

Emerging Markets Outlook

September 2020

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BlackRock

Considering different perspectives

Opposing Outlooks: Yet again, it's all about perspective. Back in May 2020, on one side of the investor aisle BlackRock emerging market equity experts saw opportunities for positive returns, while emerging market debt colleagues held a much grimmer outlook for their asset class.

As the third quarter comes to a close, EM debt and EM equities have recouped losses incurred during the spring and produced marginally positive returns year to date. But strong divergence in performance amongst emerging market assets underscores the importance of taking **deliberate regional exposures**, as highlighted by our **Emerging markets marker tool**.

Past performance is not a reliable indicator of current or future results.

Where does EM go from here?

In this piece, we outline the **complex impact of the COVID-19 crisis** on emerging markets, and discuss with BlackRock fixed income, equity, and macro experts the implications on their respective asset classes the crisis has caused, or amplified. We will discuss our views across these three categories, including:



- Investors will be increasingly focused on social and fiscal conditions in EM.
- There will be continued tension with China, regardless of the U.S. election outcome.

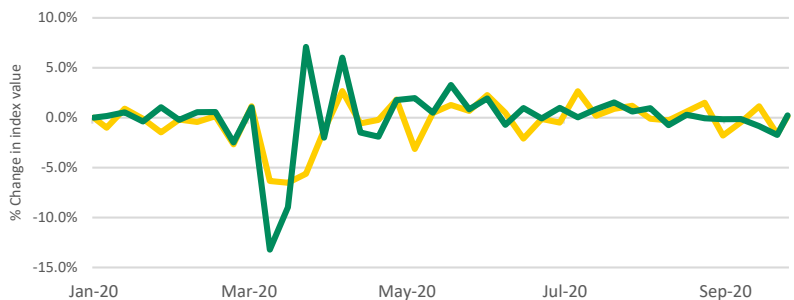


- Stronger than expected technicals are supportive of EM debt.
- EM FX should offer interesting opportunities going forward.



- We are cautiously optimistic in EM equities' potential to deliver more as we return to a low-growth, low-return environment.
- Current valuations offer an attractive entry point for long-term investors.

Emerging Market Equity versus Debt



— MSCI Emerging Markets Index — JPM Emerging Markets Bond Index EMBI Global Core
The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Source: JPMorgan, as of 25 September 2020. MSCI, as of 25 September 2020.

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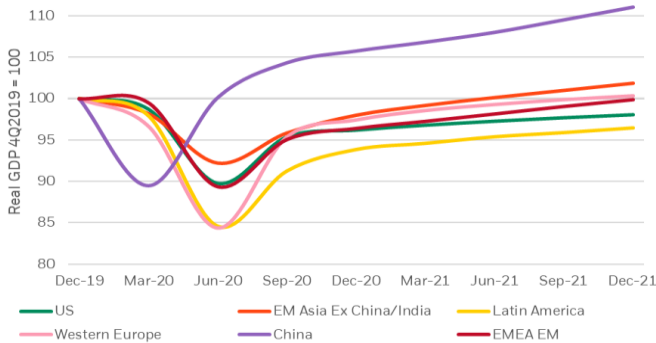
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Macro

Isabelle Mateos y Lago: How has COVID impacted growth across the EM universe?

Pablo Goldberg: The shock's size and ability to withstand it vary greatly across EM countries. For example, China's growth bottomed in the first quarter of 2020, and other countries including Poland and Russia have taken swift and large-scale actions to limit the economic fallout from the virus. For others across the emerging market world, the story has not been the same as we see the likes of Lebanon experiencing a financial crisis, and others draining reserves to keep their countries afloat. This has all come in a year during which EM growth was projected to accelerate. EM growth bottomed in the second quarter of this year and we expect the velocity at which many of these countries will be recovering the output loss of 2020 to be disappointing. In fact, many EM economies are not likely to breakeven against this year's losses by the end of 2021. Although this significant supply and demand shock hit EMs in the second quarter of this year, the consequences are likely to persist for the next several years.

Large output gaps likely to persist post-COVID



Source: JPMorgan, as of 31 August 2020. GDP forecasts from JP Morgan. **Forecasts may not come to pass.**

IMyL: Given this macro outlook, what do you think investors will be most focused on going forward?

