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Emerging markets outlook: Easing cycle broadens

An emerging market cutting cycle is underway, helped by a US ‘soft landing’. As growth slows, we expect more monetary easing, but lingering inflationary pressures, still reasonable growth and political uncertainty will likely cap the extent to which policy rates are lowered.

Key Takeaways

- Now that central banks in Asia have also started to deliver cuts, we believe an emerging market (EM) easing cycle is conclusively in progress.
- And the scope for EM central banks to ease policy further will increase as the Federal Reserve continues to lower rates.
- Headline inflation has returned to target in most EMs, however, in some economies underlying inflation measures – particularly services – remain too hot, and this will cap the extent to which policy rates can be cut.
- Moreover, inflation risks are skewed to the upside, with ongoing conflicts in Europe and the Middle East threatening food and energy supplies, and the potential for a more inflationary policy mix under the next US administration.
- The recent Chinese policy pivot could also provide a boost for its trading partners, potentially adding to a more inflationary US policy mix. But it remains unclear whether the Chinese Communist Party (CCP) really intends to move its growth model away from investment, even in the near-term.

The EM easing cycle is underway

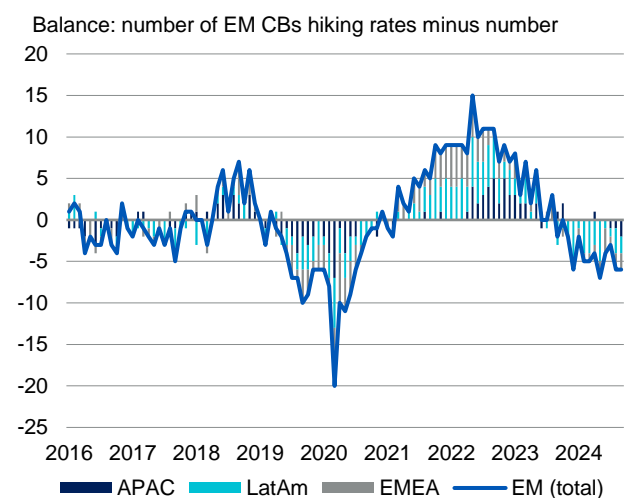
The Federal Reserve (Fed)’s rate cuts and a ‘soft landing’ in the US should encourage more emerging markets (EMs) to join the ongoing easing cycle over the coming year, and a step-change in Chinese stimulus is a potential upside to the EM activity outlook.

In September, the Fed started its easing cycle with a bang, cutting the funds rate 50bps, in what we expect to be the start of a gradual easing cycle. Indeed, eight major EM central banks also cut rates in September, reflecting an expansion of the easing cycle across regions (see Figure 1).

Indonesia and South Africa delivered their first cuts of the cycle, while Czechia, Mexico and Peru all cut for the second consecutive month. Chile, China and Hungary also eased policy.

With Asian central banks now delivering cuts, an emerging market easing cycle is now firmly underway.

Figure 1: Central banks across all regions are cutting



Source: Haver, abrdrn, October 2024



While markets have pared back expectations for a more aggressive Fed easing path in October, our base case for a gradual return to neutral remains favourable to EMs.

Volatility in market expectations for the Fed path may cause caution among central banks that are particularly sensitive to rate differentials: Bank Indonesia paused at its October policy meeting, but others press ahead with easing.

Indeed, central banks in South Korea and Thailand – both lower yielding markets – began their cutting cycles in October. This highlights the growing shift towards neutral policy stances among policymakers, with the Reserve Bank of India also verbally shifting to neutral (we expect a rate cut before year-end).

However, the ongoing conflict between Ukraine and Russia as well as the one in the Middle East pose risks to regional stability and global food and energy prices. This and the uncertainty around the US election outcome represent challenges for the EM outlook and will keep policymakers and investors cautious in the near term.

