EMERGING MARKETS QUARTERLY: DIVERGING OUTLOOKS ACCELERATE

Q2 2018 Insights

Trump imposed USD50 billion in tariffs against China with USD200 billion still pending and more in the pipeline to effectively cover all imports (USD450 billion) from China. So far, China's heels are firmly dug in, responding in kind against tariffs imposed so far, but a deal with Europe to avert auto tariffs may pose an opportunity to bring negotiators back to the table. All eyes are on China for what's to come next.

By measure of equity market performance, the US would seem to have the upper hand with equity markets within a whisker of reaching new all-time highs, while China equities have broken down – off about 18% – from the January highs, diverging significantly since early June.

Chart 1: US versus China Equities

Source: Bloomberg July 2018

US equities may be a firmer indicator that a full-blown trade war is unlikely, as Goldman Sachs' analysis predicts an event sell-off by 20%, evenly split between earnings decline and de-rating. The depressed China equities are likely more a reflection of the after-effects of acute deleveraging, including rising defaults and slowing growth.

The US may have the upper hand over China not just for the latter's greater dependence on exports in their trade relationship, but also for its firmer economic health. Trump may be ratcheting up pressure while its stronger position lasts, ideally to strike a deal sooner than later to firm up support for the GOP in the upcoming mid-term elections in November. In any case, neither can afford a trade war – the US at high risk of falling into recession and dashing Trump hopes for a second term, and China for possibly losing control of its delicate deleveraging balancing act.

The primary impasse is China's "Made in China 2025" initiative. Through subsidies and incentives, the initiative is designed to push China's technology industry up the value chain while aiming for Chinese suppliers to significantly increase market share by 2025. China has long steered capital to industries of interest, but high tech is increasingly intertwined with national security, effectively challenging the balance of power which raises the stakes.

As it stands, China has downplayed the initiative and avoided referring to its name in the press, but there is so far no concrete commitment to rolling it back. For now, the standoff continues, but as other countries cut deals with the US, China may soon feel it needs to do the same.

Trade war concerns will continue to add to market volatility, but for emerging markets (EM), the primary drivers are still the dollar and the outlook for China demand. Dollar strength began in late April, driving the EM sell-off – starting with current account deficit countries that depend on foreign funding, ultimately spreading across the EM on declining sentiment. Different from prior deflationary bouts of dollar strength that are much more problematic for EM, the dollar this time was driven by a stronger US economy versus the rest of the world. Normalising growth in the coming quarters is likely to ease the rally, allowing EM assets to regain their footing.

China growth has been a concern due to a tight regulatory squeeze on shadow banking, but the recent shift toward

easing should add to positive growth momentum in the coming quarters. Between liquidity injections to increase lending, new commitments to boost infrastructure spending and impending tax cuts, there is sufficient scope to lift China demand to support EM, from commodities to supply chains. Developed market tightening will remain a headwind to lower quality EM, while a more benign dollar and improving China demand are a sufficient tailwind to lift quality EM, particularly given the value that has emerged.

Asia growth eases, while valuations are attractive on earnings momentum

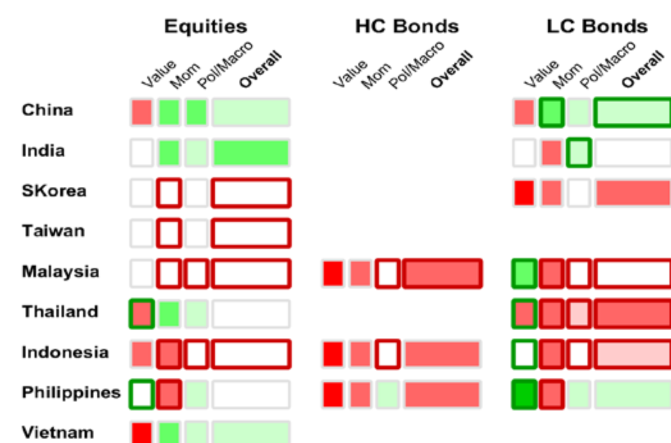
The Asia supply chain is clearly exposed to the trade spat between the US and China and while an escalation coupled with deteriorating confidence remain key regional risks, growth is still resilient and earnings robust.

Trade slowed, but mostly attributable to base effects given the outsized growth throughout 2017, though a degree of slowing China demand also factors into the mix. The shift to easier policy in China is a clear positive for the region. Importantly, the pullback in demand has not slowed earnings, leaving room for more upside as confidence improves.

Current account surpluses have helped to buffer tighter financial conditions driven by portfolio outflows and dollar strength. Indonesia and India still have current account deficits, adding to local currency pressures; however, deficits are much narrower than during the taper tantrum in 2013 to help limit their vulnerability.

China local currency bonds were upgraded this quarter as momentum shifted positive, which is notable given the rising yields across both emerging and developed markets. Downgrades across asset classes were mainly driven by downshifts in momentum.

Asset Class Scores



Score Summary: For each country and asset class, scores are represented by colours – white is neutral, green is positive and red is negative. The overall score is shown to the right with the underlying scores – value, momentum and political/macro – shown to the left. The border shows grey for no score change, while green shows positive and red negative.

