

Focal Point

EMs: a positive narrative amid headwinds

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Our Focal Point series explores topical issues on macro, markets and investment

- EM countries have faced multiple shocks year-to-date leading to dismal performances. EM fragilities have increased, leaving frontier economies vulnerable to more defaults. However, large EMs show sound fundamentals, and we do not expect systemic contagion.
- Despite the shocks, EM growth has been surprisingly resilient, and the EM narrative is turning more positive as the peak Fed Fund rate gets closer (1Q23). The latter will support a short-term rally, though concerns could still shift to recession risks.
- Historically, EM assets perform well after the Fed peak rate but US recession risk can drive higher risk premium. That said, the reopening of China will boost EM manufacturing and to a lesser extent commodity exporters' countries, thus attracting investors' interest and supporting market prices.
- Across EM fixed income, EM rates will benefit the most into a Fed pivot (rate cut in 4Q23). We will cautiously initiate receiver positions in LatAm front-end rates. For EM sovereign credit performance, a strong positive duration effect and large carry will lead to positive total return even if spreads can re-widen into the recession. We dislike European countries that should be the first to enter a recession, and where real rates are still deeply negative.
- For EM equities, headwinds over the last year emanated from the global economic weakening, a stronger US dollar, higher inflation, and tighter financial conditions. In the very short term, such negative factors will partly linger.
- By the end of Q1, we see higher chances for a better EM relative earnings momentum and expect the dollar to continue consolidating. Both would contribute to the next outperformance cycle of EM versus DM equities. Indeed, based on our historical analysis, EM equities seem to be well positioned once the Fed Fund rate peak is past. Low valuations are an additional positive factor. We see higher potential for China, India and Korea, whereas Brazil, Hong Kong, Mexico, and Saudi Arabia are relatively less attractive.

EM fixed income and equity assets have been weakening since the onset of the Fed tightening cycle, hit by the rise of global real rates and the USD strengthening. Several small EM countries face severe refinancing risks, and many headwinds remain. However, EM growth has been surprisingly resilient, and the narrative has positively changed. EM assets performed strongly before the October Fed FOMC, and the recent downside US CPI surprises give further impetus. Likewise, ending the Chinese Zero Covid policy provides hopes for more robust EM growth.

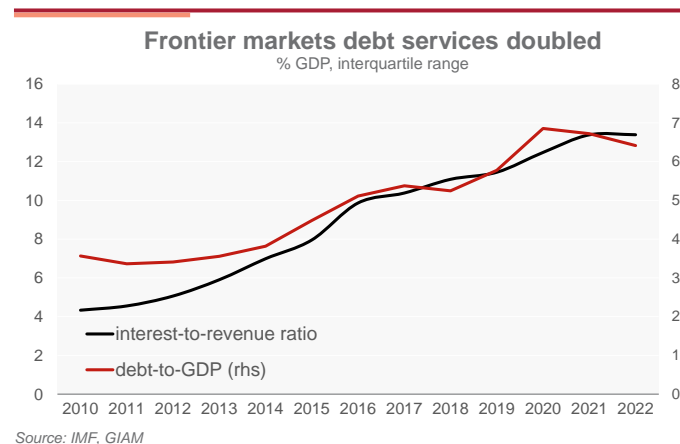
The US hiking cycle is still the dominant force, but its impact gradually fades as the tightening cycle comes closer to its end. Into next year, the Fed fund rate will eventually peak (Q1), and the US dollar strength should lose steam further, opening the doors for a much more supportive EM environment. All EM assets are not equal and will not benefit in the same way. If history is any guide, the Fed peak cycle could be followed by a recession that would be detrimental to EMs. While waiting for more economic data, uncertainty is still high, but the environment is becoming increasingly supportive with positive and more asymmetric risks. In this Focal Point, first, we will monitor the current vulnerabilities faced by EMs and identify the weakest spots. Second, we focus on what could happen to EM assets should the Fed pivot and China re-opens. Finally, we look at the current opportunities and risks across EM fixed-income assets and EM equity markets.

