Between a soft and firm landing Q3 2024

Emerging Market Debt Quarterly Strategy

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In brief

- Emerging market (EM) growth remains resilient, with the difference in growth relative to developed markets expected to continue to be above historical levels.
- EM disinflation is bottoming out, but there is still plenty of room for some EM central banks to cut interest rates given high real rates.
- Our base case remains for a soft landing in developed markets. Firm global growth with an asymmetry towards eventually lower core rates should be positive for EM assets.
- A soft landing scenario still has the potential to generate high single to low double-digit returns across EM markets for the remainder of 2024, driven by a combination of positive contributions from core duration, spread, and foreign exchange (FX).

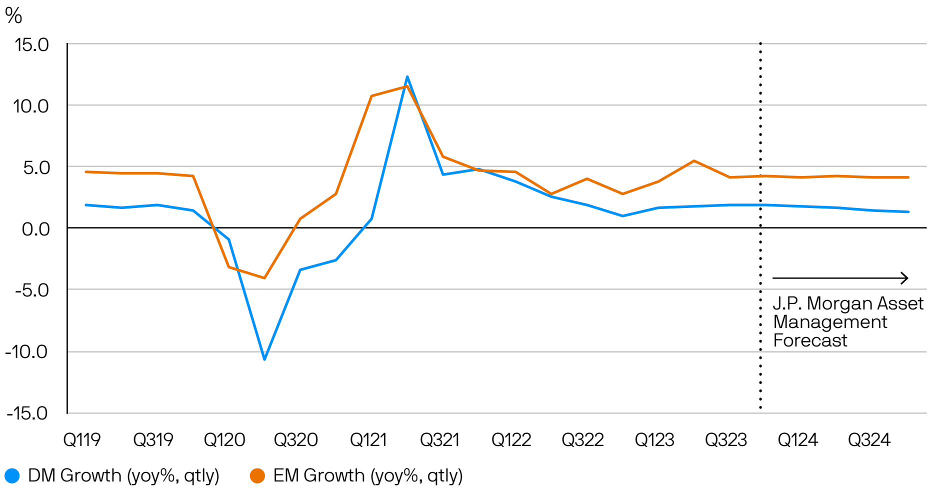
Positive growth backdrop, but uncertainty on the timing of easing cycles

Emerging market (EM) fundamentals remain resilient against a backdrop of firm global growth, but uncertainty over the timing of easing cycles may limit the performance of EM assets. While Asian growth is projected to be healthy, growth is picking up from a low base in Latin America, and in Europe, the Middle East and Africa (EMEA).

We have revised up our EM growth forecast to 4.2% from 4.0% last quarter. We are seeing a gradual normalisation of growth in the European Union and have revised our forecast up. In contrast, US growth is expected to be on the slower side compared to 2023. Overall, our forecast for the differential between EM and developed market (DM) growth–the EM-DM growth alpha–remains unchanged from last quarter at 2.6%, which continues to be above historical levels (**Exhibit 1**).

EM growth continues to be resilient and the EM-DM growth alpha remains above historical levels

Exhibit 1: EM-DM Growth Alpha



Source: J.P. Morgan Asset Management, Bloomberg; data as of June 2024.

The bulk of EM disinflation is now done and inflation is no longer the tailwind that it was. Inflation is moving sideways in a number of EM countries and regions such as EMEA may also face some upside risks. In particular, some central European countries are mainly driving European inflation. Although the disinflation process has stalled, some EM central banks still have plenty of room to cut interest rates, especially compared to the recent hawkish re-pricing of rates. However, the timing of rate cuts from the US Federal Reserve may limit the size and pace of EM easing cycles.

China GDP upgraded

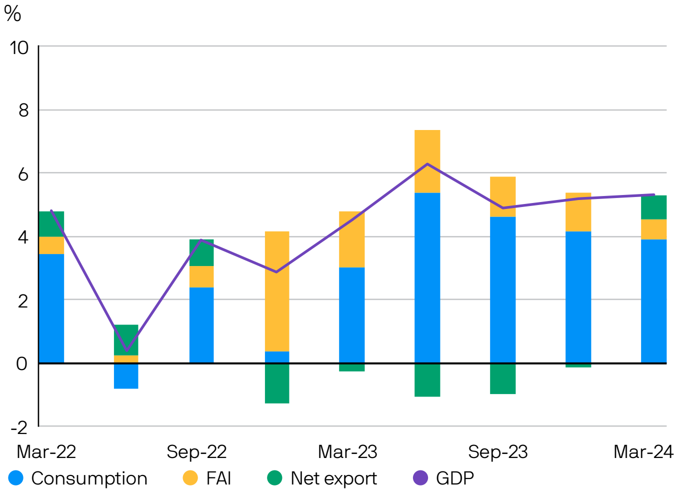
We have upgraded our 2024 GDP forecast for China to 5.0%, from last quarter's 4.8%, on the back of better-than-expected first-quarter net exports and recent policy support for the housing market, which limits downside risks. For the full year, we expect exports to be a positive contributor to GDP, supported by resilient global demand and a new technology cycle, driven by investment in artificial intelligence. Consumption data remains resilient, with tourism-related spending and electric vehicle (EV) sales continuing to be the key supporting pillars for the Chinese consumer (**Exhibit 2**).

