Investment Institute Macroeconomics

Tough love for emerging markets has improved their resilience

A better investment landscape in emerging markets ahead of US elections

Macroeconomic Research

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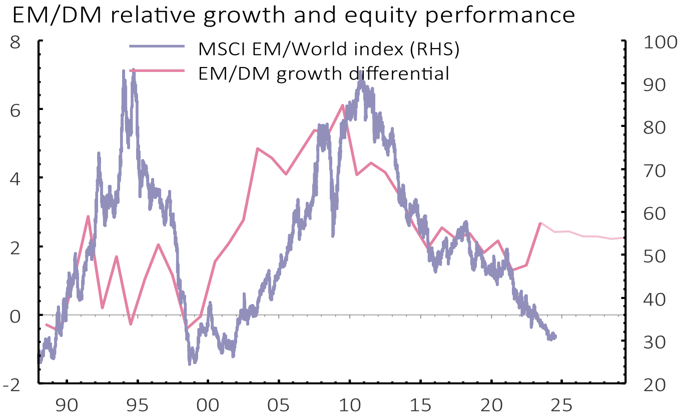
Key points

- Emerging markets (EM) have evolved significantly over recent decades supported by financial markets liberalisation and improved macroeconomic institutions
- Overall EM bond markets account for only slightly more than a quarter of global debt while equities are just shy of 10% of world market capitalisation
- Higher US yields and a stronger US dollar have drained portfolio flows from EM over the past three years, despite decreased sensitivity of EM local currency bond yields to the US during the recent Federal Reserve rate hike episodes
- Slowing US GDP and Fed easing should reverse these portfolio outflows. Continued growth resilience should trigger investors' interest in EM assets. However, this outlook would look stronger if there wasn't the possibility of the US electing a protectionist president in Donald Trump

(Almost) all we need is growth

Exposure to emerging markets (EM) allows investors to tap into and benefit from their long-term growth advantages. Exhibit 1 illustrates how EM equity markets have historically followed relative outperformance of the EM versus developed market (DM) growth.

Exhibit 1: Growth as a driver of relative outperformance



Source: LSEG Datastream and AXA IM Research 12/07/2024

In this note we consider how the structural improvements in EM over recent decades should coincide with an improving short-term growth environment, with global financial conditions looking set to ease over the coming years as the world – and specifically the US economy – passes beyond the inflation shock and central banks begin to ease monetary policy. This, combined with longer-term structural drivers, could see several EM economies supply the raw materials required for climate transition technology. Meanwhile the prospect of artificial intelligence (AI) offers unique opportunities for EM economies to accelerate institutional reforms by leapfrogging the resource-intensive methods of pre-AI developed economies.

Yet the outlook for EM will remain uncertain and varied between countries. The increasing likelihood of the re-election of former President Donald Trump threatens a less benign impact on the EM outlook via an attenuation of Federal Reserve (Fed) loosening, a renewed dollar boost, the risk of geopolitical tensions and a disruption to global trade via renewed tariff policies. However, such a backdrop could create potential opportunities for some EMs. Moreover, structurally investment in AI capabilities is something that risks diverting capital flows from EM into AI centres – although Korea, Taiwan and Malaysia appear already to be potential beneficiaries here, while AI delivery might undermine the services offering of other EMs, including India. Meanwhile, climate change threatens a fundamental challenge for EMs over the longer term (with a risk that this may emerge more quickly than feared) threatening EMs' demographic advantage over the DM world.

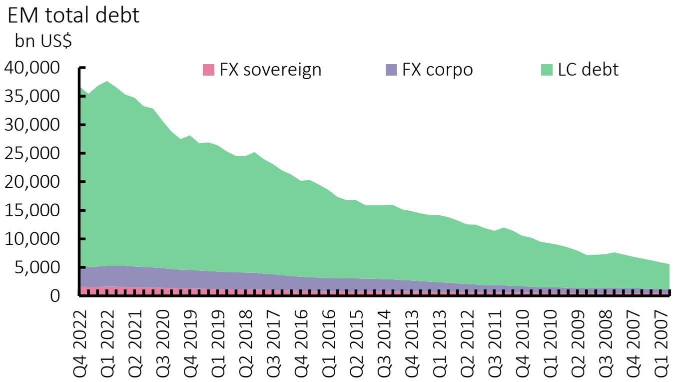
Tactically, as the likelihood of a soft landing of the global economy increases, inflation should converge towards central banks' targets which will in turn start to reduce the restrictiveness of policy rates; the cost of borrowing should start falling. At the same time, economic growth and corporate earnings are strong enough. Importantly, GDP growth in emerging markets, which we forecast at 4.2% in 2024 and 2025, is almost three times that of the developed world, in spite of an expected slowdown of China. EM excluding China GDP growth is expected to accelerate from 2.3% in 2023 to 2.6% in 2024 and 3.2% in 2025. Investing in EM is never plain sailing though. Investment universes are quite different from one EM asset class to another. Rising geopolitical tensions call for careful assessment of direct and indirect implications at country, sector and corporate levels. Understanding the two big external drivers of EMs is crucial: the evolution of global financial conditions driven by the level of US yields and the value of the US dollar which impacts capital flows in and out of EM; and China developments as a driver of commodity prices impacting terms of trade and current account balances.