EM vulnerabilities: Higher refinancing risks for frontier countries but no systemic risks

EM countries have been hit by the combination of rising US interest rates, the USD strengthening, and significant portfolio outflows year-to-date, leading to growing refinancing risks. This tightening of global financial conditions is coincidental with the rise of EM debt since 2013, which has reached all-time high levels, fuelling debt vulnerability concerns. Indeed, the number of distressed countries in the main EM bond index is close to 18 or a quarter of the EMBIG index. Rating agencies have, on average, rated 25 countries in the CCC bucket, the highest-ever level. EM defaults/restructurings have risen, reaching 6.9% of the EMBIGD weights in 2022 (including Russia). Given the high number of distressed spread countries, we would expect more defaults or debt restructuring in 2023.

During the last decade, characterized by low yields, EM government debt rose by 26 ppt of GDP to 65.1% and accelerated sharply during the pandemic, jumping by 10ppt according to the IMF. It stabilised in 2022 on the back of high inflation. However, on average, EM

countries are still running large fiscal balances, and the positive impact stemming from inflation will be hard to repeat in the coming years. The IMF forecasts a further rise to 78.5% for the same ratio in the next five years, driven mainly by China.

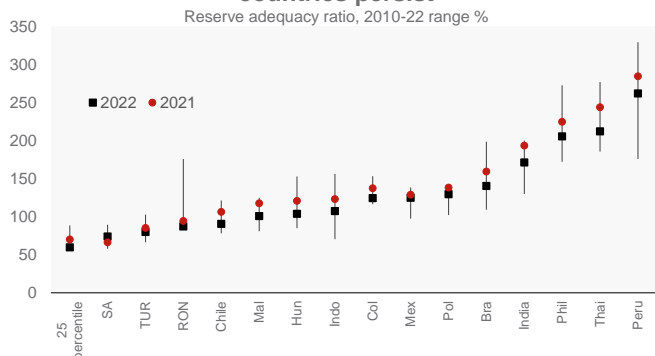


External debt has been growing slowly since 2015 and is even due to a decline in 2023. However, the balance of payment vulnerabilities has been deteriorating. According to the IMF, reserve adequacy ratios have deteriorated globally. EMs central banks have been using FX reserves to lean against USD strength, even in the most stable countries (e.g., South Korea, Romania, Chile, and the Czech Republic). In addition, the recent EMs' growth resilience has been at the expense of the depletion of domestic private savings cushions and larger fiscal gaps, leading to wider CA deficits on average.

As global financial conditions get tighter, investors will focus on future fiscal policy and external imbalances. The problem is that most EM countries are forecast to see wider twin deficits in the next five years. Current account balances or external imbalances due to rigidities are not expected to improve meaningfully. On the fiscal front, the higher marginal interest rate and worse balance sheets will limit the room to maneuver. Thus, the interest-to-revenue ratio will keep increasing.

That said, there are silver linings, and we believe that the risk of a systemic crisis is low and has barely increased in 2022, in our opinion. Frontiers markets are the most at risk, and we are seeing a growing fat tail distribution with large safe EM countries on the one hand and small and weaker countries on the other.

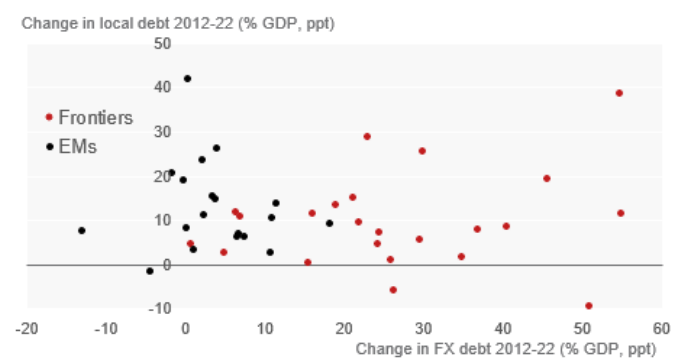
Reserves are healthy but deteriorated. Weak countries persist



On the one hand, large EM countries have been more insulated from global market negative sentiment than in 2013. Indeed, they reduced their external debt funding via external debt by increasing local currency debt. Besides, the share of foreigners in the local debt market has declined further, providing some insulation to global risk sentiment.

