Emerging markets in a fragmented world

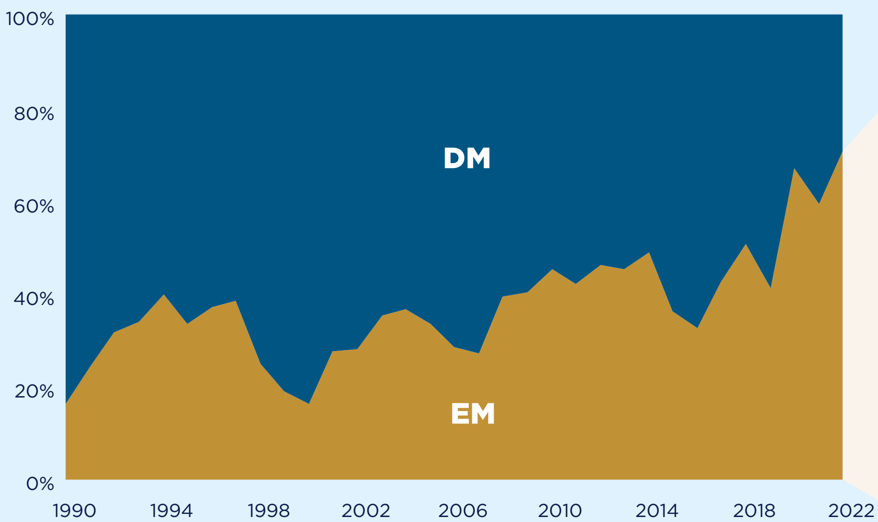
"While EM may struggle in a challenging global environment, there are nonetheless advancing structural factors that can benefit some peripheral countries."

In an environment of weak global demand, **Emerging Markets (EM) are likely to soon enter a cyclical downturn phase.** Despite China's pronounced deceleration and a tighter policy mix across the board, **EM as a whole has displayed remarkable resilience,** with GDP growth for 2023 being repeatedly revised upward. This growth has been driven by large countries such as India, Mexico and Brazil. While a broader softening of growth is expected, it is unlikely to spiral into a general recessionary scenario and a mild recovery is anticipated by mid-2024. Next year, EM growth is expected to decelerate to 3.6% on average from around 4% this year. Importantly, the **growth premium in favour of Emerging Markets over Developed Markets is projected to continue widening.** Asia is set to register the strongest contribution to world GDP once again.

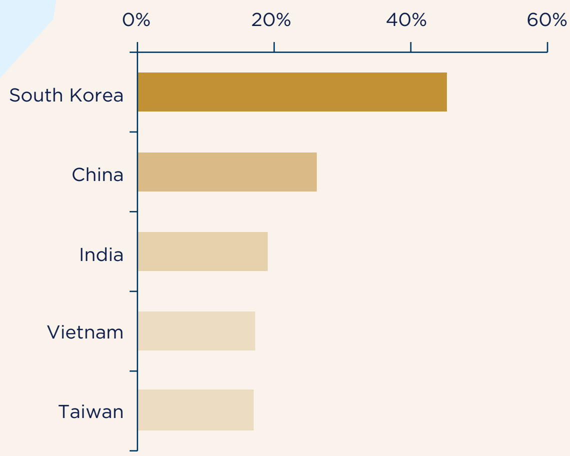
Beyond the cyclical downturn, there are structural factors at play that support EM. These factors include an incrementally higher global fragmentation, involving a **great reallocation, near/friend-shoring, supply chain de-risking** as well as the need for **critical materials** for the Net Zero Transition. Critical raw materials exporters sit mostly among EM (e.g. Chile, China).

Although fragmentation is costly, the subdued growth backdrop is expected to limit pressure on Inflation. EM inflation mostly reduced in 2023, with few exceptions where the disinflationary trend is expected to accelerate over the next few months. **In 2024, inflation is projected to land in the upper part of Central Banks' target ranges** or mildly exceed them. However, upside risks to inflation remain, such as supply-side disruptions. Additionally, the current economic downturn, coupled with a tight labour market and worker shortages, is causing core inflation to remain stickier. Hence, complacency on inflation dynamics should be avoided and a prudent policy mix should be continued. Risks of fiscal profligacy or inefficiency need to be monitored, particularly in relation to the electoral cycle. Recent pressure from global financial tightening has prompted unexpected rate hiking. Yet, a reversal of the trend is not expected, and EM Central Banks are likely to continue cutting policy rates in a gradual manner given the present circumstances.

