Repairing the ship while sailing the COVID-19 waves

Emerging Markets Outlook Q2 2021

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With the perfect storm created by the pandemic starting to abate, we are becoming more aware of the economic damage it leaves behind. The virus first exposed countries with weak health systems. Then it made it evident that the recession would be larger, and inequality would rise in places where fiscal buffers were insufficient to protect households and businesses from the impact of lockdowns. This year, most emerging markets will see annual GDP growth surge, mainly due to a low base after a dramatic contraction last year. But there is still a lot to be done for the recovery to be sustainable.

The increasing divergence across countries seems unstoppable. The outlook for advanced economies is rosier, thanks to the positive impact of stimulus and vaccination rollouts. The spillover to emerging markets results from higher commodity prices and global trade growth. And although COVID-19 contagion has peaked in many developing countries, levels are still much higher than in advanced economies. It is not helping that vaccinations are flowing slowly and, particularly in low-income countries, COVID-related spending is running out. In fact, it has become more evident over the past few months that in the race to get vaccines the poorest countries often pull the short straw.

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Economic activity at the start of the year

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In 2020, emerging markets' GDP will have shrunk by the largest amount on record. Although the recovery is now on its way, the first quarter of 2021 is still showing a mixed picture with an uneven recovery across sectors, highlighting the divergences across countries. World merchandise trade has given the largest boost to the global recovery, particularly benefitting commodity-exporting countries. At the same time, retail growth is picking up. This is mainly because of the increasing mobility and the nature of the stimulus, directed at helping households stabilise their consumption. The sectors hardest hit by the pandemic are still only crawling up slowly. For instance, tourism is still lagging. **McKinsey estimates** that tourism spending will take four to seven years to recover to 2019 levels, while the **IMF expects tourism** receipts to reach pre-pandemic levels in 2023, mainly because it will take longer for vaccines to be available in many developing countries' tourist destinations.

In emerging Asia, China continues leading the recovery and it has already started policy normalisation, including fiscal consolidation, which resulted in a credit slowdown in the first quarter. Vietnam is also seeing a robust recovery, boosted by global goods' demand and the benefits from shifting manufacturing supply chains. Countries still dealing with the virus are experiencing a fragile recovery, including the Philippines, while Myanmar has added social unrest to the damage caused by the pandemic, making it more difficult to leave the economic recession behind.

In Latin America, economic activity is bouncing back. For instance, in Central America consumer spending is increasing on the back of remittances from migrants in the US. These flows are proving vital in helping countries rebuild their economies. Remittances in El Salvador and Honduras, for example, account for more than 20% of GDP. Remittances are not only a lifeline support for households' consumption. Banks also rely on them as cheap funding for extending credit, and governments see them as an important source of tax revenues.

In the larger countries in the region, the rebound in economic activity is also on track. However, since stimulus has been more meaningful, this first quarter has been more about balancing fiscal consolidation, given that the most fragile segments of the population are still struggling, and COVID-19 contagion is not under control. Brazil and Colombia have been facing this challenge and with elections in both countries next year, the direction has been to continue with government support. Mexico has dealt with fiscal policy differently and refrained from large stimulus, instead choosing for long-term policy decisions, including expanding the role of the state-owned oil company. The reaction of markets to these policy decisions is still uncertain. Moreover, the debate about lifting or prolonging restrictions to mobility is still ongoing.

In Africa, the hard-won gains in poverty reduction in the past years are being reverted. **The African Development Bank** suggests that about 30 million Africans were pushed into extreme poverty in 2020. The countries most resilient in the region appear to be those with more diversified economic structures, including Kenya and Tanzania. Countries depending largely on tourism continued to shrink, including Mauritius and Cabo Verde. However, the impact on tourism is expected to fade over time with no large long-term effects.

In emerging Europe, the recovery is ongoing but with some bumps in the road, resulting from COVID-19 resurgence and tightened restrictions in many European countries. Vaccination rates have been increasing in several countries, but the pace is generally slow. The major concern in this first quarter has been the limited room for further easing in some countries, including Russia, Kazakhstan and Ukraine given the higher than expected inflation. Turkey's weak external finances and policy uncertainty have increased volatility, making the recovery more difficult.

