

# Emerging Markets and How to Play Them

**Krzysztof Janiga, CFA**

Senior Equity ETF Strategist

**Jason Simpson**

Senior Fixed Income ETF Strategist

Emerging markets (EM) faced enormous headwinds during 2021 and 2022 across asset classes. However, the tides appear to be turning as China has put an end to its zero-COVID policy, economies are bottoming out, the inflation battle is being won, and EM central banks appear to be ahead of the Fed and ECB in their tightening cycle.

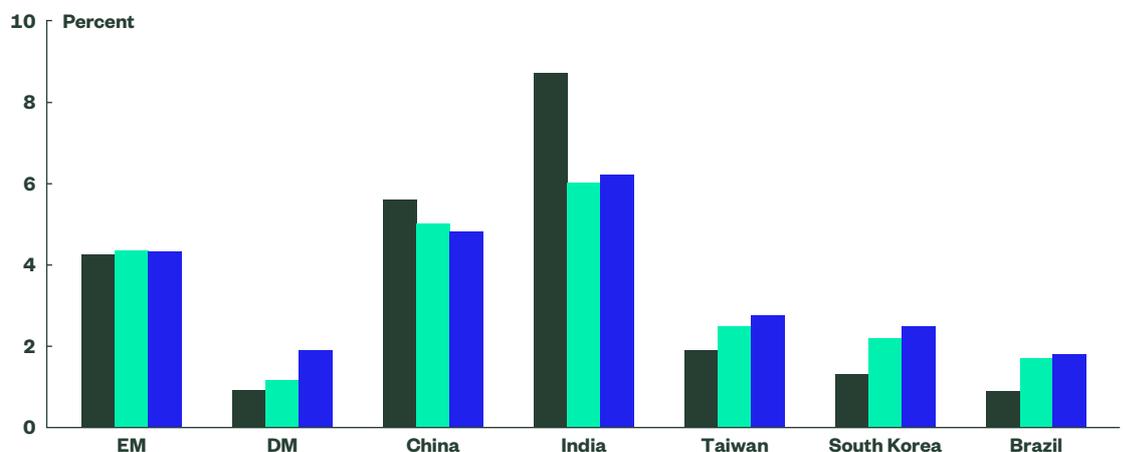
## Growth Differentiator

EM remains a pocket of growth in a world of economic slowdown. While developed market (DM) growth is set to decelerate, we expect emerging economies to expand at a solid rate, with India and China driving global growth. While there have been some signs that the rebound in China may be more muted than initially expected, EM growth should still be robust.

Inflation remains elevated but disinflationary forces are in motion, with the decline of food and fuel prices having a particularly significant effect on CPI baskets within EM. This trend should ease pressure on EM central banks in the medium term. Several may be reluctant to deliver rate cuts until it becomes clear that the Fed is at end of the hiking cycle. But with that end looking close, firm growth, lower central bank rates and a possible further weakening of the USD should support EM economies as well as local bonds and equities. Indeed, in the State Street Global Advisors Long-term Asset Class forecasts for Q2 2023, EM equities (+7.7%) and EM bonds (+7.2%) are projected to be the two best performing asset classes over the longer term.<sup>1</sup>

Figure 1  
Forecasted Real  
GDP Growth

■ 2023  
■ 2024  
■ 2025



Source: Bloomberg Finance L.P., as of 28 April 2023. Projected characteristics are based upon estimates and reflect subjective judgments and assumptions. There can be no assurance that developments will transpire as forecasted and that the estimates are accurate.

