Emerging Market Hard Currency 2024 Outlook

DECEMBER 15, 2023

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Overview

- We expect EM hard currency markets to generate low double-digit returns in 2024
- Key corporate credit metrics are expected to remain at decade peak levels, while default rates should normalize
- A busy EM election calendar combined with US elections may offer alpha generating opportunities
- Valuations remain compelling, while strong market technicals are supporting a credit spread tightening narrative – particularly in the EM corporate segment

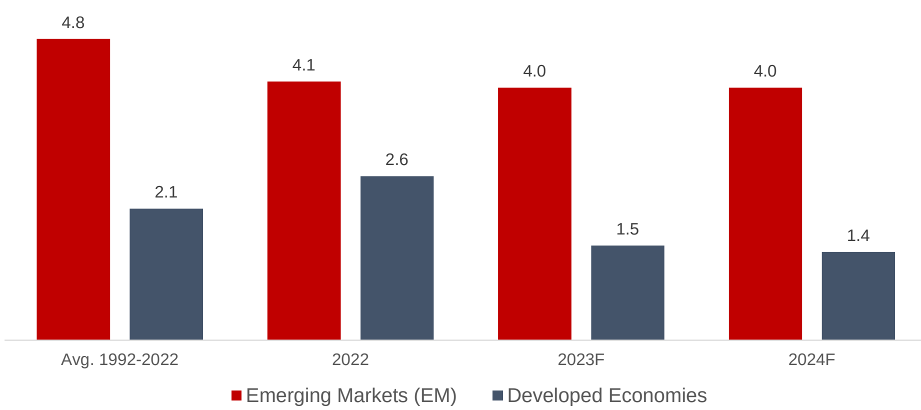
Supportive Sovereign Storyline

We expect sovereign balance sheets to remain stable in 2024, with fiscal and primary deficits to stay in line with 2023 levels at around 5.5% and 3.1% of GDP, respectively. While aggregate EM government debt is expected to increase modestly from 68% to 70% of GDP, it remains well below that of developed market countries. This more moderate debt burden should translate into positive hard currency issuance of approximately $50bn from EM sovereign credits in 2024 – which is meaningfully lower than the longer term average of $80-100bn annually.

We believe that election-driven and idiosyncratic credit stories will offer plenty of alpha generating opportunities in the coming year. Mexico, Indonesia, and South Africa, which together represent about 20% of the JPMorgan Emerging Markets Bond Index Global (EMBIG) universe, will hold general elections in 2024 (although no major changes are anticipated). We expect policy continuity in Mexico, the single largest country in the EMBIG index, under a second Morena administration, while “nearshoring” and the benefits of the USMCA run parallel in the background.

Support for the dominant African National Congress (ANC) in South Africa will be tested and may bring some volatility, but market-friendly policies from the current government should provide some cushion. In Indonesia, a potential populist tilt could trigger some market concerns, but it is too soon to expect a major policy shift in a country with good macro credentials. India’s election will also be closely watched, particularly in terms of impact on the corporate sector.

Real GDP Growth in EM and Developed Economies (YoY%)

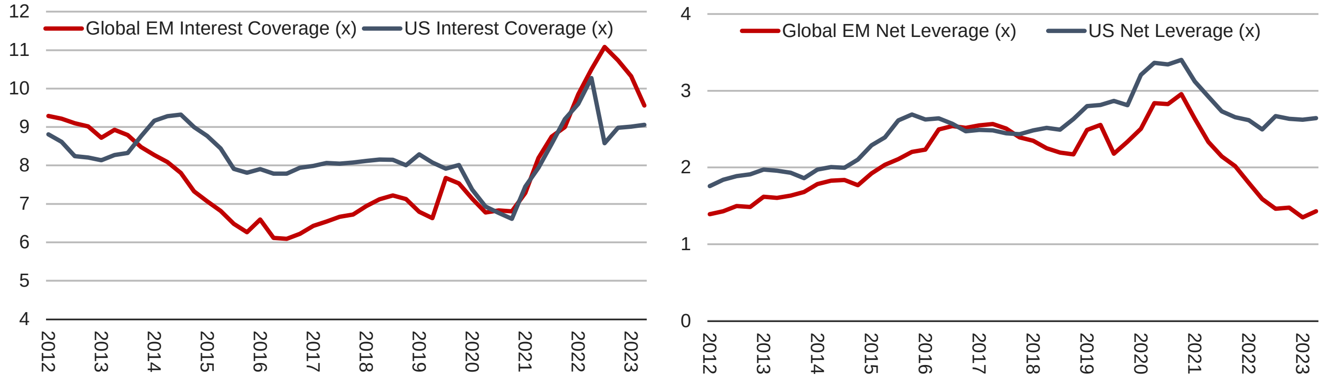


Source: IMF, World Economic Outlook, as of October 2023

Resilient Corporate Credit Fundamentals

The fundamental backdrop for EM corporates remains favorable. Key credit metrics such as interest coverage, leverage, and liquidity remain near a decade peak in terms of quality. From a macroeconomic perspective, the ongoing high nominal growth environment remains a supportive factor for credit quality. In aggregate, real GDP growth in EM countries is expected to remain around 4% for 2024, similar to 2023 levels, despite a further deceleration in China. Nonetheless, we remain mindful of potential growth volatility given a tighter monetary environment. Accordingly, we are running our strategies with a tilt towards quality and a particular emphasis on the near-term maturity profile.

