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Emerging Markets

Market Review and Outlook

September 30, 2021

Market Review:

The third quarter in Emerging Markets (EM) was driven by rate volatility and China headlines. July and August were relatively quiet yet constructive months for the asset class. It wasn't until September that inflation fears and slow growth mixed with a resurgence of China headwinds put pressure on spreads, leaving EM hard currency bonds with their biggest monthly loss since March 2020. Rates started the quarter with the 10-year treasury yield at 1.47%, hit a low of 1.18% at the beginning of August, and then saw a significant sell-off at the end of September to close out the quarter at 1.49%[1].

Global markets are pricing in greater risk coming from a confluence of factors playing out presently in China. The property sector is cooling due to macroprudential tightening, and Evergrande, a large player in the space, is facing liquidity strains that could lead to the largest default ever in the property sector. In addition, the recent escalation of regulatory tightening in pursuit of the CCP's "common prosperity" goals, which include tutoring, tech, and gaming, have added to the pressure. The "Zero Covid" policy as China's second wave is intensifying has caused an economic slowdown that had already been underway since 2Q21. All of these factors could weaken China's economic growth and have spillover effects into the global economy.

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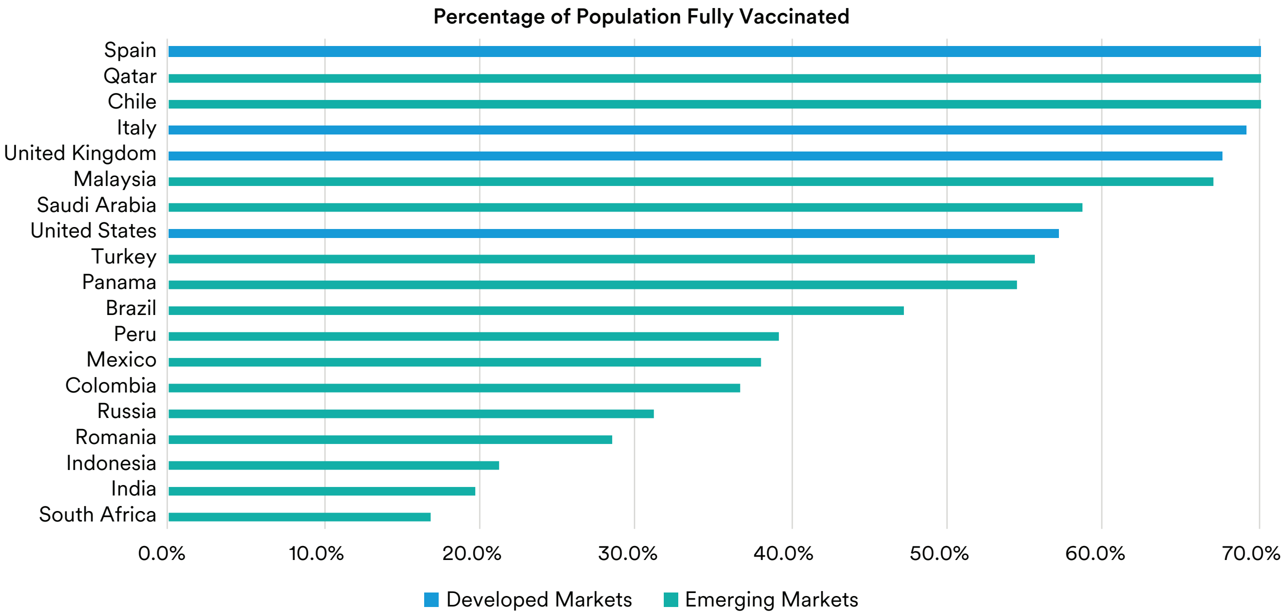
The COVID-19 recovery story continues to play out across the globe. As new variants cause waves of infections, the U.S. and Europe continue to push through the recovery process. In regions such as Asia, lockdowns had to be reimplemented as cases began to resurge and countries were lagging with vaccinations. The recovery spotlight is now on Emerging Markets, as they are next in succession with vaccinations becoming more readily available throughout countries. Growth is being closely watched for EM countries; we have been seeing growth forecasts in developed markets revised down to account for slowdowns caused by variants. The US is now in a normalizing phase, with growth peaking and remaining above trend into 2022 before reverting to pre-pandemic levels of approximately 2% over the medium term.

