

Third quarter 2018

Key messages

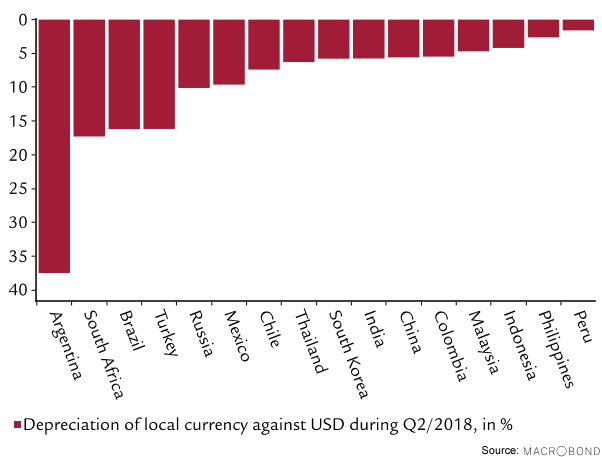
- Emerging markets assets have suffered considerably – despite improved economic fundamentals
- Outright escalation of US-China trade dispute would be negative for the whole emerging world
- China: Watering down policies on the way towards financial stability as outlook is getting clouded

Number in focus

70%

The industrial policy programme “Made in China 2025” aims to make China less dependent on foreign technology and to foster domestic innovation. For certain key industries, the domestic market share should be increased. For industrial robots, the semi-official target to be reached by 2025 is 70%. The US is fundamentally against this programme as it threatens its economic and military power. Due to this fundamental disagreement, tensions between the US and China will be long-lasting.

Chart in focus



Emerging markets currencies have lost ground against the US Dollar in the second quarter. While all major currencies were down, the size of the losses can be explained by economic imbalances and political risks. Argentina and Turkey have double-digit inflation rates and large external deficits. South Africa suffers from a long-lasting growth weakness and large budget deficit. In Brazil and Mexico, decisive elections are approaching. In both countries, candidates with a populist programme lead the polls. The Russian Rouble lost after US-sanctions.

A very clouded spring

The environment for emerging markets has become more hostile in recent weeks and months: not only have US interest rates risen and the US-Dollar strengthened but also the risk sentiment has deteriorated. The latter has suffered because of US trade policy, European politics and moderating growth in the developed world. Emerging markets assets had to book losses: Currencies have depreciated, risk premia have risen and equity markets have fallen. There is a clear differentiation across countries: Those with large economic imbalances or political risks (such as Turkey or Brazil) came under a lot of pressure. More robust countries (such as Peru) suffered to a much lower degree. Are emerging market economies strong enough to weather this more hostile environment?

Fundamentals are good enough

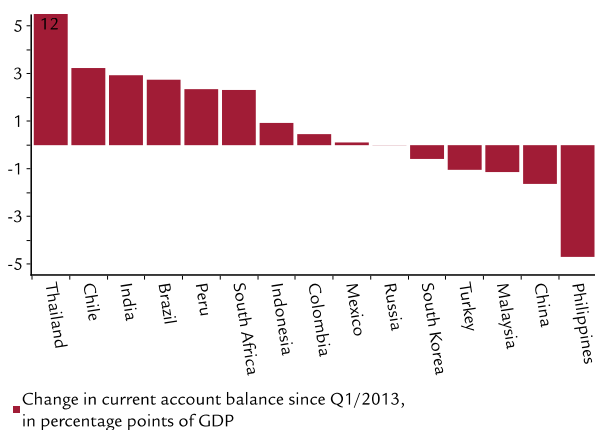
Economic balances of emerging markets have clearly improved over the last five years. In 2013, when investors started to worry about tighter US monetary policy, economic imbalances of the emerging world came into the spotlight. Today, current account balances, inflation rates and currency valuations of emerging markets are much more favourable compared to five years ago (see chart 1 and 2). In addition, the overall GDP growth rate has recovered from the recent weakness and stabilised on a solid level. We expect it to remain around 5.5% until year-end. While this healthier fundamental picture has helped to weather the recent dif-

ficulties it could by far not insulate emerging markets from troubles. Yet, not all dimensions of emerging market economies have become stronger in recent years. Budget deficits are generally large, for example in Brazil, India and South Africa. Private debt levels have increased substantially since the financial crisis. Since 2016, a lot of capital has flown into emerging markets. This bears the risk of a reversal of capital flows. Yet, in our view, overall fundamentals of emerging markets are good enough in order not to provoke a broad-based and long-lasting capital flight. From our perspective, the robustness of emerging markets fundamentals has however reached a turning point. First, current account balances should not improve any further. The reduction of the deficits was driven by import compression, a painful consequence of economic weakening and currency depreciation. In some countries, the deficits have already started to widen again, notably in commodity importing nations such as Turkey, India or Indonesia. Second, we expect overall inflation of emerging markets to detach from the current low levels. The strong depreciation of various currencies will push up import prices in these countries.

