What’s in store for emerging markets?
Q1 2021 Outlook

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Setting the scene
Emerging markets experienced a strong recovery both in activity and capital inflows in Q4 2020, supported by intense search for yield and a more optimistic global growth outlook thanks to vaccine developments. As 2021 gets underway, there are still significant tailwinds to EM assets, but the landscape has become more treacherous and less uniform.

Risks threatening positive EM momentum include:
• Global spread of new COVID-19 variants;
• Margin squeeze in some countries and sectors;
• Slowing growth and tighter financial conditions in China;
• Continued tension in U.S.-China relations;
• A snap back in U.S. rates under the weight of larger-than-expected fiscal stimulus;
• Stretched valuations.

That said, confidence in the asset class endures: EM equities have been consistently popular with investors the past few months, with another $16.4bn added to EM equity ETPs globally in February, with EPFR data showing that the week ending 24 February was the second-largest inflow week for EM equities ever, with investors favoring the asset class for its cyclical tilt and oil exposure. This takes total inflows since last November to $37bn – with international investors driving the inflows, rather than domestic buying. In the BlackRock 2020 Institutional Rebalancing Survey, 50% of client respondents said they were overweight EM and 60% are looking to increase their allocation over the next six months.

In a multi-speed world, BlackRock experts believe U.S. assets will outperform emerging markets, and anticipate increasing differentiation within the EM universe. EM Economies that have better controlled the pandemic and have credible policies to sustain stimulus are likely to outperform peers with weaker responses.

In this piece, we discuss with some of our EM experts:

Cross-cutting themes for EM
Potential limitations and growth inhibitors
A positive longer-term outlook, with turbulence expected in the short-term
Portfolio implications and positioning

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Divergent recoveries: WEO Forecast for Advanced Economies and Emerging Market and Developing Economies

Source: IMF staff estimates. Note: AEs = advanced economies; EMDEs = emerging market and developing economies; WEO = World Economic Outlook

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EM’s positive outlook at the end of 2020 needs some adjustments

Isabelle Mateos y Lago (IML): Pablo, how do you see emerging market economies and the asset class doing at this juncture?

Pablo Goldberg (PG): By the end of the last year there was a growing bullish consensus building for emerging markets into 2021, which was based on five pillars:

1. The widespread vaccination campaign was pointing to a strong cyclical recovery of emerging markets in 2021;
2. This recovery was going to build on a continuation of overly dovish monetary conditions around the world;
3. Commodity prices were expected to recover, with energy catching up with metals;
4. A weak dollar and an appreciation in emerging market currencies;
5. An overall positive fiscal outlook.

Early into 2021, we needed to make some adjustments to these pillars.

- First, the continued persistency of the COVID-19 shock, fuelled by contagious new variants, has extended mobility restrictions around the world for both developed markets and emerging markets.
- Second, the Democratic victory in the Georgia Senate led to expectations of an even stronger fiscal package in the U.S. than previously thought. It has important consequence on how we need to adjust the baseline case for emerging markets.

Risks and challenges in emerging markets

IML: Where do you see risks in EM?
PG: We are considering both pre-existing risks, and risks that have been accentuated in recent months:

Vaccine roll-out: Obstacles to the speed and effectiveness of the vaccine roll-out can be more damaging than before, given the high expectations for a successful campaign that have already been priced in.

Monetary policy: Pitfalls around the implementation or tweaking of monetary policy, particularly in the U.S. and China, could have a greater impact on the market than before.

Policy credibility: Policy credibility in stimulus-starved places is key. In Brazil, for example, there’s talk of the need for greater stimulus when the market was already too concerned about the extent of the fiscal deficit.
Evolving Outlook for EM

IML: Are these risks enough to hamper a positive outlook?

Positive EM outlook isn’t history

PG: We do not believe so. There is still an income drought around the world, so the need and search for yield and income continues. This falls against a backdrop of a strong global commitment to maintain easy monetary policy. Has that bullish case become more treacherous? Yes, particularly during this first part of the year. The longer the virus remains with us, the more stretched balance sheets become. We are likely to see a more challenged first half of the year, with improvement in the second.

IML: That sounds like a difficult landscape indeed, with many nuances. Jean-Marc, what does the EM world look like from an equities standpoint – particularly given the market’s tilt toward Asia?

Jean-Marc Routier (JMR): Interestingly, we are quite aligned across a fixed income and equity perspective. Our team is positive on EM equities because of liquidity levels: capital is like water, and it flows towards yield and growth. In this sense, EM is still extremely attractive. Additionally, the fiscal support given by EM economies during COVID-19 has been much less than what we’ve seen in the West, so the fiscal position and fundamental attractiveness of EM economies is strong and a reason to see and to expect more capital to flow in. Lastly, in equities the flows have only just started turning since fall last year. We finished last year effectively flat after having been quite negative, and we expect those flows to continue and provide positive support. Like Pablo, we’ve been forced to temper our optimism as we entered 2021. There are four key points that for us are the most influential in shifting our portfolio positioning.

1. **Vaccines:** the second wave of COVID-19 has highlighted which countries have been successful in securing vaccine supply and which haven’t. Vaccine roll-out is more of a driver during this second wave, and factoring in granular detail around different countries is key. India produces 60% of world vaccines and has secured enough supply for its population, and as has Brazil, whereas South Africa and the Philippines have not had such luck.

2. **Tightening in China:** China has already tightened the screw around property and bank lending, and we think this will have repercussions in the APAC region. With 75% of our EQ index in Asia, we anticipate a negative impact of China’s restricting conditions to come through. This has also resulted on pivoting some of our Chinese ownership.