On the other hand, the situation is different for frontier EM countries that have relied more on foreign currency funding and whose external debt has continued to increase, especially in African countries. FX reserves levels appear to stand healthy, provided by the SDR boost in 2021. Still, the buffers have been deteriorating, and the lowest-rated EM countries continue to exhibit weak ratios. These countries have a small external refinancing gap, close to USD 1 bn, but they face poor prospects for market access.

EMs issue more local debt, Frontiers rely on FX debt



Market access has already been difficult for the lowest-rated countries, albeit easing recently. In this environment, with a higher marginal interest rate, the risk of debt unsustainability is growing, and the default risk is too. Again, it is frontier economies that are at the forefront of concerns. Fortunately, redemptions and amortizations will be low in 2023. Egypt represents the

most significant share, but under an IMF program, a default is unlikely. El Salvador just did a buyback. The outlook is more complicated afterward, with growing redemptions and higher marginal interest rates that will deteriorate debt sustainability. According to the IMF, redemptions for frontier economies will peak in 2026/27.

Slower economic activity but a faster-than-expected Chinese grand reopening

Despite the recent better inflationary outlook, EMs remains vulnerable to the global economic slowdown, especially in the context of a global tightening of financial conditions. While concerns have been focused on global inflation and the Fed peak rate, they could shift to growth concerns in the medium term. If history is any guide, the Fed peak rate tends to be followed by a recession in the next twelve months.

Even if EM growth has been resilient so far, the sum of early EM tightening initiated in 2021 and DM central banks tightening in 2022 will increase, weighing on EM GDP as we move through 2023. Thus, sub-trend growth in EM countries is expected to remain in 2023.

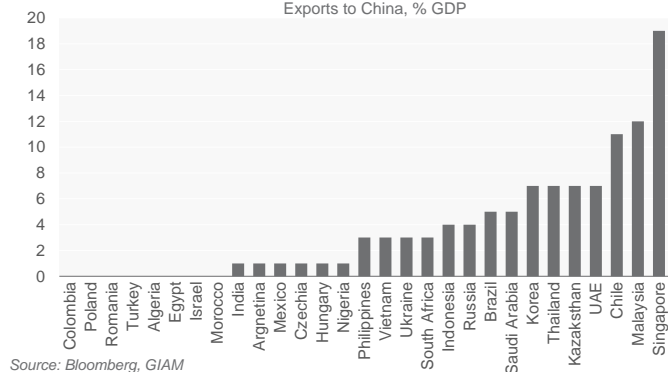
Indeed, EM global growth after a rebound in 2021 to 6.0% is expected to decline to 3.2% in 2022 and 2.7% in 2023, according to the IMF. Growth is due to a decline in all regions but the Middle East. The DM-EM ex-China growth gap is expected to narrow further, reaching around 1ppt of GDP in 2023.

Within a context of high uncertainty, EM manufacturing and commodity exporters will likely be the most vulnerable. The positive commodity price rebound seen in 2022 will hardly repeat and fade in 2023. The fate of EM manufacturing exporters could slow more than consensus expects. Global trade has indeed exhibited growing signs of a slowdown with lower freight prices, and the IMF is expecting world trade volume growth to decline to 4.3% in 2022 and 2.5% in 2023 from 10.1% in 2021. In this respect, both North Asian and CEE countries should be affected. Likewise, commodity exporters like Chile could be on a back foot, as copper is highly plugged into the global cycle. Instead, Mexico will suffer from the US deceleration but could benefit from the near-shoring trend in the longer run.

Beyond that, China's growth will provide welcome support and participate in the more positive EM narrative. The latest Politburo meeting has paved the way for a swifter-than-expected reopening. Arguably, the risk is that it will lead to a rise in cases in Q1, but ultimately it creates more upside economic risk in the medium term and alleviates one of the headwinds faced by EMs. We still expect growth to accelerate meaningfully to 1.8% in 2023 from 2.6%. Still, the latest

inflections of the Zero Covid Policy and consistent measures to support the real estate market could help to boost investors' sentiment and put a floor to the downside of Chinese growth. Nevertheless, the growth rebound will likely not be V-shaped: domestic demand will take time to respond, and consumer sentiment remains precarious. North-Asian countries and some LatAm economies will benefit the most in Q2-Q3, but the impact will not be disruptive for global EM growth as it should boost more services than exports/imports of goods.

