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WHAT'S REALLY HAPPENING IN EMERGING MARKETS?

#07

For professional investors

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Head of Strategy Emerging Markets
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(Chief Editor)

Welcome to the latest edition of the Quarterly What's Really Happening in Emerging Markets?

Using our unrivalled network of local teams across the globe, we aim to provide you with insights on important themes and debates in the emerging world.

CATCHING THE WAVE

- Positive momentum built further towards EM assets in past quarter. For the first time in three years EM equities and fixed-income quite substantially outperformed their developed market peers.
- This is just rational in the current context diminishing macro risk in EM and still ample global liquidity; very low, even quite often negative yields in core markets and rather expensive DM equities make higher yielding or cheaper EM assets more attractive for investors.
- Although the economic recovery in EM remains fragile, we still are constructive on EM assets. But without any doubt, financial markets are facing increasing uncertainty as regards especially Fed policy and US elections.
- Against this backdrop a set-back of EM versus DM assets, or to put it a different way, profit taking, especially on stellar performers within EM is a tangible risk. Within EM rotating portfolios towards Asian equities from more cyclical markets in LatAm and EMEA, but still staying in LatAm fixed income, which still trade at comfortable spreads to US treasuries also makes sense against this backdrop.

SUNSHINE THROUGH THE CLOUDS: IMPROVING FORECAST FOR EM DEBT

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Emerging markets (EM) continued to exhibit sturdy performances across various asset classes. In fact, year-to-date up to 5 October 2016, EM equities have outperformed their developed market (DM) peers by slightly more than 12% in US dollar terms, based upon a comparison of the MSCI EM and MSCI DM total return US dollar indices. Fixed income has also done very well. Sovereign bonds in US dollars, as measured by the Bank of America Merrill Lynch bond indices, have returned 16.4% year-to-date, or 5.8% more than their developed counterparts. Currencies contributed positively to the USD total returns of EM equities and bonds. According the MSCI Emerging Market Currency Index, which equates the weight of each currency to the corresponding country weight in the MSCI Emerging Market index, EM currencies as a whole have appreciated by about 6.5% against the US dollar over the same time frame[1].

There are many reasons behind the current outperformance of EM to DM assets[2]. First, for the first time in slightly more than five years, the growth differential between emerging and developed economies is again seen widening in favour of the former. Second, most experts appear to agree that the drop in crude oil prices (and the prices of most other commodities) is behind us, and continue to expect prices to strengthen, though only gradually given a still large supply overhang likely to be removed slowly only in the second half of 2017. The latter reason together with the widening of the economic growth gap in favour of EM probably represent the strongest fundamental supports of EM assets, all the more so as they are accompanied by a weakening US dollar versus most EM currencies. Other fundamental factors also further sustain the outperformance of EM assets, notably that the average growth of EM corporates' profits is turning positive and is even improving faster than in developed economies. Also the improved economic environment combined with fewer pressures on external funding and more room for manoeuvre on monetary policies is restoring business and consumer confidence, both critical elements in transforming a nascent and admittedly still fragile EM economic recovery into a more self-sustained one.

Against this backdrop of less (although not zero) macroeconomic risk in emerging markets, further increasing global liquidity, zero, or close to zero, global core bond yields, still heavily discounted EM against DM equities in price and valuation terms and interesting carry, the current outperformance of risk assets, including EM equities and bonds simply looks rational. Interestingly, the "hunt for yield or growth" has intensified since 'Brexit', which has led to a faster increase in global liquidity and a less positive growth outlook for developed economies as a whole, with downward growth revisions being concentrated on the UK and the EU.

1 Past performance is not indicative of future results
2 See also former research on this subject: EM Insights: Will the monkey smile on EM in 2016? (26/04/2016), EM Insights: Brexit doesn't mean an EM exit (20/07/2016), and EM Insights: EM equities outperformance – sprint or marathon? (03/09/2016)

We are also of the view that a rate hike by the Fed is not likely to derail this trend, provided the tightening in monetary policy is justified by evidence of improving US and international economic fundamentals and greater financial stability. In this case, expectations of more durable growth and potentially less financial risk would largely compensate for a little less policy accommodation.

In our view, a pro-cyclical tightening, the most adverse scenario for EM, is not very likely. It looks more probable that the Fed would refrain from hiking rates if it perceived some asymmetric risk on both growth and financial stability in doing so. At least that is how the Fed has acted so far.

We thus believe that the odds on EM equities continuing to outperform remain good, all the more so as the asset class is still not overweight in global portfolios. Further underpinning this view are the increasing demands for budgetary support as a complement to soft monetary policy, which would support the view of more durable growth over the foreseeable future.

But without any doubt, financial markets are facing increasing uncertainty. Monetary policy is a major factor not just in the US, but also in Japan, where the central bank decided to target long-term yields, and in the eurozone, where questions about negative rates are increasingly one of the main sources of rising uncertainty. The second most important is rooted in politics, particularly as regards the presidential election in the US, but also the Italian referendum on constitutional reform, which follows so soon after the Brexit referendum and all its resulting brouhaha.

That is why we do not rule out a set-back of EM versus DM assets, or to put it a different way, profit taking, especially on stellar performers within EM. This also why among EM we would favour fundamentally more solid or defensive equity markets in the current backdrop, as is the case for most Asian markets, which are also among the cheapest. Arthur Kwong, our Asia Pacific equity specialist highlights this case in this issue of our quarterly. Yet the case for Latin American (LatAm) bonds, which still trade at comfortable spreads to US treasuries, remains compelling too. Eduardo Yuki, our LatAm head of research, covers this subject in this issue, too.

ARTHUR KWONG
Head of Asia Pacific Equities team,
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SEARCHING FOR OPPORTUNITY AMID A NEW NORMAL

Asian equities remain a major part of BNP Paribas Investment Partners' (BNPP IP) long term investment strategy. Our conviction has strengthened further in the last 12 months on the back of the persistent resilience of this asset class even in the face of a turbulent global economy – sharp movements in oil prices, uncertainty over the US Federal Reserve's (Fed's) rate hike path, the depreciation of the Chinese yuan, the unexpected "YES" in the Brexit referendum and so on. Asian equities' resilience is reflected in the performance of the asset class – the MSCI All Countries Asia Pacific index returned 9.4% in US dollar terms between 1 July 2015 and 31 August 2016, close to the MSCI US index (11.9%) and ahead of the MSCI Europe (-2.4%)[3].

