Gradual normalisation

Emerging market debt strategy

Q4 2020

IN BRIEF

- Our base case scenario remains a "gradual normalisation," where the global economy slowly exits recession into 2021. China, which is ahead of the rest of the world in this cycle, continues to lead the recovery.
- Monetary and fiscal policies are likely to remain accommodative. While we expect the pace of easing to slow, there is ample slack in most economies and policy makers are mindful of tightening too early.
- Emerging market sovereign investment grade debt recovered relatively quickly and therefore carry will be the main driver of returns. Emerging market sovereign high yield, on the other hand, has plenty of room for spread compression, supporting the case for selective risk-taking.
- Emerging market corporate investment grade debt has (again) turned out to be more resilient than the rest of the emerging market debt complex, bolstering the view that the asset class is suitable for conservative investors with limited appetite for drawdown risk. Emerging market corporate high yield fundamentals also proved more resilient than expected, suggesting spreads have meaningful room to compress.
- The prospect of economic recovery, combined with low inflation and accommodative monetary policy, is a supportive backdrop for emerging market local rates. We are also constructive on emerging market currencies as the US dollar is expected to weaken.
- In the near term, risks are centred on the outcome of the US elections and the implications for global financial conditions. The fundamental tail risks are either an economic double dip, caused by stricter-than-expected lockdown measures mainly in developed markets, or a stronger-than-expected rebound of growth and inflation.

CHINA LEADING THE RECOVERY

Throughout the Covid-19 pandemic and related economic crisis, China has been ahead of the rest of the world. It was the first country to implement lockdowns and suffer the subsequent slump in economic output; it was the first to re-open and is now leading the economic recovery (**EXHIBIT 1**).

China has employed a multi-pronged approach that focuses on strategically important sectors, ensures liquidity in the banking sector and prevents local clusters for coronavirus cases from spreading to the wider community. Supressing the virus has been achieved by a mix of testing, quarantining arrivals from abroad and contact tracing. The strategy has so far been successful, allowing both the manufacturing and services sectors to get back close to pre-crisis activity levels.

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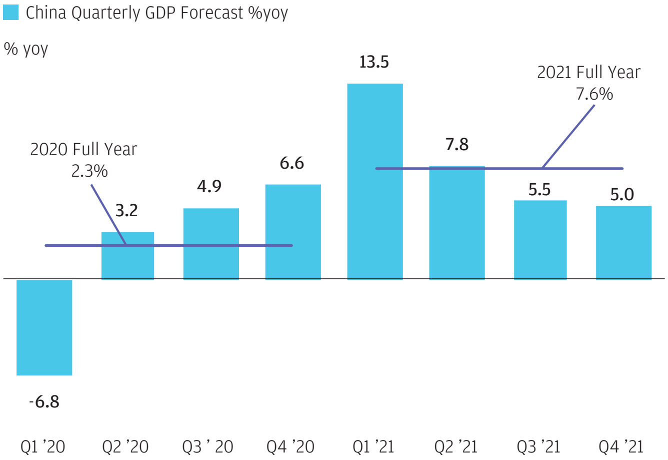
China's GDP is expected to rebound strongly in 2021 in our base case scenario

EXHIBIT 1: CHINA QUARTERLY GDP FORECAST, % YEAR ON YEAR



Source: J.P. Morgan Asset Management, Bloomberg, as of 12 September 2020. Opinions, estimates, forecasts, projections and statements of financial market trends are based on market conditions at the date of the publication, constitute our judgement and are subject to change without notice. There can be no guarantee they will be met.

Strategic sectors such as semi-conductors and electronics have been at the forefront of China's recovery, but more traditional industries, including construction, car manufacturing, power generation, aluminium and steel production, are also showing clear signs of recovery. China has also been supplying virus-related medical equipment to the rest of the world. The services sector has been slower to recover with purchasing managers' index (PMI) data suggesting activity returning close to 90% of pre-crisis levels.