The housing market has continued to underwhelm, under pressure from weak sentiment due to falling home prices, although there has been a slight deceleration in the rate of decline in secondary house prices. China's central bank, the People's Bank of China (PBoC), recently arranged a CNY 300 billion relending facility for government home purchases and we expect more supportive actions from the government if current measures prove insufficient to stabilise the housing market. We will very likely see a pickup in home sales in June for seasonal reasons, but the future path of contracted sales is still highly uncertain.

Deflation in China is gradually fading, but is still contributing to global disinflation. However, the disinflationary impact of China's exports on DM inflation is increasingly threatened by new industrial policy decisions in the developed markets, including risks related to sanctions and tariffs. We expect some fiscal support from the government to support exporters faced with substantial tariffs (in the order of 50% or more). However, tariffs on Chinese exporters are expected to be limited to just a few sectors and not broad based. If the tariffs are not substantial, then Chinese goods will remain competitive.

China's first-quarter GDP outperformed on the back of strong exports

Exhibit 2: China net exports contribution to GDP



Source: J.P. Morgan Asset Management. Data as of March 2024.

Soft vs. firm landing scenarios

Year to date, EM returns have been more consistent with a firm landing scenario, which is more of a neutral scenario for EM assets. Any upside from here will come from the market moving towards a soft landing scenario, which is our base case. In the absence of any major economic shock, we believe the most likely scenario from here is for a soft landing to be achieved (**Exhibit 3**).

Our soft landing base case scenario could still generate high single to low double-digit returns across EM markets for the rest of the year, consisting of a combination of carry, duration and risk rally. While we have increased the probability that growth will reaccelerate to 10%, from 5% last quarter, this scenario remains a low probability tail risk. Given that we see recession as a higher probability scenario than a growth reacceleration, the risks of a US economic downturn appear to be mispriced. In the case of a US recession, EM returns would be expected to be low, but better than in a reacceleration scenario.

With EM central bank cutting cycles shortened by uncertainty around the timing of US rate cuts, we prefer to be selective in our long and short rates positioning, as idiosyncratic stories will likely have a higher influence on market beta.

The US dollar has stayed strong and carry trades have worked for an extended period of time. FX volatility has been low but is likely to pick up around the US election later in the year. Against this backdrop, we prefer to keep our FX engagement on the lower side and to be selective in FX carry trades as well.

In sovereigns, we prefer to buy sovereign credits where there is evidence of fundamental improvement and where there is incrementally more supply in the local market. And in EM corporates, with spread valuations stretched and the all-in yield looking attractive, we continue to rotate into quality carry names.

Our base case scenario is for a soft landing

Exhibit 3: EMD roadmap Q3 2024: Macro Scenarios and Strategy

	Scenario	Recession	Base Case Soft Landing	Firm Landing	Re-acceleration
Macro	**Probability**	20	45	25	10
	Growth	Slowing sharply	EM-DM alpha improves and US slows	EM steady US ~trend	US-led rebound
	Inflation	Falling	Continued decline	Insufficient decline	Rising again
	Financial Conditions	Tighter first, easier later	Looser	Tighter	Tighter with higher macro volatility
	Policy Room	Room for significant cuts	EM cutting cycles continue, though terminal rates above historical lows	DM cuts priced out EM differentiated, but less room	Hikes
	Commodities	Weaker	Range-bound	Supported	Higher
Strategy	**Beta**	Long core duration; favour front-end and belly	Long duration and credit risk	Reduce beta and focus front end quality carry; short core rates	Short Beta, short core duration Long cash
	Sector View	From Credit to Duration Cautious on risk	Receive rates where CB ease OW Credit and long EM FX bias	Receive selectively where CB ease OW Credit with barbell Long USD bias; EMFX carry	Short EMFX USD long UW HY credit Pay rates

Themes for 2H 2024
EM balanced between supportive macro and (geo)political risks
EM Local offering value in both FX and Rates
EM Credit remains anchored, but rotate into carry & quality
Lower engagement in EMFX with upside risk for vol
Risks: election risk, core rate volatility, geopolitical risk, tightening liquidity **Risk Usage:** Medium

Source: J.P. Morgan Asset Management, as of June 2024. 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.

