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Global Macro Insights

Emerging markets: riding the disinflation wave

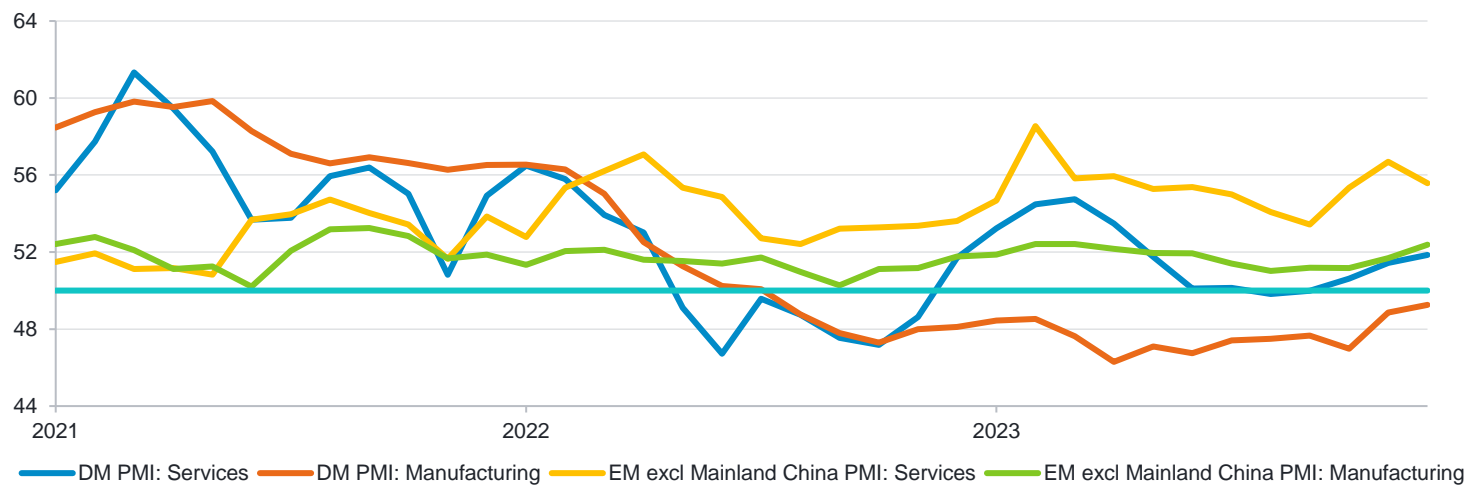
Fidelity's Global Macro & SAA team

The more benign inflation outlook in many emerging markets (EMs) means that they are further along in the economic cycle than many developed markets (DMs). Many EM central banks have the green light to continue (or start) cutting interest rates, which is presenting significant opportunities for tactical asset allocation.

The global economy is still surprisingly resilient. Soft data, including services PMIs, points to a rebound in global activity across developed and emerging markets (see Chart 1). Activity looks especially upbeat in EM (excluding China), especially India, Korea, and Brazil. Our proprietary Fidelity Leading Indicator, which includes a broad set of components, is also suggesting a re-acceleration of the global industrial cycle might be underway (see Chart 2).

