Within *Focus* we comment on extraordinary market events and analyse capital market related special topics.

Emerging markets debt: more room to run

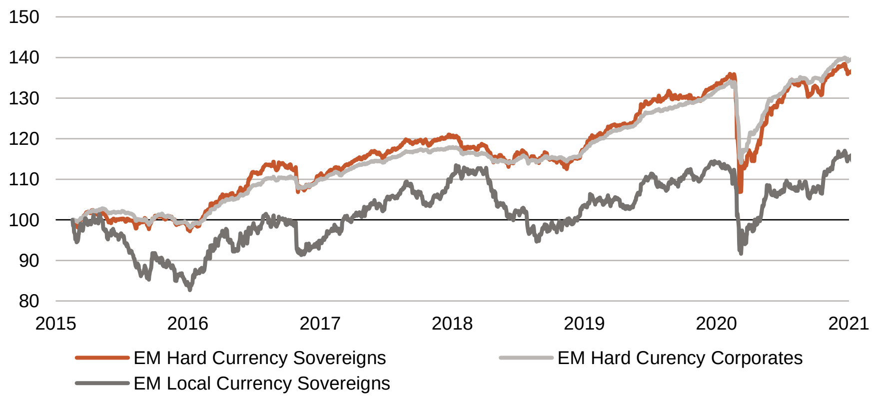
Positive ending for 2020 as fundamental tailwinds grow

EM debt in 2020 – volatile at first – resilient at last

2020 was as one of the most volatile years for emerging market (EM) debt, but in the end displayed the asset class's resilience once again. High returns in the asset class are not easy to come by – navigating its volatility is the key – and 2020 was the perfect example for it. The asset class suffered the worst quarterly drawdown in almost 20 years in the first quarter, only to be followed by its second-best quarterly return. Despite temporary volatility levels as high as those during the global financial crisis, all segments of the asset class finished the year in positive territory (see Chart 1). EM sovereigns returned 5.3%[1], benefiting from significant spread tightening in the fourth quarter, as well as from their longer interest-rate duration profile in an environment of declining US Treasury yields. This also helped EM corporate bonds, which returned 7.1%, outperforming their sovereign counterpart not only on an absolute, but also on a risk-adjusted basis, experiencing lower levels of volatility during the depth of the crisis. Meanwhile, local currency debt gained 2.7%, predominantly driven by a strong fourth quarter rally in EM currencies.

Chart 1: EM Local debt has lagged EM hard currency debt in recent years

Performance EM HC Sovereigns, Corporates and EM Local Debt (all in USD)



Date: 02.03.2015 - 02.03.2021
Source: Bloomberg, JP Morgan

A fundamental recovery paves the way

We expect that 2021 and beyond can get even better. In an environment of a global growth recovery, attractive asset class valuations, ongoing monetary and fiscal stimulus and less aggressive geopolitics support EM debt, despite the fundamental issues of rising debt burdens and inflation. This opportunity becomes even more attractive considering the still very low, or even negatively yielding, debt in the developed world (see Chart 2). Positive market technical, such as the supportive demand-supply-balance, diversification benefits and superior risk-adjusted returns mean that more and more investors add more EM debt to their portfolios. However, they need to be aware of the characteristics and differences of EM debt instru-

[1] All return figures are quoted in USD.

ments. They also need to understand what market environments and what type of instrument can add the most value for investors, both from a fixed income, as well as from a multi-asset perspective.

Fundamental drivers: almost all flashing green for EM debt

The COVID-19 pandemic has reshaped economies and markets. The recovery path will be vital for this year and beyond. In the past, EMs have often prematurely been declared to come off as the winner of crises, just to realise later that this assessment was flawed. This time it might be different, as a global macroeconomic recovery, solid bottom-up fundamentals within many developing nations, as well as attractive valuations and positive market technical are all favourably aligned.

Emerging markets benefit from the combination of monetary and fiscal support from major central banks

Significant monetary and fiscal stimulus measures from the world's largest economies are fuelling global economic growth. The world's major central banks have flooded their systems with liquidity and interest rates have gone to zero or even negative. This creates a positive backdrop for investing in higher-yielding EM debt. The US's central bank (Fed) recent introduction of a new monetary policy framework, which allows for inflation to overshoot, suggests that monetary policy could remain lax for years to come. The same is true for the European Central Bank (ECB), not least as peripheral member states such as Portugal and Ireland suffer to a much larger extent from COVID-19 than their neighbours and, therefore, might require monetary stimulus for much longer than originally anticipated. Therefore, short term interest rates should remain artificially capped on both sides of the Atlantic, even as both regions return to significant growth in 2021 and beyond.

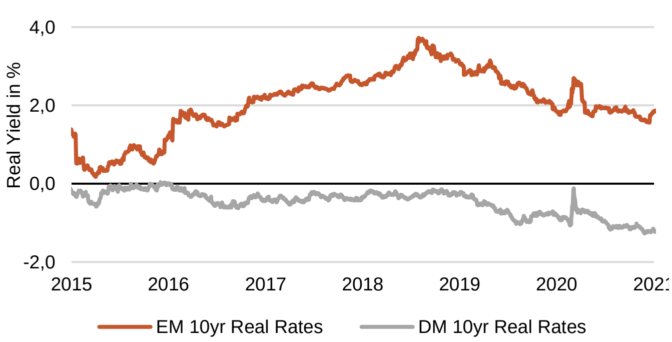
Interest rates in the developed world remain deeply negative. After adjusting for inflation, EM interest rates offer a significant uptick

EM growth rates dropped less than their pendant in the developed world in 2020 – and will rise even more in 2021

The tandem of central bank's ongoing monetary policy support and massive fiscal support packages from policymakers should propel annual growth figures for 2021, and beyond, above pre-COVID-19 crisis levels (see Chart 3). Global growth should reach its highest levels in many years, with EMs leading the way. In fact, developing nations, which contracted less than developed markets (DMs), are now expected to recover at a faster pace.

