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EMERGING MARKETS

FIVE OVER FIVE

The Structural Shifts Taking Place in EM

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PERSPECTIVES | APRIL 2024

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Prior to the onset of COVID-19, much had been written about the appeal of emerging market debt (EMD), touting the yield advantage as well as its lower correlation to other fixed income asset classes. EMD has underperformed since the pandemic, and this has left investors wondering if and how EMD fits into their asset allocation. After this difficult start to the 2020s amid sharp increases in inflation and rates, U.S. dollar strength, rising geopolitical risks, and meaningful capital outflows, conditions in the asset class warrant a fresh look. As the sector continues to develop and mature, we acknowledge that EMD performance may moderate. This does not limit its attractiveness but helps us refine our investment themes. From our perspective, we see five structural factors that should support the emerging markets over the coming five years and possibly beyond:

- The Cyclical Headwinds Turning to Tailwinds: A reversal of inflationary pressures leading to EM central bank easing cycles
- A Maturation of EM Economies: More sustainable debt structures and a growing share of GDP
- Solid Fundamentals: Lower debt-to-GDP and total debt burdens
- Favorable Demographics: Younger, growing populations that fuel growth
- Great Power Competition: EM economies expected to benefit from the global realignment

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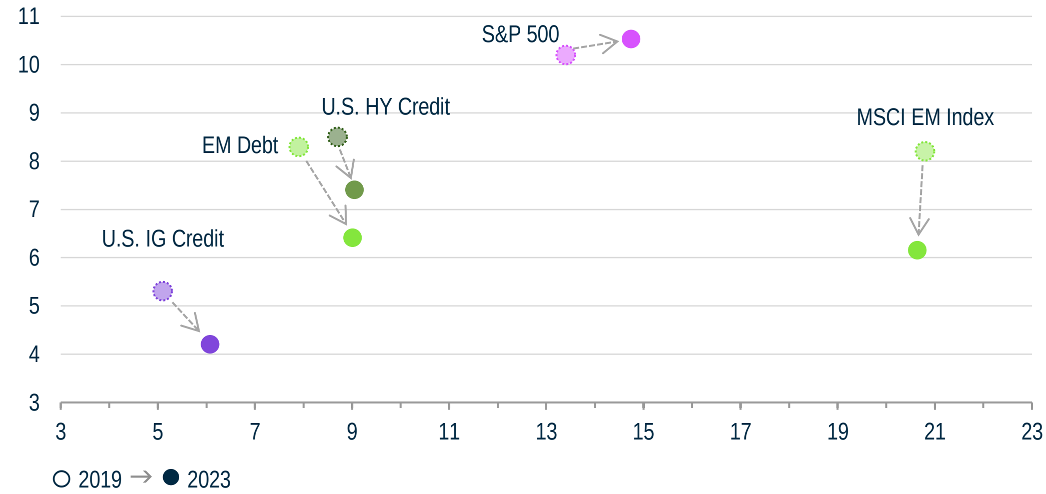
While performance varied by year, EMD returns prior to the COVID-19 crisis were meaningfully higher than the Bloomberg U.S. Aggregate Bond Index and the Bloomberg U.S. Investment Grade Corporate Index. At the same time, EMD generated returns that were in line with U.S. high yield with meaningfully less volatility (Figure 1).

Figure 1: Asset class performance since 2003 (y=annualized return %, x=volatility %)

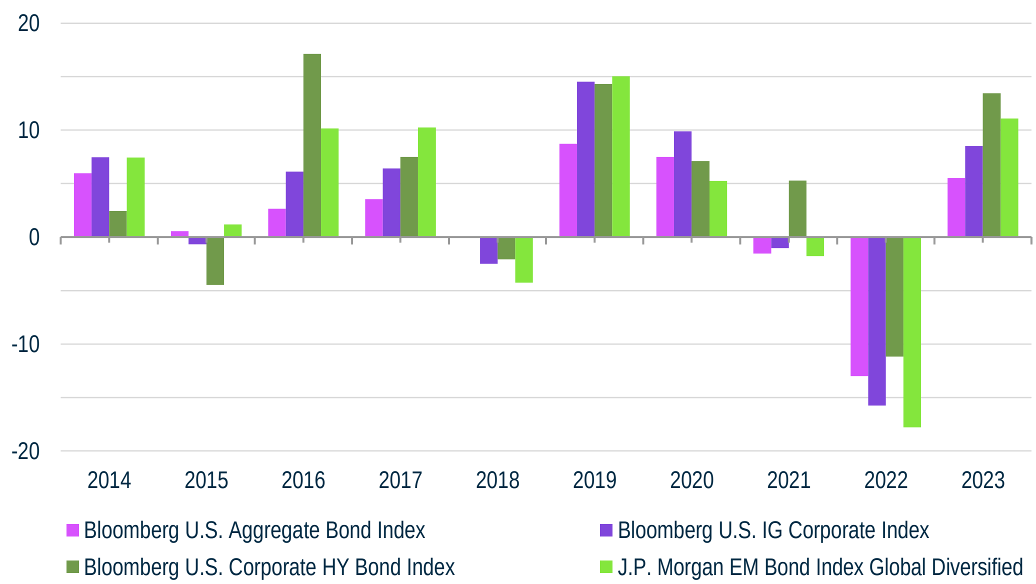


Source: Bloomberg, JPMorgan, and PGIM Fixed Income as of December 31, 2023.

However, there is no question that EMD has underperformed other fixed income allocations since then (Figure 2).

How much faster emerging markets are growing than developed markets has historically been the largest driver of returns in EM.

Figure 2: 10-year annual fixed income returns (%)



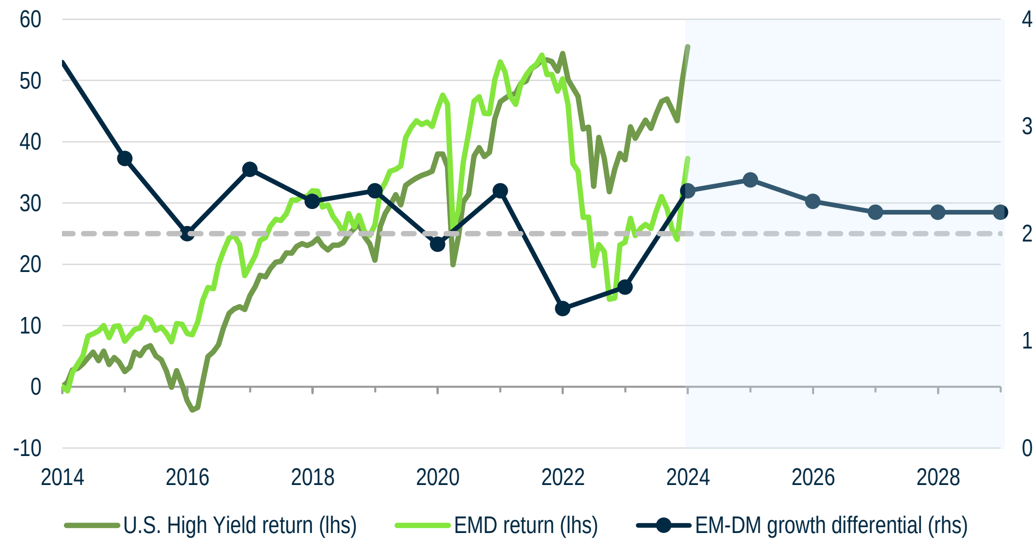
Source: Bloomberg and J.P. Morgan as of December 31, 2023.