Substantial evolution in recent decades

The financial market landscape has evolved significantly over recent decades in EMs. The rise of local currency, as opposed to foreign, alongside sovereign and corporate bond markets has probably been among the most prominent developments. This has been a natural evolution after the financial crises of the 1980s and the 1990s as governments, banks and corporates across emerging markets aimed to substitute domestic for external sources of financing to protect themselves against the dependence on volatile access to international capital markets.

The level of progress in establishing deep and functioning local debt markets varies among countries, but this general evolution was possible, among other factors, thanks to the liberalisation of financial markets and capital flows; the development of market infrastructure and regulation; and the emergence of domestic institutional investors with longer-term lending appetite such as domestic pension and insurance companies. The overall institutional framework has evolved and become more resilient as countries have adopted flexible exchange rate regimes and chosen central bank independence and inflation targeting to anchor inflation expectations, lowering the inflation risk premia and making longer-term borrowing in local currency feasible.

Exhibit 2: The EM local currency bond market take-off



Source: Bank for International Settlements and AXA IM Research, Q4 2022

By end-2022, the local currency bond market size for 21 emerging markets[1] reached close to US$31.6tn, according to the Bank for International Settlements. It has quadrupled since 2010 and doubled its size in the seven years to end-2022. In comparison, EM external debt reached just about US$5tn (Exhibit 2). China has played a massive role in the development of local debt markets; it represented merely a third of this universe of local currency EM debt in 2007 but accounted for two-thirds of it by end-2022. Even excluding China, the local currency debt market has tripled since 2007 and doubled since 2020.

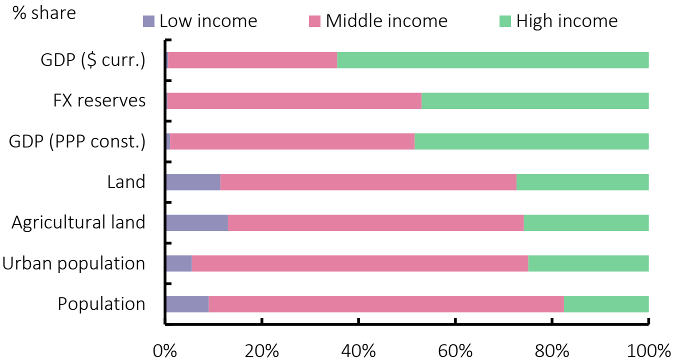
This phenomenal growth in emerging markets' domestic debt has attracted increased interest from foreign investors. Participation of non-resident investors in these markets has

[1] Bank of International Settlements (BIS) quarterly series available until Q4 2022 of Outstanding Domestic Debt Securities issued by Residents expressed in US dollar terms covering the biggest markets such as Brazil, China, Taiwan, Colombia, Croatia, Hungary, India, Indonesia, Lebanon, Malaysia, Mexico, Pakistan, Peru, Philippines, Russia, Saudi Arabia, South Africa, Singapore, Thailand and Turkey.

grown, according to IIF data[2], from often nothing to an average of 24% between 2012 to 2019. It reached more than 50% in Peru, 40% in Hungary and above 30% in Indonesia, Mexico, Poland and South Africa but was nil in China and India in 2012. As of 2014, as part of its broader capital account liberalisation strategy, China has opened its bond market to foreign investors who now hold 3.7% of the domestic debt. Less than 1% of Indian domestic debt is currently held by non-residents.

