

MARKET INSIGHTS

January 2012

Emerging market debt outlook



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Introduction

Emerging market debt was one of the best-performing asset classes of 2011, despite succumbing to the global risk aversion of the fourth quarter. In this paper, Pierre-Yves Bateau assesses the outlook for the asset class overall in 2012, examining the risks and highlighting the attractive valuations that have resulted from the fourth-quarter sell-off. He also looks at the individual outlooks for each of the three main sub-asset classes – external sovereign debt, local currency debt and corporate debt – and identifies the markets and sectors that offer the best prospects in the year ahead.

2011 in review

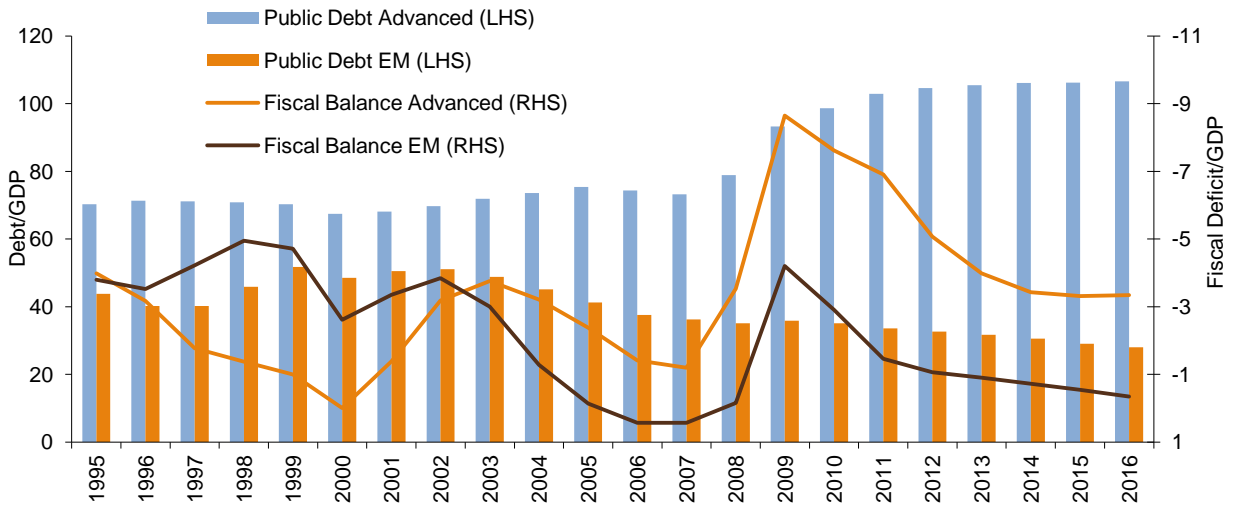
2011 was a year in which investors focused on the economic fundamentals underlying their investments. Financial markets were subject to bouts of significant risk aversion as investors reduced risk due to fears of a Lehman-style credit crisis centred on the European banking system, the lack of cohesive and concrete policies from eurozone politicians to deal with the peripheral government debt crisis, and fears of slowing global growth. Emerging markets (EM) were not immune to these bouts of risk aversion, with EM currencies in particular suffering in the late stages of the year. However, EM debt ended the year as one of the best-performing asset classes. The external (hard currency) debt index (JPMorgan Emerging Market Bond Index Global - EMBIG) closed 8.5% higher, the corporate debt index (JPMorgan Corporate Emerging Market Bond Index Broad – CEMBI Broad) returned 3.0%, and the local currency debt index (JPMorgan Global Bond Index Emerging Markets Global – GBI-EM Global) ended the year 1.7% lower.

The year ahead

It is likely that 2011's investment themes will continue in 2012. Investors will be more demanding, thoroughly reviewing and analysing economic fundamentals and searching for stronger balance sheets before they lend to sovereigns and corporates. In developed markets, the painful process of deleveraging continues. Growth rates will be anaemic, at best sub-trend in the US and Japan and likely to include bouts of weakness in Europe. Policymakers will keep interest rates at historical lows to provide some counter-stimulus to government austerity measures. Real yields in developed markets are near record lows and in most cases negative.