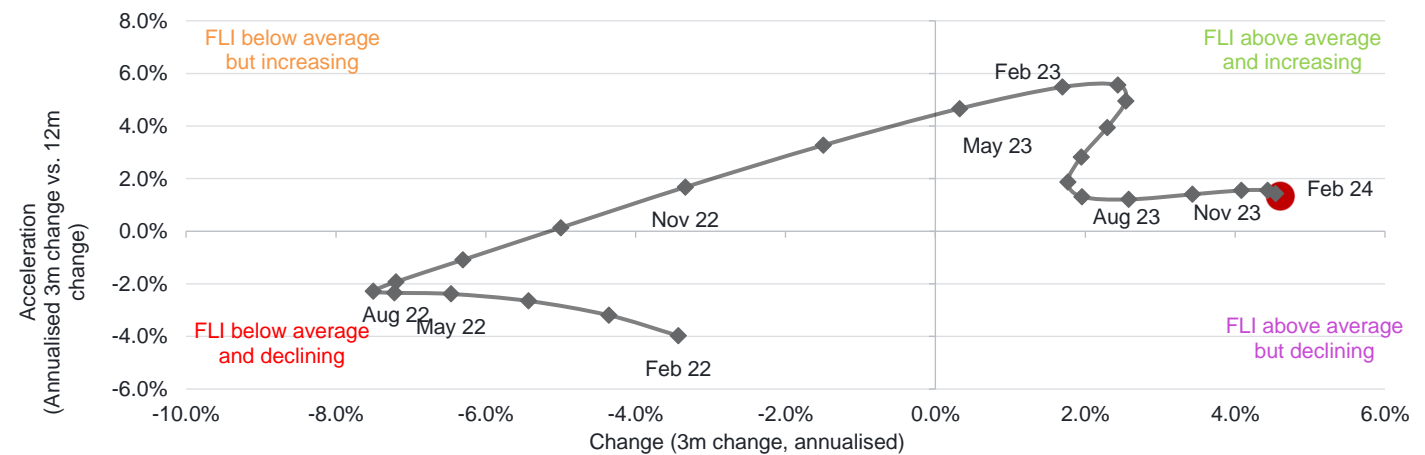
The resilience of EM economies is all the more remarkable given the unprecedented monetary policy tightening in DM and China's structural changes and disappointing recent growth. Facing rapid disinflation, many EM central banks have begun cutting rates or stand ready to do so, stimulating domestic demand. With the Fed's rate cutting cycle not far off and signs of stabilisation in China, the economic prospects of EMs this year look encouraging. But given the complex crosscurrents in place, we expect significant differentiation across countries and asset classes. In this paper we look at the key themes that will determine the winners and losers across emerging markets in 2024.

Chart 1: Global activity rebounds in early 2024, with India, Korea, Brazil driving EM uptick



Source: Fidelity International, Haver Analytics, April 2024.

Chart 2: FLI cycle tracker



Source: Fidelity International, FIL Global Macro Team calculations, Haver Analytics, April 2024.

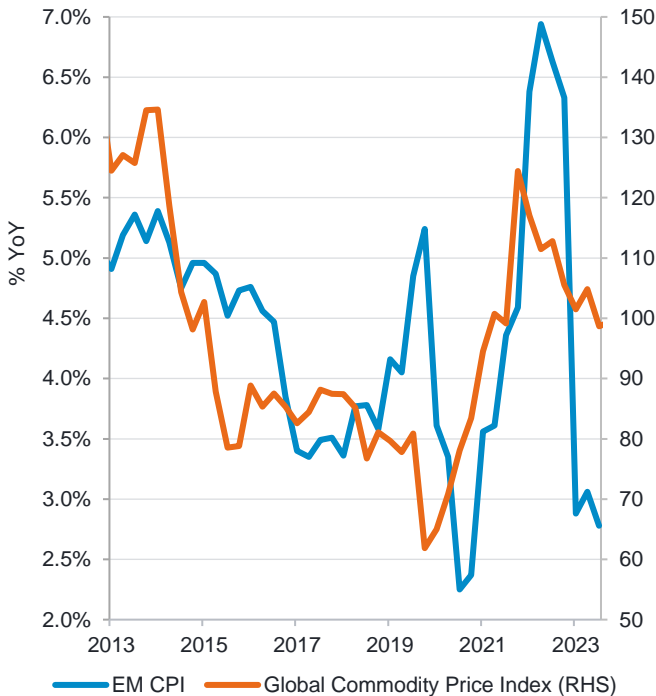
EM disinflation and the cutting cycle: first in, first out

EM economies overall delivered 4.6% real growth in 2023, and are on track to deliver 4.1% in 2024, according to Bloomberg Consensus. Vulnerabilities in EM fundamentals have in the past amplified the effects of US tightening cycles, as the so-called ‘taper tantrum’ demonstrated. However, internal and external imbalances, such as fiscal and current account deficits, have improved in many EMs, contributing to the recent macroeconomic resilience.