Chart 2: EM real rates solidly positive in contrast to DM real rates

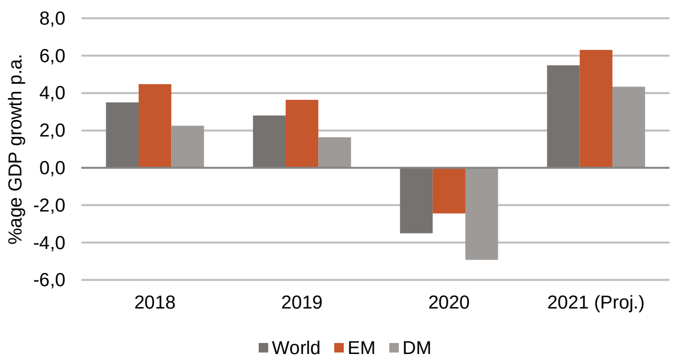
EM real rates (equally weighted average of 10yr real rates of Turkey, Russia, South Africa, Brazil, Mexico, Indonesia) versus DM real rates (equally weighted average of 10yr real rates of US, Europe, UK, Japan, Australia)



Date: 15.01.2015 - 15.01.2021
Source: Bloomberg, own calculations

Chart 3: EM economic growth continues to outperform

Historical annual growth rates since 2018



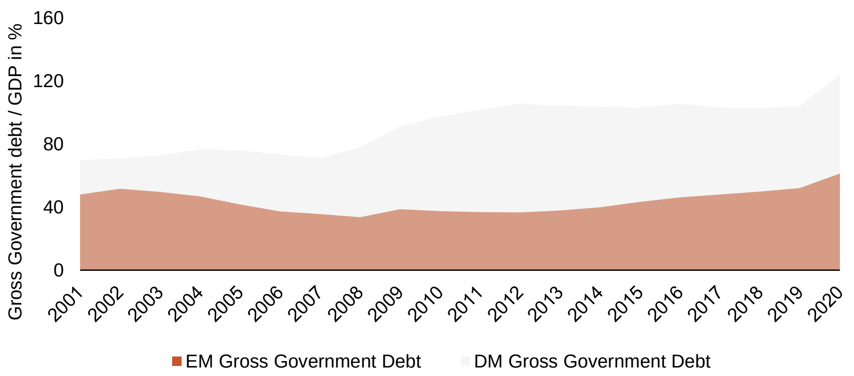
Date: as of Jan 2021
Source: IMF GEF 2021

Of course, crises, and subsequent recoveries, driven by monetary and fiscal support, come with a cost; in the short term, bankruptcies and unemployment and, in the longer-term, the risk of debt sustainability. According to the International Monetary Fund (IMF), the COVID-19 crisis has increased developed economies' budget deficits by 11% of GDP in 2020, but just by 6% in EMs.

EM with lower budget deficits and lower debt to GDP ratio than DM

In 2021, government debt is expected to rise to 125% of GDP in advanced economies, compared to only 62% in EMs (see Chart 4).

Chart 4: Lower leverage - Gross Government Debt in EM roughly half of that in DM



Date: as of Jan 2021
Source: IMF GEF 2021

Elevated debt levels are going to be sustainable if rates stay low, locally and/or in USD and EUR (for those nations that refinance substantially in those hard currencies). Some EM countries have seen their lowest domestic interest rates in history, enabling them to initiate quantitative easing-type policies to further secure liquidity in their markets and for outright financing for pandemic-related spending. Meanwhile, fundamentally slightly weaker sovereign issuers, such as Paraguay and Guatemala for example, have been supported by emergency lending programs from the IMF without many of the usual list of policy conditions and reforms, as the focus was the maintenance of debt sustainability during the heights of the COVID-19 Crisis. Therefore, EM debt fundamentals are beginning to stabilise on the back of improved growth expectations, as well as external bridge-financing. This, together with major central banks on hold and, at present, well-anchored inflation expectations in most EMs, should bode well for future investments in EM debt.

Improved growth and low financing costs should stabilize debt fundamentals De

China's strength is adding to the case for EM debt. The country emerged quickly from the pandemic and even showed positive growth rates for the full year of 2020. The economic activity in China is regarded as a leading indicator for EM (excluding China) growth. As the nation is revving up again as the world's growth engine, many developing countries, most of them exporting heavily to China, will benefit. A related issue is the recovery in the commodity sector. For many EM nations, particularly oil exporters, the COVID-19 crisis has been amplified by the fall in commodity prices. While very few commodity importers have temporarily benefited, notably India and Turkey, the overall impact on EMs is rather negative. Now, one year after the pandemic really began, commodity prices have rallied back sharply, reflecting – more than any other sector – the early stages of a global economic

The pick-up of economic activity in China, the recovery of commodity prices and reduced geopolitical risks bode well for EM debt recovery. This further supports many EMs. Finally, geopolitical risks, predominantly between China and the US, also appear to have abated.

Even as inflation rises, the US Federal Reserve will keep financing conditions in check – and preserves global financial stability

The Fed's comfort with a sustained rise in inflation[2], coupled with the prospects of a strong US infrastructure-focused fiscal stimulus package, paves the way for a scenario in which a further depreciation of the USD against the EUR is less likely in the short-run, while weakening versus cyclical EM currencies is more likely. This is because US fiscal spending could push the US as the global engine for growth this year[3]. At the same time, the Fed will do everything to ensure that any possible US real-yield rises remain non-threatening to global financial stability. This, together with investors participating in the economic recovery trade by shifting out of USD denominated safe-haven assets, or even USD cash positions, could then open the door for a more structural USD depreciation. "Weakening" USD trends have generally been good for EM debt in the past.

A structurally weaker US Dollar tends to be good for EM debt investments

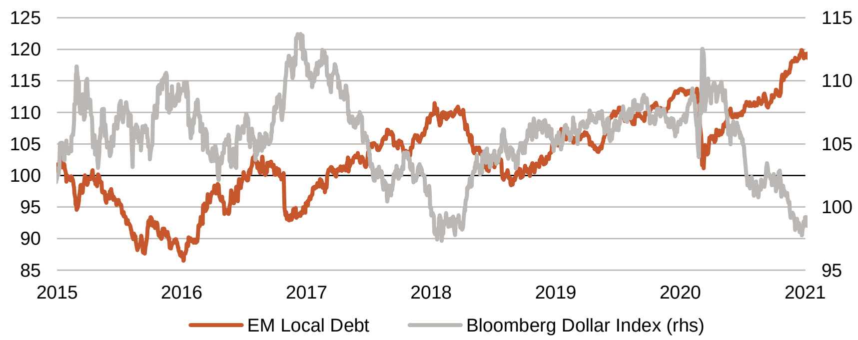
This trend could have two positive impacts on EM debt. It becomes easier for Ems to finance fiscal and external deficits and it improves balance sheets for sovereigns with negative net international investment positions. This would lead to smaller current account deficits and less need for capital inflows to cover those deficits. Their overall economic position would improve, and their respective currency, first stabilises, and then appreciates against the USD.

Strong demand for EM debt as witnessed by sold EM bond fund flows in recent months

Technical drivers: a very favorable supply-demand balance for EM debt

There is currently strong investor demand for EM debt. Following the sharp and dramatic outflows during the first peak of the COVID-19 crisis in mid-March of last year, EM debt inflows, particularly into hard currency bonds, resumed rather quickly – with inflows now adding up to almost USD60bn over the course of the last six months. Learning from experiences of the past, flows are poised to recover further in years after crisis events. Leading EM debt broker-dealers[4] expect another USD60-70bn of inflows for the remainder of 2021.

