PUBLIC FIXED INCOME

Emerging Markets

Market Review and Outlook

September 30, 2022

Market Review

	End of Quarter STW	End of Quarter YTW	3rd Quarter		YTD	
			STW Change (bps)	YTW Change (bps)	STW Change (bps)	YTW Change (bps)
JP Morgan EMBI Global Diversified	560	9.57	18	101	193	430
EMBI IG	191	5.85	2	76	48	270
EMBI HY	993	13.92	26	116	353	603
JP Morgan CEMBI Broad Diversified	385	7.86	-4	88	112	375
CEMBI IG	205	6.04	2	88	55	305
CEMBI HY	648	10.53	-19	80	164	445
GBI-EM Global Diversified		7.31	-	25	-	160
Bloomberg US IG	159	5.69	4	99	62	225
Bloomberg US HY	552	9.68	-17	79	291	463

Sources: Bloomberg LP, JP Morgan as of 9/30/2022

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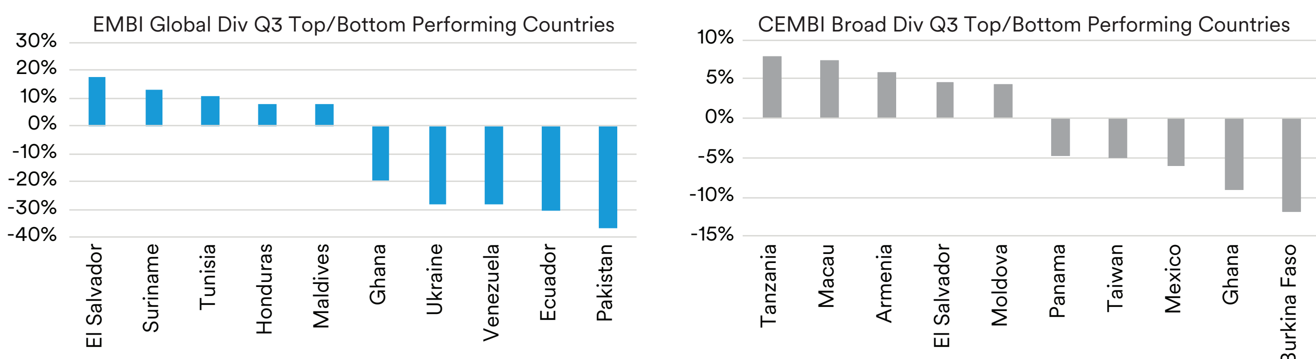
Emerging Markets (EM), similar to other risk assets, continue to be impacted by a strong dollar, rising rates to fight stubbornly high inflation, unfriendly market policy decisions out of China along with the Russian/Ukrainian war. Central banks globally have been aggressively increasing rates to combat soaring inflation which in turn has increased the probability of recession, adding to market volatility and uncertainty. China's Zero-COVID policy, common prosperity ambitions, and continued commitment to reducing leverage has resulted in slower growth, increased unemployment, and declining asset values that have weakened consumer sentiment and growth expectations. Meanwhile, Europe's historic reliance on cheap natural gas will prove problematic as the Russia/Ukraine conflict rages on. The impact on growth and inflation this winter remains unknown, with elevated natural gas prices amid tight supply.

	3rd Quarter	YTD
	Total Return	Total Return
JP Morgan EMBI Global Diversified	-4.57%	-23.95%
EMBI IG	-5.02%	-23.72%
EMBI HY	-4.09%	-24.20%
JP Morgan CEMBI Broad Diversified	-2.64%	-16.21%
CEMBI IG	-3.49%	-16.69%
CEMBI HY	-1.49%	-15.68%
GBI-EM Global Diversified	-4.73%	-18.57%
Bloomberg US IG	-5.06%	-18.72%
Bloomberg US HY	-0.65%	-14.75%

