4 Rally on emerging assets and decrease in commodity prices: a cause for concern?

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Emerging assets are the new favourites, but some market analysts are questioning the merits of this rally

Many market operators and analysts are surprised by the scope of the rally on emerging assets and wondering how long it can last (see chart 1). The question is, are they right or wrong? Economic fundamentals have improved in many countries, including the emerging and developing countries. Trump's protectionist rhetoric is abating, and expectations of US economic reflation and thus of a Fed funds increase are dwindling; this is good news for the emerging economies, and, more generally, for global growth. It is also the scenario we've been advocating for since last November: keeping global growth close to 3% over the next two years. In a low-interest-rate environment in the majority of advanced economies, emerging assets still offer attractive yields, and no reason to abandon such a profitable asset class. The emerging MSCI index, for example, has grown by nearly 15% since the beginning of the year and could continue to rise.

However, the latest price trends on the commodity markets (see chart 2) have stirred up fresh worries among analysts and market participants. The volume of inflows in the emerging economies in the last three months can then raise questions. More precisely, it is fair to question whether these flows are really in line with the improvement in economic fundamentals seen in these countries, and whether there is any risk of a sudden stop to these flows. The question of a potential excess in capital flows toward the emerging markets makes sense, since there may be a divergence between capital flows and economic fundamentals, but it never lasts very long. Let's not forget that these countries, though more resilient today than they were a few years ago, would be sensitive to a new sudden stop, because many have already been affected by i) the drop in commodity prices from 2014 to 2015 and ii) idiosyncratic shocks, generally of a political nature.

Pursuit of China's current monetary policy could drag down global demand and commodity prices

Recent measures taken by the PBoC (raising key interest rates, reserve requirement ratios) and the banking regulator are clearly aimed at limiting (if not diminishing) credit expansion (formal and informal) and the rise in real estate prices, which could spell the start of a crisis. On the face of it, this policy position is reasonable, insofar as the monetary tightening measures have been approved at a time when the real economy is sending good signals. Certainly, the Chinese authorities will want to profit from this fair weather to pursue this policy. So in the coming months, there could be new episodes of i) decline in Chinese imports and ii) reduction of liquidity, which could bring a new leg of reduced commodity prices or, at the very least, higher volatility on these markets.

Obviously, this scenario is not the best for recovery of the economic fundamentals of the emerging and developing countries, which depend on Chinese demand one way or another. However, not all countries would be affected in the same way: exporters of raw materials would doubtless be most harshly penalised. If we look at their exports as a share of GDP, as well as their commodity exposure (these products as a share of total exports), Russia, China, Peru, and Malaysia would be hardest hit (see Table 1). From this standpoint, Brazil and Mexico look most protected: the first because its economy is less open, and the second because it is more diversified.

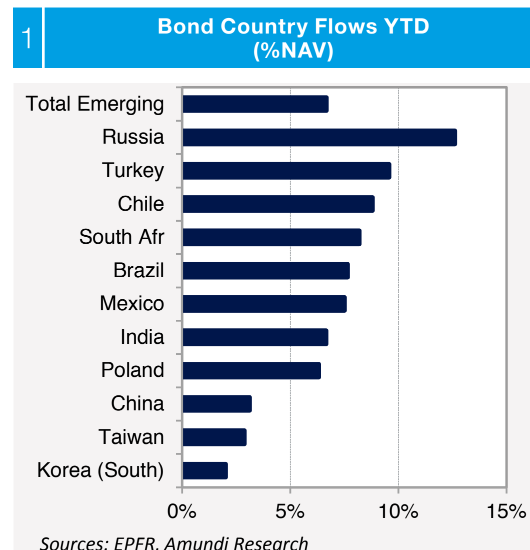
The essential

The latest price trends on the commodity markets have stirred up fresh worries among analysts and market participants.

Many are unsure how far the current rally on emerging assets will reach and how long it will last. However, although there are downside risks, mainly from China, we think it best to keep watch but not sound the alarm at this stage.

Flows are still abundant in the emerging countries, and some analysts are questioning this

1 Bond Country Flows YTD (%NAV)



Sources: EPFR, Amundi Research

The credit slowdown and the tightening of China's monetary policy could drag down global demand and commodity prices

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Sensitiveness to Commodity Prices							
	Exports %GDP	Fuels % Exports	Metals % Exports	Metals % GDP	Métaux % PIB	Fuels&Metals % Exports	Fuels&Metals %GDP
Brazil	18	7	1	11	2	18	3
Chile	30	1	0	54	16	55	16
Colombia	15	68	10	1	0	69	10
Mexico	35	6	2	3	1	9	3
Peru	25	9	2	49	12	57	14
Russia	30	63	19	6	2	69	21
South Africa	30	12	4	24	7	36	11
Indonesia	25	30	8	5	1	35	9
Malaisia	70	16	11	4	3	20	14