Chart 5: Weakening USD bodes well for recovering EM local debt (in USD)
Over time, the negative correlation between the USD and EM local debt becomes quite obvious



Date: as of 26 Feb 2021
Source: Bloomberg, own calculations

[2] At its meeting on 16 September 2020, the U.S. Federal Reserve announced that with inflation running persistently below the longer-run goal of 2%, they will aim to achieve inflation moderately above 2% for some time so that inflation averages 2% over time and longer term inflation expectations remain well anchored at 2%.
[3] IMF World Economic Outlook, Update January 2021 (https://www.imf.org/en/Publications/WEO/Issues/2021/01/26/2021-world-economic-outlook-update)
[4] JP Morgan EM Outlook and Strategy for 2021. See p5.

Indeed, there are good reasons to expect further inflows. For one, the above described fundamental drivers, particularly the global growth momentum, favour cyclical asset classes, such as EM debt, from an investor's perspective. For another, the low-yield environment fuels the yield-seeking push from investors. Chart 6 reveals that both conditions are, indeed, looking very favourable at present.

Cyclical inflows into EM debt are set to continue

But even beyond these cyclical aspects, there are good reasons to believe that flow into the asset class will continue as the high return perspectives and diversification benefits make EM debt attractive for investors in a structural sense. EM debt broadens multi-asset portfolios by differentiating versus DM sovereign exposure, currency exposure, different corporates, sectors and yield curves. EM debt, particularly local currency debt, offers a lower correlation than the rest of the portfolio, especially in periods of heightened volatility, when "classical" risky assets, such as global stocks, tend to perform poorly. An investment in EM debt should, therefore, be a welcomed return enhancing, as well as a diversifying, element in a multi-asset fixed income portfolio mix.

Higher returns and diversification benefits should result in continuous structural and strategic demand from investors

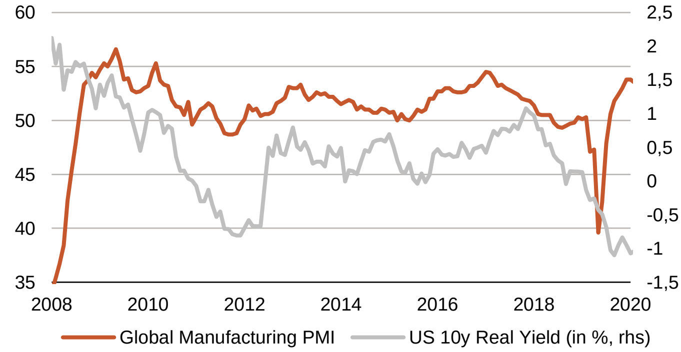
In addition, and against the widespread opinion that EM debt can only outperform in an environment of stable or falling US Treasury yields, EM debt has often shown remarkable resilience in an environment of rising US interest rates. Furthermore, as research from Morgan Stanley points out, in past periods where 10yr-US Treasury yields moved higher, if the move was mainly driven by rising inflation expectations (so called break-evens[5]), EM fixed income and EM currencies have performed rather well[6]. The current upward move in US Treasury yields was so far, predominantly, driven by rising inflation expectations of investors (see Chart 7).

EM debt can perform in a falling or rising US Treasury yield environment

On the supply side, primary market issuance is set to be lower than in 2020, which is not completely surprising, as the second half of last year, in particular, has seen a massive issuance of predominantly sovereign debt. Most countries tested markets in order to finance their ballooning fiscal deficits resulting from the funding of quick

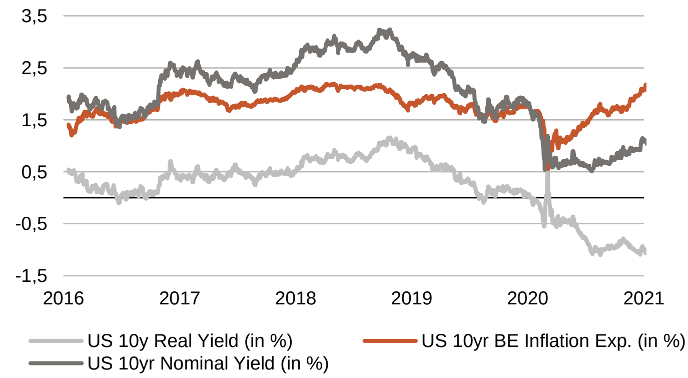
Supply of EM debt to slow down

Chart 6: Cyclical support for EM debt demand, global growth momentum and a low interest rate environment are both supportive



Date: as of 26 Feb 2021
Source: Bloomberg, own calculations

Chart 7: Rising inflation expectations have, so far, mainly driven the rise in nominal yields



Date: as of 26 Feb 2021
Source: Bloomberg, own calculations

[5] The breakeven inflation rate is a market-implicit expression of expected inflation. It equals the difference of the yield of a nominal bond and an inflation-linked bond of the same maturity. The yield of an inflation-linked bond is often called "real yield", as it represents the real interest on an asset after deducting inflation.
[6] Morgan Stanley Global EM Strategist: "How would a UST sell-off affect EM?" (November 2020)

COVID-19 relief packages. This pressure should start to ease going forward; therefore, sovereign bond supply is expected to slow down. A slightly different picture emerges on the EM corporate side, with issuance expected to rise modestly[7]. This is also not surprising, as companies will have to deal with the aftermath of business fallouts from the pandemic. However, this should not be a set back, as the overwhelming demand for EM debt, particularly visible during the latter half of last year, should easily absorb any excess supply that might come.

Emerging markets debt: understanding the available instruments

When market participants consider an investment in EM debt, they have a choice between three distinct segments: EM hard currency sovereigns; EM hard currency corporates; or EM local debt.

EM hard currency sovereigns

The performance of EM hard currency sovereign debt depends on the direction of credit spreads and US Treasury yields

EM hard currency bonds are issued by EM countries, and are predominantly denominated in USD and, to a minor extent, in EUR. Contrary to European or US credit, EM hard currency debt usually comes with an average duration of 8-9 years, which is due to the fact that most sovereigns tend to issue in maturities of 10 years, or even longer. This means that the associated risk and return drivers are mainly movements in US Treasury interest rates and the inherent credit risk in the EM sovereign itself. The latter is the so-called risk-premium, or credit spread. At a level of currently around 3.65ppt, investors receive a nice compensation for taking on EM sovereign exposure, particularly when comparing this to much lower-yielding, or even negatively-yielding, DM sovereigns.

When EM central banks shift from crisis management to recovery management, country differentiation will be key

Individual EM countries need to be thoroughly analysed from a fundamental and macroeconomic perspective. The almost "V-shaped" sovereign bond recovery in the second half of 2020 was very homogenous in nature (ie it affected all sovereign participants to more or less the same extent in the upswing) – as all have been battered down extensively during the depth of the COVID-19 Crisis. As EM policymakers now shift from crisis management to recovery management, the next step of the recovery will be different. From an investor's point of view, a larger number of countries in the portfolio usually provide a higher degree of diversification. Yet we anticipate that country differentiation will become even more crucial going forward.

