Looking to buy on dips

Emerging market debt strategy

Q3 2017

IN BRIEF

- Resilient fundamentals, milder reflation and lack of imminent external risks continue to support emerging market (EM) debt.
- Strong first-half gross domestic product (GDP) readings in China provide an additional cushion for the government to achieve its 6.5% growth target, leaving more room to focus on long-term stabilisation policies.
- Metals and oil are likely to continue to undergo a volatile period in the short term, but supply-demand dynamics will keep prices range-bound with downside risks in the longer term.
- Sovereign and corporate credit valuations are looking less enticing than previously and we therefore focus on carry as the main driver of returns. Local Rates and EM FX still offer good value even after the recent rally.
- EM countries and companies have become more resilient to external and internal shocks and we therefore see market dips and corrections as potential opportunities to buy.

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GOLDILOCKS SCENARIO PRICED-IN

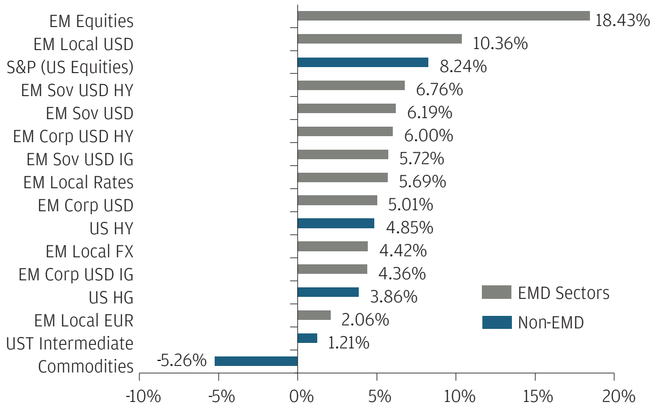
EM assets have had a strong start to the year (**Exhibit 1**, next page). The year started on a positive note as EM investors turned gradually more sanguine about the resilience of EM economies and the fading of global risks. In November 2016, investors were spooked by the newly elected US president Donald Trump and his protectionist rhetoric that was targeted towards Mexico, China and other "cheap exporters". Large infrastructure spending promises together with expected tax cuts paved the way for what we called the "new reflation era" in our Q1 2017 Emerging Market Debt Strategy report.

After an extended "race to the bottom" period, expectations of global reflation were generally a welcome change that fuelled growth forecasts and pushed asset prices to new highs across most asset classes. Recent data prints from developed and emerging markets, however, have painted a slightly different picture. Global reflation, if it happens at all, is going to be mild and gradual. This is by no means a negative development for emerging markets—mild reflation in developed markets implies slowly rising yields that carry little risk of causing a shock to countries that are dependant on external financing.

J.P.Morgan
Asset Management

Mild reflation, fading external risk and positive technicals have driven year-to-date EM performance

EXHIBIT 1: PERFORMANCE SUMMARY YEAR TO 30 JUNE 2017

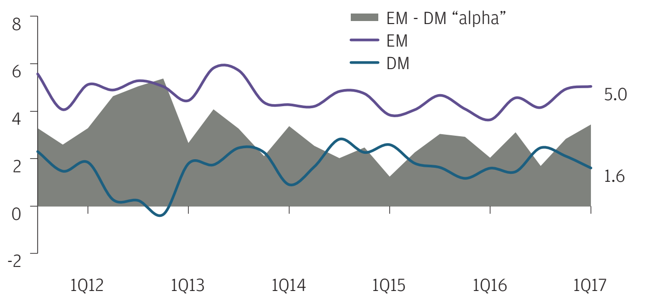


Source: J.P. Morgan Asset Management Bloomberg; data as of 30 June 2017. Indices do not include fees or operating expenses and are not available for actual investment. Past performance is not an indication of future performance. EM = Emerging market; IG = Investment grade; HY = High Yield; UST = US Treasury, EM Hard Currency Sovereign- JP Morgan EMBI Global Diversified, EM Local- JP Morgan GBI EM Global Diversified, FX = Foreign exchange, US High Yield- JP Morgan Domestic High Yield, US HG- JP Morgan JULIR ex-EM. Commodities- Bloomberg Commodities Total Return, EM Equities- MSCI EM.

EM data has been strong, with growth topping expectations in the first half of the year (see **Exhibit 2**). However, we expect EM growth to moderate and the EM-DM growth alpha to soften to about 2.5%-3%, a level that is marginally higher than what we have seen in the last several years. A subdued global reflation environment should also continue to support the risk-on sentiment in emerging markets.

