



# Emerging Markets— Dancing to Their Own Beat

EMacro  
MMonitor

Central banks set to kick off easing cycles as inflation cools.

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*Chris casts his expert eye over the latest macroeconomic developments in emerging markets.*

## HIGHLIGHTS

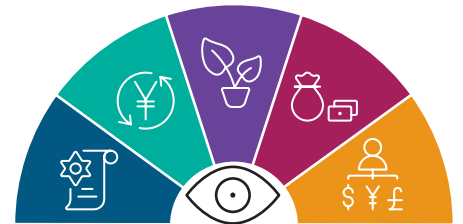
**Monetary policy:** With substantial progress made in bringing down inflation, emerging market (EM) central banks look set to kick off monetary policy easing cycles ahead of their developed market counterparts.

**China's slowdown:** The world's second largest economy is facing a challenging period amid weakness in the property sector. Downside risks are growing, threatening to create negative feedback loops.

**Economic growth:** EM growth appears resilient in the face of a slowing global manufacturing cycle and Chinese economy, but it's uncertain if it can persist.

**Inflation:** Important to monitor food prices going forward as they could face upside risks from El Niño and the termination of the Russia-Ukraine grain deal. This may delay some interest rate cuts, but it's unlikely to derail them.

**Rates, credit, and currencies:** While our enthusiasm around EM currencies has abated, the outlook for EM local rates is more positive amid disinflation and central banks rate-cutting cycles.



“...EM central banks are about to start easing—leading the turn in the interest rate cycle.

After a solid first-half performance, what does the remainder of 2023 look like for emerging markets (EM)? It could be more of the same, but it will be important to keep an eye on China and whether the slowdown there drags down the rest of EM and weighs on sentiment. For now, we are seeing resiliency on the growth side, while inflation has come down quickly. On the monetary policy front, several countries are positioned to embark on an interest rate-cutting cycle soon—striking out ahead of their developed market peers—which is an encouraging sign that EM is maturing as an asset class.



### Monetary Policy—Interest Rate Cycle Turning

With substantial progress made in bringing down inflation, EM central banks are about to start easing—leading the turn in the interest rate cycle. Not only did they start raising interest rates before developed markets, but they also hiked more. This creates a cushion for EMs to commence cutting, even though most developed markets are unlikely to be in that position anytime soon. However, there is uncertainty in terms of how far EM central banks can go in this cycle. It's possible that rates will not return to pre-hiking levels as conditions are different. EM central banks also need to be mindful of currency stability as they cut. Ongoing U.S. dollar strength and the march higher of U.S. rates pose potential headwinds, particularly for low-rate countries that lack a sufficient carry cushion.

Chile has already kicked off its easing cycle, and we expect other Latin American countries to join them over the next few months. In Central and Eastern Europe, Hungary has begun easing, and we anticipate that the Czech Republic will soon follow suit. Bucking the trend is the Asia region, where it's likely to be 2024 before cutting commences. Inflation problems there were generally not as deep, so central banks didn't need to hike as much.



### China's Slowdown—Property Sector Weighs

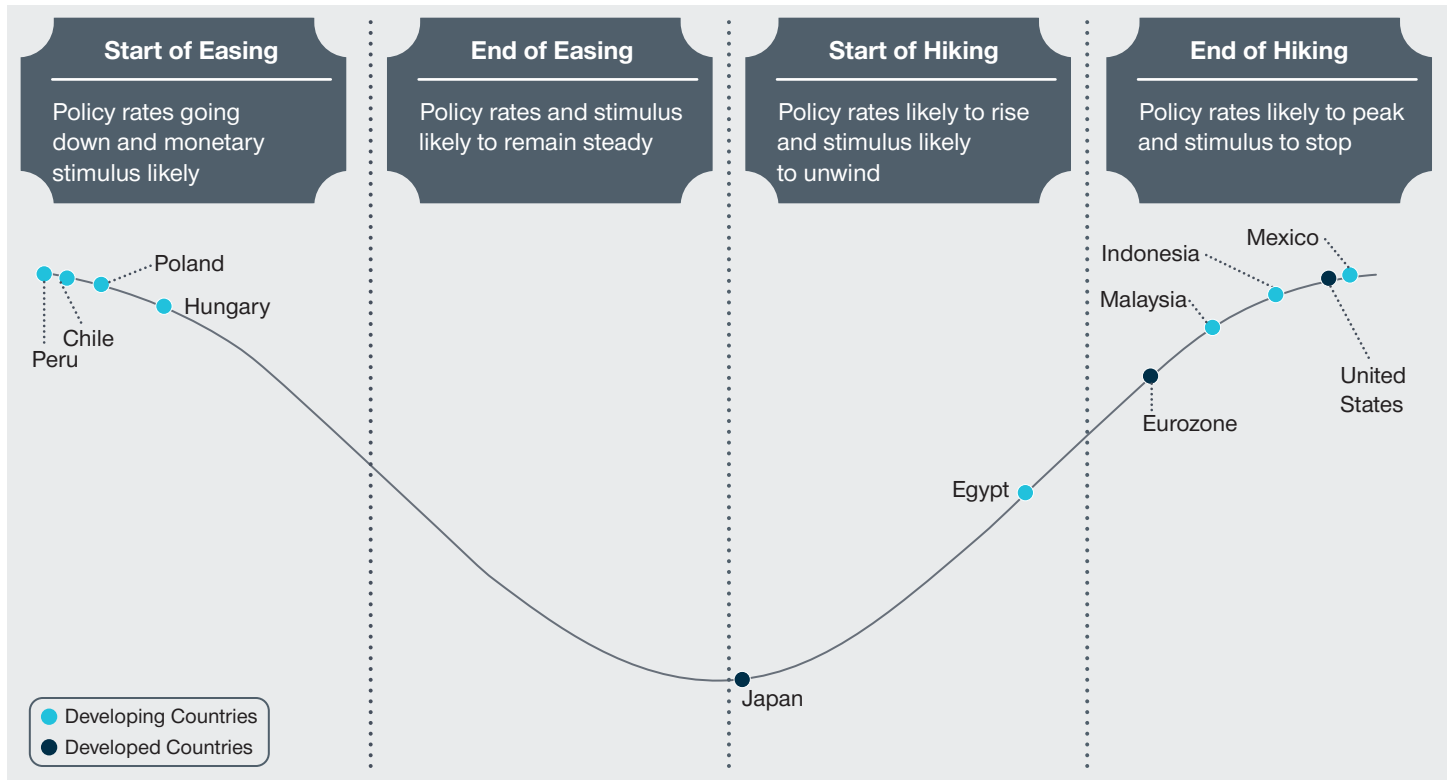
China's economy is slowing and at a faster pace than anticipated. A flurry of negative developments surrounding the property and trust sectors are likely to undermine confidence in the world's second largest economy and possibly lead to further weakness. Downside risks are growing, threatening to create negative feedback loops amid weak confidence and challenges in the manufacturing sector and labor markets.

