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Emerging markets: The stars are aligning

24 October 2024, 5:55 pm CEST, written by UBS Editorial Team

An improving global growth and liquidity backdrop benefits emerging markets. China's stimulus and Federal Reserve rate cuts are leading to less restrictive global financial conditions at a time when emerging markets already offer value. Although the stars are aligning for emerging market assets, one key uncertainty remains: the US election.

Chinese policymakers recently unleashed a broad range of measures to support the economy. The People's Bank of China cut policy rates and signaled further easing ahead. Improved rules for mortgage refinancing, lower down payment thresholds for second homes, and a significant liquidity boost for equity markets were introduced. Fiscal policies will likely follow with greater details, including local government debt swaps, housing market destocking efforts, and bank recapitalizations. China's policymakers emphasized several times recently the need for macroeconomic policy support to meet this year's 5% real GDP growth target. These decisions reflect a strong determination to put a floor under the Chinese economy, which also benefits broader emerging markets.

While these events are supportive for emerging market assets, the US election outcome poses a potentially large risk. Regardless of the outcome, Congress is likely to sustain its bipartisan support for efforts to contain China's military and economic rise. A Harris administration represents a continuation of the status quo. But a Trump administration raises uncertainty, given his preference for tariffs as a national economic policy tool and his more unilateral and isolationist approach to foreign policy.

Investors are often hesitant to increase allocations to emerging markets amid trade and geopolitical uncertainty given past performance challenges. China and Mexico, for instance, are particularly vulnerable to shifts in US policy given their deep economic linkages and the heated rhetoric on the campaign trail. While the US election outcome is important, long-term portfolio construction should remain apolitical. Emerging market assets should play a central role in portfolios, promoting geographic diversification and improved risk-adjusted returns.

Emerging market US dollar-denominated bonds, for example, offer interest rates of 6.5-7.0%, well above those of US high-yield bonds even though the majority of emerging market issuers are rated investment grade. We expect emerging market bond spreads to remain stable over the next six to 12 months, allowing investors to achieve high-single-digit returns. Emerging market bonds also provide broad diversification across countries, limiting exposure to countries in the crosshairs of US tariff policy. We recently expanded our universe of coverage to include countries such as Panama and the Dominican Republic, among the best-performing Latin American economies over the past two decades, whose bonds offer appealing interest rate carry amid high willingness and ability to pay.

Regarding emerging market stocks, it is important to remember that asset performance depends not only on actual outcomes but also on what is already reflected in the price. Emerging market equities currently trade around a 12.2x 12-month forward price-to-earnings ratio, a close to 45% discount to US stocks. While we remain constructive on US equities, investors underallocated to other regions may want to consider aligning with their strategic benchmarks.

In a complex geopolitical world, exposure to markets with lower correlation to typical US holdings is beneficial. The potential for USD weakness owing to Fed cuts further supports the case for non-US asset allocations. We find particularly attractive opportunities in Asia Pacific broadly, including in Taiwan and India. South African stocks appear tactically appealing as well on the improving domestic reforms momentum that will likely help lift the still undemanding valuations.

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Original report: **Investing in emerging markets: Opportunities ahead, 23 October 2024**.