



Emerging Markets Quarterly – 2015/4

The publication date of the last issue of this paper in late September coincided with the peak of emerging markets fears. Sovereign spreads over the US rose from 420 to 480 basis points from mid to late September. Back then, we argued that the reaction of financial markets to rising concerns in emerging markets and notably China is exaggerated. So far, this view has been confirmed and government spreads came down to almost 400 basis points. The recent upturn shows, however, that the situation remains challenging with strong external headwinds, political and geopolitical tensions as well as potential rating downgrades.

Growth – Improvement in 2016

2015 was a difficult year for emerging economies, characterised by a number of negative surprises. Will the situation improve in 2016? We believe that the light at the end of tunnel is visible. Growth should improve during next year. First, the situation in Russia and Brazil, two heavy weights, which have been in recession this year, should improve. Second, the shock of lower commodity prices will start to fade out provided that commodity prices do not fall further. Third, solid growth in the developed world should eventually lift exports from their depressed levels. Finally, we do expect an acceleration of growth in robust countries such as India or Mexico. However, the growth outlook for emerging markets in 2016 remains comparatively weak as several factors weigh on activity: External headwinds such as the slowdown in China, low commodity prices and the US hiking cycle remain. Moreover, elevated debt levels are a drag. In several countries, substantial credit creation helped to keep up high growth rates after the great recession. This not only limits the possibility to use credit creation as a stimulus going forward, but it will lead to higher debt servicing costs. Finally, structurally lower global trade flows are an obstacle to growth, particularly so for Asia.

Fragile countries – What has changed since the tapering talk?

In early 2013, when Ben Bernanke announced the tapering of the US quantitative easing programme, asset prices of emerging markets suffered. The so-called fragile countries – Turkey, South Africa, Brazil, Indonesia and India – were particularly vulnerable to tighter US monetary policy. India is the only country, which has since reduced its twin deficit (current account and fiscal deficit) and inflation to a reasonable level. Turkey and South Africa improved their position only

slightly and remain very vulnerable. The situation in Brazil deteriorated clearly. Furthermore, Colombia joined the group due to the sharp increase of its twin deficit, the free fall of its currency and rising inflation.

Commodity prices – How do countries adjust?

The renewed fall of the oil and industrial metals prices is brutal for commodity producers. Several Latin-American countries as well as Russia and South Africa seem to digest this shock with the classical adjustment: By letting their currency depreciate, the trade balance will eventually improve as imports become expensive and exports more competitive. In Brazil and Colombia, for example, this adjustment process has only just started. Today, it is particularly evident that only very few countries took advantage of the favourable environment during the long period of high commodity prices to reallocate resources towards more productive sectors and thus diversify their exports. A notable exception is Mexico, where manufacturing represents more than 80% of exports. Eventually, only non-primary exports benefit from a weaker currency.

Brazil – A severe recession and a difficult outlook

Brazil is living through the deepest recession since the early 1990s. The labour market deteriorated sharply and investment contracted by 20% in the last two years. There is no improvement at the political and fiscal front. The corruption scandal has reached new circles and a lengthy impeachment process against Dilma Rousseff started which will bring about uncertainty and volatility. Moreover, a downgrade of Moody's to below investment grade becomes increasingly likely. As S&P already assigned a rating of BB+, this would exclude Brazil from several benchmark indices, trigger forced selling and further weaken the sentiment. Brazil can, however, not become the 'Lehman Brothers' of Latin America as financial linkages are rather small.

Yuan – To enter the IMF's Special Drawing Rights basket

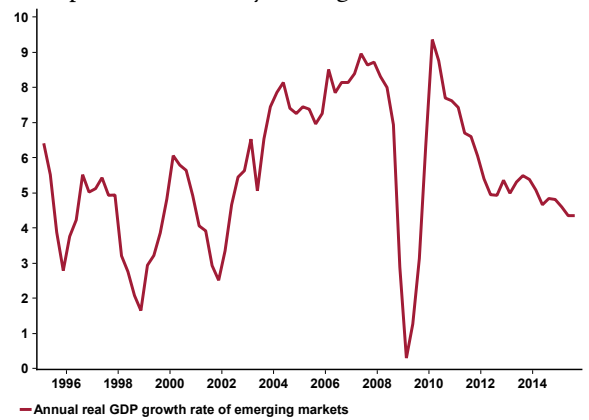
The Yuan will join the club of the big currencies as of October 2016. SDRs are mainly held by central banks. This shifting should however not have a big and immediate impact on the Yuan. China will continue its financial liberalisation, which can induce depreciation pressures. Moreover, the central bank would probably allow depreciation with further Dollar strength. In the longer term, the Yuan should, however, become a more important world currency and hence stronger.

