

Third quarter 2022

Key messages

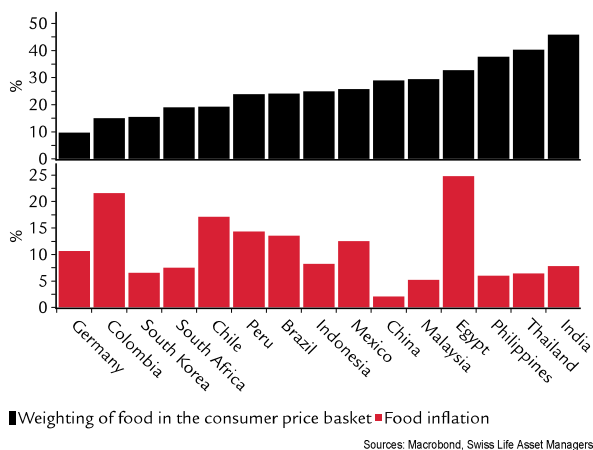
- The elevated interest rate environment is increasing the risk of default in vulnerable frontier markets
- Economic uncertainty and high interest rates are weighing on Latin America's economic prospects
- China's economy is gaining momentum, but its zero-Covid strategy carries the risk of renewed lockdowns

Number in focus

50.4%

Left-wing politician and former guerrilla Gustavo Petro won the Colombian presidential election with 50.4% of the vote, bringing the left to power for the first time in modern Colombian history. Petro's victory is a sign of the widespread desire for a more equal society. He wants to introduce free university education and pension reform. However, his proposal of banning new oil projects is discouraging investors. Oil accounts for half of Colombia's exports and almost 10% of its national income.

Chart in focus



The UN World Food Price Index is up 22.8% compared to a year ago. Ukraine exports about 10% of the world's wheat and corn production, mainly through its Black Sea ports, which are being blocked by warships. Moreover, rising fertiliser prices are increasing the cost of agricultural production and exacerbating the pressure on food prices. Higher food prices are a particular challenge for emerging economies in which food accounts for up to half the consumer price basket, as they lead to social unrest and weigh on public finances.

Latin America facing obstacles to growth

Latin America is facing several obstacles to growth in the second half of the year. Although the countries of Latin America, as commodity exporters, are benefiting from the rise in commodity prices, their growth prospects are being hampered by several headwinds. First, inflationary pressure is mounting and surpassing food and energy prices, as core inflation rates rise alongside headline inflation (see Figure 1). This is forcing the central banks, which have already raised rates significantly, to continue their cycle of rate hikes. In Brazil, for example, the central bank's key interest rate has reached double-digit territory at 13.25%, compared to 4.25% just 12 months ago. The Mexican central bank has also accelerated its rate hike steps and raised the key interest rate by 75 basis points to 7.75% in June. These high interest rates are having a negative impact on investment and economic activity. At the same time, the rising cost of living is increasingly leading to social unrest. Violent protests recently erupted in Ecuador, which severely affected oil production – Ecuador's main export – after demonstrators stormed oil fields. At the same time, economic policy uncertainty is increasing, in particular about the future course of government policy, as Latin America is shifting to the left and investors are unsettled by potentially interventionist policies (see Figure 2). Following the success of the left in Chile and Peru last year, Colombia has also followed suit and has for the first time in its recent his-

tory elected a left-wing politician, Gustavo Petro, as president (see “Number in focus”). Polls also show that Brazil's left-leaning leader Luiz Inacio Lula da Silva has a big lead over incumbent President Jair Bolsonaro for the October elections.

Increased credit risks in frontier markets

The external environment for emerging markets is deteriorating rapidly. During the economic slump caused by the pandemic, the US Federal Reserve loosened its monetary policy significantly and introduced a substantial fiscal stimulus package. This helped boost global trade and supported risk appetite and thus also emerging markets. Now, however, the tide is turning. Rising inflation rates are forcing central banks to tighten monetary policy across the board, external demand for goods is gradually ebbing, and the war in Ukraine is causing geopolitical uncertainty. This is all happening against the backdrop of a significant deterioration in the fundamental data of many emerging markets. Fiscal and current account deficits have widened significantly over the past decade. Rising interest rates are now significantly increasing refinancing pressure on many emerging markets. Particularly vulnerable are a number of smaller, riskier emerging countries, known as frontier markets, in Africa, the Middle East and Latin America, such as Senegal, Jordan, Egypt and El Salvador (see Figure 3). In a highly negative scenario,

Figure 1: Not only volatile headline inflation is soaring, but also core inflation

