Emerging Market Debt Market Commentary

Third Quarter 2020

Emerging market (EM) debt produced positive overall returns in Q3 in USD terms, albeit with bouts of volatility, in particular with a risk-off wave seen in the last weeks of September. Towards the end of the quarter, there were increasing signs of a second wave of infection in some EM regions, with a tightening in lockdown measures imposed in its wake. Economic surprises were broadly positive throughout Q3 for most EM economies, and consensus expectations across the globe – from the US to EM economies – have been revised higher for 2020 growth. The strong rebound recorded by China's economy, a swift recovery in US employment, Europe's ability to find a common policy response, and promising progress for a COVID vaccine all point to a continuation of the global recovery, lending a positive environment for EM assets. US elections present a key near-term risk, and the EM complex may experience further volatility in the final quarter of the year. EM valuations still screen as attractive in a yield-starved world, and extremely accommodative global monetary policy conditions in response to the pandemic's impact seem to have pushed capital back into EM, as witnessed by steady inflows into EM-dedicated funds over the quarter, particularly in the hard currency space.

Figure 1 - Emerging Market Debt Index Returns – As of 30 September, 2020

	1m	3m	6m	YTD	12m	3yrs	5yrs
In USD							
GBI-EM GD (EM Local Currency)	-2.02%	0.61%	10.49%	-6.32%	-1.45%	0.17%	4.78%
EMBI GD (EM Hard Currency)	-1.85%	2.32%	14.86%	-0.51%	1.29%	3.49%	6.15%
CEMBI BD (EM Corporates)	-0.48%	2.75%	14.20%	2.58%	4.85%	4.73%	6.29%
In EUR							
GBI-EM GD (EM Local Currency)	-0.07%	-3.64%	3.38%	-10.33%	-8.38%	0.44%	3.75%
EMBI GD (EM Hard Currency)	0.10%	-2.00%	7.48%	-4.76%	-5.83%	3.77%	5.10%
CEMBI BD (EM Corporates)	1.50%	-1.59%	6.85%	-1.80%	-2.52%	5.01%	5.25%

Sources: State Street Global Advisors, Bloomberg, JP Morgan as of 30 September 2020. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Performance returns for periods of less than one year are not annualized.

Figure 2: Key EM and Macro levels as of 30 September 2020

Item	Δ 1 Month	Δ 3 Months	Δ YTD	Current Level
GBI-EM GD Yield	+3 bps	-3 bps	-74 bps	4.48%
EMBI GD Yield	+10 bps	-36 bps	+23 bps	5.15%
EMBI GD Spread	+10 bps	-42 bps	+142 bps	432 bps
CEMBI BD Yield	+15 bps	-35 bps	-38 bps	4.59%
CEMBI BD Spread	+13 bps	-44 bps	+86 bps	396 bps
CDX.EM 5y	+59 bps	+36 bps	+57 bps	231 bps
10y UST	-2 bps	+3 bps	-123 bps	0.68%
Dollar Index (DXY)	+1.89%	-3.60%	-2.60%	
DOW 30	-2.28%	+7.63%	-2.65%	27,782
Oil (WTI)	-5.61%	+2.42%	-34.13%	$ 40.22

Source: JP Morgan, Bloomberg as of 30 September 2020. Past performance is not a reliable indicator of future performance.

Local Currency Market Highlights

Figure 3 - Key return drivers of EM local government bond markets

GBI-EM GD (EM Local Currency)	Monthly Return	3 Month Return	YTD Return
In USD			
Total Return (in $)	**-2.02%**	**0.61%**	**-6.32%**
FX Return (vs $)	-2.12%	-0.24%	-11.16%
Price Return (Local currency)	-0.32%	-0.46%	1.33%
Interest Return (Local currency)	0.43%	1.32%	4.11%
In EUR			
Total Return (in €)	**-0.07%**	**-3.64%**	**-10.33%**
FX Return (vs €)	-0.18%	-4.50%	-15.76%
Price Return (Local currency)	-0.32%	-0.46%	1.33%
Interest Return (Local currency)	0.43%	1.32%	4.11%

Sources: State Street Global Advisors, Bloomberg, JP Morgan as of 30 September 2020. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Performance returns for periods of less than one year are not annualized.

EM Local Currency (LC) debt returned +0.61% in US dollar terms in Q3, as measured by the JP Morgan GBI-EM Global Diversified Index. While local currency bond returns were positive in the quarter due to widespread monetary easing, EM foreign exchange (FX) strength has been a missing factor. The aggressive rate cut cycle of EM central banks slowly came to a halt in Q3, just as it did in developed markets (DM) – and market participants believe that it would be difficult for EM economies, particularly those facing currency vulnerability and a stronger inflation outlook, to deliver additional monetary easing. EM FX did not benefit from the substantial USD weakness in early Q3, and ended the quarter roughly unchanged. The outlier was the RMB, which benefited from its ongoing internationalisation and inflows spurred by the improved growth momentum in China. While EM local currency failed to recover from the COVID-related outflows earlier in the year (YTD flows in EM LC: -$21.7bn), there has been a slight reversal in this trend in the last four weeks, with EM LC witnessing +$3.1bn of inflows[1].

