Schroders
Economic and Strategy Viewpoint

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Emerging markets: Time to buy? (page 2)

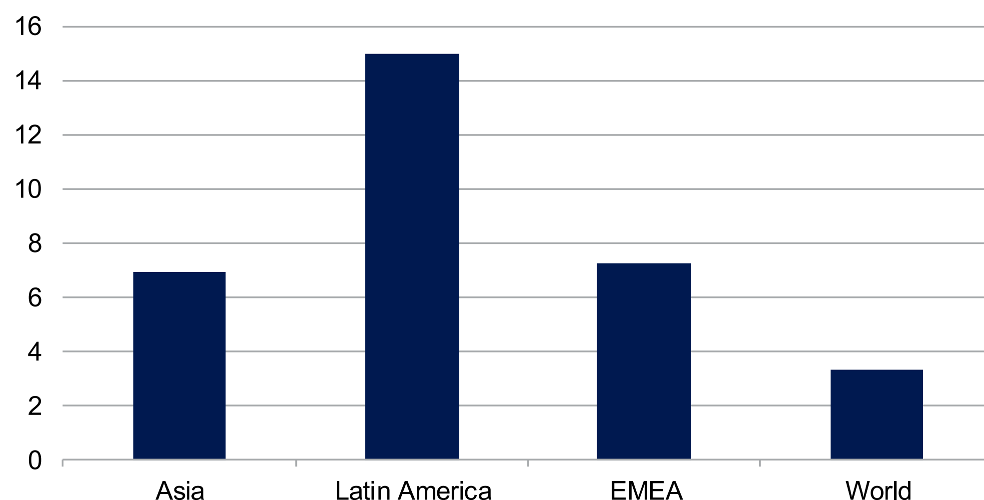
- The recent EM rally has piqued interest in the asset class again, but to us little fundamental seems to have changed. The time will come to buy EM again, but not yet.

Views at a glance (page 6)

- A short summary of our main macro views and where we see the risks to the world economy.

Chart: EM equity easily outperformed developed markets

MSCI equity market price-returns in 01/03/16 to 29/03/16 (%)



Source: Thomson Datastream, Schroders Economics Group, 30 March 2016.

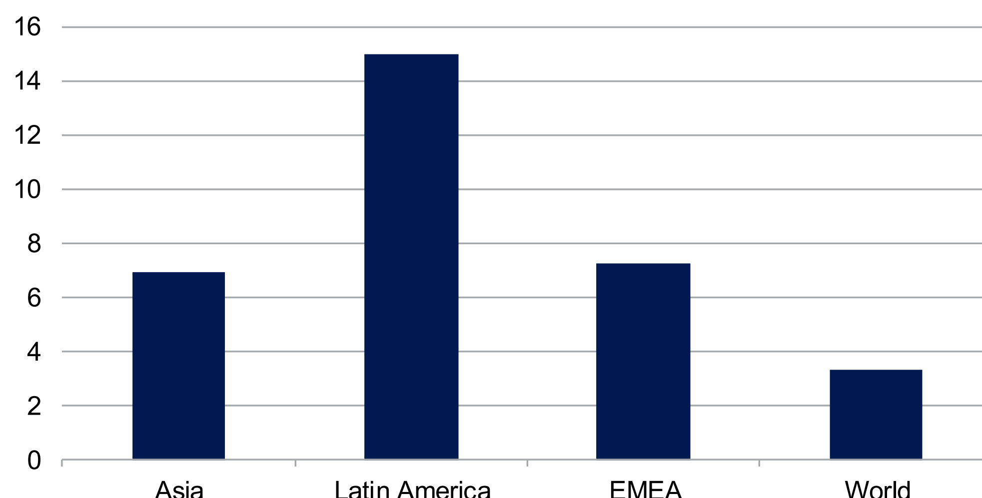
Emerging markets: time to buy?

Recent outperformance has excited investors

Emerging market equities have posted a strong performance this year, with the MSCI EM index rallying around 18% since the lows touched in January. The bulk of this rally came in March, and has coincided with stronger emerging market currency performance as well. An inevitable question then is whether this marks the turning point for emerging markets, or will instead prove to be yet another false dawn.

March rally has seen EM outperform, particularly LatAm

Chart 7: EM equity easily outperformed developed markets



Source: Thomson Datastream, Schroders Economics Group. 29 March 2016. MSCI World is a DM only equity index. All returns are in US dollar terms.

