The window of opportunity is open

Emerging Market Debt Quarterly Strategy

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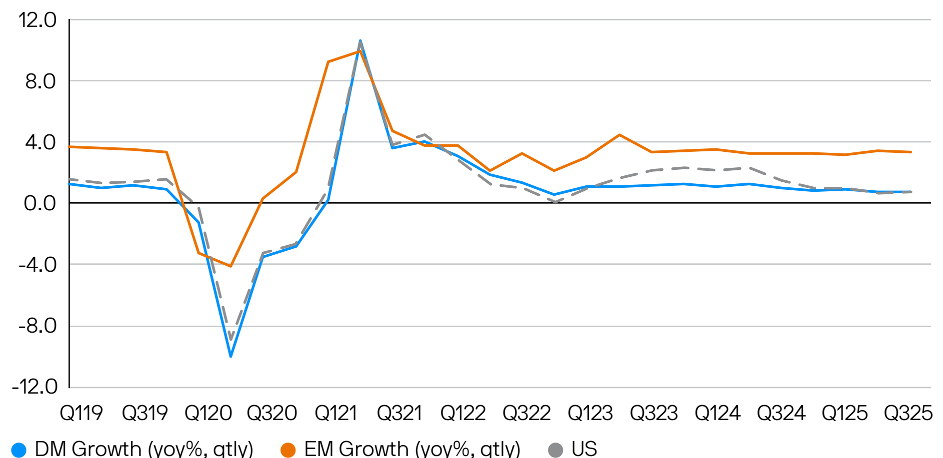
In brief

- The prospects for a soft landing in developed markets has risen since last quarter. If realised, emerging markets are set to deliver impressive high single-digit to low double-digit returns for the year.
- Emerging market assets have historically performed well when the Federal Reserve (the Fed) cuts rates. Even in the case of a US recession, emerging market returns are still expected to be positive, driven by a duration rally.
- Emerging market growth is expected to remain stable at 4.2% in 2025. The growth differential between emerging markets and developed markets is projected to exceed 2.5%, underscoring the resilience of emerging market economies.
- The combination of an increased probability of a soft landing in developed markets, Fed cuts and robust emerging market growth makes an appealing case for allocating to emerging markets. A strategic allocation can offer significant upside potential and diversification benefits in the current global economic landscape.

EM-DM growth and interest rate differentials improving

Emerging markets are poised for robust and stable growth at 4.2%. China's growth is expected to remain steady, bolstered by strong policy support, while the European Union's recovery will be gradual. US growth is expected to decline from above-trend levels towards trend or below-trend levels into 2025. As a result, the differential between emerging market (EM) growth and developed market (DM) growth is set to exceed 2.5% in 2025. Furthermore, the growth gap between emerging markets and the US is projected to widen significantly to 2.7% in 2025, from an expected 1.4% in 2024. This gap underscores the dynamic potential of emerging markets in the global economic landscape (**Exhibit 1**).

Exhibit 1: EM/US growth alpha is expected to expand meaningfully



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

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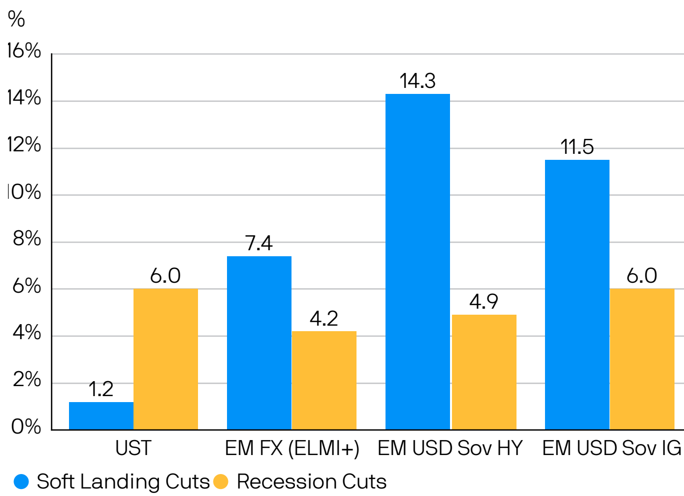
EM fundamentals are expected to improve in 2025 across growth, inflation, fiscal and debt metrics. We anticipate more sovereign upgrades than downgrades, and sovereign defaults are projected to remain low. While some EM economies have witnessed a fiscal deterioration in 2024 due to election and social spending, normalisation is on the horizon for 2025. Most countries will manage their financing needs effectively, even in the face of recessionary shocks, though some frontier markets may remain vulnerable. EM inflation remains well anchored by disinflation from China and stable commodity prices.

