Emerging Markets Quarterly – 2017/1

Emerging markets have shown surprisingly small reactions to the election of Donald Trump. Sentiment indicators and the real economy have not suffered markedly. Moreover, the overall impact on financial markets was modest. Currencies, which typically reflect investor sentiment quickly and clearly, have climbed back to the level of early November 2016 after an initial drop. Bonds and equities of emerging markets even showed a positive performance. This is particularly remarkable as US interest rates have risen and the US Dollar has strengthened since the US elections.

Donald Trump – Policy has been moderate

Our assumption that Donald Trump cannot completely change the course of economic, trade and foreign policy of the US as the system of checks and balances is well anchored has been confirmed so far. The immigration ban has for example been suspended by judiciary. There are also signs of a more moderate approach in foreign policy, for example concerning the support for NATO or compliance with the One-China policy. Uncertainties regarding future policy remain high however. For emerging markets two points are crucial: First, the evolution of US-China relations. It is beyond controversy that the tone will get tougher. If, however, negotiations about trade relations take place within the boundaries of WTO rules, there will be no clash of the two global powers. In that case, today's global trade system can persist. Second, the introduction of a so called border adjustment tax would substantially impair export opportunities of emerging countries. Similar to a value added tax, there would be a taxation of US imports but not of US exports. In our base case scenario, we expect more difficult but intact US-Sino relations. In addition, the domestic political hurdles for a border adjustment tax seem to be high. Yet, even if the risk scenario of a strongly protectionist US administration does not materialise, the outlook for emerging markets is clouded. In the US as well as in other regions, economic nationalism is in vogue. This is an obstacle for global trade and thus for the growth potential of emerging economies.

Growth – A very slow recovery

Growth of emerging markets has stabilised. However, the recovery has not yet materialised. As we have anticipated, the dynamics of commodity exporters have improved. Yet, their rebound has stuttered somewhat in the second half of 2016. For Brazil and Russia, the path out of recession is even more difficult than we have expected. The recovery of commodity exporters was not strong enough to compensate for the weakness of some commodity importers, such as India or Turkey. We stick to our forecast of a slow growth recovery in emerging markets due to the stabilisation of commodity prices and the end of recession in Brazil and Russia. While a tougher yet not escalating US trade policy will weigh on growth, it will not prevent the recovery.

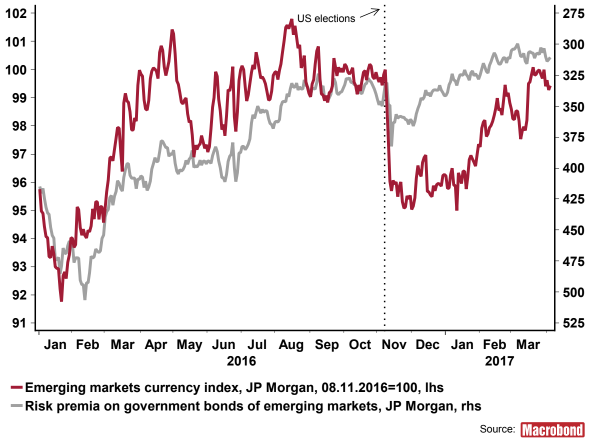
China – Goal of stability in 2017 will be achieved

The dominating theme in China is the party congress taking place in autumn which will bring about a decisive change of leadership. President Xi Jinping has ensured for quite a while that the economic environment will be stable until the congress. Due to the ample fiscal and monetary support measures as well as the stimulation of the real estate sector, growth has stabilised in mid-2016. In the beginning of 2017, the economy could even accelerate somewhat. We expect a slowdown in the second half of the year at the latest. Currently, the main goal of monetary policy is financial stability. Inflation does not take centre stage. The central bank has raised the short-term policy rates and introduced macroprudential measures. Yet, a hike of the effective target rate is unlikely due to the dampening impact on domestic demand. Which risks could nevertheless make 2017 a volatile year? At the top of the list are US policy, capital outflows and credit risks in the shadow banking system.