Sources: Bloomberg LP, JP Morgan as of 9/30/2022

These macro factors continued to negatively impact risk assets during the quarter through a combination of an aggressive treasury sell-off resulting in higher absolute yields along with spread widening. When compared to Developed Markets (DM), the Investment Grade (IG) EMBI Global Diversified (EMBI GD) performed in line, while the IG CEMBI Broad Diversified (CEMBI BD) outperformed driven by less spread widening and shorter duration. Both High Yield (HY) EMBI GD and HY CEMBI BD underperformed DM. The overall EMBI GD returned –4.57%, with high grade pressured by rates while high yield experienced more extreme spread widening. This spread widening was driven primarily by single-B and below rated sovereigns that face the most pressure as slowing global growth and a dysfunctional financing market keeps pushing them to seek more external support to meet financing needs. Strong balance sheet fundamentals in the EM corporate space, along with a significant decrease in net financing have been relatively supportive for the asset class. The CEMBI BD returned –2.64%, mostly attributable to the rate move that was partially offset by spread tightening in high yield. The risk off market tone during the quarter resulted in a strong dollar and a further widening of local rates driving down the GBI-EM Global Diversified –4.73%.[1]

Figure 1 | EM Indices Q3 Total Returns



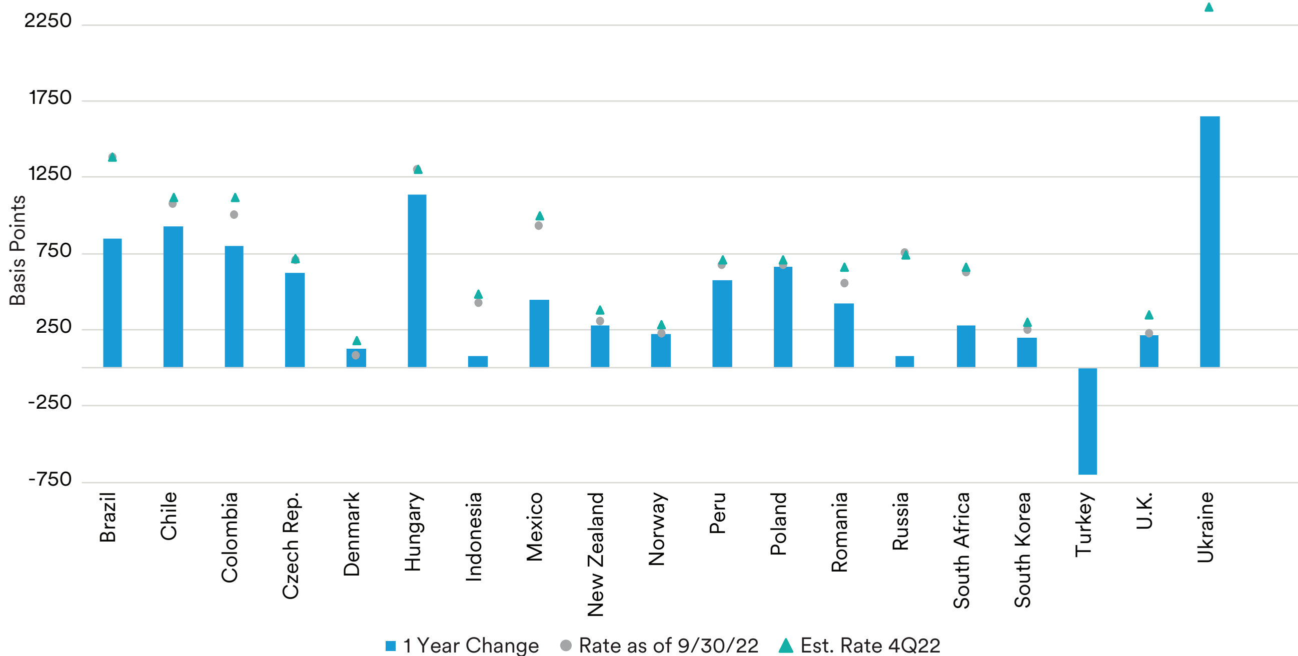
Source: JP Morgan

IMF support has continued to be robust across distressed countries. Ukraine has received immediate support from the IMF as well as working on a long-term program to address the war-stricken country's needs. Countries like Kenya, Ecuador and Costa Rica remain well engaged with the fund while others like Ghana, Egypt, and Sri Lanka are in the process of negotiations with the Fund. With the approval of the food shock window, the newest emergency-finance instrument, nations will receive support with urgent balance of payments needs. This measure comes after the IMF warned that the world is facing the worst food shock in over a decade, and likely to worsen due to supply bottlenecks, challenges to Ukraine's crops, and high prices of fertilizers and energy.

