Emerging Markets

Market Review and Outlook

FIXED INCOME | June 30, 2024

Market Review

Emerging Markets (EM) ended the second quarter (Q2) with minimal movement from a total return perspective in the hard currency space, while the dollar continued to strengthen versus its peers. Risk appetite remained largely supportive with volatility remaining suppressed, with high yielding hard currency assets the significant outperformer year-to-date (YTD). US data was mixed with April's strength being offset by some late quarter weakness. US rates peaked at 4.7% early in the quarter only to end at 4.4%, 20 basis points higher quarter-over-quarter[1].

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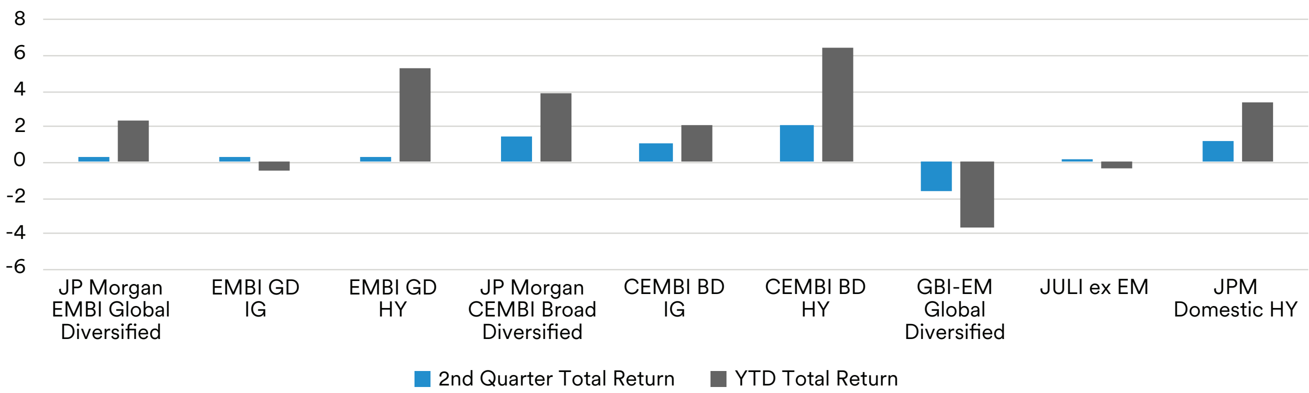
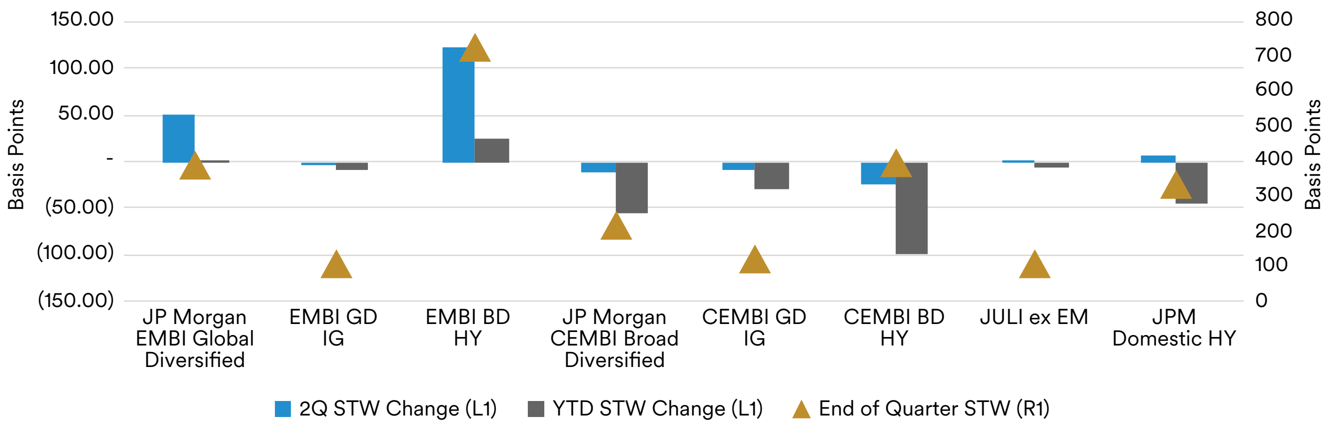
Figure 1 | Indices Total Returns (%)