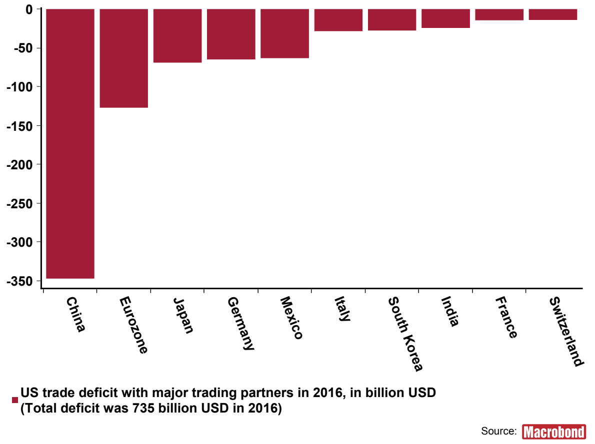
China – What happens after the party congress in autumn?

The government signalled a certain tolerance for lower growth in 2018. The slowdown is inevitable and necessary. We expect a long and painful process rather than an abrupt correction. The reform of state owned enterprises is crucial for a sustainable growth model. However, even after the consolidation of power in autumn 2017, we do not expect meaningful steps. Thus, misallocation and low productivity will remain. In addition, the growing debt mountain and unfavourable demographics will weigh on growth. As long as China has extensive capital controls, the economic system can be maintained. The pressure is mounting, yet, the government still has ample measures at its disposal to support the economy. A considerable opening of the capital account is not possible however. The risk of capital flight is too high. Accordingly, the ambition to internationalise the Yuan seems to be on hold for the time being.

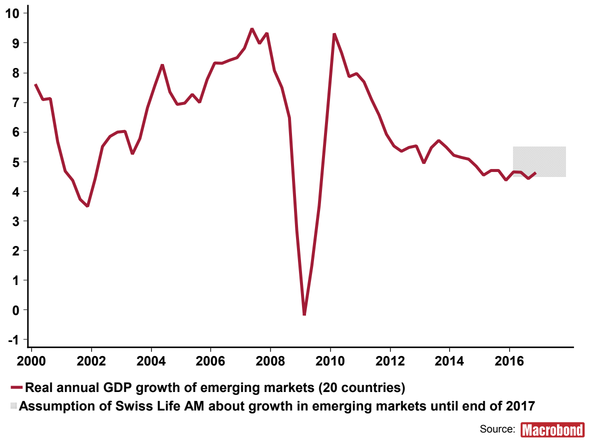
Emerging markets assets – Digested the election of Donald Trump surprisingly fast



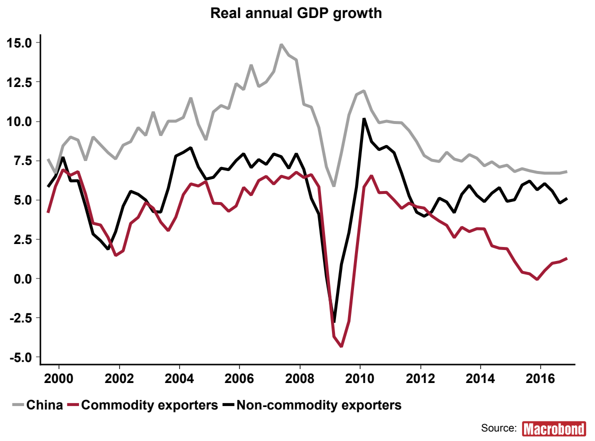
US trade deficit – Half of the deficit is due to China



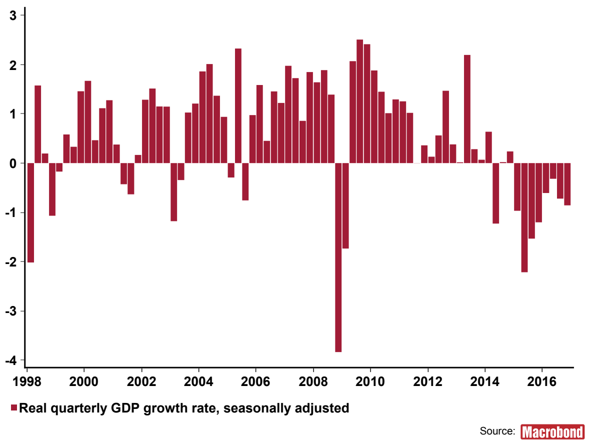
Growth – A very slow recovery



Commodity exporters – Growth recovery stuttered somewhat in late 2016



Brazil – A long and stony path out of recession



China – The government has stabilised growth