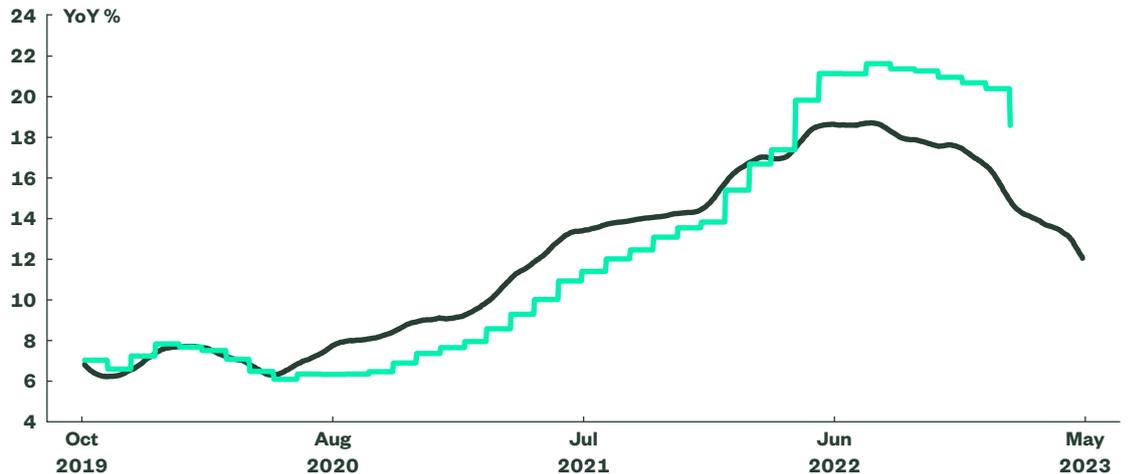
## EM Inflation is Slowing

Inflation took off faster in EM, and central banks responded more quickly than their DM counterparts. This difference is becoming clearer in the inflation trend, too. While the level of inflation remains elevated, the rate of disinflation is beginning to accelerate. This is not the result of base effects alone, as monthly prints in some countries are beginning to come in below seasonal averages, especially in Brazil and South Korea. Lower food prices are part, but not all, of this story. It's also encouraging that, in spite of China's surprise reopening at the end of 2022, PriceStats online gauges of supermarket and fresh food prices have yet to show signs of acceleration.

This backdrop could support policy normalisation as pressure from developed central banks warrant less of tightening to defend currencies versus the USD in particular.

Figure 2  
**PriceStats Suggests Online Prices are Now Easing**

PriceStats EM  
Official EM inflation



Source: State Street Global Markets, PriceStats, as of 31 March 2023. See our latest [Bond Compass: PriceStats Analysis](#).

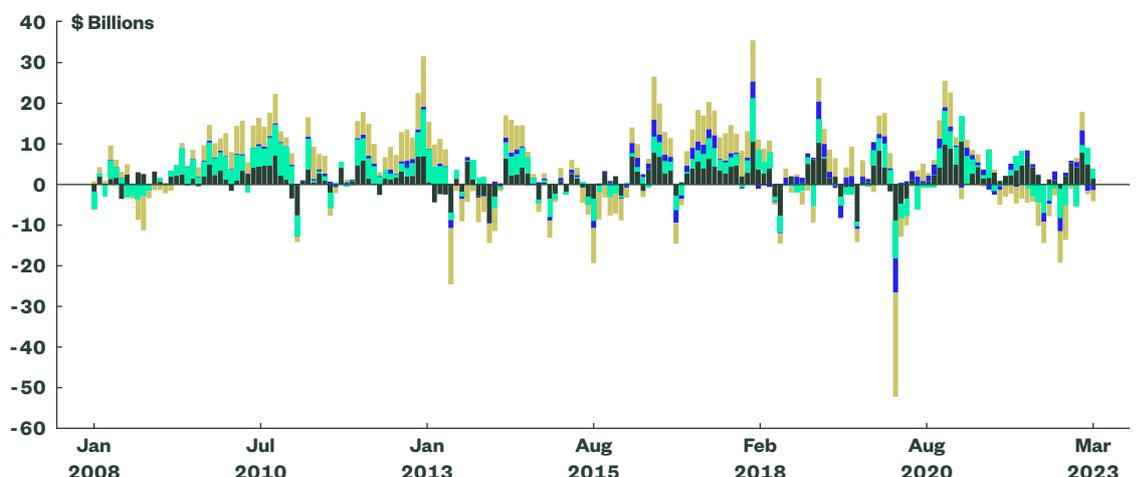
## Investors Have Begun to Position Already

While the performance of EM equities has been mixed, investors have poured c. \$25 billion into EM equity exposures and \$3.7 billion into fixed income funds. These flows have arrived since the first “pivot” that was triggered by weaker-than-expected US CPI in November 2022.

