December 9, 2024

Emerging Markets 2025 Outlook

- Contrary to the prevailing consensus, the impact of Trump 2.0 is not unambiguously negative for emerging markets.
- In the near term, policy uncertainty will keep EM asset prices under pressure, but the outlook is constructive on a one-year view.
- EM ex-China equities will outperform within a global equity portfolio, and we have a bias to upgrade Chinese equities to overweight once the earnings recovery broadens.
- EM currencies will remain hamstrung by U.S. dollar strength in the near term, but positive growth and policy drivers will lead to modest appreciation on a 6-12 month horizon.
- Total returns on EM bonds will be more muted next year than in 2024, although further outperformance within a global bond portfolio is in the cards.

EM equities and currencies have struggled in the aftermath of the U.S. election, with equities shedding 2% in U.S. dollar terms and underperforming the U.S. equity benchmark by 9% since November 4 (**chart 1**). An equal-weighted EM currency basket has also declined 2% versus the U.S. dollar over the same period. Meanwhile, U.S. assets are riding a wave of post-election exuberance. Put differently, investors now overwhelmingly believe that the U.S. economy will outperform EM counterparts in the year(s) ahead. We disagree.

Investors overwhelmingly believe that the U.S. economy will outperform EM counterparts in the year(s) ahead…

…we disagree

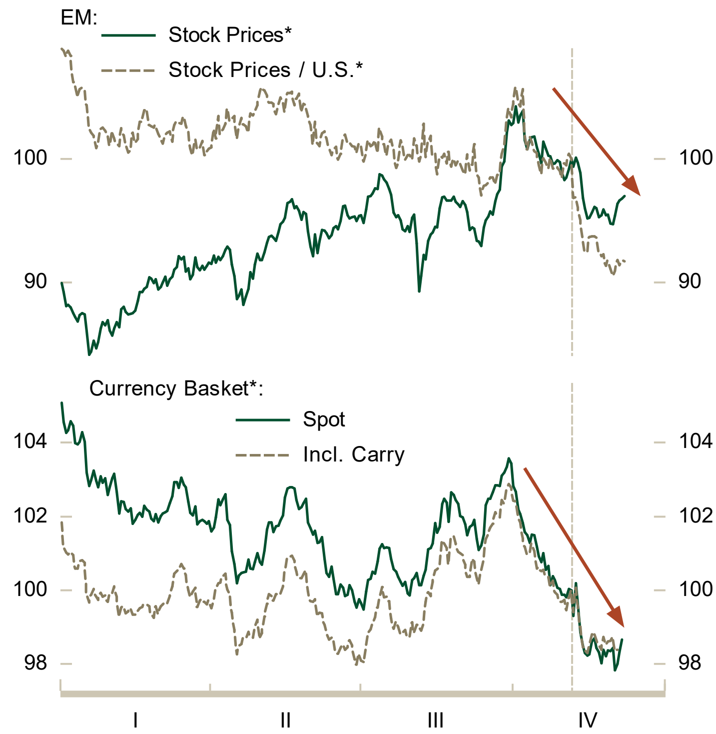
Our base-case scenario is that Trump's policy bark will be worse than his bite[1], and although many EM economies are in the crosshairs of the U.S. administration's tariff proposals, their economic fates are intertwined. If U.S. growth stays in high gear, as we expect, U.S. import demand will firm and sustain the budding global trade and EM economic recoveries.

The implication is that EM economic growth will continue to strengthen in 2025, and EM equities, currencies and fixed income should outperform their developed

[1] **MRB** "*Asset Allocation Strategy – 2025 Outlook: Ongoing Economic Expansion, But Lower Returns And Greater Volatility*", December 6, 2024

market counterparts.

Chart 1 EM Equities & Currencies Are Struggling Post-U.S. Election



* U.S. dollars; source: MSCI
** Equal-weighted index
Note: Verical line denotes November 5, 2024; all series rebased to November 5, 2024

Emerging Markets & Trump 2.0

We disagree with the prevailing consensus which views the policies of the incoming U.S. administration as unambiguously negative for EMs. There are two main channels by which the latter could be impacted by the U.S. election outcome: 1) stronger U.S. growth sustaining a strong U.S. dollar, and 2) significant new trade tariffs.

Most investors believe that Trump's policies will strengthen U.S. growth, implying a sticky U.S. policy rate, rising Treasury yields and a stronger U.S. dollar across the board. The combination of higher yields and a stronger dollar has historically been a headwind for EM assets. However, the continuation of this combination is by no means assured[2] and, more importantly, the net impact on all EM assets hinges on the state of U.S. and global growth.

If the rise in yields is accompanied by stronger growth, which is the most likely outcome in our view, the impact on EM currencies will be positive as growth tailwinds should outweigh the rise in the cost of capital. On the other hand, a stagflationary outcome in the U.S. would have negative ramifications for the EM growth and policy backdrop, and would put EM currencies under pressure.

The net impact of sticky U.S. inflation and higher Treasury yields should be positive for EM if accompanied by stronger growth