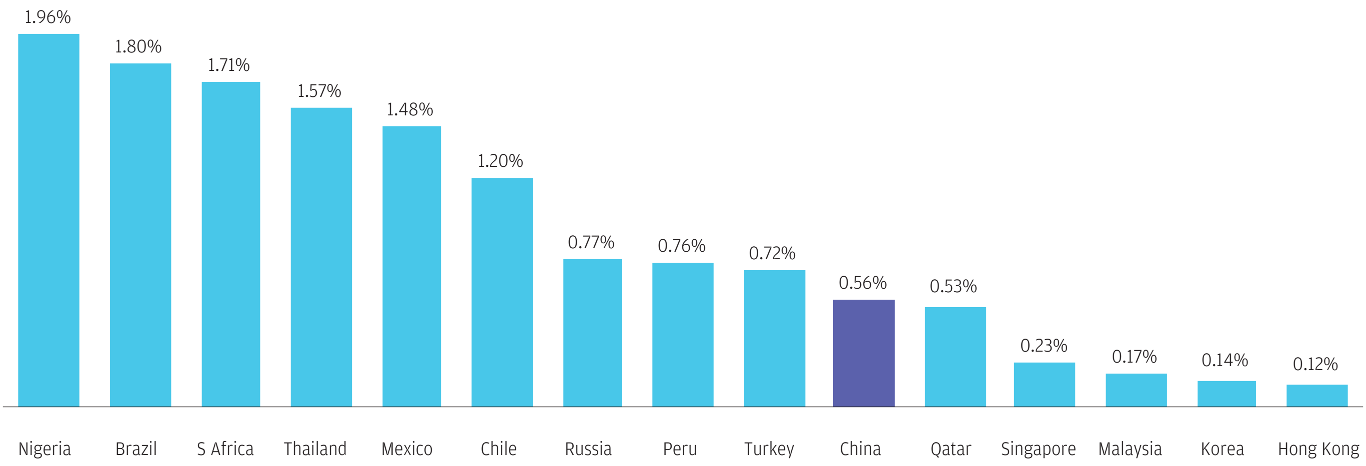
Importantly, supply- and demand-side recovery is positively impacting the labour market. In February, nearly 50% of urban employees were registered as employed but not working; by July this figure had fallen to almost zero.

This impressive performance is coming at a cost: the government actively used fiscal and quasi-fiscal spending to speed up the recovery, expanding total social financing (TSF) by an estimated 12% in 2020 and a further 12-13% in 2021. On a positive note, this is only two percentage points higher than in 2019 and significantly lower than in 2009, when TSF rose by 35%, which supports the view that China's monetary and fiscal transmission mechanism is much more effective now than a decade ago.

Nevertheless, the TSF-to-GDP ratio is forecast to increase to 280%, which raises questions about sustainability. The banking sector plays a key role because it ultimately reflects the health of corporate and private balance sheets. So far, credit deterioration looks manageable as the increase in non-performing loans (NPLs) has been within the range of expectations (**EXHIBIT 2**). The People's Bank of China (PBOC) has been keeping liquidity abundant, although it's been recently signalling a shift to a neutral policy stance. This could lead to an uptick in NPLs, but we believe the level would remain manageable. Some banks may have to use a mix of earnings and equity to write-off bad debt, while the large banks will continue to act as a backstop to the entire financial system.

Systemic risk in China's banking sector remains low

EXHIBIT 2: CREDIT CHARGE AS A % OF LOANS, 1H 2020



Source: J.P. Morgan Asset Management, Bloomberg, China Banking and Insurance Regulatory Commission (CBIRC).

CHINA ADVANCING AT ITS OWN PACE

The risks surrounding China's outlook are mostly well flagged. While the authorities have been quite successful in preventing the spread of the virus, renewed outbreaks and localised lockdowns cannot be ruled out as winter and the traditional influenza season approach. That being said, we are not expecting Wuhan-style measures with similarly drastic consequences for China's economy.

The other main risk is geopolitics. Global market sentiment will likely be even more nervous than usual about any further intensification of US-China tensions as the US presidential election nears. Some observers believe that the relationship could improve in the event of a leadership change in the US. Others emphasise the strategic nature of the tensions, encompassing not only trade and intellectual property rights but also new industries, such as 5G, human rights disputes and territorial controversies.

China's leadership has clearly signalled its intention to reduce its reliance on foreign high-tech imports and focus on innovative industries and new infrastructure sectors, such as 5G, satellite navigation and the industrial internet, that are supported by internet applications including blockchain and cloud computing. It's too early to tell how these policies will impact markets and economies in the longer run. Our base case is that real GDP will grow by 2.3% in 2020 and 7.6% in 2021.