Central banks change gear

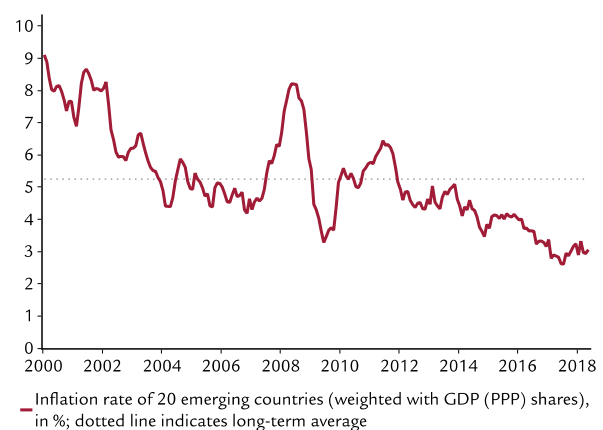
A number of central banks have reacted to the currency decline. In Turkey, Mexico, India and Indonesia, for example, policy rates were hiked in order to defend the currency and to counter inflationary pressures. This marks the end of the monetary easing cycle in emerging markets that has started in mid-2016. Central bank

Chart 1: Current account balances have improved considerably since 2013



Source: MACROBOND

Chart 2: Overall emerging markets inflation rate has declined substantially



Source: MACROBOND

policy is another improvement compared to 2013: Monetary policy of emerging markets has become more orthodox. Russia has for example introduced a free-floating exchange rate regime in 2014 and India has adopted an inflation targeting scheme in 2016.

Trade dispute

The US has taken a much more aggressive stance with respect to trade policy. They have implemented multi-lateral tariffs on steel and aluminium which led to retaliatory measures of the EU, Canada and Mexico. At the same time, the bilateral trade dispute between the US and China has aggravated. As the US concluded that China violates intellectual property rights, the Trump-administration announced to impose additional tariffs of 25% on Chinese imports worth 50bn USD. The first batch of 34bn USD will be implemented on July 6. The remaining 16bn USD are under review. China's response came immediately: It will impose tariffs with "equal scale and equal intensity". The US has threatened to impose additional tariffs of 10% on imports worth another 200bn USD should China impose tariffs on US-imports. In case of a second Chinese reaction, the US would consider tariffs on another 200bn USD. The imposition of the first batch on July 6 is very likely. The incentives to resume negotiations after this first round are high: Donald Trump has a result to present to his electorate. Tariffs on further products would probably reach consumer goods. More expensive TVs are not only a bad campaign programme but pose also the risk of a tighter monetary policy. Finally,

the US corporate world is against tariffs. Yet, there is a real risk that the conflict escalates further. Apart from tariffs, China has a variety of measures at its disposal (e.g. putting pressure on US multinationals). The ultimate tools are selling US treasuries and weakening the Renminbi. We do not expect the Chinese to use these weapons before all other possibilities are completely exhausted as they also imply big costs for China.

Policy fine-tuning in China

In autumn 2017, China's authorities have formulated two long-term goals for the economy: financial stability and gradual reorientation towards quality of growth. The implementation of corresponding policies will improve the economic model of the Middle Kingdom. Yet, they come at a cost: economic growth. As the economy is anyway about to weaken (the real estate sector has peaked) and as the outlook became more uncertain due to the trade dispute, authorities have started to fine-tune economic policies. Some easing measures have already been taken in order to support the domestic economy. What costs should we expect from the trade dispute? The direct impact on GDP growth and inflation of tariffs on exports worth 50bn USD should be limited. Yet, uncertainty will damage business sentiment. Should the US impose tariffs on an additional 200bn USD, GDP growth could decline by around half a percentage point. As China is an important export destination for many other emerging economies, this would pose a threat for sentiment and activity in various countries, in particular in Asia.

Chart 3: As the US imports more from China, they can impose more tariffs

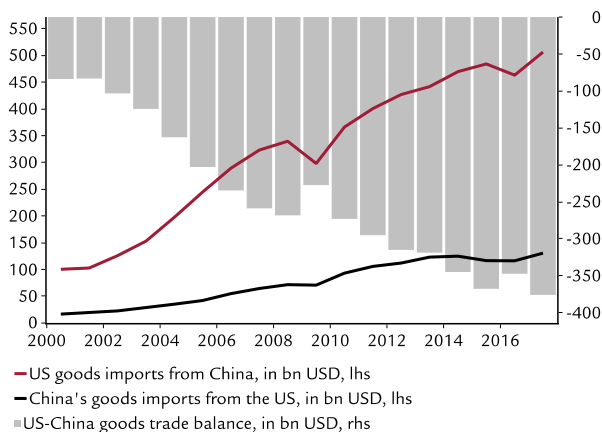
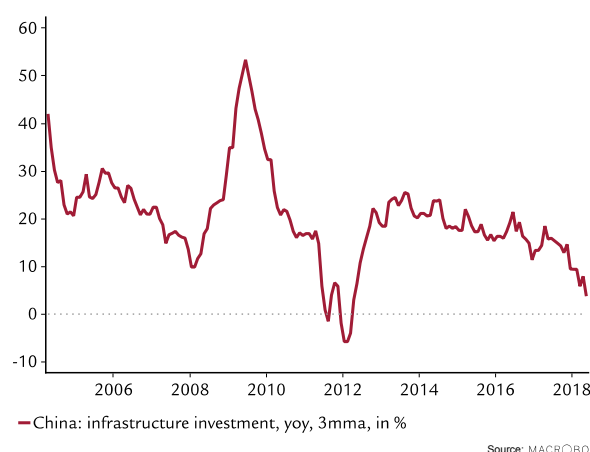


Chart 4: China's policy measures to improve financial stability leave traces



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