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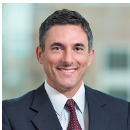
Emerging Markets Debt: Springtime in January?

INSIGHTS

With the inflation and geopolitical fogs around the world dissipating, and a monetary policy pivot potentially in the cards, 2023 is shaping up to be a promising year for emerging markets debt.



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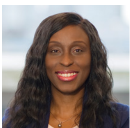

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After a dismal couple of years from an investment return perspective, 2023 is shaping up to be a promising year for emerging markets (EM) debt. As of early December 2022, EM local and sovereign debt indexes had lost a fifth of their value since peaking in December 2020 and September 2021, respectively.[1] EM corporate bonds had lost 31% from the peak in June 2021.[2] As the COVID-19 pandemic receded and the world progressively reopened, the monetary and fiscal accommodation used to cope with its effects morphed into a global inflationary spike. Russia's invasion of Ukraine in February 2022 and the sanctions that followed added fuel to the inflationary fire. Global central banks responded aggressively but late as they sought to grasp the economic whirlwinds around them.

As we look to 2023, the world appears to have started to make more sense, especially from the perspective of global central banks. Inflation has finally started reacting to the monetary tightening implemented since the first quarter of 2022, global economic activity has cooled, the war in Ukraine appears to be contained, and China appears to be revisiting its COVID policy. In a nutshell, a monetary policy pivot looks increasingly likely. Macroeconomic policy accommodation may still be some ways away, but major central banks have started to talk about slowing down the pace of interest rate increases, while EM central banks have largely completed their task. The financial markets have also started anticipating—correctly, in our view—the end of the tightening cycle. Based on the work of our sovereign debt team, we expect the next surprise for central banks to be a significantly sharper fall in inflation during the second half of 2023 than is currently expected—and accommodative policy will likely follow.

A Year of Two Halves

2023 is setting up to be a year of two halves. Over the coming six months the global economy will likely continue to decelerate as the momentum of past monetary policy decisions weighs relentlessly on activity. This should provide a strong tailwind for global interest rates, including those of EM countries. Softer global growth and firming expectations for an end of the monetary tightening cycle will also limit the upside of the U.S. dollar. As a result, the first half of 2023 should prove particularly favorable for EM local debt investments, though less so for credit strategies subject to the effects of the global slowdown. Headwinds to credit from a higher cost of funding due to past and ongoing interest rate hikes are likely to result in some increase in defaults. However, a closer look at the EM maturity profile gives us confidence that it should be manageable for the EM market as a whole, with select local markets providing an alternative source of financing to the U.S. dollar market.

1. Source: J.P. Morgan. EM local debt index: J.P. Morgan GBI-EMGD; EM sovereign debt index: J.P. Morgan EMBIGD.
2. Source: J.P. Morgan CEMBI Index.

We also expect the economic deceleration around the world to be uneven. China's economy is expected to accelerate on the back of its reopening, for instance, while developed market economies are expected to slow down. Global tourism should continue to accelerate while global trade softens further. Global investment should remain relatively buoyant compared to prior business cycles as the world eagerly develops alternative energy sources and re-arms itself to face ongoing geopolitical disturbances. Commodity prices are therefore expected to remain well-supported. Trade-dependent countries may take longer to rebound, while tourist destinations may avoid a recession. And while interest rates are likely to fall across the world, the speed of the decline is unlikely to be uniform.

In the second half of 2023, we expect global economic activity to begin bottoming as much lower inflation readings take central banks and market participants by surprise. Quantitative tightening, as we have said before, has been little studied and is even less understood. Its effects should result in a sharp fall in inflation toward the end of 2023, which is likely to once again force the hands of central banks, this time toward accommodation. An economic rebound in 2024 is likely to follow, suggesting mid-2023 may be the optimal investment entry point in select EM sovereign and corporate credits.

Sovereign Debt: Recovery Ahead

While the inflation and geopolitical fogs around the world appear to be dissipating, providing greater visibility for 2023, many countries still have work to do to adjust to the energy price shock of 2022, aspects of which are likely to remain permanent. This involves maintaining tight monetary policies, tightening fiscal policies, allowing more exchange rate flexibility, and reducing reliance on market financing given the higher costs of debt. On the positive side, we are confident that most EM sovereigns have the social resilience and policy frameworks to deliver the necessary policy adjustments and put their fiscal and external balances on sustainable footings.