Fundamentals will matter again, with most attention on the interaction of long-term growth versus debt sustainability

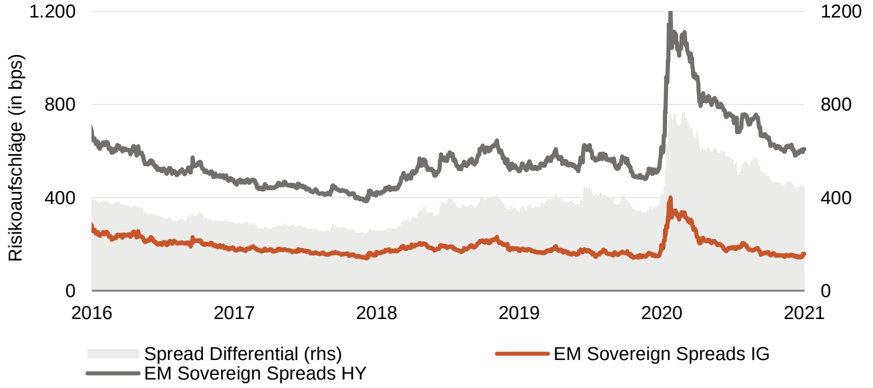
Many EMs saw weaker economic growth for almost 10 years already prior to COVID-19, as terms of trade deteriorated and many of them failed to implement structural reforms. While a global economic rebound will help, worries over EM's longer-term growth paths and debt sustainability are likely to persist. On a portfolio management level, a thorough country selection process is crucial. Particularly the impact of higher debt burdens in emerging countries is something investors should emphasise when making investment decisions. One should not solely focus on the magnitude of rebounding growth, but also have a look at the upcoming development of a nation's budget balance. How is a country managing its increasing fiscal expenses? Are foreign currency (FX) reserves rising again? Is the country re-attracting foreign direct investment inflows? How exposed is the country to cyclical factors, such as commodities?

[7] JP Morgan EM Outlook and Strategy for 2021. See p.5.

Arguably, countries with investment grade ratings have done better than their high yield counterparts, as sovereign spreads have tightened from their highs in March and April of last year, quickly back towards where they were before the pandemic. Therefore, investment grade does not offer much room for spread tightening or a substantial cushion against a potential rise in US Treasury yields. As high yield sovereigns represent the more cyclical part of the segment, and spreads are not even close to their levels at the beginning of 2020, we see pockets of value here, both from a valuations standpoint, as well as a segment that could better withstand a US Treasury yield shift upwards (see Chart 9).

High yield sovereign spreads look attractive on an absolute and on a relative base versus its investment grade counterpart

Chart 9: EM hard currency sovereign HY spreads look attractive: absolute as well as relative

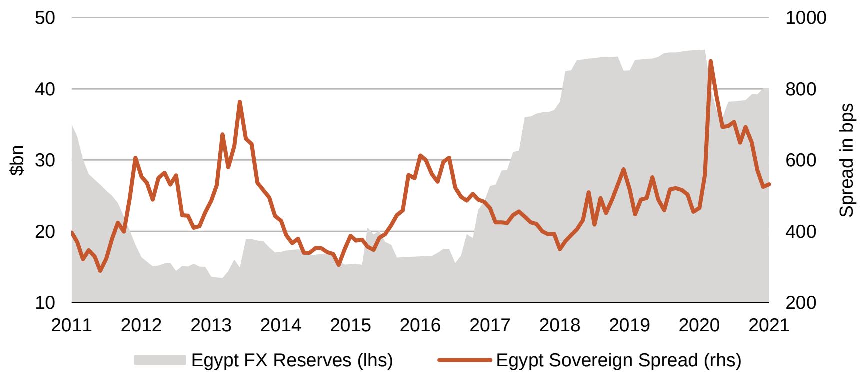


Date: 01.03.2016 - 01.03.2021
Source: Bloomberg, JP Morgan

In terms of country selection, Egypt represents a perfect example for the high yield sector. The country, which has the tourism sector as one of the primary sources of income, was hit hard during the COVID-19 crisis, but has since shown a remarkable resilience against the impact of the second wave of the pandemic. FX reserves have recovered more than 50% of its experienced drawdown last year, now standing again above USD40bn (see Chart 10). The country will be one of the few EM countries to finish 2020 with growth[8] and, according to the IMF's latest world economic update report, annual growth will be back above 5% in 2022. Finally, the nation is benefitting from a favourable maturity-debt profile, as it has no bond redemptions outstanding for all of 2021, and only one for 2022.

Egypt's bond market can benefit from a fundamental recovery

Chart 10: As FX reserves recover in Egypt, sovereign spreads should tighten further



Date: 31.01.2011 - 31.01.2021
Source: Bloomberg, IMF, own calculations

Of course, a delay in mass vaccinations poses a recovery risk, particularly in terms of re-opening tourism, but with a spread of more than 500bp above corresponding US Treasury rates, we value the nation as one of the most compelling high yielders.

Table 1: Representative IG and High Yield countries, 10yr bond yields & spreads

	Egypt	Indonesia
Credit rating	B/B2	BBB/Baa2
Average duration	7.13 yr	9.43 yr
Average yield	6.80%	3.30%
Average spread	534bp	164bp

Date: as of Feb 26th 2021
Source: Bloomberg, JP Morgan

EM hard currency corporates

EM hard currency corporates is a remarkably resilient asset class

In addition to EM governments, many companies in these countries also issue attractive bonds in hard currency. The EM corporate space has often been overlooked by investors in the past – having been seen as too complex to understand and too difficult to look-through, and, therefore, too risky to invest in. The truth is that EM corporates have been, not only during the depth of COVID-19, but also beforehand, a remarkably resilient asset class.

A universe of more than 700 issuers in EM hard currency corporates offers investors a broad choice

In order to get a better understanding of EM corporate debt fundamentals, it helps to break down the underlying investment universe[9], which is in fact larger than that of EM sovereigns. Whereas the sovereign space consists of more than 160 nations, the corporate universe contains more than 700 corporate issuers. Therefore, just the sheer size and breadth of EM corporate securities presents a good opportunity to enhance portfolio diversification.

Corporates have on average higher credit quality than sovereigns in the EM hard currency space

As previously mentioned, the EM corporate space is often described as being a riskier EM debt segment than sovereigns, probably because investors are worried about a lower degree of transparency when dealing with corporates instead of sovereigns. Looking into a little bit more detail, the opposite is true. At first there is no huge difference in the average credit quality for EM corporates (BBB-/BAA3) and EM sovereigns (BBB-/BA1). However, an analysis in terms of credit rating shows that 27.7% of the sovereign segment is comprised of B- and C-rated debt, which is 10% higher than EM corporates.

The EM hard currency corporate market is tilted towards Asian issuers

This credit quality advantage has mostly been seen since the Asian region, which represents almost 40% of all EM corporate issuance, has been the primary driver of new high-grade issuance within the asset class. New bond deals out of Asia typically find good support from local market participants that are eager to invest in USD-denominated bonds from domestic companies.

