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Overview

- Several EM central banks cut interest rates in the past month, but they maintained a hawkish bias. A US Fed cut in September would likely create a tailwind for further EM cuts.
- Our discussions in Brazil led to our view that Brazilian asset performance may continue to be weighed down by electoral and monetary policy uncertainty. Improvements in external conditions, especially the beginning of the Fed's cutting cycle, could provide support.
- The US election could have important implications for EMs through three key channels: the US dollar, US interest rates and trade policy. A Trump win, in particular, would likely affect both emerging and developed market countries through trade policy.

Interest rates, currencies and trade policy: How the Fed and US elections will likely impact EMs

Market commentary

Selected emerging market (EM) central banks continued to lower interest rates over the past month, but with a more hawkish bias. In Latin America, Colombia maintained its 50 basis point pace of rate reductions, though nominal rates remain high. Chile surprised the market by keeping rates unchanged, though a 25 basis point cut was expected. In Central and Eastern Europe, the Czech Republic slowed its pace, cutting rates 25 basis points, and indicated a higher terminal rate. Hungary and Romania cut rates by 25 basis points, in line with expectations. In Asia, China surprised the market by cutting rates to new 15-year lows, in an effort to support its fragile economy.

As US inflation data moderate and the labor market softens, financial markets are expecting the Federal Reserve (Fed) to begin cutting rates in September. We believe the Fed will cut rates multiple times this year, which should provide a tailwind to most EM central banks, whose economies are enjoying solid growth and lower inflation. However, market participants seem more concerned about politics, such as the impact of US elections on US-China and US-Mexico relations, and fiscal developments, especially in Brazil, than economic fundamentals.

Notes from the ground | Update on Brazil's challenging economy

This year has presented significant challenges for Brazil. Initially, a positive outlook prevailed, driven by strong growth, decreasing inflation and a sound monetary strategy. However, uncertainty arose among local investors about the government's fiscal policies. This, coupled with challenging market performance, significant redemptions, and changes in tax regulations have left the local investor base extremely limited. Sentiment deteriorated in the second quarter, prompting our team to visit Brazil in July to engage with key market participants who shape the local rates and currency markets, including local hedge fund CEOs, CIOs, traders, economists, and former members of Brazil's central bank.

Key takeaways

Over the course of our visit, we held various discussions on topics including economic growth, inflation expectations, politics, and the actions of Brazil's central bank, Banco Central do Brasil (BCB). However, there was no consensus on a potential catalyst to shift asset performance. Given the current position of the Brazilian government, it seems unlikely that fiscal policy will act as a catalyst, although establishing a fiscal anchor would be the most favorable outcome, in our view. For now, the responsibility for supporting assets will likely rest on the monetary side, which is hampered by a leadership change at the central bank, as the current governor will reach the end of his term by the end of the year and be replaced by a new appointee selected by President Lula.

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We expect continued downward pressure on the currency, until the central bank is forced to intervene with rate hikes, or until the external environment becomes supportive once the Fed begins cutting rates. We believe a hawkish BCB stance would allow the Brazilian real to stabilize in the 5.20-5.40 range, which could also positively impact 2025 inflation expectations and calm local markets. We do not favor using credit default swaps as a hedge, given the country's minimal external debt. The yield curve could steepen from the front end, as we are likely to see fewer rate hikes - if any - than are currently priced in. Nevertheless, we do not expect rates to fall below the lows seen this year. A lack of action from the BCB will likely have the greatest impact on the Brazilian real, driving it to higher lows and higher highs until it reaches a tipping point, where neither the BCB nor President Lula can continue to ignore it.

Overall, we found local sentiment to be bearish, with investors expecting to manage as best as possible until the local elections in October, after which they could shift attention to mid-2025 in preparation for the presidential election in 2026.

Developments since our visit

Since our visit at the end of July, Brazil's economy has remained volatile, influenced by both internal and external factors. The Brazilian real recently rebounded from a two-and-a-half year low after weaker-than-expected labor data in the US and hawkish comments from Gabriel Galípolo, the current Monetary Policy Director at the BCB, who is expected to be appointed as the new president of the BCB. He has doubled down on the hawkish tone set at the last BCB meeting, saying there could be interest rate hikes to combat inflation. These comments, coupled with expectations of Fed rate cuts in September, caused the Brazilian real to appreciate. In July, Brazil's inflation rose for the third consecutive month and employment data were better-than-expected, which both support tightening monetary policy.

Topic spotlight: What does a second Trump administration mean for EM?

If former President Trump is elected in November, we believe the market impact will be different compared to his first election in 2016. When Trump took office in 2016, his policies and positions on key issues were unknown. We believe there would be fewer surprises if Trump wins in 2024, resulting in a more limited market response. Additionally, strong EM fundamentals and technicals should help mitigate market fluctuations compared to 2016.

