Emerging Markets have had a challenging year as vaccine rollouts have lagged and economic reopening has been delayed, particular in comparison to Developed Markets counterparts. More recent headwinds include a slowing China, stronger dollar, and more-hawkish-than-anticipated Fed. Where does this leave EM investors?

In this paper, BlackRock experts discuss the following for EM equity and debt assets through the remainder of 2021 and beyond.

### Overview of the EM picture at this stage

**Key takeaways include:**

- At this stage it is challenging for EM debt investors to see a compelling risk / reward proposition for the asset class, though it remains a rare source of yield in the Fixed Income universe. Global growth is stabilizing, rather than accelerating, and EMs are being forced to tighten both fiscal and monetary policy. This creates a challenging backdrop overall.

- Despite facing similar macro factors to EM debt, our EM equity investors are more bullish on their asset class. After a sharp underperformance relative to DM equity counterparts, EM equity valuations are looking reasonably attractive. But not all EM equities should be viewed the same – we expect ongoing divergence between countries in the EM universe as to where opportunities exist.

### Top likes and dislikes in the asset class

- **Selected Asset Performance**
  - Brent crude
  - U.S. equities
  - European equities
  - U.S. dollar index
  - Global high yield
  - EM equities
  - Italian 10-year BTP
  - Hard-currency EM debt
  - Global corporate IG
  - German 10-year Bund
  - U.S. 10-year Treasury
  - Gold

Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of Oct. 7, 2021. Notes: The two ends of the bars show the lowest and highest returns at any point this year to date, and the dots represent current year-to-date returns. Emerging market (EM), high yield and global corporate investment grade (IG) returns are denominated in U.S. dollars, and the rest in local currencies. Indexes or prices used are, in descending order: spot Brent crude, MSCI USA Index, MSCI Europe Index, ICE U.S. Dollar Index (DXY), Bank of America Merrill Lynch Global High Yield Index, MSCI Emerging Markets Index, Refinitiv Datastream Italy 10-year benchmark government bond index, J.P. Morgan EMBI Index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Germany 10-year benchmark government bond index, Refinitiv Datastream U.S. 10-year benchmark government bond index and spot gold.

### What are the key risks, both upside and downside?

**Contributors**

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Overview of the EM picture at this stage

Isabelle Mateos y Lago (IML): Emerging Markets (EM) haven’t had a great year, especially if you compare them to Developed Markets (DM). Vaccine rollouts have been lagging, and as a result the reopening has lagged as well. Towards the end of the summer there was a window where it seemed that finally they would catch a break and potentially catch up to Develop Markets thanks to cheaper valuations and relief about the Fed being able to signal a taper without triggering a tantrum.

In recent weeks, however, it seems new headwinds have emerged. The Fed appeared a bit more hawkish than anticipated at its September meeting. China has been slowing down and experiencing bond market uncertainties, to put it mildly, and the dollar has been stronger. There is a sense that winter is coming, and the question for Emerging Markets is whether there is still a window to consider this an attractive asset class? We will tackle this question in three parts:

Pablo Goldberg (PG): I’ll touch on a couple of macro points that I think are important in setting the stage and understanding how Emerging Market assets can perform. The COVID shock has been much more important than anticipated, but the recovery and economic growth has also been outsized compared to expectations. This brought to light a few important points:

1. 2020 was a year of massive recession globally, and Emerging Markets were center stage; at one-point global growth was around 20% below potential. At present, it is estimated to be ~2.5% below potential, about 75% of which is derived from EMs. This indicates how EMs are lagging on the recovery compared to DM peers.

2. There has been significant divergence between countries in returning to pre-COVID GDP levels. China had an important V-shaped recovery, achieving its level of pre-COVID GDP by the end of 2020, followed by the U.S. in the middle of 2021. The rest of EM ex-China have yet to reach their pre-COVID GDP level; in places like Latin America, an output gap remains that is likely to stay open through 2022. There’s been some level of scarring in EM for most countries, debt-to-GDP ratios have increased at an average of ~15%, which is a combination of the recession as well an important fiscal response put in place to contain the impact of the COVID crisis in both households and the corporate sector. One of the big challenges ahead for EMs is to rein in that fiscal spending, which will become a fiscal drag and headwind to growth in the years to come.

3. Inflation has accelerated around the world, but has varying implications in EM. Baring a few notable exceptions, Asia is not facing an inflation problem. The inflation issue is more prevalent in Latin America, centred in countries like Brazil where inflation is about to touch 10% year over year. In the Eastern Europe, inflation in Turkey is north of 19%, and in Russia close to 7%. While inflation is about to peak in some of these places, there is going to be lingering sense of permanence around this inflation that is leading central banks to start to remove some of the policy accommodation that was put in place during the worst of COVID. Considering what we believe markets are pricing in, policy rates in Emerging Markets should go up by around 200 basis points on average over the next few years. This is pricing an important inflation premium around 50 basis point over economic forecasts, which are closer to 145 basis points.