3. **U.S.–China relationship:** while 2021 is likely to be a better year for global diplomacy, the U.S.–China relationship is not going to improve overnight. As the Biden administration increases focus on human rights issues, we anticipate continued deterioration between the two global superpowers in the near term.

4. **Tightening margins:** earnings are strong right now in EM companies as they benefit from some sense of normalisation. But commodity prices moving is resulting in squeezed margins in certain parts of the market. This has resulted in changing our exposures based on who is impacted by the margin squeeze.

Source: BlackRock Investment Institute, with data from Haver Analytics, December 2020.
**Portfolio implications**

**Fixed Income**

**IML:** Amer, how does this nuanced backdrop look from a cross-over investor portfolio standpoint?

**Amer Bisat (AB):** I’ll discuss across a three-part framework:

### Fundamentals

On a six-month view, we have conviction to be long in emerging markets. We are anticipating post-vaccine growth to surpass levels seen over the last 40 years. We expect monetary authorities to face an uphill battle in trying to normalise monetary conditions, with fiscal policy pushing aggressively in both the U.S. and Europe. We consider this positive news for EM as they benefit from the DM growth feedback loop via growth in commodities, capital inflows, and liquidity flows. However, the growth hinges on uncertainty on U.S. rate stabilisation.

### Valuations

Valuations are also becoming a constraint, particularly in investment grade where spreads are as low as they were before the COVID crisis and very close to three-year spikes. Rates, local duration in EM, and the level of yields in EM today are at historical lows. Given the favourable medium-term fundamental backdrop we’ve been discussing, we believe in owning the riskier part of EM, including dollar denominated high yield and foreign exchange.

### Technicals

We have our own proprietary way of measuring positioning, and positioning is stretched, which is cause for overcrowding concern.

**Hard currency emerging market debt spreads approaching 3-year spikes, return to pre-COVID levels**

Considering these points, we believe in being long EM over the medium term, with more cautious tactical expressions over the next few months. However macro factors and dispersion of growth within the asset class give us more conviction in higher yield and FX.
IML: Pablo and Jean-Marc, can you tell us what your teams currently like and dislike in different parts of the market currently?

PG: The world is changing at different places across countries and regions. This diminishes the expectation of a synchronised recovery; within the EM universe, we are expecting differentiated recoveries based on varying degrees of control over the virus.

In some fiscally stressed emerging markets, some doubts about policy credibility are starting to arise, and that’s generating some interesting dynamics on a price basis.

In terms of specific positioning, there are places we are seeing early warning signs on valuations. We are reacting to these by maintaining exposure to the high coupon EM assets, and other securities that help hedge the headwinds that could impact the coupon. In general, we continue to like anything around energy or currencies, because we think that we’re going to see strong recovery of mobility and of oil prices. We’ve been reducing duration generally, and we continue to like high yield in EM currencies. which this has become more than a tactical trade. In credit, we like the fact that there aren’t many places in the liquid fixed income markets where investors can get a decent coupon, so we expect to see inflows. We have a more tactical, less aggressive exposure right now, but maintain the core conviction that 2021 will be an overall good year for EM.

JMR: our largest active overweights are in India and Russia. While we are considering risks of increased U.S. sanctions on Russia under the Biden administration, we see valuations as outweighing the risk as the economy excels with oil at $55. We see Russia as a proxy to gaining exposure to oil, without owning oil-specific stocks.

A weak US dollar has tended to be positive for EM equity performance
Risks

Taper Tantrum

**IML:** What could trigger a taper tantrum? Which parts of the EM complex are most vulnerable?

**JMR:** Taper tantrum is clearly negative for EM, regardless of the asset class, and I agree it’s not so much the quantum but the magnitude and velocity of the move. I think there’s enough there from the central bankers to control that and for capital to continue to prevail in the asset class.

**AB:** We are fairly comfortable that any significant backup in real rates in the U.S. is going to be either limited in nature or eventually fought by the Fed. There are two reasons this could happen. One is ‘crowding out,’ or if there is an increased supply of treasuries because of fiscal stimulus post-Georgia, then real rates could start rising again. The second is if the economic recovery is so strong that the market starts pricing in an earlier interest rate rise than what is now priced in the market. In both of these scenarios, we could see significant liquidity drying up if markets are worried about the Fed being behind the curve. A result of significantly higher inflation, real rates also rise as investors seek protection against future inflation.

**PG:** A taper tantrum is clearly negative for EM, regardless of the asset class, and I agree it’s not so much the quantum but the magnitude and velocity of the move. I think there’s enough there from the central bankers to control that and for capital to continue to prevail in the asset class.

Inflation

**IML:** Where do you see the strongest inflationary pressures in the EM world, and which central banks do you see as getting back on the tightening path soonest?

**PG:** I think tightening is now going to be a generalised issue. I think there are still places where we might see further cuts, like Mexico, but we’ve seen a much more hawkish tone coming from Brazil. In general we will see EM central banks really keen to see how much of the pickup in inflation is just pure base effects, and a lot of the bottlenecks coming from the food price shocks that we saw in 2020, they should start displaying with favourable base effects for emerging markets. Energy, on the other hand, will point in the other direction, but prices in emerging markets have been quite well behaved, so with the continuation of the virus and mobility restrictions, our pickups will continue to be quite wide in emerging markets. I don’t anticipate a majority really rushing to hike.
**Risks**

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