RBC Global Asset Management

Opportunities in emerging markets as economies navigate a new set of challenges

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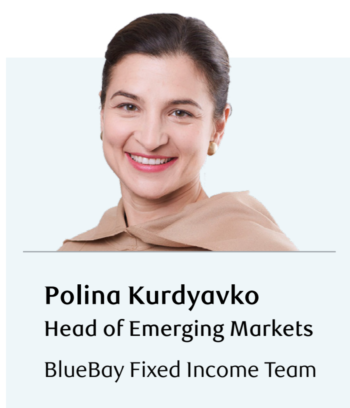

Polina Kurdyavko
Head of Emerging Markets
BlueBay Fixed Income Team

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While developed markets contend with central bank responses to high inflation, emerging economies face different challenges as they navigate rising costs and tighter budgets, yet opportunities remain in the asset class.

The past three years have thrown a curveball at emerging markets with Covid, the war in Ukraine, inflation, and social unrest from rising food and energy prices. Now, fiscal discipline comes under scrutiny as emerging economies operate with leaner budgets.

"For emerging markets, it is about whether they can manage to navigate a relatively low growth global environment, while maintaining fiscal discipline," says Polina Kurdyavko, Head of BlueBay Emerging Markets, at RBC BlueBay Asset Management.

"On one hand, as a politician, you want to offer people on the street what they want by way of change; but on the other hand, you also understand that you are constrained by what you can offer with debt, liquidity, high rates and tight fiscal constraints," she says.

Emerging market governments must remain flexible enough to prioritise affordable access to food and energy, while pursuing development needs and debt management.

"Last year, we saw a number of left-leaning leaders elected as part of the presidential elections in Latin America. It is a protest vote to some degree where people want change on the streets," says Kurdyavko.

Tighter conditions put spotlight on fiscal discipline

The global landscape has put pressure on emerging countries' fiscal budgets. In low-income countries, higher spending partly reflects the government's responses to spiking food and energy costs.

"We are looking to see if they can stick to their budgets. This year, most fiscal projections in Latin America for example, with the notable exception of Brazil, are expected to be similar, or tighter, than last year," Kurdyavko explains.

“Based on IMF predictions, Columbia is expected to reduce its fiscal deficit from -6.4% to -2.9%. That is the biggest fiscal reduction we have seen. If Columbia can deliver on this and combined with double-digit yields on the local debt and the widest levels in the last 20 years on the sovereign hard currency debt, we think that is a great opportunity,” she says.

However, Kurdyavko adds that Columbia’s performance could go in either direction if the government must spend more to keep the population happy – or if added pressure from volatile global inflation drives up borrowing costs as investors demand a higher premium for government debt.

“Brazil is a special case in Latin America because you have projected fiscal widening going from -5.8% to -7.5% this year, so that is quite wide. The jury is still out on whether the market will support that,” she says.

Corporate outlook

Apart from Chinese real estate, emerging market corporates have been very resilient over the last few years with an overall default rate of 1% in the corporate sector.

Kurdyavko expects some volatility as corporates navigate profitability and cash flow generation this year. She says in a low growth environment with tight liquidity, we could see surprises on margins if companies cannot pass their costs on to the consumer.

“On the other hand, if companies are too profitable, then the risk is that the government might look to take some of the profits from companies to support their fiscal efforts,” she says.

Support to continue

Overall, the tailwinds that underpinned the emerging markets rally at the start of the year should continue to be supportive, says Kurdyavko. First, central banks in emerging economies started their interest rate hiking cycle on average about 18 months ahead of central banks in developed economies.

“This gave confidence to domestic investors, it helped support currencies, and it helped to rein in and manage inflation,” explains Kurdyavko.

Second, balance of payments dynamics have been supported by commodity prices. “Regions like the Middle East benefitted the most, but even countries in Latin America are seeing a positive trend in current accounts. That removed a big vulnerability from emerging markets in general,” she says.

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800.553.2143 | **rbcgam.com**