THIS MONTH'S TOPIC

The emerging markets hurdles

While not envisaging any systemic risk propagating across emerging markets, the macro financial outlook remains challenging amid growth concerns, still-high inflation and tighter global financial conditions. The current geopolitical environment, with its impact on macro and financial conditions, is making an idiosyncratic crisis more likely.

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Current geopolitical and macro environment increase the probability of idyiosincratic crisis with low probability to become systemic

The policy mix has been incrementally less supportive in particular on the Monetary Policy side

While not envisaging any systemic risk propagating across emerging markets, the macro financial outlook remains challenging amid growth concerns driven by softening domestic demand and decelerating global demand, uncomfortably high inflation triggering yet more monetary policy tightening, and shifting global financial conditions from extremely accommodative to tighter ones.

Although, by nature, it should not result into systemic destabilisation, **the current geopolitical environment,** which is not expected to improve anytime soon, **with its repercussions on macro and financial conditions, is increasing the probability of idiosyncratic crisis across the EM** as well as raising the necessity of intervention by international institutions such as the IMF. In the case of Turkey, its high energy bill and ongoing important stimulus to the economy are deteriorating its external accounts further and increasing the risk of a balance-of-payments crisis once relief from summer tourism receipts has gone. Low-income countries' debt-servicing capacities have diminished sharply, magnified by high energy and food import prices and by the need to keep expensive subsidies in place. Amidst ad hoc measures (such as Pakistan's super tax hike) and more structural reforms under discussion, more countries are trying to negotiate new, or re-establish existing, IMF programs, while the Common Framework is advancing only slowly in offering comprehensive debt restructuring.

As far as growth is concerned, on the domestic demand side, several governments are trying to limit the erosion of household purchasing power from the spiking cost of living, by extending measures introduced during the pandemic or enacting new ones, such as price caps, higher subsidies, lower excise taxes and several other non-monetary measures. Generally, this is softening domestic demand at only a slow pace. Having said that, for commodity importers the impact is even more negative and not negligible on the fiscal accounts, in absence of any mitigation from higher revenues, dividends and royalties as it happens for commodity exports. Since the beginning of the year, budget balance targets for 2022 have been on a deteriorating path for many Ems, with the exception of Gulf countries, several Latam America countries, South Africa and few countries in Asia, such as Malaysia and Indonesia, where we do expect more stable economic conditions rather than a proper improvement. The complexity and heterogeneity of the universe appears even more striking when we look at countries that should actually benefit from the current environment but do not. In Nigeria, the obsolete production system as well as the amount of oil disappearing from the official accounts is making it hard to benefit from relatively high oil prices while, on the contrary, its fiscal position is suffering from the high costs of fuel subsidies.

The withdrawal of policy stimulus put into place after the pandemic outbreak on the fiscal side as well as the normalisation of monetary policy that began in early 2021 (even earlier in China, in the second half of 2020) **is going to weigh incrementally on economic activity and domestic demand.** Significantly high inflation has allowed real policy rates to stay supportive for long even in the middle of the current monetary policy tightening cycle. Only few EM countries are closer to positive real rates (China, Brazil, and Mexico, to name some). **The inflation uptrend has been stronger than expected and mostly driven by volatile global factors, such as energy and food; moreover, the absence of demand pressure, due to longer mobility restrictions together with effective subsidies policy, has differentiated the inflation picture in Asia in comparison with Latam and CEEMEA.** Looking at the next six months, on the back of a more benign trend in oil and commodities prices (in comparison with the peaks seen in the first half of the year), as well as a wider supply bottlenecks adjustment (already visible in declining freight costs on some routes), inflation dynamics should stabilise and then moderate. In our expectations, **the first and boldest hikers will get there earlier than other EMs. Brazil has already reached this turning point between April and May.**

Contrary to what normally happens, emerging markets embarked on the transition of monetary policy away from their extraordinary dovish conditions much earlier than developed markets. **The wave of monetary policy normalisation has continued unabated until today and is still not done. In particular, regarding the external drivers of EM monetary policy, while the Federal Reserve had turned more hawkish relatively late, since then, the hawkish bias has increased in tone and actions that have been undertaken.** With that to consider, EMs have more than domestic drivers to look at and increasingly tight global financial conditions have made EM monetary policy authorities more prudent. Some CBs have abandoned a premature narrative of neutral or easier MP stance while others have finally started to hike, absent any Inflation pressure so far.

