FIXED INCOME

Emerging Markets

Market Review and Outlook

March 31, 2024

Market Review

Emerging Markets (EM) witnessed a supportive start to 2024, as minimal geopolitical events dampened volatility and temporarily eased investor concerns. Lingering inflation and strong economic data out of the US led to a continued higher-for-longer narrative for most of the quarter, yet this refused to spook investors as near-term recession projections tapered. The March Q&A session with Fed Chairman Powell was more dovish than anticipated, temporarily sending the 10-year treasury yield rallying near 4% only to have strong economic data unwind the rally with treasuries ending the quarter 32 basis points higher at 4.2%[1].

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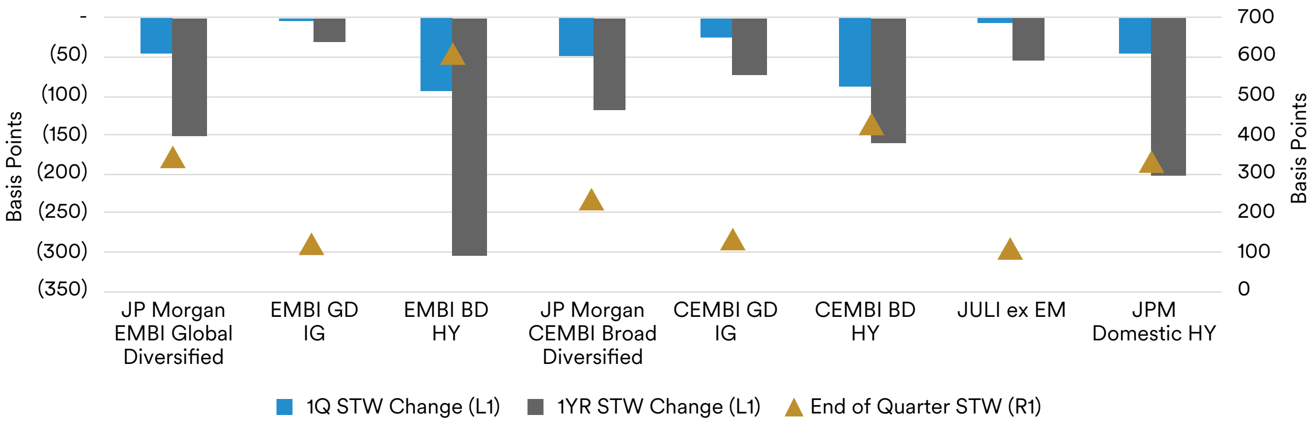
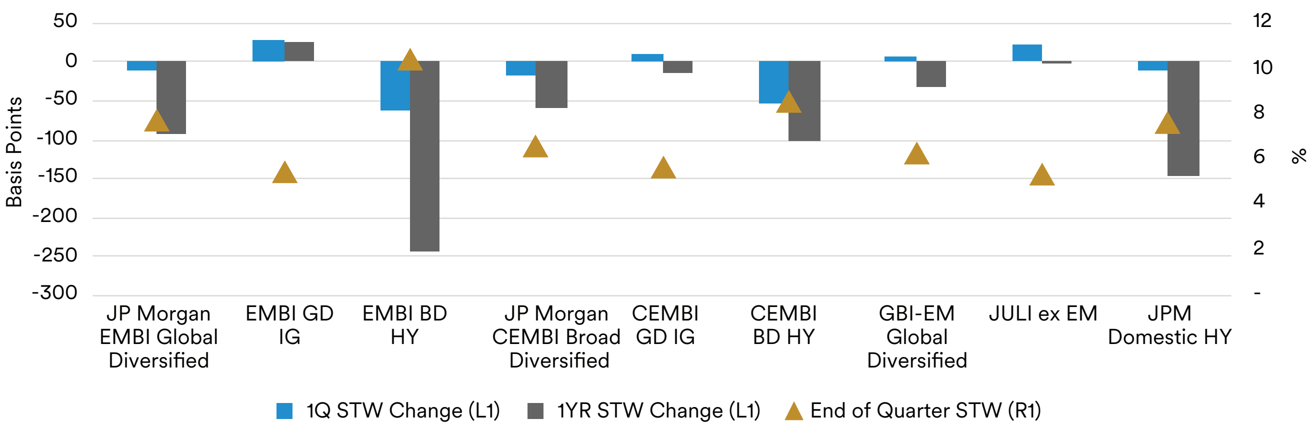
Figure 1 | Indices Spread to Worst



