Emerging markets do not constitute a homogeneous asset class. This audiocast highlights three considerations for investing amid notable dispersion across emerging economies today.

Emerging Markets Offer Diverse Opportunities

Click here for the related report: Global Insights: Some EMs Are Not Like the Others
Hello and welcome to another edition of Wealth Management Insights. I’m Chris Baxter, Investment Strategist for Morgan Stanley Wealth Management. Today is Wednesday, September 1st, and I’m recording this at my home in Brooklyn, New York.

One fundamental truth of investing in emerging markets is that they should not be treated as a monolithic entity. The grouping does enable investors to position the opportunity set in a portfolio construction context, but investors in emerging markets must resist the temptation to apply a one-size-fits-all framework.

Recent events highlight the limitations of making investment decisions for the group as a whole. There’s been some retightening of COVID-19-related restrictions in countries that are grappling with new waves of coronavirus cases. This underscores the changing face of risk for many emerging economies. Additionally, a string of rate hikes in the face of inflationary pressures further complicates the outlook for central bankers in economies where realized inflation rates are running well above target.

Concerns related to the pandemic and inflation have indeed soured risk sentiment, causing emerging market equities to underperform, even after adjusting for rapid gains in US stock markets. We recognize that emerging economies as a group have not yet turned the corner. But at the same time, we see opportunities for tactical investors willing to look beyond immediate concerns and ahead to these three potential developments: higher vaccination rates, central bank action from policymakers keen to avoid mistakes, and robust demand-driven growth.

First, investors’ fear about the potential damage from the delta variant are well-founded, but the stark differences in vaccination rates across countries warrant closer attention. According to data gathered by Johns Hopkins University, the “fully vaccinated” rates within emerging economies vary greatly. Brazil, Mexico, and South Korea have inoculation rates above 20%, while the numbers for India and South Africa sit uncomfortably below 10%. This compares to the US and UK at 52% and 63%, respectively. So there’s a meaningful gap here—and this should help focus us on emerging economies where vaccination rates are catching up to those of developed markets, and as investors pivot to less extreme risk-avoidance strategies.

Second, investors have begun to worry that central bankers in emerging economies will face pressure to normalize monetary policy or risk capital outflows. Brazil, India, Russia, and Mexico, among others, have already lifted interest rates this year to fight against inflation. But similar to vaccination rates, the inflation story remains highly differentiated, with countries like South Africa still on hold. In fact, according to data from Reuters that follows central banks in 37 emerging economies, there have been ten rate hikes so far this year through the end of May, aimed at mitigating the buildup of inflationary pressures that have continued to come in higher than market expectations. From our vantage point, the market seems to agree, as the emerging market local currency corporate spreads are well-behaved and flows are healthy. Again, we believe that proactive policymakers in certain emerging economies are best equipped to find a path through a changing landscape.

Finally, we find that tailwinds are forming behind export-oriented economies. Fueled by strong global demand, exports to advanced economies have surged year-over-year in most cases—scoring in the 90th percentile or better for the five years through April.

Given these considerations, we prefer exposure to commodity exporters with healthy trade balances as they are more likely to be more resilient in the face of inflationary pressures. We also recommend active managers with deep experience sifting through developing economies.

Thank you for listening. For more information on portfolio strategies in the current economic environment, please reach out to your Morgan Stanley Financial Advisor.
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