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INSIGHT

Emerging Markets: Second Half Outlook

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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.

First half performance for Emerging Markets Fixed Income has been characterized by the following:

- Outperformance of EM dollar-denominated sovereigns (2.34%) versus EM local currency (-3.71%), as the latter has been impacted by dollar strength (+4.5%).
- Outperformance of EM HY sovereigns, up 5.22%, with single Bs up 4.86% and distressed (C-rated) up 21.53%, compared to a return of -0.45% for EM IG sovereigns. This outperformance of high yield is largely a reflection of macro stability, fiscal consolidation, financial support from the IMF or FDI and/or progress on restructurings. More recently however, investment grade assets have started to outperform high yield as U.S. rates have rallied.
- Regional outperformance of Africa (+6.28%) and Latin America (+2.41%), with countries including Ecuador (+45.70%), Argentina (+30.94%), Zambia (+23.12%), Egypt (+20.38%), Ghana (+16.72%), and Bolivia (+16.25%) all outperformed the 14.48% return of the S&P 500.
- Spread widening of 7bps for the EMBI Global Diversified index, ending the first half at 391bps. This is largely a reflection of Venezuela re-entering the index. Excluding Venezuela, spreads would be ~46bps tighter.

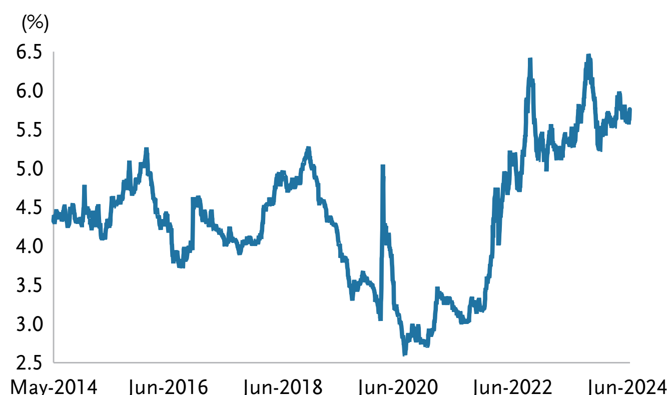
Fundamentals and Valuations Update:

- **Global Growth:** Global growth forecasts for 2024 appear largely in line with the 3.2% figure in 2023. Notably, the EM-DM economic growth differential is forecast to reach its widest level in almost a decade, as some large DM economies decelerate or struggle to recover. This is in the context of a conservative estimate for growth in China (4.75% versus the 5.0% government target). Further, Emerging Markets represent 80% of global growth.
- **Central Bank Policy:** The market is likely to continue to be driven by expectations for U.S. monetary policy. While EM central banks started hiking rates a full year before the Fed, the pace has slowed as expectations for Fed rate cuts have been pushed out. As such, real rates are high particularly in Latin America and Central and Eastern Europe (CEE), averaging 3.8% and 2.2%[1] above their pre-COVID levels, respectively. In Latin America, the Fed's stance implies a shallower rate cutting path, particularly over the next twelve months. Cutting cycles are already underway in the CEE. We believe there will be continued cuts in Hungary and Czech in the second half of this year to neutral in mid-2025. In Poland, we see only modest cuts over the horizon, following the ECB relatively closely.

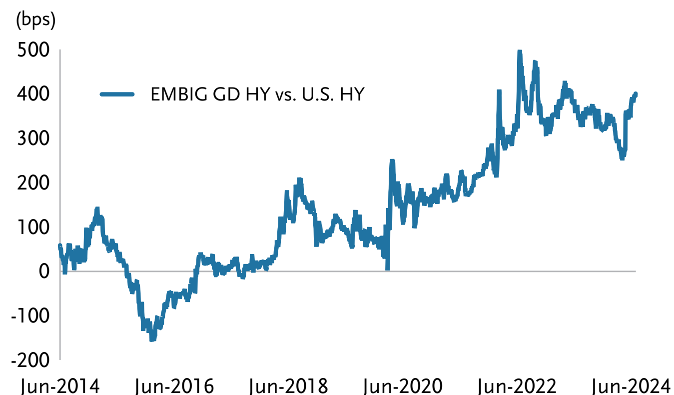
1 Calculation based on GBI-EM GD composition as of 6/28/2024

