Perspectives
Emerging Markets

SwissLife Asset Managers

Fourth quarter 2019

Key messages

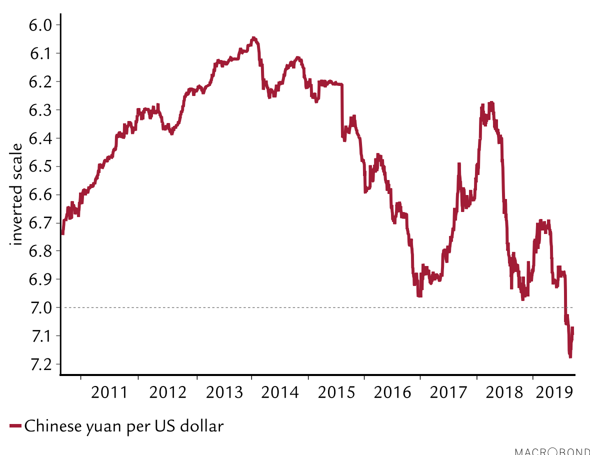
- Downturn in global trade continues to weigh on growth in emerging markets
- Central banks try to support economic activity but currency depreciation limits easing potential
- Uncertainty over US-China trade tensions increased considerably, blurring prospects of a trade deal

Number in focus

5%

India's economy has grown by only 5% between April and June this year – the weakest annual growth rate in 6 years. While consumption and investments have been dragged down by a credit squeeze at non-bank financial institutions, the deteriorating global environment adds downward pressure to the economy. The government responded with measures to boost growth, announcing to merge public sector banks in order to form stronger lenders as well as easing foreign investment rules. However, more profound reforms are needed to significantly improve the outlook.

Chart in focus



As the US-China trade conflict intensifies, China is taking on a firmer stance. The country is signalling that it is not willing to give in but has started to hit back. After President Trump's announcement to impose tariffs on the remaining USD 300 bn of Chinese goods, China let the yuan tumble to the weakest level in a decade – a move that could partially offset the negative tariff impact on its exports.

Gloomy growth picture

Higher trade tariffs have affected global trade volumes, while uncertainty about an escalation of the US-China trade conflict and further retaliatory measures remains high and weighs on investments. Moreover, violent confrontations in Hong Kong and a gloomy outlook on Argentina's economy depress sentiment. All of this has a particularly strong negative impact on emerging markets. Hence, growth dynamics across the board remain tepid. While in some countries, such as Brazil, South Africa and South Korea second quarter GDP growth improved from the weak readings in the first quarter, downward pressure remains elevated. In Brazil ongoing uncertainty of President Bolsonaro's regime as well as global considerations (US-China trade conflict, vulnerable economy of Argentina – Brazil's third-largest trading partner) are major headwinds for the country's growth prospects. In South Africa, the country's power supplier Eskom is drowning in debt and poses a significant threat to the country's credit rating. In South Korea, private investments and net exports remain weak and could be further exacerbated by potentially slowing exports to China. Moreover, economic growth has been particularly weak in Mexico as well as in India. Mexico's economy has slowed sharply on weakness in investments and industrial output amid global as well as domestic uncertainty due to the unpredictable regime of President Lopez Obrador, as well as the heavily indebted state oil company Pemex. India's economy is being dragged down by a credit-squeeze at non-bank financial institutions. Meanwhile, forward-looking indicators such as manufacturing Purchasing Managers' Indices (PMI) point to ongoing weakness in emerging economies, as PMIs remain below the 50-point mark that separates expansion from contraction in most emerging markets.

Central banks in easing mode

Amid this sluggish growth momentum, central banks are stepping in to support their economies. Emerging market central banks across the board have started to cut rates. So far this year, India's central bank delivered a cumulative 110 basis points (bps) rate cut. Indonesia has started to reverse some of its rate hikes undertaken during 2018 by cutting rates further. Brazil and Mexico have lowered rates, with Brazil surprising with a large 50 bps cut in its August meeting, signalling more cuts to come, while also Russia as well as South Africa are easing their monetary policy stance amid sluggish growth dynamics. Indeed, there is room for emerging market central banks to cut rates, as central banks in the developed world are in an easing cycle and as inflation rates broadly remain well within the central banks' target range. However, there is a limit to the easing potential, given by weak currencies. Since end of July emerging market currencies started to depreciate, driven by the re-escalation of the US-China trade conflict as well as by the sharp market sell-off in Argentina triggered by the landslide defeat in the primary elections of market-friendly President Mauricio Macri. As the global environment remains uncertain and recession fears increase, emerging market currencies could become more vulnerable. Hence, emerging market central banks might feel the need to protect their currencies by halting further rate cuts or raising interest rates once again, this being specifically true for fundamentally weak economies such as South Africa, Brazil, Mexico and India.

Chart 1: Sluggish global demand and trade tariffs are weighing on emerging market exports

