THIS MONTH'S TOPIC

Covid headwinds ease as China risks rise

At the time when EMs are navigating towards a healthier environment (Covid cases numbers shifting downward and vaccination rollouts speeding up), China's self-induced deceleration is now looming. Those economies that are most exposed to China (i.e., based on trade and commodities) with limited policy room are the ones most at risk. EM debt is still a good source of carry; we do prefer local rates, where CBs are closer to the end of their normalisation cycle. We are cautious but constructive on EM equities, whose valuations are attractive by global standards.

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EM macro context: growth trends, inflation dynamics and policy mix

Starting in July, economic momentum in the EM stabilised at strong levels in Latin America and Eastern Europe, while it has remained moderate in Asia. Asian countries have been suffering from a ravaging Delta variant, as well as lower tolerance by the authorities to the spread of the virus. Indeed, stricter and stricter lockdowns have been enforced since June in the region. The months of August and early September brought some good news in Asia on the pandemic front: the number of cases has peaked (though at different paces) and some restrictions have been lifted across Asia. Recent figures in Indonesia have been showing the smallest number of cases (on a seven-day average) in almost one year; in mid-September it reopened to foreign tourists (fully vaccinated and with a quarantine ranging from eight to 14 days). In the meantime, the vaccination rollout has sped up, though it remains slow.

The growth rebound since EMs reopened their economies has been driven mainly by external demand (especially among commodity exporters through very favourable terms of trade) and by household consumption (supported by pent-up demand and/or cash handouts). In contrast, **the recovery in investments continues to lag and is even absent in the worst cases, making the current rebound less self-sustainable going forward.** For that reason, the policy mix should remain supportive and only gradually normalise towards more neutral financial conditions and a more prudent fiscal stance. **Global financial conditions have been allowing EMs to maintain a supportive policy stance so far;** indeed, the Federal Reserve's recently well-telegraphed tapering plan has been well received by the markets, reducing for the time being the potential disruptive power of vulnerable external conditions across EMs. Of course, it helps that balances of payments are sounder in comparison with those at the taper tantrum episode. Unfortunately, stretched EM inflation dynamics have already challenged many EM central banks to start normalising their monetary policies. The pressure on inflation from costs (food, energy, and shipping rates) is in any case near to smoothing out. As a reminder of where the EM policy mix stands, the bold hiking cycle already put through (like in Brazil and Russia or in other recent hikers, like Colombia, Chile or Hungary) and the ones projected are making it possible to continue normalising liquidity conditions at a very gradual pace.

China: a "new" source of macro-financial stress for the global economy and emerging markets

Against a still fragile EM backdrop, the greater-than-expected slowdown in the Chinese economy started to manifest itself in July and August.

Growth numbers broadly surprised on the downside in Q3, with exports being the only exception. Policy tightening with the housing slowdown, self-imposed restraints (zero-tolerance Covid-19 policies and de-carbonisation production cuts and electricity rationing) and the global chip shortage have all contributed to a weaker economic performance.

For the second time in less than two months, we have downgraded our growth forecasts; we no longer expect growth to recover to trend in Q4 2021. Still, we do expect a production comeback in Q1 2022 as global supply constraints ease and as energy use quotas are renewed. Moreover, we still expect some adjustments to the zero-tolerance policy for easier domestic travel in early 2022, which should become less of a drag on the services sector. **We now expect average 2021 real GDP growth at 8.3%, down from 8.7% previously, and 2022 growth at 4.9%, against 5.4% previously.**

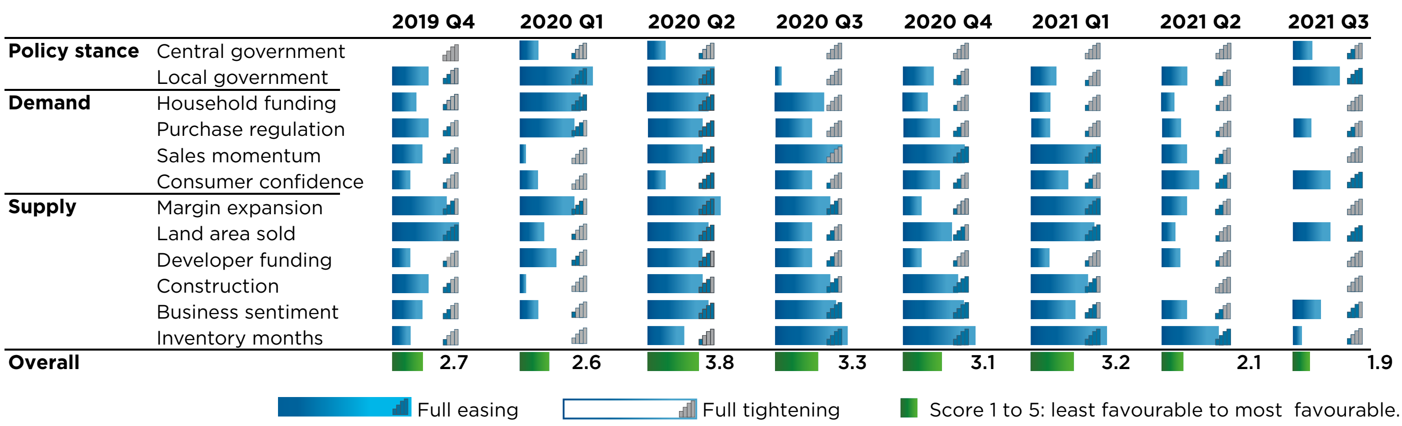
Deleveraging the housing sector and stabilising housing prices suit China long-term political agenda