Impact on markets

The initial effects of Trump's 2016 victory included higher US equities and interest rates, and a stronger US dollar, along with trade and foreign policy instability and higher US deficits. The current state of the US economy is different today than it was when Trump first entered office. In 2016, the US had considerable fiscal flexibility following the fiscal cliff showdown in 2013. Today's starting point is very different with a fiscal deficit of around 6% of GDP and a current account deficit of 3.4% of GDP.¹ In addition, valuations of US equities are already high, the US dollar is strong and US interest rates are high.

The global impact of a Trump win would likely be felt through similar channels: the US dollar, US rates and trade policy. The impact would likely affect both emerging and developed market countries, depending on the severity of the moves, especially when it comes to changes in trade policy.

Impact on the US dollar and US rates

Trump has been vocal about desiring a weaker US dollar. However, his proposal to increase US trade tariffs across the board, and some for China, would suggest otherwise. Traditionally, higher US tariffs result in a stronger US dollar, which was the case in the first half of the 2018-2019 trade wars between the US and China, until the Fed eased.

While the US dollar responded positively when Trump was elected in 2016, the surprising Republican victory in the Senate also played a significant role in the US dollar's strength, reflecting expectations of deregulation, tax reform and other pro-business policies. A republican sweep that could lead to a similar outcome is too

1. Source: U.S. Bureau of Economic Analysis.
Data as of June 20, 2024.

close to call at this stage, although our baseline remains for a divided government. Nonetheless, the question remains whether Trump can introduce tariffs across the board. It would likely weaken other trading partners' currencies against the dollar, while at the same time he might talk the dollar down as he has hinted at many times. Trump has argued that a weaker US dollar would help boost American manufacturing and reduce the trade deficit by making US products more competitive internationally. Although there are signs of a manufacturing revival in the US, especially in high technology and certain supply chains, the cost advantage of Asia's vast manufacturing base, especially in China, makes trade competitiveness through depreciation a moot point for a market of the US's size, in our view.

On the other hand, Trump's fiscal policy propositions of cutting taxes would likely imply higher fiscal deficits, which, if accompanied by no significant tightening of financial conditions, would likely lead to a weak US dollar through higher inflation expectations. However, looser fiscal policy would also argue for fewer rate cuts from the Fed and a steeper US yield curve. This could spill over to some high-beta EM yield curves, such as Mexico's, but could also limit the policy flexibility of a broader swath of EMs, and provide a tailwind to the US dollar.

Trade policy impact

The discussion of the potential impact of a Trump presidency on trade policy is largely focused on China and Mexico, although he has also mentioned across the board tariffs on all US imports to finance his potential tax cuts. Notwithstanding this possibility, we view his current rhetoric on China and Mexico as an opening salvo for further negotiations.

- **Mexico:** We believe the narrative surrounding Mexico could be different from 2016 if Trump wins a second term. When Trump ran for office in 2016, he threatened to withdraw from the North American Free Trade Agreement (NAFTA), which created volatility in Mexican assets, as the US is Mexico's largest trading partner. After taking office, Trump renegotiated and created the United States-Mexico-Canada Agreement (USMCA) to update and replace NAFTA. The USMCA still stands and will likely remain if Trump is elected for a second term. However, Trump could seek to renegotiate the agreement, leading to trade uncertainties or tariffs, if Trump feels Mexico is failing to fulfil its obligations, especially regarding border security. The greatest impact is likely to be seen in the exchange rate.
- **China:** Trump has proposed a 60% tariff on Chinese goods, which we believe is unrealistic and reflects his negotiation style. Nonetheless, expectations are that China will bear the brunt of his tariff hikes. Depending on the severity of the tariffs, we would expect a commensurate depreciation in the renminbi, similar to the the first trade war. China tends to respond to tariff hikes in a measured way, but past experience points to agricultural imports from the US as the most important retaliation target. As with "Trade War 1" we would expect this policy to lead to meaningful trade diversion, benefiting EMs in manufacturing hubs in Asia, such as Vietnam, and Eastern Europe and Turkey, and other agricultural goods exporters, such as Brazil and Argentina.

Conclusion

Overall, we believe the outlook is promising for EM local debt. Attractive income, healthy economic growth and favorable interest rate differentials compared to developed markets should all benefit the asset class. The economic environment surrounding Brazil is extremely fluid and, like the US, all eyes are on its central bank. With US inflation data moderating and the labor market softening, investors expect the Fed to begin cutting rates in September. However, unlike the upcoming Fed decision, the winner of the US Presidential election in November is more uncertain. If Trump is elected in 2024, we believe the market impact will be more limited than after his first election in 2016, but we believe diverging individual country dynamics and trade policy implications may offer compelling total return opportunities under a second Trump administration.

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