Emerging Markets

Market Review and Outlook

FIXED INCOME | SEPTEMBER 30, 2024

Market Review:

The markets showed considerable resilience during the third quarter (Q3), with assets in Emerging Markets (EM) responding favorably to the U.S. Federal Reserve's (Fed) initial rate cut of the cycle. The Fed maintained a consistently dovish tone throughout the quarter, and the softening data supported the 50-basis point (bps) rate reduction at the September meeting. The 2/10s yield curve finally entered positive territory for the first time in over two years, as further rate cuts seem likely. The 10-year Treasury yield experienced an 84-bps peak-to-trough movement within the quarter, ultimately finishing 62 bps lower at 3.78%.[1]

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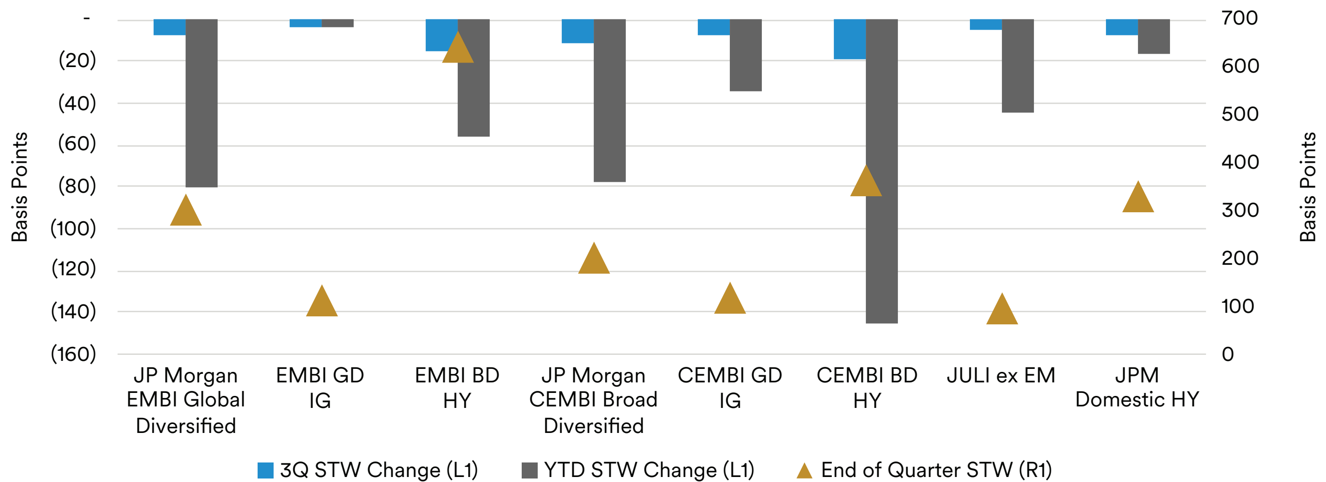
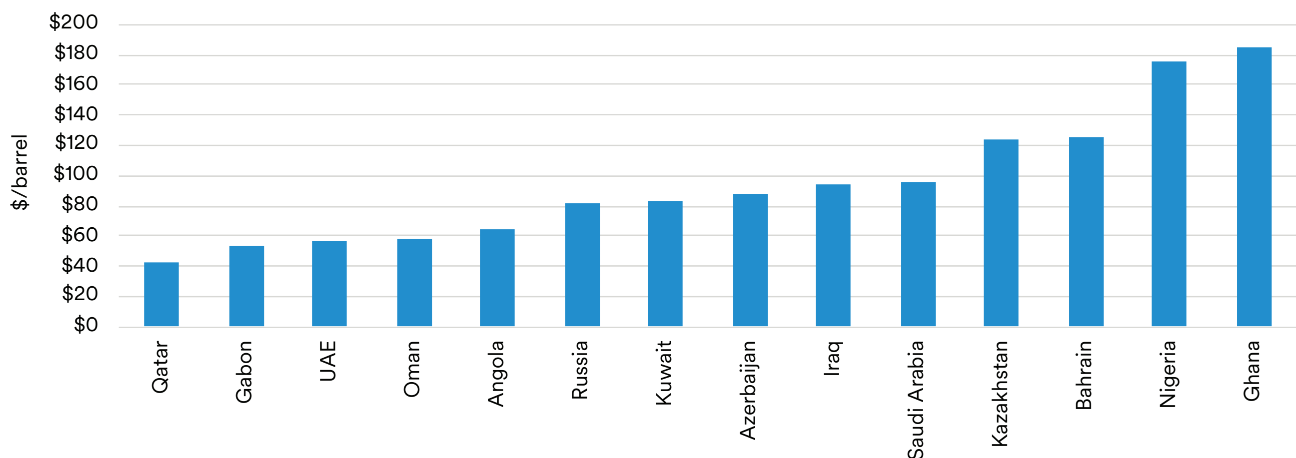
Figure 1 | Indices Spread to Worst



