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Where to, Emerging Markets?

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This article, the first in a two-part series, provides an outlook for emerging markets with focus on Asian opportunities.

Emerging market bonds rallied spectacularly in the last two months of 2020. Capital flows finally made the shift into emerging markets, buoyed by extremely abundant global liquidity conditions, China's economic recovery, rising global trade, and prospects of global vaccinations. Against this backdrop, bond valuations have tightened for most emerging markets while currencies remain somewhat cheap on a valuation basis (see Chart 1). Will these tailwinds continue to propel emerging markets in 2021 given the chase in yields, or will these markets face new challenges as developed markets re-normalize?

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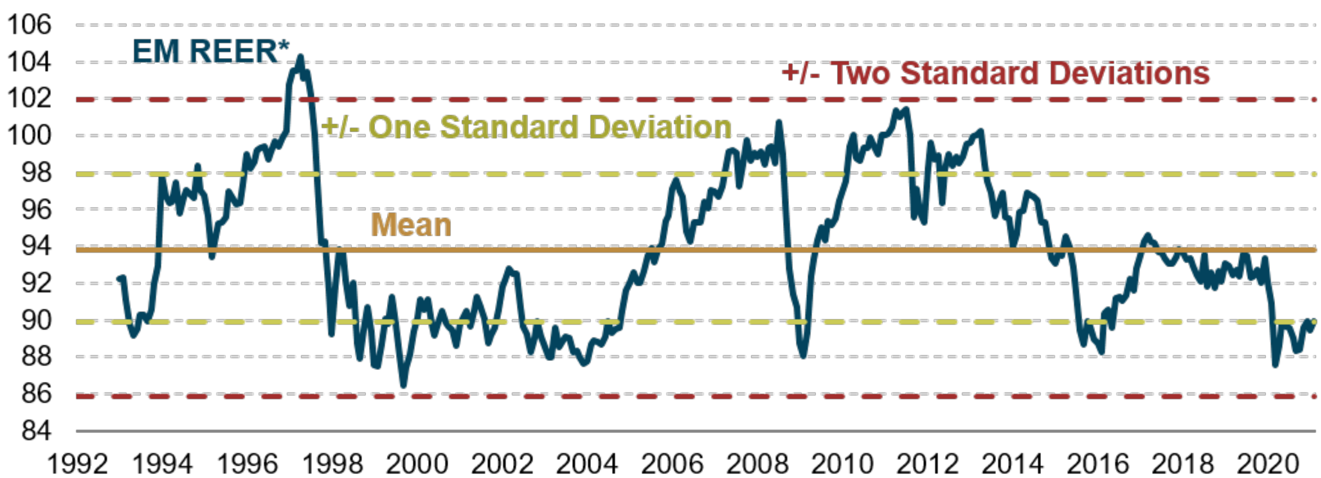
1 **Emerging Market Average Real Effective Exchange Rate***
Emerging Market REER*, As of 2/2/2021



*Equal-Weighted Average of 18 Emerging Market Countries Excluding China

Source: Macrobond

A Hint of Things to Come?

January gave investors a feel of what a withdrawal of liquidity would be like. Real rates in the U.S. seemed to be bottoming while the People's Bank of China (PBOC) toyed with the withdrawal of liquidity in the overnight repo

markets. That shook financial markets given the investor optimism reflected in positioning. Nonetheless, there are reasons to believe that emerging market tailwinds could persist.

