Emerging Markets

Slower growth in China and the Federal Reserve taper have contributed to a relatively downbeat outlook for emerging markets. Could the mood music be set to change in 2022?

As we head into 2022, it's very encouraging that the rate of vaccinations in emerging markets (EM) has seen a marked acceleration, even as new variants such as Omicron continue to pose a risk. This has helped support economic growth, but an encore is unlikely in 2022.

The markets understand that headline EM growth is set to moderate and has adjusted accordingly through 2021. However, there's potential that EM can provide a positive surprise in 2022.

Schroders' EM portfolio managers are closely monitoring the outlook for inflation and the prospect of an inflection. They're also looking for a turning point in terms of economic growth in China.

Geopolitical risk is an ongoing area to monitor; and there are several key upcoming elections, beginning with South Korea in March and culminating with Brazil's presidential election in October.

Insight from sub-adviser Schroders Investment Management

Andrew Rymer, CFA
Emerging Markets Investment Specialist

Key Points

- Going into 2022, emerging markets are better prepared to deal with COVID-19 than a year ago.
- Economic growth is slowing after the post-pandemic bounce amid a slowdown in China and tighter monetary and fiscal policy elsewhere.
- We believe that if inflationary pressures ease, policy tightening could as well.

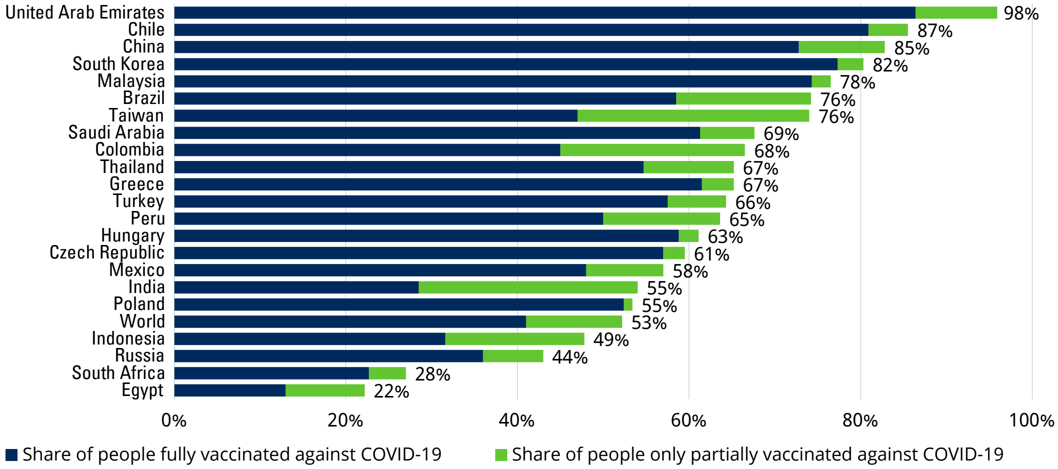
EM Economies

David Rees, Senior EM Economist

The threat of new variants presents an ongoing risk to be aware of, as the uncertainty in relation to Omicron illustrates, and these could change the outlook quite dramatically. The vast majority of EM are on track to inoculate large proportions of their population in the coming months. Ongoing recovery in economic activity should continue to benefit from these vaccinations. Improved COVID-19 outcomes would be good news for EM and could benefit services-based economies in particular, especially those that rely heavily on tourism.

FIGURE 1

Vaccine Roll Outs in EM Are Progressing Well



Alternative definitions of a full vaccination, e.g., having been infected with SARS-CoV-2 and having one dose of a 2-dose protocol, are ignored to maximize comparability between countries. Official data collated by Our World in Data. This data is only available for countries which report the breakdown of doses administered by first and second doses in absolute numbers. Source: Our World in Data, as of 11/29/21.

However, there's no getting away from the fact that EM economic growth may be slower in 2022. Many economies have already recovered to pre-pandemic levels, and this naturally makes it harder to sustain above-trend rates of growth. In 2021, growth has been flattered by the low-base comparison of last year, and this almost guarantees slower rates of expansion in 2022. Beyond this, there are other fundamental reasons to expect growth to slow.

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Downgrades to our developed-market growth projections mean that demand for manufactured goods is likely to soften in 2022. Global trade is an important driver of EM growth and while further post-pandemic restocking by companies may provide near-term support, the stellar rates of export growth seen during 2021 are unlikely to be sustained. This could be negative for small, open EM economies across Asia, in parts of Central and Eastern Europe, and in Mexico.