Fed rate cuts and the prospects for emerging markets

The Fed's pivot is a powerful catalyst for EM debt assets as they have historically thrived in Fed cutting cycles, particularly in the absence of a recession. While EM debt valuations have been more attractive in previous cycles, the current landscape is still consistent with strong positive returns for the remainder of the year. This performance implies high single-digit to low double-digit returns for the full year across emerging markets. Even in the case of a US recession, EM returns are still expected to be positive, driven by a duration rally.

With expectations for Fed rate cuts, and with EM inflation anchored, EM central banks are set to initiate or resume their own rate-cutting cycles. EM local rates have lagged the rally and real rates look very attractive compared to the US on a forward-looking basis. A soft landing scenario also provides good risk-adjusted carry and total return potential for EM sovereign and corporate markets. While the upcoming US election may introduce some volatility, the overall backdrop remains favourable, presenting a compelling window for investing in emerging markets.

Exhibit 2: EMD returns 24 weeks after the first Fed cut

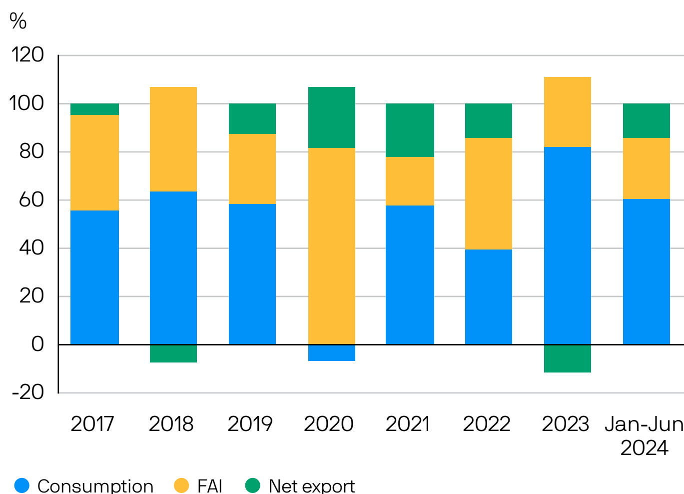


Source: Source: J.P. Morgan Asset Management, Bloomberg. Data as of September 2024. Soft Landing Cuts = '95, '98, '19. Recession Cuts = '01, '07

China GDP target remains achievable with more policy support

We have downgraded our 2024 GDP forecast for China to 4.8% from last quarter's 5.0%, on the back of weaker-than-expected second-quarter GDP and lack of evidence for a third-quarter rebound. However, we still think that the government's target of 5% GDP growth remains achievable in particular after the recently announced stimulus package. Manufacturing and infrastructure fixed asset investment (FAI) has been consistently performing well this year and will be the key growth driver. We expect exports to moderate gradually but net exports will still continue to contribute positively to growth. The Chinese authorities have scaled up funding coverage for consumer goods trade-ins and further relaxed mortgage policies, which should support domestic consumption. While the housing sector is still searching for the bottom, its drag on GDP growth is receding.