WORLD FDI (EM Share vs DM Share)



Growth in FDI: 2020-2022 vs 2015-2019 average



Source: Amundi Investment Institute on Unctad FDI World data. Annual data as of end-2021. Right chart shows growth in Foreign Direct Investments for selected EM countries.

China: a new growth trajectory

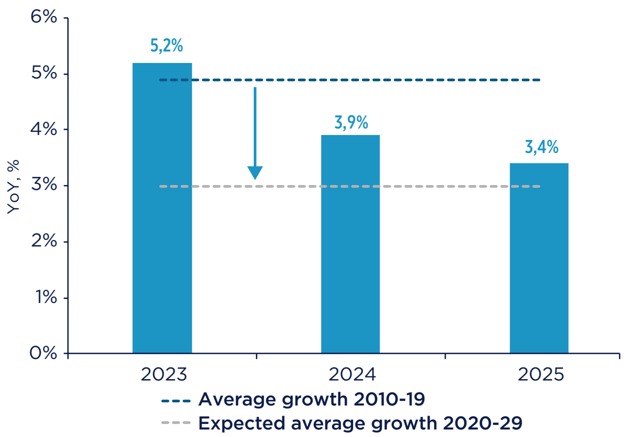
Slower growth with debt discipline

China's economy is projected to end 2023 with a growth rate just over 5%. Throughout the year, market expectations for policy stimulus have been realigned in accordance with Beijing's long-term vision, which shifts away from a singular focus on growth and incorporates national security as well as income equality. This shift comes as China grapples with secular challenges including demographic ageing, diminishing capital returns, and geopolitical fragmentation.

In 2024-25, we believe that deleveraging will be a central growth determinant. Chinese assets have weathered the storm of real estate consolidation since 2021, with remaining developers grappling to stay afloat. The next step involves Local Government Financing Vehicles that are heavily reliant on financing through land sales. This effort to control contingent public debt will restrain local government easing. We anticipate **fiscal policy to stay moderately expansionary,** setting the headline deficit at 3.4% and approving a RMB4tn special local government bond quota in 2024. **Mini monetary easing will persist, with a 20bp rate cut likely in H2 2024.**

This easing, however, is not enough to offset the drag from real estate and the new local debt discipline. **We expect China's economy to grow just below 4% in 2024.**

China GDP forecast



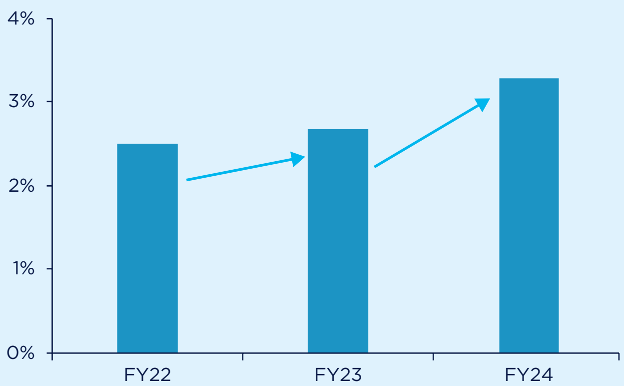
Source: Amundi Investment Institute. Data is as of 25 October 2023. Forecasts are by Amundi Investment Institute as of 24 October 2023.

India: an emerging power

Investments driving the economy

While mildly decelerating, with GDP expected to grow at 6.5% in calendar year (CY) 2023 and at 6.0% in CY2024, **India's economic prospects remain bright** and will remain supported by mainly domestic demand over external demand. Signs of deceleration will be more visible on the consumption side than for investments. The government's efforts to keep prices under control, particularly in an electoral year, will weigh on the rural sector of the economy via more compressed income. In 2024, external demand shouldn't contribute significantly to GDP growth and that, together with our constructive outlook on oil prices, will prevent a material improvement for India's current account. While maintaining an erratic path, **inflation should stay within the Reserve Bank of India's upper range and therefore the RBI won't have meaningful room for its easing cycle,** which is not expected to start earlier than H2 2024 and be aimed at neutral or only mildly positive real rates. **In addition, the policy mix is expected to remain supportive on the fiscal side.** The fiscal consolidation path is expected to advance at a very gradual pace – with the fiscal deficit at 4.5% of GDP by fiscal year (FY) 26 from 5.8% in FY24 – and the expenditure tilt should remain biased to capital expenditure in the context of an unchanged political landscape.

