EM MARKETS CHART BOOK

China's recovery may continue to benefit EM equities

- **We think the rapid economic recovery in China will lead to further gains in equities in China and other emerging markets (EM) this year.**
- Despite some recent weakness, equities in China have rallied since the end of October, as a shift toward living with COVID and a combination of more pro-growth policies have led to a rapid economic recovery there. As a result, the MSCI China Index has generally outperformed most other major constituents of the MSCI ACWI Index over the past couple of months. (See Chart 1.) Since the start of the year, for example, it has gained ~13% in local currency terms, while MSCI's ACWI and EM indices have both risen by ~8%.
- We think MSCI's China Index will generally continue to outperform other major indices this year, as we suspect that China's economy will recover faster than most anticipate. For instance, we expect a sharp bounce-back in consumer spending there. And the diminishing risk of future virus disruptions should help unlock the benefits of existing policy support, in particular with regard to bank lending. (See here.)
- Admittedly there are still some points of concern. After all, we still forecast a recession in the US, for example, this year, which we think will contribute to a drop in Chinese exports and in appetite for risk. But these headwinds would also affect most markets outside China, so we don't think they would hinder the *relative* performance of MSCI's China Index. (See here.)
- This isn't to say other equity markets won't benefit from the economic bounce back. Neighbouring economies, such as Taiwan, and large commodity producers, such as Brazil, should gain from higher Chinese imports. And although we expect China's re-opening to be inflationary at the global level, we suspect that in most cases this will only have a small impact on monetary policy and economic activity elsewhere. (See here, and here.) As a result, we have upgraded our outlook for EM equities and we now forecast the MSCI EM Index to reach ~67,400 in end-2023, which is ~9% above its current level.
- Many EM central banks have continued to tighten **monetary policy**.
- EM **LC sovereign bond** yields have dropped, as investors' expectations have been pared back.
- EM **dollar bond** yields and spreads have fallen.
- EM **equities** have gained amid an improved appetite for risk.
- **Forecast Summary**

Chart 1: MSCI Price Index Ratios (Local currency, 1st Jan. 2023 = 100)

Sources: Refinitiv, Capital Economics

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Monetary Policy

- While several EM central banks raised their policy rates in their last meetings, many of them kept rates unchanged **(2)**. What's more, we think that the tightening cycle has now come to an end in many places where the rate was hiked (e.g. Romania, South Korea, Taiwan, Indonesia). Meanwhile, in Emerging Europe, investors have generally lowered their policy rate expectations, which probably reflects some early evidence of disinflation in the region. In contrast, they appear to discount tighter monetary policy in Colombia, where inflation data for December surprised to the upside **(3)**.
- With inflation likely to remain above target in most countries, we expect interest rates to remain high this year and that EM central banks will only start to loosen monetary policy from around mid-2023 **(4)**.
- Our end-2023 policy rate forecasts are broadly consistent with what investors currently seem to discount **(5)**. There are some small discrepancies, however. In Chile, for example, we forecast policymakers to be a bit slower in cutting rates than investors seem to anticipate **(6)**. And in Czechia, we expect the economy to struggle further over the first half of the year, which we think will push the central bank to cut rates a little faster than appears to be discounted in the market **(7)**.

Chart 2: Changes In Selected Policy Rates Since 31st December 2021 (%)

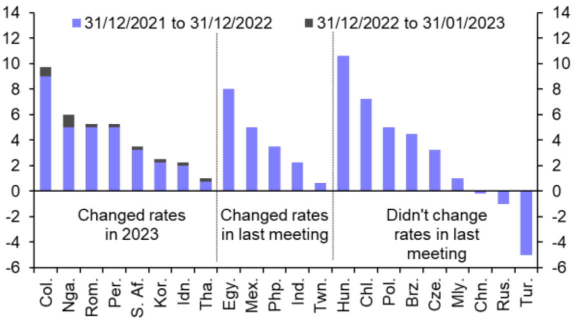


Chart 3: Change In End-2023 Policy Rates Implied By Swap Markets Since 31st December 2022 (bp)

