CIO Viewpoint

Emerging markets, rising rates and diverging fortunes

Investment Solutions

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As the US and European central banks wait for a full recovery before raising interest rates, many emerging markets are already combatting inflation by increasing the cost of borrowing. That is placing potential limits on growth, even before their economies have fully rebounded from the pandemic. Since we have addressed China's challenges in recent publications, this article focuses on other emerging nations' outlooks.

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- Many emerging markets' central banks have raised interest rates as economic recoveries triggered inflation
- Tighter monetary policy and poorer vaccine access have narrowed the difference in GDP growth between emerging and developed economies to its smallest gap in two decades
- Current account balances in most emerging markets still offer a buffer against external shocks
- Many emerging market corporates' fundamentals are sound; we maintain an overweight position in hard currency credit
- We are neutral on emerging equities and have a bearish outlook on most emerging currencies.

Emerging markets are fighting Covid with lower vaccination rates and some of the world's highest mortality and infection levels. As we publish, 54% of Brazil's population had received two doses of a vaccine and the country had recorded the world's second-highest mortality rate, at 287 deaths per 100,000 population. In Russia, where the comparable rate is 156 deaths, one-third of residents are fully vaccinated and in India the figure is 22%, with a mortality of 33.

Poorer access to vaccines in most emerging countries inevitably slows the re-opening of their economies. At the same time, globally recovering demand has created shortages. This has driven commodity prices up from crude oil and gas to shipping containers, steel and soybeans, increasing consumers' food and energy bills. Annual inflation in Brazil has recorded its fastest gains in more than five years, to reach 10.4%, and has risen to 7.5% in Russia and 4.4% in India.

Lift-off

However, unlike developed economies, central banks in some emerging nations have not been able to treat inflation as transitory. With consumer prices far in excess of central banks' targets, both Brazil and Russia's policymakers have responded by increasing their interest rates this year (see table, page 2). The Russian central bank increased its benchmark rate by 75 basis points, to 7.5%, on 22 October. With real interest rates just positive, the Russian hiking cycle may be close to their peak, with another 25 to 50 bps of increases likely. Brazil's central bankers meet again this week, and market positioning suggests another rate rise of as much as 150 bps. In contrast, India's central bank remains accommodative, using other tools such as reverse repo rate auctions, to limit liquidity in the economy.

Because of rate hikes and the slower rebound, the difference between gross domestic product (GDP) in developed and emerging markets narrowed from 2.5% in 2020 to 1.2% this year, according to the International Monetary Fund (IMF). That is the smallest difference in at least two decades, underlining the challenges facing nations trying to stimulate domestic economies (see chart, page 3).

Fiscal parameters

For the moment, current account balances in most emerging markets offer a buffer to weather any external shocks. Russia's fiscal policy presents few risks, thanks to its dependence on oil, and it will probably record a balanced budget in 2021. Public debt remains less than 20% of GDP and largely domestically held, insulating public finances from foreign borrowers and exchange rates.

India's economic growth, supported by its demographics, looks strong enough to allow the government to retain its relatively conservative fiscal stance for the next year or more.

Still, many economies lack the fiscal firepower to continue stimulating growth. During the pandemic, Brazil's spending pushed its deficit to 14% of GDP. A year ahead of a general election, Brazil's government nevertheless plans to press ahead with more spending into 2022, risking further inflation. As a result, Brazilian assets suffered last week, showing that markets are monitoring governments' efforts to reign-in public spending.

In the Gulf region, the United Arab Emirates and Saudi Arabia are well positioned to scale-back fiscal spending. The price of oil is boosting their economies, allowing them to reduce expenditure after the pandemic while maintaining low levels of government debt. Both have substantial buffers in the form of foreign currency reserves and sovereign wealth assets, along with large and widening current account surpluses, allowing them to continue attracting investors.

The oil divide

Oil markets have exacerbated budget pressures for many. With crude prices increasing almost 40% this year and 75% since April 2020, there is a clear divide between emerging market net exporters and importers. We expect high prices to continue with Brent crude remaining around USD 80 per barrel over the next six months.

There are relatively few winners from higher energy prices. The Gulf States, as well as Russia, Colombia, Malaysia and Mexico, where oil accounts for one-tenth of goods exports, have all seen revenues rise. Russia is unusual in being a net exporter of oil, gas and coal, earning more than half of its export revenue from energy. Other emerging economies, including China and India, are net importers of all three energy sources.

China's demand for commodities remains an important source of emerging markets' growth. The world's second-biggest economy is the largest trade partner of countries from Brazil and Peru to South Africa and Saudi Arabia.

Any lengthy slowing of China's economy would present a risk to emerging market exporters. For now though, China's economic slowdown this year remains rooted in its domestic power shortages and the challenges of its property market. These have lowered our expectations for China's growth this year, to an 8% gain in gross domestic product, but leave our 2022 outlook unchanged at 5.5%.

