Institute

October 2022

Emerging Markets Charts and Views
EM investing after the great repricing

Confidence must be earned

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Investment Insights | Market Stories

EM investing after the great repricing

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The great repricing of 2022: global financial markets have been caught in a highly gloomy and volatile environment since the Federal Reserve began raising interest rates in an effort to tame surging inflation (at 40-years highs). The tightening of financial conditions has also led to a strengthening US dollar, impacting all asset classes and Emerging Markets (EM) have not been an exception. Moreover, the ongoing war in Ukraine and the Chinese slowdown have further worsened inflationary pressure (via high commodity and energy prices) and harmed economic activity resulting in a deteriorating growth outlook for next year.

For 2023 we still expect a soft landing scenario for the US economy and a recession in Europe, but we also recognise that there are growing risks of a global recession amid high inflation, food and energy crises, geopolitical tensions and tightening in financial conditions.
Against this backdrop, opportunities in Emerging Markets will materialize depending on the evolution of three factors. In particular:

1. ***Increasing EM-DM growth differential*** *should play out in favour of the former, with a stabilisation / improvement of China outlook. This will depend on the development of two major challenges that the Chinese economy is facing: 1) its zero-Covid policy, 2) a housing market correction. We do not expect to see a full reopening happen overnight but a more pragmatic approach could be adopted going forward alongside with some normalisation in the real estate sector.*
2. ***Core rates stabilisation****. The hawkish stance of the Fed is now priced in. We are mindful of an alternative scenario of even more aggressive moves, to curb inflation and this is a risk to monitor. A* ***Fed pivot could be supportive for EM assets, and trigger entry points.***
3. ***EM inflation dynamics and monetary policy are in an advanced stage compared to DM****. Most EM have already acted to cool down inflation and most of the tightening cycle could be behind us, the most compelling and significant case is Brazil.*

In this context our main convictions in Emerging Markets are:

- *Entering 2023 we believe* ***EM bonds in Hard Currency can offer interesting opportunities for investors in search of income,*** *while we are more cautious on local rates and FX.*
- ***EM equities could benefit from a better backdrop and more visibility later in 2023****, but selection will remain crucial amid an increasingly complex EM puzzle.*
- ***The internal demand story is still attractive*** *with a mid-to-long-term horizon, raising exposure to China or India as their economic models shift towards domestic demand.*

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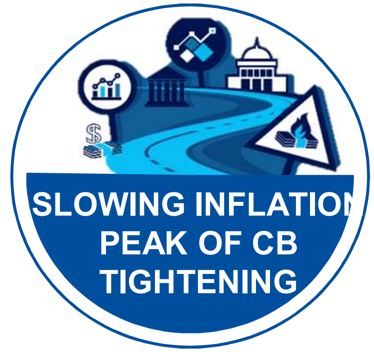
Key themes for investing in EM

Overall the EM growth gap with DM is going to increase, being a supporting factor for EM in 2023. Chinese stabilisation could mitigate the effects of a global slowdown. But this trend will mainly depend on its reopening, which is linked to the evolution of zero-Covid policy and domestic demand consumption.

Rapid and significant rate hikes could prompt a recession in DM. We believe most of the core rates repricing has already occurred. Moving towards a **new balance between growth and inflation, we expect to see a stabilisation in core rates**. This could stop pressuring EM cost of capital and the dollar effect.

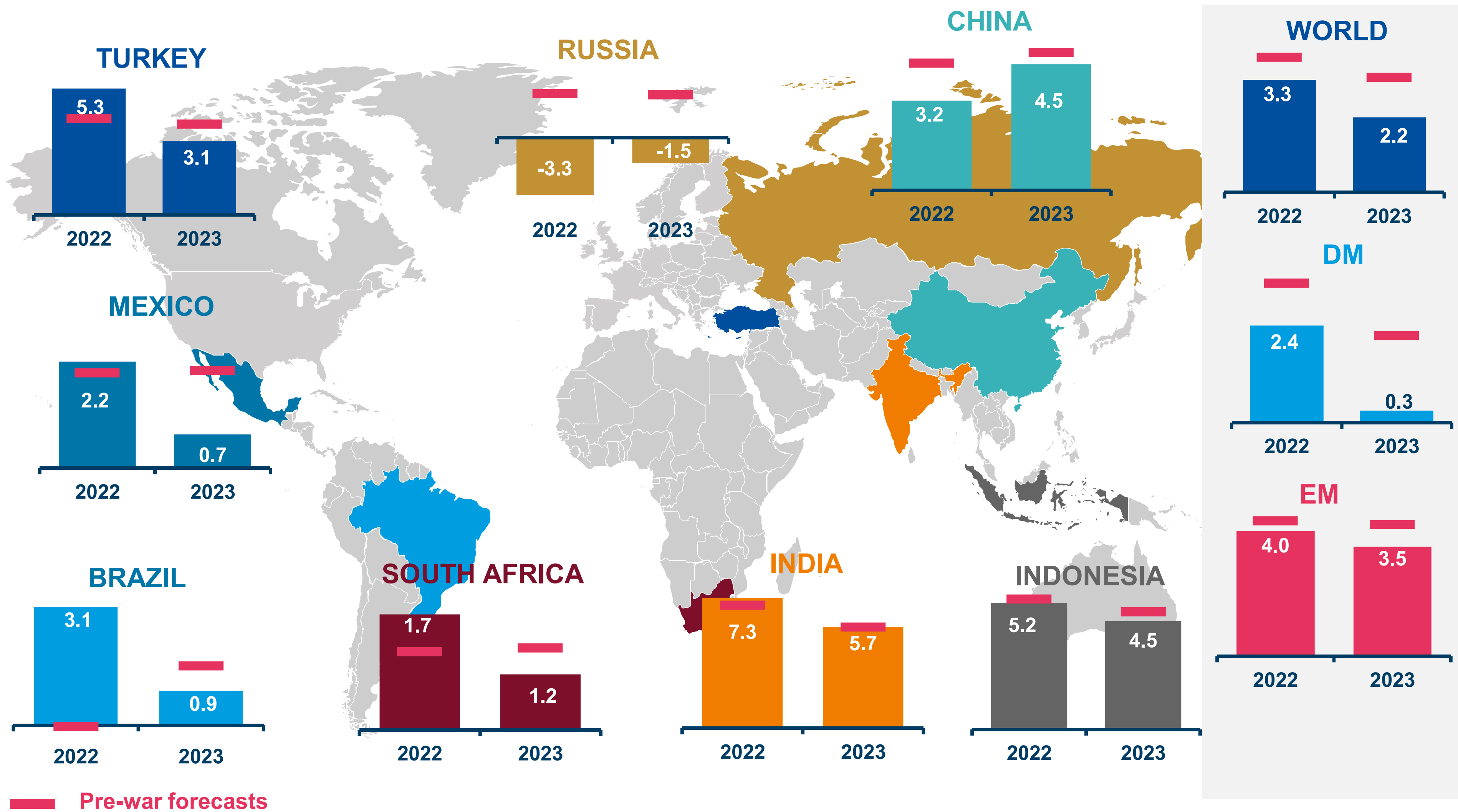


Inflation may already have peaked in some emerging economies. Given their own inflationary dynamics, monetary authorities in EM have been more proactive and advanced in their hiking cycles and we consider that **some EM countries have already completed their monetary policy normalisation** while others could be close to complete it.