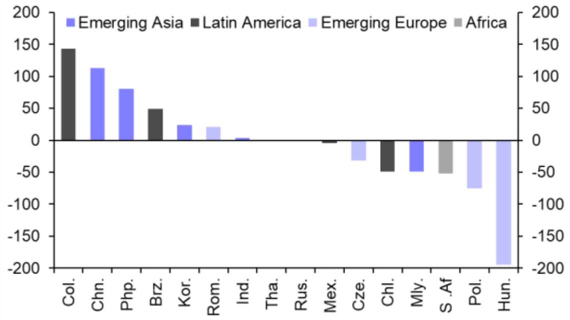


Chart 4: Average Regional Policy Rates (%)

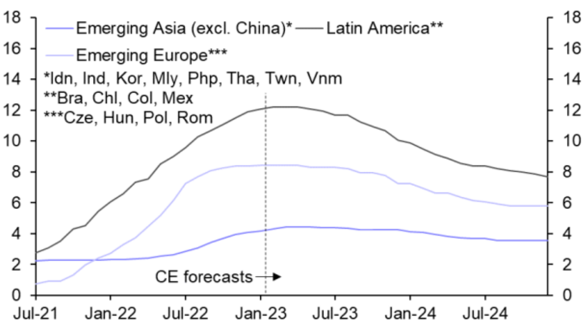


Chart 5: CE Forecasts For Policy Rates At End-2023 Less Rates Implied By Swap Markets (bp)

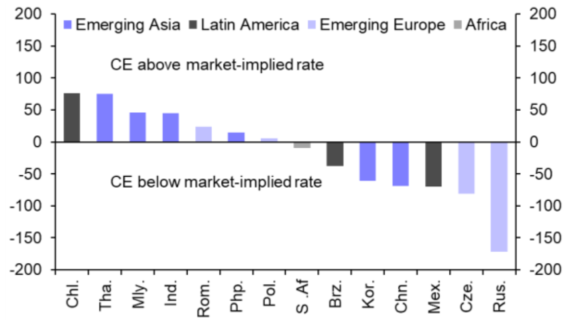


Chart 6: Chile Policy Rate (%)

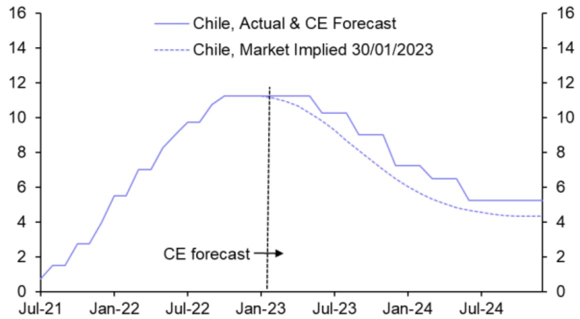
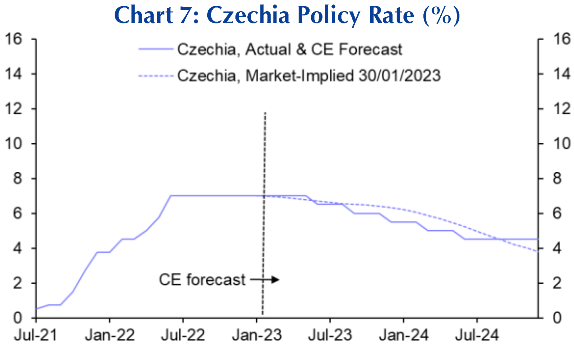


Chart 7: Czechia Policy Rate (%)



Sources: Refinitiv, Capital Economics

Local-Currency Sovereign Bonds

- The yields of 10-year EM local currency (LC) government bonds have generally fallen since the beginning of the year **(8)**, together with those in developed markets (DMs) **(9)**. Yields have dropped particularly sharply in Central and Eastern Europe, in large part due to the sustained decline in natural gas prices, which has alleviated some inflationary pressure **(10)**. Despite falling over 100bp since their peaks in the autumn, however, yields there as well as in Latin America are still elevated compared to their levels following the Global Financial Crisis (GFC) **(11)**.
- We think EM LC government yields will decline, in general, by the end of 2023, if we are right that monetary tightening has stopped adding upward pressure on yields in many places **(12)**. However, the falls in yields that we predict are limited, as our policy rate expectations are not far from investors'. (See previous section.) What's more, if we are right that recessions are underway in major economies in the first half of 2023, then investors' appetite for risk may diminish soon. Further ahead, as the economic backdrop improves and monetary easing continues across most EMs, we forecast yields there to fall further in 2024 **(13)**.