Flows in EM open-ended funds and ETFs were more subdued (on a relative basis) in February 2023 and March 2023 as US inflation failed to show clear signs of easing, but the impetus that started in November 2022 may re-ignite since the Federal Reserve has been signaling at least a pause at the June meeting and inflation prints for April were lower than anticipated. This may support the view that Fed tightening could be done for this cycle.

Figure 3  
**Emerging Market Funds — Monthly Flows (\$bn)**

EM Equity ETFs  
EM Equity Funds  
EM Fixed Income ETFs  
EM Fixed Income Funds



Source: Morningstar Direct, as of 31 March 2023. Flows are in USD billions. Includes open-ended funds and ETFs domiciled globally. Flows are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

EM equities suffered from overwhelming headwinds over the last several years as the combination of zero-COVID policy, the tech crackdown, a strengthening USD, global inflation and risk-off sentiment led to a massive 32% underperformance relative to developed equities since the beginning of 2020.

However, since Q4 2022, EM have seen major improvements to the investment backdrop. It began with a rapid abandoning of zero-COVID policy in China. That U-turn is arguably the most important factor for not only EM nations but also the global economy. While initially underappreciated and even neglected by the market, the reopening has already translated into stronger PMI numbers (the China Composite was 53.6 in April) and growth outlook.

We are likely to see China's reopening transmit to stronger expected earnings over the coming months as economic activity reverts to more normal historical levels. EM growth dynamics in general remain much more robust, making developing economies, particularly those in Southeast Asia, the engine of global growth. Furthermore, Chinese leaders appear committed to continuing both fiscal and monetary support.

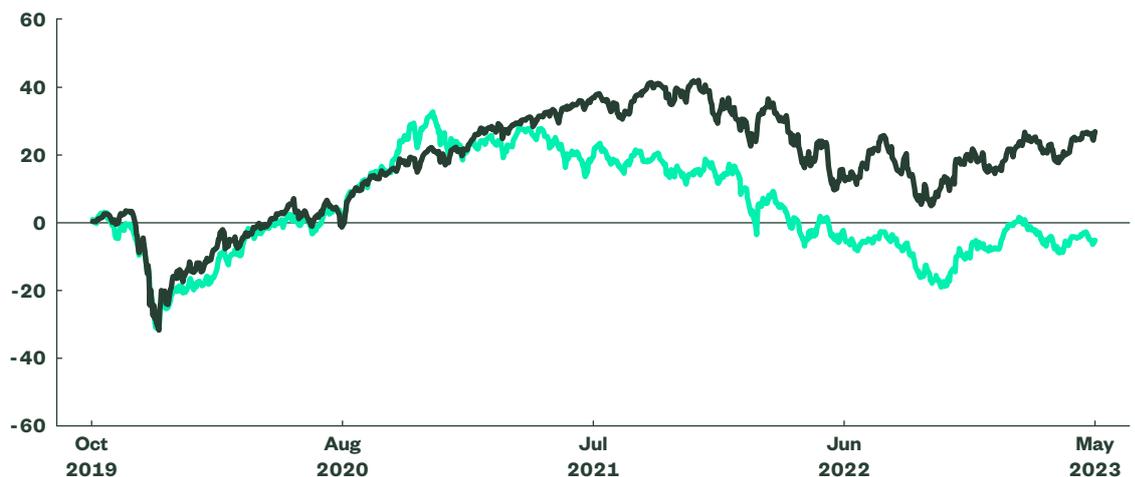
On the regulatory front, China appears to have eased its approach toward the technology sector. The plan for the Alibaba split-up is a clear signal that the tech sector will be allowed to grow. With that in mind, the regulatory stance needs to be constantly and carefully monitored. The May hike from the Fed could have been the final hike in the cycle, meaning further USD weakening over the next six months is a possible scenario. This would support both EM equities and the underlying economies.

It is worth remembering that Southeast Asia is a dominant region within the EM equity space, representing 78% of the MSCI EM Index (with China at 31%, Taiwan at 15%, India at 14% and South Korea at 12%). The EMEA and LatAm components provide a commodity cushion with the accelerated economic activity in China helping them through the channel of higher commodity prices.