Net Leverage and Interest Rate Coverage: EM Corporates vs. US Credit



Source: BofA, as of June 2023 (most recent available)

Declining Defaults

After two years of elevated default rates, driven mainly by the Chinese property sector and Russia, we believe default rates should normalize, in line with longer term averages. We expect a 2.0% default rate for EM sovereigns and 1.6% for EM corporates in 2024. Sectors such as telecommunications in select Latin American countries and certain Chinese non-investment grade rated companies will likely represent the lion's share of defaults in the coming year. In the sovereign space, most potential default candidates have very small index weights (with the exception of Egypt) and are unlikely to have a meaningful impact on the overall market.

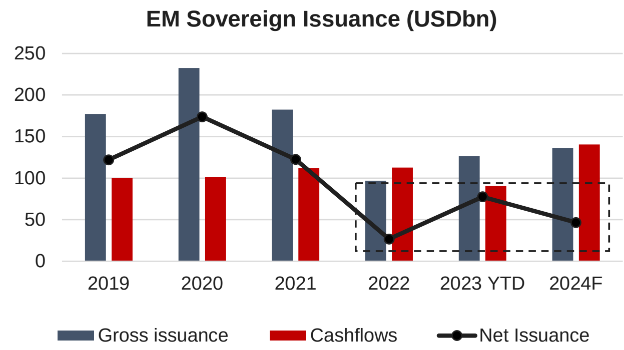
EM Historical Defaults: Expect Low Default Rates in 2024, In-line with Long-term Averages

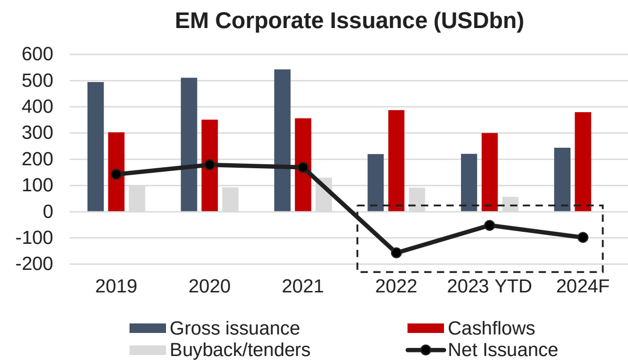
EM Corporates	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023 YTD	2024F	10-yr Avg.
Asia	1.2	1.5	3.1	1.0	1.0	2.5	1.8	3.4	13.2	16.8	8.4	4.5	4.9
EM Europe	2.3	4.0	2.5	3.6	3.6	0.0	0.0	3.3	0.0	32.0	20.5	3.0	6.5
Latin America	10.6	6.5	5.7	9.2	2.0	2.1	2.3	4.4	2.5	3.7	5.4	5.6	4.9
Middle East & Africa	0.0	4.6	4.0	5.7	3.2	0.0	1.8	2.1	0.0	0.6	0.0	0.5	2.0
% EM IG & HY bonds*	**1.3**	**1.2**	**1.4**	**2.0**	**0.8**	**0.7**	**0.7**	**1.4**	**2.9**	**5.7**	**2.9**	**1.6**	**1.9**
EM Sovereigns	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023 YTD**	**2024F**	**10-yr Avg.**
% EM IG & HY bonds*	**0.5**	**5.5**	**2.3**	**0.0**	**0.2**	**0.1**	**0.0**	**10.2**	**0.1**	**5.1**	**0.9**	**2.0**	**2.3**

**Excludes 100% quasi-sovereigns*
Sources: NCRAM and JPMorgan, as of November 2023

Strong Market Technicals

For corporates, we expect market technicals to remain highly constructive in 2024. Strong balance sheets, healthy cash flows, and conservative liquidity profiles allow corporate issuers to be selective and opportunistic in tapping the external debt markets – particularly as access to alternative sources of funding, such as local bond markets, have become more viable. As such, net new external debt issuance in the corporate segment has been negative for the past two years. While we look for this trend to continue into 2024, we also expect outflows to turn into inflows over the coming year, which will then set the scene for credit spread tightening and support our double-digit return narrative for the asset class in 2024.