Is this underperformance justified or will EMD reverse the underperformance experienced since COVID? To help answer this question, we drill down into the drivers of EMD underperformance since 2021 and provide our outlook for the five key structural shifts currently taking place, which we believe should provide a tailwind for EMD performance going forward.

THE CYCLICAL HEADWINDS TURNING TO TAILWINDS

How much faster emerging markets are growing than developed markets has historically been the largest driver of returns in EM. When EM/DM growth differentials have been above 2%, EMD has historically outperformed U.S. high yield (Figure 3).

Figure 3: EMD and U.S. HY cumulative performance and EM-DM growth differential (%)



Source: IMF, JPMorgan, Bloomberg, PGIM Fixed Income. Growth data as of October 2023. Performance data as of December 2023.

As expected, when that growth differential dipped below 1.5% in 2021 and 2022, EMD underperformed. But due to the severity of successive shocks post-COVID, the magnitude of EM underperformance was extreme. Even before the pandemic, there were signs that China's growth was decelerating as it faced challenges due to deleveraging, de-risking, rebalancing, and demographic shifts.

However, the consensus view is for emerging markets to regain that growth premium going forward—well above that important 2% figure and to remain above 2% for the foreseeable future—despite ongoing uncertainties around China's growth path (Figure 4).

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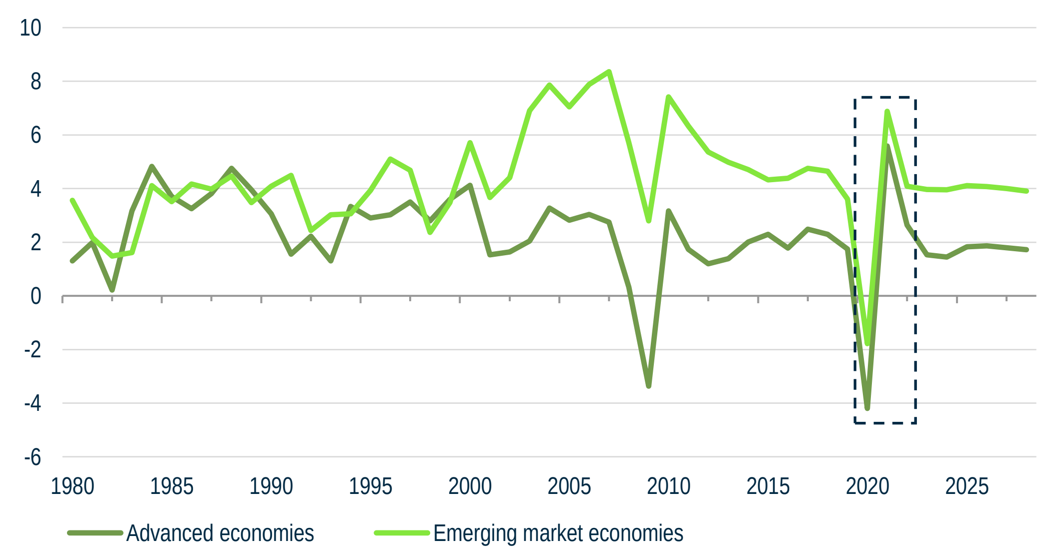
Figure 4: Emerging market and developed market growth rates (%)

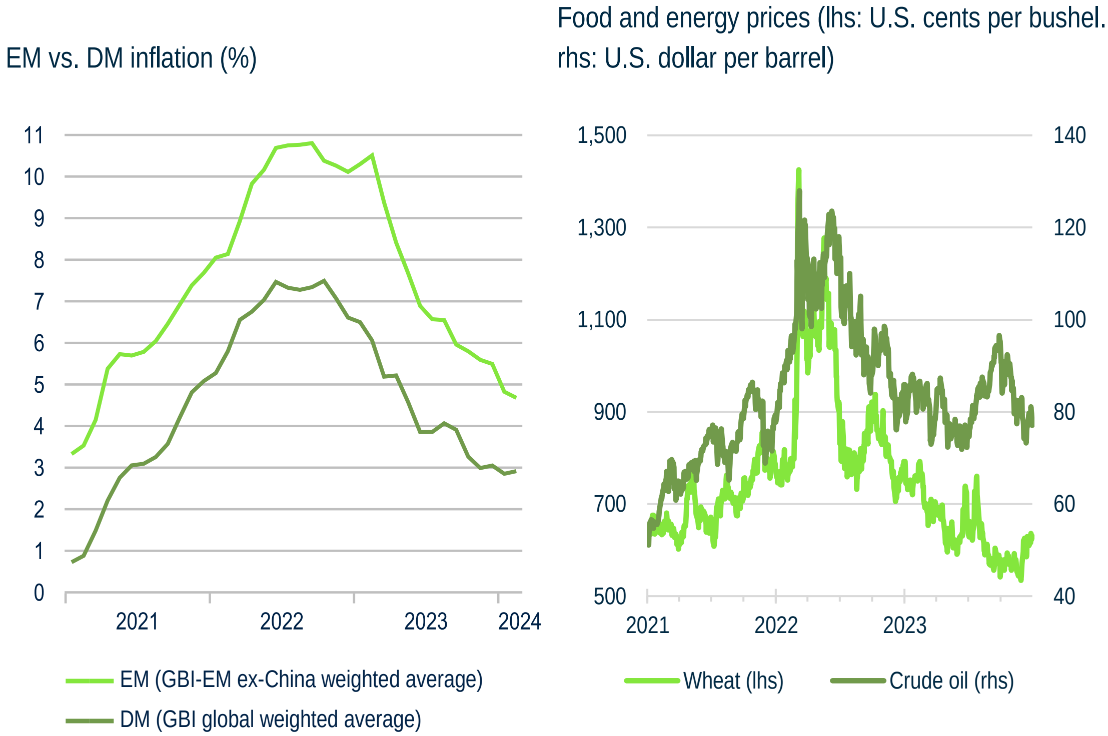


Source: IMF as of October 2023.

REVERSAL OF 2021 AND 2022 GROWTH DIFFERENTIALS

While emerging market economies were hard-hit by the COVID-19 crisis, the heaviest burden was from inflation and the subsequent monetary policy reaction from emerging market central banks. It usually comes as a surprise to developed market investors, but most emerging market central banks are highly orthodox. When global inflation began to rise in early 2021, EM central banks were quick to hike rates even as developed market central banks waited, dismissing the sharp rise in inflation as "transitory." Despite similar rises in inflation across developed and emerging markets (inflation within emerging markets did not rise faster than developed markets until Russia's invasion of Ukraine, which sent food and energy prices soaring), EM rate hikes came much earlier and with a steeper trajectory than those in developed markets (Figure 5).