Despite the clear and dramatic set of improvements to the investment backdrop, EM equities have been a sleeping beauty, lagging DM in terms of performance in 2023. In our view, given the number of EM-specific improvements, peaking rates and DM economies bottoming out, the tides for EM equity performance may also finally turn.

Figure 4  
**MSCI Emerging Market vs. MSCI World Index performance (in USD)**

■ MSCI World Index  
■ MSCI Emerging Markets Index



Source: Bloomberg Finance L.P. as of 30 April 2023. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

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## How to Access Global Emerging Market Equities

[SPDR® MSCI Emerging Markets UCITS ETF](#)

[SPDR® MSCI Emerging Markets Climate Paris Aligned UCITS ETF \(Acc\)](#)

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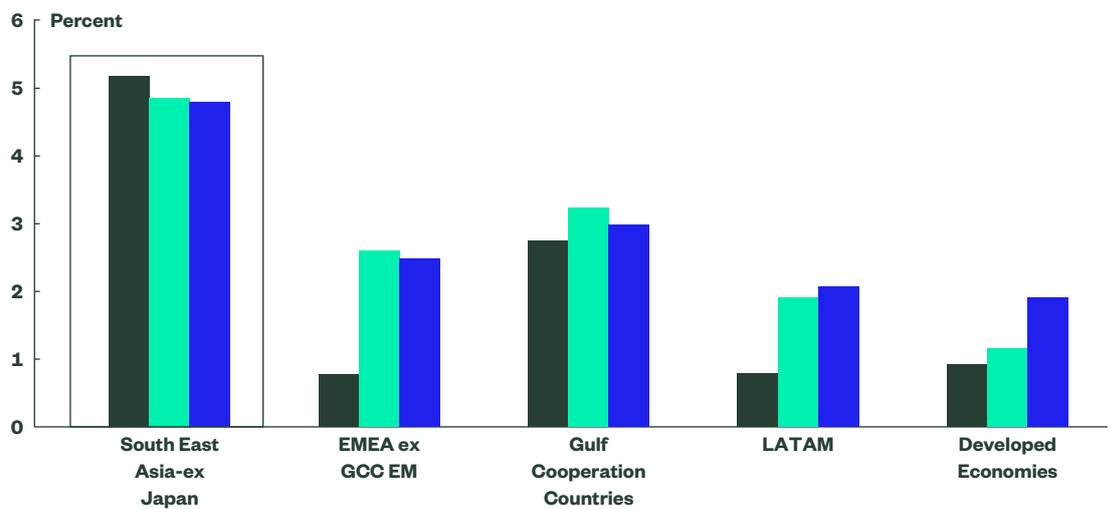
### EM Asia: The Engine of Global Growth

Global economic growth is slowing. While recession is not our central scenario, there remain risks that restrictive monetary policy may yet weigh on certain parts of the economy, leading to a more severe economic downturn.

Weaker growth disproportionately affects LatAm and EMEA EM equities, as they are more commodity driven and operate in economies where growth is expected to be somewhat slower. In their quest for pockets of growth, investors may decide to focus on MSCI EM Asia. China and India are the natural drivers but we also expect Taiwan and South Korea to enjoy stronger expansion compared to the developed world.

Figure 5  
**Asia Leading Global Growth by a Wide Margin**

■ 2023  
■ 2024  
■ 2025



Source: Bloomberg Finance L.P., as of 28 April 2023. Projected characteristics are based upon estimates and reflect subjective judgments and assumptions. There can be no assurance that developments will transpire as forecasted and that the estimates are accurate.