Looking at equity markets by region (chart 7) shows much of the performance has been driven by Latin America, though all regions outperformed the developed market aggregate. This suggests an idiosyncratic driver in Latin America that would cause it to outperform emerging markets as a whole. Given what we know about the region, the first place we would typically look is commodities. But we have written about Brazil's situation often in recent months, so it is hard to ignore the elephant in the room. It turns out that Brazil's equity market is by far the strongest regional performer, with twice the returns of any other Latin American market, which are generally closer to the performance of Asia and EMEA than of Brazil. In Brazil's case, outperformance rests on political factors (namely, hopes that current President Dilma Rousseff will be ejected) above anything else.

If all other markets are up by similar amounts, what else could be at play? There will be some inflows to global emerging market indices in pursuit of the Brazil story, but that seems insufficient on its own.

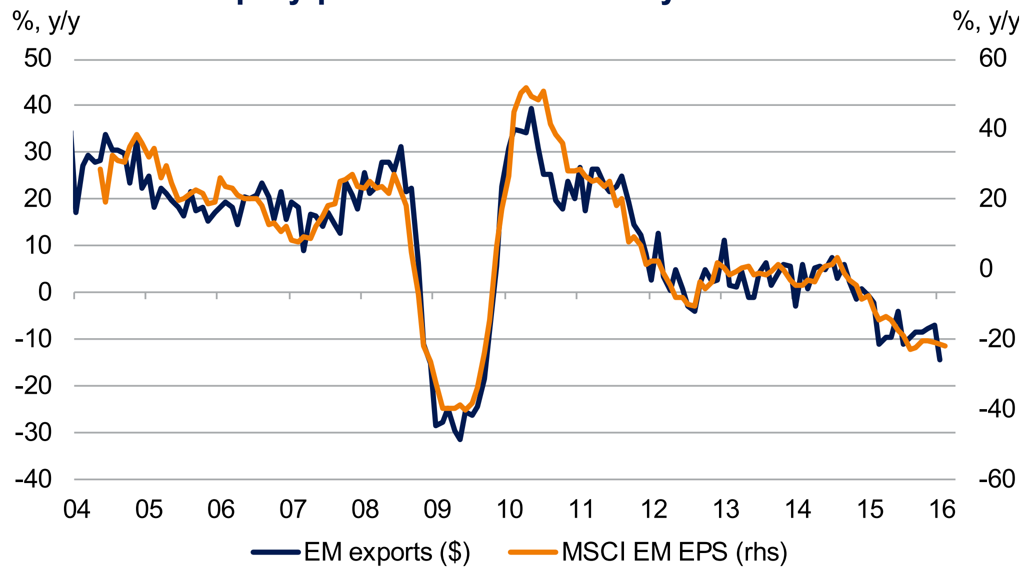
Trade is still soft

Without trade growth, earnings growth will be limited

One of the key fundamental drivers of emerging market equity performance is export performance in US dollar terms. This matters because it impacts nominal dollar GDP growth, and hence the earnings potential in emerging markets (chart 8). Intuitively this makes sense; international investors are more interested in what dividends are available in hard currency, rather than local currency, and the equity indices are typically skewed towards exporters. Consequently, the behaviour of trade will do much to determine the behaviour of emerging market equities, in aggregate (we focus on a top-down approach here, as economists;

there will likely always be individual stocks that flourish despite trade weakness).

Chart 8: EM equity performance driven by trade



Source: Thomson Datastream, Schroders Economics Group. 29 March 2016.

We do not yet have a full set of February trade data for emerging markets; roughly half the countries we monitor have reported. Of these, most reported improved export figures in February, compared to January (the glaring exception is China). While this is encouraging, we would be very reluctant to read too much into one month's data, especially given the volatility of the series. The trend so far has been decidedly negative for the emerging market outlook, as is evident in chart 8.

Trade now looks structurally weaker

The trend referred to clearly begins in late 2014, and is largely commodity price driven. That is not to say the impact has been limited to commodity exporters; commodity importers have also seen a fall in export values of a near identical magnitude. This points to a lack of pricing power (so falling costs are passed on), reflecting a weak demand situation. This is illustrated clearly when we consider global trade in volume terms (charts 9 & 10). Trade volumes are expanding at a much slower pace today than historically, on a global basis. If this is a "new normal", then even when price effects unwind, as they should do this year, emerging market trade values are unlikely to grow much faster than for the 2012-14 period, with similarly uninspiring consequences for earnings once the initial recovery phase is done.