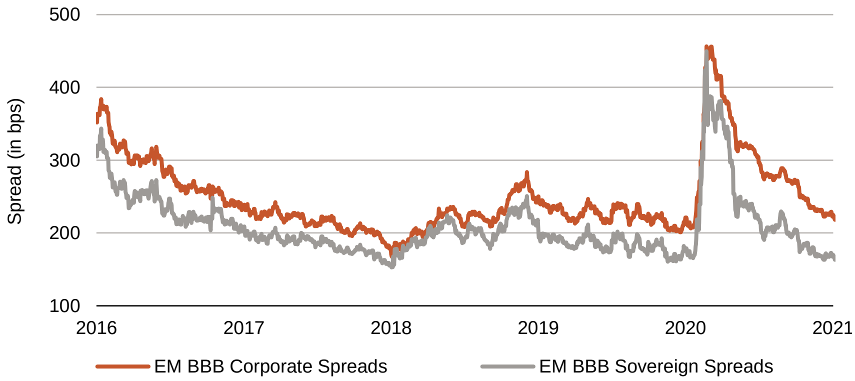
EM hard currency corporates come on average with less duration than sovereigns, but offer a higher spread

Also looking at another risk factor, namely interest-rate sensitivity, EM corporate bonds have, on average, a lower duration than their sovereign counterpart. EM corporate issuers typically prefer to issue bonds in the 5-10-year maturity spectrum, whereas EM sovereigns have shifted their maturity profile further out into the 10-30-year maturity sector. Therefore, when adjusting for credit ratings and duration,

[9] As a reference for the EM corporate investment universe, the JP Morgan Corporate Emerging Market Bond Index Broad Diversified (CEMBI) is used, which tracks total returns for US Dollar-denominated bonds issued by Emerging Market domiciled corporates.

EM corporates offer an attractive, and rather constant, spread premium compared to EM sovereigns (see Chart 11).

Chart 11: A nice spread pick-up for less duration risk



Date: As of 26 Feb 2021
Source: Bloomberg, JP Morgan

From a regional perspective, EM Asia shall lead the corporate recovery, with Latin America lagging, but catching up due to their high commodity sensitivity

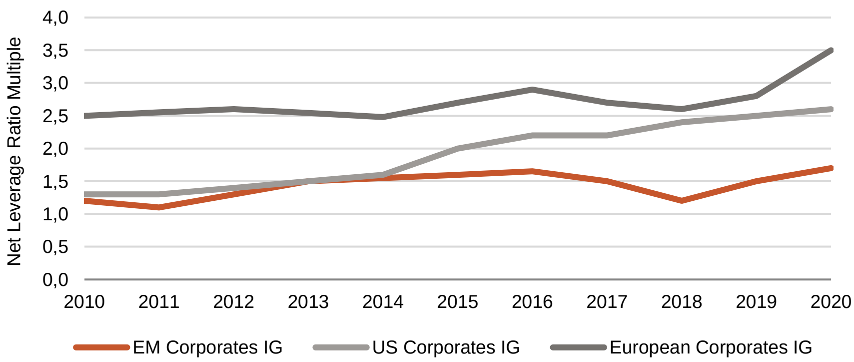
From a fundamental point of view, EM corporate issuers lived through challenging quarters in 2020, with earnings being hit across all sectors in all regions. However, comparable to sovereigns, the recovery began already in the fourth quarter of last year, with Asian companies leading and Latin American corporates lagging. The latter, however, is expected to participate over-proportionally in a continuation of the recovery in commodity prices, with some of the biggest metals' producers, particularly miners from Brazil for example, with heavy export activities in Asia.

EM corporate's credit metrics look ok – despite earnings being hit in 2020 due to the Corona Crisis

In fact, EM credit and debt metrics, which had been remarkably robust already before the COVID-19 crisis, have barely been suffering. Thanks to prudent and careful balance-sheet management, EM corporates are entering this recovery period with healthy credit metrics. This is since most EM companies deploy conservative corporate finance behaviour, and have, despite profits being down, large amounts

Chart 12: EM Corporates are less levered than their counterparts in Europe and the US; that picture has barely changed over the last year

Net Leverage Ratio = Net Debt to EBITDA for a trailing twelve-month period. Historical comparison between EM Investment Grade Corporates and its pendant from the US and Europe.



Date: 31.12.2009 - 31.12.2020
Source: JP Morgan

of liquidity on their balance sheets that keeps their net leverage ratios low and stable (see Chart 12). Another positive to look at, from a bondholder's perspective, are the continuous low capital expenditures in many sectors, such as the financial space for instance, with the majority of past- and future-debt issuance focused on refinancing, rather than capex-related funding.

When looking at EM sovereigns and EM corporates, in terms of the timing of portfolio allocations, investors must be aware of certain things. EM corporates are in fact the more defensive asset class, due to their lower duration and their higher credit quality, as described before, but also due to their geographically diverse institutional investor base. This functions as a form of anchor to not let volatility get out of hand. This "stickiness" of corporate assets comes with a cost, in the form of higher transaction costs, compared to EM sovereigns. EM government bonds are the more directional bond segment. The higher degree of "directionality" is mainly due to the high involvement of shorter-term gain-oriented ETF-flows, as well as the much easier possibility of taking a short position. EM sovereigns will perform better in recovery periods, but also experience bigger drawdowns in market sell-offs.

EM corporate's institutional investor base is well diversified, with flows less driven by tactical ETF positioning

Apart from this pure market beta perspective, market participants are inclined to invest into EM sovereigns when there is: a favourable view on a country; a limited opportunity to invest in corporates due to liquidity or issue size reasons; or dislocations, in terms of valuations of corporates relative to the country. Speaking of relative value, another aspect which investors must keep in mind is active curve tenor management – often EM corporates have only a limited number of bonds outstanding. EM sovereigns generally have a larger maturity spectrum, with numerous bonds and offer the opportunity to take tactical curve and duration positions.

EM corporates have more issuers, but fewer bonds per issuer than sovereigns, making sovereigns more suitable for tactical positioning

EM local debt

Probably the most cyclical investment opportunity, EM local debt benefits most from a sustained global economic recovery. EM local debt means bonds issued in the local currency of the EM issuer rather than in USD or Euro. In this bond space, there are just sovereign issuers as developing countries do not have liquid domestic corporate bond markets. If at all, local currency debt is issued by EM corporates in the form of debt certificates.