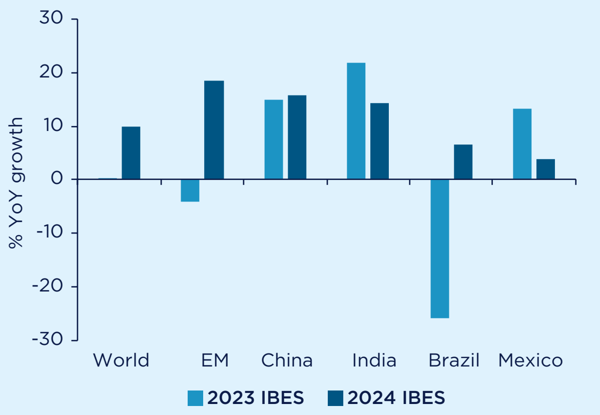
Capital expenditure as % of GDP



Source: Amundi Investment Institute, Ministry of Finance, Bloomberg Economics. Data is as of October 2023.

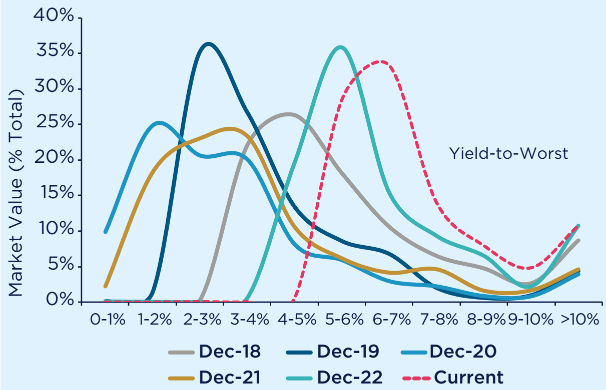
Emerging Market (EM) assets favoured due to tamer inflation and earnings recovery

Earnings Per Share growth to benefit EM



Source: Amundi Investment Institute, Datastream. IBES forecasts are subject to be reviewed due to earnings reporting season update. Data is as of 13 November 2023.

EM USD-denominated debt by yield range



Source: Amundi Investment Institute, Bloomberg. Data is as of 31 October 2023 and refers to yield to worst for the Bloomberg Emerging Markets Hard Currency Aggregate Index that includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers.

Room for optimism for EM equity in 2024

In 2023, EM equity experienced diverse dynamics with China underperforming, while MSCI EM ex China was flat and India equities outperformed. **For 2024, we expect to see the appetite for this asset class return as both the capital expenditure cycle and growth premium should be more in favour of EM, but divergences will persist.** In the short term, EM growth is expected to remain below the historical average and to decelerate mildly; this phase is still supportive for Quality and Growth styles (mainly EMEA and India). Moving further into 2024, a recovery in EM Growth would favour a shift to valuation styles (LatAm favoured). The tech sector slowdown was exacerbated by a slower global economy and less demand after Covid, and contributed to a series of negative reporting seasons during 2023 and to negative YoY trailing earnings. Yet, with the stabilisation and recovery of the export cycle, we expect GEM earnings to deliver double-digit growth in 2024.

EM bonds hard currency to be favoured

Geopolitical tensions and rising Treasury yields have recently raised concerns about the stability of EM currencies and the sustainability of external debt. On the latter, risks are lower than in the past thanks to pre-emptive hikes and the increased credibility of monetary authorities, while EM currencies are broadly undervalued in our view.

EM bond hard currency (HC) now offers a more attractive yield profile than in the last five years. The EM bond HC spread should be favoured mainly thanks to the high yield space tightening in the context of the improving EM-DM growth gap and less stretched financial conditions amid decreasing inflation, lower policy rates and yields. We are slightly positive on EM bonds in local currency, which we think are currently pricing in too much risk aversion. We favour EMEA and LatAm, which should benefit from a more rapid reduction in inflation and an advanced monetary policy cycle. We remain cautious on EM Asia, where there is less support from monetary policy and the yields are less attractive, with the exception of Indonesia and India.

ESG VIEWS

The EM sustainable fixed income universe has increased significantly in recent years. However, the size remains much smaller than DM and it's crucial for advancing the ESG agenda globally.

