Q4 2023: Between fire and ice

Emerging Market Debt Quarterly Strategy

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In brief

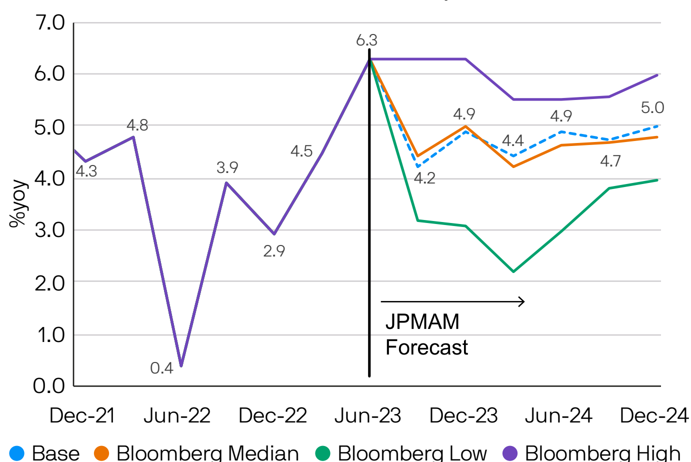
- Sub-trend growth remains our base case scenario but with larger tail risks amid ongoing US exceptionalism. We expect the US to slow down into 2024 and should see higher emerging market (EM) – developed market (DM) alpha given EM growth resilience.
- We lowered our full year GDP forecast for China from 5.3% to 4.9% and also long term Chinese GDP growth projection. We expect the combination of monetary, fiscal and credit measures to put a floor on near term Chinese growth.
- EM local rates continue to be our preferred opportunity while we are less constructive on EM foreign exchange (FX). As the US approaches terminal rates, we look for more EM central banks to begin cutting rates. We continue to remain selective in hard currency sovereign and corporate markets.

We expect sub trend global growth in the fourth quarter. The US economy appears to be cooling into 2024, while we see Europe and China both showing signs of stabilisation over the same period. In the near term, risks are skewed towards stickier inflation, where residual strength in the US consumer sustains a more hawkish Federal Reserve (Fed), higher Treasury yields and a stronger dollar. We think there is limited upside to activity in both Europe and China but tail risks remain meaningful.

We lowered our 2023 full year estimate for Chinese GDP from 5.3% to 4.9%, though we believe that policymakers will succeed in putting a floor on growth. Swift action by the People's Bank of China (PBOC) in the previous quarter should help, while support for real estate has become more effective. Taken together, these steps should enable China to achieve our growth target for next year. In the interim, the currency needs to weaken, which is a process that the PBOC will act to smooth.

Growth Assumptions – US exceptionalism not expected to last into 2024, but timing remains uncertain

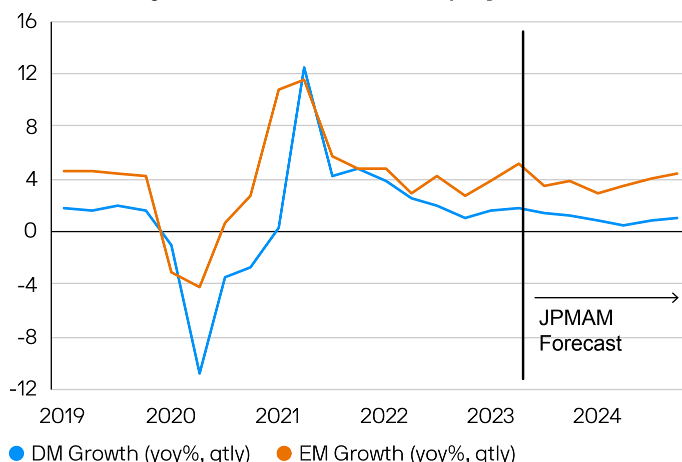
Exhibit 1: China – slowdown but not a collapse



Source: J.P. Morgan Asset Management, Bloomberg.
Data as of 5 September 2023.