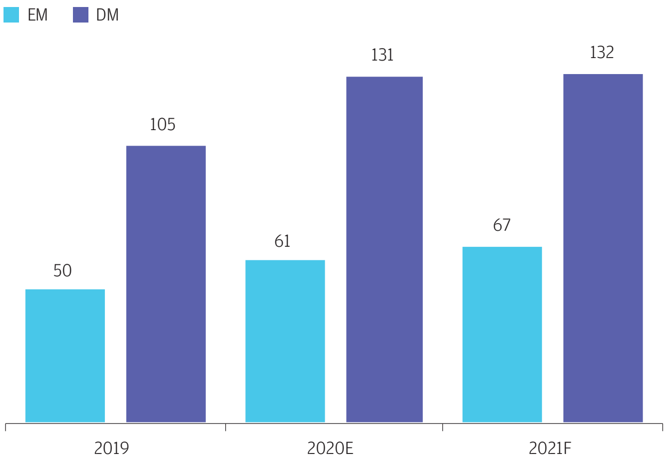
MONETARY AND FISCAL POLICIES TO REMAIN SUPPORTIVE

The fiscal and monetary policy reaction in both emerging and developed markets has been faster and more comprehensive than in previous crises. Going forward, the question is how much more room exists for additional easing. On the fiscal side, debt-to-GDP levels in emerging markets are significantly lower than in developed markets, implying that they have more room to take on more debt (**EXHIBIT 3**).

At the same time, the cost of financing is higher and access to debt capital markets is more constrained, capping room for additional leverage. That doesn't mean that fiscal policy can't provide further support. Most emerging market countries have been relatively judicious so far and debt capital market activity has remained high apart from a relatively brief hiatus. In fact, emerging market sovereign and corporate bond supply is forecast to reach new highs this year, underpinning the view that there is strong demand for emerging market bonds in a low-yield environment.

Public debt is set to rise for emerging markets but remain well below developed market levels

EXHIBIT 3: PUBLIC DEBT AS A % OF GDP



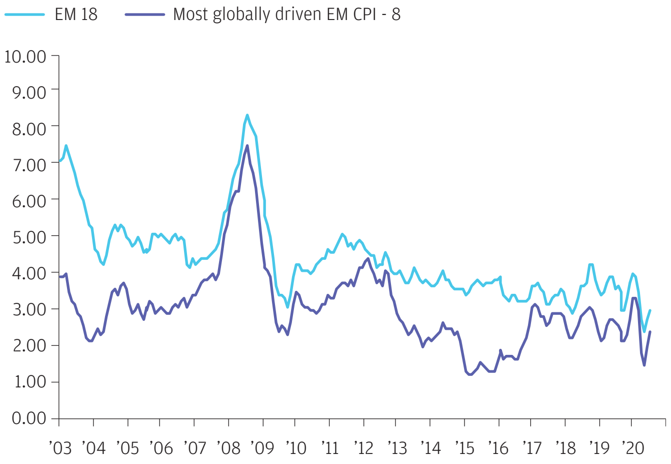
Source: J.P. Morgan Asset Management, International Monetary Fund (IMF), as of 4 September 2020. Opinions, estimates, forecasts, projections and statements of financial market trends are based on market conditions at the date of the publication, constitute our judgement and are subject to change without notice. There can be no guarantee they will be met.

On a positive note, inflation looks well anchored in emerging markets (**EXHIBIT 4**). There have been sporadic signs of higher inflation in some sectors – prices of medical supplies rose during the early stages of the crisis – but this appears to have been mainly driven by low supply rather than strong demand. There have been also some indications of services business passing on higher costs of operation due to Covid-related regulations.

However, given the overall slack demand, it is doubtful that such price increases can lead to wider inflation, especially as lockdown measures are being eased. Perhaps the biggest risk is coming from currency depreciation in countries with traditionally high currency pass-through, such as Brazil, Turkey, Russia and South Africa. That being said, inflation expectations are still trending lower and the output gap is likely to remain substantial, enabling emerging market central banks to maintain accommodative monetary policies for longer.

Emerging market inflation remains anchored despite some pressure from FX pass-through

EXHIBIT 4: CHANGE IN THE CONSUMER PRICE INDEX (CPI), % YEAR ON YEAR



Source: J.P. Morgan Asset Management, Bloomberg, Haver. Most globally-driven eight emerging market CPI: CEE3, KRW, THB, ZAR, MXN and CLP, as of 12 September 2020.

BASE CASE SCENARIO

In summary, our base case is one of gradual normalisation. China and the rest of the emerging markets are leading the developed markets in a recovery of economic activity. Monetary and fiscal policy will likely remain supportive for some time, as economic sentiment is likely to remain fragile and vulnerable to renewed, albeit localised, lockdowns.

