EM TACTICAL FOCUS

EMD & TRUMP 2.0:
THE BARK IS WORSE THAN THE BITE

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The political die has been cast: the Republican sweep in the US means the nation's political direction will change decisively in 2025. Donald Trump's return to the White House is likely to result in more headline risk and investors should be nimble, preparing portfolios for a more volatile market environment. On the other hand, the segments of EM debt having suffered the biggest drawdowns in the last few weeks have begun to look attractive - provided Trump's tariff policies will be less disruptive than meets the eye.

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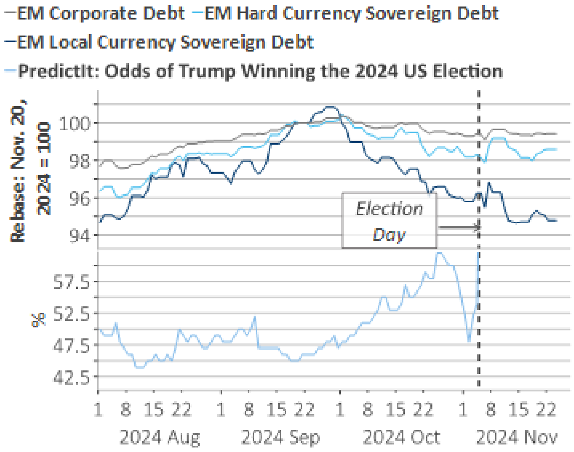
Taking stock: Is Trump 2.0 priced?
US voters have made their choice. The nation's politics will undergo a seismic shift in 2025 as Republicans won the trifecta of White House, Senate and House of Representatives. From an EM debt (EMD) investor perspective, we believe the most important consequences will be more restrictive trade and immigration policies, while fiscal policy is set to remain loose (as per our election roadmap).

Financial markets, and EMD in particular, have repriced accordingly. In fact – and admittedly with a tiny bit of hindsight - markets already started pricing in a Trump victory in the second half of September when his odds of winning the election began to rise in earnest (see figure 1). Since then, EM currencies have sold off by roughly 5 percent and 10-year US Treasury yields climbed from 3.75 percent to almost 4.50 at their post-election peak. In total-return terms, EM fixed income unsurprisingly saw losses with local currency bonds particularly hard hit, suffering a drawdown of more than 5 percent since September 20.

Still, the drawdown in local currency EMD almost exactly matches what we envisioned under such an election outcome. This begs the question of whether Trump 2.0 is already priced into local currency EM sovereign bonds. History offers scant evidence of this kind of political shift, but in light of the market reaction, we lean toward a 'yes' – at least from a short-term pricing perspective.

Figure 1: 2024 US Election & EM Fixed Income Returns



Source: Global Evolution, Macrobond and Bloomberg

Policy direction set - destination unknown
Medium term, it almost goes without saying that politics and policies will decide whether value has emerged in parts of EMD. The underlying assumption is that the global economy remains robust and a recession will be avoided. When assessing the path forward of US politics, there's little doubt about its *direction* over the coming four years; it's widely expected by market participants that trade and immigration policies will become more restrictive. Therefore, it will be the *destination*, i.e., how

restrictive US policies will end up being, that defines whether we have medium-term buying opportunity in segments that have sold off the most.

It might take a while for investors to identify the destination of fiscal and immigration policy. Trade policies, on the other hand, might change soon after Trump's January 20 inauguration as the president has considerable discretion over tariffs. Economically speaking, the impact on inflation will be felt rather quickly. Among the three key policy areas identified in our election roadmap, trade restrictions are also likely to have the greatest impact on the rest of the world.

