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2021

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PUBLIC FIXED INCOME

Emerging Markets

Market Review and Outlook

June 30, 2021

Market Review:

During the second quarter, rate volatility and several idiosyncratic stories drove market performance within Emerging Markets (EM). After the 10-year treasury yield ended the first quarter at the highest level since January 2020, yields rallied back to 1.47%, largely driven by the view that inflation will be more transitory than initially projected.

The strong economic recovery in China and the United States thus far in 2021 has boosted market optimism; however, recovery in EM has lagged. Delays to vaccine rollouts and persistently high new cases and deaths have hindered re-opening plans and put excess pressure on economies. The emergence of the coronavirus delta variant is another impediment to a quick EM recovery.

Commodities had a strong quarter across the board. Brent hit levels not seen since October 2018, while metals including Iron Ore and Zinc, along with agriculture and pulp, marched higher. The strong commodity trend is supportive for most EM countries as an offset to their weak domestic economies.

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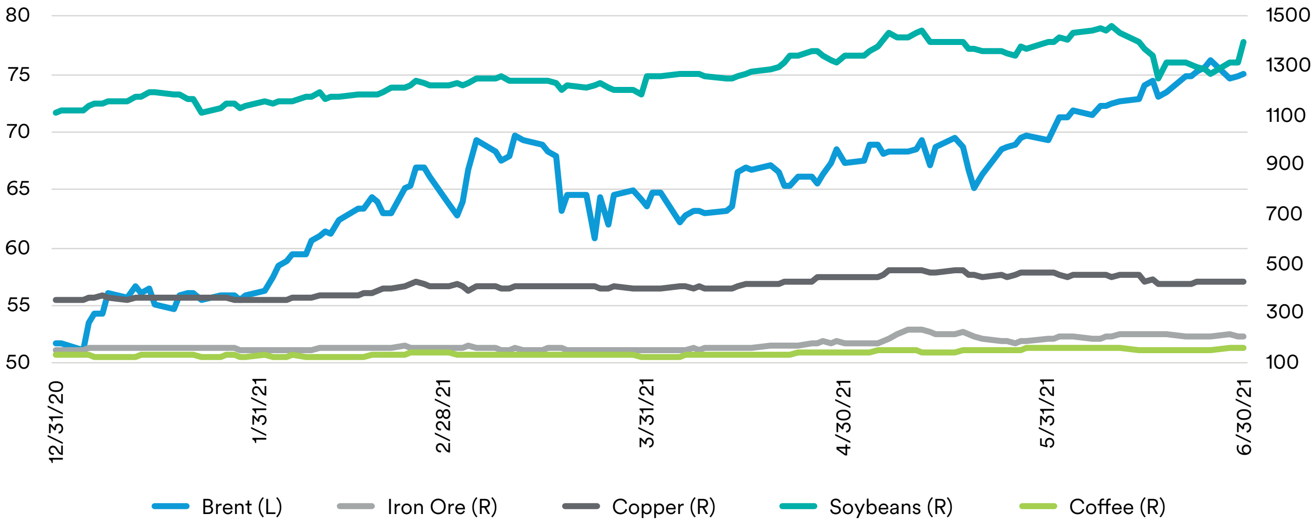
Year-to-Date Commodities Prices ($)

