EMERGING MARKETS

Seek entry points and search for carry

The essential

After a challenging year for EM assets, we expect the economic and financial environment to improve through 2019, and we see some possible entry points materialising in the second part of the year, when the Fed tightening cycle will be close to an end. Exposure to trade dynamics, low external vulnerabilities and margins of manoeuvre for policy actions will be the key factors to identifying the winners and losers in EM in equity, fixed income and FX. Selection will remain the name of the game when investing in EM in 2019.

EM growth expected to reaccelerate vs DM in H2 2019 and 2020

We expect that the EM-DM growth differential will turn in favour of EM countries in the second half of 2019, due to the likely deceleration in the US economic cycle and the mild reacceleration in the EM universe. As in 2018, the economic performance in **EM will mainly be driven by domestic demand** (household consumption and investments), more than by external demand, barring any major disruption in the US-China trade relationship. On fixed investments we could see some stabilisation/deceleration as a result of the trade tensions (already implemented and planned) impacting business confidence and therefore investment decisions (i.e., in North Asia and Mexico). Domestic projects, such as those related to filling infrastructure gaps — some already started in 2018 — will continue in 2019 (i.e., in Indonesia and the Philippines).

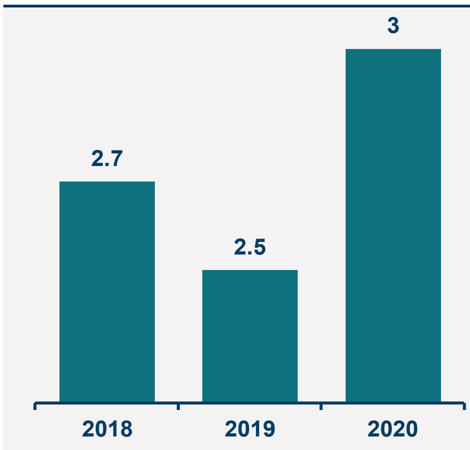
On consumption, we see an overall benign inflation environment and economies running closer to their potential reducing the slack in the labour market, which should sustain household expenditure.

Winners and losers: watch the trade dynamics and China's resilience…

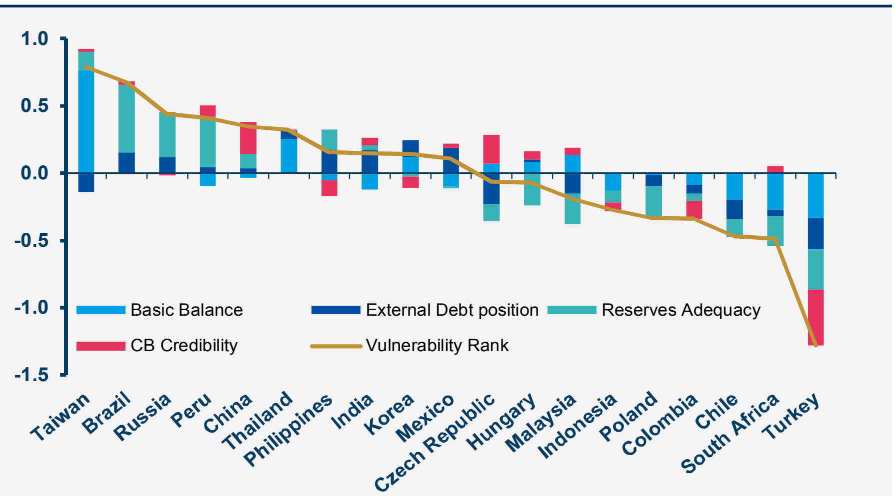
2018 has been a year of change in the globalisation dynamics around the world. Changes towards less multilateralism are ongoing, accelerated by populism and more nationalist governments in many countries. **The future global trade environment is now more uncertain**. On one side, there are still good practices to pursue in trying to keep a sort of global cooperation continuing: World Trade Organization modernisation and enforcement in some areas that today are more relevant than in the past (e.g., services) and new/in-progress effective regional agreements redesigning a more customised multilateralism. On the other side, the urgency among countries to defend their own economic cycles from the recent wave of protectionism and volatility in the FX market, is incentivising unilateral retaliations that could become more disordered in the near future (such as import tariff increases in India and Indonesia). The development in trade-related measures remains highly uncertain; we do believe that a full trade war escalation is possible, but it's not our base case yet, while a strong improvement and pullback on tariffs is, in our view, highly unlikely.

The outlook for China is crucial in the context of trade restriction. With regards to the $250bn tariffs applied by the US on Chinese exports, China's growth is likely to hold up with its policy combo underway: monetary, fiscal, and RMB.

1/ **Real GDP gap EM-DM (%)**



2/ **Amundi EM vulnerability rank**



Source: Amundi Research as of 15 October 2018.