Source: JPMorgan, as of November 2023

Potential Resumption of EM Inflows in 2024 after Two Years of Outflows

Annual Dedicated EM Fixed Income Fund Flows (USDbn)	2019	2020	2021	2022	YTD 2023
EM Total	**67.1**	**23.3**	**52.5**	**-90.0**	**-31.1**
Retail Fund	43.2	11.5	34.4	-81.8	-36.0
Strategic Fund	23.9	11.8	18.1	-8.2	4.9
Hard Currency	55.5	22.8	31.2	-44.8	-23.7
Local Currency	11.6	0.5	21.3	-45.3	-7.4

Source: JPMorgan, as of November 2023

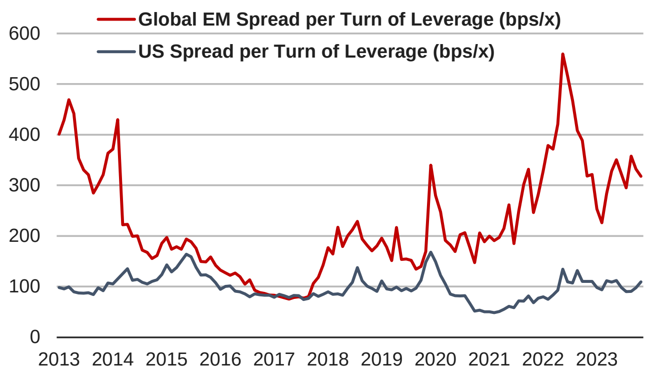
New Themes Offer Alpha Opportunities

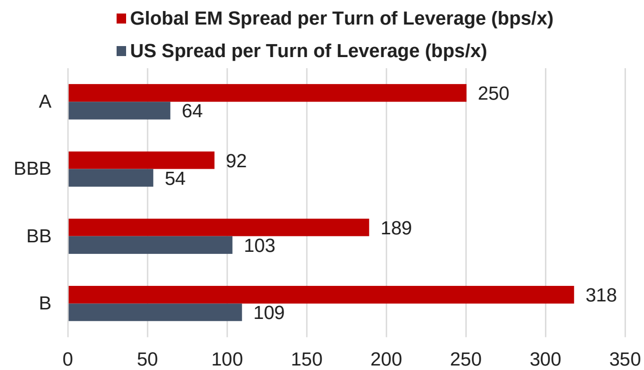
We see a range of interesting themes developing in the EM credit markets. Notably, and similar to a trend seen in the US high yield market, more companies are taking a proactive and collaborative approach to materially improving their maturity schedules. These "self-help" initiatives can significantly improve credit profiles. Specifically, we have seen a number of issuers receiving support from development financial institutions providing funding on concessionary terms, a trend we believe will continue. Other examples are tendering for debt and extending maturities through a combination of cash and longer dated new bonds. Similarly, some sovereign credits with limited or no market access have been able to obtain financing from multilaterals and other official creditors, for specifically earmarked projects. Furthermore, the prospect of easing tight monetary policies, which peaked in 2022 when major EM countries focused on fighting inflation, should be supportive – not only to stimulate domestic demand but also to provide financing options for some credits in EM countries with mature capital markets.

Valuations Remain Compelling

Against a strong fundamental backdrop, we expect attractive returns relative to other credit asset classes on a through-the-cycle basis. For corporate credit, spreads per turn of leverage, a metric helpful to understand the risk premium relative to fundamental financial risk assumed, remains elevated in absolute as well as relative terms compared to the US high yield market. As for B-rated issuers, EM corporate investors receive a spread of 318 bps per turn of leverage, versus only 109 bps for US investors. A return to historical levels offers the potential for significant spread tightening. Meanwhile in the sovereign segment, all-in yields in the investment grade space are attractive, but spreads remain near historically tight levels, leaving most of the spread opportunity set to BB and B-rated credits.

Spread per Turn of Leverage: EM Corporates vs. US Credit





Source: BofA, as of October 31, 2023

Total Return Outlook

Double-digit return scenarios in both the sovereign and the corporate segments are within reach for 2024. Our base case calls for 10% in EM corporates and 11% for EM sovereigns.

EM Corporates: 1-year Forward Index Return Scenarios including Carry

5-yr UST / CEMBI BD Spread	225	250	275	300	325	350	375
3.00	15.2	14.1	13.0	11.9	10.8	9.7	8.6
3.25	14.1	13.0	11.9	10.8	9.7	8.6	7.5
3.50	13.0	11.9	10.8	9.7	8.6	7.5	6.4
3.75	11.9	10.8	9.7	8.6	7.5	6.4	5.3
4.00	10.8	9.7	8.6	7.5	6.4	5.3	4.2
4.25	9.7	8.6	7.5	6.4	5.3	4.2	3.1
4.50	8.6	7.5	6.4	5.3	4.2	3.1	2.0

Sources: NCRAM, JPMorgan Corporate Emerging Market Bond Index Broad Diversified (CEMBI BD), as of October 31, 2023

EM Sovereigns: 1-year Forward Index Return Scenarios including Carry

10-yr UST / EMBIG Spread	275	300	325	350	375	400	425
3.00	20.0	18.2	16.5	14.7	13.0	11.2	9.4
3.25	18.2	16.5	14.7	13.0	11.2	9.4	7.7
3.50	16.5	14.7	13.0	11.2	9.4	7.7	5.9
3.75	14.7	13.0	11.2	9.4	7.7	5.9	4.1
4.00	13.0	11.2	9.4	7.7	5.9	4.1	2.4
4.25	11.2	9.4	7.7	5.9	4.1	2.4	0.6
4.50	9.4	7.7	5.9	4.1	2.4	0.6	-1.1

Sources: NCRAM, JPMorgan Emerging Markets Bond Index Global (EMBIG), as of October 31, 2023

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