Opinion **Markets Insight**

# Pain is coming for emerging markets from a Trump trade war

Investors are still not pricing in enough risks from fallout of US-China tensions

**MANIK NARAIN**

Commodity imports have, thus far, decoupled from China's slowdown amid robust infrastructure investment. But they might now be more vulnerable © Bloomberg News

**Manik Narain** YESTERDAY

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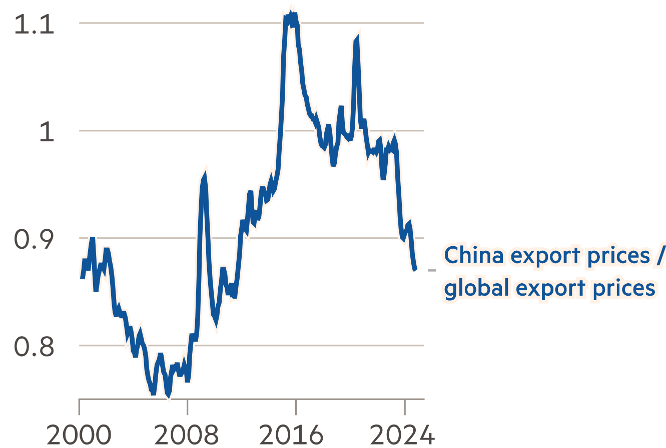
American exceptionalism dominates markets, with equities outperforming the rest of the world by 20 per cent last year alone. Yet one indicator, close to Donald Trump's heart, remains exceptionally weak: the trade balance. We expect this to motivate new, China-centric tariffs. But rather than in China itself, we see larger market moves playing out in the rest of the emerging world for five reasons.

First, China is exporting its strongest disinflationary impulse in at least 30 years: its export prices are down 18 per cent from their post-Covid peak compared with a 5 per cent decline globally, according to our analysis of CPB World Trade Monitor data. This de facto real renminbi depreciation is helping exports dominate to a degree unseen since the early days of WTO accession. Chinese export volumes have risen 38 per cent over the past five years relative to a 3 per cent rise globally. This export surge is primarily being channelled into other emerging markets.

This goes beyond a simple rerouting of Chinese products destined for the US. That

wouldn't explain Chinese export dominance over the rest of the emerging markets world. Instead, it reflects a continued march up the manufacturing value chain and the export of excess capacity. New tariffs would deepen the latter, with consequences for production and capex across emerging markets. Tariffs may be inflationary for the US, but the opposite will be true for those economies.