Activity in the housing sector is cooling fast, and liquidity pressure will remain high for the sector, barring any policy changes. Under a new regime of regulations introduced a year ago, developers will need to meet the deleveraging goals by mid-2023. Deleveraging the housing sector and stabilising housing prices suit China's long-term political agenda. To pursue Common Prosperity, the government is promoting a sustainable and healthy housing market for the greater good. Hong Kong and South Korea are constant reminders to Beijing of how elevated housing inflation could quickly erode household income and political bases. On the back of China's general commitment to financial de-risking, companies like the developer Evergrande will need to restructure

THIS MONTH'S TOPIC

their debt stock. **The real contagion, in China and abroad, from housing sector re-sizing is combining with the financial contagion starting from the property sector in the Asian credit market and questions on banking sector exposure.**

1/ China property scorecard



Source: CEIC, GS, Amundi Research - As of 15 September 2021

Among the positive catalysts for growth, on-budget fiscal is loosening with high net issuance expected to continue in September and December. The fiscal loosening should lift infra investment out of contraction, but a recovery to the low single-digits is more likely, given the higher project quality requirements and the cautious stance of local officials before the March NPC and the 2022 Party Congress. Nevertheless, we don't expect any relaxation of off-budget debt controls yet, limiting the spending from LGFVs and Local SOEs. Credit growth is bottoming out. Deleveraging in 2022 is likely to continue at a slower pace than in 2021 YTD, in order to prevent contagion risks. The PBoC should maintain loose interbank liquidity. The recent weekly liquidity injection amount was the highest in eight months, in part to meet seasonal demand. **We expect PBoC to cut the RRR again in October. However, the RRR cut alone won't help much.** The current weakness in the economy requires a suspension of tightening in credit, or a rate cut (which would be less effective without credit loosening). But there is no signal from the central bank that it intends to do so.

China slowdown: what is the impact on EMs?

EM with higher exposure to China (Trade and Commodity) with limited policy room, the most at risk

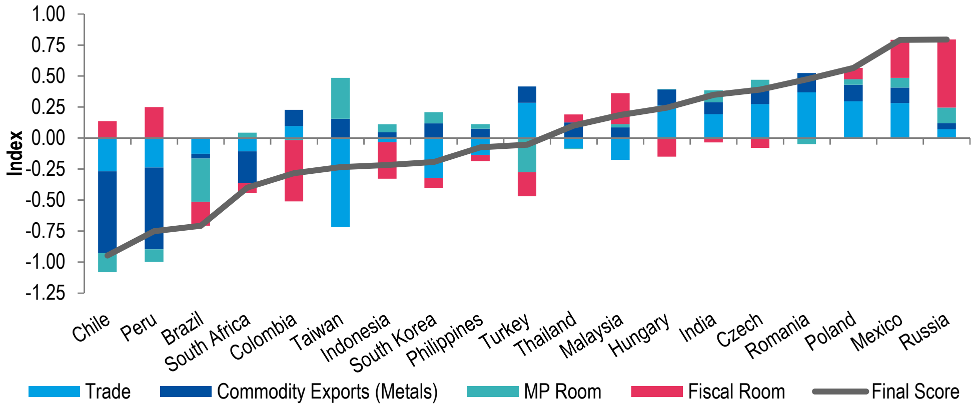
The slowdown expected in the Chinese economy should normally impact most economies across the globe. On a pure macroeconomic perspective, we have been analysing this impact along different dimensions. **The first and more direct impact is expected to be through the trade channel,** due to China's huge relevance as trading partner for many countries in the world. The first take-away in analysing the figures based on value-added trade exposure, is that, with the exception of Australia and Japan, EMs will suffer a stronger impact from a downside shock on Chinese growth than DMs. Among the EMs, generally speaking, if we put aside the regional proximity of Taiwan or South Korea, commodity exporters will be the countries more penalised, and this is already evident simply through the trade channel. However, in consideration of the negative drivers that we assume are impacting Chinese growth the most, **we want to emphasise the importance of a re-sizing housing sector (not completely offset by mildly improving infrastructure investments), while assigning a more negative rank to countries exporting metals than fuels or agro commodities.**