Sources: Datastream, Amundi Research

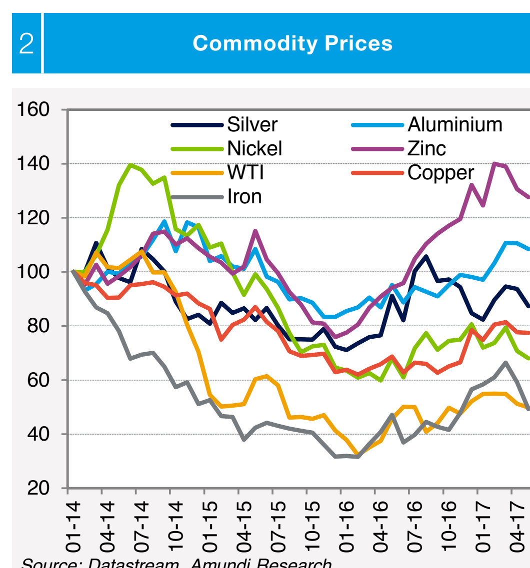
Another drop in commodity prices could compromise the quantitative easing cycle begun in several countries via a exchange rate effect

Trade ties are not the only channels for commodity prices to move through the real economy. Exchange rates play just as large a role. In fact, there is a strong correlation between commodity prices and exchange rates: the higher commodity prices go, the stronger the exporting countries' currencies are. Thus, if commodity prices were to suffer from new sustained downward pressures, these countries' currencies could depreciate once again. This movement would have two irksome direct consequences: i) increasing the cost of debt in foreign currencies and ii) increasing inflationary pressures via pass-through effects. With foreign currency debt ratios at more than 60% of GDP, Chile, Peru, Colombia, and Malaysia would be weakened. In terms of inflationary pressures, the countries where current inflation levels are already high and/or above their target could be forced to slow the pace of current monetary easing. From this viewpoint, Peru, Colombia, and Malaysia, with inflation levels above their targets, appear the most vulnerable. While these countries have recently begun lowering interest rates and the consensus calls for an acceleration of this monetary easing in the months to come, commodity price volatility could play in the opposite direction.

In Russia, inflation has converged toward its target, and inflation expectations seem solidly anchored. The Central Bank of Russia (CBR), which has very conservatively begun lowering its interest rates, could nonetheless do an about-face at the slightest aftershock on oil, given the strong pass-through between foreign exchange and inflation. However, we consider that as long as oil prices do not dip below US$40/barrel (the CBR's working assumption), the risks to the rouble are limited. Indeed, Russia seems to have emerged from the recession: according to preliminary figures, Russian GDP would have increased by 0.5% year-on-year in the first quarter, and its fundamentals (public deficit and debt, current account, etc.) are solid despite the past crisis. In Brazil, the situation is more complex. In fact, although the current deficit has been absorbed, the economic recovery is late, and there are still many economic uncertainties (pension reform must be voted on) as well as current political uncertainties. From this standpoint, the real is more fragile. If the Central Bank of Brazil should put an end to the current easing cycle, the recovery would move even further out of reach. For Mexico, a new leg of lower oil prices would be just as detrimental. Following the American presidential election, the Mexican peso depreciated sharply, bringing with it a rise in inflation, forcing the Banxico to raise its key interest rates. Further pressure on the peso would prolong the current tightening cycle, even as the economy struggles to recover.

> "If commodity prices continued to drop over the long term, countries in a quantitative easing phase could be forced to stop the cycle"

2 Commodity Prices



Source: Datastream, Amundi Research

The downside risks on commodity prices are not at zero, but it seems premature to sound the alarm

There are downside risks on commodity prices, but from our viewpoint they are relatively limited. First of all, the credit slowdown and monetary tightening in China should be moderate. In fact, in this year of political transition, the Chinese authorities will be intent on not putting the country's economic or financial stability in peril. Next, oil producers seem to be in line to reduce both production and inventories. On 15 May, Russia and Saudi Arabia entered into an agreement to reduce their inventories to their average over the last five years, which should promote a renewal of the agreement among OPEC members at the meeting on 25 May. Thus, oil prices should stabilise in the next few months, without posting another substantial upward run, due to the competition from shale. Finally, the decline in commodity prices (ex agriculture) since December 2016 is essentially affecting steel, nickel, and natural gas, with a drop of nearly 15% for the first two, and 8% for the third. The downturn in oil and copper, the commodities to which the aforementioned countries are most exposed, was smaller in scope: respectively 5% and 2%.

At this stage, we consider that there is no cause to sound the alarm, even as vigilance remains key.

Even though the downside risks seem moderate, it's best to stay vigilant

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