We have seen dampening of commodity demand due to recession concerns, with commodity indices down 25% from their peaks in June. Fed rate hikes, EU's gas crisis, and the Zero-COVID policy-related malaise in China all point to a weaker cyclical outlook. This has reversed some previous strength that commodity exporting countries recently experienced. Yet, with Brent still sitting above $80/barrel, EM energy exporters' current accounts are continuing to benefit. OPEC+ recently announced a cut to oil output by over 2 million barrels/day in order to support oil prices, sending yet another signal of slowing global growth concern.

Both DM and EM countries aggressively hiked rates during the quarter as inflation levels failed to subside. The Fed has continued a hawkish stance, promising to continue hikes for the time being. Alternatively, other DM countries have been somewhat more dovish, with the Bank of England fearful of pushing the fragile European economy into a recession. The Bank of Japan has remained dedicated to their yield curve control, which has presented consequences amid rising costs, a weakening currency and slowing global demand. The low interest rate strategy has contributed to rising prices and dramatically decreased the value of the yen. In Emerging Markets, which were quicker to start hiking during the COVID-19 recovery, we have seen signs from central banks that hiking cycles are nearing their end. Some countries are now implementing measures to avoid FX depreciation rather than more rate hikes as pressure is placed on policies.

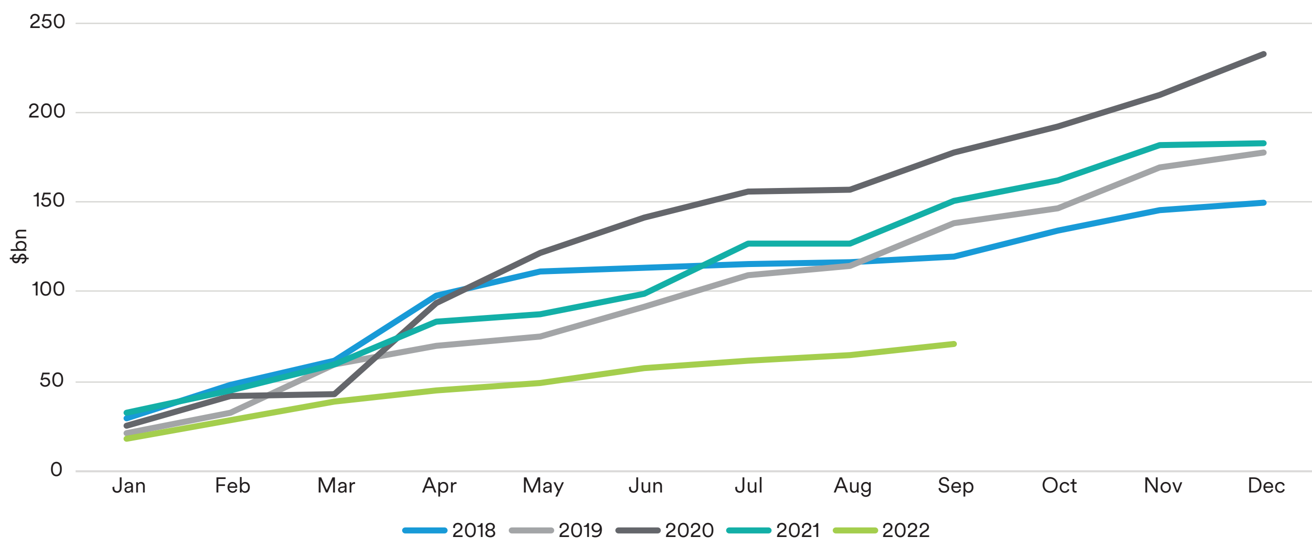
Figure 2 | Central Bank Rate Changes



