William Blair

EMERGING MARKETS DEBT

Investment Management
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2020 Outlook for Emerging Markets Debt

As we enter 2020, global market conditions remain supportive of emerging markets debt (EMD). Fundamentals are positive. Inflows and low net refinancing needs provide a solid technical backdrop. Additionally, valuations continue to be attractive. Thus, as we explain in the following pages, we expect a solid 2020 after a stellar 2019 for EMD.

February 2020

William Blair Emerging Markets Debt Team

Introduction

Marcelo Assalin, CFA

As we enter 2020, a number of factors lead us to think the outlook for emerging markets debt is positive. Last year's performance was clearly above average (primarily driven by falling U.S. Treasury yields, rather than EMD risk premia compression). This year's overall balance of factors looks marginally more constructive than last year's, based predominantly on better economic growth in emerging markets, but also on low inflation, positive EMD fundamentals, solid technical conditions, and attractive valuations.

- **Global market conditions remain supportive of EMD in 2020.** We have a constructive outlook for EMD as the favorable combination of factors that drove the strong performance of the asset class in 2019 remains in place. The global economy should continue to expand at a healthy pace, and economic activity in emerging markets is expected to accelerate into 2020. We acknowledge that the events over the past month in China are likely to weigh on economic growth in the short term, with risk of a more protracted and widespread impact. However, we expect that the response from monetary authorities will somewhat mitigate the impact on emerging markets debt. Historically, incidents of this nature have had a short-lived impact on asset-price volatility. That said, once evidence emerges that the spread has been contained, the recovery could be sharp in nature. We believe that U.S.-China trade tensions will moderate ahead of the U.S. presidential elections, inflation will remain subdued, and monetary policy will remain accommodative. Low global interest rates and ample liquidity conditions should continue to underpin investors' sentiment throughout the year. But while our outlook for the year is constructive, we are cognizant of risks: geopolitical tensions in the Middle East, the U.S.-China trade war, and the U.S. presidential election offer ample scope for volatility.

- **EMD fundamentals remain positive.** Economic activity in emerging markets is expected to accelerate in 2020 as the lagged impact of monetary policy stimulus implemented in the past year starts to materialize. We expect the growth differential between emerging and developed markets to expand in the coming quarters. A benign inflationary backdrop should continue to allow central banks to provide additional monetary stimulus as the level of real interest rates in emerging markets remains high. Moreover, external balances remain healthy in most places, fiscal and debt dynamics are at manageable levels, and the financial sector is well capitalized and regulated. We expect default rates to remain at historically low levels. Corporate credit fundamentals should remain stable as a slow capex cycle is unlikely to deteriorate leverage, in aggregate.

- **Inflows and low net refinancing needs provide a solid technical backdrop.** We expect the continuation of strong investment flows into EMD. There is strong evidence that capital flows into emerging markets intensify in periods when the growth differential between emerging and developed markets accelerates. Moreover, flows into EMD should continue to be supported by ample global liquidity conditions and low global rates. Investment flows into EMD portfolios are expected to be around $30 billion in 2020; in the meantime, net refinancing needs in the hard currency space, including sovereign and corporate credit debt, should remain relatively low, forecasted at close to $30 billion in 2020.[1]

1 Source: JP Morgan Emerging Markets Outlook and Strategy for 2020 (November 25, 2019).

- **Valuations remain attractive.** While slightly below the average of the past five years, hard currency sovereign and corporate debt spreads remain attractively priced relative to those of developed market credit. We see particular value in the sovereign credit high-yield space, where some frontier market names trade at cheap levels. We also see value in selected names in the corporate credit space. In the local currency space, emerging markets currencies remain fundamentally undervalued, and the real interest-rate differential between emerging and developed markets is at historically high levels.

All things considered, we expect a decent 2020 after a stellar 2019. While investors will likely confront bouts of volatility during the year, we tend to see those events as an opportunity to buy undervalued, fundamentally strong assets. The double-digit returns of 2019 are unlikely, but we still expect mid- to high-single-digit returns in 2020.

Details are provided in the pages that follow; we hope these provide a useful guide to the year ahead. Meanwhile, the William Blair EMD team wishes you a great 2020!

Marcelo Assalin, CFA
HEAD OF EMERGING MARKETS DEBT TEAM

Hard Currency Sovereigns

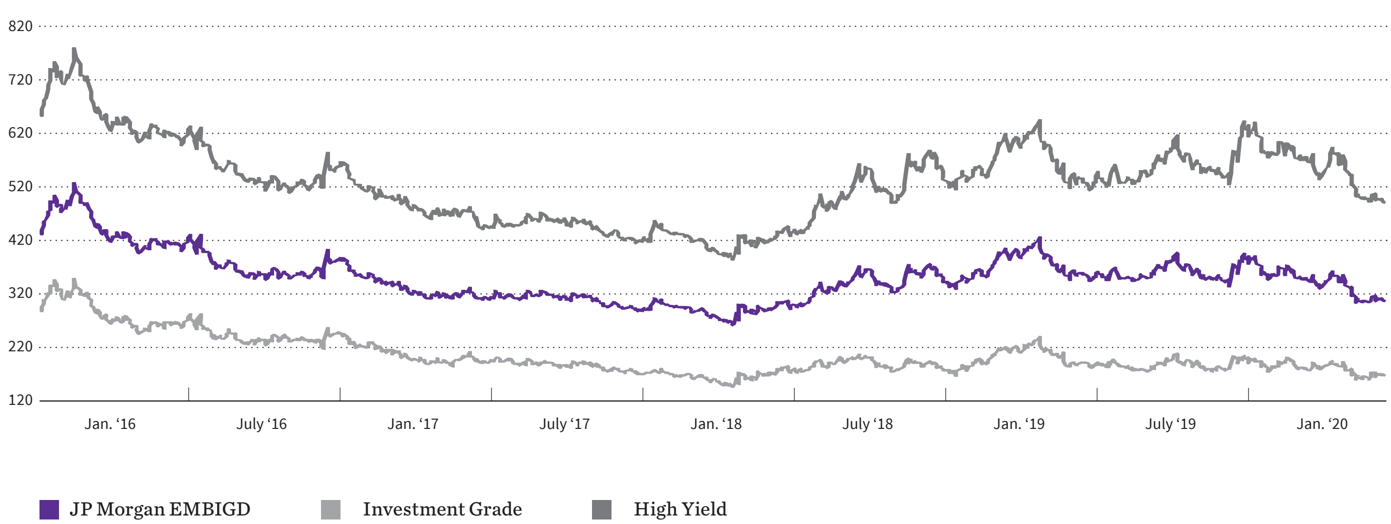
Last year was remarkable for U.S. dollar bond returns in emerging markets, which received a major lift from the rally in developed market bonds. The JP Morgan Emerging Market Bond Index Global Diversified (EMBIGD) returned 15%, more than half of which was driven by Treasury returns. Notably, the investment-grade sub-index materially outperformed the high-yield sub-index, as shown in exhibit 1. This was partly due to large detractions in performance associated with idiosyncratic developments in key markets, such as Argentina, Lebanon, and Venezuela. In contrast, frontier markets returned 19.2% in 2019.

