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EM outlook: Risks remain amid trade war de-escalation

While the threat of an escalation in the US trade war has receded, slowing global growth will be a drag, particularly on EMs reliant on trade. That said, a weaker US dollar and limited spillover from rising developed market bond yields should give EM central banks room to support their economies.

Key Takeaways

- Risks of spiralling tariff rates have eased, along with the probability of a US recession, reducing the headwinds to the emerging markets (EMs) outlook.
- That said, US tariff rates are still high and, with trade policy uncertainty elevated, we expect global growth to slow, weighing mostly on EMs highly reliant on trade.
- EMs have scope to make trade deals by offering to lower their own tariffs on US imports or opening their domestic markets to US corporates.
- That said, few countries will be willing to reduce protections on politically sensitive industries, such as agriculture, and, with reciprocal tariffs facing legal challenges, EM policymakers may have fewer incentives to concede quickly on US demands.
- China's policy response will also prove a further challenge to EM exporters, given the country's continued supply-side focused response and the economy's lack of import demand growth.
- Thus, Chinese exports could prove a disinflationary factor for EMs, and along with slowing global growth and a softer US dollar, inflation should ease in most EMs, creating scope for further monetary easing.
- Indeed, the onus will fall on central banks to support their respective economies as room for further fiscal easing may be limited amid market sensitivities to worsening fiscal dynamics globally.

US policy uncertainty ripples across EM

The threat of spiralling global tariff rates has abated in recent weeks, lowering the probability of a US recession, and, in turn, reducing risks to emerging markets (EMs).

But since President Donald Trump announced global 'reciprocal tariffs' on 2 April, the outlook for global trade has been highly uncertain. Trump has doubled down at times, raising tariff rates on China to 145% as part of a retaliatory escalation, but has since backtracked.

While on the one hand the size and breadth of the tariff announcements have surprised markets, on the other markets have tamed the Trump administration's actions. So-called bond "vigilantes" have threatened a damaging rise in yields, in response to the most aggressive tariff threats.

Indeed, with the US reciprocal tariffs currently facing legal challenges, markets are currently more optimistic.

However, given the policy uncertainty, markets have shifted away from the 'US exceptionalism' narrative that dominated at the turn of the year. This has led to a softer US dollar, offering some relief to EM assets and global financing conditions.

The 'Art of the Deal' may demand too much

US tariff rates are around 10 percentage points higher since Trump's second term began and uncertainty hangs over global decision makers given the potential for further tariff changes and still ongoing (or yet to start) trade negotiations.

We estimate the US average weighted tariff rate currently stands at 12%, close to where we expect it will eventually settle.

Despite legal challenges to his reciprocal tariffs, there are several avenues through which Trump could lever tariffs, and we expect this to remain a key feature of his presidency.

Indeed, bipartisan support for a "tough on China" approach, suggests tariffs on Chinese imports could rise back to 40% or more. The difficulty of securing a trade deal with the US, and existing legislation (232, 301), which provides an easy route for the US to raise tariffs on China, still points to decoupling being a long-lasting headwind to Chinese growth.

Other EMs will seek to benefit from the decoupling, but in the near-term face hurdles to meeting US demands to secure trade deals and avoid higher tariffs of their own.

US demands include reducing bilateral trade deficits, addressing perceived currency manipulation, minimising China's footprint within supply-chains and avoiding becoming a re-exporting partner for Chinese goods. There are also challenges around non-tariff barriers and various sector-specific complaints.

EMs are unlikely to be able to satisfy all the stated demands of the Trump administration, while it also remains unclear what the true aims of the US are.

India appears best placed to secure any early agreement, but even this now looks likely to involve an interim deal to avoid the reimposition of a 26% reciprocal tariff.

India has indicated its willingness to lower its tariff rates to 0% on manufactured goods from the US and agree to purchases of agricultural produce, military hardware and/or hydrocarbons.

However, US demands of broader agriculture access, and non-tariff barriers for US tech and e-commerce firms, will slow progress.

For India, the upsides could involve more investment into its manufacturing sector and in some areas, increased competition, supporting productivity gains and lowering consumer prices. Like other EMs, India's comparative advantage should also allow it to compete with American manufacturers in labour-intensive production.

However, reflective of the challenges faced by other EMs, Indian policymakers face domestic pressures to not bend to US demands. Lobbying from industry, farmers and from protectionist elements within the government challenge the idea of trade uncertainty being eased soon.

Exposure to global trade is now a vulnerability

The most immediate growth implications for EMs have been via trade; a front running of tariffs has led to sharp spikes in exports to the US, benefitting some EMs, such as India, Taiwan and Thailand.