Sources: BlackRock Investment Institute with data from Refinitiv Datastream and Bloomberg, October 2021.

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Overview of the EM picture at this stage

**IML**: Amer, as a non-dedicated EM debt investor how do you think about the asset class at this juncture?

**Amer Bisat (AB)**: The way we tend to look at the question of ‘do I need EM or not’ is based on three components: macro backdrop & fundamentals, technical backdrop, and flows and positioning. Assessing these factors, I am currently uninspired by EM as it is challenging to see the risk / reward trade off at this stage. Across all asset classes I consider, EM is roughly one standard deviation cheap to DM comparators. Investment grade credit in EM is actually closer to neutral compared to U.S. IG. We like to own high yielding names in EM because they are carrying income and are relatively cheap. But the problem is that one standard deviation is not enough, we need closer to three standard deviations for me to get the risk / reward I would want to see.

Technical are slightly on the positive side, but not massively. Investors’ cash levels are on the high side, and they’re cutting back on riskier assets. But inflows into hard currency debt continue to be shockingly resilient. The fly in the ointment here is in two places:

1. Local markets are getting no flows, which has been going on for the past few years as these flows have been redirected into China.
2. There is no momentum to get investors that are not exclusively focused on EM involved in the asset class. The crossover investors are the big players in the game, in the sense that what moves the asset class is when crossovers decide they want to allocate into EM.

Putting all this together, fundamentals are on the negative side, the technical story is okay, and valuations are there – but the dedicated community is not that excited about the asset class and neither are the crossover investors. So our view on EMs is that we want to be on the neutral side, and tactically a bit on the short side.

**PG**: The previous comments are valid, but let’s not lose sight of the fact that the post-COVID rebound has been much more important than we thought; if at the beginning of COVID we knew we’d still be dealing with this two years later, we would imagine most companies would be in worse shape than they are in today. In my view this is owing to the emergency policy support. And while there are still things like fiscal excesses and inflation that need to be worked out, important investment opportunities are simultaneously created in that there is a severe scarcity of income around the world. Places with positive real yields, such as EMs, are becoming increasingly attractive.

**AB**: I think the framework of income being extremely attractive is extremely important. Roughly 70% of global fixed income assets are trading below zero, and 90% are trading with negative real rates. So at this stage it’s impossible not to like fixed income assets that offer some income, and EM does that. EM is one of the few places which still has a positive premium.

**IML**: Jennifer, in the past we have often seen more optimism from our EM equity investors than on the fixed-income. What is the equity side of the story today?
**Overview of the EM picture at this stage**

**Jennifer Delaney (JD):** We are again a bit more optimistic on EM from an equity perspective – perhaps not as bullish as we are known for, but still slightly overweight. One of the significant differences is the expectations in equities are very different compared to debt – EM equities have had a significant expectation reset. We’ve seen sharp relative underperformance of EM equities relative to DMs, which has brought us now to reasonably attractive valuations. More importantly, when considering earnings and expectations, EM equities aren’t disappointing to the downside. At the margin here, it is always the better time to be buying equities when expectations are going through a reset rather than the opposite when money tends to flow most into the asset class.

**Equity risk premium for EM, 1995-2021**

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One other aspect that is important right now in the equity landscape is China – should we be splitting China out and having a dedicated allocation? This is at the core of the news flow from China and the overall equity conversation right now, as key concerns around China have been the dominant driving force of Emerging Market equities in recent months. Though we note the ability to invest in China differs across investor types and geographies depending on objectives, constraints and regulation, from our perspective, the outlook is mixed – there has been a shift in the regulatory environment that we view as structural, with an impact that is twofold:

1. The earnings multiple that investors should be prepared to pay for Chinese equities needs to come down, while the risk premium that you need to demand to be investing in the Chinese market has gone up given these uncertainties.

2. Increasingly important for active equity investors is selectivity about where to invest. There are still exciting opportunities in China, but now it is crucial to ensure investments are aligned with policy priorities in China.

