Emerging markets: Resilience in the wake of US policy shifts

Emerging Market Debt Quarterly Strategy

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In brief

- Emerging market (EM) economies are poised to demonstrate exceptional resilience, fuelled by robust growth prospects. US tariffs targeting China would be expected to have a minimal impact on broader emerging markets and likely spur a further shift in global trade, mitigating the growth impact on China.
- Our baseline scenario remains one of a "volatile trend growth, best scenario for EM", yet the uncertainty surrounding global growth introduces substantial tail risks, including the potential for the Federal Reserve to either hike or cut US interest rates.
- EM credit remains well anchored with attractive idiosyncratic opportunities. While macroeconomic uncertainties are already well reflected in EM local rates, presenting interesting selective opportunities, we maintain a cautious stance on emerging market currencies (EMFX), but expect a turn into the year on excess pessimism and positioning.

Steady EM-DM growth alpha amid US exceptionalism risks

Emerging markets are projected to grow at 4.0% in 2025, and the EM-DM (developed market) growth alpha is anticipated to remain robust at 2.0% by Q4 2025, which is above the historical range. Despite China's decelerating growth, strategic policy moves should limit the downside. We have revised China's GDP forecast down to 4.5% for 2025, which assumes US tariffs primarily aimed at China and increased stimulus. Meanwhile, the US is expected to decelerate from its above-trend growth, but policy manoeuvres may continue to bolster US economic performance.

Key risks for emerging markets include aggressive US tariffs and a tepid policy response from China. While EM fundamentals exhibit resilience, significant tariff shocks pose a threat. We believe that US tariffs targeting China will have limited impact on EM fundamentals, though rising fiscal deficits and a strong US dollar could restrict EM policy flexibility and growth potential.

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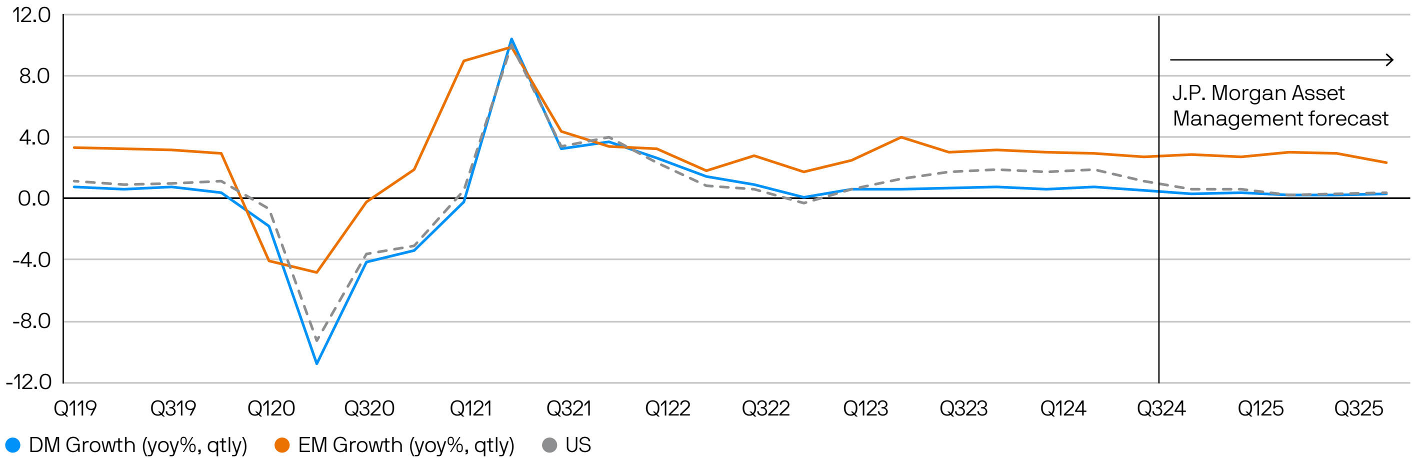
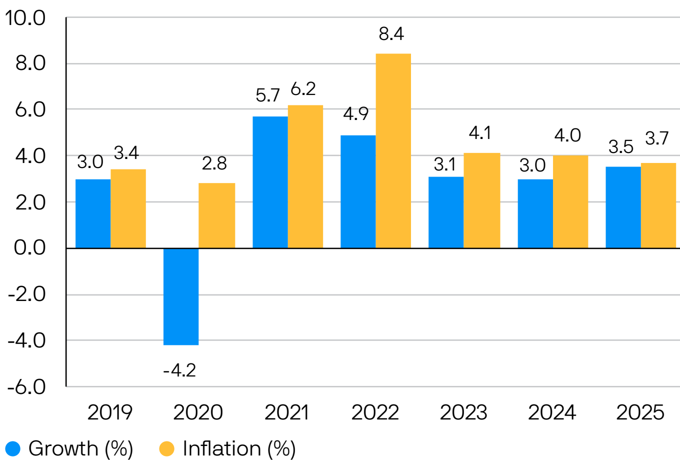
Exhibit 1: EM-DM growth alpha healthy at 2%