Exhibit 1 – Much stronger fiscal position relative to advanced economies

Divergence of fiscal deficits



Source: IMF Outlook, April 2011

Note: Data for 2011–2016 are forecasts. Forecasts are based on current market conditions and are subject to change without notice.

In this low-yield environment investors will search for yield, but they will be discriminating. EM are likely to benefit and draw investor attention and flows. EM economies will not be immune from the growth slowdown in developed markets; yet growth will still significantly outperform developed markets. We expect a deceleration of growth to a slightly below-trend rate in the year, with J.P. Morgan forecasting a growth rate of 4.6% over a year ago in 2012 for EM economies (relative to 5.6% in 2011), a mild recession in Europe and 1.8% growth in the US.

EM also have the ability to stimulate their economies through both monetary and fiscal policies, should this be necessary. Headline inflation rates peaked in 2011 and will fall in the first half of the year, allowing central banks to cut interest rates (for example, in Brazil, Chile, Mexico, Peru, Indonesia, Israel and Poland). Outside of Eastern Europe we expect further ratings upgrades for emerging market countries as stronger economic fundamentals are recognised by the rating agencies (for example, China, Russia, Turkey, Peru and Uruguay).

It is likely that the first quarter of 2012 will remain challenging as the European situation continues to govern risk appetite. However, firmer policies and further global policy stimulus will result in a better risk environment for the remainder of the year. Currently, our valuation metrics indicate that all EM debt sectors are cheap and priced for a weak growth backdrop, but not for a depression/dislocated market.

Our Base Case scenario (70% probability) factors in the addition of liquidity from both developed and EM, resulting in a rise in asset prices and tightening of spreads for EM debt. We expect all three sectors of EM debt to perform well under this scenario, with returns in the high single or low double digits.

Our Above-Trend scenario (10% probability) includes strong EM currency gains and a back-up of US Treasury yields as growth surprises to the upside. Under this scenario, EM debt returns are strongly positive for local currency and slightly positive for external and corporate debt.

Exhibit 2 – Expected return for 2012 by sector

| End of year (probability) | | Base (70%) | Above trend (10%) | Recession (20%) |
|-------------------------------|---------------|------------|-------------------|-----------------|
| External debt (EMBIG) % | | 10.0 | 2.8 | 4.3 |
| Corporate debt (CEMBI) % | | 9.9 | 3.1 | 4.0 |
| Local currency debt (GBI) % | | 12.5 | 14.5 | 0.8 |
| Assumption by scenario | 30-Dec | | | |
| EMBIG spread (bps) | 426 | 340 | 300 | 500 |
| CEMBI spread (bps) | 468 | 370 | 210 | 575 |
| GBI (%) | 6.57 | 6.35 | 7.00 | 6.75 |
| UST (%) | 1.87 | 2.10 | 3.25 | 1.50 |
| EMFX change (%) | 100 | 5 | 10 | -5 |

Source: J.P. Morgan estimates. Data as at 31 December 2011.

Our Recession scenario (probability 20%) includes a fall in equity markets, a flight to US Treasuries and a fall in EM currencies. Even in this scenario, returns for external, corporate and local currency debt remain positive.

Risks for 2012 include further disruption from the unresolved European situation, deterioration in developed market growth expectations, and geopolitical tension (for example in the Middle East and North Korea). Political risk will be present through the year in both developed and EM, with elections being held in countries representing close to 50% of the world's GDP in total (for example, the US, France, Russia, South Korea, Mexico and Venezuela). Finally, liquidity should be highlighted as a risk. Pressure from policymakers and regulators is resulting in a withdrawal of liquidity in the financial markets as banks reduce their balance sheets and their market-making activities. This is affecting the broad financial market, and investors will need to re-price securities to include an appropriate liquidity premium.

