INSIGHT

Emerging Markets: Differentiated Opportunities Amidst Volatility

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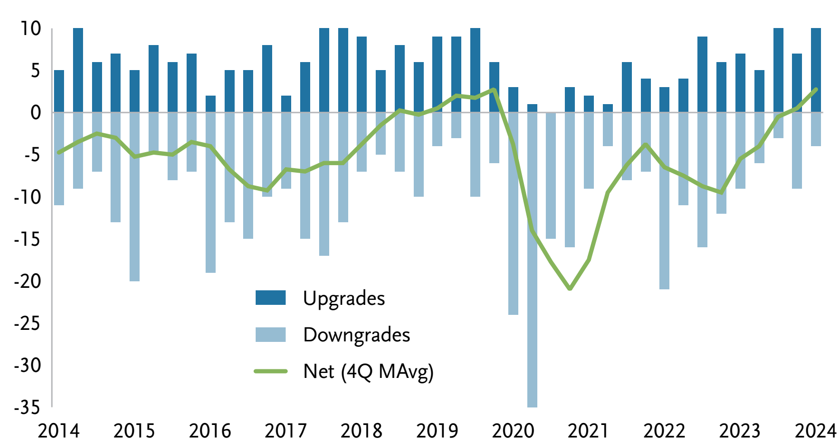
Ms. Goodly is the Portfolio Specialist for the TCW Emerging Markets Group, serving as the primary liaison between TCW's Emerging Markets investment team and TCW's client relations and marketing professionals. As part of her role, she also leads the EM Portfolio Specialist team, whose core activities include communicating investment strategies, performance and outlook, in addition to supporting product marketing and development. Ms. Goodly is also a member of TCW's ESG Group and Diversity, Equity, and Inclusion (DEI) Taskforce. Prior to joining TCW in 2013, Ms. Goodly spent eleven years at Morgan Stanley, most recently as an EM Fixed Income institutional salesperson. Ms. Goodly is the co- chair of Diversity and Inclusion for Women in Institutional Investments Network (WIIIN) and was shortlisted for "Ally of the Year" for the Women in Asset Management Awards. She is also a Founding Member of the Los Angeles chapter of Chief, a leadership network for executive women, and a member of the Los Angeles Leadership Committee for 50/50 Women on Boards. Ms. Goodly graduated with a BA in Economics from Stanford University.

April was characterized by a significant sell-off in U.S. Treasuries on the back of stronger U.S. data (ISM manufacturing, nonfarm payrolls) and concerns about sticky inflation. In addition, an escalation in geopolitical risk in the Middle East led to an increase in both oil prices and volatility, before subsiding somewhat by the end of the month. Emerging Markets (EM) sovereign dollar-denominated debt returned -2.08%, with high yield (-1.38%) outperforming investment grade (-2.78%). EM local currency debt returned -2.14% on the back of dollar strength.

Looking ahead, the economic and inflation outlook in Emerging Markets remains benign as global growth continues to exhibit some pockets of unexpected resilience, China's unbalanced recovery gains steam, and EM inflation gradually decelerates. Some large EM countries, such as India and Brazil, are still growing at a robust pace, while others are beginning to turn after brief economic slowdowns or shallow recessions. In our view, 2024 will be a transitional period towards a more supportive medium-term environment for EM due to looser monetary policies in major economies, a potentially weaker US dollar, and the return of large EM economies to potential growth and inflation targets.

Further, EM fundamentals are reasonably sound, with no sovereign defaults forecast for 2024. Debt/GDP for Developed Economies exceeds 100%, versus 67% for Emerging Markets. In addition, EM ratings upgrades are forecast to outpace downgrades for the first time in a decade; countries such as Argentina, Benin, Brazil, Ivory Coast, Jamaica, Qatar, Turkey and Uruguay are among those recently upgraded.

