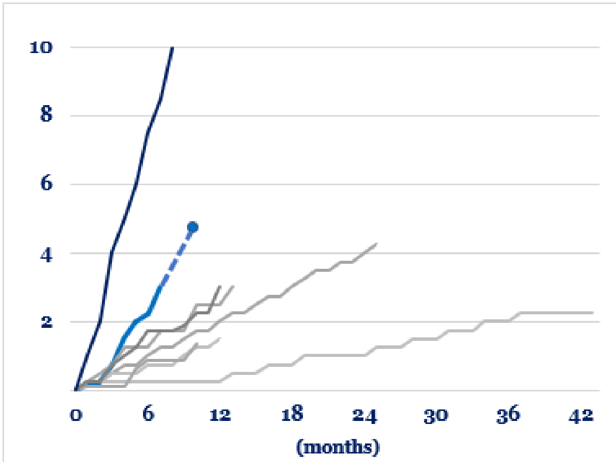
## Changing Dynamics in Emerging Markets

In the past, rising US interest rates and a stronger US dollar would have meant trouble for the Emerging Markets. As tighter financial conditions lead to a broad global slowdown, countries that have borrowed in US dollars would face heavy debt burdens, and a fall in risk appetite would cause investors to flee Emerging Markets. For example, in the early 1980s, the same monetary tightening in the US, which is receiving so much publicity today, was followed by a debt crisis in Latin America. A decade later in 1995, there was Mexico's tequila crisis. And in 2013, quantitative tightening by the Federal Reserve caused the "taper tantrum" panic, sparking capital outflows from Emerging Markets such as India, Indonesia and Brazil.

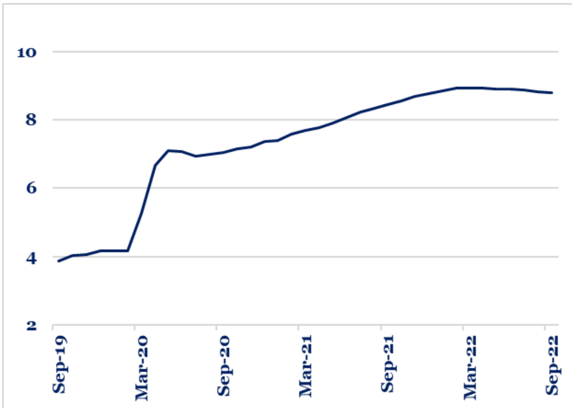
**Exhibit 1. Historical Interest Rate Increases in the United States (%)**




Source: Bloomberg, Federal Reserve

The magnitude of the current monetary tightening in the US is the fastest since the Volcker era in the 1980s (Exhibit 1). The Federal Funds target rate was raised 300bps between March and September of this year, and investors are expecting another 100-150bps by year-end, implying a target of close to 5%. And this does not account for the reduction in the size of the Federal Reserve's balance sheet as a result of quantitative tightening (Exhibit 2).

**Exhibit 2. Federal Reserve Balance Sheet (In Trillions of US Dollars)**

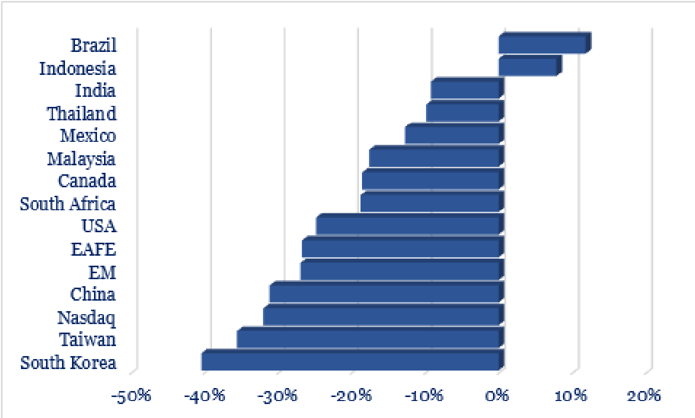



Source: Bloomberg, Federal Reserve

Given the magnitude and intensity of the current US monetary tightening, it is not surprising that the US dollar has appreciated rapidly with the US dollar index rising 18% year-to-date through September 30. However, what is surprising is that some of the Emerging Markets – especially those that were considered to be fragile in the past such as India, Indonesia and Brazil - are holding up (Exhibit 3). It is primarily because of the robust performance in these markets, that the MSCI EM index is faring better than one might expect. In the first nine months of this year, the MSCI

Emerging Markets index was down -27% (in USD) while the MSCI USA index fell -24.8% and the NASDAQ declined -32%. Meanwhile, Brazil and Indonesia have actually produced positive performance so far this year while India is outperforming.

**Exhibit 3. Performance by Region and Country (YTD through Sept 30, 2022)**




Source: Bloomberg

What is driving the Emerging Markets to perform better than they have in previous tightening cycles? First, the Emerging Markets index at 10.5 times next year's earnings is towards the low end of its range over the past 10 years. One could argue that the valuation is only as good as the denominator "E" or earnings. In Exhibit 4, we present sector exposure which shows that Emerging Markets have higher exposure to Materials, Energy and Financials. In particular, countries such as Indonesia and Brazil are benefitting from a strong demand for oil and metals. On the other hand, US equities and more specifically, the NASDAQ have a greater representation of Information Technology companies which have lagged partly due to high valuations. In addition, US technology companies generate 59% of their sales outside the US versus 30% for the S&P causing a bigger drag from the negative currency translation of the rising dollar.