EM local currency debt outlook

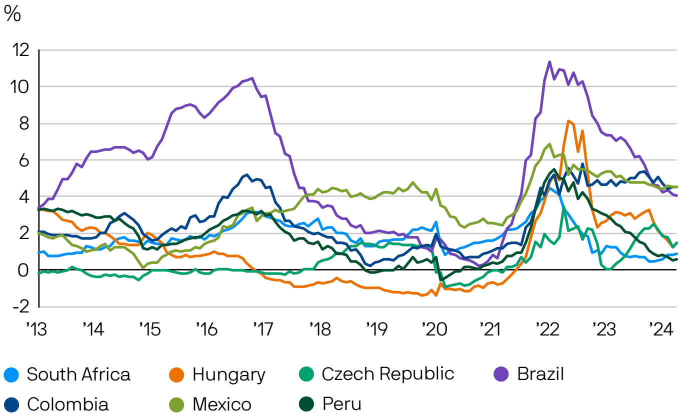
EM central bank cuts have been repriced in line with the higher-for-longer environment. Any inflation premium should now reduce as disinflation is bottoming out in a number of markets. As a result, valuations have improved, and real rates have risen at the front and back end of yield curves. The risk of reacceleration still exists and warrants some caution. Against this backdrop, we continue to be more selective, preferring countries where there is a real policy rate buffer and central bank support (**Exhibit 4**).

On the FX front, our conviction is on the lower side, given the failure of Federal Reserve rate cuts to materialise. FX volatility has been low but this is unlikely to continue ahead of the US election. Our bias remains for tactical long EMFX exposure depending on the speed of the US slowdown. We intend to focus on relative value trades, favouring carry and improving fundamental stories.

A slowdown in the US along with the upcoming election will be the key alpha drivers to look for in the third quarter. We are still in a higher for longer environment, with less US exceptionalism and a broader recovery. Idiosyncratic risk premiums will be a bigger theme and we will look to remain selective across rates and EMFX.

Some EM countries have a real policy rate buffer

Exhibit 4: real policy rates over federal reserve real policy rate



Source: J.P. Morgan Asset Management. Data as of June 2024

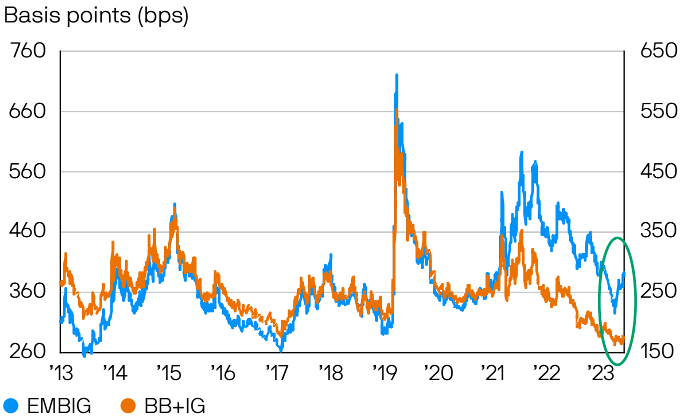
EM sovereigns outlook

A lack of inflows and tighter valuations hindered EM sovereigns. Nevertheless, investors continue to hold their long positions and are not willing to sell at current levels. As such, we think that higher for longer may not be necessarily a bad scenario for the sector given the high carry environment and resilient underlying EM fundamentals. Technicals are inversely proportioned to valuations and are looking strong. A number of countries are issuing in local markets, providing more stability for funding their outstanding debt. Absolute return expectations for the sector remain strong given the high carry environment. As a result, we continue to like diversified short duration carry baskets.

Spread valuations are tighter than last quarter. Investment grade securities continue to be expensive but are still attractive compared to their DM peers given higher yields and strong crossover participation. Specifically, BB rated names are slightly cheap compared to BBBs, and are looking attractive (**Exhibit 5**). There is also still value to be found in the single B and CCC segments. However, the contribution from these ratings will be smaller given their smaller index weight.

BB rated names are looking attractive

Exhibit 5: EMBIG vs. BB+IG



Source: J.P. Morgan Asset Management. Data as of June 2024

EM corporates outlook

Corporate fundamentals remain stable, with most sectors other than Chinese real estate still expecting positive EBITDA (earnings before interest, tax, depreciation and amortisation) growth in 2024. We expect the strongest earnings growth momentum in Asia, followed by Latin America. Earnings growth in central and eastern Europe, the Middle East and Africa (CEEMEA) is expected to be relatively flat year over year.