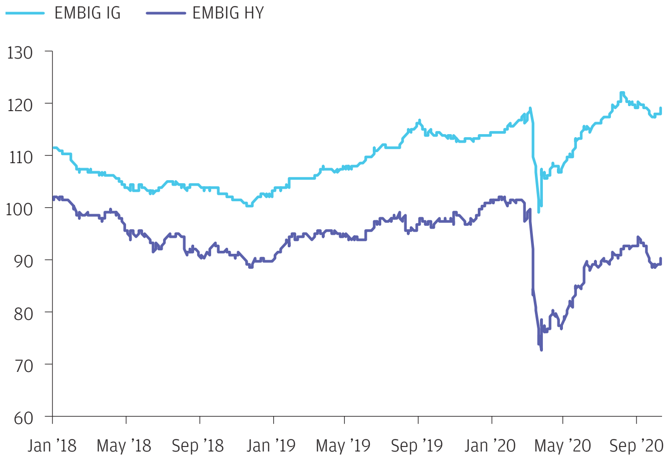
The risks are two-fold: on the negative side, a double-dip recession caused by wider and longer lockdowns, rising unemployment and businesses defaulting, remains a realistic threat. It is mitigated by fiscal and monetary policy makers' willingness and ability to pump even more money into the system, but not completely eliminated. On the positive side, economic activity could rebound faster than expected, if a vaccine – ideally combined with effective treatments – can be found for Covid-19, allowing a faster return to normality. We think both tail scenarios have even chances (20% each), but our base case is three times more likely than either of them.

EMERGING MARKET SOVEREIGN DEBT: INVESTMENT GRADE VERSUS HIGH YIELD

The year-to-date performance of emerging market sovereign debt shows a distinct divide between investment grade and high yield (**EXHIBIT 5**). Investment grade experienced practically no stress, even during the height of the market turmoil in March, with the average price of the emerging market sovereign investment grade index barely dropping below par. Performance during and after the sell-off was in line with US investment grade, which, in our view, is impressive, considering the lack of central bank buying, and a testament to the segment's inherent resilience.

Emerging market investment grade sovereign prices showed no signs of stress during the Covid-19 sell-off

EXHIBIT 5: AVERAGE EMBIG IG PRICE VS AVERAGE EMBIG HY PRICE



Source: J.P. Morgan Asset Management, as of 9 October 2020. EMBIG IG = JPM EMBI Global Diversified IG. EMBIG HY = JPM EMBI Global Diversified HY. Prices are the average of index bid-offer prices.

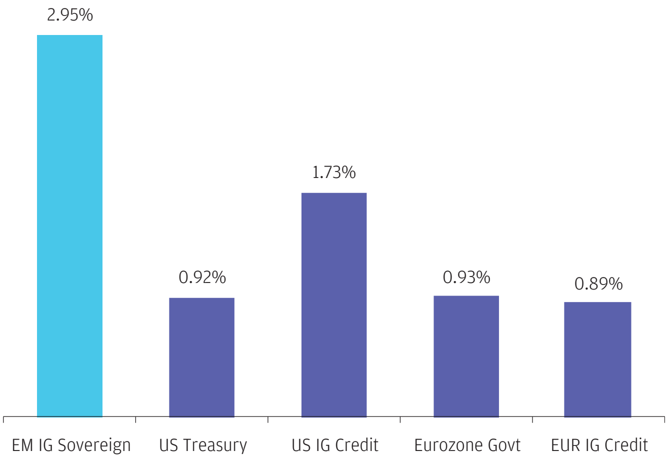
In contrast, the high yield segment, which was already under pressure from defaults in Argentina and Lebanon prior to Covid-19, experienced significant stress. The average EMBIGD HY index price dropped to the low seventies in March as a number of countries came under significant market pressure, mainly because of the sharp decline in crude oil prices. Ecuador was the most prominent victim, while a number of other countries managed to avoid default only with the help of the IMF and other international lenders.

The fundamental outlook for this segment remains mixed. On the positive side, Argentina and Ecuador have emerged from default, are back in the index and trading again. We also expect the number of downgrades to slow in the coming months, but some countries, such as Zambia or Sri Lanka, will probably remain vulnerable to refinancing risk. Therefore, we will continue to put a strong emphasis on country selection in emerging market sovereign high yield.