Source: J.P. Morgan Asset Management, Bloomberg; Data as of December 2024. EM represents weighted average of key 19 countries which included China, India, Brazil, Indonesia, Mexico, Turkey, Argentina, Poland, Thailand, Nigeria, South Africa, Malaysia, Colombia, Chile, Peru, Romania, Hungary, Saudi Arabia, Egypt. DM represents weighted average of the US, the European Union and Japan. Forecasts are not a reliable indicator of future performance.

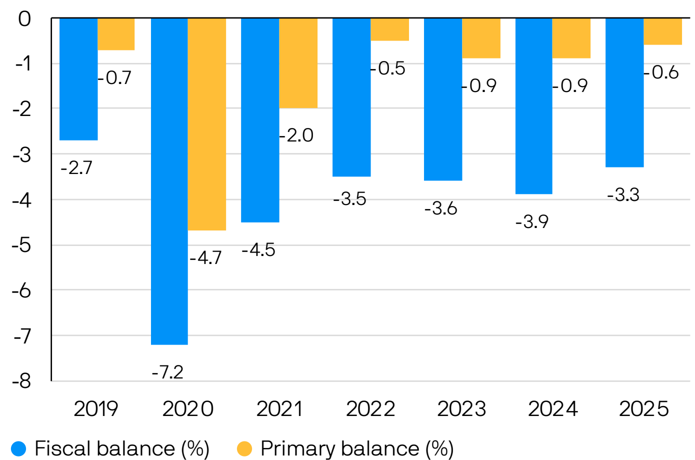
The median emerging market economy is poised for fiscal consolidation and improved growth prospects in 2025. The momentum in sovereign ratings has shifted positively, with a significant wave of upgrades anticipated, fuelled by ongoing post-Covid policy normalisation, frontier market restructurings and resilience in key countries. EM inflation is normalising, with most nations achieving their target inflation bands. However, growth in many EM economies still trails pre-pandemic levels. This environment of subdued growth and stable inflation provides an opportunity for select central banks to continue easing monetary policy.

Exhibit 2: Growth/inflation mix improving in 2025



Source: J.P. Morgan Asset Management, International Monetary Fund (IMF); Data as of November 2024. Sample includes 70 emerging market countries. Forecasts are not a reliable indicator of future performance.

Exhibit 3: Fiscal consolidation expected in 2025



Source: J.P. Morgan Asset Management, International Monetary Fund (IMF); Data as of November 2024. Sample includes 70 emerging market countries. Forecasts are not a reliable indicator of future performance.

Navigating the US tariff landscape

While US tariffs, primarily aimed at China, are expected to have a manageable, lower one-off impact that the Federal Reserve can look through, the threat of severe tariffs looms large. Such tariffs could create an environment of higher inflation and lower growth in the US characterised by US Treasury yield steepening and a strengthening US dollar.

The repercussions for emerging markets could vary widely, influenced by each country's growth trajectory, monetary policy and trade dynamics. We could see more US tariffs targeting EM countries benefitting from near-shoring or greater China trade. The direct impact of US tariffs, primarily aimed at China, on EM corporates is anticipated to be minimal, as most companies in the corporate universe have limited exports to US or are primarily focused on domestic markets.