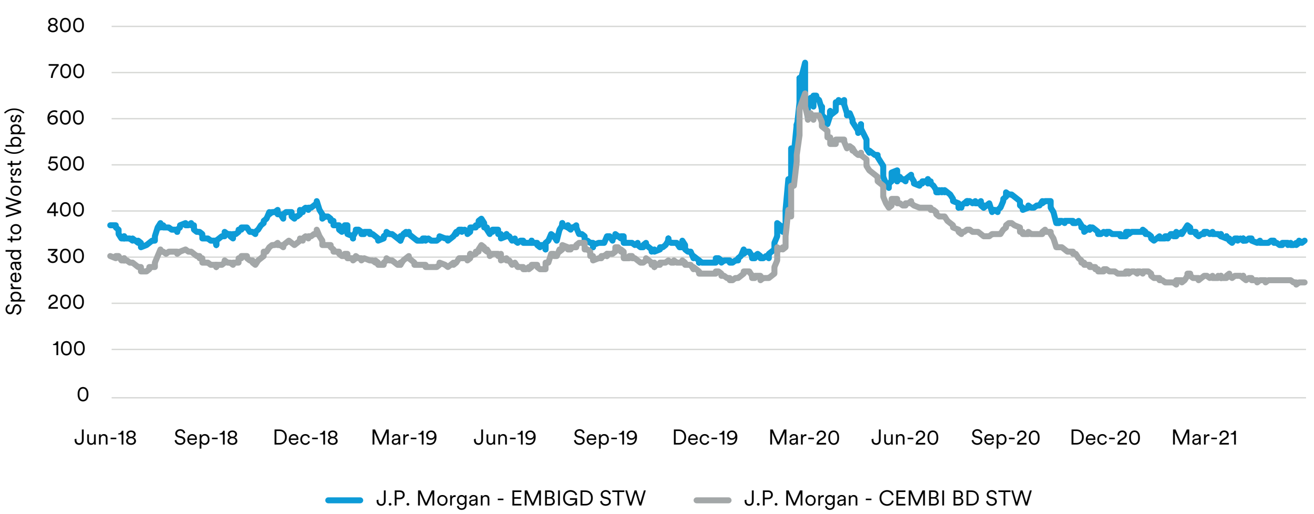


Source: Bloomberg L.P.

The Emerging Markets Bond Index Global Diversified (EMBI GD) tightened 14 basis points during the quarter to end at 339 basis points. This was driven by positive idiosyncratic stories in high yield (HY) names such as Angola, Ecuador, and Zambia. HY sovereigns tightened 37 basis points, while investment grade names widened 4 basis points. Returns were healthy (+ 4.06%) with the EMBI GD able to erase most of the losses from first quarter. Year-to-date returns for the EMBI GD stand at -0.66%[1].

Corporate spreads continued their positive trend, tightening 8 basis points during the quarter to reach 249 basis points. Corporate Emerging Markets Bond Index-Broad Diversified returns lagged hard currency sovereigns but were still positive (+2.10%) and year-to-date returns turned positive (+1.28%)[2]. The Oil & Gas sector was the top performer in the space given strong demand recovery amidst constrained supply. The Asia high yield property sector dampened corporate performance, as the Chinese government's efforts to prevent a property bubble in China placed elevated pressure on bonds.

J.P. Morgan Index Spreads (bps)

