TCW

INSIGHT

Emerging Markets: Attractive Relative Valuations; Differentiation Remains Key

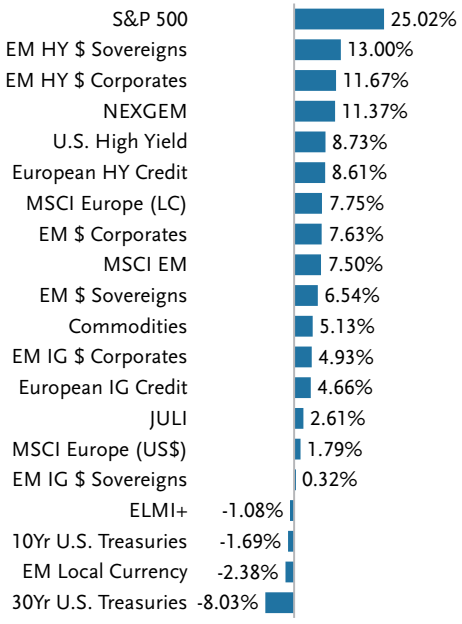
ANISHA GOODLY | 16 JANUARY 2025

KEY TAKEAWAYS

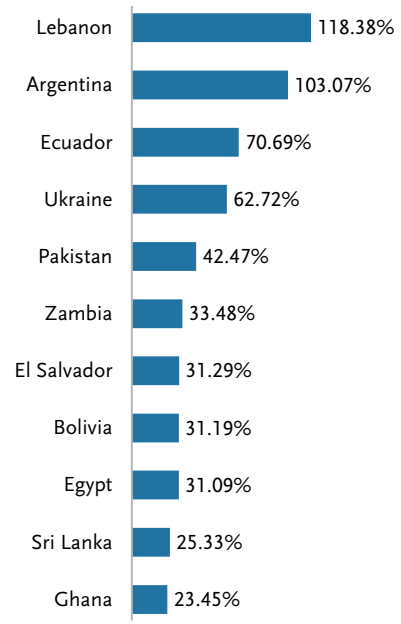
- We expect growth in emerging markets to be relatively stable in 2025, with the differential to developed markets remaining at the wider end of the past decade's range. EM valuations remain attractive against the U.S.
- We forecast China growth to slow from 2024 at a pace below consensus as lower policy rates and stimulus have limited impact on driving consumer demand.
- We expect most countries in Latin America to approach their growth potential and inflation targets by mid-2026, absent significant external shocks.

2024 was characterized by a number of market-moving events – stronger-than-expected U.S. growth leading to the unwind of Federal Reserve (Fed) rate cut expectations, a spike in volatility due to a large unwind in JPY-funded carry trades, unexpected election outcomes and elevated geopolitical risk. Still, Emerging Markets (EM) sovereign dollar-denominated debt returned 6.54% in 2024, driven in particular by a 13% rally in high yield (including a 50% return for C-rated sovereigns), reflecting a combination of macro stability, fiscal consolidation, financial support from the IMF or FDI and/or progress on debt restructurings. In fact, EM high yield (HY) sovereigns and corporates were among the top-performing asset classes globally. On the other hand, EM local currency underperformed, down 2.38%, driven by continued U.S. exceptionalism and expectations of tariffs under the incoming Trump administration.

EM Debt Delivers Strong Returns in 2024...



