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Emerging markets poised for a year of interest rate cuts

From the Field
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Key Insights

- **Inflation and monetary policy:** Inflation continues to fall in emerging markets (EM), paving the way for more countries to cut interest rates in 2024.
- **Growth and fiscal:** Persistent headwinds in China's economy mean that it's unlikely to be a growth engine for EM.
- **Rates, credit, and currencies:** The outlook for EM local rates is constructive, while signs of frontier issuers regaining market access should support EM external debt.

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What does 2024 hold in store for emerging markets (EM)? Coming off the back of fairly strong performance in 2023, there is potential for some pullback early on as markets are currently priced for the perfect soft-landing scenario. But this, of course, is not guaranteed, and how this global backdrop evolves over the next few months will have important implications for sentiment toward EM assets.

Inflation and monetary policy

Coast is clear for more rate cuts

Inflation has come down quickly with the supply shocks from the coronavirus pandemic and the war in Ukraine largely settled. Within central and Eastern Europe, core inflation continues to trend lower, while in Asia—where inflation problems were generally not as deep—core prices have drifted back toward their low historic pattern. In Latin America, there are signs of core prices meeting some resistance after a rapid deceleration, but more data are needed to ascertain if a trend is emerging here. Broadly, though, progress on bringing down inflation means that the coast is clear for more interest rate cuts.

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EM central banks are leading developed markets in this turn in the interest rate cycle. We have already seen cuts in a handful of Latin American and central and Eastern Europe countries and expect this to continue and broaden to more developing countries in 2024. There appears to be little in the way to stop EM central banks from cutting, especially as the Federal Reserve also looks set to start easing. This potentially lowers the rate floor for EM central banks and should help alleviate concerns of them cutting too far ahead of developed markets and risking currency instability.

Growth and fiscal

China unlikely to act as an EM growth engine

There is potential for a modest pickup in EM economic growth this year, led by central and Eastern Europe. But those hoping China could provide a further boost are likely to be disappointed. The world's second-largest economy continues to face structural headwinds from weak income growth, a downsizing property sector, and local government fiscal issues. Against this backdrop, it is unlikely that China can be the growth engine that it has been in the past, so EM countries will need to find new drivers, potentially from their own domestic demand, green energy, or other sources.

On the external front, current account balances are in relatively good shape in large EM countries. Deficits are not out of control like in some developed economies and should remain fairly stable this year, although they remain somewhat elevated versus history. Elections could be an important part of the dynamics, because there's a risk of some fiscal erosion in large EM countries, such as Mexico and India, heading to the polls.

Rates, credit, and currencies

Constructive on local rates

The outlook for EM local rates is constructive as inflation continues to fall, paving the way for rate cuts. The current cutting cycle is still in its middle phase—more developing countries are likely to take action to cut as the year progresses.

In the EM external sphere, the asset class remains bifurcated. At the overall asset class level, spreads look attractive, but this is largely due to issuers that are either in distress or have defaulted. When these are taken out, spread levels are tight. This year, the main source of total returns is likely to be driven by carry. Any returns beyond that are likely to hinge on the potential of frontier issuers to regain market access and/or if there's a resolution to outstanding debt restructurings. In terms of the former, there are some encouraging signs on this front already as both the Ivory Coast and Kenya have returned to the global capital markets to raise financing in 2024 so far.

For EM currencies, it's likely to be a story of interest rate differentials in 2024 unless there's a meaningful growth uplift that can shift focus away from that. For some time now, rate differentials have favored Latin American and central and Eastern European currencies over Asian currencies, but this should start to reverse as cuts come through in the former regions, while Asian countries largely stay on hold.

Global backdrop matters for EM

(Fig. 1) How EM could perform in different global economic scenarios

No landing

Negative tilt for EM assets

This scenario could drive U.S. Treasury yields higher, putting EM currencies under pressure, while high yield credit spreads in EM widen.

Soft landing

Positive tilt for EM assets

This scenario should be favorable for EM local rates and EM currencies, although this is largely priced in, which may limit upside.

Recession

Mixed for EM assets

This scenario may weigh on risk sentiment, leading to EM credit spreads widening, but EM local rates could find support from interest rate cuts.

As of January 2024.
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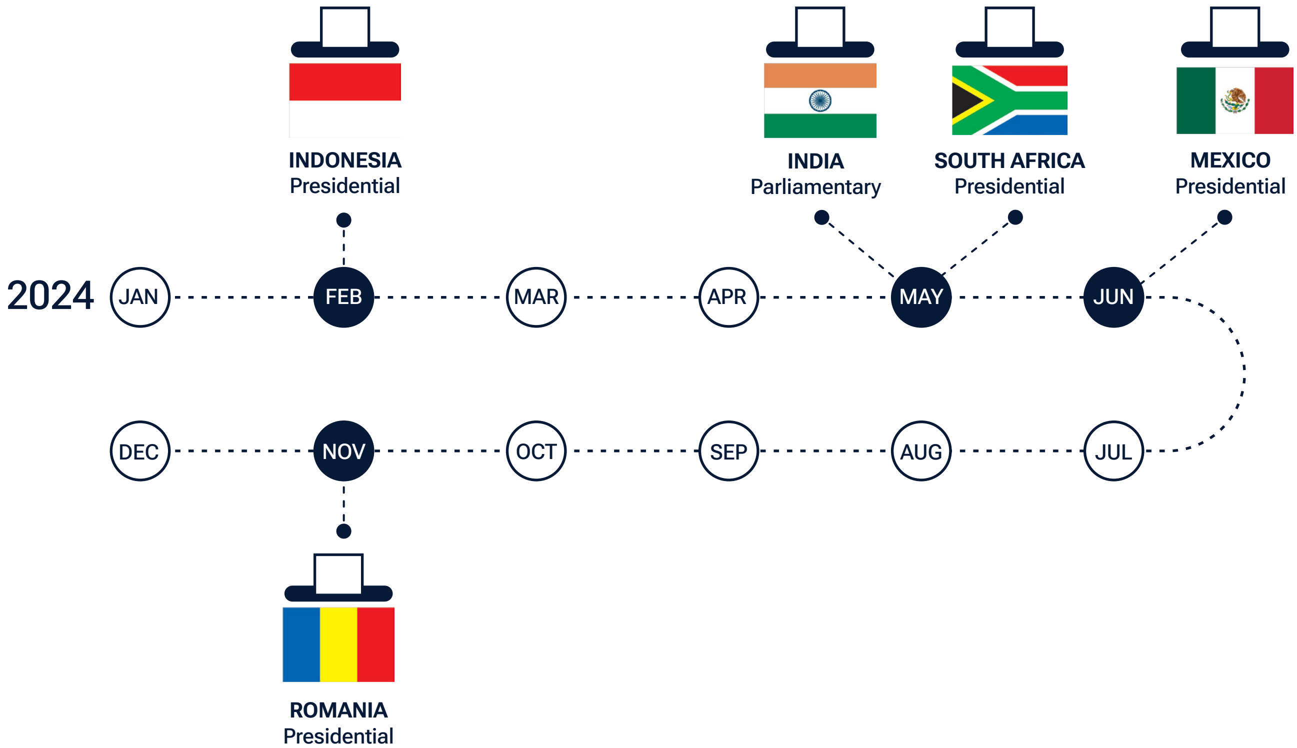
Source: T. Rowe Price.

Overview of key EM elections in 2024

(Fig. 2) Elections can test the confidence of markets and provide insights into policy direction



As of January 31, 2024.
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