PUBLIC FIXED INCOME

Emerging Markets

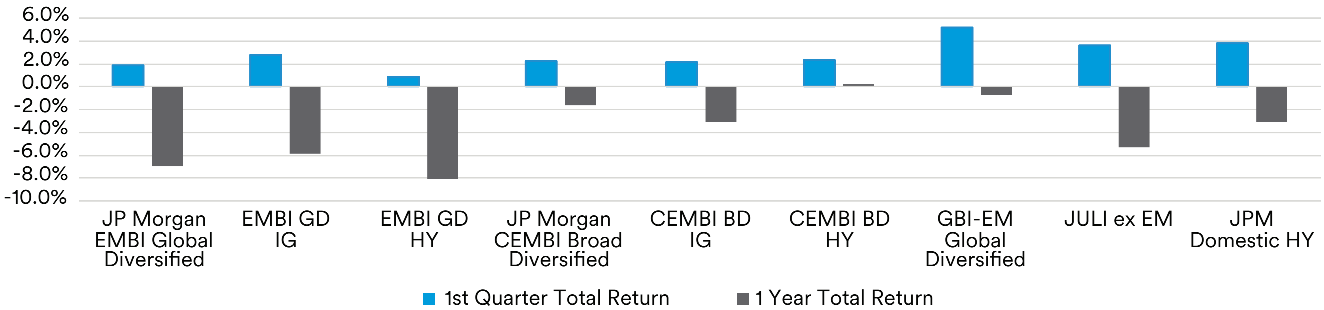
Market Review and Outlook

March 31, 2023

Market Review

2023 has thus far developed into another volatile and challenging year for investors, given tighter monetary policy leading to slower global growth and macro uncertainty. The quarter witnessed its fair share of economic push- and-pull factors. A supportive, soft-landing tone in January was pushed aside by stubborn inflation data in February, then disrupted further by the regional bank concerns in March. Despite the volatile "new normal" economic environment, emerging market (EM) indices were able to post positive returns for the quarter, with the China recovery quietly supporting the asset class in the background.

Figure 1 | Indices Total Returns



Sources: Bloomberg L.P., JP Morgan

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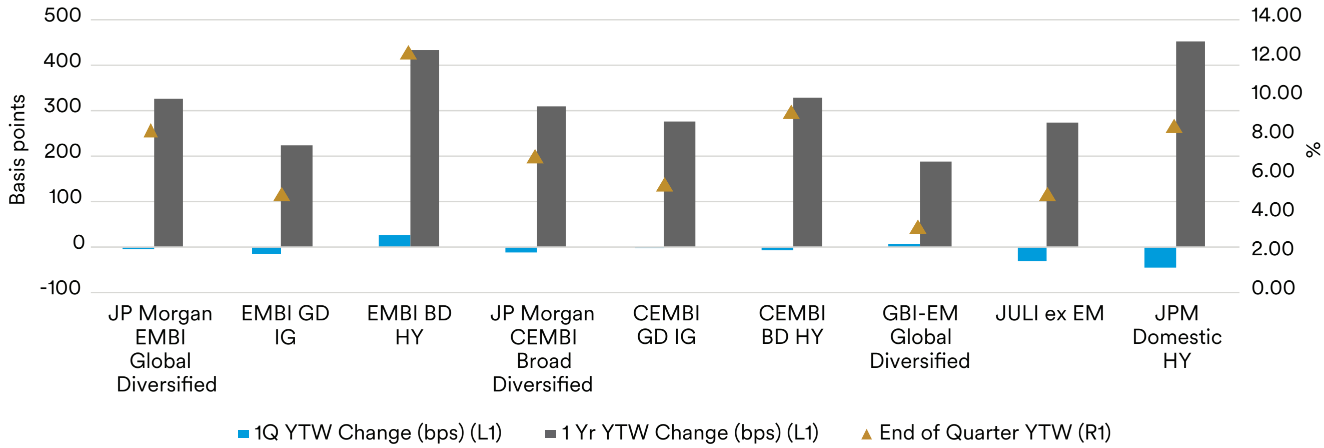
Figure 2 | Indices Yields