In 2020, we expect to see further gains in EMD sovereigns, although the returns are unlikely to match those of 2019 given the increased prospect of muted duration gains. We believe the improvement in global growth dynamics is likely to provide a relatively strong backdrop for EMD. In our view, the widening of the emerging and developed market growth differential in 2020 will bode well for capital flows to EMD. This, combined with fairly muted sovereign external borrowing requirements, is likely to set a constructive technical tone for the asset class in the foreseeable future. JP Morgan estimates that sovereign net financing needs are close to $30 billion in 2020, less than half that of 2019 and the average over the past three years.

Emerging market sovereign fundamentals remain relatively robust, in our view, supported in particular by stronger economic activity. Emerging and developing economies are projected to expand by 4.5% in 2020, up from 3.9% last year, while major advanced economies are likely to slow to 1.5%. This partly reflects the dissipation of shocks in key economies—such as Mexico, Turkey, and the Gulf Cooperation Council (GCC) countries—as well as the more general reduction in trade tensions. Elevated debt levels and fiscal deficits will likely limit the scope for fiscal stimulus across high-yielders; however, we expect there to be additional fiscal thrust across emerging Asia and Russia, as well as monetary stimulus across high-yielders. Markets are pricing a high likelihood of debt restructuring in Argentina, Lebanon, and Zambia this year; we do not believe this presents a systemic risk to the asset class.

EXHIBIT 1

JP Morgan EMBIGD Z-Spread (Basis Points)



Source: JP Morgan, as of January 2020.

We continue to see pockets of valuations in EMD hard currency sovereigns as attractive despite the strong rally in 2019—especially if one considers valuations in the context of the low and negative yields present in the developed world. In particular, we see value in the high-beta sub-component of the asset class, in part because the spread tightening over the past year was largely led by the investment-grade and low-beta sub-component of the universe. In our view, valuations have become increasingly stretched in this area, with less material duration gains likely to emerge in 2020. Furthermore, there have been important changes in the composition of the underlying benchmark, which meaningfully reduced the spread level of the index. These changes included the removal of Venezuela and the gradual inclusion of the GCC countries.

High-Beta Credits

Among high-beta credits, Ukraine offers select value, in our view, despite the strong performance already witnessed in 2019. We believe economic and bureaucratic reforms should support improved activity levels, while prudent macroeconomic policies are likely to assist in reducing public debt levels further.

We further believe macroeconomic rebalancing under an International Monetary Fund (IMF) program is also likely to support Angolan credit in 2020. The lack of economic diversity remains a vulnerability in Angola. However, we believe economic reform, commodity prices, and limited financing needs are sources of strength this year.

Although we will likely continue to see turbulence in the defaulted (and virtually defaulted) credits of Venezuela and Argentina, we do think the low levels of the bond prices offer asymmetric payouts. Argentina's president, Alberto Fernandez, is pursuing policy that is markedly different from that of his vice president, former president Christina Fernandez de Kirchner, but he clearly faces a challenging macro environment. Consumption, investment, the peso, and confidence all continue to remain moribund.

Lebanese bonds were hit hard by the market in 2019 as increased street protests triggered greater investor focus on the weakness of the government balance sheet and its broken funding model. As we enter 2020, the market is now priced for default. While we agree that it is highly unlikely that Lebanon will avoid a restructuring of sorts, we are likely to again see high volatility of bond prices as market focus shifts to when the default will occur, the details of the restructuring, and potential recovery values. Key to this in the short term is the ability of Lebanon to form a working government to address these issues.

Medium-Beta Credits

In the medium-beta bucket, Brazil is in the midst of a radical economic transformation as the economy benefits from positive feedback loops inspired by Paulo Guedes' economic policies. Leftist presidents are seeing a resurgence in Latin America, but are overall more moderate in their rhetoric and more pragmatic than they were a decade ago.

In Mexico, President Andrés Manuel López Obrador's (AMLO's) populist bent will likely lead to credit deterioration over time, but we expect it to continue to be slow and gradual, as AMLO has shown himself to be more balanced than we initially feared.

Prospects for South Africa remain challenging, with a combination of very subdued levels of business confidence, supply-side constraints to the economy, subdued growth, and risks of further fiscal slippage pressuring spreads.

Senegal, on the other hand, is likely to see further strength amid strong economic growth, foreign investment, and improving public debt levels.

Low-Beta Credits

Guatemala continues to offer attractive spreads among low-beta credits. Growth is likely to accelerate as business confidence surges following President Alejandro Eduardo Giammattei Falla's electoral wins. We remain uncertain of his ability to enact change. However, strong growth, low public debt and fiscal deficits, and robust import coverage gives us little concern about Guatemala's ability to repay external creditors.

Prudent fiscal and monetary policies in Indonesia have led to spread tightening to such levels that we do not see much upside from here. Indonesia's key macroeconomic factors have been very stable. President Joko Widodo's policies will focus on maintaining economic and political stability, accelerating reforms, and improving infrastructure.

Chile has been affected by shocking political unrest and a material decline in confidence. Growth in 2019 will likely end up slightly above 1% (1.2% consensus forecast) and remain relatively subdued in 2020 (1.5% consensus forecast). Although Chile is arguably the most developed country in the region, inequality was an important driver of the unrest. Protests have abated recently, but the upcoming referendum on a new constitution will likely continue to weigh on confidence and inhibit private sector investment. Although significant uncertainty remains, our base case is that if Chile pursues a new constitution, it will not completely dismantle the institutional structure that has made Chile so relatively successful in Latin America.