Source: Bloomberg LP, JP Morgan as of June 30, 2024

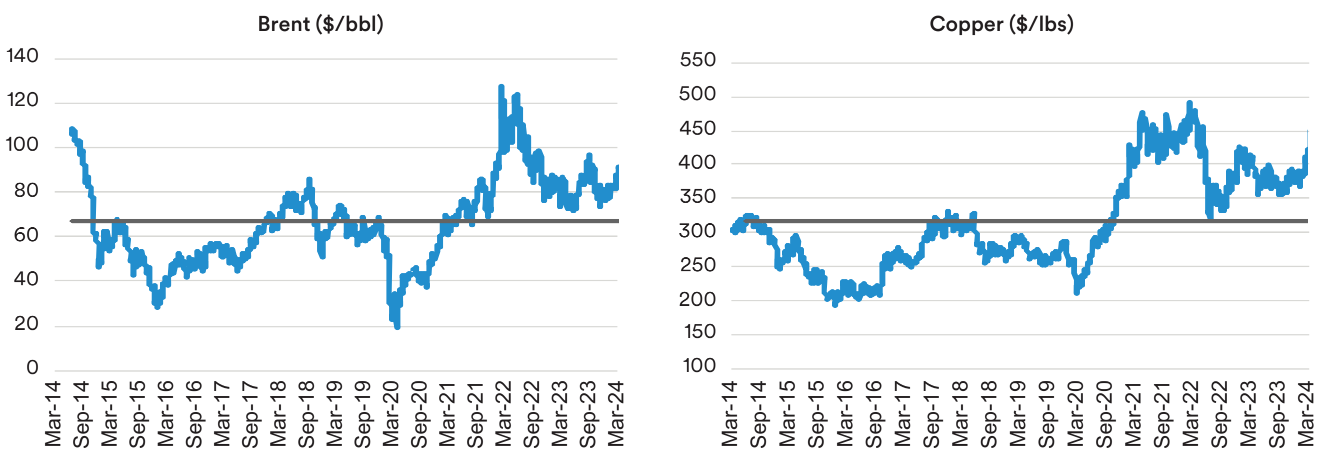
Figure 2 | Indices Spread to Worst



Source: Bloomberg LP, JP Morgan as of June 30, 2024

Brent crude saw some volatility within the quarter, closing down 1.2% at $86.41[2]. Rising summer demand, consistent OPEC output in Q2, and Middle Eastern tensions drove energy prices above $85 a barrel. Meanwhile, gold and copper have been bolstered by supply crunches and robust demand, with gold continuing to be a go-to asset amid global political and geopolitical uncertainties.