In hardest-hit **Eastern Europe**, we believe investment grade sovereigns, including Croatia, Hungary, Poland, and Romania, are well underway in terms of adjusting to the energy and food price shocks—helped along the way by the EU Cohesion and Recovery funds. BB-rated sovereigns are also responding well to the price and growth shocks, with countries like Macedonia and Serbia securing new International Monetary Fund (IMF) programs. The **ex-Commonwealth of Independent State** countries of Armenia, Azerbaijan, Georgia, and Uzbekistan have benefitted from the Russia-Ukraine war, receiving both human and financial capital fleeing the conflict zone. In **Latin America**, Brazil and Mexico have maintained strong fiscal policies since the initial COVID shock of 2020. As a result, their balance of payments are sustainable, and reliance on foreign savings minimal. In **Central America**, Costa Rica and Dominican Republic pursued remarkably strong fiscal policies in 2022 and have benefitted from their links to the U.S. economy via trade, remittances and tourism. **Asia's** energy importers, including India, Indonesia, the Philippines and Thailand have been hit hard, but virtually all of them remain solid investment grade credits with capacity to adjust further and maintain well-deserved access to both local and global financial markets. Additionally, these countries now face upside amid China's re-opening, including from China's residents traveling abroad.

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When it comes to the weaker, single-B EM sovereigns, many are facing challenges, and exposure to these countries requires a deep understanding of their institutions, social resilience and policy frameworks—and a conviction that they will not only cope with price and growth shocks, but also improve over time. To be sure, several EMs are in debt distress or currently restructuring debt—among them Ethiopia, El Salvador, Ghana, Lebanon, Pakistan, Sri Lanka, Ukraine and Zambia. However, it would be a mistake to allow these countries to paint a misleading picture of all EM sovereigns, as they constitute only a marginal portion of the EM sovereign universe, with a current market cap of 2.8%.[3]

Corporates: A Strong Starting Point

Within the EM corporate space, corporate balance sheets have remained resilient despite the cost inflation pressures that followed the pandemic and Russian invasion of Ukraine. While high inflation will likely create further cost pressures into 2023—leading to some weakness in profit margins and a slight deterioration in leverage metrics—most companies are coming from a strong starting point. In particular, revenue and EBITDA are back to pre-pandemic levels for many issuers, and leverage levels remain in reasonable territory, around 1.8x for high yield companies and 1.0x for investment grade issuers.[4] EM corporates also benefit from having been active in managing maturity needs over the last two to three years while interest rates were low, with gross supply of more than US$500 billion in 2020 and 2021.[5] As a result, EM corporates' maturity walls appear to be fairly manageable in the near term, and many corporates have solid interest coverage metrics and good liquidity.

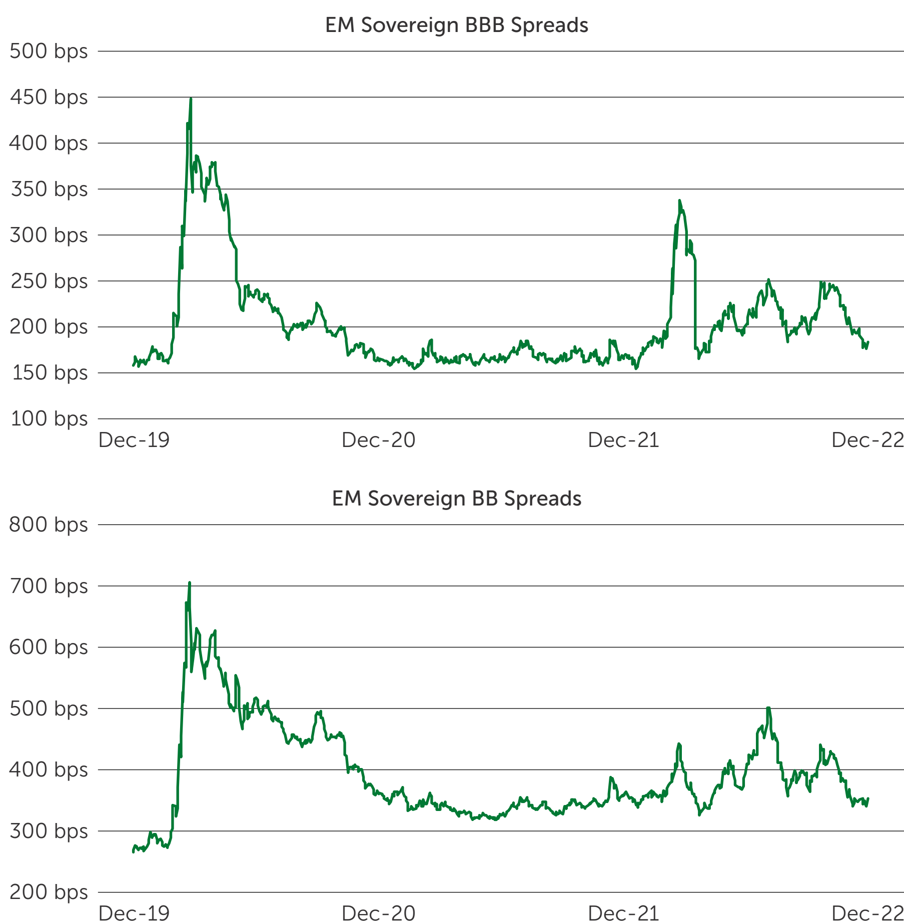
In this environment, we remain focused on navigating near-term volatility and identifying attractive entry levels until the market starts to recover and differentiate between credits. Within investment grade corporates, long duration BBBs look particularly attractive, especially those from Latin America, Asia ex-China, and Gulf Cooperation Council countries. A number of corporates from these countries are commodity-producers, and continue to benefit from the supply disruption—especially the low-cost producers in Mexico, Brazil and Chile. In the high yield segment, we see value in BBs in Latin America as well as India, which is becoming an EM standout.