Figure 1 | Global Vaccination Rates



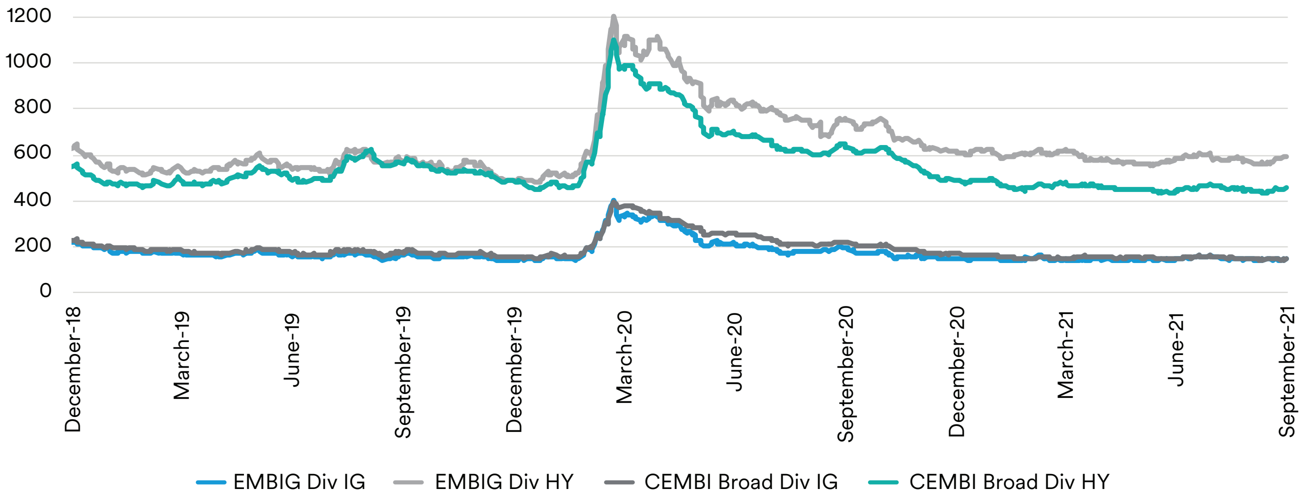
Source: John Hopkins University & Medicine Coronavirus Resource Center as of October 12, 2021

Natural gas was the notable outperformer in the commodity space. Gas exporters across the globe have benefited from this rise in prices; however, importing countries such as Brazil, where the worst drought in 90 years has depleted hydroelectric output and caused an increased need for natural gas, are suffering from the sharp rise. China's efforts to secure energy for the winter also worried investors. This power shortage has mixed impacts on metals; sharp production cuts to aluminum helped prices rally, while copper and other metals weaker demand outlook dampened prices. Iron ore erased noticeable strength from earlier in the year, driven by a slowdown across the China property sector. As demand continues to recover and OPEC+ has remained disciplined in increasing production to keep pressure on supply, Brent ended the quarter +8%, hitting a level not seen since October 2018[2].

The EMBI Global Diversified widened 17 basis points and returns for the quarter were -0.70%[3]. High yield (HY) underperformed investment grade (IG) in the sovereign space. Lebanon and Zambia were top performers. 13 months after the country's previous government resigned, Lebanon now has a new government established. The government has also promised to re-start negotiations with the IMF towards a reform program. Zambia's election delivered a positive surprise; Hakainde Hichilema beat incumbent President Edgar Lungu and received nearly 60% support which is promising for a smooth transition and reform implementation. El Salvador was the biggest detractor, as a number of controversial government initiatives caused tension with the IMF and US and has caused the country's program with the Fund to be put on hold.