Table 3: Major Differences between EM Corporates, EM Sovereigns and EM Local Debt

	EM hard currency sovereigns	EM hard currency corporates	EM local debt
Constituents	Sovereigns; quasi-sovereigns	Corporates; financials	Sovereigns
Major Index	JP Morgan EMBI Global Div	JP Morgan CEMBI Broad Div.	JP Morgan GBI EM Global Div.
Credit Rating	BB+/Ba1	BBB-/Baa3	BBB/Baa2
# of countries	74	60	19
# of issuers	166	751	19
Average Duration	8.44	4.99	5.28
Average Yield	4.48%	4.27%	4.54%
Average Spread	324bp	299bp	-

Date: as of 31 Jan 2021
Source: JP Morgan

In previous years, there was a heightened amount of optimism that EM local debt was ready to be the best performing EM debt segment, and each year market participants have been disappointed as EM local debt underperformed its hard currency

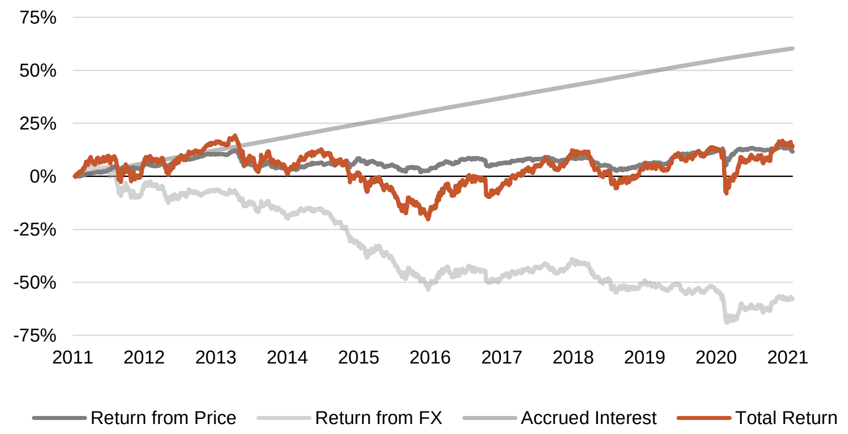
The Corona crisis might have turned the corner for EM local debt.

counterpart, in most years by a significant margin. So now, as strange as it sounds, the COVID-19 crisis might just have been the turning point for EM local debt to perform better in the years to come.

Sovereign risk in EM local debt is driven by the movement of the domestic currency, rather than credit spreads

For EM Local debt, currencies, rather than spreads, are the major issue. Whereas investors in EM hard currency sovereign and corporate debt are exposed to spread risk relative to the hard-currency yield curve, market participants in EM local debt are exposed to currency risk. This means that if EM hard currency bond prices fall due to spreads widening in a market risk-off scenario, EM local bond prices tend to fall due to currencies depreciating against the USD. In the past, often EM Local was presented in an oversimplified fashion, such as "a lower duration, high carry investment, where high coupons from local EMs will compensate for higher investment volatility, which might come with it". To really understand the performance of EM local debt, one must break it up into its driving forces. The poor performance of EM local debt is, to a very large extent, coming from the local currency component. If a US investor had invested USD100 in an EM local debt basket[10] exactly 10 years ago, his total return would have been 16.8%, despite collecting an average local coupon of 6.2% each year. The chart below perfectly illustrates that almost the full amount of accumulated carry was captured by negative currency performance (see Chart 13).

Chart 13: Over a 10-year holding period, there is not much left other than price performance



Date: 26.02.2011 – 26.02.2021
Source: Bloomberg, JP Morgan, own calculations

In a fundamental recovery, EM currencies can benefit from rising growth in combination with favourable terms of trade

The "turning point" for EM currencies to start appreciating could be the global economic recovery, in combination with a significant pick-up in economic activity. This, in turn, should increase the demand for goods and services from Ems as those countries, after years of currency devaluation, are offering favourable terms of trade, adjusted for inflation. In other words, one could purchase product X domestically for USD10, or take advantage of the favourable exchange rate, and exchange these USD10 into 36 Peruvian sol, which will have the purchasing power of two products in Lima. As most of these products are commodities, and as discussed previously, commodity prices are expected to rise with an improved economic

[10] As a reference for the EM local debt universe, we refer to the JP Morgan Government Bond Index EM (GBI EM) which tracks total returns for debt instruments issued by Emerging Market sovereigns in domestic currency.

recovery outlook along with supressed demand for save- haven currencies – like the USD – EM currencies should be able to benefit. In fact, looking at the direction of commodity prices, and USD in general, gives investors a good idea on where EM currencies are heading, but there is one more technical factor that gives us confidence about an upward path for EM local debt (see Chart 14).

In the past, many investors shied away from local debt investments due to the elevated political risk premium

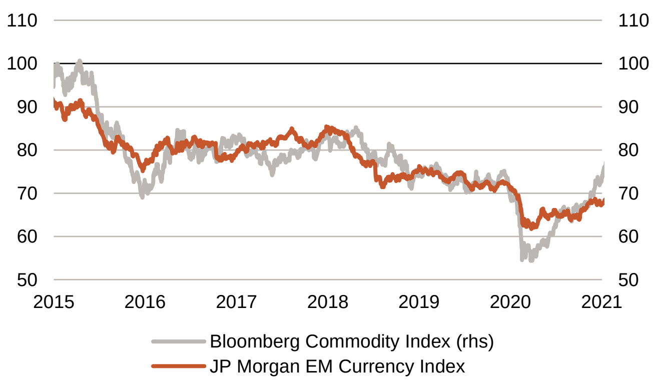
The unprecedented level of policy uncertainty during the past four years, mainly created by the US administration under former president Donald Trump, generally increased the risk premium in EM assets, and this was specifically visible in EM currencies. This was true particularly over the course of the last two years, when sudden and sometimes random spikes in volatility stopped investors out of their local debt positions. This happened even though investors gained on their long local duration positions, as local interest rates fell while EM central banks took advantage of monetary policy manoeuvring room that opened when the Fed cut interest rates close to zero. Therefore, being invested in EM local debt is now the opposite of a crowded trade[11]; investor positioning is low and clean, which is a situation that bodes well for an asset price recovery.

The direction of local currencies determines the direction of capital flows in EM local debt

Against the backdrop of a global macroeconomic recovery, EM currency volatility should decline, and capital inflows into the asset class would further increase. This, in turn, makes EM local debt “stickier” in market participants’ portfolios in the future, which should, ultimately, change the asset class segment’s risk-reward ratio for the better. The recent increase in EM local debt inflows was driven by the recovery in local currencies. The local currency performance component is a significant driver (much more than duration) of inflows into EM local debt (see Chart 15).

Chart 14: If commodities go, local currencies will follow

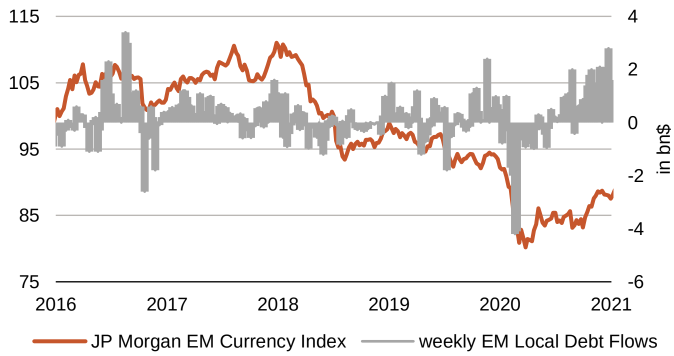
Global Commodities and EM Local FX Performance are highly correlated. Therefore, one should expect a catch-up move in EM Local Debt with regards to the recent spike in commodity prices



Date: 31.01.2015 - 31.01.2021
Source: Bloomberg, JP Morgan, own calculations

Chart 15: EM Local FX Performance drives inflows into EM local debt

EM Local FX Performance is a good indicator of the direction of EM Local debt capital flows



Date: 31.01.2016 - 31.01.2021
Source: Bloomberg, JP Morgan, own calculations

[11] A crowded trade is defined as a collection of similar positions in a particular asset by investors who share a common investment philosophy and might, therefore, want to trade in the same direction at the same time. If this investment philosophy changes, particularly exiting those positions can lead to significant drawdowns.

