

Emerging Markets Update

Indonesia and India leading the pack

The whole emerging world is benefiting from improved capital flows and easier financial conditions. EM growth has started to pick up, despite the ongoing growth decline in China. Endogenous drivers of growth in EM remain weak. Exceptions are Indonesia and India, where investment in infrastructure is growing fast and where progress is made with fiscal reform and deregulation. We visited Indonesia and India recently. The conclusions from our trip are the main topic of this EM update.

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Relative performance emerging / developed equities

-1Y = 100, US\$, MSCI EM / MSCI World (source: Datastream)



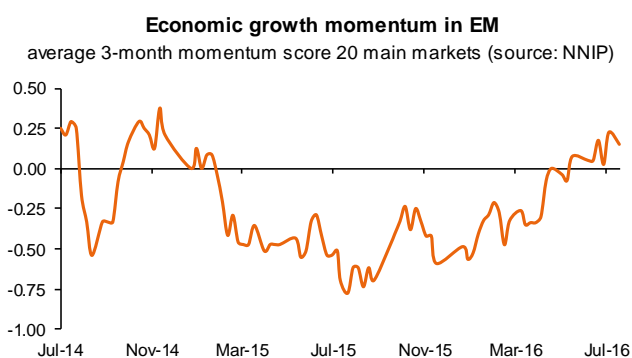
Better positioned to deal with headwinds

Both emerging equities and debt continue to perform well, benefiting from the global search for yield and the tentative improvements in EM fundamentals. On the latter, it remains important to note that the better overall EM capital flow picture and the pick-up in EM growth momentum are to a large extent linked to the benign global liquidity environment of the past quarters. But regardless of the exact explanation, the general state of the emerging world is much better now, compared with the last few years and the beginning of this year.

There is no situation of critical capital outflows that can easily make policy makers panic, EM growth has been picking up somewhat since June and EM exchange rates have adjusted to a more realistic level. This partly explains why EM assets have not been affected by the declining oil price in July, the repricing of Fed rate hikes following better US labour market data, and the recent far-from-convincing Chinese data. In other words, EMs are better positioned now to deal with headwinds, that only a few quarters ago caused serious financial-market turmoil.

Of course, we should also not forget that recent moves by the Bank of England and expectations about the Bo and the ECB have kept investors confident that easy DM monetary policy will continue for longer. In this environment, some adverse data and news flow are considered manageable. At any case, investors are not willing to throw the towel on the EM yield theme yet.

Particularly remarkable is that the sharp decline in the oil price in June and July did not affect emerging bond and equity markets. Oil-sensitive markets such as Russia and Colombia underperformed, but EM as a whole did not suffer. This in contrast with the second half of last year, when the falling oil price created a lot of additional nervousness about the overall EM growth picture and the external and fiscal vulnerabilities of the commodity-exporting economies.



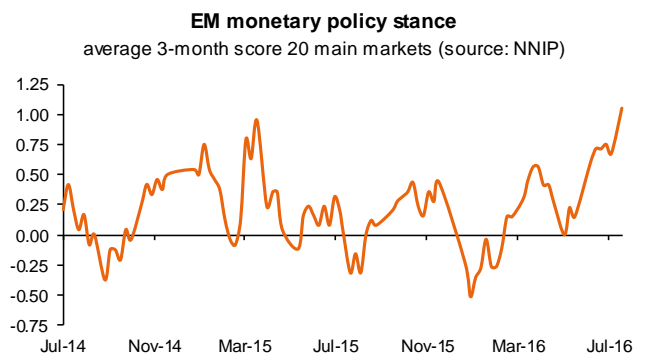
The main explanation of the different market interpretation of the lower oil price lies in the better EM growth picture. Growth momentum is clearly improving throughout the emerging world (see graph above). This makes it easier to believe that oil was declining for supply-side reasons primarily and, thus, that this time a lower oil

price was not evidence of a worsening EM demand problem.

In our base-case scenario, the Fed will hike interest rates in December. A December hike was completely priced out a month ago. Now, the probability is 50% again. The re-pricing of a Fed rate hike this year has not affected emerging bond markets and we feel that a further re-pricing of a December hike should not be a big problem either. This because of the better EM growth backdrop and reduced external financing requirements in most emerging economies. A crucially important condition for a limited market impact of the re-pricing of Fed tightening is that the market continues to believe that the normalisation of US interest rates will remain a very slow process.

