

Emerging market debt sector commentary

Executive summary

- U.S. dollar-denominated emerging market sovereign debt, as measured by the JPMorgan Emerging Markets Bond Index Global (EMBI Global), gained 3.76% during the second quarter.
- Emerging market local-currency sovereign debt, as measured by the JPMorgan Government Bond Index-Emerging Markets Global Diversified, rose 5.64% during the second quarter.
- According to Western Asset Management ("Western"), a dovish Federal Reserve Board that continues to signal potential rate cuts in 2019 provides a more benign environment for emerging market debt.
- Western Asset continues to favor countries with ample foreign exchange reserves, low external economic dependency, low political uncertainty and effective policy executions.

Market recap

The emerging markets (EM) hard-currency and local-currency markets turned in yet another strong quarter. Both EM local markets, as measured by the JPMorgan Government Bond Index-Emerging Markets Global Diversified, and EM hard currency, as measured by the JPMorgan Emerging Markets Bond Index Global (EMBI Global), posted strong results, returning 5.64% and 3.76%, respectively, during the second quarter.

Spreads for EM hard currency ended relatively flat for the quarter. In contrast to the first quarter, within the EMBI Global and JPMorgan Corporate Emerging Markets Bond Index Broad, investment grade outperformed high yield.

Inflows into EM debt continued into the second quarter, but at a moderately slower pace. An additional \$12 billion of net flows were invested into the asset class during the quarter to end the first half of 2019 with approximately \$45 billion of inflows. At mid-year, inflows are primarily comprised of hard currency (\$38 billion, or 84%), while local market investors added \$7 billion. Year to date, flows have now more than doubled flows in 2018, although the surge in flows is not necessarily surprising, given the shift in market conditions

and sentiment. While we welcome the supportive factors during the first half of the year (i.e., a more dovish U.S. Federal Reserve Board ["Fed"], no U.S. recession on the horizon, and accommodative central banks), U.S.-China trade frictions and concerns of a global growth slowdown remain concerns and do weigh on markets from time to time. This, in turn, poses downside risks that result in bouts of high volatility in EM and risk markets.

Outlook

Emerging markets debt continues to be our core secular conviction across the firm's portfolios, despite ongoing uncertainty related to global growth conditions and trade tensions. A dovish Fed that continues to signal potential rate cuts in 2019 provides a more benign environment for EM debt. In light of the trough experienced in 2018, we continue to believe that fundamentals in emerging markets remain resilient. Compared with developed markets (DM), secular fundamentals remain relatively strong. The cyclical growth recovery continues to remain intact (with certain exceptions) after battling the challenging years marked by the "taper tantrum," collapsing commodity prices and political scandals. Fiscal and external balances are encouraging. In aggregate, external debt as a percentage of gross domestic product (GDP) for EM countries continues to be in relatively better shape than for DM countries. We believe most EM economies are better positioned to absorb exogenous shocks than at any time over the past few years.

Furthermore, valuations and technicals are likely to be supportive of the asset class over the medium term. Valuations are more compelling post-spread widening, and we believe EM real yields and real yield differentials are supportive and have scope to compress. The Fed's dovish pivot and its openness to potential rate cuts in 2019 and beyond are constructive for EM financial conditions and flows. Diminishing impacts of U.S. fiscal stimulus and the reintroduction of both monetary and fiscal stimulus in China augur well for the resynchronization of global growth. In our view, these factors should be positive for global risk markets in the near term, and they are conducive to an attractive carry trade in EM.

From a medium-term technical standpoint, EM debt remains

underrepresented in global indices despite the rising gravitational force of EM economies. In this regard, the progressive inclusion of sizable markets, notably China and Gulf Cooperation Council countries, will increase the asset class's visibility and investor demand. EM fund flows have surged in 2019, but contagion risks do bear watching.

As a risk asset, EM debt is not immune to the market overshooting on the downside, with near-term risks including disruptive U.S. trade tensions, a synchronized global growth slowdown and geopolitical pressures. Given the heterogeneity in EM, the evolving set of opportunities requires differentiation, customization and rotation across different EM segments at specific points of the market cycle. The upshot is that, properly calibrated, the allocation to EM fits into the fundamental conviction of global investors with a long-term value discipline. Notwithstanding the short-term challenges, we believe there are attractive opportunities for long-term investors in select countries where fundamentals are broadly intact. We continue to favor countries with ample foreign exchange reserves, low external economic dependency, low political uncertainty and effective policy executions.

Investment risks

All investments are subject to risks, including the possible loss of principal. Investments in bonds are subject to credit risk, inflation risk, income risk and interest rate risk. As interest rates rise, bond prices fall, reducing the value of an

investment. High-yield bonds possess greater price volatility, illiquidity and possibility of default. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging or developing markets.

Glossary

The **JPMorgan Emerging Markets Bond Index Global (EMBI Global)** is a U.S. dollar-denominated, investable market cap-weighted index representing a broad universe of emerging market sovereign and quasi-sovereign debt. An investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

Gross domestic product (GDP) is an economic statistic that measures the market value of all final goods and services produced within a country in a given period of time.

The **JPMorgan Corporate Emerging Markets Bond Index Broad** is a global, liquid corporate emerging markets benchmark that tracks U.S. dollar-denominated corporate bonds issued by emerging market entities.

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