Source: Bloomberg LP

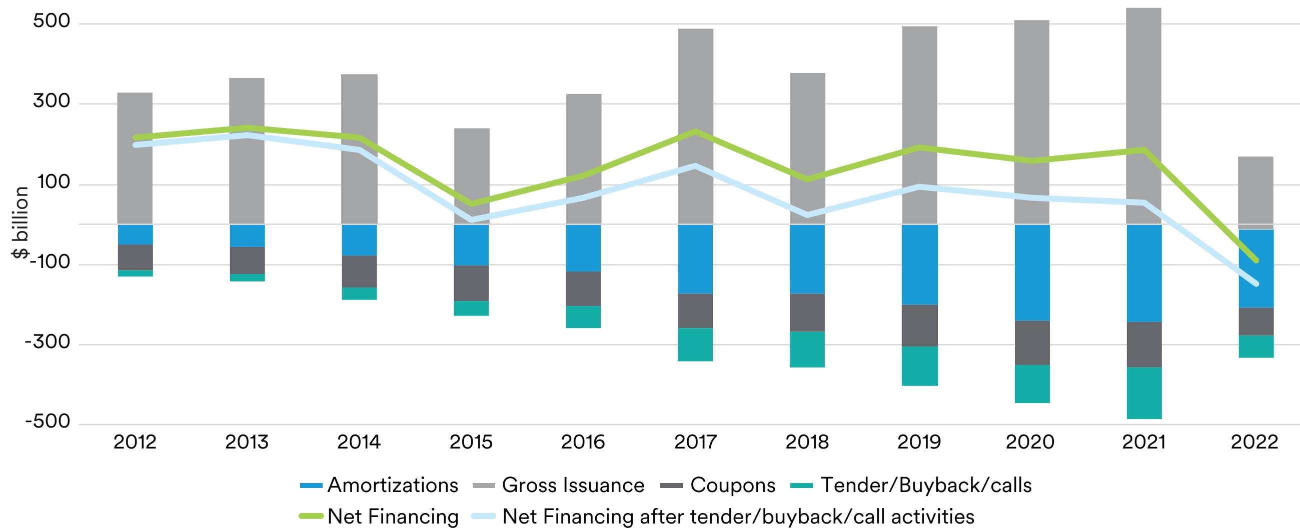
As we head into the final quarter of the year, issuance has not kept pace with expected annual levels. The lack of primary deals since the end of summer has been exacerbated by volatility and the rising rate environment. Issuers have remained selective on coming to the primary market, with some lower quality issuers currently losing access to the market and the cost of issuance becoming more expensive. Year-to-date (YTD), HY EM sovereign issuance is at the lowest level since 2008 with only $19.8 billion of issuance, and total issuance is on pace for the slowest year since 2015. Corporate gross supply is running at an 11-year low, with net financing reaching a new all-time low. IG EM corporate issuance is at a record high of 79% of total issuance YTD, further supporting the inability of lower quality issuers to come to market in this environment. Positively, corporates are not as strained for funding given their continued work on liability management over recent years. Sovereigns have been able to access local market funding as an alternative to issuing in the dollar market, reducing their external financing needs, but at a higher cost and potentially crowding out local private sector issuers. Additionally, commodity exporters, including the large majority of GCC countries, do not need to issue as oil remains above their fiscal budgets. Outflows continued to pressure EM bond prices as investors were forced to raise cash to fund client drawdowns. Hard currency funds have witnessed YTD outflows of $36.3 billion and local currency outflows of an additional $33.7 billion.[2]