We expect EM growth to moderate and the EM-DM growth alpha to soften

EXHIBIT 2: EM-DM GROWTH ALPHA VS. EM AND DM REAL GDP GROWTH



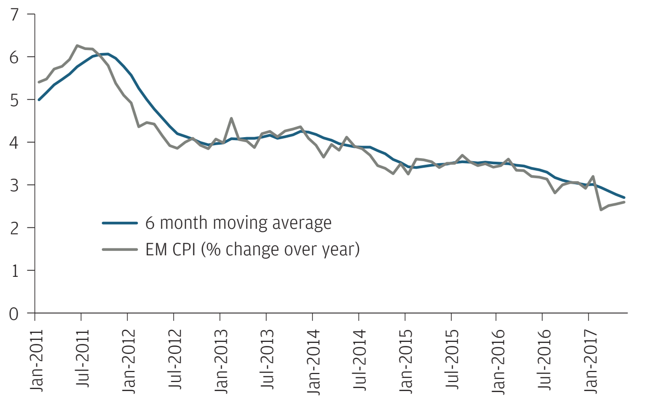
Source: J.P. Morgan Asset Management; data from Jul 2011 to Jun 2017.

EM INFLATION TRENDING LOWER

Most EM regions have seen inflation trending lower since 2016 (see **Exhibit 3**). As we expect crude oil prices to remain subdued in the medium term, and taken together with an expected slowdown in China and mild global reflationary pressures, this leads us to expect the disinflationary environment in emerging markets to continue in the coming months.

"We expect a disinflationary environment in EM in the coming months"

EXHIBIT 3: EM CONSUMER PRICE INDEX (% CHANGE YEAR ON YEAR)

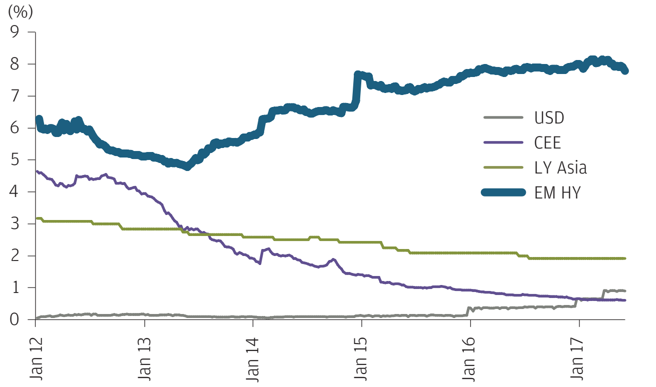


Source: J.P. Morgan Asset Management, Bloomberg; data from Jan 2011 to May 2017.

Such a backdrop should create a favourable environment for EM central banks to maintain or ease monetary conditions–this is likely to be particularly pronounced for EM high yielding countries, such as Russia, Colombia or Brazil, which have tightened monetary policy (see **Exhibit 4**), but have seen inflation falling despite stronger DM inflationary pressures and a rebound in commodities.

EM central banks have room to ease policy as inflation falls

EXHIBIT 4: AGGREGATED CENTRAL BANK POLICY RATES



Source: J.P. Morgan Asset Management; data from Jan 2012 to Jul 2017. USD: US Fed Funds Target Rate. CEE: Central-Eastern Europe (Hungary, Poland, Czech Republic, Romania). HY: High-Yielding emerging markets (Brazil, Colombia, Turkey, Russia, South Africa). LY: Low-Yielding Asian emerging markets (Malaysia, Philippines, Thailand). Forecasts, projections and other forward looking statements are based upon current beliefs and expectations. They are for illustrative purposes only and serve as an indication of what may occur. Given the inherent uncertainties and risks associated with forecasts, projections and other forward statements, actual events, results or performance may differ materially from those reflected or contemplated.

MANUFACTURERS VS. COMMODITY EXPORTERS

One of the growing themes over the past quarter was the weakness of oil despite attempts by the Organization of the Petroleum Exporting Countries (Opec) to put a floor on the price range. The second quarter started with relatively positive sentiment in the oil market—crude oil prices traded in the low USD 50s per barrel, inventory levels appeared to be peaking, and Opec was determined to extend cuts and continue with relatively high compliance. Nonetheless, oil went through a bumpy ride in the quarter, eventually reaching lower price levels of around USD 45 per barrel.