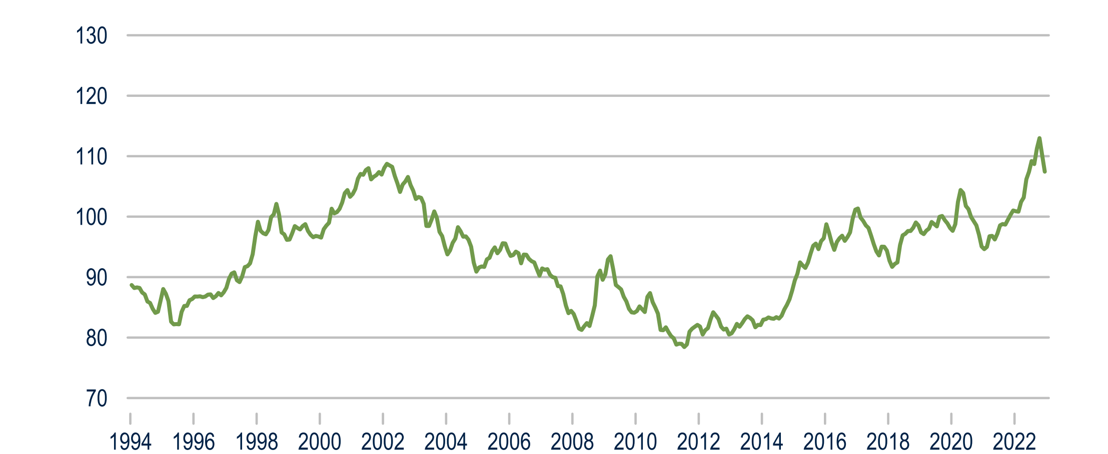
Figure 5: **Russia's Invasion of Ukraine Sent Food and Energy Prices Soaring**



Source: Macrobond (lhs) and Bloomberg (rhs) as of December 31, 2023.

Rising rates in EM had the textbook effect on EM economies: they slowed corporate and household spending, reducing growth and eventually bringing down inflation. Unrelenting U.S. dollar strength (Figure 6) added further pressure and impacted EM debt ratios.

Figure 6: United States Real Broad Effective Exchange Rate (BIS Real Broad Effective Exchange Rate Index)



Source: Macrobond as of January 18, 2024.

The reversal of inflationary pressures has led many EM central banks to begin rate cutting cycles, and we expect that to continue.

Since then, the reversal of inflationary pressures has led many EM central banks to begin rate cutting cycles, and we expect that to continue. The easing in domestic funding conditions should remain supportive of EM growth.

THE MATURATION OF EM ECONOMIES

Just as important as the reversal of headwinds from rising rates, the tailwinds that have been powering EM growth for years are nearing a tipping point as many EMs move from *maturing* to *matured*. While some weaker emerging markets have suffered—including some well-telegraphed defaults from Argentina, Ecuador, Ghana, Zambia, and Sri Lanka—most emerging market economies have remained quite resilient from a fundamental standpoint in the face of these shocks.

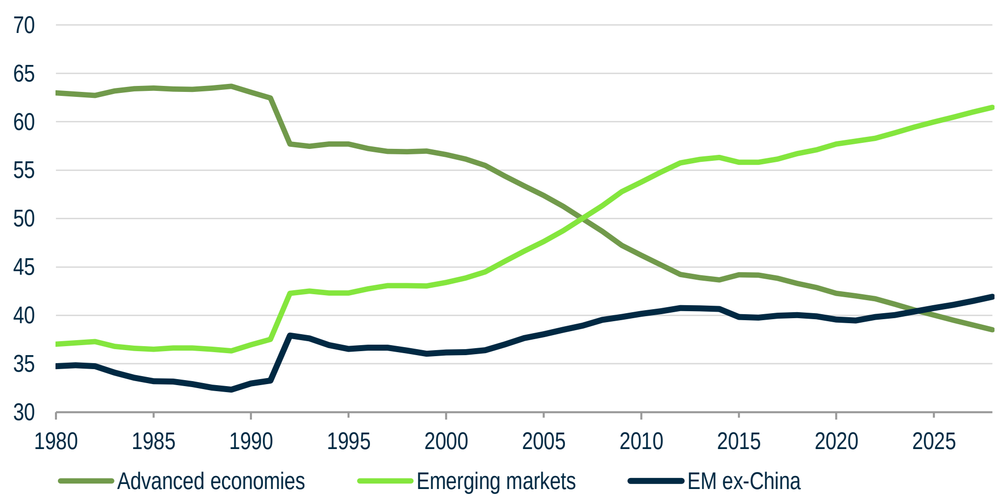
Emerging market sovereign fundamentals and growth structures have matured and improved since the "taper tantrum" of 2013 while their sensitivity to external shocks has diminished. This is a result of better policy implementation by emerging market governments and central banks, as well as exports' boost to growth and current account surpluses.

This recovering growth led to increased income convergence and high domestic savings and, when combined with orthodox monetary policy, has enabled emerging markets to better withstand shocks. As this income growth and savings has taken hold, EM local markets have further developed as a method of savings. With more disciplined monetary and fiscal policy, debt structures have become more biased towards domestic and high-quality funding. As a result, the sensitivity of EM local markets to higher rates and U.S. dollar strength is lower. As domestic demand now plays a higher role in driving growth than it did in the past, growth rates have become more stable.

LARGER SHARES OF GDP

Emerging markets are not only home to the fastest growing countries, but they also control the majority of the world's GDP (Figure 7).

Figure 7: Share of Global GDP (ppp %)



Source: IMF as of October 2023.

In 2007, emerging markets overtook developed markets share of global GDP as China's rapid growth after 2000 drove significant gains. Since then, EM has only continued to widen that gap.

Excluding China, emerging markets' share of global GDP began accelerating a few years after China's initial ascent and is now expected to overtake developed markets this year.

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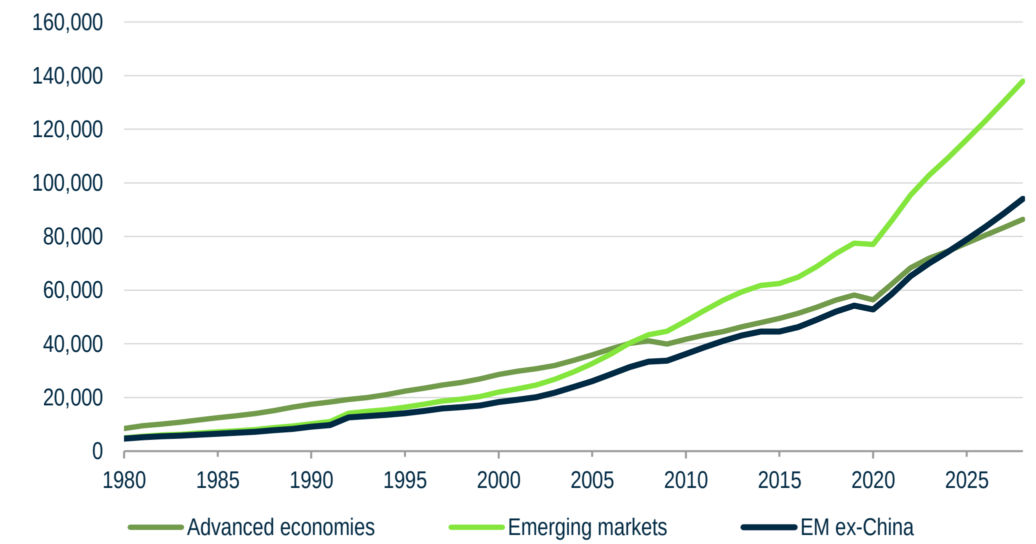
Figure 8: GDP (USD billions, ppp)



