GUARDIAN CAPITAL

Emerging Markets Quarterly Outlook

QUARTER THREE 2021

A CHALLENGING LANDSCAPE

One of the constants over the past year has been the fact that, despite the ongoing pandemic and its headwinds for the global economy, the dataflow has persistently come in better than expected.

Moreover, while it was the case that this time last year the beats were largely the result of economic performance not being as poor as the overly pessimistic forecasts anticipated, this year so far has seen outright positive signals from both the "hard" activity and "soft" survey data in both Developed and Emerging Markets (DM and EM, respectively) that have been exceeding what have proven to be cautiously optimistic expectations.

The surprising and persistent underlying economic strength has resulted in forecasters repeatedly revising their projections for global growth higher not only for the current year, but for next year as well, with earnings expectations consequently undergoing upward revisions that provide fundamental support for equity markets.

A backdrop of improving economic momentum is typically unambiguously positive for the EM, given their role as a major supplier of inputs to production and finished goods (especially consumer goods). Indeed, EM have been the big beneficiaries of the recovery to this point with industrial production and exports supporting their own economic rebounds, while the related upswing in commodity prices also bolstered the performance of natural resource-oriented EM economies — particularly in Emerging Europe, Middle East and Africa (EMEA) and Latin America.

Further, the prospect of increased capital expenditure by DM businesses in need of capacity and productivity-enhancing investments to address production shortfalls as well as the large-scale public infrastructure plans being rolled out in the US and Europe — not to mention the scope for continued robust strength in household spending underpinned by ample built-up savings — bode well for the significant links of the global supply chain that run through EM to continue to pull the region's economies forward at a decent clip in the months ahead.

To jab and jab not

With that said, one of the more significant developments in recent months has been the fact that the upgrades to the outlook for DM have significantly outpaced those seen among EM, which has resulted in a sharp narrowing in the anticipated growth premium not only for the current year (where the DM growth is now expected to effectively match that of the EM for the first time in more than two decades) but in 2022 as well.

The biggest factor driving this uncharacteristic convergence of forecast growth rates — and divergence of financial market performance in the second calendar quarter — has been the relative progress with the pandemic in DM versus EM.

More than half of the population is at least partially vaccinated against COVID-19 in the DM and more than one-third have received their full complement of doses. In contrast, less than one-third of people across the EM have received a jab and less than one-in-five have been fully vaccinated.

The relative dearth of vaccine immunization has prevented EM policymakers from easing public health restrictions to the same degree as their DM counterparts (mobility, however, is not necessarily more restricted in EM than DM) and has left populations more vulnerable to infection. This has become a rising concern as a more transmissible and dangerous strain of COVID-19 has driven a resurgence of contagion, most notably in the likes of South Africa, Mexico, Indonesia, Russia and Turkey.

The result has been that not only have internal drivers of economic growth been comparatively restrained in EM relative to DM that have reopened more broadly (though the more pandemic-sensitive services sectors do play a comparatively smaller role in EM), but the recoveries that have gained traction may well prove to be less sustainable over the near term. The key examples here being that pandemic success stories such as China and South Korea have had to recently reinstitute stringency measures to quell the spread of the virus.

Vaccination is expected to accelerate in the second half of this year as more supply becomes available across EM, however, herd immunity thresholds are unlikely to be hit until well into 2022 — which creates wider confidence intervals around economic forecasts and hinders relative earnings visibility.

Inflated sense of self-worth

Unfortunately for EM, the pandemic is not the only notable headwind.

One of the by-products of the combination of the resurgence in DM-consumer-driven demand and pandemic-induced constraints on global supply chains over the last year-and-a-half has been increasing price pressures. In conjunction with the "base effects" arising from the weakness in prices last year at the onset of the pandemic, gauges of annual consumer price inflation have spiked in recent months to their highest rates in decades across many major economies (though pressures remain benign across most of Asia so far).

While DM central banks have expressed willingness to tolerate what may prove to be temporary increases in inflation — with pressures expected to subside as bottlenecks on making and moving goods ease in the coming months and base effects fade — those in EM, with their generally spotty track record at managing inflation, do not have that luxury.

Monetary authorities in Brazil, Mexico, Russia and Turkey have already abandoned their crisis-era dovishness and hiked policy rates in reaction to elevated inflation prints, and others may soon follow.

The tightening in domestic financial conditions is less than ideal given the delicateness of the recovery at the moment, however, the moves so far do not yet appear to be prohibitive to growth. Should inflationary pressures have more staying power than anticipated that could quickly change.

Political economy

For now, financial conditions remain benign thanks in part to the decline in general market interest rates from highs earlier in the year and flattening of the yield curve, which have mitigated the impact of EM policy decisions.

These market moves also factored in the reversal of earlier weakness of EM currencies, which in turn helped to further ease lingering concerns over EM financial vulnerabilities — and that's in addition to the diminished external stresses resulting from EM current account balances improving significantly on the strength of exports across the grouping.

Other areas of policy in EM, however, remain highly challenging and complicate the ability of governments to fully address the economic problems plaguing their economies.

