

In Touch

BNP Paribas Investment Partners' update on Emerging Markets

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WILL THE MONKEY SMILE ON EM IN 2016?

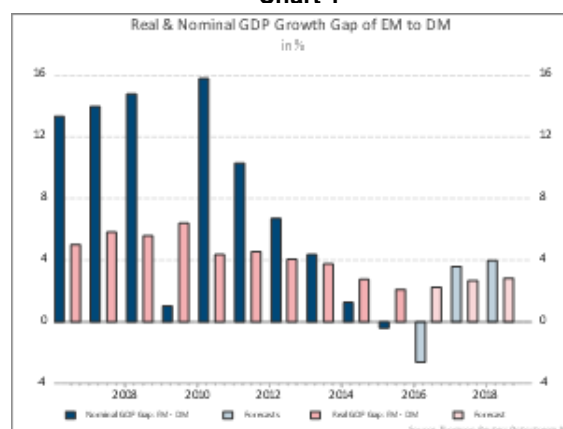
The International Monetary Fund (IMF) released its long-awaited spring report on 12 April, which as always provided a lot of usual information and insights. Its rather gloomy title, "Too slow for too long", gives a good idea of its content. The IMF has slashed its world GDP growth forecasts to 3.2% in 2016 and 3.5% in 2017. Furthermore it has warned of increasing downside risks and strongly recommends policymakers to support accommodative monetary policies with expansionary fiscal policies and supply-side reforms. Interestingly, the IMF also further trimmed its inflation forecasts for developed economies, while raising them slightly for emerging economies. Admittedly, since the IMF updates its forecasts just three times a year, it is often criticised for lagging the market. And indeed, the IMF has been slightly too positive on global growth in the past few years. But then so have private economists, although they can adapt their forecasts faster to changing data. Nonetheless, the IMF report supports the idea that emerging market equities could outperform their developed market peers this year. So let us look more closely at this notion.



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First, the IMF projects real and nominal GDP growth to pick up faster in emerging economies than in developed ones from late 2016 onwards. The growth differential between the two zones, which narrowed from slightly more than 6% in 2009 to roughly 2% last year, was one of the main factors that caused emerging market equities to underperform their developed peers. A widening growth gap, though modest, should thus support the former versus the latter (chart 1).

Chart 1



Second, rather moderate growth and subdued inflation in developed markets give substance to the view that monetary policies in developed economies will remain very accommodating. In the US, the IMF sees annual inflation growing by just 1.5% on average by 2017 from a meagre 0.8% in 2016. In Japan and the European Union it projects yearly inflation to grind higher very slowly to slightly more than 1% in 2017, thus remaining well below the respective central banks' targets. The message here is that there is no strong rationale for a noticeable increase in developed market yields or the US dollar, i.e. funding costs for emerging markets are not likely to deteriorate much from their current levels, if at all. This is all the more likely as global liquidity should remain plentiful, making the search for yield crucial now that yields for core sovereigns are negative or close to zero, while having moved to appealing levels in many of

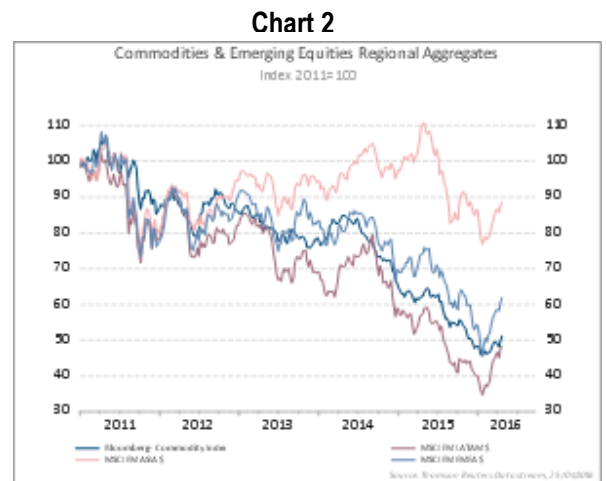


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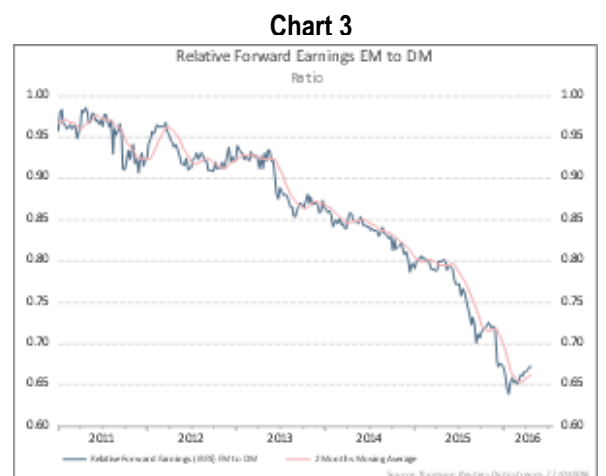
the emerging markets. Argentina is a good example of this unabated thirst for yield. The country's first sovereign USD 16.5 billion issuance in more than a decade in mid-April was the largest emerging market debt sale on record, and was four times oversubscribed!