Easy fiscal policies since the pandemic have also helped EMs by counteracting tighter monetary policy. And while the economies most dependent on China’s demand for commodities, goods and services have been hurt by China’s recent travails, the pandemic re-shaped supply-chains and fragmented trade in ways that have mitigated this.

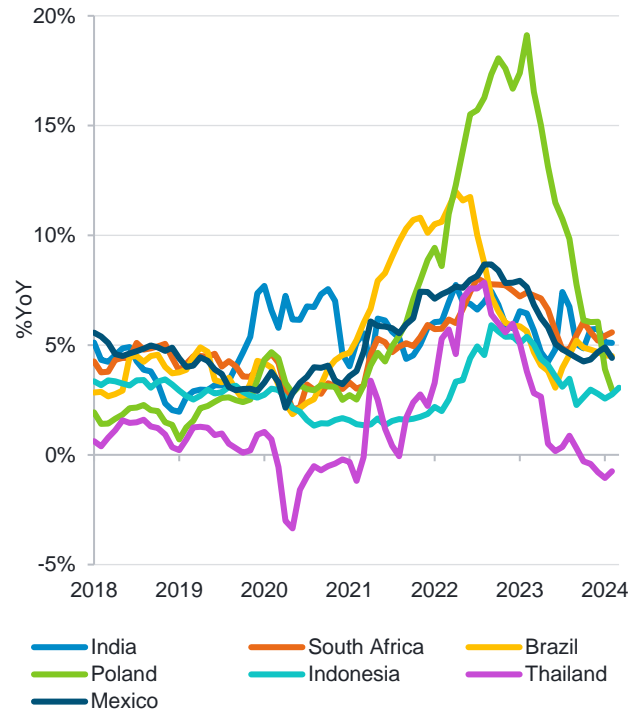
While the Fed deliberated over whether inflation was transitory or persistent, many EMs, particularly those with a history of hyperinflation, raised rates first and asked questions later. That early response, in addition to increased commodity supply easing price pressures, means that many EM central banks are now in a position to lower rates due to steady disinflation (see Chart 3).

Chart 3: Global commodity prices and EM inflation



Source: Fidelity International, Bloomberg, April 2024.

Chart 4: Headline EM inflation rates



Source: Fidelity International, Haver Analytics, April 2024.

However, this picture of disinflation has not been uniform across EMs, spurring markedly different reactions across EM central banks. For instance, Brazil succeeded in taming inflation, which peaked at 12% in mid-2022 but ended 2023 below 5%, thanks to the early reaction of its central bank and its decisiveness in pushing real rates well above the neutral rate. With short-term inflation expectations anchored, the central bank has already cut rates by 250bps since last summer and is expected to cut another 175bps by the end of 2024.

In contrast, the Mexican central bank, Banxico, only began to cut rates on the 21st March due to high core inflation and a resilient labour market. The Fed’s hawkishness during 2023 also prevented Banxico from cutting rates in line with other Latin American peers, but the March meeting could present an opportunity to start a cutting cycle. With their own presidential elections in June and US elections in November, Banxico’s reaction function is also likely to be skewed to the hawkish side, attuned to potential market vulnerabilities depending on election outcomes.

In Asia, most central banks completed their rate hiking cycles in 2023. The scale of cuts in 2024 may be smaller compared to other EM countries because many Asian EMs raised rates less to begin with. Some economies

such as Indonesia and Thailand with clearer disinflationary impulses may need to cut rates earlier, although market expectations point to the second half of the year as the more likely timing for cuts. In contrast, the Philippines and India may need to hold rates unchanged for longer, to wait for food prices to ease. The central banks in Taiwan, Korea, and Singapore are unlikely to rush into easing yet as the tech-led rebound may have provided some support to domestic demand, putting core inflation at higher than historical average levels.