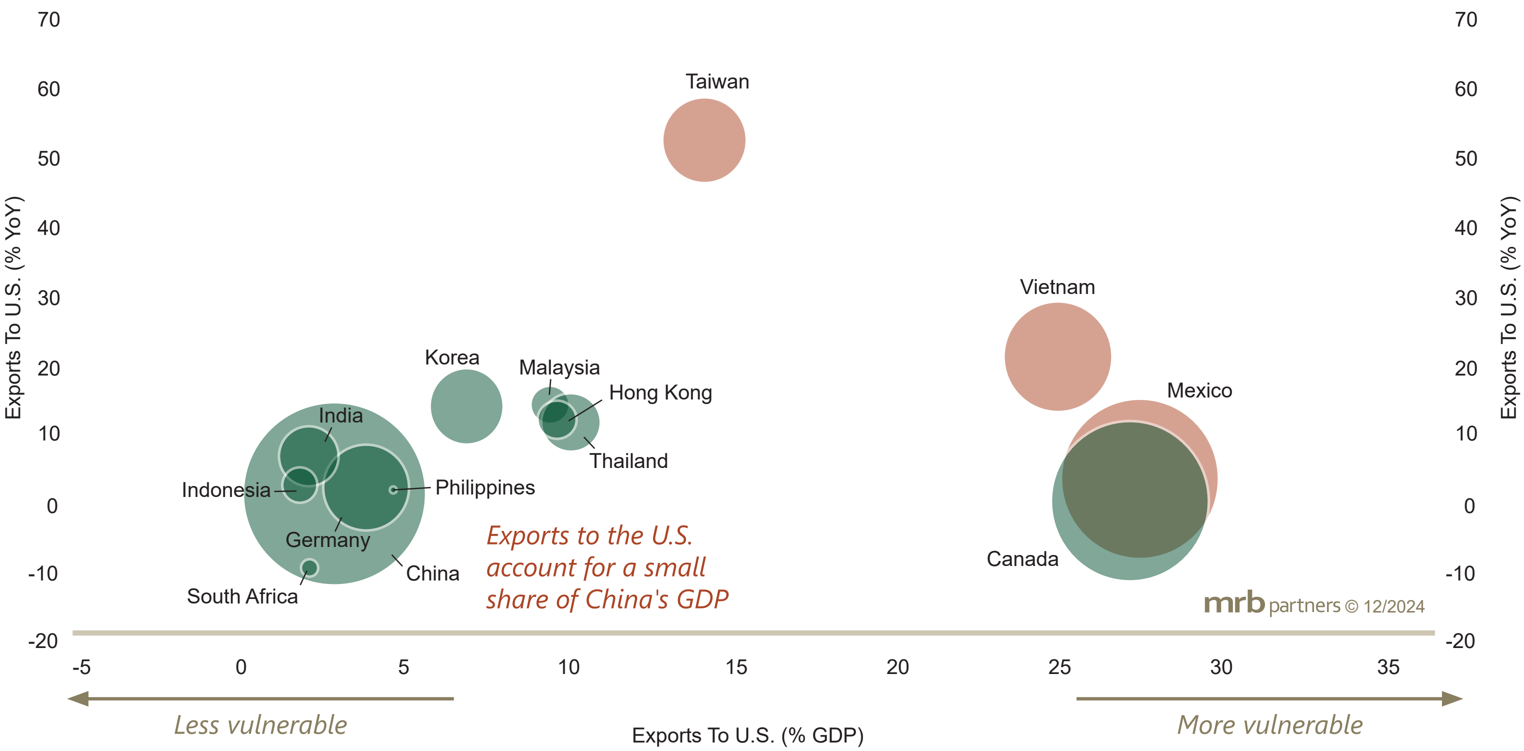
Further, with EM relative growth likely to firm, interest rate differentials will be at least a neutral (certainly not a negative) driver of EM currencies. And although inflation has been muted, most EM central banks will be under no pressure to materially cut their policy rates throughout 2025.

The second threat facing EM economies are tariffs, and there are several directly in the firing line by way of their large trade surpluses with the U.S., most notably China, Mexico and Vietnam (**chart 2**). However, the outcomes on this front are still highly uncertain, and we would caution against drawing hasty conclusions.

First, it isn't yet clear if the threat of trade wars is mostly a negotiating tactic, rather than being ideologically driven. Trump's two most recent tariff-related tweets were

[2] **MRB** "*Positioning For The New Fat Tail U.S. Economy*", November 20, 2024

Chart 2 **Among Emerging Markets, Mexico, Taiwan And Vietnam Are The Most Vulnerable To U.S. Tariffs**



Note: Size of bubble reflects U.S. bilateral trade deficit with respective partner

conditional, suggesting that the threat of tariffs is likely to be deployed to achieve other economic/geopolitical wins. Similarly, the apparent exclusion of Robert Lighthizer[3] from any position in the incoming administration suggests a desire not to encumber future flexibility with ideologically-entrenched views.

Incoming President Trump's policy bark will likely be worse than his bite

Furthermore, in many cases, U.S. corporations have no alternatives for many imports, suggesting potential exemptions for a range of important goods (e.g. autos from Mexico and semiconductor imports from Asia). This, along with the evasion associated with such loopholes, would greatly dilute any negative impact on EM growth, as would the combination of weaker currencies and strengthening U.S. import demand (insofar as Trump tax cuts and deregulation will boost growth).

Barring a stagflationary outcome in the U.S., global trade should continue recovering

In the final analysis, it is unlikely that the Trump administration would try to damage U.S. growth, and so the most likely outcome is that the U.S. economy stays resilient, and U.S. imports continue to firm and global trade recovers further over the next 6-12 months. The path may be volatile, but directional improvement beckons.

One clearly negative scenario would be if U.S. tariffs lead to a substantial rise in U.S.

[3] Robert Lighthizer served as the architect and chief negotiator of the tariff policy in the first Trump administration. He is a noted trade hawk, with high-profile and hardline views on the advantages of trade protectionism.

inflation that dents consumer demand. In this case, the budding global trade recovery would falter, and EM growth and assets would likely underperform given their larger exposure to trade. Mexico and Vietnam are the most vulnerable to such an outcome given their large trade surpluses with the U.S. and because exports to the U.S. represent approximately a quarter of their GDP (**chart 2**). Malaysia, Thailand and Taiwan are also vulnerable on this front.

Final Word: *Barring the near-term noise and volatility induced by the policy proposals of the Trump administration, the most likely outcome is that stronger U.S. economic growth will ultimately sustain the recovery in U.S. import demand, and therefore global trade. This backdrop is positive emerging markets.*

Chart 3 The Global Economic/Trade Backdrop Is Positive

* Smoothed; source: CPB World Trade Monitor
** Smoothed; source: U.S. Census Bureau

Growth: More Uncertainty, But Still Positive

Emerging markets are more sensitive to global trade than their DM peers, and it is understandable that EM growth forecasts are being downgraded amidst the threat of trade wars. However, the uncertainty about trade policy will likely be a temporary headwind for EM growth.

Moreover, the risk of tariffs should be viewed in the larger global context where U.S. import demand is firming, global trade and EM exports are recovering (**chart 3**), and a still-strong U.S. economy implies that these trends should continue.

Many emerging market economies saw an export-led acceleration this year, driven almost entirely by the sharp recovery in semiconductor exports (itself associated with investment on A.I.), with the main winner being EM Asia. However, ***there are now signs that the export recovery is broadening beyond the A.I. sector***, with the most important being that U.S. import demand for capital goods is broadening beyond semiconductors. Importantly, U.S. imports of ***consumer goods*** are now also unambiguously recovering (**chart 3, panel 2**).