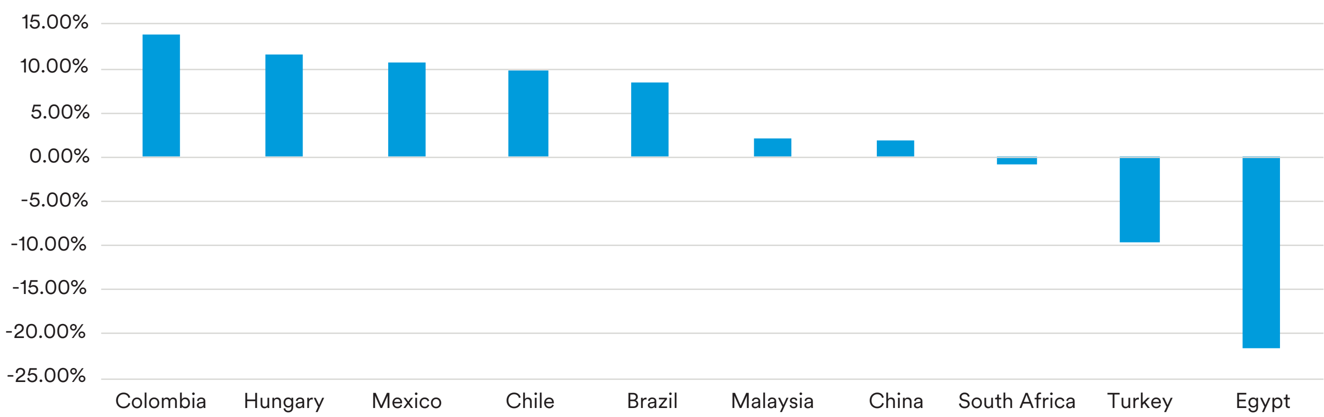


Sources: Bloomberg L.P., JP Morgan

The 10-year Treasury remained volatile, hitting 4.05% in early March, only to close the quarter at 3.47% as the market grappled with the fallout from Silicon Valley Bank (SVB) and its implication for tighter lending standards going forward. The banking uncertainty within the U.S. and Europe has remained more of an idiosyncratic story rather than a systemic one, leaving EMs relatively detached from the headwinds. Therefore, while EM assets have traded down in sympathy with the market, EM banks have been well isolated from contagion risk and stand out for their strong capitalization.

The Fed is facing a unique situation: Inflation remains stubbornly high, while the recent banking unrest, worsened by elevated interest rates, leaves a question mark around the trajectory of growth moving forward. The latest language by Fed Chair Powell, after the Fed's ninth-consecutive rate hike, hinted at a soft-landing recession scenario, but that remains to be seen. Recent sentiment around a more predictable path of Fed policy, given the concerns around lending standards, continues to support non-dollar assets in both the developed and emerging worlds. As a result, higher-beta local currencies were able to rally for much of the quarter, largely unfazed by banking concerns and more focused on attractive real rates.

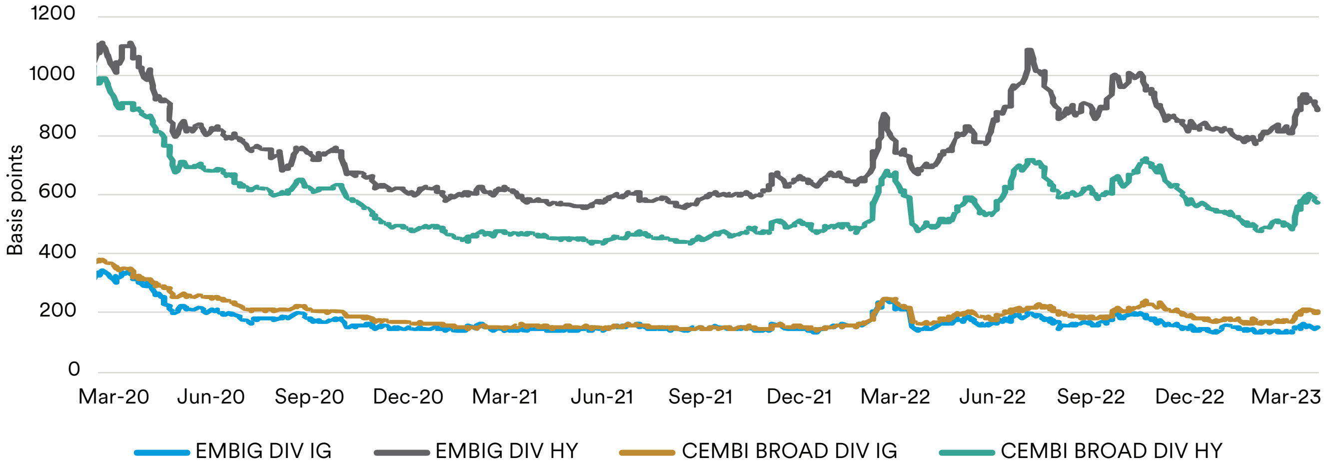
Figure 3 | GBI-EM Global Div Q1 Top/Bottom Performing Countries