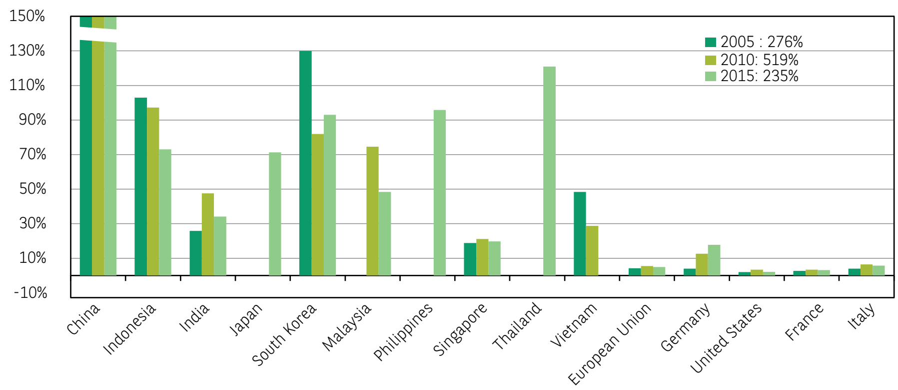
Our confidence in the region's economic growth outlook is rooted in the evidence of improved political stability and progress in various Asian countries, as highlighted by the appointment of the new Reserve Bank Governor in India, and the new leader elected in Taiwan. Furthermore, we expect oil prices to continue to trade in a range of USD 40-60 per barrel given the extended oversupply situation, which looks set to continue into H2 2017. This favours oil-consuming countries, keeping inflation low. Most importantly, the region's demand growth continues to be empowered by its relatively young demographic profile and rising disposable income levels.

FED RATE HIKE COULD PUT TEMPORARY PRESSURE ON ASIAN STOCKS

Most Asian economies have become more defensive since the Asian Financial Crisis by managing their FX exposure – they have raised and maintained higher FX buffers (reserve/debt) (fig. 1) – and by enhancing their national banking systems and developing stronger domestic economies. Given that oil prices are lower than in recent years, we expect inflation to ease further and Asian central banks to have room for monetary stimulus to support growth in the near term. For instance, Bank Indonesia changed its reference rate to the 7-day reverse repo rate in August and cut it by another 25bp to 5.0% in September (the fifth cut in 2016).

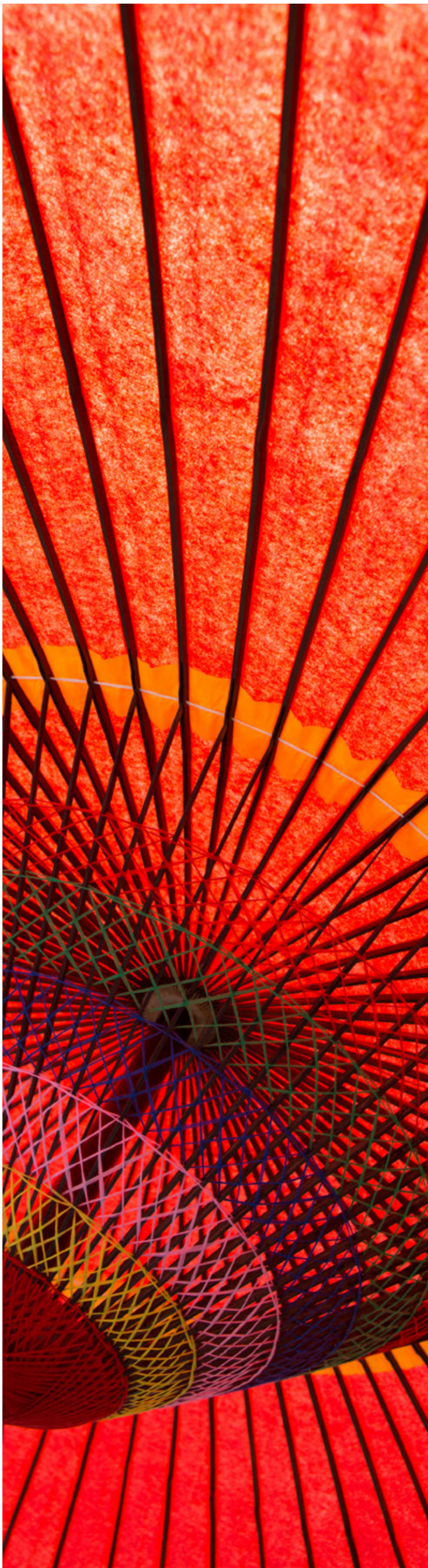
Given the improving macroeconomic background in the US and diminishing global risk, an interest-rate hike by the US Federal Reserve (Fed) in the near term looks increasingly probable. This is likely to create pressure on Asian currencies and investment flows, but we think the effect will be temporary given Asia's robust economies and growth outlook. However, we are prudent on stocks that are currency-sensitive and yield-oriented.

Figure 1: FX reserves as a percentage of external debt



Source: CEIC, J.P. Morgan, BNPP IP as of September 2016.

3 Past performance is not indicative of future results.

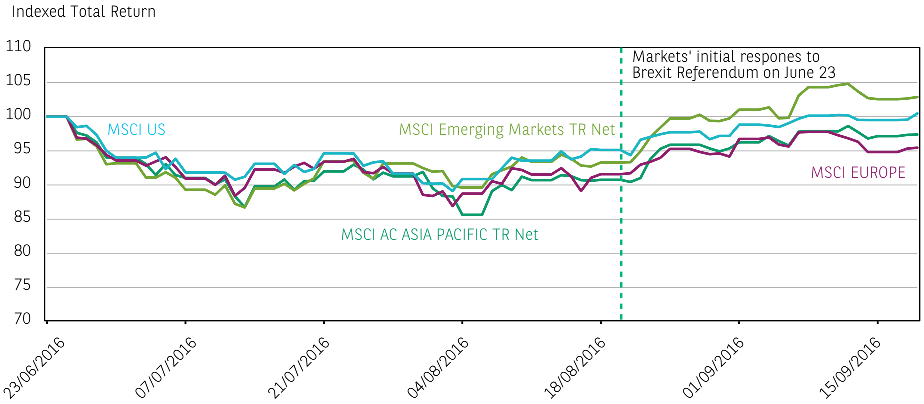


BREXIT DECISION LIKELY TO HAVE MINIMAL IMPACT IN ASIA

The unexpected "Yes" outcome of the 23 June Brexit referendum shocked financial markets. However, the effect was short-lived and Asian equity indices have since recovered (fig. 2). Notably, ASEAN currencies have also remained firm against US dollar while the British pound has substantially depreciated. The ongoing Brexit discussion between all the European Union (EU) members is likely to increase market volatility. We view any market correction driven by Brexit as opportunities for investors to subscribe to Asia's long-term growth prospects in view of the region's growing trade relationship and diminishing dependence on European markets.