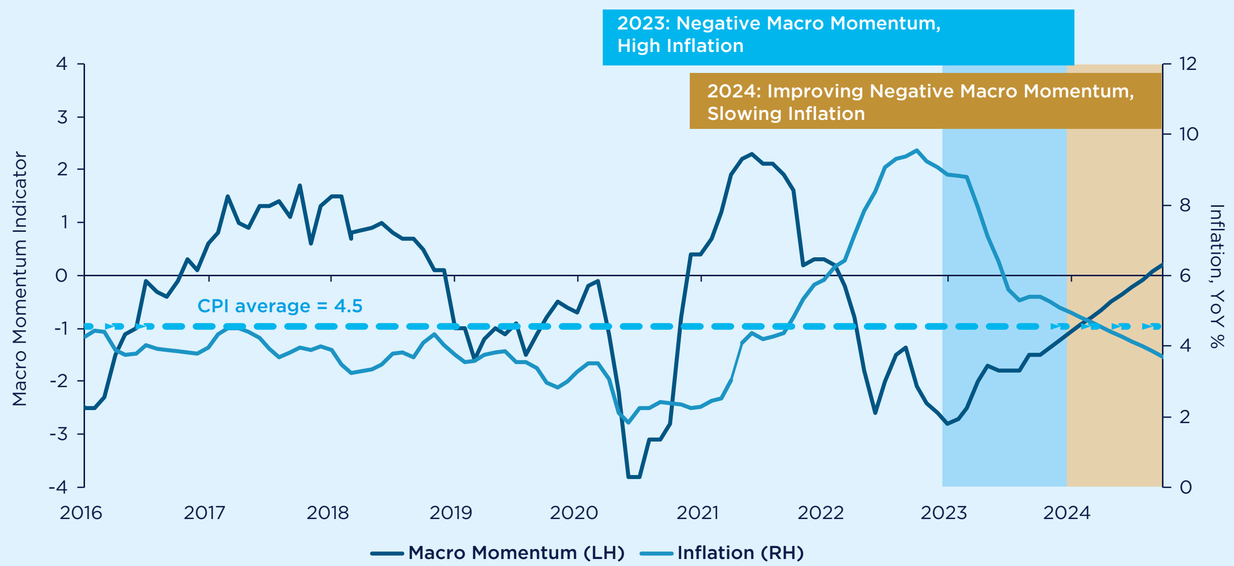
Fiscal policy will be key to financing the energy transition, but many EM countries face **difficulties in financing the green economic transformation** (debt and higher interest rates).

China leads the manufacturing and trade of **clean energy technology,** becoming the leader of energy transition supply chains worldwide for the vast majority of technologies.

Emerging market convictions 2024

We expect emerging markets to enter a positive backdrop in 2024, as inflation is trending lower allowing for a continuation of the easing cycle by EM Central Banks initiated in 2023. At the same time macro-economic momentum, while remaining low, is improving. In the past, this combination has been supportive for EM assets, particularly equities. Yet, the EM world remains a highly fragmented universe and not all countries are set to benefit to the same degree from this turning point.

Emerging markets cycle at a turning point



Source: Amundi Investment Institute on Bloomberg data. Data as of October 2023. The Macro Momentum is based on a broad based set of indicators aiming at assessing short-term momentum building in the economy. To follow the pillars considered: GDP expectations revisions, Domestic and External Demand Momentum, Fiscal Impulse Revision, Inflation Short Term expectations and Central Banks stance expectations for Brazil, Chile, China, Colombia, Czech Republic, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Philippines, Peru, Poland, Russia, South Africa, Taiwan, Thailand, Turkey.

EM CONVICTIONS

	$ DEBT	LC DEBT	EM equities	EM FX
Overall stance	+ Positive on HC debt with preference for HY over IG given current spread levels.	= + Positive on LC debt with focus on areas of attractive real yields.	+ Positive on EM equities, with focus on valuations and structural themes (internal demand, supply chain relocation).	= + We are slightly constructive on EM FX, with preference for high-carry currencies.
Regional preference	▪ LatAm (Brazil, Mexico, Argentina); ▪ Indonesia; ▪ South Africa.	▪ LatAm: supported by quality of carry, Brazil, Mexico; ▪ Indonesia; ▪ South Africa; ▪ Romania; ▪ India.	▪ LatAm, especially Brazil; ▪ India; ▪ Indonesia; ▪ Vietnam (largest in the MSCI Frontier Index).	▪ Brazilian real; ▪ Mexican peso; ▪ Peruvian Sol; ▪ Indonesian Rupee; ▪ Indian Rupee.