The near-term outlook – still about stimulus and vaccinations

With increasing mobility and positive spillovers primarily from the US and China, we expect some rising momentum in emerging markets in the coming quarters. For emerging markets, the most immediate challenges are vaccination rollouts and being able to maintain stimulus until the virus is under control. Preparing for the withdrawal of stimulus and for unexpected events is also critical. For instance, financial markets are still pricing in that the Federal Reserve will raise interest rates sooner than expected. Expectations of higher rates will likely increase financial stress for emerging markets with weaker fundamentals. The sum of these developments points to near-term downside risks.

Stimulus

The IMF estimates that advanced economies on average deployed about 24% of GDP in fiscal measures, compared with only 6% by emerging markets and less than 2% by low-income countries. These differences in size, policies and allocation choices, as well as the timing have translated into different recovery paths. Fiscal support in several countries, particularly low-income countries is falling short, with rising poverty as a consequence. For the poor segments of the population, additional support means money to buy food. Surveys conducted periodically by the World Bank in the past few months show significant numbers of people running out of food or reducing their consumption of essential goods. Meanwhile for small viable businesses, receiving government support means they can keep their business open until economies normalise. Should stimulus be withdrawn too early, efforts to reduce the impact of the pandemic could fail. This is why international cooperation for additional debt relief and concessional financing remains critical.

Vaccinations and the pandemic path

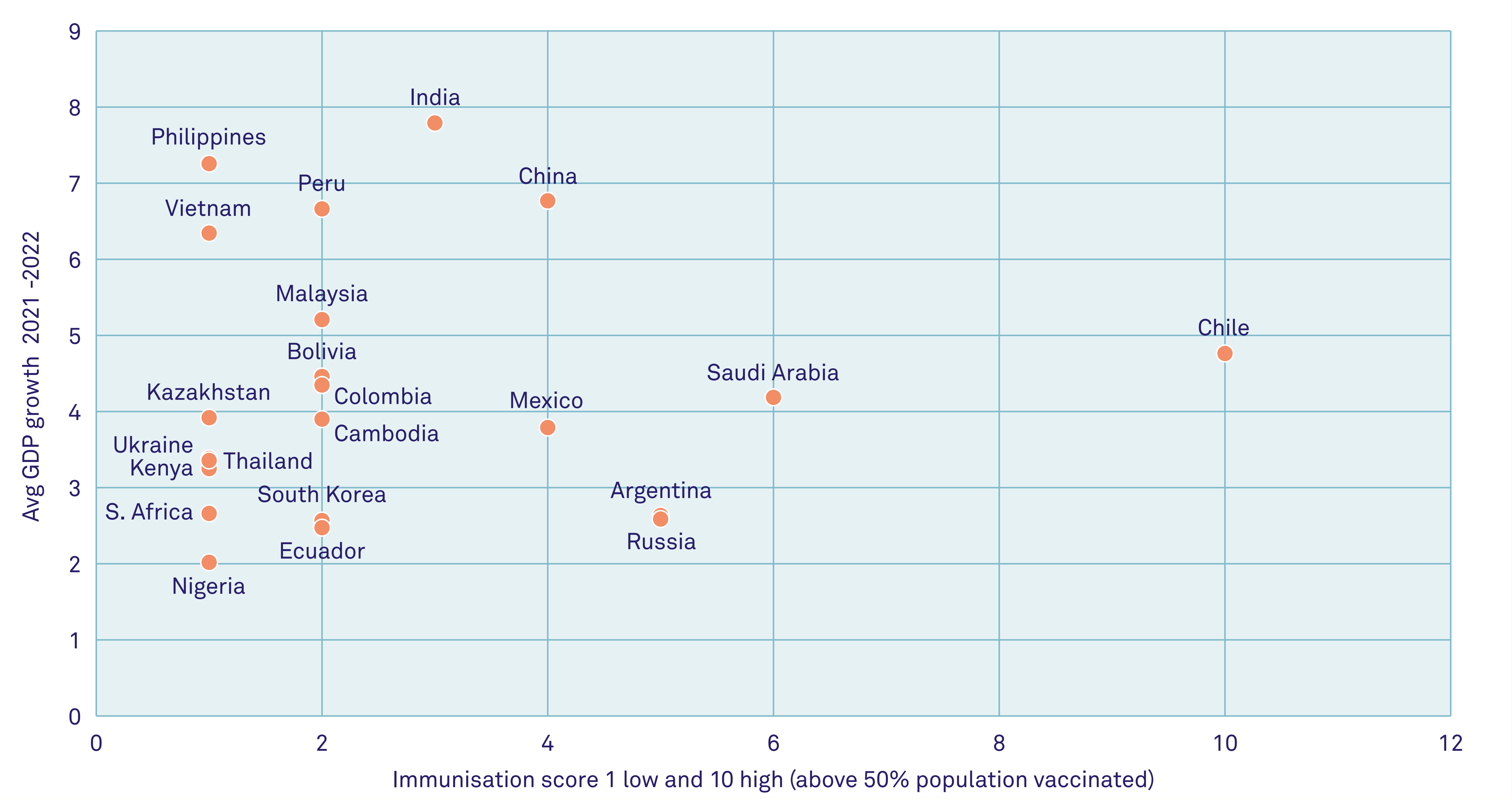
Since the start of the year, the levels of contagion in most emerging countries may have declined, but with economies opening and new virus mutations the path to the recovery remains bumpy. And as the virus continues to spread, no country is completely safe. The larger emerging economies have sketched different deadlines for achieving herd immunity through vaccinations. China has said it will conclude its vaccination roll-out this year. India expects to conclude the roll-out by mid-2022. Chile, Serbia and Hungary will have a large part of their population vaccinated quite soon. Many low-income countries are waiting for the COVAX programme, an initiative for equitable global access to COVID-19 vaccines. In a first round running until May 2021, a total of 138 countries are expected to participate in this programme after the delivery of 237 million doses. This is slightly less than the population of Indonesia, which suggests that the coverage is still limited. COVAX has already started with Ghana and Cote d'Ivoire. This is a start.

