Where to turn on the road ahead

Emerging market debt strategy

Q2 2021

IN BRIEF

- Our base case scenario for the asset class shifts to reflation with a more robust global recovery. We expect emerging market growth of 7.1% in 2021, led by China with 8.6% growth.
- With rising potential for inflation, we expect Federal Reserve (Fed) policy to be a key driver of global markets. We assume the 10-year US Treasury will close the year with a yield of around 1.875%, meaning we see a moderately higher yield and steeper curve versus the current consensus. We do not believe this will result in a replay of the 2013 "taper tantrum."
- Emerging market debt may broadly underperform in periods of higher real yields, though higher-yielding emerging market credits tend to outperform investment grade and currencies. In our base case reflation scenario for the next 12 months, the JPMorgan – EMBI IG returns 4.3% and the JPMorgan GBI – EMGD returns 5.7%.
- In hard currency sovereigns we continue with our lower beta exposure, maintaining our overweight in BBs while looking to exit single B exposures that feel rich to us.
- Fundamentals have improved for hard currency corporates, but valuation is an issue. We see the JPMorgan – CEMBI trading at the lower end of the 2018 to 2019 spread range, with investment grade notably trading near the 2018 tights. The high yield space continues to offer value, while the duration-adjusted premium of emerging market investment grade to developed market investment grade remains attractive for crossover investors.
- In local currency debt, we are reducing our emerging market currency long position, shortening duration and shifting to a tactical and short bias. Within this positioning, we favour cyclical, "safer" emerging market currencies. We are also focusing on carry and markets that are less correlated with the core, such as the frontier universe. In local rates markets, we see low front-end rates leaving currencies vulnerable to repricing, while back-end real rates still offer value in some areas.

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DEBATING THE OUTLOOK

Our team recently gathered to debate the outlook for emerging market debt at a pivotal time, with rising 10-year US Treasury yields prompting debate over changing expectations around both growth and inflation. For emerging markets, real growth is good, while inflation can be more challenging. In recent quarters, the emerging market story has been supported by broadly prudent policymaking and efficient corporate execution. Asset prices have been further supported by the multi-year trend of index inclusion that has led to a growing institutional presence in the higher quality segments of the market. But in the foreground, a rapid rise in 10-year Treasury yields flags a changing global macroeconomic picture, requiring us to be nimble in our approach.

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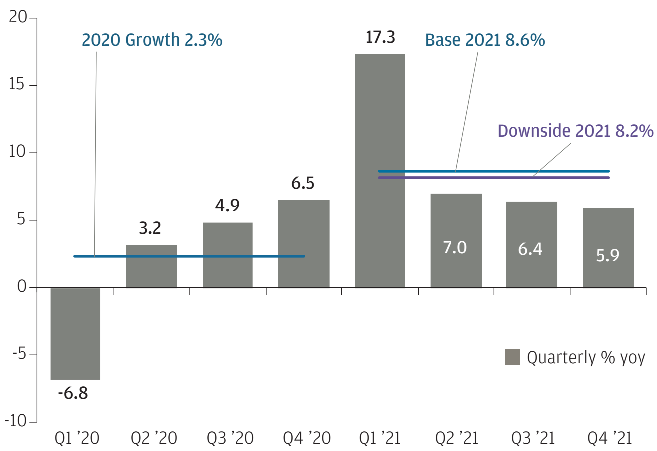
In response, our base case scenario for the asset class shifts to reflation with a more robust global recovery. Risk scenarios include inflation, where Fed guidance will be increasingly tested, and temporary setbacks to the recovery, such as a new wave of Covid-19, or tighter financial conditions. Overall, we expect emerging market growth will remain elevated and reach 7.1% in 2021. Rising exports and commodity prices will drive much of this growth while the domestic growth story remains challenged by the pandemic – but only for a few quarters, not years. Combined with the expected acceleration in developed market growth, the emerging markets growth premium declines to 2.2% in 2021.