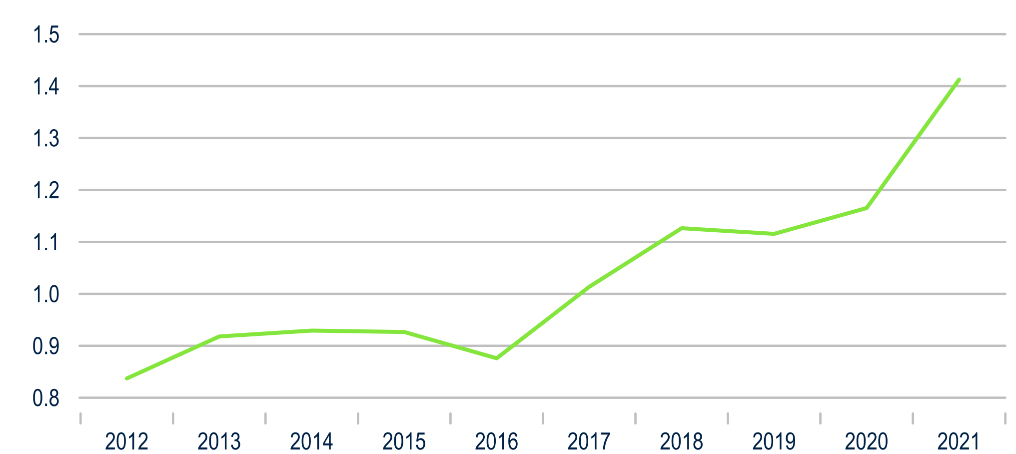
Source: IMF as of October 2023.

EXPORTS

Commodity exports have been emerging markets' most durable source of growth given the sector's open stance on free trade and large share of the world's critical resources. While commodities remain vital to EM growth, the export mix is adapting with the global economy. The inclusion of technology to the mix has also reduced the volatility of EM growth. Many middle-income countries (a large majority of the EM indices) are moving away from low-value industries and towards higher value-added or service-oriented industries.

Considering EM's large shares of copper, lithium, nickel, rare earth minerals, agricultural products, and hydrocarbons, these commodities should continue driving growth in conjunction with those higher value-add businesses. Thus, the demand for EM exports should continue rising amidst the latest tech advancements and the transition to green energy (Figure 9).

Figure 9: Time series of World Bank EM high tech exports (USD, trillion)



Source: Macrobond as of April 2024.

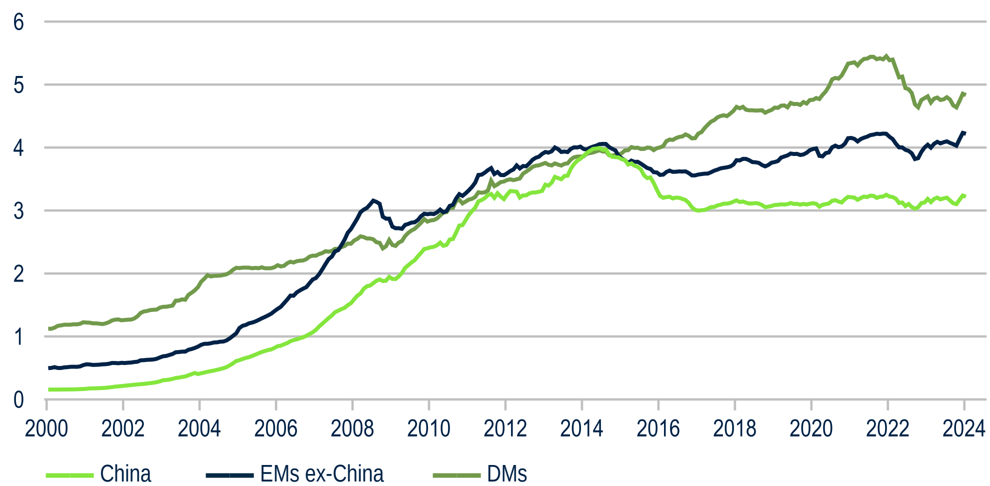
One of the bright spots in global sovereign debt over the last two decades has been the considerable and broad-based accumulation of reserves within emerging markets.

Clearly, trade policies by the major global powers could impact trade volumes as well as the flow of funds, direction of trade, and balance of payments. The outcome of the U.S. Presidential elections, with Trump's campaign promises of significant tariffs, could disrupt this dynamic. However, it is far too early to assess how much of an impact this might have over the long term.

HIGH RESERVES

One of the bright spots in global sovereign debt over the last two decades has been the considerable and broad-based accumulation of reserves within emerging markets. Over the last 20 years, reserves as a percent of GDP have doubled (Figure 10).

Figure 10: International reserves (total reserves excluding gold, USD trillions)



Source: Macrobond as of February 27, 2024.

This reserve build has been primarily driven by the combination of increasing exports— leading to current account surpluses— and higher sustainable growth. On top of this, reserve management continues to become more sophisticated, allowing governments to provide liquidity during a crisis.

Historically, external liquidity has been the largest driver of sovereign stress. Given the improvement in external accounts, many EMs have important buffers which should lower growth volatility and continue supporting convergence towards DM spreads over the long term.

SOLID FUNDAMENTALS: LOWER DEBT-TO-GDP

Investing in debt is primarily about fundamentals combined with long-run growth potential and, in both of these aspects, emerging markets are beginning to stand out when compared to developed markets. These aspects also underscore the importance of in-house economic coverage by country.

An important, yet surprising, aspect of EM fundamentals is that most economies have lower debt-to-GDP ratios than those in developed markets. Emerging markets entered the COVID crisis with meaningfully lower debt-to-GDP ratios than developed markets and that gap has only widened as developed markets fiscal deficits remain historically wide (Figure 11).

Of course, given the higher vulnerability to shocks, albeit now with lower probabilities due to the factors listed above, EM debt-to-GDP should be lower, but the relative magnitude matters. Total debt burdens are also meaningfully lower given significantly less corporate and household debt within emerging markets.