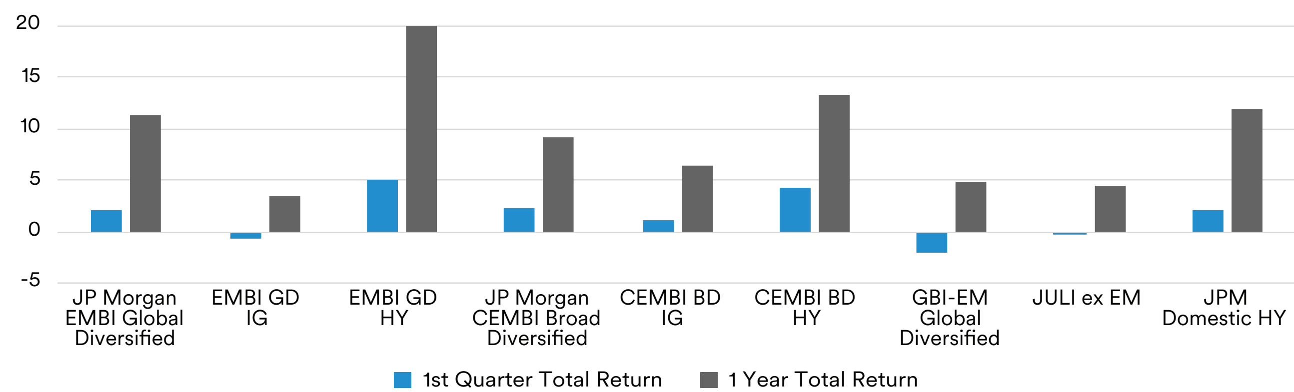
Source: Bloomberg LP, JP Morgan, as of March 31, 2024.
Spread to Worst: Spread-to-worst (STW) in bond markets is the difference between the yield-to-worst (YTW) of a bond and yield-to-worst of a U.S. Treasury security with similar duration. The STW is either yield-to-call (YTC) or yield-to-maturity (YTM), whichever is lower, and is expressed in "basis points (bps)."

Figure 2 | Indices Yield to Worst



Source: Bloomberg LP, JP Morgan, as of March 31, 2024.
Yield to Worst: Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting. It is a type of yield that is referenced when a bond has provisions that would allow the issuer to close it out before it matures.

Figure 3 | Indices Total Returns (%)

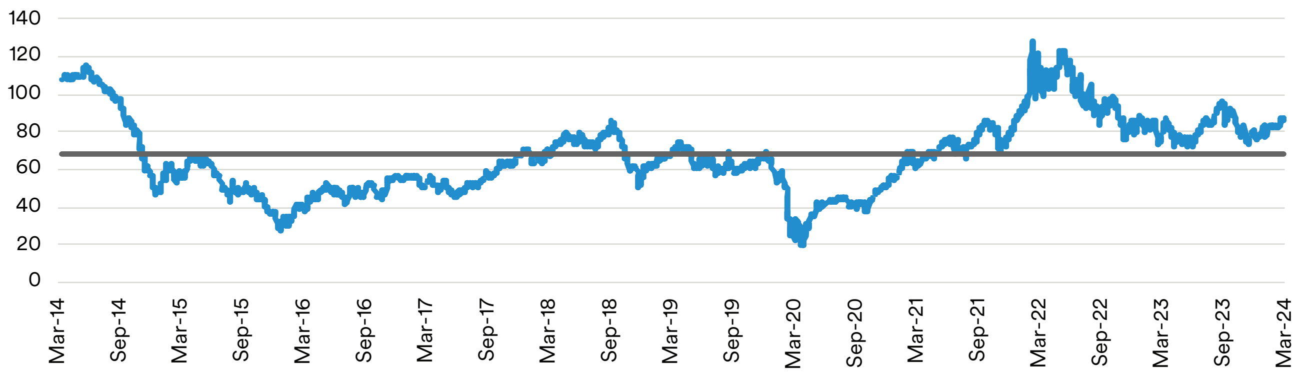


Source: Bloomberg LP, JP Morgan, as of March 31, 2024.