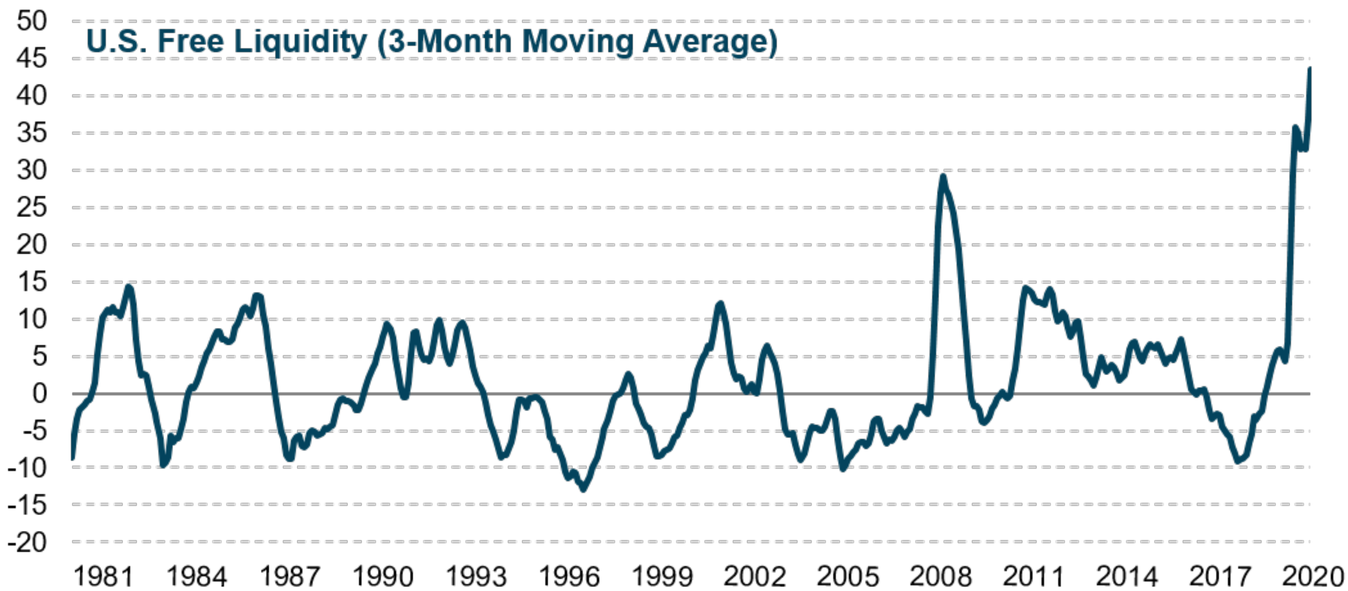
Still, Signs of Support

Despite talks of tapering, the Federal Reserve (Fed) remains committed to its new policy regime shift of average inflation targeting, and liquidity remains ample (see Chart 2). Moreover, emerging markets thrive on burgeoning global growth and global trade. In this aspect, fears of a collapse in China's credit impulse may be overstated at this point. While the Chinese credit cycle is turning with the Chinese government refocusing on stabilizing leverage in the system, the Chinese economy needs to overcome the second wave of the virus. Therefore, fiscal stimulus still could likely be somewhat supportive of the economy this year. Indeed, fiscal impulse leads China's Purchasing Manager Index (PMI), and the current trajectory implies China's PMI will likely stay above 50 this year (see Chart 3). That said, one may need to pay more attention to the credit impulse after the Chinese Communist Party's 100th anniversary meeting in July.

