Global Insights

Will Emerging Markets Face a Tight Squeeze?

More restrictive monetary policy will tighten financial conditions, which should in turn lift equity risk premiums. This time around, we think that modestly tighter financial conditions could favor emerging market (EM) equities.

This edition of Global Insights examines market returns during prior tightening cycles and explores the dynamics that could help emerging markets outperform.

- EM equities have tended to outperform the S&P 500 when financial conditions have tightened from previously very accommodative levels.
- Recent US dollar strength could give way to weakness in the second half of the year, fueling better-than-anticipated performance for EM equities.
- The monetary policy divergence between the Asia Pacific and Latin America regions highlights the importance of an active approach to EM investing.
As central banks start withdrawing emergency support, more restrictive monetary policy should tighten financial conditions and, in turn, lift equity risk premiums (see Exhibit 1). The Federal Reserve is expected to raise short-term interest rates next month, and investors are speculating that it will begin reducing its balance sheet later this year. In fact, Morgan Stanley & Co. economists expect G-4 central bank balance sheets to shrink by $2 trillion by June 2023. For many, this is a stunning turnaround after months of assurances that inflation would be transitory.

Because EM weakness has historically been associated with tighter-than-average financial conditions, it is important for investors to understand how emerging markets have performed during prior tightening cycles and to contemplate whether this time will be different.

Exhibit 1: Emerging Market Equity Risk Premium Suggests Weakness May Already Be Priced

Note: The equity risk premium for the MSCI Emerging Markets Index is calculated as the spread between the MSCI Emerging Market Index earnings yield and the 10-year US Treasury yield. The equity risk premium for the S&P 500 is calculated as the spread between the next 12-month consensus earnings yield and the 10-year US Treasury yield. Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Feb. 16, 2022

In January 2022, the International Monetary Fund cautioned that a faster-than-anticipated pace of Fed rate hikes in response to inflationary pressures could incite EM capital outflows and currency depreciation. From a historical perspective, the 2013 taper tantrum stands out as an example of the degree to which sudden tightening of financial conditions can weigh on risky assets.

To better understand EM performance in the context of prior tightening cycles, we considered the impact of shifts in financial conditions across multiple equity indexes. Using the Morgan Stanley Financial Conditions Index, which considers changes in equities, short- and long-term interest rates, and

the US dollar, we divided the last 25 years into three distinct regimes. Finally, we evaluated the average annualized returns across the various regional indexes (see Exhibit 2).

Exhibit 2: Emerging Market Equities Have Done Well When the Financial Conditions Index Has Tightened From Very Accommodative Levels

Note: Emerging Markets, Latin America and Asia Pacific ex Japan are MSCI Indexes. Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Feb. 8, 2022

Our scenario-based analysis found that EM equities have tended to outperform the S&P 500 Index when financial conditions tighten from previously very accommodative levels. When financial conditions are neutral and tightening, or tight and tightening, emerging markets have tended to underperform. Our analysis of sovereign and corporate credit, moreover, tells a similar story (see Exhibit 9). Historically, emerging markets have done well at the start of a tightening cycle and have weakened as conditions have become more restrictive. We think this time will be different because emerging markets should see fewer headwinds as the tightening cycle begins.

First, EM equities have shown signs of life despite recent dollar strength. The link between EM risk-asset performance and the dollar is well documented. Having languished in the second half of 2020 and first half of 2021, the dollar recently traded off its highest level since July 2020 (see Exhibit 3). That being said, we believe the recent run-up will be short lived, and we anticipate weakness in the second half, lifting the relative performance of emerging markets versus the US and other developed markets.
Although the dollar has not had a sizable pullback in the past 10 months, we think the greenback could be running out of steam. Our research shows that the dollar has tended to strengthen ahead of the first rate hike before declining 4.5%, on average, in the following nine months (see Exhibit 4). If history is a guide, this presents an opportunity for EM investors. In fact, money is already flowing into EM equities (see Exhibit 11). Since the start of the year, the MSCI Emerging Markets Index has outperformed the S&P 500 Index by nearly 7%, indicating that the market has already started to discount future dollar weakness.

Second, a higher federal funds rate does not appear to be a death sentence for emerging markets (see Exhibit 5). In fact, this time around, we think certain emerging economies are even better prepared given diverging policy trends.

Third, EM valuations have already experienced sizable adjustments (see Exhibit 6). While large liquidity injections from central banks in advanced economies have helped emerging markets on an absolute basis, investors are concerned that tighter financial conditions will lead to slower growth as the same central banks withdraw liquidity.