While the demand side for oil looks to have been, if anything, supportive, the key change in the market looks to have been the surprise on the supply side—namely the improved efficiencies of shale producers and their ability to raise cheap finance to quickly ramp up production. Given the current environment, we do not expect oil prices to escape the USD 45-55 range in the near-term as Opec can deepen and widen the cuts or involve additional countries.

The upside is, however, limited by shale producers, as they can relatively swiftly increase production. In the medium and long term, we hold a less constructive view, as latent supply pressures appear to be building up with not only shale, but also deep-water oil drilling coming back to the market.

Similarly, metal prices have seen large swings over the quarter, especially as commodities, such as iron ore, copper and aluminium, are closely tied to China, where a clear shift of policy from a pro-growth agenda to deleveraging and reduction of overcapacity has been seen.

CHINA: A MANAGED SLOWDOWN

The Chinese economy, as in the previous quarters, remained one of the core factors in our overall macro outlook (**Exhibit 5**). The continued efforts from the Chinese government to gradually steer the economy to a more stable long-term growth path have so far been successful.

Efforts from the Chinese government to gradually steer the economy to a more stable long-term growth path have so far been successful

EXHIBIT 5: CHINESE ECONOMIC SCENARIO ANALYSIS

12-MONTH SCENARIO	PROBABILITY UNCHANGED VS LAST QUARTER	CHINA GROWTH
Rapid deterioration	20%	3-4%
Soft landing	10%	4-5%
Stabilisation	70%	~6-7%
Acceleration	0%	>7%

Source: J.P. Morgan Asset Management, Bloomberg; data as of Jun 2017.

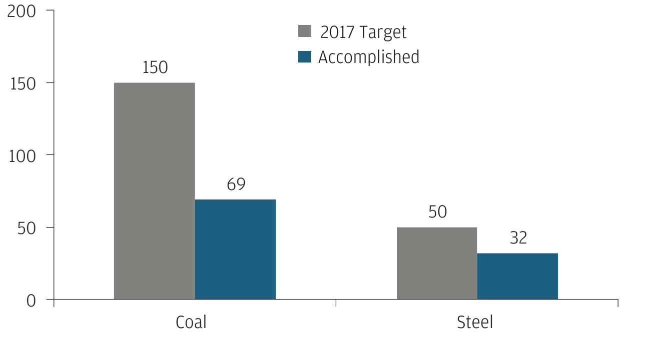
The GDP readings in China are healthy. First-quarter GDP came in at 6.9% year on year, while the second-quarter purchasing managers' index and other indicators showed strength, leaving the country comfortably on the path towards achieving 6.5% growth for the full year. This allows the government to tackle the excess capacity in such industries as coal and steel (see **Exhibit 6A**), intensify the shadow banking crackdowns and target economic stability. We do, however, estimate that this will also lead to a slowdown of China's growth towards 6.3%-6.4% in the second half of this year.

Financial leverage has been picking up considerably in recent years in line with non-financial debt, drawing attention from both investors and policymakers. At the same time, real estate prices have been ballooning, especially in tier 1 cities, and shadow banking activity appears elevated as restrictions on financing push borrowers to alternative financing sources as evidenced by the growth of interbank lending and off balance sheet wealth management products.

Reflecting these concerns, policymakers look more than ever willing to tackle these difficulties. Money supply growth, for example, has been tightened and this has resulted in the slower growth of so-called free liquidity, which is the difference between money aggregate (M1) growth deflated by the consumer price index (CPI) and GDP growth. This has already fed into real estate prices, which appear to have peaked in late 2016 and are likely to come under further pressure in the future (see **Exhibit 6B**).

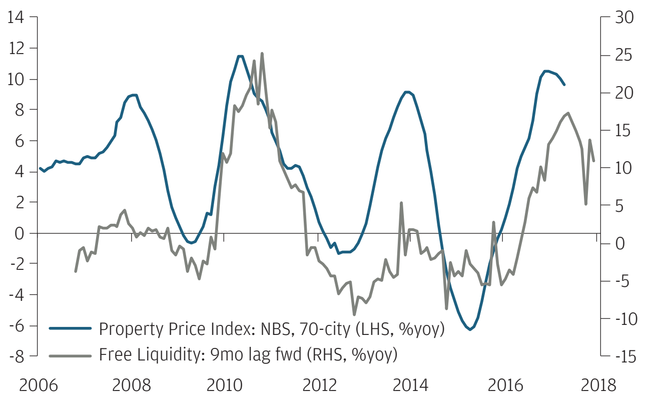
46% of coal and 63% of steel 2017 target capacity has been cut and policies are being implemented to try to prevent asset price bubbles

EXHIBIT 6A: CUTS IN CHINESE COAL AND STEEL PRODUCTION (MILLION TONNES)



Source: Shanghai Securities Daily, Morgan Stanley Research; data as of Jun 2017.