2

Excess Liquidity

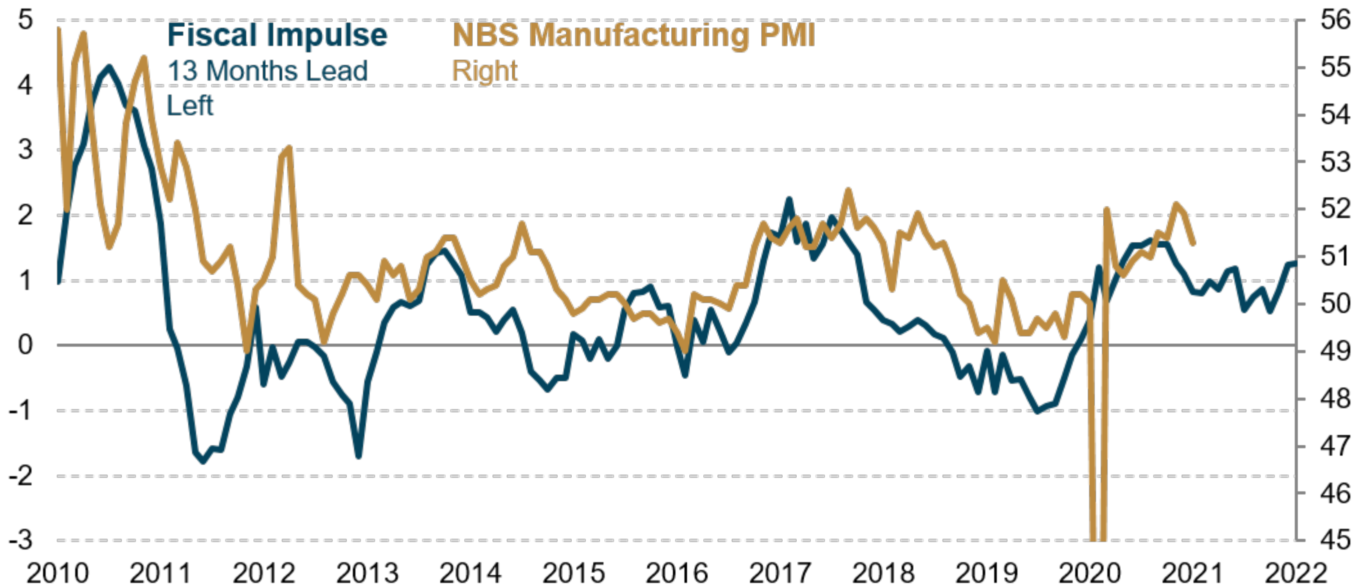
Year-over-Year Growth, As of 12/1/2020



Source: Macrobond

3 **China's Fiscal Impulse and Manufacturing Purchasing Manager Index**

Left: % GDP, Right: Index, As of 1/31/2021



Source: Macrobond

Within the Asia region, there are some potential beneficiaries of Chinese and emerging market stability this year. Among these, the Indian rupee stands out. From a bond perspective, Chinese bonds remain positive.

India

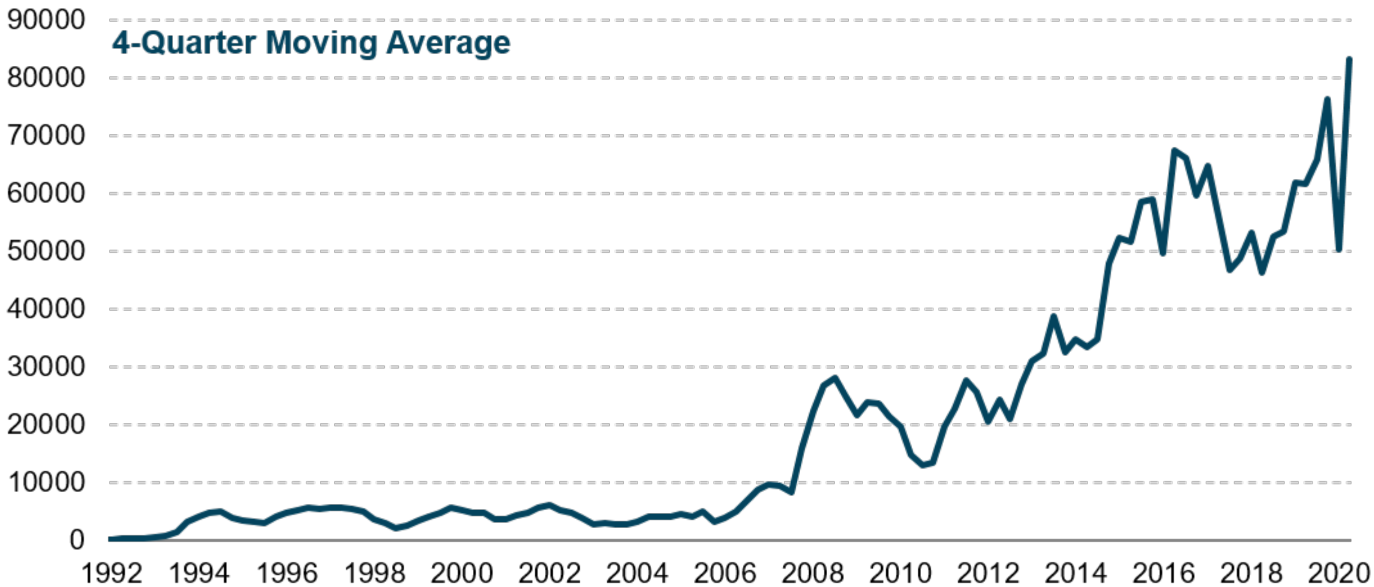
India has overcome the COVID-19 pandemic quite successfully. Recoveries continue to outpace new cases. Vaccinations have risen to 270,000/day, although it may take until mid-2022 to vaccinate two-thirds of the Indian population. Despite that, overall industrial activity has almost fully recovered. Services activity is now roughly at 95% of pre-COVID levels. Over the past two quarters, India has seen strong foreign direct investment and equity inflows. Meanwhile, the central bank has been intervening to keep the currency on the cheaper end. However, with the amount of liquidity circling in the economy, the central bank may at some point be more comfortable with intervening less.

