Global Insights

Some EMs Are Not Like the Others

Emerging markets are not homogenous. While the shorthand enables investors to position the opportunity set in a portfolio construction context, the differences within the group can be striking. Recent events have highlighted the limitations of making investment decisions for emerging markets as a whole. A weaker US dollar has boosted commodity prices and consequently generated inflation and policy challenges for commodity-importing nations. Monetary authorities in the emerging markets, sensitive to changes in policy footing from the Federal Reserve, have embarked on a tightening cycle in preparation for higher US interest rates. While US policymakers attempt to calm worries over tightening financial conditions, investors in emerging markets have become wary, as some of the more vulnerable economies work to reduce inflation pressures and limit capital outflows.

- We see supply chain issues and pull-forward demand boosting inflationary pressures in the emerging markets through 2022.
- We remain cautious on commodity importers whose growth rates are vulnerable to inflationary pressures and risk stumbling just as the economic recovery in emerging markets is underway.
- Food price inflation and higher input costs risk stoking political unrest, especially in countries that are lagging in vaccination rates.
- We prefer exposure to commodity exporters with healthy trade balances as they are more resilient in the face of inflationary pressures.
- We recommend that investors consider active managers with deep experience sifting through developing economies while limiting exposure to passive strategies that allocate capital to emerging markets as a whole.
Amid surprisingly strong inflation, investors have begun to worry that central bankers in emerging markets will face increasing pressure to normalize monetary policy, or risk capital outflows at a time when their economies are vulnerable to the lingering effects of the pandemic. In fact, data from Reuters shows that emerging markets central bankers delivered nine net interest rate hikes in the three months ending May 31 to mitigate the buildup of inflationary pressures that continue to top market expectations (see Exhibit 1).

Inflation could be more problematic for certain emerging markets than others, as the effect of higher commodity prices will not be felt evenly. While commodity exporters are likely beneficiaries of price shocks, commodity importers need to finance the difference at a time when worries over peaking data could spark a de-rating of risk assets.

Investors in emerging markets must resist the temptation to view the group as a monolith. Although the classification system enables them to position the opportunity set in a portfolio construction context, the differences within the group can be striking.

First, although robust demand and a weak trade-weighted dollar underpin higher commodity prices, emerging market equity returns are not as correlated as you might think. A country’s current account balance as a percent of GDP is an important indicator of an economy’s health. A positive current account balance indicates a healthy trade balance and higher resilience against inflationary pressures. Given that commodities account for a sizable portion of trade for emerging markets, we think that a country’s current account balance roughly approximates the degree to which it imports or exports commodities. Conventional wisdom tells us that higher commodity prices should benefit emerging economies that are net exporters, while simultaneously punishing economies that are net importers. While this can be the case over the long term, shorter-term realities remind us that the devil is in the details (see Exhibit 2).

Second, even for commodity exporters, rising inflation is not necessarily a net positive because supply chain challenges and difficult weather conditions have implications for other parts of the economy and have sent food prices soaring. The UN Food and Agriculture World Food Price Index, which measures the change in a basket of cereals, vegetable oil, dairy products, meats and sugar, is just off of its highest level in 10 years. Faced with higher food prices, the number of undernourished people has started to climb, as food share as a percent of consumer expenditures has grown to dangerously high levels in many emerging markets. According to data from Strategas Research Partners, food as a percentage of consumer expenditures has reached above 25% in Russia, Argentina, India, Kenya and Nigeria. We see higher food prices, which are a reliable predictor of geopolitical unrest, leading to greater uncertainty for many emerging markets. In fact, the World Uncertainty Emerging Economies Index has turned sharply higher versus the World Uncertainty Advanced Economies Index, reflecting these concerns and emerging market nations’ more muted growth prospects (Exhibit 3).

Another complicating factor is the resurgence of COVID-19 outbreaks, which have been uneven, with the potential to significantly impact investment returns. Great care must be taken regarding the relative outlook for vaccination rates and other related factors when selecting emerging market exposures. To wit, according to data gathered by Bloomberg, countries with the highest incomes are getting vaccinated at a rate that is 30 times faster than those with the lowest incomes. The same analysis noted that, of inoculations that have been administered, more than a third have gone to the 27 wealthiest countries, further highlighting the opportunity
to add value via selective exposure.

