

Q3 2020: From beta to value

Emerging market debt strategy

Q3 2020

IN BRIEF

- Our updated base case view, to which we assign a 60% probability, looks for global growth to bottom out and gradually transition to a shallow recovery. We see only a moderate risk of inflation, as activity and commodity prices remain low. In this core scenario, we expect central banks to remain accommodative, which we think will support emerging market assets.
- Emerging market growth alpha, the difference between emerging and developed market growth, should reach a high not seen since 2012. Over the next 12 months our base case suggests the potential for 11-12% returns in emerging market debt.
- Hard currency sovereign debt has rarely been rated so strongly at current valuations, making it our preferred asset class. Our base case view looks for a mid-single-digit return from the JPMorgan EMBI Global Diversified for the remainder of the year. This view is predicated on Treasury yields of around 1.00% and spreads of around 450.
- We have become more constructive on local currency duration and are engaged in some tactical trades in local currencies. Key considerations in the local currency debt market are the impact of both developed and emerging market quantitative easing and the state of US and China trade relations.
- We expect a challenging quarter for emerging market corporate fundamentals, with survivors, rather than clear winners, and a broad dispersion of losers. We seek to take advantage of value opportunities in specific issuers, rather than broad sectors.

At our most recent quarterly meeting, we updated our base case view to one of gradual economic normalisation following the shock of the Covid-19 pandemic. We assign a 60% probability to our base case view, which looks for global growth to bottom out and gradually transition to a shallow recovery. We see only a moderate risk of inflation, as activity and commodity levels remain low. In this core scenario, we expect central banks to remain accommodative, which we think will support emerging market assets.

At the country level, differentiation in policy sustainability will remain a key driver of performance, helped further by a gradual recovery of commodity prices. In this scenario, we want to stay engaged in emerging market carry, while rotating from more defensive beta exposure into value positioning. Hence we favour steeper curves in rates, and turn more constructive on emerging market currencies, albeit with a quality bias.

We assign a 30% probability to our more negative scenario, which foresees a more extended lockdown into the third quarter and results in a deeper recession in emerging markets with negative growth of 4%. We assume a resumption in disinflationary pressure, tightening credit conditions, and rising risk premiums - all of which may challenge emerging market fiscal and monetary policy room. Softening commodity prices add to the challenge. In such a scenario, we think the optimal positioning remains longer duration and more defensive. Shorts against high yield credit and currencies should work well.

AUTHOR

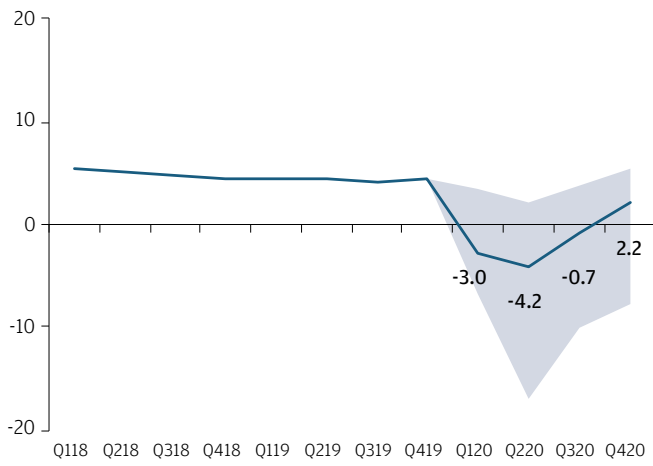


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In our base case, we think that emerging market growth will tip negative for the full year to -1.4% (EXHIBIT 1), though this is still a large premium over the weaker growth in the developed world. We think the majority of the economic contraction from Covid-19 has unfolded in the first half, setting the stage for a gradual recovery in the second. Emerging market growth alpha, the difference between emerging and developed market growth, should reach a high not seen since 2012, though this achievement is more reflective of the depth of the challenge confronted by developed economies. We think Chinese growth will slow to 1.5%, with the potential for an intensifying trade conflict with the United States presenting a key risk.

Emerging markets could see growth bottom in the second quarter and exit recession towards the fourth quarter

EXHIBIT 1: QUARTERLY EM REAL GDP GROWTH (YOY%) BASE CASE



Source: J.P. Morgan Asset Management; as of 31 May 2020. Emerging market growth forecast shown calculated from country-level forecasts for 20 major emerging market countries representing more than 80% of total emerging market GDP.