Third, commodity prices in general, and particularly those of crude oil, may well have seen their lows. This is not to say that prices will rise in a straight line. Against a background of overcapacity and substantial inventories, any fundamentally justified increase in commodity prices will likely be slow and volatile. In many sectors, notably crude oil, experts are gradually becoming more positive, though. The International Energy Agency (IEA), for instance, believes the oil market could balance out in the second half of 2016, with global demand increasing while global supply softens as US output is increasingly cut (IEA Oil Market Report, 14 April 2016). Moreover, according to the latest Bloomberg consensus forecasts, base metals and agricultural prices are projected to bottom in the second half of 2016. Here too, though, the move upward will be subject to high volatility and be very gradual since, in general, inventories and overcapacities remain plentiful. Despite the fact that the share of commodities in emerging stock markets is now around 11%, compared to just over 30% a few years ago, even a modest positive momentum on commodities would in our view provide strong support for the asset class in general, and for commodity exporters in particular (chart 2).



Fourth, the idea that China could experience a hard landing this year or next is not in our view a worry for financial markets any more, at least not for the foreseeable future. In fact, economists and the IMF have even revised their Chinese economic forecasts to the upside. The IMF now believes that China will grow by 6.5% in 2016 and by 6.2% in 2017 - 0.2 percentage points more than in their January forecasts. These upward growth revisions come as no great surprise. The details of the 13th five-year plan revealed that China will prioritise growth over reforms for the coming period, with the target of expanding the real economy by at least 6.5% each year until 2020. As the massive credit expansion, the significant fiscal boost and the softer monetary policy prove, Beijing is prioritising meeting whatever the cost for future growth; a policy whose effects are starting to show up in activity data. There is no doubt that China will have to address the question of unsustainable debt leverage at some stage, with funding tensions in the corporate sector already starting to materialise. But in the absence of any exogenous shock, China still has enough ammunition to postpone painful deleveraging and difficult reforms until "better times". Against this current backdrop, and with capital accounts still under control, fears of the renminbi depreciating strongly have vanished, too. In short, the China factor is no longer playing adversely on the asset class.

Fifth, looking at earnings growth, one of the main equity drivers, there seem to be tentative signs of emerging market earnings growth momentum turning for the better and moving more in line with that in developed markets (chart 3). We all know that one swallow does not make a summer, but against the backdrop described above, the gradual closing of the profit growth gap between DM and EM looks more likely than at any time in the post global financial crisis years, particularly since monetary and budgetary margins of manoeuvre are on aggregate much bigger in emerging economies than in developed ones.



Finally, we do not believe that valuations alone can drive a market, at least not over a short to mid-term horizon, unless they are at extreme levels. But the fact that emerging markets are still at a notable valuation discount against DM is certainly helpful if the momentum towards the still under-owned asset improves – as, indeed, is currently the case, the momentum triggers being the factors highlighted above. According to Institute of International Finance (IIF) calculations (March 2016 EM Portfolio Flows Tracker and Flows Alert, 29 March 2016), estimated non-resident portfolio flows to EMs surged to a 21-month high of USD 36.8 billion in March, following a USD 5.4 billion inflow in February, with both bonds and equities witnessing sizable inflows. Interestingly, all EM regions attracted inflows in March, with Asia's USD 20.6 billion leading the pack.

Of course, as we have already noted above, there are many risks to the view expressed here. The US dollar, for instance, looks technically oversold. Against the backdrop of an improving dataflow in the US, there is thus a good probability of a short-term rebound of the greenback, which would weigh on commodity prices. More worrying is the very rapid build-up in Chinese private debt, which has almost doubled in the last 10 years and which has accelerated markedly in the last few months. As said above, we do not believe this is going to lead to a hard landing, but it is certainly likely to impair growth once the necessary deleveraging starts. In the meantime, fears of the devaluation of the Chinese yuan could re-emerge. Also, a sudden rise in core yields, notably in the US, would undoubtedly derail the above scenario.

However, the positive point is that most EM governments are aware of these risks and are doing what they can to prevent them. Currency reserves are being built up, external debt is being bought back, NPLs are being acknowledged and tackled, but above all, structural reforms are being seriously pursued and in many emerging markets, actively implemented. This is at least as important for the market direction as the various supportive factors mentioned above.

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