As the quarter came to a close, Chinese PMI signaled expansion for the first time since September, further helping risk sentiment. Relief within the property space remains fleeting but ICBC, China's largest bank, did its part to help the country's economy, providing $41 billion of financing to stimulate tourism into China and earnings within the major non real estate sectors remained stable despite 2023 worries[2].

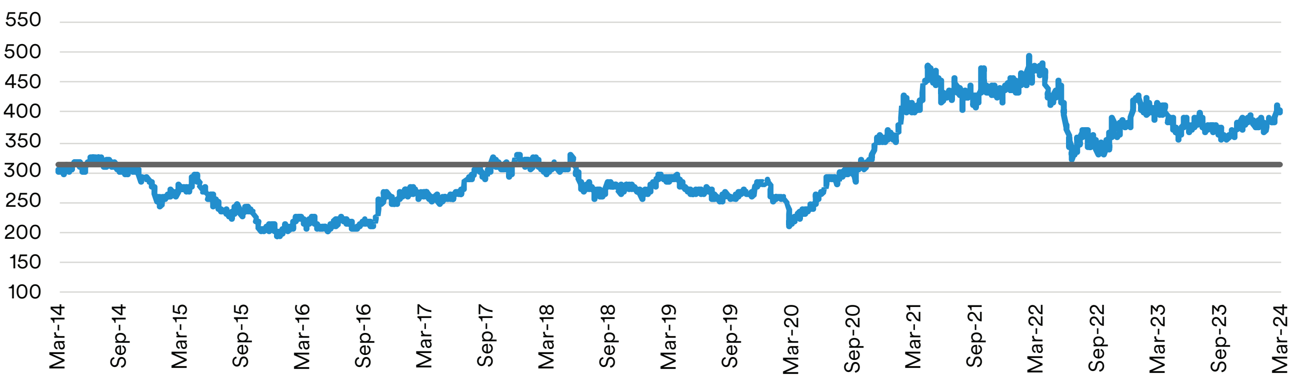
The combination of OPEC+, geopolitical pressures from Ukraine striking Russian oil refineries and Houthi militant attacks in the Red Sea causing delivery detours around South Africa have supported oil prices with Brent rallying 13%, closing the quarter at $87.50[3]. Copper witnessed a rally into quarter end as positive factory data out of China, a top copper consumer, coupled with potential output cuts by leading smelters buoyed prices. After facing demand complications for the large part of the last year, copper recovered to levels last seen in April 2023. However, commodity prices overall are still facing a ceiling as the US Fed is moving slower than initially anticipated with cutting rates.

Figure 4 | Historical Brent Prices ($/bbl)



Source: Bloomberg LP, as of March 31, 2024.

Figure 5 | Historical Copper Prices ($/lbs)