The weaker China outlook is likely to have implications for certain EM. For example, if subdued real-estate sector activity leads to softer demand for commodities, such as industrial metals, this could impact exports of economies in Latin America and Sub-Saharan Africa.

Within EM, tighter monetary and fiscal policy will increasingly weigh on growth. We believe the sharp increase in EM inflation, which stifled many EM in 2021 and forced central banks into relatively aggressive interest-rate hikes, could subside. However, higher rates typically weigh on activity with a lag of six to nine months. Combined with the possibility of some fiscal retrenchment, as governments attempt to repair the damage to budget positions caused by the pandemic, tighter policy is likely to be a significant drag on activity. That may ultimately mean central banks don't deliver the tightening that is priced into markets, opening a potential window of opportunity for investors in local markets.

The upshot is that we expect EM GDP growth to slow from an expected 6.5% in 2021, to around 4.5% in 2022. If we are right, then EM growth is unlikely to outpace that in some developed markets. And while that shouldn't be a complete surprise to investors, such a narrow growth premium has typically set a tricky backdrop for markets.

EM Equities

Tom Wilson, Head of EM Equities

The global stimulus in response to the pandemic is now fading with liquidity growth falling away and the US taper imminent. Anticipation of tighter monetary conditions has put upward pressure on the US dollar, which is a headwind for emerging-world financial conditions. Bottlenecks, labor-market disruption, rising energy prices, and post-COVID economic catch up have also created more persistent inflation than anticipated, which has been driving stagflation fears.

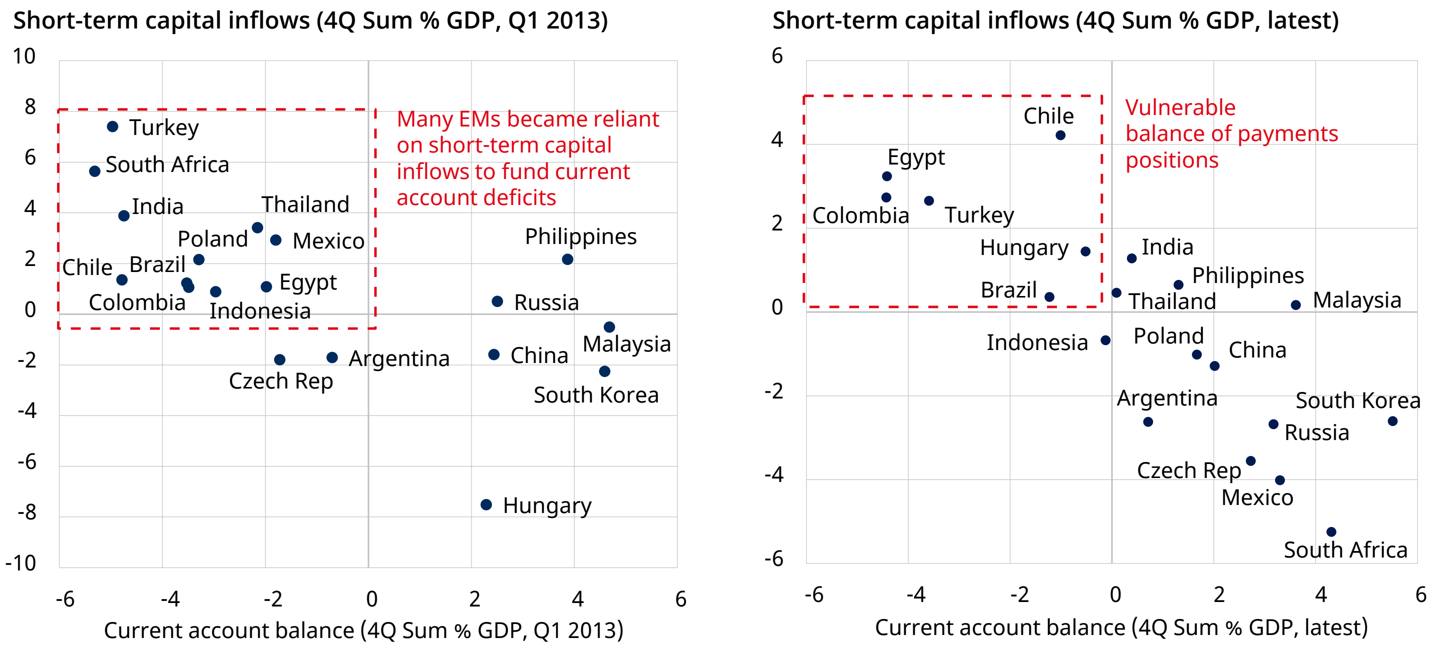
There's been ongoing normalization globally, underpinned by vaccine distribution, as well as high levels of post-infection immunity. Vaccine penetration in EM has been catching up with developed markets, while studies, including in India, show elevated levels of natural immunity after infection. In general, this could result in fewer future restrictions on activity, enabling bottlenecks to be addressed and reducing disruption to manufacturing and logistics in 2022.