## China's export prices drop while its volumes outpace global growth



Source: Haver, CPB, UBS

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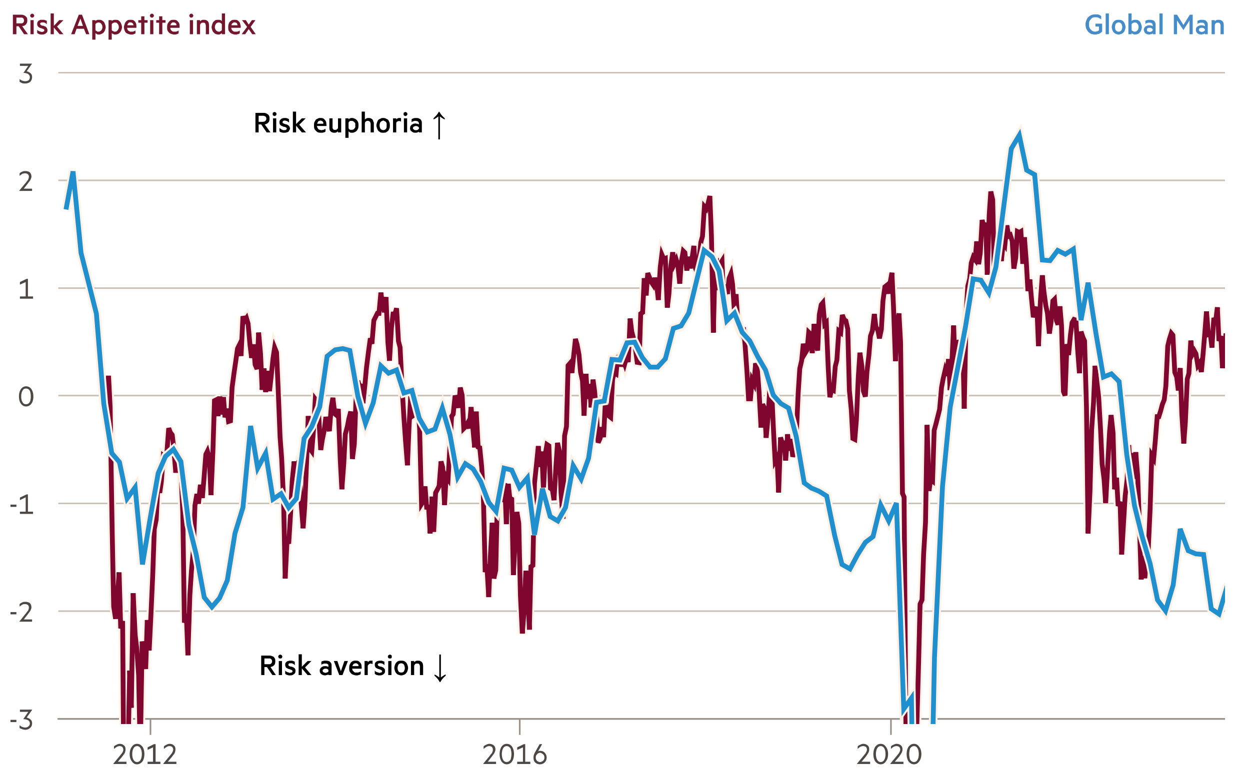
Second, tariffs may accelerate a slowdown in Chinese imports that was already coming. Commodity imports have, thus far, decoupled from China's slowdown amid robust infrastructure and manufacturing investment. New tariffs would exacerbate fiscal pressure and weaken profitability, challenging this resilience. As such, while manufacturing competitors to China have borne the brunt of its slowdown thus far, the next phase of growth deceleration will probably hit commodity exporters, too. Fiscal stimulus won't compensate. That is tilting towards consumption — positive for the consumer and internet companies that dominate Chinese stocks — but with little spillover to broader emerging markets.

Third, with growth now slowing in large parts of developing economies, markets are in a weak position to navigate a potential Trade War 2.0. Outside China, where we see tariffs driving GDP growth to 3 per cent next year, emerging markets investment is stuck at 2008 levels as a share of GDP. Exports also have flattened out and foreign direct investment is failing to accelerate despite hopes of "friendshoring". Stronger support in the form of monetary policy easing is needed but persistently elevated US

support in the form of monetary policy easing is needed but persistently elevated US rates limit the ability of emerging markets to provide this without disturbing currencies and, in several cases, credit spreads.

Fourth, tariff-sensitive industries such as autos, steel, transport infrastructure and electrical equipment constitute a higher share of emerging markets equities, particularly outside China, than in developed economies. This vulnerability is arguably reflected in Chinese equity valuations, which haven't recovered from Trade War 1.0 but not in the rest of emerging markets where valuations are 30 per cent higher despite flat return on equity.

EM investors are unduly optimistic given the state of global growth




FINANCIAL TIMES Source: Bloomberg, Haver, Macrobond, UBS

Finally, emerging markets outside China also face more challenging trade negotiations with Trump than ever before. US trade deficit composition has shifted dramatically such that China now accounts for "only" 27 per cent while the rest of the emerging markets world constitutes 55 per cent. Deficits with Mexico, Vietnam, Taiwan, Korea and Thailand have risen particularly quickly, bringing greater uncertainty.

Some investors believe that valuations already price in such risks after recent underperformance. We disagree.

The UBS Emerging Markets Risk Appetite Index stands roughly halfway between risk neutrality and risk euphoria — atypically strong relative to the state of global growth. Analysts expect 14 per cent earnings growth in emerging markets in 2025-26 compared with 4 per cent realised during the 2018-19 trade spat. The cost of purchasing protection against even half the renminbi depreciation seen in 2018-19 is in the bottom quartile of a 10-year range. Emerging market credit spreads across all ratings buckets have now compressed to the 18th percentile or lower of their distribution after the financial crisis.

The biggest draw for emerging markets is high real rates and disinflation. This provides opportunities in fixed income, particularly currency-hedged local debt. But growth-sensitive assets — equities and especially currency — look vulnerable.

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