PUBLIC FIXED INCOME

Emerging Markets

Market Review and Outlook

September 30, 2023

Market Review

Two months of relatively quiet yet firm market tone came to an abrupt halt at the close of the third quarter. Persistent inflation data coupled with the market's view that recession risk has declined, caused an aggressive bear steepening of the entire treasury curve. The 10-year treasury yield rose 73 basis points to 4.57%, hitting the highest level since October 2007. Adding to the pain of the rate shock, Emerging Markets (EM) felt an additional layer of stress during the quarter as slowing China growth weighed on the asset class. Despite China home sales seeing a mild recovery following Beijing's measures to support growth, the lack of material progress continues to dampen overall sentiment. The trickle effect from China is felt far and wide. Most recently, the European Central Bank cut its growth forecast, as unease over the restrictive rate environment coupled with the weak economic backdrop from China are affecting even Developed Market (DM) countries.

Brent crude rose almost 30%, to close out its best quarter since 1Q2022, as lower supply and increased global demand have supported prices. This revival of a stronger energy environment has mixed impact on EM nations. Higher oil prices may impact real incomes and growth of net importing countries, putting downward pressure on currencies and causing Central Banks to reconsider the timing and intensity of monetary easing. However, energy exporters benefit from these elevated prices, as margins remain high and well above fiscal budget breakeven levels. Nonetheless, for investors, these elevated levels are dampening hopes that interest rates will fall anytime soon as price pressures rise.

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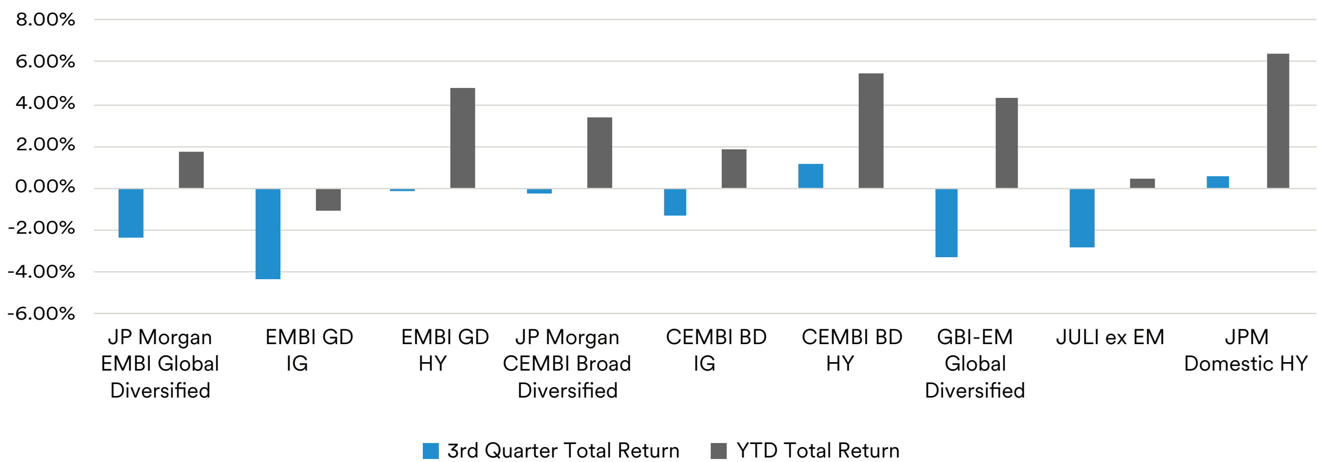
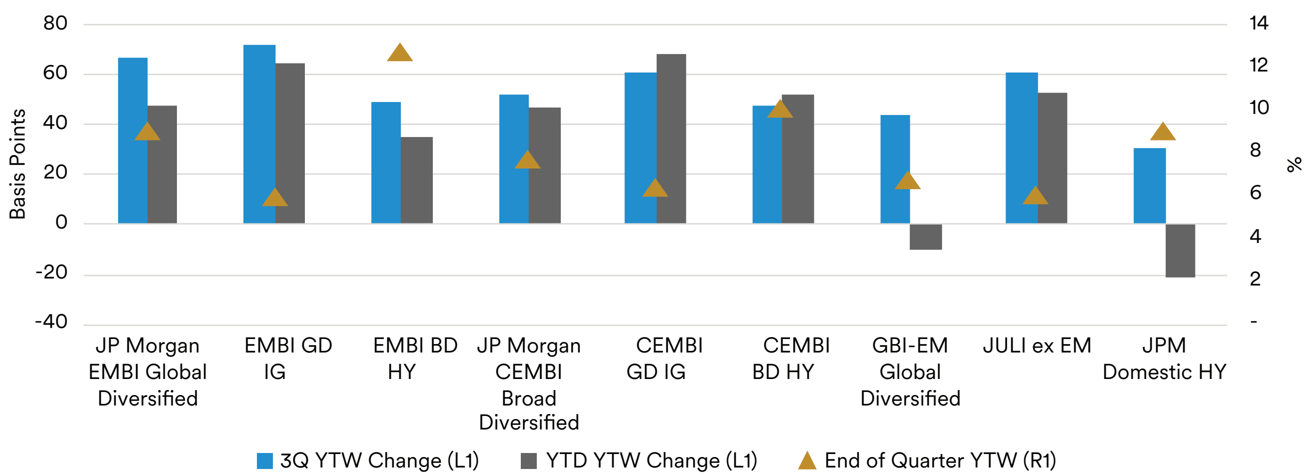
The rate move largely dictated the performance of EM assets, with longer duration high quality sovereigns weighed down the most. Corporates on the other hand, were slower to reprice as trading liquidity was more readily available in sovereigns for investors to raise cash. Increased refinancing costs due to this recent treasury move led to further decompression in EM between Investment Grade (IG) and High Yield (HY) issuers. Even with the macro-overhang, lack of issuance coupled with limited real money outflows has helped EM perform relatively in line with DM assets despite tight relative value.