PG: We see three key themes as being the primary areas of focus:



SOLVENCY: In 2021, we think investors will be focused on economies regaining some path to solvency, and how quickly this will happen. Some economies are already entering a restructuring process, as is the case of Argentina and Ecuador where it has already been completed. We believe other countries including Lebanon, Belize or Suriname are also likely to resort to restructuring.



SOCIAL & FISCAL CONDITIONS: We are paying more attention to the tension between social demands and the ability of governments to deliver viable solutions. The COVID-19 crisis is expected to bring even higher unemployment, higher income inequality, and a demand of governments for better and stronger provision of public services – many of these economies will have to adjust fiscal planning accordingly. We strongly believe ESG (Environmental, Social and Governance metrics) have gained a larger role in the selection process, we see the “S” factor in particular gaining traction as a driver of returns and volatility.



U.S. PRESIDENTIAL ELECTION: Investors are going to be watching the U.S. elections, trying to forecast different outcome scenarios and the potential implications on EM.

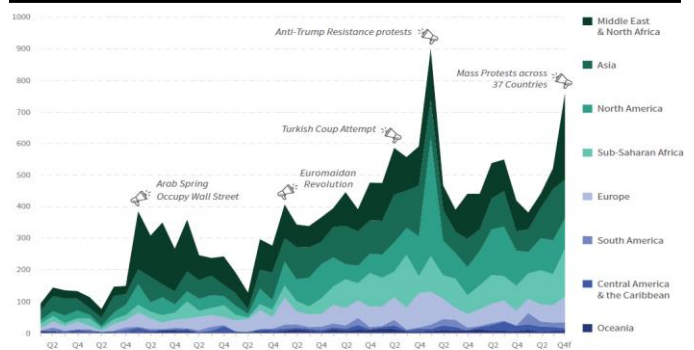
IML: What have been the fiscal and monetary policy responses? Are we seeing some common trends?

PG: The crisis generated an important shock to growth, while simultaneously **deviating** many EM countries from the path to more prudent fiscal and monetary policy. Several of the EM economies came to the rescue of their private sectors, both households and companies, through direct fiscal expansions or credit policies. This is pushing some countries to bear quite a large fiscal burden. For instance, Brazil has made a very impressive effort to respond, yet it's very dangerous from a debt sustainability standpoint.

On the monetary side, we see EM central banks significantly cutting rates and, in most of these cases, taking rates to negative real levels. We are also seeing central banks expand aggregate money by significant amounts via credit policy, reduction in reserve requirements, and in certain cases with quantitative easing.

There is monetisation by central banks of fiscal deficit. While it appears that EM central banks are attempting to mimic developed market methodologies, they are not issuers of reserve currencies to back these policies up – essentially, an experiment of which the outcome is unknown. We are left with Debt-to-GDP levels that have increased significantly both as a result of rising debt, but also because GDP is expected to be weaker compared to pre-COVID expectations. In addition to these policy measures, EM countries are also bringing back the **IMF as a global actor**, as many have been forced to ask for short-term dollar funding and structural advice.

Civilian anti-government protests increasing



Source: Centre for Strategic and International Studies, as of 31 December 2019

Fixed Income

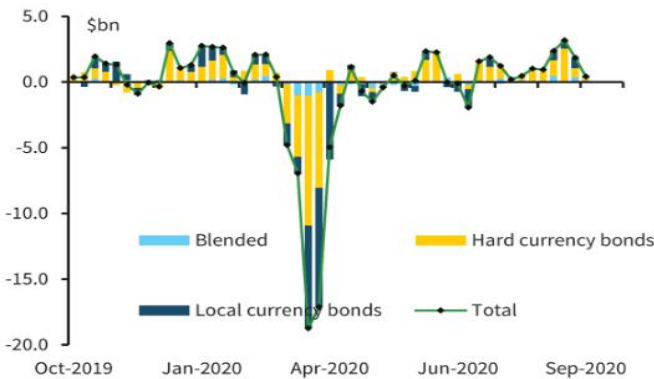
IML: Amer, given this backdrop, what's to do with an EM debt portfolio?

