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MFS® Emerging Markets Debt Team View

Market Insights
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Impact of US Election Outcome on Emerging Market Debt

President-elect Donald Trump's return to power in the United States brings renewed uncertainty and headwinds for emerging market assets, such as a stronger US dollar, higher US Treasury yields and the risk of higher tariffs. However, the probability of an economic soft landing has increased with a Republican sweep of Congress in anticipation of a progrowth agenda, which would be supportive of EM. In addition, the US Federal Reserve cut interest rates at its last two meetings, and EM central banks' easing cycles are generally underway. We also expect some stabilization in China, another tailwind for EM assets.

What does the election outcome mean for US inflation and the Fed?

Although there is uncertainty postelection, Trump's policies — a mix of tax cuts, tariffs and tighter immigration — could lead to a higher inflation environment in the US. Tariffs will likely come first. Plans to impose tariffs of 60% on Chinese goods and a 10% to 20% levy on other imports would also put upward pressure on prices at a time when inflation appears to be coming under control. An extension of the 2017 tax cuts could take time to implement, but if additional cuts are enacted, they would add to already expansive US fiscal policy. Higher disposable income because of tax reform would likely increase consumption. In addition, Trump plans to reduce immigration and to deport unauthorized immigrants. While many believe large-scale deportations would be inflationary since they would shrink the labor supply, deportations would also reduce overall demand, potentially offsetting the inflationary impulse.

The Fed is increasingly confident that US inflation is returning sustainably to target. It made a larger-than-expected interest rate cut of 50 basis points in September, followed by a 25-basis-point cut in November. While the Fed will wait for Trump's proposed policies to be implemented before they incorporate them into their outlook, market concerns could lead to higher US Treasury yields as investors fear that inflation could reverse course. The Fed will be keen to avoid a resurgence, and while we expect additional rate cuts, the pace of the easing cycle may slow.

In China and the eurozone, the imposition of US tariffs would slow growth and therefore be deflationary. Their central banks would likely respond with additional easing, and we would expect their currencies to weaken. A key uncertainty is what counter-tariffs they would impose on the US. Whatever they impose could be inflationary, but we think the impact of slower growth would dominate.

What does it mean for the EMD universe?

Additional tariffs would slow growth in those EM countries that export much in the way of manufactured goods to the US. China is the primary concern as it is potentially facing a 60% tariff, and its economy is already struggling. Generally, goods manufacturing and trade-dependent economies such as those in Asia would likely be more negatively impacted as tariffs lead to reduced trade flows and put downward pressure on growth. Conversely, large, domestically

focused economies such as India may be more insulated as they are less trade-sensitive. Latin America could be impacted negatively, but less so than Asian countries. Many Latin American countries are commodity exporters and therefore less vulnerable to tariffs.

It remains to be seen whether the threatened 60% will be levied on China as there doesn't appear to be broad support among US businesses to implement tariffs at that level. In addition, China has already made significant fiscal stimulus announcements, and further stimulus is likely if the US tariff hikes turn out to be large. It is worth noting that the tariffs put in place during the first Trump presidency slowed Chinese exports to the US. However, the impact on overall growth in emerging markets wasn't large and spreads continued to perform well during that time.

Trade tariffs would likely have a greater impact on EM currencies than on EM bond spreads. Typically, the currency of the country imposing tariffs appreciates versus the country whose goods face levies. Therefore, some EM currencies could suffer under the new administration. For example, Europe would be a target of the tariffs and in the emerging market debt space this weakness could be reflected in Central and Eastern Europe. More broadly, a stronger US dollar would lead to weaker EM currencies that could then put pressure on EM policymakers to slow or halt their monetary policy easing cycles to defend their currencies.

Other Trump policies could have an impact on some EM countries. For example, Ukraine may benefit from a quick end to the Russia–Ukraine war. Mexico, meanwhile, will need to work closely with the US to reach an agreement on issues including migration and a review of the USMCA trade deal due in 2026. Elsewhere, Trump's mass deportation policy may hurt countries in Central America (such as El Salvador and Guatemala) and the Caribbean that depend heavily on remittances.

Despite these concerns, EM sovereign fundamentals are in relatively decent shape. EM growth has proved resilient and maintained a healthy differential with developed economies, EM real interest rates are still relatively high, EM exchange rates aren't overvalued and EM external balance sheets are relatively strong and exhibiting only modest external financing needs. EM ex China household and corporate balance sheets don't appear stretched either. Moreover, several weaker EM sovereigns have now emerged from default thanks to IMF supported reform programs. These strengths should help EM economies absorb global shocks (like tariffs).

Where are the opportunities and hurdles in the wake of the election?

During Trump's first term, EMD returns were very strong despite the administration's "America First" policies and are evidence that EM can do well under a Trump administration. In addition, if we look at historical EM performance two years after the first Fed rate cut, the returns are relatively impressive, illustrating the positive impact that Fed easing has historically had on the asset class. These two factors combined lead us to believe that the return outlook for the asset class is strong, although we do expect increased volatility in the near term.

In our view, the biggest tail risk is the Middle East. Trump's policy of "maximum pressure" on Iran and his supportive stance toward Israel risks raising tensions in the region. A significant escalation would lead to higher oil prices and a broader risk-off market. As of October 2024, we were heavily underweight the region in our EMD hard currency portfolios because of this risk.

Is the team considering adjusting portfolios?

We have maintained a cautious risk stance in our MFS EMD hard currency portfolio given rich valuations and the risks of trade tariffs and an escalation in the Middle East mentioned above. Currently, we remain underweight EM spread duration while emphasizing higher-quality sovereigns in the portfolio.

In the local currency and blended portfolios, we are currently long the US dollar and have a reduced position in duration. We expect the stronger US dollar environment to persist for a while. However, we believe that EM central banks will eventually continue or resume rate cuts and are therefore holding onto rate positions in certain countries.

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