Moving away from a proper direct impact from the Chinese slowdown, it's worth assessing how much policy room (monetary and fiscal) is available across EMs to offset this kind of external shock on growth. **EM monetary policy room depends mainly on two aspects, external global financial conditions and domestic macro conditions (namely growth and inflation).** While in our outlook the global financial conditions driven by the main CBs' stance are tilting towards tightening, there is still some asynchrony among them, and the narrative of "not enough growth" continues to dominate the theme of more persistent than expected inflation. Therefore, even if not compelling yet in discriminating certain EMs versus others, in a changing global context we need to be mindful of where the external vulnerabilities are today. The crisis has triggered a nice external rebalancing that some countries are currently seeing deteriorating slightly on the back of their domestic economic rebound. While global conditions have been giving EM CBs time to adjust their exceptional dovishness, domestic conditions and inflation above all are significantly reducing their room for manoeuvre. The tightening process in EMs has only accelerated, and the ability to scale it down is far from possible in the near term, with the exception of EM Asia, where policy normalisation hasn't even started (with the exceptions of China and South Korea). As for fiscal room, it's fair to say that the pandemic

THIS MONTH'S TOPIC

has deteriorated all countries' fiscal positions with no exceptions. In comparison with DMs, the fiscal deterioration in EMs has been due more to revenues shortage due to poor economic performance than to the strategically important fiscal packages put in place (with cash handouts, social assistance/subsidies, and health sector support being the main tools). Beyond the general deterioration, the pre-pandemic fiscal fragilities, which have not significantly changed in relative to post-pandemic conditions, are still shaping EM relative fiscal room: Brazil, Colombia or Indonesia will have some issues in finding new fiscal room, unlike Russia and Mexico.

2/ **Chinese slowdown impact**



Sources: OECD, WTO, CEIC, Bloomberg, IMF, Amundi Research - Data as of September 2021.

EM fixed income. With rising rates and increasing inflation, could EM debt still provide a source of carry for global investors?

EM debt is still a good source of carry; we do prefer local rates, when CBs are closer to the end of their normalisation cycle

Inflation has continued to surprise on the upside, in both EMs and DMs, driven by strong domestic demand and supply bottlenecks. We are monitoring inflation to understand how sticky it proves to be. We think it is still too early to make a definitive call on the transitory-versus-structural inflation debate and do not expect rates hikes in DMs for at least another year. However, core market rates are too low and we therefore expect rates to pick up from the current levels. Hence, our bearish view on duration.

Our forecast on 10-year US Treasury yields is for a gradual rise in rates to 1.6-1.8% (vs. 1.5% at this writing). The Fed should remain data-dependant, in our view, with the current macro configuration pointing towards a reduced risk of a rapid normalisation, despite inflation prints continuing to surprise on the upside. Although tapering remains a risk and is forecast to start as early as November, the Fed's early flagging and gradualist approach amidst softer macro data should help to mitigate a 'tantrum' scenario. We think that, instead of fearing Fed policy normalisation, investors should welcome it, as it would mark confidence in the sustainability of growth.

Against a backdrop of gradually rising yields, which are still low compared to historical levels, emerging market debt continues to offer the potential of an attractive yield pick-up, across both local and hard currency debt. The local currency benchmark is yielding approximately 5% and in hard currency, and spreads are around 335 bps. While we do not expect significant spread compression this year, we continue to believe that EM debt provides a source of carry. However, given the divergent paths of EM economies, selection remains key. We remain constructive on the asset class over the long term and view emerging markets' resilience as evidence for its ability to perform once its relative growth rate improves.

In our view, inflation should be less of a concern for hard currency spreads – in fact, higher inflation is boosting nominal GDP growth in countries such as Brazil, bringing debt/GDP ratios lower than expected, whilst the surprise element of inflation is helping to boost primary fiscal balances – this is a positive for credit. We maintain our constructive outlook on EM hard currency debt overall.

In local currencies, while we do not think it is time to buy EM rates indiscriminately at this stage, as much of the sell-off has been warranted by a turn in central bank policy inclination away from easing towards tightening, and by the emergence of inflationary pressures. Having said that, **we have moved to a more positive bias on EM rates compared to the beginning of the year.** While overall local rates markets appear expensive, we see local rates to be a lot closer to fair value in many EM countries than they are in core rates markets. Therefore, we continue to favour countries where EM tightening cycles are closer to the end rather than the start of a hiking cycle.