The CEMBI Broad Diversified widened 9 basis points. Despite the spread widening, returns for the quarter remained positive, at 0.25%[4]. Similar to sovereigns, higher quality corporates outperformed. Transport and Infrastructure were the top performing sectors in the third quarter, as re-openings continue across countries and travel regains momentum. Real Estate was the notable underperformer, driven down by the elevated pressure on the Asia property space due to Evergrande.

Figure 2 | EMBI & CEMBI Spreads



Source: Bloomberg L.P., J.P. Morgan as of September 30, 2021

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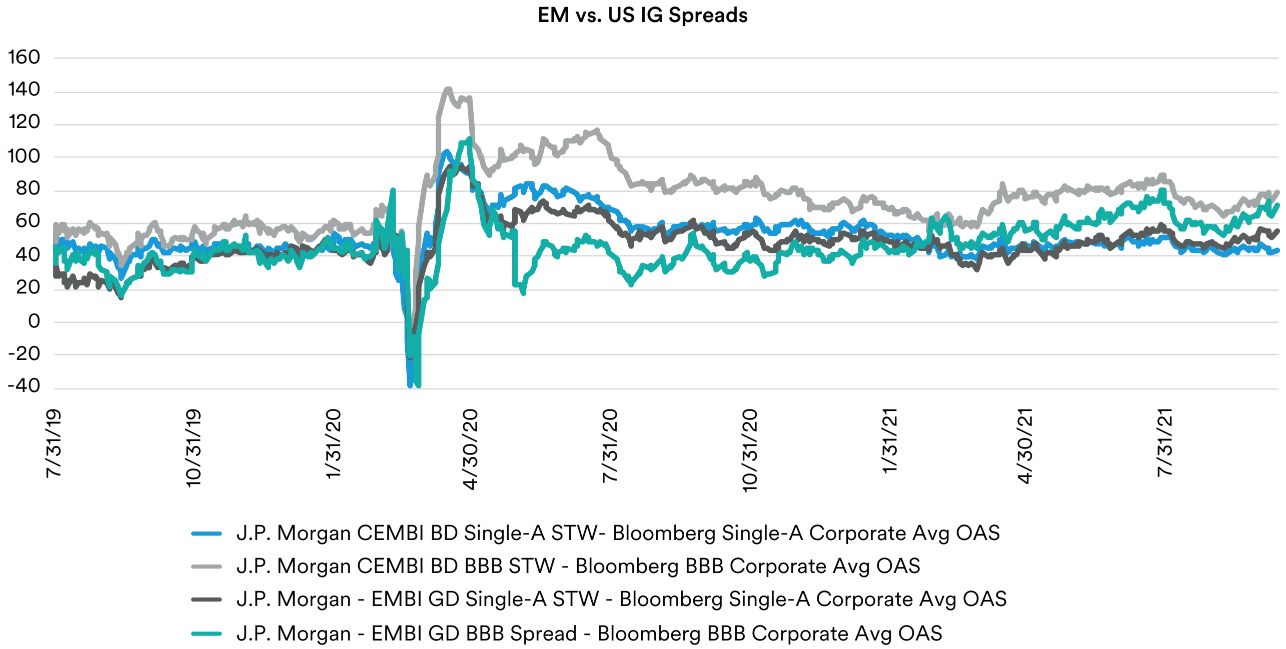
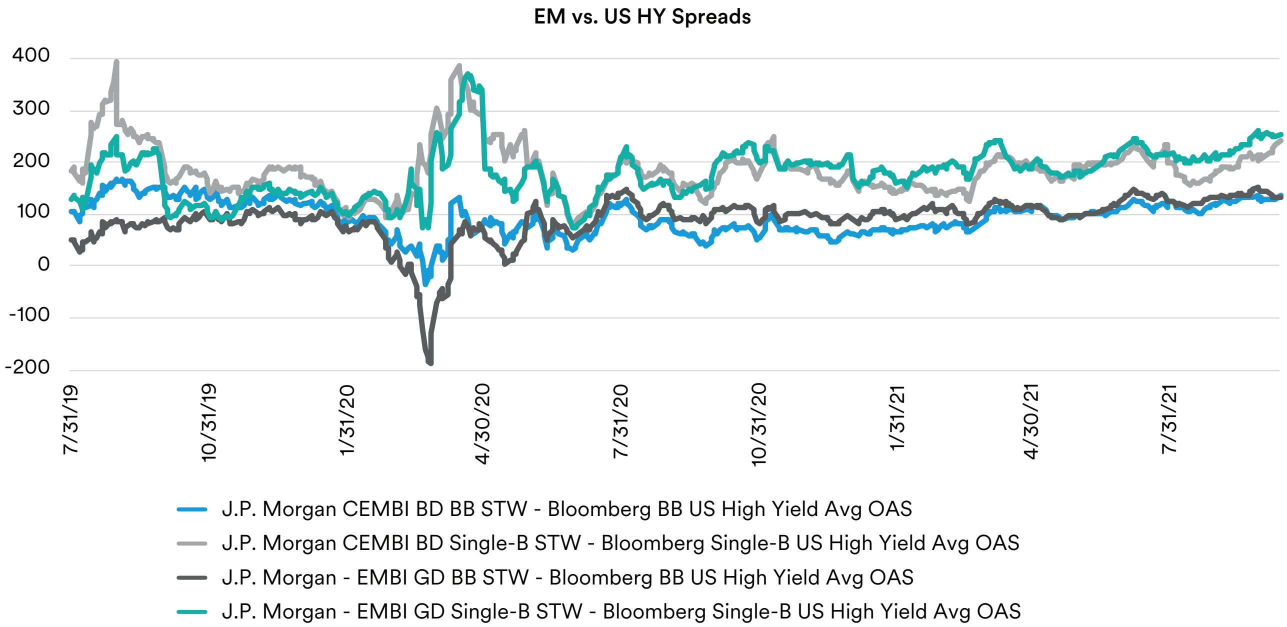
Tough conditions in September caused the GBI Global Diversified to erase all gains from earlier in the quarter. The market grappled with adjustments in Fed policy shifts and idiosyncratic local factors, ending with quarterly returns of -3.10%[5]. Latin America was the worst performing region on the local side, dragged down by Chile, Peru, and Brazil. Asia was the only positive returning region, led by strength in China and Indonesia local.