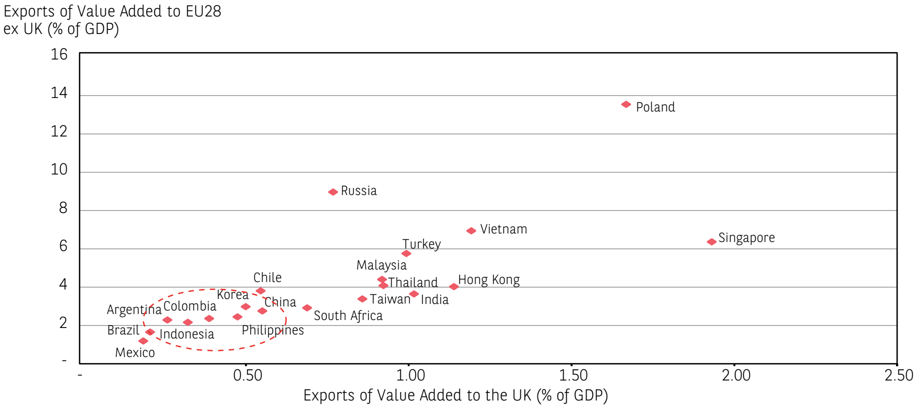
Many Asian economies' increasing independence from developed markets over recent decades has come about by diversifying their economic structure, in particular by shifting from a manufacturing and export focus to services and intra-Asia/domestic trade. Asia has a lower share of exports to the EU than non-Asian emerging nations such as Poland, Russia and Turkey (fig. 3). Meanwhile, numerous Asian governments are continually improving their regulatory environments and tax systems to encourage public and private investment, which is helping to lower unemployment rates and support consumption growth. Among all Asian countries, we see Indonesia and the Philippines as being the least likely to be affected by Brexit and any EU volatility that might arise, given the low level of their value-added exports to the UK and the rest of the EU.

Figure 2: MSCI equities indexed performances in 2016, 01 Jan 2016 = 100, in USD

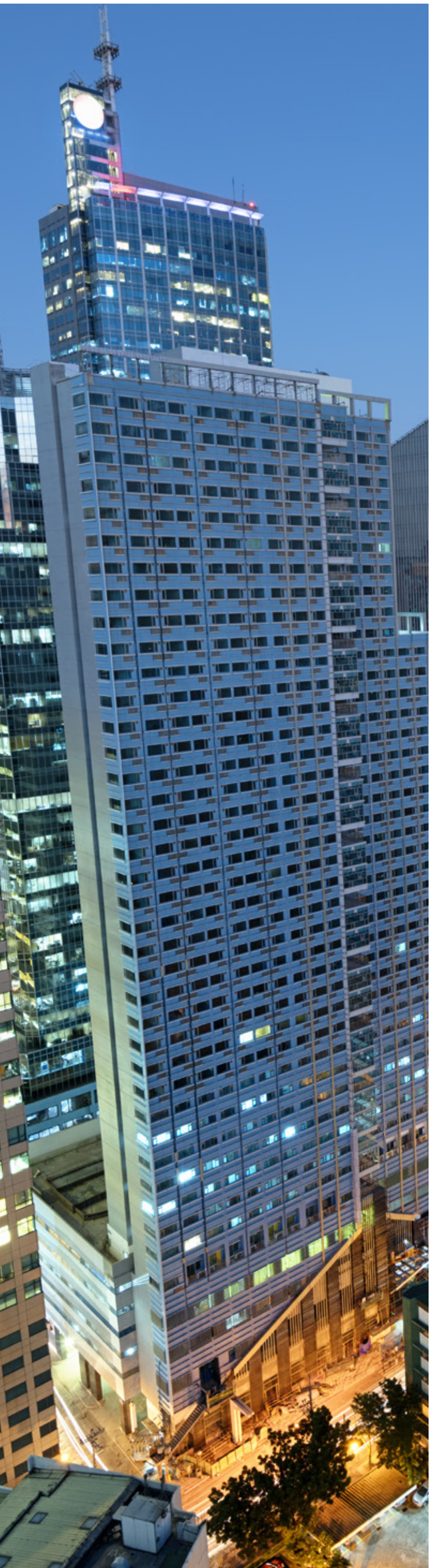


Sources: Bloomberg, MSCI, BNPP IP, 27/09/2016

Figure 3: Emerging countries exports of value added to the UK and to the EU ex-UK (% of GDP, 2011 data)

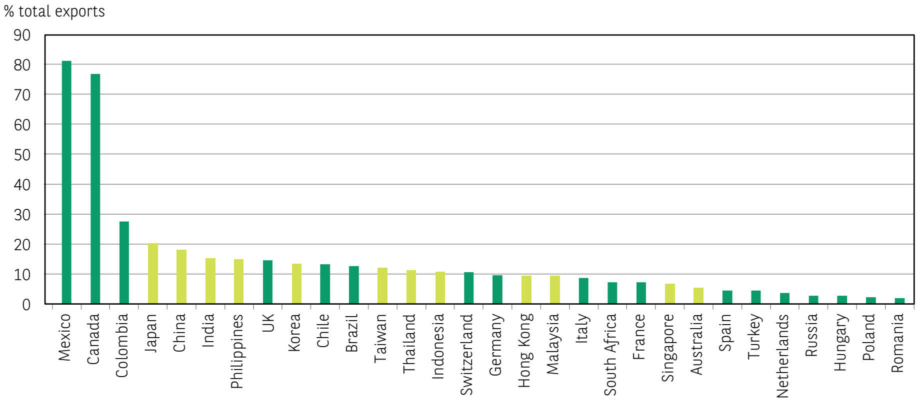


Source: CEIC, Credit Suisse, BNPP IP as of September 2016



What we are conscious of is the potential risk of trade treaty renegotiations and/or withdrawals, and the uncertainties of the Trans Pacific Partnership (TPP) as the US presidential election approaches in November. This "protectionist" idea poses higher risks to Mexico and Canada because the US accounted for over 75% of their 2015 total exports; and within Asia, Japan, China, India and the Philippines are more likely to be affected (fig. 4). It is still too early to estimate the exact revenue impact. We foresee a long road to achieve this protectionism given the potential lobbies by various business communities and in view of political opposition. For instance, in recent years, economic growth in the Philippines has been well-supported by business process outsourcing (BPO) demand from developed markets, e.g. US banks seeking to benefit from lower wage costs.

