Emerging Markets Quarterly – 2016/1

SwissLife Asset Managers

The first quarter of 2016 was characterised by large fluctuations in risk appetite. After the panic reflected in prices of risky assets at the beginning of the year, the sentiment turned in March due to abating fears about a US recession, rising commodity prices and accommodative central banks. Emerging market assets showed an impressive rally in the second half of the first quarter. The environment for the emerging world clearly improved due to stabilising commodity prices and a cautious Fed. Yet, the fundamentals of emerging countries did not change materially. There are several triggers, which could weigh on sentiment in the near future. The obvious ones are a renewed fall of commodity prices, geopolitics and a repricing of Fed hikes. Moreover, economic and political issues in some of the heavy weights – namely China, Brazil and South Africa – could induce renewed concerns about the condition of emerging markets.

Growth – Only slowly improving throughout 2016

We still believe that GDP growth of emerging markets will trough in the first half of this year. The acceleration of activity throughout 2016 will however be moderate. We do not expect a pronounced pickup as the recession in Brazil remains severe in 2016 and commodity prices should stay low. In Russia, the worst part of the recession is likely behind us. The yearly growth rate of GDP and other activity indicators such as industrial production remains negative but the pace of contraction will moderate as the shocks of lower commodity prices and political difficulties are fading out. We expect the through of the level of GDP to be reached in mid-2016. The recovery will be L-shaped, and thus very slow, as the oil price should stay relatively low and the economy still faces political and structural obstacles.

China – Policy priorities intensify imbalances

China has reached a critical junction. After 20 years of extraordinary growth, authorities generated high growth even during the great recession. The rapid rebound after 2008 was only possible with a massive stimulus. Today, China faces high leverage and misallocation. The necessary reform agendas have been developed. Yet, rebalancing and deleveraging an economy comes at a short-term cost in terms of growth. The recent National People's Congress highlighted that growth has priority. The relatively high growth target for this year of 6.5%-7.0% emphasizes the government's high willingness to support the economy with fiscal and monetary easing. Implementing reforms and cutting down overcapacities come second. Leverage will even accelerate and rebalancing is slowed. At the same time, the mix between centralised and market-based prices threatens the credibility of Chinese policy-making. Although depreciation pressures for the Yuan have abated recently, the fundamental problem of the aim of a stable currency and a partly market-based price determination remains. When market pressures are high, it is costly to counter them as illustrated by the rapid fall in FX reserves. Should depreciation pressures be large and ongoing, the PBoC might prefer (some) depreciation over costly support measures. Rating agencies are increasingly worried about the structural issues in China. Both Moody's and S&P have changed their outlook to negative as the fiscal situation is weakening, policy priorities allow further leverage and might slow rebalancing and finally external strength is decreasing.

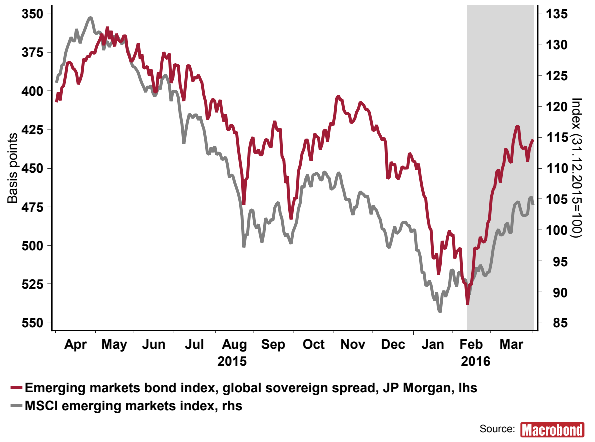
Brazil – Too much euphoria about impeachment?

The recession in Brazil is very severe and long. GDP contracted by 7% since the peak in the first quarter of 2014. Investment literally collapsed, it declined by 25%. Although the level of GDP should continue to decline throughout 2016, the annual contraction will likely start to diminish by mid-year. We expect an L-shaped and thus slow recovery for Brazil. On the political front, Dilma Rousseff is getting more and more isolated. She lost her biggest coalition partner, the largest protests ever demanded her resignation and the corruption scandal moves closer to her as her allies are investigated in this matter. An impeachment is now very likely. In response, Brazilian assets rallied as political change is necessary to turn around the situation. Yet, the potential for disappointment under a new government is considerable. Vice president Temer's PMDB is also highly involved in the corruption scandal. Moreover, a new government would have a hard time to pass reforms as the Congress remains fragmented.

