Perspectives
Emerging Markets

First quarter 2019

Key messages

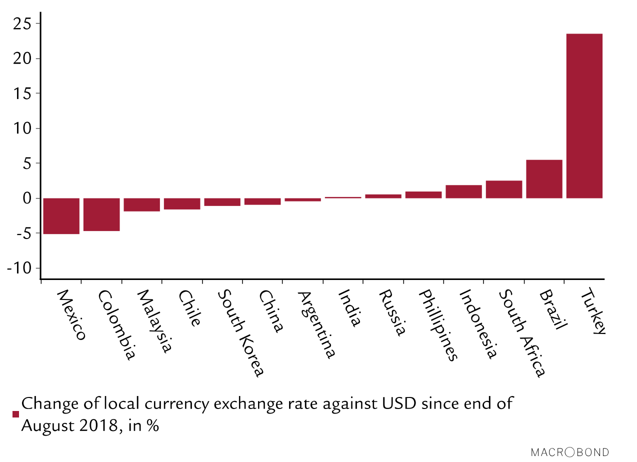
- Economic situation in emerging markets stabilised, as countries tightened their monetary policy stance
- US-China trade truce positive first step, but hard work on trade negotiations still needs to be done
- Political uncertainty in Brazil and Mexico, as both countries elected outsider candidates

Number in focus

66%

On December 1, Andrés Manuel López Obrador took office as Mexico's new president. Although the leftist politician caused uncertainty among economic agents, pledging to abolish free-market policies and attacking neo-liberalism, he enjoys approval ratings as high as 66%. Almost seven out of ten Mexicans are confident of his ability to fight corruption and reduce poverty and crime. However, the policy framework that is likely to be based on the new president's ideological convictions rather than economic criteria, is weighing on business sentiment.

Chart in focus



Higher US rates and a stronger US Dollar led to tightened financial conditions in emerging markets. Combined with trade tensions between the US and China that caused uncertainty around the globe, emerging markets have been hit by negative external headwinds that resulted in an economic slowdown in the second half of 2018. However, the economic situation in emerging markets has stabilised. In response to the tightening of the US Federal Reserve, emerging market central banks increased their interest rates as well, which led to a strengthening of their currencies, reduced inflation and contained current account deficits.

Fundamentals improved but headwinds remain

While the economic situation in emerging markets stabilised in recent weeks, with strengthened currencies, a decline in inflation and contained current account deficits, manufacturing purchasing manager indices (PMI) in major emerging countries show a mixed picture. Some countries, such as Brazil and India have seen an uptick of their PMIs due to improved domestic demand. However, PMIs in most of the countries are pointing to ongoing weak economic dynamics, with latest readings remaining below the 2017 average. The main drivers of this slowdown are contracting export orders, as the trade conflict continues to hurt global demand, and rising policy rates. In China, the official November manufacturing PMI dipped to 50, with the main drag being contracting export orders, remaining at a 3-year low at 47 points. A level of 50 is the dividing line that separates expansion from contraction. Continued weakness in China's PMI likely indicate further headwinds for the country's trading partners.

Temporary ceasefire in the US-China trade dispute

In a working dinner following the G20 summit in Argentina, US President Donald Trump and China President Xi Jinping concluded a temporary ceasefire of their trade dispute. The two parties agreed to enter negotiations on a broad range of structural issues in the next 90 days, such as China's alleged property theft and forced technology transfers, while no additional tariffs will be imposed in the meantime. This means the US will not increase tariffs on USD 200bn of Chinese products from 10 to 25 percent in January 2019, as originally announced. In return, China agreed to increase imports from the US of agricultural, energy and industrial goods, to put Fentanyl as a controlled substance to help the US fight on the opioid epidemic and to approve the Qualcomm-NXP deal, should the case be presented again. However, if no deal on China's structural issues can be reached within the three-month period, a new escalation of tariffs would arise. Therefore, although the temporary truce of the dispute should reduce short-term uncertainty, the hard work on negotiations still has to be done. While 90 days are a short time to negotiate complicated structural issues, China already announced to improve its intellectual property (IP) court system and increase punishments on IP violations. Moreover, China is likely to agree to speed up market openings in various industries. If this however, will be enough for the Trump administration not to impose further tariffs remains uncertain. In the end, the threat of a future escalation is likely to continue to weigh on sentiment in both countries, so that the major gain of the temporary truce is mainly time, during which both sides can work on strategies for potential long-term de-escalation of the conflict.

