

# MARKET INSIGHTS

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## Emerging Market Debt: 2011 Outlook



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### Introduction

*Emerging market (EM) countries enter 2011 in a stronger economic and fiscal position than they did in 2010. Since the financial crisis, emerging markets have driven global economic growth, compared to the sluggish growth experienced by developed markets. EM economies have expanded at above trend growth levels through 2010, allowing most EM central banks to start to normalise policy rates, stemming the tide of excess liquidity. We expect this dichotomy in growth between developed and emerging markets to persist throughout 2011. However EM growth is likely to be slower compared to 2010.*

*Developed markets remain in a slow growth environment and although the risks of a "double-dip" recession and a deflationary scenario have reduced, the housing market remains weak and unemployment stubbornly high. Against this macroeconomic backdrop, we expect central banks in the developed world to keep interest rates low and potentially ease further their monetary policy.*

*Inflows into Emerging Markets Debt (EMD) should remain strong in 2011, driven by the search for higher yielding opportunities, investor rebalancing of strategic allocations and the wider recognition of the strength of EM economies compared to developed markets.*

*Against this strong fundamental and technical backdrop we expect positive, high single digit returns for all three sectors within EMD (local currency debt, corporate debt and external debt). Risks to our assessment include risk aversion induced by European peripheral stress, further US treasury volatility and the potential for policy mistakes by EM central banks facing higher inflation and strengthening currencies.*

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### 2011 return expectations

Emerging markets have not decoupled from developed markets, yet the links are becoming weaker as increased domestic consumption drives and sustains superior growth rates. With this in mind, we have set out three global scenarios and forecast returns under each. The first scenario - our central scenario which we consider most likely - is for a continuation of low interest rates in developed markets coupled with positive, but sub-trend growth. The second and third scenarios we recognise as important but we would assign a low probability to, namely: deflation or inflation affecting developed markets.

Under each of these three scenarios we expect positive returns for local currency debt, corporate and external debt, with our central scenario giving high single digit returns.

Exhibit 1 – Expected return for 2011 by sector

End of year	Scenario 1 Central	Scenario 2 Reflation pressure	Scenario 3 Deflation pressure
External debt (EMBIG)	8.1%	1.3%	11.5%
Corporate debt (CEMBI)	8.2%	1.7%	9.8%
Local Currency debt (GBI)	9.9%	6.5%	10.7%

Assumptions by scenario				
	Current	Scenario 1 Central	Scenario 2 Reflation pressure	Scenario 3 Deflation pressure
EMBIG	270	215	250	260
CEMBI	315	252.5	310	310
GBI	6.7%	7.10%	7.50%	6.70%
UST	3.30%	3.50%	4.00%	2.75%
EMFX	100	5.00%	3.00%	4.00%

Source: J.P. Morgan Asset Management as of 15 December 2010

## Local debt

Within local currency debt, our main themes are inflation, relative fiscal positions and slow developed market growth. EM countries are in varying stages of their economic cycle and many output gaps are disappearing adding to inflation concerns. Central bank credibility will need to be watched closely, as those central banks that are perceived to be behind the curve may lose credibility. Within inflation, the focus will be on countries with larger output gaps and more credible central banks, where inflation pressures are either far-off or controlled.

Exhibit 2 – Top rate themes

Top overweights	Comments
South Africa	Steep yield curve, with real rates too high
Brazil	High real rates, with inflation already priced in
Inflation linkers	Attractive break evens and selective real yields

Top underweights	Comments
Poland	High fiscal deficit, negative on inflation
Thailand	Low yield and high inflation

