Emerging Markets Quarterly – 2017/4

SwissLife
Asset Managers

2017 was a very good year for emerging economies. The healing process after the rough period in 2015 and early 2016 continued. China's economy accelerated slightly. In addition, the global environment was very benign: A weakening Dollar, low US interest rates, slightly rising commodity prices. This led to strong capital inflows into emerging markets. Can this favourable momentum continue in 2018? In our view, GDP growth of emerging markets will remain on a solid level next year. Yet, we do not see much upside potential from current levels. While we expect a favourable external backdrop in 2018 – i.e. a gradual rise of US interest rates, no sharp appreciation of the Dollar and an average oil price of 60 Dollars per barrel – we do not expect it to be as positive as in 2017.

Growth – Limited upside potential for 2018

Growth of emerging markets has climbed higher during the year 2017. The yearly real GDP growth rate was at 4.8% at the end of 2016 and reached 5.4% in the third quarter of 2017. The gradual recovery of commodity exporters was the main driver for this improvement. The strong uptick in the third quarter (from 5.0% to 5.4%) is to some extent a result of the spike of the annual growth rate in Turkey. It is in double-digit territory because of the low base in the third quarter 2016 when the coup attempt acted as a drag. Given the current level of 5.4%, we only see limited upside potential for average annual GDP growth of emerging markets in 2018. Growth should reach a plateau next year. Latin America is the only region for which we expect a growth acceleration in 2018. The Brazilian economy should recover further next year. Chile, Peru and Colombia have room to the upside. In Asia, however, we foresee a slight deceleration. The Chinese economy should gradually slow. This weighs on the activity of other Asian economies. In addition, the impulse of international trade will not be as big in 2018 as it was in 2017. India is the exception: The economy is recovering from the short-term costs of reform implementation. This should continue in 2018. In EMEA, we also expect a slight deceleration of GDP growth. Russia has already reached a growth plateau. Turkey's economy should slow as the impulse of public and private consumption is likely to decline. We expect growth in Eastern Europe to remain solid, yet, to moderate due to private consumption and a lower impulse from the Eurozone.

Politics will be a major factor in 2018

Many elections will take place in 2018. We will watch the ones in Brazil and Mexico particularly closely. Whether or not Brazil can fix its fiscal situation depends on the President who will be elected in October. The crucial task is the passing of a pension reform. Otherwise spending on pensions will rise dramatically. In Mexico, relations to the US and NAFTA renegotiation take centre stage in politics. At the same time, the populist candidate has large support according to the polls for July's presidential election. Moreover, politics remain crucial in South Africa, Turkey and Saudi Arabia. In our view, the risk of a disruption of US-Sino relations has declined, yet cannot be neglected.

China – No big surprises from the party congress

The party congress did not bring about big surprises. Xi Jinping consolidated his power for the second term and paved the way for a decisive influence after 2022. There were three indications for economic policy: First, growth remains a priority for the government. Second, the previous reform path is continued (e.g. reduction of overcapacity) and the pace of reforms remains moderate. Third, over the longer term, the focus will shift from quantity of growth towards quality of growth. The "new era of socialism" under Xi Jinping addresses the needs for a better life (e.g. environment or inequality). In sum, this implies that the imbalances of the Chinese economy are tackled only slowly.

Which countries have the highest risks?

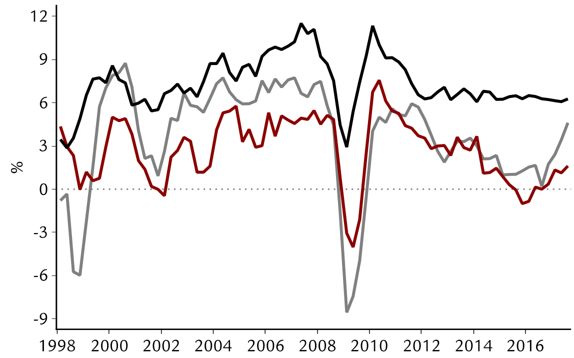
Turkey and South Africa figure among the most vulnerable emerging countries. Turkey has a large current account deficit and a lot of short-term external debt. Inflation is in double-digit territory and consumer credit has risen rapidly. Political risks are numerous and institutions weak. South Africa not only suffers from political risks and a long phase of weak growth but also from a worrying fiscal situation. In our view, government finances are the weak point of emerging markets in general. Over the last few years, many economies have substantially lowered their current account balance and inflation rate. Yet, the fiscal situation remains problematic in many countries, for example in Brazil, South Africa, India and Colombia. Although China, Peru and many countries in the Middle East have low government debt, their fiscal deficit is large.