Exhibit 3: EM in the global economy

Low/middle income countries in the world

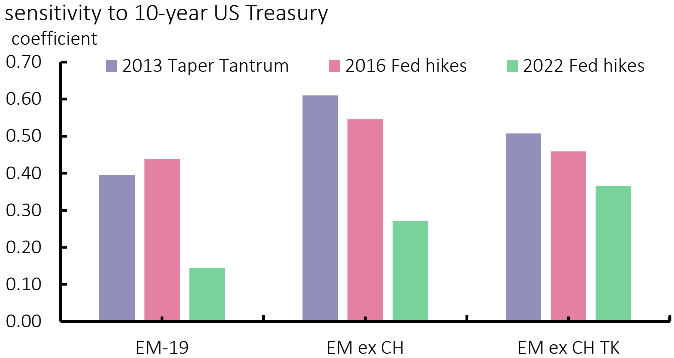


Source: LSEG, World Bank and AXA IM Research, July 2024

Within the global bond universe, the share of emerging markets bonds has evolved to above 25%. This can still be considered relatively low as emerging markets represent a significant portion of the global economy (Exhibit 3) and, as such, their bond markets could potentially have a larger share, as economic development, market liquidity and investor preferences improve. This also applies to the EM equity universe. As per MSCI data, emerging market equities account for less than 10% of global equites at present.
China.

Exhibit 4: EM local rates growing less US dependent

Changes to 10-year Local Currency Gov. bond yield sensitivity to 10-year US Treasury



Source: LSEG and AXA IM Research, June 2024

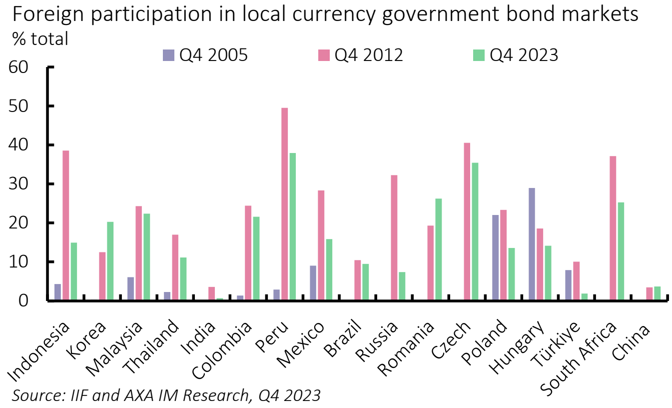
Indeed, along with the evolution of the market infrastructure, regulation and improved macroeconomic fundamentals, EM fixed income markets have become less sensitive to changes in US yields. This has been a consistent finding during recent episodes of rising US yields, such as the 'Taper Tantrum' in 2013, 2016 and the recent 2022 Fed hikes periods. This is particularly true when we exclude China from the comparison (Exhibit 4). The same analysis on a regional aggregate GDP-purchasing power parity-weighted yields basis holds for Asia ex-

Non-residents more cautious post-pandemic

In spite of the above structural improvements, since the pandemic, foreign interest in EM assets has weakened, to say the least. Participation in local currency government bond markets started to slide: by mid-2023, the interest of non-residents in EM domestic debt fell to 16%, from 23.5% on average in 2019. Of course, figures vary among countries, but there has been a general sense of reduced appetite for EM local debt (Exhibit 5).

Exhibit 5: Falling foreign participation in EM local debt

Foreign participation in local currency government bond markets



Source: IIF and AXA IM Research, Q4 2023

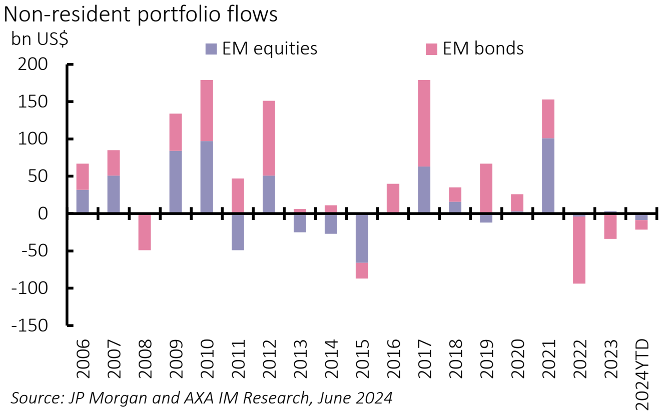
According to JP Morgan, emerging markets have been reporting non-resident portfolio outflows for three years in a row (Exhibit 6). The series of risk-off events since COVID-19 has dented investors' confidence in EM. After strong inflows in 2021, minor outflows were recorded in the EM equities space while strong outflows have continued in the fixed income markets since then, for an unusually long period of time.