CHINA: THE RECOVERY IS REAL

China remains a key driver of both the emerging markets recovery and the growth premium. We think China's growth trajectory remains healthy and expect base case growth of 8.6% year on year in 2021, with a downside case of 8.2% (**EXHIBIT 1**). We believe Chinese authorities are likely to continue their steady policy path, with no fiscal cliff expected. However, we think tension with the US is likely to remain.

China's growth trajectory remains healthy

EXHIBIT 1: QUARTERLY CHINESE GDP GROWTH (%, YOY)



Source: J.P. Morgan Asset Management; data as of March 2021.

The upcoming 14th Five-Year Plan (2021-25) will unveil more details on the Chinese Communist Party's long-term strategic initiatives that will help achieve President Xi's two-stage development plan to ensure "socialist modernisation is basically realised." This goal requires GDP to double or income per capita to reach the level of "moderately developed" economies by 2035, implying a 4.7% minimum growth target between 2021 and 2035.

China´s underlying economic activity remains firm, although with considerable variation between sectors, and consumer price index (CPI) inflation is under control. The recent sell-off in rates unwound the previous year-end rally, though we expect the People's Bank of China (PBOC) to keep a relatively neutral monetary policy with no changes in policy rates in the near term. We see the PBOC promoting credit growth generally in line with nominal GDP growth. More neutral policy, supply seasonality and regulatory tightening may lead to some continued defaults on the corporate side and some pressure on rates, but the usual liquidity injections by the bank should steady any meaningful sell-off or systemic risks.

Alongside China's recovery, investors need to consider the prevalent calculus around the Covid pandemic, as governments implement mass vaccinations in a race against more virulent virus mutations. Global manufacturing supply chains are so far improving in 2021 and should further normalise for the rest of the year. However, component shortages, logistical issues in shipping, such as port congestion and scarce containers, and rising raw material input costs pose a headwind to manufacturer revenues.

UNITED STATES: POISED TO SURGE

Risks to the emerging markets outlook begin in the US, where we see US fiscal stimulus turning the backdrop more reflationary. The pace of inflation's rise, beyond an expected spike in the second quarter, will likely realign policy and markets, but we expect bouts of volatility along the way. That said, the US is set to post its highest growth since 1984 on massive fiscal stimulus, closing the output gap by the third quarter. This makes the Fed policy path the key driver for global markets. On a trend basis, we see the Fed's core personal consumption expenditures (PCE) measure only rising gradually, but we think sequential monthly inflation will increase more quickly. Rising inflation may see a new test in the second quarter.

With the US economy poised to surge and the market questioning central bank policy, we see some investors querying the possibility of a "taper tantrum"-style event, similar to what happened in 2013. While we are sympathetic to the concern, we think financial feedback loops will limit a yield surge, though we see back-end yields continuing to rise this year. We assume the US 10-year Treasury will close the year with a yield of around 1.875%, meaning we see a moderately higher yield and steeper curve versus the current consensus. This steepening argues against a taper tantrum, which needs a bigger surge in front end real yields – an event more typically associated with a policy error.

For investors, this means risk needs to be sized and managed accordingly. In emerging markets, external balances are strong and positioning is less crowded than it was in 2013, during the last tantrum. Emerging market countries will have more fiscal flexibility, as an increase in economic activity brings higher revenues. Monetary policy could be more challenged as many emerging markets still have negative real policy rates.

The impact of all of these factors on the US dollar is crucial to the outlook for emerging market currencies. We maintain a mixed view. Historically, higher US growth is more associated with a weaker US dollar; bouts of higher real yields can trigger episodes of US dollar strength, though the correlation is not strong.

Recently, Treasury markets flipped from rising breakevens and declining real yields to declining breakevens and rising real yields. In our view, stable or modestly higher breakevens and gradually rising real yields seem more justified. Historically, rising real yields produce relatively lower emerging market debt returns and favour higher-yielding sovereign and corporate issuers over lower-yielding sovereign investment grade and emerging market currencies. Current valuations appear consistent with this positioning.