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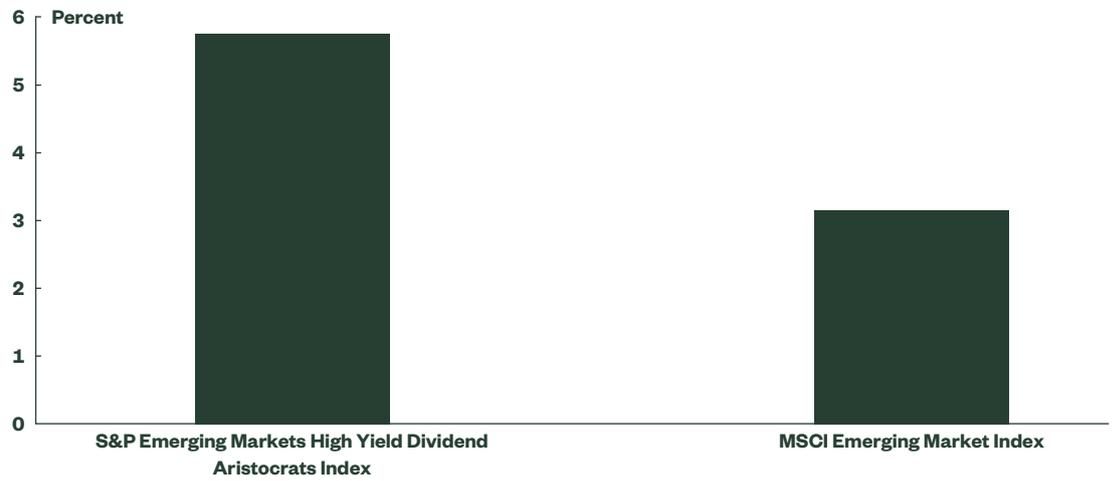
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### EM Dividend Aristocrats: China Reopening with More Traditional Tech Exposure

China abandoning its zero-COVID policy is arguably the strongest tailwind for the global economy. The softer approach from the Chinese regulator toward internet giants within the technology sector is a likely scenario, but we appreciate that in the past there has been disappointment on that front.

We cautiously expect the regulatory easing toward tech to continue. That said, investors who would like to play the China reopening story with more exposure toward semiconductors and hardware rather than internet/software giants (which in the past have been targeted) could opt for EM Dividend Aristocrats. This exposure not only provides access to companies backed by robust cash flow but it also tends to overweight the more traditional types of businesses relative to new economy stocks. In general, we expect dividend stocks will continue to attract investors over the course of 2023 given the combination of built-in defensive and value features.

Figure 6  
**12-Month Dividend Yield (Gross)**



Source: Bloomberg Finance L.P., as of 28 April 2023. Yields are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

### How to Access EM Dividend Equities

[SPDR® S&P® Emerging Markets Dividend Aristocrats UCITS ETF \(Dist\)](#)

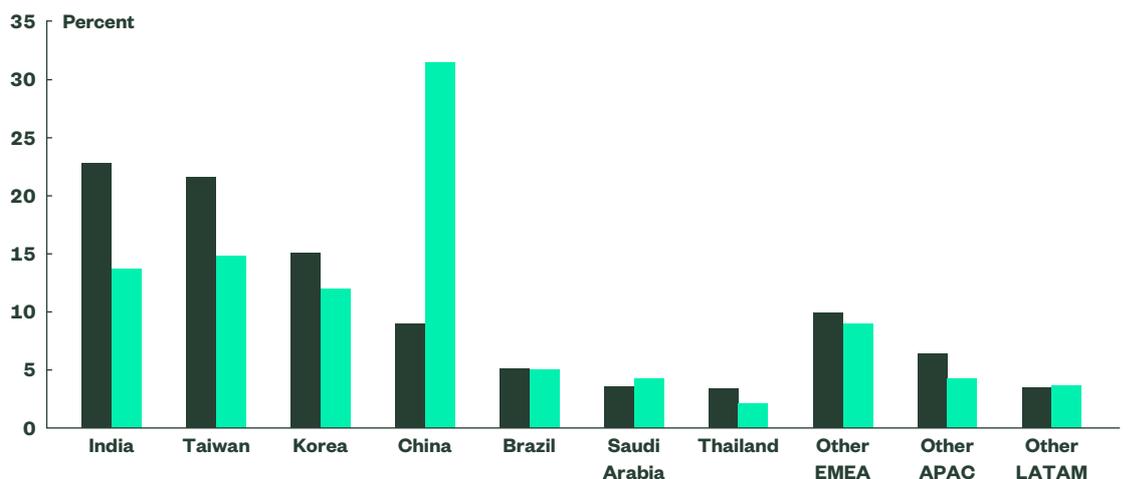
EM Small Caps:  
 Economic Growth  
 beyond China

EM small cap companies allow investors to gain significant exposure to Southeast Asian countries with limited exposure toward China, which represent only 9.0% of the index. Meanwhile, EM small caps may offer an interesting alternative or complement to broader EM exposure given Taiwan, South Korea and India represent in total nearly 60% of the MSCI EM Small Cap Index.