The medium-term story for India is even more important and suggests an increasingly brighter outlook. The government has revived its "Make in India" national program, providing more incentives for foreign companies to invest in the country (see Chart 4). In the latest fiscal budget, the focus was on increasing infrastructure capital expenditures (capex) as well as establishing an asset management company to take over stressed debt from banks' balance sheets. India's investment-to-gross domestic product (GDP) ratio has been falling over the past decade. This investment push along with the clearing up of banks' balance sheets may be a booster shot for growth.

4

India Balance of Payments: Net Direct Investment

10m Rupees, Not seasonally adjusted, As of 9/30/2020



Source: Reserve Bank of India, Haver Analytics

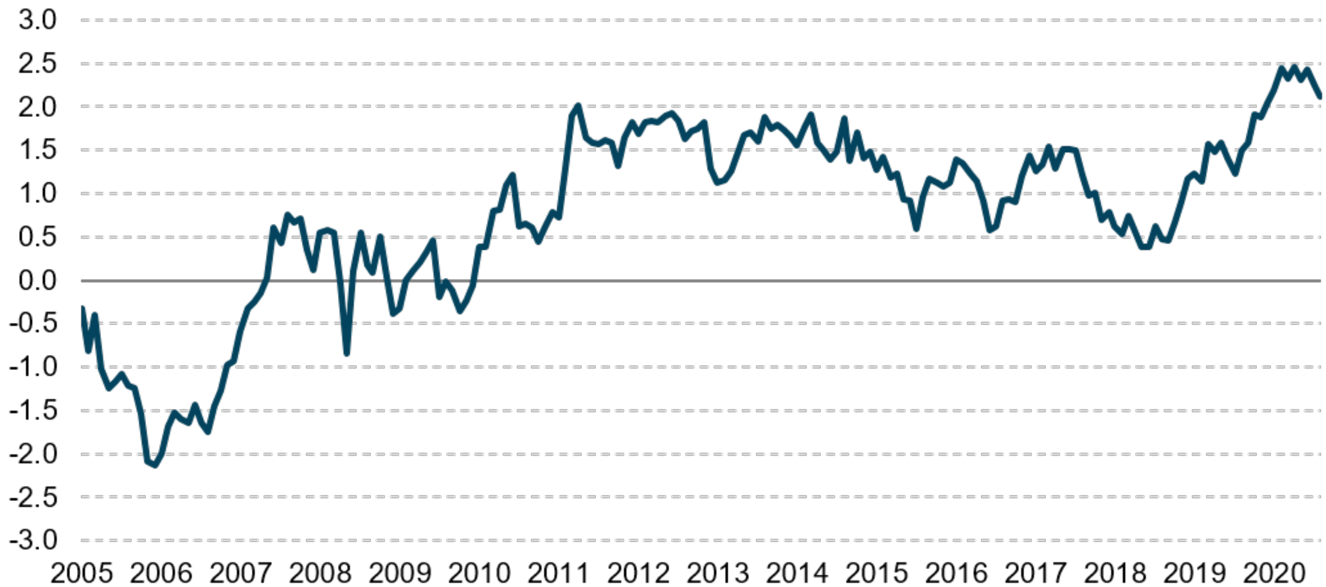
China

The wide yield spread between Chinese government bonds and U.S. Treasuries is by now a well-known story. That spread has widened further as the Chinese economy has been the first to recover from the COVID crisis. Chinese yields are now back to pre-pandemic levels. Going forward, that spread will likely narrow as the U.S. economy starts recovering at a faster pace. However, China may also keep rates at a relatively high level to encourage portfolio inflows to support the current account as the country moves toward domestic circulation. A relatively stable Chinese renminbi with a decently high carry for an investment grade-rated country is a good reason to remain positive on Chinese government bonds. In the event of slower-than-expected Chinese growth, Chinese bonds hedged could serve as a safe haven as well.

5

Chinese 10-Year Government Bonds and U.S. Treasuries Spread

%, As of 2/9/2021



Source: Bloomberg (© 2021, Bloomberg Finance LP)

Putting It All Together

Emerging markets will need to contend with the ebbs and flows of global liquidity as it may start to wane this year. However, a stronger global recovery driven by the developed markets, coupled with a relatively stable China, could remain supportive. Furthermore, the U.S. dollar will continue to be crucial to the emerging market story. As my colleague Anujeet Sareen concluded in his blog post last month, the dollar is likely to fall further in the first half of 2021 but with more volatility. Emerging markets, which still offer relatively higher yields compared to developed markets, may continue to generate decent returns for fixed income investors if these parts continue to work together this year.

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