Emerging Markets Quarterly – 2016/2

Fundamentally, the impact of Brexit on emerging markets is limited as ties to the UK are small and as we do not expect a huge impact on Euro Area growth. Global trade and capital flows will however suffer somewhat. Within the emerging world, Eastern Europe will be most affected. Emerging markets assets suffered surprisingly little given the heightened uncertainty. Yet, the very accommodative stance of central banks around the globe spurs, once again, the hunt for yield.

Growth – Brexit does not hinder the recovery

The Brexit vote does not change our long-held view of a growth recovery in emerging markets starting in mid-2016. GDP growth of the emerging world should pick up during the course of this year as the two heavy weights Brazil and Russia are getting out of recession and as the shock of lower commodity prices is fading out. We have always expected a slow recovery as several issues weigh on growth: Commodity prices are structurally lower, political issues remain in a number of countries such as Brazil, Russia, Turkey or South Africa, many countries suffer from structural problems such as low investment spending or high debt mountains and finally announcements of big bang reforms are rare. The Brexit vote constitutes an additional headwind for growth slightly lowering global demand and hence trade flows. Thus, there is an additional reason to expect the growth recovery to be slow.

Brazil – Economic activity bottomed

The trough of economic activity has been reached. High frequency data series such as industrial production, retail sales or even the monthly GDP estimate bottomed in early 2016. Consumer confidence has stabilised and business confidence already picked up during the second quarter. Nevertheless, the levels of economic indicators are still exceptionally low. Business confidence is almost as depressed as during the crisis of 1998 and 2008. Moreover, the recovery will take a lot of time. Annual GDP growth should only return to positive territory towards early or mid-2017. We expect the recovery to be slow as political and structural obstacles remain. On the political front, the most important question is, whether interim president Michel Temer is able to restore Brazil's economic credibility. His team as well as his plans, for example the social security reform, are promising. Yet, Michel Temer faces several obstacles regarding the implementation of his plans. His party and his allies are strongly implicated in the corruption scandal and his popularity is low. Moreover, it is difficult to form a majority in a Congress, which is fragmented and still busy with the scandal. Finally, action in the Congress will soon slow down due to local elections and the Olympics. In our view, there is room for disappointment as financial markets have reacted overly positively to Michel Temer's arrival.

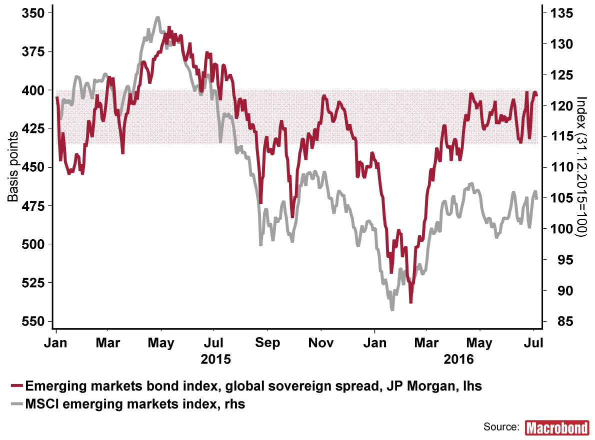
China – The mini cycle has already peaked

China's economy strongly depends on exports. Yet, as we expect only slightly lower global demand, the negative impact should not be large. The government's growth target for 2016 is 6.5%-7.0%. We still believe that even the lower bound is challenging. In order to stabilize growth, there was substantial monetary and fiscal easing in late 2015. Consequently economic activity as well as the property sector, credit creation and infrastructure investment accelerated in early 2016. Yet, this stabilisation is short-term as it is driven by the "old-style" growth model of debt creation and easing. In our view, the peak of this mini cycle has already been reached. The Brexit vote had a direct impact on policy making. Since June 24, the People's Bank of China (PBoC) allowed a third episode of depreciation. The Yuan fell rapidly against the Dollar and continued its steady decline against the currency basket. This latest depreciation attracted little attention as other headlines dominated. Moreover, capital outflows and the meltdown of foreign reserves have calmed down. Yet, market pressures on the Yuan can resume any day and render fighting a fast depreciation costly for the PBoC.