Figure 3 | Sovereign Issuance Trends



Source: JP Morgan

Figure 4 | Corporate Net Financing



Source: JP Morgan

Despite overall slow supply, Green, Sustainable, and Social (GSS) issuance continues to be top of mind. YTD corporate GSS issuance has risen to 30% of total issuance, while sovereign GSS supply has slightly declined to 13%. This trends well above the US High Grade level of 4.8% of total issuance. Historically "greeniums" on GSS bonds have existed over traditional securities; however, when markets are under pressure this premium has been slightly diluted, giving investors opportunities to participate in GSS securities at more attractive levels than historically. More traditional EM investors are involved in GSS investments than ever before, with the share of GSS EM corporate bonds in traditional portfolios growing to 8.4%, up from 6.4% at the end of 2021.[3]

Chileans rejected the proposed New Constitution by a wider-than-expected margin of 62% vs. 38%. The participation rate of 87% of registered voters was notably larger than the already high rate from the 2nd round presidential elections in 2021, showing broad disapproval of the proposal across the country. Chileans want a stronger welfare state that guarantees wider access to better public services including healthcare, education, and pensions. The Brazilian first round presidential election resulted in a better turnout for Bolsonaro than expected, depriving Lula of a first-round victory. Lula took 48% of the votes, while Bolsonaro reported 43%. This will likely force Lula to moderate his positions further going into the October 30th second round.

The China growth story continues to leave markets uncertain, coupled with the stress on the China property space. Recent liquidity enhancements coupled with reopening announcements and relaxation of travel requirements for the country have been positive indicators for economic recovery. China recently announced a tax incentive to spur home purchases, with residents who buy a new home within one year of selling their old home receiving refunds for personal-income tax. In the property space, companies received state guarantees on local debt sales that helped temporarily ease some concerns; however, no further signs of support have caused bonds to reach new lows as pressure on issuers continues.

Russian President Vladimir Putin's move to draft 300,000 reservists to reinforce his troops in Ukraine triggered protests around the country, the biggest since the early days of the war, and conscription-age men rushed to find ways to flee. A week later, Putin delivered a speech announcing the annexation of four regions of Ukraine, a dramatic step in the opposite direction of a path to peace. In the most anti-Western rhetoric yet, he criticized the West and called on Ukraine to stop fighting and negotiate, reiterating that the four annexed oblasts would be forever Russia's.

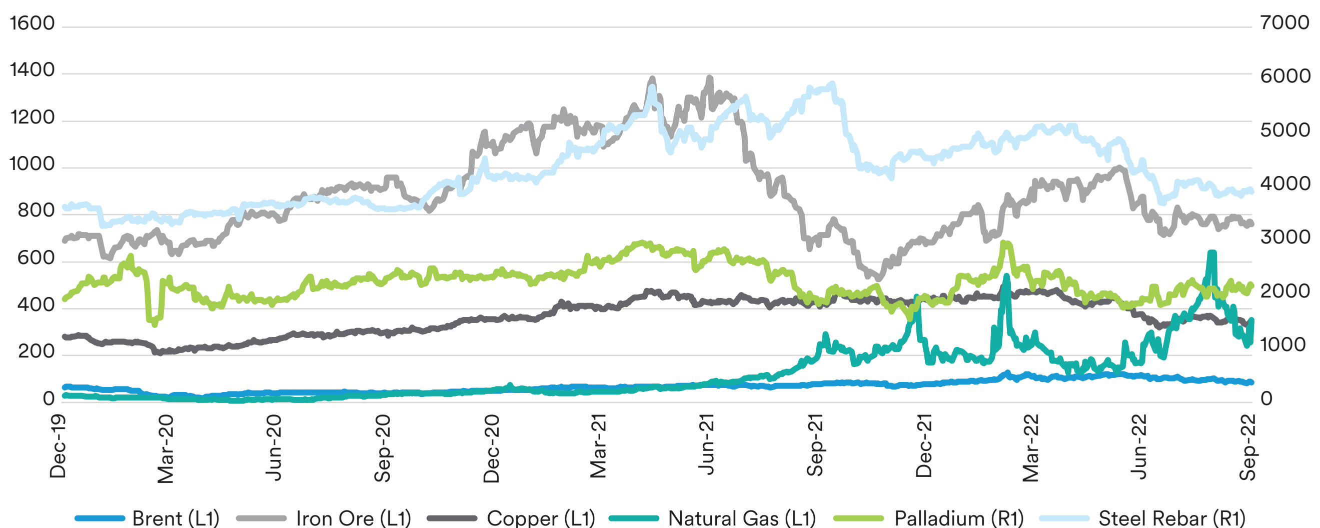
Outlook:

