RBC Global Asset Management

Emerging market central banks forge a new credibility

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The scourge of inflation and a cycle of rising interest rates have made for a turbulent couple of years, but in their wake, they have also left a new landscape in which emerging market (EM) investors are well placed to benefit.

The old stereotype that EMs are always inflation-prone and ill-disciplined is no longer true. Indeed, policymakers in many emerging economies are coming out of the latest cycle with a new-found credibility, as their central banks have acted swiftly and decisively in the last few years, pre-empting their developed market (DM) counterparts in hiking rates. For investors this means EM currencies could offer an attractive long term valuation anchor as they seek compelling opportunities within global markets.

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More room for rate cuts

Rates are now expected to fall across the world’s economies and all eyes are now on the US Federal Reserve (Fed). Its first reduction will be widely regarded as the unofficial start of the rate-cutting cycle. In line with their caution during the tightening period, EM central banks have been careful not to act prematurely. But their discipline should soon pay off. Lower inflation pressures together with disciplined action over the last two years, means many are now in a position to cut rates aggressively.

The price of oil is naturally a key component in global inflation, and we expect oil prices to remain broadly around their current level. The one risk is that the challenges of managing a soft landing get away from the larger central banks, increasing the risk of a hard landing with sharper demand destruction driving down oil prices. The resulting downside pressure on headline inflation would provide more scope for EM central banks to pursue interest rate cuts even more vigorously.

The picture is of course not uniform, and some emerging economies still face tough rate decisions and may even have to raise rates before they can turn the corner. But for several major EM economies, such as Mexico and Brazil, we see room for rates to be cut far harder than the market is currently pricing.

The recent inflation and interest rate cycle has been a testing time for many economies and investors, but out of the fires of that cycle, EM debt has emerged as a strategic investment opportunity. We believe that investors can best capitalise on this by taking an unconstrained approach. A fluid and flexible approach to asset allocation can come into its own in volatile markets when the universe offers a multitude of opportunities for investors to achieve outsized returns yet avoid taking excessive credit risk.

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