Exposure to China reopening
Exports to China, % GDP



Source: Bloomberg, GIAM

Fed pivot: EM markets are an early play for re-risking but mind the recession in the medium term

EM assets have been resilient since early October, even before the well-received October US inflation surprise. EMBIGD spreads tightened by 100bp since October; EM FX strengthened by 3.6%, while the EM MSCI index rebounded by 10.2%. The hawkish rhetoric of the October FOMC hardly altered their resilience. Instead, the downside US inflation surprise provided further support, cementing the positive EM performance. It further fuels the narrative on the Fed pivot and shifts the focus on what happens after the Fed peak rate.

The past tightening cycle provides some views on the potential EM assets' performance, even if the sample is small, and all past tightening episodes have their own particularities. For example, in 1995 and 1997, EMs crises were numerous as markets were not mature and FX regimes were pegged. On the other hand, in 2000, EMs benefited extensively from the super commodity cycle and, to a lesser extent, in 2006, before the GFC two years later. In our view, the most comparable period to the current situation is 2018, but at that time, the recession was slow to materialize. An unexpected and exogenous shock then triggered it.

Based on the 2006 and 2018 cycles, EM fixed income assets performance is negative and close to flat only before the Fed rate peak. Local debt unhedged and EM

corporate credit tend to outperform. Post-peak, all assets performance is positive, and again, local debt unhedged is the best performer, followed by EM sovereign credit.

EM assets performance during past Fed hiking cycles

Months before/after last hike	1994					1997					2000					2006					2018									
	-6	-3	3	6	12	-6	-3	3	6	12	-6	-3	3	6	12	-6	-3	3	6	12	-6	-3	3	6	12					
DX	-4.2	-3.6	-3.9	-0.4	0.4	-7.2	-7.0	1.0	2.5	7.2	-6.2	-2.6	4.1	0.8	9.9	4.5	1.1	1.0	-1.8	-3.8	-1.8	-2.2	6.4	10.4	11.4	-1.8	-1.1	1.2	0.0	0.2
EMBIGD	-13.2	-12.9	17.2	23.1	41.9	8.2	0.3	9.1	16.3	16.5	-1.8	-2.2	6.4	10.4	11.4	-1.8	-2.2	6.4	10.4	11.4	-1.8	-2.2	6.4	10.4	11.4	-1.8	-2.2	6.4	10.4	11.4
CEMBI											-1.1	-0.6	4.9	7.6	9.9	1.3	0.0	5.2	8.8	13.1										

Source: Bloomberg, GIAM

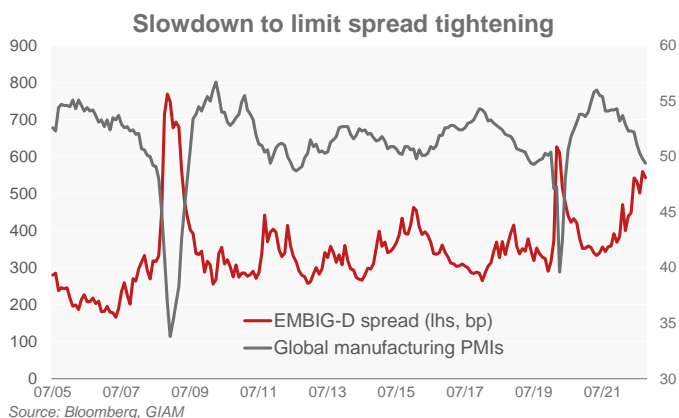
One of the most significant peculiarities of the current cycle is that EMs have already corrected sharply, and portfolio outflows have already been substantial before the peak rate. In our view, we are in a sort of transition period when the EM assets perform on the relief of the Fed's less hawkish stance. The only perception of a less hawkish Fed rhetoric and the idea of an upcoming Fed peak rate is enough to lift EM sentiment, at least temporarily. As time passes, the probability of a Fed peaking rate will technically increase, and the EM outlook will turn more positive. The last hike should be the all-clear signals to add EM positions. More favorable market technicals will support a more robust EM assets' performance than in the past Fed tightening cycle.