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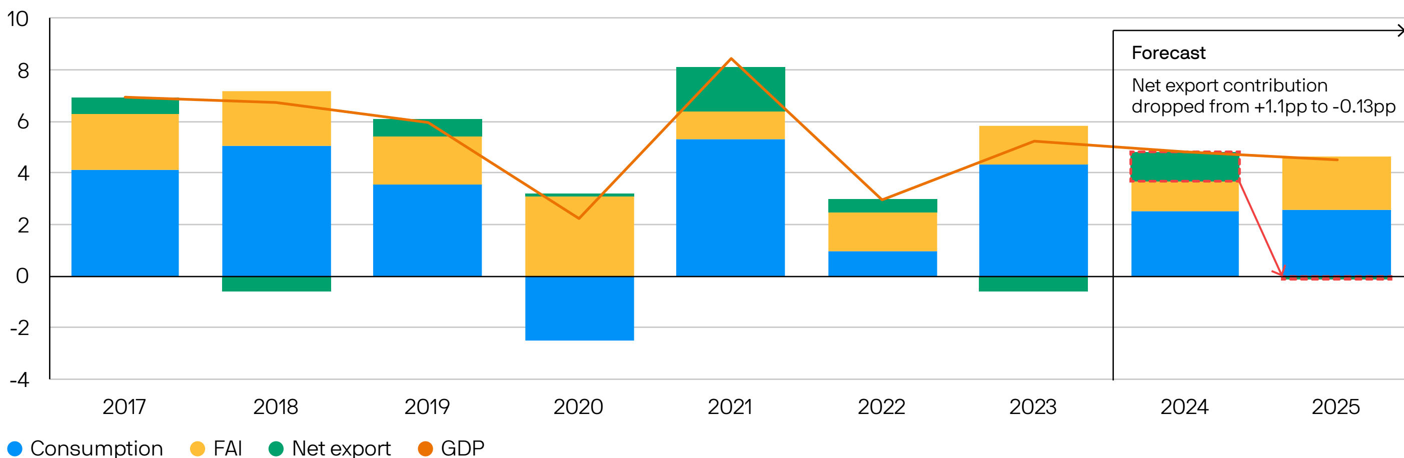
China's growth set to be hit by trade tensions, Stimulus on the horizon

We expect the Chinese authorities will continue to set their growth target at ~5% in March 2025, but lower growth may be accepted if trade tensions escalate meaningfully. To reflect the trade risk, we downgraded our China GDP forecast for 2025 to 4.5% (from 4.7%), with net exports now expected to become a drag on growth in 2025. However, the negative contribution from exports is expected to be mitigated by higher domestic demand, boosted by expansionary fiscal arrangements and continued monetary easing.

Exhibit 4: Net exports are expected to become a drag on China's GDP



Source: J.P. Morgan Asset Management, WIND. Data as of December 2024. Forecasts are not a reliable indicator of future performance.

A shift in global trade has already led to a reduction in China's trade balance with the US, with the beneficiaries of this shift, such as Mexico and several south-east Asian countries, reaping the rewards from the initial wave of "Trump 1.0" trade policies. A fresh round of US tariffs targeting China may trigger a further diversion in global trade, mitigating the impact on China's growth, with Asia in particular poised to capitalise. At the same time, China's supply chain continues to innovate and explore "re-routing" alternatives, which could prompt the US to extend tariffs to countries with growing trade surpluses, such as Vietnam and Mexico. Should the US impose sweeping tariffs on the rest of the world (RoW), the repercussions could be substantial, with potentially significant negative fallout for the US itself.

Exhibit 5: China's exports to the RoW are growing, while exports to the US have declined

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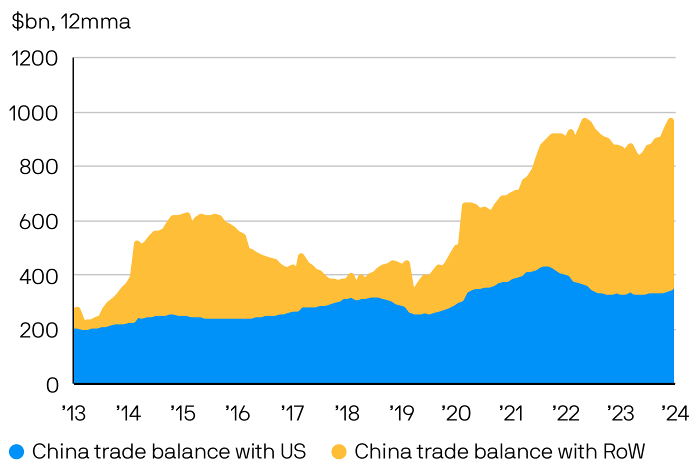

Source: UBS, Haver. Data as of November 2024.

Macro scenarios: "Volatile trend growth" is still the base case but with fatter tails

Our baseline scenario remains one of a "volatile trend growth, best scenario for EM", yet the risk landscape has shifted, with fatter tail risks compared to the last quarter. The baseline scenario reflects a relatively benign global outlook, characterised by limited China-specific tariffs and the absence of significant fiscal stimulus. Markets, particularly risk assets, seem to have largely priced in this scenario.