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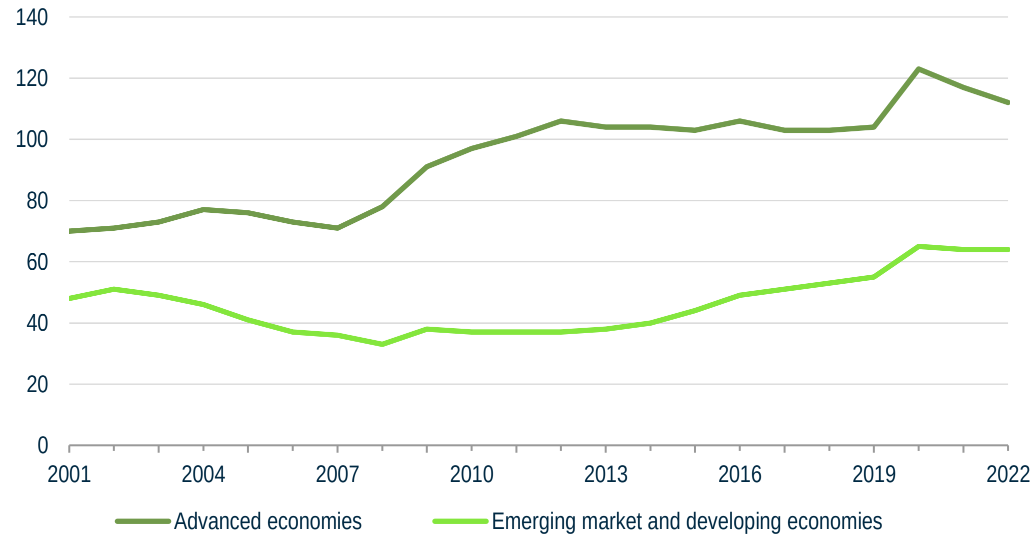
Figure 11: Developed versus emerging market deficits (% of GDP)



Source: IMF as of October 2023.

In particular, the U.S. may be entering a period of fiscal dominance, in which macroeconomic outcomes are increasingly determined by fiscal actions (or inactions) rather than central bank policy. Even before the pandemic, the U.S. was running the largest peacetime budget deficit in history outside of a recession at 4.6% of GDP. In 2023, with the pandemic over and many consecutive quarters of above-trend economic growth, the U.S. is running an even larger budget deficit of 6.8% of GDP.

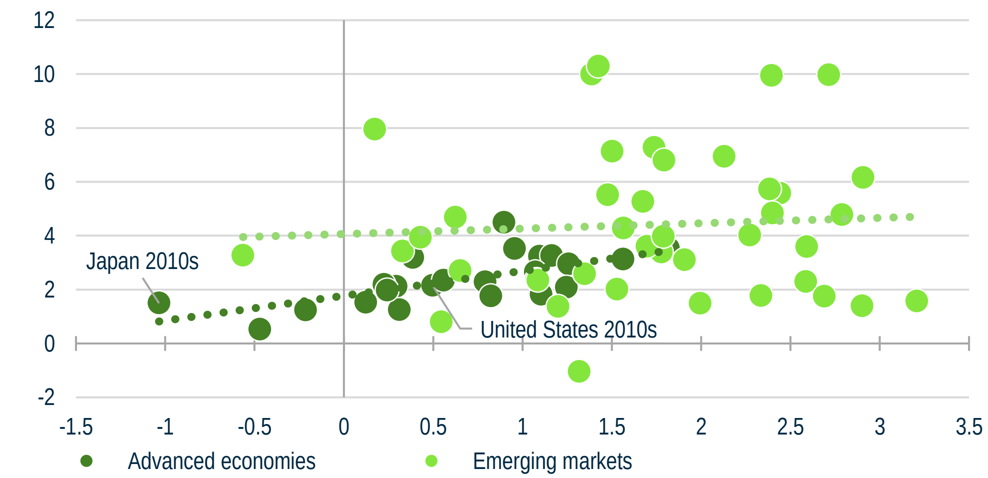
There are many reasons why developed markets have greater debt capacity, primarily higher GDP per capita, lower volatility of growth and funding in their own, often reserve currencies. However, rising government debt has generally been accompanied by weaker growth.

MORE FAVORABLE DEMOGRAPHICS

In developed markets, there is a strong relationship between the working age population and economic growth as this determines the tax base, revenues, and growth engines of a country going forward. Baby boomers were in many ways responsible for higher developed market asset prices over the last half century. However, aging demographics and slower labor force growth are now likely to weigh on future growth as workers retire and demand weakens. A 1% decline in the working age population has resulted in nearly a percentage point decline in real GDP growth.

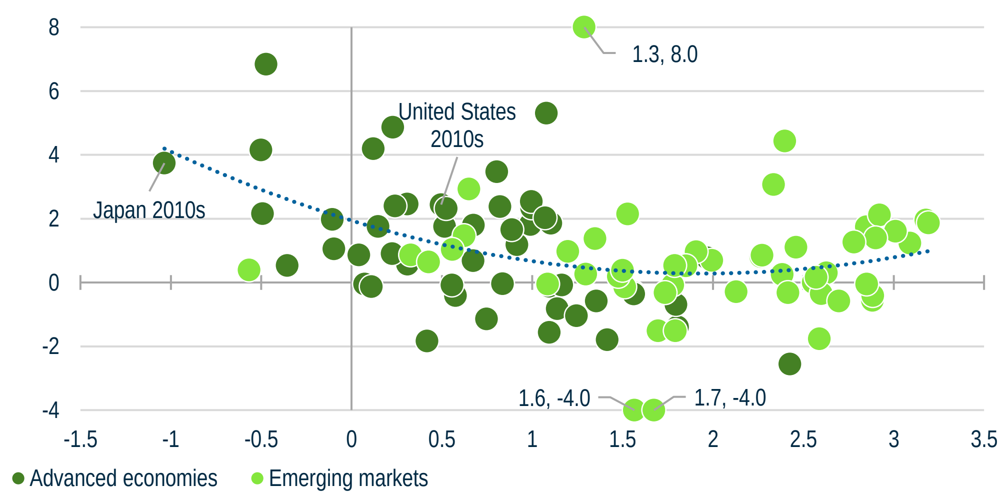
Aging populations are now leading to rising developed market debt burdens as they are not being met with an accompanied rise in working age populations. Japan's demographics peaked in the 1990s at the same time the country's asset bubble burst. Demographic shifts in the U.S. and euro area have been more gradual, but the trajectory in the coming decades is only slightly less severe (Figures 12 and 13).

Figure 12: Working age population and economic growth (y = average real GDP growth, %; x = working-age population growth, %)



Source: PGIM Fixed Income, National Statistical Agencies, Haver, United Nations as of April 10, 2024. Note: Decadal averages (1980s, 1990s, 2000s, and 2010s) for six advanced economies and ten emerging markets.