The recent broad-based expansion of U.S. imports is a sign that the global trade recovery is broadening beyond the A.I. sector

Meanwhile, China's imports of machinery and electronics are continuing to recover, which is another source of growth for EM[4]. And while imports of commodities have been largely flat, partly reflecting weakness in the housing sector and construction, to the extent that the China's housing market bottoms out in 2025 and China's growth will likely grow above trend next year, then Chinese commodity imports should stabilize (**chart 4**).

While emerging Asia has so far disproportionately benefitted from the global trade recovery, the improvement will broaden to other EMs next year. And because exports-to-GDP are typically higher in the EM world, the impact on domestic demand will also be more pronounced in emerging markets relative to their DM peers.

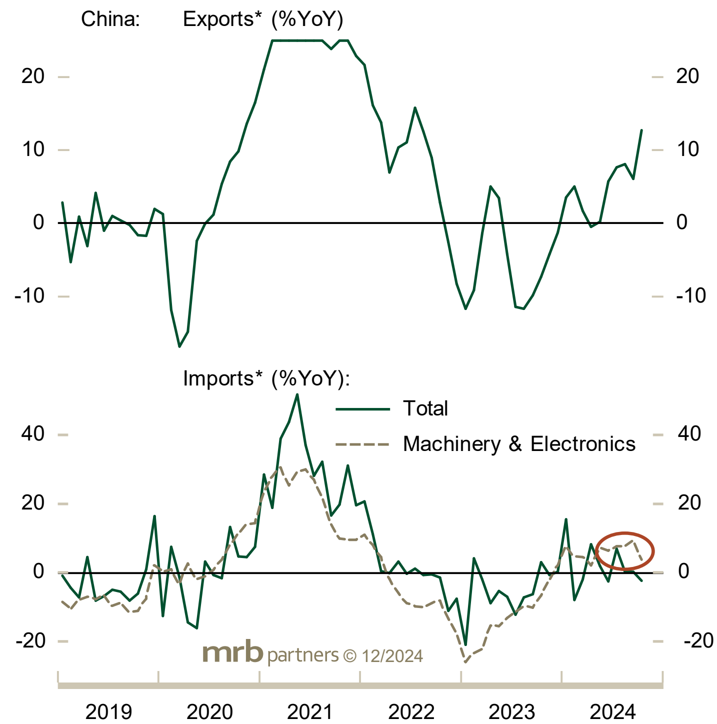
Final Word: *With import demand in China and the U.S. improving, EM economic growth will improve and broaden beyond emerging Asia next year. Moreover, the gap between EM and U.S. growth will continue to widen in favor of emerging markets.*

Policy: More Constrained

While EM monetary policy was a tailwind for capital markets since the second half of 2023, and some EM central banks may trim their policy rates over the next 2-3 months as insurance against the threat of tariffs, policy is unlikely to provide a meaningful boost to EM economic growth throughout most of next year.

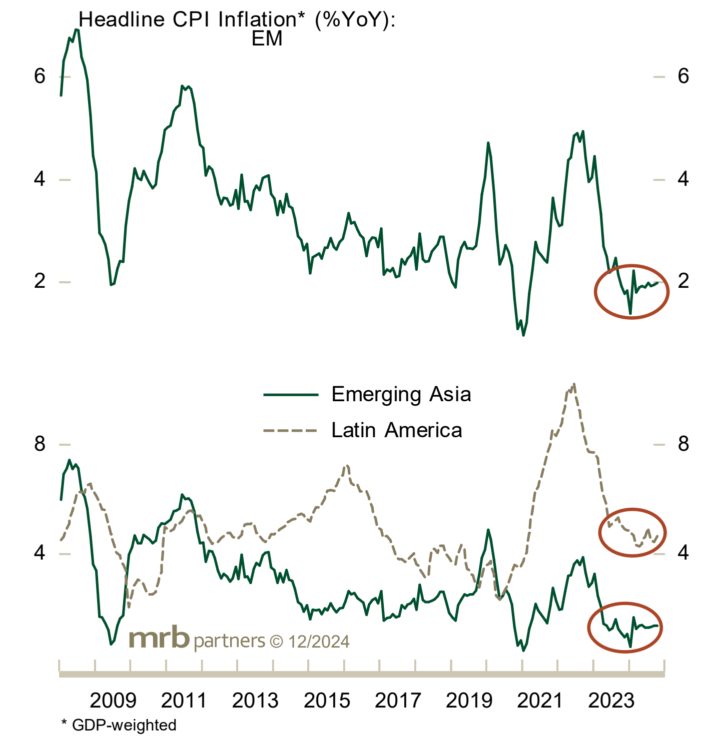
So far, inflation is still contained in ***most*** emerging markets, and current inflation rates in aggregate remain below the averages of the 2010s, i.e. their pre-pandemic averages (**chart 5**). However, all

Chart 4 China's Growth Will Support The Rest Of Emerging Markets Next Year



* U.S. dollars; smoothed; source: China National Bureau of Statistics
Note: Panel 1 truncated above 25

Chart 5 Inflation Is Benign In Most Emerging Markets



* GDP-weighted

[4] MRB "*China's Feel-Good Fiscal Non-Stimulus*", November 11, 2024

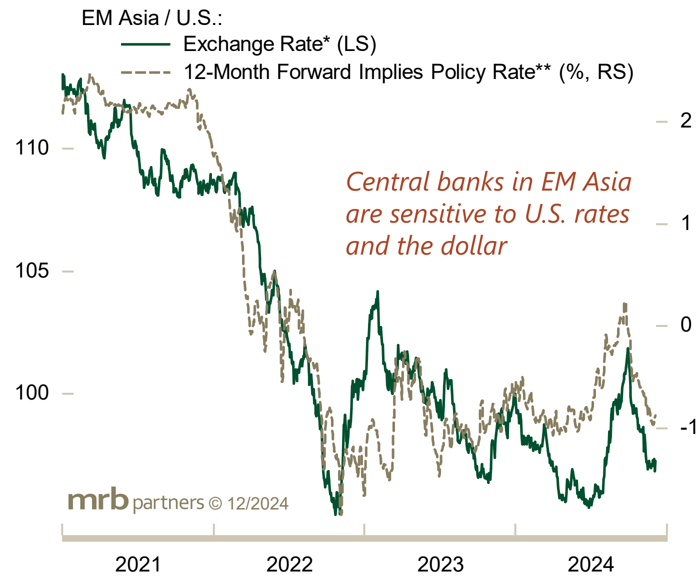
EM central banks pay heed to the U.S. dollar, fed funds rate and U.S. Treasury yields. And in 2025, strengthening U.S. growth and sticky inflation may keep the U.S. dollar well-bid versus other major DM currencies.

