J.P.Morgan
Asset Management

THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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A local surprise

Emerging market (EM) local bond yields have defied historical relationships by resisting much of the recent risk-off move. Can this de-correlation with risk markets persist, or are EM local bonds due for a correction?

Fundamentals:

The fundamental strength of emerging markets was recently reaffirmed by January purchasing managers' indices, with nearly 90% of EM countries registering in expansionary territory. Our proprietary quantitative EM models suggest that this positive growth trend will persist, as forecasts for future data releases are very bullish and leading economic indicators point to above-trend growth. Positive idiosyncratic developments have also helped to buoy parts of the EM complex this month. In South Africa, the political transition away from current president Jacob Zuma is progressing, contributing to a rebound in consumer and business sentiment. Meanwhile, in Turkey, January's below-expectation inflation print suggests that inflation may be stabilising, which would reduce pressure on the central bank to raise rates.

Quantitative valuations:

Emerging markets have not been immune to the recent sell-off, which has been more of a market repricing story than the result of fundamental weakness. Spreads on the EM hard currency sovereign index are 30 basis points (bps) wider month-to-date, driven by high yield countries, which have widened an average of 41 bps over the same period. Combined with the rise in underlying base rates, this move has led to the highest yield on the EM hard currency sovereign index in over a year. However, EM local rates—which typically trade as a higher-beta market—have been relatively stable. The yield on the EM local rates index has risen just 8 bps in February, for a total month-to-date return of -0.2%. While the currency portion of the local sovereign market has sold off by 1.6% month-to-date, this is still pretty benign in the context of moves seen across financial markets, particularly given that currencies tend to be the most sensitive to risk moves (all data to 13 February).

Despite typically trading as a higher beta market, EM local rates have held up well amid the risk-off move

Source: J.P. Morgan, Barclays Live, Bloomberg, S&P, MSCI; data as of 13 February 2018. Global aggregate and global high yield returns shown USD hedged.

Technicals:

EM debt mutual funds recorded their first weekly outflow since mid-December in the week to 13 February, with USD 1.9 billion of redemptions. The demand picture warrants monitoring, particularly as this mutual fund outflow follows an outflow from exchange-traded funds the previous week. However, the long-term trend for EM debt flows continues to be overwhelmingly positive: over the past year, USD 64 billion has gone into the EM debt space. Limited new issuance, which has quieted down considerably ahead of the Chinese New Year, is also helping to keep the supply/demand equation in balance.

What does this mean for fixed income investors?

In an environment in which a broad range of markets, from equities to US Treasuries, have sold off, EM local rates have been surprisingly immune. Despite this de-correlation with risk markets, we do not believe that EM local rates are due for a correction: fundamental factors remain very solid and valuations are compelling, suggesting that demand for the sector will persist. While there has not been much new value created in the EM local market, it remains our preferred sector within the EM debt space. Not only are absolute yield levels still attractive, at above 6%, but inflation-adjusted yields are meaningfully positive. In particular, we favour higher-yielding countries with positive fundamental catalysts, where real yields are approaching 3.5% on average.

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