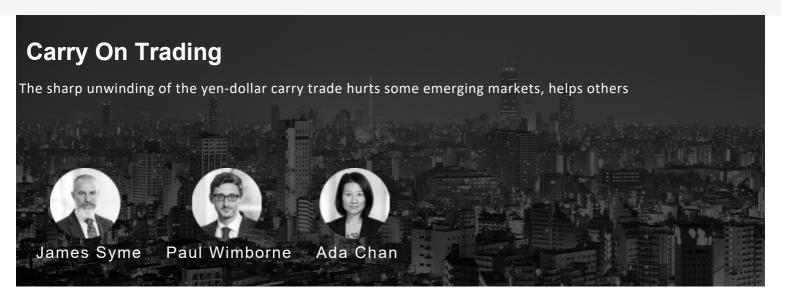


News



09 Aug 2024

July (and the early days of August, up until this piece was written) has seen significant volatility in global financial markets, including emerging markets. The main cause of this is a combination of softer US economic data coinciding with an increase in policy interest rates 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, in turn causing a rapid risk-off move across most global financial markets.

In the emerging markets space, this has particularly meant that the segments of markets with the highest exposure to international investors have seen 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 seen the sharpest sell-offs.

The key question about these adjustments is: what happens next?

We find it hard to be overly positive about the information technology sector despite the reset in valuations from the 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 some key semiconductor names held in the portfolio, we have not seen sufficient evidence of this opportunity. From a country view, this translates into ongoing caution towards Korean and Taiwanese equities.

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, but local central banks have been unable to respond with interest rate cuts as they have faced stubbornly high US bond yields and interest rates and a stronger US Dollar. If the Federal Reserve is to move to reducing policy interest rates, emerging Asian central banks can respond more directly to domestic growth and inflation conditions.

Some Emerging Asian central banks have locally-specific issues that may constrain this effect, notably the Bank of Korea's concerns regarding household leverage and the Reserve Bank of India's worries about the growth of unsecured lending. However, we see output gaps, low core inflation, and concerns about currency weakness in both Indonesia and China, and both of these markets, which are held as overweight positions in the portfolio, could see significant monetary stimulus in the next few quarters.

The other markets which look well placed in the medium term are Mexico and Brazil. Firstly, despite the currency weakness caused by market volatility, the interest rate gaps that drove bond market inflows remain and a period of market stability is likely to see a resumption of inflows. 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 to June was only 1.4% of GDP, small by historical standards. Thirdly, real interest rates in both countries remain very high compared to historical levels, with US rates and yields the dominant constraint on cuts. The faster the Federal Reserve moves to cuts, the faster Banxico and the Brazil Central Bank can follow, which should be highly stimulative for both economies.

Global markets have been challenging, but we believe that the fallout is ultimately positive for emerging equity markets and particularly positive for the markets we hold as overweight positions in the portfolio.

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