At this stage we are more concerned about the recent deterioration of Chinese data. We still think that the Chinese economy is printing reasonable numbers, but doubts about the growth stabilisation have emerged again. Real estate sales growth has probably peaked, while private investment growth continues to struggle. A big positive change compared with last year and the beginning of this year remains the capital flow picture. The authorities have been successful in stabilising flows, which suggests that policy makers are in control again.

We are keeping our view that Chinese growth is in a multi-year slowdown. A sharp deceleration with increasing system pressures was what we feared last year. Recent data still give enough comfort that the current pace of slowdown is manageable. But at the same time, we continue to think that a sharp deterioration in Chinese growth is the single-most important risk to all EM assets. So if we talk about the recent resilience of EM, we feel that the most remarkable has been that investors have shrugged off the disappointing Chinese data.



As long as the global liquidity environment remains benign and inflation in EM continues to decline, authorities in the emerging world will continue to loosen monetary policy. Our monetary-policy-stance indicator has been in positive territory since March and has sharply risen since May (see graph above). It tells us that monetary conditions have eased substantially in recent months. For emerging debt markets this is hugely important. Not only because declining yields push the value of the bonds higher, but also because more easing of financial conditions should help the EM growth recovery to broaden out and strengthen. Particularly for EM equities this is very welcome, after six years of steady growth declines.

Indonesia: helped by flows, for sure, but there is endogenous change as well

When the uncertainty created by the renminbi devaluation last year led to sharp capital outflows from the emerging world, Indonesia was one of the countries that weathered the storm relatively well. Between August and February, there were only three months of outflows and in total a net inflow of USD 4 billion could be recorded. The prudent monetary policy of the preceding years and the reduced fiscal and external imbalances had made the country less vulnerable. This clearly paid off in times of high EM stress.

And now, in times of high risk appetite for EM assets, Indonesia is well positioned to attract portfolio investments. In July alone, USD 9 billion of fresh foreign capital entered the country. Since February, the inflows have amounted to USD 21 billion, which is the highest number of all emerging economies with the exception of Turkey. The strong inflows have enabled the central bank to lower interest rates (by a full percentage point, to 6.5%) and have played an important role in the modest pick-up in credit growth. This is now helping consumer demand growth, which has been sluggish for years, to recover. Retail sales growth has risen by 5 percentage points in recent months.

So the global environment has helped Indonesia to ease its financial conditions, which is now leading to some improvements in consumer demand growth. This and the stronger rupiah (+11% since the low in September) are helping companies to increase their margins. The banks are seeing this reflected in their non-performing loan portfolios, which have been showing some tentative signs of improvement recently. Declining NPLs should create more room for future credit growth. The current pace of credit growth is 9%, slightly above nominal GDP growth.

But it has not only been the global search for yield and the strong capital inflows that have led to improvements in economic data. At least as important has been the strong execution in public infrastructure investment by the Jokowi administration. An ambitious infrastructure investment agenda, better coordination between Indonesia's ministries and increasing direct investment by foreign companies explain why infrastructure investment growth was able to reach 35% in the first half of the year. Projects include toll roads, seaports, railways, bridges, power plants, LNG plants and the prestigious Jakarta metro. The need of much more new infrastructure after decades of underinvestment, the large pipeline of viable projects and the growing interest of foreign contractors suggest that investment growth in the sector will remain high for years.

Solid infrastructure investment growth not only helps to bring overall

economic growth to a higher level than the current 5%. It also helps improving the country's weak competitiveness. In the end, a structurally higher export growth is required for higher economic growth without widening macro imbalances. Until recently, a painful lack of infrastructure improvements was the main obstacle. Here we are now seeing encouraging change. Apart from this, the government has also made some progress cutting red tape and with deregulation in general. It has become easier to start a new business and to organise paperwork, for both companies and private citizens, thanks to more use of online applications. In Jakarta – this is just one small example – it takes only 15 minutes these days to renew a driving license.

The Jokowi government's focus on governance and creating the conditions for higher growth is also becoming increasingly visible in a more pragmatic trade policy. The trend of the past decade of having a more assertive nationalist agenda in international relations and in trade issues specifically seems to have broken. We heard several economists and political analysts mentioning that one of the biggest changes of the past years, since Jokowi came to power, has been the increased pragmatism in the area of foreign trade. There is more room for foreign direct investment in an increasing amount of sectors. Infrastructure is a good example, but also manufacturing, tourism and even mining. Another good example of a more pragmatic approach in foreign trade is the reduced protectionism in agriculture. More room has been given for food imports in order to bring down food price inflation.

