Perspectives
Emerging Markets

Fourth quarter 2023

Key takeaways

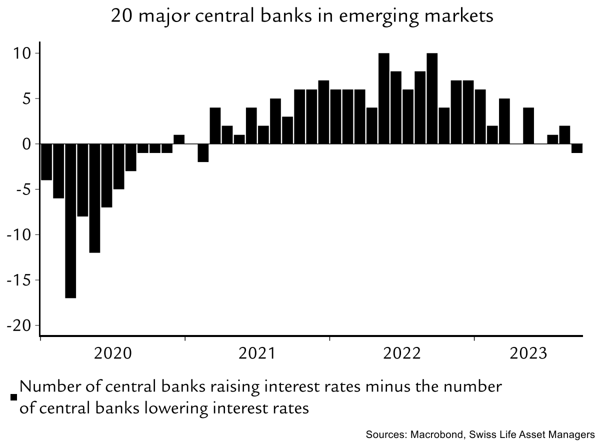
- Despite the economy stabilising in August, the recovery in China falls short of expectations
- Southeast Asian economies are likely to suffer in particular from the collapse in demand from China
- Slowing inflation dynamics should allow for further monetary easing

Number in focus

51.4

The Manufacturing Purchasing Managers' Index for emerging markets stood at 51.4 in August. This is significantly above the figure for many developed nations, which have experienced a slump in sentiment over recent months. In August, for example, the Purchasing Managers' Index for the industrial sector stood at 43.5 in the eurozone and 47.9 in the US, both of which are well below the growth threshold of 50.0. In recent months, the index for the emerging markets has remained robustly above 50.0 and hints at some divergence between emerging and developed markets, despite the surprisingly short-lived rebound in China following the reopening of its economy.

Chart in focus



While central banks in developed markets are only slowly reaching the end of their cycle of interest rate hikes, the major central banks in emerging markets are already one step ahead. The central banks in Brazil and Chile, for example, have already started to lower key interest rates again due to the favourable inflation trend. Thanks to the early and consistent tightening of monetary policy, emerging markets have succeeded in somewhat reducing their dependency on the monetary policy implemented by the US Federal Reserve and are already lowering interest rates ahead of the Fed, without local currencies incurring significant losses.

China stabilises, but nothing more

After a weak July, China's activity data for August came as a positive surprise. There was an unexpected improvement in industrial production and retail sales growth compared to the previous month. The strong recovery in retail sales was particularly surprising as it contrasts with the weakening of the Purchasing Managers' Index for the services sector in August. Higher revenues in sectors that have particularly benefited from the summer holidays (e.g. restaurants, accommodation and travel) were the main driver. Industrial production was mainly supported by a recovery in automobile production and the production of solar batteries. These are both sectors that are likely to have benefited from the political support measures introduced. The turnaround in producer prices is another indication that the industrial sector is slowly stabilising again. Although producer price inflation is still in deflationary territory, developments in recent months have shown an upward trend. In addition to activity data, foreign trade data also improved slightly in August compared to the previous month. All in all, it looks as if the support measures introduced by the government could finally be having a visible impact on the economic data. While this is a welcome development, we still do not expect these measures to boost growth significantly; rather, they are likely to have a stabilising effect.

Concerns over the real estate sector remain

While the economic data hints at a slight stabilisation, the Chinese real estate sector again showed no signs of improving in August. All key indicators for the sector remained weak in August. Growth in real estate sales in August was negative for the first time this year, while residential construction starts and real estate investments continued to show negative growth. A house price index in China's 70 largest cities also showed negative price growth for the third consecutive month. In recent months, the government has announced various support measures for the real estate sector. In addition to monetary easing, mortgage lending conditions have been eased and individual restrictions on purchasing real estate have been relaxed since the end of August. We assume that these measures will take a few months to have a visible impact on the real estate sector. As on the economic side, however, we do not expect the measures to accelerate growth, rather they should have a stabilising effect. The broader real estate and construction sector and its suppliers account for around 30% of China's GDP. As a result, sluggish real estate activity is likely to further dampen economic prospects in China.

Chart 1: The main economic indicators in China pointed to a stabilisation in August

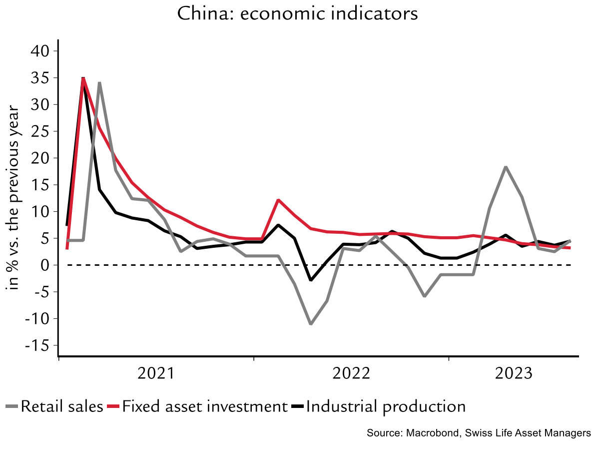
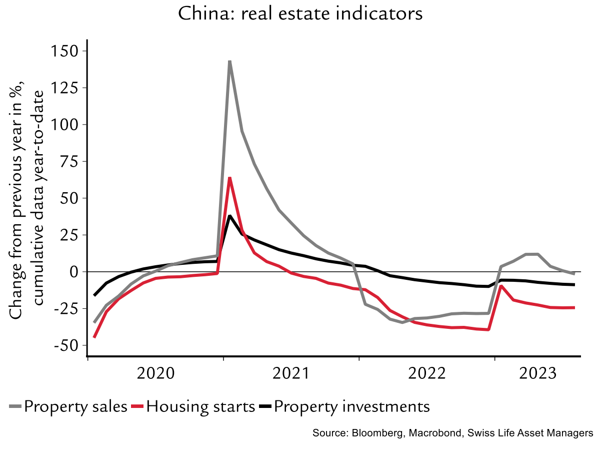