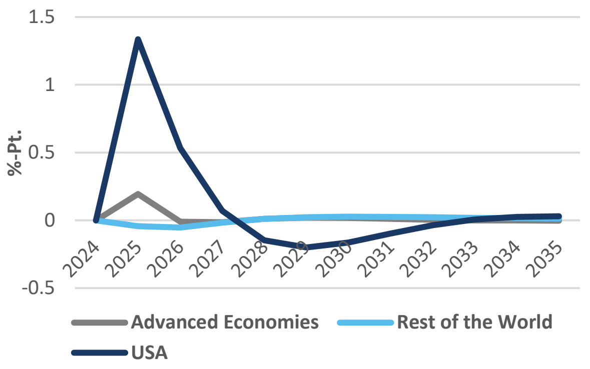
The other key policy areas are also important but are more relevant when looking beyond the tactical horizon. The economic impact will likely take longer to play out. Meaningful fiscal policy adjustments, for instance, require budget reconciliation, i.e., backing from Congress, and are not immune to filibustering[1] due to a slim Republican majority in the Senate. In the same vein, reduced employment growth due to immigration curbs or even outright deportation will lower growth and lift inflation over the medium term rather than have any significant short-term impact on the key macro variables. This is not to say that markets won't make attempts to price in fiscal and immigration policies. Still, trade policy might be a clearer signpost for the destination US politics under Trump 2.0.

How hard will Trump's tariffs hit the global economy? On the campaign trail, he warned about 10% extra tariffs on imported products and up to 60% on Chinese goods. However, it is our belief that the bark is worse than the bite. There are good reasons to believe Trump's trade policies will be less harmful to the rest of the world than what was postulated during his campaign.

Trump's tariff conundrum

Why is that? First and foremost, Trumps policies are inherently inconsistent with his mandate from voters to reduce inflation. Figure 2 illustrates how inflation could increase as a consequence of 10% extra tariffs on imported goods, including the realistic assumption of retaliation from other countries. According to the calculations from the Peterson Institute of International Economics, US inflation will be boosted by more than 1 percentage point in 2025. We consider this scenario not to be far-fetched as it does not even include the 60% tariffs on Chinese imports Trump aired during his election campaign.

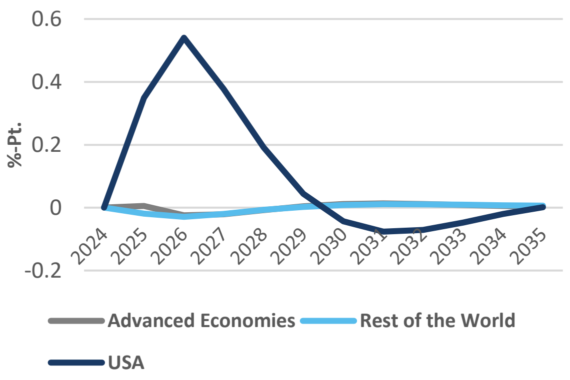
Figure 2: 10% US Tariff on All Countries & Retaliation: Inflation Impact re. to Baseline



Source: RealTime Economics | PIIE. "Rest of the world" refers to countries outside G20.

The picture would have looked even worse if immigration policies were added to the mix. While less important from a short-term perspective, immigration has a crucial role to play in defining the medium-term path of inflation. As illustrated in figure 3, the initial impact of deportation of unauthorized immigrants is muted, but it has longevity. This contrasts with the inflationary impact of tariff policy, which according to the model calculation is more hefty but also more short-lived as it approaches zero from 2027 onwards.

Figure 3: Deportation of 1.3m US Immigrant Workers: Inflation Impact rel. to Baseline



Source: RealTime Economics | PIIE. "Rest of the world" refers to countries outside G20.

The simulations highlight inconsistencies between Trump's tariff push and his mandate from voters to

1 "A filibuster is a political procedure in which one or more members of a legislative body prolong debate on proposed legislation so as to delay or entirely prevent a decision." Source: Wikipedia

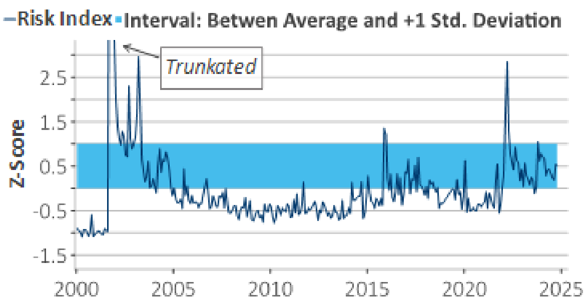
curb inflation. To solve this conundrum, in our opinion trade restrictions will in all likelihood turn out to be less severe than feared. Therefore, we believe 10% across the board tariffs and 60% tariffs on Chinese goods are unlikely to see the light of day during Trump 2.0. By the way, a more benign tariff scenario would be perfectly in line with Team Trump's ambition to use tariffs as a negotiation tool. So qualitatively, there's little doubt that the new US government moves in the direction indicated during the election campaign. Quantitatively, we have strong doubts that things will become as bad as postulated.