Of course, much remains to be done. Despite a more coherent strategy to achieve competitiveness gains, Indonesia continues to lag most of its regional peers. Labour and judicial reforms are urgently needed, but no progress is visible here. Foreign direct investment has been strong in recent years (some USD 30 billion on an annual basis), but this has been concentrated in infrastructure and power. Foreign interest in the labour-intensive manufacturing sector remains low. It remains to be seen whether this will change much in the coming years, given the bleak global trade picture and the success of other countries in the region, such as Vietnam and Cambodia, in attracting foreign investment in manufacturing.

But for now, the momentum found in infrastructure investment and the less protectionist, more pragmatic approach in foreign trade policy give hope for the future. Less red tape and less infrastructure bottlenecks should help the country to become more competitive and to increase potential growth. At any case, as Indonesia continues to speed up its efforts to close its large infrastructure deficit, the economy as a whole should benefit. It will remain crucial that the investment climate improves as well, because private investment needs to pay most of the bill. Some more room for public investments have been created by subsidy rationalisation, but tax collection remains insufficient to sustain a more ambitious public infrastructure investment agenda.

In this context, it is encouraging that President Jokowi was able to convince the former Finance Minister Sri Mulyani to come back from the World Bank to lead the Finance Ministry again. From her we can expect more progress in the important field of tax reform. She will have to increase tax revenues, which currently represent only 12% of GDP, and control spending below the 3% deficit ceiling. She also will have to manage the tax amnesty programme, which started in July

and has created very high expectations. In our view, expectations are too high, maybe not about the projected proceeds for the budget of around USD 12 billion, but about the increase of the tax base. The tax amnesty involves the declaration of assets, not income, which makes it difficult for the authorities to increase future tax revenues on the basis of the money that might be repatriated now.

So short-term gains can be expected, for the budget, but particularly for the balance of payments. But longer-lasting positive effects are doubtful. This underlines once again the importance of meaningful tax reform to increase tax collection. At this stage it is not clear yet what plans the new Finance Minister exactly has.

For now, the relevance of the tax amnesty programme for investors primarily lies in the expected inflows seriously reducing depreciation risks for the rupiah. At this stage, capital flows to the emerging world are strong, but this can easily change again. In a scenario of investor risk appetite for EM assets drying up, portfolio flows to Indonesia would suffer as well. But the repatriation of capital in the context of the tax amnesty programme would not be affected. This makes the rupiah in the coming quarters less risky than other high-yielding EM currencies.

So good prospects for capital inflows, thanks to both the global search for yield and the tax amnesty, should sustain the easier financial conditions and reduce the depreciation risk of the rupiah. In this environment, business and consumer confidence should be able to recover and help the positive growth momentum to broaden out. The work done by the government to achieve a high level of infrastructure investment growth and the recent progress made with creating a more business-friendly investment climate are additional positives that should help to push overall economic growth higher.

The 7% GDP growth target of the Jokowi government still looks too ambitious, but 6% is within reach. In the current context of emerging markets, where growth is still scarce and where recent improvements are primarily the result of a favourable global liquidity environment, Indonesia looks relatively attractive, not only because of its high structural growth rate, but also because growth is benefiting from more effective governance and reforms.

India: waiting for the pick-up in private investment growth

The main advantages of Indonesia are also present in India: high structural growth, a government that has found its way in getting things done, strong infrastructure investment growth and evidence of reforms. Again, this combination is scarce in the emerging world these days. The problem only in India compared with Indonesia is that investors probably still have too high expectations for growth and reforms.

From our meetings in Mumbai and Delhi we got confirmation that the government is doing a good job in infrastructure investment and that progress has been made in the repair of banks' balance sheets. We also see the potential benefits of the new goods and sales tax. But we remain sceptical about the implementation of this big reform and we still see only limited evidence of the long-awaited pick-up in private investment growth. All in all, India remains a good long-term investment story. But we struggle to see additional positives materialising in the short to medium term. India benefits from the global search for yield and the strong investor risk appetite for EM assets, but not as much as other countries with a more liquid bond market. So India - as always - will have to rely more on endogenous drivers to see its growth moving higher.