EM fixed income: Positive return but spreads to widen with the recession risk

The narrative has turned more supportive for EMs with the ease of US inflationary pressure, the less central bank's hawkish stance, and more positive Chinese news flow. It opens the possibility for a continuation of the EM FI assets rebound. Everything is not yet clear, but EM FIs have already experienced max drawdowns similar to the previous EM crisis. That said, we will distinguish with the medium-term outlook where the risk of US and European recessions will ultimately weigh negatively.

Based on history, we will prefer EM local debt over external debt, initiating receiver positions cautiously, especially in LatAm, where real yields are high. In LatAm, the BCB tightening is coming to an end but given fiscal risk, we focus on the front-end. Peru and Chile are close to the end of the tightening cycle. We will be prudent in Mexico as Banxico will remain the steps of the Fed. In Asia, central banks have started late their hiking cycle, and the end is not yet in sight. In EMEA, recession

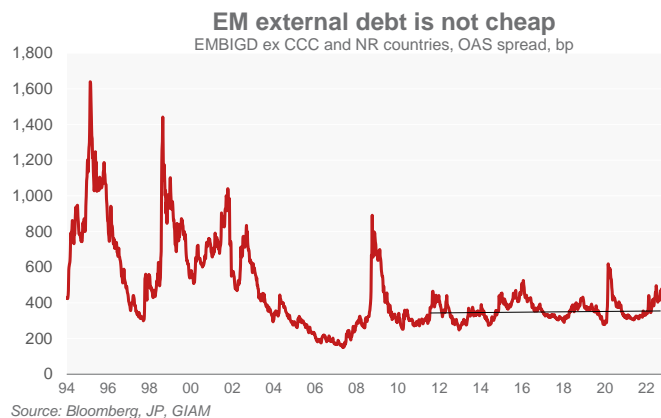
risk coupled with still inflation due to high energy prices will likely favour flatteners. Receivers are attractive given the recession risk and the less hawkish central banks' stance. However, real rates are still deeply negative.



For EM sovereign credit, we need to distinguish the positive total return provided by a significant carry and duration effect and the more benign outlook for spreads. EM spreads have already tightened, and there is room for more tightening until the Fed peak rate. However, we see two caveats leading to a more challenging H2. First, spread performance will remain limited as long as global financial conditions and real rates do not ease meaningfully. This is because OAS spreads tend to be highly correlated with US financial conditions and real yields. Second, the heightened recession risks will likely trigger a proper Fed pause in Q2/Q3. It is a scenario where EM spreads do not perform well and will widen again, albeit probably less than the highs seen in 2022. The silver lining is that the US rate selloff will lose steam in all scenarios, and the bulk of the negative duration effect is likely behind us.

Moreover, despite this year's selloff, EM spreads are not cheap from a historical point of view. The numerous distressed names distort EM bond indexes. Nearly a quarter of the EMBIGD index is at distressed levels, and half of the index spread widening has been driven by CCC names. EM spread ex-distressed countries is close to its long-term average, suggesting that the risk premia is not high.

At the rating level, we favour BBB and BB buckets. Initially, EM HY should globally outperform even the weakest names benefiting extensively from the risk-on environment. However, afterward, the recession risks and spread widening will be detrimental to B and lower-rated countries. There are too many idiosyncratic stories in distressed countries that will not disappear rapidly. EM HY return usually underperforms when US nominal yield declines while IG outperforms.



On the IG side, the highest-rated countries have been expensive, with spreads currently close to their tightest levels. Given their rich valuations, they could be disproportionately affected by the spread widening. The positive is the longer duration of the IG segment that will benefit from the US rate stabilisation/decline in a recessionary environment. Hence, we prefer the BBB bucket.