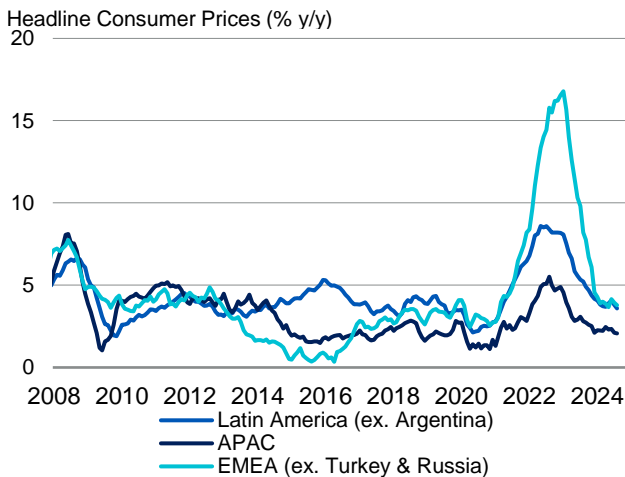
The EM easing cycle is likely to slow through 2025 as more central banks return policy rates to neutral or accommodative territory. We expect the Fed to cut 125bps through 2025, moving policy towards neutral, and this will ultimately cap the extent to which some central banks can lower rates.

Inflation is increasingly well behaved, but challenges lie ahead

Policymakers have been able to loosen monetary conditions because inflation has fallen to within target ranges in a growing number of EMs. Indeed, many of them began easing before the Fed, while others will opportunistically follow it.

Regional averages show headline inflation is now back around pre-pandemic rates and high-frequency core measures signal a significant moderation of underlying inflationary pressures across the vast majority of EMs.

Figure 2: Headline inflation has returned to pre-pandemic levels



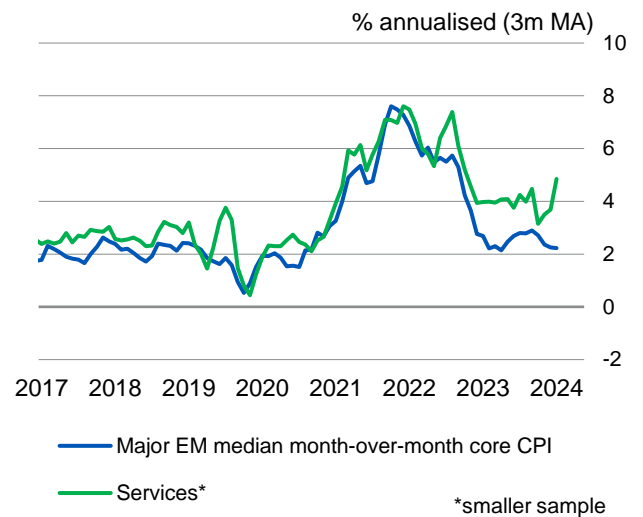
Source: Haver, abrdrn, October 2024

However, the story is not uniform, and some EMs still face sticky inflation dynamics. Hungary and Poland stand out, with resurgent high-frequency core measures, and Brazil also faces a challenging ‘last mile’ of disinflation, which has forced the central bank (BCB) to make a u-turn and hike rates.

Hungary’s core inflation is in part a reflection of processed food pressures and several of the spikes in inflation in some other countries can be attributed to electricity tariffs hikes or removals of fuel and utility subsidies.

However, there is enough lingering inflationary pressure in Hungary, Poland and much of Latin America (LatAm) to motivate policymakers to move cautiously. Indeed, services inflation is proving harder for EMs to curtail (see Figure 3). This may ultimately mean these central banks have to keep policy conditions restrictive for longer.

Figure 3: Services inflation still a challenge, even if core inflation is running at pre-pandemic rates



Source: Haver, abrdrn, October 2024

The key question heading into 2025 is whether further convergence with targets will occur and whether services inflation will dissipate. There are risks of supply-side shocks, particularly to food and energy, and more stimulatory fiscal policies, both domestically and externally, specifically in the US, which could push up on inflation.

Food and energy inflation has eased substantially since early 2023, but disinflationary base effects are likely to fade over the coming months. La Niña weather conditions and the Ukraine-Russia conflict pose a threat to global food supplies. Concurrently, the conflict in the Middle East poses a threat to global energy prices and shipping routes.