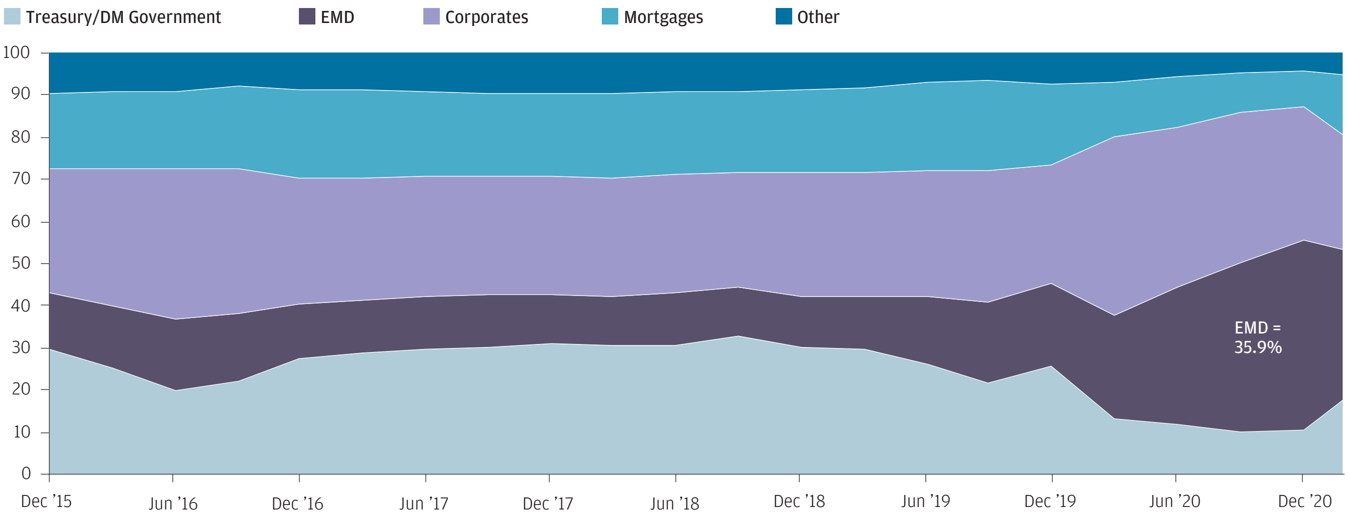
Taken together, we think headline emerging market growth should outperform in the first quarter, led by China, but that lead will come under pressure from a resurgent developed world in the second quarter, helped by vaccine rollouts and announced stimulus. Economic slack across the emerging market universe remains differentiated, but we think is set to narrow across the board in 2021; we expect fiscal spending to continue, but at a slower pace versus 2020.

EMERGING MARKETS: THE BENEFITS OF DIVERSITY

Diversity is a strength of the emerging markets universe, allowing investors to turn towards countries benefiting from a particular market environment. Currently we prefer countries with commodity exposure and lower core rate sensitivity. Among strong credits, we like Russia; among weaker credits, our appetite depends on policy signals and currently South Africa looks attractive. Our experience shows that emerging market debt may broadly underperform in periods of higher real yields, though higher-yielding emerging market credits tend to outperform investment grade and currencies. For this reason, we expect lower returns for the asset class on a 12-month forward basis. Our base case reflation scenario is the JPMorgan – EMBI IG returns 4.3% and the JPMorgan GBI – EMGD returns 5.7%. However, as core yields stabilise, we think returns could improve later in the year, when higher emerging market carry and growth are discounted by the market (**EXHIBIT 2**).

Despite lower projected 12-month returns, emerging market debt still accounts for 36% of the Barclays Global Aggregate yield

EXHIBIT 2: YIELD CONTRIBUTION (%) OF MAJOR FIXED INCOME ASSET CLASSES TO TOTAL BARCLAYS GLOBAL AGGREGATE YIELD



Source: J.P. Morgan Asset Management, Barclays Global Aggregate (Unhedged) benchmark; data as of 26 February 2021. DM = developed market.

Yield is not guaranteed and may change over time.