The main area for attention is a possible **further tightening of financial conditions due to a more hawkish Fed**, adding pressure to some EM CB and EM FX. **Geopolitical risks are still rising** due to escalating regional tensions and the ongoing war in Ukraine. The final risks to monitor are idiosyncratic stories and internal vulnerabilities, which are increasing EM fragmentation.

Source: Amundi as of 24 October 2022. DM: developed markets. EM: emerging markets. CB: central banks.

Weak global growth outlook, more healthy in EM world



Source: Amundi Institute. Data is as of 25 October 2022. Latest forecasts are as of 25 October 2022. Bars represent the latest real GDP growth (YoY%) forecasts, while red markers represent our pre-war forecasts as of 14 February. Within our forecasts, we incorporate higher risk premium on the commodity space due to the Russia-Ukraine war.

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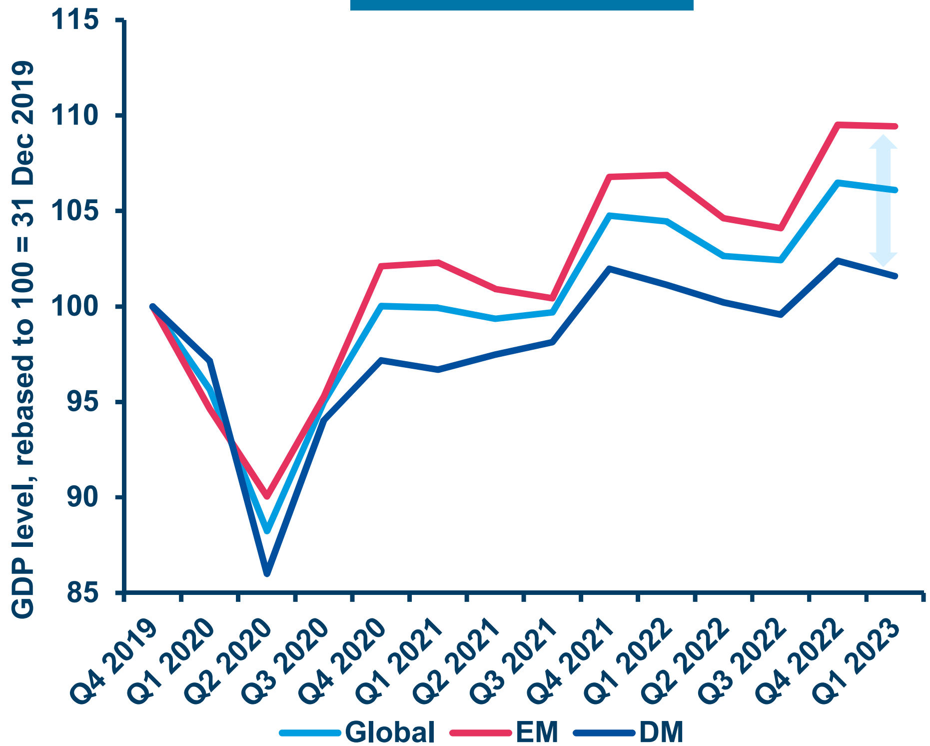
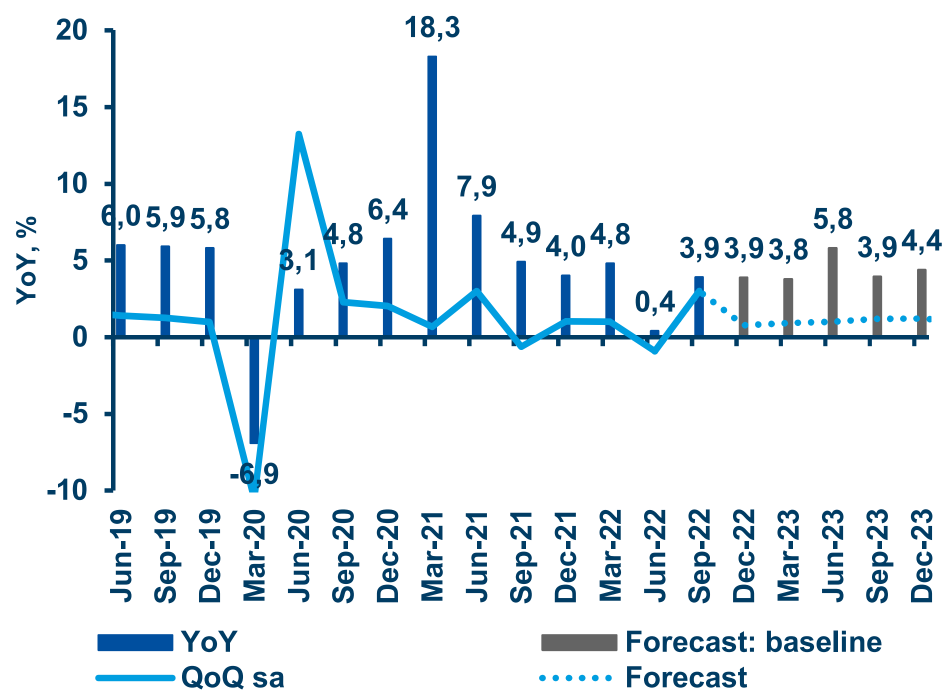
Growth premium moving in favour of EM, mainly driven by China's expected stabilisation