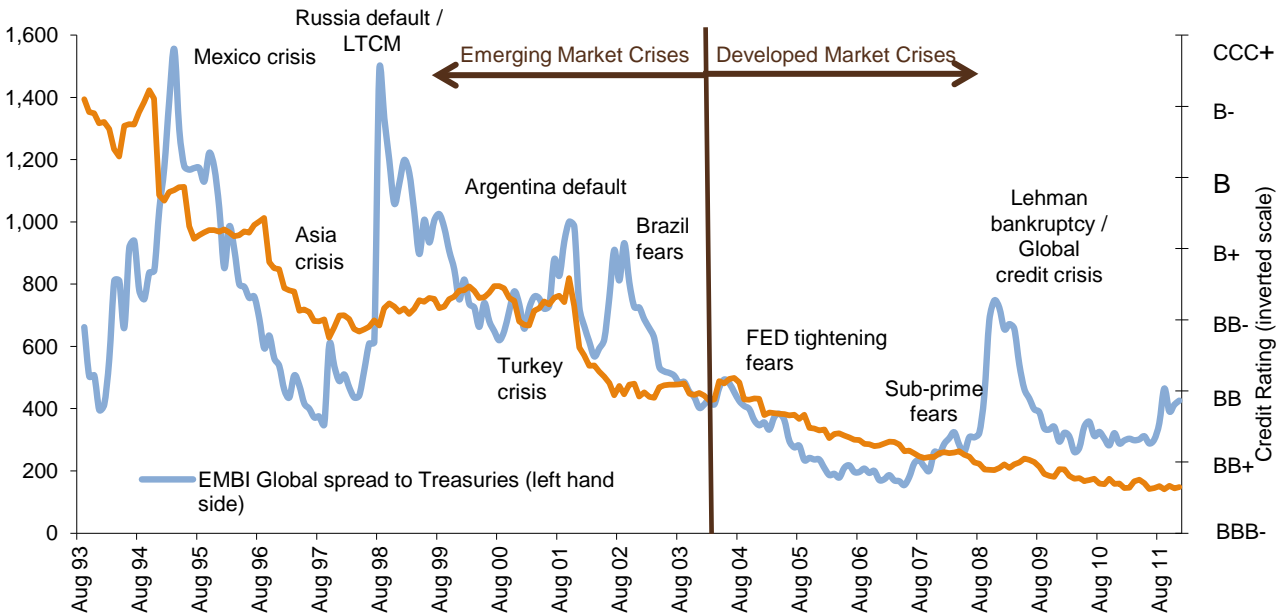
External debt

We remain structurally constructive on external debt markets, as we expect the rebalancing theme (from developed markets into EM) to continue to drive inflows,

particularly into high quality/high-rated sovereigns with strong balance sheets and credible macroeconomic policy frameworks. Moreover, with the EMBI spread at 420 bps, valuations remain attractive relative to developed markets on a risk-adjusted basis. Net issuance is once again expected to be negative, (that is, coupons and amortisations should outweigh sovereign supply), making EM debt a well-bid market. Hence, from a valuation, a fundamental and even a technical perspective we view external debt markets as an attractive asset class in 2012.

However, our base view is for a challenging macro and technical environment to persist early in the year, as newsflow in Europe, the US, and even EM (China and EM politics) will likely remain fluid and volatile. While valuations remain attractive in the sovereign space, persistent tightening and decoupling is unlikely. Therefore, we expect range trading to be the appropriate strategy early in 2012. We also expect differentiation among EM sovereigns to continue throughout 2012, and particularly in the first half of the year. By region, we view Latin America most favourably, with EMEA (Europe, the Middle East and Africa) as the least attractive region and Asia somewhere in between.