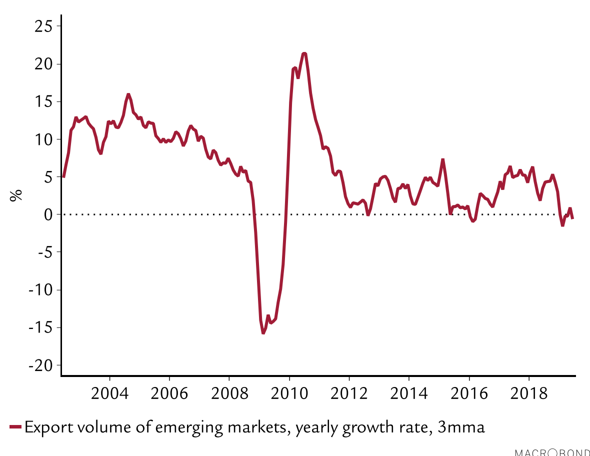
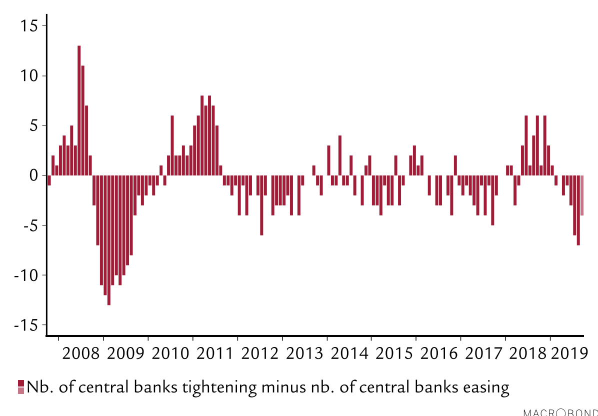


Chart 2: Emerging market central banks cut rates in order to support economic activity



China: tough on trade, soft on stimulus

The trade truce agreed on at the G20 summit end of June was short-lived. Already beginning of August, President Trump announced to impose tariffs on the remaining USD 300 bn of Chinese imports that have not been affected so far, prompting China to retaliate. As of 1 September, the US implemented a 15% tariff on roughly USD 110 bn of Chinese goods. Although meanwhile the two trading powers agreed to a new round of high-level talks scheduled for October, this latest escalation of trade tensions triggered a major change: China is taking on a harsher stance and is signalling that it is not willing to give in but is ready to hit back. While China still shows willingness to ease the trade spat by increasing imports of US agricultural goods, it is unlikely to soften its preconditions on a potential trade deal. Hence, prospects of a swift trade deal in 2020 are receding. Meanwhile, China is feeling the drag of the trade conflict on its economy. The country's exports have slowed down, driven by the tariffs and overall sluggish global demand. Moreover, key economic indicators, such as industrial production, fixed asset investments and retail sales have gradually decelerated. China's September private survey manufacturing PMI surprisingly rebounded past the 50-point mark that separates expansion from contraction, however the index' export order sub-component fell sharply further into contraction, pointing to ongoing elevated downward pressure. This however, did not change China's prudent stimulus stance. While the government is still committed to support the economy, it made clear that a strong stimulus of the property market is not an option to spur growth. Hence, the country's major property indicators have followed a gradual downward trend. Moreover, the PBoC, China's central bank, introduced a new lending benchmark, with the aim to bring down loan rates, while being reluctant to lower its official benchmark policy rate. Such a move would signify a broader easing stance, but at the same time put downward pressure on the currency.

Trade is not the only concern

Fears of a return to populism intensified in Argentina as the opposition candidate Alberto Fernandez won the primary elections with a wide margin, claiming more than 47% of the votes, compared with the incumbent President Mauricio Macri's 32%. This spurred a tremendous market sell-off, causing the Argentine peso to lose a quarter of its value since August 11, and will likely push inflation – that stands already at above 50% – even higher. There is a risk that Argentina's fragile economic situation rekindles concerns over the stability of other fundamentally weak emerging economies. Moreover, the woes on the streets of Hong Kong are adding to the uncertain global environment, thereby, the biggest risk being a military intervention by mainland China. Such a move would unleash global sanctions against the mainland and consequently cause a brutal slowdown of the global economy, as the world's second-largest economy would be hit. However, as China is aware that the consequences would be tremendous, we think that the probability of this scenario remains very low. Moreover, on 4 September Carrie Lam, Hong Kong's leader, officially withdrew the legislation to allow extraditions to China (the trigger of the demonstrations), which may help to ease the historic unrest.

Chart 3: Emerging market currencies depreciate amid intensifying trade tensions and recession fears

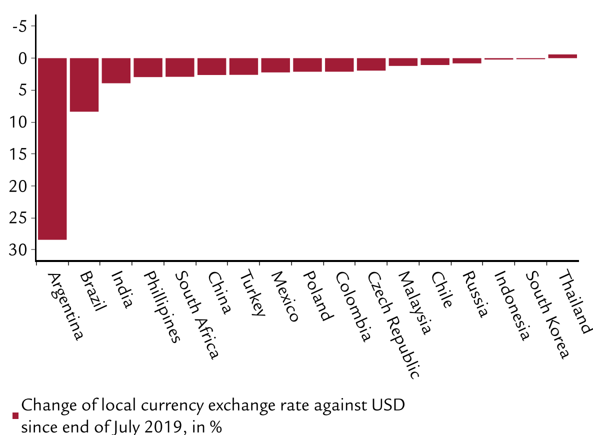
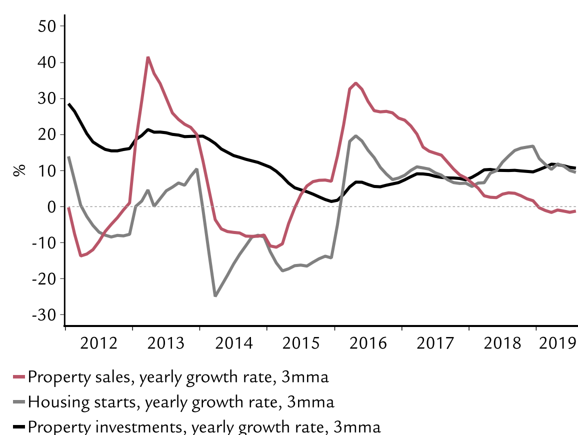


Chart 4: Property indicators are gradually slowing, as China refrains from strong property stimulus



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