Source: JP Morgan

Investment-grade assets outperformed during the quarter. Investors rotated up in quality as uncertainty increased, reducing high-yield overweights and extending duration in high-quality, long-duration assets. Over the past few months, there has been an increased focus on sovereigns, with investors looking to increase portfolio liquidity, reduce tracking error in dedicated portfolios, and take advantage of recent issuance that priced attractively.

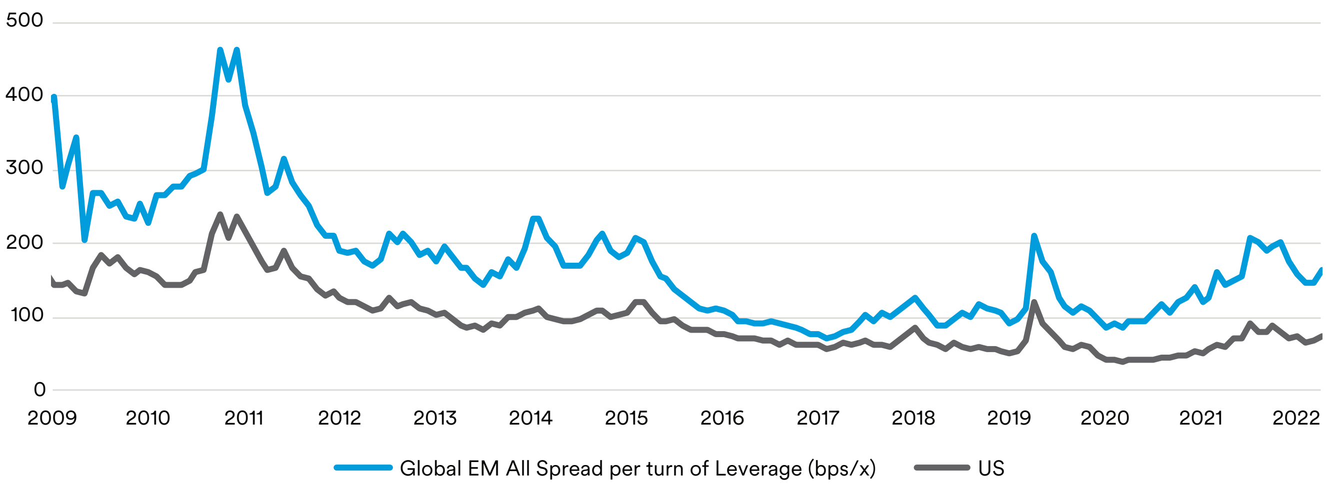
Figure 4 | Emerging Market Indices' Spreads



Sources: Bloomberg L.P., JP Morgan

At the index level, strong fundamentals continue to be a theme among EM corporates. This has proven especially true as of late, with the recent banking turmoil putting pressure on developed market (DM) financials, while EM issuers have held more stable. Therefore, despite EM valuations screening tight relative to DM, EM corporate fundamentals remain durable. Positively, spread-per-turn of leverage continues to screen attractive across EM assets.

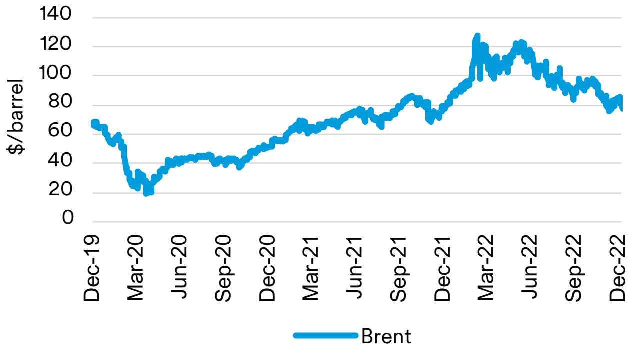
Figure 5 | Spread-per-turn of Leverage (bps/x)