EXHIBIT 6B: REAL ESTATE PRICES AND FREE LIQUIDITY



Source: Bank of America Merrill Lynch, NBS (National Bureau of Statistics of China), J.P. Morgan Asset Management; data from Jan 2006 to May 2017. Free Liquidity [(M1 deflated by CPI) less GDP]

RISKS: POLICY MISPRICING, POLITICAL RISKS AND LATE CYCLE SIGNS

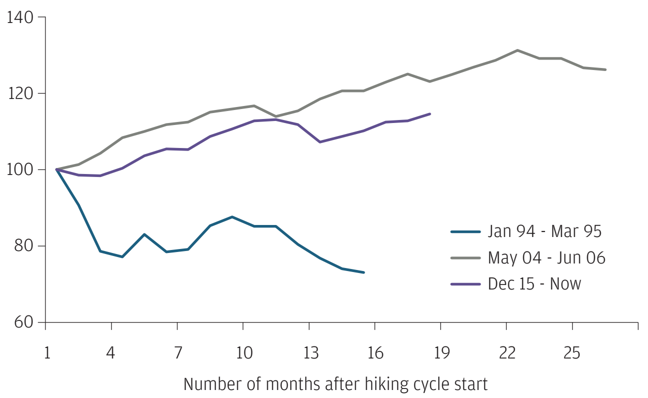
The key risks that EM investors had to stomach at the beginning of the year—US protectionism and rapid reflation followed by successive policy rate hikes—appear to have faded for now. Although we see few exogenous risks that could substantially derail the positive sentiment in emerging markets, certain risk scenarios persist that may add pressure on already rich valuations.

Policy errors from DM central banks can still be disruptive. The market continues to price in substantially fewer hikes than the Fed is signalling and similarly in Europe investors appear to be neglecting the European Central Bank's (ECB's) plans to taper its balance sheet in 2018. This leaves the market positioned unfavourably in the event of any quicker policy shifts from central banks.

So far, however, the Fed has been very active in telegraphing its next steps and we expect a continued slow and gradual monetary tightening, which should be more reminiscent of the US rate increase cycle in 2004-2006, when EM assets performed very well (see **Exhibit 7**).

US rate hikes should be more reminiscent of the 2004–2006 period, when EM assets performed very well

EXHIBIT 7: EM SOVEREIGN RETURNS DURING HISTORICAL US FEDERAL RESERVE TIGHTENING CYCLES



Source: J.P.Morgan Asset Management, Bloomberg; data as of 6 Jul 2017. Returns measured using J.P. Morgan EMBIG index. Rebased to 100 = start of Fed interest rate hiking. Past performance is not a reliable indicator of current and future results.

Political developments in EM countries remain a large concern. In Brazil, the bribery scandal involving the current president Michel Temer has been damaging for Brazilian assets, causing spreads to widen. The key concern of the market was that the political instability and the inability of the president to gather support for his reform agenda will start to increasingly weigh on the fiscal situation of the country if labour and pension reforms are not passed.

Other negative political developments, such as those in South Africa, South Korea or the political tension in the Middle East involving Qatar are all mainly concentrated in those countries and regions, but if these events spread and deepen, they may eventually feed into aggregate fundamental data and cloud the overall outlook for EM debt.

Among other potential risks, we give small probabilities to weaker commodities or a more rapid slowdown in China derailing sentiment. We are also growing evermore conscious of the fact that rich valuations and stronger growth across EM and DM countries point to a late cycle stage.