Amer Bisat: As a portfolio manager, I tend to look at three things – fundamentals, technicals and valuations. Currently, I believe technicals are very strong in EM; if I have been surprised by anything over the past few months, it has been the strength of technicals. We are seeing sector inflows come back quite aggressively, and enormous amounts of interests, coupons or amortizations that are coming every single month because of debt that was already issued and refinanced cashflows. We aren't quite as positive on the fundamental picture but are hoping that the worst is behind us. Importantly, cross over investors are finding EM very attractive for its yield enhancement, which is a function of the massive amount of liquidity currently in the system as a result of DM central bank action.

IML: Your broad outlook seems rather positive. Let's go more granular. What parts of EM Debt do you like and dislike at the moment?

AB: The safe emerging markets, which bear no default risk, have done extremely well since April; technicals in EM corporates are even better than those in sovereigns right now. For high yield, the way we measure valuations is by looking at the compression rate between high yield and high grade. At the peak, the difference between these asset classes was 400 basis points, today it is 130. There is still room for further compression, but we don't believe you have to be overly selective for these types of bonds. We do not see significant opportunities in duration or interest rates right now. They have rallied massively and are significantly below where they were before COVID-19 as a result of the monetary policy. However, there are certain countries where they are not done cutting rates like Mexico and Russia – curves are steep, so the long end will do better than the front end.

Portfolio flows are slowly returning to EM



Source: EPFR Global, Barclays Research, as of 15 September 2020. \$ refers to USD.

IML: With monetary policy expansionary in most EM countries so far through this shock, how do you see the relative merits of dollar debt versus local currency debt?

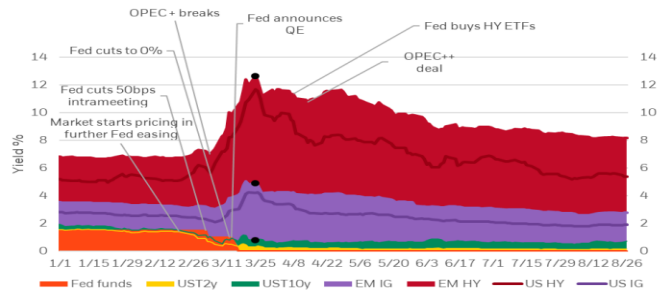
AB: FX has been the laggard in EM, the one part of the asset class that has not recovered, which can be attributed to loose monetary policy. Carry has been very negative. The money supply has been chasing the FX. However, there are three reasons why we think there are opportunities in EM FX now:

1. **It's extremely cheap.** By any valuation metric, FX stands out as relatively cheap against history, against competitors, against fundamentals.

2. **The U.S. dollar right is clearly turning.** EM FX is extremely negatively correlated to the U.S. dollar. So the weaker the big dollar, the stronger EM FX is. If you think that trend of the dollar weakening will continue, which we tend to think it will, then EM FX will do well.

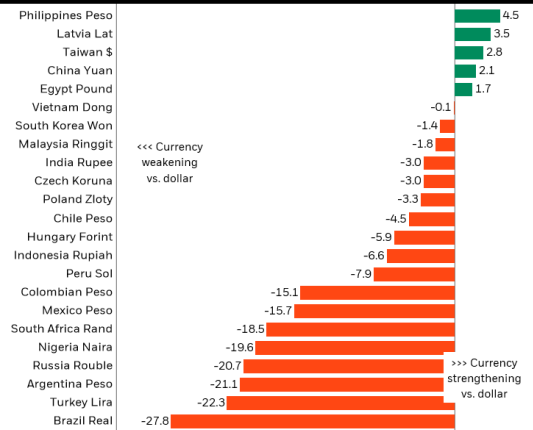
3. **There also is a technical argument** - EM FX is not widely owned right now. Given the low ownership, we think it could be one asset class where there is potential for an upward move. Despite fundamentals arguing the opposite, technical valuations and big dollar considerations we believe are sufficiently powerful – we are leaning long FX right now and watching very carefully.

Effect of policy stimulus on fixed income



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Emerging FX performance YTD



Source: Refinitiv Datastream and BlackRock Investment Institute. 27 Sept. 2020. Note: The bars represent the year to date percent change in each currency versus the U.S. dollar.

Equity

IML: Turning to equities, Jean-Marc, the asset class has broadly recovered from its Q2 losses, but does it have further up to run?