Figure 4: Countries' goods exports to the US in 2015



Source: CEIC, Nomura, BNPP IP as of September 2016

NEWLY ELECTED LEADERS DELIVERING REFORMS

A number of Asian leaders have started to deliver structural reforms that are being well received. In our view, the most remarkable example is Indonesia's President Jokowi, who showed further political effectiveness with his latest cabinet reshuffle and the approval of the Tax Amnesty scheme. He recently appointed Ms. Sri Mulyani Indrawati as Minister of Finance, which was well-received by investors and business communities in view of her global experiences at the World Bank and her track record as Minister of Finance in 2005/10. Other milestones were the tax amnesty approval in June and 13 stimulus packages – on minimum wages and simplifying licensing processes, for example – with the objective of accelerating infrastructure spending and encouraging foreign and private investment. We expect the government to slowly unfold the Real Estate Investment Trust (REIT) regulation and further tax reforms, such as lowering the corporate tax rate from 25% to 17%-18%.
Philippines's newly elected President Duterte and his cabinet have set 10 top economic priorities, among them encouraging foreign direct investment (FDI) and reducing poverty. They have also approved nine infrastructure projects; all of this achieved in less than three months. Nevertheless, we identified some potential risks from his first national address, e.g. the shift to a federal system, which may lead to inappropriate allocation and use of resources. The current risk level is low, in our view, given that such a change would require amending constitutional laws, which was last done in the 1980s after campaigning for three years.

After years of discussions, India's Goods and Services Tax (GST) Council eventually had its first meeting on 14 September, at which it proposed a tax structure of 8%, 10%, 18% and 26%, which differed from market expectations of 12% and 17% or 18%). The council also decided on who should be the administrators for various businesses (segregated by the scale of their annual revenue) and the GST exemption limit (below INR 2 million). The next GST meetings take place on 17-19 October. Despite the tax rate discrepancy, we perceive this event as positive. The level of information disclosed clearly demonstrates Prime Minister Modi's and his team's strong determination to get things done. The GST should result in a wider tax revenue base and support public expenditure in the long term.

CHINESE YUAN DEPRECIATION LIKELY TO CONTINUE, ALTHOUGH THE RISK LOOKS MANAGEABLE

We believe the People's Bank of China (PBoC) and China Securities Regulatory Commission (CSRC) will continue their effort to maintain a steady currency against a trade-weighted currency basket while pushing for internationalisation, part of China's financial liberalisation. This means a possible further depreciation against the US dollar. To keep the currency steady in effective terms, we foresee the Chinese government continuing to encourage Chinese companies, especially State-owned Enterprises (SoE), to invest overseas, predominantly via mergers and acquisitions, and keep tight control of capital account movements. Meanwhile, the PBoC and CSRC are setting up more yuan connections between onshore and offshore with the ultimate goal of raising the yuan's global status. The near-term milestones we are watching closely are the inclusion of China A-shares within global equity indices, and greater A-share flows through foreign stock exchanges, primarily in the form of derivatives.

In summary, we see Asian governments' continuing efforts to strengthen their economies and sustain their GDP growth outlook, offering investment opportunities to all types of long-term investors, including yield-seeking investors during the prolonged low-rate environment. Asian equities currently have an average dividend yield of 2.6% and significant cash reserves, i.e. over 10% of their total assets, on average. We believe the potential yield upside can also be further driven by the formalisation of real-estate investment trust and infrastructure funds, as part of the tax reforms in several Asian countries. For global fixed income and developed-market focused investors, Asian equities can diversify portfolio risk due to their low correlations with other equities. Most importantly, Asian equities are trading at a forward price-to-book of 1.52x and a forward price-to-earnings multiple of 13.0x, both of which are more attractive than US and European equities, in our view.

Of all Asian countries, we are more optimistic, and thus have larger investment exposures in, India, Indonesia and the Philippines, whose economic growth is being boosted by their low-in-debt populations against a backdrop of improving political certainty and business environment. We remain prudent and selective on Malaysia and other Asian countries. Our preferences are mainly consumption-related, for instance insurance in China, where market penetration is low, and certain fast-moving consumer goods companies in the Philippines and India.

EDUARDO YUKI
Head of Economic and Market Analysis

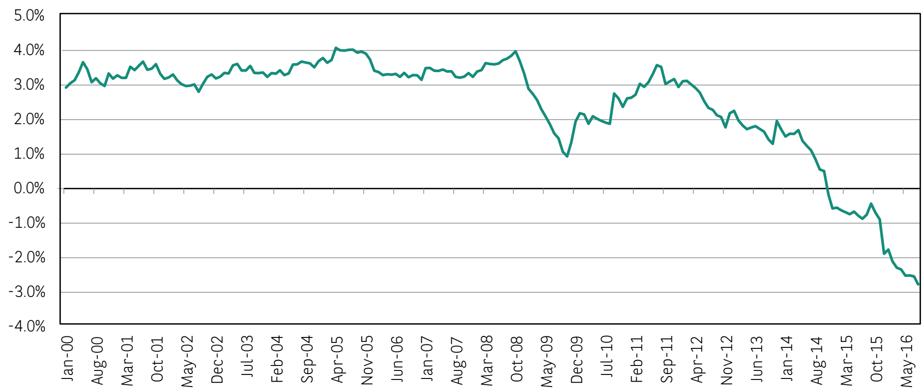
LATIN AMERICA

Economic growth looks set to improve next year, but will likely remain below potential. We expect a gradual recovery in Brazil and activity deceleration in Chile, Colombia, Mexico and Peru. Spare output capacity will further weigh on inflation and improve the interest-rate environment. In view of this, lower opportunity costs could support Latin American equity markets in the medium term.