VALUATIONS: BIAS TO CARRY, RATES AND EM FX

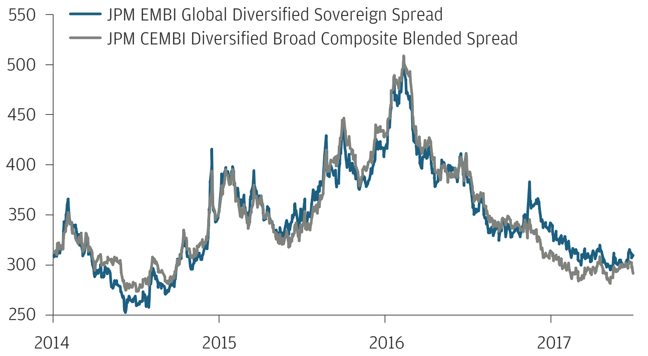
Sovereign and corporate credit spreads, as measured by the JPM EMBI Global Diversified and JPM CEMBI Broad Diversified indices, reached recent lows in the second quarter of this year (see **Exhibit 8A**). In fact, corporate spreads narrowed to post-Lehman lows, suggesting limited room for further spread compression in the absence of positive catalysts beyond what is already priced in. Sovereign spreads, on the other hand, still offer some value compared to 2013 and 2014 lows. Overall, we will continue to favour carry and shorter duration high yielding names in sovereign and corporate credit given current spread levels.

Local currency debt, on the other hand, offers decent value. Since the beginning of this year, the average EM local currency bond yield has drifted moderately lower, while US Treasury yields have traded in a range and eurozone government bond yields have ticked a bit higher. Nonetheless, with a nominal yield of 6.3% in early July, EM local currency debt still offered a meaningful yield pick-up over seven-year US Treasury and eurozone Treasury yields of 2.2% and 0.1%, respectively. The real yield differential paints an even more enticing picture. While EM local currency bonds offer positive real yields, US real and eurozone real yields remain negative (see **Exhibit 8B**).

EM currencies (EM FX) also offer good value in our opinion. EM FX has rallied since the beginning of 2017, mainly against the US dollar. However, EM FX has moderately depreciated against the euro and has traded in a range against the G4 currencies. In addition, EM FX remains significantly undervalued according to estimates based on purchasing power parity (see **Exhibit 8C**). Mild global reflation taken together with gradual monetary policy tightening, improved EM-DM growth alpha and positive real interest rates suggests room for more EM FX appreciation in the coming months.

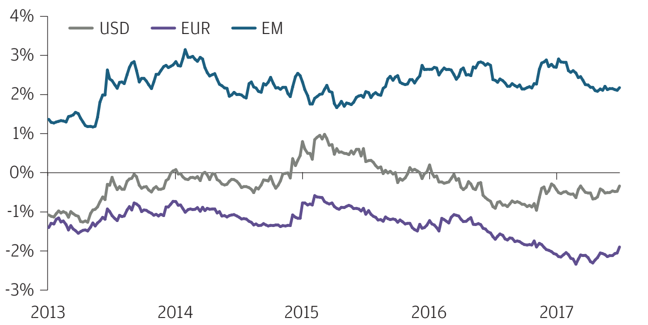
Selective local currency rates, mostly within high yield countries, and EMFX still offer decent value

EXHIBIT 8A: EM CORPORATE AND SOVEREIGN SPREADS



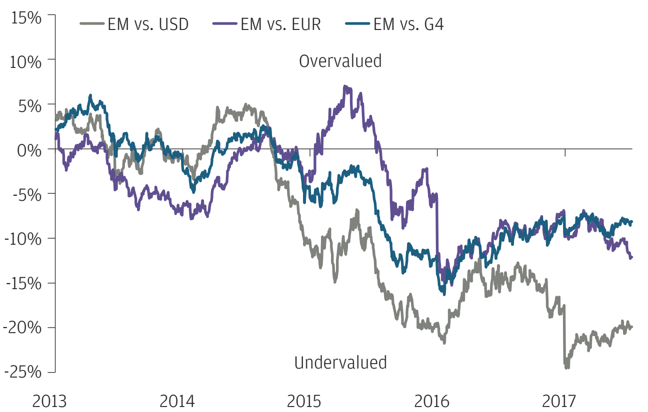
Source: J.P. Morgan Asset Management, Bloomberg; data from Jan 2014 to Jun 2017.

EXHIBIT 8B: REAL BOND YIELDS (%)



Source: J.P.Morgan Asset Management, Bloomberg; data from Jan 2013 to Jul 2017. EM real yields based on equally weighted JPM GBI-EM Global Diversified Index countries

EXHIBIT 8C: EM FX REMAINS UNDERVALUED AFTER 2017 RALLY



Source: J.P.Morgan Asset Management, Bloomberg; data from Jan 2013 to Jul 2017. EM FX vs USD and EM FX vs G4 based on nominal exchange rates relative to PPP-exchange rates and adjusted for GDP per capita.