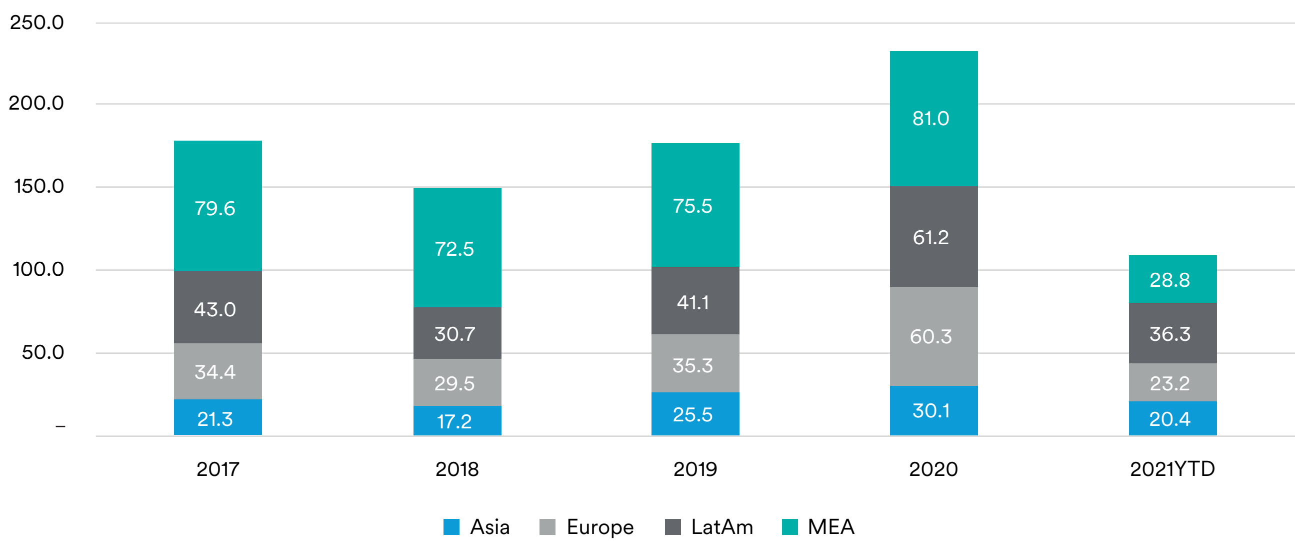


Source: Bloomberg L.P., J.P. Morgan

Local markets saw strong performance during most of the quarter, which faded in June when the Federal Reserve signaled a more hawkish bias that rekindled a strong dollar environment. Global Bond Index returns for the quarter were able to hold in at +3.54%; however, the index remains in negative territory for the year (-3.38%)[3].

Corporate issuance continues to be robust. $159 billion of deals were priced in Q2; of which, over $100 billion was investment grade issuance and at a regional level Asia accounted for over $83 billion. Sovereign issuance remains on pace with 2019 levels. Q2 issuance of $40 billion puts year-to-date primary deals at $109 billion. Mexico is the largest sovereign issuer thus far; however, Indonesia is expected to be the largest issuer by the end of 2021 with over $4 billion more borrowing expected[4].

EM Sovereign Annual Issuance by Region

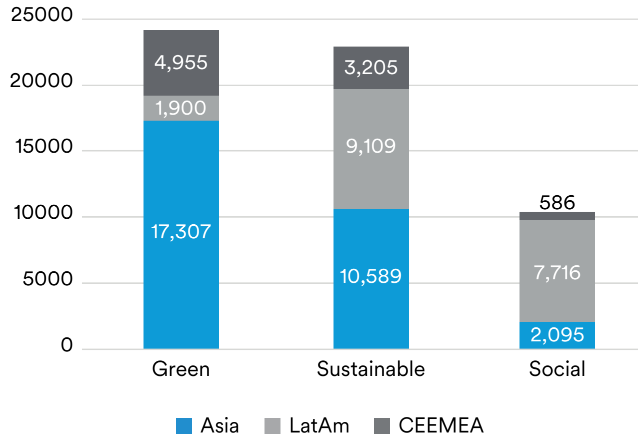


Source: J.P. Morgan as of July 1, 2021

The EM HY corporate default rate remains at a relatively mute level of 1.2%, with no defaults out of EM Europe or the Middle East and African (MEA) regions in the first half of 2021. The full year 2021 projection remains at 2.5%, with an expected recovery rate of over 40%[5].

As demand from ESG focused investors becomes more prevalent throughout fixed income, both corporate and sovereign issuers have greatly increased the issuance of environmental and social bonds. The adoption of ESG in the EM universe has been a slower process than in developed markets; however, we continue to see sharp increases in the EM ESG universe both in terms of issuance and demand. In the first quarter, out of the $11 billion of inflows, $2 billion of that was ESG dedicated inflows[6]. Combined amongst corporates, financials, government agencies, and sovereigns, ESG-labeled bonds in the first quarter reached $56 billion versus the $79 billion total issued in 2020[7]. Year-to-date through the second quarter, 16% of total EM corporate issuance has been ESG-labeled bonds[8]. A climate bond initiative survey conducted at the end of 2020 revealed that 22 sovereigns had already issued a combined $96 billion of green, social and sustainable bonds since 2016 and at least 14 other sovereigns indicated intentions to issue bonds of similar nature[9].