The DM cutting cycle will be a tailwind for EMs – but not yet

As EM central banks get deeper into their cutting cycles - or closer to their start - the upcoming DM cutting cycles will be a boost for most EMs, especially the Fed for Latin America and, the ECB for Central and Eastern Europe. However, the risks that DM central banks will be forced to delay rate cuts, especially the Fed, are rising.

The US economy remains resilient, while activity in the euro area and the UK is improving moderately, driven by services. Inflation in DMs is proving sticky, especially the services components of core inflation. DM labour markets are still tight, meaning the last mile of disinflation may well be harder than central bankers believe. Rate cuts could come later than currently expected.

Indeed, in response to continued resilience in activity data as well as further evidence of inflation stickiness, we have recently changed our end-of-2024 DM scenario probabilities by raising the likelihood of no landing scenario to 30% (from 15%) and reducing the probability of a soft landing to 40% (from 45%) and a cyclical recession to 25% (from 35%). The probability of a balance sheet recession remains unchanged at 5%.

While we still believe that a soft landing is a more likely scenario to materialise, the no landing narrative is already starting to drive markets. We expect this to continue until more clarity on the direction of the cycle and central banks' reaction functions emerges in the coming months. In this environment, some EM central banks may find it difficult to proceed with their own cutting cycle, wary of currency depreciation if interest rate differentials versus the US get too wide.

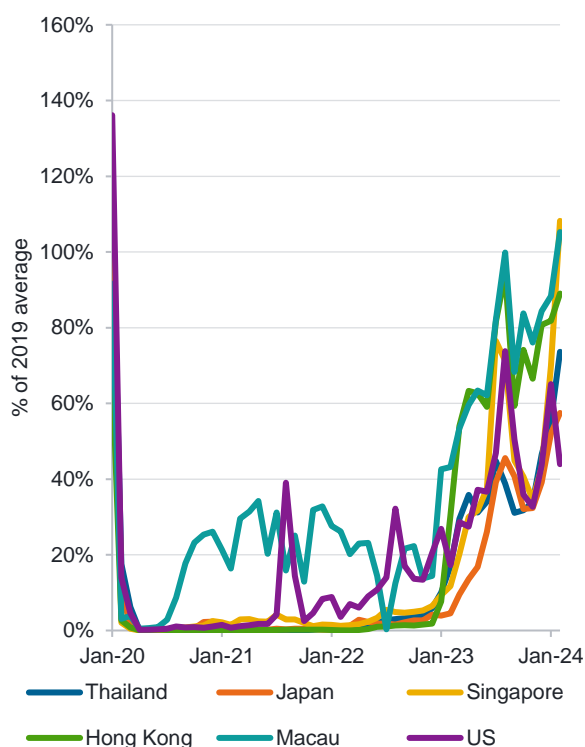
Ultimately, a no landing outcome is unlikely to be sustainable into 2025 as either 'high for longer' rates in the US or even further hikes would drive the US economy into recession or the labour market rebalances alongside lower rates leading to a soft landing outcome. Either way, uncertainty about rate cuts in the US will likely also keep uncertainty about EM central bank actions high.

Challenges and opportunities from China's transition

We expect growth rates in China to fall over the coming years as the country transitions away from debt-financed investment, particularly in the property sector, to a new model of growth based on consumption and high-quality manufacturing. The country faces several structural headwinds, including elevated debt levels and an aging population. Declining growth means Chinese policymakers will be less willing and less able to prop up growth with state-led spending and investments. As a result, growth patterns within China will become more divergent, as sectors consolidate, and long-term policy focuses on nurturing new growth drivers.

This stable but divergent transition in the Chinese growth model is not unequivocally bad for EM economies and, as always, there will be winners and losers. Viewed through a traditional lens, the impact of China's outlook on EM can be assessed through three main channels: trade, commodities, and financial flows.

Chart 5: Chinese tourist arrivals remain well below pre-pandemic levels



Source: Fidelity International, Wind, Haver Analytics, April 2024.