EM Growth – EM-DM alpha to improve in 2024 on EM resilience amidst DM slowdown

Exhibit 2: DM growth to decelerate more rapidly vs. EM



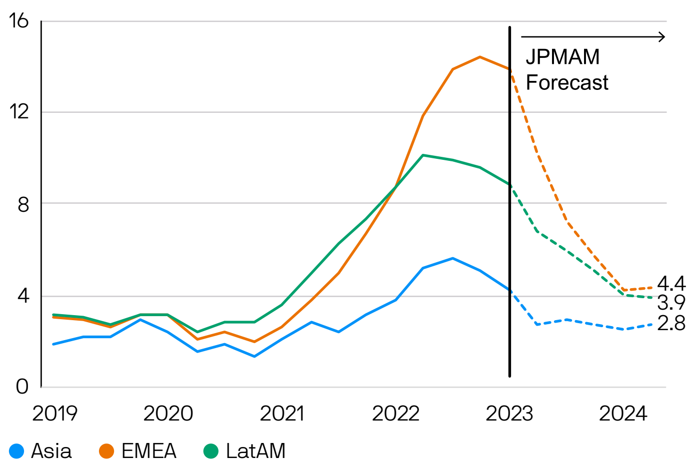
Source: J.P. Morgan Asset Management, Bloomberg.
Data as of 5 September 2023.

Until growth returns, we think Chinese credit will be challenged, though we like a long Chinese rates bias as a tail hedge. Importantly for global investors, we think China's future growth is slowing, consistent with long-term issues with demographics, deleveraging and decoupling. We note external studies suggesting that China's potential growth is headed for 3.0-3.5% per annum in the second half of this decade.

We see EM growth alpha – the difference between EM and DM growth – improving into 2024. This is powered by Chinese stabilisation and a broad based EM growth recovery. We think an economic cooling on the DM side should help to accentuate this alpha. Crucially, EM continues to experience a more rapid decline in inflationary pressure, which gives local central banks more space to cut rates. Many will wait for the Fed's signal before doing so, suggesting we may see higher terminal rates this cycle.

EM Cycle – below potential growth and past peak headline inflation

Exhibit 3: EM inflation (%YoY) has now peaked in all regions



Source: J.P. Morgan Asset Management, Bloomberg. Data as of 5 September 2023.. Inflation country list: Asia (China, India, Indonesia, Thailand, Malaysia, Korea), EMEA (Poland, South Africa, Romania, Hungary, Czech Republic, Israel, Egypt), LatAm (Brazil, Mexico, Colombia, Chile, Peru).

At present, we see greater uncertainty around US growth compared to EM growth, despite increasing medium term concerns in China. China's slowdown will be somewhat mitigated through supply side adjustment, while trade flows have largely adjusted to China's focus on self-sufficiency. The EU may positively contribute to the demand outlook through a small recovery. We forecast 2024 EM GDP growth at 3.7% from 4.1% in 2023. In this phase of the cycle, we expect variable investor confidence, meaning that returns will be sensitive to revisions and surprises.

US disinflation appears on track to unfold in 2024 and we look for the US consumer to slow in the coming months. While the dollar appears overvalued to us, it is no longer so extreme and thus will remain sensitive to relative growth versus the rest of the world. EM central banks are therefore well positioned, with plenty of space to cut given present growth and inflation levels, though this process may not fun.

Fundamentals remain resilient for both sovereign and corporate issuers. A higher rates backdrop should bring more differentiation to the space, rather than broad concerns about fundamental erosion. We see primary deficits returning to pre-pandemic levels, while external financing needs remain low. South Africa, Mexico and Peru look like winners this quarter, while Indonesia, Turkey and Romania appear more vulnerable.

While our central scenario looks for 4-5% returns for the rest of the year, we hold less confidence in our forecasting given rising tail risks. Sticky inflation remains the most challenging bear scenario for the asset class, as it could lead to higher Treasuries and a stronger dollar – outcomes which could tip performances into negative territory for hard and local currency alike. A recession scenario also threatens lower returns, but some downside is offset by a potential rally in core yields.