Chart 2: The Chinese real estate market continues to weaken



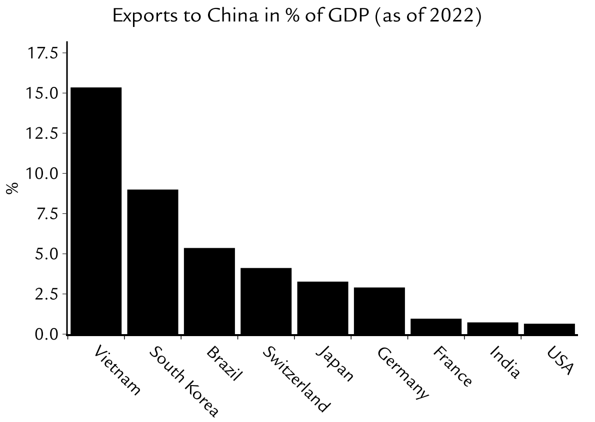
What does a weakening China mean for the rest of the world?

The global economy had hoped for a strong upswing in China at the start of the year following the lifting of the last Covid restrictions there. This upturn has now proved to be significantly shorter and weaker than expected. We stressed early on that the positive impact of the Chinese upswing on the global economy is likely to be somewhat smaller this time around, as the recovery is being largely driven by the services sector, in contrast to previous upturns where the industrial sector was the driving force. The Chinese industrial sector is particularly important given the demand it drives in various industrialised countries, such as Germany. Southeast Asian countries such as South Korea or Vietnam, which are heavily dependent on exports to China, are much more vulnerable, however. They are likely to be hit particularly hard by the slump in demand. Vietnam, for example, exports goods amounting to around 15% of its GDP to China. This slowdown is already reflected in the data. Chinese imports from the Association of Southeast Asian Nations (ASEAN) and exports to the ASEAN region have fallen particularly sharply. Commodity exporters are also particularly exposed. China is the largest consumer of most industrial metals. Due to the weak real estate sector, demand for these commodities is also expected to remain subdued. The slowing Chinese economy has also led to producer price deflation in the country, though this should prevent China from exporting any additional price pressure to the rest of the world.

Central banks reaping the rewards of their success

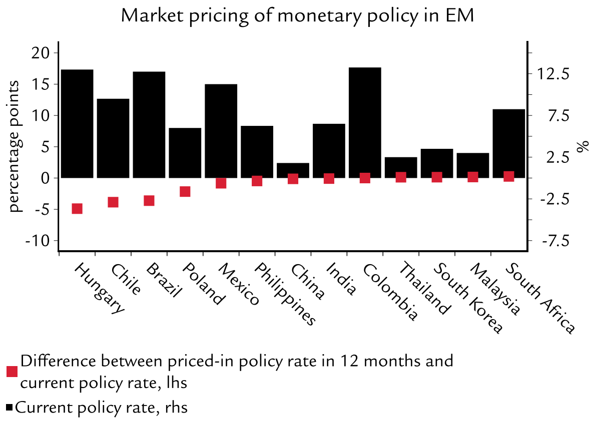
As already discussed in the “Chart in focus”, the consistent tightening of monetary policy in emerging markets has resulted in inflation in certain economies already being brought back into line with the inflation target. While the decline in inflation has recently been interrupted by rising energy and food prices, core inflation is still declining and is now below headline inflation in some countries. This fall in core inflation is currently being driven by falling goods prices in particular, thanks in part to the economic weakness in China. Services inflation is also declining, albeit at a slower pace. These developments should be reassuring for central banks in emerging markets. We expect central banks in Latin America and Eastern Europe in particular to be able to make further interest rate cuts over the next few months. In Asia, on the other hand, central banks are somewhat more cautious and have so far refrained from rate cuts (with the exception of China), partly due to increases in food and energy prices and partly due to the risk of capital outflows. Another important factor in determining monetary policy across emerging markets will be the performance of the US dollar. Despite initial interest rate cuts, real interest rates remain at a high level, particularly in Latin America. This should offer some protection for local currencies against any potential increase in the strength of the greenback. Nevertheless, the priced-in market expectations for further rate cuts (see Chart 4) seem too high in our view given the current inflationary trends and currency dynamics.

Chart 3: Southeast Asian countries are particularly exposed to weak demand in China



Source: Bloomberg, Macrobond, Swiss Life Asset Managers

Chart 4: Further rate cuts expected by the market



Source: Bloomberg, Macrobond, Swiss Life Asset Managers

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