HARD CURRENCY SOVEREIGNS: THE CHEAPEST HOUSE ON AN EXPENSIVE STREET

With Treasury yields rising, we think a paradigm shift is underway, as the "Goldilocks" qualities of the previous period fade away with the idiosyncratic reasons to own hard currency sovereigns. In our previous quarterly, we noted that investors were content to ride risk, helped by an accommodative Fed – even at a time when some emerging market fundamentals appeared to be deteriorating, at the margin. This pushed managers to find value in those stories and resulted in a tightening of single-B to BB credits. Our approach last quarter was to trim beta to below one, and to take profits in quality high yield, while remaining selective in single Bs; essentially, staying with the crowd in the winners and resisting the temptation of value in the left-behind losers.

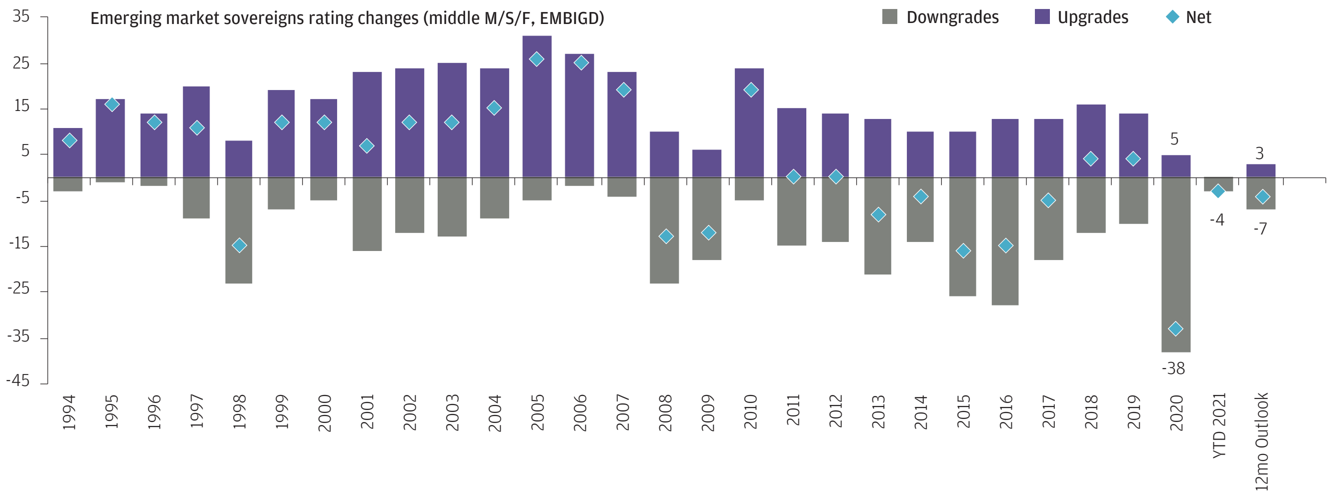
We now see hard currency emerging market sovereign debt as the cheapest house on an expensive street. With negative returns for the year to date, we worry that later arrivals to the space may lack staying power as the market shifts into a paradigm of stop, reset and go periods.

We continue with our lower beta exposure, maintaining our overweight in BBs while looking to exit single B exposures that feel rich to us. Unlike last quarter, where we found security in more crowded trades, we now are content to reduce exposure. The challenge now becomes more around portfolio construction and where to position for the next steps. We continue to like Pemex, Ukraine, Belarus, Nigeria, Kenya and El Salvador.

In defence of the asset class, emerging market hard currency debt has never been as strongly rated as it is now, which helps explain its appeal (**EXHIBIT 3**). In addition, emerging markets are benefiting from increased index representation, leading to greater levels of ownership from institutional investors seeking to add income or diversify risk. As these investors are drawn to the asset class for diversification, rather than higher risk/reward opportunities, they tend to be biased towards investment grade debt in an effort to minimise default risk. This helps explain why high yield remains attractive, especially when we compare BB to BBB spreads. However, further tightening may yet occur with only USD 32 billion in new issuance expected for the remainder of this year and the highest level of repayment this year likely coming in March.