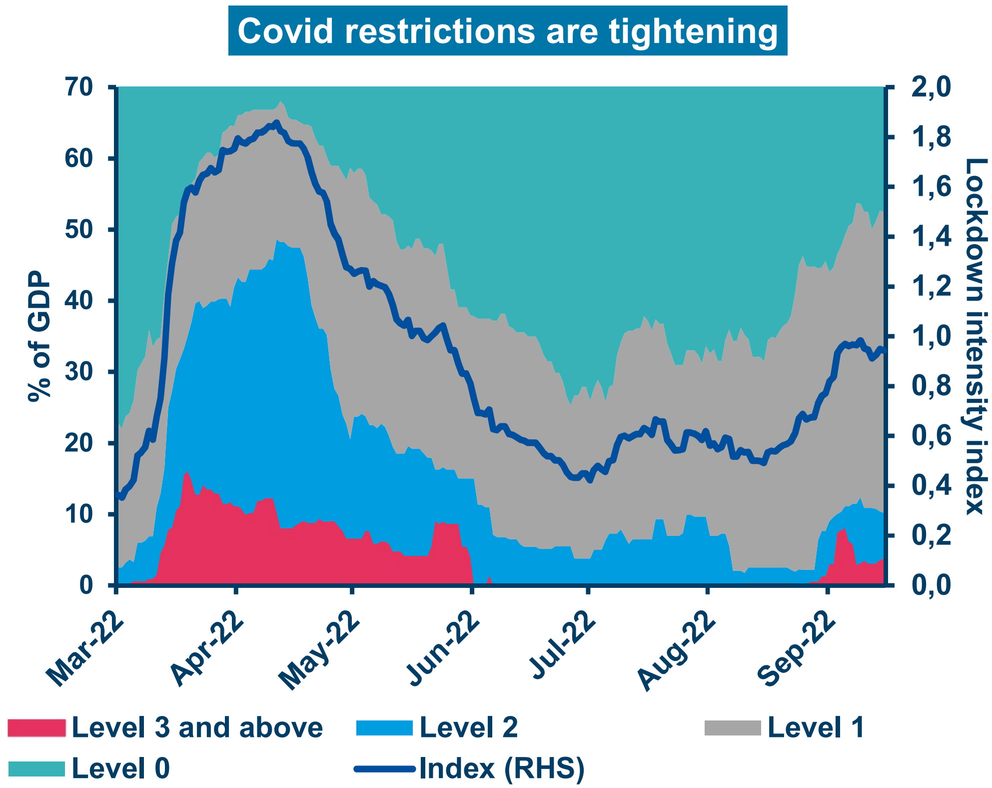


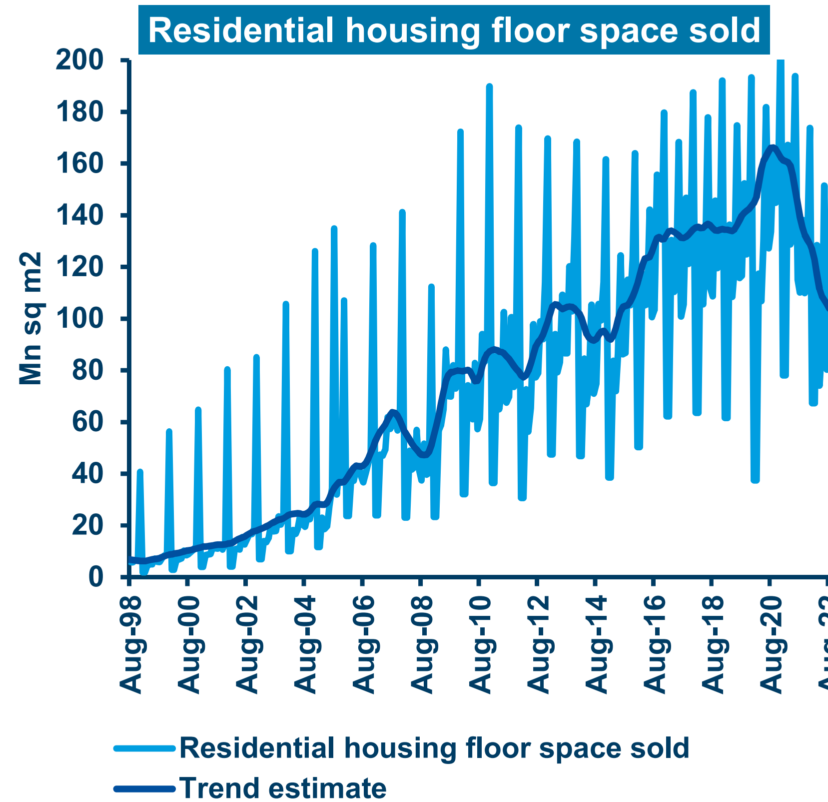
» Although the stagflationary scenario is gaining momentum and affects all geographies, DM should be more impacted than EM. We expect growth in the next couple of quarters (end of 2022 and early 2023) to be more in favour of EM, including the expectation of growth recovery in China next year.

Source: Amundi Institute on CEIC, data is as of 17 October 2022.

Source: Amundi Institute, NBS, CEIC. Data and forecasts are as of 25 October 2022. sa: seasonally adjusted. PBoC: People's Bank of China.

Two headwinds for China growth in 2022: the zero-Covid policy and the crisis in the real estate sector





The combination of China's strict zero-Covid policy and the deepening turmoil in the real estate sector has impacted Chinese growth for 2022. We expect the zero-Covid doctrine to stay with us in most of 2023, our conviction of full reopening in late 2023 is lower, harming growth for the upcoming year. With regards to the housing market, we expect sales to trend down throughout the rest of the year before starting to stabilise in 2023.

Source: Amundi Institute on Gavekal Dragonomics / Macrobond, Wind. Data is as of 26 September 2022. 12-months moving average.

Source: Amundi Institute, CEIC. Monthly data as of 29 September 2022.

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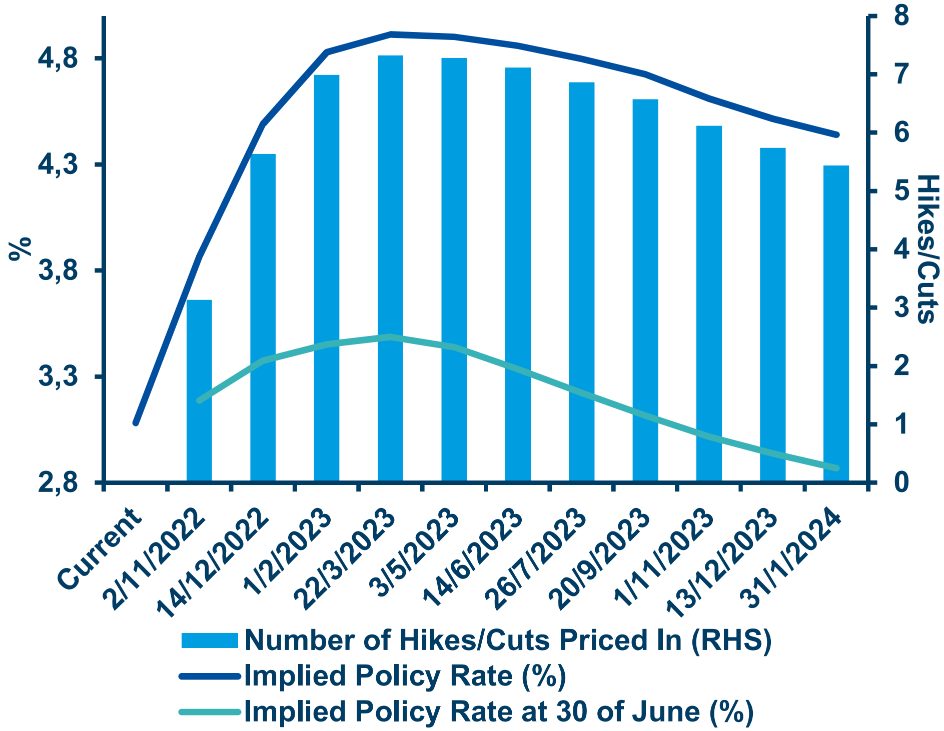
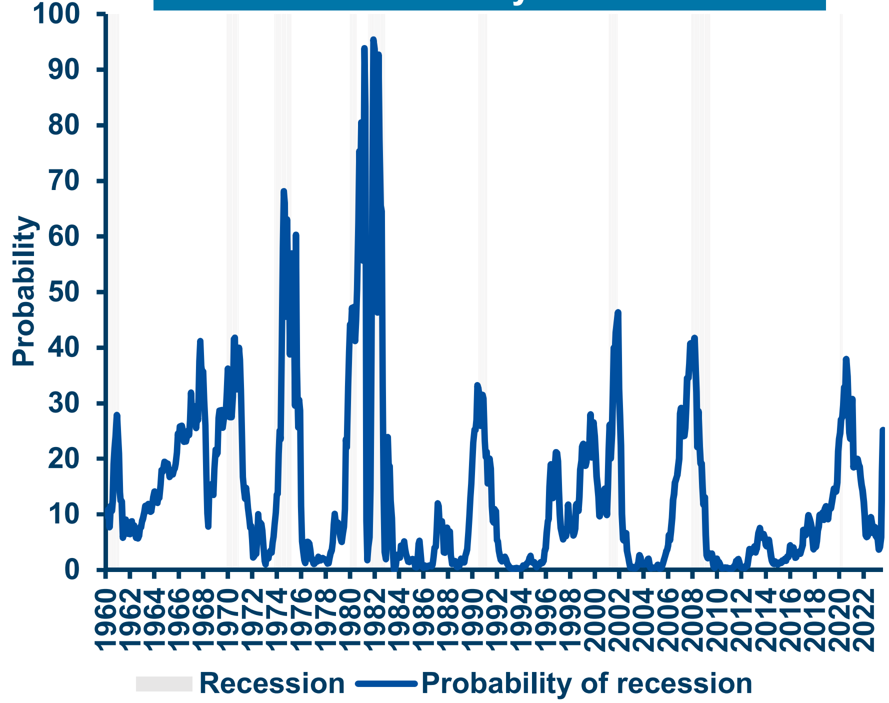
A cornerstone point for EM: the market is now eyeing the possibility of a Fed pivot