**Top likes and dislikes in the asset class**

**IML:** Now let me ask you each in turn what parts of the asset class do you like and dislike most?

**PG:** Considering all EM flows, 50% went into China, and looking at flows in local markets, the vast majority went into China. But the recent regulatory crackdowns have investors rethinking the China value proposition; I hope we will see some of these flows get redistributed around other EM as a result. Our view is that you can play the China factors by investing in other places in the EM universe, which is a positive factor from a technical point of view.
For example, when considering the cross-section between countries and sectors there is talk about what higher inflation means. It is clearly a world in which rates are moving higher, so you need to be in places with spread to contain part of the duration drive on your performance – and this is specific to the high yield space. There are also several places where you can play China by being long commodities; while China is slowing in the property sector, the demand for copper due to decarbonization globally will continue. My view is you want to be long in commodities and high yield to play China, without being in China.

The other factor I think is important is that Chinese yields have been decreasing, and probably will decrease even more as the PBOC stops tightening and starts easing to some extent. The yield of Chinese assets is being squeezed and there are ways to play the income away from China.

As for risks, everything we have discussed thus far stems from a baseline of a tapering without a tantrum in the U.S. If we were to have a significant shock in U.S. rates that lead to a VaR or volatility shock, it would be challenging to contain the impact in portfolios. The only diversifier there is cash, which is an issue across asset classes. We consider this a solid baseline, but one that needs to be shocked to see what the hedges are that you would want to have in place.

AB: I like sticking to the top side of the asset class and looking for places that offer some income over the DM counterparts. However, I don’t see value alone as being enough – I need to see value with some momentum and strong fundamental backdrop. If you buy something because it is cheap, but doesn’t offer any true cash flow or value, you’ll end up losing money. In a world where we see the best as being behind us in DM, we still don’t want to risk owning problematic assets just because they are cheap. So I prefer to own high-grade in the EM space, even if it is not extremely cheap. I think Mexico is a place with a solid balance sheet and economy, which is fiscally and monetarily prudent and does very little experimentation. Russia is another place I think has a strong balance sheet, despite some challenges politically. In Asia, I tend to look at Indonesia as a place that is being reprised as a story that is less about high yield, and more about high-grade.

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I see the biggest risk as the Fed being caught in a position of having to react when the fiscal multiplier could eventually work in reverse and inflation and rates go higher at the same time because of technical reasons, not policy. EMs tend to perform poorly in this scenario, where it spreads rather than absorbs higher rates and we see volatility shocks. I’m less concerned with decelerating global growth, I think there is still a lot of pent-up demand that emerging markets can benefit from.

One point that is also very interesting is the ESG angle – there is a lot of chasing of ESG characteristics, and in EM there is space to capture some of that.
**PG:** There is a policy discussion on whether there should be structural support for companies that are making the biggest effort on improving their ESG metrics versus rich countries that are better in ESG metrics just because they’re richer – which is a source of tension between EM and DM. This is an interesting point, but we are still seeing capital flowing into EM green bonds, social bonds, transition bonds, etc., which is also an important point for the EM space.

**AB:** To start with my positive scenario, the reopening trade because of the vaccine started quite aggressively, so we could see that coming back. Q3 ends up being a bit of a weak spot because of supply disruptions but then we’re back off to the races because of all the pent-up demand and policy accommodation that still exists in Q4. The big surprise could be Europe – it is the only place we are seeing momentum and it is a very large global economy. So we could go back to an economic recovery that has been interrupted for a bit, and then we recover – inflationary fears subside as it proves transitory and global central banks leave accommodative policies in place. This could be a very positive scenario, where we would go back to a ‘Goldilocks’ environment, in which case EM would look very attractive given the income it provides. I don’t give this a very high probability, as I think the best is behind us and the next policy move is more likely to be tighter not easier – but I wouldn’t give this a zero probability, either.

What keeps me up at night, besides the fear that the Fed ends up having to tighten faster than expected, is China. China is going through a bit of a perfect storm and the regulatory shifts are proving disruptive. Evergrande has triggered a shock to the property sector, and we are also seeing power shortages. I am most concerned that this weakness could continue into Q4 and Q1’22 – which EM would not be prepared for.

**JD:** Primary concerns from an equity perspective are a repeat of early pandemic performance. In terms of upside risk, given that China is 35% of our EM universe there is potential upside surprise if there were to be an event we are not positioned for, like really sharp stimulus out of China that significantly drives activity, or any sort of policy shift to offset the weakness that we’re seeing.

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**China GDP, real vs estimates, Sept 2021**

Forward looking estimates may not come to pass. Sources: BlackRock Investment Institute, China’s Ministry of Finance with data from Haver Analytics, October 2021. Notes: The chart shows actual and projected GDP growth. Consensus forecasts are from Reuters polls as of 22 September, 2021. The “downside scenario” path is our estimate of how growth may evolve in the absence of any policy easing.
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