**Exhibit 4. Sector Exposures**

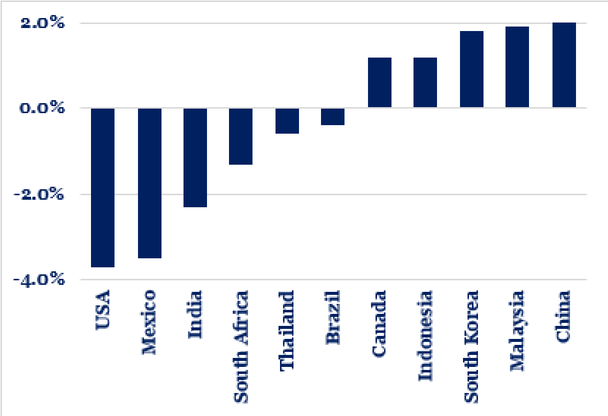
| | MSCI USA | MSCI EM | Difference |
|---|---|---|---|
| **Financials** | 10.8 | 22.6 | 11.8 |
| **Materials** | 2.6 | 8.7 | 6.2 |
| **Discretionary** | 11.7 | 14.0 | 2.3 |
| **Comm Services** | 8.1 | 9.7 | 1.6 |
| **Energy** | 4.5 | 5.3 | 0.8 |
| **Utilities** | 3.0 | 3.2 | 0.2 |
| **Staples** | 6.9 | 6.6 | -0.3 |
| **Real Estate** | 2.9 | 2.0 | -0.9 |
| **Industrials** | 7.9 | 5.8 | -2.1 |
| **Info-Tech** | 26.9 | 18.3 | -8.6 |
| **Health Care** | 14.9 | 3.9 | -11.0 |

Source: MSCI

Second, many EM countries were ahead of the US Federal Reserve in fighting inflation. Brazil started raising its Selic target rate in March of 2021 from 2% to 13.75% at present. Meanwhile, South Africa started tightening in November 2021, and has raised it 275bps to 6.25%. Furthermore, the target for policy interest rates at many EM countries never reached as low a level as in the developed markets thus the real effective interest rate was still positive. For example, the latest inflation data in Indonesia was 3.5% compared with the Bank Indonesia repo rate at 4.25%. As many Emerging Markets were already proactive in fighting higher inflation, they already felt the pain of higher prices last year. Meanwhile, the US and many developed countries adopted zero interest rate policies thus pushing real interest rates deep into negative territory and keeping monetary policy loose when inflation spiked to high single and low double-digit levels.

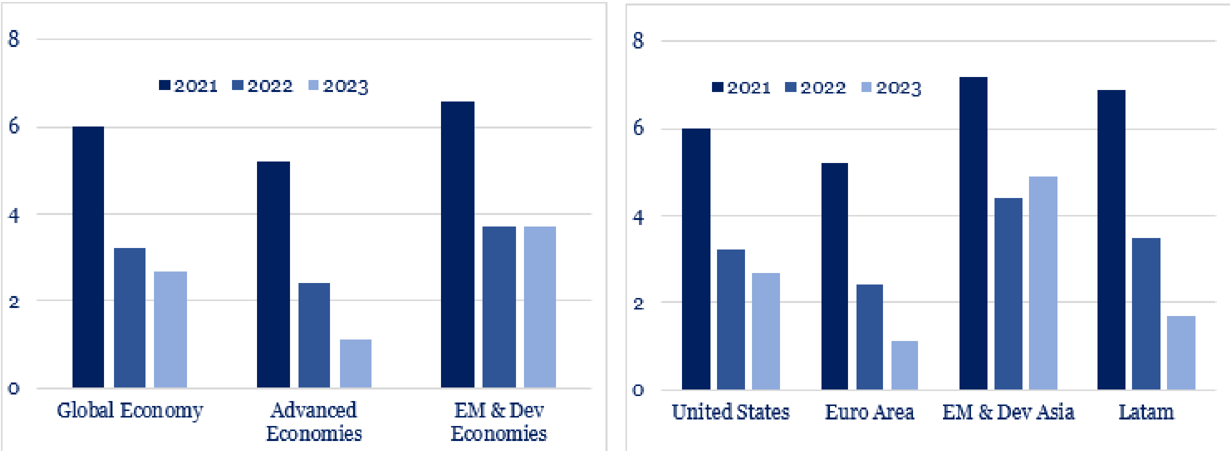
Lastly, the current account balance and foreign exchange reserves are healthier in many Emerging Markets than they have been in the past. At the end of June 2022, Brazil and India's current account balance was roughly -2% while South Africa, Indonesia, China and South Korea had surpluses. These countries also have enough foreign exchange reserves to cover at least 9-months' worth of imports, which is significantly higher than a minimum of 3-months.

**Exhibit 5. Current Account Balance**




Even though some of the Emerging Markets have defied gravity so far, one needs to be cognizant of the delayed effects of monetary tightening. According to the IMF, global growth is forecast to slow from 6% in 2021 to 3.2% in 2022 and 2.7% in 2023, marking one of the weakest growth profiles since 2001. Growth in advanced economies is expected to fall from 2.4% in 2022 to 1.1% next year while Emerging and Developing economies are expected to growth at 3.7% in both years. However, Developing Asia is expected to grow faster at 4.9% in 2023 driven by a pickup in growth in China to 4.4% from 3.2% while India is expected to maintain a solid pace at above 6% and almost 5% growth in ASEAN-5 (Thailand, Indonesia, Malaysia, Singapore and the Philippines).

**Exhibit 6. Global GDP Growth Projections (%)**




Source: IMF

There is also heightened geopolitical risk related to Russia-Ukraine war and a new era in China-US relations. In particular, investors have been spooked by President Xi Jinping having come out even stronger in his third term thus increasing the likelihood of adopting policies that are not market friendly. Nevertheless, with attractive valuations, robust current account balances and adequate foreign exchange reserves, Emerging Market fundamentals, especially in those countries that were historically considered fragile, look more robust today.