To support the economy, the People's Bank of China has begun easing monetary policy, a trend we expect to continue over the coming weeks and months. But with credit demand low, the monetary transition mechanism may be weak—so it remains to be seen just how effective easing measures will be.

On the fiscal front, the response from authorities has been incremental. If this approach continues, it's going to take time to revive household and business confidence. So far, there appears to be an aversion to the types of large-scale stimulus the authorities have implemented in the past due to the risk of higher debt ratios. Instead, they appear keen to structurally reorient the economy and put it on a more sustainable long-term path even if it costs some growth in the near term. If the challenges continue to deepen, the resolve of the Chinese authorities will likely be tested. We think that authorities will ultimately want to guard against the risks of negative feedback loops becoming a bigger financial crisis or dragging the economy into recession. Fiscal policy will likely have to be the main lever to manage these risks, though there is ongoing debate over how much to do and the design of any fiscal program (even more modest ones).

## EM Central Banks Leading the Turn in the Interest Rate Cycle

Illustrative interest rate cycle



As of June 30, 2023.

These represent estimates of where the stated countries are in their monetary policy cycle. Actual future outcomes may differ materially. Country classifications in the chart are in line with IMF groupings as of reporting date.

Sources: IMF, CB Rates. Analysis by T. Rowe Price.

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### Economic Growth—Resilient So Far

EM growth is so far showing resiliency in the face of a notable slowdown in the global manufacturing cycle and China's economy. Like developed markets, the nonmanufacturing side of EM economies have held up better, while the slowdown in China is yet to translate into a deeper downturn for commodity prices. This is encouraging for EM, but it's important to note that the quality of growth is mixed and there is some geographic dispersion.

Broadly, services have remained resilient like developed markets. This indicates a rotation in EM from goods consumption to services. Import compression is also

playing a role, which may help boost headline gross domestic product, but it's not usually a sign of growth being sustainable. Furthermore, an inventory correction appears to have been growth-supportive for EM, but similar to import compression, its impact is unlikely to be long-lasting.

Going forward, whether EM growth resiliency can continue is likely to depend on three factors. First, whether commodity prices remain stable in the face of a weakening industrial cycle. Second, how the tension between manufacturing slowing and services/labor market resilience plays out more broadly. Third, whether China can do enough to keep its economy stable and not turn into an outright drag on EM growth.

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### Inflation—Vigilant on Food Prices

Inflation has come down fast in EM after the structural shocks of the pandemic and Russia's invasion of Ukraine. Going forward, we are keeping a watchful eye on food prices due to the upside risks posed by El Niño and the termination of the Russia-Ukraine grain deal. Although vigilant on the latter, our expectation is that the impact should be modest compared with the price shock caused last year when the war first broke out.

The weather phenomenon known as El Niño, which occurs every few years and causes a rise in sea temperature in the Pacific Ocean with knock-on implications for weather conditions worldwide, has returned. Select Asian and Andean countries of Latin America are likely most exposed but in different ways. For example, Colombia could face more drought conditions, while Ecuador and Peru could see more heavy rainfall. Even within countries the effect may vary; some of Brazil's regions may see shortfalls of rain while others may experience higher-than-normal rainfall and stronger harvests. The risk is that the more extreme weather causes a disruption to agriculture, with knock-on implications for food prices and inflation.

Overall, we believe that the upside risks signal an inflection point in the food disinflation trend toward a more neutral/two-way period. This in turn may slow the pace of rate cuts should risks materialize into upside inflation surprises, although this is not our base case. Given that EM is coming off a period of tight monetary policy and growth is around, or somewhat below, trend in a range of countries, the risks of second-round effects on inflation from food price shocks should be contained.

### Rates, Credit, and Currencies—Constructive on Local Rates

The backdrop of disinflation and central banks embarking on rate-cutting cycles is constructive for EM local rates, in our view. Although we are mindful that a lot of easing is priced in, and the asset class has had a strong run this year. Nonetheless, our analysis shows that long local rate positions have historically tended to generate positive returns during cutting cycles.

In the EM external sphere, we are encouraged by the low volatility and resiliency we are seeing in the high-quality segment of the market. But after a strong run, valuations are tight in this space, which is pushing some participants to chase the more distressed parts of the market, where fundamental research and security selection is essential. Broadly, we see more value in the EM corporate space over EM external debt at present.

For EM currencies, our enthusiasm has waned as the interest rate differential looks set to weaken as EM central banks start cutting interest rates before developed markets. While we believe there is still attractive carry to be made, it will be important to pick the spots to do this in carefully.

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