For EM central banks, cutting rates too aggressively in this backdrop would risk material currency weakness and a resurgence of inflation. This is especially the case in EM Asia where the carry is negative, and currencies have been more sensitive to changes in interest rate differentials (**chart 6**).

In addition, there will be less pressure to cut rates as the EM economic expansion broadens beyond EM Asia. And while exports have done most of the heavy lifting so far, the positive spillover effects on domestic demand will likely be felt in 2025. This, in combination with recent DXY strength, upward pressure on Treasury yields and the current rise in global food prices, ***may*** well propel EM headline inflation higher in 2025. EM central banks will likely shift to a less dovish stance next year.

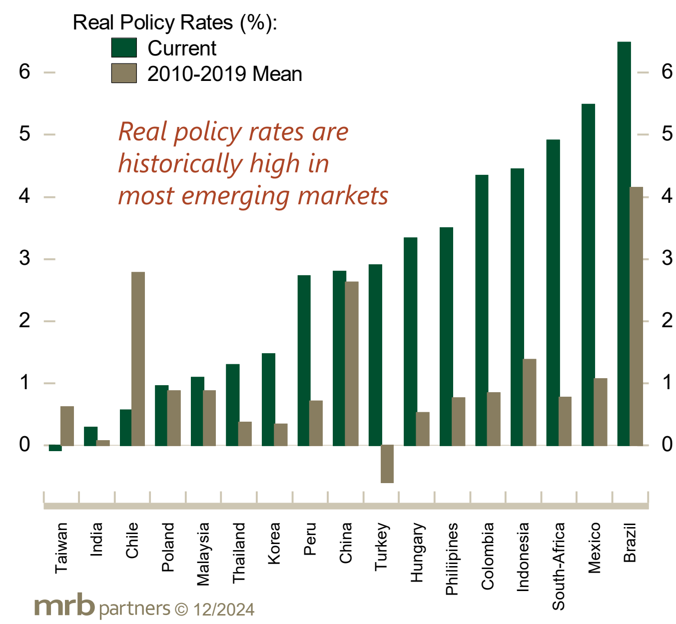
That said, the hurdle for hiking rates is high because most EM central banks have maintained policy rates that that are higher than justified by domestic considerations, with real policy rates elevated across most EMs (**chart 7**). Consequently, a modest pickup in inflation is likely to bring real rates closer to their historical averages as EM central banks remain on the sidelines. The risk of EM rate hikes will rise ***if*** the increase in U.S. inflation leads to another wave of ***sharp*** upward adjustment in fed funds rate expectations, although for now the probability of such an outcome is low.

Chart 6 EM Asian Central Banks Are More Constrained By U.S. Policy



* Equally-weighted aggregate
** EM Asia minus U.S.; source: Bloomberg

Chart 7 Monetary Policy Is Tighter Than Justified By Domestic Condition



Final Word: *Some EM central banks are likely to take out insurance against the threat of tariffs and cut rates in the near term. However, next year, the scope for rate cuts will diminish as U.S. growth firms and inflation proves sticky.*

Equities: Near-Term Pain, Long-Term Gain

Uncertainty about U.S. trade policy will persist and keep EM equity prices under pressure in the near term. However, we remain upbeat on EM equities for 2025.

Over the past two years, the outlook for EM equities had been bifurcated between the positive performance of EM ex-China, which offered strong earnings growth at a time when the latter was scarce, and the unappealing backdrop for China (**chart 8**). In this context, EM equities in aggregate underperformed.

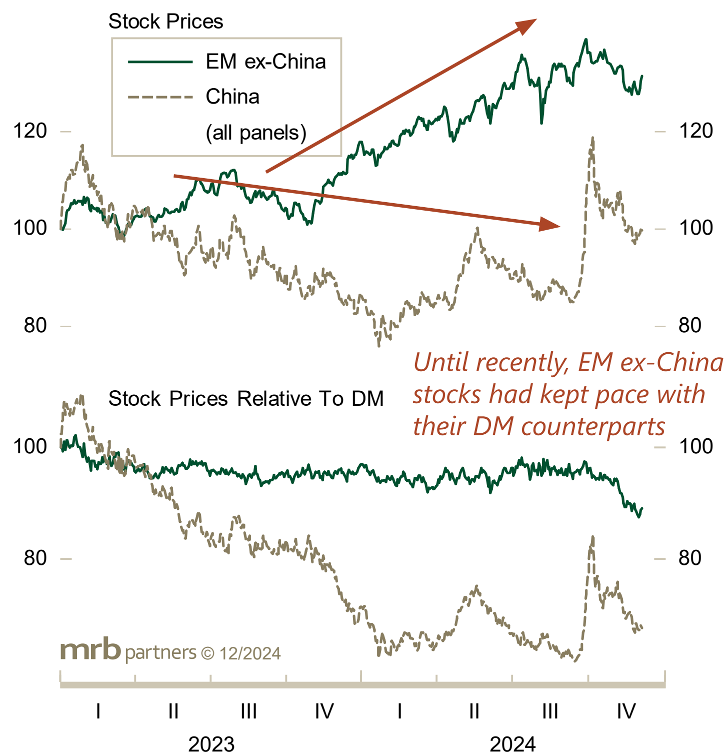
However, we expect that as 2025 progresses, China's economic conditions will be sufficient to broaden the earnings recovery, which would trigger our upgrade bias on Chinese equities[3]. Meanwhile, the relative earnings outlook for EM ex-China, which is much more strongly correlated with global trade, will remain favorable in 2025 (**chart 9**).