We believe the vast majority of emerging markets will manage to weather the large shocks presented by 2020, though some higher-yielding countries could face challenges if a downturn persists longer than expected. Against this backdrop, we have begun to selectively re-engage with risk in situations where we feel adequately compensated and where we have reasonable confidence in the direction of travel. We continue to re-position towards value, where we see opportunity supported by fundamentals, and risk premia remain elevated. In balancing selective high yield exposure with quality duration, we move towards a barbell strategy.

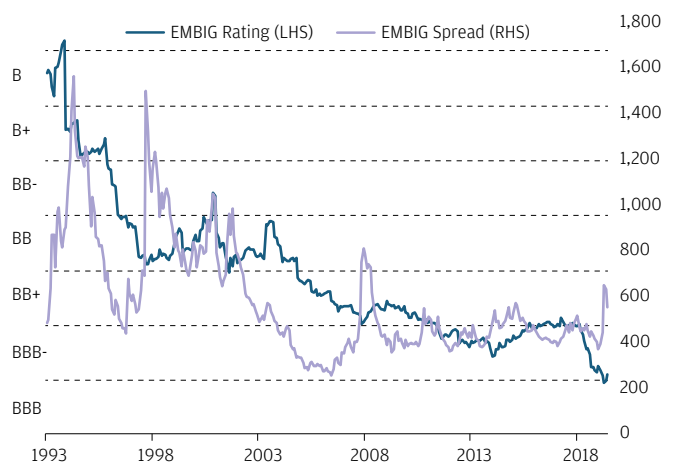
We think emerging market returns may climb back to positive territory later in the year as the market digests uncertainty around economic recovery and the pandemic. Over the next 12 months our base case assumption turns more bullish, with the potential for 11%-12% returns, helped by easy monetary and fiscal policies. We continue to favour hard currency debt, where we like BBB and BB names. In local currency debt, we seek to remain longer duration, playing the five-year point on steeper curves. We see bias to a softer US dollar as supportive of emerging market currencies, but we prefer quality in light of fat tail risks and expected bouts of volatility. Risks to our positioning include a deeper recession, tension between the US and China, and social unrest.

HARD CURRENCY DEBT: HARD CURRENCY SOVEREIGN IS OUR PREFERRED ASSET CLASS

External emerging market debt has rarely been rated so strongly at the current valuations (EXHIBIT 2). Crossover demand for higher quality credits have supported the market, while investors have pushed weaker issuers wider. The global financial crises saw an aggregate half-notch rating across countries, setting up a singular question in the market: just how bad will the Covid-19 impairment become? The pessimistic view at current levels is that the market expects a more severe downgrade cycle; the optimistic take sees room for a mean reversion.

Hard currency emerging market debt has rarely been rated so strongly at the current valuations

EXHIBIT 2: HARD CURRENCY SOVEREIGN RATING AND SPREAD HISTORY



Source: J.P. Morgan Asset Management; data as of June 2020.

Key to recall here is that 72% of the market has been able to access funding, meaning that investment grade demand will remain solid and that an income-hungry market will absorb high yield issuance. We think we have seen the majority of sovereign fallen angels for the year in the first half of 2020, meaning that the market is now focusing on events in 2021 or beyond. Hard currency sovereign debt from Mexico, Colombia and Indonesia is already pricing in a one- or two-notch downgrade. In this more difficult environment, additional downgrades are possible; what matters for investors is where they actually happen.

One common bear argument is that emerging market debt lacks an equivalent “sponsor” to central bank bond buying seen in the developed world currently. This view holds that, minus implicit external support, emerging market debt must underperform those assets that benefit from direct central bank support. We would argue that the current potential default picture is not high versus historic standards, in part because emerging markets entered this crisis less levered compared to mature market peers. Hence, we think valuation will prove a robust source of support. In addition, the International Monetary Fund has been active in announcing a number of facilities to address these challenges, and in places we have seen an increase in their usage.