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China earnings upgrades despite deleveraging woes

Despite slowing growth, tighter liquidity and rising defaults, earnings estimates have continued to be adjusted to the upside. Potential trade wars are still a clear tail risk, but it is really credit conditions and the government's response that determines the earnings trajectory.

According to data compiled by Bloomberg, defaults currently stand at about USD5 billion so far in 2018, including 9 private and 25 public offerings. These are big numbers that are set to worsen, and the main risk is tighter credit with the potential to damage the real economy.

The shift to easier policy including bank injections to support credit should ease concerns. Coupled with fiscal stimulus including infrastructure investment and tax cuts, the growth outlook is increasingly positive.

China's pivot toward easing weakened the currency, but the speed of the adjustment drew concerns that China could continue to devalue as a trade war response and risk having another bout of capital flight as experienced in the summer of 2015. We are less concerned for three reasons:

- The currency was overvalued, especially relative to major trade partners including Europe and Japan, but is now approaching fair value to complete the adjustment.
- The speed of the drawdown may have partly been a response to the fast escalation of threatened tariffs, but ultimately, China is still highly motivated to support a stable currency.
- The capital account is more closed and growth is far healthier than in 2015, limiting both the ability and incentive for capital to flow out of the country.

Despite the 18% decline in equity prices from the January highs, earnings estimates continue to rise, reflecting a far healthier growth environment than in 2015.

Chart 2: Chinese equities price versus earnings

Source: Bloomberg July 2018

In 2015, earnings plunged on weak demand and falling purchasing prices (Producer Price Index (PPI): -6% in December 2015) subtracting directly from industrial profits. Through supply slide reforms, PPI stands at +4.7% in June 2018 that

coupled will new infrastructure investment, should only improve top line growth.

While industrial profits remain important drivers of the index, "new China" continues to thrive. New China companies, and companies in the region that feed into its supply chain, have replaced cost leadership with technological expertise to increasingly take market share from global multinationals. The indiscriminate sell-off therefore presents opportunity.

Malaysia Election surprise

Markets were shocked when opposition leader Mahathir Bin Mohamad managed to win the General Election in a major upset against incumbent Najib Razek who is known to be seriously corrupt but also tolerated for pushing pro-growth policies including a significant investment from China's Belt Road Initiative (BRI).

Formerly Najib's mentor, 92-year old Mahathir was so disgusted with the corruption that he switched to the opposition party, managing to win the election after a relatively brief campaign. Clearly, Najib's corruption was central to his defeat, but Mahathir also appealed to a certain degree of distrust in China's investment initiative that he committed to scaling back.

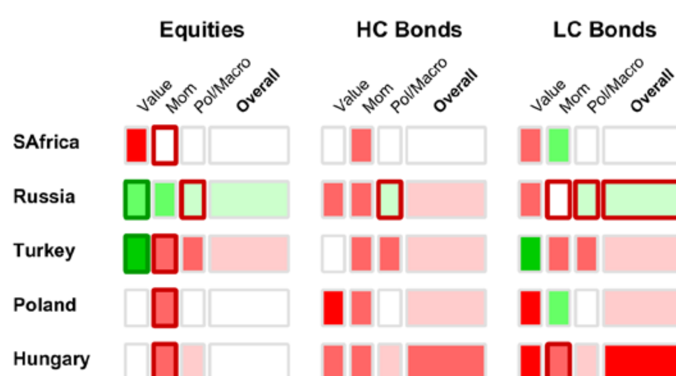
Mahathir does lean populist, and while taking out a corrupt leader is a positive result, his move to reduce infrastructure investment weighs on the growth outlook while eliminating the Goods and Services Tax (GST) portends a potentially deteriorating fiscal position.

Long term growth may be set to slow with less clarity on the fiscal trajectory, leading to a downgrade across asset classes.

EMEA fragility exposed

The outlook for EMEA remains mixed, but the overall trajectory has turned more negative as external imbalances are increasingly vulnerable against tighter global financial conditions. Questionable policy in Turkey presents major challenges against high inflation as well as a widening current account deficit, and South Africa faces new political headwinds in pushing fiscal reforms while growth slows. Russia's economy continues to improve, though hampered by heavy sanctions issued in April, while Eastern Europe risks overheating as relations with Brussels continue to sour.

Asset Class Scores



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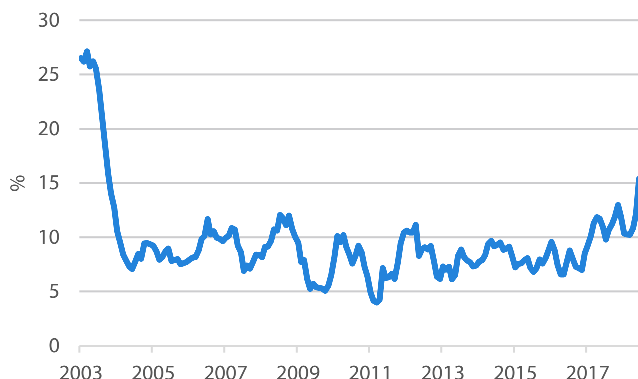
Headwinds for Turkey and South Africa

As central banks across the developed world remove stimulus, tighter financial conditions are less forgiving to those economies dependent on easy money to fund external deficits, leaving Turkey and South Africa among the most exposed.