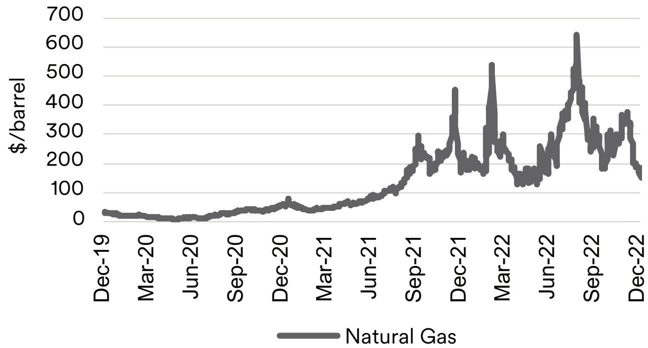


Source: BofA Global Research. Fundamental Data as of June 30, 2022, Spreads as of March 31, 2023

Europe has been able to avoid the worst-case energy shock scenario and does not face the same financial risks as the U.S., with Credit Suisse viewed as an isolated event. Gulf Cooperation Council (GCC) economies continue to persevere, as energy prices remained stable through January and February before growth concerns caused a sell-off in March. OPEC+'s delivery of a surprise production cut, after quarter-end, helped support brent prices, providing an ongoing positive technical for many EM countries and companies.

Figure 6 | Historical Brent & Natural Gas Prices

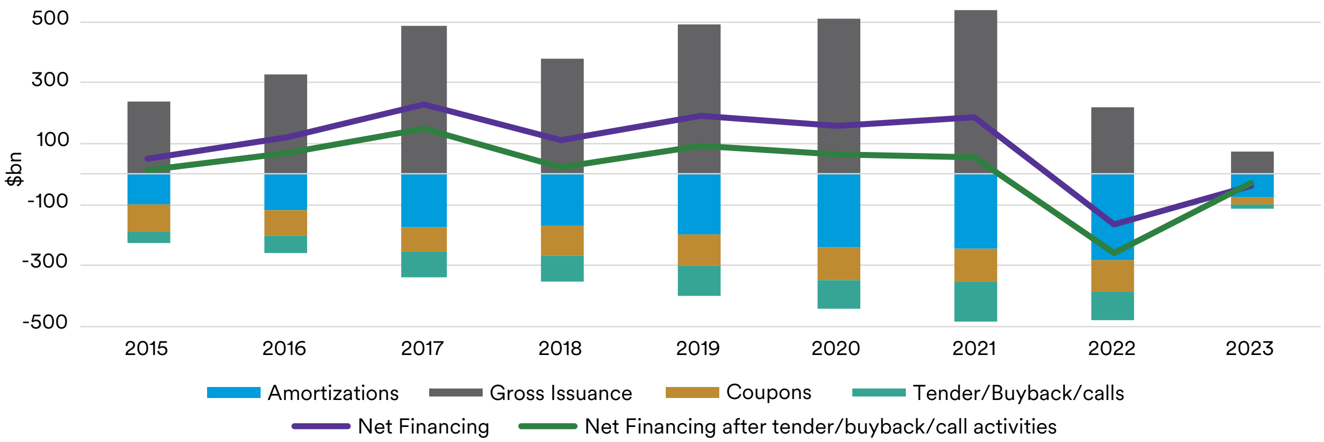




Source: Bloomberg L.P.

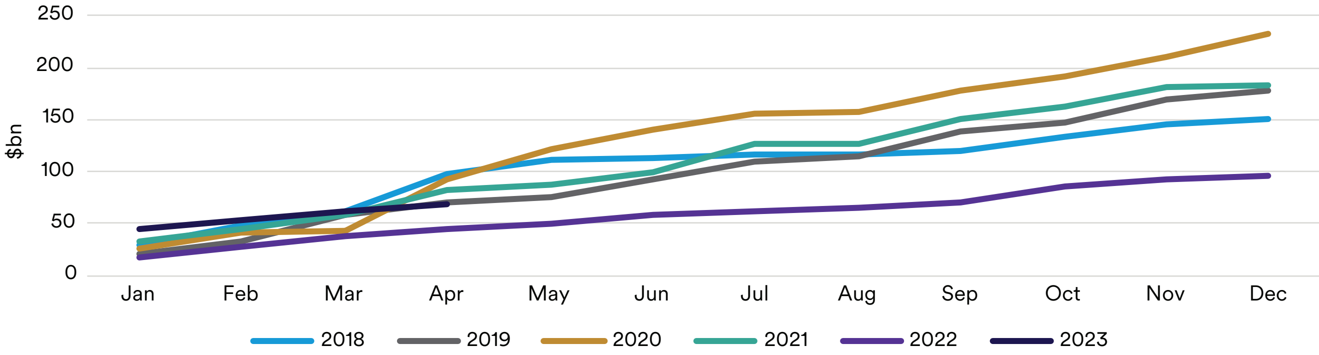
Issuance continues to be subdued, principal and interest payments remain high, and non-dedicated investors have low exposure to the asset class, leaving room for future demand and positive price reaction. Issuance trends followed spread movements, with January being the largest month of supply, representing 65% of the $68.2 billion in sovereign issuance for the quarter. Corporate year-to-date supply of $76 billion was the slowest first quarter of issuance since 2016 ($50 billion). Issuance is projected to remain light going into the second quarter. Corporates largely don't need to issue; they have done a good job with their balance sheets, and some can issue locally at lower rates. This has been highlighted through the continued negative net financing (-$40 billion year to date) that we have seen consistently since 2022[1].

