Back to a value market

Emerging market debt outlook

Q1 2016

IN BRIEF

- We think emerging market debt will be driven more by idiosyncratic alpha than broad market beta in 2016 and, therefore, country differentiation will be crucial to seek out the best alpha opportunities.
- We find that economic conditions are broadly supportive. Growth is finally stabilising across the emerging world after several disappointing quarters, although Chinese rebalancing may constrain Asian and commodity exporting economies in particular.
- Emerging markets are less vulnerable to external financing pressures in the face of rising U.S interest rates, given smaller current account deficits.
- Private sector debt has increased, largely because of China, but still remains below private sector debt in the developed markets.
- Capital outflows intensified in the lead-up to the U.S. interest rate decision at the end of 2015, but we are hopeful that the marginal pressure on flows will fall now that the Federal Reserve has finally started on the path to normalisation.
- We continue to prefer emerging market hard currency sovereign credit given the still-favourable US dollar environment, and relatively stronger fundamental and liquidity characteristics of the sector versus emerging market corporate credit.
- For emerging market local currency debt, corporate credit and FX we prefer to take a more selective and relative approach. While local currency valuations are attractive with yields close to 5 year highs, we prefer to take a more cautious approach given the lack of a meaningful catalyst on the FX side.

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EMERGING MARKET DEBT 2015: RESOLUTE IN THE FACE OF MULTIPLE CHALLENGES

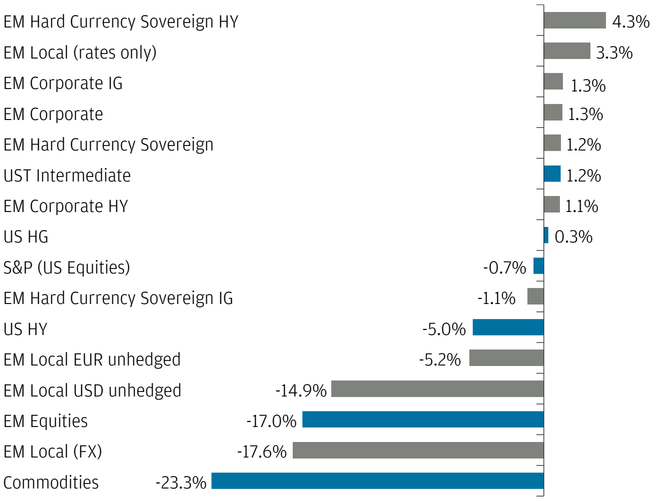
Despite a challenging year for emerging markets—punctured by ongoing concerns over growth prospects, significant commodity underperformance and a series of idiosyncratic pressures in major emerging markets including China and Brazil—the performance of several emerging market debt sectors was remarkably resolute in 2015.

Emerging market high yield sovereign credit had the best return, outgaining equities and US credit equivalents, despite considerable headwinds (**Exhibit 1**). Several factors explain the performance of high yield emerging market debt, including the segment's relatively short duration profile, high levels of carry (which cushion adverse spread and US Treasury movements), and positive developments in several high yield names, such as Russia, Ukraine and Argentina.

J.P.Morgan
Asset Management

Emerging market debt has displayed considerable resilience

EXHIBIT 1: EM DEBT ASSET CLASS PERFORMANCE, 2015



Source: J.P. Morgan Asset Management, Bloomberg; data as of 31 December 2015

EM=emerging market; HY=high yield; IG=investment grade; HG= high grade; DM=developed market; FX=foreign exchange; UST=US Treasury.

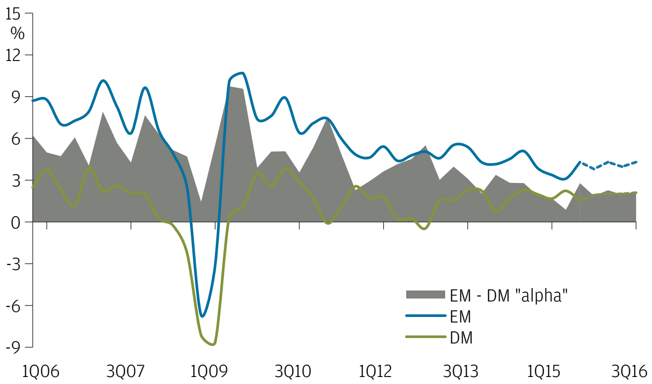
The emerging market high yield sovereign credit results contrast starkly with emerging market local currency debt, expressed in US dollar unhedged terms, which ended the year deep in negative territory. The local currency story warrants closer scrutiny, however. The bond component of return has been positive, with high levels of carry more than offsetting a move higher in yields. Currency has been the overwhelming detractor. While lagging emerging market fundamentals have certainly precipitated currency weakness, the underlying cause has been as much U.S. dollar strength, as illustrated by the relative outperformance of emerging market local currency debt investments funded in euros, for example.

