Emerging Markets Quarterly – 2017/2

The positive sentiment towards emerging markets has been well supported in the second quarter of 2017. This was reflected in strong capital inflows into the emerging world. There are good reasons for this support: Fundamentals keep improving, Trump's policy is less aggressive than feared, US interest rates are low and the Dollar has softened. As we do not expect commodity prices to fall sharply or US interest rates to rise rapidly, we believe that the positive sentiment can continue. The risk list is dominated by politics. At the top are North Korea, the Middle East and Brazil.

Donald Trump – Why has his impact been so small?

Emerging markets did not suffer much since the election of Donald Trump. So far, initial concerns turned out to be exaggerated. We have always anticipated a "tamed" Trump. Yet, checks and balances and the Russia investigations have limited his room for manoeuvre even more than that. Compared to the level of early November 2016, US interest rates are not massively higher today. The Dollar is not stronger than in fall 2016. The initial rate rise was well digested by emerging countries as they have smaller imbalances compared to 2013. In addition, US trade policy is less aggressive than feared. The orientation of foreign policy has however changed. So far, there are no real changes regarding NATO. Yet, the new US president seems to care less about stability in the Middle East. Going forward, we do not expect the US to introduce a border adjustment tax. We believe that the US will get tougher on China one day, yet overall our base case assumes intact US-Sino relations.

Growth – A good start into 2017

Regarding growth, emerging markets had a good start into 2017: Activity in China accelerated and the recovery of commodity exporters gained steam. According to our proprietary index, the yearly GDP growth rate of commodity exporters increased from 1.3% in the last quarter of 2016 to 1.9% in the first quarter of 2017. The low point was -0.1% in late 2015. Moreover, in late 2016 the strongest rebound of international trade since the great recession has started. It is particularly driven by the emerging world. Both export and import volumes have picked up. The latter implies that also domestic demand has strengthened. However, it is appropriate to assume a slow and moderate GDP growth recovery. Low commodity prices and politics remain a challenge: The recovery in Brazil will take more time (see below). South Africa is in a technical recession. The Middle East has a weaker economic outlook. And finally, Chinese growth has peaked in early 2017. We expect the economy to slow in the second half of 2017.

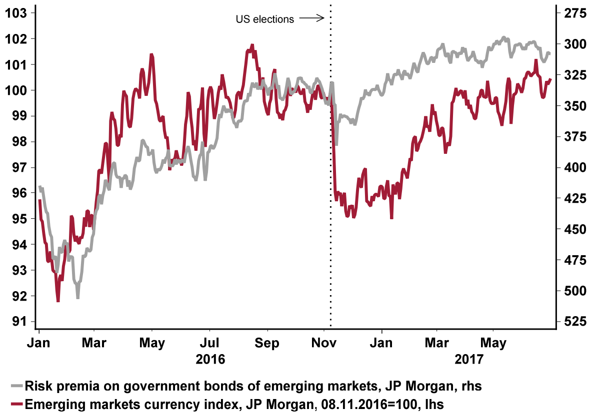
Inflation – At a record low

The inflation environment is very benign. According to our own calculations, the overall emerging markets inflation rate has fallen below 3% for the first time ever. Inflation is particularly low in the BRIC countries. In Russia and Brazil, inflation declined significantly after the hefty rise caused by currency depreciation. In India, inflation dropped from two-digit levels back in 2013 to almost 2%. In all three countries, central banks have improved significantly in anchoring inflation expectations. India and Russia finally adopted an inflation targeting policy a few years ago. In addition, the temporary impacts of administered prices and currencies pushing inflation upwards have disappeared. In Turkey and Mexico, the transitory effect of higher import prices is still unfolding as these currencies depreciated after Trump's election. Going forward, we expect inflation to climb somewhat higher, yet to remain on a comparably low level. The macroeconomic environment of emerging markets also improved in other areas: Current account balances have improved for quite some time. Finally, the fiscal situation started to improve in a number of countries. Yet, there are notable exceptions, such as China, Russia or Chile.