If an additional $267bn is implemented (covering the full amount of China's exports to the US), **China will need to pursue further reserve requirement ratio cuts, and possibly benchmark bank rates cuts**, as well as more aggressive fiscal policy and further RMB depreciation, to partially offset the potential damage. In addition, the negative contagious effects could come from possible shifts in the Chinese supply chain, which is deeply integrated with other countries, mainly in the Asian region. While we expect China to make more effort to climb towards middle- and high-end manufacturing, the shift of low-end and some middle-end towards other EM could speed up. There are already strategic talks in some countries in the region, such as Indonesia, about possible production relocation of sectors like furniture.

...and focus on countries with lower external vulnerability and margins of manoeuvre in policies

Since April 2018, when the USD started a more convincing strengthening path, CBs' focus has clearly shifted from prevailing domestic considerations towards more global/external factors. For 2019, we do expect this trend to continue as long as the perceived hawkishness by the Fed continues. However, deteriorating macroeconomic conditions (mostly externally driven) will soon start to weigh more on CBs' decisions. **We identify the countries where the monetary policy could turn supportive for the economic cycle as the least externally vulnerable** (safer in an environment of tighter US monetary policy), with the inflation outlook more stable within the CBs' target range. On fiscal policy, the different governments should make progress in building up fiscal buffers through sustainable debt trajectories, prudent and credible fiscal targets, higher tax bases, better targeted subsidies policies (if any) and transparent fiscal rules. On this front, we do not believe that Argentina's fiscal target as defined in the revisited IMF plan is credible and affordable; at a certain point, it will need to be renegotiated. These buffers will allow some countries to better navigate the late cycle environment.

EM bonds

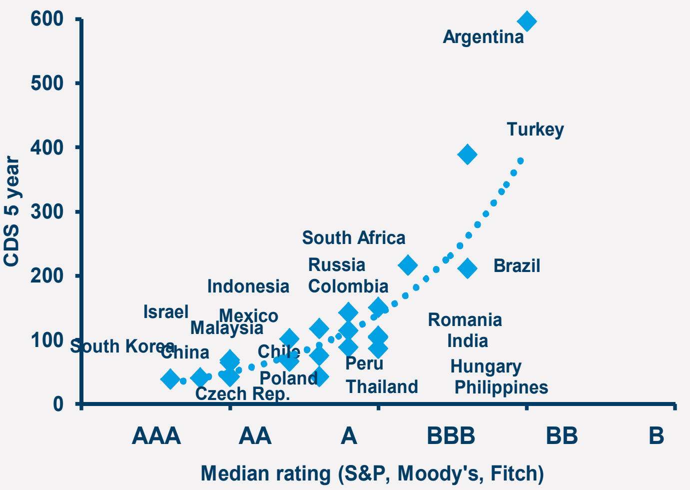
After a challenging year, we believe that conditions will progressively improve throughout 2019. In the first part of the year, we still expect some pressure on the asset class, as the Fed will continue normalising its balance sheet and raising rates, in the context of tighter liquidity momentum, which is less favourable to risky assets. External vulnerabilities have to be strictly monitored during the next few months, because tighter financial conditions can trigger stress not only in the most vulnerable countries, responsible for idiosyncratic risks in 2018, but also at a broader level. **In local currency (LC) debt, we see currency valuations as not particularly attractive for the asset class**, and we expect real rates to increase in 2019, although remaining slightly lower than the post tapering average. For hard currency (HC) debt our target for the EBMI spread for 2019 is close to 400 basis points, slightly higher than current levels. Due to a still challenging outlook for EM FX (see next page) **our preference for the year ahead is still for HC debt**. Moving into the second part of next year, we see more supportive conditions both for HC and LC, when signs of a US economic slowdown will materialise, and we will approach the end of the Fed tightening cycle. In this environment, we believe that EM bonds will be back in focus, thanks also to the **attractive yields offered to investors**. Selection will be extremely important, with a strong focus on debt sustainability, especially in the corporate sector. Finally, it is worth noting that some technical factors could affect the asset class next year. In April, Chinese bonds will be included in the Bloomberg Barclays Global Aggregate Index. Foreigners now own only 2.3% of what is the third largest bond market in the world. Moreover, in 2019 Gulf Cooperation Council (GCC) states will be added to JPM EM USD Sovereign Index. Including GCC

3/ EM fiscal vs monetary policy (MP) capacity

	Fiscal capacity		
MP capacity	LOW	MEDIUM	HIGH
LOW	Poland, Turkey	Mexico, Philippines, South Africa	Chile, Indonesia, Malaysia
MEDIUM	Brazil, Hungary, India		Colombia, Czech Rep., Peru, Russia
HIGH		China, South Korea, Thailand	

Source: Amundi Research, data as of 15 October 2018.