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

Energy prices started to experience the strain from decelerating global growth forecasts, resulting in their poorest quarterly performance of the year. Brent crude, which had reached a high of $87 per barrel, saw a significant decline, concluding the quarter with a 17% drop to $71.8 per barrel.[2] A lack of demand put pressure on prices, while concerns around a Middle East-driven supply disruption provided some support at lower levels. On the other hand, copper prices took a round trip during the quarter. The initial decline due to China's economic conditions and anticipated drop in demand was later countered by a combination of the Fed's rate cut and optimism around more significant Chinese stimulus.

Figure 2 | Fiscal Breakeven Oil Prices



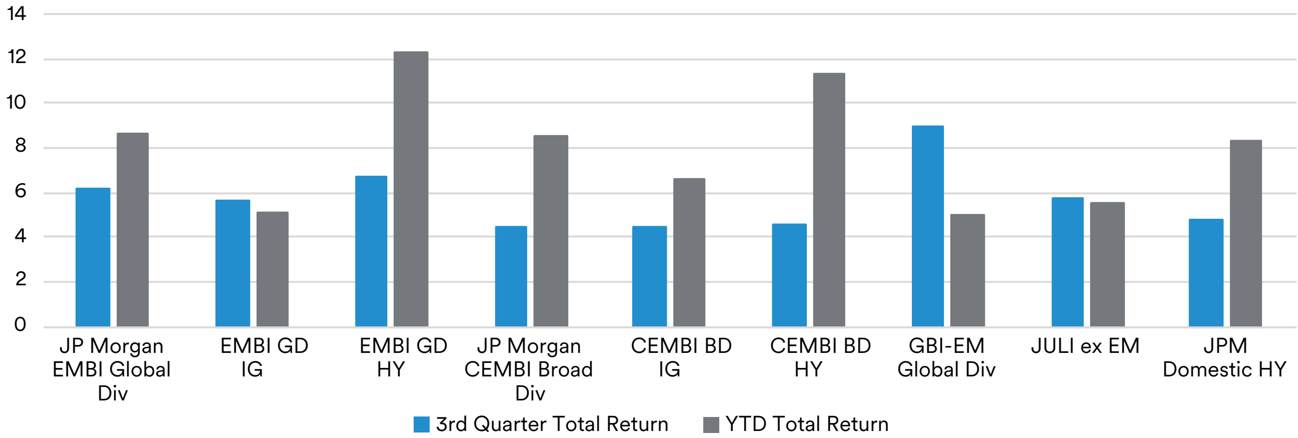
Source: Barclays Research as of September 11, 2024

Following the most recent Politburo meeting in China, Beijing's tone around economic policy shifted. Policy-making institutions in the country are expected to announce as many measures as needed until the country sees stabilizing growth, with the first round including lowering down payments on homes, supporting more state-owned enterprises (SOEs) and preparing for more infrastructure development.

EM indices experienced a dual benefit in Q3, with investment-grade (IG) assets supported by the rally in interest rates and high yield assets boosted by the demand for yield out the curve, with the soft-landing view firmly in play. This, along with storied credits, drove strong positive returns. Latin America was the best-performing region across both hard currency sovereigns and corporates. High-yield (HY) sovereigns, including Argentina,

