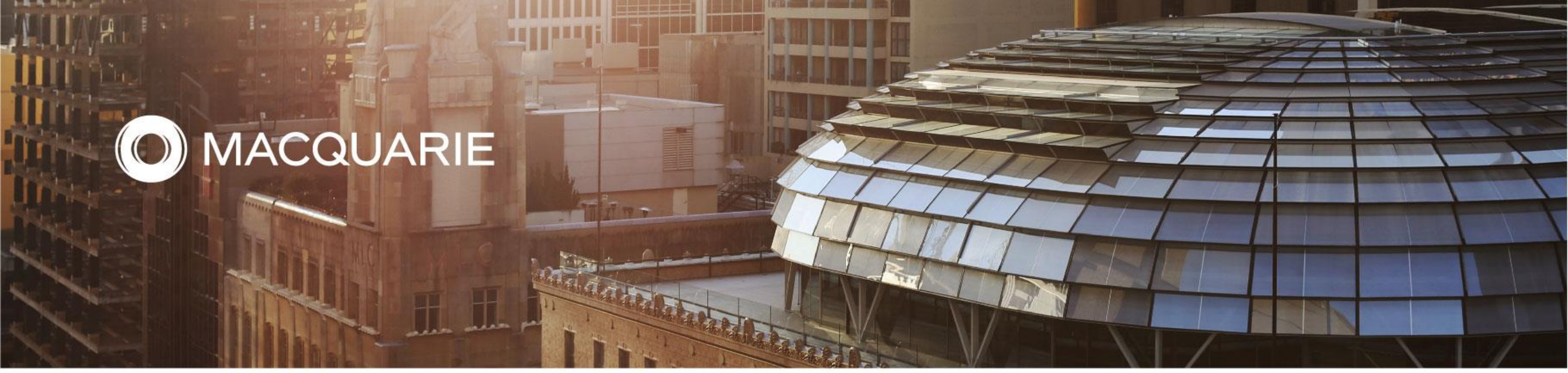


Investment Strategy Update #116

Emerging Markets: Too early to go back in

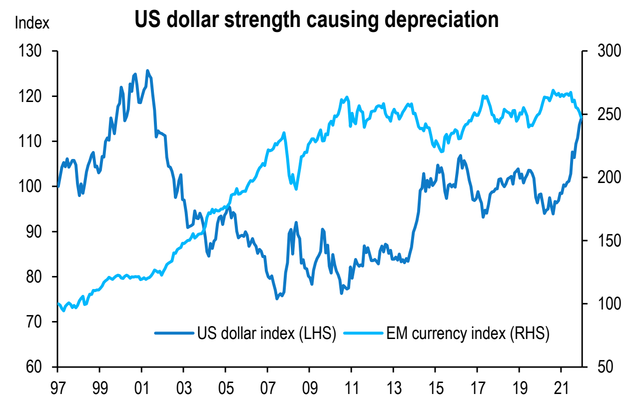
- We are underweight EM assets – both equities and fixed income, where we believe a confluence of headwinds poses further downside risk to the outlook.
- Higher policy rates to combat inflation, a stronger US dollar, and lower global growth prospects render EMs vulnerable to capital flight that is likely to put further pressure on asset prices – even if outflows remain orderly.
- While EM equity valuations have declined this year and look attractive compared to historic levels (0.64x versus 0.73x), sustained upside will require an improvement in macroeconomic fundamentals and not just cheap asset prices.
- Caution is also warranted across EM sovereign and corporate debt. We favour less risky investment grade debt issued in hard currencies as credit market pricing does not yet reflect continuing uncertainty and rising downside growth risks (see *Investment Strategy Update #115, Credit: Not yet priced for ongoing uncertainty*).
- China remains a wildcard. They have the tools to support growth and put a floor in the property sector should stringent pandemic restrictions be eased, but until that time, further stimulus is working against mobility restrictions.
- Overall, we remain underweight EM assets despite more attractive (relative) valuations. We are particularly cautious on peripheral economies where external balances are more worrying and who may face difficulties in repaying foreign denominated liabilities.

A difficult year for EM assets

Several factors have caused EM asset prices to decline sharply through 2022. These declines, across both debt (-17%) and equity (-15%) markets, have occurred alongside accelerating capital outflows that have put pressure on exchange rates, intensifying market volatility. We think several of these headwinds remain intact and have the potential to see EM assets trade even lower into 2023. These include:

- **Geopolitical tensions** – The ongoing conflict between Russia and Ukraine, and escalating tensions between China and Taiwan, have increased the general level of uncertainty for investing in EMs (raising the risk premium). The risk-off sentiment that dominated the market narrative in the early part of this year is still intact.
- **Higher policy rates** – As central banks adopt an increasingly tighter monetary policy stance, widening interest rate differentials between advanced and developing economies will weigh on the performance of EM assets. Here, for stable income and downside protection, we favour exposures to real assets and alternatives that can benefit from the elevated inflationary environment and increased market volatility.
- **Stronger US dollar** – A steeper trajectory for interest rates in the US is expected to drive further weakness in EM currencies, adding to capital outflow pressures. This poses additional downside risk to asset prices and financial stability. Unsurprisingly, some smaller EMs have already defaulted on government debt, including Sri Lanka, Lebanon, and Zambia. While we do not believe this to be a systemic problem, we note that peripheral economies are particularly vulnerable to a further appreciation in the US dollar.