Chart 8: Changes In 10-Year LC Government Bond Yields Since 30th December 2022 (bp)

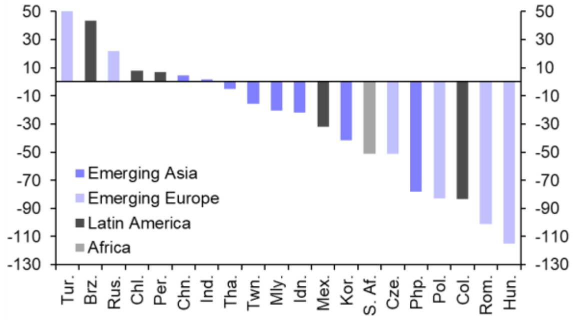


Chart 9: 10-Year LC Government Bond Yields (%)

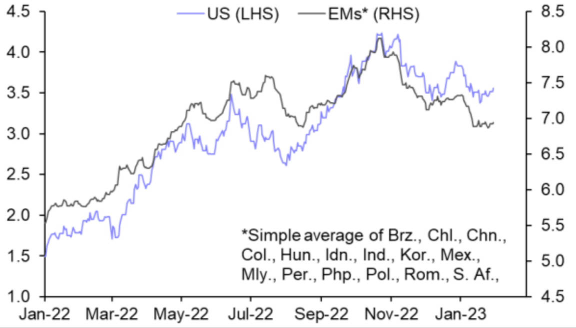


Chart 10: 10-Year LC Government Bond Yields & The Price Of European Natural Gas

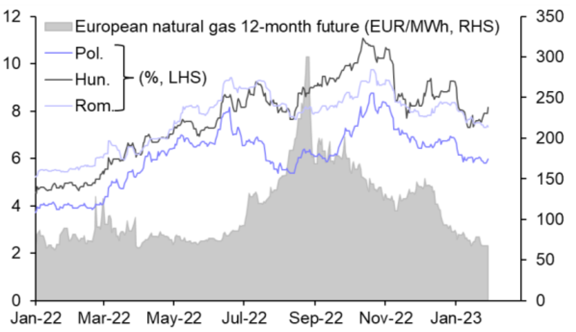


Chart 11: 10-Year LC Government Bond Yields (%)

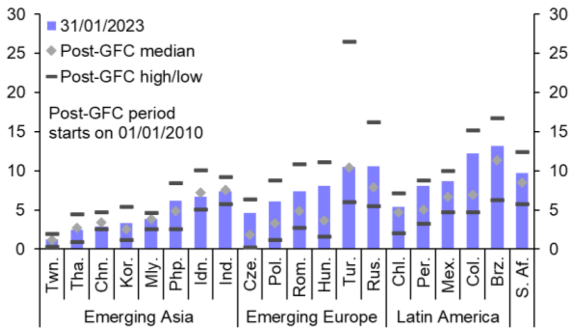


Chart 12: Changes In 10-Year LC Government Bond Yields Implied By CE End-2023 Forecasts (bp)

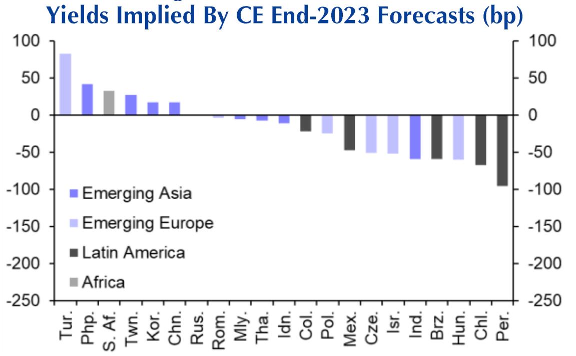
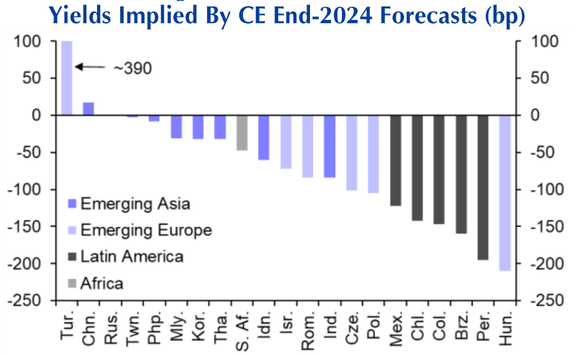