Growth – Limited upside potential in 2018

—Yearly real GDP growth rate of 20 emerging markets (weights: GDP PPP)
Assumption of SL AM about EM growth in 2017 ■2018

Source: MACROBOND

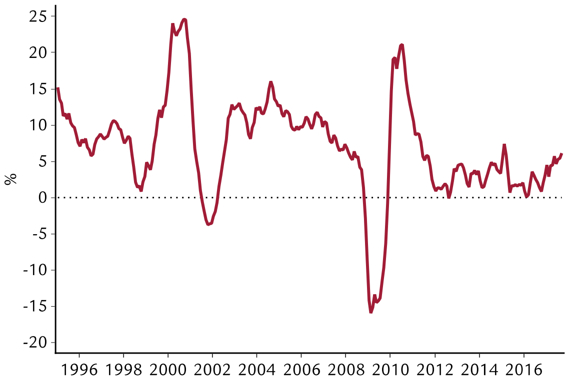
Growth – Latin America is the only region, where we expect an acceleration in 2018



—Yearly real GDP growth rate in Asia (weights: GDP PPP) —Latin America
—EMEA

Source: MACROBOND

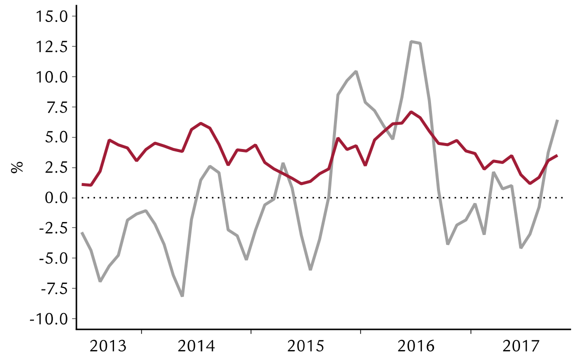
Trade – Rebound of international trade will hardly be repeated in 2018



—Export volume of emerging markets, yearly growth rate, 3mma

Source: MACROBOND

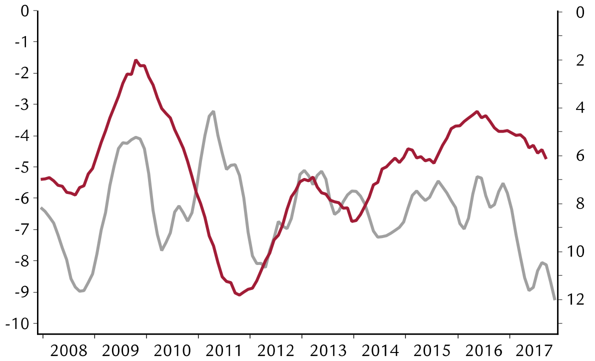
India – The economic recovery has started in the third quarter of 2017



—Industrial production, yearly growth rate, 3mma
—Industrial production, capital goods, yearly growth rate, 3mma

Source: MACROBOND

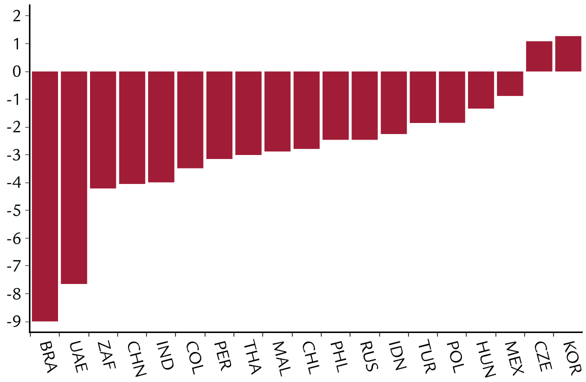
Turkey – Vulnerable to a reversal of capital flows



—Current account balance in % of GDP, 12m trailing sum, lhs
—Inflation rate in %, 3mma, rhs (axis inverted)

Source: MACROBOND

Fiscal situation – The weak point of emerging markets



■Fiscal balance in % of GDP, 12m trailing sum

Source: MACROBOND