Potential for EM Upgrades to Outpace Downgrades in 2024

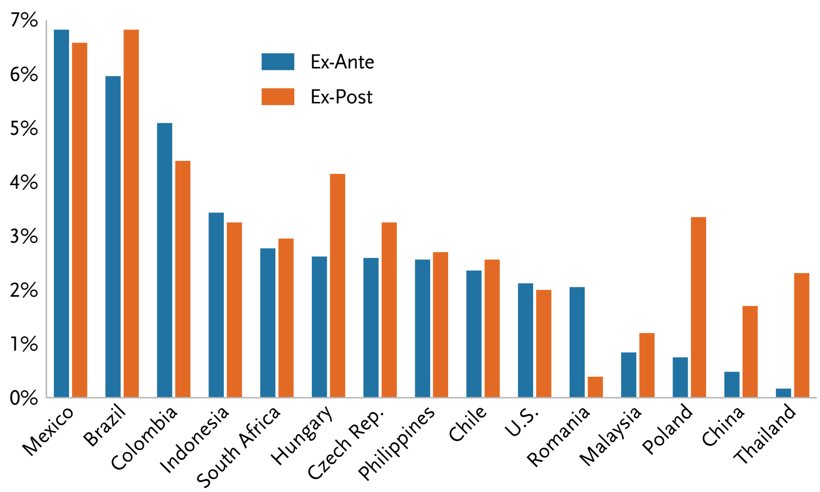


Source: Deutsche Bank; Quarterly data as of March 31, 2024

In the near term, the market is likely to be driven by expectations for U.S. monetary policy and global growth expectations. We anticipate that volatility will decline once there is greater clarity on the start of the Fed's easing cycle, driving inflows into Emerging Markets and other risk assets. For the year, we anticipate that returns for EM hard currency will be driven largely by carry (for context, yields on the EMBI Global Diversified are around 8.5%), with some support from lower U.S. rates. Given the extent to which spreads have rallied, we anticipate spread compression to be a minimal driver of returns from here, outside of idiosyncratic situations in high yield, where spreads average close to 700bps (versus 321bps for U.S. high yield).

As for local currency, EM real rates continue to remain attractive versus Developed Markets. For example, ex-ante real rates in Brazil and Mexico are approximately 6-7%, around 5% in Colombia, and 3-3.5% in Indonesia and South Africa, well above the 2.1% U.S. real rate. The recent sell-off in local currency duration was not only driven by higher U.S. yields but also higher U.S. rates volatility. As the volatility shock subsides, we believe that EM Central Banks with strong disinflationary trends will be able to cut rates even if the Fed is on hold for longer.

Real Interest Rates in EM Attractive Versus the U.S.



Ex-ante real interest rate: [12m implied policy rate] - [12m inflation expectations]
Ex-post real interest rate: [current policy rate] - [current inflation]
Source: Bloomberg, TCW Research; Data as of May 6, 2024

The US dollar has been in a directionless range since the beginning of 2023, and in our view, should begin to weaken once the markets are confident that the Fed is on a path to easing. Another important factor for dollar performance going forward will be growth in the rest of the world. While very early in the cycle, global PMIs are starting to turn and demand for commodities is increasing. The European outlook appears to be improving after high rates and lower Chinese demand weighed on growth in 2023. In addition, while China's recovery has been tentative and uneven, data this year has been surprising to the upside, as a range of more targeted measures, including lower interest rates, removal of housing restrictions, and local government debt swaps, are starting to have an impact.

U.S. Dollar is Overvalued Relative to History

Real Effective Exchange Rate Index (REER)
Source: Bloomberg; Data as of May 3, 2024

We are monitoring the following risks:

- **Geopolitical risks** remain a source of concern. Although our base case for the Israel-Hamas war has assumed that fighting would remain relatively contained within the region, recent escalatory events between Israel and Iran/Iranian proxies have raised chances of a conflagration and will likely extend the conflict for at least several more months. Industry experts believe global oil prices currently factor in a geopolitical risk premium of $5-10/barrel, but a broader war contagion that affects oil supply (infrastructure and/or shipping) could trigger a spike well above $150/barrel.
- **Election Risk:** The U.S. election could be a source of volatility as we head into the second half of the year, given divergence in the candidates' trade and foreign policy. For example, if Donald Trump were to be elected president, he could move to impose his discussed 60% tariffs on China and also hit longtime allies (e.g. EU, Canada) with large new tariffs. In addition, Trump could walk back support for NATO, resulting in less support for Ukraine.
- **Hard Landing:** U.S. data has been suggestive of a soft, rather than hard, landing. However, the risk remains that higher-for-longer-rates send the U.S. economy into a downward spiral, driving spread widening, particularly in high yield. ■

Index Definition

JP Morgan EMBI Global Diversified is a market capitalization-weighted total return index of U.S. dollar-denominated Brady bonds, loans, and Eurobond instruments traded in emerging markets.

Glossary

BPS: Basis points; ISM Manufacturing: Institute for Supply Management index, formerly known as the purchasing managers index (PMI), measures the condition of the U.S. economy based on a monthly poll of purchasing managers in over 400 manufacturing companies; Nonfarm Payrolls: The number of paid U.S. workers in all businesses, excluding those who work for farms, serve in the military, volunteer for nonprofit organizations, and perform unpaid work in their own household; GDP: Gross Domestic Product; PMI: Purchasing Managers Index is a measure of the prevailing direction of economic trends in manufacturing; NATO: North Atlantic Treaty Organization is a group of 32 countries from Europe and North America that exists to protect the people and territory of its members