With High Yield Issuers Outperforming



Source: Bloomberg; Year 2024 data as of December 31, 2024

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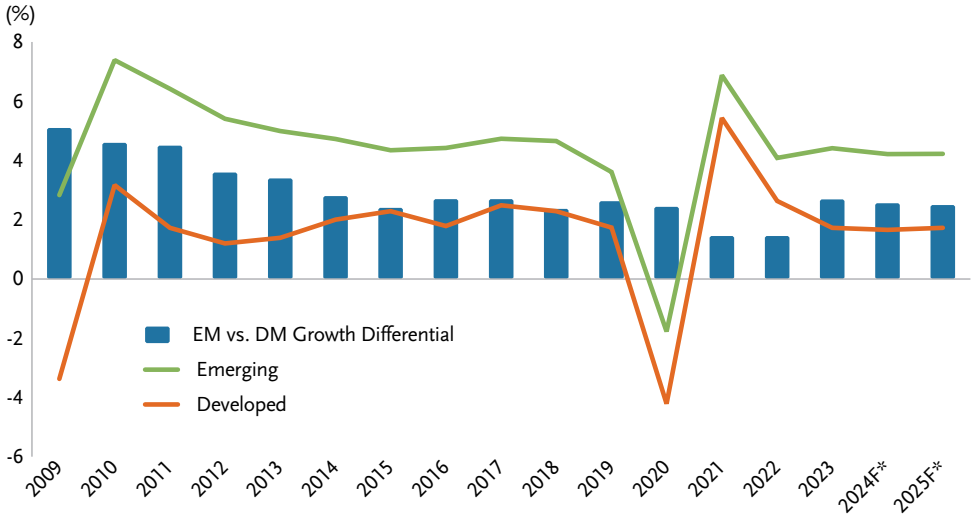
Ms. Goodly leads TCW's Emerging Markets/ Global Portfolio Specialist team, whose core activities include communicating investment strategies, performance and outlook, in addition to business development and product marketing. In this role, Ms. Goodly serves as the primary liaison between TCW's Emerging Markets/ Global investment teams and TCW's client relations and marketing professionals. Prior to joining TCW in 2013, Ms. Goodly spent eleven years at Morgan Stanley, in various roles spanning Fixed Income Strategy, Leveraged Finance and Emerging Markets Institutional Sales. Ms. Goodly is the co- chair of Diversity and Inclusion for Women in Institutional Investments Network (WIIIN) and was shortlisted for "Ally of the Year" for the Women in Asset Management Awards. She is also a member of the Los Angeles Leadership Committee for 50/50 Women on Boards and serves on the Advisory Board of Moving the Needle. Ms. Goodly graduated with a BA in Economics from Stanford University.

Supportive EM fundamentals and financial resilience anchor our long-term constructive view of the asset class. During the COVID-19 pandemic, Emerging Markets followed a more fiscally conservative approach by necessity, thereby addressing defaults early on. Disinflation trends in EM have been stronger than in Developed Markets (DM) and we anticipate the disinflation process to continue, in part supported by lower commodity prices. Moreover, in EM, current account deficits and external borrowing needs appear moderate. The IMF is engaged with countries representing over a quarter of the EM sovereign debt index, which helps drive a continuation of conservative fiscal and monetary policies at the lower end of the credit spectrum and the availability of financing in the absence of market access.

We anticipate growth in EM to be relatively stable in 2025, with the EM-DM growth differential remaining at the wider end of the range over the last ten years. We forecast somewhat lower Chinese growth in 2025 versus 2024, as lower policy rates and stimulus have had limited impact on driving consumer demand. While there is elevated uncertainty around the sequencing and magnitude of trade policy, increased fiscal spending is likely to be used as a counter measure against higher tariffs from the U.S. In Latin America, we anticipate that most countries will approach their growth potential and inflation targets by mid-2026, absent significant external shocks. We forecast stronger CEE GDP growth in 2025, particularly as fiscal policy generally remains stimulative across the region and inflation converges towards targets.

EM-DM Growth Differential Near Decade Wides



*IMF WEO Forecasts

Source: IMF, TCW EM Research, Data as of January 6, 2025

As for monetary policy, Developed Market rates have been restrictive with periods of elevated volatility as investors fear that data-dependent DM central banks are falling behind the curve. The easing bias in DM should provide room for EM central banks to ease policy rates further during 2025, although the Fed's increased caution and other exogenous factors (e.g., U.S. tariffs, geopolitical tensions) can still limit the pace of cuts in EM.

From a valuation perspective, while absolute credit spreads are at the tighter end of historical ranges, we continue to see value both on an all-in-yield basis and relative to U.S. credit. Spread differentials between EM investment grade (IG) and U.S. IG are on the tighter end of the historical range for the past decade, but on an absolute basis, EM IG trades approximately 45bps wide to US IG. EM HY yields of 10.14% are in the 74th percentile versus history and the spread differential between EM HY sovereigns (559bps) and U.S. HY (287bps) is in the 74th percentile over the past decade. While EM dedicated funds have experienced over $140bn of outflows in aggregate the last three years, demand from cross-over and global investors has been strong, likely demonstrating the value in Emerging Markets relative to other fixed income alternatives.