Vaccines and property rights

South Africa and India are proposing an intellectual property waiver in the World Trade Organisation (WTO) to allow data, knowledge, and technologies to be shared in order to increase the production and supply of COVID-19 vaccines. This proposal is now supported by 80 countries, largely developing countries.Proposals of this type need the backing of 164 WTO members to pass. The main **argument in favour** is that without greater efforts to increase the number of suppliers of essential medical tools globally, the virus cannot not be brought under control. The **arguments against** suggest that protecting these intellectual rights encourages further research and innovation, including to address emerging COVID-19 variants and that the technology used in vaccines is too complex to replicate.

However, there should be room for collaboration since investments have been co-financed by governments and this is clearly a public health crisis of unprecedented dimensions. Moreover, the costs for governments are piling up as a result of the undesirable setback in poverty, education and threats to food security. Several emerging markets that have reported timelines for vaccinations are expecting to reach herd immunity towards the end of this year. This assumption is behind the GDP growth forecasts for 2021 and 2022. Some countries, including the Philippines, have ambitious growth forecasts, but still low vaccination coverage and it remains to be seen if this will not pose a threat to the recovery (see graph).

Figure 1 Vaccine rank and projected GDP growth



Source: IHS, One World

Building resilience

Although crisis management has been an issue throughout the pandemic, there are countries that have installed more effective crisis controls by considering the long-term impact of their decisions. Peru, a country severely hit by the pandemic, has given a strong impulse to banking supervision and monitoring to safeguard financial stability, while Honduras has improved its institutional framework by passing laws relating to corruption and governance.

Moreover, the crisis itself has reduced some imbalances, making economies more resilient to some extent. As economies contracted, imports fell, resulting in current account surpluses. South Africa, India, Peru, and Chile have stronger current account positions. The more vulnerable countries with high current account deficits, including Brazil, Turkey, Nigeria, and Kazakhstan will have to reduce their imbalances to improve investor confidence if they want to access capital markets. Some of these countries (Brazil and Turkey) are already tightening interest rates to mitigate capital outflows resulting from markets pricing in rate hikes in the US. It also helps that inflation rates remain subdued in many emerging markets. This will provide room for additional stimulus if needed.

Finally, the recovery will also be subject to the availability of (concessional) financing and debt relief. In the case of low-income countries another round of debt relief seems unavoidable given the duration of the pandemic. Emerging Europe's EU members access to additional financing for the coming years will be a boost for long-term investments.