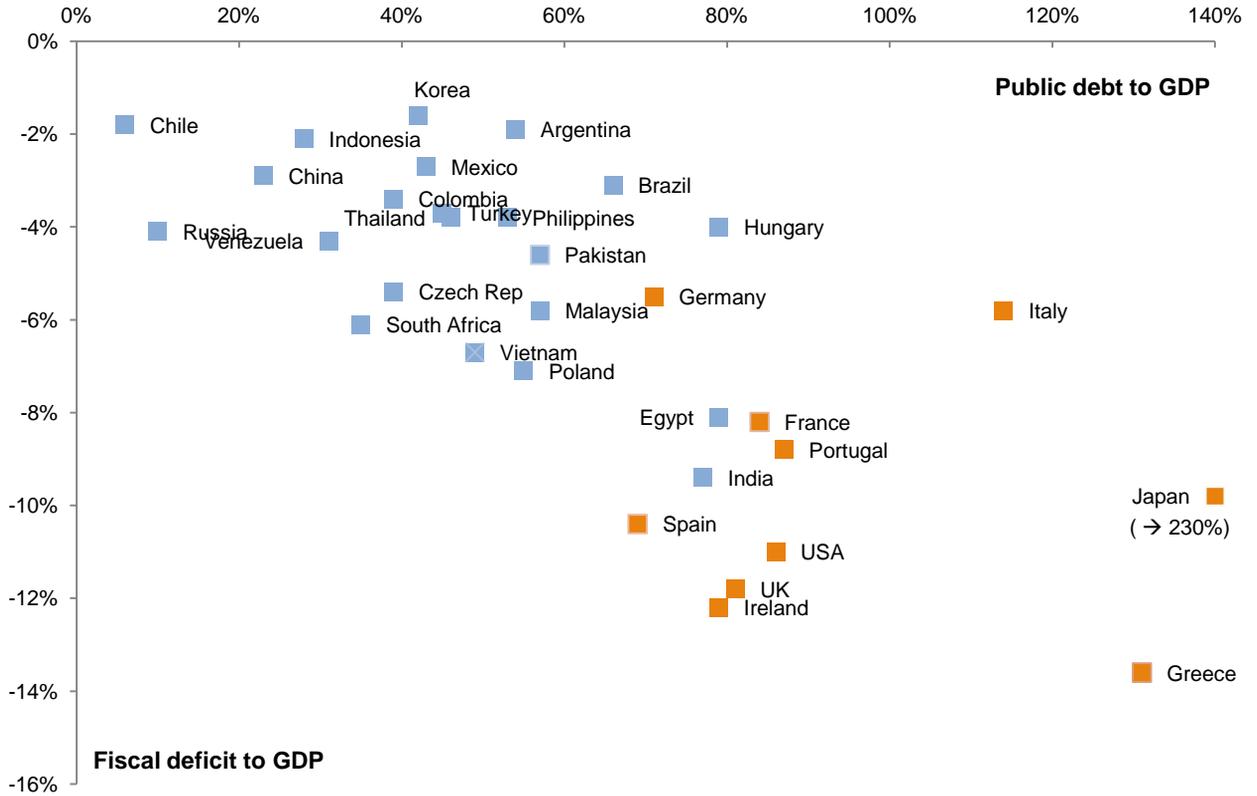
“Developed market growth... is expected to remain subdued...”

Fiscal positions have come to the forefront during 2010 and will continue to be a hot topic during 2011. Peripheral European debt concerns, in particular, will need to be resolved and further contagion is a potential risk. Those countries with stronger balance sheets pose a lower risk should risk aversion return to the markets.

Developed market growth, while picking up in the latter months of 2010, is expected to remain subdued and below long-term averages. The US Federal Reserve Board has maintained in its FOMC statement its pledge for low rates for an “extended period.” Low developed market rates should continue to drive investors in a search for yield.

This reallocation of capital away from developed bond markets into EM debt also reflects investors’ search for countries with strong fiscal discipline. In particular, the current fiscal dynamics in the US, Europe and Japan look increasingly challenging to sustain. Against the backdrop of the fiscal crisis that has been spreading throughout the eurozone, investors will increasingly focus on fiscal policy as a discriminating factor between various bond markets. This focus will be a positive for EMD given that over the past decade emerging nations have significantly cut back their national debt and reduced their reliance on foreign lenders to fund their borrowing needs. **Exhibit 3** illustrates the diverging fiscal dynamics between the developed and EM nations: while most EM nations have debt-to-GDP ratios ranging between 45% and 55%, for developed nations this statistic is typically between 65% and 90%.

