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Asset Management

Emerging markets: Will history repeat itself or is it time to buy?

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Against a backdrop of rising US rates and dollar appreciation, some commentators have written off emerging markets (EM). But we believe the region continues to offer return potential for active investors. EM FX, in particular, is an asset class poised for a rebound.

Here's why.

1.EM central banks are returning to orthodox monetary policy

In a move to limit the damage of Covid on their economies, the majority of EM central banks mirrored their developed-market peers in cutting rates to zero or near enough – levels you would never have expected to see in these countries.

For most, the concern was that they would then be slow to unwind these cuts, because – let's face it – which country doesn't want higher growth and lower rates?

However, those concerns have largely been put to rest with multiple EM central banks acknowledging the rise in inflation and the fact that they – unlike the US Federal Reserve (Fed) – do not have the luxury of questioning whether these inflation levels are transitory or permanent. Instead, they have learnt from their histories of high inflation and reverted to an orthodox playbook and hiked rates.

Whilst outliers remain, leaders in this space include Russia, Brazil, Chile, Mexico, Hungary and the Czech Republic. And for those that haven't yet started hiking, such as Colombia, they've turned decisively hawkish and indicated imminent increases.

All of this suggests that by the time the Fed hikes rate, most EMs should have already conducted an entire hiking cycle. This is key, because when you draw comparisons between the taper tantrum of 2013 and the present, the former came about when real rates were at the bottom of where they had been for 15-20 years. Whereas today, we anticipate that we are going to enter the first rate hike with real rates at the top end of this spectrum.

2. The improvement in EM current accounts

Unlike in 2013 when real rates were too low and current accounts were in deficit, nine years later it's the opposite scenario. Real rates are going higher and current accounts are in the best shape they've been in 15 years.

This is a combination of two things: exports and imports.

Whilst commodity prices have been a definite support for exports, other (less volatile) factors, such as technology, have been notable contributors, meaning that those EMs whose economies have a tilt towards metals, oil or technology are looking pretty robust, in our view.

On the import side, because EM populations have yet to be fully vaccinated, they are unable to reopen properly. Whilst this has been a drag on growth, it has helped to compress imports.

South Africa is the most extreme example of this, where exports have been held up by metals prices and imports have been relatively compressed because the country keeps going into lockdown, meaning that the current account is 3-4% of GDP this year – at the point of the 2013 taper, it was -4% of GDP.

This phenomenon isn't limited to South Africa either, it's broad-based across several other EMs, including India, Indonesia and Russia.

The window of opportunity for EM FX

With the combination of real rates in the right direction (and likely in a better shape by the time the Fed hikes), and more robust external balances, why is now the time to consider EM FX?

The trigger for our constructive view has been the massive unwind in short dollar positioning that has happened since the June Fed meeting, making EM FX valuations look particularly attractive.

Where do the opportunities lie?

We see opportunities in those EM economies that have hawkish central banks but that have not performed well recently.

One example is Hungary. Its central bank has made a very significant shift to hawkish rhetoric, surprising market expectations during the last meeting. However, the currency has underperformed for years, purely because of its inappropriately loose monetary policy. We think it ticks a lot of boxes from an investment standpoint.

Our key takeaway is that with the right active approach, investors have the potential to capitalise on EM FX, which we believe is an asset class poised for a rebound in the final four months of this year.

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