Figure 13: Working age populations and government debt (y = average change in government debt, % of GDP; x = working-age population growth, %)



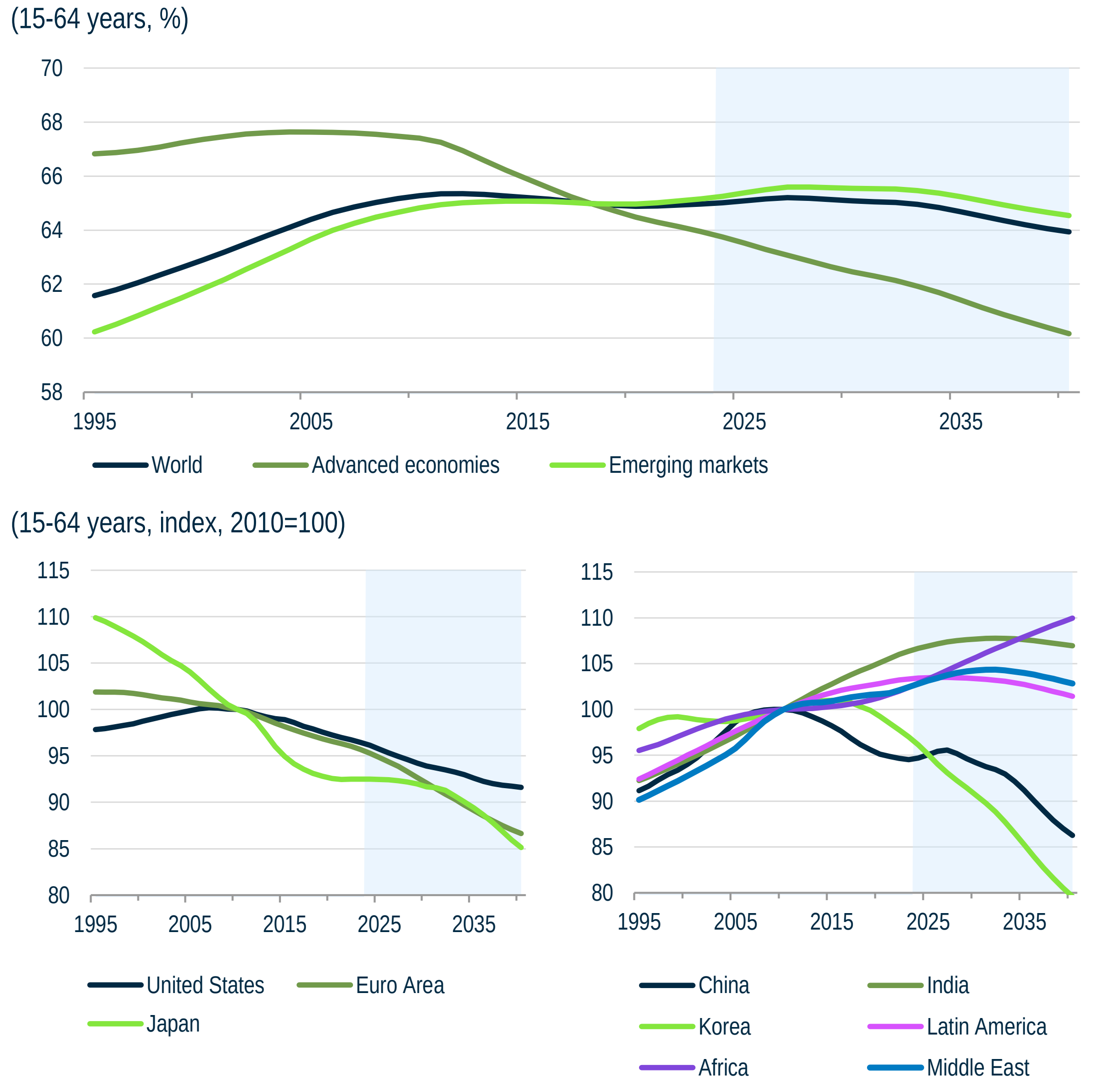
Source: PGIM Fixed Income, National Statistical Agencies, Haver, United Nations as of April 10, 2024. Note: Decadal averages (1960s, 1970s, 1980s, 1990s, 2000s, and 2010s) for nine advanced economies and nine emerging markets.

The demographic shifts are likely to intensify challenges for fiscal policy, especially for countries like the United States that have not made adequate preparations—this will inevitably mean increased expenditures on public pensions and healthcare. If working age population declines result in a slowdown in growth, that will translate into a corresponding slowdown in tax revenues. So, either taxes on the working population need to rise or debt levels need to climb, both of which would weigh on economic performance and likely lead to difficult political outcomes.

By contrast, the relationship between working age populations and growth in emerging markets is smaller and statistically insignificant as the effects of demographic shifts on growth are muted by an array of other economic factors, policies, and shocks. Even so, EM economies simply don't face the same demographic challenges that DM economies currently do. While some EMs, such as China and Korea, have demographic profiles similar to developed markets, India's working age population only flattens in the coming decades, Latin America's trajectory declines only slightly, and Africa's growth continues unabated (Figure 14).

EM economies simply don’t face the same demographic challenges that DM economies currently do.

Figure 14: Working-age population share



Source: PGIM Fixed Income, National Statistical Agencies, Haver, United Nations as of April 10, 2024.

As such, the demographic shift currently taking place could help support EM growth for decades even as aging populations increasingly weigh on DM economic performance.

GROWING MIDDLE CLASS

Given access to increasing quality of education and technology, as well as more accessible electricity and healthcare, the middle class within emerging markets is growing. With this, spending patterns are shifting, and EM consumers are, in turn, now spending more on education, entertainment, and healthcare. This is creating further domestic demand not only for those goods and services, but also for financial assets, which is creating a captive buyer base for local sovereign debt. The rise in income has generated a virtuous cycle that further improves EM governments funding base and decreases its sensitivity to external shocks. We expect this dynamic to continue as the consensus expectation is for the EM middle classes to continue to expand.

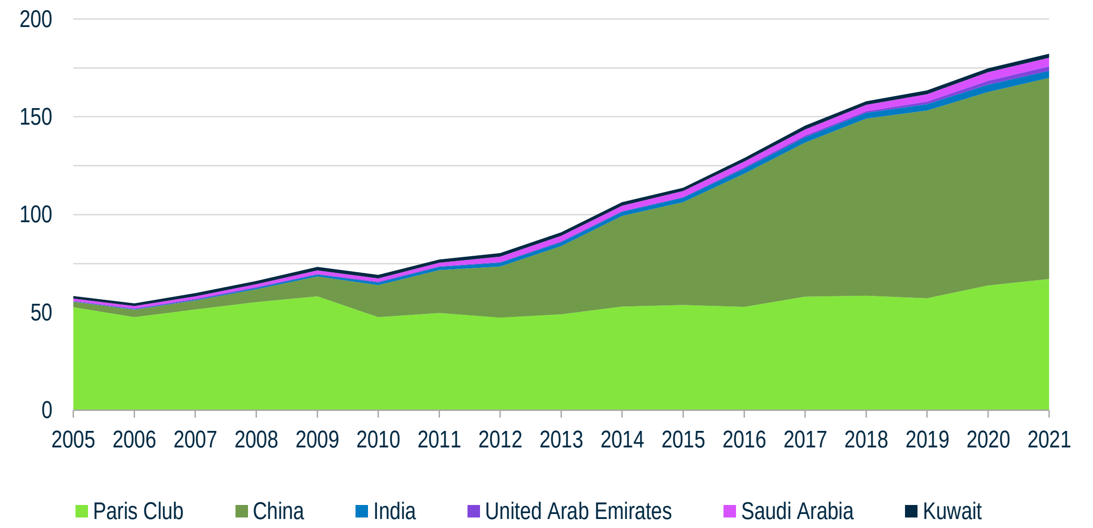
THE GREAT POWER COMPETITION

Competition between the U.S. and China is creating geopolitical realignment, with both countries vying to gain more influence in EMs, particularly the global south. The U.S. has lost influence in

The West has set out to counter China's influence by using a type of economic realpolitik—competing with China on the quantity and quality of financing it provides to geopolitical swing states, all of which are in EM.

the global south to China over the last 20 years as China's Belt and Road Initiative to funding in Emerging Markets has grown in importance (Figure 15).