Since re-opening from Covid lockdowns, China's economy has been subdued. Instead of the usual suspects benefiting (commodity exporters), there has been significant differentiation across sectors and economies. While China's domestic tourism has rebounded sharply after the pandemic, outbound tourism has seen a structural slowdown. Tourist arrivals are well below pre-pandemic levels in key destinations, including Thailand, Japan, Singapore and the US (see Chart 5).

The fall in Chinese demand for commodities used in the property sector, such as iron ore and steel, has hurt countries that export them, such as Brazil, Chile and Peru. However, opportunities may exist in areas where China is willing to become more integrated in global supply chains. This includes battery and EV production, industries that are also benefiting from growing capex investment in new production capacity globally. Thailand and Indonesia in particular stand to benefit from this evolving trend.

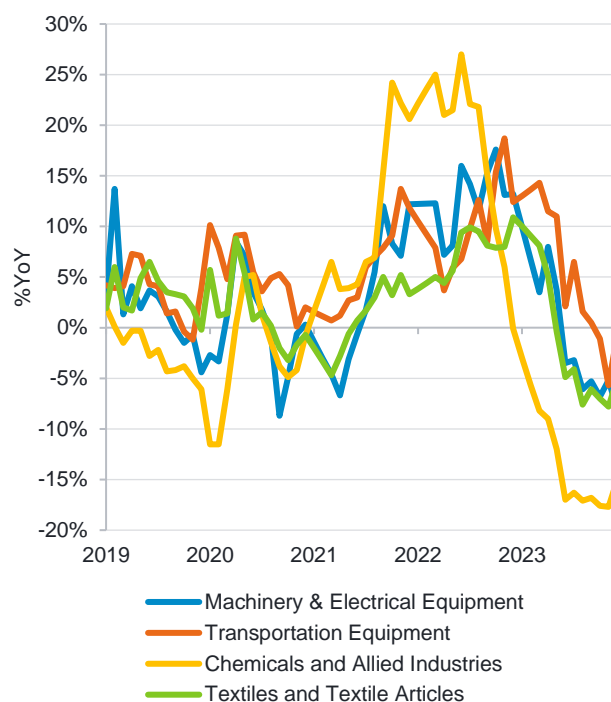
Our base case assumes China's consumption recovery will broaden only at a moderate pace. This means Asian EMs will still benefit through tourism and trade. For some countries, such as those in Central & Eastern Europe, Middle East and Africa (CEEMEA), where bilateral trade with China is relatively small, will benefit from China's recovery indirectly by increased trade with economies that do trade more directly with China, such as developed Europe.

China's deflation tailwind

China's recent focus on enhancing production capacity and manufacturing supply chain upgrades has started to create overcapacity in some sectors, which would exacerbate if global demand slows. China has significantly increased capacity in several emerging industries, such as green transition enablers (EV, solar panels, and batteries), and semiconductors. As a result, export prices in these industries have fallen during the last few quarters, which has in turn lowered inflation in the countries that are significant importers from China (see Charts 6 & 7).

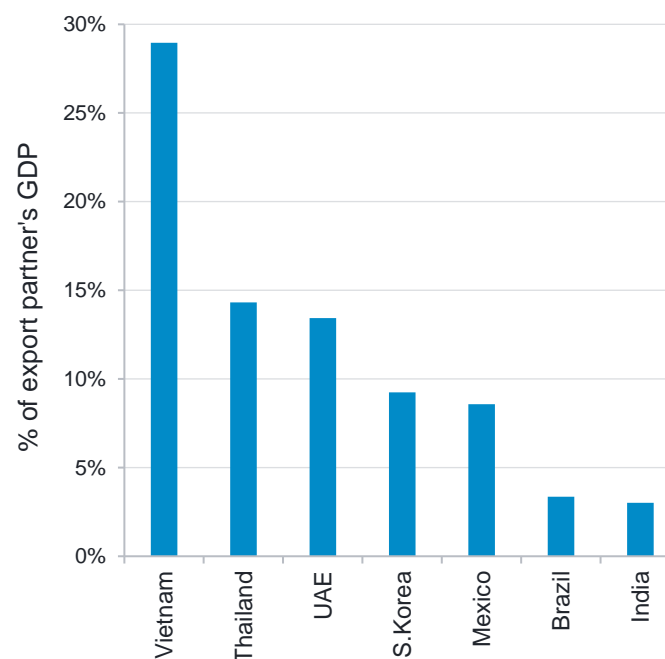
Inflation baskets in DMs assign relatively large weights to sticky services and wage-related categories that are primarily driven by domestic demand. However, EM inflation baskets are generally more influenced by the inflation of imported goods. As a result, Asian countries are well positioned to benefit from China's continued deflation, which should create some headroom for policy rate cuts to spur domestic demand, especially when the timeline of US rate cuts becomes clearer.