Fed implied policy rate and hikes / cuts



NY Fed US recession probability index, based on the yield curve



» Higher terminal rates, compared to the end of June, show that the inflation element still dominates CB monetary policy rhetoric on the growth / inflation dilemma. Moving ahead, further tightening in financial conditions and increasing risk of recession could lead to a possible Fed pivot.

Source: Amundi Institute, Bloomberg. Data is as of 17 October 2022. CB: central banks. Specific date refers to upcoming FOMC by the Fed.

Source: Amundi Institute, Bloomberg. Data is as of 17 October 2022. The model uses the slope of the yield curve, or "term spread," to calculate the probability of a recession in the US twelve months ahead, and it is calculated by Federal Reserve Bank of New York.

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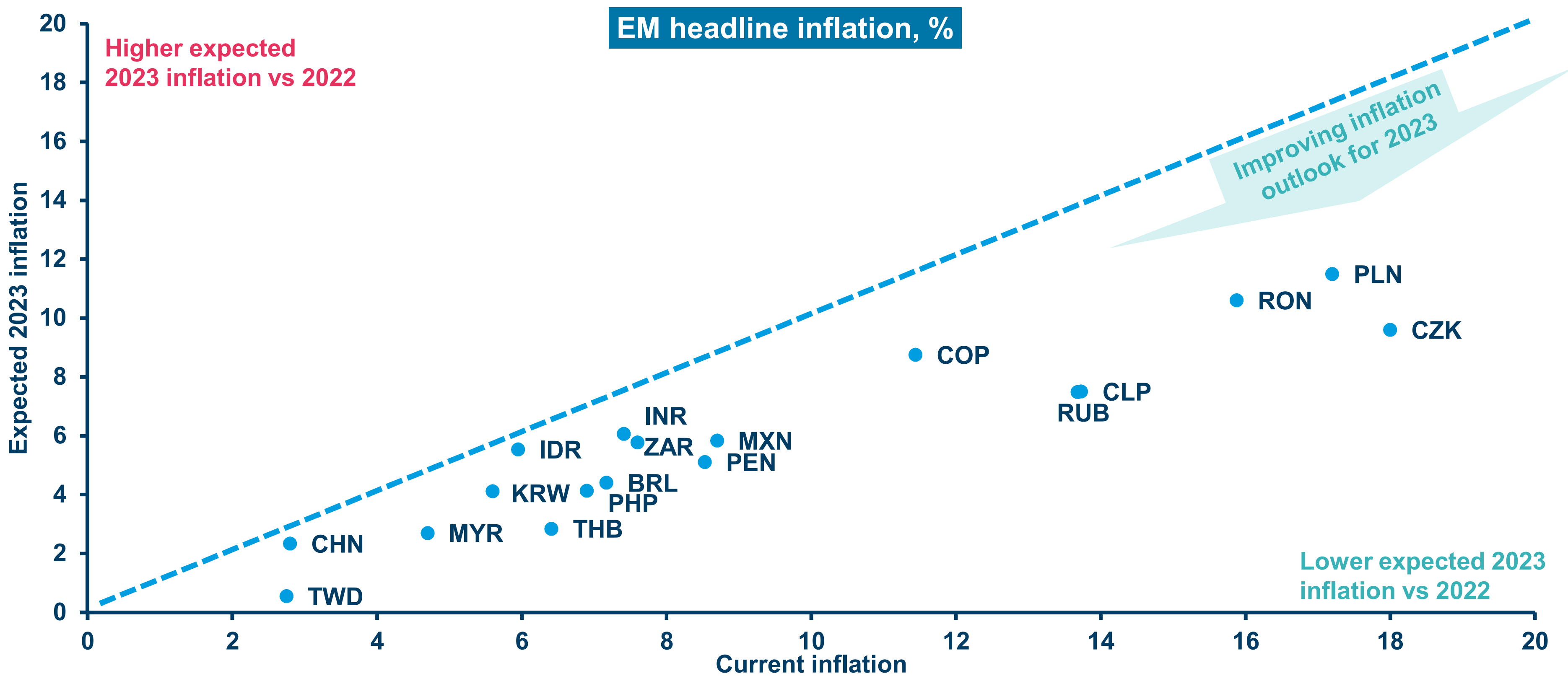
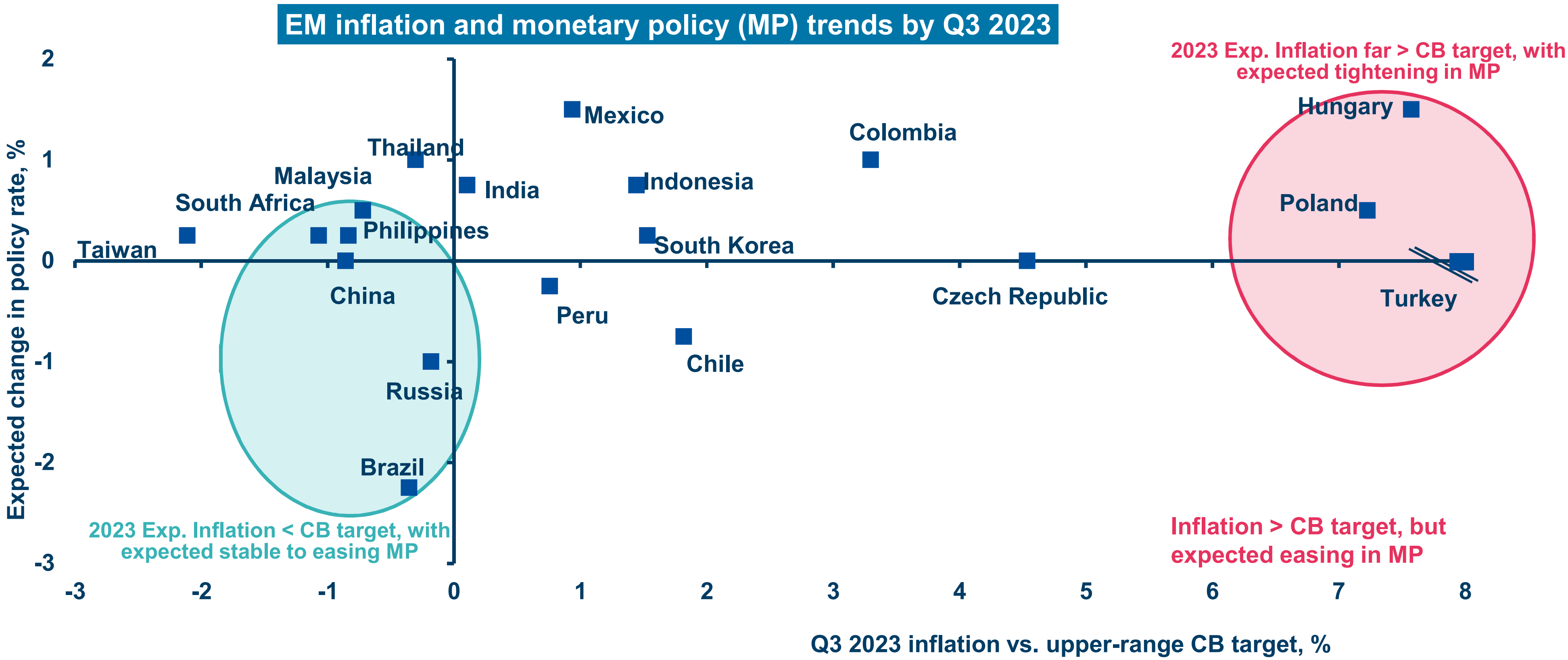
A declining path for EM inflation expected