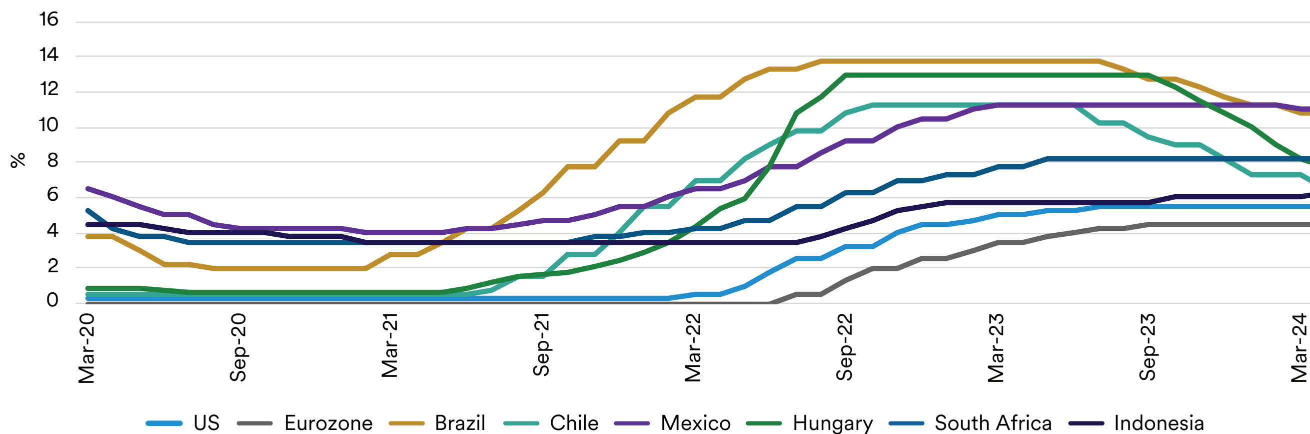
El Salvador and Ecuador, recorded double-digit returns in the third quarter, driven by positive policy changes following elections over the past year. The Oil & Gas sector even posted strong returns, as attractive carry kept investors interested in the space despite pressure on prices. The local currency index was the best performer, with inflation data, lower U.S. yields and Fed policy all leading to a weaker U.S. dollar.[3]

Figure 3 | Indices Total Returns



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

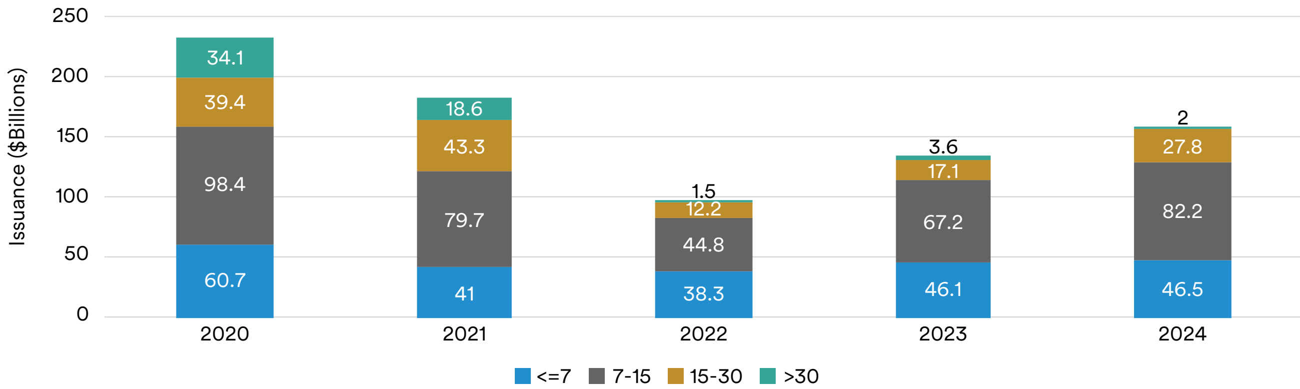
Figure 4 | Developed Markets (DM) and EM Rates