As small cap equities tend to be more domestic, the MSCI EM Small Cap Index may facilitate playing the EM economic rebound in a more direct way. Relative to the broader EM index, the MSCI EM Small Cap Index overweights industrials (+9.8%), materials (+5.4%) and health care (+5.3%) and underweights financials (-11.9%) and communication services (-6.2%). Investing in small caps, particularly in regions such as EM, requires diversification; the 1,868 constituents provide that necessary feature.

Figure 7  
**Country Breakdown:  
 MSCI EM Small  
 Cap Index vs.  
 MSCI EM Index**

■ MSCI EM Small Cap Index  
 ■ MSCI EM Index



Source: FactSet as of 28 April 2023. Weights are as of date indicated, are subject to change and should not be relied upon thereafter.

## How to Access EM Small Cap Equities

### SPDR® MSCI Emerging Markets Small Cap UCITS ETF

#### EM Debt: The Drivers of Returns Align

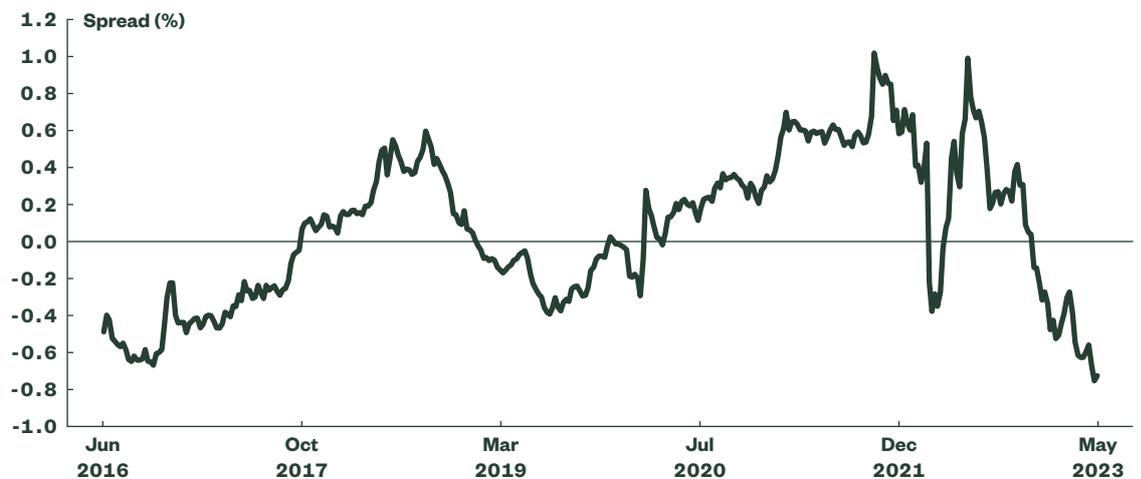
Returns year to date have been positive for EM debt with the key drivers — bond prices, currency returns and coupons — all contributing positively. The question on investors' minds is whether this favourable backdrop for EM will persist.

The first four months of the year have not been without their challenges. Rising US Treasury yields in February, in response to fears that the Fed would have to tighten more, pushed EM yields higher. However, in contrast to the issues in March 2022, which saw investors desert EM debt, the problems in the US banking system saw EM local currency yields decline. This is significant, as the uncertainty generated by the nearing of the end of the Fed rate cycle and by US banking problems could easily have seen investors shy away from riskier assets.

EM resilience may in part derive from relatively high levels of conviction that returns can remain strong in the coming months. Again, breaking down the stream of returns into the bond, forex and coupon components, all three have the potential to continue to deliver.

Bond price returns typically accrue as markets sense central banks will ease policy. As the figure below shows, the 0- to 2-year curve slope<sup>2</sup> is currently inverted, which suggests that expectations for imminent rate cuts are high. Real rates, in LatAm in particular, are high and, along with easing inflation pressures, could allow central banks to justify cutting rates. However, there is clearly some caution around delivering cuts before there is more clarity on where the US fed funds rate peaks as aggressive cuts could now result in weaker currencies.