Meanwhile, the withdrawal of stimulus and fading pent-up demand may see inflation pressures ease and should calm stagflation fears. Of course, new variants pose an ongoing risk and could materially change the outlook, especially if they evade existing vaccines and lead to higher mortality rates.

Policy tightening from the Federal Reserve (Fed) may be an ongoing headwind, but EM are more resilient when compared to the last Fed hiking cycle, as **FIGURE 2** illustrates. External accounts are typically in good shape, recent capital inflow has been less hot than in 2013, EM currencies are generally looking cheap, and the yields on EM local debt are relatively attractive.

FIGURE 2

EM Economies Are Less Vulnerable to Fed Policy Tightening in 2021 Relative to 2013



Source: Refinitiv, Schroders Economics Group, November 2021.

The reduced availability of credit in China is being felt. Economic conditions are worsening due to a negative credit impulse, the 12-month change in new lending as a share of GDP, and broad-based regulatory action. The latter has created uncertainty for the market and had direct economic impact via the real-estate sector. We expect policy to become more stimulative and the credit impulse to trough and recover. We also believe that regulatory noise may have peaked.

The credit impulse normally impacts economic activity with a nine month lag, as **FIGURE 3** shows, suggesting that the Chinese economy will remain weak until the middle of next year. However, in the second half of 2022, there's potential for the macroeconomic outlook in China to improve. Although corporate profits could be impacted by this year's growth slowdown, markets are forward looking and may begin to factor in a recovery.

FIGURE 3

Macroeconomic Outlook in China to Improve

Source: Refinitiv, Datastream, Schroders Economics Group, as of 10/21.

Risks For 2022

Key risks include geopolitics, new COVID-19 variants capable of evading vaccines, the scenario in which inflation does not prove transitory, and the future path for regulation in China. The latter point relates to the government's common prosperity objectives in terms of addressing inequality and improving social mobility. The pace of new initiatives appears to have eased but we continue to monitor developments closely, in particular ahead of the National Party Congress in Q4 of 2022.

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Valuations

In aggregate, EM valuations are not cheap relative to history. However, this masks considerable variations in terms of country, sector, stock, and investment style. There's also some uncertainty over company earnings next year, stemming from economic growth pressures fed by monetary-policy tightening. Valuations when compared to the US, however, look more attractive, while various EM currencies are look increasingly cheap.

Moving through 2022, we may begin to see a more positive backdrop. Monetary policy has anticipated higher inflation, and real rates look attractive. Should inflationary pressure ease, this could provide scope for monetary easing. Meanwhile, there's potential that China's economy could begin to improve.

Countries to Follow

In terms of our current market preference, we maintain a relatively less favorable view on China, although we have reduced the scale of our underweight in recent months. Although we continue to see long-term promise in India, underpinned by reform progress, expensive valuations continue to temper our appetite.

Conversely, we like the Eastern European EMs of Poland and Hungary where economic growth is strong, and valuations are reasonable. Russia is a market we favor given cheap valuations, and because it's a beneficiary of higher commodity prices. Geopolitical risks persist, though, and with tensions with the West recently rising, we're monitoring developments closely.

Brazil may also present an opportunity in 2022—valuations reflect elevated political risk and an inflection in inflation could create scope for monetary easing in the latter part of 2022. We remain modestly overweight Korea due to a broad selection of stock opportunities and attractive valuations.