Jean-Mac Routier: A few months back, in middle of the COVID-19 crisis, it was very clear to us the market was pricing an outsized impact on EM economies. China has proven us right in a spectacular fashion. In fact, when looking at any economic numbers from China – industrial production, GDP, fixed asset investments, credit growth, exports, all the way down to retail sales – China has demonstrated their ability to recover very strongly. It's also important to note that only half of the fatalities related to COVID-19 have been in emerging markets, despite 85% of the world population living there. This extraordinary statistic shows the resilience of these economies.

IML: Across your investment universe, what is your outlook from here?

JMR: While the recent sell-off and bounce are in line with history, we think EM equities could be delivering more as we return to a low growth and low return environment. Some reasons we plan to pay attention.

Rates

While rates in developed markets hover around 0%, emerging markets continue to **offer attractive yields** while also providing central banks with more flexibility to ease further.

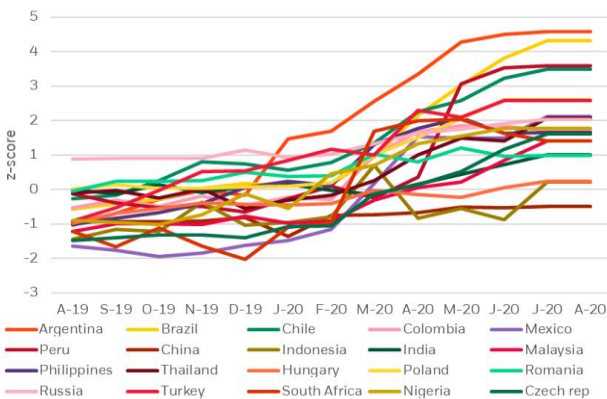
Liquidity

Liquidity should remain elevated following **staggering levels of monetary and fiscal support**. The vast amount of liquidity we're seeing in the market right now could flow into a higher yielding assets like EM.

Valuations

Valuations remain attractive and we believe P/Bs are signalling a **good entry point** with potential for good returns over the next five years, as illustrated by the graph below.

Accelerating money supply



Source: BlackRock on Bloomberg data, as of 31 August 2020.

IML: Are there any risks or limitations you're keeping an eye on in regards to these views?

JMR: There are two elements in particular we are keeping an eye on.

China is a dominant player in our EM equity universe – it represents close to 50 percent of our benchmark. If China goes ahead and launches tightening measures to prevent accelerating beyond intention, the asset class would be greatly impacted, EM equity in particular.

China

Narrowness of the market

Only a handful of stocks have provided most of the performance this year in EM equity. We are keeping a close look on this market concentration. We think it can unravel in an orderly fashion, but there is a risk that it doesn't.

IML: How do you play this in a portfolio? Do you have any country or sector preferences?

JMR: We have been realizing some profits on growth and defensive names, recently moving the portfolio more toward cyclicals while maintaining a balanced portfolio between factors.. On a country basis, we are sticking with India and Indonesia as our highest convictions as we think normalization and attractive fiscal positions will eventually draw investors. On sectors, we have been adding to some beaten down industries such as airlines and hotels, which stand to benefit as economies normalize. .

Emerging vs. developed equities



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Cross-cutting themes

U.S. Presidential Election

IML: How does the U.S. election – and its different scenarios – stand to impact EM?

PG: While the outcome is obviously unknown, investors are already trying to determine the consequences of different U.S. administration scenarios and their implications for emerging markets. A few observations:

President Trump provides a more unpredictable backdrop for emerging markets. The Trump Administration has been using sanctions and trade conflicts as instrument of foreign policy. From a macro perspective, Trump will likely continue to pursue its 'America First' agenda, which could in turn lead to a stronger dollar, and potentially higher rates.

With a **Biden Administration**, the landscape will be less erratic for emerging markets. Having said that, it's also important to understand there are some policies which seem to have bipartisan agreement. The idea to contain China is something that cuts across both parties – there is likely to be a continuation of some of the anti-China policy no matter who wins, in our view. Similarly, the use of some sanctions towards Russia will continue, regardless of the election outcome. From now until the election, investors are starting to focus not only on the result of the election but how long it may take the market to know the result.