Key indicators for select emerging economies

Country	Cumulative 2021 change (basis points)	Central bank policy rate	Real policy rate (minus inflation)	Inflation YoY Sept. 2021	GDP YoY 2021 (IMF estimate)	GDP YoY 2022 (IMF estimate)	Unemployment rate 2021 (IMF estimate)
Brazil	+425	6.25%	-4.1%	10.4%	5.2%	1.5%	13.8%
Russia	+325	7.5%	0.1%	7.4%	4.7%	2.9%	4.9%
Mexico	-25/+75	4.75%	-1.3%	6.1%	6.2%	4.0%	4.1%
India[1]	0	4.0%	-0.4%	4.4%	9.5%	8.5%	n/a
China	0	3.85%	3.2%	0.7%	8.0%	5.6%	3.8%
South Africa	0	3.5%	-1.5%	4.9%	5.0%	2.2%	33.5%

Sources: Lombard Odier calculations and International Monetary Fund's World Economic Outlook

[1] Estimates for India are based on fiscal, not calendar years.

Emerging assets

The IMF has provided record reserves in the form of USD 250 billion special drawing rights (SDRs) to emerging countries. However, the amount of sovereign debt remains a concern, and we are therefore underweight emerging market government bonds.

We expect high inflation to weigh on emerging debt in local currency in the coming months, and instead prefer the hard currency credit segment. Emerging corporates' earnings remain positive and net leverage is close to its lowest levels since 2011. These fundamentals should cushion the segment against higher rates, and we therefore keep our overweight position in emerging corporate credit. Any improvement in global risk appetite would be rapidly reflected in the asset class.

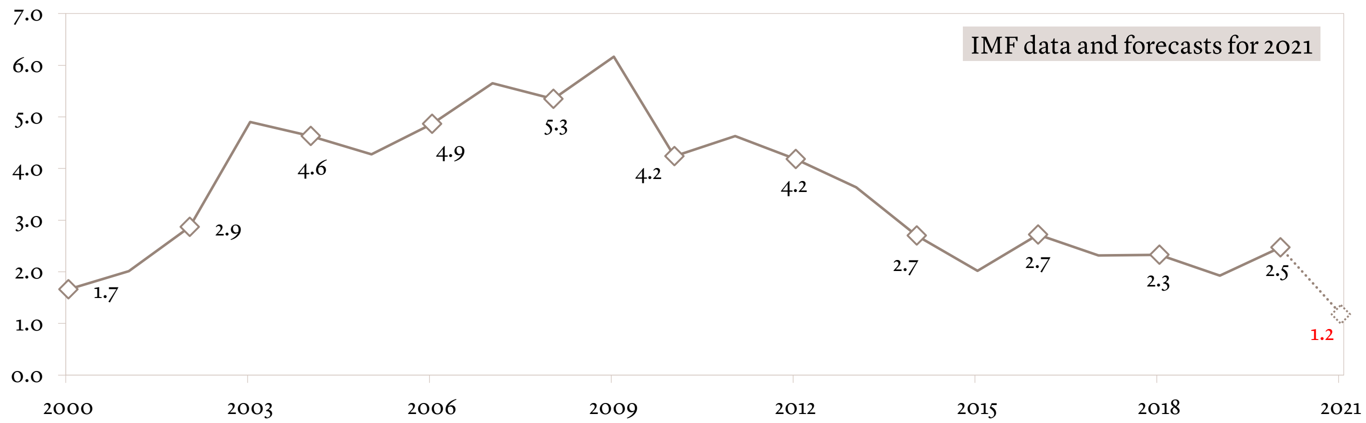
We remain neutral on emerging equities. Valuations are historically high, but improving vaccination rates, reopening economies, rising yields, inflation and oil prices should all support cyclical stocks in 2022. On the other hand, concerns over China's growth and the stronger US dollar have undermined earnings expectations, which still lag developed stock markets.

We adopted a bearish outlook on emerging currencies in the second half of this year. We expect more depreciation pressures as trade balances worsen: slowing global exports will probably coincide with a recovery in imports, as domestic demand normalises. We believe that the Chinese renminbi, Taiwanese dollar, Indonesian rupiah, Israeli shekel, Mexican peso and Russian ruble should all fare better among emerging currencies.

The Russian currency has gained almost 13% against the US dollar this year. We are cautious on the Thai baht, Turkish lira, Polish zloty, Colombian peso and Brazilian real. Declining demand for Brazilian assets has meant that the real has fallen 13% against the US dollar since July.

Emerging economies have not yet fully recovered. With world trade likely to level-off next year, the gap in economic growth compared with developed nations will remain historically narrow. While the first half of 2022 will remain challenging for emerging markets, once vaccination rates are higher and central banks' hiking cycles complete, the second half of the year may offer opportunities to outperform developed markets.