For Korea and Taiwan, technology is by far their largest sector, and global demand for semiconductors dominates their earnings cycle. Although global semiconductor sales are now past the peak of the previous cycle, most of the improvement in demand has been driven by the massive increase in A.I. capex, which is a new and chip-intensive source of demand.

However, other end markets, which are closely correlated with global trade, are now beginning to recover: global sales of mobiles, PCs and other consumer electronics have been picking up in recent months, which will add another source of growth for the industry and sustain the uptrend in EM technology earnings[5] (**chart 10**).

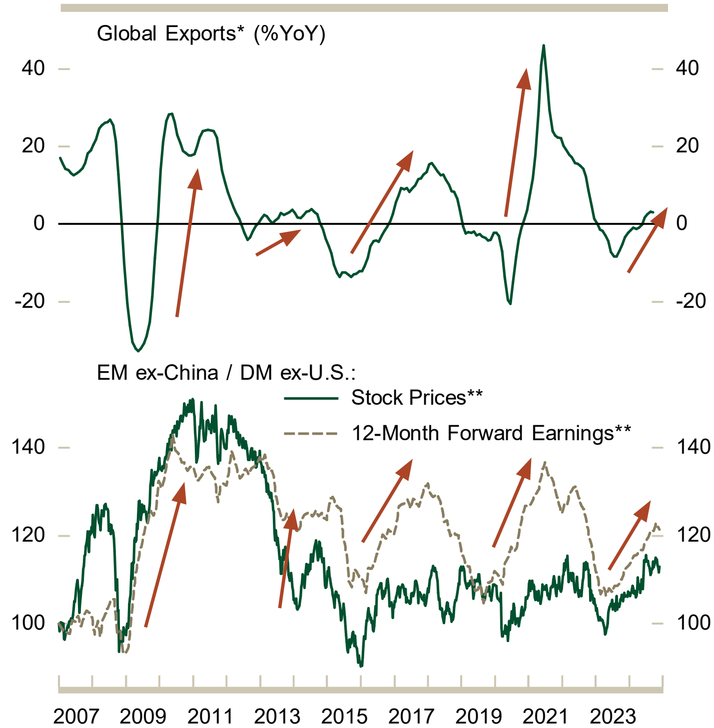
[5] MRB "*Why We Prefer EM Over U.S. Semiconductor Stocks*", October 3, 2024

Chart 8 **EM ex-China Stocks Have Performed Well**



* U.S. dollars; rebased; source: MSCI

Chart 9 **The Global Trade Recovery Will Sustain EM ex-China Outperformance**



* Smoothed; nominal exports; U.S. dollars; rebased; source: CPB World Trade Monitor
** U.S. dollars; source: MSCI
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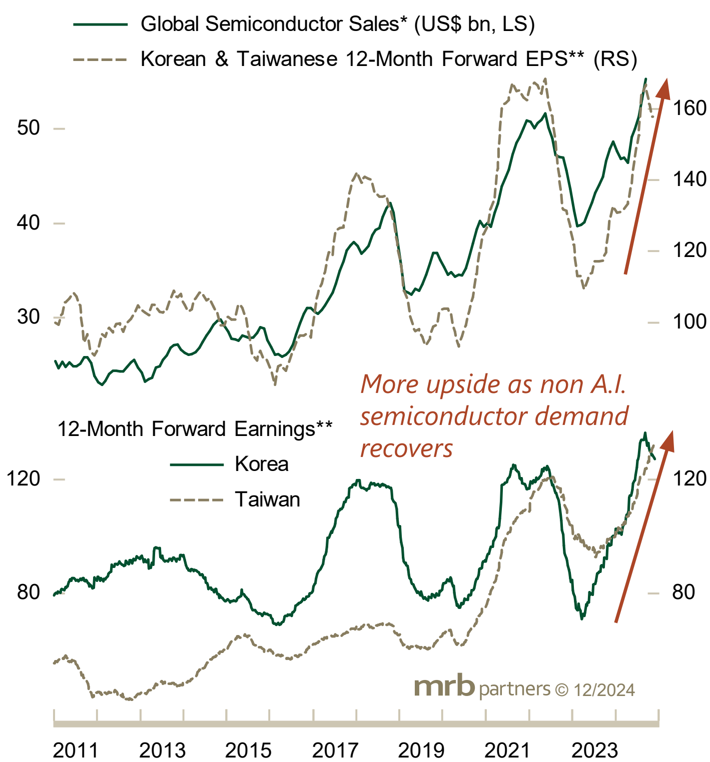
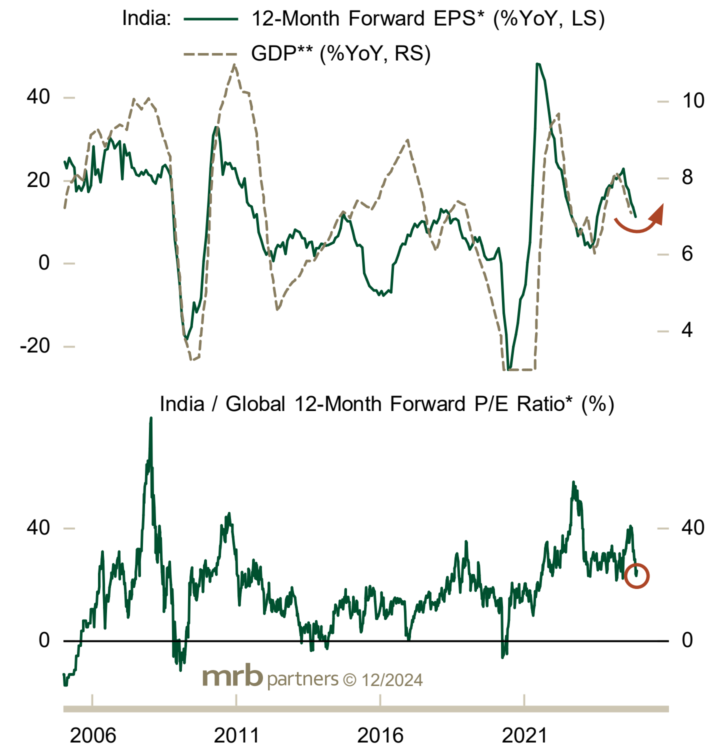
Chart 10 More Upside For Global Semiconductor Sales & EM Tech Earnings