Emerging Markets debt: key aspects from a cross-asset perspective

So how do EM debt fundamentals, valuations, and the available instruments all make sense from a cross- or multi-asset perspective? Why should EM sovereigns, EM corporates, and EM local debt be a part of an investor's multi-asset portfolio mix?

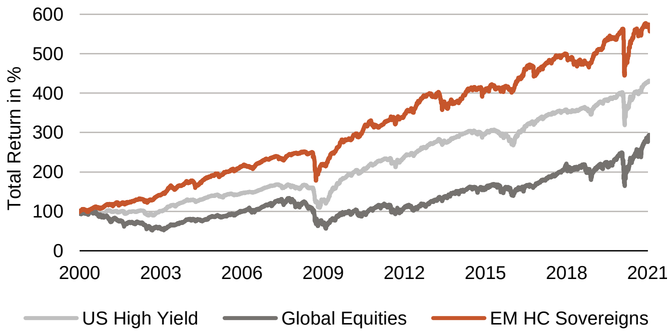
EM sovereigns, in the long run, prove to be much more stable than most people would have expected. Looking at 12-month return periods of USD denominated EM sovereign bonds over the course of the 21st century, almost 98% of all-time periods were positive. The average annual return over the course of the last 21 years was approx. 8.5%. This stands out particularly against US high yield, which has a similar volatility, but returned approx. 1.5% pa less over the same period. Also, global equities, another popular risky asset class, has only returned 5.6% pa over the same time period, which emphasises the attractiveness of the EM sovereign asset class considering that global equities also experienced higher volatility, as well as more periods of negative 12-months returns, during that time (see Chart 16).

EM hard currency sovereigns are one of the highest returning asset class segments over the last 20 years

Like other risky asset classes, EM sovereigns experienced hefty drawdowns over the course of the last 20 years, but as severe as those were, the subsequent recoveries were almost as fast. Defining a drawdown as a temporary loss of value of more than 10% from peak to trough, EM sovereigns needed on average of seven months to recover. Comparable drawdowns in global equities took more than double that time. Certainly, part of this can be explained due to market liquidity reasons, but what we would like to point out here is the "buy-the-dip" mentality of many strategic long-term EM debt investors. Investing in EM sovereigns is a long-term game, where investors shall not shy away from periods of higher volatility, but rather use them as an attractive entry-point (see Chart 17).

Chart 16: Performance of EM hard currency sovereigns; US high yield; and global equities (since 31.12.1999, USD)

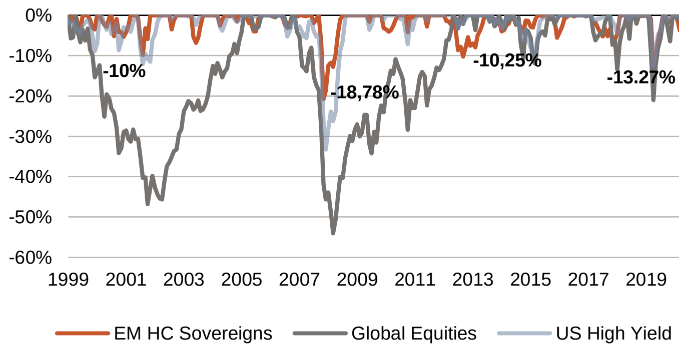
For market proxies, the MSCI World for global equities, the Bloomberg Barclays US Corporate High Yield for US high yield, and the JP Morgan EMIB Global Diversified for EM hard currency sovereigns has been used.



Date: 31.12.1999 – 31.01.2021
Source: Bloomberg, Barclays, JP Morgan

Chart 17: Drawdown comparison of EM hard currency sovereigns; USD; and global equities (since 31.12.1999, USD)

For market proxies, the MSCI World for global equities and the JP Morgan EMBI Global Diversified for EM hard currency sovereigns has been used. A drawdown is defined as fall in prices from peak to trough of 10% or more.



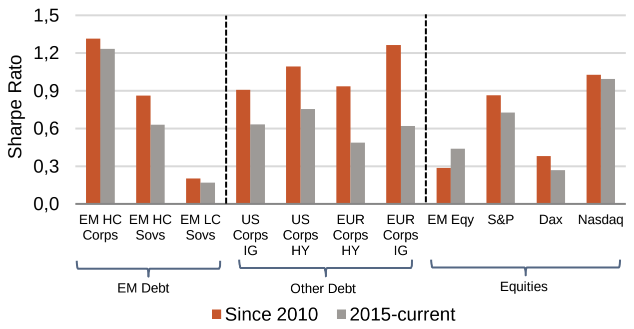
Date: 31.12.1999– 31.01.2021
Source: Bloomberg, JP Morgan, own calculations

Moving beyond just EM sovereigns, the EM hard currency corporates segment has evolved into an asset class that can achieve competitive, and particularly over the last few years, superior risk-adjusted returns (see Chart 18). Specifically, in times of rising US Treasury yields, it might well serve as an element of diversification with superior risk-adjusted carry.

EM hard currency corporates deliver constant superior risk-adjusted returns

Chart 18: Since 2010 as well as since 2015 the Sharpe ratio of EM corporates beats just about any other asset class

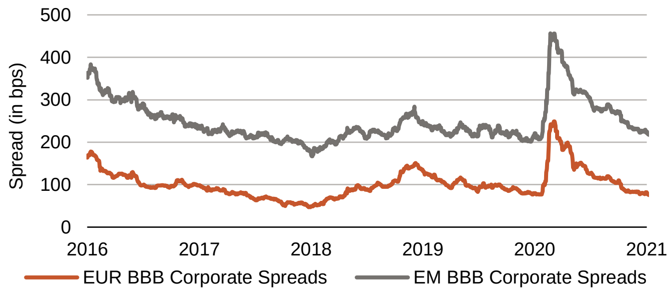
Annualised Sharpe ratios based on weekly returns over two different time frames.



Date: as of 26 Feb 2021
Source: Bloomberg, JP Morgan, Merrill Lynch, Barclays, own calculations

Chart 19: EM hard currency corporates; same credit quality, higher carry

Since the costs of hedging USD bonds back into EUR have been falling sharply in 2020 EM Investment grade corporates offer a pick-up in spread versus its European pendant.