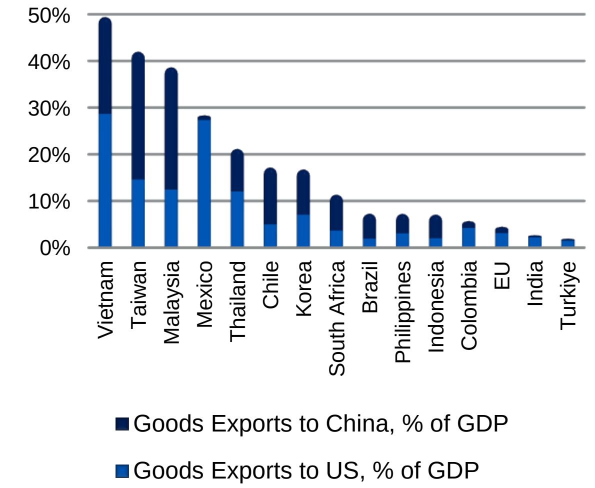
However, this boost to EM growth will prove fleeting given US inventories have already built up.

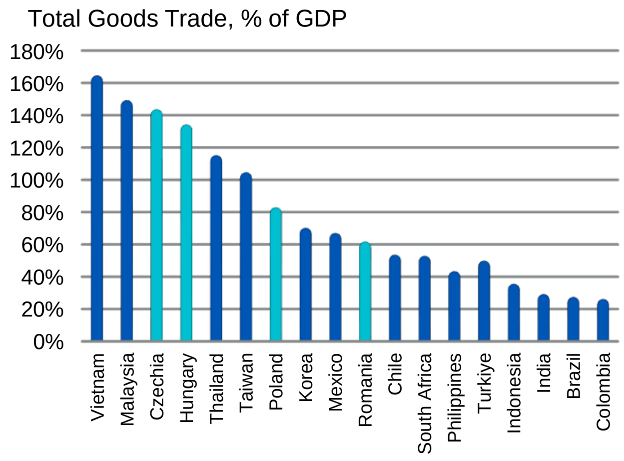
Further volatility and heterogeneity in US tariff setting is likely to continue to make judging underlying economic momentum difficult, but the direction of travel i.e. slower global growth and a less supportive external environment is less uncertain.

Even economies with low direct trade exposure to the US, or even to China, but with high trade openness are likely to experience some drag from their respective export sectors (Figures 1 & 2).

This is the case, for example, of Central and Eastern European (CEE) economies, which are heavily reliant on external demand, whereas, as a region, LatAm (excluding Mexico) stands out as being less exposed.

Figure 1 & 2: LatAm and MEA face smaller direct (and indirect) growth risks





Source: Aberdeen, Haver, June 2025

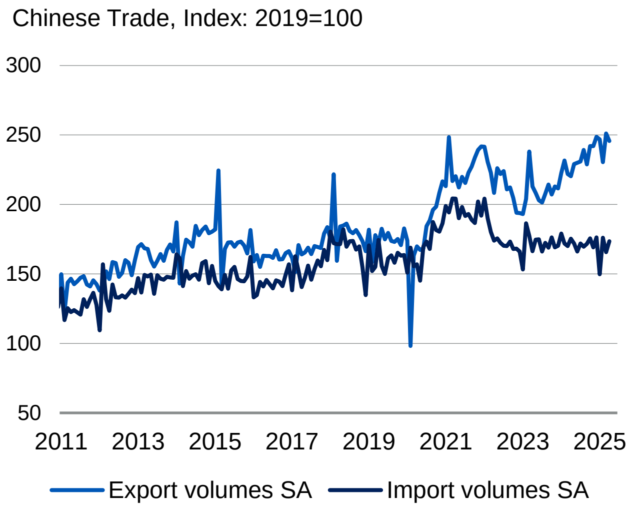
Chinese exporters seek alternative markets

Additional trade headwinds stem from China's response to US trade pressure.

China's policymakers may have touted stronger domestic consumption as a policy focus at this year's "two sessions", but the overall stance remains firmly reliant on investment.

Certainly, the authorities' policy pivot since September has yet to yield any real boost to imports and therefore positive spillovers to other EMs (see Figure 3).

Figure 3: Chinese import demand has flatlined despite stimulus



Source: Aberdeen, Refinitiv, June 2025

Moreover, continued falls in China's export prices are indicative of firms using pricing power to re-home their goods as access to the US market shrinks. Indeed, this will allow China's exporters to continue to be competitive in other markets.