Figure 1 | Indices Total Returns



Sources: Bloomberg L.P., JP Morgan

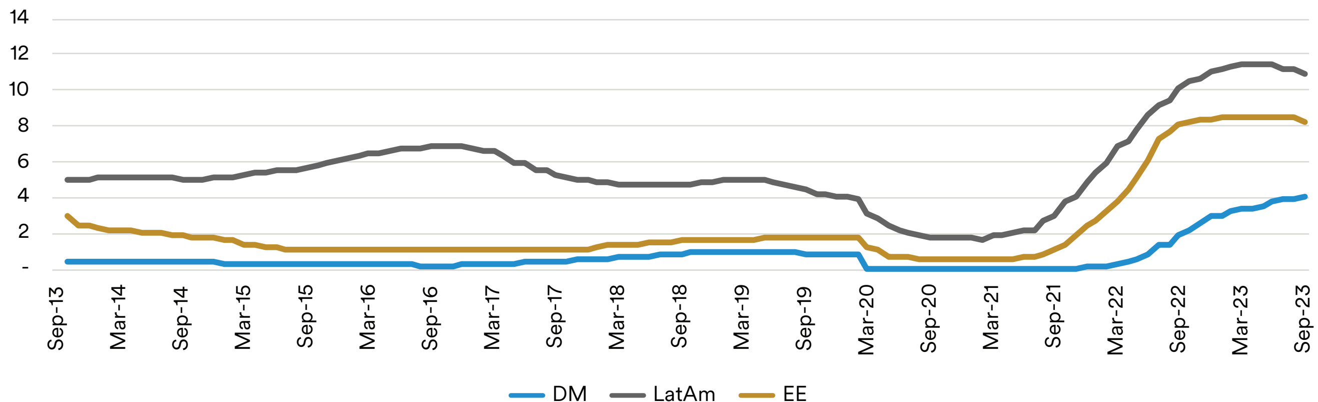
Figure 2 | Indices Yields



Sources: Bloomberg L.P., JP Morgan

EM local currency assets faced a different path during this US rate volatility. The proactive response of EM central banks to hike rates at the beginning of the COVID-19 pandemic proved supportive for many countries. Now, as inflation has been largely tamed across these countries and is trending downward, central banks including Chile, Brazil, Peru, Hungary, and Poland have begun cutting rates. All the while sticky inflation is keeping US rates higher for longer, strengthening the dollar.