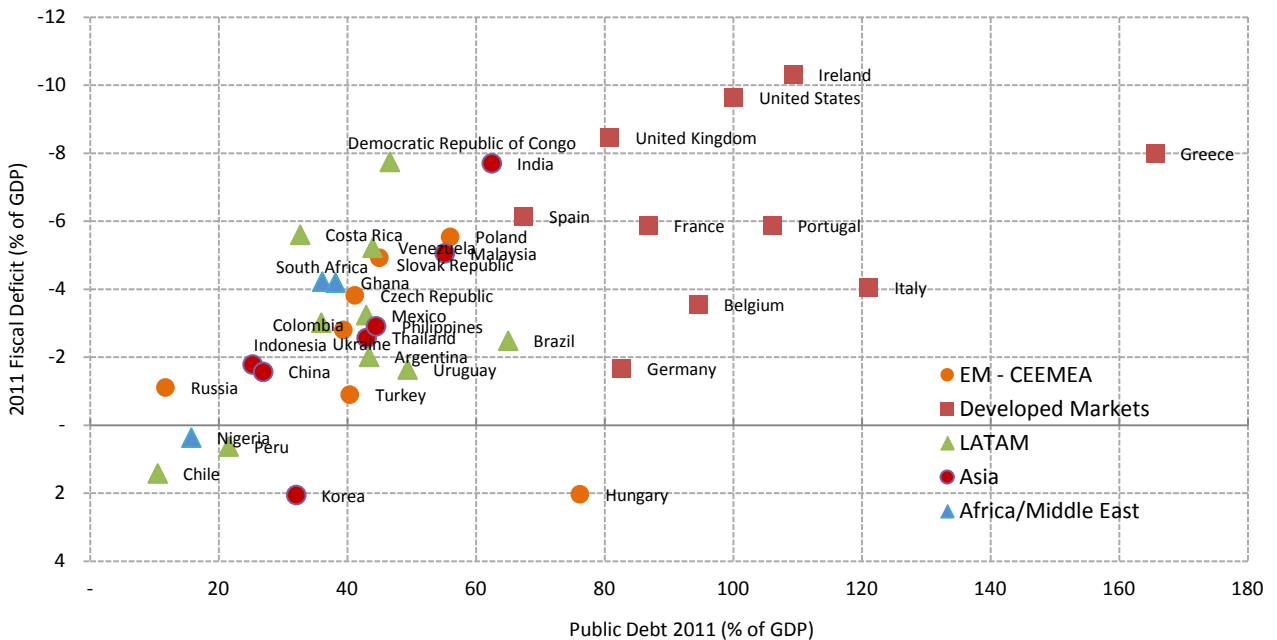
Exhibit 3 – EM Debt – a different asset class: credit ratings reflect improved fundamentals



Source: J.P. Morgan Asset Management. Data as at 31 December 2011.

Note: The J.P. Morgan Emerging Markets Bond Index Global (EMBI Global) is representative of the sovereign debt market.

Exhibit 4 – EM countries are generally in a stronger position than developed markets



Source: IMF Outlook as at September 2011

Opinions, estimates, forecasts, and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice.



Exhibit 5 – Top overweights and underweights by country/region

| Top overweights: | Comments: |
|-------------------------|--|
| Investment grade | Peru, Mexico, Russia and Kazakhstan |
| High yield | Argentina, Venezuela, Serbia, Dominican Republic, Sri Lanka, and the Philippines |

| Top underweights: | Comments: |
|--------------------------|--|
| Investment grade | South Africa, Lebanon, Malaysia, China, Poland, Panama and Chile |
| High yield | Hungary, Ukraine and Vietnam |

In Latin America, we still see value in both investment grade and high yield securities. As such, our Latin American overweight exposure is more strategic than tactical in nature. Our EMEA exposure, on the other hand, is more tactical (ie we are structurally underweight), as the deleveraging process in Europe is likely to pose constraints in the region. We also remain positive on the Commonwealth of Independent States (the former Soviet Republics), particularly Russia and Kazakhstan, recognising the strength of the balance sheets in these markets, but also acknowledging the potential for political volatility in 2012. Our view on Ukraine remains cautious for 2012.

We see the triggers that would lead to a more risk-seeking environment as being twofold. First, markets will remain data dependent. We expect economic data to show further weakness in the first quarter, reaching a bottom sometime in the first half of 2012. Early indications suggest that the monetary easing starting to be seen in EM is proving effective in capping the economic decline, and any clear pickup in data would improve risk appetite. Second, we would see a move toward excess global liquidity as an important market inflection point. This may come from the introduction of further quantitative easing globally and lower EM policy rates.

Hence, our strategy for 2012 is driven by technical factors through the inflow/outflow story and by fundamentals. We see investment grade sovereigns as a core exposure to start the year. By region, we prefer Latin America over other regions, while treating EMEA tactically. We deem it prudent to continue holding some high yield exposure among sovereigns, particularly those in which we have high conviction views. Among these, Argentina and Venezuela continue to be our preference over Hungary and Ukraine. We therefore believe the appropriate strategy for 2012 will be a barbell strategy of overweights both in investment grade and in selected HY, where we feel comfortable with the fundamentals.