The spread differential between US IG and EM IG widened back out in July as EM underperformed DM. Then in August, that spread differential reversed as EM IG saw spread tightening while US was slightly wider. Finally, in September, we once again saw EM underperform versus DM, leaving potential for future spread compression going into year-end. The High Yield space told a somewhat different story. US HY was more volatile and saw a large sell-off during July into August before rallying back at the beginning of September. At the same time, EM HY was somewhat stable, with the CEMBI single-B space seeing the most spread widening in July, but then was followed by notable tightening in August while the US space was still weakening. Similar to the IG space, EM HY underperformed DM in September to end the quarter as concerns of a China slowdown driven by the property sector weighed on Emerging Markets as a whole.

Figure 3 | Spread Differentials EM vs DM





Source: Bloomberg L.P., J.P. Morgan as of September 30, 2021

Sovereigns issued $48.7 billion of new deals in the third quarter. This brings the year-to-date (YTD) total to $148bn, which is on track to outpace 2017 – 2019 levels. Net issuance for the year stands at $99 billion[6]. At a regional level, Latin America has the most primary issuance thus far in 2021 ($44.6 billion), followed by the Middle East and Africa ($40.8 billion). Chile now leads sovereigns with total borrowing ($14.6 billion YTD), followed by Indonesia ($11.3 billion YTD), both of which are expected to come to the market with additional deals prior to year-end. Corporates issued $110.6 billion in primary deals over the quarter. Year-to-date issuance is now at $437.1 billion, while net issuance remains at a manageable level of approximately $100 billion[7]. In the quarter, investment grade new debt was heavy, with 62% of new deals IG rated. 67% of third quarter corporate issuance was out of Asia. This continues the trend seen for much of the year as both new and existing issuers most notably in Asia are taking advantage of the low yield environment. Apart from the second quarter, hard currency flows in Q1 and Q3 have been relatively benign this year. Local currency on the other hand is witnessing the best year of flows in the past three years.