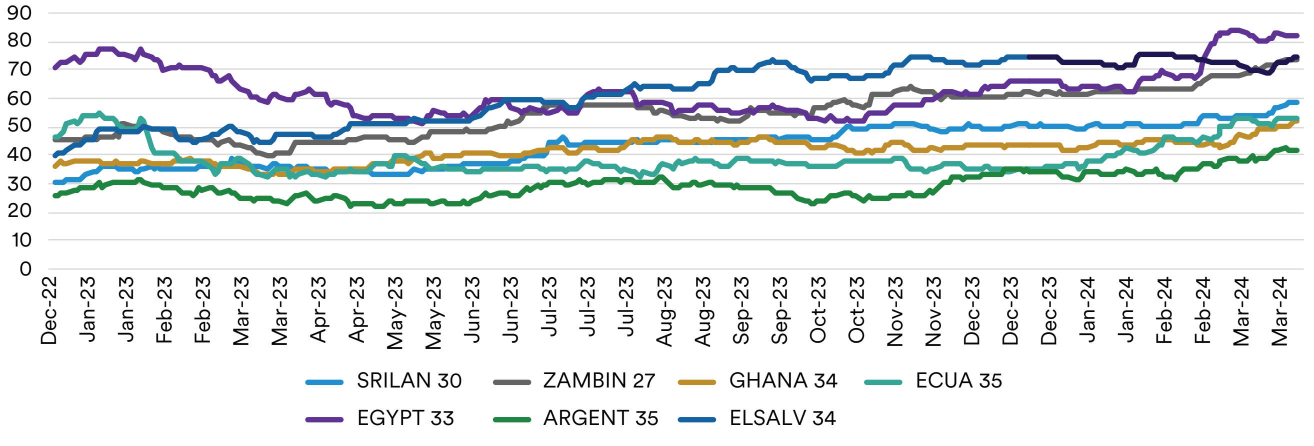


Source: Bloomberg LP, as of March 31, 2024.

EM saw spread compression across both Investment Grade (IG) and High Yield (HY) assets as investors sought out attractive yield opportunities and technicals remained supportive. HY sovereigns outperformed as investors gained confidence in turnaround stories within idiosyncratic high beta countries. African sovereigns in aggregate returned +6.6% during first quarter (Q1), with Zambia, Pakistan, Lebanon, Ghana, and Egypt witnessing double digit returns, supported by positive progress with the IMF and access to capital markets[4]. Additionally, repeat defaulters Ecuador and Argentina were top performers as the governments stepped up policy reforms after bringing in new cabinet members post-elections.

Alternatively, IG sovereigns were mildly weighed down by primary deals and rising rates, despite being largely well absorbed and coming with modest concessions.

Figure 6 | Opportunistic Idiosyncratic Credits ($)



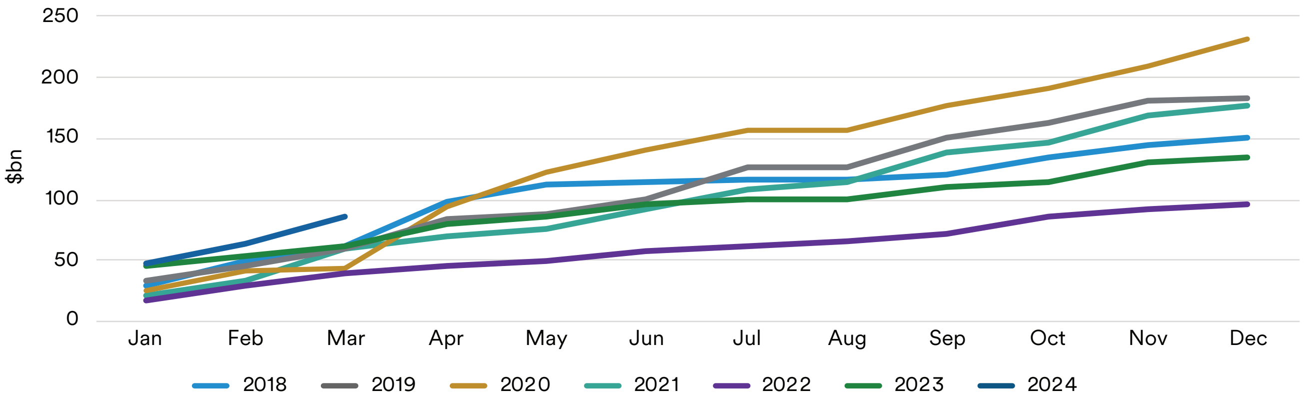
Source: Bloomberg LP, as of March 31, 2024.

EM corporates were less preferred relative to sovereigns during the quarter as investors desired to keep more liquidity within portfolios. Despite this, negative net supply and less duration sensitivity helped spreads stay well supported. Corporate credit headlines were relatively benign after a difficult fourth quarter, and high yield assets were able to benefit from risk sentiment. The one outlier to this was WOM in Chile, where the telecom company failed to refinance short term maturities and witnessed multiple downgrades due to growing pressure on the company's liquidity. This series of events ultimately led to the company filing for Chapter 11 bankruptcy protection just after quarter end.