Chart 13: Changes In 10-Year LC Government Bond Yields Implied By CE End-2024 Forecasts (bp)



Sources: Refinitiv, Bloomberg, Capital Economics

Dollar Bonds

- EM dollar bond yields, as measured by the yields of the JP Morgan EMBI Global and ICE BofA EM Liquid Corporate Plus indices, have dropped since the start of the year **(14)**. The fall has reflected both lower "risk-free" yields and narrowing spreads **(15)**, as interest rate expectations in the US have been pared back and risk appetite has improved. The spreads of both sovereign and corporate bonds have generally dropped to their lowest levels since April **(16)**.
- Admittedly, some spreads have widened since the start of the year, such as those for sovereigns in Emerging Europe and the Middle East **(17)**. But the bigger picture is that in Emerging Europe the regional spread is still much lower than it was for most of 2022. And in the Middle East, it is below its 10-year average **(18)**.
- We expect additional upward pressure on the yields of dollar sovereign bonds in the first half of 2023, as we think global economic activity will decelerate and reduce appetite for risk. But later in the year, we forecast spreads and yields to fall as economies start to recover and to end 2023 near their levels now **(19)**.

Chart 14: Yields Of EM Corporate & Sovereign Dollar-Denominated Bonds (%)

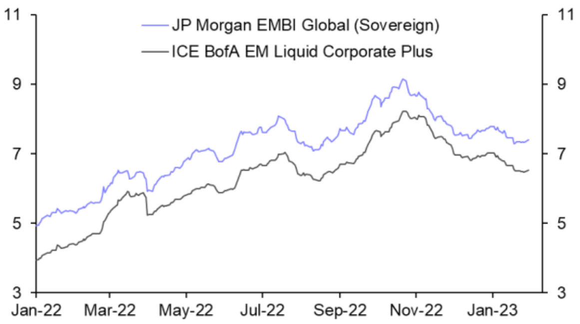


Chart 15: Changes In Yields & Components Of EM Corporate & Sovereign $ Bonds Since 30th Dec. 22 (bp)

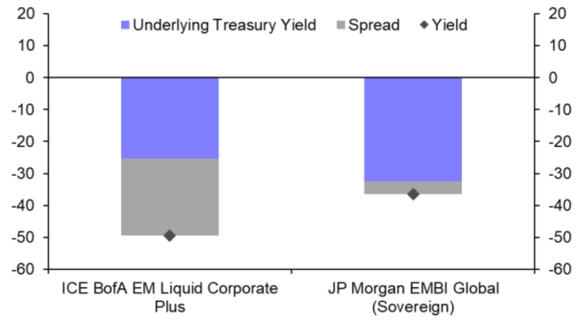


Chart 16: Spreads Of EM Corporate & Sovereign Dollar-Denominated Bonds (bp)

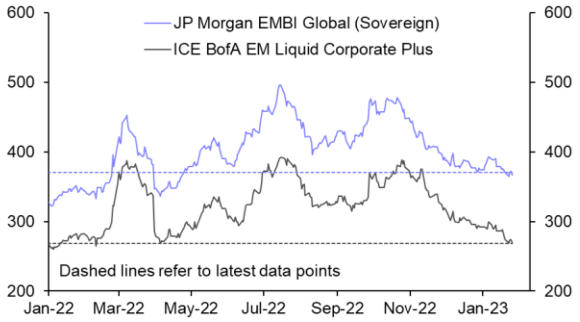


Chart 17: Changes In Spreads Of JP Morgan EMBI Global Indices Since 30th December 2022 (bp)