Higher tail risks play out in different ways for different assets. In EM hard currency, we see sovereign spreads pricing in a benign outlook. Recession risks warrant more caution around high yield issuers, though we note that an extended late cycle may cause them to continue to perform. In local currency, we think the easy part of disinflation has passed. As a result, we need to be more selective around real rate opportunities against a more challenging and complex EM FX backdrop.

Exhibit 4: EMD roadmap Q4 '23: Macro scenarios and strategy

	Scenario	Recession	Base Case sub-trend	Stickier inflation
Macro	Probability	30	45	25
Macro	Growth	Slowing sharply	EM-DM alpha improves China stabilizes, EMxCN recovers US slows	Improving US and RoW growth
Macro	Inflation	Falling	Continued decline	Inflation decline insufficient or rising again
Macro	Financial Conditions	Tighter first, easier later	Bias for looser conditions	Tighter with higher macro volatility
Macro	Policy Room	Room for cuts	EM cutting cycles continue, though terminal rates above historical lows	Cutting cycles priced-out or potential hikes
Macro	Commodities	Weaker	Range-bound Metals more vulnerable than oil	Increased volatility
Strategy	Beta	Long core duration	Long duration, focus on CB cuts Remain engaged in carry	Short Beta Long cash
Strategy	Sector View	From Credit to Duration Cautious on risk assets (HY credit & EMFX)	Receive high real yield EM Long EM Credit selectively Carry EMFX, USD neutral	Short EMFX, USD long UW HY credit Pay rates

Themes for 2H 2023
EM-DM growth alpha stabilizing with upside risk with China bottoming. Supportive for EMD
Risk parity returns as inflation more controlled and duration cheaper
EM CB cutting cycle supporting front-end and belly rates
EM Credit provides selective opportunities
Risks: Resurgent commodity prices, sticky core inflation, tightening liquidity **Risk Usage:** Medium & build FX vol and credit hedges

Source: J.P. Morgan Asset Management, September 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.

Outlook

While disinflation continues in EM economies, we are entering into a theme of central bank cutting cycles becoming the primary driver for EM rates. With inflation potentially bottoming, EM central banks have plenty of space to cut rates and prop up EM growth. As a result, we think EM fundamentals look good, supported by a steady growth outlook. Real rates are extremely attractive compared to historic ranges, which should attract some crossover support.

We retain our long duration bias and neutral EM FX view however, we are willing to short low carry FX. Stickier US inflation remains a risk and we are cautious in our selections, with a clear preference for rates over FX. However, we have priced in US exceptionalism and think that direction of travel is towards a soft landing. We intend to increase duration and short the dollar at some point in near term.

We continue with a conservative view on EM sovereign amid global macro uncertainty, volatile investor sentiment and tight valuations. Technicals are supportive due to low issuance, which has partially offset outflows so far this year, but could deteriorate given an expected increase in primary market activity. Investment grade plus BB spectrum continue to offer attractive yields though spreads remain relatively tight. We see more value in single Bs and distressed credits, which have outperformed in recent months, but these segments remain more vulnerable to both tail risks and swings in investor sentiment. Investors will likely continue to favour countries with resilient fundamentals, but the overall flow picture is likely to remain challenging as we approach terminal rates in the US and elsewhere. We therefore intend to maintain our selective approach to risk taking in the sovereign space.

EM corporate fundamentals should remain resilient despite weakening earnings momentum on the back of slowing economic growth and lower commodity prices. However, we see a divergence in growth outlooks across countries, sectors and issuers and therefore expect balance sheet strength to be prised by investors. Higher refinancing rates could challenge some issuers around debt servicing, potentially contributing to an increase in default rates; much of the corporate universe should be able to service their debt without issue.

China's macro weakness impact should be limited to a narrow range of Asian names and sectors like metals and mining. However, geopolitics and policy uncertainty in China remain risks to monitor for broader markets.

Other key challenges for the sector are an extended higher rates environment, which would likely put downward pressures on ratings, and a deeper global recession which would probably weigh on earnings growth. Whilst carry is attractive, spreads are relatively tight, especially for fundamentally well positioned issuers. Against this background, we intend to maintain our cautious positioning, preferring defensive and recovering sectors.

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LV-JPM54526 | 09/23 | 09ja230410143938

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