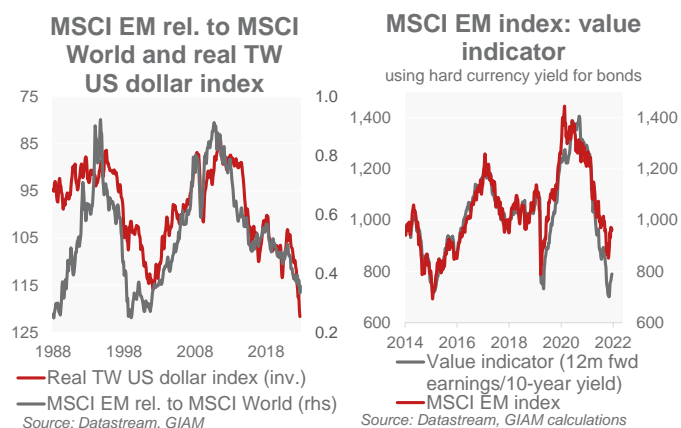
Region-wise, European countries will continue to underperform, likely entering first into the recession and still at risk of being hit by higher energy prices. Middle East IG and HY names are rich, but it could benefit from stable oil prices via the China reopening and their longer duration than the EM average. We would prefer LatAm and Asia, though Asia should fully benefit from the Chinese reopening only in Q2. The reopening will be gradual, and so the effect will be protracted.

Within the equity universe China looks quite attractive

Over the last year, global economic weakening has weighed on EM, along with a stronger USD dollar (+10.0%), higher inflation, and tighter financial conditions. EM yields have increased by 350 bps and EMBI spreads by 73 bps. As a result, EM equities have been on a downward trend, losing since the middle of 2021 around 30% of their value, which is 20pp more than their developed peers. In China, stocks have been under pressure due to weaker local growth (partly caused by zero-Covid policy), woes in the overheated Real Estate sector, and a regulatory crackdown on education and technology companies. All these factors have contributed to lower earnings growth, which has been the main driver of the underperformance vs. MSCI World.



As a result of this underperformance, EM equities now trade at a significant discount to developed market stocks. Thus, EM multiples are now at a discount of 17% vs. their history, while MSCI World trades at a premium of +13%. Moreover, using the Shiller PE (cyclically adjusted price-to-earnings ratio, which adjusts ten years of earnings for inflation), EM stocks look pretty appealing from the longer-term perspective as they trade at a discount of around 40% vs. MSCI World. However, more near-term metrics do not look as compelling: in terms of conventional PE, EM equities look fairly valued vs. the developed one, and the PEG ratio (PE divided by long-term earnings growth), further adjusted for COE/ROE (which signals the ability to produce a return on capital higher than the cost of it) is about 1.82, with Japan's and EMU's ratio being on par at 1.8, UK's one 1.5 while only the US ratio is less attractive at 2.1.



In the short term, EM equities will be pressured by deteriorating financial conditions and weak macro surprises. While the yield advantage (vs. the US) looks favourable, global trade/ manufacturing will continue contracting in the next 4-6 months, thus representing headwinds for EM earnings.

Furthermore, our value indicator indicates overvaluation,

justifying our neutral stance, which we have recently upgraded from UW. That said, after dragging on EM assets over the past quarters, a weaker USD will gradually turn into a tailwind.

In our analysis of the possible reaction to Fed easing, we started with the evaluation of the market's reaction to the Fed's easing cycles since 1989 (historical series limited by the availability of EM prices). Brazil, India, Indonesia, and Korea used to outperform the other EM markets in the first three months after the start of the easing cycle. China's outperformance was more modest.

We also look at the current value gap (defined as 12-month earnings / 10-year government bond rate minus the market's price) for each EM market and take signals from our quantitative models, which are based on machine-learning (ML) approach, into account. Additional considerations are correlations with US yields and the US Dollar index (DXY). As yields would fall and USD would become weaker, markets with negative correlations with these two variables should benefit.

China's, HK and South Africa's equities typically outperform MSCI EM when US yields fall, while the Brazilian market seems to be at a disadvantage. As to DXY depreciation, it has been historically positive for Chinese and Korean equities.

