

Third quarter 2019

Key messages

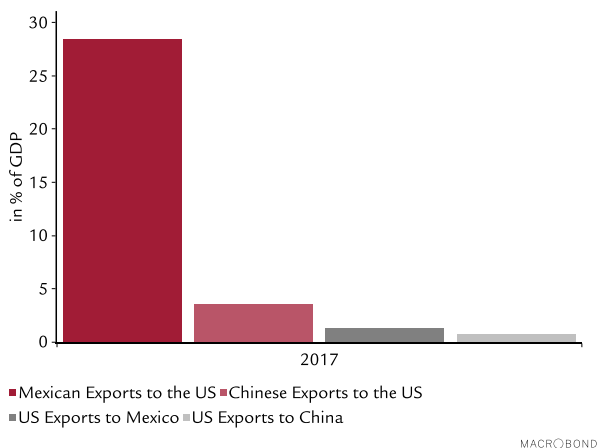
- Emerging markets had a weak start into 2019, with low first quarter GDP growth rates
- Re-emergence of trade dispute between China and the US is blurring prospects of a swift EM rebound
- Accommodative central banks as the only bright spot to support subdued economic activity

Number in focus

303

Indian Prime Minister Narendra Modi's BJP (Bharatiya Janata Party) secured a second landslide single-party majority in this year's general elections, winning 303 of the 542 seats. Modi is pressured to deliver much needed reforms, such as privatising indebted state banks and easing labour law restrictions to get India's economy back on track, that has been slowing to 5.8% in the first quarter of 2019 (0.8 percentage points below the previous quarter). Uncertainty remains high, if Modi will push through these tough reforms, while not having delivered on them in his first term.

Chart in focus

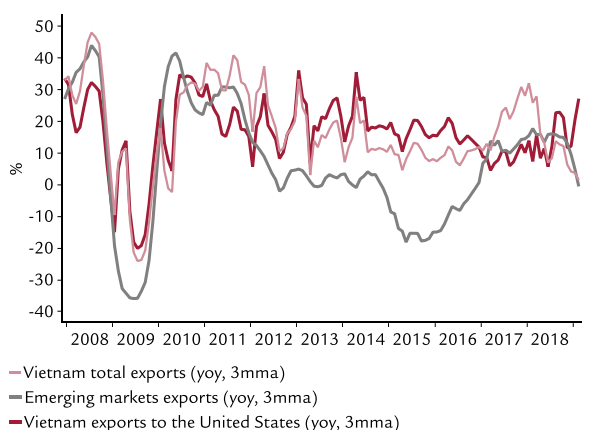


Trade tensions re-escalated this year, with US President Trump raising tariffs from 10% to 25% on USD 200 bn Chinese products early May and vowing to impose tariffs on Mexican imports early June, unless the country stems the flow of migrants to the US. Luckily, the tariff threat on Mexico could be averted. The imposition of tariffs would have hit the trade-dependent economy hard and would have likely tipped it into recession. Almost 30% of the country's GDP rely on exports to the US. While Mexico's vulnerable situation gives it little bargaining power, US negotiations with China are likely to be more difficult as China is much less reliant on trade with the US.

No winners in a trade war

Many emerging countries rely on robust world trade to stimulate their economic expansion. The re-emergence of trade tensions between the US and China reinforces the challenge of already weak global demand. Of particular concern is the decreased demand from China for intermediate inputs that are used for exports, as Chinese exports to the US will likely be hit by the imposed US tariffs. Besides the negative impact on trade flows, the reheated tensions are causing uncertainty and are weighing on sentiment: After upbeat March and April manufacturing PMIs (Purchasing Managers' Index) in the developing world – a very good forward-looking indicator for economic expansion – the aggregate Emerging Market PMI dipped lower in May, reflecting deteriorating confidence and weaker export orders. Meanwhile, as US and Chinese importing companies are shifting towards third countries to source their goods in order to avoid the burden of the imposed tariffs, the question arises whether there are winners emerging from this trade conflict. While Chinese importers are shifting mostly to South American countries looking for substitution of agricultural products, such as soybeans, US importers are turning mainly towards Asian countries in the search for electronics and furniture. So far, Vietnam has been one of the biggest beneficiaries from the trade diversion as it has seen its exports to the US surge sharply. However, the country's total exports remained subdued, reflecting weak export growth to China. Moreover, on balance, the benefits of trade diversion to specific countries, are not enough to offset the overall trade weakness caused by trade tensions, reflected in the slump in overall emerging markets export growth (see Chart 1).