Exhibit 3: We expect FAI to continue to be a driver of China's GDP growth in 2024 and 2025



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

As mentioned above, policymakers have announced a sweeping set of policy measures to reignite economic growth in the country. The People's Bank of China (PBOC) has taken decisive action with significant rate cuts and robust support for the struggling housing and equity markets. Key measures include: 1) a 20 basis points (bps) cut of the seven-day reverse repo; 2) a 50bps cut to the reserve requirement ratio (RRR); 3) the relaxation of mortgage policy; and 4) new instruments to support stock market development, guiding banks to provide loans to support listed companies and shareholders in share buybacks and shareholdings. This announcement has exceeded market expectations and represents the most comprehensive easing effort since 2015.

Exhibit 4: EMD Roadmap Q4 2024 – Macro scenarios and strategy

	Scenario	Recession	Base Case Soft Landing	Firm Landing
Macro	Probability	25	60	15
Macro	Growth	Slowing sharply	EM-DM alpha improves and US slows	EM steady US at or above trend
Macro	Inflation	Falling	Continued decline	Sticky or rising
Macro	Financial Conditions	Tighter first, easier later	Looser	Tighter
Macro	Policy Room	Room for significant cuts	EM cutting cycles continue, though terminal rates above historical lows	Fed cuts but less than expected EM differentiated, less room
Macro	Commodities	Weaker	Range-bound	Supported
Strategy	Beta	Long core duration; favour front-end and belly	Long duration and credit risk lower beta	Reduce beta and focus on front end quality carry; short core rates
Strategy	Sector View	From Credit to Duration Cautious on risk	Receive EM rates OW Credit but up in quality; selective EM FX	RV on EM rates OW Credit with barbell Long USD then re-engage in cyclical EM FX

Themes for Q4 2024
EM supported by growth differential
EM rates differential attractive
EM Credit remains anchored, but rotate into quality (& idiosyncratic stories)
Increase EMFX into FED easing and US elections
Risks: election risk, volatility, geopolitical risk, tightening liquidity Risk Usage: Medium

Source: J.P. Morgan Asset Management, as of September 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 individual measures were anticipated, their magnitude is larger than forecast. The simultaneous move in one comprehensive package is clearly designed to restore market confidence and drive economic recovery.

Deflation persists but is gradually easing, with minimal impact on US prices. As China becomes more self-sufficient and invests heavily in value-added manufacturing capacity, the country continues to export large volumes of goods, exerting significant deflationary pressures overseas, particularly in Southeast Asia. However, profit squeezes are triggering substantial sectoral reshuffles in industries burdened by overcapacity, leading us to anticipate a gradual reduction in producer price index (PPI) deflation. The influence of China's exports on inflation in developed markets is increasingly disrupted by new industrial policies and the steady implementation of protectionist measures, such as sanctions and tariffs. These factors significantly curtail the overall pass-through to US prices.

Macro Scenarios: Shift from centre right to centre left

We have eliminated the firm landing scenario from our macro forecast, as "right tail risk" has significantly diminished due to low US inflation and moderating job growth. Our estimate of a soft landing has increased from 45% to 60%, driven by the economic slowdown and Fed easing. As the US labour market shows further signs of rebalancing, we have raised our recession probabilities, indicating a decisive shift from "right tail risk" to "left tail risk".