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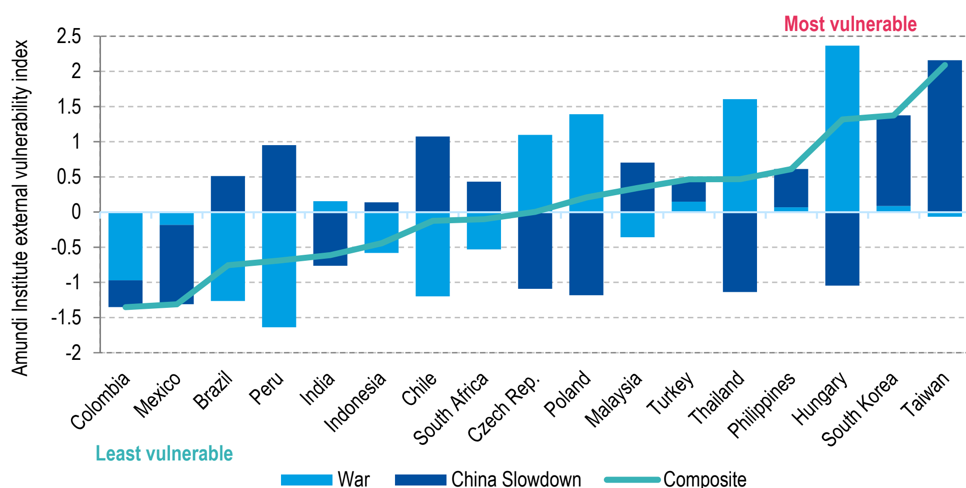
However, considering our EM inflation outlook, as well as the house outlook vis-à-vis Fed hiking (with a terminal rate of around 3.75% by early 2023), US yields and the USD, the EM monetary policy turning point, starting form few countries, has been only slightly pushed forward from the end of 2022 to early 2023.

Chinese economy expected to get traction after the transitory recession

Coming back to the growth dynamics from an external angle, it's worth highlighting that, in the aftermath of the conflict in Ukraine, global growth expectations have been revised down sharply and, almost simultaneously, we have seen a resurgence of local lockdowns in China. All of a sudden, global demand has become an orphan of its most important contributors – European growth will flirt with zero/negative rates; US GDP has been significantly revised down; and China is expected to perform less robustly than the official growth target set in late 2021 (around 3.5% YoY vs 5.5% YoY). Across the EM, some partial relief will come from the commodity boom for the commodity exporters, alleviating/offsetting the demand deceleration. Indeed, recent trade balance figures are highlighting clear positive dynamics between commodity exporters while negative for the commodity importers; only across Asia the different Trade Balance trends between Indonesia and Philippines highlight that. Unfortunately, more protectionist measures aiming at directing raw material production to the domestic market instead of exporting it are partly limiting the benefit of commodity high prices.

As far as China is concerned, the enforced lockdown is likely to have sent China into a transitory recession in Q2. However, since April, new Covid cases have fallen and activities have been recovering steadily, and a realistic assumption would be for reopening continuing to get traction moving forward. Our H2 China growth outlook is far more constructive on these assumptions. Together with the reopening, China has been pursuing economic policies on its own: it is on an easier monetary policy path and supportive fiscal policy path that has sped up since May. The improvement in the outlook in China is an important pillar for the EM growth story to hold up relatively well moving forward.

1/ **War and China slowdown heighten fragmentation across EM**



Source: Amundi Institute on ComTrade, IMF, CEIC, Bloomberg. Data is as 15 June 2022.

The gloomy macro backdrop appears priced by the markets

In recent months, it looks as if the **emerging asset classes have already discounted most of the aforementioned negative environment.** Yields have been spiking in both hard and local currencies debt, while the EM currencies have depreciated significantly vs USD, with the only exception being the Russian rouble and a few Latam currencies. Meanwhile, equity markets have underperformed more acutely in the EMEA region, penalised by the conflict proximity and increasing uncertainties on growth and inflation expectations.