This fundamental gap is reflected in investment grade and high yield valuations. Investment grade spreads are trading around the long-term average of 200 basis points, which leaves some room for spread compression, considering the pre-Covid low of around 150 basis points. However, this means that carry will likely be the main driver of returns going forward. From this perspective, emerging market sovereign investment grade offers a very compelling investment case, especially compared to US or European investment grade bonds (**EXHIBIT 6**). Yields in the US and eurozone are likely to remain exceptionally low for a long time, making a strong investment case for emerging market investment grade bonds for conservative investors looking for higher carry with low risk.

Emerging market investment grade sovereign debt is offering significant yield pick-up

EXHIBIT 6: YIELD ACROSS SELECT DEBT SECTORS



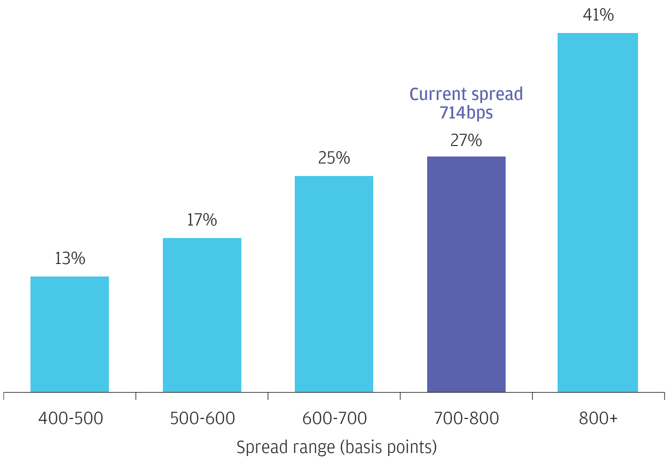
Source: J.P. Morgan Asset Management, Bloomberg, as of 30 September 2020. EM IG Sovereign = JPM EMBI Global Diversified IG. US Treasury = JPM US Treasury Index. US IG Credit = JPM JULI ex-EM 7-year. Eurozone Govt = JPM EMU IG Index. EUR IG Credit = JPM Maggie Credit Index hedged to USD.

Emerging market sovereign high yield, on the other hand, has much more room for spread compression. The current spread of 760 basis points is in line with the high following the 2008-2009 financial crisis (excluding the Covid sell-off) and is some 200 basis points above the long-term average. As mentioned earlier, the fundamental credit risk in this segment is higher than in investment grade. Argentina and Ecuador have successfully restructured their debt but Lebanon remains in on-going default and may take longer to resolve given the complicated domestic political and economic situation.

The other countries at risk of credit stress or restructuring – Sri Lanka, Zambia, Belize, Suriname and Angola – represent a relatively small part of the universe and the risk is largely priced in. The current spread, therefore, adequately compensates for the credit risks, in our opinion. Historically, 12-month returns have been around 13% and 24-month returns around 27% for emerging market sovereign high yield at current spread levels, which supports a selective shift from defensive investment grade to cyclical high yield assets in the overall EMBIG strategy (**EXHIBIT 7**).

Emerging market sovereign high yield spread levels support a selective shift from investment grade to high yield

EXHIBIT 7: EMERGING MARKET HIGH YIELD SOVEREIGN HISTORICAL TWO-YEAR RETURNS FOR GIVEN SPREADS



Source: J.P. Morgan Asset Management, Bloomberg, as of 9 October 2020. EM HY sovereign = JPM EMBI Global Diversified High Yield.

EMERGING MARKET CORPORATE DEBT: THE MOST RESILIENT SECTOR (AGAIN)

Emerging market corporate debt was once again the most resilient emerging market credit sector (**EXHIBIT 8**). The drawdown in March from peak to trough was lower than for EM sovereign, which is partly explained by structural factors, such as the small portion of CCC- and lower-rated credits, shorter duration and lower liquidity. Hence, this was not entirely unexpected. However, emerging market corporate debt also significantly outperformed US investment grade in the sell-off, underpinning its reputation for resilience in periods of market stress.

The flip side is a lower beta in a rebound, but the return since early March is broadly in line with higher beta asset classes, bolstering the view that emerging market corporate investment grade bonds are suitable for conservative investors with limited appetite for drawdown risk.

Emerging market corporate investment grade has outperformed other investment grade credit during drawdowns

EXHIBIT 8: PERFORMANCE OF SELECT INVESTMENT GRADE DEBT IN 2020

	Pre-Covid peak to trough (6 Mar - 20 Mar)	Pre-Covid peak to date (6 Mar - 9 Oct)
EM corporate IG	-9.84%	1.42%
EM sovereign IG	-15.04%	1.62%
US IG	-15.24%	1.32%

Source: J.P. Morgan Asset Management, Bloomberg, as of 9 October 2020. EM IG Corporate = JPM CEMBI Broad Diversified IG. EM IG Sovereign = JPM EMBI Global Diversified IG. US IG Credit = JPM JULI ex EM. Past performance is not a reliable indicator of current and future results.