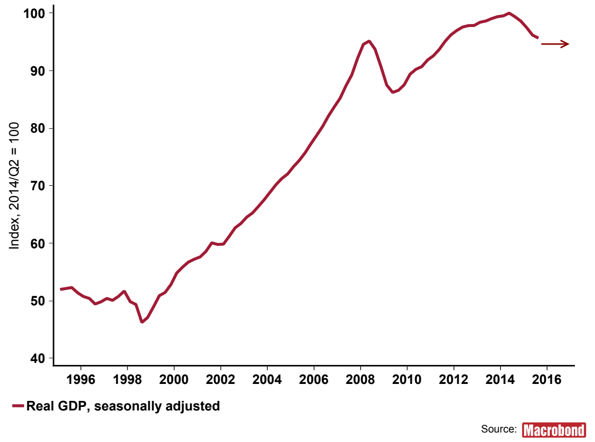
South Africa – Risk of a downgrade to junk in 2016

Rating agencies are concerned about fiscal sustainability, growth and the external financing situation in South Africa. The country needs to tighten monetary as well as fiscal policy in an environment of weakening activity. The consensus for GDP growth in 2016 decreased from 2% to 1% in only five months. In addition, political problems are increasing. There are allegations of corruption and mismanagement of the government.

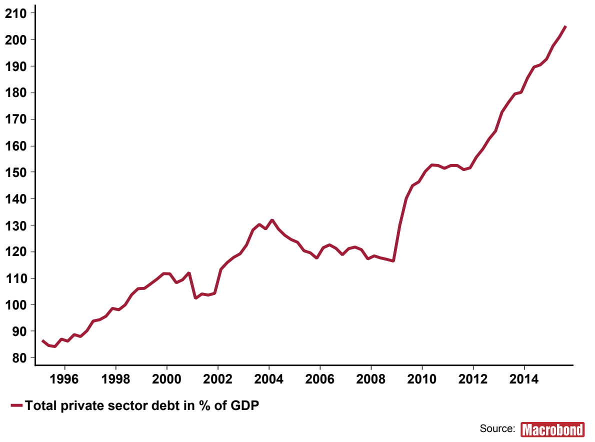
Spreads and equities – An impressive rally after the panic at the beginning of the year



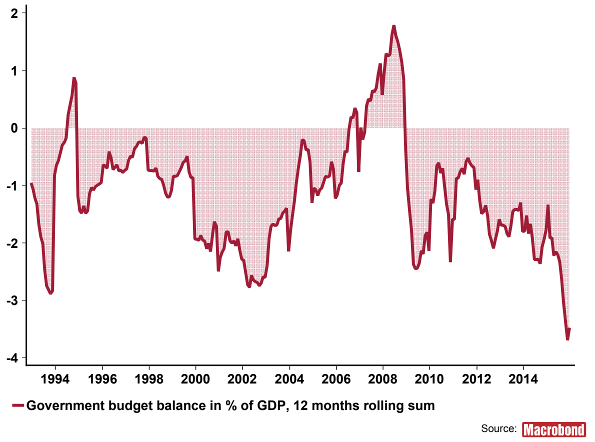
Russia – Past the worst of the economic deterioration and ahead of an L-shaped recovery



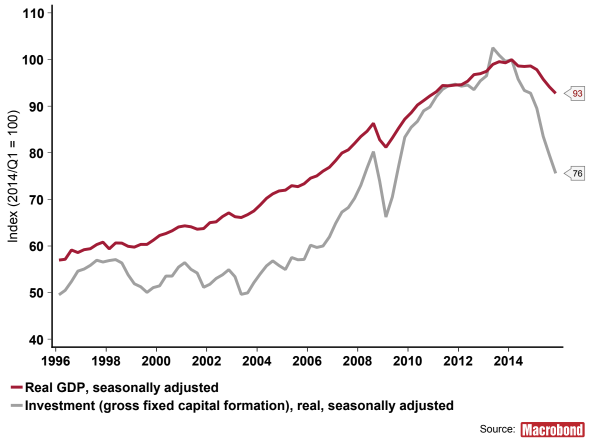
China – No signs to stop the massive increase in private debt, which is mostly driven by firms



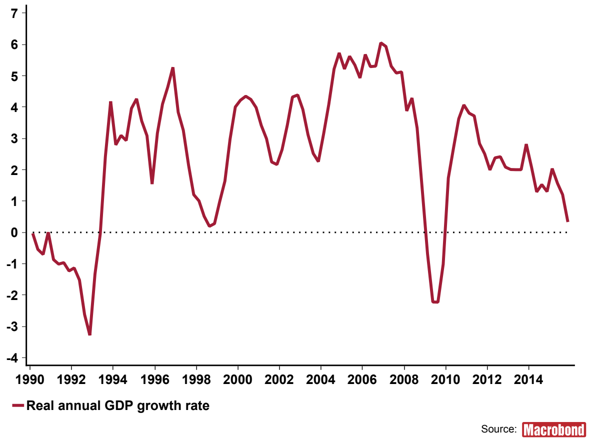
China – The fiscal balance deteriorated to -3.5% of GDP in 2015, it might weaken even further in 2016



Brazil – The worst recession since 1930, or maybe even worse



South Africa – A distinct slowdown in economic growth



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