3. Source: Bloomberg and J.P. Morgan EMBIGD. As of November 30, 2022.
4. Source: J.P. Morgan. As of September 30, 2022.
5. Source: Bloomberg and J.P. Morgan EMBIGD. As of December 2, 2022.

2022 Drawdowns Due Mostly to U.S. Treasury Moves

Top-down return statistics demonstrate the significant extent to which the U.S. Treasury selloff drove EM performance in 2022. The EM Sovereign index had returned -17% year-to-date, with the 10-year U.S. Treasury yield jumping 200 basis points (bps) during the same period.[6] Considering that the index has a 7-year duration, the U.S. Treasury move produced a -14% index return. In other words, over 80% of the 2022 drawdown was due to the move in U.S. Treasuries. Year-to-date changes in spreads by rating category confirm this finding, with investment grade through BB countries remaining relatively flat through the end of 2022.[7] The "excess" loss above and beyond the U.S. Treasury move has concentrated in distressed debt cases, now classified as C-category.

Figure 1: Sovereign BBB and BB Spreads are ~20 bps Off of Mid-year Lows



Source: J.P. Morgan EMBIGD. As of December 6, 2022.

6. Source: Bloomberg and J.P. Morgan EMBIGD. As of December 2, 2022.
7. Source: Bloomberg and J.P. Morgan EMBIGD. As of December 2, 2022.

Similarly, in the corporate index, year-to-date returns were -12.73%, with a U.S. Treasury return of-7.49%.[8] Based on the index duration of 4.3 years, 59% of the 2022 drawdown is attributable to the U.S. Treasury move. Despite what will likely be a bumpy road ahead in 2023, we think the potential for attractive returns over the next 12-24 months—as has been the case historically following a peak selloff in markets—makes a compelling case for EM debt **(Figure 2)**.

Figure 2: Historical 12-month Forward Returns Following Max Drawdown (EM Corporate Debt)

Period	Max Drawdown	Months to Recovery	12-month Total Return from Max Drawdown
COVID Pandemic (February 2020–October 2020)	-17.0%	9	+27.1%
Commodity Crisis (June 2015–March 2016)	-6.8%	10	+19.7%
European Sovereign Debt Crisis (May 2011–March 2012)	-13.8%	11	+22.7%

Source: J.P. Morgan CEMBI Index.

Key Takeaway

There are certainly risks to our baseline scenario, but for the most part to the upside. The tightening cycle of global financial conditions has been one of the largest and most synchronized in recent history. The destruction of financial wealth that followed with double-digit negative returns across most financial assets, including cash, could result in a faster economic deceleration, a stronger tailwind for global interest rates, and a weaker U.S. dollar. Should geopolitical events prove us wrong, economic activity is likely to suffer further, making interest rates even more attractive and accelerating the timing of global monetary policy accommodation. An unexpected positive surprise on the geopolitical front (Russia/China), while not our base case scenario currently, would rapidly reduce the risk premia and make the case for EM debt even more attractive.

Downside risks are undoubtedly present, but the pronounced outflows that the EM asset class has suffered in the past year paint a relatively positive picture from the technical side as well. The asset class has seen significant outflows across the board, while those investors who have remained are likely familiar with the risks at this point. This suggests that unless something even more dramatic than the events of the past three years were to happen in 2023, we are unlikely to see material outflows going forward—and, by extension any less negative development will likely be perceived as positive.

8. Source: J.P. Morgan CEMBI. As of December 5, 2022.

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