China to increase easing measures as slowdown continues

While the temporary ceasefire is positive for the short-term outlook, tariffs of 25 percent on USD 50bn of Chinese goods and 10 percent on USD 200bn of goods remain in place and the threat of a future trade escalation will likely continue to weigh on business sentiment. Moreover, the possibility of a future tariff hike

Chart 1: Overall emerging markets inflation rates started to decline again in recent weeks

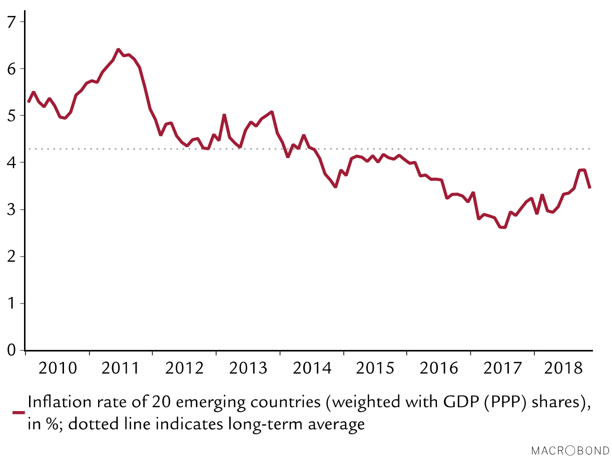
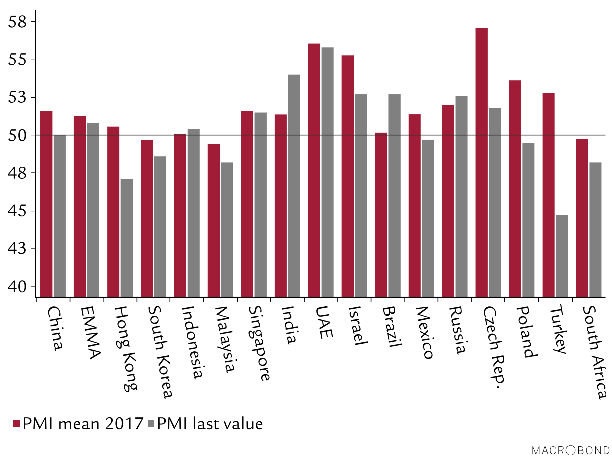


Chart 2: Despite some stabilization, PMIs point to ongoing headwinds



could lead to ongoing front-loading of shipments, that would boost exports from China to the US in the short-term, but create a risk for an even sharper drop in exports later on. Besides the pressure from the trade conflict that is likely to persist, China's economy still feels a drag of lagged effects of its deleveraging campaign enacted over the past year, with an intensified policy tightening on shadow banking weighing on investment and consumption. Therefore, there is little doubt that China will increase stimulus over the coming months to support its economy, with further tax reductions for the private and the corporate sector, increased issuance of local government bonds, further cuts in the reserve requirement ratio, and an enhanced transmission from the released liquidity to credits, especially for the private sector. While the scope of the easing measures will depend on incoming data and US trade policies, China's policy stimulus is likely to focus more on fiscal easing and restoring of private sector confidence, rather than massive infrastructure investments. Other than in previous episodes, China's policymakers are emphasizing on growth quality over quantity and are ready to tolerate some slowdown of the economy.