ESG Bonds Issued by Region in USD



Source: BondRadar

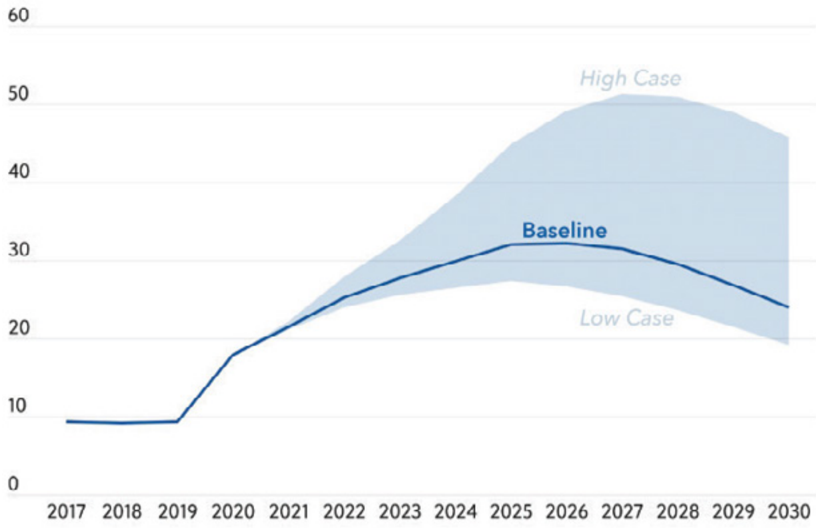
Idiosyncratic developments, especially in the Latin America region, were abundant during the quarter. Ecuador's moderate businessman Guillermo Lasso won the second-round election in April. The markets responded positively to this news, with bonds rallying on hopes that the country will make quick progress on a program with the IMF and reduce political uncertainty. In Peru, the official election result is still unconfirmed at quarter end, as leftist candidate Pedro Castillo holds a small lead that is being challenged in the courts by Keiko Fujimori. So far, the country's reaction has remained peaceful. In Chile, the election for the 155 members of the Constitutional Assembly was held and the political left did well, as center-right parties did not reach the minimum one-third threshold needed to block significant constitutional changes. Mexico's mid-term elections revealed Andrés Manuel López Obrador's Morena party losing the majority, therefore weakening his chances of passing constitutional reforms to further his nationalist agenda. In El Salvador, the new congress voted to remove the Attorney General and Supreme Court magistrates, leading to tensions with the U.S. and causing delays for an IMF program. Protests in Colombia that initially started around the proposed tax bill turned into protests of resentment of the general government. The country was downgraded to high yield as the country's medium-term fiscal plan pointed to a slower than expected fiscal consolidation.

> IMF progress was robust during the quarter: Senegal had its third review, Gabon received a three-year extended fund facility, Angola completed its fifth review, Kenya had its first review, and the Fund increased Jordan's borrowing access. [10]

President Biden continues to show his presence across the globe, recently meeting with the leaders of Turkey and Russia. Despite ongoing tensions, the discussions appeared constructive overall. The U.S. did take another step in sanctions with Russia by applying restrictions to local OFZ primary issuance (federal loan obligations). Europe imposed economic sanctions on Belarus following the kidnapping of a journalist and what the European Union viewed as human right violations by the country. South Africa's anti-corruption measures made positive progress, with former President Jacob Zuma imprisoned and secretary-general Ace Magashule suspended by the African National Congress (ANC). Argentina made a partial payment and delayed the balance on its remaining Paris Club credit line, while negotiations continue with the IMF for a new program. IMF progress was robust during the quarter: Senegal had its third review, Gabon received a three-year extended fund facility, Angola completed its fifth review, Kenya had its first review, and the Fund increased Jordan's borrowing access[10].

Figure 5 | High Demand for Fund Concessional Financing

Low-income countries' demand for Fund support expected to quadruple over the medium term (stock of outstanding PRGT loans, USD billion)