The market’s clear scepticism around the emerging market response to the Covid-19 crisis has resulted in extreme valuation abnormalities in the high yield arena; we see the BB universe looking more attractive than the single B space, which looks tighter to BB than perhaps risks demand. Access to capital has not been an issue for most emerging markets, with investment grade issuers raising USD 80 billion between May and June alone. The repayment picture remains benign, with June and July projected as average months. Were the market not to re-open to high yield, the impact might challenge some weaker issuers and lead to a higher default rate.

Our base case view looks for a mid-single-digit return from the JPMorgan EMBI Global Diversified for the remainder of the year. This view is predicated on Treasury yields of around 1.00% and spreads of around 450 basis points. A softer landing would support a longer duration position and could lead to much higher returns, while the Federal Reserve falling behind the curve would be a more negative outcome, in our view. Based on historical returns, there is a clear case for staying long, with prior returns versus risk suggesting a strong potential opportunity.

LOCAL CURRENCY DEBT: WHAT DOES QUANTITATIVE EASING (QE) MEAN FOR THE LOCAL CURRENCY MARKET?

We begin the quarter constructive on local duration and selectively engaged in emerging market local currencies, as we see the market shifting to discount a recovery - whether shaped like a famous shoemaker’s “swoosh” or a more traditional v-shape. Our preferred asset remains local duration and we see emerging market currencies as a more tactical call. The quarter is starting with a cleaner technical position in local currency debt, as many investors have likely moved to neutral following the Covid-19 shock. Volatility and fat tail risks are still prevalent features in this area.

Our key considerations in the local currency market organise neatly into two themes. The first is around the impact of QE on emerging market local debt markets. From a top-down perspective, we see evidence that the Fed’s asset purchasing has impacted the trade-weighted dollar, and likely will continue to do so. As a result, we see a potential opportunity to play dollar-softening beta, likely through countries such as Indonesia, Peru and Hungary.

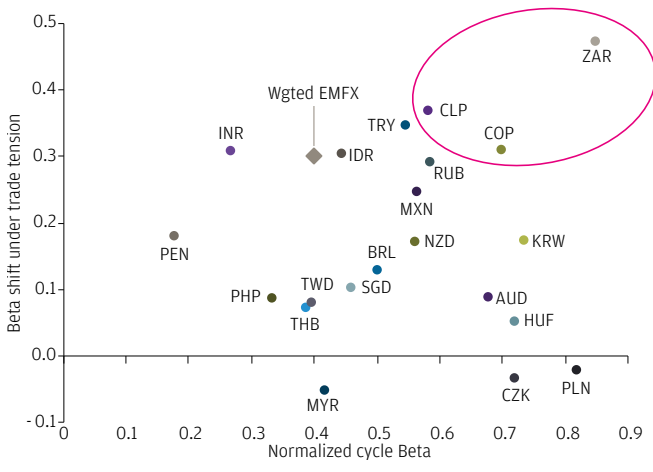
This theme needs to be balanced by the second: the impact on returns of recent emerging market central bank steps to manage domestic liquidity conditions. Policy buffers vary by country, which could lead to a wide dispersion of returns, especially among countries adopting more “covert” QE approaches.

Among emerging market countries, most QE or QE-like policy packages are deployed for stability reasons, rather than to protect the fiscal position at the lower end of the policy boundary. We naturally look to the outliers for trade ideas. In this context, we prefer the Russian rouble, Korean won, Czech crown and Thai bhat because these countries have policy buffers robust enough to afford QE, but are not currently doing QE. Conversely, we are more worried about the South African rand, the Brazilian real and the Indian rupee. We see Turkey’s more constrained policy options making it an outlier.

A re-emergence of US-China tensions presents a clear risk to local currency returns. When we look at the relationship between Chinese renminbi depreciation cycles and normalised cycle betas, we see the South African rand, as well as the Chilean and Colombian pesos, as acutely vulnerable to potential Chinese currency weakness (**EXHIBIT 3**). Hedging the portfolio against these risks is possible because some pairs show value in the options market: for example, we see value in some Asian currency options, and we think that Korean won and South African rand options look interesting as higher beta plays.

Which countries are most vulnerable to trade tensions between the US and China?

EXHIBIT 3: BETA SHIFT DURING TRADE TENSIONS VS NORMALISED CYCLE BETA



Source: J.P. Morgan Asset Management, Bloomberg; data as of June 2020.