As supply-side shocks hit the global economy in the wake of the pandemic, EM central banks embarked on sharp tightening cycles in an attempt to tame inflationary pressures that spiked abruptly. This weighed on the refinancing ability of indebted emerging markets as well as on their public finances as debt service costs became more expensive. Economic growth weakened considerably and several low income and highly indebted countries dependent on external financing saw their access to market financing cut. Defaults and restructurings followed. These idiosyncratic events clearly constituted a

[2] The International Institute for Finance (IIF) provides quarterly data of foreign participation in local currency government bond markets for 17 countries: Indonesia, Korea, Malaysia, Thailand, India, Colombia, Peru, Mexico, Brazil, Russia, Romania, Czech Republic, Poland, Hungary, Turkey, South Africa and China.

deterrent, pulling portfolio flows away from EM. Since then, private or multilateral sector support has been provided, but in many cases has included domestic policy shifts and reforms to improve the sovereign fundaments of these countries.

Exhibit 6: An unusually long period of EM bond market outflows



Source: JP Morgan and AXA IM Research, June 2024

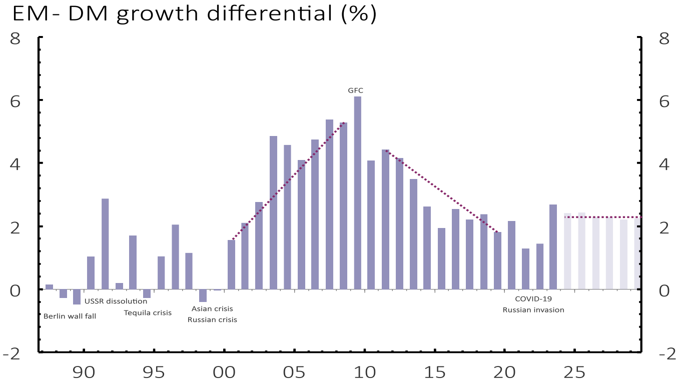
The tightening of global financial conditions appears to be an even more influential factor in the recent non-resident portfolio outflows episode, keeping funds from returning to EM. In a context of higher US interest rates and a strong dollar, investors can get higher returns with lower risk than before from US investments. The authors of a working paper published by the Federal Reserve Bank of Dallas in 2022[3] found that fluctuations in the global financial cycle explained a third of EM portfolio inflows between 2020-2023.

An end to non-resident outflows in sight?

There are reasons to believe we may be getting closer to an end of these portfolio outflows. Firstly, the events that have sparked investor risk aversion, including the pandemic and wars, have been extreme. It is perhaps not too bold a hope that the coming years, while uncertain, will not deliver a similar scale of geopolitical concerns.

Moreover, the global financial environment may also start to be less harmful to EM. The US economy seems to be eventually reacting to the Fed's monetary policy tightening and a rather orderly soft landing appears to be emerging, with a labour market now in better balance, helping inflation return towards the Fed's 2% target over the forecasting horizon. This should allow the Fed to begin to ease monetary policy restrictiveness, which in turn should ease the pressure from a dollar that remains around historically strong levels. In summary, lower US rates – even as we recognise that longer maturity yields will adjust less than the policy rate – will reduce the attractiveness of the US to funds, increasingly allowing capital to flow to other destinations, weakening the US dollar in the process.

Exhibit 7: EM heading likely into a "better" decade



Source: LSEG Datastream and AXA IM Research 24

More fundamentally, idiosyncratic issues have been mostly addressed of late and EM markets are likely to operate in a more benign environment. As always, vulnerabilities exist and are well mapped, but many of the very problematic situations seem to have been resolved. As an illustration, more than 70% of EM rating actions by global international rating agencies have been in a positive direction this year. This should increase the attraction of funds into EM. To this respect, we continue to underline the growth resilience across the EM universe. In spite of exceptional US growth, weak and volatile Chinese growth, which averaged just 4.7% during 2020-2023, the difficulty of balancing a pandemic while facing a rapid monetary tightening domestically and abroad, emerging markets have shown stark resilience, again reflecting improved institutional and structural frameworks.