In Brazil, aggregate demand is set to continue declining in the short term because all economic agents need to complete their deleveraging cycle.

Federal and local governments have to implement a major fiscal consolidation process to stabilise public debt in the medium term. Primary fiscal deficit reduction results are deteriorating and diverging from the official targets of -2.7% of GDP in 2016 and -2.1% of GDP in 2017. It will require severe expenditures cuts and revenues increases to get nearer these targets, which would lower real GDP growth by 0.8 percentage points by next year.

Chart 1. Brazil – primary fiscal result – as a percentage of GDP

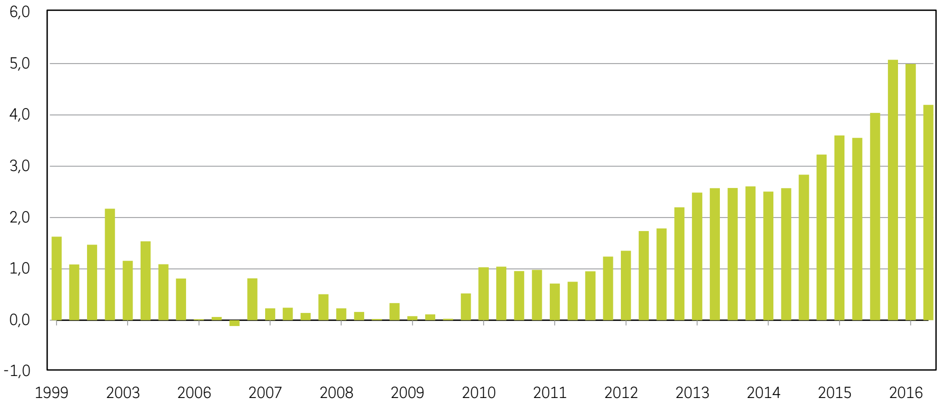


Sources: Brazilian Central Bank, BNPP AM Brazil as of 31/08/2016

Brazil's Congress is discussing a new rule to cap government expenditure in line with the previous year's inflation. According to our simulations, if approved, this measure will improve dramatically the fiscal accounts in the medium term, increase national savings and reduce the long-term real interest rate.

Regarding the corporate sector, fixed investment is likely to recover only gradually in the coming quarters. Profitability is still below the base interest rate which means negative economic profit and a smooth deleveraging cycle ahead. The net corporate debt to EBITDA ratio declined from 5.0 in Q1 2016 to 4.2 in Q2 2016, but remains far above the historical average of 1.5. Additionally, manufacturing capacity utilisation has not recovered from depressed levels.

Chart 2. Brazil – net corporate debt to EBITDA ratio



Sources: Economatica , BNPP AM, as of 30/06/2016

Household consumption is also likely to decline further in the next few quarters. First of all, unit labour cost expansion is likely to lead to a higher unemployment rate and, consequently, lower purchasing power. Also, a household debt service ratio at 22% of disposable income does not speak for a robust credit impulse in the short term.

Chart 3. Brazil – Household debt service ratio – as a percentage of disposable income

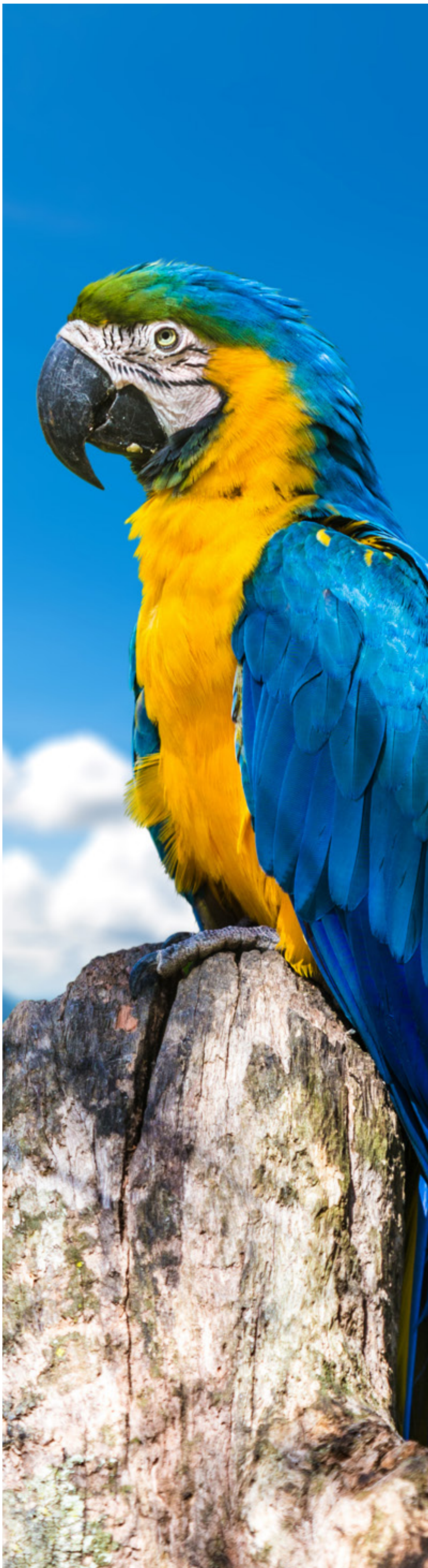
Sources: Brazilian Central Bank, BNPP AM Brazil as of 31/07/2016

We have been arguing that deleveraging cycles are tough periods characterised by weak domestic demand. On the other hand, they generally lead to sustained activity recovery in the medium term through economic reforms.

The first reform to be approved will be the cap on government expenditures described above. It could improve the primary fiscal result from -2.7% of GDP this year to zero in 2020 and +2.0% of GDP in 2023 (Bloomberg).

Another reform to be approved relates to the pension system, which represents 42% of primary expenditure. According to the local media, the federal government will propose the adoption of a minimum retirement age of 65 years. We believe that the population will support this, because Brazilians have understood the necessity of a huge fiscal reform to improve employment conditions.