Figure 15: Low **income countries' external debt b**y creditor (USD billions)



Source: World Bank International Debt Statistics as of April 2023. Note: measures public and publicly guaranteed debt of Debt Service Suspension Initiative eligible countries to nations specified.

This was apparent following Russia's invasion of Ukraine when only one-third of the world's population went along with U.S. sanctions.

Since then, the West has set out to counter China's influence by using a type of economic realpolitik—competing with China on the quantity and quality of financing it provides to geopolitical swing states, all of which are in EM. The first phase of this is the G7's Partnership for Global Infrastructure and Investment (PGII), which is set to disburse over half-a-trillion dollars of financing by 2027. It is no coincidence that the first recipient of PGII was Indonesia as it is one of the world's most populous countries and a geopolitical swing state courted by the west.

Further, the West has recognized that in order to compete, it needs to provide credible assurance to borrowers that there is a long-term replacement to China's funding. We expect the U.S. and G7, as well as the World Bank and the International Monetary Fund (IMF), to increase financing capacity to backfill for potential losses of Chinese financing in some countries. Evidence of this exists in the IMF's policy adjustment on arrears to official creditors, which is an attempt by the U.S. and G7 to convince debtor countries to run arrears to China if it refuses to restructure debt on comparable terms to those of Paris Club creditors in a timely fashion. At the World Bank, leadership change from David Malpass to Ajay Banga has coincided with a shift in priorities from maintaining a AAA credit rating to making its "balance sheet work harder" as the bank looks to increase its lending power by over $100 billion through balance sheet changes and new contributions from wealthy countries.

Furthermore, more rivals to the traditional and regional development banks, such as the New Development Bank and the Asian Infrastructure Investment Bank, as well as funding from Middle Eastern sovereign wealth funds, are emerging as smaller alternatives. This creates more bargaining power for EMs and enhances their funding quality.

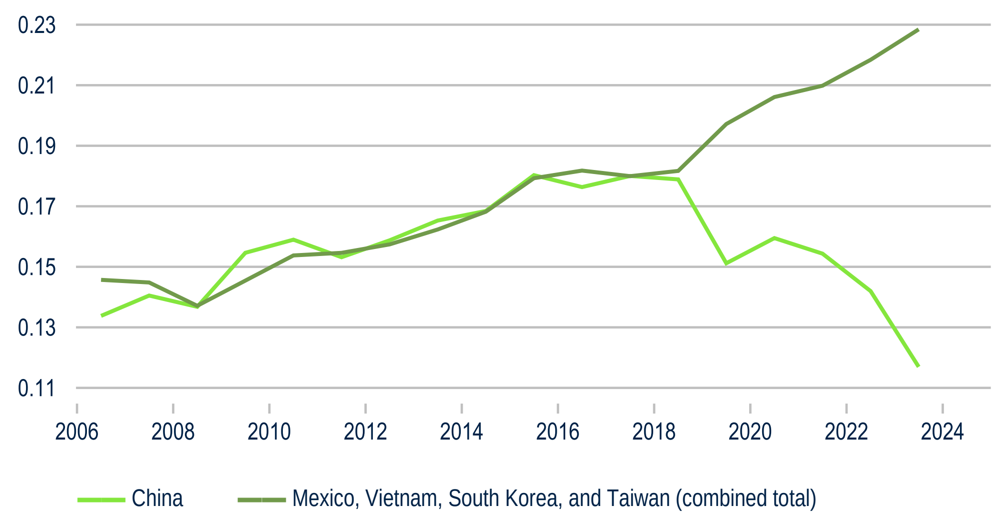
Over time we expect that more of the upstream production chain will become consolidated in non-China trade partners located primarily in emerging markets.

SUPPLY CHAIN REORIENTATION

Closely related to the intensified competition between the U.S. and China is the reorientation of global supply chains. We expect global supply chains to move away from a singular focus on achieving efficiency and finding the lowest cost producer toward a concept of resilience that's more geared around geopolitical alliances to source critical goods, such as semiconductors, EV batteries, pharmaceuticals, and critical minerals. This is not just a matter of speculation as the commitment to "de-risk" was made at the highest levels of government in the G7 statement released in Hiroshima. Indeed, we counted 20 specific references to China in the leaders' most recent statement, which ran contrary to the longstanding tradition for communiques to abstain from referencing individual countries. Three years ago there was no mention of China at all.

Against this backdrop, we're beginning to see hard evidence of de-risking in trade patterns. Only five years ago, China accounted for almost 20% of U.S. imports. Now it is below 15% as a share of the total, with Mexico, Vietnam, South Korea, Taiwan, India, and other EM countries gaining in share (Figure 16).

Figure 16: Annual U.S. imports of goods and services (% of total imports)



Source: Macrobond as of April 5, 2024.

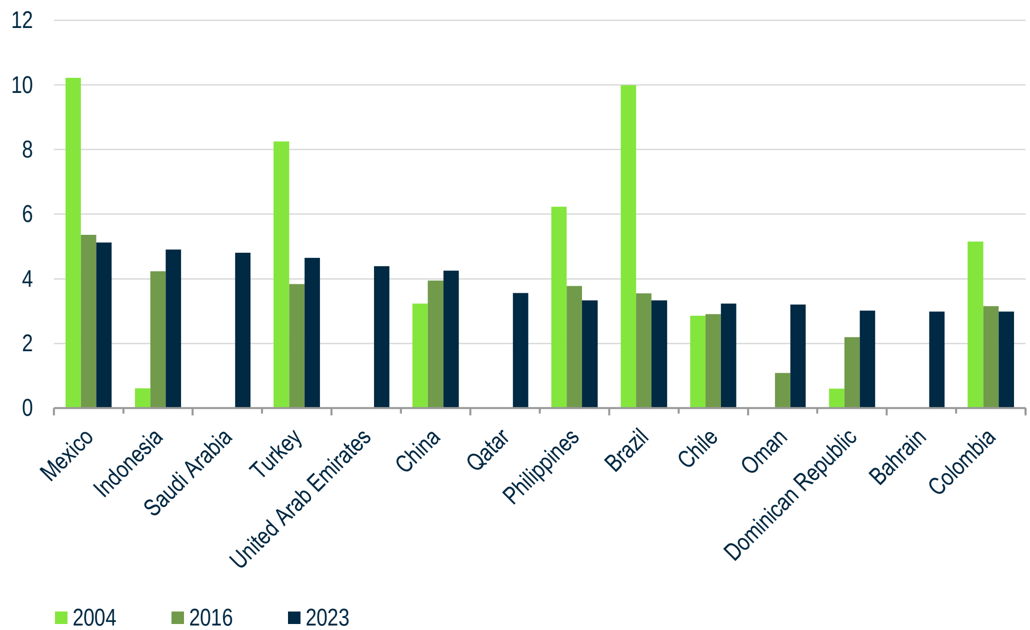
To complicate matters, it appears that many of the countries that are gaining share of U.S. imports are also increasing the volume of what they source from China. However, over time we expect that more of the upstream production chain will become consolidated in non-China trade partners located primarily in emerging markets.