We are mindful that emerging markets will face some headwinds, but we see evidence that forward price/earnings (P/E) ratios have started to anticipate slower growth. In fact, at 12.3x forward earnings, the MSCI Emerging Markets Index is 14% below its 10-year average. This compares to a 20.4x forward P/E ratio for the S&P 500, which is nearly 20% above its 10-year average.

Said another way, the MSCI Emerging Markets Index has a sizable valuation advantage should growth slow materially. We see the reduced valuation as reason for a more constructive medium-term view should overtightening in developed markets threaten global growth.
Finally, a divergence in inflation dynamics has led to very different policy outcomes for emerging Asia Pacific and Latin America. The Citi Inflation Surprise Index, which measures inflation surprises relative to market expectations, has surged for the largest economies in Latin America. In fact, the region’s 41.6 reading is just below its highest level since 1999 (see Exhibit 7).

**Exhibit 7: Inflation Surprises Debunk the Transitory Argument**

Although emerging markets began tightening last year, it was not broad-based. In fact, while central banks in Latin America hiked rates aggressively, central banks in the emerging Asia Pacific region kept policy more accommodative.

Investment Implications

The setup for emerging markets in general, and Latin America in particular, is compelling, as developed markets prepare to tackle stronger inflation by tightening monetary policy. All else equal, Latin America, which hiked aggressively last year, should be able to weather global monetary tightening, while formerly more accommodative central banks may find themselves hiking into a lower growth environment. Because EM central banks began tightening in earnest last year, they now have more room to ease should accommodation become necessary (see Exhibit 8).

**Exhibit 8: Latin America Is Home to Some of the Most Aggressive Central Banks in the Emerging Markets**

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Jan. 31, 2022

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Feb. 13, 2022
**Exhibit 9: Emerging Market Debt Has Done Well When the Financial Conditions Index Has Tightened From Very Accommodative Levels**

![Graph showing financial conditions and returns](image)

Note: US Debt is Bloomberg US Aggregate Bond Index, Latin America is ICE BofA High Grade Latin America Emerging Markets Corporate Plus Index, Asia Emerging Markets Debt is ICE BofA Asia Emerging Markets Corporate Plus Index, Emerging Markets Debt is Bloomberg Emerging Markets Hard Currency Aggregate Index.

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Feb. 8, 2022

**Exhibit 10: The Velocity of Change in Financial Conditions Can Impact Returns**

![Graph showing velocity of change in financial conditions](image)

Note: Financial conditions reflect changes in the Morgan Stanley Financial Conditions Index. The financial conditions regimes are split into deciles.

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Jan. 31, 2022

**Exhibit 11: Emerging Market Equity Funds Have Seen Strong Flows When Developed Markets Have Tightened**

![Graph showing emerging market equity fund flows](image)


**Exhibit 12: The Performance Gap Between Latin America and Emerging Asia Pacific Could Narrow**

![Graph showing performance gap](image)

Note: FTSE/ASEAN Index represents Singapore, Thailand, Indonesia, Malaysia and the Philippines.

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2021

Please refer to important information, disclosures and qualifications at the end of this material.
Current Readings From Our Quantitative Framework

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Levels
- Red: Unfavorable
- Neutral
- Green: Favorable

Changes
- Deteriorating
- Unchanged
- Improving


Ongoing Development Spotlight

Last year, as inflation accelerated, Turkey discontinued its tightening policy by cutting its key short-term interest rate. The unorthodox decision fueled the Turkish lira’s collapse and put additional strain on the economy. In January, Turkey’s annual inflation rate came in at nearly 49%—the highest in 20 years. At its Feb. 17 meeting, the Turkish central bank kept the key rate unchanged. In fact, it was the second consecutive meeting at which it was held constant. The decision may be too little, too late, as Morgan Stanley & Co.’s economists forecast the country’s inflation ending the year at 49.4%. – Brad Fulton

Exhibit 13: Inflation in Turkey Hits 20-Year High

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Jan. 31, 2022
Disclosure Section

Index Definitions

For other index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealthinvestmentsolutions/wmir-definitions

Glossary

Equity risk premium is the excess return that an individual stock or the overall stock market provides over a risk-free rate. The risk-free rate represents the interest an investor would expect from an absolutely risk-free investment over a specified period of time.

Risk Considerations

Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. Investing in currency involves additional special risks such as credit, interest rate fluctuations, derivative investment risk, and domestic and foreign inflation rates, which can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions. In addition, international investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets and frontier markets, since these countries may have relatively unstable governments and less established markets and economies. Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies. Technology stocks may be especially volatile. Risks applicable to companies in the energy and natural resources sectors include commodity pricing risk, supply and demand risk, depletion risk and exploration risk. Health care sector stocks are subject to government regulation, as well as government approval of products and services, which can significantly impact price and availability, and which can also be significantly affected by rapid obsolescence and patent expiration.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

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