Local debt

The fundamental outlook for local currency debt remains positive, in line with our longer-term secular theme of convergence and rebalancing between emerging and developed markets. Local currency market performance will depend on the market's perception of the credibility of EM central bank policy. Headline inflation is falling, but core could remain sticky and growth has slowed, which could exert pressure on government balance sheets internally (fiscal) or externally (balance of payments).

Exhibit 6 – Top country/regional overweights and underweights

Top overweights: Comments:

| | |
|-------------------------------|---|
| Mexico (rates & FX) | High real rates, compelling FX valuation, linked to US recovery |
| Indonesia (rates & FX) | Sound balance sheets, inflation coming down, high yield, central bank flexibility |
| Frontier markets (rates & FX) | High rates, diversifying stories, high potential/receipt of investment flows |

Top underweights: Comments:

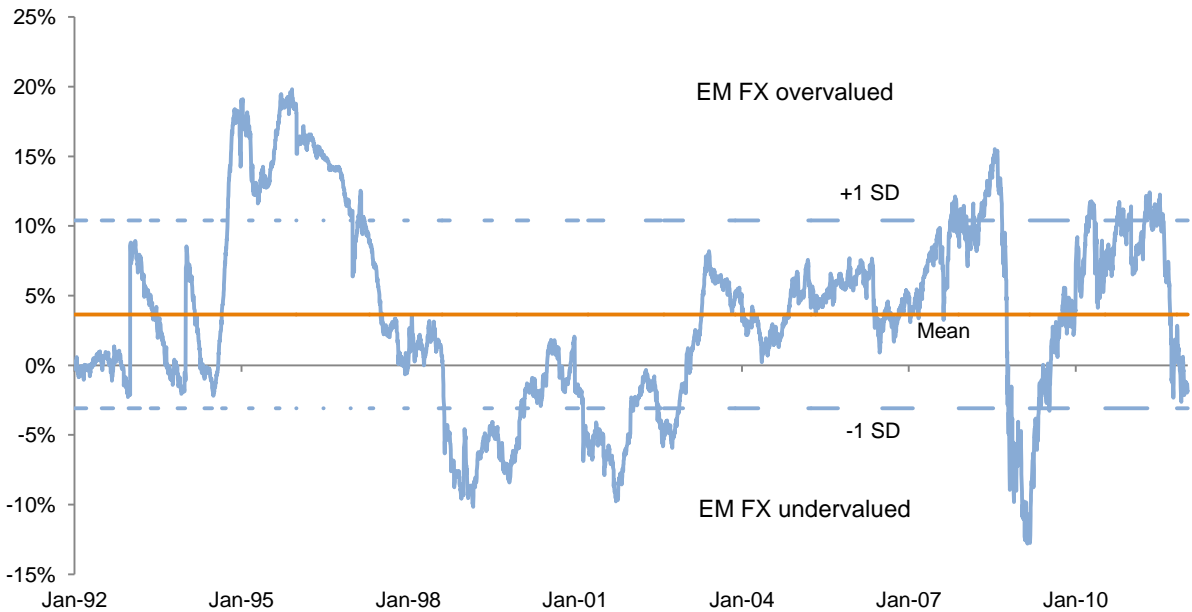
| | |
|---------------------|--|
| Czech Republic (FX) | Small open economy linked to eurozone, low yield |
| Poland (rates) | Deteriorating fiscal deficit, sticky inflation, linked to eurozone |
| Thailand (rates) | Low yield, low political risk premium |

Valuations remain attractive, and with the benchmark index (JPMorgan GBI-EM Global) yielding 6.60% investors will likely continue to allocate to the sector. The US Federal Reserve Board has maintained its pledge to keep rates low for at least another year and a half. The ECB and other developed market central banks have also resumed easing monetary policy. This means that we will

remain in a low developed-market rate environment for the whole of 2012. This should continue to drive investors towards EM rates in a search for yield.

At one standard deviation from historical average, EM currency valuations appear compelling, following the September-October 2011 sell-off.