> "We have seen spread compression on the back of inclusion of GCC countries and removal of Venezuela."
>
> **Yvette Babb**

Spread Compression

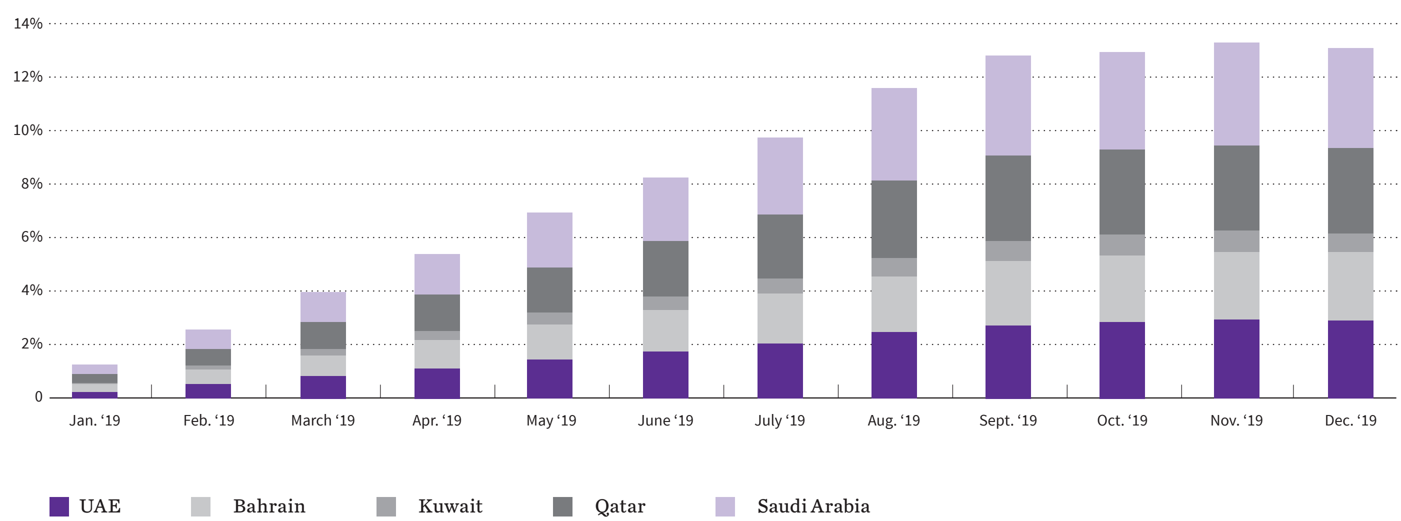
We have seen spread compression on the back of inclusion of GCC countries and removal of Venezuela.

The spread compression in the overall JP Morgan EMBIGD in 2019 was a meaningful 100 basis points (bps). However, changes in the composition of the index were a significant driver of this change. The inclusion of GCC countries over 2019 (to 13.0%; see exhibit 2) as well as the removal of Venezuela (from 1.1% in January 2019; see exhibit 3) led to a meaningful decline in the headline spread.

The Z-spread on the JP Morgan EMBIGD compressed by 60 bps in 2019 to 299 bps. The Z-spread on the JP Morgan EMBIGD, excluding the GCC countries, compressed by a far less meaningful 34 bps to 325 bps. And the Z-spread on the JP Morgan EMBIGD, excluding both Venezuela and the GCC countries, compressed by 43 bps to 315 bps. As a result, the latter is now 24 bps below the JP Morgan EMBIGD in January 2020 compared to as much as 56 bps above the EMBIGD at the onset of 2019. Exhibit 4 illustrates.

EXHIBIT 2

Weight of GCC Countries in the JP Morgan EMBIGD



Source: JP Morgan, as of January 2020.

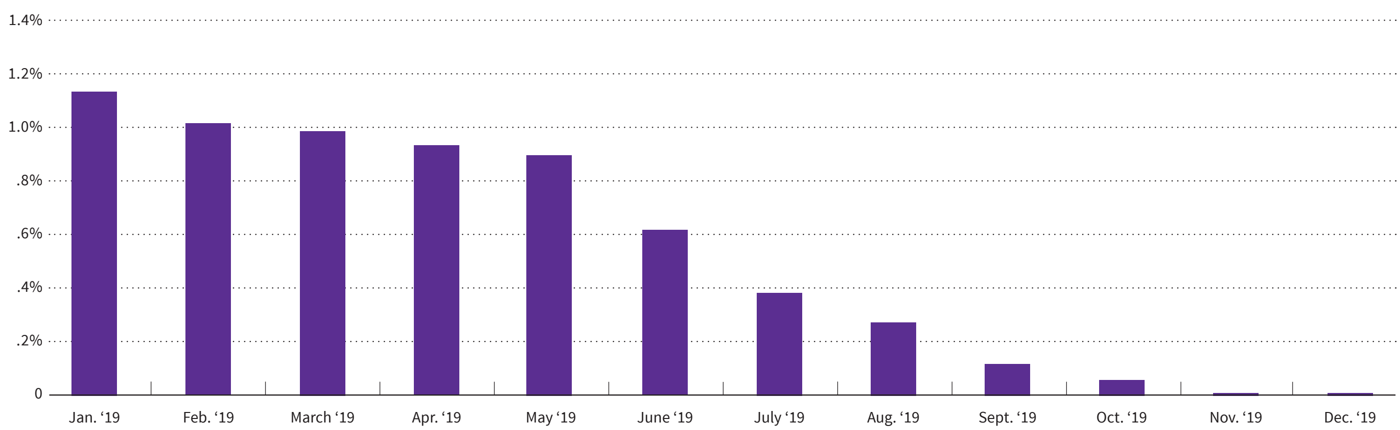
Outlook for Hard Currency Sovereigns

Overall, we have a constructive medium-term view given the benign global background, robust emerging market sovereign fundamentals, positive technicals, and still fairly attractive valuations (especially in high-beta countries).

However, volatility may increase in 2020 due to the potential for slower-than-expected global growth, renewed trade tensions between the United States and China in their phase two discussions, commodity price decreases, and the U.S. presidential election cycle.