Exhibit 3 – Diverging fiscal dynamics



Source: J.P. Morgan Asset Management as at Q2 2010

Powerful capital inflows into emerging economies is putting upward pressure on emerging currencies. A number of countries have resisted these appreciation pressures by accumulating foreign exchange reserves through FX interventions. This strategy is now being challenged by rising inflationary pressures: growing FX reserves makes it harder for central banks to control the credit creation in their domestic economy. This transmission mechanism is pushing many central banks in EM nations to either let their currencies appreciate or prevent capital from flowing in by enforcing stricter control of the capital account. While capital control measures can appear appealing on a short-term basis, we believe that many countries understand the medium-term risks such policies are exposing their economies to. As a result, we expect EM currencies to be allowed to appreciate further in 2011.

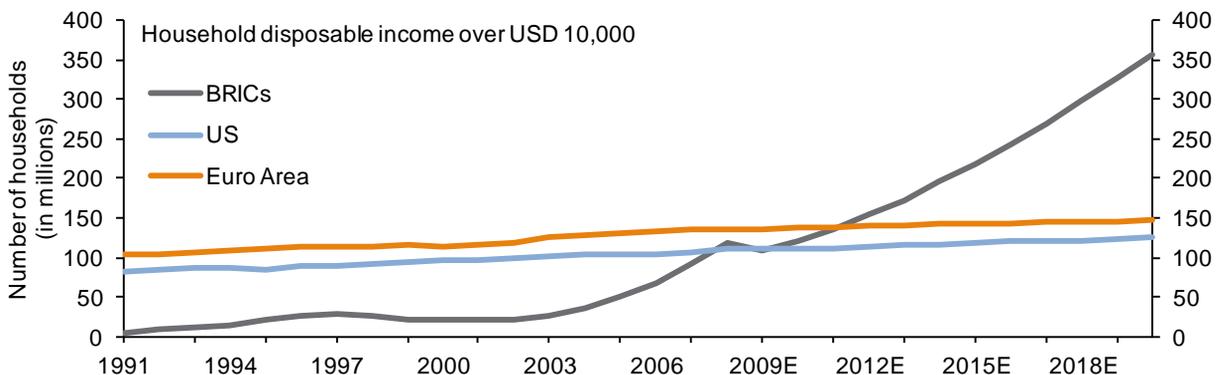
Exhibit 4 – Top FX themes

Top FX themes	Rationale	FX picks
Central bank credibility	Inflationary pressures intensifying, will test central banks and the extent to which they are willing to tighten policy	Favour currencies which are tightening credibly, via rate hikes and/or allowing currency appreciation (THB and PLN). Cautious on those behind the curve/showing reluctance to tighten despite inflation (IDR, TRY)
Equity outperformance relative to debt	Dividend yields attractive relative to rates; growth in EM may be re-accelerating; capital appears to be being increasingly directed towards equities over other assets	Prefer equity sensitive currencies (MXN, KRW, RUB) rather than debt sensitive ccys (IDR)
Strong balance of payments	Provides support for currencies amid higher volatility and gamma	Favour ILS, KRW, MYR

Corporate debt

Within corporate debt, we believe the market will continue to attract assets as the market offers a significant growth premium to developed markets and a lower relative risk profile. We favour EM corporates focussed on domestic consumption, those benefitting from infrastructure spending, and companies with positive cash flow and low refinancing requirements. We continue to have a high yield bias due to the attractive yields and low expected default rates. We will look for EM companies that may be M&A targets for developed market companies. For example, in 2010, internationally known Pepsi Co., with a single A credit rating purchased 60% of Wimm-Bill-Dann, a Russian producer of dairy products, with a single B credit rating. This is a positive story as it highlights the growth and attractiveness of emerging market companies.