Markets	Shiller PE, discount	Value Gap using Fed model (Fair V. - Price)	Exp. TR = DY + next years' EPS growth	PEG adj *	rel. perf. - 6M (TR)	rel. perf. - 12M (TR)	Country Score (lower = better)
Brazil	-15%	-18.4	11%	1.54	5.3	23.6	34
CHINA	-43%	9.5	16%	1.26	-6.5	-12.3	9
CHINA (A-shares)	-42%	14.0	15%	1.40	4.4	6.8	6
HONG KONG	-24%	-14.1	11%	4.08	-3.3	3.7	38
INDIA	27%	-14.1	18%	1.95	18.6	26.7	39
INDONESIA	-15%	-38.6	19%	1.66	8.7	31.4	23
KOREA	-25%	20.9	6%	2.98	-5.1	-6.3	35
MEXICO	-25%	-34.0	16%	2.24	7.9	21.2	29
SAUDI ARABIA	5%	12.8	14%	2.32	-15.0	10.2	42
SOUTH AFRICA	-16%	-33.6	16%	1.70	11.4	24.5	27
TAIWAN	3%	20.3	12%	1.42	-3.9	-1.3	17

Note: Shiller PE: Price earnings ratio based on average inflation-adjusted earnings from the previous 10 years. Fed model is based on 12-m fwd earnings / 10-yr gov't bond rates. PEG is PE divided by expected EPS long-term growth. PEG adj. (higher = expensive) PEG is modified by the ratio COE/ROE, which signals the ability to produce a return on capital higher than the cost of it. Country score is derived from valuation (80%) and the average relative performance (20%) (which considers 6m and 12m relative performance of each market vs the MSCI World).

The table below summarizes the signals from our ML models and correlations with US 10-year yields, the US dollar index (DXY) and the MOVE index, which measures US interest rate volatility. It should be noted that the correlations with the DXY seem to be the most significant.

Markets	corr w/ US 10yr ylds	corr w/ DXY	corr w/ MOVE	Z-score (ML) *
Brazil	19%	-2%	11%	2.6
CHINA	-12%	-11%	-5%	-2.0
CHINA (A-shares)	-9%	17%	8%	0.1
HONG KONG	-10%	3%	-18%	n.a.
INDIA	4%	9%	15%	-1.1
INDONESIA	-4%	14%	6%	n.a.
KOREA	18%	-11%	-18%	0.3
MEXICO	6%	14%	8%	2.4
SAUDI ARABIA	25%	16%	6%	n.a.
SOUTH AFRICA	-6%	11%	6%	1.2
TAIWAN	-3%	5%	-3%	0.0

Note: Z-score from our quantitative models based on machine-learning (ML) approach, levels below -2 indicate significant undervaluation.

According to the overall assessment, EMs seem well positioned once the Fed Fund rate peak is over. Low valuations are an additional positive factor. We see higher potential for China (both international and domestic A-shares), India and Korea, whereas Brazil, Hong Kong, Mexico, and Saudi Arabia are relatively less attractive.

For China, additional tailwinds are making their equities more appealing. Thus, in a recent meeting of the new Politburo Standing Committee, it was decided to continue with the "dynamic zero" response. Still, members urged local officials to carry out the reaction in a more targeted manner to limit the spread of the virus to avoid damage to the economy. This may be seen as a precise inflection in China's policy on Covid. Chinese regulators announced an extensive package to bolster the troubled real estate sector financing. China's rescue package to bail out its real estate market is detailed in a 16-point playbook for finance officials across the country. It lays out multiple financing measures for the real estate industry. Going forward, this latest newsflow related to the change in China's Covid policy and the larger extent of the real estate sector's support are likely to continue affecting investment sentiment positively.



Additionally, the Chinese equity markets should benefit from China's improving credit impulse and bottoming leading indicators. Lastly, compared to relatively high inflation in the EM universe, China's benign inflation also supports Chinese equities. However, among the risks, we see prolonged spikes in Covid cases caused by too rapid 'zero-COVID' exit. This could overwhelm China's healthcare system and affect social stability as well as propensity to spend. Escalating geopolitical tensions (relevant both for China and Taiwan) is still another risk. Overall, we remain OW on China in a mixed equity portfolio but are getting a bit more cautious after the recent big rally.

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