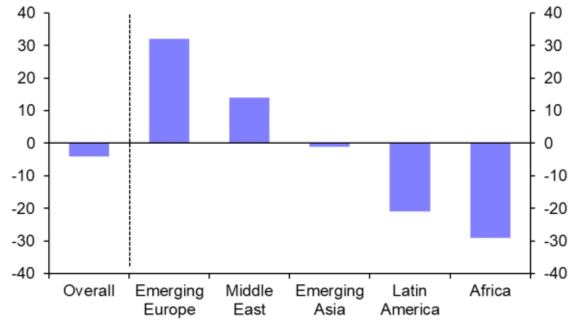


Chart 18: Stripped Spreads Of JP Morgan EMBI Global Indices (bp)

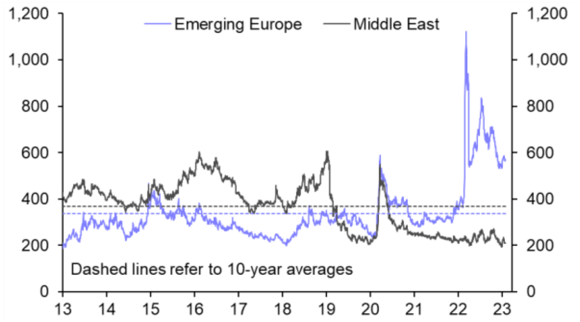
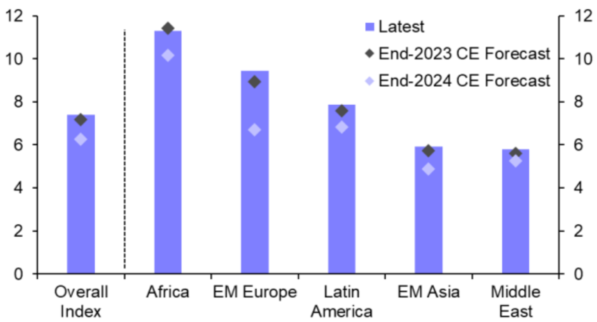


Chart 19: Yields Of JP Morgan EMBI Global Indices (%)



Sources: Refinitiv, Capital Economics

Equities

- EM equities have generally rallied since the start of this year: the MSCI EM Index, for example, has gained ~8% in local-currency terms. And even if we exclude from this index the MSCI China Index, which has outperformed most other major MSCI indices, it has still increased by ~4%. This is roughly in line with gain made by MSCI's World Index of developed markets **(20)**.
- The rally in EM equities has been broad-based, with most major regional and country-level MSCI indices having increased since the start of the year **(21 & 22)**. Almost all MSCI EM sector indices have risen, which is consistent with a broad improvement in risk appetite. Interest-rate sensitive sectors, such as communication services, have gained the most **(23)**, which probably reflects a general decline in investors' rate expectations. The 10-year TIPS yield, for example, has fallen by ~35bp so far this year **(24)**.
- We think EM equities will generally struggle over the next few months as global growth concerns weigh on both earnings expectations and appetite for risk. But we forecast EM equities to recover thereafter, ending 2023 above their current levels **(25)**. We project the MSCI EM Asia Index to make the biggest gains, largely because we think there is still more to go in the market rally in China, despite its recent weakness.

Chart 20: MSCI Indices (LC, 1st January 2023 = 100)

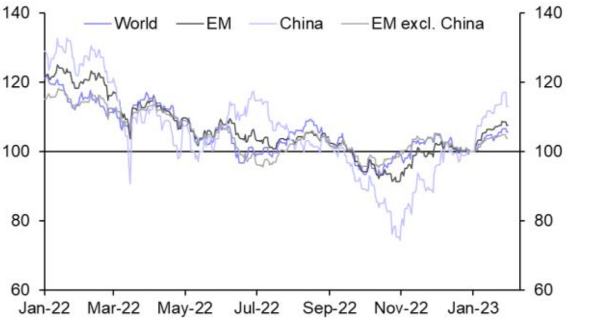


Chart 21: Regional MSCI EM Indices (LC, 1st January 2023 = 100)