How to navigate the post-election landscape

If our analysis is right, value has emerged in the realm of EM fixed income but at the same time uncertainty and volatility will remain high. So how to position portfolios for the opportunities and challenges of such a post-election investment landscape?

Firstly, the election-related market action has created attractive entry points in parts of EMD. This is especially the case with very limited recession risks in the coming quarters. More concretely, we believe a buying opportunity has emerged in local currency EM debt. As depicted in figure 1 and explained above, this segment faced the biggest drawdown and the initial "red sweep" shock is likely priced in. Combined with our expectation that trade headwinds from Trump's protectionist policies will turn out to be less harmful than feared, local currency EMD stands out to be the main winner of reduced uncertainty in the aftermath of the US election. If Trump's first-term presidential period serves as a blueprint, geopolitical noise and headline risk will remain elevated during his presidency. This should result in geopolitical risk indices (please see figure 4) to settle above their historical average, but avoiding extreme readings as we saw in 2015 or 2022. Under Trump 2.0, we expect geopolitical risks to fluctuate in the lower part of the light blue band shown below in figure 4.

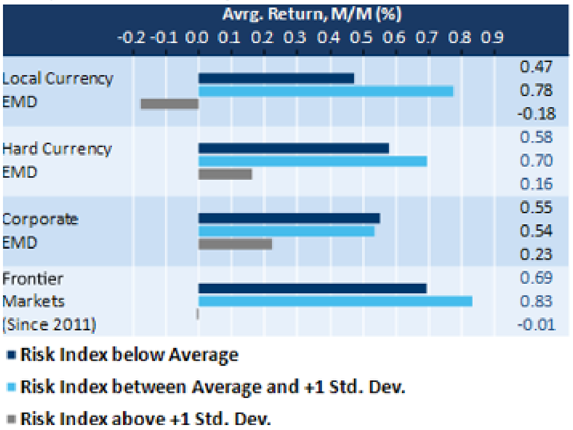
Figure 4: Quantifying Global Geopolitical Risks



Source: Global Evolution, Macrobond and Bloomberg

In such regimes of high - but not extreme - readings of geopolitical risks, local currency EM sovereign bonds have actually outperformed the other main segments of the EMD universe with the notable exception of Frontier debt (see figure 5). From a valuation perspective, local currency EM sovereign bonds are close to their fundamental fair value. Hard currency EM sovereign bonds meanwhile still appear expensive relative to fundamentals and their own history.

Figure 5: Average Monthly Returns in Different Geopolitical Risk Regimes since 2003



Source: Global Evolution, Macrobond and Bloomberg

Within the local currency universe, Latin American and Eastern European countries look particularly attractive. The former have a relatively low correlation to core yields, reducing vulnerabilities to lingering inflation risks. The latter are closely correlated with the euro which seems oversold at current levels.

Secondly, investors should emphasize flexibility. Elevated uncertainty about the ultimate destination of US politics and lingering inflation risks should result in more frequent swings in the asset return cycle. It is hard to argue that Trump's policies won't add to a deteriorating growth/inflation trade-off over the coming years. Fiscal policy will stay lose and labour supply is under pressure from immigration curbs in the context of a US economy that already runs very close to full capacity.

The consequence is a shortening of the monetary easing cycles as inflation remains very responsive to any kind of stimulus, be it fiscal or monetary. Shorter monetary cycles should be reflected in shorter market cycles. Together with persistently high geopolitical uncertainty, such a tactical market environment calls for a dynamic asset allocation overlay in EM fixed income portfolios. The ability to actively allocate between the various EMD segments in blended strategies should reduce drawdown risk and volatility.

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