RBC Global Asset Management

Emerging markets: Finding direction for the year ahead

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"The question now, for rate-sensitive risk assets, is that with good news now priced in, what's next?"

The last two months of 2023 were nothing short of miraculous. The Bloomberg Global Aggregate Index rallied an impressive 9.4%[1], turning a negative year-to-date number comfortably positive – and delivering the best two-month return for the index since numbers began.

At the heart of this was falling inflation and a dovish pivot from the Fed, which saw the 10-year yield drop by more than 100bps – and a sharp flattening of the yield curve (although it is still negative as this is published). The question now, for rate-sensitive risk assets, is that with good news now priced in, what's next?

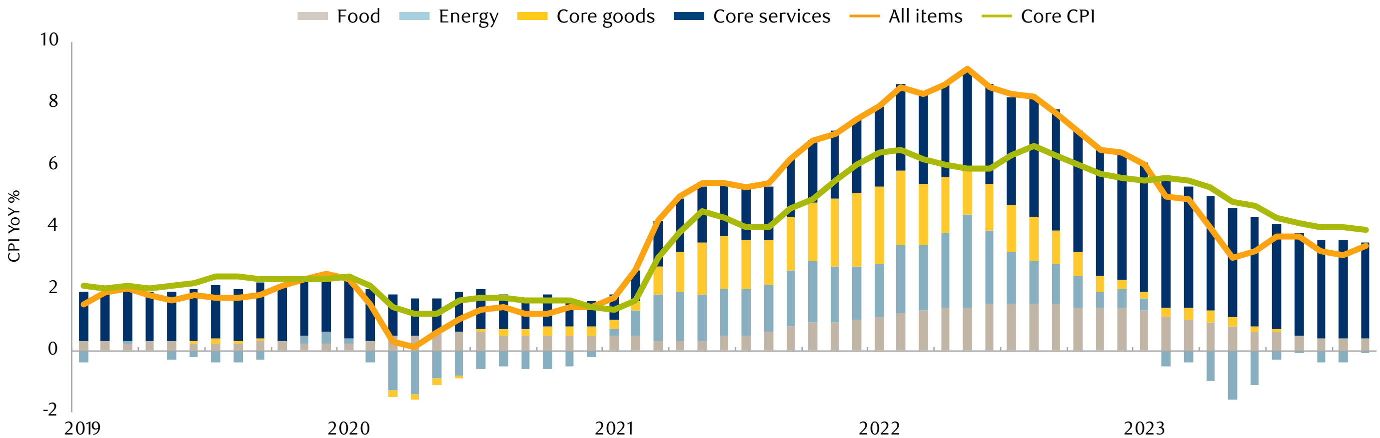
Two months into 2024, the narrative and key questions for the year are starting to take shape. Top of this list are secular themes – including deglobalisation and reshoring, higher interest rates and lower growth. Amidst this, there is push and pull between fiscal and monetary policy against the backdrop of an unprecedented election calendar. Consensus views are in short supply, and improving economic data is battling the spectre of lag effects. Historical precedents that would suggest the worst is yet to come, and a fair amount of improvement already priced in.

From an investor perspective, these macro issues boil down to:

- Inflation and the path for rates
- Unplugging the money printer
- Trade and currencies, and the role of China.

[1] Bloomberg, 29 December 2023.

Chart 1: US inflation



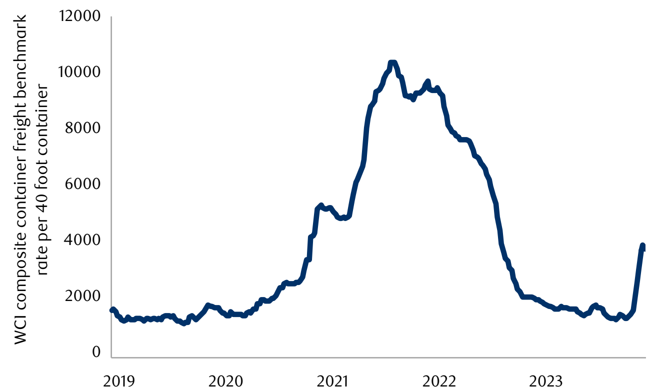
Source: Bloomberg, 31 January 2024.

Inflation and the path for rates

Both core and headline inflation are falling. Core goods, food and energy have largely driven this, with wages and core services leading. Recently, energy has been more range-bound. With the shutdown of the Red Sea container, shipping costs have started to spike. In short, the secondary effects are still being felt through wage pressure and shelter costs. Going forward, it is clear that areas of disinflation have run their course – and with a stronger than expected consumer, it's unclear if central banks have the clarity needed to make all the cuts that the market expects.