Exhibit 5 – Growing domestic demand/consumption trends within emerging markets



Source: Morgan Stanley Research



Exhibit 6 – Preferred sector and regional bias

Preferred sector bias	Comments
Banks	Russian & Brazilian, exhibit improved credit quality metrics
Consumer discretionary	Supported by emergence of the middle class
Metals & mining	Supported by increased infrastructure spending
Regional bias	Comments
Argentina	Our favourite, offers highest quality companies and transparency
Russia	Undervalued
Asia HY	High yield, lower duration and scarcity value

Specific to corporate bonds, political risks, aside from elections, exist. Government ownership of corporates has the ability to cloud otherwise responsible management. Intra-EM increased M&A activity will require more detailed analysis on investors' part to ensure that the merger in question is of good value to both companies.

### External sovereign debt

We see a potential re-acceleration of activity from emerging markets within the first half of 2011, driven by domestic demand, followed by a slowdown in the second half. Regional rotation will be the key in 2011, as we see a slowdown as more likely in Latin America, where many central banks are already implementing capital controls and moving to fight inflation. Eastern Europe, on the other hand, may benefit from upside potential to growth, as the region has been the laggard of emerging market countries.

Domestic demand within emerging markets should continue to grow, even if a manufacturing slowdown does occur. Additionally, countries with a more established domestic, consumer-driven economy are less sensitive to our possible risk scenarios involving China and peripheral Europe.

“...potential re-acceleration of activity from emerging markets within first half of 2011...”

Technicals in external debt should be a strong positive in 2011. 2011 issuance is forecast at approximately USD 77 billion. After accounting for maturities and coupon payments of about USD 67 billion, net issuance is set to be a mere USD 10 billion, even lower than 2010. Emerging Asia is actually forecast for a net negative in issuance. Issuance should also be viewed alongside demand; inflows into the asset class were multiples of this forecasted net issuance in 2010.

#### Exhibit 7– Preferred overweights and underweights

Top overweights	Comments
Argentina	Structural story, improving fundamentals & increasingly co-operative
CIS (Russia Kazakhstan)	Cheap Valuation, positive catalysts to kick in
Middle East	Commodity exposure favours Qatar; high yielding
Venezuela	Tactical long. Stronger growth with higher spread and lower duration
Top underweights	Comments
Brazil	Expensive relative to other Latin America sovereign debt
Poland	Deteriorating fiscal position, still viewed as EMEA "safe haven"
Central America	Growth prospects challenging, tight spreads

Peripheral Europe will continue to drive spreads within emerging Europe. While we are optimistic, we are aware that contagion risk remains high. US Treasury duration will be an ongoing theme, and we enter 2011 slightly short duration amid rising US yields.

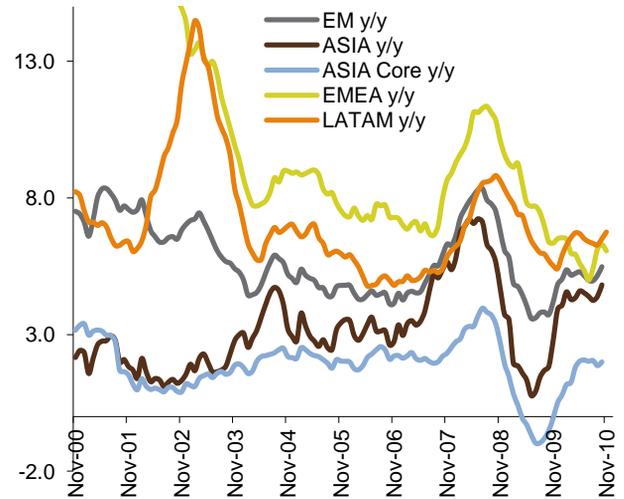
Factors to watch and risks to our view

Inflation risks will be an ongoing theme within both developed and emerging markets. Partially as a result of further quantitative easing from developed markets, we expect commodity prices to appreciate further in 2011, which could push food and energy prices higher. Also, as many EM countries are further along in their recoveries, output gaps are closing, which could push core inflation higher. This looks to benefit net exporters of commodities, such as Venezuela, and the Middle East. Countries with higher output gaps such as South Africa and Colombia should not be forced to increase or normalise monetary policy to the same degree as Indonesia or Brazil.