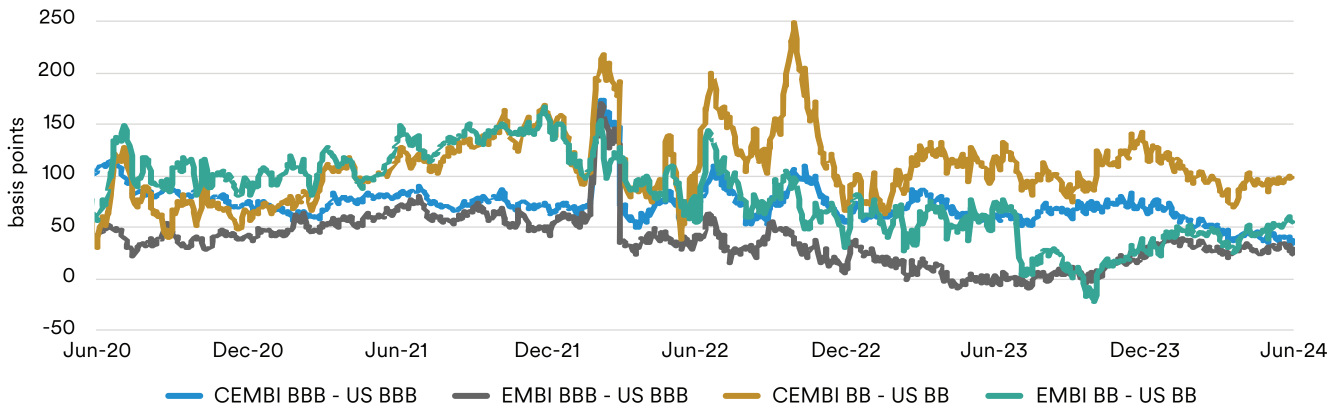
Figures 3 & 4 | Brent and Copper Prices



Source: Bloomberg LP as of June 30, 2024

Investors gearing up for a quieter summer are leaning towards the carry trade, favoring popular trades like Mexico and the Dominican Republic. This supported BBB and BB sovereigns and corporates, providing attractive spread without the risks associated with idiosyncratic credits in the higher beta space. Yet the carry trade also supported some of these less liquid frontier markets such as Tajikistan, Zambia, and Suriname as double-digit yields enticed investors. Further, single-B corporates were the best performing EM sub-set by rating, supported by a rally in China property assets[3].

Figure 5 | EM vs. US BBB and BB Spread Differentials

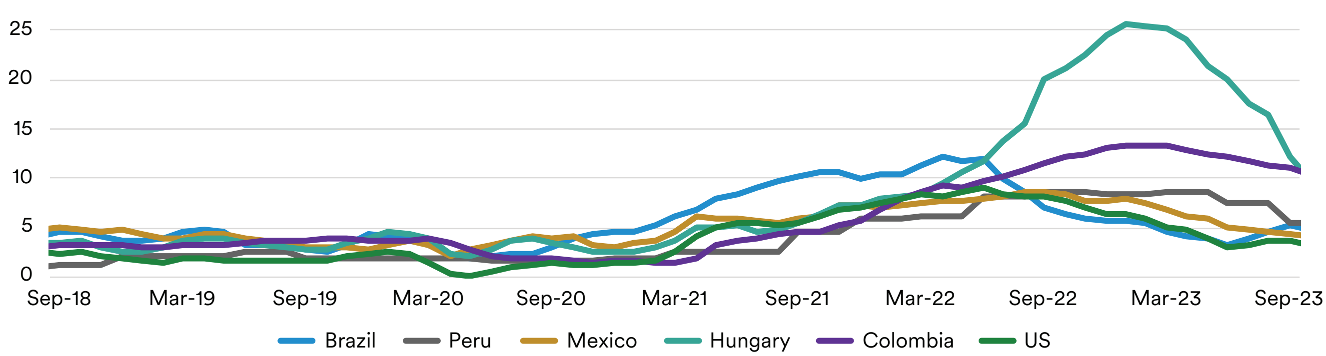


Source: Bloomberg LP, JP Morgan as of June 30, 2024

China property remains in the spotlight as the country continues searching for ways to support the sector and boost overall economic growth. Property names saw some strength during Q2 after local governments began removing home buying restrictions with the hope of increasing demand and improving market sentiment. Shanghai's latest housing policy adjustment in May included the relaxation of qualification for property purchases, funding costs, and down payment ratios. While the data has yet to show material improvements from these measures, the optimism around sector support helped bond prices rally.

While hard currency assets continued to post positive returns, local currency assets witnessed another challenging quarter. At large, EM currencies were pressured by prolonged dollar strength. As EM countries have done a respectable job curbing inflation and subsequently cutting rates, the US "higher for longer" environment has pressured EM local assets. Further, idiosyncratic stories both positively and negatively impacted currencies in countries including Mexico, South Africa, and Brazil. Brazil local was the worst performer as President Lula has not been able to ease investor skepticism around Brazil reaching its fiscal goals for the year. The president's undermining of spending cuts and concerns around a dovish central bank pivot when BCB President Neto culminates his position at year end have weighed on the currency.