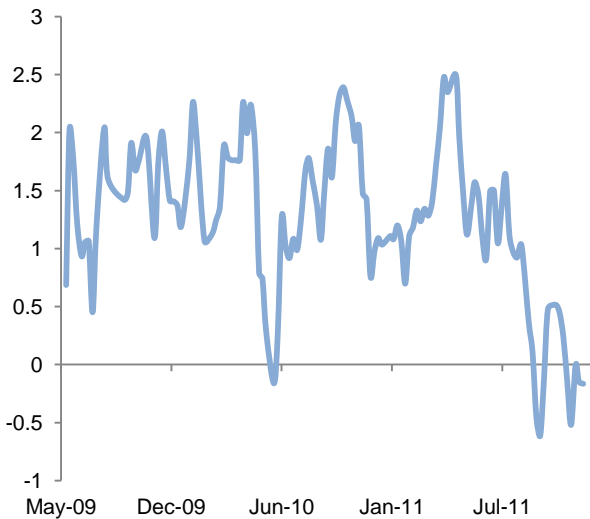
Exhibit 7 – EM vs. G4 valuation



Source: J.P. Morgan Asset Management. Data as at 31 December 2011.

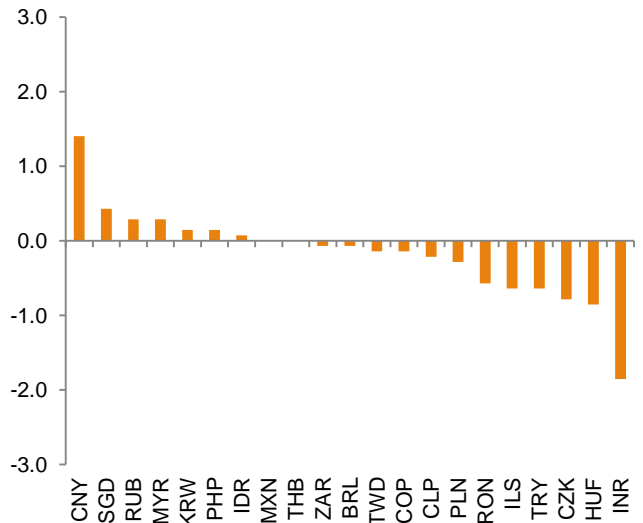


Exhibit 8 – Total EM currency positioning (survey)



Source: J.P. Morgan Asset Management. Data as at 31 December 2011.

Exhibit 9 – Traders' perception of market positioning (survey)



Source: J.P. Morgan Asset Management. Data as at 31 December 2011.

The technical picture at the beginning of the year also appears sound as investor exposure is limited, especially to currencies.

However, after the sharp sell-off across most emerging market currencies in 2011 and the extremely high volatility in the fourth quarter, investors are likely to remain cautious about re-engaging wholeheartedly in EM currency exposure. Despite broadly attractive valuations and a cleaner technical picture from a positioning perspective, investors are also likely to factor in the challenging prospects for global growth, which will provide headwinds to the performance of EM currencies.

Regional differentiation will be important this year, with Latin America and Asia poised to outperform central Europe due to the continuing question marks over the architecture of the eurozone and the likelihood that growth in core Europe will come under pressure.

Overall, local currency debt currently looks compelling from a valuation and positioning perspective. Developments in global markets will remain in focus, and an erosion of volatility from the extreme levels of the fourth quarter is likely to be a prerequisite for the sustained positive performance of this sector.