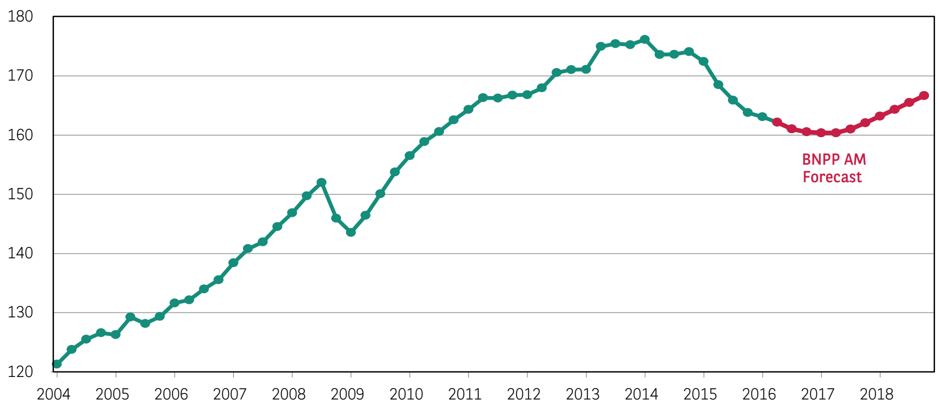
The third reform, the deregulation of the labour market, will be discussed in the second semester of next year.



The new economic agenda has improved business and consumer confidence indicators, the first step in an economic recovery.

We believe that huge spare output capacity will continue improving inflation expectations and soon lead to an important easing monetary cycle. Lower interest rates should gradually benefit the credit market and domestic demand next year.

Chart 4. Brazil – real GDP level

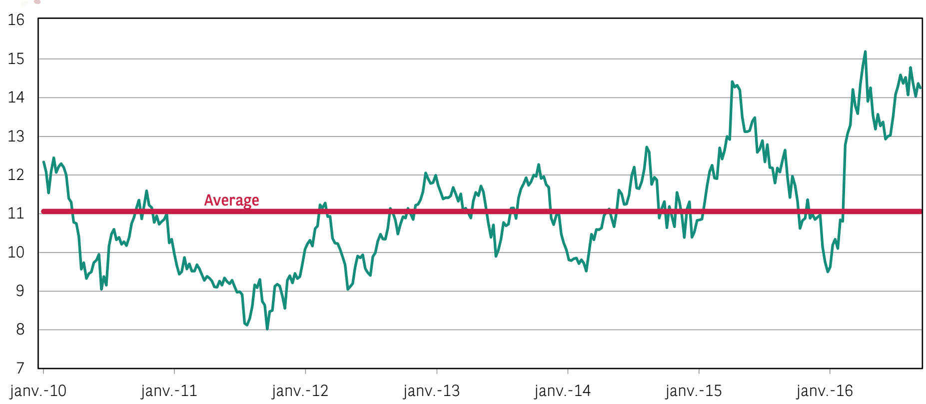


Sources: IBGE, BNPP AM, as of 31/03/2016

We expect the central bank's key interest rate to decline to 9.5% next year, which is below the current market price of around 10.9%. In US dollar terms, sovereign bond yields are at around 3.2% for the next five years, substantially above the yield on US Treasuries which is close to 1.2% (Bloomberg). Fixed income can still provide good opportunities.

The local stock market is not cheap. The favourable outlook on the economy and reforms is already priced in. The current forward price to earnings ratio is around 14 times, which is above its historical average of around 11 times. Our dividend yield model suggests that the index is close to its fair value, even taking into account our interest-rate scenario. We favour a stock-picking approach to take advantage of sectors linked to the monetary cycle.

Chart 5. Brazil – stock market (IBX) forward PE

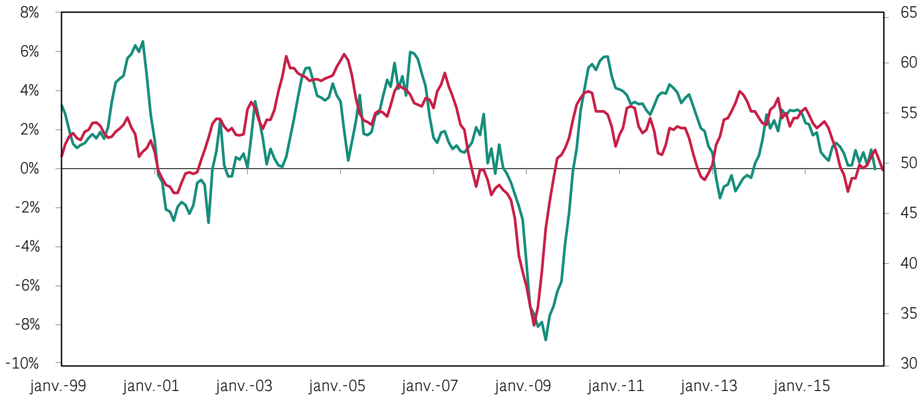


Sources: Bloomberg, BNPP AM, as of 29/09/2016

Thus, we reiterate our positive view for the Brazilian fixed-income market. Sustained economic recovery and opportunity cost reduction should also create a better environment for equities in the medium term.

In Mexico, household consumption has been growing at a fast pace due to the falling unemployment rate. However, leading indicators are anticipating a slowing of economic activity. In fact, industrial production and exports have stagnated since last year. The slowdown of corporate profitability supports our view that job creation will moderate in the medium term and maintain inflation close to the target in the foreseeable future.

Chart 6. Mexico – industrial production



Sources: Bloomberg, BNPP AM, as of 30/09/2016

Moreover, Mexico's recent trade balance improvement favours our sentiment that the *real* exchange rate does not need to depreciate further to adjust external accounts.

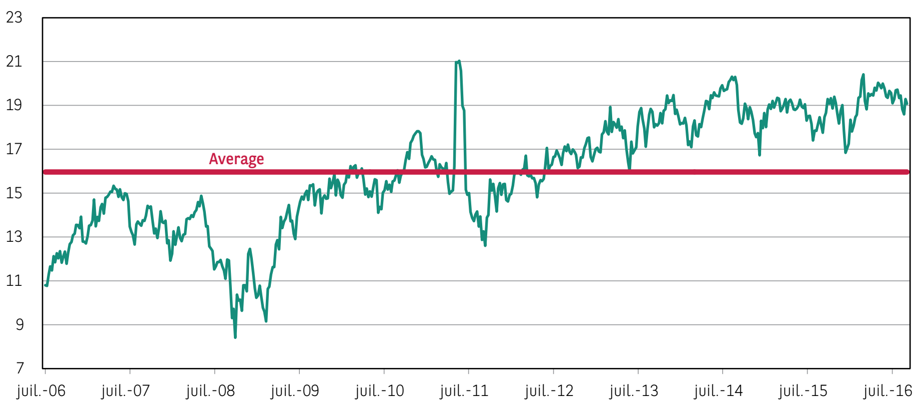
Note that the worsening fiscal conditions have not impacted substantially on Mexican CDS. Part of this favourable risk premium performance could be attributable to the government´s plan to cut expenditure next year.