Still, our growth projections continue to point to a stable and relatively strong growth differential in favour of emerging markets when compared to advanced economies (Exhibit 7). And this in spite of expectations of a slowing Chinese economy to below EM averages as soon as of next year and through the forecasting horizon. This should provide a rather fertile ground for investment opportunities across EM asset classes, debt and equities alike.

More strategically, as the planet shifts towards net zero, we will pay more attention to the exposure of many emerging markets to the nascent commodities boom. Metals like copper and nickel - key components in the building of clean energy and electric vehicle infrastructure - are likely to be in higher demand. More than a third of the world's copper production comes from Chile and Peru while Indonesia, the Philippines and Russia account for two-thirds of nickel production.

[3] The Global Financial Cycle and Capital Flows During the COVID-19 Pandemic, J. Scott Davis and Andrei Zlate, Federal Reserve Bank of Dallas, Globalization Institute Working Paper 416, May 2022 (Revised November 2022)

AI is also likely to profoundly transform our world, and its potential to reshape development, especially in EM, could be revolutionary. Technology could in the long run help critical teacher and doctor shortages in EM; improve tax collection and better target social transfers; and improve productivity by boosting automation. In short, AI offers an opportunity to achieve developed economy standards in some areas by leap-frogging previous infrastructures. An example of this is Togo, which used AI to improve tax collection and better target social transfers[4] to prioritise the rural poor aid during the COVID-19 crisis in the absence of a social protection system able to cope with such a shock. For now, advanced economies, and particularly major technology firms, seem to be capturing most of the gains, albeit in the short run; the dominance in semiconductor production of Taiwan and South Korea are nonetheless great opportunities.

Never plain sailing

A non-negligeable political event still keeps investors cautious of emerging markets, namely November's US presidential election. The spectre of Trump winning raises a series of questions concerning the fate of global trade and possible implications for open EM economies which are part of global supply chains[5].

Domestically, a second Trump administration looks set to embark on an economic agenda that might reverse the expected declines in US yields and the dollar, at least in the near term. Externally, it looks set to take a more protectionist approach to trade, which may harm export demand in Mexico, China and other Asian countries, further cementing the friendshoring process. Admittedly, this could in turn benefit the more US-aligned countries, as the US and China may seek to relocate production facilities into countries facing less punitive trade tariffs. But we suspect these implications would be felt rather in the medium to long term, while a more direct implication for EM investing may come from the impact of higher trade barriers on inflation and interest rates. Geopolitical tensions may also rise.

AI may also prove a double-edged sword. While expected to improve productivity by boosting automation, it may also threaten some emerging markets' global offering, for example challenging India's global services exports. The expected boost in productivity may also challenge the creation of new jobs for the incoming young working-age population, which could turn EM's demographic dividend into a demographic burden. In addition, we have considered the emergence of AI as a broader, new wave of technology, similar to historic waves[6]. Economist Carlota Perez has convincingly argued that previous periods of new technology emergence have "sucked" capital from economies not at the cutting edge of the new technology. This also risks continued adverse capital flows for EMs, even as global financial conditions improve.

Finally, while we consider the benefits to EM from increased efforts to avoid climate change, climate change itself is a significant threat to EMs. The costs of transition may prove a challenge to many EMs. However, the geography of many EMs leaves them incredibly vulnerable to changing conditions, which in the extreme could leave regions increasingly unliveable.

A better environment, but Trump a risk

All in all, we continue to see growth resilience for emerging markets in the near future thanks to structural institutional improvements which should allow them to better face future shocks. Additionally, expected easing global financial conditions should continue to support their growth outlook and eventually translate to financial market performance. The outlook would have been cleaner without the possibility of Trump winning the US election, which is now our base case scenario. Investors need to adopt a finer assessment of potential winners and losers from the possible protectionist measures to be implemented by the future Trump administration as well as potential shifts in geopolitical importance of various EMs from a global security policy point of view.

[4] Lawson, C., Koudeka, M., Cárdenas Martínez, A.L., Iñaki Alberro Encinas, L. and George Karippacheril, T., "Novissi Togo: Harnessing Artificial Intelligence to Deliver Shock-Responsive Social Protection", World Bank's Social protection and jobs discussion paper, No 2306, September 2023

[5] Page, D., "US 2024 presidential election preview: Trump faces new adversary", AXA IM Research, July 2024

[6] Page, D., "The macro impact of Generative AI: Learning from previous tech revolutions", AXA IM Macro Research, 25 Sept. 2023

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