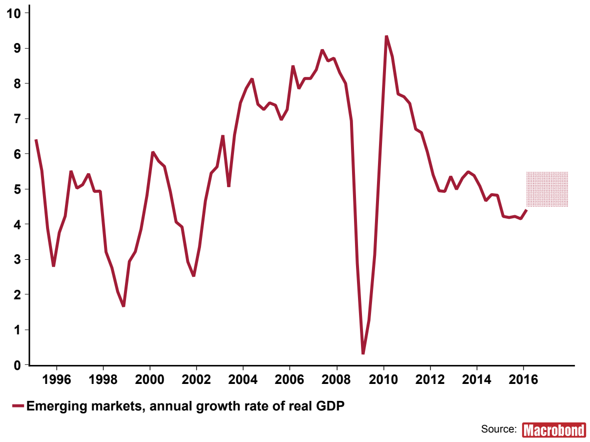
Current account deficits – Natural adjustment has started

A fall of commodity prices typically induces a natural adjustment process. Currencies of raw material producers depreciate, which makes their imports more expensive and their exports more competitive. Thus, the trade balance rises. This mechanism helps commodity producers with large external imbalances to lower their current account deficit. In Brazil, for example, the current account deficit decreased from 4.5% of GDP in early 2014 to 2.5% in early 2016. The recession was an additional factor, which compressed imports and hence improved the trade balance. In contrast, in Colombia the adjustment process has only just begun. The current account deficit declined from 7% of GDP in the third quarter of 2015 to 6% of GDP in the first quarter of 2016. Thus, there is still a long way to go to reach the long-term average of 2.5% of GDP.

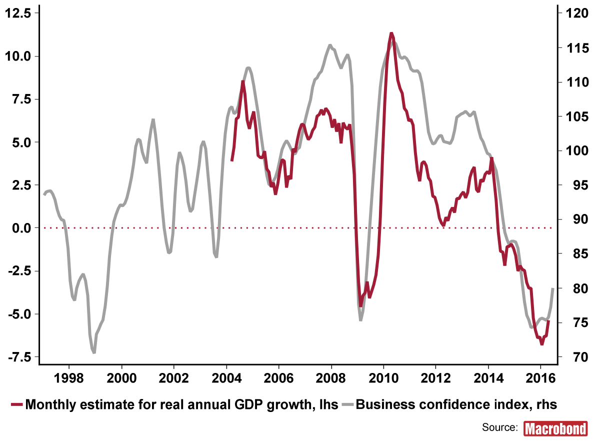
Spreads and equities – Emerging markets suffered surprisingly little after the Brexit vote



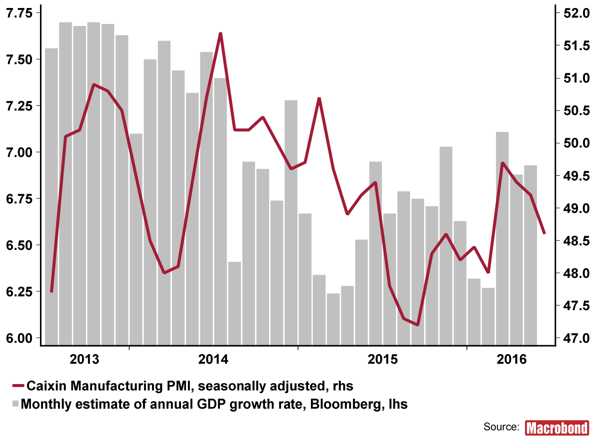
Growth – A slow recovery for emerging markets



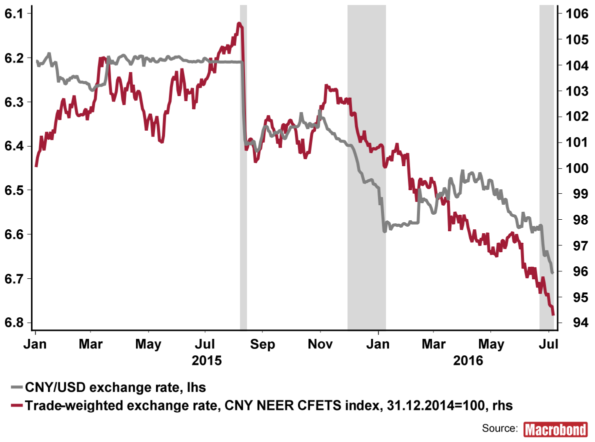
Brazil – Economic activity has reached the trough but is still far away from positive growth rates



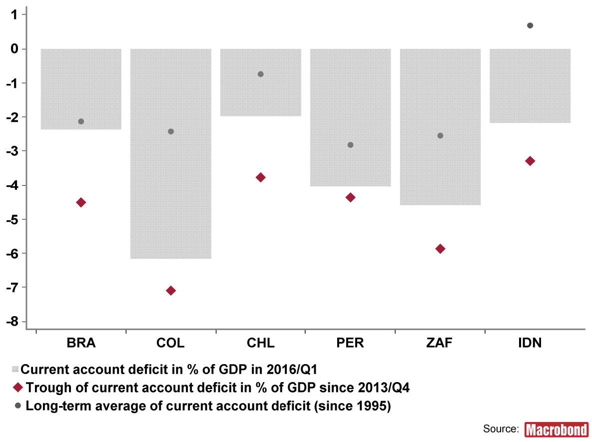
China – The recent mini cycle is still ongoing but it has already peaked



China – Third episode of Yuan depreciation started after the Brexit vote



Trade – Current account deficits of commodity exporters are adjusting



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