While several factors contributed to the strength of emerging market corporate investment grade debt, we would like to highlight two.

First, the asset class benefited from solid underlying fundamentals. Most issuers have been managed prudently in recent years, leading to lower gross and net leverage (**EXHIBIT 9**) and significantly higher cash-to-debt levels compared to US investment grade credit.

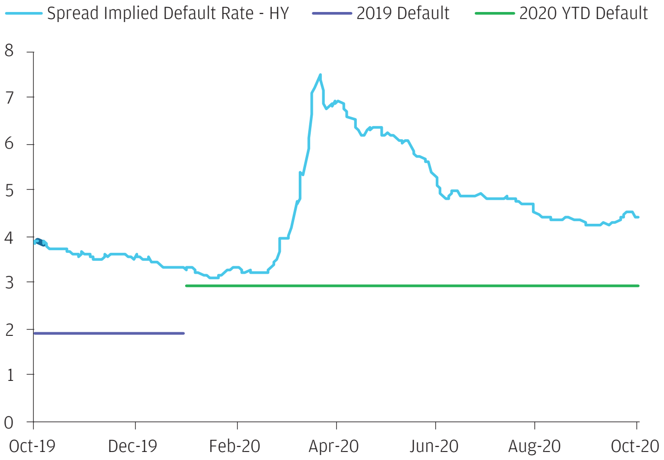
Second, the portion of strategic investors in emerging market corporate debt is relatively high. More than half are the investors are local, predominantly from Asia and, to a lesser extent, from the Middle East, Europe and Latin America. Other long-term investor groups include dedicated emerging market debt strategies and institutional investors, such as pension funds and insurance companies, across the US and Europe. The portion of opportunistic cross-over credit and multisector strategies is not negligible, but it is nevertheless a minority.

Emerging market corporate high yield fundamentals also turned out to be more resilient than expected. The year-to-date default rate of approximately 3% is well below spread-implied levels, which were quick to discount defaults in excess of 7%. As the spread-implied default tends to be too pessimistic, analyst forecasts initially ranged from 6% to 7%. Since then, analysts have lowered their expectations to 4.5%, and most recently to 3.5%, which is still around one percentage point below the implied level.

We expect a default rate of approximately 3% in the next 12 months, which would be lower than the long-term average of 3.5%. Similar to emerging market corporate investment grade, prudent balance sheet management has kept leverage relatively low and ensured sufficient cash levels. Earnings are likely to remain under pressure but risks contained, even in a sluggish recovery. In addition, we believe that the earnings cycle is past the worst and that the likely deterioration of credit metrics is manageable.

The emerging market corporate high yield default rate is well below spread-implied levels

EXHIBIT 9: EMERGING MARKET CORPORATE HIGH YIELD ACTUAL DEFAULT RATES AND SPREAD-IMPLIED DEFAULT RATE



Source: J.P. Morgan Asset Management, J.P. Morgan, as of 9 October 2020.

The investment case for emerging market corporate debt is attractive at current valuations. The all-grade composite index spread is currently trading around 400 basis points, which is some 100 basis points above pre-Covid levels and 150 basis points above post-financial crisis lows. Historically, the sector has returned around 12% over 12 months and 20% over 24 months at this spread.

A breakdown by investment grade and high yield shows a similar picture: spreads have recovered approximately 75% of the Covid sell-off, leaving room for further compression. For the investment grade segment, this means that there is scope for spreads to tighten by an additional 50-60 basis points. This segment is attractively valued compared to historical levels and versus US investment grade credit. The relative spread was trading at around 80 basis points in early October, which is tantamount to one standard deviation above the 10-year median.

The relative carry picture is also offering a good point of entry for conservative investors searching for low-risk income with a pick-up of approximately 100 basis points over US investment grade credit and 180 basis points over European investment grade credit, after hedging.

Emerging market high yield corporate debt is naturally offering more scope for spread compression – up to 150 basis points compared to the post-financial crisis low in 2018. Within high yield, the B rated segment continues to trade at a bigger discount than in pre-Covid times, but as we are mindful of credit risk, we prefer to engage more selectively. Overall, we are most constructive about the BB rated segment, which represents the sweet spot for emerging market corporate debt (**EXHIBIT 10**).