Investing in EM in the current environment remains challenging, aggravated by limited liquidity and a hawkish Fed. Macro factors led by the Russia/Ukraine War, global inflation, and China growth are driving recent risk-off appetite, steering asset valuations, and overshadowing EM fundamentals. These macro headwinds are significant for assets; however, the buffers across many EM corporates and sovereigns are substantial and underrealized. Corporates have priced in downside risk but remain hostage to elevated sovereign spread levels that are weighed down by global factors. As we begin to see clarity on the macro side, we expect stability in spreads and a repricing to better reflect fundamentals, supporting the overall EM asset class and risk appetite. We believe that the macro landscape will remain the primary driver of a bullish or bearish course for EM fundamentals and asset returns over the coming 2-3 quarters.

Latin American countries are being forced to moderate their political tone to receive enough support from both sides to get policies passed. The Brazilian presidential candidates are likely to moderate their stance further before the October 30th second round election in order to gain more center votes. The Chilean New Constitution has gone back to the drawing board to appeal to a broader audience to get the approval votes needed. Balance of power in Peru has limited leftist president Castillo as he lacks support from his congress on more radical proposals. It remains important to monitor how this leftist shift develops in the region, paving the way for sovereign political and economic stability.

The recent weakening of foreign currencies has exerted downward pressure on commodity cost curves. With US interest rates at high levels, commodities have been caught in a negative loop between higher US rates, US dollar appreciation, and weaker non-US economic growth largely from Europe and China.[4] Commodities including nickel and aluminum will likely continue to face near-term pressure from slowing demand, rising supply, and inventory dislocations. Yet we believe that supply constraints in most commodities should support fundamentals, especially in grains, crude, and copper, further supporting EM exporters. The energy crisis in Europe has added additional pressure to energy levels as Europeans brace for the winter months, with uncertainties over Nord Stream pipeline supplies from Russia persisting.

