Emerging Markets Quarterly – 2015/1

In its March meeting, the Fed prepared markets for the hiking cycle to start soon. Yet, the policy makers kept their flexibility by emphasising their decisions to depend on incoming macroeconomic data. Thus, it is now more likely that the Fed will start hiking in September rather than June. With a data-dependent Fed, however, volatility in the emerging world will increase as markets react to publications such as the US labour market data which is volatile itself.

Differential impact of tighter US monetary policy

Countries in the emerging world are differently positioned for tighter US monetary policy. Rising US interest rates render investments in emerging markets relatively less attractive and reduce liquidity. This can induce capital flowing out of certain economies. First, countries with a large current account deficit, which is financed by short-term capital such as portfolio investments rather than long-term foreign direct investments, are exposed as they need to finance this deficit on international capital markets. The success of this financing depends on investor sentiment. Second, countries with extensive short-term external debt are vulnerable as they need to find new investors when this debt matures. Asian countries are generally well positioned as most of them run a current account surplus and external debt is usually small. Certain Latin American countries are exposed due to their external deficit and debt, e.g. Brazil, Colombia and Peru. However, the most vulnerable are Turkey and South Africa. They have a current account deficit of 5.5% - 6% of GDP and especially Turkey carries a lot of external debt. Therefore, the risk premium on their bonds should increase and their currencies, which are currently even weaker than in 2008 and early 2014, lose further. Yet, we do not expect a situation as in the late 1990s, where the US hiking cycle triggered the Asian crisis for instance. Emerging markets are better positioned today: Many have a mostly floating exchange rate, foreign currency reserves are higher and monetary as well as fiscal policy are more prudent.

A slowing China and accelerating India

China's slowdown has accentuated over the last weeks. In the fourth quarter of 2014, the economy grew at its lowest rate in over 20 years, the government reduced the growth target for this year to around 7% and economic activity data had a soft start to 2015, with annual growth of industrial production slowing to a 6-year low of 6.8%. The slowdown is inevitable after a boom, extensive government stimulus and a doubling of average income over the last ten years. Richer countries grow less fast as there are fewer low hanging fruits left. Thus, we should not be too worried about the slowdown as long as there is no hard landing of the Chinese economy. Although China is confronted with a number of deep structural problems – overcapacity in the manufacturing and property sector, looming risks in the financial sector and a lot of local government debt – an abrupt halt in China is not our base case. Furthermore, in absolute terms, China is growing as much as at the peak in 2007 and three times as much than the US. The sheer size of China is represented by being the world's largest exporter since 2009 and the world's largest economy since 2014. In contrast, India, the world's third largest economy, is accelerating. Until recently, there was a debate about whether India will grow faster than China already in 2016. With India's revised GDP calculation methodology, resulting in considerably higher growth rates, this happened already in the third quarter of 2014. With the new series, India's GDP grew by 7.5% on an annual basis in the last quarter of 2014. This rapid acceleration from roughly 4% in early 2013 poses questions as it is not reflected in high frequency data such as industrial production.

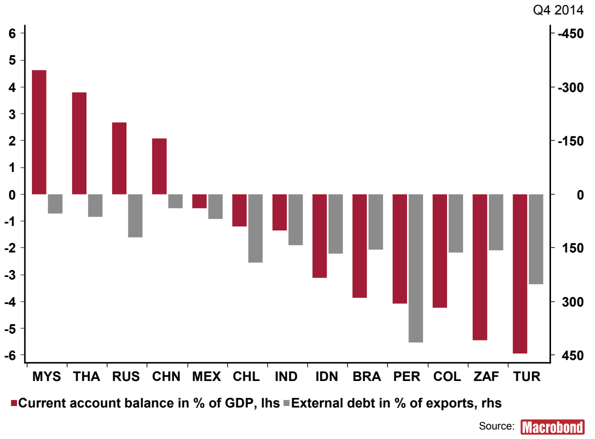
Brazil – Accumulating drags

Brazil not only has a fragile macroeconomic environment with a substantial external and internal deficit as well as high and sticky inflation but also a further weakening of economic momentum due to lower commodity prices. In addition, fiscal and monetary tightening, which is absolutely necessary, is under way. Furthermore, the Petrobras scandal poses several political risks. It weakens the already unpopular president Rousseff, it can render adoption of unpopular fiscal austerity measures by Congress more difficult and it led to the biggest political protests since the 1980s.