Even in our base case, in which a full-scale war between Israel and Iran is avoided, we see the possibility of oil prices spiking as high as \$100 a barrel during bouts of volatility. This could add 0.5ppt to headline inflation for some EMs, albeit temporarily. Exporters such as Brazil and Colombia would benefit from higher prices.



There is a risk that politicians could try to offset supply-side shocks on households via additional fiscal support. Fiscal policy has been a key area of concern for investors in Brazil. The slow progress in fiscal consolidation has helped to boost domestic growth and could be why Brazil's inflation is taking longer to recede.

Indeed, rising inflation expectations linked to the concerns around the fiscal path have forced the Brazilian central bank into a policy pivot – having begun the year easing, a hiking cycle began in September.

Other markets face similar fiscal concerns. Poland's central bank paused its easing cycle over fiscal slippage concerns and Mexico's easing cycle could also end abruptly if fiscal policy among other factors, such as minimum wage increases, prove inflationary.

Inflation readings have at least broadly surprised to the downside over the course of 2024, but, with these potential supply shocks, EMs where inflation is at the upper bound of the central bank's target range may judge that a more gradual monetary easing path is appropriate.

In contrast, those where inflation is undershooting target or with very subdued core inflation, have more scope to cut through this uncertainty. Much of Asia and the likes of Peru, Czechia and South Africa are well placed to ease.

Economic growth seems set to slow

Growth appears to be softening but not dramatically (see Figure 4). Indeed, real GDP growth in Q2 was still running at 4.3% annualised, which is above our potential growth estimate of 3.5% for the economies included in our EM ex. China Index.

Figure 4: EM growth proving strong



Source: Haver, abrdrn, October 2024

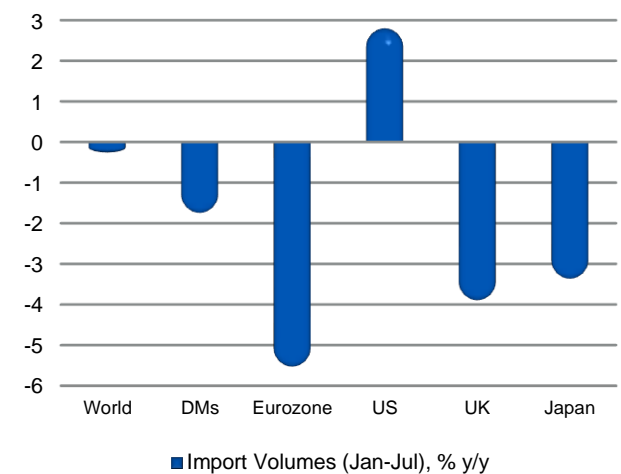
However, since late July, emerging markets' macroeconomic data have largely fallen short of consensus expectations, potentially signalling that aggregate growth has fallen below trend.

Despite some signs of an upturn in the first half the year, the manufacturing cycle once again appears to be turning through Q3. Global new manufacturing export orders have been cooling, alongside output, weighing on the EM manufacturing index (see Figure 6).

One area of strength continues to be the semiconductor cycle. Taiwan's exports have bucked the trend thanks to still strong semiconductor demand from AI-related investment. Markets such as Malaysia, South Korea and China should also benefit from strong semiconductor demand.

That said, while tech could defy gravity for a while longer, global goods demand is likely to slow further given our expectation for the US economy to cool. The US has been a major driver of global goods demand recently (Figure 5) and, while we are not expecting a sharp drop in US demand, this is another reason to expect global trade to soften into 2025.

Figure 5: US slowdown a major challenge for manufacturers



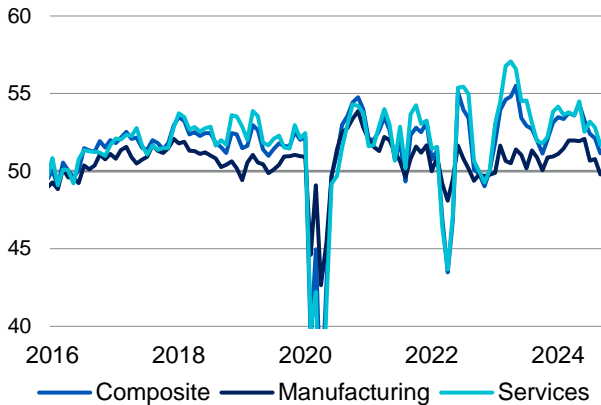
Source: Haver, abrdrn, October 2024

Weakness in recent PMIs is not confined to manufacturing. Services have also moved notably lower, pushing the EM Composite PMI to its lowest level since October 2023 (see Figure 6).