The bottom line is that rates will fall, but likely not as fast, or as far, as people expect.

Chart 2: Drewry World Container Index



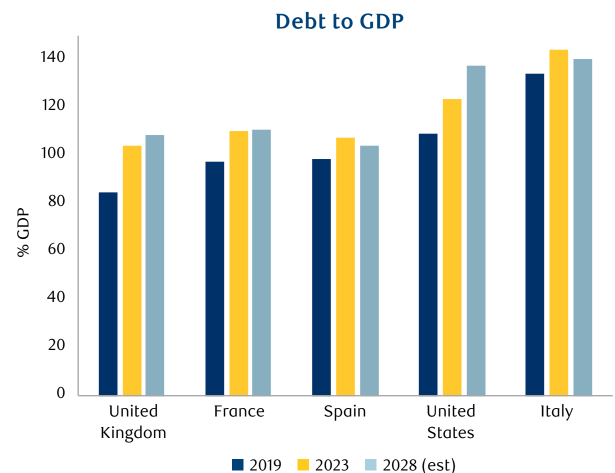
Source: Bloomberg, 31 January 2024.

Unplugging the money printer

Quantitative easing has been a mainstay of central bank policy response since the financial crisis. While central bank balance sheets have grown, the cumulative effects of greater money supply and risk asset demand have provided economic stimulus. Today, the direction of travel has reversed – with balances expected to decline and inventory of assets starting to roll over. In the UK and other countries, there are plans to aggressively sell down assets. This has come as growing deficits in developed markets have worsened by the impact of higher rates and ballooning debt levels on the back of fiscal support. The result is limited capacity for fiscal easing, which was largely the secret ingredient to the US growth story over 2023.

The bottom line is everything to play for in an election year, but risk assets will remain challenged as growth slows and stimulus is removed.

Chart 3: Fiscal constraints



Source: Bloomberg, 31 December 2023.

Geopolitics and the slowdown in China

China's inability to escape the setbacks of its property crisis and Covid lockdowns continues to weigh on global growth. It has struggled to stimulate its economy and encourage consumption, and is pinned between its desire to see higher growth whilst not undermining its currency. The expectation is that it will continue accepting some weakness, but not do much more from here.

The situation in China is exacerbated by friction with the US and the potential for a Trump presidency in 2025. Restrictions and tariffs will not ease from here, and the trend of onshoring (or friend-shoring) is likely to endure. Add to this commodity pressure because of the conflict in the Middle East and the war in Ukraine, and you have further setbacks and pressure for global trade and growth.

Global trade will continue to be a wild card for inflation, while pressures on China affect global growth and demand.

Bucking the trend

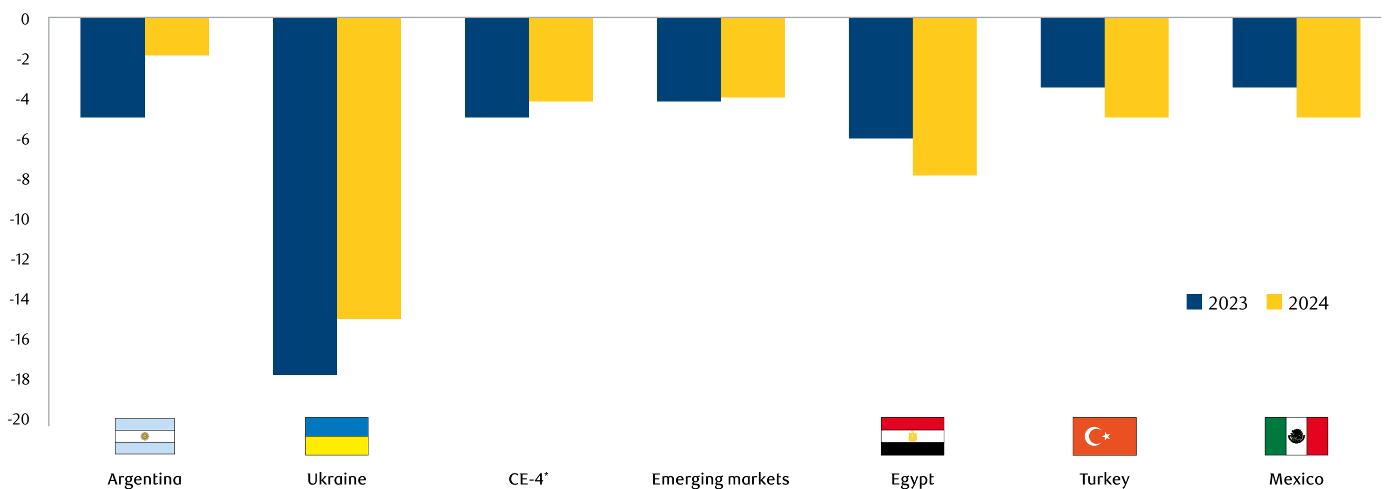
One area where we see more certainty in the outlook for an unconstrained approach is emerging market debt (EMD). The beta of the overall asset class is looking favourable, but within individual emerging markets (EMs), some of these global macro issues are creating significant dispersion.

