GUARDCAP

Emerging Markets Quarterly Outlook

QUARTER TWO 2021

A CONFLUENCE OF FACTORS EMERGING IN MARKETS

The stark improvement in the global macroeconomic outlook this year, driven by increasing vaccinations against COVID-19 and a new wave of fiscal stimulus, has continued to underpin further improvements in investor sentiment. Accordingly, risk assets have sustained the upward momentum established in 2020.

With that said, the strength has been far from uniform across markets. Instead, there have been a confluence of factors that have resulted in differentiation in performance across geographies and sectors.

For starters, the anticipation that broad-scale economic reopening is now set to happen sooner rather than later, signs of abundant pent-up demand and savings on the part of both households and businesses, as well as impending fiscal stimulus have provided a significant lift to earnings expectations. This is especially the case for those segments of the market that were most impacted by the crisis and that now stand to benefit most from a cyclical upswing. The relative improvement in earnings momentum has been a big factor in the sector rotation in markets that has seen the more "value"-biased cyclical stocks play catch up with those "growth" sectors that materially outperformed last year.

This change in sector leadership to more economically-sensitive areas is a general boon for emerging markets (EM), which traditionally skew more heavily in this direction; however, the region's markets have not been able to fully reap the benefits, as ongoing difficulties with the pandemic make the near-term outlook far less clear than that of developed markets (DM).

Despite the likes of Brazil, India and Russia serving as significant production hubs for vaccines, rollout of inoculations has been much more successful in DM than EM to this point. Current projections indicate that DM populations will likely be able to hit herd immunity thresholds by the fall, whereas such a development in EM is likely to be a 2022 story. This relative lag creates comparatively less earnings visibility for EM and serves

as a headwind for near-term growth momentum — and that goes doubly for regions (such as India and Brazil) that are having greater problems at containing the virus, as well as those more dependent on tourism and travel (which count many in the EM complex amongst that list).

With that said, the better overall outlook and the general upward revisions to the global growth forecasts have resulted in a corresponding shift higher in inflation expectations. While firming price pressures, particularly for raw materials, have been increasingly evident worldwide, they are especially a concern within EM, where economies have historically struggled to get inflation under control. These early whiffs of inflation may force policymakers to react aggressively at the risk of hindering their countries' nascent recoveries — indeed, central banks in Brazil, Russia and Turkey have already raised rates this year in an effort to get ahead of the curve.

More generally, the combination of renewed investor focus on being compensated for the impact rising prices have on eroding the future purchasing power of money, increasingly buoyant growth forecasts and rate hike expectations being brought forward drove a sharp increase in market interest rates and supported a broad firming in the US dollar — with the latter feeding negatively into the inflation picture and tightening financial conditions in EM as well.

While markets, including those in EM, can generally continue to perform well when rates rise in conjunction with an improving growth backdrop, the speed and magnitude of the move was a source of investor angst. Moreover, given the prevalence of US dollar-denominated debt in some corners of EM, the rising costs of capital and firming greenback raised concerns over financial vulnerabilities within the group.

Finally, not only has the increase in market yields been a drag on debt markets, but it also provided a headwind to equities as well. The intrinsic value of a stock is derived from the cash flows that the underlying company is able to generate both now and in the future; higher interest rates reduce the present value of those future cash flows. As a result, those companies that are valued predominantly based on their future prospects have been impacted more by the up-move in the rates market, which has further supported the rotation away from the "growth"-oriented areas of the market that had previously flourished over the last year — such as those North Asian markets that account for the bulk of the weight in the MSCI Emerging Markets Index.

These factors have all contributed to EM equities (+2.3% total return in US dollar terms in Q1) lagging DM (+4.9%) so far this year, while they also have their fingerprints on the regional disparities within the not-so-homogeneous EM group itself. For example, Emerging Europe, the Middle East and Africa (EMEA) generated the strongest returns (+8.1%) as the more economically sensitive and natural resource-skewed bourses benefited from the strength in commodity prices, especially that of crude oil. Latin America has a similar "value"-titled composition to its market benchmark; however, concerns over COVID-19 outbreaks and rising political uncertainty weighed on its performance (-5.3% in Q1). Asia and its Tech and "growth"-heavy markets took a bit of a breather (+2.2%) after handily pacing its peers in 2020.

A Balance of Risks

Just as it has been the case since the pandemic first began, the ability to get the spread of COVID-19 under control will be a key determinant of economic and market performance in the months ahead. As such, it appears that near-term momentum in EM will be comparatively restrained relative to that of DM.

Vaccination is expected to accelerate in the second half of this year throughout EM as more supply becomes available. The COVID-19 Vaccines Global Access (COVAX) Facility is committed to distributing vaccines equitably across low-to-middle income countries, with a goal of supplying two billion doses by year-end — the initiative has issued just 53 million doses to date.

While that suggests that EM economies will not put the pedal down and move into the passing lane until later this year, there is still scope for EM growth to shift into a higher gear in the coming months.