EXHIBIT 3

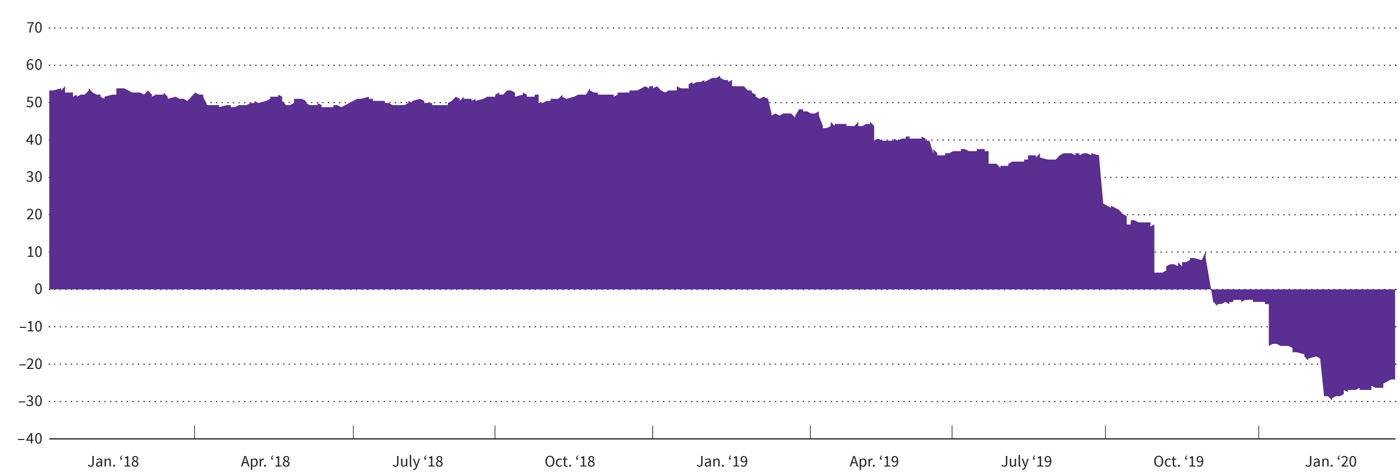
Weight of Venezuela in the JP Morgan EMBIGD



Source: JP Morgan, as of December 2019.

EXHIBIT 4

Difference between JP Morgan EMBIGD and EMBIGD ex-Venezuela and GCC Z-Spread (Basis Points)



Source: JP Morgan, as of January 2020.

Hard Currency Corporates

> "With cyclically strong fundamentals, supportive technicals, and fair valuations, we believe hard currency corporates are poised for solid relative returns in 2020."

Luis Olguin, CFA

After posting its best return since 2012 and growing steadily to over $1 trillion in debt outstanding, the JPMorgan Corporate Emerging Markets Bond Index (CEMBI) began 2020 on a stable footing. With cyclically strong fundamentals, supportive technicals, and fair valuations, we believe hard currency corporates are poised for solid relative returns in 2020.

Fundamentals

Even in the diverse world of emerging markets corporates, fundamentals tend to follow a cyclical path. Overall, the past few years have seen a reduction in gross debt, improving margins, lower capex, and better working capital management. This virtuous cycle began a slight downturn in 2019 as macro factors, in particular those related to global trade, affected top-line growth and margins. We expect tensions around U.S.-China relations to continue to add volatility to fundamentals for the foreseeable future, yet most recent actions suggest a somewhat more tepid period as we start the new year. Given this backdrop, we expect corporate credit fundamentals to be mostly stable in 2020, as show in exhibit 5.

Asia

For 2020, the multiyear planned rebalancing of the Chinese economy is poised to deliver its first sub-6% growth year in almost 30 years. While Chinese issuers, particularly high-yield industrials, are affected by slower growth, other drivers are also at play in China and the broader region. One of the largest sectors in the index, China's real-estate sector continues to be a focus, although consolidation, access to capital for the majors, and recent increases in property prices are all supportive.

India's growth is also slowing while its banking system copes with credit deterioration and an uptick in corporate credit stress.

Meanwhile, unrest in Hong Kong will likely lead to deterioration in the important real-estate and financial sectors. The Macau gaming sector, the largest sector in Asia, should see stable fundamentals as recent and new property developments balance a potentially lower traffic outlook.

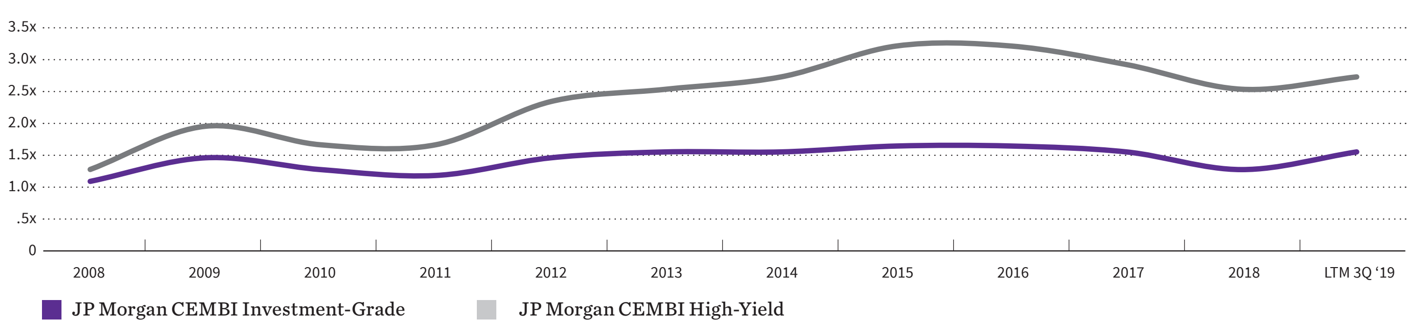
Central, Eastern Europe, Middle East, and Africa (CEEMEA)

The CEEMEA region is comprised of emerging Europe, Africa, and the Middle East, yet its overall reliance on commodities binds it together.

While balance sheets overall look quite solid, particularly in Russia and the Middle East, we believe a slight deterioration is likely as higher capex, increased dividends, and weaker pricing take a toll. In our view, UAE real-estate fundamentals continue to deteriorate.

EXHIBIT 5

CEMBI Leverage Trends



Source: JP Morgan, as of third quarter 2019.

The cycle also seems to be turning for corporates in Ukraine as capex is expected to rise, and we see stability to slight improvement in Turkish corporates, mostly based on improving yearly comps (although the banking sector is still likely to see weakness from the economic slowdown).

Several African issuers are past large capex cycles and could benefit from improving top lines. Oil producers in Africa exhibit quite idiosyncratic stories, yet none are expected to deviate significantly from oil-price performance.

Latin America

Although culturally similar, the Latin American region comprises diverse investment opportunities.

Brazil is the largest regional economy, with the second-largest number of issuers and the second-most sector diversity in our index after China. Large issuers remain on a deleveraging trend although other priorities, such as dividend payments and investments, are emerging. Brazilian gross domestic product (GDP) is expected to improve into 2020, setting a good backdrop for domestic economy issuers at the same time as improved pricing provides a tailwind for the more export-oriented protein and paper industries.