EMs have benefited from orthodox monetary and fiscal policy over the last few years, with improving country balance sheets and falling inflation. Cuts in EM rates have been expected for some time now. With a clearer economic outlook in the US and expectations of cuts by the Fed this year, they may now have enough confidence to begin. For investors, part of this is reading the direction of monetary policy – and also looking for indications of the extent of the slowdown in growth globally. With a more managed weakening, there is room for a very expensive-looking dollar to fall in value, providing a boost for EM currencies. A challenge to this would be a more aggressive global slowdown that may encourage flight-to-safety into USD – known as the "dollar smile".

> **"China's inability to escape the setbacks, of its property crisis and Covid lockdowns, continues to weigh on global growth."**

Equally, prudent fiscal management has allowed many the opportunity to re-examine the stimulus. EM is no stranger to elections. While Taiwan's, Egypt's and Indonesia's have already passed, we still have India and South Africa still to come, to name a few. This year, more than 45% of the global population will go to the polls (Deutsche Bank Estimates[2]), led by large populations in EM countries. Unlike their DM counterparts, however, debt levels are much lower on average, and spending has been sustainable in the context of higher overall nominal growth.

Chart 4: Overall EM budget deficit will narrow in 2024 but with plenty of divergence



Sources: RBC Global Asset Management, JP Morgan, 31 December 2023 and IMF, WEO, 31 October 2023.
*CE4 countries are Czech, Hungary, Poland and Slovakia.

[2] Deutsche Bank, Haver Analytics, UN World Population Prospects, European Commission, January 2024.

The final piece of the pie is geopolitics and the impact of a Chinese slowdown. From a debt perspective, China is a smaller overall part of the universe. However, its impact as a trading partner has been large. While global growth and demand wane, it is clear that we are in the midst of a trading partner reshuffle within EM. Capital flows may be flat, or negative in aggregate, but they are on the move. Already, Vietnam, India, and Mexico appear to be early winners. However, this is an early point in this transition for manufacturing, and positive trends in changing commodity demand are also likely to benefit individual countries. Additionally, the impact from a corporate issuer perspective will also be present, as these effects translate into opportunities for shorts, longs, and illiquid investments.

Overall, EM is not a homogenous asset class. While it is set to benefit from secular trends, we are likely to see large dispersion across countries, currencies and corporates, allowing for a raft of conviction views to be exploited.

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EM Credit Alpha Strategy: leveraging the full portfolio toolkit in EM Debt

The Emerging Market Credit Alpha strategy invests across the full spectrum of EM fixed income; sovereign and corporate, issued in both hard and local currency. The strategy focuses on capitalising on dispersion and price dislocation across EMD with a bias towards the under-researched USD4 trillion credit market. The strategy looks to implement long and short positions across sectors and regions, allowing the potential for positive performance throughout the market cycle. Since inception, this strategy has delivered notable returns uncorrelated to the underlying assets in the universe, as well as to other asset classes. For more information about the fund that matches this strategy, please visit our website here.

Bottom-up fundamental analysis drives the investment process to identify the best ideas across a broad range of countries, sectors and credits. At any time the strategy has around 60 long and short positions in a combination of strategies, including relative value, event driven and restructuring/distressed opportunities.

The strategy is managed by Polina Kurdyavko and Anthony Kettle, who have worked together for over 16 years. It benefits from the expertise of the the wider EM team of 30 investment professionals with an average investment experience of 19 years, and over USD10.7 billion of EM debt assets under management (as at 31 December 2023).

Portfolio Manager Perspectives
Our experts offer their perspectives on the latest developments in global credit and the state of the markets.

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