EMERGING MARKETS ARE EXPERIENCING A CYCLICAL STABILISATION IN GROWTH

Although the year's growth picture was disappointing as a whole for emerging markets, the pace of growth picked up in the third quarter. Tepid growth in developed markets, deceleration in China, commodity price softness and tighter financial conditions were among the factors weighing on emerging markets. While we do not expect a significant pickup over the next 12 months, emerging markets are now stabilising (**Exhibit 2A**)—a trend that we expect will consolidate in 2016 with growth rates marginally stronger. Indeed, cyclical indicators such as retail sales, purchasing managers' indices (PMIs) and industrial production all show tentative signs of firming (**Exhibit 2B**).

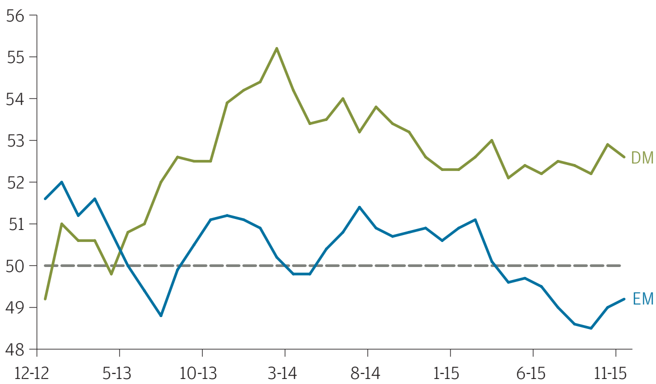
Emerging market "growth alpha" picked up over the third quarter; cyclical indicators now show modest signs of rebounding

EXHIBIT 2A: GDP GROWTH (QUARTER ON QUARTER, SEASONALLY-ADJUSTED ANNUALISED RATE)



Source: J.P. Morgan, data as of 31 December 2015.

EXHIBIT 2B: MARKIT MANUFACTURING PMI



Source: Markit, J.P. Morgan Asset Management; data as of 30 November 2015.

Modest recoveries in 2015's recession-hit economies, such as Russia, Ukraine, Venezuela and Brazil, would most likely drive any advance. The risks to this view, which we elaborate on below, are to some extent structural, with commodity prices, tighter financial conditions and an overhang of private sector debt among the key factors to monitor during the coming year.

CHINA CONTINUES TO ENGINEER A SMOOTH GROWTH DECELERATION

China's rebalancing towards domestic consumption with a greater emphasis on services is ongoing. While growth is slowing (**Exhibit 3A**)—the full-year growth print for 2015 is likely to be the lowest since 1991—the rebalancing process has been smooth and orderly. We expect GDP to increase nearly 6.5% next year, with the increase coming principally from consumption and little contribution from real estate or net exports. To manage the transition, the authorities have been implementing countercyclical monetary and fiscal policies (**Exhibit 3B**). Recent policy initiatives should sustain infrastructure spending, including quasi-fiscal support through the national policy banks that manage government-directed spending and an expansion in the local government debt swap programme. On the monetary side, the authorities have eased policy through cuts to banks' lending rates and required reserve ratios and we believe there is scope for further easing here.

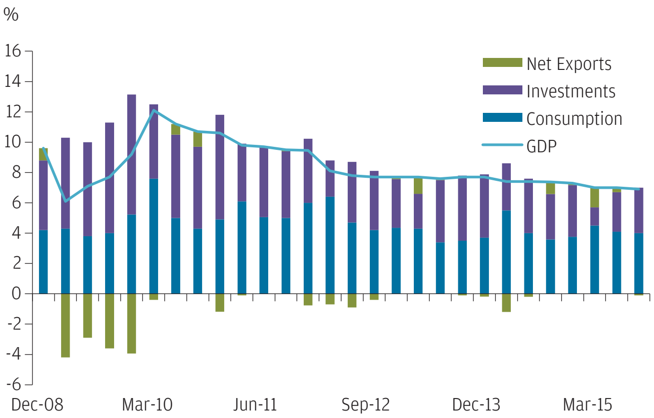
China's rebalancing toward services and less resource-intensive manufacturing sectors has two clear global implications. The first implication, softer commodity prices, played out over the course of 2015, with crude oil and industrial metals both undergoing sharp declines. Commodity prices will likely remain weak for much of 2016. The second implication is a squeeze on emerging market economies intricately linked to China's manufacturing supply chains. These economies, which are mostly Asian, will suffer from a slowdown in China's industrial output. Thus, while China's incremental rebalancing might be good for China in the long term, it's not necessarily supportive for the rest of emerging markets in the short term.

