Emerging Markets Spotlight

Global Pendulum Swing Spells Opportunity for Emerging Markets

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KEY POINTS

- The recent sell-off has been concentrated in parts of the emerging market asset class most held by international investors; in equities, this was information technology stocks; in fixed income, it was Brazil and Mexico.
- A key factor driving the EM outlook is the decline in US yields and markets counting on the Federal Reserve to cut rates sooner rather than later.
- This should alleviate some of the pain EM Asian central banks are experiencing amid slowing demand and low core inflation to provide monetary stimulus.
- When markets stabilize, Mexico and Brazil should return to attracting fixed-income inflows, but the real potential is for lower US interest rates to spur significant rate cuts in both markets, supporting economic growth and equities.

The month of July leading into the first week of August has experienced significant volatility in global financial markets, including emerging markets.

The pendulum swinging followed soft US jobs data and policy rate hikes in Japan. This has led to multiple dislocations in fixed interest and currency markets, as carry trades (funding in a low-yielding currency to invest in a higher-yielding currency) were aggressively unwound, spurring a rapid risk-off move and sending global financial markets tumbling.

The rout deeply impacted emerging markets, where sectors with the highest exposure to international investors drove the most volatility and weakness. In emerging market equities, the pain has been concentrated in the information technology sector and in Korea and Taiwan; in currencies, the high-yielding Brazilian Real and Mexican Peso have prompted the sharpest sell-offs.

These adjustments beg the question: **"What happens next?"**

We find it difficult to maintain enthusiasm about the information technology sector, even with the reset in valuations stemming from market weakness. The entire sector has re-rated substantially in recent years, despite essentially soft demand in key end-demand segments such as PCs and mobile phones. This optimism has been attributed to the potential demand shift from widespread adoption of generative AI but, beyond a handful of key semiconductor names held in the portfolio, we have not seen sufficient evidence of this opportunity. From a country vantage, this translates into siding on the err of caution toward Korean and Taiwanese equities.

In our view, the last six weeks' price moves have generated opportunities in emerging market interest rates and underscored their potential as drivers of broad domestic demand and local financial markets. The sell-off has inspired a repricing of expectations regarding US policy interest rates. Yields in the middle part of the US Treasury's yield curve have declined by over 0.5%, while the twelve-months-ahead futures-derived expectation for the US Federal Funds policy interest rate has declined by nearly 1% since May of this year.

In Emerging Asia, some economies have failed to fully close the output gap that the Covid slowdowns created. This has been accompanied by undershoots in inflation and core inflation, leaving local central banks unable to respond with interest rate cuts in the face of stubbornly high US bond yields and interest rates and a resilient US Dollar. If the Federal Reserve is swayed to reduce policy interest rates, Emerging Asian central banks could respond more directly to domestic growth and inflation conditions.

Some Emerging Asian central banks have regionally specific issues that may constrain this effect, notably the Bank of Korea's concerns regarding household leverage and the Reserve Bank of India's growing worries about risky borrowing. On the brighter side, we see output gaps, low core inflation, and currency fluctuations emerging in Indonesia and China. Both markets, which are held as overweight positions in the portfolio, could see significant monetary stimulus over the next few quarters.

Mexico and Brazil are two other markets that look well-placed in the medium term. First, despite the currency weakness caused by market volatility, the interest rate gaps that drove bond market inflows remain intact, and a period of market stability is likely to see a resumption of inflows. (Brazilian policy interest rates held at 10.5%, while Japanese policy interest rates were hiked from 0.1% to 0.25%.)

Secondly, we believe that the Peso and the Real went into the sell-off with some challenges from weaker export revenues, but in no sense overvalued. Mexico had a trailing current account surplus in the first quarter of 2024, while Brazil's trailing deficit through June was roughly 1.4% of GDP, a small slice by historical standards.

Real interest rates in both countries remain elevated when compared to historical levels, with US rates and yields the dominant constraint on progress. The faster the Federal Reserve moves to cuts, the faster Banxico and the Brazil Central Bank can follow suit, which should be highly stimulative for both economies.

The past few weeks have undoubtedly proved challenging for global markets. Yet, we are confident the fallout will ultimately be positive for emerging equity markets — especially for the markets we hold as overweight positions in the portfolio.

Source: Bloomberg/MSCI/JOHCM.