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Fixed-income market perspectives

Emerging-market bonds: even optimists need to be selective.

Despite an often difficult economic and political backdrop – particularly in Brazil – Latin America has been the best performing market this year. Accompanying Brazil's probably not sustainable performance has been Argentina's return to the capital markets, with a large and oversubscribed new issue following an agreement with investors in its old bonds earlier this year. This is an encouraging restructuring story.

Latin America's recent successes remind us of two things. First, that markets like to look forward – and that if they think a positive solution is possible for an underlying problem (e.g. the Brazilian leadership), then they are prepared to overlook the intervening uncertainty. Second, that historical issues (e.g. Argentinean debt) can be resolved, often years after the original event.

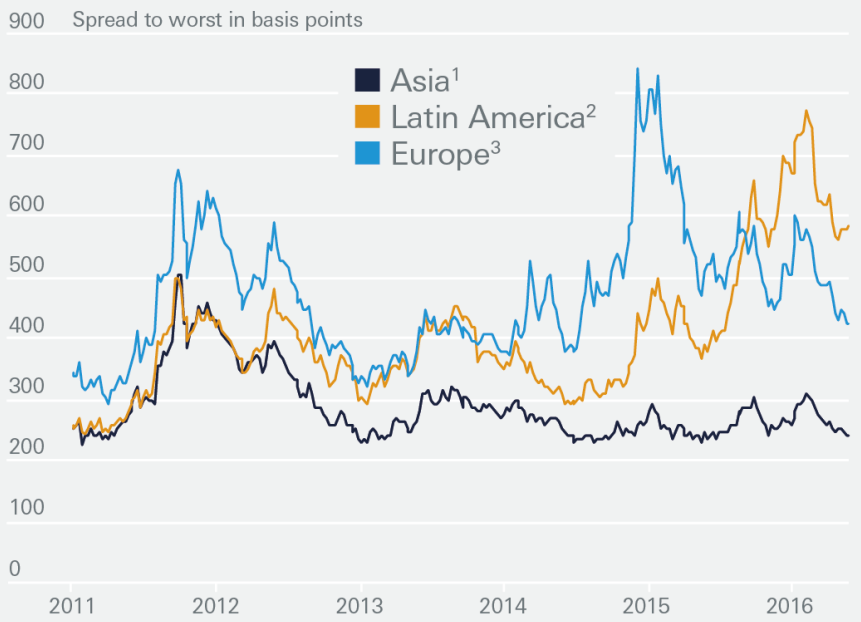
But these are specific issues. Is it possible to identify some broader, universal factors that have given emerging-market fixed income a helping hand? The answer is yes, if you are an optimist. In aggregate, it has gained from a positive mix of higher oil prices, a weaker U.S. dollar (until recently), reduced concerns over China and the associated recovery of other commodity prices. But to what extent is improved sentiment underpinned by fundamentals?

The most obvious point is that China's problems are not resolved: many concerns (e.g. about credit bubbles and loan defaults) remain. Moreover, governance issues remain in many emerging-market economies – recent experiences in Mozambique and South Africa serve to remind us of what can happen here. Mozambique's "tuna-bond" saga demonstrates to what extent emerging-market borrowing can be tangled up with government financing, and that clarity is difficult to get.

A second point is that many of the correlations between emerging-market performance and fundamentals are more complex than they might appear. The one exception to this is their relationship with the U.S. dollar: history suggests that reverses in emerging markets are usually accompanied by a stronger U.S. currency (with an exception in 2014). Our long-term forecast is for U.S.-dollar appreciation and this would likely be overall negative for emerging markets. The impending Fed rate hike is not likely to help either.

So while this is a generally positive environment, setbacks are still possible. We would favor being selective – and on the basis of facts rather than hopes.

Emerging-market spreads fall back



[1] J.P. Morgan Corporate Emerging Markets Bond Index (CEMBI) Asia
[2] J.P. Morgan CEMBI Latin America
[3] J.P. Morgan CEMBI Europe
Source: J.P. Morgan Securities LLC; as of 05/27/16

Spreads over U.S. Treasuries have fallen in all regions in 2016, helped by a variety of factors. But renewed U.S.-dollar strength and China concerns could weigh on this heterogeneous asset class.

Glossary

Appreciation

In relation to currencies, **appreciation** refers to a gain of value against another currency over time.

Bubble

A **bubble** is characterized by prices surging higher than warranted by fundamentals, followed by a drastic drop in prices as a massive sell-off occurs.

Correlation

Correlation is a measure of how closely two variables move together over time.

Default

Default is the failure to meet the legal obligations of a loan, for example when a corporation or government fails to pay a bond which has reached maturity. A national or sovereign default is the failure or refusal of a government to repay its national debt.

U.S. Federal Reserve (Fed)

The **U.S. Federal Reserve**, often referred to as "**the Fed**", is the central bank of the United States.