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Emerging Markets: The Impact of the U.S. Election and Slowdown

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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.

Despite an initial bout of volatility at the beginning of August, Emerging Markets (EM) sovereign and corporate dollar-denominated debt returned +2.32% and +1.69%, respectively, for the month. Further, EM fixed income outperformed U.S. credit markets during the month:

- EM investment grade (IG) sovereigns and corporates were up 2.4% and 1.7%, respectively, versus 1.6% for U.S. investment grade.
- EM high yield (HY) sovereigns were up 2.2%, with spread tightening of 12bps, versus a 1.6% return and 2bps of spread widening for U.S. high yield.
- Spreads on the EMBI GD tightened by 12bps and ended the month at 388bps, whereas U.S. IG and HY were a few bps wider.

In addition, EM local currency fixed income returned +3.07%, supported by dollar weakness (-2.30%).

In the near-term, two key areas of focus remain the impact of the U.S. election and the slowdown in U.S. growth on Emerging Markets. As for the election, we would note the following:

- There will likely be winners and losers given that the EM sovereign index is comprised of more than 70 countries, ranging from AA to CCC.
- EM fixed income assets performed well in the first year of Trump's first term, both on an absolute and relative basis. In 2017, the EM HY corporate market was up 10.5% and EM HY sovereigns gained 11.4%, both outperforming U.S. HY corporates by 300-400 basis points. EM investment grade-rated sovereign bonds returned 9.2% that year, 300bps ahead of the 6.3% return for U.S. IG corporates, while EM IG corporates returned 6.3%, exactly in line with U.S. IG corporate returns for the year.
- The entry of Harris/Walz has made the 2024 Presidential race more competitive and lowered the odds of a red wave, which reduces the probability that the entirety of the Trump tax cuts will be extended at the end of 2025. That said, neither party is likely to be fiscally conservative, but that is likely more of a concern for the market over the medium term.
- Trump's tariff proposal, if enacted in full, will likely result in short term (all other things being equal) in a stronger US dollar coupled with weakness in Asian currencies (particularly the CNY). The magnitude and length of Asia FX weakness will be conditional on how much central banks come in to "smooth" volatility. Medium term, we anticipate dollar weakness given the likely negative impact of tariffs on growth and inflation.

- In either case, low yielders should benefit from U.S. monetary policy easing, with potential for meaningful outperformance in the case of a Harris win as local corporates and investors "de-dollarize" with the receding risk of broad-based tariffs.
- Under a Harris/Walz administration and divided government, we would anticipate similar trade and foreign policies as under Biden, which are likely neutral to favorable for EM. Trump, on the other hand, is more skeptical of U.S. aid to Ukraine than the current Biden administration and may push for negotiations that result in Ukraine making concessions to Russia. Further, the USMCA is due for a review in 2026, which could have implications for Mexico's economy in particular.

As for the impact of a U.S. recession on EM:

- The impact of a U.S. recession on risk assets, including EM, would depend on its depth and duration and the reaction function of the Fed. Since early August, the consensus odds of a U.S. recession have increased from a low of 15-20% to a third or more, as we see labor market weakness and increasing concerns around consumer demand.
- The starting point for EM appears sound, given a supportive fundamental backdrop. EM growth is forecast to exceed DM growth this year and next year by around 240bps, close to the widest spread over the last decade. EM financial resilience has increased significantly since the taper tantrum of 2013, with many of the major Emerging Market countries establishing a track record of more prudent macro policies. Current account balances, a major source of EM vulnerability in earlier periods of stress, have turned from negative to positive. Inflation in EM has fallen faster than in Developed Markets and has already reached down to pre-COVID levels. EM rating upgrades are expected to exceed downgrades in 2024 for the first time in a decade, reflecting this much better governance and financial resilience.

That said, EM will likely be impacted by volatility in Developed Markets in the short term. In our total return portfolios, we have reduced our overweight to high yield, focusing on those supported by idiosyncratic factors and reducing beta driven names. We have also increased our exposure to corporates, which tend to outperform sovereigns in a risk off environment given their higher quality and shorter duration.

In our total return portfolios, we continue to focus largely on dollar denominated assets with limited local currency exposure expressed solely through options. In our local currency portfolios, we are focused on idiosyncratic opportunities (Egypt, Turkey) and relative value exposure, reducing our exposure to overall market beta. We see opportunity to add local currency over the near to intermediate term, as the U.S. rate cutting cycle should create room for EM central bankers to re-focus on domestic fundamentals and restart rate cutting cycles which were put on hold waiting for the Fed to start. Further, we see the potential for exporters to unwind their USD exposure and repatriate assets into local currency, once there is more certainty about the outcome of the U.S. election.

We continue to see value in Emerging Markets fixed income...

- EM sovereign yields are currently in the 78th percentile relative to the last ten years and the 340bps spread differential between EM HY sovereigns (707) and US HY (368) is in the 84th percentile over the same period.
- In the case of EM corporates, net leverage stands at 1.4x on average, the lowest in over a decade. This compares to a U.S. corporate market with an average leverage of 2.7x. Spread per turn of leverage for the EM corporate universe stands at 120bps/x or 2.5 times the 50bps/x for U.S. corporates.
- EM dedicated funds have seen an aggregate outflow of $150 billion in the last three years so from a technical perspective, positioning is light. Notably, new issues have been oversubscribed multiple times which indicates, in our view, substantial demand from crossover/global buyers seeing value relative to other fixed income alternatives.

...and continue to invest in core themes:

- The declining macro stability in the developed world and increasing geopolitical tensions globally have expanded the EM story from one of simple convergence to one of strategic opportunity in a multi-polar world.
- Emerging Markets offers the opportunity to capitalize on improving macro prudential policies and deleveraging, favorable demographics and a fast-growing middle class, structural demand for commodities and the diversification of supply chains.

- EM exports have risen more than those of Developed Markets, suggesting that globalization is in fact continuing, just at a slower pace. Specifically, since the start of the pandemic, EM Asia ex-China exports have increased by 15% and both Latin America and CEE exports are up by around 7.5%. Exports from Africa and the Middle East are broadly unchanged. The reshuffling of global trade flows has in fact hurt developed markets -- the UK and the European Union.
- Over the longer term, EM should benefit from favorable demographics and a growing middle class. From 2024 to 2030, 95% of global growth in the middle class is forecast to come from EM, as is a greater share of higher-end product demand. This, together with rising trade barriers in the U.S. and other developed economies, should continue to accelerate intra-EM trade and investment. Clear beneficiaries here would be Asia, particularly India and Indonesia, the CEE, Egypt, Nigeria and Latin America.
- Commodity demand has suffered in the last twelve months from a structural slowing in Chinese growth and cyclical issues elsewhere. There are a couple of important offsets to that which should support commodity demand and prices over the medium term. First, the limited investment in new greenfield projects in major metals including copper in recent years has resulted in significant supply constraints. These, coupled with long term structural demand from the energy transition and AI, will likely be supportive for these markets going forward. Moreover, China and others have been stockpiling key commodity inputs to reduce their vulnerability to trade sanctions. This is likely to continue since industrial policy seems to be growing as an economic and political tool. Finally, concerns about supply risks for a number of critical minerals dominated by China have led to enhanced FDI flows to other EMs to develop alternative sources of supply.

Bottom Line: Short term volatility driven by trends in Developed Markets (recession risk, U.S. election) are likely to dominate sentiment in the near term. However, the scope for both growth and credit improvement in Emerging Markets, coupled with attractive valuations, provides opportunities to differentiate and capitalize on a number of core themes. ■

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