Inflation is still high vs the EM CB targets but should be on a declining path over the coming quarters, the picture is diverse across EM countries, but the peak could be behind us for the vast majority of countries. The expected average inflation for 2023 is generally lower than the last reading, showing a descending trend.

Source: Amundi Institute. Data is as of 18 September 2022. Current inflation reflects September CPI YoY, except for Malaysia and South Africa that is as of August 2022. Expected inflation is the average on quarterly internal forecasts for 2023.

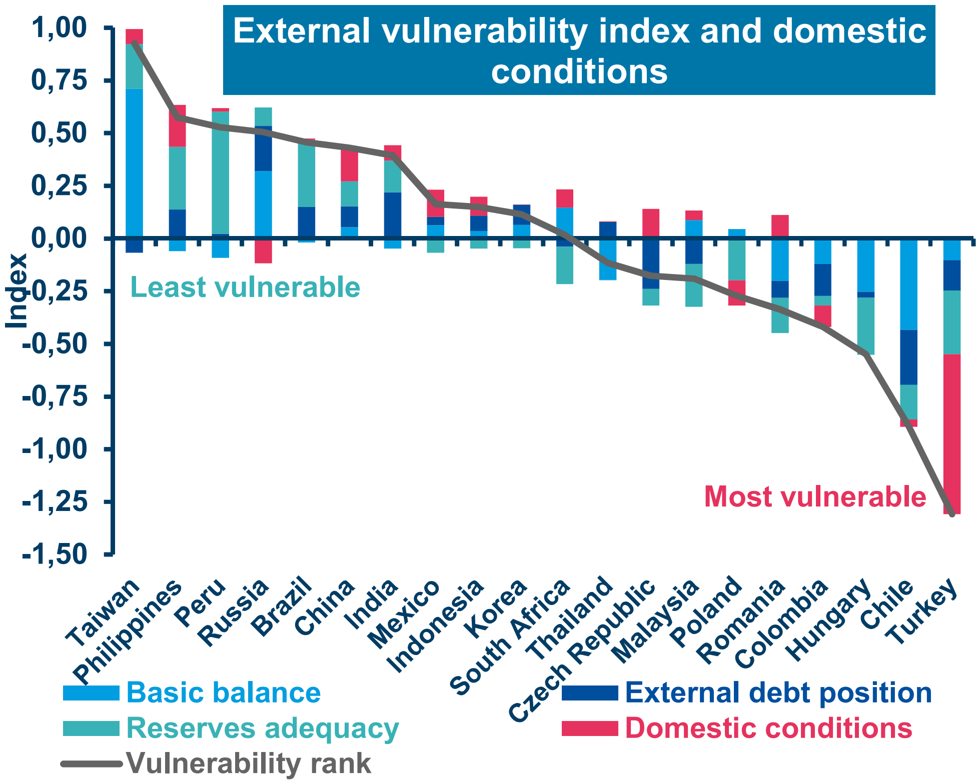
Substantial monetary policy and inflation divergences across EM

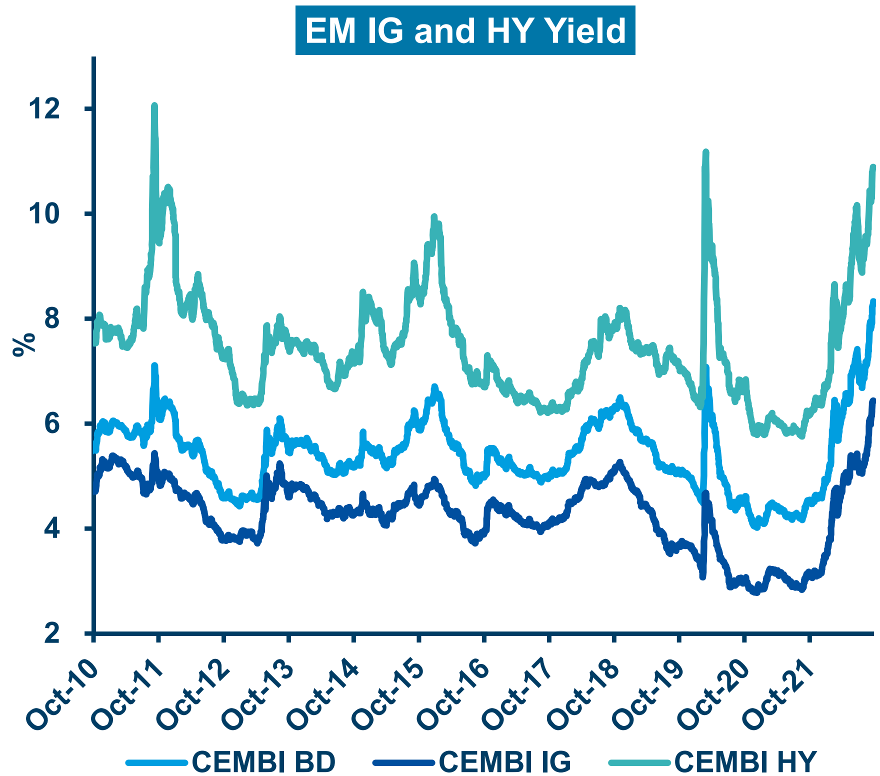


The EM space shows a scattered picture with some countries being less impacted by the inflation shock (the vast majority of Asian countries) and others which are more advanced in their monetary policy normalisation (reflected in the green circle). Brazil deserves a special mention, due to its shift towards the most constructive quadrant. On the other hand, the red circle highlights countries exposed to tightening and rising inflation, as well as Turkey, which is an idiosyncratic story.