In the long run, EM reshoring 'winners' will emerge from the decoupling of US-China trade, given we remain sceptical over the ability of the US to 'onshore' significant amounts of manufacturing.

However, the more immediate impact will be that China's exporters will increasingly seek to challenge incumbents in emerging markets, creating disinflationary pressures on goods prices.

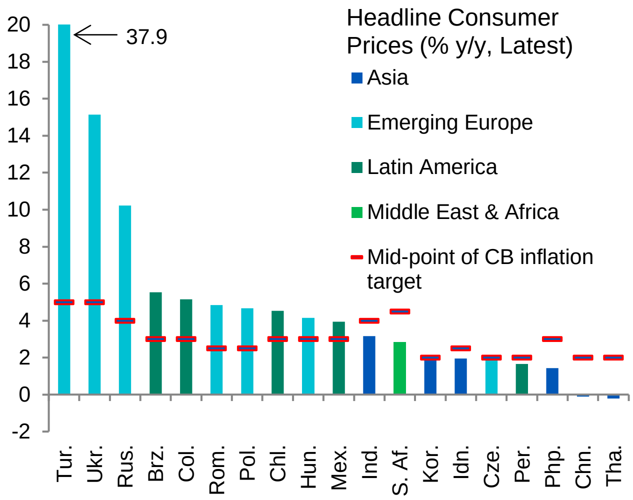
Disinflationary trends should continue

Inflation has continued to moderate across most markets and a combination of lower global growth, a weaker dollar, and the potential for Chinese competition to drive down goods prices should help bring inflation rates lower, offsetting any potentially inflationary aspects from supply-chain disruptions or reshoring trends for potential long-run "winners".

However, if the tariff shock is set to be smaller, as both we and the market expect, the disinflationary impact on underlying inflation will also be more moderate.

For some countries, like Türkiye and Colombia, which are less exposed to global trade, the onus remains on domestic policy setting to prove disinflationary. While in Mexico and parts of CEE, external disinflationary pressures can play a larger role.

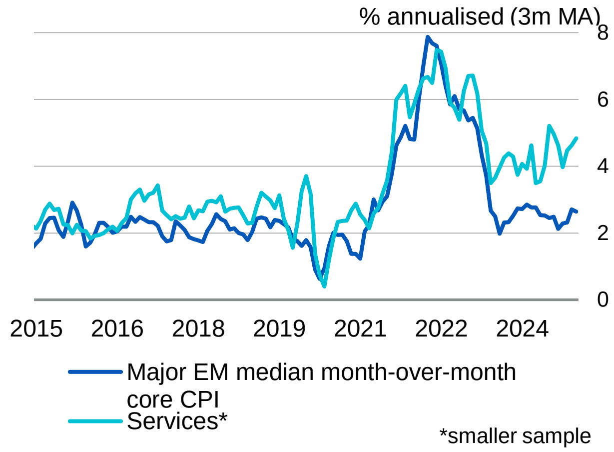
Figure 4: Inflation is around target for most EMs



Source: Haver, Aberdeen, June 2025

Nevertheless, there remains a lingering stickiness to services inflation (see Figure 5), in part due to still tight labour markets in markets such as Brazil and Hungary.

Figure 5: Policymakers will move cautiously given lingering underlying price pressures



Source: Haver, Aberdeen, June 2025

As such, we maintain our call for cautious easing by EM central banks. Further monetary easing is most likely in the economies highly exposed to trade, such as Thailand, Malaysia, Taiwan and South Korea, but also where inflation has moderated, such as the Philippines.

Moreover, the lack of FX-depreciation to offset higher US tariffs risks proving a terms-of-trade shock for many EMs, creating further downward pressures on growth and inflation.

In this sense, lower policy rates may help policymakers to weaken currencies to regain some of their export competitiveness. The challenge will be managing market expectations around such a policy.

Outside of Asia, we expect a more cautious approach given less exposure to global trade or sticky inflation dynamics. Core inflation continues to run hot in Brazil, Colombia and Hungary.

While we do not expect policymakers to reverse their policy easing like Brazil, delays to further cuts or maintaining rates above neutral are likely if employment and activity data are holding up.