EXTERNAL ADJUSTMENT IS WELL UNDERWAY

Emerging market economies have undergone a major cyclical adjustment since the "taper tantrum" of 2013. They no longer face the same external vulnerabilities they once did, with current account deficits in particular having improved considerably. The adjustment has been recessionary, with imports collapsing across emerging markets and exports not meaningfully recovering. Nevertheless, despite a backdrop of weak and declining commodity prices, current account improvements have been broad-based across Latin America and the emerging Europe, Middle East and Africa (EMEA) region.

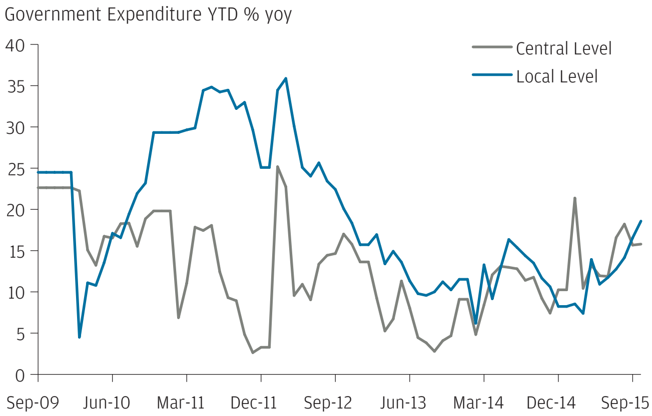
Consumption and infrastructure are set to drive Chinese growth, supported by monetary and fiscal easing

EXHIBIT 3A: CONTRIBUTORS TO CHINA GDP GROWTH



Source: EMED (Emerging Markets Economic Data); J.P. Morgan Asset Management; data as of December 2015.

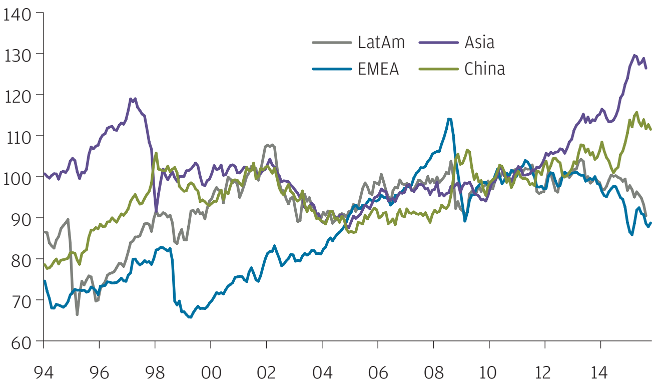
EXHIBIT 3B: CHINA GOVERNMENT EXPENDITURE



Source: National Sources, J.P. Morgan Asset Management; data as of December 2015.

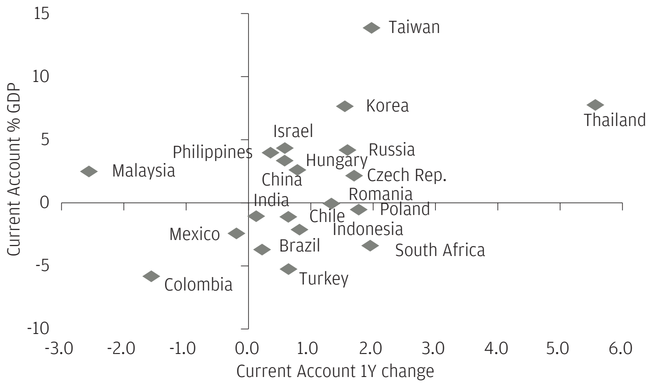
Currencies are adjusting across Latin America and EMEA, while current account positions are improving

EXHBIT 4A: EMERGING MARKET CURRENCY REAL EFFECTIVE EXCHANGE RATES



Source: Haver Analytics, J.P. Morgan Asset Management; data as of 31 December 2015. REER=real effective exchange rate. Series rebased to 2010=100.

EXHIBIT 4B: EMERGING MARKET CURRENT ACCOUNT LATEST AND ONE-YEAR CHANGE AS PERCENTAGE OF GDP

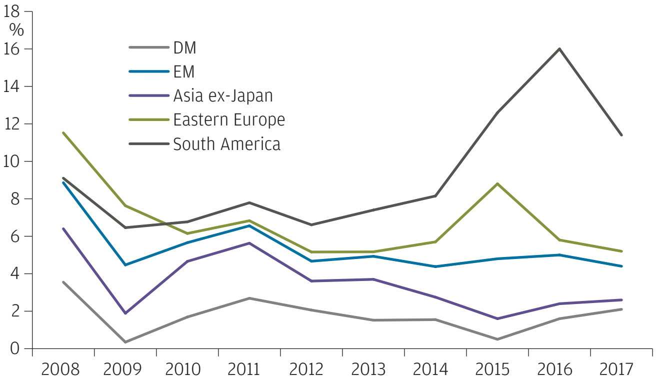


Source: Haver Analytics, J.P. Morgan Asset Management; data as of 31 December 2015.