Spreads – Markets calmed since late September, yet the path ahead of us is anything but smooth



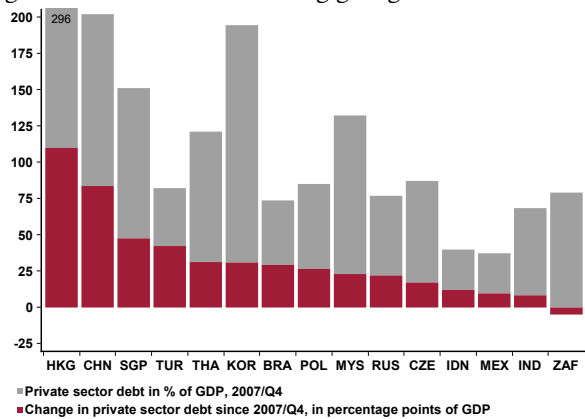
Source: **Macrobond**

Growth – We expect growth in emerging economies to improve moderately during 2016



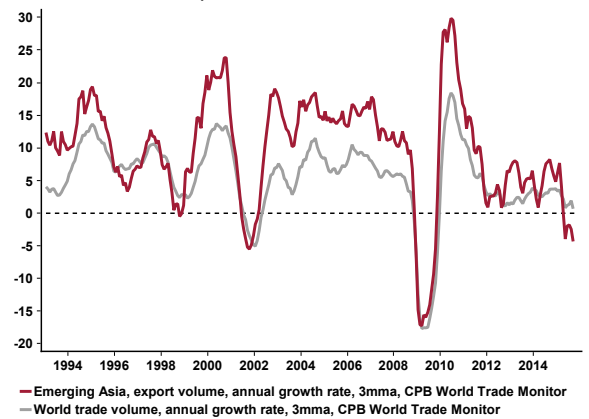
Source: **Macrobond**

Debt – The rapid increase in debt levels since the great recession will be a drag going forward



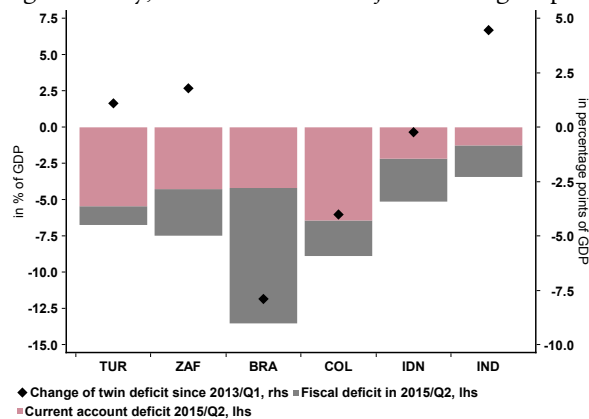
Source: **Macrobond**

Asian exports – Such depressed levels have only occurred in 1998, 2001 and 2009



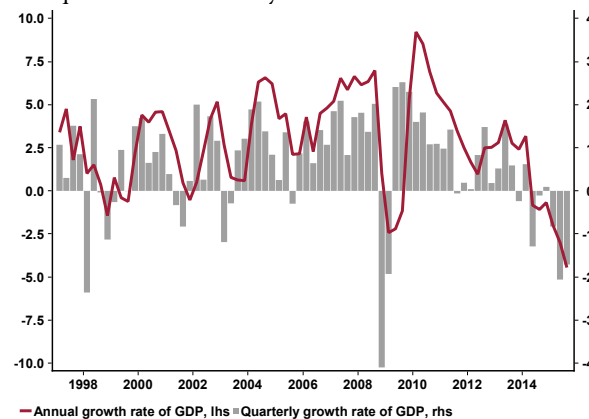
Source: **Macrobond**

Fragile countries – India improved its situation significantly, whereas Colombia joined the group



Source: **Macrobond**

Brazil – Lives through the deepest recession in the last quarter of a century



Source: **Macrobond**

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