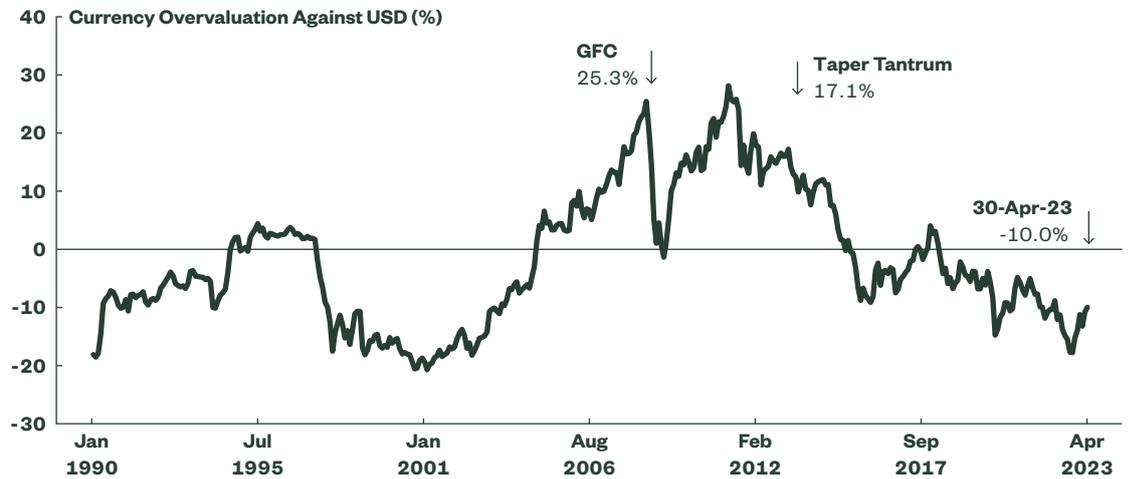
Figure 8  
**Inverted 0- to 2-Year Slope Suggests Market is Waiting for Central Banks to Ease**



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 12 May 2023.

Forex returns have been a key driver of overall returns since the USD peaked in October 2022. The long-term model of fair value run by State Street Global Advisors estimates the basket of currencies that make up the Bloomberg EM Local Currency Liquid Government Index to be close to 10% undervalued versus the USD as at the end of April (see chart below). In short, there remains plenty of scope for USD depreciation to continue supporting returns.

Figure 9  
**From a Longer-Term  
 Perspective, USD  
 Still Looks Rich vs.  
 EM Currencies**



Source: State Street Global Advisors, as of 28 April 2023.

That said, the fact that the USD has already undergone a meaningful depreciation and the relatively high levels of volatility in the forex markets do hint that the direction of travel may not be all one way. In addition, if EM central banks do start easing, then this may cushion the descent of the USD.

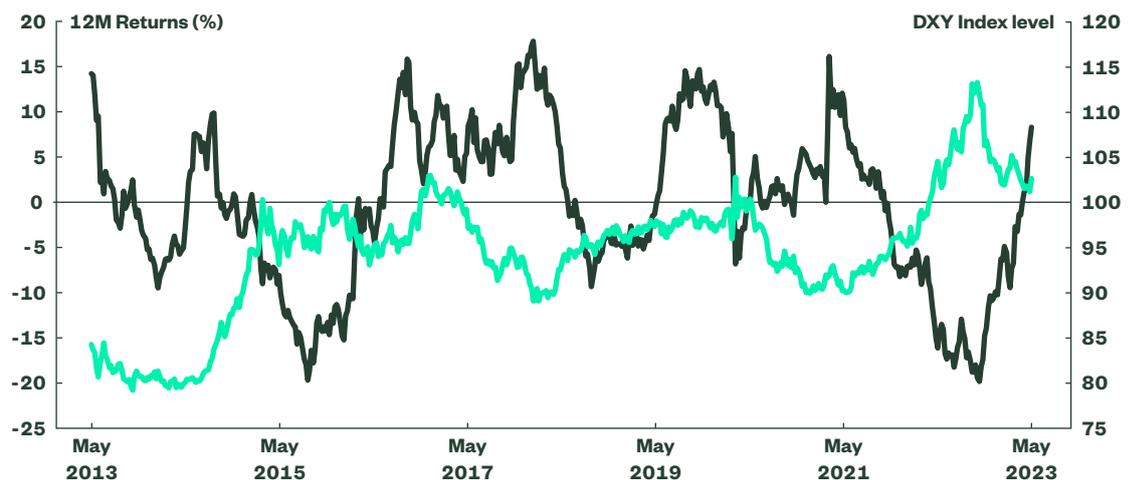
The final link in the chain is coupon interest. This is running at 4.9% on an annualised basis so, even if central banks do not deliver substantial policy easing and the USD trades sideways, investors will still generate a healthy return. In addition, the coupon component should start to increase as new, higher coupon bonds come into the index.