Currency depreciation has been the primary mode of the adjustment, particularly for economies in Latin America and EMEA, as illustrated by the declines in regional real effective exchange rates (**Exhibit 4A**). It has not been so much the case in China and broader Asia, where countries largely maintain current account surpluses and tend to be net exporters of capital. **Exhibit 4B** reveals the extent of the adjustment taking place within emerging markets. Looking at the horizontal axis, it is clear that the vast majority of emerging market current accounts have undergone a positive change over the past year.

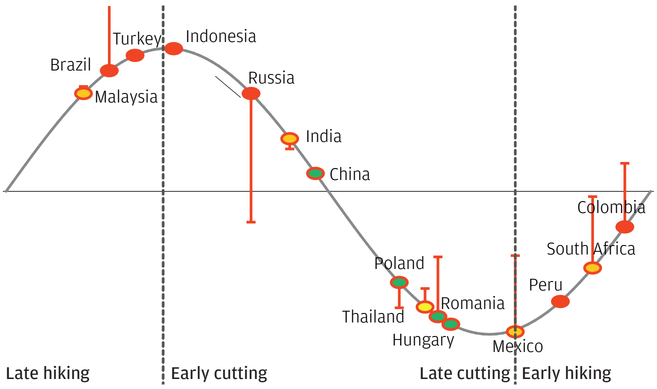
No broad-based inflationary pressures appear to be on the horizon

EXHIBIT 5A: INFLATION BY REGION, YEAR-ON-YEAR PERCENTAGE CHANGE



Source: International Monetary Fund, J.P. Morgan Asset Management; data as of 31 December 2015.

EXHIBIT 5B: MONETARY POLICY CYCLE



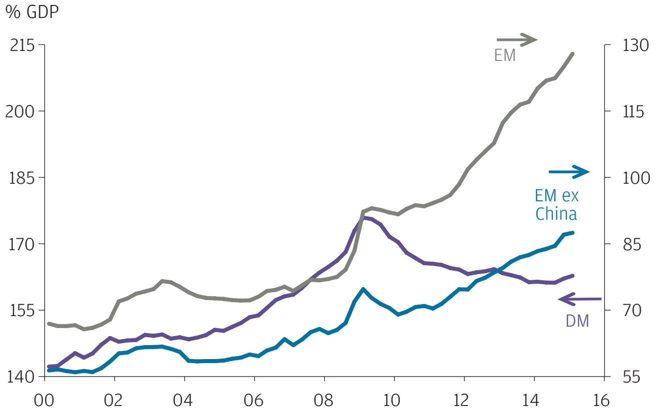
Source: Bloomberg, J.P. Morgan Asset Management; data as of 31 December 2015. Note: Red bars represent central bank rate moves that are priced into the curve. Red, orange, yellow and green circles represent how expectations for the 12-month consumer price index compare to target. Green=below lower band; yellow=in the range below mid; orange=in the range above mid; red=above upper band.

INFLATION REMAINS WELL ANCHORED

With growth in emerging markets below trend, inflation in aggregate is not an issue, although isolated pockets of inflation pressure exist (for example, in Colombia, Brazil and Turkey). We may see tentative signs of a pickup in inflation later in 2016 from currency pass-through and commodity price normalisation, but we anticipate the picture will stay highly differentiated across regions and countries (**Exhibit 5A**).

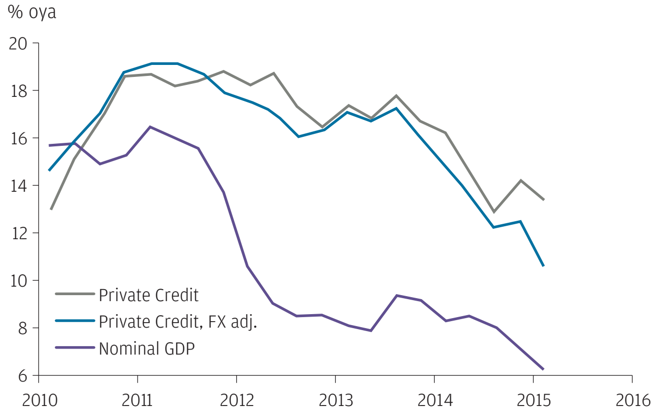
Private sector debt build-up may weigh on growth, but no crisis is expected

EXHIBIT 6A: BROAD PRIVATE NON-FINANCIAL CREDIT AS PERCENTAGE OF GDP



Source: J.P. Morgan; data as of 30 November 2015.