Source: Bloomberg LP as of September 30, 2024

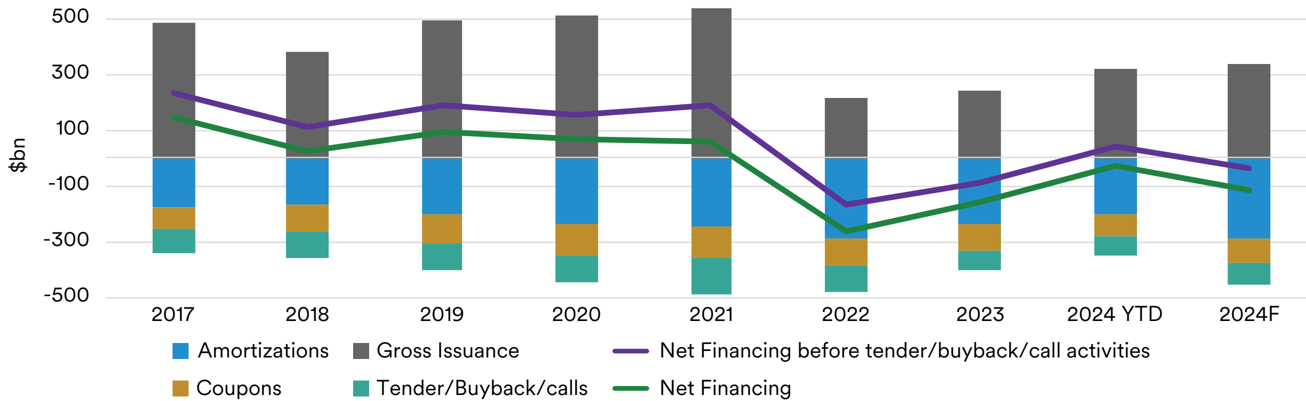
September issuance made up for the quiet summer months. Sovereigns and corporates across all regions took advantage of the firm market and rate rally, creating favorable conditions for issuers. Q3 issuance of $114 billion surpassed the five-year average ($97 billion). Net financing year-to-date (YTD) continues to remain negative (-$30 billion), including China, but remained positive ($39 billion) when excluding the country. Similarly to corporates, half of the $35.1 billion of Q3 sovereign deals came to market in September. Issuance was primarily seen among investment-grade issuers, with no high-yield sovereigns entering the market in September and 77% of YTD sovereign issuance from IG countries. Issuance has been concentrated in the 15–30 year maturity bucket, enabling issuers to extend maturity walls at the current lower rates.[4]

Figure 5 | EM Sovereign Issuance by Maturity



Source: JP Morgan as of September 30, 2024

Figure 6 | Corporate Net Issuance



Source: JP Morgan as of September 30, 2024

Outlook

U.S. economic data has been strong but softening from previously elevated levels. The Fed continues to be very data dependent, and the path for interest rate cuts remains intact but it remains unclear at what pace. Given the thoughtfulness of the Fed during this most recent cycle with regards to its path and speed of rate moves, it continues to play the see-saw game of preventing a hard landing, while not being too accommodative in the short term so that inflation expectations reaccelerate. While China has historically been a major driver for markets, especially within EM, the impact has been minimal with the market waiting on stimulus details and the U.S. election banter yet to impact prices.

Now that the majority of EM and global DM elections are behind us, all eyes are shifting to the upcoming U.S. election in November. Topics, including trade, globalization, defense spending and China, will be highly anticipated themes surrounding campaign rhetoric. The ongoing conflict in the Middle East will be a fine line for both candidates to walk, given the U.S.' historical stance with Israel, coupled with navigating the localized war and ensuring no further escalation. The war developments further impact the energy sector, where concerns around the conflict and supply disruptions have supported energy prices that were previously pressured by the softening macro outlook. With polls not pointing to a clear favorite at this time, we expect to see some volatility heading into the election and even afterward, as markets digest the results and the trickle effect across the globe. At large, we are comfortable with how Emerging Markets are fundamentally positioned for this election in either outcome.

Figure 7 | Post-Election Policy Bias: Harris vs. Trump

	HARRIS	TRUMP
TCJA Extension**	Partial	Full
Corporate Taxes**	↑	↓
Regulations	↑	↓
Trade Tariffs	Status Quo	China, Europe, other?
Energy policy	Status Quo	↓ Green / ↑Fossil Fuel
Immigration	Status Quo	More Restrictive
Growth and Rates	↓	↑
US Deficit & Debt	Neither will resolve high deficit and rising debt	
EM countries most likely to be impacted by the U.S. Election: China, Ukraine, Venezuela, Mexico, El Salvador, Argentina		

***Requires Congress*
Source: MIM as of September 30, 2024

EM sovereign fundamentals have largely stabilized from the growth and inflation shocks that were trigged by the global pandemic. Aggressive central bank hiking early in the cycle has given central banks room to begin easing rates to support growth. We have seen some higher-quality, high-yield BB-rated countries demonstrate strong consistent fundamental performance, fiscal discipline and minimal political risk, which have led to improved debt characteristics and the potential for ratings upgrades.[5] The sovereign team has been laser focused on identifying the candidates well before the upgrade is on the market's radar, leading to spread compression across a few of our larger BB positions.