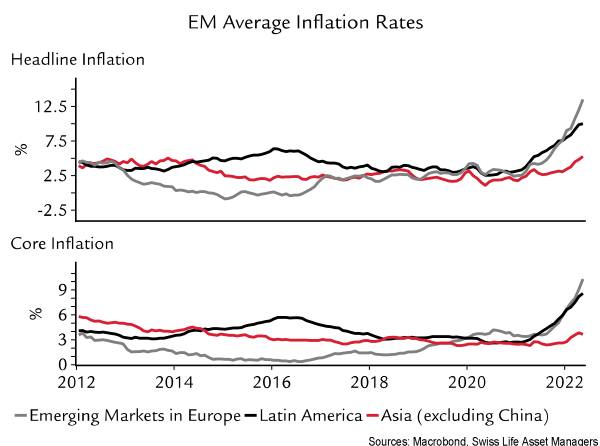
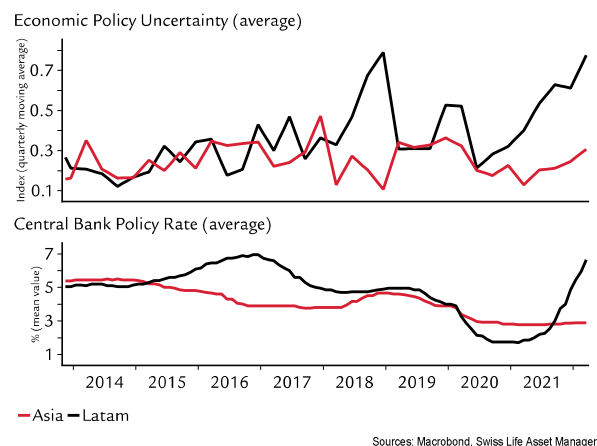


Figure 2: High interest rates and policy uncertainty are weighing on Latin America's economy



credit defaults in these countries could increase risk aversion towards other larger economies and place heavily indebted countries such as Brazil or South Africa in a precarious situation.

China: a bumpy road to recovery

After the two-month lockdown in Shanghai that ended in June, China's economy is now on the road to recovery. The economic data for May already showed a marked improvement. With 0.7% growth year-on-year, industrial production even moved slightly into positive territory. High frequency data for June now point to an even more significant improvement in economic performance. By mid-June, the daily congestion index in the country's five largest cities had returned to pre-lockdown levels, suggesting a considerable improvement in the mobility situation. Even in the battered real estate sector, daily real estate transactions have started to pick up, although they are still below last year's level. Consumption remains last in terms of recovery. Daily car sales are picking up slightly, but remain well below the long-term average. This shows that consumers are concerned about the future prospects of the economy and are reluctant to make any major purchases. One reason for this reluctance is the

fact that the unemployment rate, which currently stands at 5.9%, is significantly higher compared to 2021. The situation among young people is particularly precarious, with almost a fifth of 16-24 year olds unemployed. Another significant reason for consumers' uncertainty is China's zero-Covid strategy, which the government is sticking to. The reopening of Shanghai, for instance, involves a number of containment measures. In addition to a number of places such as restaurants remaining fully or partially closed, Shanghai's residents have to take regular PCR tests to use public transport. In addition, districts are being closed off again in the event of positive cases. Therefore, for as long as the zero-Covid approach remains in place, the road to economic recovery will be a bumpy one. One catalyst that could push China's Covid containment strategy towards a more flexible approach is the broader vaccination of the vulnerable population with a third dose. While there is no regular information on the vaccination rates of different age groups in China, the headlines in the state newspapers are increasingly claiming that the vaccination rate among older people is rising. This suggests that the government is focusing more on vaccinating older people, which may give it more scope to move away from its current strict containment regime in the next year.

Figure 3: Fiscal and current account deficits have widened over the past decade

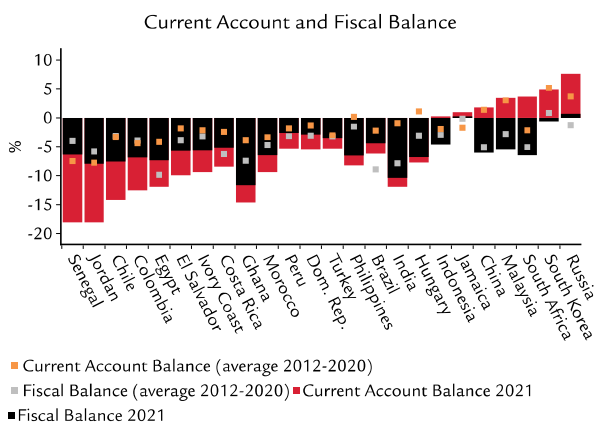
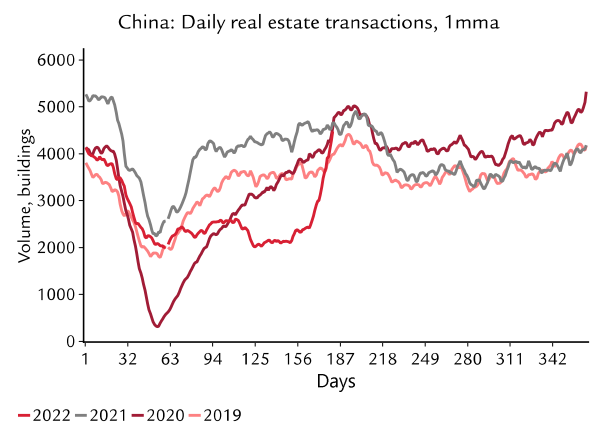


Figure 4: China: Activity in the real estate sector has bottomed out, but remains below previous years



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