EXHIBIT 6B: EMERGING MARKET BROAD PRIVATE NON-FINANCIAL CREDIT AND NOMINAL GDP GROWTH



Source: J.P. Morgan; data as of 30 November 2015.

This differentiated inflationary environment is reflected in a wide dispersion of monetary policy cycles among emerging markets—a dispersion that should provide scope for relative value opportunities across interest rate curves (**Exhibit 5B**, previous page). Countries such as Russia, India and China have wider scope to ease policy further and may prove attractive markets in which to take overweight or long duration positions. Conversely, central banks in Colombia and South Africa, where inflation is pushing beyond the set target band, may need to tighten monetary policy to manage inflation expectations. In these markets, taking underweight or short exposures may make sense.

PRIVATE AND PUBLIC SECTOR LEVERAGE IS MANAGEABLE

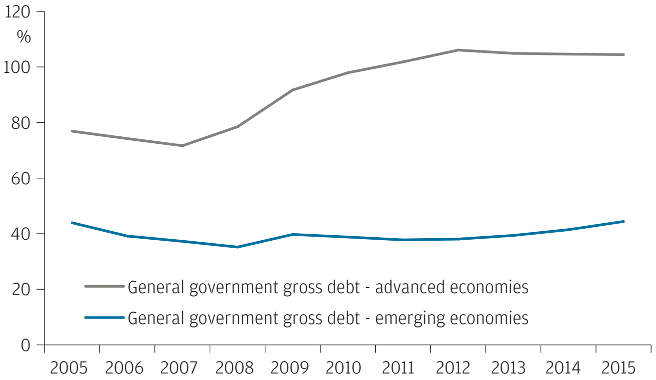
One potential structural headwind relates to the build-up of private sector domestic debt in emerging markets since the global financial crisis of 2008. At a time when developed markets have been deleveraging, emerging markets—particularly China—have been using the low rate environment globally as an opportunity to re-leverage (**Exhibit 6A**). While the rate of credit growth has been slowing over the last number of years (**Exhibit 6B**), it remains higher than nominal GDP growth. Therefore, even though financial conditions have tightened, meaningful deleveraging has yet to occur.

Much of the credit build-up has taken the form of local currency domestic bank loans to corporates. Inevitably, this will create challenges for banks in emerging markets as lending conditions tighten, non-performing loans accumulate and funding becomes more difficult to obtain. Accordingly, we maintain a generally defensive view of emerging market financials and are cognisant of the overall risks to growth over the coming year.

However, other segments of emerging market credit look more sanguine. While we have seen an increase in general government debt since 2008, it remains relatively low in absolute terms at 44% of GDP—well below sovereign debt levels in developed markets (**Exhibit 7A**, next page). Furthermore, of the total general government debt in emerging markets, just 7% is denominated in hard currency, equivalent to the lows of 2008. This all means limited sovereign refinancing risk in the face of weak emerging market currencies.

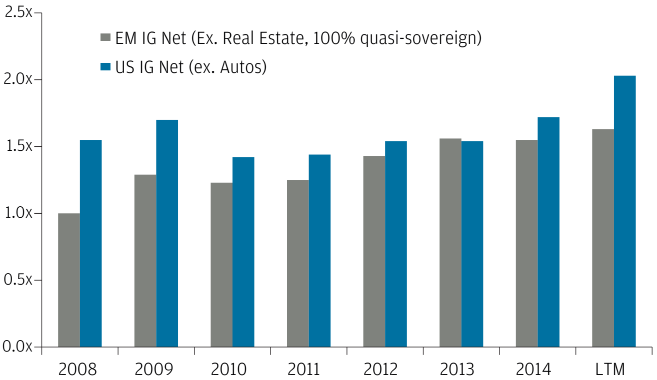
General government debt and investment grade corporate leverage remains below that of developed markets

EXHIBIT 7A: EMERGING MARKET AND DEVELOPED MARKET GOVERNMENT DEBT



Source: International Monetary Fund, J.P. Morgan Asset Management; data as of 31 October 2015.

EXHIBIT 7B: EMERGING MARKET IG AND U.S. IG NET LEVERAGE



Source: J.P. Morgan; Bloomberg; Capital IQ; data as of 30 November 2015.

Corporate net leverage metrics also look relatively more favourable in emerging markets vs. the US. Presently, EM IG net leverage stands at 1.6x with US IG net leverage at 2.0x (**Exhibit 7B**). With refinancing needs expected to be contained in the coming year, forecasts for emerging market defaults predict only a modest increase to 3.5% in 2016, largely focused on Brazilian and other commodity issuers.