Political uncertainty in Latin America

Brazil and Mexico both elected outsider candidates in 2018 and the uncertainty of how the two new administrations will govern the countries is going to determine their future growth prospects. In Mexico, Andrés Manuel López Obrador (also referred to as AMLO) began his six-year term as the country's president in December. In his first speech, the leftist president pledged to abolish free-market policies and attacked neo-liberalism, alarming business leaders. The new president inherits a rather sound Mexican economy, with positive consumer sentiment amid a tight labour market and rising real wages. However, the new government's economic policy framework is weighing on business sentiment. In particular, AMLO's decision to cancel the construction of an already partially-built Mexico City airport through an irregular public poll, has raised uncertainty about future policy and led to a sharp depreciation of the Mexican Peso. Concerns about the future use of such non-institutional consultations to impose policy that risks to be based on ideological motives rather than economic criteria, is likely to take a toll on investments and drag down economic growth.

In Brazil, president-elect Jair Bolsonaro will take office on January 1, promising a very liberal agenda, advocating privatisation and pro-business reforms. Bolsonaro's first cabinet appointment of Paulo Guedes, University of Chicago PhD economist, as future Economy Minister, has reinforced enthusiasm among economic agents. The improvement in sentiment is likely to accelerate investments next year and support private consumption as well. However, the improvement in confidence will depend on the successful implementation of much-needed fiscal reforms, particularly the reform of Brazil's pension system, which is necessary to stabilize the country's fiscal accounts – with Brazil having one of the largest fiscal deficits among emerging market countries. With Bolsonaro's party having a minority in both houses of Congress, uncertainty of timely and comprehensive implementation of reforms remains high, since a stable coalition in Congress is needed to pass important fiscal reforms.

Chart 3: China key economic indicators point to a slowing economy

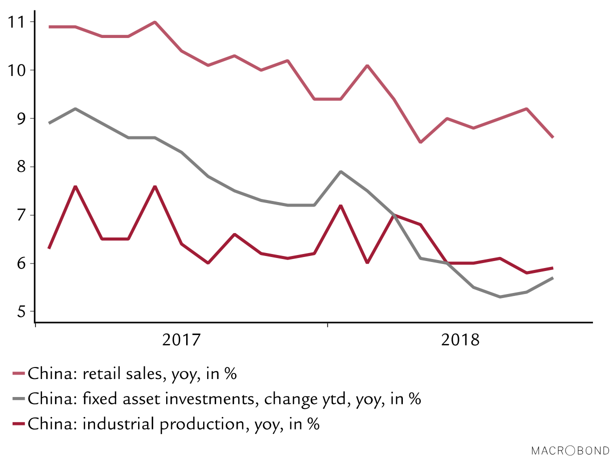
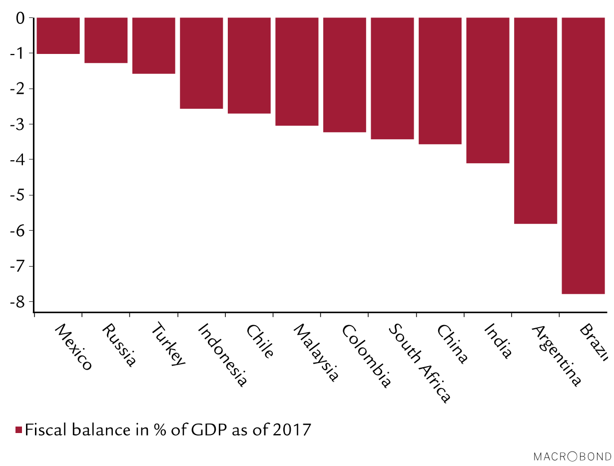


Chart 4: Reforms in Brazil necessary to bring down fiscal deficit



Economic Research

Marc Brütsch
Chief Economist
marc.bruetsch@swisslife.ch
@MarcBruetsch

Francesca Boucard
Economist Real Estate
francesca.boucard@swisslife.ch
@f_boucard

Do you have any questions or would you like to subscribe to this publication?
Please send an email to: info@swisslife-am.com.
For more information visit our website at: www.swisslife-am.com/research