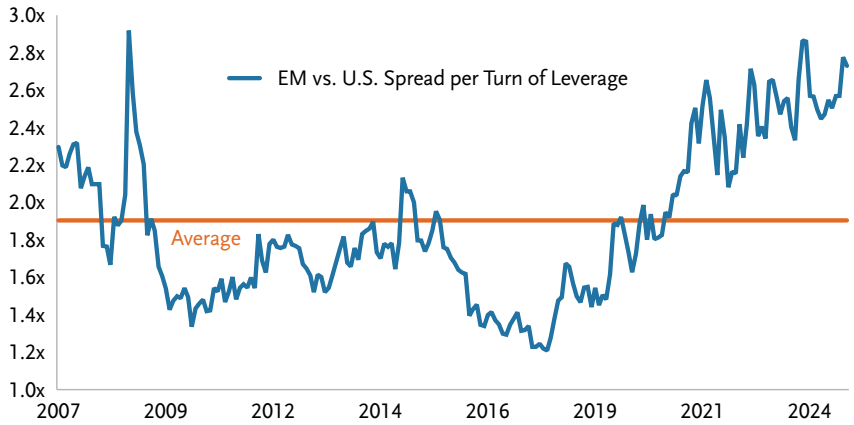
EM Debt Valuations Attractive Relative to U.S. Credit

	Spreads (bps)	Yield-to-Maturity
EM Sovereign Index (IG and HY)	325	7.9%
EM IG Sovereigns	122	5.9%
EM IG Corporates	128	5.8%
US IG	77	5.3%
EM HY Sovereigns	559	10.1%
EM HY Corporates	394	8.5%
U.S. High Yield	287	7.6%

Source: JP Morgan, Bloomberg; Data as of December 31, 2024

In our total return portfolios, we continue to overweight high yield relative to investment grade, focusing on high yield idiosyncratic sovereigns such as Egypt, Gabon, Senegal and Turkey. We also see value in select sovereigns such as Brazil and Colombia that have underperformed this year and are more shielded from trade tariffs. We are currently overweight Africa, Latin America, and high yield Europe, funded with a significant underweight to Asia. Additionally, we are maintaining a tactical allocation to EM corporates as this sector tends to outperform in periods of market volatility given higher spreads and shorter durations relative to EM sovereigns. In addition, EM corporate leverage is near the lowest levels in a decade and well below U.S. peers.

EM Spread Per Turn of Leverage at Historically Attractive Levels vs. U.S. Peers



Source: BofA Securities; Leverage Data as of 2Q 2024, Spreads as of December 31, 2024

We currently have no local currency exposure in our total return portfolios given the strong dollar environment although we continue to look for opportunities at the country level for potential divergence between dollar and local currency returns. US dollar strength remains supported by strong relative growth and higher market interest rates than most DM and a large swath of EM. The USD (i.e., DXY) is within 4% of its 20-year highs, but sustained weakness will require both Fed cuts and stronger growth in the rest of the world in our view. That said, there are risks to continued USD strength, including U.S. fiscal policy excess; possible political pressure on the Fed to ease monetary policy; President-elect Trump's stated desire to weaken the dollar (albeit without clear policy proposals to date); heavy positioning (global investors own a lot of U.S. assets); the possibility of faster growth in Europe (e.g. the new German government easing fiscal policy, a sustained peace deal in the Russia-Ukraine war); or a growth policy stimulus bazooka from China.

In our local currency portfolios, we continue to emphasize idiosyncratic trades and relative value opportunities given our expectation of on-going dollar strength in the short term.

We believe that risks to Emerging Markets are likely to come more from external than internal factors, including uncertainty around economic and trade policies in the developed world, particularly the United States, and their impact on interest rates, growth and inflation. As the year progresses, there will be more clarity about the extent and sequencing of various policy elements of the new Trump administration and the speed of easing cycles by both the Fed and the ECB. In general, we believe there will be EM winners and losers in this environment and are positioning accordingly.

As for geopolitical risk:

- **Middle East:** The Israel-Hezbollah ceasefire brokered by the U.S. and France and the ousting of the Assad regime from Syria have increased prospects for longer-term de-escalation. Settlement of the conflict would bode well for the region, and in particular for Lebanon, with market optimism for debt restructuring following the formation of a government. That said, a desperate reaction from Iran's leadership in the wake of recent defeat, as well as President-elect Trump's signaling of his intention to renew "maximum pressure on Iran", remains a tail risk scenario. The new Trump Administration's ultra-hawkish views towards Iran could also embolden Israeli Prime Minister Netanyahu to disregard international pressure and strike Iran directly.
- **Russia/Ukraine:** Many market participants assume that the incoming Trump Administration will pull back financial and military support from Ukraine in an attempt to force Kiev to the negotiating table with Moscow. However, it is not clear what Trump can offer Putin who retains maximalist objectives in Ukraine and Russia and could try to seize this opportunity to try and go much bigger against Ukraine.
- **South China Sea Tensions:** We are monitoring the potential spillover risk of elevated South China Sea tensions into direct confrontation between China's Navy and Air Force and Taiwan, the U.S., and Washington's other Asia-Pacific allies. We do not believe any of these parties want to see an escalation in hostilities in the near term, but there is always the possibility for mistakes leading to unintended consequences. ■