EMERGING MARKETS:
AN EVOLVING LANDSCAPE

MARTIN CURRIE
A Franklin Templeton Company

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For institutional investors in the US only

THE US

US HEADWINDS ARE EXPECTED TO EASE

As the landscape within Emerging Markets (EM) continues to shift and adapt, we believe the possibility of EM's positive returns appears promising. In this report, we highlight how the changing tides in US policy and macroeconomics may favourably impact the EM asset class.

- Core inflation has stabilised
- Policymakers have signalled that rates have peaked
- US dollar is expected to weaken following rate cuts

The US backdrop is increasingly favourable for EM investors

As can be seen in the chart below the Consumer Price Index (CPI) continues to fall. This signals the stabilisation of inflation levels. The high rates environment which was merited to manage inflation will no longer be needed, so we anticipate yields* to follow the same trend as inflation and decrease.

US headline CPI compared to US 10-year treasury yields

Source: FactSet as at 31 May 2024.

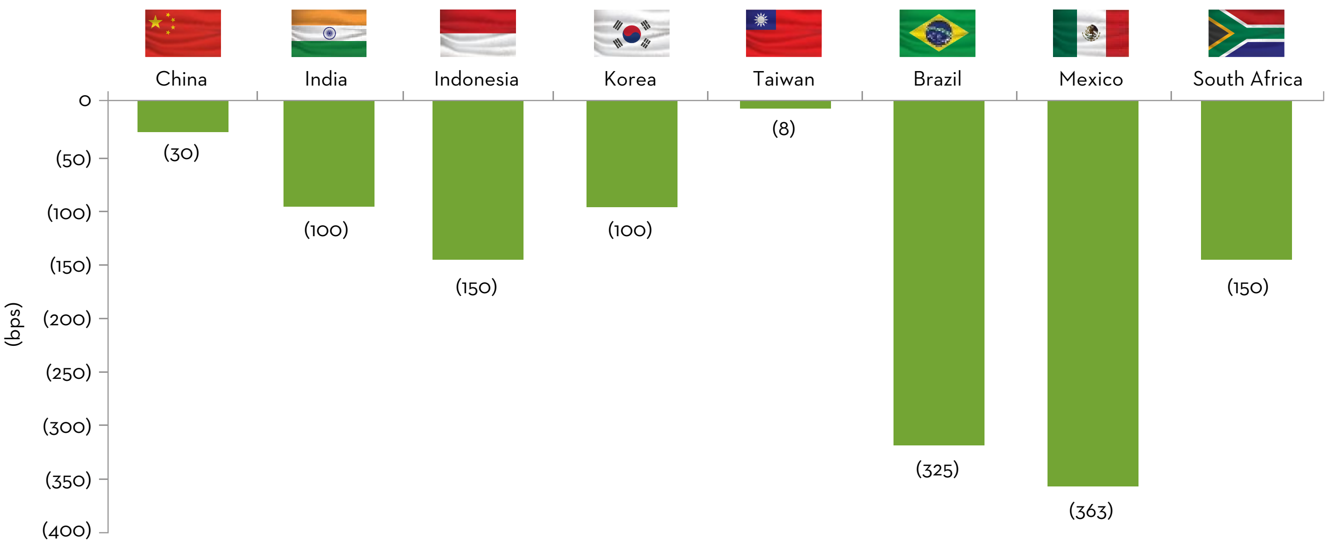
*Yield refers to how much income an investment generates, separate from the principal.

"The high rates environment which was merited to manage inflation will no longer be needed"

The peaking of US interest rates and the anticipation of rate cuts from the Federal Reserve[1] (and other developed nations) have the potential to turn the tide for investors' style preference and in their developed vs. emerging market allocation. Rate stabilisation and decreases in 2024 could also provide a boost if it leads to a weaker US dollar. Once the US establishes its first rate cut, we expect that other global policymakers will respond, including many in emerging markets.

Broadly speaking, policy rates should become more accommodative in emerging markets. In addition, EM economies have been more disciplined in the post-Covid era with superior monetary and fiscal discipline. From a big picture perspective, most significant emerging economies are expected to have some form of policy rate cut. We highlight those of major economies in the chart below. Of the largest index countries, eight are expected to cut rates over the next two years: China, India, Indonesia, Korea, Taiwan, Brazil, Mexico and South Africa. These countries alone account for around 85% of the index and with the addition of the Middle East this increases to over 90% of the index.[2] A lower rates environment should stimulate domestic spending and boost EM economies, which would be positive for equity markets.