- **Inflation:** EM central banks started hiking rates a full year before the Fed. As a consequence, EM inflation has fallen faster than inflation in the developed world and consistently surprised to the downside. The inflation outlook does vary across regions. Emerging Asia continues to see a disinflationary drag from China. The CEE is forecast to have inflation close to target by the middle of 2025. Turkey and Egypt, the high inflation economies in the region, are both likely to see substantial normalization over the course of 2025. In Latin America (ex-Argentina), disinflation continues but at a slower pace with easing toward targets over the next 12-18 months.
- **Fiscal Dynamics:** While Debt/GDP and deficit levels continue to rise in Developed Markets, many EM countries have established a track record of more prudent macro policies, including more conservative fiscal management, a gradual reduction of subsidies, and a growing commitment to monetary orthodoxy via inflation targeting. Many countries have programs with the IMF which impose fiscal constraints, some have obtained substantial financial support from regional peers, and others have instituted more orthodox policies post elections to tackle macroeconomic imbalances. In light of these macro improvements and financial resilience in many EM countries in recent years, we do not anticipate any sovereign defaults in 2024, and likely not in 2025 as well. Ratings upgrades are also likely to exceed downgrades for the first time in a decade in both 2024 and 2025.
- **Valuations:** While credit spreads are at the tighter end of historical ranges, yields remain attractive in EM. For example, over the past decade, EM IG yields are in the 94th percentile and the spread differential between EM HY sovereigns (730bps) and U.S. HY (337bps) is in the 96th percentile.

Investment Grade Yields Are in the 94th Percentile Versus History



Spread Differential between EM HY Sovereigns and U.S. HY in the 96th Percentile



Source: JP Morgan; Data as of July 1, 2024

We are monitoring the following risks:

- **Election Volatility:** Election-related uncertainty is likely to increase market volatility into and following the November 5 election. Key risks include both a contested U.S. election result and highly divergent potential outcomes for U.S. fiscal, trade and foreign policies, with implications for the US dollar and U.S. Treasury yields. Under a Trump presidency, economic policy could eventually lead to higher inflation and slower growth if policy proposals with regard to increased tariffs and extreme curbs on immigration are carried out in full. Geopolitical risks could increase as well stemming from less financial support for Ukraine, an uncertain U.S. commitment to NATO, and Trump campaign pledges to deport millions of illegal immigrants. The second round French National Assembly elections (July 7) may weaken France's position at the heart of Europe. If the right-wing National Rally party wins a majority, it could spark tensions between France and the EU/Germany with possible knock-on effects for EU support of Ukraine, EU sanctions against Russia, and the EU's green transition. Mexico's transition to a new Congress (September) and new President (October) may see the ruling Morena party attempt controversial constitutional reforms to the judiciary that could have a structurally negative impact on business and investor confidence.

- **Israel/Hamas:** Our base case is that the Israeli/Hamas conflict remains relatively contained within the region. That said, the rules of engagement clearly changed after Iran and Israel exchanged direct attacks in April. Air strikes from both sides were calibrated to provide a path towards de-escalation, but we believe there is still an elevated risk of miscalculations from all parties involved. We also continue to monitor Netanyahu's political standing as he attempts to avoid an early election.

We are positioning as follows:

- Broadly speaking, the declining macro stability in the developed world and increasing geopolitical tensions globally have transformed the EM story from one of simple convergence with the developed world to one of strategic opportunity in a multi-polar world. We are emphasizing the following themes: improving fiscal dynamics, demographic tailwinds, commodity demand and increased regionalization of trade.
- We anticipate that returns for hard currency will be driven largely by carry, with some support from lower U.S. rates given indications that the U.S. economy is slowing. We anticipate spread compression to be a minimal driver of returns for the balance of the year given the extent to which spreads have rallied YTD. As such, in our hard currency portfolios, we have reduced overweights to select frontier sovereigns where further appreciation will need to rely on external factors (a beta rally), while continuing to emphasize those with idiosyncratic drivers.
- We would anticipate that the dollar weakens once the markets are confident that the Fed is on a path to easing. We believe another important factor for dollar performance going forward will be growth in the rest of the world. However, escalating political risks in Europe and the upcoming U.S. election could limit dollar weakness over the balance of the year. As a result, in our total return portfolios, we are emphasizing hard currency over local currency, while maintaining a basket of EMFX call options to capture a turn in the dollar. In our local currency portfolios, we are emphasizing relative value trades and countries with idiosyncratic drivers (Egypt, Turkey, Nigeria) over exposures more dependent on U.S. rates policy or a general reduction in volatility. ■

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