Date: 31.01.2016 – 31.01.2021
Source: Bloomberg, JP Morgan, Merrill Lynch, own calculations

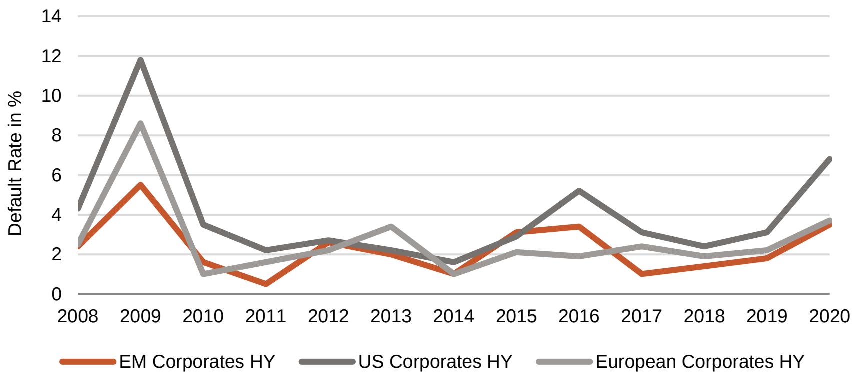
In fact, with a comparable average rating or credit quality it offers investors a higher yield than European corporate bonds, even after considering the cost of hedging[12] the USD-exposure back into EUR (see Chart 19).

EM corporates have shown a high resilience during recent financial crises. For example, and contrary to common belief, EM corporates experienced lower default rates than US high yield bonds during both the global financial crisis of 2008 and the COVID-19 crisis of last year. Moreover, over the last few years, even their default rates have dropped below the one of European corporate bonds (see Chart 20). This goes along with EM corporates also having higher recovery rates versus other advanced market corporates. Being at 42%, the average recovery rate for EM high-yield corporates is significantly higher than it is for US high yield (21%) for example.[13]

In a fundamental recovery with rising US yields, investors should look for cyclical investments with low duration

If the cyclical fundamental backdrop continues to improve, reflationary trends persist and – further down the road – realised inflation remains higher than before the pandemic, particularly in the developed world, EM local debt stands to benefit

Chart 20: EM corporates have very low default rates - and the COVID-19 crisis didn't change the picture



Date: 31.12.2007 - 31.12.2020
Source: Bloomberg, JP Morgan, Standard & Poor's

[12] The current negative term spread between short-term EUR and US Dollar rates at approx. 0.85% p.a. is reflected in the cost of hedging a US Dollar denominated bond back into Euro.
[13] JP Morgan Research as of 12/31/2020

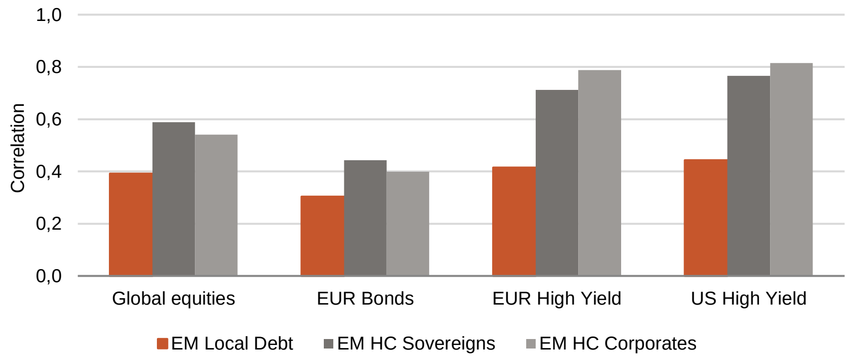
from more any other EM debt asset class due to its greater cyclicality and low interest rate sensitivity. Particularly, if longer dated US Treasury yields continue to rise, lower duration and higher yielding local bonds can make more sense than duration-sensitive hard currency bonds, as most of the investor's expected return in EM local debt is driven by the currency component, and only a smaller extent by duration.

One of the most compelling features of EM local debt, from a portfolio allocation perspective, is the diversification potential it can offer. Within the EM debt space, local currency bonds have, historically, provided the greatest diversification benefits in comparison to hard currency EM sovereigns or EM corporate bonds – as measured by the segment's relatively low correlation to other asset classes that usually have a significant allocation in a traditional portfolio mix (see Chart 21).

EM local currency offer diversification benefits and currency appreciation potential in a cyclical macroeconomic recovery environment

Chart 21: Out of the three available EM debt instruments, EM Local debt has the lowest correlation to other risky asset classes

11-year correlation based on weekly returns since Jan 2010, all return in US-Dollar



Date: as of Feb 26th 2021
Source: Bloomberg, Barclays, JP Morgan, own calculations

The diversification advantage is predominantly driven by the two different sources of return that EM local debt provides: appreciation potential from foreign currency; and relatively high local interest rates. Those should be defined in the short to medium term by the return of organic reflation, which ultimately depends on the speed of vaccinations and the easing of social distancing measures (ie improving conditions for ease of doing business). This stands in contrast to the outlook in the USD and EUR area. The major difference lies in the fact that EM central banks will be able to react to organic reflation pressures, whereas the ECB and the Fed will have to stay put for now. A possible resulting increase in interest rate differentials would then lend another round of support to EM currencies. Investors should consider this and diversify their increasingly rich-looking corporate bond or equity exposure with EM local currency bond exposure.

Lessons for investors

The challenges of 2020 have turned into structural advantages and beneficial secular trends in EMs that bode well for the future. An expected recovery in global economic growth, robust fundamentals, and attractive valuations – especially in the most cyclical parts – put the asset class EM debt back in focus. Nevertheless, two key risks remain. On the one hand, COVID-19 vaccines might not prove to be as successful as anticipated. This mainly concerns delays in widespread distribution and the ability, or lack of, to handle virus mutations. On the other hand, a premature tightening of global financial conditions might occur, particularly if US Treasuries continue to rise and, at a later stage, US real rates – particularly in shorter-dated maturities – would turn around too.

Despite the remaining uncertainty in the near term, EM debt should have a long-term spot in investors' portfolios. We now have more liquid, deeper markets, with heterogeneous asset classes, and sovereigns and corporates are managed better than they have been in the past. Investors with a higher risk tolerance should take advantage of the attractive expected-return potential in high-yield sovereigns, even considering their higher volatility associated, relative to investment grade sovereigns. With regards to a longer-term strategic fixed income allocation, EM corporate debt can serve as a well-diversified, risk-adjusted complement in a fixed-income portfolio. It also comes with a lower duration than EM sovereigns, which might serve well if US Treasury yields continue to rise. Finally, after years of underperformance, investors' focus should also include EM local debt, as the combination of high-expected growth, positive interest rate differentials and a structurally weaker USD gives the currency component a chance to appreciate and drive the recovery.

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IMPORTANT NOTICES

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