Figure 7 | Corporate Net Issuance



Source: JP Morgan

Figure 8 | Cumulative Gross Sovereign Issuance



Source: JP Morgan

Defaults across EMs have been limited. From the sovereign side, the IMF has helped smaller countries by extending borrowing limits. Recent program advances with Sri Lanka, Papua New Guinea and Jamaica have provided an additional layer of comfort to higher-beta countries. While strong corporate fundamentals and access to local financing have helped the corporate default rate remain low, bonds trading at distressed levels remain elevated. This is driven by refinancing concerns in a higher developed-market rate environment and worries about capital controls in distressed sovereign countries. Excluding the troubled sectors from last year, (Chinese property, Ukraine and Russia) over 10% of the HY Corporate index is trading at distressed levels[2].

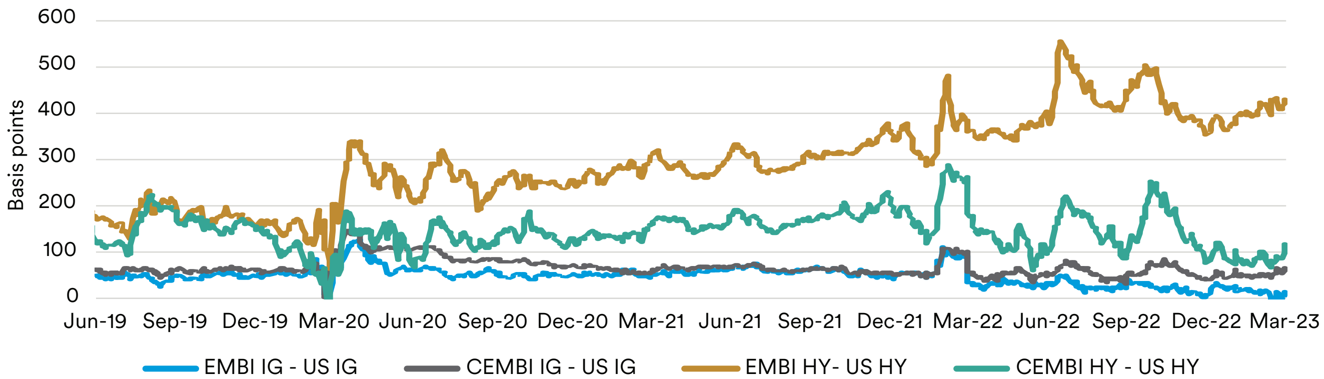
Outlook:

The near-term outlook remains uncertain for fixed-income markets, with macro headlines and trends remaining the main driver of EM performance. Will the banking sector fears subside and the market return to a soft-landing scenario? If that is the case, will the Fed continue its higher-for-longer stance? Or will banking problems materialize, leading to contagion and further investor fears, forcing the Fed into rate cuts too soon and risking inflation progress reversing course? While we have more clarity around some of the idiosyncratic stories in EM countries, such as political concerns within Latin America, assets have still been weighed down by the broader unease. Any significant developments around global inflation, growth or geopolitical tensions would likely lead to a repricing of EM assets.