The Mexican economy should also rebound from the mild recession of 2019, but this improvement does not necessarily signify improving credit quality because 1) domestic issuers are already quite high quality and 2) other industrials and mining companies are more affected by global trade and/or growth factors.

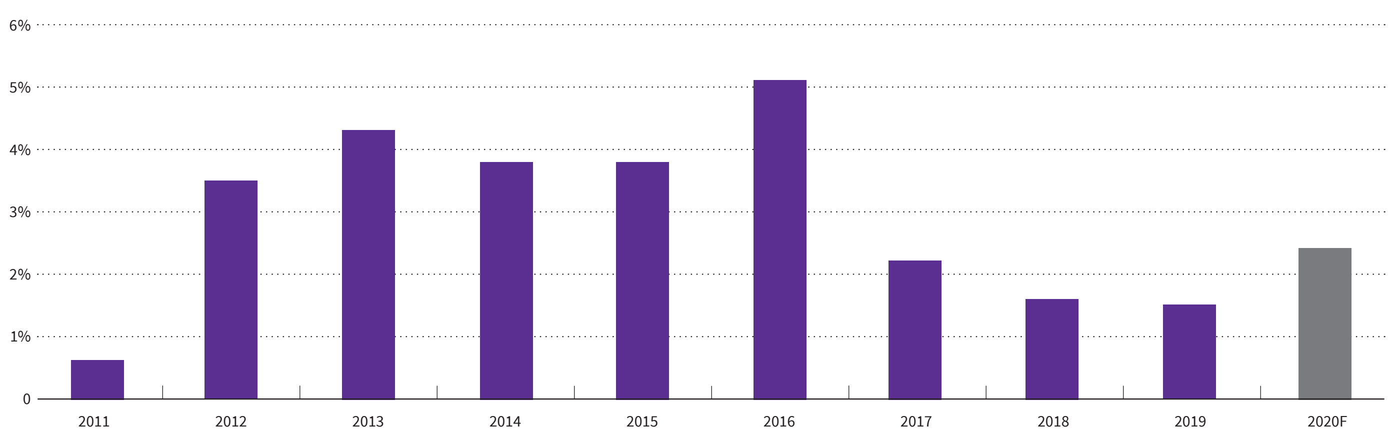
The Andean countries could see some deterioration in Chile and Colombia, with Peru likely being more stable. We do not expect credit deterioration in Central American issuers, although macroeconomic performance has worsened at the margin.

Defaults and Ratings

Last year, strong refinancing conditions and still good credit quality led to the lowest default experience since 2011, as exhibit 6 illustrates. At 1.5%, the universe default rate was lower than in developed market corporate credit. Out of the 20 defaults in 2019, 10 occurred in Asia, seven in Latin America, and three in CEEMEA. On a country basis, China had seven defaults and Mexico four. While sovereign risks such as Ukraine in 2015 or possibly Argentina in 2020 can cause countrywide stress, we believe corporate credit defaults are unique events and must be approached on an individual basis. For example, the largest default in 2019 occurred through a distressed-debt exchange, as a Jamaican-based telecom continued to suffer from high leverage, negative currency effects, and an unsustainable capital structure.

EXHIBIT 6

JP Morgan CEMBI Default Rate



Source: JP Morgan, as of January 2020.

Within the CEMBI universe, approximately 60% is rated investment grade and 40% is rated high yield. After peaking in the first quarter of 2018, upgrade/downgrade ratios have moderated, particularly as sovereign-level downgrades in countries such as Turkey and Argentina pressured those countries' corporate ratings. By analyzing rating outlooks, we get a sense of the potential ratings migration of the universe. Currently about three-quarters of the rated universe has a stable outlook, 18% has a negative outlook, and only 7% has a positive outlook.

Recent market pricing suggests a continued mild default experience going into 2020, with less than 2% of the CEMBI broad trading below 80 cents. Market pricing can certainly adjust quickly to changing expectations, yet we use the price-bucketing analysis as a real-time tool to gauge market sentiment. With the cycle beginning to turn, we believe defaults should rise slightly, but remain tempered by still ample market liquidity conditions. We expect that default rates for the emerging markets corporate universe in 2020 should be in the 2% range, with the caveat that a sovereign restructuring in Argentina could lead to a wave of exchanges and restructurings for the country's corporates.

Technicals[2]

We expect supply technicals to be supportive for the asset class in 2020, with net financing after liability management transactions (expected calls, tenders, and buybacks) estimated at $4 billion, according to JP Morgan, significantly lower than last year's $88 billion. Gross supply is expected to decline by 12% to $432 billion in 2020 following last year's record gross issuance of $489 billion, which matched the all-time high set in 2017. Maturities and coupons should pick up to $355 billion, driven by a 25% year-over-year surge in amortizations, absorbing more than 80% of the new supply and limiting the need for external flows into the asset class.

Asia accounts for most of the expected gross supply reduction in 2020 (in U.S. dollar terms) at $274 billion following last year's record supply. Nevertheless, the region should continue to represent the bulk of emerging markets corporate debt new issuance, accounting for almost two thirds of the expected gross supply. The decline in new issuance activity in Asia is largely explained by lower expected supply from high-yield corporates, particularly in China's high-yield property sector, a positive technical.

With total gross supply forecast at $64 billion, the Latin America region stands out given negative net financing after calls, tender, and buybacks at –$23 billion. Low growth in the region (particularly in key countries such as Brazil and Mexico), political uncertainty, a potential sovereign debt restructuring in Argentina, and the absence of a pickup in the capex cycle are expected to keep supply in check, with new issuance activity driven by refinancing needs.

Gross supply in CEEMEA is expected to decline the least, with new issuance only down by 5% from last year to $94 billion. This is a result of an increase in the gross supply from emerging Europe, the only region where gross supply is expected to be higher than in 2019. This occurs on the back of regulatory capital instrument issuance from Polish banks and Russian corporates.

In terms of demand, we note several supporting factors. Both dedicated and crossover investors in emerging markets remain underweight, according to JP Morgan's most recent monthly positioning survey. Early-year new issue oversubscription trends are quite strong. And last year's retail fund corporate-only flows were at an all-time high of $14.6 billion.

Valuation

Following strong returns in 2019, we still see pockets of value on a relative-value basis. The JP Morgan CEMBI Diversified returned 13.55% last year, closing at a +239 Z-spread. While current spreads are inside three-year averages, there is still quite a bit of room to reach the index's all-time tight Z-spread of +193, experienced in February 2018. The yield on the index is currently slightly above 4%, hovering near all-time lows. In the absence of a significant improvement in global growth acting as a positive catalyst, we believe spreads are likely to remain range-bound around current levels.