Chart 1: Benefits of trade diversion not enough to offset overall trade weakness



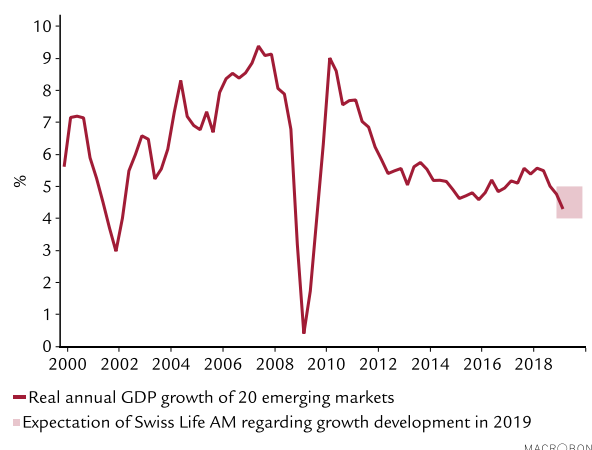
Growth: weak start into 2019

In addition to the increased uncertainty due to trade tensions, emerging markets growth data provide little support for sentiment. First quarter GDP growth in many emerging markets has been weak and disappointed expectations. In Brazil and Mexico, political uncertainty due to the two new governments has weighed on investments, while also idiosyncratic shocks (rupture of Vale dam in Brazil) contributed to the weak economic expansion, with Brazil growing by only 0.5% in Q1 2019 from a year ago (Q4 2018: 1.1%) and Mexico reporting a growth rate of 1.3% (Q4 2018: 1.7%). In India growth slumped to 5.8% in the first three months of the year compared to a year ago (Q4 2018: 6.6%) driven by a fragile financial system with bad debts in the state-denominated banking sector and a liquidity squeeze at non-bank financial institutions. South Africa's economy suffered its most severe quarterly slump, with its first quarter GDP dropping by 3.2% on an annualised basis, driven by severe power cuts in February and March due to the struggling energy provider Eskom that led to a slump in the mining and manufacturing output as well as weak investments. Moreover, also smaller trade dependent economies in the Asian area suffered from weak global demand, with growth in Vietnam, Thailand and Malaysia that was dragged down by weak exports.

Monetary policy as the only bright spot

Amid these subdued economic prospects, one supportive measure is the monetary policy stance of emerging

Chart 2: First quarter 2019 GDP growth in emerging markets remained subdued



markets central banks. Dovish central banks in the developed world, downside risks to growth and core inflation rates at benign levels, encourage emerging markets central banks to reverse some of their policy tightening implemented during the second half of 2018 and to cut policy rates. This month, the central bank of Russia delivered a 25 basis points cut to 7.5%, and also the Reserve Bank of India lowered interest rates by another 25 basis points to 5.75% – its third cut this year and signalling the possibility of further easing. However, further room towards a monetary easing bias is given only as long as the US dollar does not strengthen significantly against emerging market currencies, in case of a sharp risk-off movement. Indeed, a strong US dollar would force emerging countries to hike interest rates in order to limit depreciation pressure on their local currencies, specifically those that are fundamentally more vulnerable, with current account deficits.