Figure 3 | Average Central Bank Rates by Region (%)



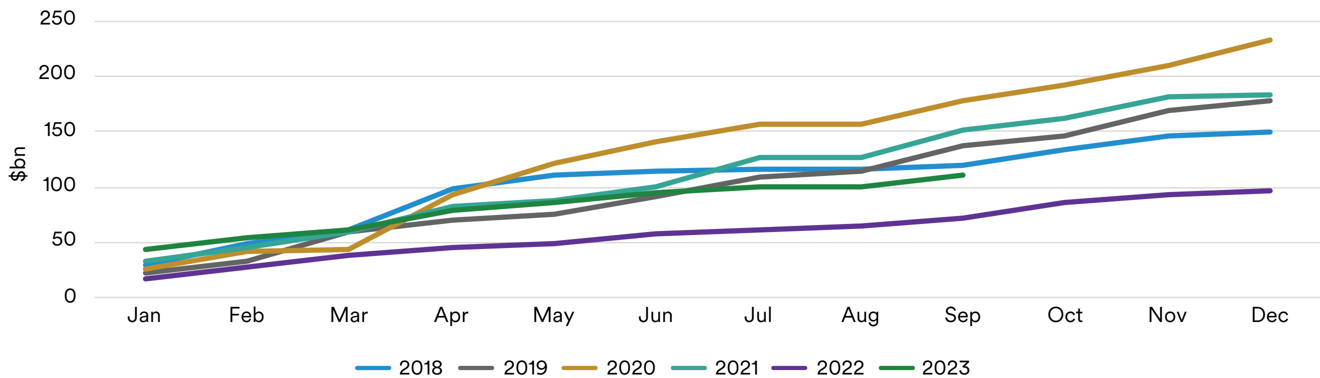
Sources: Bloomberg L.P.

> If issuers start to project that rates will stay higher for longer, higher quality sovereigns may resume issuance to pre-fund for next year.

Politics and elections remain an important driver for the EM landscape. Ecuador held snap general elections just two weeks after one of the candidates was assassinated. Bonds initially rallied following the incident on optimism over changes to address a surge in crime during the next regime. However, after results pointed to a runoff between socialist candidate Luisa Gonzales and entrepreneur Daniel Noboa, bonds retraced gains. Turkish President Erdogan was reelected and has adopted more conventional economic policies, highlighting a shift from previous measures that were blamed for sky high inflation and a mass exodus of foreign money. Four days after Gabon's election, military officers in the country announced that they seized power from President Ali Bongo. Bongo had been declared the winner of the election with over 60% of the vote. However, the elections took place in a media blackout as the government denied entry to all foreign news outlets and the government shut down the internet at the last minute to combat 'disinformation and manipulation'. Albert Ossa, leader of the opposition coalition, claimed victory before the results were announced and called into question the legitimacy of the electoral process.

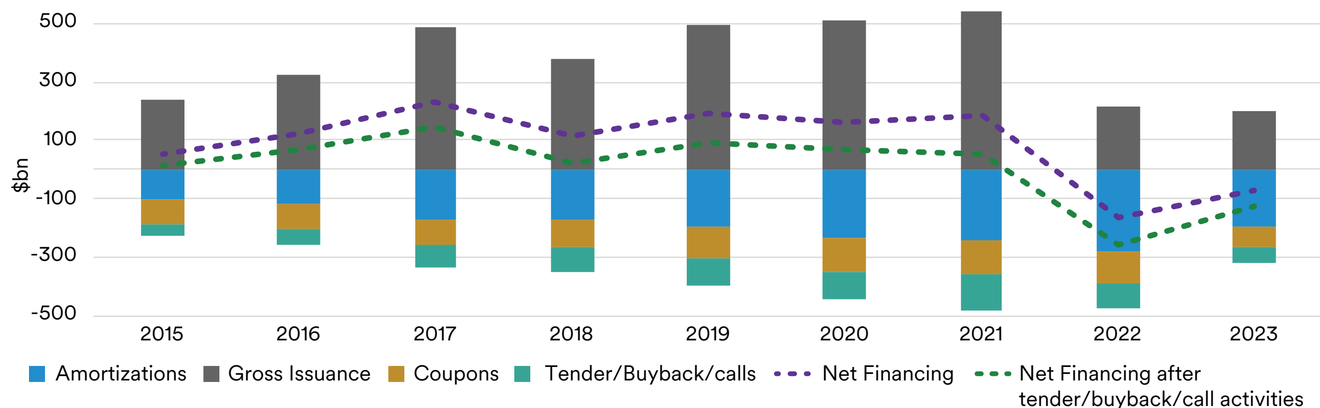
Issuance has remained underwhelming in EM, as high-quality issuers delayed coming to market and high yield issuers faced prohibitive yields. Early September provided a temporary period of improved liquidity and decent risk backdrop; however, the subsequent sharp spike in rates sidelined investors. If issuers start to project that rates will stay higher for longer, higher quality sovereigns may resume issuance to pre-fund for next year. Only $16.8 billion of sovereigns issued during the quarter, with investment grade issuers representing 74% of that total. Corporate issuance of $59 billion was almost double the Q3 2022 issuance level, but still well below the $100 billion five-year average for the quarter. Despite the September rebound being the most active supply month of the 2023, corporate net financing remained negative due to robust scheduled cashflows and elevated liquidity management exercises. As investors shift to more ESG awareness, issuers have been structuring deals to include various relevant targets and metrics such greenhouse gas intensity, social equality, and environmental causes, to help reduce borrowing costs.