Figure 6 | YoY CPI (%)

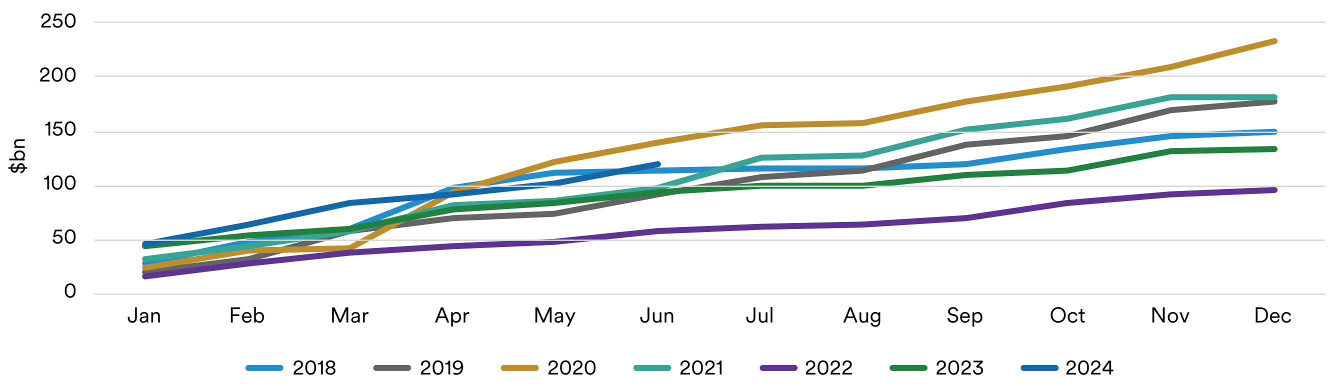


Source: Bloomberg LP as of June 30, 2024

EM countries witnessed surprising outcomes during Q2 elections in Mexico, India, and South Africa. Mexico's controlling left-winged party achieved close to a super majority of seats across the government as ruling coalition candidate Claudia Sheinbaum was elected president. Mexican assets sold off on the outcome with local currency significantly underperforming due to a combination of worries around Morena policies and crowded positioning. We believe the concerns are overdone given the move but acknowledge policy continuity is less certain than originally thought. South African and Indian elections resulted in legislative bodies that are more fragmented than expected; therefore, the controlling parties will need to work with coalition partners to get things done. The news was taken positively in South Africa as the ANC party announced the formation of a government of national unity including opposition party DA. The rand rose past 18 per dollar for the first time in more than 10 months on the news[4].