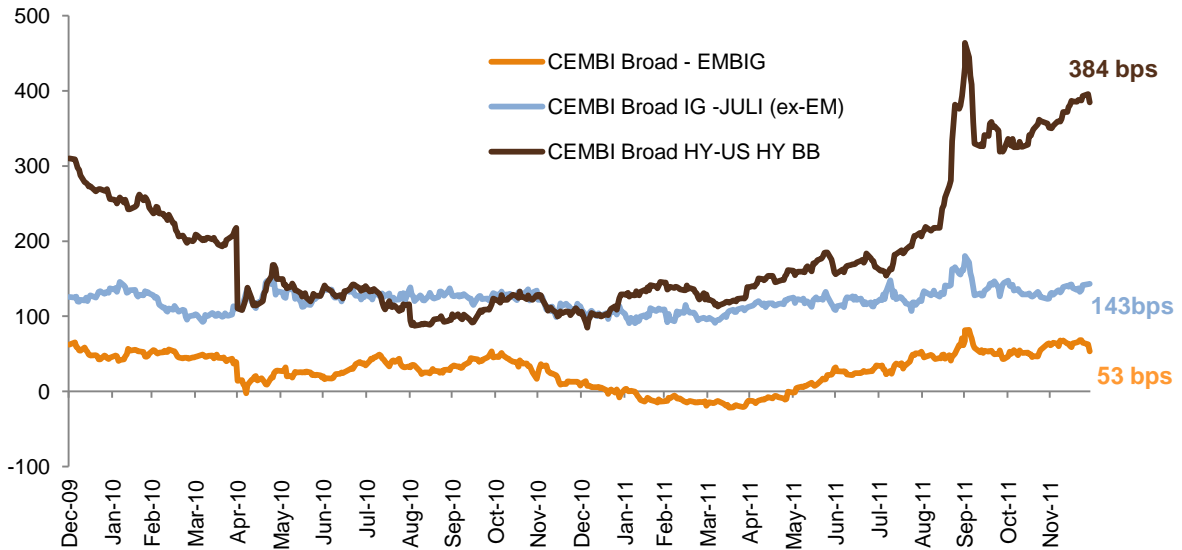
Corporate debt

After a positive but underwhelming 2011, we expect EM corporates to perform well in 2012. After the sell-off in the fourth quarter, valuations have reached very attractive levels, with year-end yields of 5% for investment grade and 10% for high yield. Fundamentals remain strong, but are expected to peak this year as the expected global growth slowdown impacts corporate earnings. Despite increased demand from dedicated and cross-over investors, technical factors remain challenging as pressure on bank balance sheets reduces their market-making activities.

In a low yield environment, investors will find EM corporate valuations attractive, especially when compared to EM sovereigns (the CEMBI is trading at a premium to the EMBIG) and to US high yield (the CEMBI BB-rated portion of the index is trading with a 3.0% premium to US high yield BB-rated securities, as at 31 December 2011).



Exhibit 10 – EM corporate value has been created versus sovereigns and US corporate

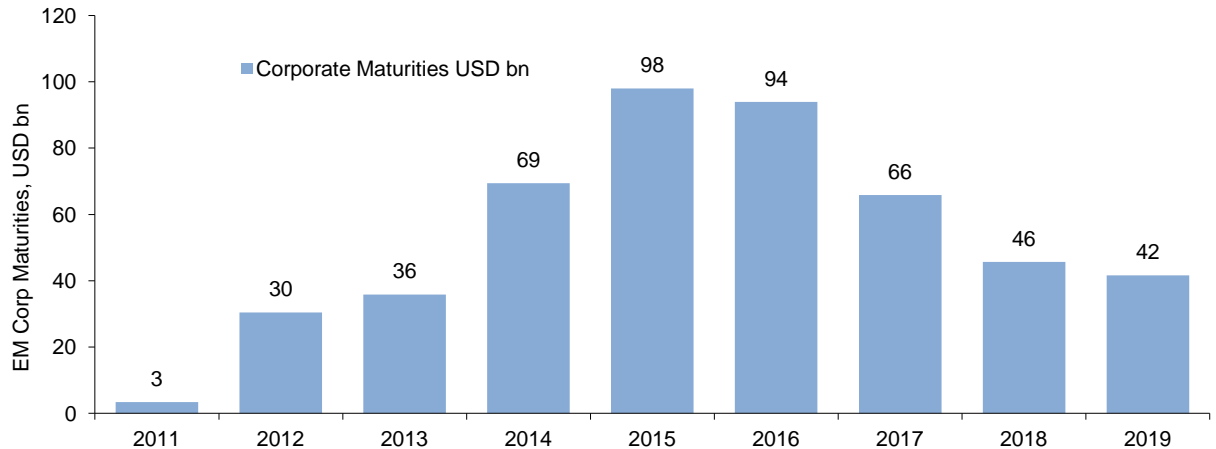


Source: J.P. Morgan Asset Management. Data as at 31 October 2011.