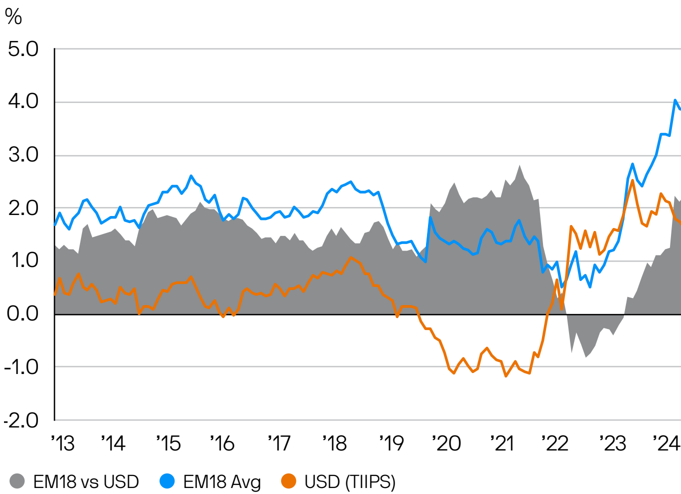
With the EM real rate differential appearing highly attractive, we favour high-quality long positions, especially given the tilt towards recession risk. EM credit remains stable, and we prefer exposure in countries with fundamental improvements, low issuance, and incremental increases in local currency denominated issuance. Despite tight EM corporate spread valuations, the all-in yield remains compelling. As scenarios increasingly tilt towards a weaker US dollar, we plan to increase our EM foreign exchange (EMFX) exposure into the Fed easing and the upcoming US elections. While the overall backdrop for emerging markets is positive, we remain vigilant about US election risks, geopolitical uncertainties and tightening liquidity.

EM local currency debt outlook

Our strategy is to maintain long duration positions as Fed rate cuts are set to boost EM rates, which have lagged the rally. EM valuations remain compelling in the long term, with both real and nominal rates appearing undervalued. Anchored EM inflation provides ample room for central banks, particularly in Latin America and Asia, to cut rates. While some Latin American countries continue to benefit from rate cuts and disinflation, we anticipate new cutting cycles across Asia and intend to be overweight in the region, favouring higher-quality assets.

We also intend to be long EMFX, focusing on high-quality currencies, as the overvalued US dollar is biased to weaken. This environment creates a supportive technical backdrop, especially for Asian currencies. Although the US macro environment generally favours EMFX, we remain cautious of recession risks and the potential volatility from the US elections.

Exhibit 5: EM rates are still quite cheap



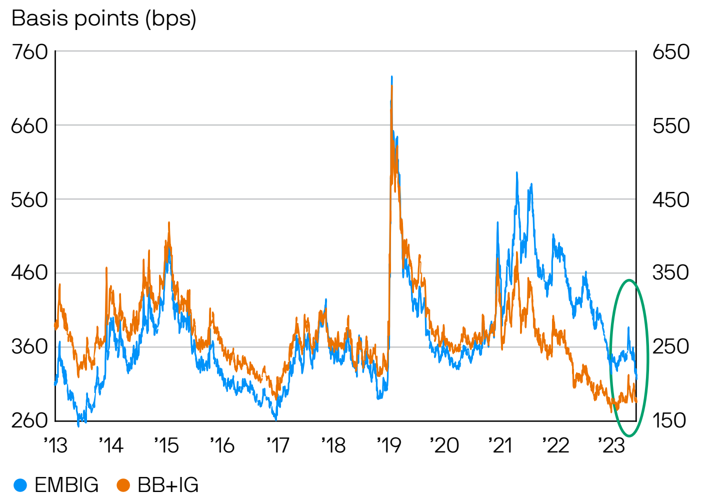
Source: Bloomberg; data as of September 2024.

EM sovereigns outlook

EM sovereigns remain well positioned to deliver high single-digit or low double-digit returns against a supportive backdrop of Fed rate cuts. While tight valuations are a risk, EM sovereigns do benefit from a better technical picture. The supply/demand picture remains supportive, as net supply remains very manageable even for an asset class that has been deprived of inflows for a couple of years. Positioning among crossover investors also remains supportive as the asset class has been out of favour for the last couple of years thanks to volatility around the Fed hiking cycle. Furthermore, there has been a large proliferation of local investors that have been buying their own dollar-denominated securities as well as countries embarking on more local issuance in order to improve the breakdown between their dollar- and local FX-denominated public sector debt ratios.