Local currency assets underperformed while the higher for longer stance prevailed. Resiliency of US data and therefore a stronger US dollar pressured performance of EM local assets. Into quarter end, there had been some support step in from investors as valuations look attractive relative to hard currency assets. While EM inflation has been steadily receding, EM bond yields have not moved accordingly therefore leaving us with the highest real yield levels seen since 2009. The Mexican peso outperformed in Q1[5] as attractive yields, supportive growth, lower volatility, and more liquidity made it a favorable place for investors to deploy cash.

Issuance surpassed expectations in Q1, most notably within BBB sovereign issuers. Sovereign issuance was the highest on record for a first quarter ($85.6 billion), as investors used the firm market and bursts of rate rallies to come to the primary market. While 78% of sovereign issuance was from IG issuers, higher beta issuers have also been able to access the markets with reasonable concessions, therefore easing liquidity concerns. Sovereign issuance has surpassed 50% of projected gross issuance and represents over 75% of projected net issuance. Corporate issuance of $110 billion represents almost half of expected total issuance for 2024. While volumes remained below the 5-year average of $120 billion for Q1, this did represent a 50% increase year-over-year, and signified the highest issuance in the last 10 quarters[6].

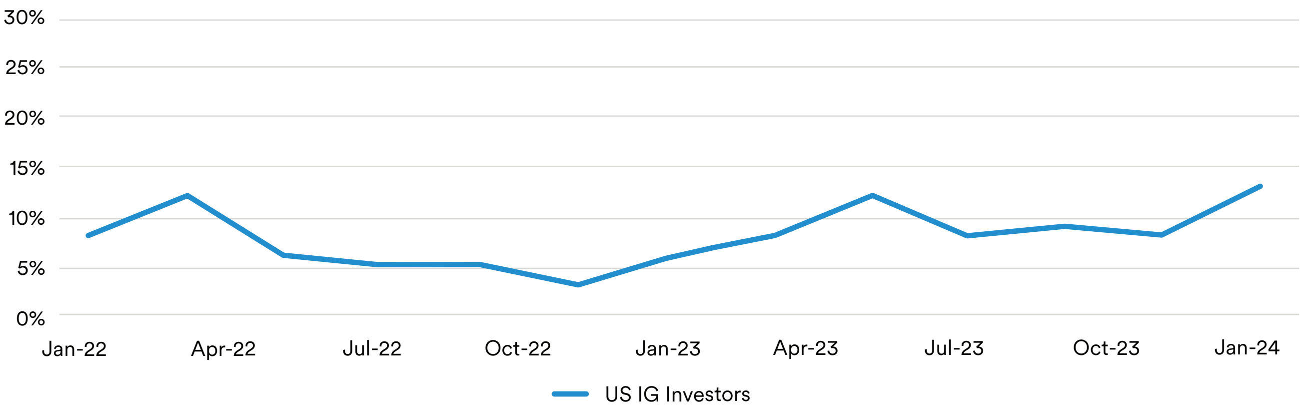
Figure 7 | Cumulative Gross Sovereign Issuance



Source: JP Morgan, as of March 31, 2024.

EM continued to see outflows from ETFs, with AUM of the seven major EM credit ETFs down 25% from their all-time highs[7]. However, non-dedicated interest in the asset class has reemerged since the beginning of the year, supported by the heavy burst of attractive primary issuance. Crossover investors have the most EM exposure seen in the last 3 years, as valuations relative to DM comparable credits have once again sparked interest.