However, we now assign a slightly higher probability to a "re-acceleration" scenario, in which US growth is boosted by the potential for broader China tariffs and deregulation efforts. Conversely, a "recession" scenario looms if there is a substantial increase in tariffs, which could severely undermine global growth prospects.

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Exhibit 6: EMD Roadmap Q1 2025 – Macro scenarios and strategy

	Scenario	Recession	Base Case Volatile Trend	Re-acceleration	Themes for Q1 2025
Macro	Last IQ	20	55	25	Increasing policy uncertainty, but EM base case still supported by strong growth alpha
	Growth	Demand contraction on trade war	EM-DM alpha improves as US slows	US remaining above trend	
	Inflation	Falling, but settling higher than trend	Continued decline	Sticky or rising	
	Financial Conditions	Tighter first, easier later	Looser	Tighter	EM rates differential attractive, but cycle can be challenged by macro vol
	Policy Room	Room for cuts, but less than normal cycle	EM cutting cycles continue, though terminal rates above historical lows	Fed ends easing cycle with hikes on table	
	Commodities	Weaker	Range-bound	Supported	EM credit remains anchored with focus on idiosyncratics
Strategy	Beta	Long core-like duration	Supportive for risk: long HY credit and EM rates	Reduce beta and focus on front end quality carry; short core rates	Cautious on EMFX given US policy risks to USD; lower oil prices mitigates FX impact on inflation
	Sector View	From credit to duration; cautious on risk	Receive EM rates OW HY credit; selective EM FX	RV on EM rates OW credit with barbell Long USD, then re-engage incyclical EMFX	Risks: tariffs/trade uncertainty and other Trump policies (fiscal); changes to Fed path, FCI tightening; oil Risk Usage: Medium

Source: J.P.Morgan Asset Management December 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.

While US inflation remains anchored, the looming uncertainty surrounding global growth next year introduces fatter tail scenarios, including the possibility of the Federal Reserve either hiking or cutting rates. Amid this heightened macroeconomic volatility, emerging markets are poised to demonstrate resilience, buoyed by robust growth prospects.

EM credit remains stable, and our focus will be on identifying attractive idiosyncratic opportunities. With macroeconomic uncertainty already well reflected in EM local rates, the market presents interesting selective opportunities. Although some US dollar strength is already priced in, ongoing tariff uncertainties are likely to keep the dollar elevated. Consequently, we maintain a cautious stance on EMFX, but expect a turn into the year on excess pessimism and positioning.

EM local currency debt outlook

EM local currency has had a positive start in 2025, benefiting from capital gains and EM FX appreciation against the US Dollar. However, uncertainty is likely to remain heightened in the first quarter with anticipated volatility on the horizon. The technical outlook is clouded by negative flow dynamics, as well as the potential implications of the Trump presidency, which is raising the bar for EM local markets following the negative alpha of 2024 and persistent tariff concerns. Conversely, valuations are attractive but the market is in need of a catalyst to launch an extended rally.

While EM fundamentals exhibit resilience, they will be rigorously tested as US policy shifts come into play. Inflation in emerging markets is expected to remain stable, even as growth projections and oil prices trend lower. Navigating beta moves is increasingly complex given the current macroeconomic environment, prompting a tactical approach in the near term. Our focus sharpens on bottom-up narratives, strategic frontier allocations, and agile trading around rates and FX. Although we foresee a constructive stance on rates in the future, our immediate strategy centres on capitalising on relative value opportunities.

EM sovereigns outlook

Emerging market resilience has been thoroughly tested over the past few years, and the sovereign market now boasts a proven track record. Sentiment among crossover investors has been more optimistic than that

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of dedicated investors, reflecting growing confidence in EM prospects. We continue to expect more sovereign upgrades than downgrades, with upgrades more concentrated in frontier markets, while downgrades are more prevalent in the investment-grade space. Sovereign default risks are expected to diminish as vulnerable credits seek support and implement policy improvements. Except for select frontier countries, financing needs remain manageable for most countries, even in the face of recessionary shocks.

With the US elections now behind us, EM sovereign bonds have become more attractive relative to developed markets. While EM investment-grade sovereigns may appear expensive from a spread perspective, they still offer compelling value when considering the all-in yield. We find that the bulk of the value still lies at the lower end of the rating spectrum. The technical picture looks strong with issuance supportive for high yield credits as well.