Figure 2 Current account / GDP (in %)

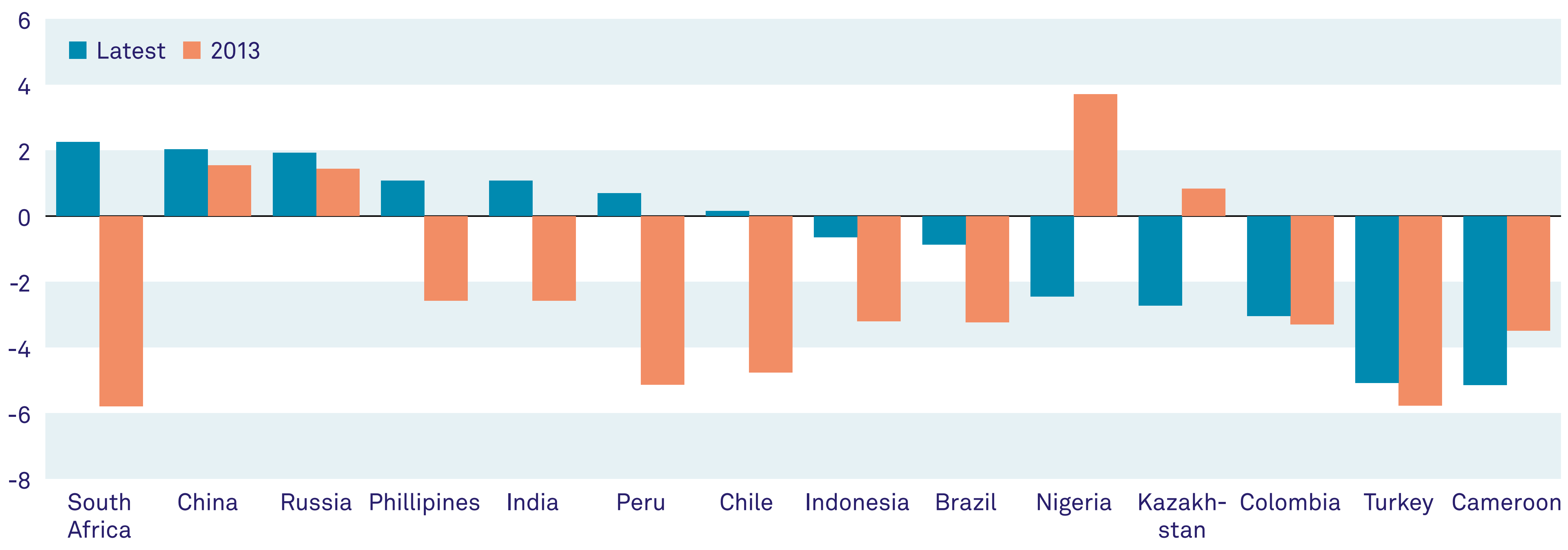
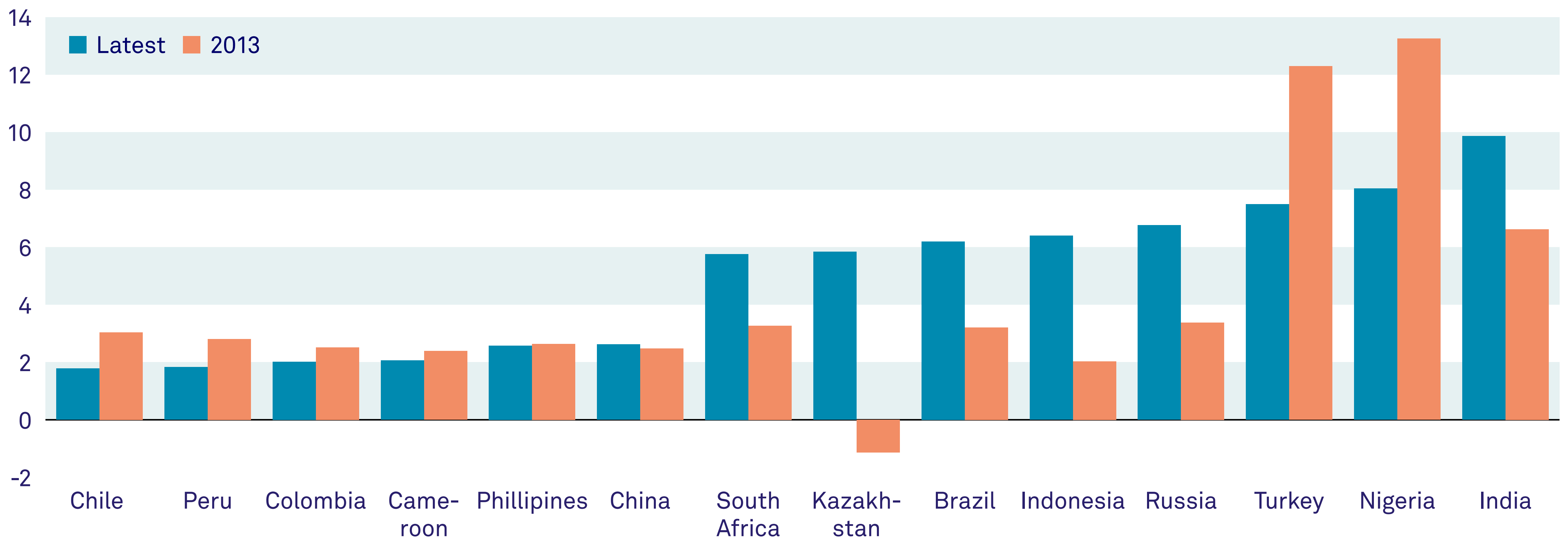