* Source: Semiconductor Industry Association
** U.S. dollars; rebased; source: MSCI

Chart 11 India's Earnings Momentum Will Recover

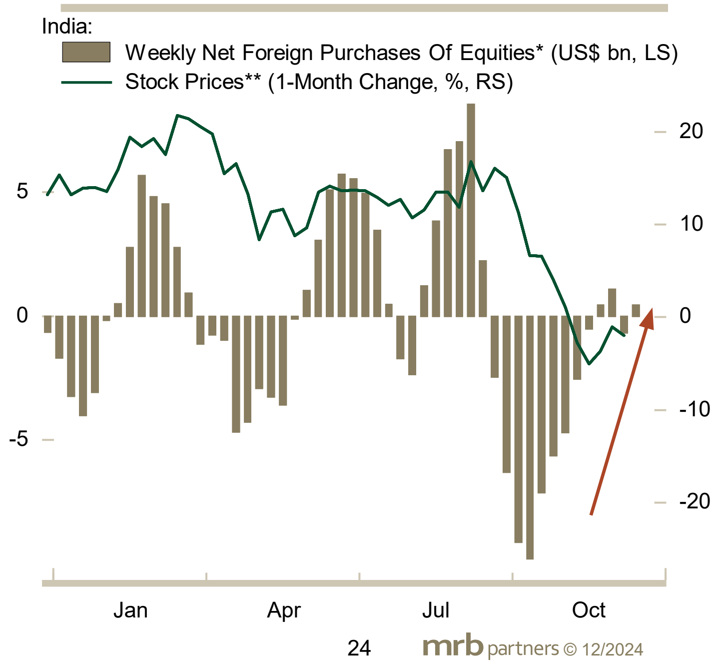


* Local currency; source: I/B/E/S Global Aggregates
** Four-quarter sum; truncated below 3%
*** Percent premium (+), discount (-); source: I/B/E/S Global Aggregates

This is especially important for Korea, which had underperformed in the second half of this year as Samsung Electronics lagged its competitors in the A.I. race. The recovery of the non-A.I. semiconductor demand and global trade more generally should lead to upward EPS revisions in Korea.

Meanwhile, the outlook for India's equity market is also improving[6]. After slowing down from its blistering pace earlier this year, firming rural consumption, an export recovery and the removal of this year's fiscal drag will lead to improving economic growth prospects next year. The strong correlation between GDP and earnings growth implies that the latter will also recover, at the same time India's equity valuations have materially come off the boil (**chart 11**). In terms of capital flows,

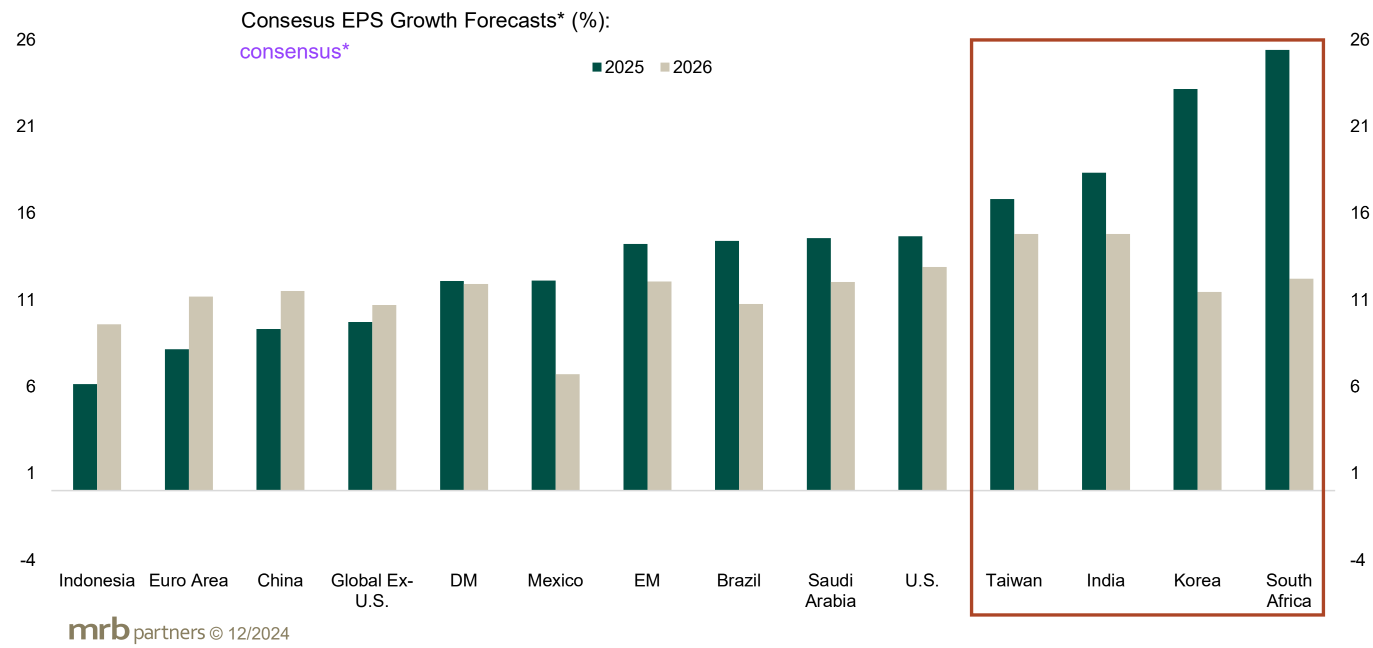
Chart 12 Equity Outflows In India Have Subsided



* Source: Securities and Exchange Board of India

6 MRB "*India: Why We Are Still Overweight Equities*", October 30, 2024

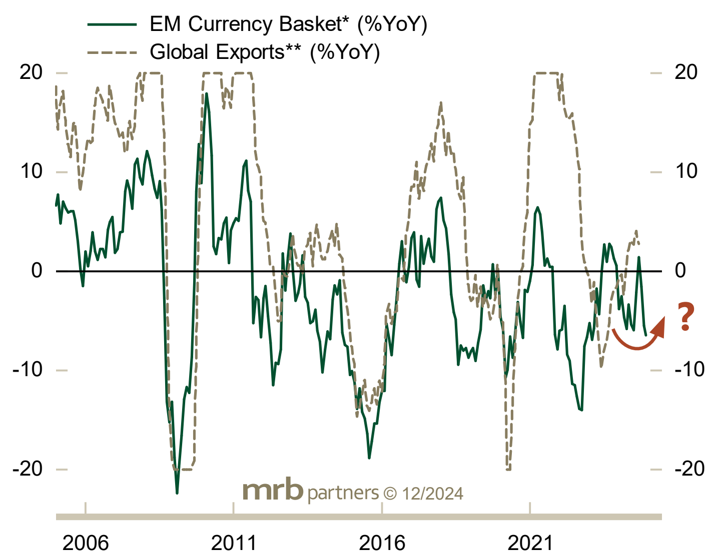
Chart 13 **2025 EPS Growth Will Be Higher In EM ex-China**



much of the rotation from Indian equities to China has largely played out, and foreign net selling of Indian equities is already subsiding (**chart 12**).