Source: Amundi Institute on Bloomberg Intelligence data. Data is as of 28 September 2022. EM includes CB from: Brazil, Chile, China, Colombia, Czech, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Peru, Philippines, Poland, Romania, Russia, South Africa, South Korea, Thailand, and Turkey. DM: developed markets. EM: emerging markets. Fed: Federal Reserve.

External vulnerability rank: increasing the fragmentation of EM space





» The EM fragmentation increased in 2022 due to the impact of the Chinese slowdown and the ongoing war in Ukraine; to such respect the vulnerability ranking shows Eastern European countries as the most vulnerable area while LatAm and Asian are more resilient. Moreover, some low-income countries are already trading at distressed levels, as the HY index shows in an aggregate yield level.

Source: Amundi Institute's external vulnerability rank. Source: Amundi Institute, CEIC, IMF, WTO. Data as of 5 October 2022.

Source: Amundi Institute, Bloomberg. Data is as of 18 October 2022. Bloomberg. Indices are: J.P. Morgan CEMBI Div Broad Composite Blended Yield, J.P. Morgan CEMBI Broad Diversified High Grade Blended Yield and J.P. Morgan CEMBI Broad Diversified High Yield Blended Yield.

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Convictions for investing in emerging markets

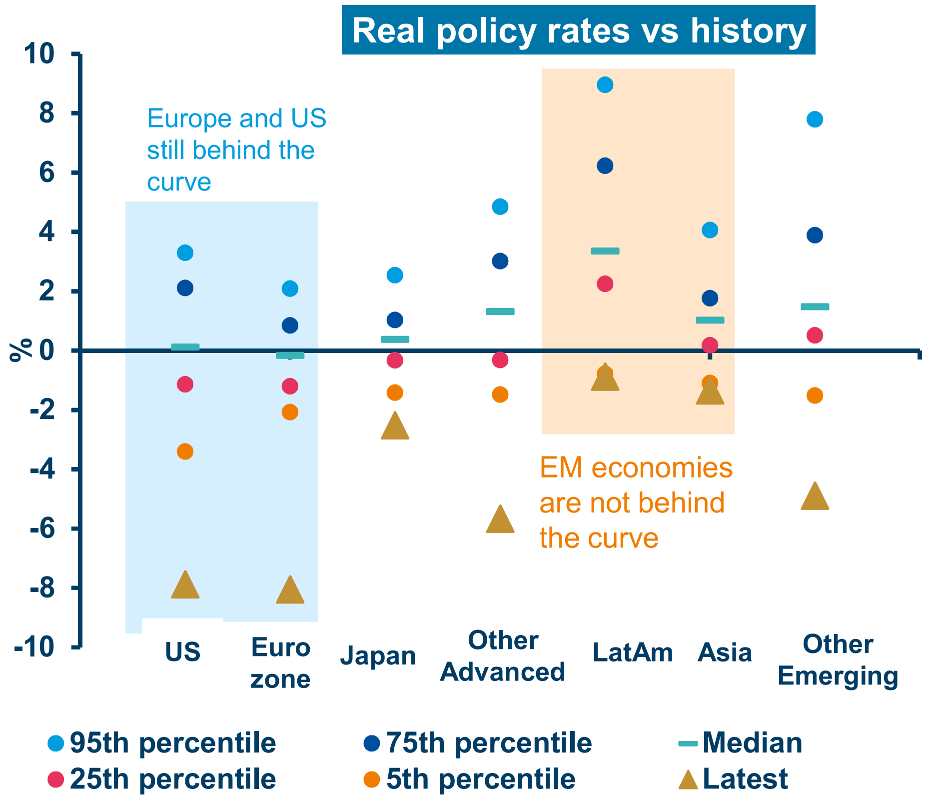
EM high-conviction ideas

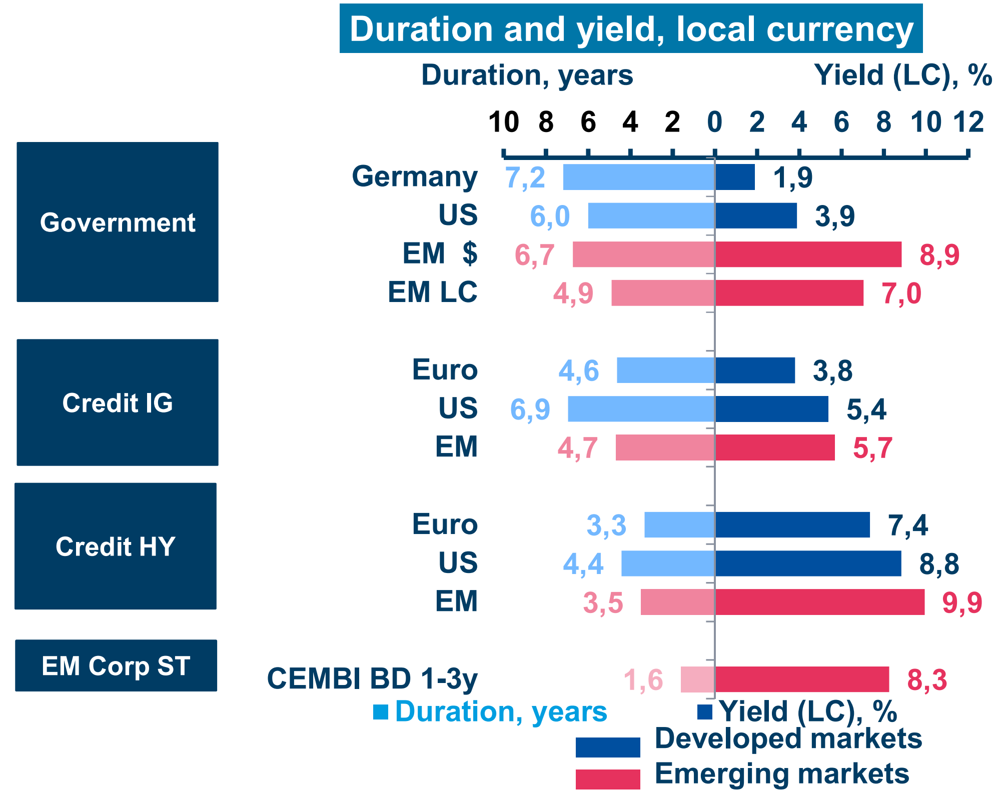
Main conviction for the end of 2022 and entering 2023 → **During 2023 depending on the backdrop** → **Mid-to-long-term perspective**

EM bonds as source of income (focus on HC, cautious in EM FX)	Selective EM equity to play EM-DM growth	Asia and China in global portfolios	The rise of ESG in emerging markets
After the global repricing of yields and spreads, **EM bonds offer an interesting entry points in absolute and relative terms**. Our preference is for **HC bonds**, while we are cautious on EM local rates and FX. Overall, we maintain a focus on countries where CB have been proactive in anchoring inflation coupled with interesting levels in terms of carry.	Later in 2023 we could be approaching a Fed pivot and a possibly weaker dollar, EM equities should start to benefit from a better backdrop for EM FX and from the EM-DM growth premium as well as from attractive valuations. **A highly selective approach, focused on fundamentals and domestic growth** will be key amid increasing fragmentation in the EM world.	**Chinese and Asian markets may offer an interesting source of diversification for global investors**. The Chinese equity market (A share) is well diversified at a sector level and could benefit from domestic demand dynamics while government bonds have been quite stable amid the global debt sell-off and we expect them to be supported by the PBoC in an easing mode.	EM and low-income countries are among the **most vulnerable areas to the effects of climate change**. Growing investor demand for green, social and sustainability-linked bonds could help EM to achieve a green transition while mitigating social effects.