We do not want to discount the support from the China recovery. Despite being relatively quiet thus far, we expect that in the second half of this year, as growth accelerates, the positive support will help EM outperform DM. The recent pullback of Zero COVID Policy within China, along with the domestic authorities' shift to a more pro-growth stance, could be constructive for the asset class. As of recently, good economic news out of China has been largely overshadowed by the relentless flow of geopolitical headlines. The shift to a more domestic-oriented growth policy should insulate China's exposure to wobbles within the U.S. and Europe and provide a stable outlet for EM exports. Additionally, more active Chinese consumers would support the service sector within tourist destinations. This idea of consumption over investment is not like what we have seen in previous recoveries, helping some economies but not others, and leading to differentiation among countries.

The push and pull of DM uncertainty, coupled with a better Chinese growth outlook, will likely drive asset prices. We believe the market will reward data or dialogue that starts to remove some of the uncertainty around either Fed policy or worries of a hard landing. We see value in some of the better stories within high-yield and investment-grade assets that screen cheap to DM assets. The market focus remains on stories that need capital in both the sovereign and the corporate space, with official creditors in the driving seat in countries like Sri Lanka and Zambia, as well as bank lenders in control on the corporate side.

Figure 9 | EM versus DM Spread Differentials

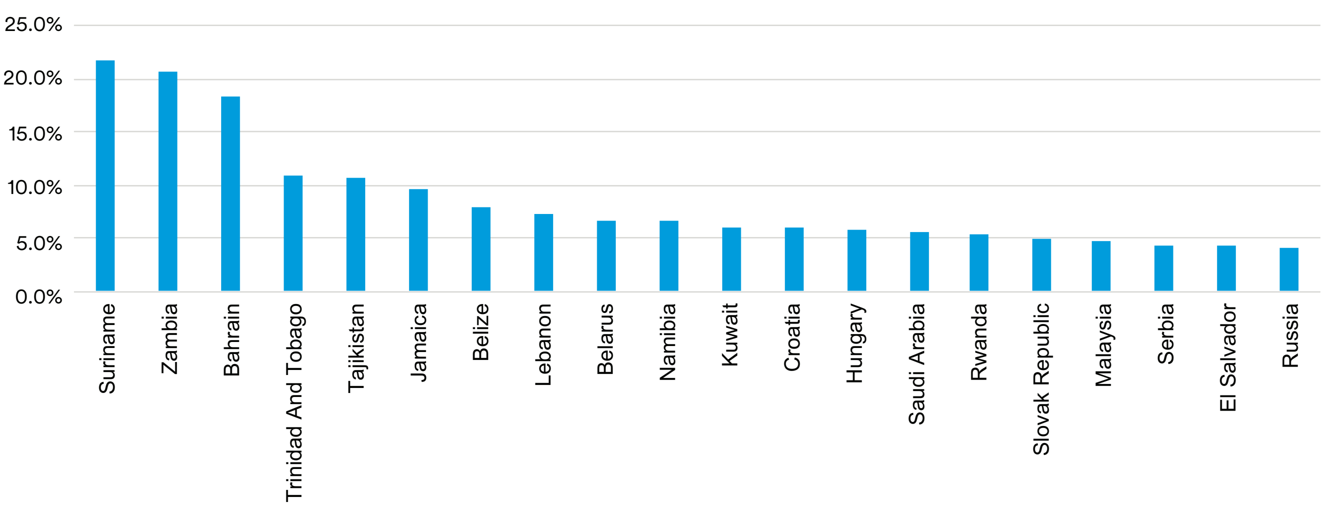


Sources: Bloomberg L.P., JP Morgan

Along similar lines, the damage done to the economy from elevated financial risks, assuming risks dissipate from here, provides a near-term environment of lower growth, cooling inflation and a Fed near its peak. This backdrop, along with steady recovery in China, present opportunities for non-dollar assets. Given the policy moves over the past two years and the continued hawkish bias of many central banks, EM rates, especially out the curve, could provide a great opportunity as the market becomes more comfortable with the path of disinflation this year. Therefore, the unfolding environment proves favorable for high-quality, long-duration hard currency and local currency assets, in our view.

The combination of increased multilateral funding, governments waking up to a new world in which the cost of capital has increased, and political environments not being as nationalist as some initially thought, could lead to differentiated returns at the country level. Countries have been more fiscally disciplined, as local institutions have pushed back on governments to keep them more moderate and therefore limit spending. For example, Boric's socialist agenda in Chile has stalled, and we believe Colombian reforms will need to be more moderate to pass. If these countries should need funding, the external market has been supportive of sovereign issuers, with deals largely oversubscribed and minimal concessions needed to spark investor demand. For distressed countries that are finding it more difficult to access the market, the IMF has continued to help ease economic challenges in the near term. With this support, defaults remain relatively contained, and in some cases, official sector-led restructurings may put multiple economies on more sustainable paths and help some distressed assets recover significantly higher than where they are currently trading.