Figure 8 | US Credit Investors: EM Allocation History

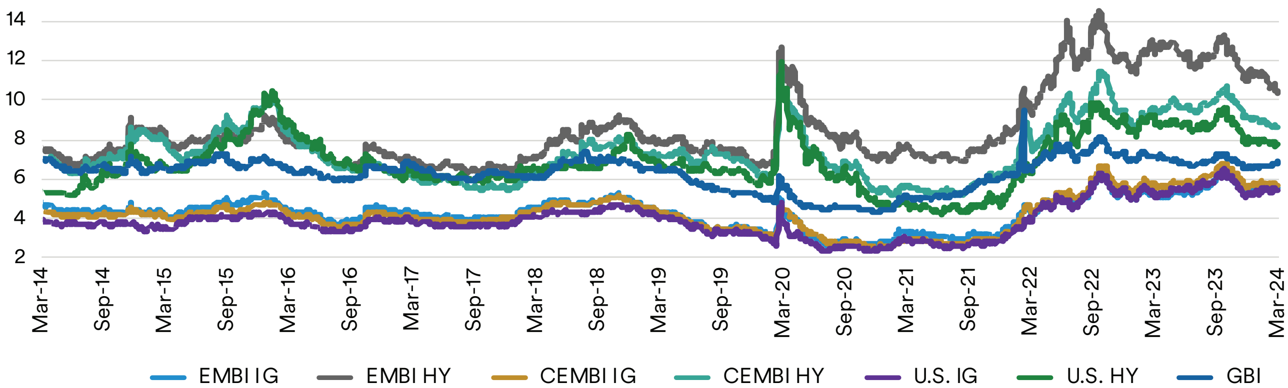


Source: BofA US Credit Investor Survey, BofA Global Research as of February 26, 2024.
Bloomberg LP, JP Morgan, Bond Radar, MIM

Outlook

We are constructive on EM fundamentals and while yields at current levels are attractive, we recognize that EM spreads are tight relative to historical index levels. The macro picture is pointing towards a favorable backdrop with US inflation showing signs of slowing and some positive economic data out of China pointing in the right direction; however, EM remains vulnerable to backups from geopolitical headwinds. While China-US trade tensions remain in the spotlight, “friendshoring” has been supportive for other EM economies including India, Mexico, South Korea, and Taiwan, where US goods deficits have risen to a record high.

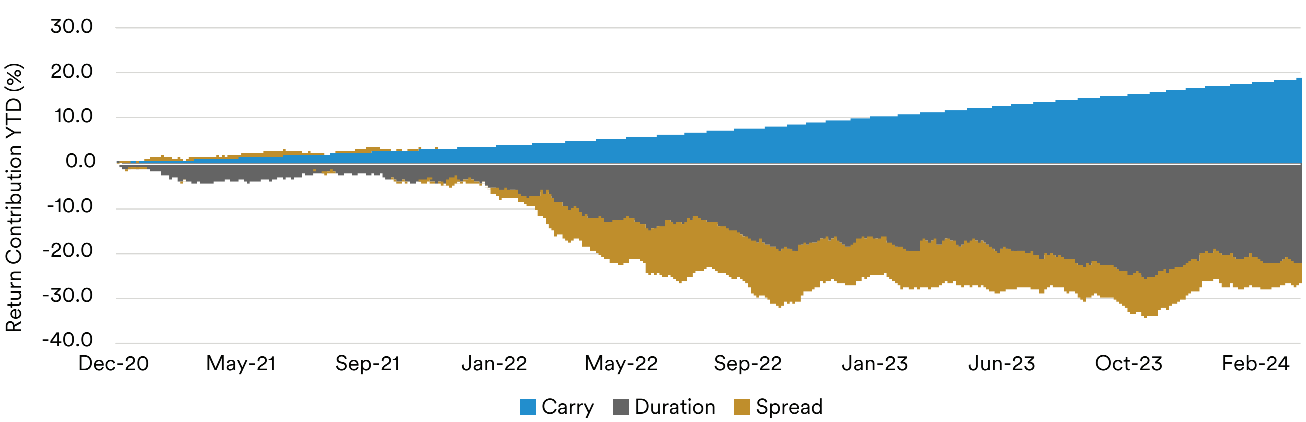
Figure 9 | Yield to Worst (%)



Source: Bloomberg LP, JP Morgan, as of March 31, 2024.

