

# Insight

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## Emerging Markets: the hurdles blocking outperformance

While the attractiveness of emerging markets in the longer term isn't in question, a number of obstacles could stop them from outperforming in the coming months.

### Covid reality

Throughout last year, many EMs handled the pandemic much better than the rest of the world. Indeed, many Asian economies were 'Covid-free' for most of 2020. However, their vaccination rollouts have been slower as a result, leaving them vulnerable to clusters and renewed restrictions.

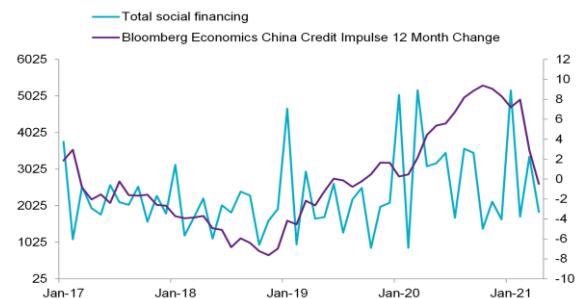
Elsewhere, the pandemic rages on, with ongoing crises in India and Brazil, to name a few. With EMs dependent on other nations for mass vaccination and generally hosting dauntingly large populations, challenges are likely to persist for some time yet. This suggests delayed reopening and softer growth.

### All about China

The biggest driver for EM growth and performance is China. However, Chinese growth is set to decelerate into the end of the year. China is far in advance of the West in its recovery and is likely to soon return to pre-pandemic growth levels from the current 'rebound levels'. As such, policymakers are gradually withdrawing stimulus. Credit growth is slowing, as is the property market, though liquidity remains ample for now. Already, fiscal expansion was much lower than in other major economies. Policymakers were wary of the excesses that resulted from massive fiscal spending after the 2008-2009 global financial crisis and avoided the same mistakes. As such, the slowdown will be softer, but likely sooner.

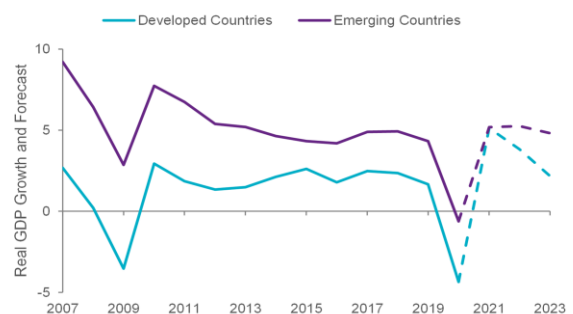
With EM economies dependent on Chinese growth for export demand, the EM complex is likely to take more time to recover if Chinese growth slows just as

they are recovering. In addition, Asian exports could get impacted by semi-conductor shortages, and slower Chinese growth means less Chinese demand for commodities. Until the rest of the EMs can decouple from China, their fortunes are tied to it.



Source: Bloomberg, Natixis IM Solutions, 20 May 2021

In addition to potentially slowing Chinese growth, the global reopening is set to be slow and gradual as travel and tourism are unlikely to resume properly until vaccination rates pick up more meaningfully across EMs and beyond, which is still some time away. EM economies should find some support from a booming US economy and the European reopening later this year, but this might not make up for lingering risks. As such, EM growth may not exceed developed market growth this year, especially considering the fiscal support from the Biden administration. In this context and with China slowing over the latter part of the year, EM equities might struggle to outperform their DM counterparts.



Source: Bloomberg, Natixis IM Solutions, 20 May 2021

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### Technology & Regulation

From an investment perspective, the EM outlook is closely tied to China's given its huge weight in EM indices. As such, there are multiple challenges to a constructive view on China.

In addition to decreasing stimulus slowing growth, the tech sector is facing obstacles from Chinese regulation. With the 'new China' tech stocks gaining so much power in recent years, regulators are set to limit their influence through antitrust rules, though their scale and scope is as yet not certain. In 2020, EM equity outperformance has been led almost entirely by large-cap tech stocks. With ongoing uncertainty surrounding regulation and higher yields, their recent underperformance could persist, challenging the whole EM equity complex.