The idea of a **contested election heightens risk aversion and could result in EM volatility.**

JMR: We are slightly more positive towards the U.S. election, but are in consensus that is going to be challenging to call. We believe there will be a **continued tension with China** – regardless of who is in charge. A Trump presidency is status quo; if it's Biden, things may ease a bit but in general the trend will continue. We are concerned about how China reacts to this, if their aggressive behaviour toward peers over the summer is any indication of what could come.

The path ahead for oil and EM implications

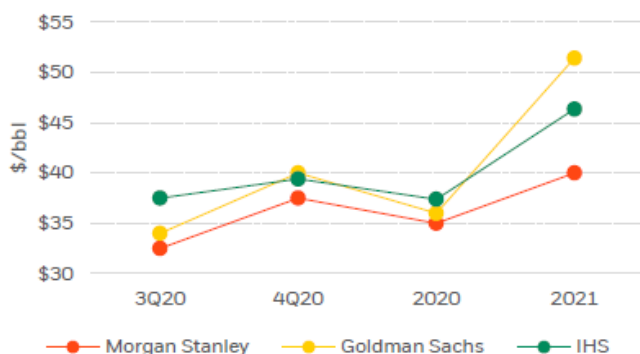
IML: A couple of months back, we had hopes that oil prices would be substantially higher by the end of the year. What are your thoughts on oil price prospects, and how will they affect the case for EM?

AB: The correlation between oil and emerging markets seems to have waned, and it appears the former is having less of an impact on the latter. EM has been driven by increasingly more by other asset classes such as global credit, global equities, and industry and metals.

What do we think about oil from here? We think oil will be challenged over the medium-term due to a combination of global supply shocks and the effect of a number of countries experiencing sanctions. Some OPEC agreements are not being adhered to, so "cheating" is continuing. Paired with this, demand is weak and likely to remain so despite the global economic recovery we're seeing.

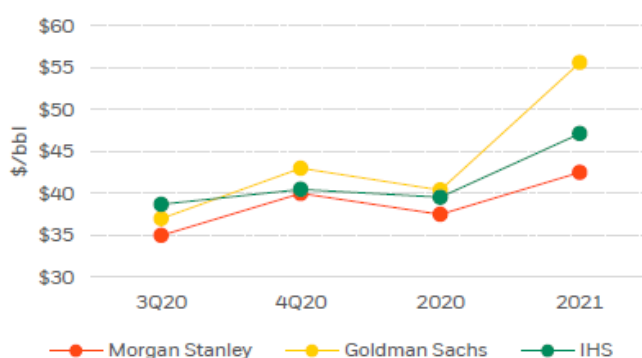
On the supply side, you have upside risks and on the demand side you have downside risks. We're not surprised by the weak tone in oil, and we think it could continue. The good news is that while it affects several countries directly, it doesn't act as a systemic headwind to the asset class the way it has in the past.

WTI price forecasts



Source: Morgan Stanley, Goldman Sachs, HIS, 16 July, 2020. **There is no guarantee that any forecasts made will come to pass.**

Brent price forecasts



Source: Morgan Stanley, Goldman Sachs, HIS, 16 July, 2020. **There is no guarantee that any forecasts made will come to pass.**

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Proxy Indices

Global govt bonds = Bloomberg Barclays Global Treasury index

Japan govt bonds = Bloomberg Barclays Global Treasury Japan Index

Euro area credit = ICE BofA Merrill Lynch 10+ Year Euro Corporate Index

Global high yield = ICE BofA Merrill Lynch Global High Yield Index

Euro area govt bonds = Bloomberg Barclays Euro Aggregate Treasury Index

U.S. credit = Bloomberg Barclays U.S. Credit Index

Global IG credit = Bloomberg Barclays Global Aggregate - Corporate

Inflation-linked bonds = ICE BofA Merrill Lynch Global Inflation-Linked Government Index

Euro area inflation-linked bonds = ICE BofA ML EMU Direct Government Inflation Linked Index

US TIPS = Bloomberg Barclays US Government Inflation-Linked Bond Index

EM debt, local = JP Morgan GBI-EM Index

EM debt, hard = JP Morgan EMBI Global Diversified Index

Japan equities = MSCI Japan index

European equities = MSCI Europe index

EM ex-China equities = MSCI Emerging Markets ex-China index

DM equities = MSCI World index

EM equity = MSCI Emerging Markets Index

Onshore Chinese equities = MSCI China A Inclusion NET Index

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