Emerging Markets – living on the (dollar) edge

Irina Topa-Serry,
Senior Economist (Emerging Markets),
Macro Research – Core Investments

Key points

- Emerging markets (EM) are on a structurally sounder footing amid tighter global financial conditions. Access to international capital markets may remain difficult for some frontier markets
- We expect growth recovery in Central Europe and Asia, but diverging trends within Latin America
- The monetary easing cycle will likely be shallow, guided by the Fed's stance and domestic disinflation. Fiscal consolidation could be limited by a heavy electoral year across EM regions in 2024

This is not the 1990s

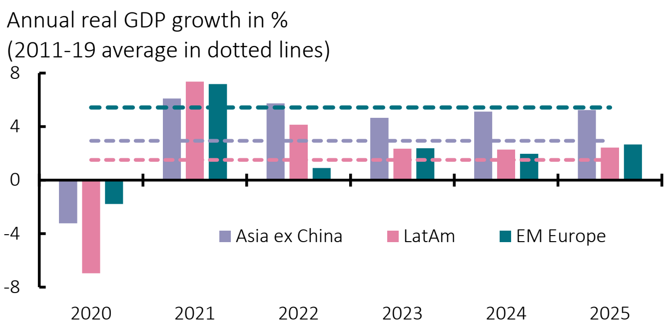
The expected "high for long" scenario of US monetary policy is reminiscent of the 1990s which saw a series of major crises in emerging markets (EM): the 1994 Mexican 'Tequila' crisis, the 1997 Asian financial crisis and the 1998 Russian crisis. For sure, high real US yields and a strong dollar will continue to exert pressures on many countries, particularly those in already precarious financial positions which rely extensively on hard currency borrowing. Easy global financial conditions post the global final crisis allowed many frontier market (FM) economies to raise unprecedented amounts of capital on international bond markets. Sovereign issuance remained particularly depressed for most FMs for a second year in a row in 2023, while some countries lost market access altogether. Several countries are in advanced debt restructuring negotiations, and multilateral funding has increasingly stepped in to help cover governments' financing needs. Fragile situations needing close monitoring remain in Egypt or Kenya, to name some.

Beyond this specific market segment, EMs are undeniably structurally and institutionally better equipped to face external headwinds than they were during the 1990s. Local debt markets have developed significantly, decreasing their reliance on external financing; exchange rates have been allowed to float, reducing pressure builds; institutional credibility is higher with central banks better able to anchor inflation expectations and to ensure financial stability thanks to foreign exchange reserves management while banking systems are also better capitalised. There are of course exceptions; for example Argentina or Turkey, but a general structurally-sounder footing should limit the risk of a systemic crisis. Moreover, portfolio outflows from EM debt markets for the past two years signal light foreign investors' positioning.

Growth divergence between and within regions

From a bird's eye view, our 2024 and 2025 EM GDP growth forecasts may appear to suggest quite an impressive resiliency, forecasting overall EM growth of 4.0% in 2024 and 4.1% in 2025, from an expected 3.9% this year – more so as China's average GDP growth is slowing. Excluding China, growth should pick up from 3.3% to respectively 3.7% and 4.0%. Yet much of this acceleration comes from smaller countries, on which we rely on International Monetary Fund (IMF) estimates, which make up more than 35% of EM ex-China GDP. Our assessment on bigger EM economies is somewhat less rosy as we see growth decelerating in 2024 and stabilising in 2025 along easier monetary policy stances. GDP growth in 2025 is nonetheless expected to remain below its post-financial crisis to pre-pandemic average in both Asia and EM Europe. We see strong divergence between and within regions (Exhibit 1).

Exhibit 1: Nearing post-crisis/pre-COVID-19 growth averages



Source: IMF and AXA IM Research, November 2023
Regional IMF GDP-PPP weights for Asia (India, Indonesia, Malaysia, Philippines, Thailand, South Korea, Taiwan, Singapore), Latin America (Brazil, Mexico, Chile, Colombia), EM Europe (Russia, Turkey, Poland, Hungary, Czech Republic)

Asia stands out as the only region forecast to see growth accelerate in 2024. Across Asia, India and Indonesia growth which has held up remarkably well in 2023 is expected to continue, while activity in other smaller economies should also pick up. In Latin America, activity in Brazil and Mexico will decelerate, having been supported by exceptional harvests in the former this year, and with positive spillovers from strong US growth to the latter. Meanwhile, we should see a better backdrop for Chile and Colombia, which have had to deal with issues in the mining sector and political uncertainty this year. EM Europe remains a highly-divided region; Russia and Turkey are expected to slow, while activity in Central Europe should be supported by consumption recovery and European Union funds being partially unlocked in 2024/2025.

