EMERGING MARKETS DEBT

HIGHLIGHTS

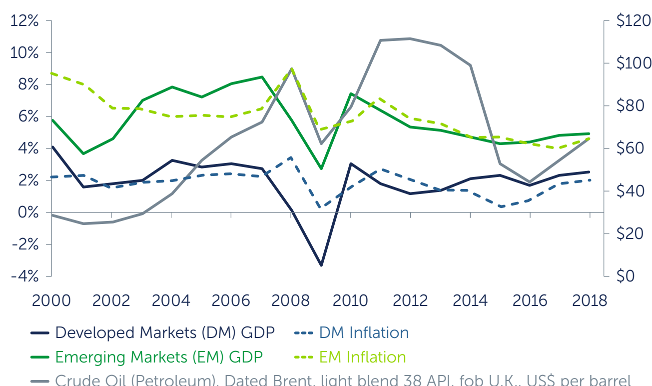
The second quarter of 2018 proved to be unpredictable, as a number of strong wind shears turned tailwinds into headwinds for emerging market (EM) debt assets. All three indexes fell, with EM local debt returning -10%, EM sovereigns losing -3.25% and EM corporates falling -1.6%. Although the U.S. Congress passed its tax cut overhaul in late 2017, generating expectations of further growth and fiscal stimulus in the U.S., the U.S. dollar fell during the first quarter, only to sharply reverse course during the second quarter, leading to the worst quarter for EM currencies since 2015 (-8.3%)[1]. The combination of a more assertive U.S. Federal Reserve, President Trump's trade protectionism policies aimed at foes and allies alike, and the announcement of a terminal date for the European Central Bank (ECB)'s quantitative easing program all put downward pressure on EM assets.

Contrary to expectations for synchronized global growth, called by the International Monetary Fund earlier in the year, the Eurozone saw an unexpectedly rapid slowdown, while the U.S. economy accelerated. The widening growth gap between the U.S. and Europe led to wider interest rate differentials and resulted in a weaker euro, which also added to the downward pressure on EM currencies. Despite higher energy prices, weaker currencies and moderate economic growth, EM inflation remains at 17-year lows. While the full effect of recent market volatility has not yet been reflected in current inflation figures, the low starting point for inflation provides a strong backdrop for EM local rates to potentially continue to come down in select countries over the next 12 to 18 months.[2]

Higher U.S. interest rates affected EM countries with large current account deficits and weak credit ratings, as well as those most in need of foreign financing, such as Argentina, Ecuador, Turkey and South Africa. Argentina and Turkey were among the worst performers for the quarter, with bonds and currencies down -34% and -22%, respectively, while EM currencies as a whole fell -8.3%. Spreads widened by 60 and 66 basis points in EM corporates and sovereigns, respectively, led by Argentina, Ecuador and Turkey[1].

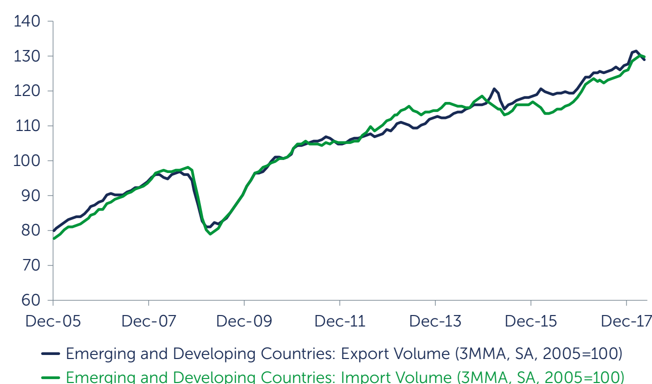
EM corporate earnings have continued to be largely positive, while sovereign and corporate default rates remain below historical averages. While higher U.S. interest rates may prove challenging for some sovereigns and corporates, stronger developed market growth overall should provide for a mostly favorable backdrop for EMs going forward, in our view. The key risks over the remaining two quarters of the year lie in what policies are actually implemented from the U.S. trade protectionist agenda and their potential effect on global trade. Commodity prices have been supportive of stronger EM currencies; however, should China experiences a material slowdown in demand/growth, this would likely put pressure on commodity-producing countries and companies.

EM GDP Growth and Inflation Have Followed a Similar Pattern as Their DM Counterparts Since 2000



SOURCES: International Monetary Fund; World Economic Outlook Database. As of April 2018.

Global Trade Volumes Continue to Grow



SOURCE: Haver Analytics. As of April 2018.

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1. Source: J.P. Morgan. As of June 30, 2018.
2. Source: J.P. Morgan. As of December 31, 2017.

EMERGING MARKETS DEBT, CONTINUED

OUTLOOK

- Global growth remains healthy overall. We expect global GDP growth to remain high by historical standards in 2018, with EM continuing to lead the way.
- Balance of payments and current accounts across EM countries are generally sound. Many EM economies have seen substantial adjustments to their external accounts.
- Company fundamentals continue to improve on the back of healthy economic growth and higher commodity prices, while corporate leverage is expected to decline. These positive trends have translated into historically low default rates; however, some corporates appear vulnerable, meaning we may see a slight increase in defaults over the next 12 to 18 months due to higher funding costs.
- Global trade volumes have continued to grow, a trend that could be at risk given aggressive U.S. implementation of trade protectionist policies.
- As we saw in the second quarter, EM country and credit selection will remain crucial through the remainder of 2018 due to a heavy election calendar, geopolitical risks, and limited spread differentiation between higher- and lower-quality credits.
- We continue to take a constructive view of EM debt as a whole and expect particularly healthy returns from EM local debt due to moderate growth, contained inflationary pressures and continued fiscal/external adjustments across many countries. With sovereign hard currency spreads having widened materially this year, we see select opportunities where we believe spreads continue to overcompensate for defaults, mostly in investment-grade countries and select issuers within vulnerable countries.

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Head of Emerging Markets Debt

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**As of June 30, 2018*