Outside of the largest EM ex-China equity markets, the earnings backdrop is also positive in several other EM, including in ASEAN, South Africa and Brazil. In short, EPS growth will be higher in most emerging markets compared to their DM peers (**chart 13**).

Chart 14 **EMFX Outperforms When Global Growth Is Supportive**

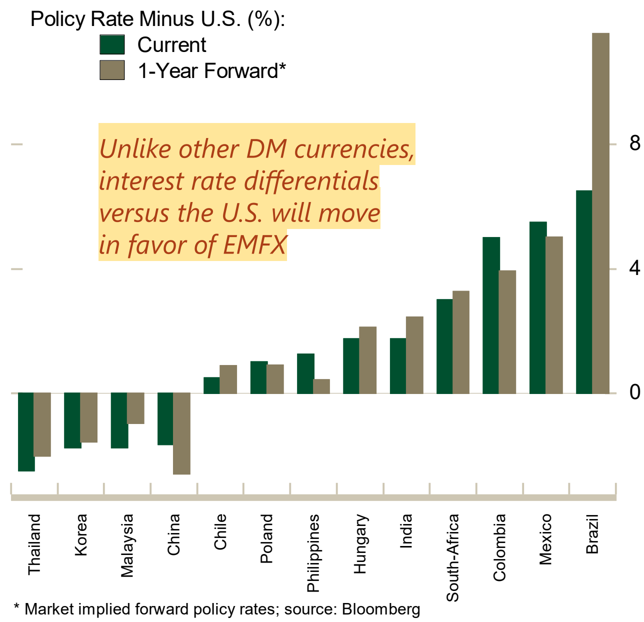


* Equal-weighted aggregate
** Truncated above 20 and below -20; source: CPB World Trade Monitor

The key strategy question is whether investors will continue to view the EM equity space via a zero-sum lens, i.e. if an upgrade of China necessitates a downgrade of EM ex-China. We think not. The competition between EM ex-China and China can be justified in a world where growth is scarce, and investors are risk averse and selective. However, as growth becomes more broad-based, and investors find attractive opportunities in both China and EM ex-China, the capital flow tide will lift most boats.

Final Word: *The recovery in global trade, even if less robust than previously forecast, is expected to broaden in 2025. This, plus an economic recovery in India, will provide* *support for EM ex-China equities in 2025. Against this backdrop, we are maintaining an overweight in EM ex-China within a global equity portfolio. Further, we still have an upgrade bias on China, which we will trigger once we see evidence that earnings growth is broadening and extending to the financials sector.*

Chart 15 **EM Policy Rate Spreads Versus The U.S. Will Widen In 2025**



* Market implied forward policy rates; source: Bloomberg

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Currencies: Growth Tailwinds Will Eventually Triumph

There are many crosscurrents facing EM currencies next year, with the net impact being modestly positive against the U.S. dollar and other major DM currencies.

EM growth is accelerating relative to most developed markets, and this has historically been associated with the outperformance of an EM currency basket versus the U.S. dollar (**chart 14**, previous page). Furthermore, as exports have driven the economic recoveries in most cases, the majority of EMs are running current account surpluses or historically small deficits which are, in any case, more than offset by net foreign direct investment[7]. Currency valuations have also improved over the past several months, so EM currencies have far less downside risk than in the past.

A strong U.S. dollar versus other major DM currencies is a near-term headwind for EMFX…

The fly in the ointment is that as the U.S. economy expands relative to other DMs, the DXY is likely to be firm. It is much easier to make the case for U.S. dollar strength versus other DM, rather than EM, currencies since EM growth momentum is stronger. Indeed, policy rate spreads are expected to widen versus the U.S. for most of the EM world (**chart 15**). Despite this, investors are still operating under the assumption that a strong DXY by default implies weaker EM currencies (i.e. they have been unwilling to differentiate between other major DM vs EM currencies). While this sentiment will weigh on EM currencies in the near term, it will become much less of a headwind as investors become more confident that global trade will broaden and continue expanding.

… but should become increasingly less so as investors grow more confident that global growth will stay firm

Furthermore, if a large-enough tariff is imposed on Chinese goods entering the U.S., the CNY currency management regime may come under pressure, with a potential devaluation in the cards. In that case, many EM Asian currencies would also face significant pressures, although it would take a massive (e.g. 50-60%) and abrupt imposition of tariffs

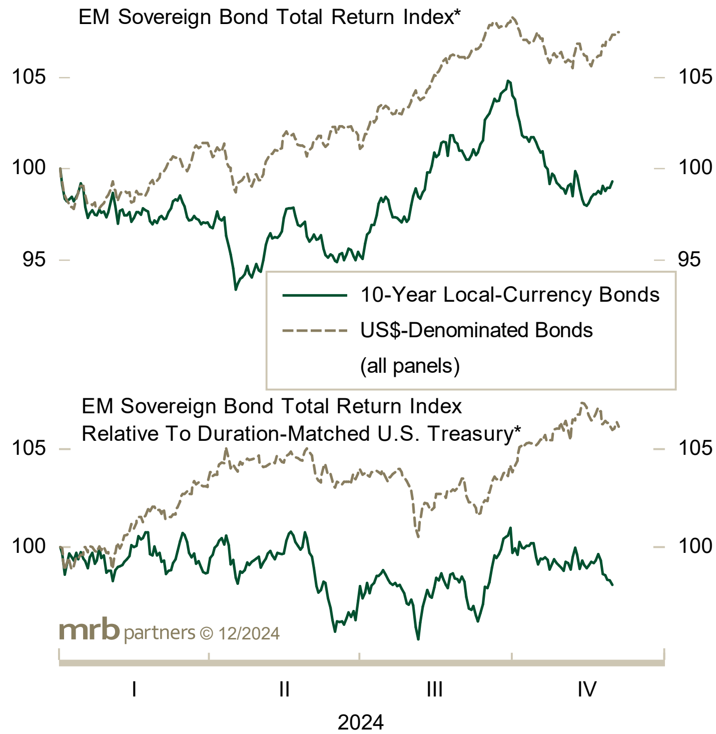
7 When net FDI is positive and exceeds a country's current account deficit, capital inflows are almost always currency-supportive.

on China to trigger such an outcome, which is not our central scenario.