A number of emerging market countries moved early to raise funds domestically and now do not need to come back to the market in size in the second half, if at all. In this regard, we note that central and eastern European countries are generally ahead of their annual issuance schedules. These markets also benefit from relatively larger QE programs. This combination is especially visible in Poland, relative to market size, and will likely support the Polish market. Elsewhere, we like some of the steeper curves on offer, where we prefer to play the belly of the curve. We think the supply progression outlined above impacts the slope of some curves and will influence asset swaps. We see value in the belly of curves in the Andean region, Mexico, Russia, India and Indonesia.

Rising inflation presents another, perhaps longer-term risk to local currency emerging market debt. Our base case expectation looks for dovish inflation prints in the coming quarter, at least partially because of the collapse in global demand triggered by the Covid-19 pandemic. However, the risk

of a global recovery increasing inflationary pressure is real. In the past we have seen a relationship between demand disruption, recovery and inflation - most recently in the global financial crisis of 2008-2009 - and it seems likely this could happen again via commodities or merchandise exports. For example, we see a correlation between oil prices and inflation in oil-exporting countries, evidenced by the resurgence of inflation post the global financial crisis in places as diverse as Russia, Turkey Mexico and Brazil, which suggests something similar could happen again. So long as core rates remain anchored by developed market central banks, we probably will not see rates repricing. As a result, we think that inflation-linked bonds offer better hedging characteristics.

CORPORATES: IN SELECTION WE TRUST

We see a challenging quarter ahead for emerging market corporate fundamentals, though we see the asset class offering value. We have also turned more positive on the market technicals. The current reality in the emerging market corporate space is one of fundamental headwinds testing corporate credit quality. We expect all sectors to suffer an earnings hit because of the impact to activity presented by the Covid-19-induced slowdown, but would add that the sectors most directly impacted are not a highly significant component of our benchmark. In our view, successful outcomes in emerging market corporate debt can be achieved through careful selection, as issuers differ meaningfully within sectors and regions.

Broadly, we see Latin America and EMEA being weaker than Asia, with higher-yield issuers in the commodity and metals space especially affected. The central risk to our scenarios is the length of the lockdown; a three-month global lockdown is manageable, but a more protracted shutdown will sharply increase pressure on issuers. We see emerging market corporates as a secondary beneficiary of developed market central bank support, and see crossover demand for exposure as evidence that this is a broadly held view.

To better understand the fundamentals of emerging market corporate debt, it helps to look across the composition of our universe, defined by the JPMorgan CEMBI* Broad Diversified Index (CEMBI). CEMBI is an investment grade index, with only a 41% weighting to high yield. In our view, the index is not overly sensitive to Covid-19, offers a relatively stable ratings trajectory and therefore should not see a material risk of falling angels in the coming quarter. Thanks to prudent balance sheet management previously, emerging market corporates are entering this period with healthy balance sheets, though weaker currencies will likely have a corrosive effect on this quality.

* CEMBI = Corporate Emerging Market Bond index

We see few weak sectors, but many weaker companies being challenged by the current conditions. This feature is especially visible in high yield across more vulnerable segments of the market including the financial, oil and gas, metals and mining, and transport sectors. Looking at the impact of Covid-19, the worst hit sectors account for only 15% of the total index weight. CEMBI also differs from EMBI** by geography. Here again, the difference is in CEMBI's favour, as the weakest EMBI sovereigns account for around 8.5% of CEMBI; of these, the best known also represent the majority of CEMBI's exposure: Brazil and South Africa.

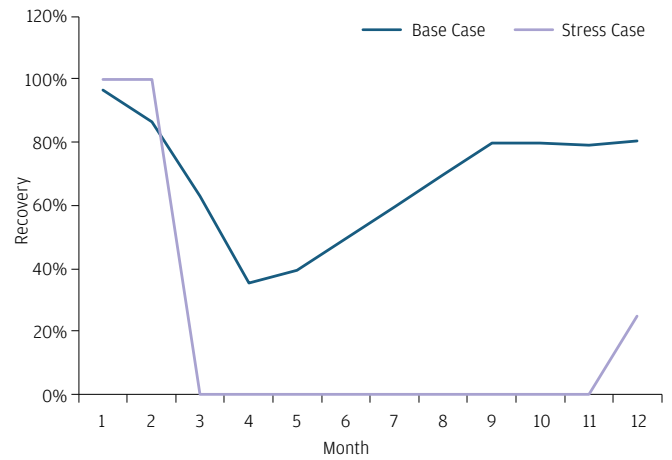
For investors, the crucial question around the emerging market corporate opportunity is embedded in the global economy's likely path of recovery from the disease. For simplicity, our analyst team has developed two core scenarios to evaluate the opportunity: a base case view that incorporates our economists' estimates for leading indicator progression, and a more severe stress case that tries to estimate the impact of a prolonged lockdown scenario (EXHIBIT 4).

