Emerging Markets Quarterly – 2015/3

Is the dramatic fall of emerging markets' financial assets justified from a fundamental point of view? These economies have weakened over the last months. First, domestic problems have aggravated. Political difficulties have intensified in a number of countries, such as Brazil, Russia, Turkey and Malaysia. In addition, several countries face weak economic growth, for instance South Africa, South Korea and again Brazil and Russia. Second, external headwinds have intensified. Demand in China, an important export destination, has slowed a bit faster than expected. The renewed drop in commodity prices is a challenge for raw material exporters. While the postponed first Fed hike provides some breathing space for countries with an external deficit, the Fed's comments about uncertainties in emerging markets weigh on sentiment. Overall, the situation has deteriorated but is not as dramatic as markets suggest.

China — How severe is the slowdown?

China's economy has slowed a little faster than expected. This is reflected, for instance, in industrial production which slowed from 8% in January to 6% in August or the weak manufacturing PMI. Such data series represent the industrial sector, which has slowed down substantially. The real annual growth rate of the industry and construction sector was 7.5% in the second quarter of 2014 and has diminished to 6.1% one year later. As attention is biased towards the manufacturing sector, the solid services sector is often neglected. Its yearly growth rate accelerated from 7.6% to 8.2% from the second quarter of 2014 to the second quarter of this year. With a share of almost 50% of GDP, the tertiary sector is the largest sector. The services PMI suggests continued solid growth. However, the support of the financial industry will diminish. While the services sector is important to gauge dynamics within China, it is less relevant for the impact China has on other countries. The industry and construction sector absorbs most imports, in particular commodities. Three groups of countries depend strongly on Chinese demand: Hong Kong and Singapore serve as trade hubs, close countries like South Korea, Malaysia or Thailand export both commodities and higher quality goods to the Middle Kingdom and commodity exporters such as Chile, Brazil or South Africa export raw materials.

China — The government's credibility has suffered

First, China's government massively and ineffectively intervened in the equity market. Then, the People's Bank of China (PBoC) communicated the change in the exchange rate policy poorly. As of now, the Renminbi has depreciated by 3% against the Dollar and is more or less flat. This calls into question whether the PBoC really allows more market forces or whether she does not dare to allow further depreciation and thus uses its reserves to support the currency. A strong commitment to economic reforms would help to improve confidence. Unfortunately, the recently published plan on the state-owned enterprise reform is not such a signal as it does not strive for any major privatisation.

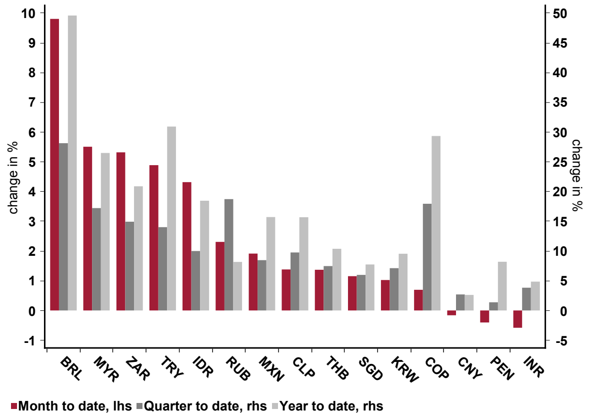
Brazil — Has reached the next level on its downward slide

Brazil lowered its fiscal target for 2016 twice this summer. This is a result of the political stalemate and economic weakness. The rating agency S&P has doubts about the ability and willingness of the Brazilian government to improve the fiscal situation in order to stabilize debt. It therefore lowered Brazil's sovereign debt rating to below investment grade on September 9. Does this serve as a wake-up call? Brazil absolutely needs to show that the administration can cooperate and makes an effort for fiscal consolidation. Without a distinct change in politics, it will be hard to prevent another downgrade. If Brazil also loses its investment grade rating of Moody's, it will be excluded from several benchmarks, with the consequence of forced selling. Brazilian assets have already deteriorated sharply, due to preemptive selling and ever falling sentiment.

What about other countries' ratings?

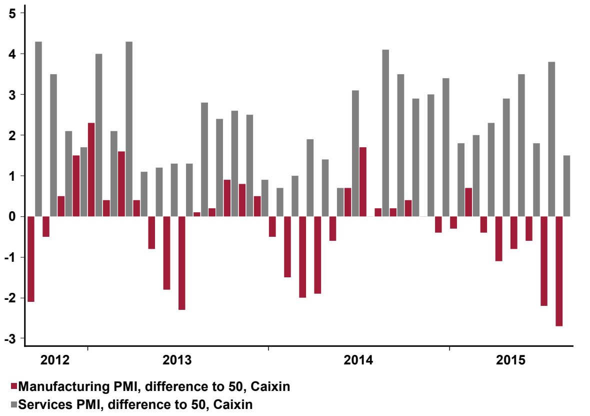
Among the larger emerging markets Turkey, India and South Africa have a rating close to the border of investment grade. Turkey is most at risk of a downgrade. The vulnerabilities are numerous: Pressure on institutions, political uncertainty, a difficult financing situation as well as concerns about growth. Moody's rates the Turkish sovereign with BBB- and has a negative outlook. A downgrade would exclude Turkey from several benchmarks as S&P already assigns a below investment grade rating. South Africa is in a better position. It has an investment grade rating with stable outlook from both agencies and concerns are less severe. The risks are: external financing, weak growth, the fiscal situation as well as power supply and potential strikes. India is not at risk of a downgrade in the short-term. Although the reform agenda is behind schedule and the acceleration of economic activity is slow, the overall situation improved over the last years and the sentiment is positive.

Currencies – Some currencies depreciated again substantially against the Dollar

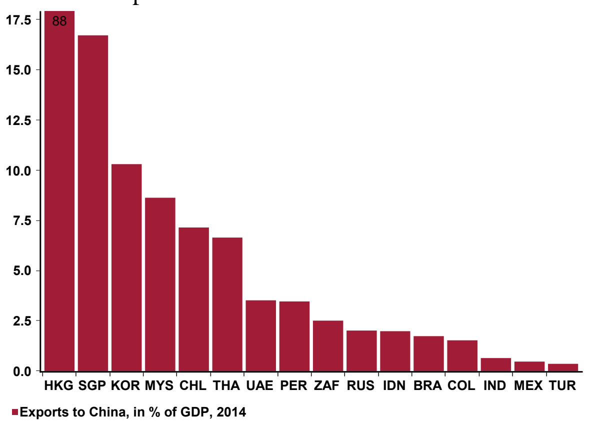


China – The secondary sector slows down considerably, whereas the tertiary sector is stable

China – Purchasing manager indices (PMI) indicate differential dynamics across China's sectors



Exposure to China – Asia and commodity exporters are most dependent on Chinese demand



Brazil – The government needs to fix the fiscal situation

Turkey – Leverage has risen considerably and the external financing situation is worrying