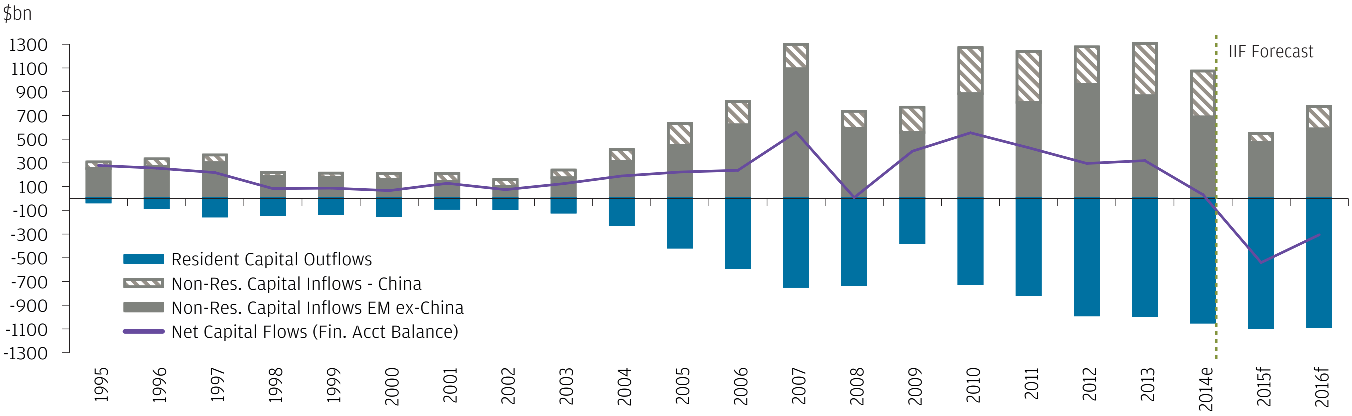
CAPITAL ACCOUNT VULNERABILITIES MAY COME UNDER SCRUTINY AS U.S. RATES INCREASE

In December 2015 the US Federal Reserve (the Fed) finally embarked on the long-anticipated start to its policy normalisation process. Anticipation of tighter financial conditions in emerging markets had led to significant capital outflows, with net emerging market capital flows for 2015 expected to be negative for the first time since 1998. Unlike the "sudden stop" of 2008-09, we believe current outflows represent structural trends. While we expect a small recovery, capital flows are likely to remain a headwind in 2016, with bank lending and foreign direct investment areas to monitor (**Exhibit 8**).

The good news is that much of the 2015 outflows came ahead of the Fed's rate rise. With the normalisation process now underway, a large part of the adjustment should be behind us, and pressures should ease. Another positive to note is that the projected trajectory of Fed policy normalisation is flat and gradual. While that may augur further volatility, ultimately we expect it will lead to an economic and market environment that is supportive of emerging markets.

Net capital flows into emerging markets are forecast to turn negative for 2015

EXHIBIT 8: CAPITAL FLOWS TO EMERGING MARKETS, ANNUAL DATA



Source: Institute of International Finance; data as of 31 October 2015. Resident capital outflows exclude reserves.

When looking for emerging market alpha opportunities, effective country differentiation is vital

EXHIBIT 9: EMERGING MARKET COUNTRIES CATEGORISED BY KEY ECONOMIC DRIVERS

	1. FX	2. Current account + Trade balance	3. Private deleveraging	4. Refinancing risks/ Fiscal	5. Capital outflows
Done or Well-understood	CEE Russia Mexico India	India	Hungary	Russia	
Adjustment well-underway	Brazil Turkey	Indonesia			Russia
Adjustment starting/ Ongoing	Malaysia Colombia Indonesia	Brazil South Africa Turkey	Russia	Venezuela	China (?)
Vulnerable	China Taiwan Korea Thailand Singapore Chile	Colombia Peru	China Korea Thailand Malaysia Turkey Brazil South Africa	Ukraine Argentina Turkey Chile	Turkey South Africa Chile Colombia

Source: J.P. Morgan Asset Management. As of 31 December 2015.

WE EXPECT THE COMING QUARTER TO BE MORE ALPHA THAN BETA DRIVEN

The past couple of years have seen a substantial repricing of emerging markets, with considerable value created. In our view, the market is becoming driven more by idiosyncratic alpha than broad market beta, with differentiation increasingly important. The key question therefore becomes where to find alpha. The grid in **Exhibit 9** lays out five critical variables to take into account when addressing this question—FX adjustment; current account and trade balance; private deleveraging; refinancing risks/fiscal; and capital outflows—and gives our assessment of how selected economies are managing them.