Overall, economies will have to cope with weaker, albeit not collapsing, growth in the US. At the same time, positive real rates in the US are likely to continue to exert pressure on the level of nominal rates in EM. Investment may still struggle into early 2024 but external demand could start to benefit from stronger sequential growth in China. Moreover, a recent turnaround in Korean exports suggests the global manufacturing cycle may be slowly turning. We will continue to assess the positive fallouts from adjusting manufacturing supply chains, closer to the developed market consumer (near-shoring in Latin America) and/or away from China (friend-shoring in Asia) via incoming foreign direct investments.

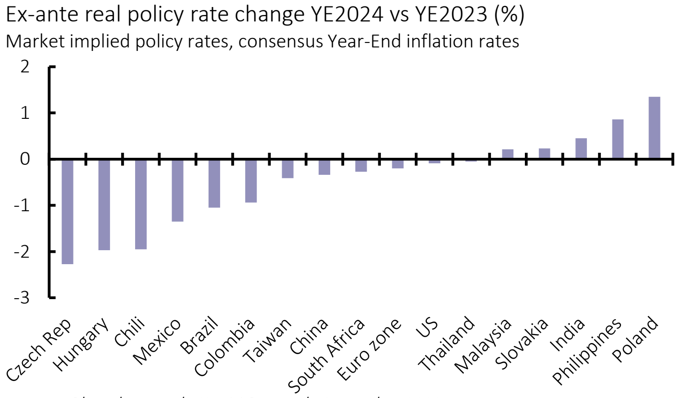
On the consumer side, we could start seeing some benefits of past disinflation improving purchasing power for households. In Central European countries, real wage growth is expected to become positive in 2024. Labour markets have proved resilient so far and we do not envisage a significant deterioration in the years to come. Additionally, according to the IMF, the cumulative excess savings from the COVID-19 period remain across EM, providing a potential cushion to household private consumption, although we may question the uneven distribution of such savings.

Inflation and the Fed to guide monetary easing

Inflation moderated generally more than expected across EMs on the back of supply shocks reabsorption post-pandemic reopening. Energy prices played an important role in the disinflation trend; food price inflation also came off the boil, but risks remain on certain segments on the back of weather-related production disruptions, which could be further distorted by producers imposing export bans, as currently for rice. The possible lifting of remaining price subsidies on fuel or food products in various countries is another upside risk to inflation estimates moving forward. Still, with the notable exception of Turkey, core inflation in EM has come down since its peak roughly a year ago. Headline inflation is expected to reach central banks' targets at various speeds during the next two years of the forecasting horizon in most countries that we cover. Absent any additional external shock, market focus will move from disinflation to monetary policy easing.

Disinflation allowed several developing countries' central banks to start cutting policy rates as of 2023, including in Uruguay, Chile, Brazil or Peru across Latin America, Hungary and Poland in EM Europe. More will do so in 2024 and thereafter. Yet we suspect that relatively high US real yields and a strong dollar will prevent aggressive easing, much depending on the pace of disinflation ahead. We note increasing signs of cautiousness among EM central banks that are keen to ensure that inflation is decisively converging on their targets while maintaining the right level of rates to ensure financial stability and maintain foreign investors' interest. The starkest example being the Bank of Indonesia (BI), which hiked its policy rate by 25bps to 6% in October, having kept rates unchanged since the beginning of the year. Indonesian inflation is close to the lower-end of the BI band (2%-4%) and even though expected to accelerate from here, it should remain well in the BI's comfort zone. BI rather reacted to the weaker rupiah since April 2023 and reacted preventively to cushion against any souring of foreign investor sentiment. Market-implied ex-ante real policy rates are nonetheless suggesting an easing of the monetary stance in many EM countries in 2024 (Exhibit 2).

Exhibit 2: Monetary policy easing expected ahead



Source: Bloomberg and AXA IM Research, November 2023

Absent faster-than-expected disinflation and thus against a backdrop of a rather tight monetary stance – outside Asia – governments across EM will feel increasingly constrained as debt loads have risen since 2020 and the increased interest burden is limiting fiscal policy room for manoeuvre. Anti-inflation shields, which supported the consumer this year, should be phased out, and the fiscal impulse is expected to be contractionary but any fiscal consolidation may provide some surprises in the busiest EM electoral year in decades. Tensions between the fiscal and the monetary authorities may become more palpable, and we tend to believe that central banks will respond by more hawkishness (and less dovishness) to fiscal drifts putting downside pressure on our 2025 growth forecasts.