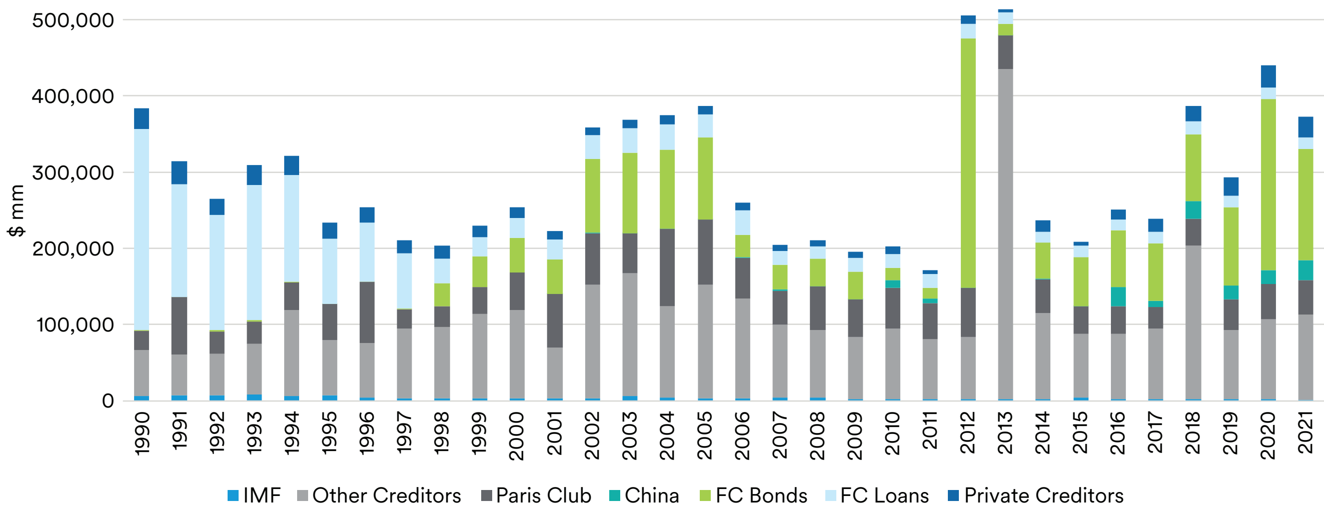
Figure 5 | Commodity Prices



Source: Bloomberg LP

We expect to see a steady rise in defaults and downgrades across the EM space in the coming months. Despite continued robust fundamentals, a weaker macro backdrop and persistent inflation will likely continue to deteriorate corporate balance sheets from current peaks. We feel defaults will continue to be led by the China property space, as well as Russian and Ukrainian corporates. We are also prepared for a stretch of sovereign defaults as a handful of countries with weaker fundamentals face debt trading at distressed levels and elevated restructuring risk.

Figure 6 | Total Sovereign Debt in Default

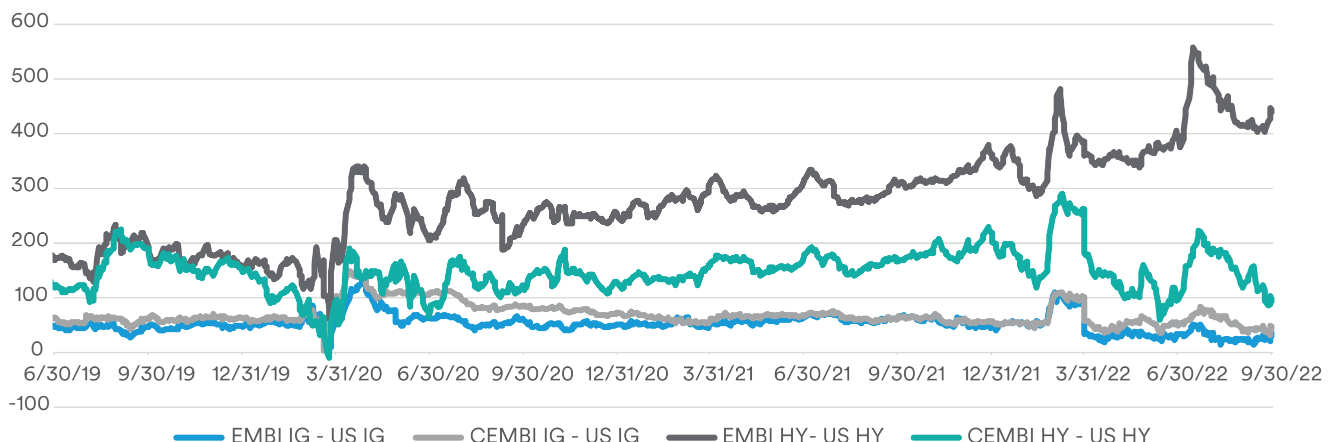


Sources: BoC–BoE Sovereign Default Database 2022, Morgan Stanley Research;
Note: Shows amount of defaulted debt by creditor. FC = foreign currency.

Security selection has proven to be more important than ever in identifying issuers with strong fundamentals despite a sell-off due to market technicals. We believe this current environment presents opportunities for EM securities, where yields on the indices are at levels not seen since 2009. With double digit negative performance YTD, this weakness could drive performance over the next year horizon.

Despite its own idiosyncratic risk factors, EM has historically remained highly correlated to DM credit, with EM historically outperforming later in the cycle. As the current market cycle continues unfolding, as expected EM has underperformed relative to DM thus far. Signs of China growth recovery and a peak in inflation would be positive drivers where we would expect to see spread compression between EM and DM securities, with EM catching up and outperforming.