Figure 4 | Cumulative Gross Sovereign Issuance



Source: JP Morgan

Figure 5 | EM Corporate Net Issuance



Source: JP Morgan

While outflows have continued across both hard currency and local currency accounts, -$17.4 billion of combined outflows year-to-date, the biggest selling derived from ETFs which recorded 8 consecutive weeks of outflows. Real money accounts on the other hand have kept their allocations fairly steady. Non dedicated investors continue to prefer DM risk given relative value and uncertainty over economic data and interest rates.

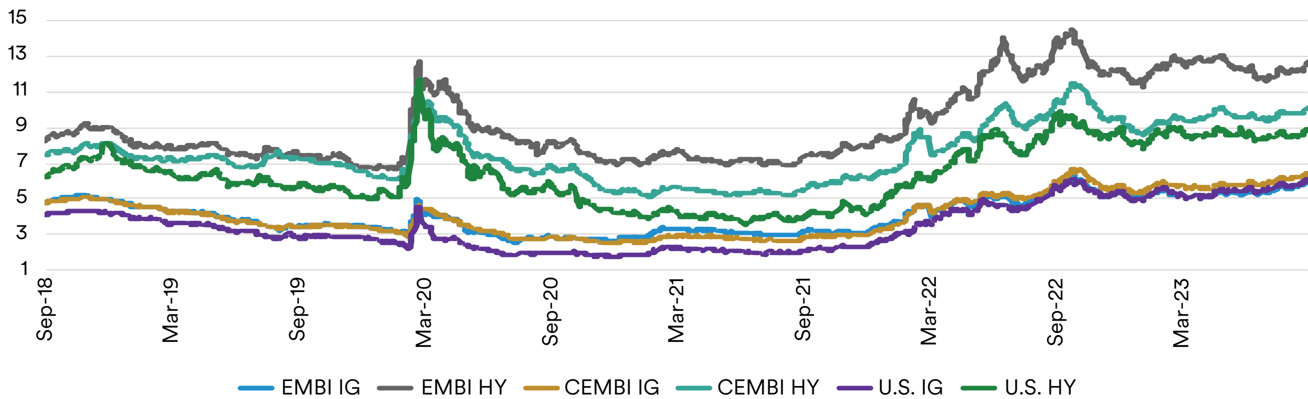
Outlook

Investors remain cautious for the remainder of the year as the path of US interest rates remains uncertain and is the major driver of performance and sentiment. Investors are looking for a combination of the US inflation slowing and a consistent rebound in China's economy. We will continue to monitor global growth, inflation, and geopolitical tensions as they are the main drivers of EM outlook. The recent conflict in Israel is the newest geopolitical concern weighing on sentiment; as such, the escalated uncertainty and fluidity of the situation factors into portfolio positioning. Additionally, the outlook around energy prices into year-end is now even more uncertain, as Middle Eastern tensions may increase volatility. The recent market environment has highlighted the importance of security selection within portfolio construction. The overall market volatility has led to a bifurcation in performance between strong sought after credits and those which may face refinancing risks.

As a result of current valuations and volatility of interest rates and commodities, our portfolios have reduced risk and began shifting to higher quality, more interest rate sensitive sovereigns with low financing