4/ EM CDS levels vs rating



Source: Amundi Research, data as of 15 October 2018.

sovereign debt could prove to be a major boost to the region, perhaps at the expense of high yielding countries. Also in this case, as with China, global investors could see broadening the diversification set as an opportunity.

EM equities

EM equities this year have suffered multiple headwinds in terms of growth, liquidity tightening and higher US rates. **Some headwinds will remain in 2019**: the tight Fed policy in H1, more hawkish EM central banks, the decelerating global economy and ongoing trade issues. Moreover, 2019 is set to be another **busy year for the political agenda in EM** and volatility will likely remain high. Also, the **commodity outlook will likely be another factor to watch**: on one hand, the expected correction in oil prices in 2019 is negative for GEM equity overall, both in terms of price and earnings and a net negative for oil exporters like Russia; on the other, lower oil prices can partially offset the deceleration in global activity for oil importers such as India, the Philippines and Turkey. For the broad GEM market, valuations are neutral/slightly cheap versus cyclical adjusted levels. This means that the recent correction on GEM has been too abrupt and probably, even with a decelerating cycle, **some upside could be justified**. Investors' positioning is also not excessive on GEM and this could set a floor on the downside. In terms of **earnings expectations,** we are more conservative than the market. Deceleration in EPS growth has already characterised 2018. Considering that we see a not brilliant scenario for global demand, EM exports and oil, GEM EPS is set to decelerate further; our internal forecasts for 2019 are low single-digit (+4%) and below IBES consensus (close to +12%). Possible positive surprises could come from an ex-oil commodities rebound (both base metals and agriculture) and from a USD trade-weighted depreciation vs EM FX, which has historically benefited EM EPS.

In terms of styles, we believe that value and, in particular dividend, will also be key factors to watch in 2019. Dividend has been among the top performers YTD in GEM, in the context of increased risk perception. Many EM companies are increasing their pay-out ratio and we think that dividend yield (DY) will remain in favour due to a general repositioning towards a cyclical economic slowdown. DY is very high in Czech Republic, Turkey, Russia and Taiwan but is increasing also in other countries such as Turkey, Indonesia, Philippines and China. Also in India DY is improving but, despite the recent selloff, valuations are still a bit expensive. The other factor that should continue outperforming in the late cycle is **quality,** mainly for companies with a high and stable return on equity (ROE). In terms of forward ROE, we see good numbers for Indonesia, Turkey, Mexico and India, as well as some improvements for Brazil.

All the elements described above (politics, trade disputes, commodities and earnings outlook) will determine the winners and losers in EM equities. **For this asset class some entry points will materialise, possibly in the second part of the year,** but a very selective approach will remain key to navigating the ongoing challenges. Our country preferences for the next year are:

- In **Asia,** China, the Philippines, Indonesia and, partially, India. They show a good combination of supportive fundamentals, valuations and macroeconomic solidity. In the case of Indonesia, external vulnerability has to be closely monitored. India, Indonesia and the Philippines should benefit also from lower oil prices.
- In **Latam,** Brazil and Peru. In Brazil fundamentals improved in terms of valuations, expected profitability and dividends, but some uncertainties surround the reform agenda that will be implemented by the new government.
- In **EMEA**, we are currently positive on Russia, on positive economic conditions and oil prices, but we are more cautious for 2019 due to oil dynamics. Turkey appears quite attractive on the fundamental side but decelerating growth due to the tight monetary policy imposed by FX fragilities will derail GDP growth in the next year. Our base case is for a recession in 2019.

EM FX: drivers and outlook

We are still cautious on EM FX. It will be very important, in our view, to be selective among countries that show EM FX supportive valuations. We continue to prefer the high carry/low volatile FX that are less exposed to external vulnerabilities and with decent valuations (Ruble, Brazilian Real, Mexican Peso, Renminbi, Thai Baht, South Korean Won, Indian Rupee).

USD outlook	We see a marginal appreciation of EM FX vs USD, mainly due to still undervalued MXN and, in our view, to appreciation of the CNY (in case of no trade war escalation). Repatriation of US corporate earnings will continue to put pressure on EM FX.
US yields and EM real rates	Real rates are expected to increase, due to the tightening bias among EM CB. On US rates, we expect that the US 10Y yield will remain flat for the next year, but every sudden movement will be watched by investors and EM CBs seen as a risk for FX.
Trade disputes	In our base case, tensions on trade will remain but will not escalate. However, the situation will not evolve in a linear way and probably these debates will provoke some depreciation on FX in countries worried about domestic growth.
Role of Renminbi	We see an appreciation of CNY to 6.7 as it is taking a growing share of the world's foreign exchange reserves, starting from Asian CBs. This view could be challenged in case of trade escalation: further CNY weakness would hurt the rest of EM FX.

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2019 Outlook Special Issue

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