Coupled with this, we see EM opportunities for differentiation at both the sovereign and corporate levels which could lead to a better flow picture for the asset class. Net issuance continues to be subdued, principal and interest payments remain high, and non-dedicated investors have begun putting money back into the asset class, supporting demand and subsequently positive price reactions. With the belief that the hiking cycle is over, EM provides investors the ability to gain exposure to the combination of both yield and duration outside of Developed Markets (DM). This allows for interest rate exposure closer to the IG market while receiving income closer to the HY opportunity set. While duration has been a drag on EM performance YTD, the carry and spread the asset class provides has more than offset it. The aggressive spread tightening that we have seen within idiosyncratic, higher beta sovereigns has provided a supportive tailwind to EM. We expect for duration to positively contribute by year end if rates begin to come down, in addition to the support from coupon income, which is elevated relative to historical returns.

Figure 10 | EM Dollar Credit: Contribution-to-Return

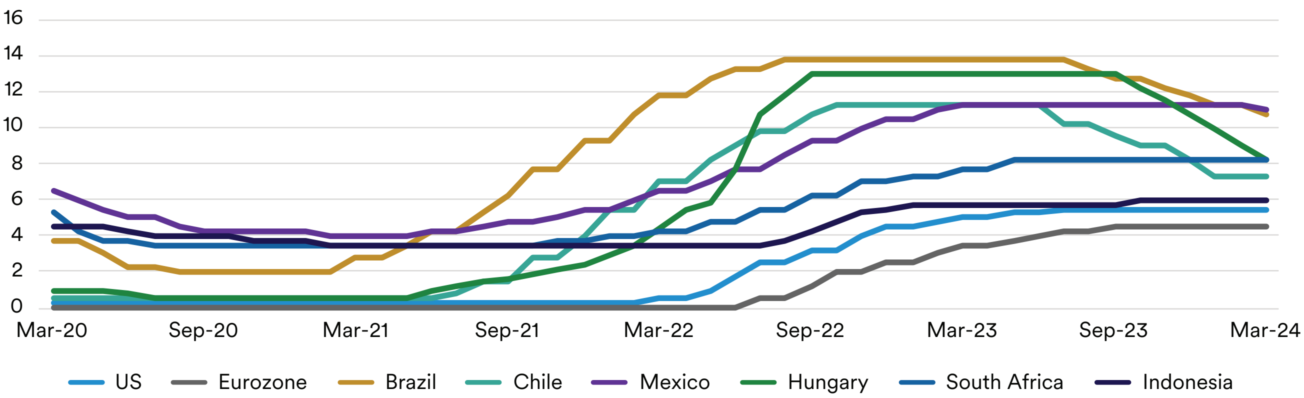


Source: Bloomberg LP and Bloomberg Intelligence, as of March 31, 2024.

Going into this year's election cycle, the market did not expect any shakeups from EM governments. Thus far, this has played out as expected, with none of the elections and subsequent political changes affecting the economic impact of these countries. Still upcoming in this heavy election year, our eyes are on Panama and South Africa in May and Mexico in June. Panama's election has a wide range of potential outcomes, from a more fiscally conservative candidate to an extreme socialist candidate. This comes at a time where the country is on the brink of a downgrade to high yield and is facing fiscal stress from a lack of revenues due to the closure of the copper mine. South Africa's national election could see the ANC party go below 50% wherein they need a coalition to form a government for the first time since Nelson Mandela formed the party. Mexico's election is pointing towards the ruling party winning and therefore a continuation of current policy; however, with AMLO not running for a second term, we are guaranteed to have a new president in office. The most important election this year will be the US presidential election in November. This election will impact many facets of the geopolitical and financial world given the linkages of the US to every economy across the planet. We expect more noise as we get closer to the election, as the outcome will most likely be very binary.