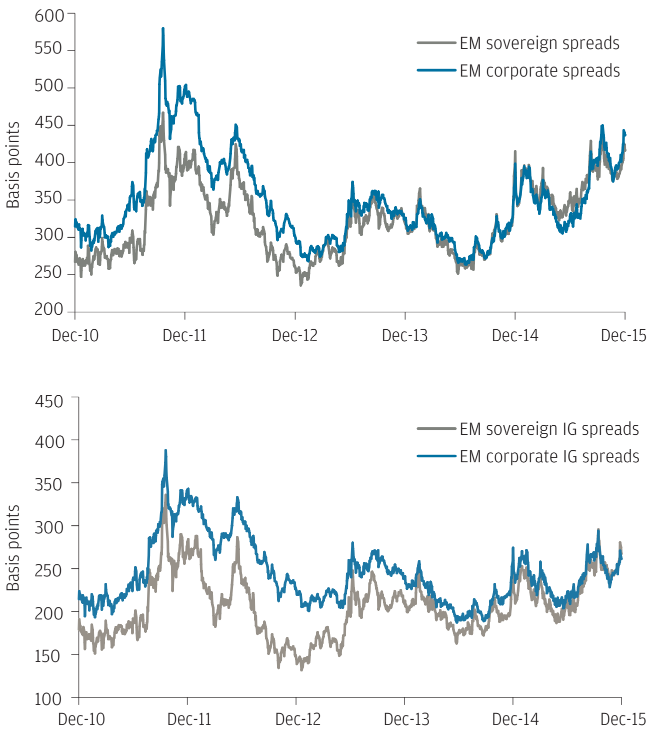
For example, with respect to FX adjustment, we prefer those countries where currency risks are well understood or where currencies have already repriced considerably, such as Russia, Mexico and India. Conversely many Asian economies, where currencies have yet to meaningfully adjust—and China in particular—are vulnerable and may provide opportunities to generate alpha from the short side. From a refinancing risks and fiscal standpoint, Russia serves as a positive example. The Russian government has made clear its commitment to good fiscal management and has executed a policy of sacrificing growth and populist measures for the sake of fiscal prudency. On the debt servicing side, refinancing risks are limited, owing to low levels of external debt—under 13% of GDP—with a manageable repayment schedule. In comparison, countries such as Ukraine, Argentina and Turkey are more vulnerable to refinancing and fiscal risks and will require a more cautious approach.

Timing exposure to the turnaround stories will also be critical, with Brazil a key country to watch. Brazil has already experienced important currency and current account improvement, accumulating a trade surplus of nearly USD 20 billion in 2015 compared with a deficit of USD 4 billion in 2014. However, Brazilian assets must cope with political uncertainty, a lack of clarity on the capacity to implement reforms, and a still-sizable USD private sector debt burden. With progress in currency and trade well underway and valuations attractive, any resolution in the political situation and forward movement on private deleveraging could spark a reversal in sentiment towards Brazil in 2016.

As 2016 evolves, segments of emerging market credit, both corporate and sovereign, may see increased levels of stress and this will require a selective approach to investing. Particularly at risk are those aforementioned financials issuers linked to the private sector debt build up (notably Asian, Turkish and Brazilian names), higher-cost and inefficient commodity producers and those issuers with weak balance sheets.

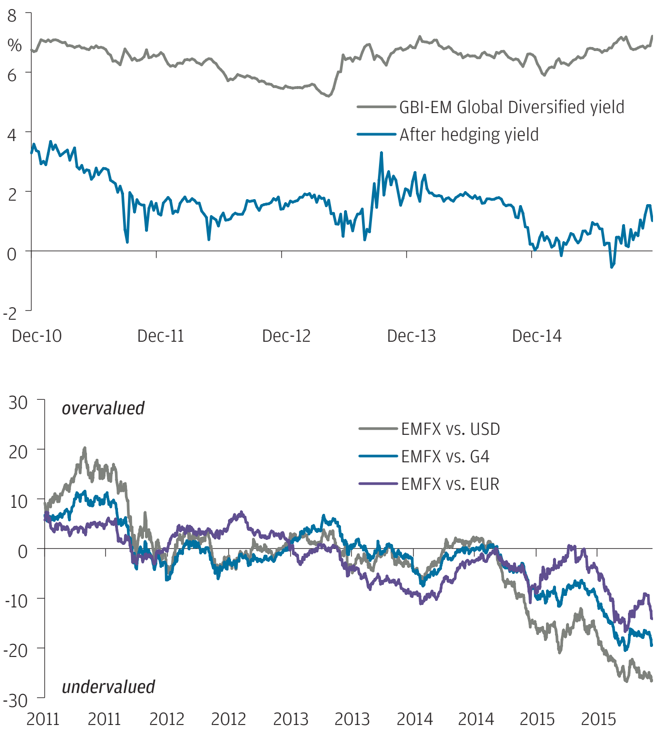
Value has returned to the emerging market debt asset class

EXHIBIT 10A: EMERGING MARKET SOVEREIGN AND CORPORATE SPREADS



Source: J.P. Morgan Asset Management; data as of 31 December 2015.