The corporate default rate ended the quarter at 1.7%. The year-end forecast has been adjusted upwards to 5.5%, accounting for the China HY space. Excluding China, year-end defaults are still expected to remain relatively low at 1.8%. In the EM HY corporate space, 4.8% of bonds are trading at distressed levels (i.e. <$70 bond price), and the Asia property sector accounts for the largest percentage of those securities[8].

The issuance of ESG labeled bonds remains a fluid theme in primary markets as sustainability becomes more of a focus among investors and issuers. In the third quarter, corporate ESG issuance was $26.6 billion, representing 24% of total issuance and well above the YTD run rate of 19%.[9] Out of the $48.7 billion of sovereign issuance in Q3, approximately 25% of it was labeled as green, sustainable, or social bonds. This included deals from Chile, Indonesia, and Mexico[9].

The IMF approved its record $650 billion special drawing rights allocation, the most recent action taken by the IMF to provide global support to countries recovering from the financial burdens that the COVID-19 pandemic brought on, or in some cases exacerbated. 42% of the record allocation is going towards emerging and developing countries[10]. Some of the most benefited countries include smaller, lower rated countries such as Sri Lanka, Pakistan, Ecuador, Argentina, and El Salvador, which can use the funds to resolve external liquidity pressures.

Figure 4 | Representative List of Emerging Market SDR Allocations

Country	% of Total SDR Allocation	SDR Allocation ($mm)
India	2.8%	12,570
Russian Federation	2.7%	12,368
Brazil	2.3%	10,583
Saudi Arabia	2.1%	9,578
Mexico	1.9%	8,542
Argentina	0.7%	3,055
South Africa	0.6%	2,924
Philippines	0.4%	1,958
Egypt	0.4%	1,953
Pakistan	0.4%	1,947
Pakistan	0.4%	1,947
Ukraine	0.4%	1,928
Chile	0.4%	1,672
Peru	0.3%	1,279
Ecuador	0.1%	669
Sri Lanka	0.1%	555
Oman	0.1%	522
Panama	0.1%	361
Costa Rica	0.1%	354
El Salvador	0.1%	275

Source: IMF as of August 23, 2021

As for fundamental developments across the EM space, Latin America once again dominated the headlines over the quarter. In Peru, President Castillo officially started his term. During his inauguration speech, he was less moderate than recent comments, promising a new Constitution, rebuilding the pension reform, and a more active state. Castillo will not likely have support in Congress for most of his initiatives. Moody's downgraded Peru's credit rating to Baa1 from A3, and changed the outlook from Negative to Stable, citing increased political risk and weakened policymaking capacity. Argentina's ruling coalition suffered a large defeat in the mid-term election primaries. Markets reacted positively on the expectations of more orthodox economic policy, and a possible regime change in the 2023 presidential elections. It is still unclear whether the ruling coalition will double down on unorthodox policies or shift to a more sustainable macro mix. In Mexico, President AMLO continues moving forward with an electricity sector reform that would devolve power from regulatory bodies and private sector players back to the state-owned company (CFE), among other measures. However, this reform faces a likely rejection by Congress after AMLO's coalition lost its qualified majority over the summer. Chile is in the process of approving a 4th pension withdrawal bill, despite President Pinera's efforts to have it rejected. If approved, this latest measure would inject up to $20 billion into the economy.

Outlook:

The uncertainty around the path of inflation, the easing of supply side constraints, the scale of tapering, as well as the future composition of the Fed are major factors unfolding over the next quarters. In both EM and DM, the rates story is going to play a large role in the direction of markets. So far, EM central banks have responded more aggressively to inflation versus DM by increasing rates.

China's crackdown on the use of leverage and focus on "common prosperity" will likely continue to create market uncertainty and volatility as evidenced in the tech, education, property, gaming and energy sectors. This along with the "Zero Covid" policy and energy shortages amidst a strong decarbonization push add headwinds to the economy's growth rate. With so many competing objectives, the risk of policy miscalculation is high. However, Beijing's goal is to provide social and financial stability and although historically the government has not always communicated its intentions clearly it has had success managing its policies to prevent larger shocks to its economy. China will likely look to offset some of these risks by loosening monetary and fiscal policy as we progress into the fourth quarter, primarily through increasing credit.

