3 Emerging economies:don't throw the baby out with the bathwater!

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The essential

The markets have sharply revised their forecasts since Trump's election.

At first, this resulted, as with any new source of stress, in a pull-out from emerging economies. However, over the past month, the markets have returned to emerging economies, which we feel is justified.

An asset class offering many opportunities but not always easy to promote

The emerging market universe is still relatively unfamiliar to the public at large and even to most portfolio managers. True, it's not easy to closely cover a universe with so many countries – 21 for the MSCI and 65 for the EMBIG. In the collective unconsciousness, these countries and their assets, because they are not well-known, are always regarded as risky. So these asset classes are still highly neglected and the emerging universe is still underinvested. And yet, this universe offers some great investment opportunities that should not be disregarded.

In particular, the diversity of this universe in both geographical and risk-category terms is instrumental to optimising asset management, as it makes it possible to invest in more than 60 sovereign bonds and more than 500 corporate bonds in dollars, in euros or in local currencies. Moreover, this universe – which is now a liquid and deep market with more than 14 trillion dollars investable, or more than 10% of global debt – should continue to expand as these countries' financial markets develop.

However, over the past few years, these economies have faced a number of economic, financial and political shocks that have not made promoting these assets any easier. The toughest shocks have unoubtedly been Ben Bernanke's 2013 announcement that US monetary policy would move back to normal (the “taper tantrum”), the drop in commodity prices the next year, and doubts on how the Chinese economy would land in 2015.

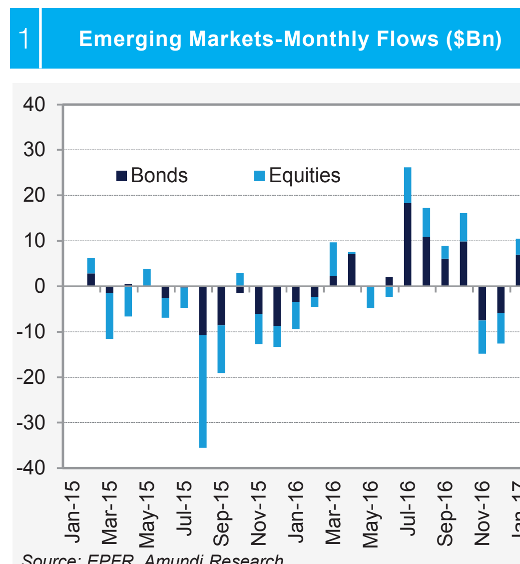
However, not all emerging markets were affected in the same way. Net commodities exporters were no doubt hit hardest, led by Russia and Brazil, which, of course, also had to deal with (geo)political shocks. Meanwhile, despite the various shocks, the various emerging asset classes outperformed their European and US counterparts from 2013 to 2016. Keep in mind also that a distinction is to be made between the performances of financial assets and the countries' macroeconomic situations. For example, while Brazil was mired in a serious recession, its debt was among the best performing during the period.

> “Since spring 2016, the economic environment has become more favourable to emerging economies”

Moreover, since spring 2016, the economic environment had become more favourable to emerging economies. Signs of stabilisation of the Chinese economy, higher commodity prices, and only slight increases in US interest rates have restored some leeway. However, because of Trump's positions on protectionism and free-trade agreements, as well as his virulent language regarding countries such as Mexico and China, his election to the White House once again cast a pall over emerging economies. As the markets also began to price in a greater likelihood for US reflation, inflows into emerging markets shrank somewhat and most of their currencies lost some value. Because of its trade and financial links, the Mexican peso was the first one hit, forcing the central bank to drastically raise its interest rates to anchor inflation expectations even as the Mexican economy slowed compared to 2015.

However, since the start of the month, capital has been flowing back into emerging economies (see chart 1).and almost all currencies have made up the ground they lost after the US election. The current market correction makes sense, as the initial shift did look overdone

1 Emerging Markets-Monthly Flows ($Bn)



Source: EPFR, Amundi Research

Robust fundamentals despite challenging past years.

