GUARDCAP

Emerging Markets Quarterly Outlook

THIRD QUARTER – 2020

TO 'V' OR NOT TO 'V', THAT IS THE QUESTION

The COVID-19 pandemic has dealt a historic shock to the world economy with Q1's decline alone comparable to the peak-to-trough decline in the worst recession before the 2008/09 financial crisis. Moreover, the anticipated cumulative drop in the first half of this year in excess of 10% more than doubles the hit from that historic downturn a little more than a decade ago.

At the onset of the crisis in Q1, the heightened uncertainty, concern and pessimism over the current situation permeated into expectations for growth and led to a wave of fairly indiscriminate panic selling of any assets perceived as carrying risk. Capital flowed from Emerging Markets (EM) at its fastest rate on record as investors sprinted to the exits, compelling EM stocks and bonds to turn in their worst quarterly performance in over a decade.

Importantly, however, these downbeat views largely neglected to take into account what actually happened to the global economy.

For one, the fact that the downturn, sharp as it is, is the result of an exogenous shock to the supply-side of the economy rather than structural issues impacting demand, making it very different from previous experiences. Typically, in scenarios of this kind, activity can normalize fairly quickly once those external forces subside, resulting in rapid 'V'-shaped rebound in momentum.

Furthermore, the expectation that conditions would only continuously deteriorate ignored the role of policy. In times of economic crisis, policymakers on both the fiscal and monetary side typically step in to try to blunt the impact of the collapse of private demand and provide a general backstop for the economy. This time was no different — though it was quite different in terms of the speed and magnitude with which these official bodies acted.

Since March, governments across the G20 economies have pledged nearly US$8 trillion (11% of the group's GDP) in fiscal support from programs, including direct payments for individuals, to loans for businesses, to infrastructure investments. There is considerable variation across countries though, with the major Developed Market (DM) committing nearly 10 percentage points more of their GDP in support than their more fiscally-constrained EM counterparts.

Keeping Economies Afloat

While emergency measures are warranted to help keep economies afloat through this crisis, the substantial associated deterioration of fiscal balances, and resultant surge in public debt, will undoubtedly prove to be a burden. This burden will need addressing down the road via fiscal restraint that could carry material negative effects over the longer-term, especially among the EM.

For the foreseeable future, however, the cost of carrying that growing debt burden is far from onerous given that market yields sit at never-before-seen lows. Central banks across the globe have slashed interest rates to levels viewed as their effective lower bounds. Simultaneously, they are also ramping up the size and scope of asset purchase programs to pump liquidity into the financial system and ease dislocations in funding and credit markets, helping prevent the public health crisis from turning into a financial crisis.

Over Q2, with these measures providing a backstop, market expectations began to shift – while still not pricing in outlooks that can be viewed as optimistic, the weight assigned to the worst case scenarios declined substantially. As a result, the distribution of potential outcomes shifted to the positive side as investors realized the first sharp leg lower represented an overshoot to the downside.

Accordingly, EM outflows slowed before ultimately reversing course at the end of Q2 while markets rallied sharply through the piece. The MSCI Emerging Markets Total Return Index jumped 18% over the three months ended June, its best quarter since 2010, to recoup a significant portion of Q1's declines. In sharp contrast to the first three months of the year, all 26 component countries in the index saw their regional stock markets rise in Q2 (all but four notched gains in excess of 10%; nine rallied more than 20%) and each of the 11 industry sectors posted gains as well.

For their part, EM bond prices (as per the Bloomberg Barclays EM Aggregate Total Return Index) surged 10% (best quarter since 2009) to almost completely retrace the weakness at the start of the year.

The Road to Recovery

Of course, hope can only go so far. The improvement in expectations was buoyed by the fact that data covering everything from housing to consumer spending to construction to industrial production worldwide, started exhibiting a conspicuously sharp inflection from the lows registered amid widespread shutdowns. This inflection resulted from success in slowing the spread of infection and mitigating the strain on healthcare systems permitted policymakers to scale back the measures put in place and start to reopen their economies.

Indeed, the North Asian economies that were hit by the pandemic earliest and led on the way down have so far been the leaders on the way up as well. China, for example, which registered its first quarterly contraction in economic activity in decades in the first quarter, actually managed a record-setting rebound in Q2 as easing restrictions saw production rapidly come back on line. This initial bounce though was, in part, a reflection of a need to rebuild depleted inventories rather than a recovery of demand as DM economies endured the worst of the shutdowns through the quarter.

Lost Ground to Make Up

The gap between economic output and its previous peaks has narrowed; however, there is still plenty of lost ground to make up. Things are getting better for sure, but are still not in a place that can be considered 'good' in an absolute sense – and it will still likely be a long time until the damage inflicted on the global economy by this public health crisis has been fully repaired.

If the resumption of idled activity continues, there is upside risk to growth in the near-term as hopes of a 'V'-shaped recovery are realized. For such a scenario to play out, however, the stringent measures implemented by governments around the world need to continue to be rolled back and permit consumers and businesses to return to something akin to 'business as usual.' Of course, what was 'usual' is not likely to continue in future. Secular trends (for example, toward digitalization) have been accelerated by this crisis, creating substantial disruption among many traditional industries that will leave some economies (particularly those in North Asia) better positioned than others.

The continued economic reopening, however, is becoming increasingly difficult amid signs that the spread of COVID-19 is escalating aggressively in not only several major EM economies (most notably Brazil, India, Mexico and South Africa), but also the more economically important US – and any renewed weakness stateside will undoubtedly carry significant ripple effects to the many EM economies that are heavily reliant on trade and investment flows from America.

There is limited, if any, appetite for renewed lockdowns in the US or elsewhere. Moreover, in many EM economies (particularly those in Latin America), fragile fiscal positions and a general inability to tap international capital markets highly constrain governments in their ability to provide any sort of necessary economic stopgap absent international aid packages (which do not appear to be forthcoming to any meaningful extent). At the same time, any such mitigation efforts are also more inherently difficult and less successful given how densely packed some cities in the group can be. Accordingly, the base-case assumes that stringent policies continue to be cautiously reversed, for better or worse.

Variations Across Regions

That said, should such measures be necessary to once again arrest the contagion in the absence of vaccines or therapeutics (which are on the horizon, but not ready yet), a renewed lockdown could stop the recovery in its tracks and increase the likelihood that the growth outlook is more 'W'-shaped which would likely be more pronounced throughout the more cyclically-sensitive EM.

To the extent that the likelihood of a return to March-like conditions can be diminished — for example, by indications that the contagion is coming under control or progress is made on the development of therapeutics — that would present upside risks to the outlook. While there is still likely to be variation across regions – Asia is likely to pace the recovery throughout EM, for instance — it still appears that the overall balance of risks is tilted in this direction.

Undoubtedly, plenty of risks linger over the horizon. Beyond the pandemic, there is a laundry list of concerns such as persistent tensions in US-China relations, the upcoming US election, and ongoing civil unrest simmers on the backburner. It appears, however, that for the time-being the global economy is back on the (long) road to recovery. The path of least resistance for the coming months looks to be toward improvement underpinned by a continued abundance of fiscal and monetary stimulus that will serve to limit near-term pressures on EM currencies and financial conditions.

As such, assets in the EM space appear primed to continue on their own road to recovery from their crisis lows as investors continue to pare the undue weight assigned to the worst-case scenario outcomes – but the journey is unlikely to be an easy and smooth ride with markets remaining prone to bouts of headline-driven volatility.