> The abundance of important elections in Latin America continue to play an important role in the forward-looking outlook for the region.

As we close out 2021, election noise is winding down. There will be important elections in Chile and mid-terms in Argentina, as well as a Presidential election in Honduras. Looking forward into 2022, Colombia and Costa Rica have elections on the calendar. The abundance of important elections in Latin America continue to play an important role in the forward-looking outlook for the region. With power shifting hands in many countries, policy changes will be closely monitored.

The IMF will likely remain accommodative going into 2022. The increased SDR allocation should be helpful for countries that need to pay multilaterals, such as Argentina and Sri Lanka. The SDR "onlending" from rich countries could provide additional support; however, it is unsure what will be required in return. The G20 heads of state/government are scheduled for the Leader's Summit October 30 – 31st in Rome. Prior to this meeting, an extraordinary meeting of the G20 major economies will be held October 12th to discuss the Afghan crisis that is fueling worries within the European Union over massive flows of migrants.

Figure 5 | Leftist Shift in Latin America: Biggest Concern

	Consensus Rating	Current Leftist government	Election Risk next 12 months	Violent Protests 2019-2021	Constitutional Reform Proposal	Mitigants to Political Shift
Mexico	BBB	✔			✔	AMLO has executed responsible fiscal policy. Hasn't pursued an aggressively leftist agenda.
Chile	A-		✔	✔	✔	Robust institutional and credit strength provides cushion for ratings.
Peru	BBB+	✔			✔	Society and broader government not committed to leftist path, president is showing signs of moderation.
Colombia	BB+		✔	✔		Committment to reform has stabilized ratings. Leftist candidate has stalled in the polls.

Source: MIM

Sovereign issuance is still expected to be robust into the end of the year, as many countries still need to pre-finance 2022 needs. However, higher rates could dissuade countries that were considering pre-financing future needs, as a large portion of the forecasted issuance is discretionary. New deals from China, Brazil, Kuwait, Ghana, Ivory Coast and Israel are likely before year-end. Corporate issuance is expected to hit new records for 2021; however, a pickup in tenders and buybacks have kept net supply in the corporate space manageable.

Positioning/Strategy:

In this the low yield environment, we believe there is attractive value in Emerging Markets relative to Developed Markets. We seek to capture these opportunities through focused security selection within our portfolios. While sovereign balance sheets are undergoing recovery, corporate balance sheets have recovered, and in some cases stronger than they were prior to COVID-19. In addition, in an environment of higher rates, shorter duration profiles are more favorable. Therefore, we feel corporates continue to remain the sweet spot in the EM space given the current market environment. However, over the coming months we do anticipate more clarity on both US tapering policy and China's growth, at which point we could foresee outperformance within the sovereign space. For instance, we see potential opportunities in energy-based high yield sovereigns including Oman and Angola, as well more stable investment grade names such as Indonesia and Mexico. Mexico continues to be attractive based on relative fundamentals versus the rest of Latin America. On the more tactical side, the recent move in Chinese asset prices could be an opportunity, as we expect policy responses to the more subdued domestic growth outlook in the fourth quarter.

With the macro picture pointing towards the potential for rising inflation and decelerating growth, the environment presents challenges for local currencies. The US dollar generally benefits from monetary policy uncertainty and an increasing willingness to begin removal of excess liquidity. Non-dollar exposure continues to be a cautious and tactical portion of portfolio allocations as we transition from massive global stimulus to rate hikes in many parts of the world. We believe continued elevated inflation risks, policy decisions, and liquidity needs will weigh on relative prices.

Endnotes

[1] Bloomberg L.P.
[2] Bloomberg L.P.
[3] J.P. Morgan
[4] J.P. Morgan
[5] J.P. Morgan
[6] J.P. Morgan
[7] J.P. Morgan
[8] J.P. Morgan
[9] J.P. Morgan
[10] IMF

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