Emerging market sovereign downgrades will continue to outnumber upgrades in 2021, but the trend is improving from 2020

EXHIBIT 3: EMERGING MARKET SOVEREIGN RATINGS CHANGES



Source: J.P. Morgan Asset Management; data as of 8 March 2021. Rating change outlook does not include changes between CC/C/D as these are often technical and temporary changes. The M/S/F refers to our taking of the middle the three major rating agencies – Moody's/S&P/Fitch. The EMBIGD refers to our using only the index constituent universe.

Opinions, estimates, forecasts, projections and statements of financial market trends are based on market conditions at the date of the publication, constitute our judgment and are subject to change without notice. There can be no guarantee they will be met.

HARD CURRENCY CORPORATES: WELL POSITIONED TO TIGHTEN

We expect the recovery in global growth and subsequent expansion following a period of low rates to produce a strong broad-based rebound in earnings and earnings metrics in 2021, returning to levels last seen in 2019. The recovery in commodity prices has been an additional tailwind for emerging market corporate earnings. As earnings recover, it is likely that credit metrics will improve, particularly if management teams remain disciplined. Emerging market corporates will have the capacity to borrow for growth opportunities, which could be a risk, but we think 2021's issuance can be easily absorbed, in light of current net supply dynamics.

The ratings picture has also stabilised and although we see upward pressure, we expect a measured pace of revision. To us, refinancing risks appear manageable, with an active new issue market and attractive funding levels. This leads us to expect below average defaults in 2021. Defaults have been relatively contained in 2020; we expect a similar trend in 2021, with potential for a positive surprise. Our base case assumption is for a 2.1% emerging market corporate high yield default rate of 2.1%, or 0.9% for the CEMBI overall.

The main issue is valuation. We see the JPMorgan – CEMBI trading at the lower end of the 2018 to 2019 spread range, with investment grade notably trading near the 2018 tights. As with sovereign debt, the high yield space continues to offer value, while the duration-adjusted premium of emerging market investment grade to developed market investment grade remains attractive for crossover investors. Hence we think spreads could compress further, especially given the CEMBI's historical ability to absorb potential rate rises.

LOCAL CURRENCY: SHIFTING GEARS

We see the current backdrop for emerging market local currency bonds supported by improving growth, relatively attractive valuations and less crowded positioning (and therefore more generous pricing) across the range of local markets. As we enter the second quarter, growth and inflation are likely to accelerate from current levels, prompting an increasing focus on reflationary dynamics within the emerging markets. We believe central banks are likely to remain on the side lines, leaving scope for markets to price in a greater inflation premium, especially in lower real-rate markets. Inflation-linked bonds and select high-yielding rates markets should outperform, as should the emerging market frontier countries.

A return to US growth leadership later in the year may heighten emerging market volatility, especially as the outcomes of US fiscal stimulus play out. We expect relative outperformance in selected emerging market high-yielding currencies and current account surplus currencies. Lower-yielding payers should also outperform in this scenario. We will watch Asian central banks especially closely, as they have increased interventions and could reduce upside on Asian currencies.

We are reducing our emerging market currency long position, shortening duration and shifting to a tactical and short bias. Within this positioning, we favour cyclical, "safer" emerging market currencies, but this trade needs a weaker or stable US dollar to really perform. Instead, we are focusing more on carry and markets that are less correlated with the core, such as the frontier universe. In local rates markets, we see low front-end rates leaving currencies vulnerable to repricing, while back-end real rates still offer value in some stories; hence we want to be selective in our engagement.

CONCLUSION: SOMETHING GOOD FOR THE ROAD AHEAD

As we look ahead, we see the expected rebound in global growth as supportive for emerging market debt, though the inevitable tightening of financial conditions that follows may present headwinds. We favour credit over rates as monetary policy normalises, preferring issuers with exposure to commodities and those with lower financing needs. Subsequently we think it makes sense to sell duration on strength, rotating into credit and carry. We see risks in financial conditions, from an equity correction and around strengthening inflation. As such, we think having a lower beta and being underweight duration makes sense, while targeting higher-quality high yield issuers and playing relative value in emerging market foreign currency.

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