China currently accounts for about one-third of global manufacturing production in value added terms (roughly equal to the U.S., Japan, Germany, and India combined), largely because it's one of the lowest-cost and most productive suppliers. The reduction of China's role in global supply chains to improve resilience and to advance national security objectives will likely imply lower global efficiency, lower economies of scale, and higher input costs at the margin—at least over the short term. However, given the size of China's economy compared to other EMs, a shift in that manufacturing production would be very meaningful to GDP. As "friendshoring" and "nearshoring" plans are fleshed out, we expect several emerging economies to benefit as suppliers of upstream inputs, labor, or both.

CHANGING INDEX COMPOSITION

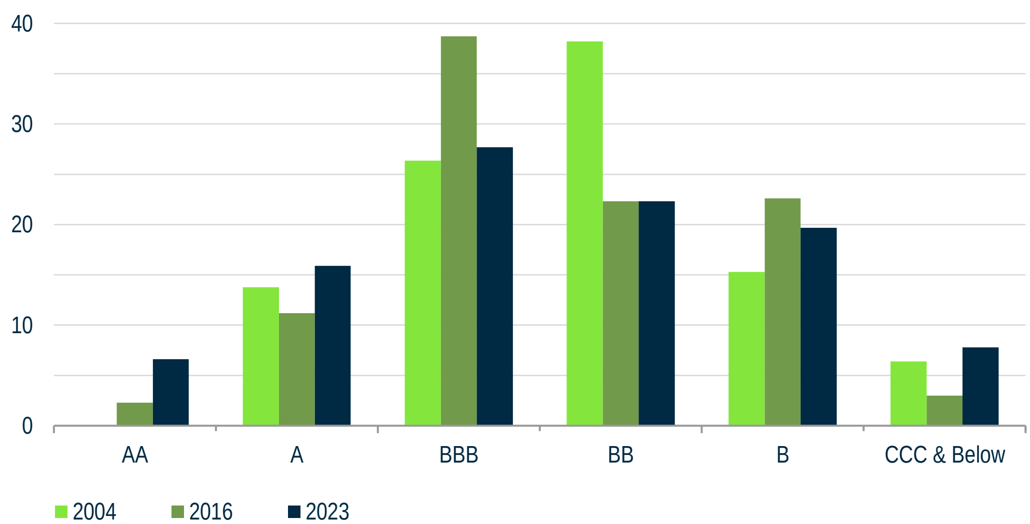
Given how out of favor EMD has been since the onset of COVID, many of the positive changes in EM indices have gone unnoticed. The addition of very high-quality Gulf Cooperation Council countries (Saudi Arabia, Qatar, United Arab Emirates) for a combined current weight of 14% has increased the credit quality of indices and provided more diversification (Figures 17 and 18).

Figure 17: Very high-quality GCC countries are now in EM indices (EMBI Global Diversified country weights over time, %)



Source: JPMorgan as of December 31, 2023.

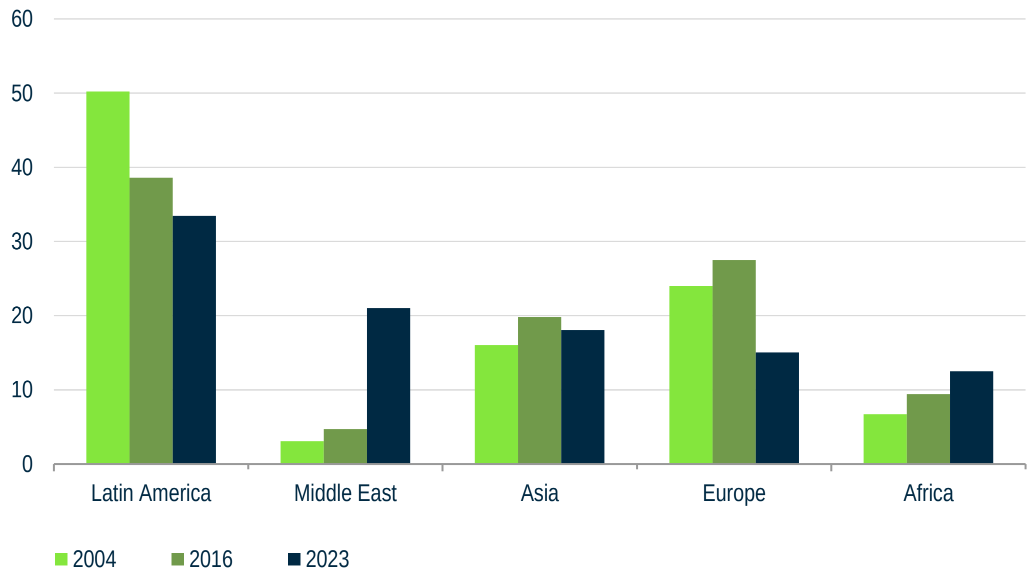
Figure 18: Credit quality of indices has improved (EMBI global credit rating over time, %)



Source: JPMorgan as of December 31, 2023.

Additionally, as countries have diversified their funding sources, their external debt as gone down, lowering weights in hard currency indices (Figure 19).

Figure 19: Regional index exposure (EMBI Global Diversified country weights over time, %)



Source: JPMorgan as of December 31, 2023.

LOOKING FORWARD

Following several years of underperformance, we believe EM debt is now poised to outperform other fixed income asset classes. Headwinds from sharp increases in inflation and interest rates, U.S. dollar strength, and slower growth are now reversing course. Thus, the tailwinds from lower rates, higher growth, and improving credit quality are setting the table for positive EM performance going forward. At the same time, emerging markets are converging fundamentally, taking on a position of growing global importance. Accelerating growth versus developed markets, improving fundamentals, a rising share of global GDP, a shift toward higher value-add industries, and demographic shifts should also benefit the asset class. Meanwhile, the shift in global power dynamics and a supply reorientation toward "nearshoring" is a potential boon to EM issuers. Given the five favorable structural shifts likely to have a profoundly positive effect on EM markets over the next half decade, we believe current valuations do not adequately reflect the upside potential, and that now might be the time to make a strategic long-term allocation to EM debt.

NOTICE: IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of April 2024.

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