In Turkey, President Erdogan won the presidential election in June, but less anticipated were his rapid efforts to consolidate his increasingly autonomous power. He named his son-in-law, Berat Albayrak, as Finance and Treasury Minister, who recently failed to raise rates as markets had expected, stirring fears that he may be taking orders from his father-in-law who dangerously believes rates should be lowered, not raised, to curb inflation.

Inflation climbed to 15.4% to June, not seen since 2003 when Turkey was exiting its last bout of hyper-inflation. By keeping rates "on hold" at 17.75% with inflation still on the rise, real rates will dangerously compress, risking deeper capital outflows and potentially a balance of payments crisis. Given the relatively large size of the economy, such an event risks triggering broader contagion, which is something to monitor closely.

Chart 3: Turkey CPI YOY%



Source: Bloomberg 30 June 2018

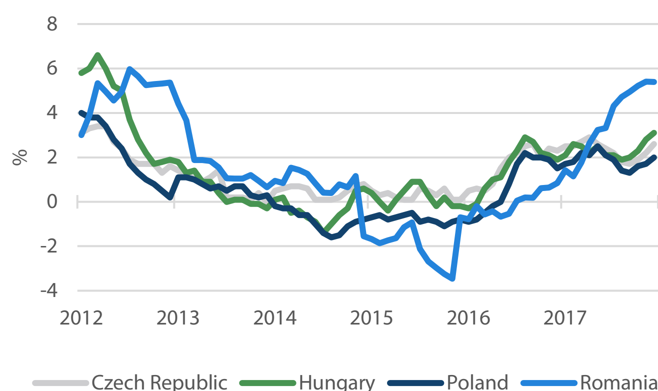
South Africa was upgraded last quarter on the back of Cyril Ramaphosa's winning the election as the new head of the African National Congress (ANC) Party and as the country's new President, finally putting the country on course to push badly needed fiscal reforms.

His leadership remains a positive development, but it is becoming increasingly apparent the political path to execution will be a difficult if not insufficient. Coupled with softer growth, the risk of further fiscal slippage is rising.

Central Eastern Europe risk of overheating

Central banks in Eastern Europe have kept policy unnecessarily easy while their economies are strong and showing signs of overheating with inflation consistently hitting above the European Central Bank (ECB)'s target of 2%. The Czech Republic is the only one tightening with the overnight rate currently standing at 1%, while the rest of the region is behind the curve with real rates turning increasingly negative.

Chart 4: Eastern Europe CPIs YOY%



Source: Bloomberg 30 June 2018

As central banks defy their ECB mandate, policymakers strongly disagree with Brussels over the immigration crisis. Brussels usually gets its way, except the axis of power is changing with Austria supporting the Eastern block's view and now also Italy which has firmly joined the populist wave. It is difficult to know how events will unfold, but increasingly emboldened populist leadership does not bode well for business-friendly policy.

LatAm commodity headwinds

Latin America (LatAm) has felt the pain from commodities selling off about 8% from the late May peak. Headwinds include the strong dollar and softer data in China and, of course, the tail risk of an all-out trade war. China's shift to easing supports demand for commodities and should support LatAm over the medium term, but near-term dollar strength and trade war uncertainty likely remain headwinds for now.

Relative political risks continue to diverge. Argentina was deeply punished by markets, leaving the central bank unable to support its currency that required an International Monetary Fund (IMF) bailout with tough conditions. Uncertainty still surrounds Brazil elections, where markets have lately been less willing to give the benefit of the doubt on the critically important pension reform. On the positive side, Chile, Colombia and Peru benefit from better politics, improving sentiment and higher growth. Mexico also found firmer ground as President-elect Andrés Manuel López Obrador (AMLO) appears less a populist threat than originally feared.

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Argentina: an even less certain future

Last quarter, we noted concerns for stubborn inflation and a deep drought not only weighing on the economy but also dragging the current account even more deeply negative. Coupled with high levels of external debt, the country is particularly vulnerable to tighter financial conditions.

External debt has grown precipitously in recent years on the back of easy money with the hope that reforms could ultimately lift the economy back into balance. Blaming the slow speed of reforms, confidence ultimately gave way to

panic with the Argentina peso losing 27% since late April, making the dollar denominated debt burden that much more difficult to service.

Chart 5: Argentina External Debt

Source: Bloomberg 31 March 2018

President Macri turned to the IMF for a USD65 billion bailout – above the USD50 billion originally asked – but the currency slipped even further as market judged the stipulated inflation and fiscal targets as too ambitious. The currency has since stabilized from mid-June, but the outlook still remains far from certain. Yes, the IMF bailout provides a backstop, but unfortunately President Macri is suffering the blame for having to turn to the IMF in the first place, which makes his job to execute even more difficult.

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