The fundamentals underpinning the EM corporate sector remain strong. EM corporates have reduced leverage over the past three years, strengthened their liquidity positions and extended their debt maturity profiles. With high yield at a current spread of close to 900 bps over US Treasury bonds, the market is pricing an expected default rate of around 8-9%.

This is at least double the default rate we are expecting in 2012. At these levels we find the BB-rated sector increasingly attractive and expect spread tightening to add return to the already substantial carry. In our view, the market is pricing in too much risk premium due to the continued lack of a European solution and an enlarged liquidity premium.

Exhibit 11 – USD360 billion issued since Jan 2010 helped pushing out refinancing risk



Source: J.P. Morgan estimates. Data as at 31 December 2011.

Exhibit 12 – Top country/sector overweights and underweights

| Top overweights: | Comments: |
|------------------------------|---|
| Russian banks | Supportive government, stable credit metrics, high deposit growth, strengthened capital position and improving ratings. |
| Indonesia coal and utilities | Sound balance sheets, inflation coming down, high yield, strong liquidity, stable operating profiles, predictable cash flows, robust demand dynamics, limited supply. |
| Latin America | Lower expected default rates, lower political risk, and attractive valuations. High yield in Argentina and investment grade in Chile. |
| Top underweights: | Comments: |
| Kazakhstan banks | Weak banking system and balance sheets, high stock of non-performing loans, intense competition with resulting pressure on margins. |
| Ukrainian banks | Weak funding structure, highly levered, high stock of non-performing loans, sovereign risk uncertainty, reduced availability of external funding. |
| Mexican telecoms | Investment grade names generally expensive, high yield names in a weak competitive and financial position. |

The technical situation is likely to remain challenging in the first part of the year. We view the reduction in liquidity from bank market makers as structural. Combined with market risk aversion, investors should therefore be prepared to buy and hold. Issuance is expected to be slightly lower than in 2011, with gross issuance of around UD 185 billion forecast by J.P. Morgan. We believe that market issuance will be well taken by the market as demand from cross-over investors and from institutional investors diversifying their developed market allocations remains high.

From a risk perspective there are a number of themes we are watching with regard to our corporate exposure. Although we have minimal exposure to Chinese property and banks, it is important that the Chinese allow a more controlled deflation of property prices in certain cities. In Ukraine, we are monitoring the gas supply negotiations with Russia, discussions with the IMF and any further stress on the currency. The deleveraging of the European banks may well impact the banking sector in eastern Europe more broadly, especially in the Czech Republic, Hungary and Slovakia.

Conclusion

The bullish strategic investment case for EM debt remains intact, supported by stronger balance sheet and growth prospects (resulting in a better capacity to pay back debt than in developed markets). The key headwinds of 2011 – central bank rate rises to contain inflation and a sharp global growth revision are now priced or over-priced in to valuations. The current cheap valuations bode well for EM debt and should attract investors in search of yield and solid diversification. The asset class is likely to remain volatile, however, driven by continued deleveraging, fiscal austerity and monetary stimulus. We will start 2012 with a defensive stance in our strategy and move to a more cyclical positioning once the euro crisis has peaked and investors gain comfort that China is heading for a soft landing.

Pierre-Yves Bureau, managing director, is the head of the Emerging Markets Debt team. In this role, Pierre-Yves is responsible for coordinating resources located in New York, London, Asia and Latin America. He is also tasked with broadening our investment set to include the Middle East and Africa. Prior to joining the firm in October 2009, Pierre-Yves was at Fortis Investments for 10 years, serving as the chief investment officer for Emerging Markets Fixed Income. At Fortis, Pierre-Yves oversaw teams based in London and Singapore, guided strategy decisions and managed a range of emerging markets mandates. Before that, he spent two years at FP Consult (France), an emerging markets bond and equity boutique, working as a portfolio manager. Pierre-Yves began his career at BAREP Asset Management, a hedge fund boutique owned by Societe Generale, in 1991 serving as an emerging markets portfolio manager. Pierre-Yves holds a graduate degree in finance and a master's degree in management from the Groupe Ecole Supérieure de Commerce et de Management Tours-Poitiers (ESCEM) in France.

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