Risks and uncertainties abound, as always

As always, policy gyrations in China and the US, the direction of travel for the US Treasuries, the dollar, geopolitics and commodity prices remain major risks to our EM macro and market outlook. Local politics will come into the spotlight with many elections, be it local, parliamentary or presidential, scheduled in 2024 – starting with Taiwan in January, Indonesia, India and Korea in spring, Mexico and South Africa during summer, Romania and Uruguay towards the year-end, to name a few. Many frontier markets will also come to polls (e.g., Senegal, Ghana, Sri Lanka). The US Presidential Election may nonetheless be the utmost important electoral deadline for EMs this year given its broader and deeper implications as per the possible trade and investment shifts that it could deliver.

Emerging Europe – looking better, after all

Irina Topa-Serry,
Senior Economist (Emerging Markets),
Macro Research – Core Investments

Key points

- After a weak 2023, growth should revive in 2024 and 2025 across Central Europe. Disinflation should restore consumer balance sheets and allow monetary policy to ease. Fiscal tightening is expected later in Poland, but EU funds are expected to be unlocked
- Turkey opted for a gradual shift to orthodox policies to curb accumulated imbalances ahead of March 2024 local elections. This choice bears risks and will likely leave Turkey still exposed to portfolio flows for financing its external financing needs

Central Europe: Diverging from Germany's woes?

Central Europe (CE) economies will continue to operate under weak external demand, particularly from Germany to whom they direct 20%-35% of their exports. The automotive industry accounts for 25% of total Czech exports, 10% of industrial production in Poland, 14% of GDP in Slovakia and will have to continue to remodel itself away from the basic European car manufacturers assembly line for combustion engine vehicles. We see better outcomes for Hungary and Poland with a focus on electric vehicles' (EV) batteries production, already benefitting in terms of export activity. New production lines will be coming online in 2024 which should support output and exports, despite major trading partner activity weakness.

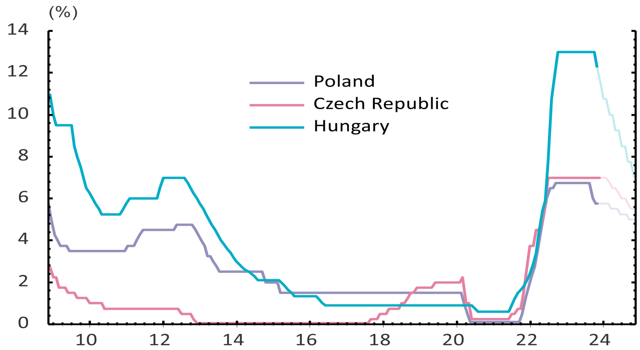
CE's accelerating growth will also be supported by improved consumers' purchasing power. Strong disinflation will support positive real wage growth, while savings remain ample and could be used to support consumption ahead; we are already seeing tentative signs of turnaround in retail sales in Poland. Housing markets have been affected by tighter monetary policy although various measures such as subsidised or capped mortgage rates and subsidised housing loans will be supportive in Poland and Hungary.

Public finances consolidation appears obvious for Hungary and the Czech Republic as of 2024, while there are risks of slippages for Romania and Poland next year as the former heads into a quadruple election and the latter is in the process of forming an opposition-led government which made several spending pledges during the campaign. More positively, the future Polish government will strive to unlock the frozen European Union (EU) Recovery and Resilience funds, starting with the €25bn RePowerEU grants and loans, which could be released towards the end of 2024. Conversely, Hungary is focused on unlocking EU Cohesion Funds (€13bn) for which it needs to achieve several milestones to comply with the EU's "rule of law".

Central banks in Poland and Hungary have already started to cut rates; the Czech central bank should join them soon. Inflation has been better than expected, both on the retreat of volatile price shocks and thanks to weak activity this year. It should be back, or close to targets, in the next couple of years with significant adjustments in policy rates (Exhibit 3).

Exhibit 3: Monetary easing in response to inflation falling

Central Europe: policy rates, history and forecasts (%)



Source: LSEG Datastream and AXA IM Research Nov 23

Turkey: The fine rebalancing act

Since 2023's elections, the new administration, under a re-elected President Recep Tayyip Erdoğan, has engaged in the rebalancing of large economic imbalances accumulated in recent years, starting with a set of orthodox policies, including raising interest rates (to 35% in October), regulatory and quantitative tightening and tax increases. Real interest rates nonetheless remain negative with core inflation close to 70% in October 2023 and inflation expectations a year out hovering at 45%. Fiscal policy should remain stimulative beyond earthquake reconstruction spending efforts, at least until March 2024 local elections. Beyond this, we assume policy action will continue to favour gradual, but not decisive rebalancing, which should translate into continued currency depreciation for the period under review. Inflation is likely to peak by mid-2024 but the pace of disinflation may be altered if the central bank cuts rates hastily. We expect GDP growth to halve in 2024 from above 4% in 2023 but this will likely be insufficient to lead to a massive improvement in the current account *à la* the 2018/2019 episode, leaving Turkey exposed to oil price volatility and foreign investor appetite when it comes to its external financing needs.

