market hard currency corporate credit

Fundamentals appear strong, with corporates well positioned to withstand headwinds, although technicals remain negative. Emerging market corporates have generally exhibited good capex discipline, using cashflow to pay down debt. Leverage levels are at historical lows, and likely will not get much better form here. We think emerging market corporates are well positioned to handle currency weakness, though there are exceptions.

Strong fundamentals should provide resilience, should the expected economic recovery not unfold, although commodities – especially metals and mining – would be most exposed. Critically, we think the banking sector is in solid shape. with systemic risk contained. We note that ratings have stabilised, with 82% of our issuers on stable or positive outlooks. We are generally wary of high yield, with a focus on bottom-up stories. We use selection to avoid weaker balance sheet and illiquid bonds.

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