The country's monetary authority has committed to increase interest rates in line with the Fed's actions, but an activity slowdown and the absence of price pressures could limit Banxico's actions next year.

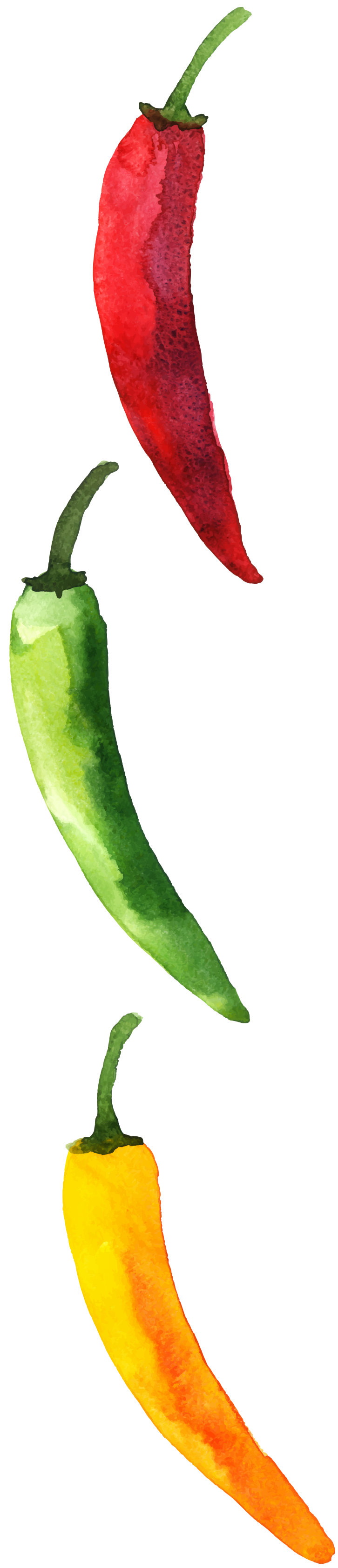
In US dollar terms, the sovereign yield curve is around 3.1% for 10 years ahead, which is above the yield on US Treasuries of close to 1.6% (Bloomberg).

Regarding the local equity market, Mexbol's forward P/E ratio remains at around 19 times, which is above its historical average. The lower equity risk premium also corroborates our preference for fixed income.

Chart 7. Mexico – stock market forward PE

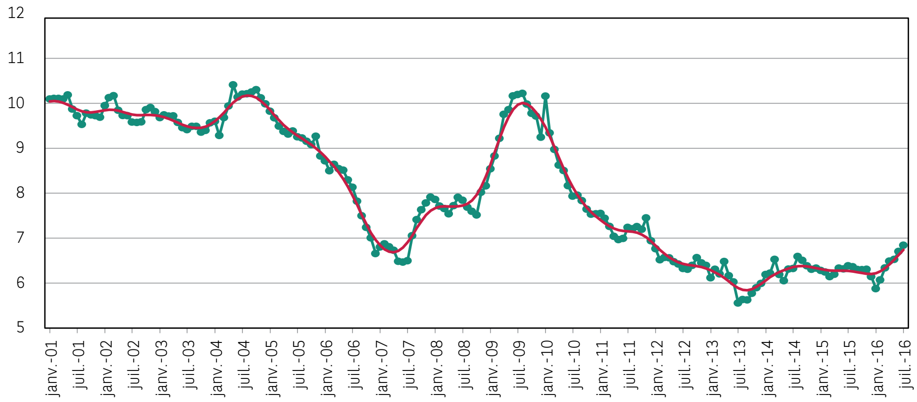


Sources: Bloomberg, BNPP AM, as of 29/09/2016



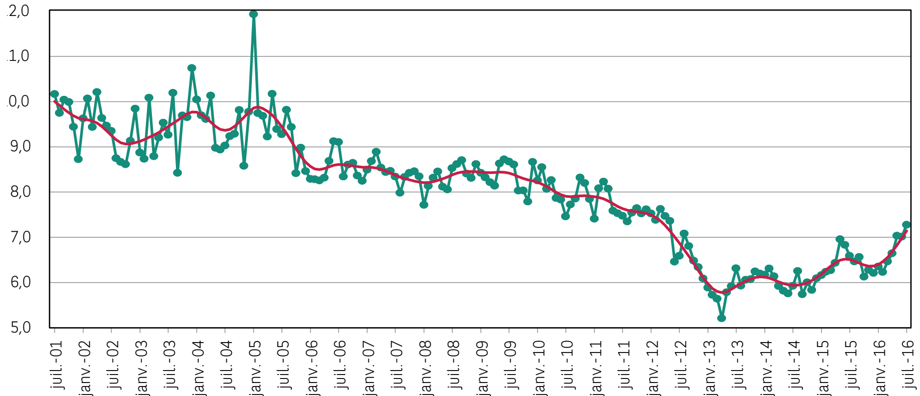
Chile and Peru are still adjusting their economies to the new reality of lower commodities prices. Business confidence indices have anticipated a significant slowdown in economic activity. The unemployment rate has already risen moderately in the last few months, which supports inflation expectations close to the target.