The persistently surprising strength of DM economies

has underpinned a surge in factory activity worldwide, as domestic production has struggled to keep pace with bulging order books and inventories have dwindled, creating a need to rely on imports to meet demand. International merchandise trade volumes (which had largely been stagnant since 2018 against the backdrop of heightened tensions and rising tariffs and other barriers) have rapidly rebounded from their crisis lows and now stand 4% above their previous peaks globally, with EM reaping a good share of the newfound strength — the reluctance of EM policymakers to tighten restrictions to the same degree as their DM counterparts means that EM have been able to operate at a higher capacity than their more developed peers.

The imminent wave of stimulus and savings/wealth-driven pent-up spending and investment that are set to be unleashed in the coming months as DM economies re-open will only serve to strengthen this growth tailwind for export-oriented, goods-producing EM economies.

On a related note, the resurgence of exports has helped to materially improve the overall external financial position of EM. The median current account balance shifting from deficit pre-crisis into surplus (the likes of Argentina, India, Mexico, Poland and South Africa have seen this switch) helps mitigate financial vulnerabilities. Furthermore, the International Monetary Fund appears likely to approve a new US$650 billion allocation of special drawing rights (SDR; international reserve assets used to supplement official reserves), that will be distributed mid-August and help ease funding pressures within EM.

A diminishing focus on these external financial stresses provides more scope for policy to support domestic economies, though the capacity for governments (particularly those in Latin America) to provide support is constrained by still generally fragile fiscal positions. Additionally, rising inflationary pressures are limiting the willingness of EM central banks to loosen policy any further — indeed, there is a growing hawkish bias in monetary policy proceedings across the region.

The challenging policy backdrop is further complicated by rising political volatility in some corners of EM.

Brazilian President Bolsonaro has seen his popularity plummet thanks to the handling of the pandemic, and that has led to turnover within the government's ranks via cabinet reshuffling. Add to that the recent court decision to overturn the corruption convictions of left-wing former president Luiz Inácio Lula da Silva, and it opens the door to a contentious election next year (slated for October 2, 2022) that could dim the prospects for Brazil's much needed economic reforms.

Similarly, the upcoming second round of the Peruvian general election (June 6) presents a material risk to the country's outlook, as frontrunner Pedro Castillo's socialist Free Peru Party has taken a hardline stance on the country's mining sector, with proposals to nationalize the industry.

For his part, Mexican president Andrés Manuel López Obrador has continued to press to reverse his predecessors' efforts to increase privatization in the economy — for example, the reform to the Electricity Industry Law that came into effect in March strengthens the role of the state-owned electric utility (Comisión Federal de Electricidad) in Mexico's energy sector.

Colombia has recently been hit by a wave of civil unrest, initially in response to President Ivan Duque's (since withdrawn) fiscal reform measures that included an increase in the country's value-added tax. The protests have now expanded into broad calls to address deep economic inequality in Latin America's fourth-largest economy, while the government's violent response to these public actions has only seen tensions escalate.

Of course, the biggest source of political risk for EM as a whole surrounds China's relationship with western democracies, chiefly the US.

While it appears to be the case that the new administration in the White House is adopting a less-hostile approach to foreign relations than its predecessor, the US is unlikely to take China's efforts to displace it on the world stage sitting down. As such, further sparring between the world's two largest economies remains likely — and as has been evident over the last four years, investor risk appetite tends to ebb when tensions rise on this front, leaving EM economies and assets vulnerable to being caught in the crossfire.

Cautious Optimism

While domestic conditions within EM remain challenging with respect to the pandemic and policy, and rising market yields and the potential for further firming in the US dollar pose risks, the overall outlook has improved for the group, which gives reason for cautious optimism regarding the prospects for EM assets.

The continued vaccine-induced improvement in the global economic outlook and the persistent abundance of fiscal and monetary stimulus will provide a key support to the more cyclically-sensitive segments of the market to which EM are traditionally more skewed — this would be a particular support for EMEA and Latin American economies that have so far lagged in the recovery. Asia also stands to benefit from these developments while their comparatively better management of the pandemic (India aside) and consequent faster normalization of domestic activity should support relatively stronger growth.

Further ahead, the broader easing of domestic restrictions and the reopening of economies to tourism and travel permitted by vaccination, combined with the expected sustained trade-driven boost from above-trend growth in DM, would appear to support a widening of the EM growth differential.

That said, the confidence intervals around growth forecasts remain persistently wide, especially relative to DM, which translates into elevated risk premia on EM assets. EM equities continue to trade at wider-than-normal discounts to their DM counterparts on both a price-to-earnings and price-to-book basis, and these gaps are even greater in the context of earnings growth expectations beyond just the current year.

Should the outlook evolve as expected and key forecast risks subside, conditions appear ripe for EM assets to perform well in the months ahead, though not free of a few bumps along the way.

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