Figure 4 - Best and worst performers across EM local government bond markets in USD*

Third Quarter 2020	Country	Total Return USD (%)	Bond Return (%)	FX Return (%)	Index Weight	Index Impact (BP)**
GBI-EM GD		**-0.33**	**-0.25**	**-0.08**		
Top 5 Performers	Dominican Republic	13.1	13.1	0.0	0.2%	2
	Uruguay	11.1	11.9	-0.7	0.1%	2
	Philippines	7.5	4.6	2.9	0.2%	1
	Romania	6.3	2.5	3.8	2.9%	18
	Mexico	5.7	1.0	4.7	9.6%	55
Bottom 5 Performers	Indonesia	-0.3	3.9	-4.2	9.4%	-3
	Thailand	-2.4	-0.1	-2.3	8.9%	-21
	Brazil	-3.3	-0.7	-2.6	8.7%	-29
	Russia	-8.2	-0.1	-8.2	8.2%	-68
	Turkey	-13.8	-3.2	-10.7	2.3%	-31

Source: State Street Global Advisors, JP Morgan as at 30 September 2020. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. * Country and currency performance of JP Morgan GBI-EM Global Diversified Index. **Index impact is calculated by multiplying the period end weight by total return.

[1] Source for flows: Morgan Stanley

While **Dominican Republic** (market friendly general election results, rising gold prices), **Uruguay** (relatively effective virus control, small fiscal deterioration) and **Philippines** (benign inflation, central bank support) saw strong returns over Q3 from their local currency bond components, their contribution to index returns were negligible due to low weights.

Romania performed well, returning 6.3% and contributing +18 bps to index returns. Its currency strengthened in tandem with the strengthening of EUR/USD in Q3, as European Union leaders struck a deal on the €750 billion coronavirus recovery fund aimed at helping hard-hit bloc members recover from the economic fallout of the pandemic. The eurozone is Romania's main trading partner. Romania's inflationary pressures in the aftermath of COVID-19 were less visible than for other CEE countries, and while its inflation rate is lowest in the CE4 context, its policy rate remains the highest. The National Bank of Romania delivered one interest rate cut in Q3 at its August meeting, and market participants expect a further 25bps cut in October.

Mexico delivered returns of +5.7% for the three months, mostly through its FX channel, and was the largest contributor to index returns (+55 bps). The MXN continued its recovery in Q3 after a sharp selloff earlier in the year (Q1:-19.5%) as the country's sectors linked to the US economy, such as manufacturing, have recovered back to pre-COVID levels, in part due to the substantial fiscal stimulus in the US. The central bank of Mexico cut its overnight rate target by 25bps to 4.25% on September 24 in line with consensus, and has delivered cuts totaling 275bp since its March 2020 decision. It has admitted to having limited room for further easing in its latest policy statement however, as it continues to face a difficult trade-off with weak growth and high inflation.

Turkey was the worst performer, returning -13.8% in the quarter, and was the second largest detractor (-31 bps) from index returns. In a surprise move, Turkey's central bank raised its policy rate by 200bps to 10.25% on 24 September and reinforced tightening steps to contain inflation that stood at 11.7% and limit upside risks to the inflation outlook. Investors have been cautious of Turkey's consistent overshooting of its 5% inflation target, low central bank credibility and its large current account deficit, in addition to the country's political risks in relation to its activation of its Russian S400 anti-aircraft missile system.

Russia returned -8.2%, almost all of which came through the FX channel and it was the largest detractor (-68 bps) from index returns. A multitude of geopolitical risks has combined with a surge in COVID-19 cases to erode investor confidence in Russian assets. Part of this weakness seems to have been caused by investors taking out hedges against the ruble to protect positions in Russian government bonds, on the prospect of new sanctions from the West. Even though the Bank of Russia said that it would increase foreign currency sales to $2 billion over the next three months, market participants believe that it would not be enough to reverse the ruble's slide.

Brazil was among the worst performers in Q3 (-3.3%) and was a significant detractor from index returns (-29 bps). The Brazilian real weakened over the quarter, and bonds sold off as well on fiscal concerns as debt reaches 90% of GDP. The commitment to fiscal prudence, both in the executive and legislative branches, as well as the reformist agenda that kicked off in 2019 with the new administration, remain uncertain. The recurrent tensions between President Bolsonaro and important elements of the political establishment which are required to pass unpopular fiscal reform measures have not helped to ease market concerns.