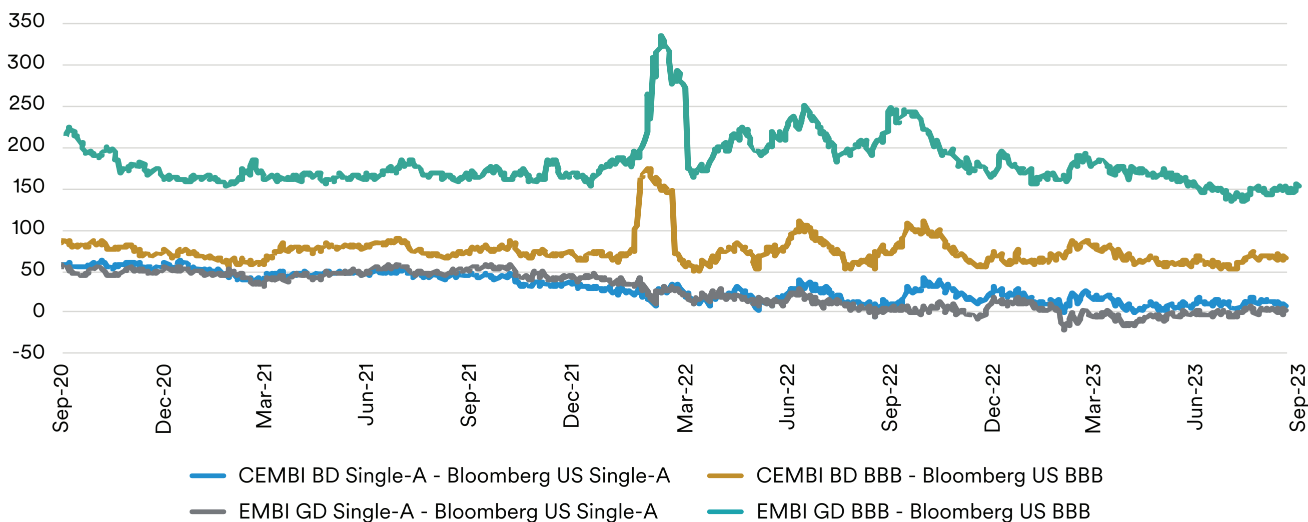
needs and ability to tap the market. Given attractive all-in yields with US treasury yields above 4.5% and relatively neutral portfolio duration, we feel more comfortable going out the curve in higher quality names where you historically were not compensated for the risk. While the overall beta of our portfolios remains lower than historical levels, we continue to look for more focused risk opportunities in idiosyncratic special situations that we believe are likely to rally in a better market environment and in worst case scenarios have recovery values at or above current levels. The primary market has been another place where we look to opportunistically add exposure and take advantage of new issue concessions.

Figure 6 | Yield to Worst (%)



Sources: Bloomberg L.P., JP Morgan

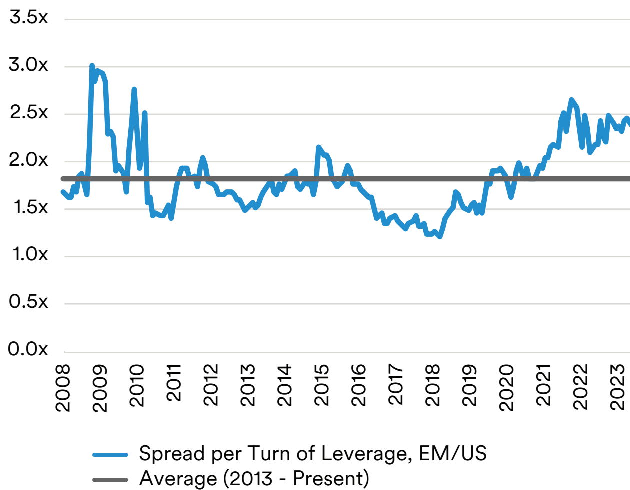
Figure 7 | EM vs. US IG Spreads (bps)



Sources: Bloomberg L.P.

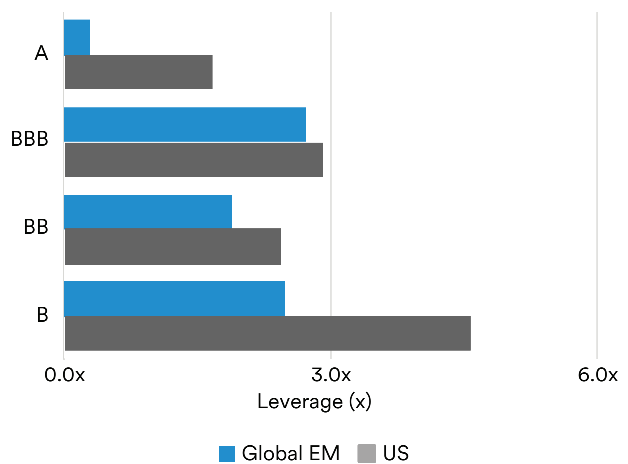
While corporates continue to perform well at the balance sheet level, we think credit quality has peaked and operating metrics will begin to show some softening from here. Additionally, headlines around a few large issuers have increased investor questions, putting a larger focus on governance. We like hard currency revenue-generating BB corporates as well as BBBs, where balance sheets remain supportive and access to capital is not challenged by either more uncertain macro conditions or the rise of interest rates. While we historically do not take much China risk directly given persistent overvaluations, recent repricing of the Asian financials space has presented some compelling opportunities.