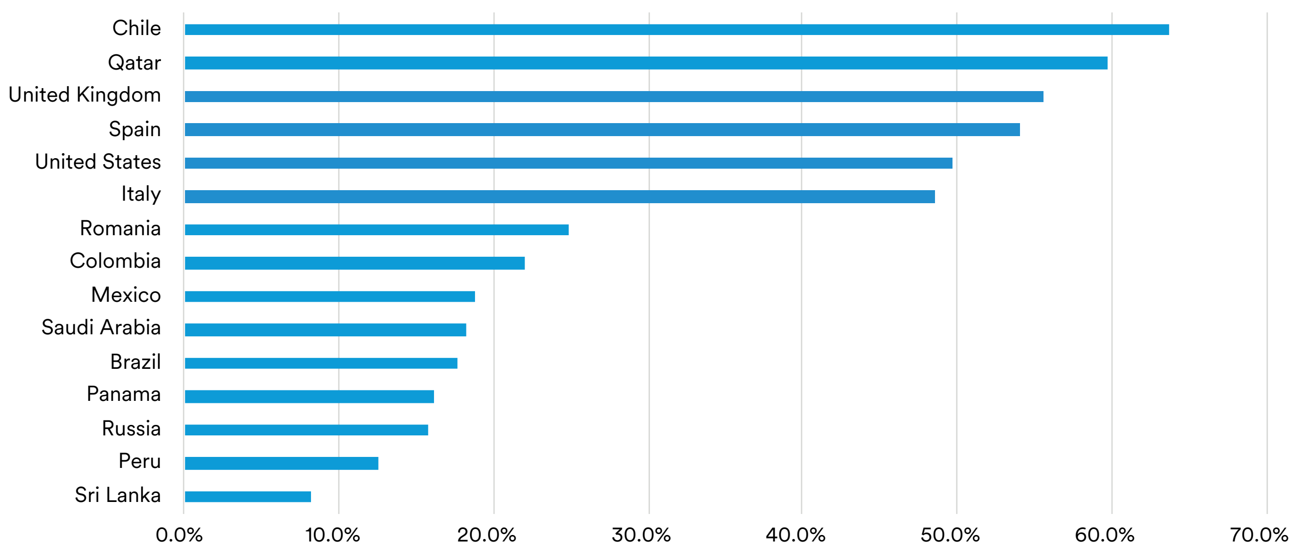


Source: IMF staff estimates
Note: Assumes annual lending from 2025 of USD 2.4 billion under Low Case and Baseline and USD 4.3 billion under the High Case.

Outlook:

The global recovery is in full swing, but likely nearing a peak, resulting in a favorable investment backdrop but with more risks and moments of increased volatility. China was first in its growth recovery, then the U.S. and now Europe, with EM becoming more of a 2H21 into 2022 story. The countries or regions that emerged first and recovered a significant amount of lost growth are starting to take active steps to reduce some of the unprecedented policy actions. China's rate of credit expansion is slowing rapidly while the Federal Reserve has acknowledged it is discussing tapering of asset purchases. The pandemic recovery is, in many ways, just as remarkable as the pandemic related growth shocks. As we look forward, growth expectations remain healthy albeit more moderate than the first half of 2021. There are threads of uncertainty around growth's durability, the timing and magnitude of stimulus withdrawal, the risks around inflation amid damaged supply chains, and longer-term effectiveness of vaccines. In a more "normalized" world in early to mid-stages of the cycle, global interest rates should move higher. Rising real rates could pressure bond prices as spreads are at or near all-time tights. These factors and others contribute to a more challenging investment environment than over the previous 12 months, but we remain optimistically cautious given still robust accommodation, supportive growth and positive flow dynamics.