Hard Currency Market Highlights

Figure 5 - Key return drivers of EM hard currency government bond markets in USD

EMBI GD (EM Hard Currency)	Monthly Return	3 Month Return	YTD Return
Total Return	**-1.85%**	**2.32%**	**-0.51%**
Spread Return	-1.94%	2.59%	-9.59%
Treasury Return	0.09%	-0.26%	10.05%
IG Sub-Index	-0.61%	2.58%	5.79%
HY Sub-Index	-3.38%	1.99%	-7.80%

Sources: State Street Global Advisors, Bloomberg, JP Morgan as of 30 September 2020. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Performance returns for periods of less than one year are not annualized.

EM Hard currency sovereign debt was up 2.32% in Q3, as measured by the JP Morgan EMBI Global Diversified Index. EM HC spreads tightened by 42 bps in the quarter on the back of overall positive risk appetite amid strong equity performance; investor sentiment was bolstered by steadily improving EM economic data, stable oil prices after the slump earlier in the year, and improving prospects for a COVID-19 vaccine. Recent successful restructurings in Ecuador and Argentina have also provided broader positive signaling effects for the distressed EM sovereign segment. The US Treasury curve initially flattened, but as the average inflation targeting framework was announced by the Fed, it steepened again to end the quarter roughly where it started. EM Hard Currency (HC) has recovered from the COVID-related outflows earlier in the year and flows for the year to date are now positive at about $1.0bn.[2]

Figure 6 - Best and worst performers across EM hard currency government bond markets*

Third Quarter 2020	Country	Total Return (%)	Spread Return (%)	TSY Return (%)	Index Weight	Index Impact (BP)**
EMBI Global Diversified		**0.51**	**1.88**	**-1.35**		
Top 5 Performers	Suriname	36.6	36.4	0.2	0.0%	2
	Venezuela	21.9	21.9	0.0	0.0%	0
	Ecuador	10.9	12.2	-1.1	1.3%	14
	Dominican Republic	9.1	9.9	-0.7	2.5%	22
	Barbados	8.6	8.3	0.2	0.1%	1
Bottom 5 Performers	Mozambique	-2.7	-2.8	0.1	0.1%	0
	Ghana	-3.0	-3.2	0.2	1.2%	-3
	Cote D'Ivoire	-3.4	-3.5	0.1	0.5%	-2
	Zambia	-4.2	-4.4	0.1	0.2%	-1
	Lebanon	-11.2	-11.3	0.1	0.3%	-4

Source: State Street Global Advisors, JP Morgan as at 30 September 2020. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. * Country and currency performance of JPM EMBI Global Diversified Index **Index impact is calculated by multiplying the period end weight by total return.

Suriname was the best performer and saw returns of +36.6% over Q3, although its contribution to overall index returns was small (+2 bps). Suriname spreads tightened in the quarter – aided by the rally in gold, and from the debt restructuring that it completed in July.

[2] Source for flows: Morgan Stanley

Ecuador was among the best performers, returning +10.9% and contributing +14 bps to index returns. Both S&P and Fitch upgraded the country's HC debt rating to B- in early September, reflecting the completion of a distressed debt exchange that settled its default earlier in the year. Despite deep economic challenges and political uncertainty, the distressed exchange has helped support repayment capacity by reducing near-term debt service costs and paved the way for a new 27-month $6.5bn Extended Fund Facility with the International Monetary Fund (IMF).

Dominican Republic was among the best performers, returning +9.1% and contributing +22 bps to index returns. Spreads on its bonds tightened as the recently-elected president Luis Abinader is seen as market-friendly with the capability to pass reforms and implement adjustments that could be necessary in the aftermath of the COVID-19 crisis. The country's recent economic data have also shown a relatively fast recovery from the lows of April, reducing the risk of a double-digit contraction.

Lebanon was the worst performer, returning -11.2% over the quarter, and detracting the most from index returns (-4 bps). Lebanon spreads continued to suffer in Q3 in the absence of key steps toward plausible economic and fiscal policy reform and the failure to secure an IMF deal. Market participants expect its debt-to-GDP ratio to exceed 375% by the end of 2020, which would be the highest ever in the world. S&P downgraded more Lebanese government debt issues on August 21 after missed payments, citing the country's worsening economic crisis. It maintained the SD (selective default) rating for Lebanon's foreign debt, after the country first defaulted in March, but three more bonds were cut to D from CC.

African countries such as **Ghana**, **Cote D'Ivore** and **Zambia** saw modest negative returns with minor impact on index returns on broad concerns around debt sustainability as they continued to use available lines of credit to secure resources to fight the COVID-19 pandemic. The shock dismissal of Zambia's central bank Governor Denny Kalyalya in August without any specified reason also raised concerns among investors, who saw him as a credible governor trying to keep a spendthrift government in check.

Source: State Street Global Advisors, JP Morgan as at 31 August 2020. Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends

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