USD to weaken, EM currencies to recover

2024 USD: walking on eggshells

Intense geopolitical tensions, restrictive financial conditions and high macroeconomic uncertainty make it hard to identify imminent catalysts for a substantial USD sell-off. Aside from US "exceptionalism", further shocks in energy prices pose the major risk, given the pass-through to inflation and the implications for the Fed (higher for longer). In our view, **these are the main reasons for concern that make us believe that a mild US recession** (our base case for H1 2024) **may not be as positive for the USD as in the past.** Barring a hard-landing scenario, worsening US data should hurt the USD via two main channels: i) reversal of US exceptionalism (even more likely if China stabilises) and ii) the Fed shifts focus to growth and enters a cutting cycle. Entering 2024, should the USD continue to trade at a higher premium relative to fundamentals (that have dropped compared to last year), it will be vulnerable to pullbacks when moving from policy tightening to policy easing.

When it comes to the JPY, prospects for policy normalisation are good news. Yet unless the BoJ takes significant steps, a more pronounced growth shock may be required for sustained appreciation vs peers. **We maintain the JPY as the best hedge for hard-landing risk.**

EM currencies set to recover in 2024

Following several months of correction, EM currencies vs USD seem oversold and are now extremely cheap. In addition, our USD internal expectation for depreciation reinforces our constructive view for the asset class in 2024.

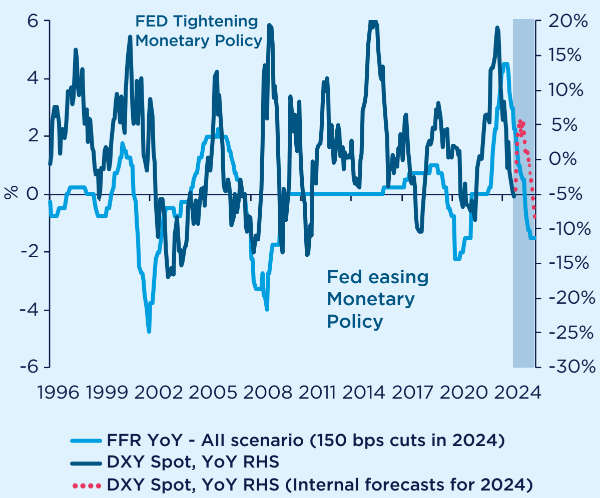
We expect EM Central Banks to continue cutting rates to support the domestic economy, also in line with the sizable price stabilisation. This will result in slightly higher real rates, with CEE countries still enjoying most of this. The region will benefit from its strong undervaluation as well as from its ties to the EUR, which is expected to strengthen during the year.

On the other hand, LatAm currencies have already enjoyed some recovery in 2023 and valuations are now more stretched.

Overall this translates into positive expectations mainly for EMEA and EM Asia currencies.

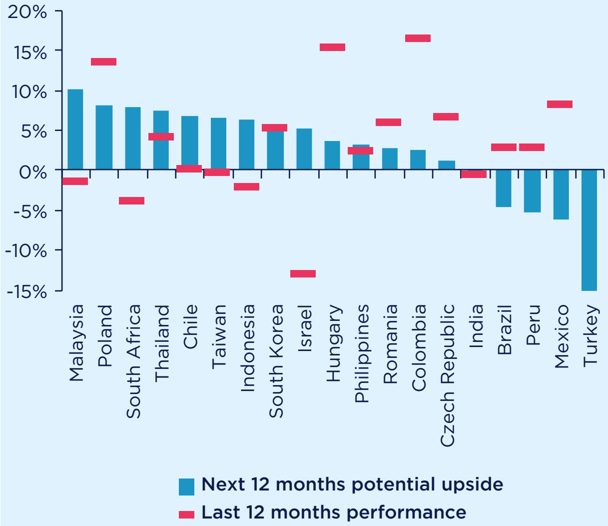
The main risks to this constructive outlook stem from geopolitical tensions resulting on one side in volatility spikes (detrimental for such a liquid asset class) and, on the other hand, in higher commodity prices (impairing the ability of EM Central Banks to ease as expected because of a stickier or higher inflation).

2024 will see a shift in monetary policy and we see it as headwind for the USD



Source: Bloomberg, Amundi Investment Institute. Data as of 30 October 2023. DXY: US Dollar Index. FFR: Fed fund rates. *Policy easing (Policy tightening) if FFR YoY negative (positive).*

Recovery still expected mainly in EMEA and EM Asia



Source: Amundi Investment Institute, Bloomberg. Data is as of 30 October 2023. Potential upside is based on fair value, including our 12-month scenario: Oil at 87.6, 10Y US Treasury at 3.7, USD at 1.16, and all the CPI forecasts by country. Turkey's figures (not fully included above) are -33.61% (last 12 months) and -50.34% (next 12 months potential upside).

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IMPORTANT INFORMATION

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