Although economic profiles diverge from one country to the next, the emerging universe is, on the whole, still very attractive. First of all, after a sharp deceleration in growth in 2015 (4.2%), due to recessions in countries like Brazil and Russia, emerging market growth should rebound in 2017-2018 to about 4.5% at a time

when advanced economies are likely to stagnate (at less than 2%), (see chart 2). Moreover, some Asian countries continue to expand at paces greater than 6% (India, China and the Philippines). On the inflation front, things are also improving (see chart 3). In Asia and emerging Europe, which have been hit hard by deflationary pressures in recent years, reflation is in progress. In Asia, it's no doubt the stabilisation of the Chinese economy and the return of producer prices into positive territory that have caused this increase in prices. In emerging Europe the ageing of the population is squeezing the job market and wage pressures are spilling over into the rest of the economy. In net commodity-exporting countries, hawkish monetary policy has strangled inflation, a trend that is likely to continue with the stabilisation (and even the appreciation in their currency). Russia and Brazil are two remarkable examples. Whereas Russia and Brazil had seen inflation of, respectively, 16% and 10% in 2015, since the end of January 2017 they have been back below 6%. This retreat of inflation and inflationary pressures are giving central banks new leeway. Some of them, like those of Chile and Brazil have already made one or more rate cuts. Looser monetary policy is likely to jump-start growth. As a result, countries like Russia and Brazil, which suffered two consecutive years of steep recessions, are likely to return to positive growth rates – very soon for Russian and by the end of 2017 for Brazil.

Of course, these shocks did have an impact on public deficits in some countries, but, with a few exceptions (Brazil and Saudi Arabia), they remained mostly under control. Meanwhile, public debt ratios are still under 50% of GDP in most countries, which is far from being the case in most advanced economies (see chart 4).. Moreover, with the exception of emerging Europe (Bulgaria, Croatia, Romania and Hungary), the rate of non-performing loans in these countries is comparable to that seen in advanced economies. Emerging debt is therefore of good quality. Regarding external accounts, the situation is also far better than in 2014-2015 (see chart 5).. In Q3 2016, apart from Turkey, the only countries that were still showing heavy current account deficits (i.e., over 3%) were net commodities exporters (South Africa, Peru, Colombia and Venezuela), which have been hit head-on by falling prices. Venezuela is an extreme case, due to its total dependence on oil, and it will take time for it to resorb its deficit, barring a return of oil prices to past levels. In contrast, the current-account deficit of the three other countries is likely to shrink rapidly. On an aggregate level, the emerging universe is seeing current-account surpluses of more than 2% of GDP, while advanced economies are still in deficit.

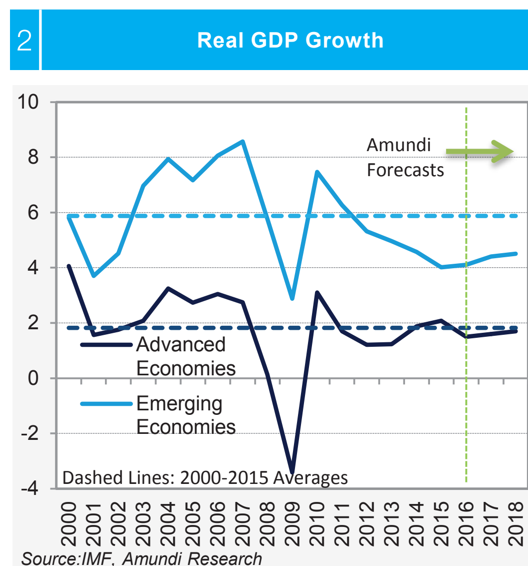
Downside risk unlikely to disappear but it should remain limited

As we pointed out, strength in emerging economies depends on several factors, including commodity prices, the normalisation of US monetary policy, dollar trends and the stabilisation in the Chinese economy. Risks involving these factors look rather low. Economic indicators from China are reassuring. Our baseline scenario sees a stabilisation of the Chinese economy in 2017-2018, something that should drive demand and, hence, commodity prices. Moreover, barring an additional economic and/or geopolitical shock, oil producers are unlikely to question the agreement reached this winter. In the US we don't believe the US will be able to put through all the measures announced, as Congress is not amenable to expanding public deficits. As a result, additional growth is likely to be lacklustre and not show up until 2018. Underlying inflation should therefore remain under control. We see two 25bp rate hikes, which have already been priced in by the markets and are therefore unlikely to have a major impact on emerging economies. Likewise, long US bond yields are unlikely to rise significantly. And, lastly, currency markets will no doubt remain highly volatile, driven by Trump's pronouncements, but the dollar should, on average, level off.