Chart 8. Chile - Unemployment rate - seasonally adjusted



Sources: Bloomberg, BNPP AM, as of 31/07/2016

Chart 9. Peru - Unemployment rate - seasonally adjusted



Sources: Bloomberg, BNPP AM, as of 31/07/2016

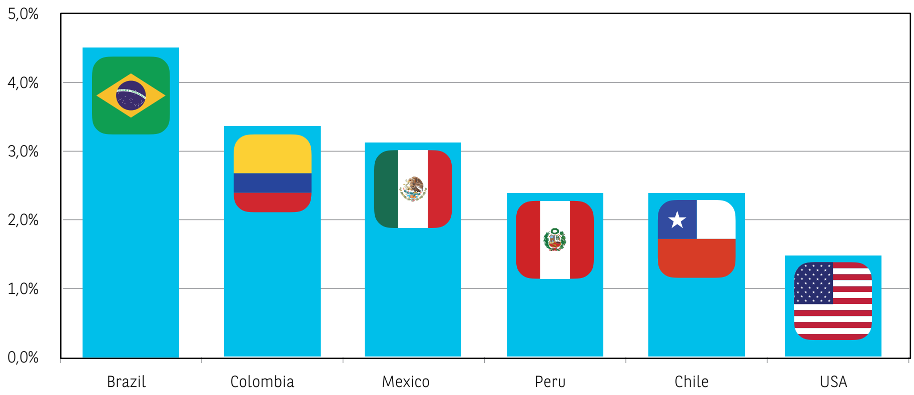
In Colombia, the situation is different. The country's huge oil dependence has worsened its external and fiscal accounts. Currency depreciation drove inflation up to 8.1% in August 2016 and reduced purchasing power. Monetary policy must remain tight for several quarters to bring inflation back to the target. Consumer confidence is anticipating a contraction in retail sales with a consequent negative impact on local production.

In general, Latin America is facing fiscal challenges due to an activity slowdown and commodity price declines. Adoption of tighter fiscal policies should gradually improve this situation in the coming years and maintain countries' solvency. The International Monetary Fund estimates that, in 2020, net public debt as a percentage of GDP will reach 57% in Brazil, 6% in Chile, 36% in Colombia, 47% in Mexico and 10% in Peru. We see these as being reasonable levels when compared to global standards.

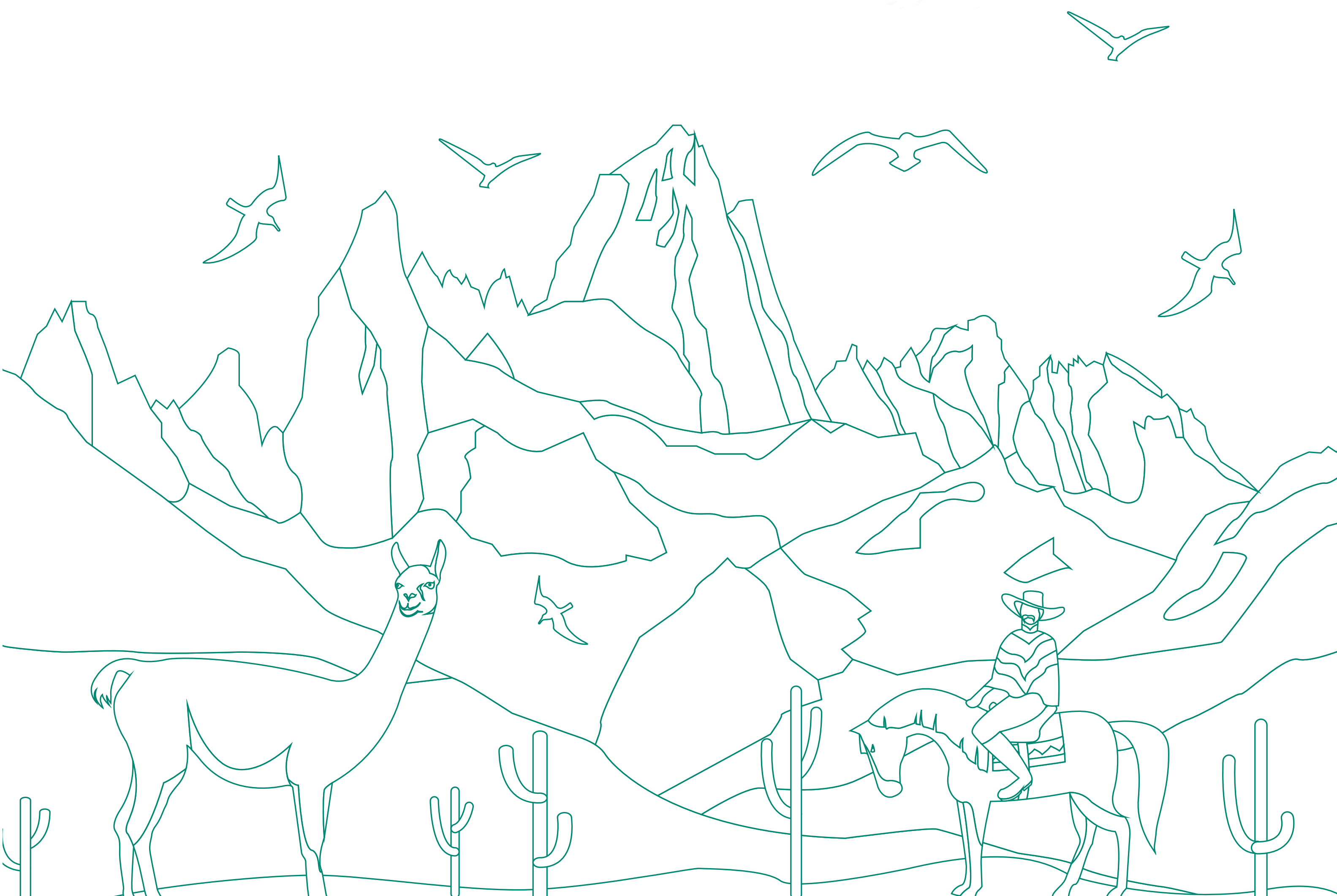
The fiscal consolidation process in the region and inflation expectations moving closer to the countries' respective targets could combine to represent an interesting opportunity for investing in the LatAm fixed-income market. We must also remember that lower interest rates could support the equities markets.

For those investors concerned about the impact of a possible interest rate hike by the Fed, we suggest they take a look at LatAm sovereign bond yields in US dollar terms (currency hedged). Welcome to Latin America!

Chart 10 – LatAm: 10-year USD sovereign yields



Sources: Bloomberg, BNPP AM, as of 03/10/2016

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CZECH
MALAYSIA
MOROCCO

The value of investments and the income they generate may go down as well as up and it is possible that investors will not recover their initial outlay.

Investing in emerging markets, or specialised or restricted sectors is likely to be subject to a higher than average volatility due to a high degree of concentration, greater uncertainty because less information is available, there is less liquidity, or due to greater sensitivity to changes in market conditions (social, political and economic conditions).

Some emerging markets offer less security than the majority of international developed markets. For this reason, services for portfolio transactions, liquidation and conservation on behalf of funds invested in emerging markets may carry greater risk

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