EXHIBIT 10B: LOCAL CURRENCY EMERGING MARKET DEBT YIELDS AND CURRENCY VALUATIONS



Source: J.P. Morgan Asset Management; data as of 31 December 2015.

VALUATIONS ARE INCREASINGLY ATTRACTIVE

The adjustments that emerging markets have made since the taper tantrum in 2013 are reflected in valuations. Across sovereign and corporate spreads, local currency bond yields, and currencies, they have improved markedly, leading to more attractive entry points. Sovereign and corporate spreads rose above 400 basis points in 2015, a level last seen during the European sovereign debt crisis in 2011 (**Exhibit 10A**).

Local currency markets, where the bulk of the realignment has occurred since 2013, are pricing in yield levels close to five-year highs, with significant adjustments to currency valuations (**Exhibit 10B**). Clearly the improved valuation environment presents considerable opportunity. However, entry timing depends also on fundamental and technical considerations, which are the two pillars—alongside valuations—that we use to analyse opportunities in our investment process.

While emerging market currencies have depreciated considerably, we still think that fundamental catalysts are lacking for a meaningful turnaround, with the outlook for commodities and global growth challenging as trade volumes fall. Compounding the challenges, the US economy is showing evidence of meaningful growth momentum as the Fed commences policy normalisation. This makes for a favourable environment for US dollar outperformance. In these circumstances, emerging market US dollar credit remains our preferred investment destination (**Exhibit 11**, next page).

Within US dollar credit, we prefer emerging market sovereign debt over emerging market corporate debt, owing to the former's comparatively stronger fundamental and liquidity profile. That said, supply-side technicals for both emerging market sovereign and corporate debt look promising in 2016, counterbalancing positive technicals against expected weak investor demand. Emerging market sovereigns are expected to require USD -4.6 billion of net financing, while emerging market corporate net financing, expected to be USD 35 billion for the year, would be the lowest since the onset of the global financial crisis.[1]

For corporate debt, local currency rates and FX, we prefer to take a relative value approach. While we believe conditions are conducive for duration, the backdrop for FX is predominantly unfavourable—hence our preference to choose

[1] Source: Emerging Markets Outlook and Strategy, J.P. Morgan, December 1 2015.

rates selectively, hedging FX exposure where we believe it makes sense. While emerging market corporate valuations look cheap on an absolute basis, they are expensive vs. US equivalents. Value is concentrated in the high yield segment of the market, in single-B rated names in particular.

Overall this is an investment environment where performance will be derived from idiosyncratic alpha rather than broad-based market beta. We will look for opportunities to rotate from countries where the adjustment process is advanced and well priced toward countries starting—or in the middle of—the adjustment cycle. We will remain cautious about countries where the adjustment process has not started and vulnerabilities remain high.

A developed market-led recovery remains our base-case scenario

EXHIBIT 11: OUR EMERGING MARKET DEBT ROADMAP, FIRST QUARTER 2016

Scenario	Contraction scenario	Base case scenario (DM-led recovery; EM below trend)	Expansion scenario	Investment themes and strategy
Probability	25%	**65%**	10%	Monitor cyclical stabilisation
Growth	EM growth alpha narrowing	**EM growth alpha flat**	EM growth alpha widening	
Inflation	Disinflation	**Differentiated, selective base effects**	Inflation expectations increasing	Downside risks from structural challenges : (Fed and rates, Commodities, Credit deleveraging)
Financial conditions	Capital outflows accelerate, deleveraging	**Moderately tighter Fed & lending conditions, capital flows**	Faster Fed normalisation cycle	
Monetary environment	Diverging, some constrained	**Differentiated policy cycle, limited room to ease**	Tighter across EM universe	Alpha market: Relative value trades, winners and turnaround stories
Rates/FX	Bear flattening/USD bullish	**Differentiated, bias to long duration, FX still USD positive but more relative values**	Selective EM FX support, bear steepening	
Market & positioning	Risk off EM FX weaker/CNY devaluation Credit spreads widening Liquidity gap	**From Beta to Alpha** **Barbell trades: solid Balance sheet and turnaround stories (across sovereign and corporate)** **Add to local on a RV basis**	Short duration Cyclical corporates and selective EM FX	**Strategy**: favour sovereign spread, corporate credit barbell, selective local rates duration, EM FX relative value trades

Source: J.P. Morgan Asset Management. Views are as of December 2015.

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