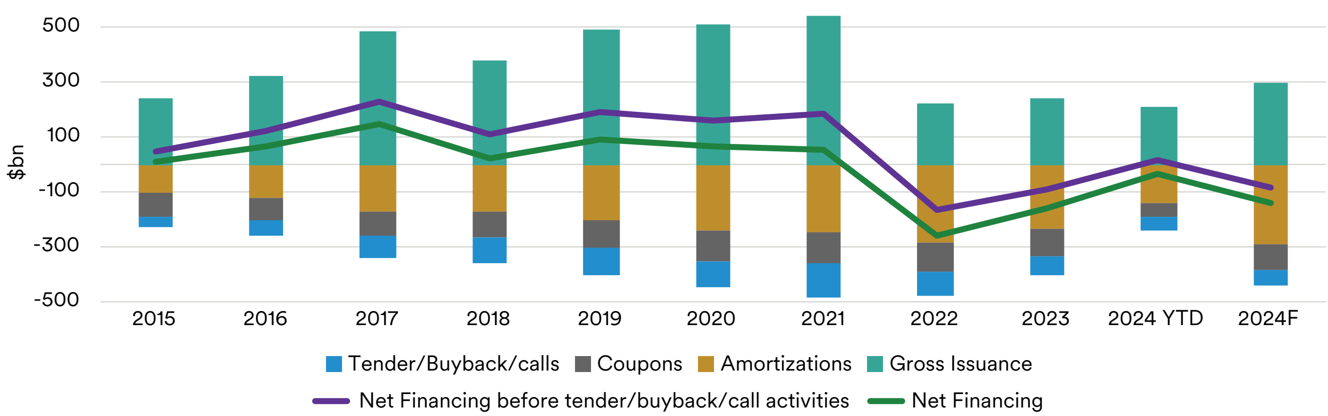
Receding rates coupled with low volatility and supportive investor appetite helped issuance remain active ahead of the summer months. Year-to-date (YTD) sovereign issuance of $120.3 billion represents 70% of expected issuance for the year. Favorable market conditions allowed high yield countries to access the market, with 23% of Q2 sovereign issuance coming from below investment grade names. While Q2 corporate issuance of $96 billion is over 50% higher than the same period last year, it remains below the five-year average for the quarter. Similar to sovereigns, $209 billion of corporate issuance YTD represents 70% of the expected corporate primary deals for 2024. While gross issuance was notable, robust cashflows caused corporate net financing to turn negative (-$35 billion) in the second quarter. EM dedicated flows saw a slight uptick during Q2 but remained lackluster until the end of June. Hard currency bond funds seeing the largest inflows since January 2023 in the last week of the quarter, bringing YTD bond flows to -$13.0 billion[5].

Figure 7 | Cumulative Gross Sovereign Issuance



Source: Bloomberg LP as of June 30, 2024

Figure 8 | Corporate Net Issuance

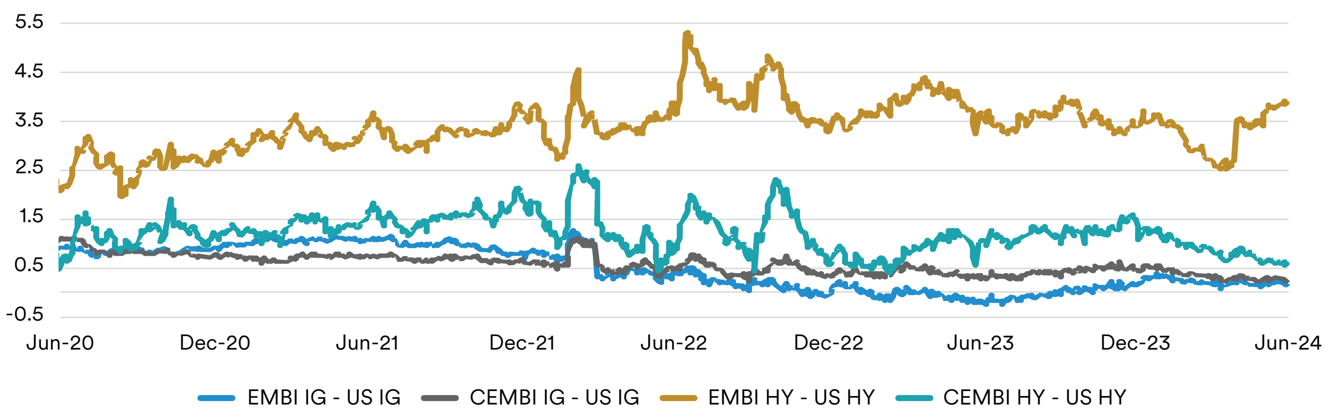


Source: Bloomberg LP as of June 30, 2024

Outlook

As we close out the second quarter, EM spreads remain attractive relative to Developed Markets (DM) especially as we move down the credit spectrum. However, the upcoming US election and, more importantly, the campaign rhetoric could keep new allocations to the asset class on the lighter side. A confluence of factors including trade, globalization, defense spending, and China will be highly anticipated hot topics. As we enter summer months, liquidity will be more constrained which could lead to bouts of elevated volatility; however, we do not expect any policy shifts that will significantly shift the fundamental dynamics. As a result, we believe there may be opportunities to add EM risk into increased election driven uncertainty at attractive valuations. During the near term, we are more optimistic on portfolio positioning and have increased beta, as the path of US interest rates has become marginally clearer and is a large driver of performance and sentiment. We continue looking for a combination of the US inflation slowing and a consistent rebound in China's economy.