For the time being, these lingering risks are likely to offset any positive relative growth and policy drivers. However, looking further out into 2025, we expect that once there is more clarity on U.S. trade policy and enough confidence that the global economic expansion will persist, then an EM currency basket will outperform the U.S. dollar.

In terms of intra-EM positioning, the lower-yielding currencies in EM Asia have the growth tailwinds, larger current account surpluses and their central banks are less dovish than their global counterparts. As a result, we expect those currencies to outperform on a 6-12 month horizon, even if the risk of CNY devaluation holds them back for the time being.

Chart 16 **Fed Rate Cuts Helped EM Debt, But This Tailwind Will Likely Fade In 2025**



* Shown in U.S. dollars; rebased

Meanwhile, currencies in EM ex-Asia offer a healthy carry buffer, but if our forecast is correct and global trade continues to recover, then they are likely to underperform in aggregate given their weaker growth profiles and more dovish central banks. In this group, those with stable/improving fiscal or economic governance are likely to perform best, including the rand and Turkish lira.

Final Word: *For the time being, EM currencies will remain hamstrung by a stronger DXY and the risk of FX devaluation in EM Asia. However, once there is more certainty about U.S. trade policy, we expect growth and policy drivers to drive EMFX outperformance versus the U.S. dollar and major DM currencies.*

Further outperformance is in the cards for EM debt next year…

…but total returns will be more muted

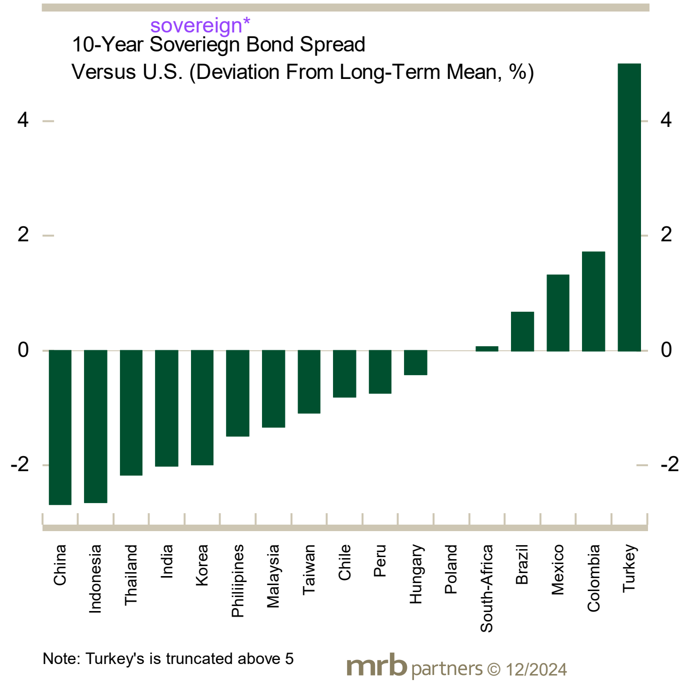
Fixed Income: Runing Out Of Juice

Earlier this year, we struck a more a cautious note on emerging market debt, arguing that spreads had fallen to near historic lows and EM central banks were turning less dovish[8]. Indeed, throughout much of 2024, both flavors of EM debt had delivered only modest positive returns and, more recently, U.S. dollar strength has wiped out all the gains for EM local currency bonds (EMLCD) in common-currency terms (**chart 16**).

8 **MRB** "*EM Debt: Any Juice Left To Squeeze?*", April 4, 2024 and **MRB** "*EM Debt: Stick With High Yielders?*", July 25, 2024

Still, relative to their U.S. counterparts, EM US$-denominated debt (US$D) outperformed, while EMLCD has been flat year-to-date, almost entirely due to U.S. dollar strength; EM local-currency debt has outperformed in local-currency terms.

Chart 17 **EM Sovereign Spreads Are Materially Below Historical Averages**



Looking ahead, the outlook in 2025 is less positive, for several reasons. First, although 2024 was characterized by disinflation in developed markets and the start of the Fed rate-cutting cycle, the backdrop will be less bond-friendly next year as U.S. growth firms and inflation proves sticky. This implies upward pressure on U.S. Treasury yields and by extension EM bond yields, even if the latter are less sensitive to U.S. Treasurys than in the past.

Moreover, the potential for U.S. dollar strength is a near-term risk to common-currency returns for EMLCD, while in the U.S. dollar bond space, it will manifest via deteriorating finances of the weaker-credit issuers with a relatively high share of US$-denominated debt. This removes a major tailwind for EM$D given that those markets were almost entirely responsible for the outperformance this year. In short, like their global counterparts, common-currency returns on EM bonds in absolute terms are unlikely to be attractive.

Still, a backdrop in which growth is resilient has historically been positive for the ***relative*** performance of EM debt, and we expect the asset class to outperform next year. That said, EM sovereign bond spreads are already tight by historical standards (**chart 17**), with only four issuers offering spreads currently above their long-term mean (Colombia, Mexico, South Africa and Turkey), suggesting limited room to narrow further. This means that any outperformance is likely to be muted compared to this year.

Final Word: *A less friendly global bond backdrop next year will weigh on the performance of both flavors of EM debt in absolute terms. However, within a global bond portfolio, we still expect EMLCD and EM$D to outperform as EM growth firms and improves overall credit quality of the asset class.*

Amr Abdel Khalek
Strategist, Emerging Markets

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