Figure 6: PMIs point to a weaker Q3

EM manufacturing, services & composite PMIs (latest = September)



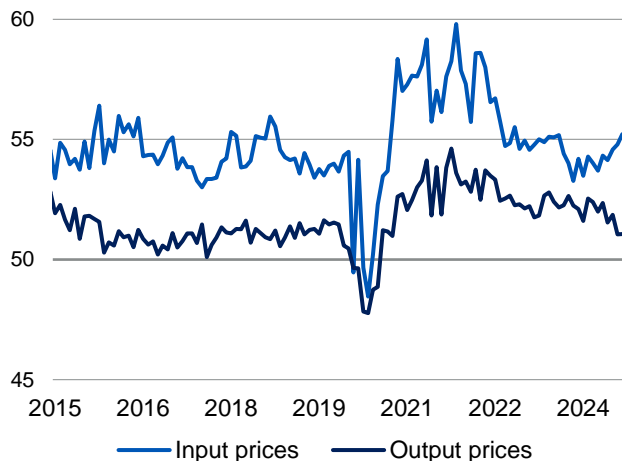
Source: Haver, abrdrn, October 2024

Services activity has been driving EM growth, as tight labour markets, recovering tourism sectors and strong external demand, have all proved supportive.

But a turn in services activity could see EM growth fall below trend, potentially creating the output gaps needed to crack the 'last mile' of inflation. Indeed, this could determine how much the rise in input costs is translated into output prices.

Figure 7: Services activity key to inflation outlook

Services PMI sub-components



Source: Haver, abrdrn, October 2024

Chinese stimulus is no GFC repeat, but it should help trading partners and reduce disinflationary impulse

While the US economic path is a key factor in the outlook for emerging markets, China's economic direction will also play a major role.

Author

Michael Langham

Chinese policymakers have initiated a coordinated policy pivot, promising to stabilise the property sector, deal with local debt problems and boost domestic demand.

The extent to which stimulus will generate positive spillovers for other EMs is very uncertain. The size and composition of the fiscal package, which will be key to determining import intensity, remains undisclosed. And the extent to which the authorities are really planning on boosting household consumption also remains unclear.

For now, China's investment and supply-side biased growth model continues to exert downward pressure on other countries. The export price deflator continued to trend down in September and is now 15% lower than its peak 18 months ago.

This may be helpful for some countries still battling inflation but also threatens the competitiveness of goods produced in other markets, adding to the headwinds faced by manufacturing sectors elsewhere. If household confidence returns and consumption picks up in China, it would go some way to reducing trade tensions, but it is unclear whether markets are over-reading the CCP's intent.

Political risks are at the forefront

Potential tailwinds from Chinese stimulus or the Fed easing cycle will come with the turbulence of the US election in November. Whoever sits in the Whitehouse will have a key influence on the paths of global growth, trade and geopolitics. This uncertainty is likely being taken into consideration by policymakers, and while it has yet to be a barrier to central banks delivering rate cuts, it may become increasingly part of the policy decision.

A Harris presidency with a divided Congress is our base case and would provide a limited shock to both the US and EMs. However, we see four other combinations of president and congressional control, which could result in large policy shocks for the US.

On the one hand, a 'market friendly' Trump presidency, for example, could be good for EMs: the Fed may cut less but his pro-business stance would boost global growth and contribute to a 'risk on' market sentiment, supportive of EM financing conditions.

On the other hand, a second trade war would be much harder to navigate, creating a wide range of winners and losers across EMs. This is a particular risk for China but could ultimately benefit countries that are able to capture the reshoring of manufacturing.



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