"EM FX" comprises weighted average of JPM GBI-EM Global Diversified Index countries

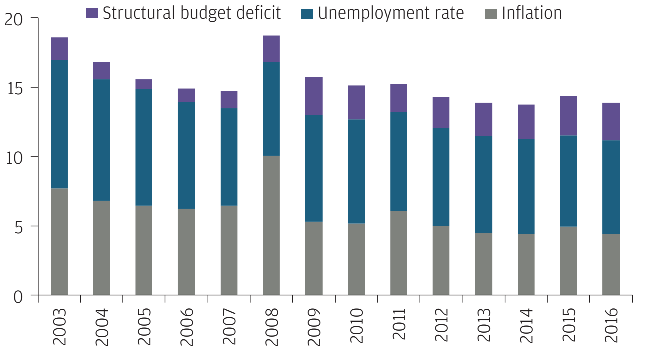
EM RESILIENCE: OPPORTUNITIES TO BUY ON DIPS

In view of less enticing EM debt valuations than previously and the prospect of combined monetary tightening in the G3, we see an increased risk of dips or even more pronounced market corrections. However, we believe that such dips and corrections could offer an opportunity to buy, in particular in countries that have the ability to cope with external shocks.

First, most EM countries have continued to pursue prudent macroeconomic policies in recent years, which has strengthened their resilience to shocks. Policy efforts have been focused on reducing or keeping structural budget deficits, unemployment and inflation under control, and as a result the "EM Misery Index" (which is the combination of these three measures) stands at the lowest level since 2003 (see **Exhibit 9**). In addition, central banks have stepped up efforts to maintain or increase FX reserves. **Exhibit 10** shows that overall FX reserves at EM central banks are now well within the suggested adequacy range by the International Monetary Fund (IMF).

Most EM countries successfully pursued prudent macro economic policies

EXHIBIT 9. EM MISERY INDEX: STRUCTURAL BUDGET DEFICIT, UNEMPLOYMENT AND INFLATION



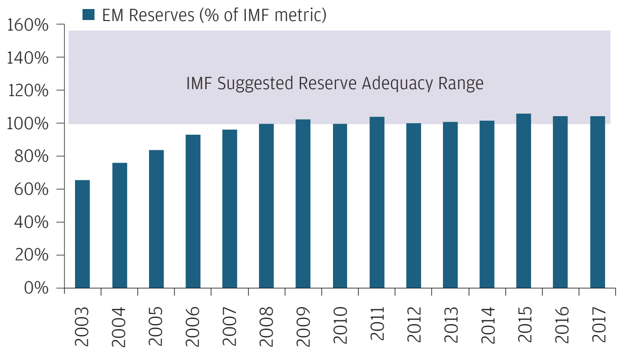
Source: J.P.Morgan Asset Management, Bloomberg, Haver; data from Jan 2003 to May 2017.

Similarly, EM companies have also gone through meaningful adjustments through reduction of capital expenditures, sales of non-core assets and efficiency improvements to their operations. This is evidenced by peaking leverage ratios and improving profit margins—both of which translate into better and improving upgrade/downgrade ratios (see **Exhibit 11**).

Also, the EM corporate high yield default rate for the year is expected to drop from 5.1% in 2016 to a low of 2% in 2017. The combination of improved top-down and bottom-up fundamentals leaves EM countries and companies in a significantly better position to cope with internal and external shocks than previously.

Emerging markets have an adequate cushion to weather external shocks

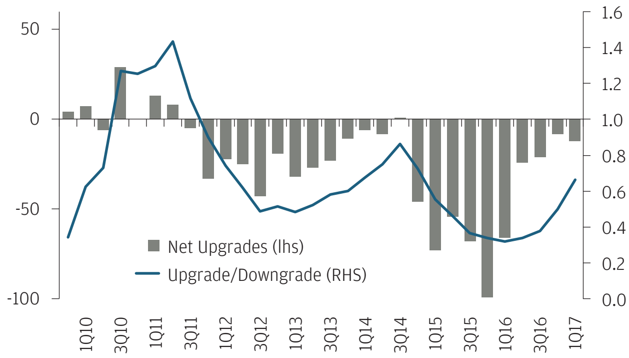
EXHIBIT 10: EM RESERVES (% OF IMF METRIC)



Source: J.P.Morgan Asset Management, Bloomberg, Haver; data from Jan 2003 to May 2017.