From a sector perspective, we expect more positive momentum in the consumer, utilities, oil & gas, and metals & mining sectors. Company balance sheets remain strong across all regions and most corporates have a buffer to absorb a higher rate and/or lower growth environment. Local currency markets, as well as both international and local bank lending, remain viable alternative funding sources for a large part of the universe, providing an additional buffer. However, in the event of prolonged rates stress, we believe 12% of high yield issuers, excluding the idiosyncratic names in Chinese real estate, would come under pressure. At this stage, we view this stress case as a low probability tail risk.

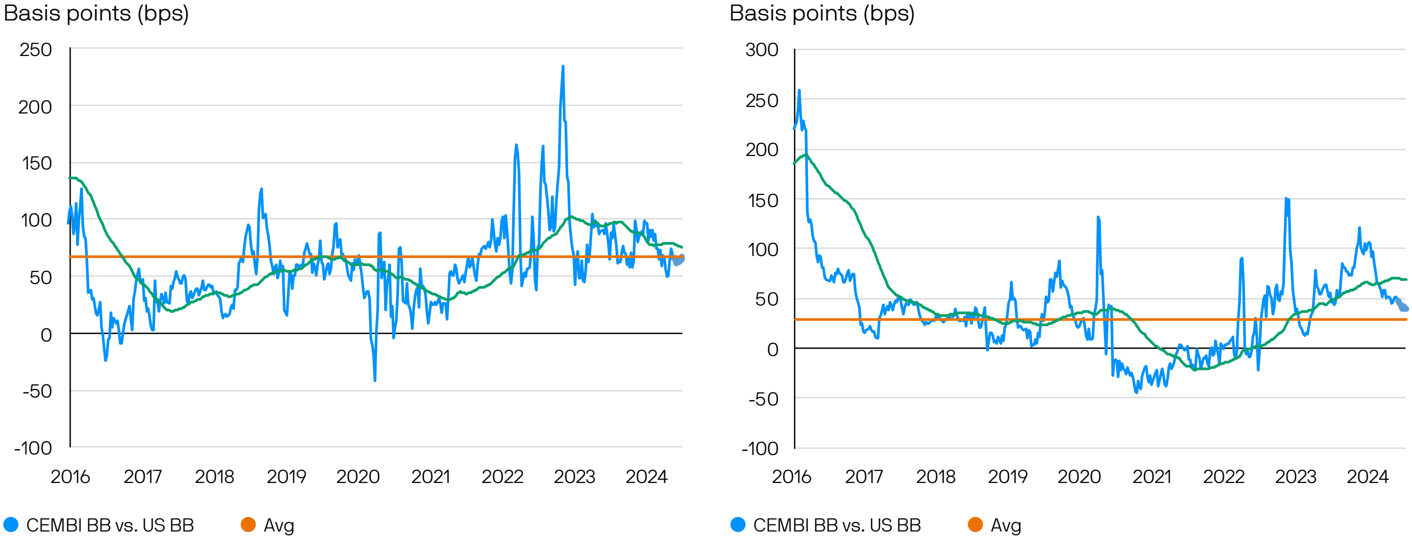
Overall, corporate index spreads are at historically tight averages, though in the EM high yield market the BB segment in particular may still have some room to tighten (**Exhibit 6**). We would also highlight that index duration has shortened and the quality component of the index has increased over the past few years, which if adjusted would see the index trading at tight levels rather than historically tight levels. Credit markets can remain in low spread ranges for extended periods, and the current overall yield is still historically attractive.

Our focus for next quarter will be on relative value and high conviction carry trades across regions. From a relative value perspective, we see the most value in Latin America, followed by CEEMEA and Asia.

The technical picture remains strong on the back of large negative financing, driven by Asia. Given a strong fundamental and technical picture, as well as an overall constructive view on global growth, we are comfortable with some duration exposure where we think there is adequate spread cushion. Overall, we are traversing close to the benchmark given the tail risks of a firm landing and a growth reacceleration. In the case of any pickup in inflationary pressures, we are well positioned with a current bias towards quality carry.

BBs offer better relative value

Exhibit 6: CEMBI BB vs. US BB and EMBI BB



Indexes used for returns and spreads: EM corporate debt = J.P. Morgan Corporate EMBI Broad Diversified; EM sovereign debt = J.P. Morgan EMBI Global Diversified; EM local currency debt = J.P. Morgan GBI-EM Global Diversified Composite Unhedged USD.

Indexes used for returns and spreads:

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EM Local currency debt: **J.P. Morgan GBI-EM Global Diversified Composite Unhedged USD**

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