Chart 6: Select Chinese export price inflation rates



Source: Fidelity International, Haver Analytics, April 2024.

Chart 7: Imports from China as % GDP across selected EMs



Source: Fidelity International, Haver Analytics, Bloomberg, April 2024.

Geopolitical risks add to inflation pressures

Two of the key geopolitical events we are monitoring currently are the inflation shock from the Red Sea shipping disruptions and the US elections in November, particularly in the context of international trade and global security.

The outcome of the US election could lead to further fragmentation in international trade and geopolitics. While China is likely to remain in focus, other economies which have increased their market share of US imports over the past few years, such as Taiwan, Korea, Thailand, and India could also be impacted. Any tariffs would obviously add to more structural inflationary pressures as a result of global trade fragmentation.

Since October last year, Yemen's Houthi rebels have been attacking ships in the Red Sea. While shipping costs on various measures have increased, they are only around a third of the peaks reached during covid-driven disruptions. PMI components (supplier delivery times and input price indices) are reflecting lengthening travel times and some limited price pressures. But there is little evidence of significant supply disruptions at this time. Indeed, global trade has learned some key lessons from logistics disruptions during the pandemic and since the start of the war in Ukraine, including how to improve resilience through additional capacity, geographical diversification, accommodating lengthened lead times for production and maintaining higher inventory levels where possible.

For now, the impact on inflation has been muted. Using research from the IMF¹, we estimate the disruption will cause around 15bp for global headline in 2024, with a higher impact for Europe, particularly CEE, as well as Asian EMs. However, if the crisis extends throughout 2024, supply disruptions may be exacerbated by the demand side, especially during the peak holiday shopping season into year end. This could in turn bring about a significant re-acceleration of the goods

components of inflation, which have so far been the major drivers of disinflation.

Spillovers accumulate gradually, and we might not see the peak effect of the shipping disruption on inflation until 2025. It could force many central banks to slow their rate cutting cycles or to finish them sooner. Of course, if the current disruptions broaden into a bigger regional conflict, affecting oil and other commodity prices, the resulting inflation shock will be rapid and large enough to cause an immediate course correction in many EMs.

Market implications

The more benign inflation and growth outlook in many EMs means that they are further along in the economic cycle than many DM countries. With disinflation in Latin America and Central and Eastern Europe continuing apace and inflation expectations in most places coming inside central banks' target ranges, EM central banks have the green light to continue (or start) cutting. Despite a number of headwinds for EMs, this backdrop presents opportunities across asset classes.

The Fidelity Solutions & Multi Asset team is constructive on risk overall. We have a positive outlook for several Latin American and Asian equity markets. Within those regions, we are focusing on some key themes: the semiconductors rebound, expressed via South Korea and Taiwan; structural growth stories in India and Indonesia and; value opportunities in Brazil and Greece.

Furthermore, attractive real yields and our expectations of rate cuts in certain regions means we are constructive on select EM local currency bonds, such as Brazil and South Africa. That said, a nuanced approach is required for EM FX. As Banxico has started cutting rates, we have become cautious on the Mexican peso due to domestic challenges and uncertainty about the US presidential election.

¹ Y. Carriere-Swallow et al., March 2022, "Shipping Costs and Inflation", IMF Working Papers 2022, 061.

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