Figure 7 | EM vs DM Spread Differentials

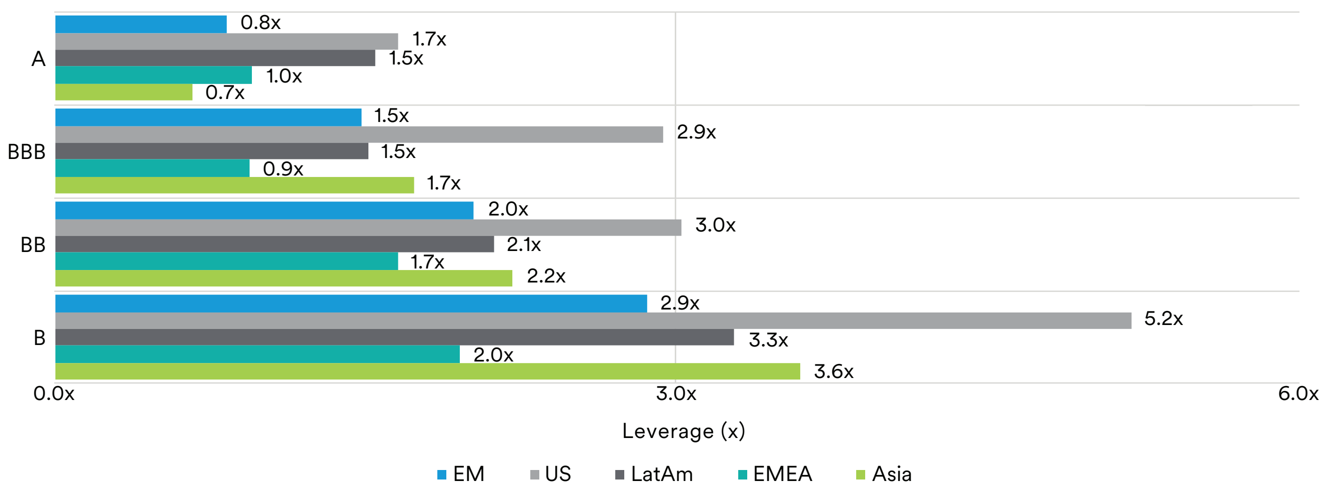


Sources: Bloomberg LP, JP Morgan

In the sovereign space, we see duration risks more balanced as the 10-year US treasury hovers near 4%. We see potential opportunities in some energy-based high yield sovereigns including Oman and Angola as energy remains at comfortable levels. In the low beta space, we continue to like stable names such as Indonesia and Mexico. Mexico continues to be attractive based on relative fundamentals versus the rest of Latin America. With distressed countries receiving meaningful external support from the IMF, we look for idiosyncratic stories where we believe potential restructuring scenarios offer more upside than current levels.

Given a lingering global slowdown, we do expect for corporate fundamentals to see some reversal from recent strength. However, even with this, we believe that EM issuer balance sheets will remain well positioned relative to DM. Recent asset price moves of corporates look exaggerated in our opinion, driven by forced selling and low liquidity, even if fundamentals do weaken going forward. We see opportunities in the telecom and consumer staples areas, in addition to our bias towards hard asset companies that are free cash flow positive. We will look to add risk in the shorter maturity bucket following recent curve flattening. Latin America and commodity-based African securities are places where we are more comfortable owning active risk, as commodity exporters' current accounts continue benefiting from elevated levels.

Figure 8 | Corporate Net Leverage



Source: BofA Global Research. Fundamental Data as of December 31, 2021, Spreads as of September 30, 2022

We believe we are nearing the peak of the inflationary environment where EM central banks could slow the pace of tightening. This environment could present opportunities for non-dollar assets; however, market volatility continues to cause near-term weakness. We are focusing positioning within countries that have been aggressive with rate hikes and are nearing the end of the cycle, along with commodity exporting countries. The lingering recession fears in Europe coupled with uncertain energy supply may pose challenges in the coming months, and we remain cautious in that region.

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 BofA

[4] Goldman Sachs

Disclosure

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