EM-DM real GDP growth differential, YoY, %



Source: IMF World Economic Outlook

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SWITZERLAND

GENEVA
Bank Lombard Odier & Co Ltd[1]
Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com
Lombard Odier Asset Management (Switzerland) SA
Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG
Banque Lombard Odier & Cie SA · Bureau de Fribourg[1]
Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE
Bank Lombard Odier & Co Ltd[1]
Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY
Banque Lombard Odier & Cie SA · Agence de Vevey[1]
Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH
Bank Lombard Odier & Co Ltd[1]
Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

BRUSSELS
Lombard Odier (Europe) S.A. Luxembourg · Belgium branch[2]
Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
Credit institution supervised in Belgium by the National Bank of Belgium (NBB) and the Financial Services and Markets Authority (FSMA).

LONDON
Lombard Odier (Europe) S.A.· UK Branch[2]
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
london@lombardodier.com
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Lombard Odier Asset Management (Europe) Limited
Queensberry House · 3 Old Burlington Street · London W1S 3AB · United Kingdom
london@lombardodier.com
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LUXEMBOURG
Lombard Odier (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com
Credit institution authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg.
Lombard Odier Funds (Europe) S.A.
291, route d'Arlon · 1150 · Luxembourg · Luxembourg
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Lombard Odier (Europe) S.A. · Sucursal en España[2]
Paseo de la Castellana 66 · 4ª Pl. · 28046 Madrid · España · madrid@lombardodier.com
Credit institution supervised in Spain, by the Banco de España and the Comisión Nacional del Mercado de Valores (CNMV).
Lombard Odier Gestión (España) S.G.I.I.C, S.A.U.
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MILAN
Lombard Odier (Europe) S.A. · Succursale in Italia[2]
Via Santa Margherita 6 · 20121 Milano · Italia
milano-cp@lombardodier.com
Credit institution supervised in Italy by the Commissione Nazionale per le Società e la Borsa (CONSOB) and la Banca d'Italia.

MOSCOW
Bank Lombard Odier & Co Ltd · Representative Office Moscow
Letnikovskaya st. 2, bld. 1 · 115114 Moscow · Russian Federation · moscow@lombardodier.com
Under the supervisory authority of the Central Bank of the Russian Federation.

PARIS
Lombard Odier (Europe) S.A. · Succursale en France[2]
8, rue Royale · 75008 Paris · France. RCS PARIS B 803 905 157 · paris@lombardodier.com
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Bank Lombard Odier & Co Ltd · Abu Dhabi Global Market Branch
Al Maryah Island · Abu Dhabi Global Market Square · Al Khatem Tower · 8th floor · P.O. Box 764646 · Abu Dhabi · UAE · abudhabi@lombardodier.com
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Lombard Odier (Brasil) Consultoria de Valores Mobiliários Ltda.
Avenida 9 de Julho No. 3624, Torre DGN 360, 6° andar · Jardim Paulista · CEP 01406-000 · São Paulo · Brasil
sao.paulo.office@lombardodier.com
Supervised by the Comissão de Valores Mobiliários of Brazil.

DUBAI
Bank Lombard Odier & Co Ltd · Representative Office Dubai
Conrad Business Tower · 12th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE
dubai@lombardodier.com
Under the supervisory authority of the Central Bank of the UAE.

ISRAEL
Israel Representative Office · Bank Lombard Odier & Co Ltd
Alrov Tower 11th floor · 46 Rothschild Blvd. · Tel Aviv 6688312 · Israel · telaviv@lombardodier.com
Not supervised by the Supervisor of Banks in the Bank of Israel, but by Swiss Financial Market Supervisory Authority which supervises the activities of Bank Lombard Odier & Co Ltd.

JOHANNESBURG
South Africa Representative Office · Bank Lombard Odier & Co Ltd
4 Sandown Valley Crescent · Sandton · Johannesburg 2196 · South Africa · johannesburg@lombardodier.com
Authorised financial services provider Registration number 48505.

NASSAU
Lombard Odier & Cie (Bahamas) Limited
Lyford Cay House · Western Road · P.O. Box N-4938 · Nassau · Bahamas · nassau@lombardodier.com
Supervised by the Central Bank of the Bahamas and the Securities Commission of the Bahamas.

PANAMA
Lombard Odier & Cie (Bahamas) Limited · Representative Office in Panama
Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
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Lombard Odier (Panama) Inc.
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ASIA - PACIFIC

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Lombard Odier (Hong Kong) Limited
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A licensed entity regulated and supervised by the Securities and Futures Commission in Hong Kong.

SINGAPORE
Lombard Odier (Singapore) Ltd.
9 Raffles Place · Republic Plaza #46-02 · Singapore 048619 · singapore@lombardodier.com
A merchant bank regulated and supervised by the Monetary Authority of Singapore.

TOKYO
Lombard Odier Trust (Japan) Limited
Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan · tokyo@lombardodier.com
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