Exhibit 3: Uncertainty is Elevated in Emerging Economies

Investment Implications

History tells us that commodity price inflation can persist for some time. We continue to believe there are opportunities underneath the broad emerging markets banner for the selective investor, in comparison to more well established markets that have grown quite expensive in recent years. Consequently, we prefer active managers with deep experience sifting through opportunities in countries best positioned to take advantage of higher commodity prices. We recommend investors focus on high-quality companies with higher pricing power that are better equipped to withstand inflationary pressures. By contrast, commodity importers with somewhat smaller cash reserves and weak currencies may be disadvantaged as the resurgence in COVID-19 variants and related growth concerns leave them vulnerable to capital flight. Recent political unrest in South Africa and Cuba, and the assassination of Haiti’s president, call to mind the anti-government protests and uprisings of 2010-2013. One of the lessons from that time is how quickly things can go from bad to worse.
Charts You Can't Miss

Exhibit 4: Emerging Market Currencies Battered by Delayed Recovery

Exhibit 5: International Monetary Fund Average Consumer Price Forecast

Exhibit 6: High Food Prices Threaten Political Stability

Exhibit 7: Emerging Markets Face Capital Outflows

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of July 17, 2021

Source: Strategas Research Partners, Morgan Stanley Wealth Management Global Investment Office as of July 17, 2021

Source: Institute of International Finance, Morgan Stanley Wealth Management Global Investment Office as of July 17, 2021
Exhibit 8: Brazilian Water Crisis May Exacerbate Commodity-Driven Inflation

Ongoing Development Spotlight

Rainfall levels in Brazil have not been this low since 1931. According to Bloomberg, the rainfall shortage has resulted in dangerously low hydroelectric reserves, causing electricity bills in Brazil to rise as much as 15%. The drier-than-normal conditions have also hurt the country’s agricultural centers, a concerning development given that Brazil is the world’s top exporter of sugar, soybeans, orange juice and Arabica coffee beans. Crop shortages and worsening drought conditions have many worried that demand for Brazilian commodities will quickly outstrip supply. Brazilian farmers are already beginning to renege on their sales contracts, which could result in delays for buyers at a time when supplies are tight and food inflation is high. The prices of Arabica coffee beans and sugar have touched four-year highs, and orange juice prices have jumped, with the country’s orange production having shrunk 31% from the previous season—the most in 33 years. If prices continue to rise, there is concern that companies may be forced to pass on the higher prices to consumers.

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of July 17, 2021
Disclosure Section

Risk Considerations

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.

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

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.

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.

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, since these countries may have relatively unstable governments and less established markets and economies. Investing in foreign emerging markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks.

Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

Certain securities referred to in this material may not have been registered under the U.S. Securities Act of 1933, as amended, and, if not, may not be offered or sold absent an exemption therefrom. Recipients are required to comply with any legal or contractual restrictions on their purchase, holding, and sale, exercise of rights or performance of obligations under any securities/instruments transaction.

Disclosures

Morgan Stanley Wealth Management is the trade name of Morgan Stanley Smith Barney LLC, a registered broker-dealer in the United States. This material has been prepared for informational purposes only and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security or other financial instrument or to participate in any trading strategy. Past performance is not necessarily a guide to future performance.

The author(s) (if any authors are noted) principally responsible for the preparation of this material receive compensation based upon various factors, including quality and accuracy of their work, firm revenues (including trading and capital markets revenues), client feedback and competitive factors. Morgan Stanley Wealth Management is involved in many businesses that may relate to companies, securities or instruments mentioned in this material.

This material has been prepared for informational purposes only and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security/instrument, or to participate in any trading strategy. Any such offer would be made only after a prospective investor had completed its own independent investigation of the securities, instruments or transactions, and received all information it required to make its own investment decision, including, where applicable, a review of any offering circular or memorandum describing such security or instrument. That information would contain material information not contained herein and to which prospective participants are referred. This material is based on public information as of the specified date, and may be stale thereafter. We have no obligation to tell you when information herein may change. We make no representation or warranty with respect to the accuracy or completeness of this material. Morgan Stanley Wealth Management has no obligation to provide updated information on the securities/instruments mentioned herein.

The securities/instruments discussed in this material may not be appropriate for all investors. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Morgan Stanley Wealth Management recommends that investors independently evaluate specific investments and strategies, and encourages investors to seek the advice of a financial advisor. The value of and income from investments may vary because of changes in interest rates, foreign exchange rates, default rates, prepayment rates, securities/instruments prices, market indexes, operational or financial conditions of companies and other issuers or other factors. Estimates of future performance are based on assumptions that may not be realized. Actual events may differ from those assumed and changes to any assumptions may have a material impact on any projections or estimates. Other events not taken into account may occur and may significantly affect the projections or estimates. Certain assumptions may have been made for modeling purposes only to simplify the presentation and/or calculation of any projections or estimates, and Morgan Stanley Wealth Management does not represent that any such assumptions will reflect actual future events. Accordingly, there can be no assurance that estimated returns or projections will be realized or that actual returns or performance results will not materially differ from those estimated herein.