Another risk that we will be monitoring closely is the fiscal situation in parts of Europe, which could continue to impact the mood across global markets. While the vast majority of emerging market countries do not have the fiscal deficit issues that their developed market peers are faced with, risk aversion in the face of more unwelcome news from peripheral Europe may pose risks to weaker balance sheets and parts of Eastern Europe. Fiscal vulnerability therefore, will be a risk, but also an opportunity throughout 2011.

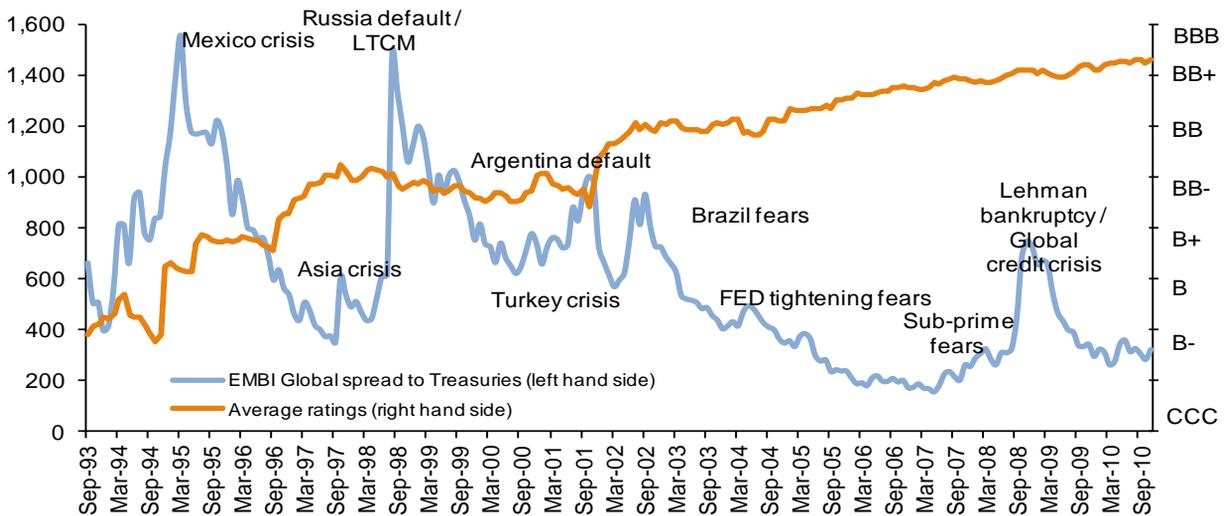
Countries with strong balance sheet positions should be benefiting. While emerging Europe fiscal positions have been improving, a rotational strategy provides better opportunities, as unwarranted yield movements higher should provide attractive prospects.

Exhibit 9 – EM inflation Y/Y



Source: Bloomberg, 2010

Exhibit 8 – External debt average credit ratings continue to improve



Source: Bloomberg, Standard & Poors, 2010



## Conclusion

EMD has proven since the recent financial crisis that it has developed into a mature asset class. Emerging market nations have demonstrated their ability to maintain fiscal responsibility while promoting both economic growth and price stability. We expect EM countries to continue to drive global growth throughout 2011. Average credit ratings for all three sub-sectors are today investment grade and we expect further upgrades in 2011. Combined with strong growth, an improving fiscal balance and a spread over developed market bonds, EMD remains an appealing investment proposition. In this environment, we expect global rebalancing to continue to drive capital flows towards emerging markets. In particular, we expect pension funds, which remain under-allocated to the asset class, to continue to increase their EMD allocations.

While we will be monitoring a number of risks in 2011, most of them stem from the developed world rather than EM nations. The US economy, while improving, still remains dangerously close to deflationary territory and still struggles to create jobs. Peripheral European debt continues to scare the markets and will continue to do so periodically throughout 2011, especially during the first half of the year. Rising inflation is also a focus going into 2011. We note however that many countries have already moved to curb inflationary pressures. Specifically, policy normalisation has been well underway for many EM countries. We would consequently view an inflationary scare as providing an attractive entry point for long-term investors looking to increase their allocation to the asset class.

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