Credit upgrade/downgrade ratios are improving

EXHIBIT 11: EM CORPORATE UPGRADE/DOWNGRADE RATIO (EXCL. SOVEREIGN RATING DRIVEN RATINGS CHANGES)*



Source: J.P. Morgan Asset Management; data from Jan 2010 to Jun 2017.

*The chart excludes all corporate credit rating changes that were driven by respective sovereign credit rating upgrades/downgrades.

OUR INVESTMENT STRATEGY AND ROADMAP

Our updated investment roadmap for the third quarter (**Exhibit 12**) has not changed dramatically since the last quarter. While we continue to expect reflationary pressures to gradually push yields higher, this scenario has been seriously challenged by the "fade" case, to which we now assign a 10 percentage point larger probability than three months ago. This highlights one the main takeaways of this quarter: that the strong version of the post-US election global reflation theme is less likely and only a gradual and milder version looks probable when assessing all components. Inflationary pressures in developed markets are not expected to feed into emerging markets, where headline inflation is likely to slide marginally as commodity prices weaken, growth slows in China and EM central banks tackle inflation. Overall, our macro backdrop of decent positive growth and subdued inflation presents a positive "goldilocks" environment for EM debt, although most of this positive backdrop is already priced in.

A goldilocks environment exists for EM debt, but much of the positive backdrop has been priced in

EXHIBIT 12: EMERGING MARKET DEBT ROADMAP THIRD QUARTER 2017

	Scenario	Fade	Base Case: Mild Reflation	Acceleration
MACRO	Probability	30%	55%	15%
MACRO	Growth	Global growth falls back below trend	EM-DM alpha intact, recovery anchored	DM growth above trend, output gap closes
MACRO	Inflation	Global disinflation resumes	Disinflation in EM	Inflation pressures build
MACRO	Financial Conditions	Central Banks are unable to tighten	Remain very accommodative, but head towards gradual tightening	Markets forced to reprice global tightening
MACRO	Policy Space	Policy mistakes increase global uncertainty	EM have built some policy space, but differentiation remains key	US fiscal policy delivers more than expected
MACRO	Commodities	Weaker	Range-bound oil with downside bias, weakness in metals	Stronger
STRATEGY	Beta	Long duration, IG	Reducing beta over the quarter, looking for hedges	Short, wait for better re-entry point
STRATEGY	Alpha	From Credit to Duration Long rates IG long-end	Selective long HY rates Local Frontier basket From B to BB in Credit Commodity bias neutral to short	Long USD, EMFX Pay rates Long commodity exporters

Themes
Goldilocks priced-in: **From beta to alpha**
Buy EM disinflation: Selective basket of HY rates
Favour **manufacturers over commodity** exporters
EM resilience: Looking to buy the dips
Risks: Late cycle signals, China/growth scare, commodities, policy mispricing

Source: J.P.Morgan Asset Management. As of Jun 2017. Forecasts, projections and other forward looking statements are based upon current beliefs and expectations. They are for illustrative purposes only and serve as an indication of what may occur. Given the inherent uncertainties and risks associated with forecasts, projections and other forward statements, actual events, results or performance may differ materially from those reflected or contemplated.

On the monetary policy side, we expect the Fed to continue to gradually normalise policy as deflationary risks have subsided and financing conditions remain very favourable. The ECB and Bank of Japan, on the other hand, are expected to maintain their relatively dovish stance as they await clearer signals before tapering or hiking policy rates.

Within emerging markets, the situation is more mixed as some countries are in monetary tightening cycles and some are in expansionary cycles. The main risks in the upcoming months are related to the regulatory changes in China, weaker commodities, policy mispricing and late cycle signals.

The strategy for the quarter is more cautious on beta—we aim to focus on alpha, reduce directional exposure and look to buy on the dips. Local currency denominated debt continues to offer more value, but we are also selective in this market, with a preference for high yield countries where real yields are becoming attractive as inflation trends lower.

Within corporates, we want to tilt more towards BB rated countries and corporates and away from riskier B rated names given the better return-risk potential. Given the downside risk related to commodities, we have shifted allocations more towards manufacturers and aim to hold a neutral-to-short bias towards the oil & gas sector and in other commodity exporters. As part of this shift, we have already rotated part of our exposure from Latin America to Europe, the Middle East and Africa.

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