

Weighing The Emerging Markets

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Does the pullback of the last few weeks ring time on the rally that lifted emerging market assets and currencies from October to January? Or does it present an attractive entry point for investors who may have missed the first stage of a protracted period of outperformance that promises to stretch through the rest of 2023?

To determine the likely answer, it will help to weigh the forces that propelled the initial rally against those behind the pullback. Between late October and late January, the MSCI emerging markets index rose 25% in US dollar terms, handsomely outperforming the MSCI US index, which climbed just 4%. Behind this run-up were two principal forces: (i) hopes for a “pivot” away from policy tightening by the US Federal Reserve, which would lead to easier US dollar financial conditions and a softer US dollar against emerging market currencies; (ii) expectations that Beijing’s abandonment of strict Covid controls would lead to a vigorous rebound that would boost China’s demand for exports from other emerging markets.

As a result, investors poured money into emerging markets, with the Institute of International Finance estimating net portfolio inflows of more than US\$65bn in January alone.

Since the end of January, however, hopes of an early halt to US rate rises have given way to expectations that the Fed will tighten further and be slower to cut. Meanwhile, investors have refined their view of the Chinese upturn, which is likely to be driven mainly by consumption and services, rather by surging investment like previous Chinese rebounds. In response, the US dollar has regained ground against emerging currencies, and the MSCI emerging markets index has given back -4.5%, pulled down a by -8.7% fall in the MSCI China index.

So, where does this leave us? Were earlier expectations of emerging market outperformance misplaced? Or do they still hold good, despite the pullback?

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
Eurozone construction output fell -2.5% MoM in Dec , versus -0.1% in Nov	N/A; YoY, construction output fell -1.3%, versus 1.6%	Builders hit by high material and labor costs and rising interest costs; activity will stay muted
Eurozone consumer confidence index rose to -19.0 in Feb , from -20.7 in Jan	As expected	Confidence still depressed; likely to pick up up as inflation falls
Indonesia's current account surplus widened to US\$4.3bn in 4Q22 , from US\$4.5bn in 3Q	Wider than US\$4.2bn expected	External surplus at historic high; provides buffer for Indonesian assets
Taiwan's export orders fell -19.3% YoY in Jan , versus -23.2% in Dec	Less weak than -24% expected	Supported by demand for communication products, which returned to growth

First, China. Policymakers are not ramping up stimulus on the scale of 2009 and 2016. But they

are aiming to support the recovery, especially in the property sector. This implies support for global commodity demand, with a potential upside kicker for prices as increased Chinese oil demand puts upward pressure on global energy prices, and by extension on prices across the commodity complex.

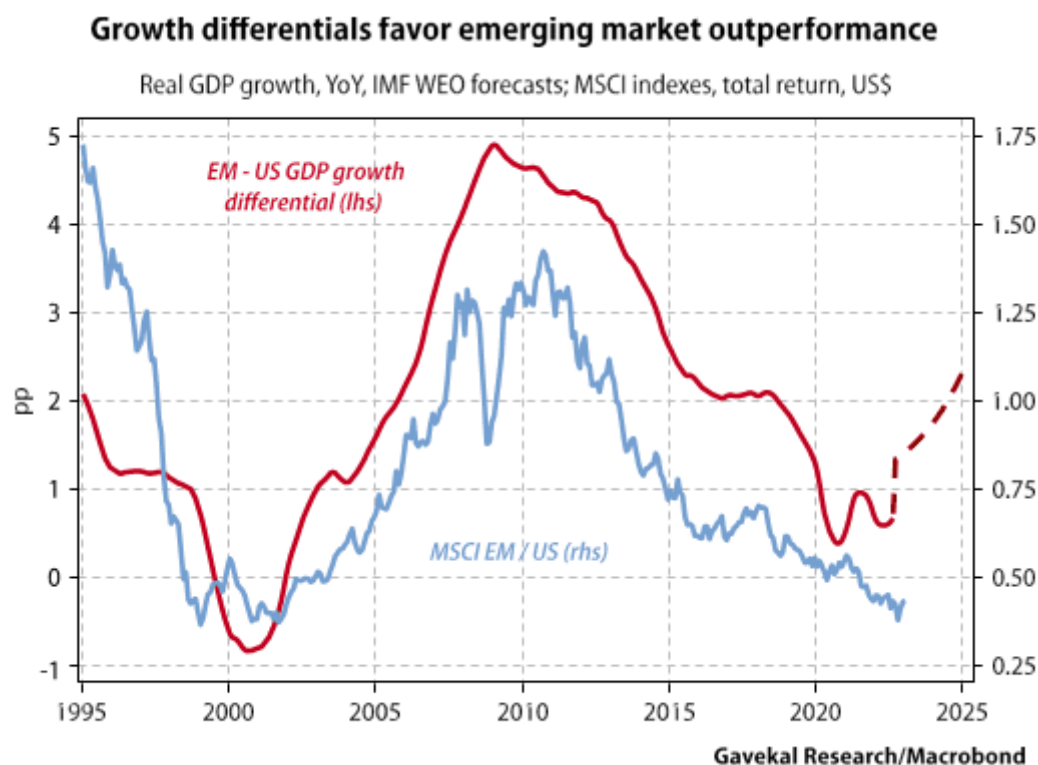
Meanwhile, the return of Chinese spending on outbound tourism, which could rise by US\$100bn in 2023, will disproportionately benefit emerging markets, especially in Asia.

Next, the US. There is intense debate—including within Gavekal—whether or not the US is heading into recession. A US recession would be negative for global final demand, which all else equal would weigh on emerging market growth through the trade channel. But all else is seldom equal, and the main influence of the US on emerging economies is not through trade but through the financial channel.

Here the big risk for emerging markets is that continued aggressive rate rises by an overly-hawkish Fed propel another sharp rally in the US dollar, further tightening financial conditions for emerging economies. However, with the Fed acknowledging that “a disinflationary process has started” few investors are looking for more than another 50bp of US rate hikes in the near term.

With the US dollar richly valued by historical standards, a halt to US rate hikes over the coming months implies a softening of the US dollar and easier financial conditions for emerging markets. This will allow emerging economies which were early to tighten policy—notably Brazil and Chile—to compound the beneficial effect with domestic rate cuts.

The balance of forces therefore is still likely to net out as positive for emerging market growth relative to developed markets. And historically, that has been bullish for emerging market assets. The pullback is a buying opportunity.



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