Source: Amundi as of 19 October 2022. EM: Emerging Markets. HC: Hard Currency. PBoC: People Bank of China.

Monetary policy normalisation is more advanced in EM, offering fresh opportunities in terms of risk-reward





EM monetary policy normalisation is at an advanced stage compared to DM. EM debt yields are attractive, even if we do not experience any significant spread compression this year. The preference remains for HC bonds and for countries where tightening is already advanced; accurate selection remains crucial.

Source: Amundi Institute on BIS. Data is as of July 2022. Per cent real policy rates from 1990 for the Advanced economies and from 2000 for the Emerging economies.

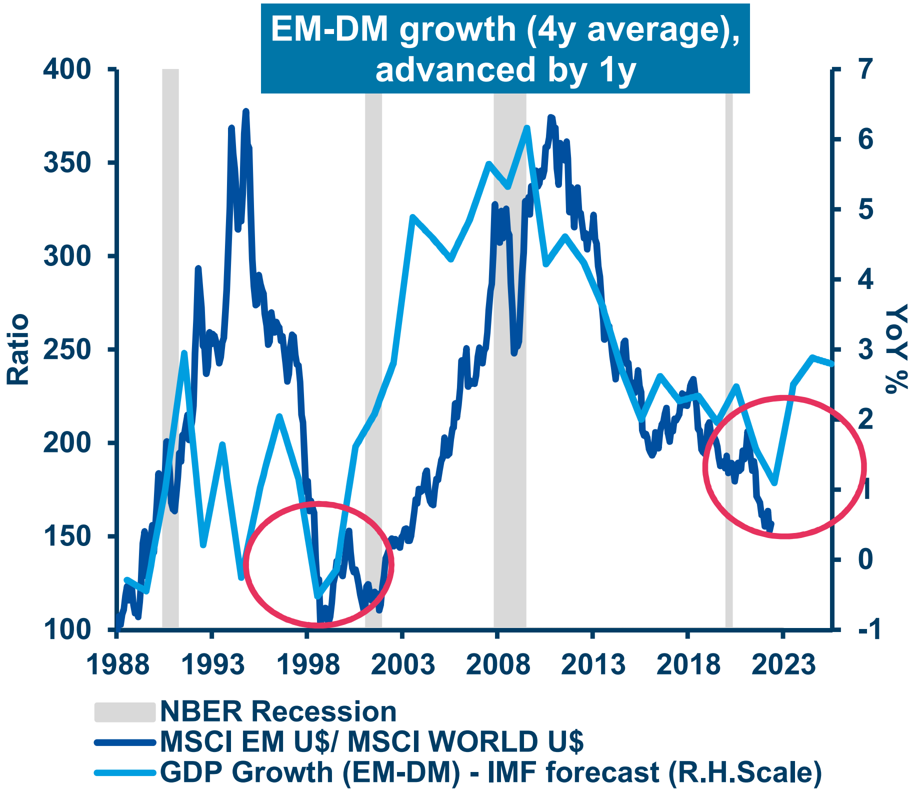
Source: Amundi Institute. Analysis on Bloomberg data. Data is as of 23 September 2022. Government and EM indices are from JP Morgan. Euro and US credit indices are from ICE-BofA. HC: hard currency. LC: local currency. IG: investment grade. HY: high yield. ST: short term. Yield for EM Corp ST is JP Morgan CEMBI Broad Diversified 1-3 Year while duration is JP Morgan CEMBI IG+ 1-3 Years.

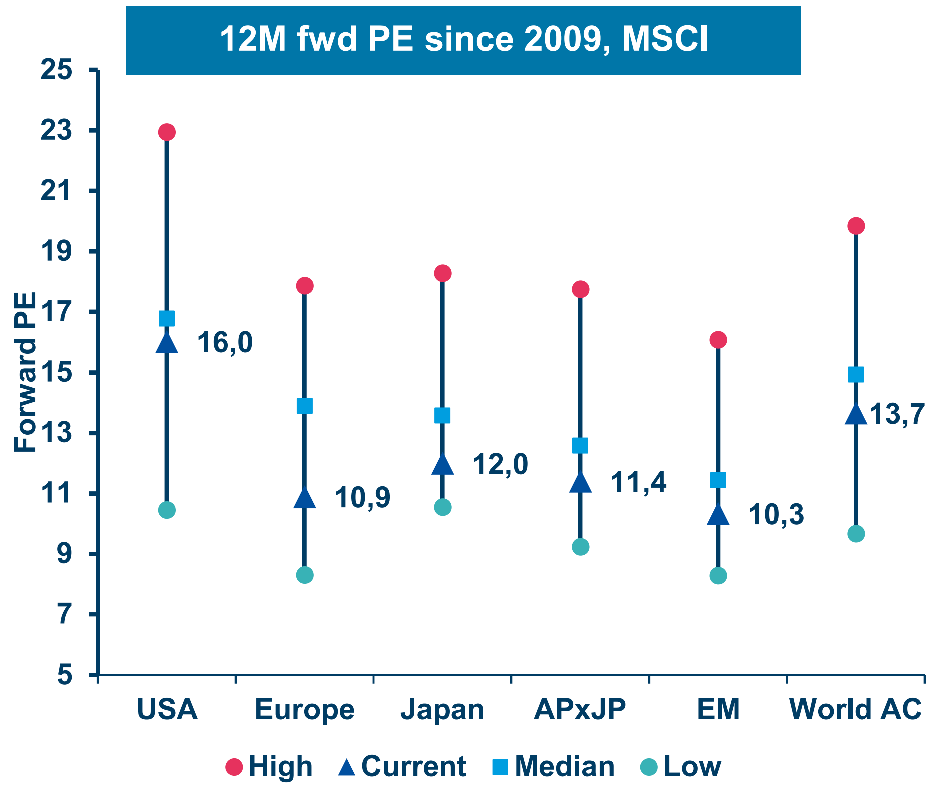
Major investment convictions in EM bonds and FX

SOV	HC bonds: spreads offer a compelling entry point in terms of carry and valuations from a historical standpoint, selective approach still required	Brazil, Mexico, Indonesia, Argentina
LOC	More discerning view on local rates, focusing on countries and currencies where the tightening cycle is almost over	Brazil, Mexico, Indonesia, South Africa
CORP	Valuations are supportive, attractive spreads vs. DM credit	Brazilian corporates, Mexican energy, GCC quasi
FX	Defensive stance. Select countries supported by commodity prices and also less affected by geopolitics	BRL, MXN, IDR, INR

Source: Amundi as of 19 October 2022. HC: hard currency. GCC: Gulf Cooperation Council. BRL: Brazilian Real. MXN: Mexican Peso. IDR: Indonesian Rupiah. INR: Indian Rupee.