Brazil – Politics again in the driving seat

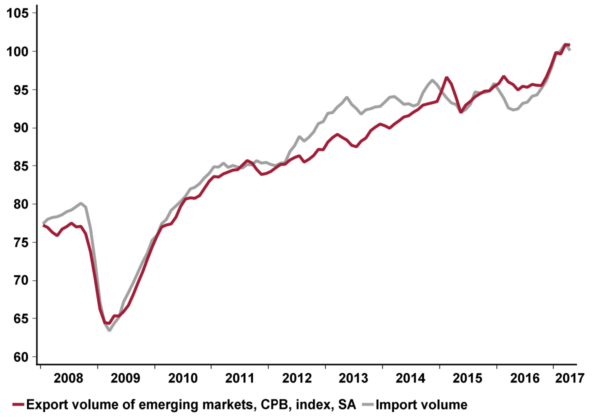
The severe recession in Brazil has finally ended. After eight consecutive quarters of contraction, GDP increased by 1% during the first quarter of 2017. After the "fresh" start with President Temer, confidence came back. He proposed two crucial reforms to consolidate the fiscal situation: a public spending cap and a pension reform. Michel Temer most probably had an active part in Brazil's corruption scandal. He is highly unpopular, yet does not want to resign. Currently he has enough support to avoid judicial procedures at the Supreme Court. Yet, the story of Dilma Rousseff showed how quickly such coalitions can fall apart. Under these circumstances, it is much more difficult for Temer to push reforms. Moreover, attention is again on politics instead of economics. The growth recovery will therefore be more muted. There is even the risk of a double dip recession. Yet, Brazil is much better positioned today than in 2015. Thus, despite the new episode of the political drama, the worst is clearly behind us.

Financial markets – Benefited from positive sentiment and capital inflows



Source: Macrobond

Trade – Strongest rebound of emerging markets' exports and imports since the great recession



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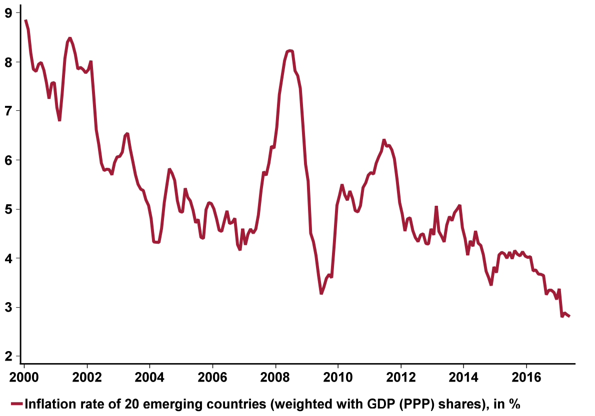
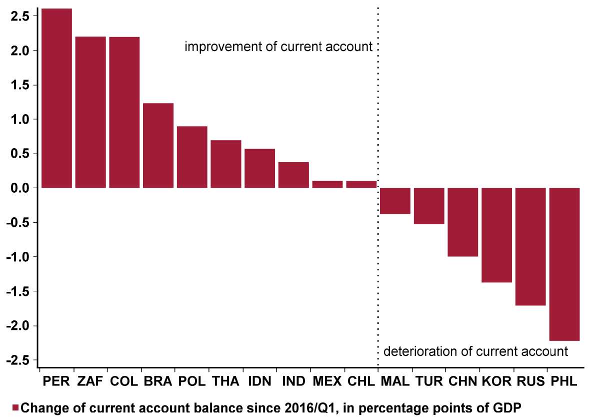
Inflation – At a record low



Source: Macrobond

Current account – Further improvement over the last twelve months



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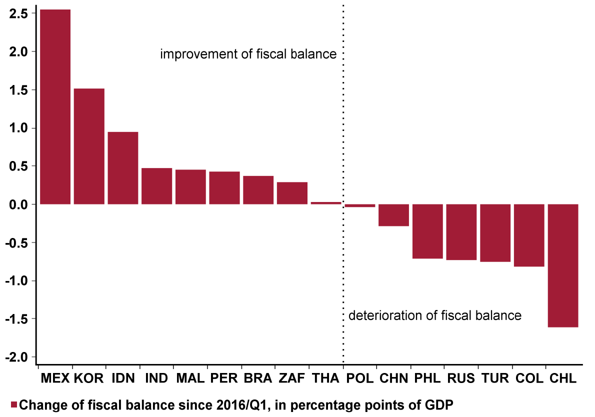
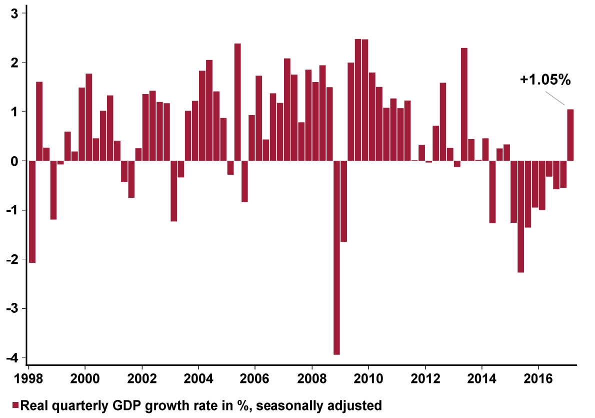
Fiscal balance – Finally the situation started to improve in a number of countries



Source: Macrobond

Brazil – The recession is over: first positive quarter after two years of GDP contraction



Source: Macrobond

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