The big positive of the past period has been the strong public investment growth in infrastructure. The Modi government has been successful in the execution of existing investment plans and is now also moving forward in lining up new viable projects. Particularly road construction is going well, with 15 thousand kilometres of new roads likely to be built this year, which would be more than double the amount of last year. At the base of this success lies the better coordination between relevant ministries and the more decisive management at the most senior level. And although private involvement in the investment in infrastructure remains rather low – which is where India clearly differs from Indonesia now – there have been signs of improvement here as well. Japanese contractors are involved in some of the bigger projects and their tight control of the operational organisation has minimised construction delays.

A good example of the more pragmatic and decisive approach of the Modi government towards infrastructure is the railway ministry. External specialists were brought in to improve efficiency and to make the ministry more adaptive to market forces. We met one of the people leading this process and were impressed by the positive change compared with the last time we visited the ministry, three years ago. One of the things that have become normal now is that freight rates are being adjusted frequently in response to changes in demand and supply. This has helped the railways to improve capacity utilisation.

The disappointing link in the Indian economy remains private investment. So far, the infrastructure improvements, the good monsoons this year, the lower level of interest rates and the solid household consumption growth have not led to a meaningful pick-up in private investment growth. The main explanations are the large excess capacity in Indian industry, specific problems in the steel and power sectors, the low commodity prices which have made existing investment projects in the commodity sectors not viable anymore, and the tight lending standards in the banking system.

Recent improvements in business confidence are encouraging and suggest that private investment growth will start recovering in the coming months. The main risk to this positive scenario lies with the banking system. The central bank continues to put pressure on the Indian banks to deal with existing non-performing loans (some 14% for the system as a whole) and to repair their balance sheets. This has helped to reduce system risks but it is keeping banks conservative. 70% of the banking system is still state-owned. Here the asset quality is particularly bad. As long as the bank clean-up process continues, there is limited room for an acceleration in credit growth. Current

credit growth is 9%, substantially below the 13% nominal GDP growth.

We were in Delhi on the day that the new national goods and sales tax (GST) was approved in the Upper House. Excitement was high among all policy makers we met that day. This is fully understandable given the potential benefits for the fiscal accounts, corporate profitability and economic growth, and particularly given the long time Indian politicians have been struggling to get this law approved. When we started covering the Indian market, in 1998, the GST project was already underway, and – we remember it very well – a heated topic of discussions.

The new national tax, when implemented, will make a big difference. Companies no longer will have to keep warehouses and other physical presence in all 29 states for tax reasons, and no longer taxes will have to be paid at every state border. Tax accounting will become cleaner and tax compliance should improve. So efficiency gains for the corporate sector should be substantial, while revenues for the federal state will be boosted as well. This, eventually, should help both private and public investment growth. Eventually, because the GST is unlikely to be fully implemented before 2018. Lots of details still have to be sorted out between the states and the federal government.

So while the GST is undeniably a long-term positive, it is unlikely to yield results in the coming years. For the Modi government it is a major success, as it fulfills one of its main reform ambitions. Overall, when we look at the government's performance, we think that most progress has been made with execution of government plans. There have not been many new reforms so far. Apart from the GST, the main reform achievement of the government has been the transfer of some economic responsibilities to the states. States now, for instance, are allowed to attract their own foreign direct investment.

Where change has been absent or absolutely insufficient is in education and health. In our view, this is the main reason why only little progress is made in the reduction of inequality in India. We met several people during our trip, both in the public and private sector, who mentioned that education has been neglected by the Modi government.

This, in the long term, will make it difficult to improve the country's competitiveness. So far, despite the high-profile "Make in India" campaign, little has been achieved. Indian export growth is not higher than export growth in most other emerging economies, which means that India's share in global trade is not increasing. This also implies that the reduction of India's current account deficit in the past years from -5% to -1% has been mainly the result of weak investment growth and lower oil prices. The structural external imbalance remains high as long as the competitiveness of the export sector does not improve in a meaningful way.

All in all, Narendra Modi's track record remains good in an emerging markets context. His reform achievements might be mixed and perhaps below expectations. But at least his government has been able to make some progress. When implemented, the GST could become a game changer. And for now, the better execution of government policies is leading to more public infrastructure investment than we have seen in decades. The combination of a

positive reform momentum, meaningful improvements in infrastructure and a high structural level of economic growth somewhere between 6% and 8% continues to be an attractive one. Risks lie with the immediate growth prospects – can private investment pick up with banks maintaining their tight lending standards?

M.J. Bakkum
Multi-asset team

**Maarten-Jan Bakkum**

Senior Emerging Markets Strategist

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