Emerging market corporate spreads still trading above pre-Covid levels

EXHIBIT 10: EMERGING MARKET CORPORATE INVESTMENT GRADE AND HIGH YIELD SPREADS (BASIS POINTS)

Source: J.P. Morgan Asset Management, Bloomberg, as of 9 October 2020. EM Corp IG = JPM CEMBI Broad Diversified IG. EM Corp HY = JPM CEMBI Broad Diversified HY. RHS / LHS = Right / Left Hand Scale.

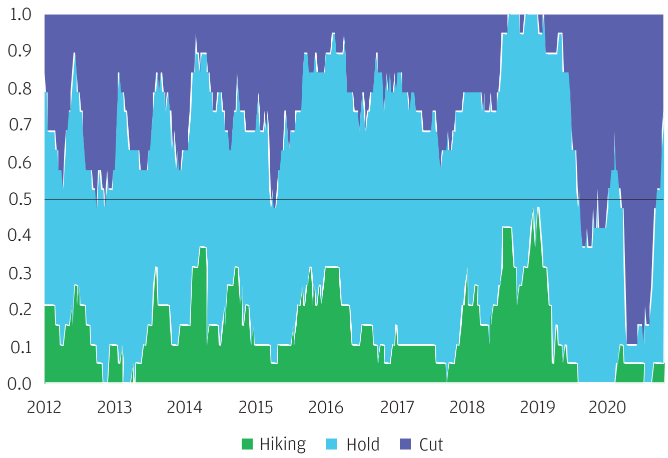
LOCAL CURRENCY DEBT: SCOPE TO PERFORM

In March, the predominant view was that emerging market local currency debt would probably suffer most given the inherently higher volatility of the currency component. In reality, the sell-off and subsequent recovery turned out to be less volatile than feared, and the asset class has so far even avoided the double dip that occurred during the financial crisis. Critically, emerging market central banks have been intervening faster and more aggressively than previously, which has played a key role in managing volatility in the local currency bond market. This demonstrates that local bond markets are already a major source of credit in some emerging markets, and that they are likely to grow in relevance as central bank policies evolve towards those in the developed markets.

In fact, emerging market central banks are still easing policy, albeit at a slower pace than previously. Our proprietary diffusion index shows that at the peak of the easing cycle, more than 90% of the central banks monitored were easing. While this has slowed to approximately 70%, it still means that a significant majority continues to ease policy (**EXHIBIT 11**). Furthermore, traditional easing continues to be enhanced by less conventional policies including liquidity provisioning and quantitative easing.

Emerging market central banks are still in easing mode

EXHIBIT 11: PERCENTAGE OF EMERGING MARKET CENTRAL BANKS CUTTING, HIKING OR HOLDING POLICY RATES (THREE-MONTH MOVING AVERAGE)



Source: J.P. Morgan Asset Management, Bloomberg, as of 9 October 2020.

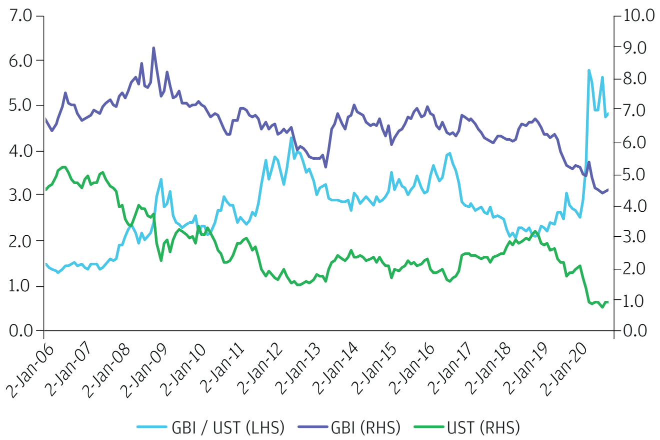
The prospect of economic recovery, albeit sluggish, combined with low inflation and accommodative monetary policy, provides a supportive backdrop for emerging market local currency debt.

The absolute level of emerging market rates, although at a historical low, is attractive compared to core developed market rates. In fact, the ratio of emerging market local currency debt yield to US Treasury yield is still substantially higher than in previous crises, including the financial crisis, in spite of the rally since March this year. This shows that tail risks are largely discounted by emerging market rates (**EXHIBIT 12**).