Within EM corporates, although spreads do not look cheap on a historical basis, they appear attractive compared to other asset classes, particularly in DMs. We are focusing on bottom-up selection and continue to see attractive carry opportunities with earnings recovery continuing in 2021. The EM HY space continues to offer more value in our opinion as these credits are supported by

THIS MONTH'S TOPIC

improving fundamentals and lower sensitivity to US rates. We are positive on Mexico energy where spreads have been attractive; we are focusing on quasi-sovereign names here as they serve as the most liquid beta. We think exposure to the US economy will help fuel growth in Mexico, as well. Trade between the countries has been recovering, even as cyclical indicators are improving. We also like the utilities sector in Ukraine. In terms of risks, we are closely watching revisions in macro growth expectations for 2022 and their impact on earnings growth. We are also monitoring the contagion from the Evergrande saga. The need to bring leverage down across China's real estate sector, triggered by regulatory pressures and tighter monetary conditions, could weigh on growth in the sector but should bring a necessary adjustment to issuers' financial profiles and benefit the sector in the medium to long term. Technicals have been weak, due to idiosyncratic stories, but we believe that this should improve over time. On the micro level, we assign a high likelihood to the government's intervening in the restructuring process, as it will not want to see Evergrande restructure in a disorderly manner. On the macro level, we expect steps to provide more liquidity to the sector.

EM FX

Overall, we have dialled down our bullishness on EM FXs, given their strong performance following the latest US data, which are pointing towards a much slower labour market versus much higher than expected wage growth. It is not clear to us that this set of data should trigger further weakness in the USD, given the data's stagflationary flavour, which is the most feared market environment for risk assets. **We do not see great risk-reward in EM FX at this juncture and hence hold a neutral view, with a preference for currencies that may have lagged the rally but whose fundamentals and positioning are supportive.**

We have downgraded our view on the Brazilian real and are now neutral given the currency's outperformance versus other EM high yielders year-to-date. While the currency suffers from political noise, we believe that the broader macro backdrop of strong growth, healthy balances of payments, and tightening monetary policy should ultimately prove supportive.

We are now more cautious on the Mexican peso, given the currency's strong performance this year, despite a half-hearted tightening cycle by the central bank. The currency may also face downward pressure from a US economy with negative delta on growth.

Meanwhile, we are constructive on the Colombian peso, as we believe that forced selling due to the country's downgrade to HY should be behind us. Meanwhile, we have turned more negative on the Chilean peso.

In CE/EMEA, the key change has been a shift towards a positive view on the Polish zloty. The currency has significantly underperformed its regional peers. In our view, the persistently high inflationary prints may force the perma-dovish central bank towards a more hawkish stance at its upcoming monetary policy meetings. In the rest of the region, we maintain a positive view on the Russian rouble, while we are neutral elsewhere.

EM Equities. What are the main catalysts and risks for investing in EM equities?

Cautious but constructive on EM equities, whose valuations are attractive by global standards

We have a cautious but constructive view on emerging markets equities. While emerging market countries have clearly lagged US and Europe in terms of vaccination roll-outs, we are seeing increasing efforts to accelerate vaccination programs. Our base case remains that this should be enough for Covid-19 outbreaks to be controlled, even if the emergence of new variants continues to slow down the pace of reopenings.

The Fed's less dovish stance is clearly positive, as it reduces the probability of economies going through a sustained period of overheating. It also anchors inflation expectations at lower levels while reinforcing the view that inflationary pressure is more likely temporary. Overall, this is very positive for emerging markets as it decreases significantly the tail risk of sharper rates hikes.

While EM equity valuations are no longer depressed on an absolute basis, they remain very attractive in a global context, particularly for long-term investors. Earnings have started to rebound in line with economic growth, but remain far below 2019 levels. We expect normalisation of earnings and profitability to remain supportive for markets.

On a longer-term view, we continue to think that improvement in capital expenditure discipline, the lack of major macroeconomic imbalances, and increasing payout ratios should help emerging economies reduce economic and profit volatility.

Our highest conviction country view is on India, as it appears to be in the early stages of an earnings upcycle. We are also positive on Russia, given its solid macro-economic resilience, central bank credibility and compelling valuations. Meanwhile, we are exercising caution on China amidst the tightening of regulatory conditions, which is putting earnings and multiples at risk. We are also cautious on Mexico, given the deterioration of fundamentals due to the government's poor management of the pandemic. By sector, our favourite idea is consumer discretionaries, which are being supported by the reopening of global trade activity and attractive valuations. On the other hand, our least favourite sectors are healthcare and consumer staples.

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