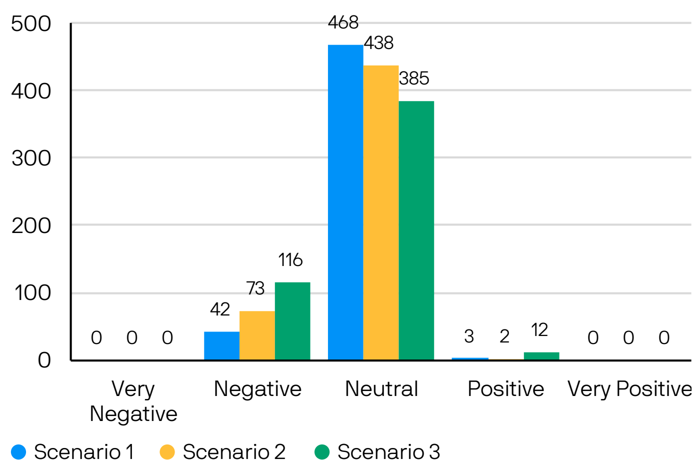
EM corporates outlook

Corporate fundamentals continue to be resilient and strong balance sheets should provide EM companies with a buffer against headwinds to global growth. We expect low- to mid- single-digit growth in earnings before interest, tax, depreciation and amortisation (EBITDA) in 2025, led by Asia, central and eastern Europe, the Middle East, and Africa (CEEMEA). While EBITDA growth is expected to be diversified across various sectors, 80% of the companies in the EM corporate universe are expected to grow. We also anticipate low leverage ratios, which are near historical lows, and high interest coverage ratios for EM corporates. This environment would lead to EM corporate default rates continuing to fall in 2025.

Despite the strong fundamentals, we expect a rise in volatility as the market grapples with uncertainty around US tariffs and lower oil prices. However, EM corporates benefit from limited exposure to US export revenue, as many companies in the EM corporate universe either have a domestic focus within their local market or are not reliant on a single export market. Many companies with exposure to the US market have US-based operations, which are unlikely to be impacted by tariffs. In our worst-case scenario, 27% of the index would see some adverse impact, but in aggregate, we expect companies to be able to withstand tariffs. Many EM corporate oil names benefit from contractual prices, low costs of production, and/ or strong balance sheets; however, we are becoming more cautious about the weaker names in the sector, which represent approximately 1.2% of the Corporate Emerging Markets Bond Index (CEMBI).

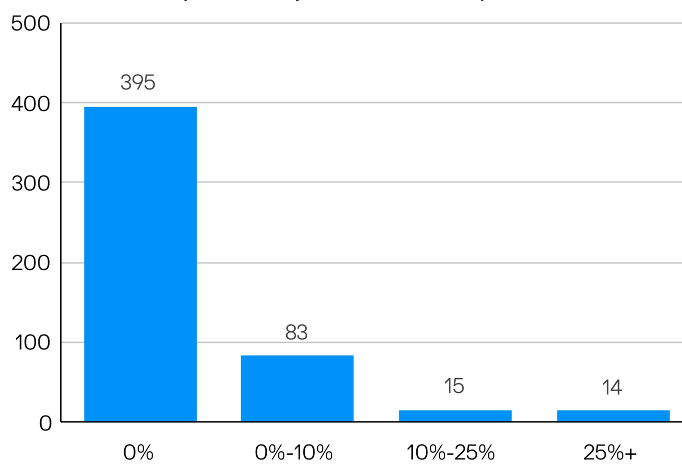
EM corporate spread valuations are stretched, although the all-in yield remains attractive. There is continued resilience in balance sheets, apart from specific idiosyncratic names or sectors. There is support from technical factors, though a more cautious approach is warranted regarding flows into the sector.

Exhibit 7: Tariff scenarios suggest no deeply negative implications for EM companies



Source: J.P. Morgan Asset Management; In Scenario 1, tariffs on existing Chinese products increase to 60%. Scenario 2 involves expanding these tariffs to a broader range of Chinese products, also at 60%. In Scenario 3, broad tariffs are applied across major trading partners, with 60% on Chinese products, 25% on Mexican and Canadian products, and a universal 10% tariff on products from the rest of the world. Sample included c.80% of the CEMBI MV% and 513 tickers.

Exhibit 8: US exports as percentage of revenues suggest limited EM corporate exposure to US export revenues



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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**

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