China: economy under pressure as trade tensions re-emerge

After a long period of easing trade tensions between the US and China, which raised hopes that a deal between the two trading powers can be reached, the trade dispute re-escalated again in May and is putting pressure on China's economy. The US raised tariffs on USD 200 bn of Chinese goods from 10% to 25% and is threatening to impose tariffs on the remaining Chinese imports that have not been affected yet, amounting to around USD 300 bn. In response, China retaliated by increasing tariffs on USD 60 bn of US imports. Although China's economy has become much less reliant on exports over the years, shipments to the US still ac-

counts for around 4% of the country's GDP. Hence a significant drop of shipments to the US, in case tariffs are raised on all Chinese export products, would have a considerable negative impact on China's economy. Moreover, increased uncertainty, weighing on business confidence and therefore investments could further undermine the country's economic expansion. Making things worse, the re-escalation of tensions is not limited to trade but expanding towards a "tech war", as the US is ratcheting up technology restrictions against Chinese firms, including the country's technology giant Huawei – denting hopes of a swift trade deal in the near future. Meanwhile, China's May activity data slowed down. Annual industrial production growth slowed to 5.0%, the weakest reading since 2002. Fixed asset investments also dropped to a 9-month low, growing at 5.6% (April: 6.1%), with weaker infrastructure and real estate investments. Only retail sales growth jumped in May to 8.6% (April: 7.2%), but part of this increase was likely driven by a different timing of Labour Day holidays, with more days off in May this year compared to a year ago. Hence, Chinese policy-makers are pressured to unleash further stimulus measures to prevent a sharp slowdown of the economy. China still has room for further easing measures, with targeted as well as broad based cuts in the required deposit reserve ratio for major domestic banks, tax rebates for exporting companies that are affected by trade tariffs, more local government bond issuances to support infrastructure investments, as well as an improved execution of already promised tax and fee cuts. Nevertheless, as the Chinese government is still emphasizing on a more sustainable growth path, specifically trying to enhance financial stability, any further stimulus will likely remain measured and reactive rather than broad-based and proactive.

Chart 3: Low core inflation rates to allow for monetary easing in emerging markets

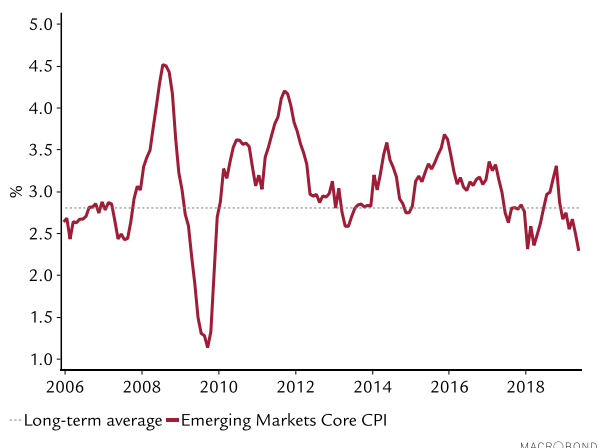
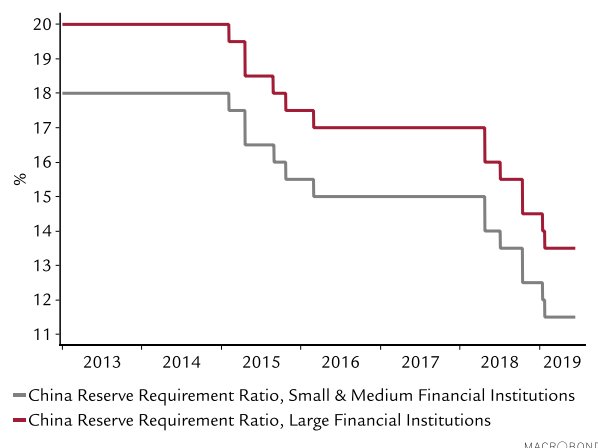


Chart 4: China still has room to enhance stimulus, as trade tensions are weighing on its economy



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