Perspectives
Emerging Markets

SwissLife
Asset Managers

Second quarter 2019

Key messages

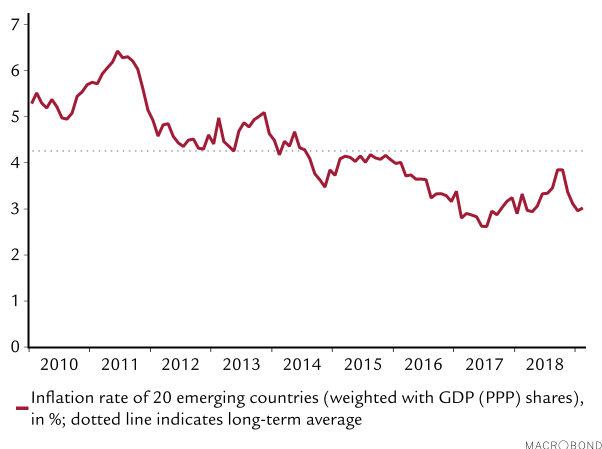
- Emerging markets central banks turn more dovish as inflation rates remain well within central banks' target
- China: first indicators point to a stabilisation of the slowing economy
- Despite improvement of fundamentals and a more benign external environment, vulnerabilities remain

Number in focus

1 trillion

Brazil's president Jair Bolsonaro presented his proposal for social security reform to congress, estimated to save more than 1 trillion Brazilian Real over the next 10 years. A successful implementation of the pension reform is crucial to stabilise the country's fiscal situation, with Brazil having one of the highest fiscal deficits among emerging countries. However, the proposal has a long way to go in congress before the final vote. Delays or an excessive dilution of the expected savings could undermine the improvement in confidence seen over the last couple of months.

Chart in focus



The tightening of the US Federal Reserve and a strong US-Dollar put emerging markets under a lot of pressure in the second half of 2018, as US denominated debt became more expensive to redeem. This led to a plunge in local currencies and increased inflation rates. However, in response to the Fed tightening, central banks in emerging markets have tightened their monetary policy stance as well, which led to a strengthening of local currencies. This strengthening has eventually translated into a decrease in inflation rates across the board, staying well within central banks' inflation targets.

Central banks turn more dovish

As optimism over further growth prospects in the US started to fade – driven by volatile financial markets, the uncertainty of the impact of higher borrowing costs, as well as a negative sentiment due to the trade conflict between the US and China – the US Federal Reserve has turned away from its tightening stance, implemented over 2018, towards a more dovish one. Now that the pressure from the tight monetary policy stance of the Fed has eased, and inflation rates in emerging markets have come down and remain well within central banks' target range, emerging market central banks are starting to shift towards a looser monetary policy stance as well. While most of emerging markets central banks left their policy rates unchanged in the latest policy decision meetings, the Reserve Bank of India has surprised with a cut in its interest rate by 25 basis points at the beginning of the year.

Growth potential remains limited

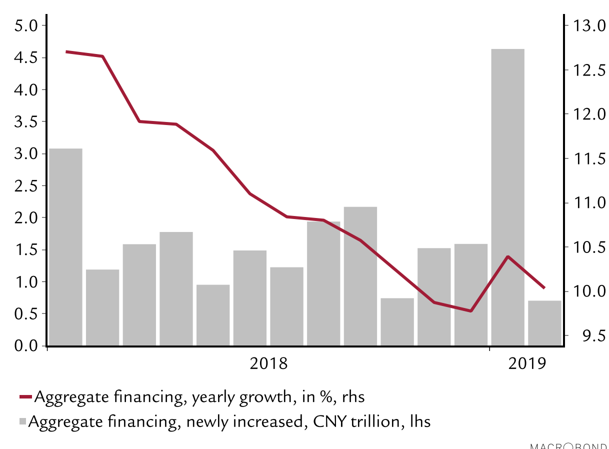
Compared to last year, conditions for emerging markets have improved considerably in 2019: On the one hand, we have a more constructive external environment with eased pressure from a strong US-Dollar. On the other hand, also a more dovish bias of emerging market central banks is a supportive element. Nevertheless, further upward growth potential remains highly uncertain. More specifically, manufacturing purchasing managers' indices (PMI), which are a good forward looking indicator of economic activity within a country, do not imply a very optimistic growth picture, as many emerging market countries report PMIs at moderate levels. Specifically, China's manufacturing PMI remains at a low level, just below the 50 points expansion mark, and weighs on other emerging countries, primarily those in Asia. This implies that a stabilisation of the slowing Chinese economy is a key element for further upward growth movements in emerging markets.