Over the next few months, we expect markets to remain on high alert, with a focus on growth slowdown and inflation dynamics (stagflation risk) and a possible shift in geopolitical risks.

Positive catalysts for the Chinese Equity markets

Having said that, it's fair to add some **possible positive catalysts.** High frequency indicators are confirming the story that China has bottomed out and that the worst is behind us. In 2021, Chinese equity markets suffered a prolonged sell-off, starting with the implementation of a new regulatory framework whose impact has affected mainly the tech and property sectors, amplified by policy tightening and the lack of clarity on the delisting issue. Although these elements are taking time to fade away and are contributing to a very volatile environment, they should already be priced into Chinese equity market valuations. **The deceleration in the regulatory effort as well as more supportive policy signals, together with the ongoing lifting of restrictions should help the recovery in the H shares market,** which has been neglected by investors in recent months. At the same time, domestic A shares should benefit from the current domestic policies, aimed to boost domestic demand and domestic production, showing attractive entry points at this stage.

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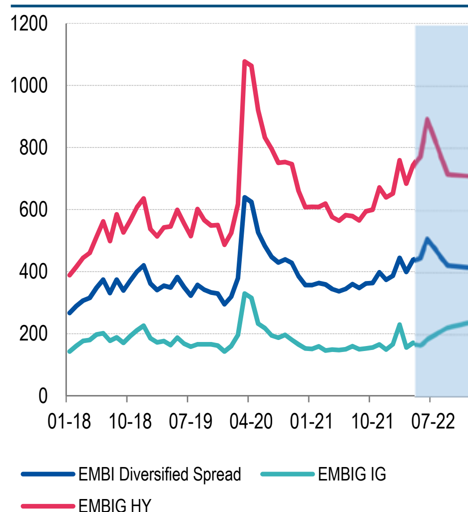
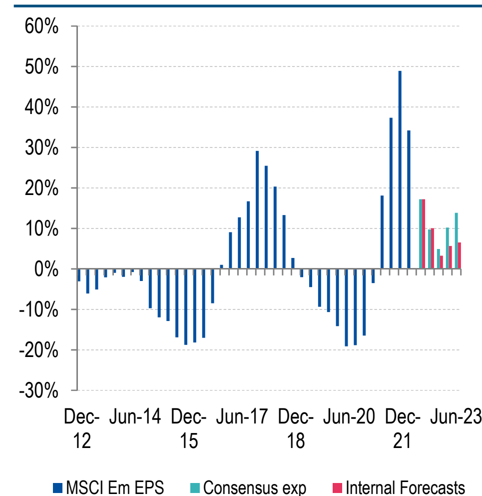
2/ **HY EMBI Diversified spread expected to tighten**



Source: Bloomberg & Factset, Amundi Institute - Data as of June 2022

3/ **MSCI EM - EPS forecast - USD**



Source: Bloomberg & Factset, Amundi Institute - Data as of June 2022

Moving into the second half of the year and early 2023, the macro drivers resulting in a wider growth premium in favour of EMs should set a floor on certain emerging asset classes that have so far underperformed significantly. Commodity exporters in the emerging space are benefitting from the substitution effect (vs Russian oil and gas) and from improving terms of trade. Inflation is stabilising/peaking, with some decline expected over the next few months, albeit remaining at higher levels than pre-pandemic. With a strong USD, we recommend high selectivity and tactical positioning on the EM FX markets (commodity exporters, a brighter growth outlook and a sound MP environment). **In the fixed-income space, we continue to prefer the hard currency segment, high yield over IG, and taking advantage of a strong US dollar and a still sustained oil price.** For the time being, we see less support for local debt even though stable (or not spiking) US 10y yields, together with stabilising, if not turning, local monetary policies could soon offer some attractive entry points. The first hikers, like some Latin America countries, are seeing, or will see soon, inflation peaking and the end of the monetary policy tightening cycle. Eastern European countries offering attractive carry will be late on the same path. An increase in geopolitical uncertainty and the consequent increase of stagflationary risk represent the main risk for emerging markets debt.

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