2 Source: JP Morgan.

Although the index-level spread is currently below its historical average over several time horizons, it is still possible to find some pockets where relative value looks moderately attractive.

Within the investment-grade bucket, the A-rated and BBB-rated portions of the JP Morgan CEMBI Diversified offer a 40% to 45% higher spread pickup than their corresponding rating buckets within the U.S. investment grade index, despite having better fundamentals (such as lower net leverage) than the investment-grade portion of the JP Morgan CEMBI Diversified.

In terms of regions, the Latin America investment-grade segment of the JP Morgan CEMBI Diversified screens as the most attractive, with a current spread pickup greater than 100% to U.S. investment grade, above its two-year average of 90%.

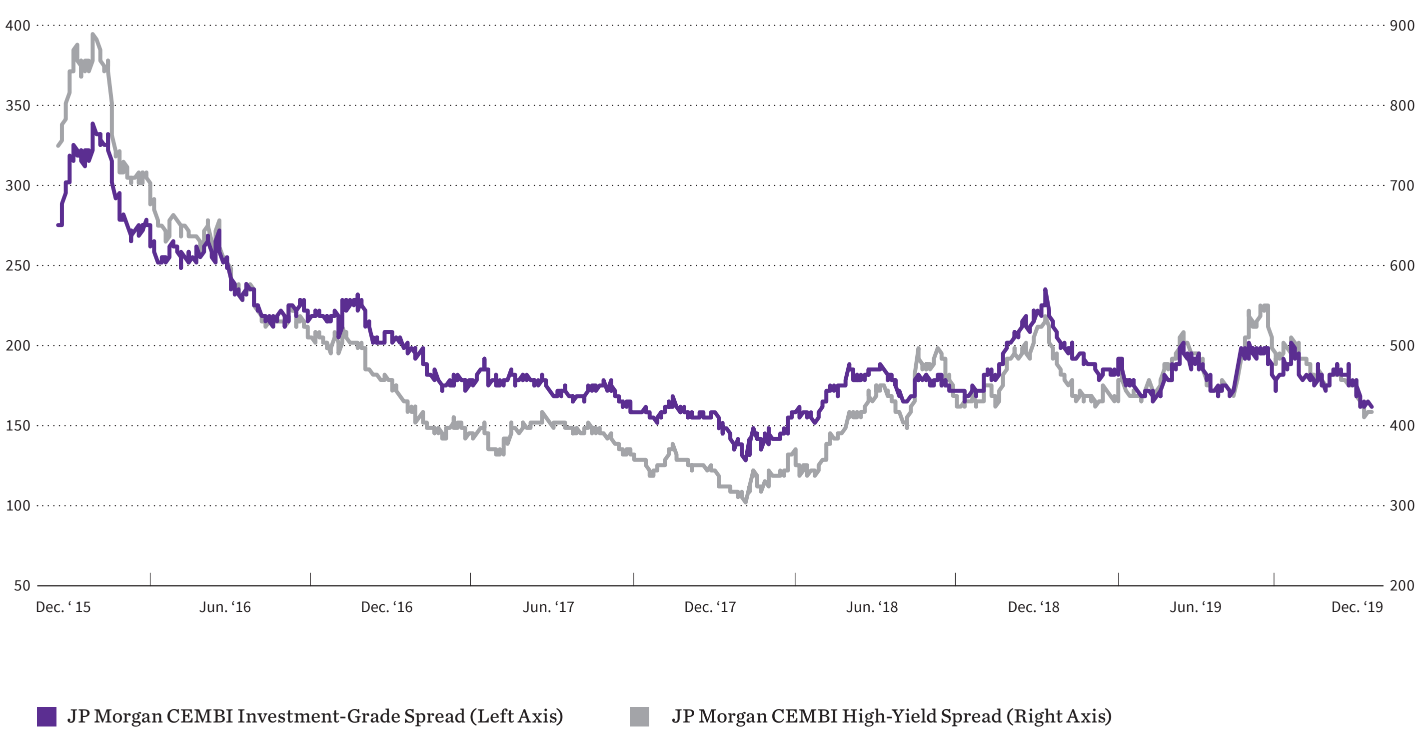
In the high-yield segment, the JP Morgan CEMBI Diversified trades tighter than U.S. high yield, mostly due to index composition in rating and sectors particularly as the U.S. high-yield index has a higher percentage of credit rated B and CCC. When looking at the BB rating, the spread pickup from emerging markets is still positive at around 30 bps or 13%, close to the long-term average on a percentage basis. Exhibit 7 illustrates.

Return Expectations

Since inception in 2001, the JP Morgan CEMBI Diversified has had seven years of double-digit positive returns. Of those years, only two were followed by another double-digit return year. Four were followed by years with lower but still positive returns, and one was followed by a year with negative returns. We believe 2020 will likely exhibit positive but lower returns than 2019.

EXHIBIT 7

JP Morgan CEMBI Investment-Grade vs. High-Yield Spread History (Basis Points)



Source: JP Morgan, as of January 2020.

Local Currency Bonds

Performance for emerging markets local currency sovereign bonds has been mixed over the past several years. However, 2019 was a strong year for the asset class.

As shown in exhibit 8, rates have performed very well (in line with developed market yield curves), driven by ample global liquidity, weaker-than-trend growth, low inflation, and fiscal consolidation among emerging markets issuers.

However, currency performance was much more moderate. Investors have been wary of exposure to normally higher volatility emerging markets foreign exchange (FX), particularly as the cost of hedging back to dollars or euros has fallen as central banks cut rates.

Looking out over 2020 and beyond, however, we believe that many of the headwinds holding back emerging markets currencies should fade, and spot appreciation, combined with relatively attractive real interest rates, have the potential to deliver strong results for investors willing to hold local assets on an unhedged basis.

More broadly, in the context of a wider range of asset classes and investment opportunities encompassing both emerging and developed markets, emerging markets FX stands out for being attractively valued relative to fundamentals.