### A double US hit

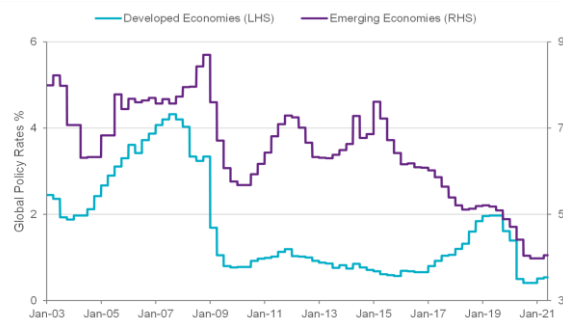
In addition to localised hurdles, a stronger US dollar and rising US bond yields are a double negative for EM assets. This perception often leads to knee-jerk selling across EM positions. Indeed, a stronger dollar typically leads to capital outflows and higher servicing costs (in local currency terms for hard currency sovereign debt). In addition, a stronger dollar could lead local central banks to hike sooner to support their currencies, chocking off the recovery. However, we do not expect this to be the case, as the dollar should not strengthen much from here and EM currencies are recovering from already low levels. As such, we are likely to see only gradual hiking as inflationary pressures should remain contained once base effects and higher commodity prices work themselves through. This should lead a number of EM currencies to rebound, though selectivity is key.

Given how big the move in US yields has been already, this may no longer be problematic for EM. Still, it is not yet a tailwind. In addition, the weaker dollar of recent weeks has not sufficed for EM equities to outperform, despite commodity prices remaining higher, suggesting that growth, reopening and China remain the overarching concerns for markets.

### Not the same as previous crises

Despite challenges, there are also a number of preconceived notions that no longer hold true today. EM economies are not in the same position as they

were during past crises. Their debt and deficit levels are generally lower (with regard to pre-Covid spending) and they have become less exposed to moves in the US dollar since local currency debt issuance has grown for sovereigns. Leverage levels have improved, though banking systems are not particularly healthy. Also, they have generally been less fiscally expansionist than the developed world in response to the pandemic.



Source: Bloomberg, Natixis IM Solutions, 20 May 2021

### Long-term winners

It is clear that a number of hurdles could block emerging market outperformance in the coming months. That said, we still expect to see both improving earnings and stronger growth compared to developed markets over the long term.

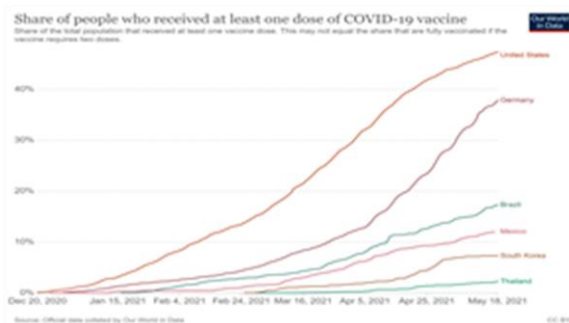
In addition, a number of winners should emerge from the pandemic. Mexico bucked the global trend for huge fiscal responses to the pandemic so its balances remain healthy, and it should benefit from both the strong US recovery and the restructuring of global supply chains to reduce dependence on China. In Asia, both Korea and Taiwan should benefit from their tech sectors and global demand for semi-conductors.

Conversely, a number of countries face idiosyncratic situations, suggesting selectivity remains key. The Turkish central bank's ongoing 'game of musical chairs' and simmering geopolitical tension are likely to remain concerns, in addition to its poor handling of the pandemic. The Brazilian political situation is also complicated, though assets could rebound in the short term as they suffered significantly during Covid.

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### Conclusion

Over the coming months, a number of challenges remain for EM assets, with more questions around EM equities than debt. As such, we are more cautious on the segment, though we still believe these are attractive entry points for the long term. As US rates and the dollar stabilise, the global reopening progresses, and EM vaccination accelerates, EMs should quickly do better again.



Source: Our world in data, 20 May 2021

For now, we see more opportunities in the credit space, and particularly in EM hard currency corporates, where spreads have further potential for tightening, especially if we have seen the big part of the move in US yields already. We also believe that corporates have more interesting indices than the sovereign space in terms of country diversification and sector exposure, with a bigger focus on Asia where we see attractive yield opportunities. Moreover, with countries shifting debt to local currency to avoid a dollar squeeze, the sovereign space is shrinking whereas corporates are expanding.

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