Figure 3 Inflation average (%)



The long-term outlook – urgency for more global collaboration

The balance of the pandemic's first year shows that deliberate and structural attempts to address growth potential and entrenched inequality are still missing. This is understandable, as governments acted as quickly as possible to reduce the immediate impact of the pandemic. In doing so, they were focusing on health systems and invigorating demand through different measures including cash transfers, financing for SMEs and tax incentives for businesses. Therefore, plans for long-term improvements are mostly still in the making.

Moreover, many emerging markets are still struggling with the virus (as are some advanced economies) and will come out of the pandemic with high fiscal deficits and debts. This requires fiscal tightening in the years to come to avoid the risk of debt distress. There is a sense of urgency though, to prevent an even larger setback in poverty and inequality. That is why more hands are needed in rebuilding a more sustainable economy.

Indeed, only with global collaboration and synchronised investments in advanced economies can we devise a plan to amplify the effectiveness of spending and reduce the likelihood of a new global crisis. Collaborating in impact investments that require capital allocation towards productive activities, such as building structures, improving human capital and creating intellectual property in the form of sharing information and knowledge, as well as financing can help us move at a faster pace towards a sustainable recovery.

Triodos Investment Management offers many examples of collaborative sustainable investing in infrastructure that propels economic vitality through for instance new and cleaner technology (see box), in financial inclusion that embraces digital processes and in implementing sustainable methods of production.

During this past year, the challenges for impact investors have been large, but the commitment to build a better world even larger. Our task in the coming time will be to assess the risks and opportunities in the transition from general emergency support to targeted support. We will be pushing forward for a more inclusive economy that is in balance with our environment. The pandemic has proven already that it is difficult even in times of crisis to persuade governments and citizens to work together in common interest. But there is no other choice given the urgency and the dimension of the challenges.

Nigeria: Keeping the lights on during the pandemic

The pandemic has accelerated many trends, including some positive ones like decarbonisation. According to the International Energy Agency, the recession triggered by the pandemic significantly reduced demand for oil and carbon, while clean energy was the only part of the energy sector that grew. Some countries, particularly those producing fossil fuels, are expected to bear the costs, and they are expected to offer resistance in the transition towards renewable energy.

However, this does not necessarily need to be the case. Nigeria, a country with a high dependency on fossil fuels, has opened its doors to renewable energy. During the pandemic, Hivos-Triodos Fund and Triodos Groenfonds co-financed one of the first large-scale mini grid projects in Africa. This project is part of a major electrification program in Nigeria supported by the World Bank. It will provide access to affordable energy to schools, more than 10.000 households and SMEs by means of solar mini grids. Nigeria currently is one of the countries with the largest deficit in energy access in the world. Access to grid electricity is limited and power outages are common.