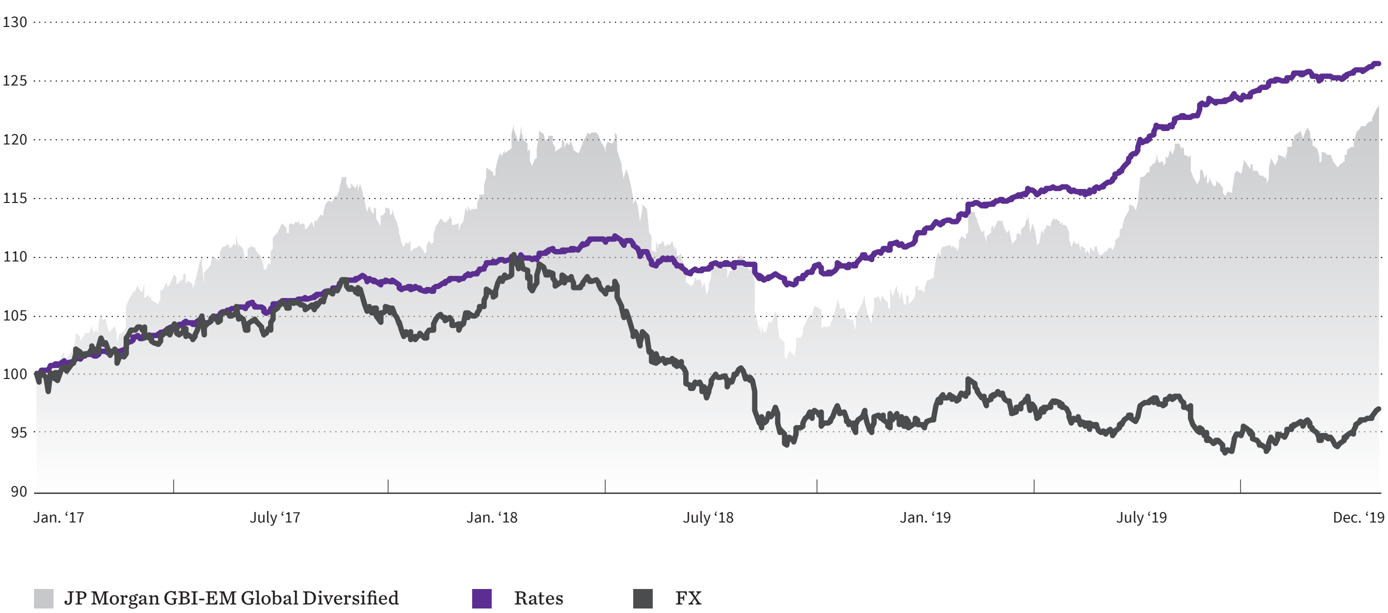
The United States, China, and Trade

While our expectations certainly rely on a supportive macro picture in emerging markets, the outlook also depends heavily on the world's two largest economies—the United States and China—working out some of their differences and reaching a tentative agreement on trade.

With the recent signing of phase one of a wider trade negotiation, both sides have signaled their willingness to de-escalate. Indeed, a framework for dispute resolution was a critical element of the agreement, which should help anchor expectations in coming months before U.S. elections move to the forefront of investors' minds.

EXHIBIT 8

Breakdown of Benchmark Returns, 2017-2019



Sources: JP Morgan and Bloomberg, as of December 2019. **Past performance is not indicative of future returns.** A direct investment in an unmanaged index is not possible.

Admittedly, it will take some time before we see improved trade dynamics show up in the data (particularly given the sharp but transitory impact of the coronavirus shock), but the boost to investor confidence and the reduction of tail-risk probabilities should elicit some economic green shoots in the growth outlook for a number of major emerging economies. A pickup in trade should also help the U.S. economy push recessionary risks further out. While we do not believe that we are likely to see any significant acceleration in growth from current levels, tight labor markets and easy monetary policy should continue support consumption. One potential risk that we have flagged is for U.S. inflation to pick up in a scenario of steady growth at around the 2% level combined with rising wages and a weaker dollar. In our view, this would likely result in a modest steepening of the Treasury curve, whereas the bar for the Fed to actually reverse course and tighten rates is very high. After years of inflation undershooting, the Fed has signaled a willingness to tolerate some excess inflation in support of the growth side of its dual-mandate goals.

For emerging markets, this would likely put upward pressure on local curves, particularly among the low-yielding countries that have seen the strongest flattening trend over the past year. Some of the higher-yielding countries, where policy makers have been slower to loosen policy, should be more insulated, owing to a larger term-premium cushion. With this greater degree of rates return dispersion expected, our strategy is to be highly selective in our duration exposures and more cautious in terms of the overall share of rates risk.

Macro Fundamental

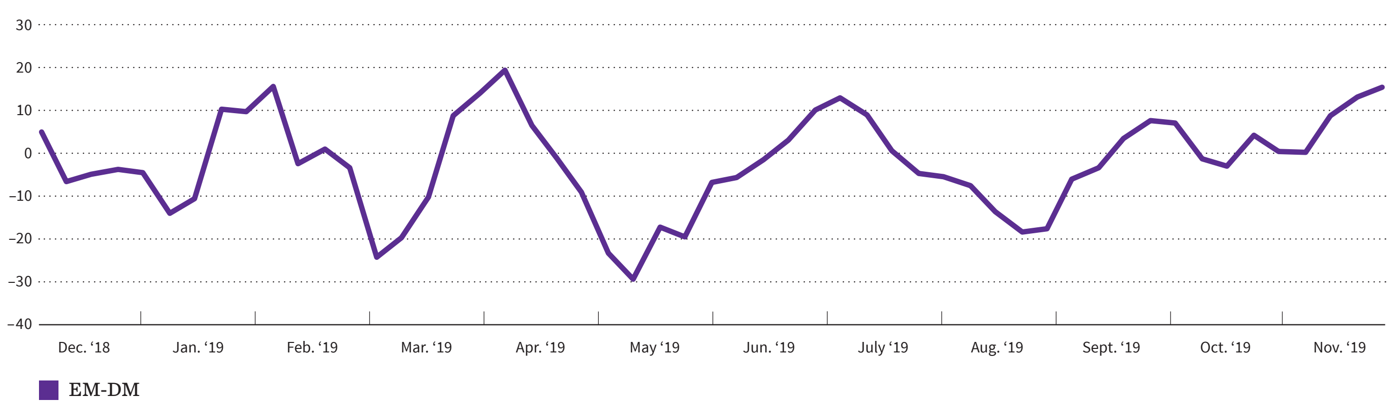
In terms of our outlook for emerging economies themselves, we have been encouraged by a number of positive macro trends that should continue through the coming year under our central scenario.

