For professional investors

In Touch

BNP Paribas Investment Partners' update on Emerging Markets

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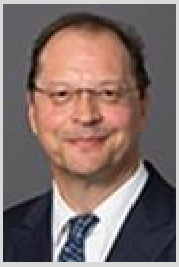
BREXIT DOESN'T MEAN AN EM-EXIT!



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Back in April we explained why we believed emerging market (EM) equities would likely outperform developed markets' (DM) in 2016 and possibly beyond (Will the Monkey smile on emerging markets in 2016? - EM Insights 24/04/2016). In advancing this case, we implicitly assumed that the UK would vote to stay in the European Union (EU). However the opposite has happened. Now that the Brexit dust has settled, we wanted to check whether the UK's decision to leave the EU changes our call for EM to further outperform DM.

To be to the point, we don't see Brexit as changing our call. In our view Brexit reinforces, rather than weakens, the case for EM equities to further outperform their developed markets counterparts. We also believe that the returns of EM bonds will not lag those of developed economies for much longer.

Let's rapidly review the rationale behind these views, bearing in mind that in the period between the Brexit vote and 17 July, EM equities significantly outperformed their DM peers, while local currency sovereign bonds posted close to double-digit positive returns. Most interestingly, EM currencies as a whole were roughly flat against the US dollar according to the MSCI Emerging Market Currency Index (which equates the weight of each currency to the corresponding country weight in the MSCI Emerging Market index).

Table 1

	Total Exports (%GDP)	Exports to… (%GDP)					
		US	EU	Eurozone	UK	China	Japan
Brazil	10.8	1.4	1.9	1.6	0.2	2.0	0.3
Chile	25.9	3.4	3.4	2.8	0.3	6.8	2.2
China	20.8	3.7	3.2	2.3	0.5	-	1.2
Colombia	12.2	3.3	2.0	1.8	0.2	0.6	0.2
Czech Rep.	87.1	2.1	72.6	56.4	4.6	1.0	0.5
Hungary	81.7	2.3	66.5	48.5	3.3	1.2	0.5
India	12.7	1.9	2.1	1.5	0.4	0.5	0.2
Indonesia	17.5	1.9	1.7	1.4	0.2	1.8	2.1
Malaysia	67.5	6.4	6.8	5.5	0.8	8.8	6.4
Mexico	33.3	27.0	1.6	1.3	0.2	0.4	0.3
Peru	17.3	2.6	2.8	2.3	0.2	3.8	0.6
Philippines	20.1	3.0	2.5	2.1	0.2	2.2	4.2
Poland	41.7	0.9	33.1	23.5	2.8	0.4	0.1
Russia	25.9	0.7	12.5	10.1	0.6	2.2	1.1
South Africa	28.4	2.1	5.7	4.3	1.2	3.2	1.3
South Korea	38.3	5.1	3.5	2.3	0.6	10.0	1.9
Taiwan	49.0	6.8	4.7	3.3	0.8	15.1	3.9
Thailand	53.4	6.0	5.4	3.8	1.0	5.9	5.0
Turkey	19.6	0.9	8.7	5.8	1.4	0.3	0.0

Source: IMF Direction of Trade Statistics (DOTS), IMF WEO, Ministry of Finance (Taiwan), 31/12/2015

Firstly, the trade exposure in goods and services of most emerging economies to the UK and the European Union (EU) is relatively small, except for Eastern Europe and to a far lesser extent Turkey and Russia. EM trade with the US and China is often as significant as it is with the EU (table 1). However, intra-regional trade takes by far the biggest share of GDP, as it represents roughly 40% of total emerging markets exports. Brexit will no doubt weigh on global growth; especially on economic activity in the UK and EU. However, given the relatively modest trade links described above, the impact on emerging economies as a whole should remain limited. We see this as particularly important in an environment where global GDP growth is not expected to collapse, thanks to a resilient US economy and an improvement in activity in many emerging countries, notably Brazil and Russia.

Furthermore, the increased risk to global growth will likely lead to a postponement of policy tightening in the US and to additional monetary easing and fiscal support almost everywhere else in the world. Particularly, as the Chinese economy is again showing signs of weakness.

This brings us to the second argument, namely global liquidity, which in this environment of higher growth uncertainty should, we believe, remain abundant. Global capital will once more be forced to search for better value or higher yields. Emerging markets should benefit. In fact EM equities as a whole are still trading at a significant discount to their developed peers. EM sovereign debt risk premia in nominal and real terms remain far higher than those of developed markets, where more than one third of debt securities, representing round 9 trillion US dollars, trade with negative yields (according to Bloomberg's global developed sovereign bond Index). In short, positive yields and growth are becoming increasingly difficult to find in developed markets. Meanwhile, it might make more sense to invest in EM from a risk-adjusted point of view. In fact, for the first time in many years, it appears that uncertainty around economic activity and consequently financial markets is focused more on DM than EM.

Thirdly, we believe that funding costs will not meaningfully tighten from here for EM, and may even recede in some emerging economies. Thanks to abundant global liquidity, both global and local rates are softening. Against this backdrop we do not anticipate that the main funding currencies will strengthen meaningfully against EM-FX in the medium term. Downward revisions to rate hike expectations in the US and soft, if not softer, monetary policy in Europe and Japan against the backdrop of weakening growth do not suggest to us that there's scope for the US dollar to rally strongly.