Figure 8 | EM Sovereign Rising Star Candidates

	Ratings (+/s/-) F / M / S	Probability upgrade to IG within 2 years	Likely timing
Serbia	BB+ (+) / Ba2 (+) / BBB- (s)	HIGH	2025
Azerbaijan	BBB- (s) / Ba1 (+) / BB+ (s)	HIGH	2026
Oman	BB+ (s) / Ba1 (+) / BBB- (s)	HIGH	2026
Paraguay	BB+ (s) / Baa3 (s) / BB+ (s)	MEDIUM	2026
Morocco	BB+u (s) / Ba1 (s) / BB+ (+)	MEDIUM	2027
Guatemala	BB (s) / Ba1 (s) / BB (+)	LOW	2028
Dominican Republic	BB- (+) / Ba3 (+) / BB (s)	LOW	2028
Trinidad & Tobago	NR / Ba2 (s) / BBB- (s)	LOW	2029

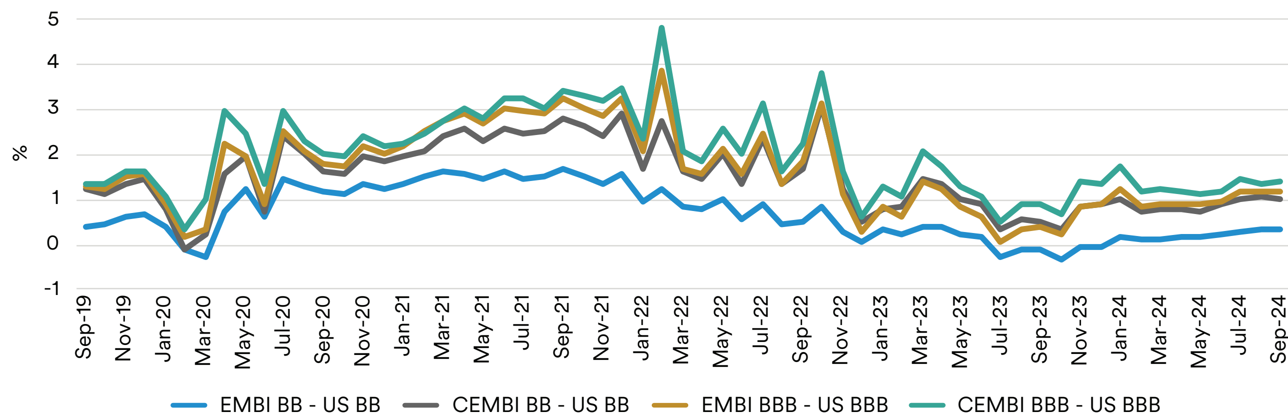
Sources: MIM, Moody's, S&P, Fitch as of September 30, 2024

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. The 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 earnings before interest, taxes, depreciation and amortization (EBITDA) to decline from recent highs. This may show an uptick in leverage, while remaining at manageable levels. We expect margins to remain healthy, even as revenues decline from their recent peaks. Free cash flow should remain strong, as capital expenditures continue to focus on maintenance rather than expansion.

We continue to have a bias toward high-yield (HY) over investment-grade (IG) sovereigns based on valuations coupled with current risk appetite. We like opportunities including restructuring stories, as well as countries that have been witnessing encouraging policy reform and the potential for subsequent positive rating momentum. Within the IG space, we like low-BBB sovereigns in the 7-10 year part of the curve where all-in-yields screen attractive, and where we see the most new issuance opportunities.

We 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 corporates year to date, the spread per turn of leverage remains over double—46 bps/x for U.S. credits versus 115 bps/x for Global EM.[6] In the utility space, we see value in assets with consistent cash flows that have strong structures, especially within Latin America. Infrastructure projects in the Middle East are enticing, where we can get a pickup of ~100 bps over comparable DM credits.

Figure 9 | EM vs. DM Yield Advantage



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

Local currency valuations look attractive relative to hard currency assets. While EM inflation has been steadily receding, EM bond yields have not moved at the same rate, leaving us with enticing real yields. The converging environment between EM and DM has allowed investors to begin capitalizing on attractive real yields across the local space, with more room to go. Our preference is within local currency markets, which are less U.S. rate sensitive and rather more of a real yield carry play. The compelling real rate environment in Latin America is most enticing, while Europe is valued more fairly. While regional yields in Asia are lower, the currencies appear undervalued, as growth rates and trade flows are improving. Further, Asia benefits more directly from a lower U.S. rate environment.

Endnotes

[1] Bloomberg LP as of 9/30/2024

[2] Bloomberg LP as of 9/30/2024

[3] Information in this paragraph sourced from JP Morgan as of 9/30/2024

[4] Information in this paragraph sourced from JP Morgan as of 9/30/2024

[5] MIM as of 9/30/2024

[6] BofA Research as of 9/30/2024

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