Percentage of Population Fully Vaccinated

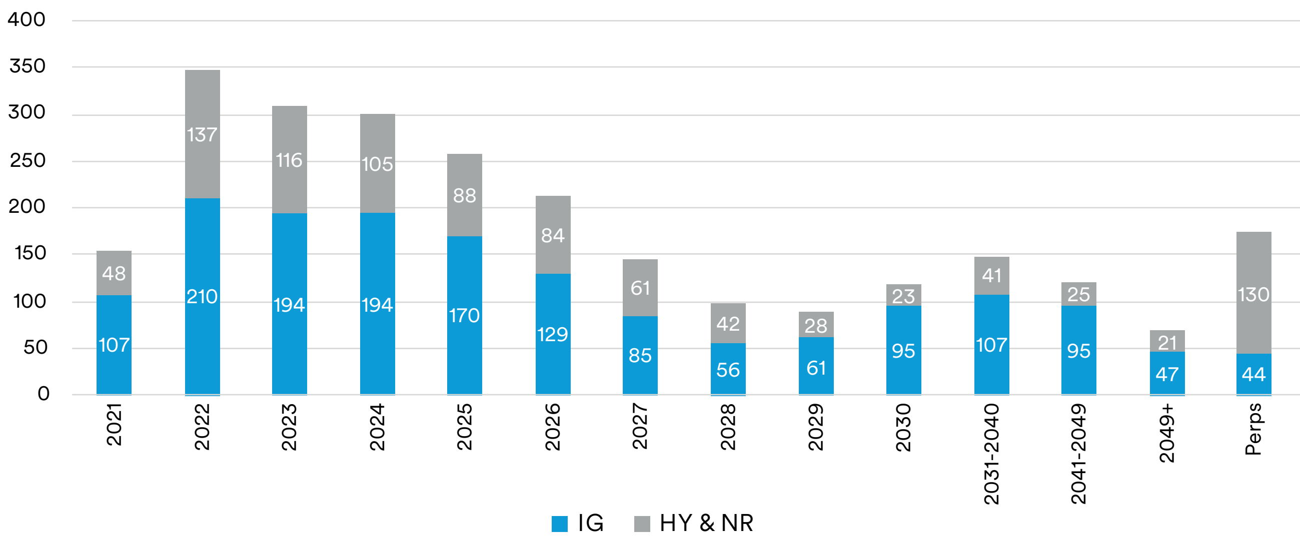


Source: John Hopkins University & Medicine Coronavirus Resource Center as of July 26, 2021

In the upcoming quarter, we will continue to monitor the changes in the Mexican government, which could be a potential catalyst for improved governance in Pemex, Mexico's state oil producer. In Peru, we are watching the government transition and cabinet designations for clues about policy continuation. Later this year there will be important elections in Chile and mid-terms in Argentina. In countries such as the Dominican Republic and Sri Lanka, the revival of tourism remains a key factor for economic recovery. Interest rate hikes from Brazil, Russia and likely others are expected in the second half of 2021. We are also awaiting the disbursement of IMF Special Drawing Rights allocations and news that G7 countries may lend ~$100 billion of their allocations to EM nations that have been hit hardest by the pandemic. The IMF also remains in active discussions with countries including El Salvador, Ecuador, and Argentina. Oil will remain in the spotlight with ongoing production discussions from OPEC as well as Joint Comprehensive Plan of Action (Iran nuclear deal) progress.

On the primary front, the market has already seen much of the expected issuance from sovereigns. However, we expect for the sovereign issuance calendar to remain active in the second half as countries may choose to prefund for 2022. Corporate issuance is expected to be lighter in the second half of the year given the Asia region's tendency to issue the majority of deals in first half. We also anticipate continued liability management issuance across the regions if rates start to move.

Emerging Market Corporates Maturities (Hard Currency)



Source: J.P. Morgan as of June 12, 2021

Positioning:

Security selection remains critical in the current environment of idiosyncratic country stories and low yields. We continue to have a constructive view on EM corporates relative to sovereigns given stronger fundamentals and lower volatility. Within the corporate space, we reduced some risk into quarter end, allowing us room to reload into any widening. In the sovereign space, idiosyncratic stories remain an important determinant of positioning. Investment grade countries such as Peru and Chile, as well as high yield names like El Salvador and Angola, remain pockets of opportunity in the market that have seen recent volatility.

Given the changes in the macro backdrop as we transition from a stimulus-heavy recovery to one with moderately tighter liquidity conditions, we remain cautious on non-dollar currency, duration in certain local curves, and more speculative sovereign issuers. With elevated risks of stimulus removal later this year and continued elevated inflation risks, policy decisions and liquidity needs will become more impactful on relative prices.

Endnotes

1 J.P. Morgan
2 J.P. Morgan
3 J.P. Morgan
4 J.P. Morgan
5 J.P. Morgan
6 Bank of America
7 Bank of America
8 J.P. Morgan
9 World Bank
10 Bloomberg L.P., IMF,

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