EM assets are inversely correlated to the US$



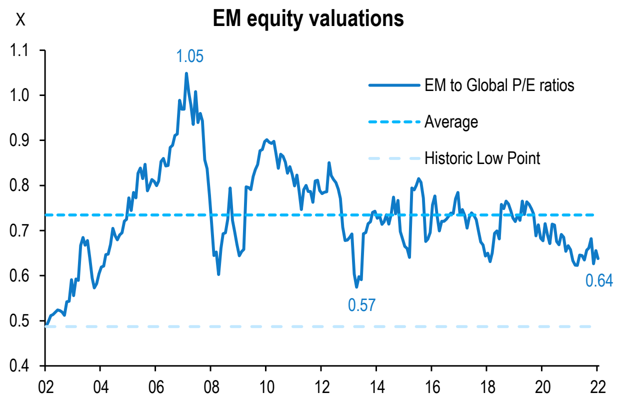
Source: Bloomberg, MWM Research, September 2022

EM equities – Not yet attractive enough for rising risks

EM equities have declined 15% this year resulting in a modest PE compression versus developed equities. While at face value EM equities appear attractive, during economic recession periods EM equities have traded cheaper than current levels. In addition, valuations have rarely been the catalyst for upside in EM assets, especially when growth and capital flight risks are high. We do not see this changing.

In addition, we think the dependence of most EMs on commodity exports, and a lack of sectorial diversity across their respective equity markets, creates concentrated pockets of risk. If global growth moderates and commodity prices continue to decline, EM equity valuations are likely to suffer further downward revisions toward the lower end of long-term averages (0.49x).

EM equities have not reached recession levels

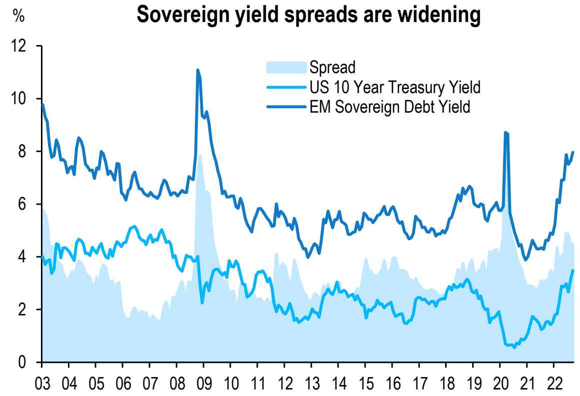


Source: Bloomberg, MWM Research, September 2022

EM debt – Yields and spreads are not appealing enough

Higher policy rates have seen a rise in compensation for holding EM sovereign debt. Specifically, the spread between EM and US sovereign bond yields has widened by around 1% since the beginning of the year, reaching levels that are now beyond long-term averages (~320 basis points).

EM spreads likely have further upside



Source: Bloomberg, MWM Research, September 2022

While on an absolute basis the rise in EM sovereign bond yields may look attractive, we believe the risk-return trade-off favours DM sovereign bonds. We hold a similar view for corporate credit, where higher quality investment grade exposures are preferred to high yield and EM debt.

Chinese policymakers can ease financial conditions further

Concerns over the creditworthiness of property developers, combined with the effects of zero-COVID policies on economic activity, have resulted in broad declines in Chinese asset prices since the start of the year, with equities underperforming the broader EM index (-23% vs. -15%). While these developments have been idiosyncratic thus far, any further weakening in the Chinese economy will have ramifications for the performance of EM assets more widely, primarily due to trade interdependencies and the size of China within the EM basket.

One advantage of the Chinese economy compared to other EMs is the means to mitigate risks to financial stability via further monetary easing. We believe Chinese policymakers can act hastily to ease financial conditions as they have done in the past, setting monetary policy *asynchronously* to the rest of the world. While monetary easing has *so far* been unsuccessful in counteracting negative sentiment, we think there is ample headroom for injecting more liquidity. Looser financial conditions may set a price floor under EM assets, especially given the heavy presence of China as part of most EM portfolios. The extent of this price floor and whether it can offset further declines remains to be seen.

China can set monetary policy asynchronously

Source: Bloomberg, MWM Research, September 2022

We recommend investors remain underweight EM assets. While there is some relative value emerging, a sustained upswing (and re-rating) will require downside risks to subside or for a clear upside catalyst to emerge (i.e., China stimulus or an end to Fed rate hikes). Until then, “cheap” valuations are unlikely to be enough to reverse recent performance. Within equities, stay with the more quality biased markets and while in fixed income, we think sovereign bonds and investment grade credit look more appealing than high yield and EMs.

Macquarie WM Investment Strategy Team

The report was finalised on 26 September 2022.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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