Civil unrest is becoming increasingly prominent in many EM economies, with perceived failure in pandemic responses acting as a catalyst behind broader protests of inequality in the likes of Brazil, Colombia, South Africa and Thailand, among others.

Against this, recent EM elections have seen notable shifts in the political landscape.

Mexico's midterm elections saw the coalition led by President Andrés Manuel López Obrador lose its supermajority in the legislature — a sign the leftist policymaker's star is fading three years into his six-year term. The ruling MORENA Party still holds a majority in both chambers of Congress, which means it can pass laws, but it will face greater checks that may inhibit its ability to get broader constitutional reforms approved.

In Peru, Pedro Castillo of the socialist Free Peru Party continued his unexpected ascendance with a victory in the Presidential election. His ability to push through proposed increases to social spending and significant changes to the nation's mining sector (which is the world's second largest copper producer), however, are likely to face push-back from the opposition-controlled Congress.

These outcomes serve as a poor omen for Brazilian President Jair Bolsonaro's potential re-election in just over a year (the vote is scheduled for October 2, 2022), as well as the prospects for much-needed economic reforms. The right-wing leader has seen his popularity plummet as Latin America's largest economy has been hit hard by COVID-19 and he faces a formidable challenge in left-wing former President Luiz Inácio Lula da Silva who currently holds a commanding lead in opinion polls.

China in a bull shop

The biggest source of political risk in the EM, however, continues to be China — and the concerns on this front have intensified of late.

For starters, while animosity between the US and China may not be as forthright now as under the last Administration, tensions do remain elevated and the trade actions imposed by the previous American President largely remain in place.

Recent efforts at thawing diplomatic relations between the world's two largest economies have proven unsuccessful and sparring over the South China Sea (the US rejects China's territorial claims on the key waterway), and military exercises being conducted jointly by Beijing and Russia, do not give hope that a more conciliatory tone to proceedings is imminent.

As important as these geopolitical developments are for EM — and the last four years have shown investor risk appetite tends to ebb when tensions rise on this front, leaving EM economies and assets vulnerable to being caught in the crossfire — it is the recent shift in domestic-focused policies in China that have had the greatest impact on embedded risk premium across the complex.

The Chinese government has taken swift action of late to combat what it views as sources of systematic inequality that threaten social stability; that is, anti-competitiveness and areas like education and housing — as well as addressing concerns over financial risk and data security.

These measures have been generally consistent with the long-standing goals of the Chinese Communist Party, but that does not change the fact that they have had a material impact on the valuations of Chinese-listed companies and have raised the regulatory uncertainties associated with investing in the Middle Kingdom.

Party officials have tried to quell market concerns over broadening government overreach while emphasizing the country's strong economic fundamentals and ample capacity for monetary and fiscal policy to support domestic growth. Markets have staged a modest recovery so far, but investors understandably remain incredulous, and trying to forecast and time further efforts for market intervention is inherently difficult.

Opportunity knocks

Given that China is a such a big piece of the EM, any investment headwinds there only serve to compound the near-term economic challenges for the broader group and could weigh on the aggregate performance of the group, especially relative to DM.

The elevated risk premiums at the moment, however, do provide opportunities for taking a more selective approach to managing exposures to China and EM more broadly.

The crackdowns have been focused on industries that are perceived to threaten long-term sustainability and social fairness in China — further moves in areas such as healthcare and real estate seem likely and markets appear to have already priced in a tighter regulatory backdrop.

At the same time, though, the overarching positive macroeconomic drivers within the Chinese economy remain in place and Beijing appears likely to increase its promotion and support of industries and companies that are advancing the interests of China (and thereby the Party) — those that are innovating and driving the rotation of the economy toward higher valued-added production and technologies, and supporting a stronger consumer class.

The increased policy risk, however, may be a deterrent to some investors and businesses, which stands to create opportunities for other EM economies that can fill the void — the tech-biased and export-oriented markets of South Korea and Taiwan would appear to be well positioned.

Better days ahead

The EM face a series of headwinds over the near term, which could well be compounded by the impact of a stronger US dollar resulting from American monetary policymakers moving to the exits of the crisis-era stimulus sooner than currently assumed.

Continued above-pre-crisis-trend growth (underpinned by a broader reopening of DM economies), however, should support the more cyclically-sensitive areas to which EM are traditionally skewed — this would continue to be a particular benefit for EMEA and Latin American economies that have seen momentum accelerate in recent months.

As the recovery matures into next year and DM policy supports are withdrawn, structural factors will again dominate cyclical forces and global growth dynamics will revert back to something resembling pre-pandemic tracks.

Market focus, therefore, will undoubtedly return to those areas that can generate sustained above-average growth in a world where growth will be far more scare than it is currently.

Such an environment would be positive for EM assets, given the expectation that less-developed economies will re-establish their growth premium over DM.

Of course, patience is warranted for now, given that clouds are obscuring the vision of forward-looking financial markets and confidence intervals around EM growth forecasts remain persistently wide, especially relative to DM.

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