First and most importantly, aggregate GDP growth in emerging markets is forecast to rise from approximately 4.3% in 2019 to 4.5% in 2020.[3] At the same time, developed market GDP growth is expected to decelerate from 1.7% in 2019 to 1.5% in 2020. Widening growth differentials historically have been an important driver of capital flows and currency valuation, and we do not expect this relationship to change in 2020. Indeed, one of the strongest drivers of U.S. dollar strengthening since 2014 has been the country's above-potential GDP growth amid a period of greater global uncertainty.

Consensus forecasts have been further supported by recent high-frequency data in terms of expectations versus surprises in actual data. After a strong third quarter, looking at Economic Surprise Indices, developed markets have trended downward and have been in negative territory since October. Emerging markets, on the other hand, have been more or less neutral over the same period, spiking back into the green this year. See exhibit 9.

EXHIBIT 9

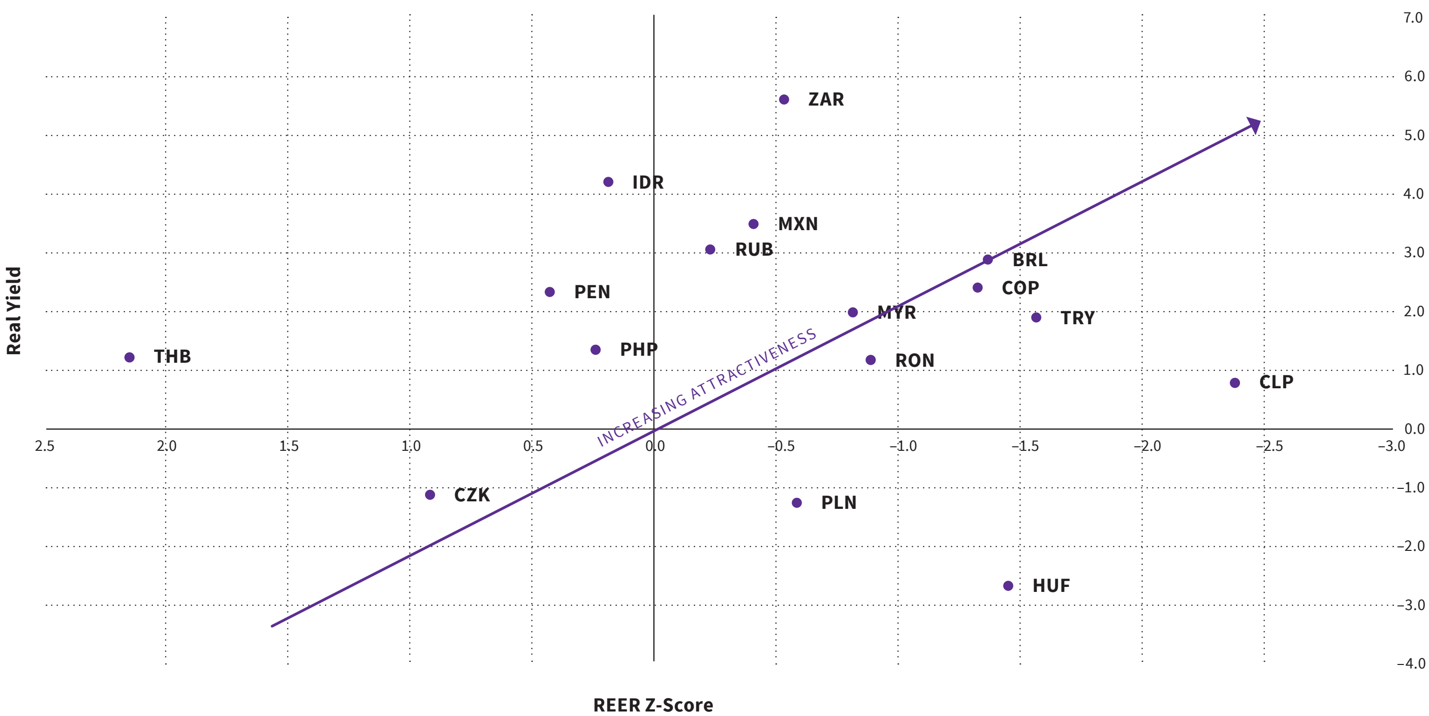
Economic Surprise Indices



JP Morgan and Bloomberg, as of December 2019. | 3 Source: JP Morgan.

EXHIBIT 10

Emerging Markets Real Rates vs REER Z-Scores



Sources: Bloomberg, JP Morgan, and William Blair estimates, as of January 2020.

Technicals and Capital Flow Dynamics

Overall, we expect this combination of positive real rates, attractive valuations, and stable-to-improving fundamentals to drive strong portfolio flows into local markets in the coming year.

From what we have seen so far in the reported fund data, not only have investors been allocating new money to the asset class, but active managers have also been adding risk. We are still early in the rebalancing process, and far from stretched levels in both dedicated positioning and global investor allocations to local emerging markets debt, so this trend still has legs, in our view.

In terms of aggregate flows across various emerging markets sub-asset classes (sovereign credit, corporates, and equities) relative to 2019, the consensus expectation is for a somewhat lower total given a lighter monetary tailwind. However, this is tempered somewhat by lower expected issuance. In recent years, we have seen emerging markets issuers extend further along the curve, leading to a relative lull in refinancing requirements for 2020.

FX and Rates Valuations

Lastly, we come to valuations for emerging markets FX and local rates. This presents a fairly mixed picture when we consider emerging markets alone, but is considerably more positive when we consider emerging markets on a relative basis.

> "We expect this combination of positive real rates, attractive valuations, and stable-to-improving fundamentals to drive strong portfolio flows into local markets in the coming year."
>
> **Lewis Jones, CFA, FRM**

First, we estimate that for the countries composing the main local debt benchmark, the JP Morgan GBI-EM Global Diversified, emerging market currencies are between 3% and 5% cheaper than fair value averaging using a number of longer-term valuation methodologies (such as purchasing power parity, real effect exchange rate, and fundamental effective exchange rate). Combined with an average real cash rate of around 2.2%, this makes a compelling case for holding local assets, whether rates or equities, unhedged.

On the rates side, however, term premium has all but disappeared from the curves of many of the lower-yielding investment-grade names. High-yield curves have also flattened, but this is also reflective of much lower current inflationary pressures and expectations over the next few years.

Additionally, for most benchmark countries, we have also passed the peak years of debt re-profiling that saw an increasing share of issuance locally (versus externally in U.S. dollars).

Ultimately, though, it is the huge amount of negative-yielding debt globally that will continue to encourage investors to increase allocations to emerging markets. And while we do not anticipate a repeat of 2019's strong performance, we believe curves will remain well supported.

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