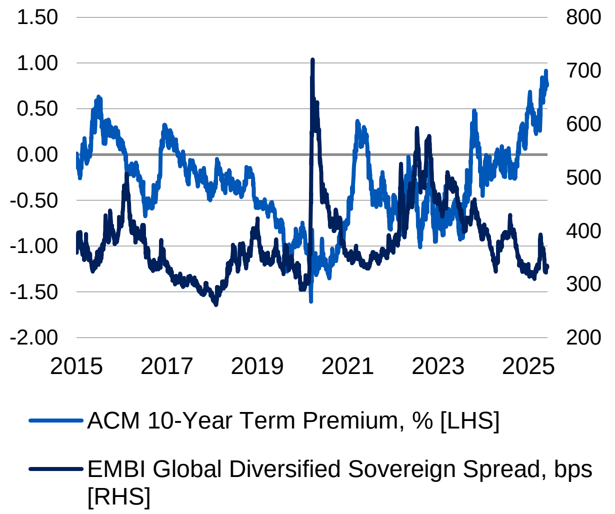
Still where signs of weakening growth are evident, such as in Mexico, we expect central banks to look through lingering inflationary pressures and take the lead in providing policy support to their economies.

Markets may be increasingly sensitive to fiscal slippage

A key factor in our continued call for monetary easing is the fact that markets have become increasingly sensitive to fiscal slippage.

Developed market long-end bond yields rose sharply in May, in part due to worsening sentiment around fiscal paths, but EM bonds have been notably resilient (see Figure 6).

Figure 6: EM bonds have been resilient to rising DM fiscal concerns



Source: Aberdeen, Haver, June 2025

This likely reflects the fact that a degree of fiscal slippage from some EMs has already been priced in and the appreciation of EM currencies against the US dollar in the year-to-date. Indeed, this has boosted foreign investor returns in local currency bonds.

Supportively, many EMs announced fiscal consolidation for the year providing another tailwind for bonds (see Figure 7). However, we see growing risks that governments fall short of their fiscal targets as growth disappoints.

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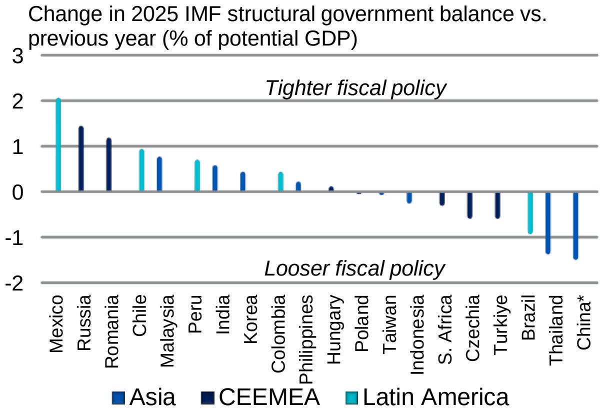
Figure 7: Scope for fiscal slippage is constrained

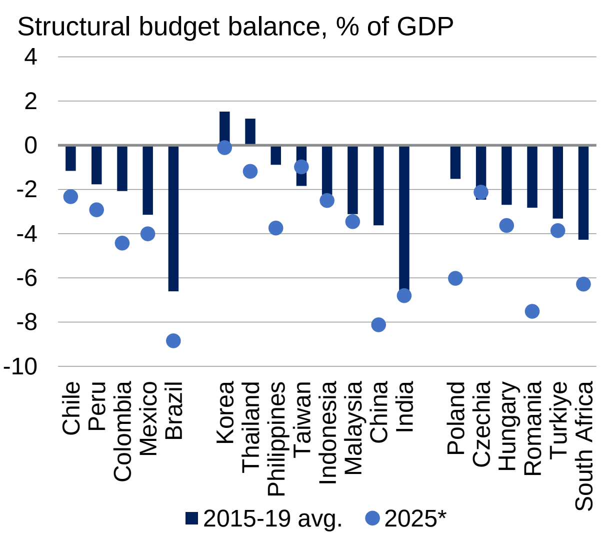


Source: Aberdeen, Haver, June 2025

Markets regularly give the cold shoulder to fiscal slippage in EMs; in the year to date Colombia, Indonesia, Brazil and Romania have been notable examples of where markets have reacted negatively to perceived fiscal ill-discipline, leading to bond prices falling and currencies weakening.

Fiscal fundamentals have deteriorated since the pandemic across most EMs, with public debt ratios and fiscal deficits climbing. Despite plans for fiscal consolidation, deficits in many EMs will remain larger than pre-pandemic averages (see Figure 8).

Figure 8: Fiscal slippage risks for many EMs



Source: Aberdeen, Haver, IMF, Refinitiv, June 2025

As such, policymakers will need to tread carefully to avoid unnerving markets sensitive to fiscal slippage. This may ultimately limit the extent some governments can support their economies in slowdowns.

All told, we'd caution against the latest market moves being termed 'EM exceptionalism' but the upside for the EM outlook should be more supportive monetary conditions as the year progresses.

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