For a country like Nigeria with a high-country risk profile, given the significant dependency on oil and the volatility of oil prices, finding investors that could lead the country towards sustainable growth can be challenging. Impact investors seeking to improve the balance between development and environment see this as an opportunity. This type of investment requires a rigorous risk analysis that is broad and detailed enough to address different downward scenarios and allow sufficient risk mitigation. At the same time, local communities in Nigeria with increased access to affordable, clean and stable energy will be able to cover their basic needs and explore new economic activities, resulting in additional, stable sources of income and hence economic development. Surveys suggest that getting electricity is one of the major impediments for doing business in Nigeria.

Growth projections 2020-2021

	GDP growth (% yoy)			**Inflation** (CPI, % yoy avg)			**Government debt/GDP** (%)			**Government balance/GDP** (%)		
	2019	2020	2021 forecast	2019	2020	2021 forecast	2019	2020	2021 forecast	2019	2020	2021 forecast
Argentina	-2,1	-10,7	2,4	52,8	40,5	44,9	89,6	98,9	100,7	-3,7	-9,9	-6,4
Brazil	1,4	-4,4	3,4	3,7	3,2	5,7	75,3	90,1	92,9	-5,9	-13,8	-7,8
Chile	1,0	-6,0	5,7	2,6	3,0	3,2	20,4	20,1	19,1	-2,8	-7,5	-5,4
China (mainland)	6,0	2,3	8,5	2,9	2,5	1,5	17,0	20,4	20,9	-4,9	-6,2	-4,3
Colombia	3,3	-6,8	5,2	3,5	2,5	2,7	45,6	57,5	51,1	-1,9	-7,4	-8,2
Hungary	4,6	-5,0	4,0	3,4	3,4	3,7	64,1	71,6	77,8	-2,0	-7,3	-7,9
India	4,1	-8,2	9,8	3,7	6,6	5,5	41,5	51,4	54,9	-4,2	-8,6	-6,8
Indonesia	5,0	-2,0	3,7	2,8	2,0	2,2	30,7	39,0	44,5	-2,2	-6,1	-5,7
Malaysia	4,3	-5,6	5,1	0,7	-1,1	1,7	53,3	61,8	62,0	-3,5	-5,8	-5,3
Mexico	0,0	-8,5	4,5	3,6	3,4	3,0	36,1	40,8	38,1	-1,7	-2,9	-2,5
Peru	2,3	-11,2	8,7	2,1	1,8	2,2	26,0	34,0	39,3	-1,4	-7,7	-6,1
Philippines	6,1	-9,4	7,4	2,5	2,6	4,0	39,7	54,5	51,1	-3,3	-7,5	-8,6
Poland	4,6	-2,7	3,0	2,1	3,7	3,1	46,3	60,2	63,2	-0,6	-8,0	-5,9
Russia	1,3	-3,1	2,8	4,5	3,4	5,2	13,1	14,7	14,2	2,1	-4,1	-1,7
South Africa	0,2	-7,0	3,3	4,1	3,3	4,3	61,4	76,2	80,0	-4,5	-11,8	-9,8
South Korea	2,0	-0,9	2,6	0,4	0,5	0,7	42,8	42,2	44,0	-0,6	-3,3	-0,4
Taiwan	3,0	3,1	4,5	0,6	-0,2	1,1	29,1	27,8	26,7	0,0	-0,4	-0,1
Thailand	2,3	-6,2	3,1	0,7	-0,8	1,0	34,0	39,3	40,9	-2,7	-5,5	-4,2
Turkey	1,0	1,8	4,0	15,2	12,3	14,4	30,8	36,6	32,8	-2,9	-4,2	-5,4

Note: 2020 includes forecasts for some countries

Source: IMF and IHS

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With over 25 years of experience as a globally active impact investor, and as a wholly owned subsidiary of Triodos Bank, Triodos Investment Management has developed deep sector-specific insights across Energy & Climate, Inclusive Finance, Sustainable Food & Agriculture, and Impact Equities and Bonds. Offering impact solutions through private equity, debt, and listed equities and bonds, our assets under management amounted to EUR 4.9 billion as per 30 June 2020.

Investing in positive change

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Published
April 2021

Text
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Design and layout
Via Bertha, Utrecht

Cover photo
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