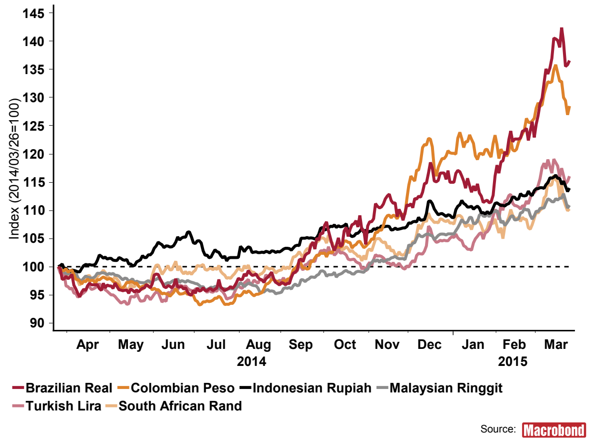
A chance to cure the Dutch disease

Should commodity prices stay low, this offers a chance for commodity exporters to change their growth model and reallocate resources towards more productive sectors. As policy makers' intentions to diversify the economy are rarely implemented, lower commodity prices are a chance as they can enforce this rebalancing.

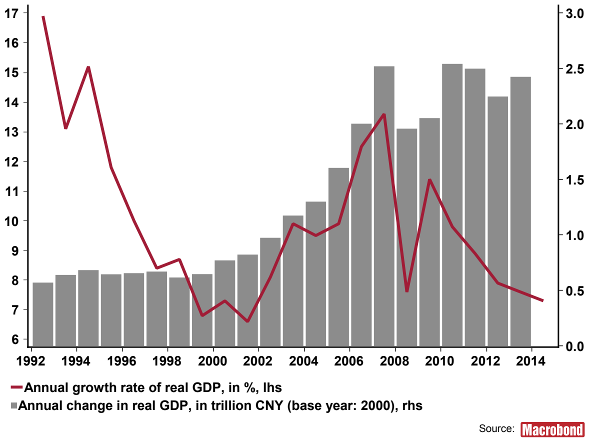
Exposure to Fed – Countries with a large external deficit and debt will depend on investor sentiment



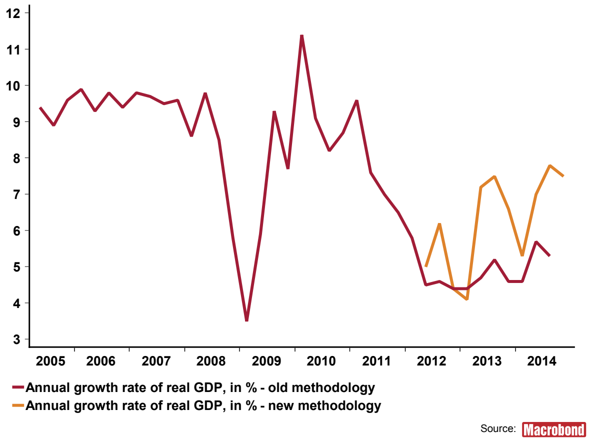
Currencies – Commodity exporters and those exposed to Fed hike depreciate against USD



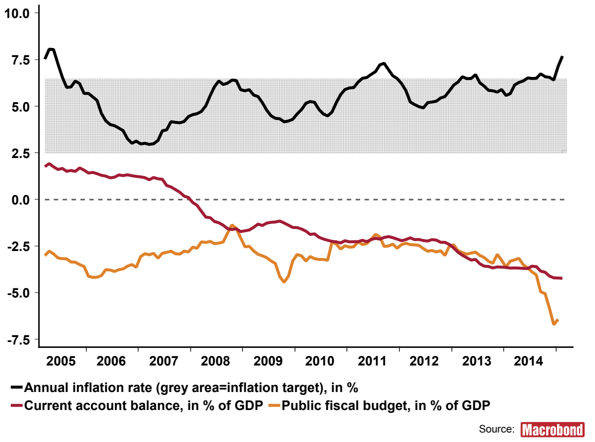
China – The increase of China's economy in absolute terms is still elevated



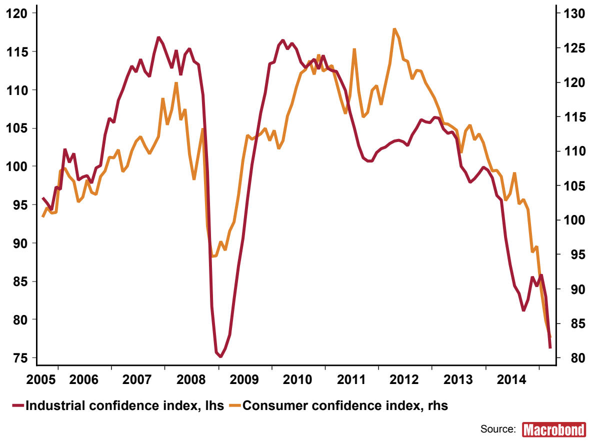
India – The acceleration according to the new GDP series seems a bit too fast



Brazil – Fragile macroeconomic environment



Brazil – Now, also business confidence approaches low of 2009



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