The relative valuation case within rates, however, clearly supports high-yielding markets. As expected, investors have favoured markets with lower perceived risks, mainly in Asia and central and eastern Europe (CEE). Relative valuations have moved closer to the long-term median in recent weeks, but we see ample room for relative carry compression, especially as investors will be looking for higher carry opportunities.

Yield on emerging market local currency debt appears cheap versus US Treasuries

EXHIBIT 12: RATIO OF EMERGING MARKET LOCAL DEBT YIELD TO US TREASURY YIELD



Source: J.P. Morgan Asset Management, Bloomberg, as of 30 September 2020. GBI = JPM GBI-EM Global Diversified Yield. UST = JPM US Treasury Index.

The outlook is equally supportive for emerging market currencies. Not only are currency valuations back to long-term lows, especially in Latin America and select high-yielding currencies, but historically emerging market cyclical currencies have performed positively in similar scenarios (**EXHIBIT 13**). In addition, the US dollar is expected to weaken, as growth and carry differentials against the rest of the world are narrowing.

There is a lot of speculation about post-election US economic policy, but these hypothetical scenarios are highly dependent on several conditions, meaning uncertainty will remain high for now. Moreover, a new fiscal stimulus may boost growth expectations, but the impact on the US dollar will depend on the details and the potential implications for monetary policy. We therefore remain constructive on emerging market currencies.

Cheap valuations, particularly in Latin America, suggest room for catch-up in currencies

EXHIBIT 13: REAL EFFECTIVE EXCHANGE RATE INDICES RELATIVE TO 10-YEAR AVERAGES

Source: J.P. Morgan Asset Management, Bloomberg, as of 09 October 2020. 100 = 10-year average.

ASSESSING THE RISKS

US elections pose the main tail risk in the near term. While opinion polls point to a democratic sweep, uncertainty remains high. The traditional knee-jerk reaction to higher uncertainty is underperformance of higher-beta assets, including emerging market debt, versus core developed market debt and reserve currencies. This time is no different and hence emerging market volatility is likely to remain elevated in the coming weeks. The fundamental tail risks are either an economic double dip, caused by stricter-than-expected lockdown measures mainly in developed markets, or stronger-than-expected rebound of growth and inflation.

The probabilities of these tail risks are relatively low, at 20% each, and conventional policy reactions largely expected. An economic double dip would most likely lead to more fiscal easing and a re-pricing of credit risk, especially at the lower end of the credit curve. A strong rebound would probably prompt select monetary policy tightening and re-pricing of the duration trade. However, either scenario would offer opportunities to add high quality emerging market risk to portfolios, mainly in the BBB to BB range and segments less sensitive to US Treasuries.

EXHIBIT 14: EMERGING MARKET DEBT ROADMAP 4Q 2020

	Scenario	Double Dip	Base Case Gradual Normalization	Rebound
Macro	Probability	20%	**60%**	20%
	Growth	Covid setback hurts recovery pace	**Global growth bottomed but shallow recovery ahead**	Recovery faster than expected
	Inflation	Global disinflation resumes	**Bottoming but consistent with targets**	Inflation normalizes
	Financial Conditions	Credit tightens, forcing central banks to deploy new tools	**Central Banks maintain accommodation, supporting EM assets**	Some easing unwind, but still accommodative
	Policy Room	EM fiscal and monetary room constrained by rising risk premium	**Differentiation in policy sustainability**	EM benefits from global risk rally
	Commodities	Weaker	**Range-bound**	Stronger
Strategy	Beta	Long duration, defensive riskier assets, conservative with liquidity	**Stay engaged in EM value**	Short duration – IG & LY rates, longer risk-linked assets
	Sector View	From Credit to Duration Short HY credit, short EMFX	**Cyclical EMFX Select HY vs LY in bonds**	Long EMFX Pay rates

Themes

Gradual EM-led recovery will boost the sustainability of EM policy

Extension of monetary and fiscal easing will continue to compress EM risk premia

From quality to value/ cyclical as risk premia remain elevated: **Favour HY and EMFX**

Fat tails remain, expect bouts of volatility. Use CDS/X, FX options, Swaptions

Risks: Deeper recession, US/ China tensions, inflation
Risk Usage: Medium, add on dips

Source: J.P. Morgan Asset Management, September 2020. Opinions, estimates, forecasts, projections and statements of financial market trends are based on market conditions at the date of the publication, constitute our judgement and are subject to change without notice. There can be no guarantee they will be met.

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