EM Debt

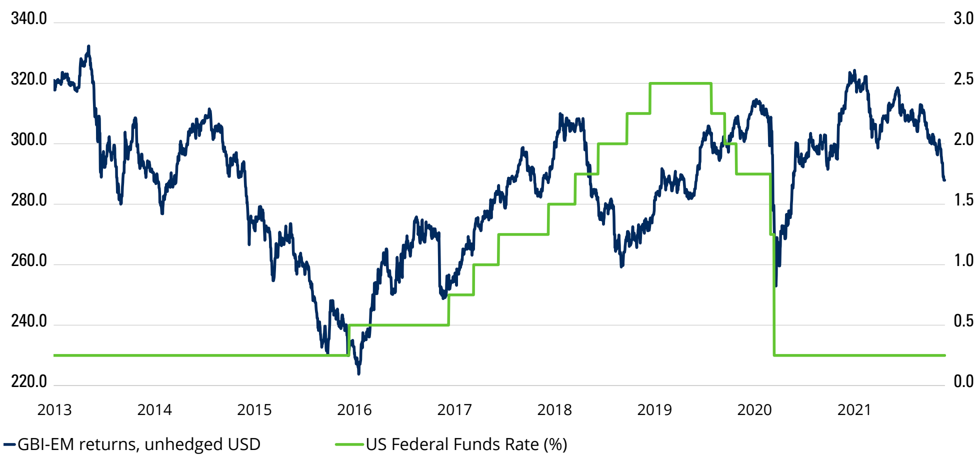
James Barrineau, Head of Global EMD Strategy

The Fed's official launch of the bond-tapering program is an appropriate coda to a year when emerging market debt (EMD) investors have struggled mightily with flashbacks from the 2013 taper tantrum. As the Fed follows a similar strategy this time around, we don't think investors will have the same negative experience this time.

While investors might fear the effects of higher US interest rates, markets are discounting machines and a lot has been priced in. As **FIGURE 4** shows, the kick-off of the last hiking cycle in December 2015 coincided with a recovery in local-market returns for investors that lasted two years. This cycle—from talking about tapering, to tapering, to lift off—is on track to be to be much shorter, suggesting a high percentage of pain has already been priced in.

FIGURE 4

EM Local Market Returns and US Federal Funds Rate



Source: Bloomberg, as of 11/29/21.

The dollar is 18% higher than it was at the start of the previous cycle. EM central banks have been preemptively hiking for many months, widening the nominal rates difference with the developed world. Currencies have, by and large, never fully regained their real valuation levels from before the first tapering cycle. Valuations are much brighter this time around.

If inflation moderates and returns close to central-bank target levels in 2022, then the outlook for local-currency EMD investors could be very bright. Over the course of this year, the local EMD market yield, as measured by the JP Morgan GBI-EM Global Diversified Index,[1] rose from 4.2% to 5.65% as hiking cycles progressed. The spread[2]—or difference in yield—to Treasuries with a similar duration[3] has soared to just over 430 basis points (4.3%).[4]

The most highly credible central banks, such as Russia and Mexico, could be the first to tap the brakes on rate hikes. Others in central Europe and Brazil may take more time to corral inflation trends. Asian countries are closer to

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developed-market credibility than other EM regions, and while local yields are lower, currency volatility is also much more subdued. Over the course of 2022, we expect virtually the entire asset class to have completed hiking cycles and be left with real interest rates well above their developed counterparts, perhaps with rate-cutting cycles coming into view.

Currencies will have to cooperate with bullish rate views for most investors to be lured into investing. The stability of China's renminbi, where real rates—that is, net of inflation—are the most positive in the asset class, signals that positive rates are a powerful lure despite significant sovereign issues. We also favor Malaysia and Indonesia in the region for similar reasons. The Russian rouble looks nearly bulletproof with strong external accounts. In Latin America, Mexico is the standout given its proximity to the US and a lack of fiscal strains.

On the dollar-debt side the prospects are less bright. In investment-grade EMD, the yield spread to US Treasuries is historically low, yet still offers a modest pick-up to similarly rated developed debt, which has anchored stability. High-yield EM bond spreads are more attractive than US high yield but lack the stable operating environment. Being active and taking a selective approach is key. Some lower-rated credits will struggle with funding requirements and the need for fiscal tightening (many sub-Saharan and frontier countries). Others might not be default candidates but will struggle with the politics of regaining debt sustainability as both growth and spending slows.

For more information about EM, talk to your financial professional.

[1] JP Morgan GBI EM Global Diversified Index is a comprehensive global, local emerging-markets index, and consists of liquid, fixed-rate, domestic-currency government bonds.

[2] Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

[3] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[4] A basis point a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices and the yield of a fixed-income security.

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