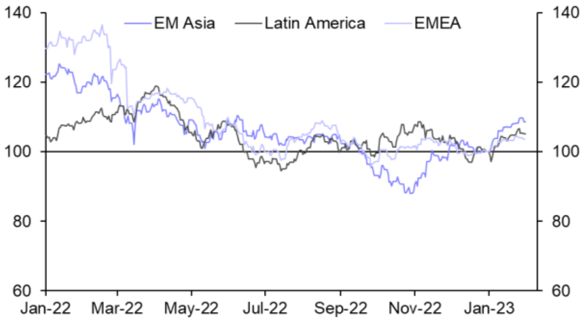


Chart 22: Changes In MSCI EM Country Indices Since 30th December 2022 (LC, %)

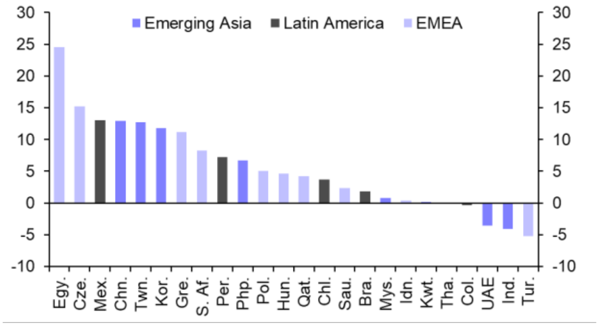


Chart 23: Changes in MSCI EM Sector Indices Since 30th December 2022 (LC, %)

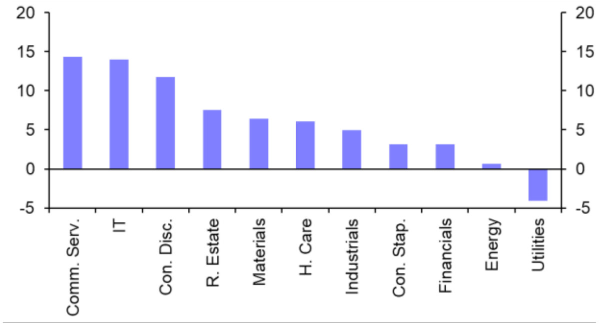
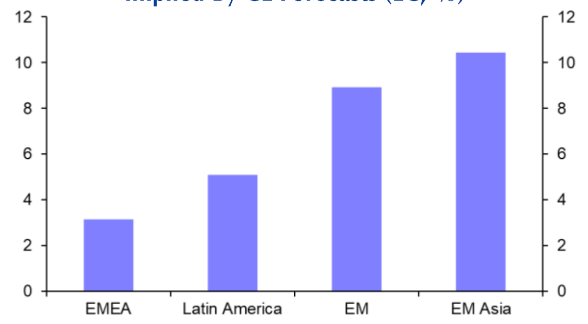


Chart 24: 10-Year TIPS Yield (%)

Chart 25: Changes In MSCI EM Indices To End-2023 Implied By CE Forecasts (LC, %)



Sources: Refinitiv, Capital Economics

Forecast Summary

Forecast Summary	Latest (30th/31st January)	End (2023)	End (2024)
Stock Market Indices (Local Currency)[1]			
Emerging markets	61,874	67,400	73,950
Emerging Asia	951	1,050	1,140
Latin America	92,825	976	1,080
Europe, Middle East & Africa	499	515	580
Stock Market Indices (USD-Basis)[1]			
Emerging markets	1,044	1,130	1,270
Emerging Asia	566	620	700
Latin America	2,320	2,360	2,740
Europe, Middle East & Africa	198	200	235
10-Year Local-Currency Sovereign Bond Yields (%)			
China	2.93	3.10	3.10
Brazil	13.18	12.60	11.60
India	7.34	6.75	6.50
South Africa	9.69	10.00	9.20
Dollar-Denominated Bond Yields (%)[2]			
Emerging markets	7.41	7.20	6.30
Emerging Asia	5.92	5.70	4.85
Latin America	7.88	7.60	6.85
Europe	9.43	8.90	6.70
Africa	11.30	11.40	10.15
Dollar-Denominated Bond "Stripped" Spreads (bp)[2]			
Emerging markets	370	380	310
Emerging Asia	219	230	170
Latin America	419	420	370
Europe	569	550	350
Africa	759	800	700

Sources: Refinitiv, Capital Economics

1. MSCI Indices.
2. JP Morgan EMBI Global Indices.

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