Our base case sees a gradual recovery from month four, while the more prolonged scenario sees no improvement until month 11. For the broad CEMBI universe, gradual normalisation impacts credit metrics but appears broadly manageable; perhaps predictably, the more severe case is expected to push leverage metrics to historic highs. Investment grade credit on emerging markets' balance sheets is sufficient to weather the downturn without seeing leverage metrics rise above US investment grade. For emerging market high yield issuers, the severe scenario produces a more complex outcome that could surprise our default forecast. Regardless of scenario, the reality is challenging; we do not see winners, only survivors.

Refinancing risk in the emerging market corporate space is less of an immediate risk, though high yield is a potential source of concern. The pace of re-opening is therefore a critical question around impairment. We see Chinese issuers accounting for some 47% of outstanding debt in what is a generally lumpy financing outlook into 2021. Our default rate expectation is 7.01%, representing around USD 8 billion of at-risk bonds in the CEMBI universe. The bonds expected to default are primarily from central and eastern European issuers, with a meaningful number from Latin America as well. Default risk is idiosyncratic; we see no weak sectors, only weak names.

Stress testing two scenarios for emerging market corporates post Covid-19 lockdowns

EXHIBIT 4: MAGNITUDE OF RECOVERY VS TIME



Source: J.P. Morgan Asset Management; data as of June 2020.

Corporate valuations have begun to tighten across a range of ratings buckets. Valuations gapped wide on pandemic risks and investors have begun to bargain hunt, which has led to a sharp pull back from recent wides. The investment grade market has given back 45% of the recent spread widening and the move has been more pronounced in high yield, where the market has retraced some 60%. Given that the high yield arena is also the locus of our issuer-specific concerns, it is notable that the relative spread move implies the market is less optimistic on investment grade than high yield - despite investment grade's superior fundamentals. We see emerging market investment grade corporates continuing to offer some premium over developed markets in both single A and BBB, while BB trades relatively tighter. In our base case view, we see select high yield issuers continuing to outperform, though we like the more balanced outlook we see in the investment grade arena.

Across emerging market corporate debt we see survivors from the current slowdown, and a broad dispersion of losers. We see opportunity in selective engagement by focusing on specific issuers, rather than broad sectors. In this way, we think we can mitigate some of the market's default risk while enabling participation in the attractive valuation opportunity.

**EMBI = Emerging Market Bond Index

CONCLUSION: ROTATING INTO SELECT VALUE OPPORTUNITIES

We continue to have a positive outlook for emerging market debt as an asset class. We remain constructive on longer-duration assets but are beginning to rotate toward select higher-yield opportunities in both hard and local currency. Following the strong recent beta momentum, we are looking to rotate some higher-beta assets into more carry- and alpha-orientated trades. To do this we will be rolling down the curve in some high yield securities and adding to the local rates trade. With the market pricing in a v-shaped recovery, our focus remains on fundamentals with the risk of a deeper and/or longer slowdown being our main concern.

We highlight that emerging market debt's quality has rarely been priced at current levels. While the current valuation discounts a one- to two-notch downgrade for the space, it is worth pointing out that today's emerging markets benefit from the broadening, diversification and growth of the previous decade; they are now more resilient and have entered the current economic downturn relatively less levered than comparable peer assets. In addition to downgrades, key risks, in our view, include a longer recovery from the pandemic, or a second wave, which would lengthen the economic slowdown. Inflation and intensifying trade tensions with the US are other risks we are watching closely. We remain constructive and have begun the process of rotating from beta to value.

UNLESS OTHERWISE STATED ALL DATA IS SOURCED FROM J.P. MORGAN ASSET MANAGEMENT AS AT 30 JUNE 2020.

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