Latin America – Growth to bottom out in 2024

Luis Lopez-Vivas,
Economist (Latin America),
Macro Research – Core Investments

Key points

- Led by strong performances from both Brazil and Mexico, regional growth in 2023 surpassed expectations but will likely run out of steam in 2024 due to weaker US and China growth
- Inflation is on a firm downward trend, paving the way for easing. But risks remain including a potential El Niño event and foreign exchange weakness
- Despite 2024's packed electoral calendar including Mexico's presidential election, the region is unlikely to face substantial political risks.

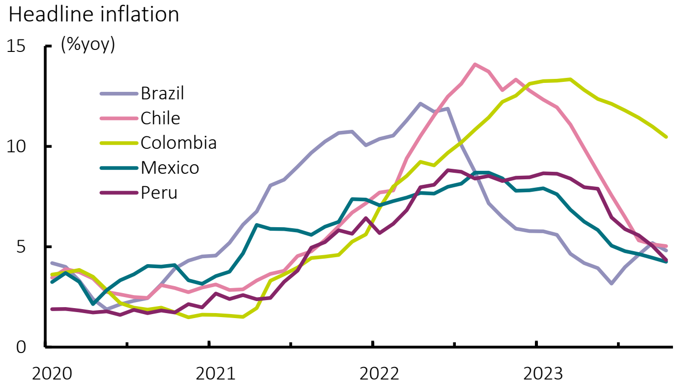
Resilient 2023

Although 2023 was anticipated to be a challenging year for Latin America because of inflation tackling restrictive monetary policy, the region's economic activity has shown remarkable resilience. This strength is mainly the result of robust growth in the US, the post-COVID-19 reopening in China and sturdy consumption supported by tight labour markets. As such, we expect the so-called LA4 region (Brazil, Chile, Colombia and Mexico) to grow 2.7% (2022:3.6%), significantly surpassing our initial estimates of 0.9% at the beginning of 2023. Nonetheless, this regional figure obscures considerable disparities among countries; the two largest economies, Brazil and Mexico, have been the key drivers behind this stronger-than-expected performance.

Brazil is projected to grow 3.0% in 2023, boosted by a robust agricultural sector and strong private consumption. Similarly, Mexico is forecast to register a 3.3% expansion, thanks to factors like the US economy avoiding recession and increased construction activity related to public projects and potentially to nearshoring activities. In contrast, Chile should register a small contraction of -0.5% while Colombia will see modest growth (1.6%) due to the withdrawal of policy stimulus and political uncertainty that has hampered investment.

Disinflation has also been a positive development this year, thanks to the proactive stance of the region's central banks, which began hiking rates earlier than in other regions. Inflation in Latin America is now at 5.5%, a significant drop from the 7.9% at the end of last year (Exhibit 4). With this improved situation, monetary policy is expected to continue its easing trajectory into 2024. Both Brazil and Chile have already embarked on easing cycles and Mexico and Colombia should follow suit next year. However, it's hard to predict the timing given concerns around the higher-for-longer rates and possible foreign exchange vulnerabilities from potentially lower commodity prices.

Exhibit 4: Inflation close to target across the region



Source: LSEG Datastream and AXA IM Research estimates, November 2023

Challenging 2024

However, there are some challenges on the horizon. In 2024, the LA4 region is projected to see a slowdown in growth (1.8%) due to factors like softer annual growth in China, the potential for a US recession, and lower commodity prices. Once more, significant divergences are expected among countries, with Mexico and Brazil poised for deceleration. Mexico's growth will be hindered by sluggish economic conditions in the US, while Brazil would require an unexpected boost like this year's record harvest to regain strong growth, which is unlikely. Meanwhile Chile and Colombia should see a resurgence in activity driven by looser monetary policy and reduced political uncertainty. In Chile, the constitutional process will have concluded, and in Colombia, the likelihood of radical reforms is limited given President Gustavo Petro's lack of support in Congress and declining approval ratings.

Risks ahead

For 2024 the balance of risks to our outlook is tilted to the downside. A severe El Niño event would be a drag on growth in Peru and Colombia and drive food prices higher across the region. Likewise, any escalation in global conflicts could fuel food and energy prices. A weaker economy in either the US or China would be a blow to the region's outlook due to its trade dependence on these two countries. Finally, 2024 will be a busy electoral year with presidential elections in the Dominican Republic, El Salvador, Mexico, Panama and Uruguay, but none of them pose a significant risk to their outlooks.