Table 2

	International Investment Positions - Liabilities				
	Direct Investment (%IIP-Liabilities)	Portfolio Investment (%IIP-Liabilities)	Other Investment (%IIP - Liabilities)	Financial Derivatives (%IIP - Liabilities)	IIP - Liabilities (IIP - Assets)
Brazil	50.5	29.5	19.0	1.0	1.6
Chile	63.8	20.1	14.2	1.9	1.1
China	61.5	17.5	20.9	0.1	0.7
Colombia	54.0	25.9	20.1	0.1	1.9
Czech Rep.	56.5	20.6	21.5	1.4	1.3
Hungary	72.2	14.7	12.5	0.6	1.3
India*	29.6	25.2	45.3	0.0	1.7
Indonesia*	39.5	34.8	25.7	0.0	2.9
Malaysia*	36.0	42.2	21.1	0.7	1.0
Mexico	37.1	47.4	15.5	0.0	1.7
Peru	51.2	24.7	24.0	0.0	1.6
Philippines	32.2	39.5	28.2	0.1	1.2
Poland	43.1	29.7	25.9	1.3	2.2
Russia	41.2	16.9	40.8	1.1	0.7
South Africa	35.0	47.1	14.3	3.5	0.9
South Korea	18.6	58.7	18.7	4.0	0.8
Taiwan	11.5	47.1	39.7	1.8	0.4
Thailand	49.1	27.7	22.4	0.8	1.1
Turkey	24.7	25.1	50.2	0.0	2.7

** Data as of end of 2014 rather than end of 2015.*
*** Financial Derivatives (Other Than Reserves) & Employees Stock Options (%IIP - Liabilities)*

Source: IMF Financial Statistics (IFS), CBC (Taiwan), 31/12/2015

In terms of country selection, it is of course advisable to hold countries in an EM portfolio that are less vulnerable to an increase in global yields or a strengthening of funding currencies in a longer term perspective. These are those countries, which are net creditors to the rest of the world or those that are financed mostly by direct investment rather than "hot money", i.e. portfolio investments (table 2). But these countries are generally the least attractive in terms of carry or valuation. As long as global liquidity remains plentiful, i.e. risk perception contained, less solid emerging countries from a macroeconomic and balance sheet point of view offer even better opportunities over the medium term.

Fourthly, as hinted at above, the bias for the growth differential between EM and DM to widen further has strengthened, which argues in favour of EM financial assets. In fact, negative revisions in GDP growth are centred mainly on the UK and the European Union and to a lesser extent Japan and the US.

In EM economies, notably Eastern European countries, growth is likely to be revised down too, but the weight of these countries in EM GDP is rather small. The risk to growth in China is negatively biased too, but it looks rather unlikely that consensus growth forecasts, 6.5% this year and 6.2% next, will be revised down, in the context of still unbalanced, but nonetheless resilient, growth in China.

We do not expect global growth to weaken significantly from here as a consequence of Brexit, since in addition to softer and sometimes very soft monetary policy, fiscal support will come to the rescue. This seems to be notably the case for the UK, but also Japan, South-Korea, Turkey, following the failed coup-attempt, and China; which is likely to be moving forward again and has capital account related constraints on classical monetary policy tools.

Finally, if, as we assume, global growth and the USD stabilise roughly at current levels, then the risk of a sudden fall in commodities, notably crude oil, looks relatively remote. As oil inventories are still increasing, there is no apparent reason to believe in a strong oil rally yet. But with demand and supply for oil balancing out over the next couple of quarters (according to the International Energy Agency

(IEA) and the consensus), there are grounds for believing that the rise in oil prices closer to their supposed fair value of around 60 US dollar a barrel for Brent, will resume.

In conclusion, we believe that the call we made last April in favour of EM outperforming DM is still valid after Brexit. Within the asset class we would tend to avoid investment in Eastern European countries, excluding Russia, where we see good opportunities in both equity and fixed income. In the medium term, Latam, especially high-yielding Brazil, offers excellent opportunities in fixed income and to a lesser extent equities. Admittedly this comes at a higher risk than a more defensive Asia, where we would prefer to invest on a longer time horizon.

It goes without saying that there are many risks to the views expressed here. Risks related to external debt and its funding for instance cannot be ignored, despite higher international reserve cushions and more flexible financial markets in most EM. Also, political instability in key emerging economies could boost the US dollar via its “safe-haven” status. This would in turn likely lead to a chain of EM adverse, mainly risk-aversion driven reactions, particularly impacting the externally most fragile EM economies and commodity exporters. The very recent events in Turkey show that such a scenario can materialise quickly and unexpectedly. It may well be that as the situation in Turkey was rapidly brought back under state control that the reaction of risk-assets in other EM markets was relatively limited.

This limited reaction may also be due to the fact that firewalls and regulations in EM financial markets have been strengthened over the past years and, in our opinion, to an increasingly differentiated approach to various emerging economies among investors.