EM equity: attractive valuations could support a recovery later in 2023





EM equity markets show historically cheap levels if you look at the valuation metrics, offering interesting entry points on a standalone basis and relative to DM for global investors. However, a dedicated approach is required in a fragmented EM universe.

Source: Amundi Institute, Datastream. Data is as of 30 September 2022. EM: emerging markets. DM: developed markets.

Source: Amundi Institute, Datastream. Data is as of 12 October 2022.

Equity opportunities in Asia

1 **China** – *neutral to positive*
Although earnings momentum should deteriorate further, we are becoming more constructive, as the regulatory crackdown is peaking, credit growth should be bottoming, inflation is not an issue and will not prevent further monetary and fiscal easing, whereas the rest of the world is in tightening mode. Small preference for A vs H shares.

2 **India** – *neutral*
Digital transformation, Made in India, financialisation of savings and increasing weight in indices with more IPOs to come in new economy sectors; although in short term, this is offset by high valuations, higher oil prices and rising fiscal risk.

3 **Taiwan** – *cautious*
Turning cautious on semiconductors due to valuations, with most of the positive news on pricing and volume already priced in and showing signs of rolling over coupled with a slowdown in the earnings cycle.

4 **South Korea** – *cautious*
Healthy but peaking exports, attractive valuations. Turning more cautious on technology hardware and the auto sector on US / Europe slowdown, but more constructive on cosmetic names. The earnings cycle is showing a slowdown.

10 **Indonesia** – *positive*
Beneficiary of rising commodity prices; favour banks and commodity-related names.

5 **Thailand** – *cautious*
Tourism still at risk with zero-Covid strategy in China. Favour oil-related names while remaining cautious on banks and reopening plays.

9 **Vietnam** – *positive*
Now the largest in the MSCI Frontier index. It could benefit from an upgrade to EM status in MSCI indices. Favour banks and real estate.

8 **Hong Kong** – *positive*
Focus on reopening plays, excluding real estate. Still favour insurance and travel-related consumer names.

7 **The Philippines** – *cautious*
Cautious on sectors exposed to domestic consumption and investment (banks and conglomerates).

6 **Malaysia** – *cautious*
Cautious on sectors exposed to domestic consumption and investment (banks, construction, telecoms); more constructive on exporters (e.g. commodities)

Colours indicate Amundi equity view on the country moving into 2023

Cautious **Neutral** **Positive**

Source: Amundi Institute. Data is as of 20 October 2022. EM: emerging markets.

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Indices reference and definitions

Bond Indices (JPMorgan)

Sov. HC HY = JPM EMBI Global Diversified High Yield; Sov. HC = JPM EMBI Global Diversified Composite; Sov. HC IG = JPM EMBI Global Diversified Inv. Grade; Local FX = JPM GBI-EM Global Diversified FX Return; Local HC = JPM GBI-EM Global Diversified Composite Unhedged USD; Local Euro = JPM GBI-EM Global Diversified FX Return in EUR; Local Rates = JPM GBI-EM Global Diversified Composite LOC; Corp. HC HY = JPM Corporate Broad EMBI Diversified High Yield; Corp. HC = JPM Corporate EMBI Broad Diversified Composite; Corp. HC IG = JPM Corporate Broad EMBI Diversified High Grade.

Equity Indices (MSCI)

Argentina = MSCI Argentina Net Total Return; Brazil = MSCI Brazil Net Total Return; China = MSCI China Net Total Return; Czech Republic = MSCI Czech Republic Net Total Return; Colombia = MSCI Colombia Net Total Return; Egypt = MSCI Egypt Net Total Return; India = MSCI India Net Total Return; Indonesia = MSCI Indonesia Net Total Return; Mexico = MSCI Mexico Net Total Return; Peru = MSCI Peru Net Total Return; Philippines = MSCI Philippines Net Total Return; Poland = MSCI Poland Net Total Return; Russia = MSCI Russia Net Total Return; South Africa = MSCI South Africa Net Total Return; South Korea = MSCI Korea Net Total Return; Taiwan = MSCI Taiwan Net Total Return; Thailand = MSCI Thailand Net Total Return; Turkey = MSCI Turkey Net Total Return; Emerging Markets = MSCI Emerging Net Total Return.

Yield & Duration Indices

German Govt Bonds = JP Morgan GBI Germany Index; US Govt Bonds = JPMorgan GBI US Index; Euro IG Bonds = Bloomberg Barclays Pan European Aggregate Corporate; US IG Bonds = Bloomberg Barclays US Aggregate Credit; Euro HY bonds = Bloomberg Barclays Pan-European High Yield ISMA; US HY Bonds = Bloomberg Barclays US Corporate High Yield; EMBI Div = JPMorgan EMBI Global Diversified Blended; CEMBI BD = JPMorgan CEMBI Div Broad Composite Blended; CEMBI BD HY = JPMorgan CEMBI Broad Div High Yield; Euro Corp Short Term = Bloomberg Barclays Euro Corporate 1-3Yr; US Corp Short Term = Bloomberg Barclays US Corporate 1-3Yr; EMBI Short Term = JPMorgan EMBIG Diversified 1-3Yr.

Definitions

- **Basis points**: one basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Carry**: the carry of an asset is the return obtained from holding it.
- **Correlation**: the degree of association between two variables; in finance, it is the degree to which assets or asset class prices have moved in relation to each other. Correlation is expressed by a correlation coefficient that ranges from -1 (perfectly negative correlated) through 0 (absolutely independent) to 1 (perfectly positive correlated).
- **Credit spread**: differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **Diversification**: Diversification is a strategy that mixes a variety of investments within a portfolio, in an attempt at limiting exposure to any single asset or risk.
- **Duration**: a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.
- **External vulnerability index**: this index is built by aggregating five different indicators that can monitor a country's dependence on overseas economies and capital flows.
- **FX**: FX markets refer to the foreign exchange markets where participants are able to buy and sell currencies.
- **Green bonds:** A green bond is a type of fixed-income instrument that is specifically earmarked to raise money for climate and environmental projects.
- **Investment grade**: Refers to securities issued by an issuer of negotiable debt securities (Treasury bonds…) or bonds for which the Standard & Poor's rating is greater than or equal to BBB-. 'Investment grade' bonds are considered by the various rating agencies as having a low risk of non-repayment.
- **High yield**: High yield paying bond with a low credit rating due to the high risk of default of the issuer.
- **P/E ratio**: The price-to-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings (EPS).
- **Spread**: the difference between two prices or interest rates.
- **Volatility** is a statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

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