With inflation rampant post the outbreak of the COVID-19 pandemic, we saw EM central banks quickly respond by hiking interest rates throughout 2021. DM countries were reluctant to follow, but were aggressive when they started, with the first US rate increase in March 2022 and the ECB following in July 2022. For the better part of 2023, most of the globe was unified in a "wait and see" environment. Governments assessed how their economies and subsequently inflation were responding to a world of higher rates. More recently, we have seen a divergence resurface, with EM countries including Brazil, Chile, Hungary and others cutting rates as their inflation rates converge towards target while the path for the Fed remains less clear. This divergence in rate markets as well as policy flexibility should keep EM spreads, specifically local rate markets, well behaved as rate volatility dampens throughout 2024. This environment will allow investors to capitalize on attractive real yields across the local space and provide more confidence going down into the more idiosyncratic hard currency stories.

Figure 11 | DM & EM Rates (%)

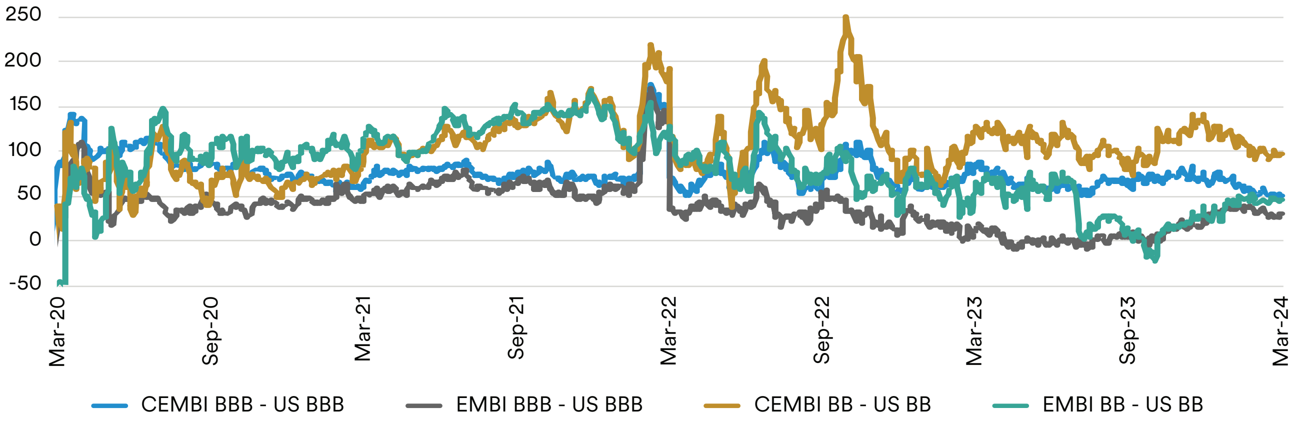


Source: Bloomberg LP, as of March 31, 2024.

In the sovereign space, given the recent rally in idiosyncratic high beta sovereigns, we have looked to take profit and redeploy capital into high conviction names upon any weakness. With the 10-year remaining above 4% and the potential for rate cuts later this year, 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. The primary market has been a place where we look to opportunistically add exposure, notably within higher quality issuers where existing bonds trade fair.

We see opportunities in BB and BBB corporates, in sectors that generate hard currency revenues or have effective FX liability management. 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. Given the outperformance of IG corporates relative to sovereigns during the first quarter, security selection is critical in identify high conviction names where valuations remain attractive. We like convexity and dollar price protection where we can get it.

Figure 12 | BBB & BB EM vs. US Spreads (bps)



Source: Bloomberg LP, JP Morgan, as of March 31, 2024.

Local performance YTD has been underwhelming given resiliency of US data and a mildly stronger US dollar. However, we believe this has created a better entry point for adding duration in the local currency space given valuations. These recent conditions have provided attractive opportunities in some high yielding markets such as Colombia, Mexico, and Brazil. The compelling real rate environment in Latin America is most enticing, while Europe is valued more fairly, while Asian local yields are overall lower and therefore less compelling. We use local exposure as a liquid way of expressing views on risk in the market, and give ourselves room to put money to work as opportunities present themselves.

Endnotes

1 Bloomberg LP
2 Bloomberg LP
3 Bloomberg LP
4 JP Morgan
5 JP Morgan
6 Data in this paragraph sourced from JP Morgan
7 Bloomberg LP

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