China: first stabilisation

China's annual GDP growth has slowed down to 6.6 percent in 2018, representing the slowest annual growth rate since 1990. China's economic slowdown was mainly driven by Beijing's campaign to control financial risk, which led to a drop in infrastructure spending and limited credit access for privately owned companies. Moreover, the trade conflict with the US is weighing on business and consumer sentiment, and took a toll on the economy. Looking ahead, economic growth is expected to remain sluggish on the back of ongoing weak trade dynamics: Exports are expected to remain subdued due to overall subdued global demand as the global economy is cooling, but also as front-loadings of shipments to the US, driven by the threat of further tariff hikes on Chinese products, have started to pay back. Nevertheless, we do not expect a sharp downturn of the Chinese economy, as the Chinese government will likely step up fiscal and monetary stimulus measures to support economic activity. This has been reaffirmed this month in the government work report – the roadmap of China's economic targets for the current year – in which Chinese premier Li Keqiang unveiled a tax cut amounting to RMB 2 trillion as well as an increase in the issuance of local government bonds to support infrastructure spending. Although the announced easing measures reaffirm a

Chart 1: Upside growth potential in emerging markets remains limited

Chart 2: China's credit growth points to first stabilisation of the slowing economy



growth supporting policy stance, they remain prudent compared to past stimulus cycles, as the country remains focused to follow a more sustainable growth path, emphasising on growth quality over quantity. For 2019, China lowered its growth target to a range of 6 – 6.5 percent, showing its willingness to accept a slower economic expansion, amid an elevated debt level. Meanwhile, first indicators already started to show signs of stabilisation of the slowing economy: China's broad credit measure has improved, growing at a double-digit rate in January and February this year, with special local government bonds, used for infrastructure projects, that have picked up. In addition, the new orders PMI sub-index has rebounded, pointing to an improved domestic demand, while retail sales continued to stabilise as well, growing at 8.2 percent in the January/February period from a year ago. Moreover, the suspension of planned tariff increases on Chinese products that were due on March 1 is a positive first step and reduces the risk of the trade conflict between the US and China breaking out into a trade war. Nevertheless, the hard work in negotiations over a trade deal, also covering strategic issues, still has to be done.

Vulnerabilities remain

Against the backdrop of a sharp contraction in domestic demand in the second half of 2018 in various emerging countries, emerging markets fundamentals improved: Reduced demand led to a decline in imports and narrowing current account deficits. This combined with a decrease in inflation rates thanks to a monetary tightening, shored up investors' confidence at the beginning of the year. Nevertheless, vulnerabilities remain. Turkey, for instance, slid into recession in 2018 with its economy contracting by 2.4 percent in the last quarter 2018. Although fundamentals did improve, with a narrowing current account deficit and a lower inflation rate, the country is not out of the woods yet. An ongoing high level of US-Dollar denominated debt in the private sector and an inflation rate of above 19 percent, make a swift recovery unlikely. Should monetary policy be eased too soon to shore up political support amid upcoming local elections end of March 2019, risks of another balance of payments crisis would increase. In Argentina, which was also hit by a severe balance of payments crisis in 2018 that led to an inflation rate of more than 47 percent, risks remain high as well, although the country has improved its fundamentals. A prudent fiscal policy, dictated by the International Monetary Fund (IMF) that provided the biggest ever bailout package to the country, led to a decrease in the fiscal deficit and a sharp reversal of the current account deficit. This combined with a currency that is now on a weaker level, is reducing the risk of another currency crisis in 2019. However, after three months of slowing inflation rates late last year, that allowed the central bank to lower policy rates to 44 percent, the Argentine Peso has lost in value again this year, leading to another spike in inflation and prompting the central bank to increase rates sharply. This underscores the challenge of Argentina's leadership to bring the country out of recession. Besides, there is also uncertainty on the political front. For the current president Mauricio Macri to have a chance of winning presidential elections that take place in October this year, another currency crisis needs to be avoided. An unexpected increase in the chances of the opposition could add weakening pressure on the Peso, as a continuation of the tight monetary and fiscal stance under the current government would be put into question.

Chart 3: Despite some fundamental improvement, Turkey's economy remains vulnerable

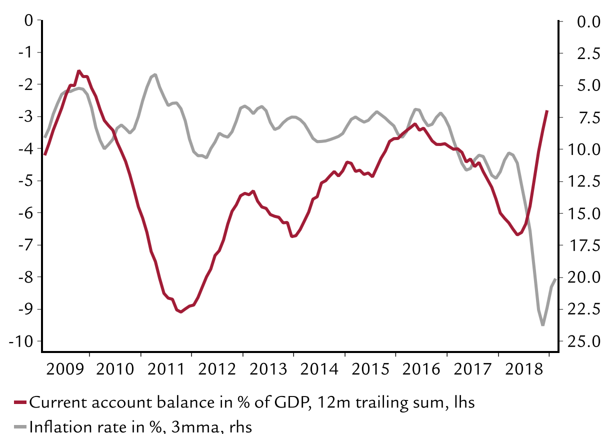


Chart 4: Continued weakness of Argentine Peso, reflecting the challenge of economic stabilisation

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