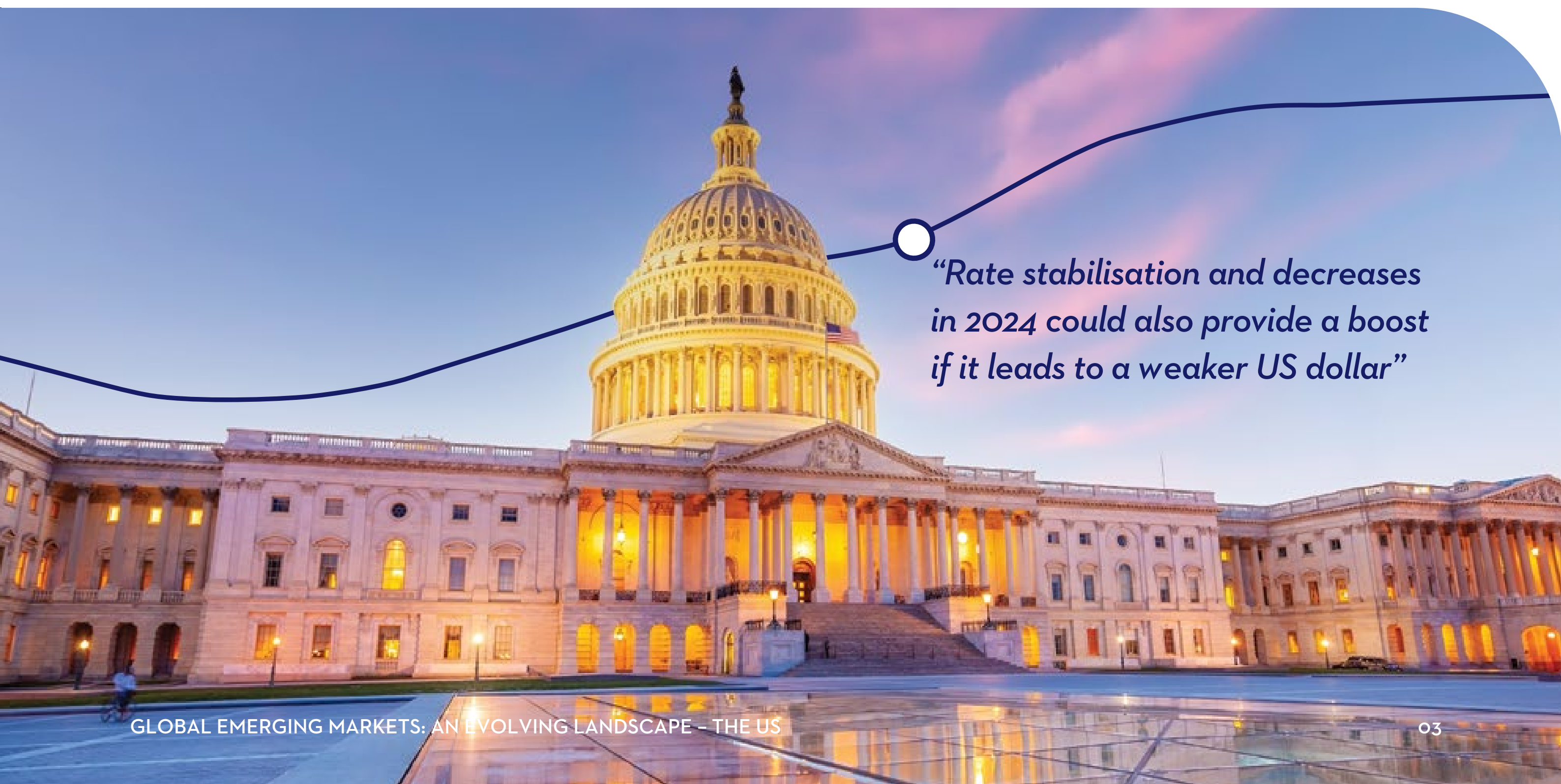
Large EM economies forecasted to cut rates over the next two years



Source: FactSet. Consensus projected rate change over two years (2023-2025), as of January 16, 2024.

[1]Financial Times, https://www.ft.com/content/862f14fd-da31-4e38-8404-e70904a8fd4b

[2]Source: FactSet, May 2024.



"Rate stabilisation and decreases in 2024 could also provide a boost if it leads to a weaker US dollar"

With the Federal Reserve fund target rate expected to fall over the next few years, we believe this will add to US dollar headwinds. Macroeconomic factors such as a surging federal debt levels and increasing fiscal deficits may add to US dollar weakness as well as the potential shift of allocation from US dollar assets to non-US dollar assets. Besides the overweight that allocators have to US equities, there are many other asset classes (such as Private Equity and Private Credit) which are largely dominated by US-domiciled firms and as such are predominantly US dollar-driven.

However, EM equities can also benefit from a strong US dollar environment. For export-dominated EM economies such as China, Korea, and Taiwan, a weak local currency is a net beneficiary to export economies (makes exports more competitively positioned). From a company perspective, there is also positive operational gearing. For example, for semiconductor companies in Korea and Taiwan, they often have local operations with local currencies and sell products to US clients in US dollars. This means that even in a weakening local currency environment, these companies and countries could see positive terms of trade and positive operating levers.

We think that a weakening dollar can support EM performance, given the widely-held belief that they are negatively correlated by market participants. We anticipate that this will remove a further headwind which EM economies have faced in recent years.

The first step in mapping the EM landscape

As we witness the beginning of an easing cycle, we expect that monetary policy in the US and in EM will be more accommodative of EM equities. The weaker US dollar, rate cuts and stable inflationary environment should also be more supportive of quality growth companies – the types of characteristics that we look for. Those companies with high returns on capital, strong balance sheets, and market leadership will be able to shine again. We believe that the baton will pass from value to quality growth in the next phase of inflation and interest-rate stabilisation.

"We believe that this more favourable US backdrop will be a crucial way for EM to break through to the next phase of its evolving journey"

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