Spread valuations remain towards the tighter end of the historical range. Investment grade (IG) securities continue to be expensive but are still attractive compared to their DM peers. BBs remain slightly cheap compared to A rated names, especially for those issuers that we expect to be the next candidates for promotion to investment grade status. There is also still value to be found in the single B and below segments.

Exhibit 6: EM sovereign BBs are staging a comeback vs investment grade



Source: Bloomberg. Data as of September 2024.

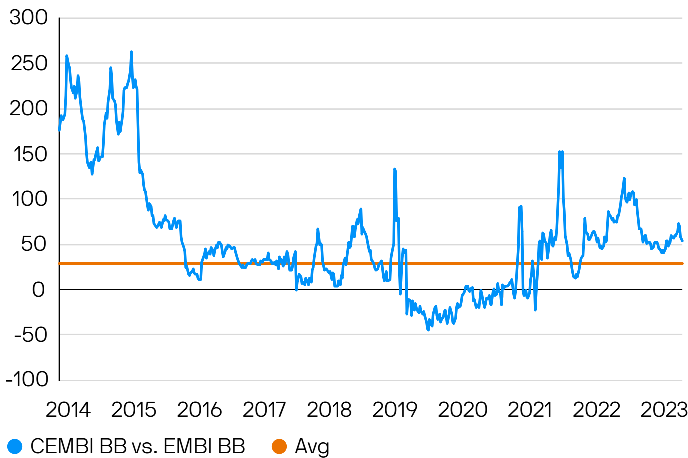
EM corporates outlook

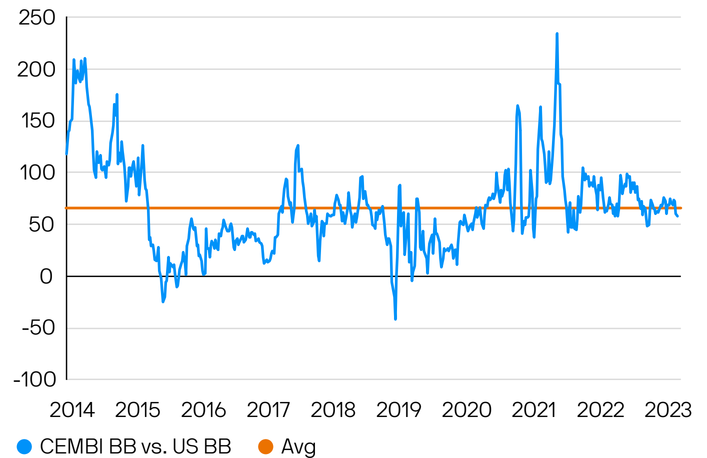
Corporate fundamentals remain robust, and our top-down view has remained consistent since the last quarter. While performance momentum has shifted in some sectors, the majority—excluding real estate—anticipate positive growth in 2024. We project the strongest growth momentum will be in Asia, followed by Latin America, with central and eastern Europe, the Middle East, and Africa (CEEMEA) expected to see relatively flat growth year over year. From a relative valuation perspective, Latin America offers the most value, followed by CEEMEA and Asia.

Balance sheets are resilient, with most corporates well positioned to withstand higher rates and a lower growth environment. However, idiosyncratic weak spots may surface in the bottom 12% of high-yield issuers during prolonged stress periods. Default rate expectations are slightly lower than last quarter but remain largely unchanged. Overall, EM corporates are in strong health, with risks being idiosyncratic and external to the asset class.

Our focus remains on idiosyncratic stories, new opportunities with attractive new issue premiums and carry opportunities that may also benefit from near-term upside catalysts. The spread pickup in the BB space is still attractive in absolute terms. In the medium term, the intention is to continue to rotate from short duration carry trades to a more balanced risk profile. In the short term, while we look to the new issue market to re-engage in quality credit along the duration curve we will manage our duration through futures and continue to achieve spread pick-up in shorter-dated opportunities.

Exhibit 7: EM corporate BBs remain attractive in absolute terms





Source: Bloomberg. Data as of September 2024.

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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