Figure 9 | EM vs. DM Yield Differentials



Sources: Bloomberg LP, JP Morgan as of June 30, 2024

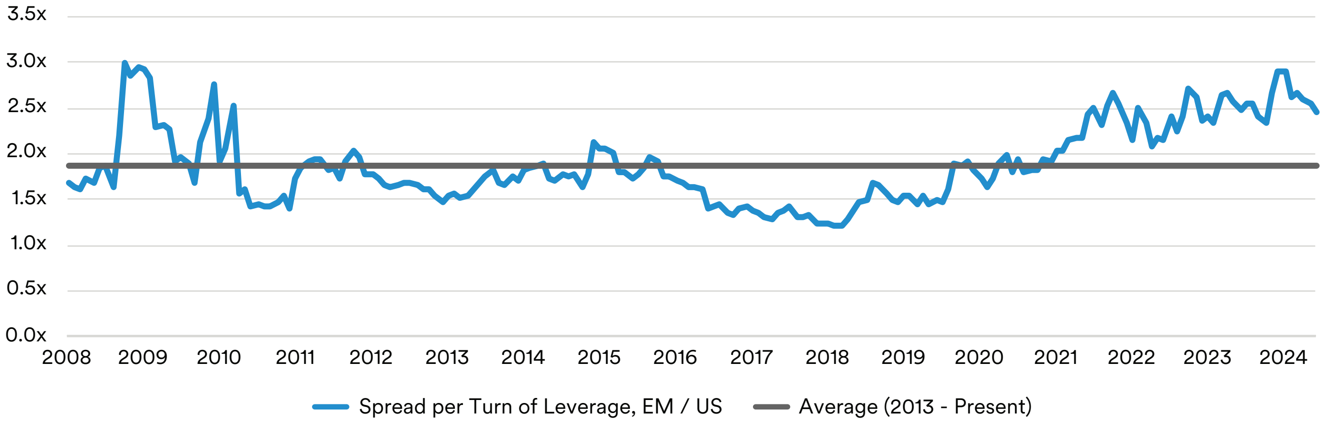
EM sovereign fundamentals have largely stabilized from the growth and inflation shocks since 2020. The EM growth differential versus DM is expanding, and EM growth is more balanced. Most countries are running at or above potential, with commodity exporters and those more exposed to China seeing a drag. Aggressive central bank hiking has led to inflation coming down from peaks seen in 2022 and while some central banks have begun to ease, most remain on hold in restrictive territory. Ratings trajectory is also balanced, with roughly 1/3 of EM countries facing downgrade risk due to rising debt dynamics that require some fiscal adjustment, and only one IG country is at elevated risk of descending into HY territory over the next 12-18 months[6].

We continue to have a bias towards high yield over investment grade sovereigns. We like idiosyncratic opportunities including restructuring stories as well as countries going through elections and subsequent positive policy reform. Within the IG space, we like low-BBB sovereigns in the 7-10 year part of the curve where all in yields screen attractive. Our preference is for countries who face low financing needs or have demonstrated ability to tap the market.

Fundamentals of EM corporates and banks remain healthy, and we acknowledge that metrics may moderate while staying resilient. Balance sheets remain strong and active liability management has led to reduced concerns over refinancing risks. Successful liability management has pushed out the maturity wall, notably for higher quality issuers. While we do not expect debt levels to change materially, we expect EBIDTA to decline from recent highs. This may show an uptick in leverage, while remaining at manageable levels. Free cash flow should remain strong as capital expenditures continues to focus on maintenance rather than expansion. Default rates have remained below expectations, with the default rate of 1.8% YTD largely driven by the China property space and idiosyncratic stories in Latin America. Noteworthy, the amount of outstanding HY bonds trading at distressed levels (spread-to-worst > 1000 basis points) dropped a significant 7%, down to 9.2% of the EM Corporate HY universe[7].