The reason for this is that Trump's coming to power is a new source of uncertainty for emerging economies, but we think the market has overreacted somewhat and that the current correction makes some sense. Obviously, a pull-out from free-trade agreements would be a brake on global growth and some economies could suffer. But, before these agreements are set aside or amended, emerging economies will have a certain amount of time that they will probably use to

Economic fundamentals have improved, including in most countries that have been hit hard in recent years

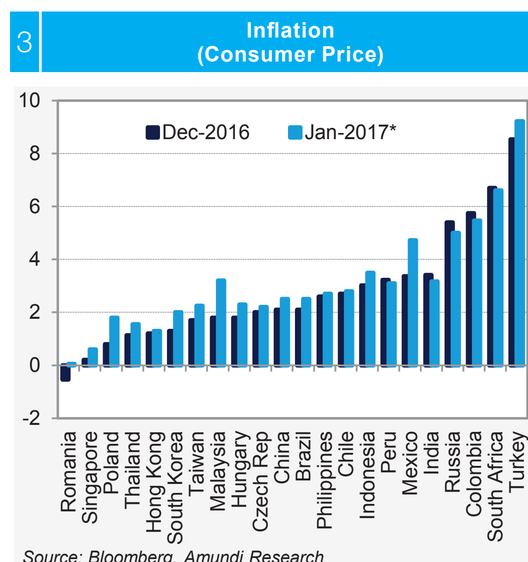
2 **Real GDP Growth**



Source:IMF, Amundi Research

Trump's election is a new source of uncertainty that should not be overstated at this point

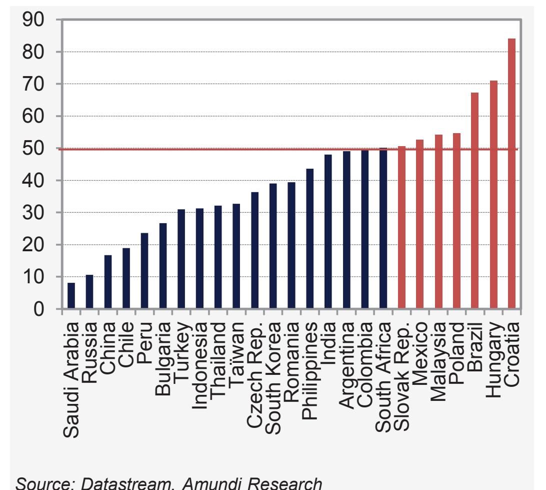
3 **Inflation (Consumer Price)**



Source: Bloomberg, Amundi Research

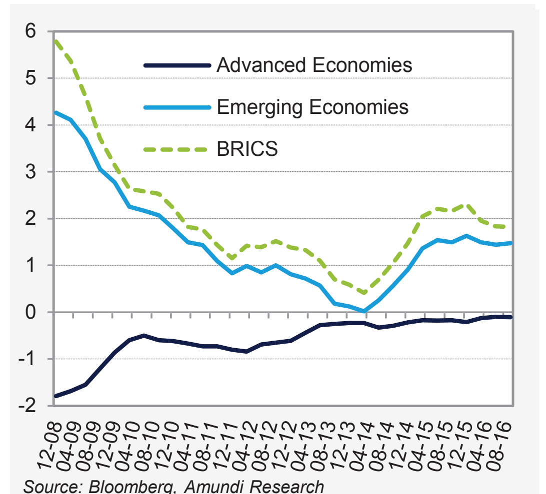
push through new bilateral agreements with other countries. Lastly, Trump's accusations levelled against China, which we felt were the biggest risk, have come in waves, but so far it has been all talk and we still haven't seen any major action taken by the White House. The Chinese, for their part, don't seem to be especially concerned, even though, with just a few months to go until a Communist Party congress, President Xi Jinping has just shuffled his economic and financial team in order to better manage the slowdown in the economy, local government debt, capital outflows and other issues. Between bombastic speeches and pragmatism, the Chinese authorities appear to believe that the new US president will be forced by circumstances to give into reason. Otherwise, the heirs of *The Art of War* will no doubt have their weapons ready when the time comes.

4 **Government Debt (Q3 2016, %GDP)**



Source: Datastream, Amundi Research

5 **Current Account (Q3 2016, % GDP,SA)**



Source: Bloomberg, Amundi Research

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