Figure 10 | IMF Potential Additional Regular Access ($ as % GDP)



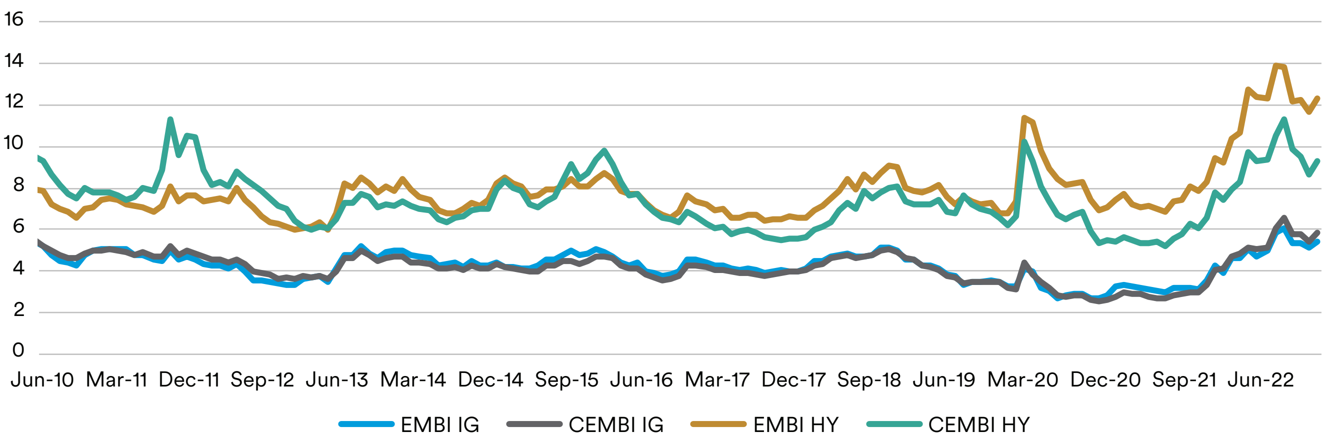
Sources: Morgan Stanley Research. Includes the top 20 countries by GDP %

The new issue market has remained below historical averages in the midst of a challenging market environment. With April being the highest cash flow month of the year for sovereigns[3], it is likely that sovereign issuers will use stability to fill their financing gaps. We continue to keep a healthy cash balance so we can be liquidity providers, given the day-to-day volatility, and remain focused on balance sheet liquidity and asset quality as the main driver of major portfolio shifts.

Developed market growth and inflation data will likely drive the near-term direction of risk assets, while the team will look for opportunities when short-term fluctuations provide good entry points for longer-term value. Expect portfolios to remain tactical with a bias to use noise to increase risk in our most favored names, including sovereigns that have low financing needs or demonstrated ability to tap the market. We will maintain a higher level of scrutiny with any sovereigns or corporates that are fully dependent on market financing or have untenable capital structures.

While corporates continue to perform well at the balance sheet level, we think credit quality has peaked, and operating metrics will begin to show some softening from here. Additionally, headlines around a few large issuers have increased investor questions, putting a larger focus on governance. We see opportunities in the telecom and consumer staples sectors in companies with hard assets that are free cash flow positive. With recent curve flattening, we have been looking to add risk in the belly of the curve. We like higher-beta BB risk that has recently come under pressure. We believe the market is underestimating some issuers' ability to tap both bank lines and local markets, which will support better asset price performance moving forward.

Figure 11 | Historical Yield to Worst (%)



Sources: Bloomberg L.P., JP Morgan

Politics remain an important factor within EM countries. Upcoming elections in Turkey and Argentina are crucial, with polls currently pointing to regime changes. In Turkey, a victory by the opposition would likely bring an improving shift in macro policies that may not fully take hold until after local elections next March. The opposition in Argentina is projected to win in a narrower race than initially anticipated, but challenging social and economic conditions will continue to pose constraints to policy changes.

Endnotes

[1] Data in this paragraph sourced from JP Morgan

[2] Data in this paragraph sourced from JP Morgan

[3] Data in this paragraph sourced from JP Morgan

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