We continue to see opportunities in BB and BBB corporates, in sectors that generate hard currency revenues or have effective FX liability management. Even with the outperformance of EM corporates relative to DM YTD, the spread per turn of leverage remains over double, 49 bps/x for US credits versus 120 bps/x for Global EM[8]. In the utility space, we see value in assets with consistent cashflows that have strong structures, especially within Latin America. Infrastructure projects in the Middle East are enticing, where we can get a pickup of ~100bps over comparable DM credits.

Figure 10 | EM vs. US Spread per Turn of Leverage



Sources: BofA Global Research. Fundamental data as of December 31, 2023, Spreads as of June 30, 2024

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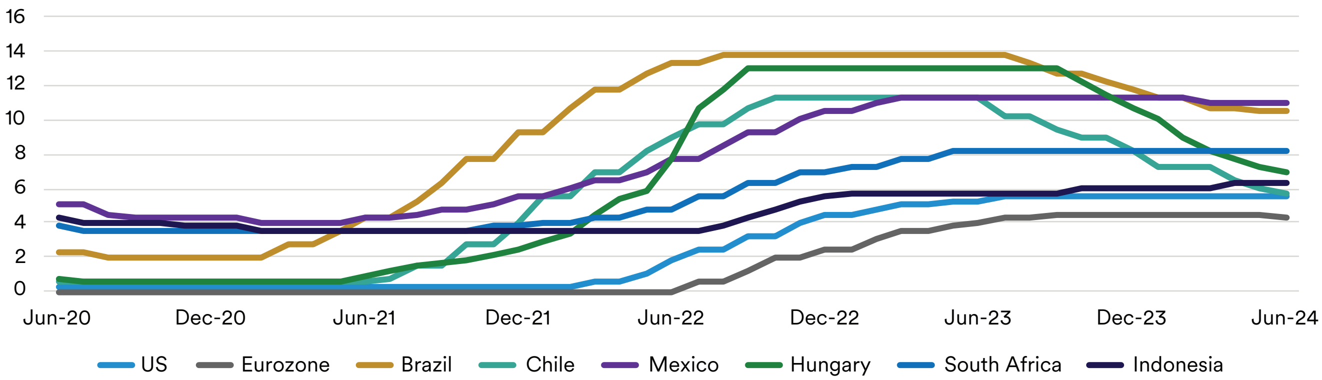
Local currency valuations look attractive relative to hard currency assets. While EM inflation has been steadily receding, EM bond yields have not moved accordingly, leaving us with the highest real yield levels seen since 2009. Local yields have underperformed YTD primarily due to monetary policy divergence. EM countries including Chile, Hungary, and others are cutting rates as their inflation rates converge towards target while the path for the Fed remains less clear. However, this divergence feels poised to change in the later half of 2024 as federal reserve policy is more likely to be reduced. This environment will allow investors to capitalize on attractive real yields across the local space as well as provide more confidence going down into the more idiosyncratic hard currency stories. Our preference is within local currency markets which have significant yield compression possibilities while capturing robust real yields. The compelling real rate environment in Latin America is most enticing, while Europe is valued more fairly, and Asian local yields are overall lower and therefore less compelling.

Figure 11 | DM & EM Rates (%)



Source: Bloomberg LP as of June 30, 2024

Endnotes

[1] Bloomberg LP
[2] Bloomberg LP
[3] Information in this paragraph sourced from JP Morgan
[4] Bloomberg LP
[5] Information in this paragraph sourced from JP Morgan
[6] MIM
[7] BofA Global Research
[8] BofA Global Research

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