Figure 8 | EM/US Spread per Turn of Leverage



Source: BofA Global Research. Fundamental data as of December 31, 2022, Spreads as of September 30, 2023

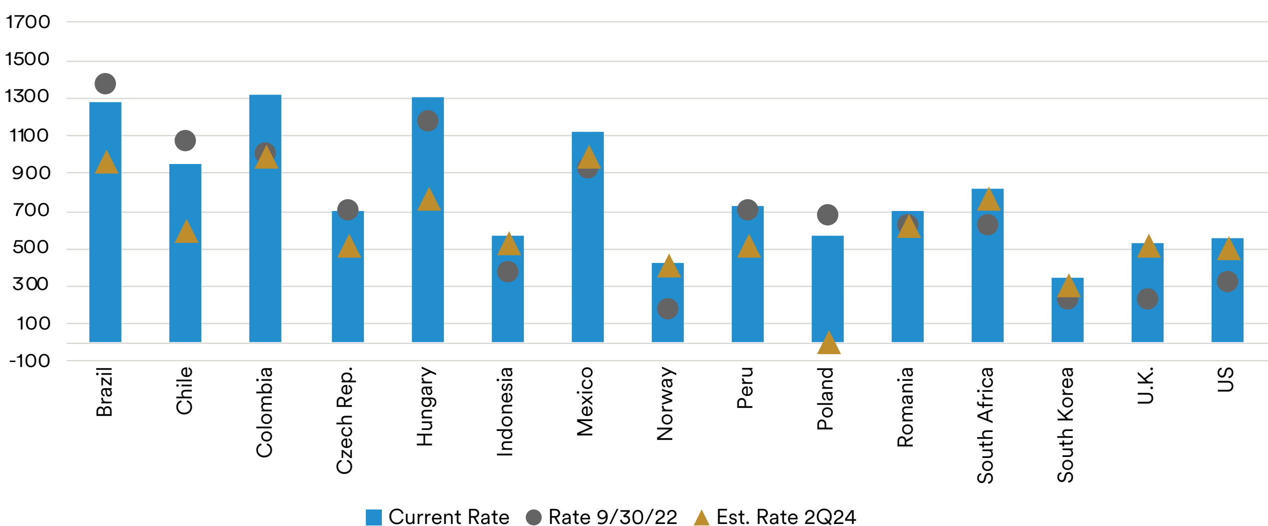
Figure 9 | EM vs. US Leverage by Rating



Source: BofA Global Research. Fundamental data as of December 31, 2022, Spreads as of September 30, 2023

The current strong dollar, US Fed actions, and lingering uncertainties around global growth are providing a challenging backdrop for EM local currency bonds to outpace hard currency assets in the current environment. However, the recent interest rate sell-off has coincided with continued downward pressure on inflation globally. This has provided good entry levels for 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, and Asia screens rich.

Figure 10 | Rate Changes (bps)



Sources: Bloomberg L.P.

The political landscape continues to shift with a number of critical elections coming up during 4Q23. Argentina's sky-high inflation, loose fiscal and monetary policies, and lack of international reserves are setting the stage for the challenges the next regime will step into starting in December. Egypt's inflation has risen to new highs as the country heads towards its own election in December where current President Abdel-Fattah El-Sisi is likely to win his third term. The country is looking for an uneventful election cycle

to help access more financing from its IMF rescue package while facing pressure to devalue its currency once again. The upcoming election in Poland may socially and politically steer the direction of the country further from Western Europe and reveal if European constituencies will put aside growing war fatigue to remain united in their support of Ukraine. While a new draft of the Chilean constitution was approved by the Constitutional Council, Chilean voters remain unimpressed with the new document, and it is unlikely to pass as written in the December referendum. President Boric has signaled that if rejected, the government will not seek a third constitutional rewrite process, therefore the current business-friendly constitution from 1980 will remain in place despite 4 years of attempting to rewrite a new constitution. The upcoming Colombian regional election at the end of October will likely result in a loss for Petro's coalition, pressuring reforms to be diluted or overall less likely to advance as moderation is expected. Ecuador will also transition to a new government following its elections in mid-October, hopefully with the ability to tighten fiscal policy and remain engaged with the IMF.

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