## More to Give

The backdrop may promise rewards but, in the context of the 13.5% returns seen over the past six months,<sup>3</sup> some investors may feel that the best days of EM are already past. However, history suggests that periods of strong returns can persist. The most notable period started in 2016 after the market had undergone a similarly large correction to the one we saw in 2022. The strong 2016 rebound was followed by several years of 5% to 15% returns. In other words, following a big correction, there is scope for returns to remain strongly positive for some period of time.

Figure 10  
**12-Month Index  
 Returns vs. DXY**

■ Bloomberg EM LC Liq  
 Index 12M Returns  
 ■ DXY



Source: Bloomberg Finance L.P. as of 12 May 2023.

The early-stage returns in 2016 were not driven by USD weakness, with the DXY proving relatively stable between 2015 and late 2016. The USD did fall between early 2017 and Q2 2018, which reinvigorated returns. The DXY is currently at similar levels to those seen at the 2016 peak and thus still have the potential to contribute meaningfully to returns.

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## How to Access EM Local Currency Exposure Hedged to EUR

[SPDR® Bloomberg Emerging Markets Local Bond USD Base CCY Hdg to EUR UCITS ETF \(Acc\)](#)

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### EM Hard Currency

Our view that the USD can depreciate further means we favour local rather than hard currency exposures. However, correlations are high between the asset classes: the JP Morgan EMBI Global Diversified Sovereign Index has had a 78% correlation to the JP Morgan GBI-EM Global Diversified Index during the past five years.<sup>4</sup> This suggests that the positive backdrop for local currency debt should support its hard-currency counterpart.

A key component underpinning demand should be the yield, with the JP Morgan EMBI Global Index yielding more than 7.5%. Much of this yield derives from the worse-rated credits within the index,<sup>5</sup> hinting that there is a fair amount of bad news already priced into the lower-rated countries. With hard currency exposures offering a purer credit play than local currency, the fact that growth appears to be holding up well may provide some additional support.

USD risk can be hedged out and, for investors who are reluctant to take on duration as well as EM risk, the short end of the curve offers a significant pick-up to US Treasuries. The ICE BofA 0–5 Year EM USD Government Bond ex-144a Index yields around 6%, which is over a 200 bps pick-up to US Treasuries. Investors can access all that yield for a duration of approximately 2.5 years.

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## How to Access EM Hard Currency Exposure

[SPDR® ICE BofA 0–5 Year EM USD Government Bond UCITS ETF \(Dist\)](#)

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## How to Access EM Hard Currency Exposure Hedged to EUR

[SPDR® ICE BofA 0–5 Year EM USD Government Bond EUR Hdg UCITS ETF \(Acc\)](#)

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### Endnotes

- 1 See: [Long-Term Asset Class Forecasts: Q2 2023](#).
- 2 Weights for the 0- to 2-year slope are in line with those of the Bloomberg Emerging Markets Liquid Government Index as at 28 April 2023.
- 3 Returns from the Bloomberg EM Local Currency Liquid Government Index have 13.54% (non-annualised) in the 6 months to 8 May 2023.
- 4 Source: Bloomberg Finance L.P., as of 28 April 2023. Based off weekly changes.
- 5 Source: JP Morgan, as of 12 May 2023. The yield to worst on the high grade component is 5.08% against 11.95% for high yield.

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