Charts 9 & 10: Trade volumes and the trade multiplier

Source: Thomson Datastream, Schroders Economics Group. 29 March 2016.

As to whether or not this is a "new normal", consider the trade multiplier shown

Lower trade multiplier reduces beta of EM to global growth

above. This is a fairly simple measure, we use the ratio of growth in trade volumes to growth in global real GDP, but it tells you whether the rate of growth in trade we see today is purely a result of slower growth, or if something has changed in the trade intensity of world growth. The trade multiplier exhibits a clear downward trend over the period (the global financial crisis distorted the measure), which tells us that for this level of GDP growth, we should have nearly two-to-three times the amount of trade growth. So this is not a problem we can easily "grow out of"; we would need global growth of over 6% to see trade grow at its pre-crisis rate. Global GDP pre-crisis typically grew around 4%.

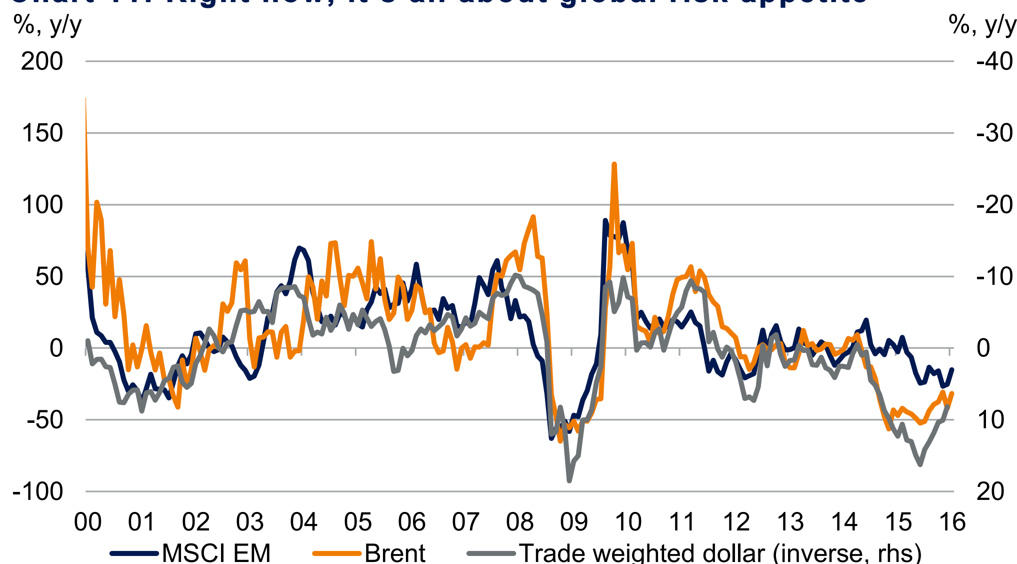
The fundamental support for emerging market equities, then, looks weak. Trade looks to be structurally weaker and we do not see any immediate or even near-term catalysts for that to change. One short-term positive for emerging market assets should be the unwinding of commodity-related price effects on trade values. Assuming a relatively flat profile for commodity prices from here would imply this occurs in H2 of 2016. As these price effects unwind, nominal dollar earnings will be boosted which should aid equity performance in the short term. But ultimately we will return to the stale export growth profile of 2012 – 14, unless we see a serious boost to global growth. Of course, there is also a downside risk here: even if values recover, it may be that at these commodity price levels, some commodity exporters are unprofitable, rendering the longer term outlook rather bleak, particularly with credit tightening. Lacking that fundamental support, how to explain the emerging market equity rally?

Risk on, risk off

EM, oil and the trade weighted dollar are all ways to play global risk

We have already mentioned earlier in this month's Viewpoint the improvement in global risk sentiment since January, aided by ebbing concerns over China. This change to the global risk environment is reflected clearly in the behaviour of oil and the trade-weighted dollar. As chart 11 shows, it is also reflected in the behaviour of emerging market equities.

Chart 11: Right now, it's all about global risk appetite



Source: Thomson Datastream, Schroders Economics Group. 30 March 2016.

There is a misconception we should address here, which is that emerging markets are "all about commodities". But the region is much less dependent on commodities for growth than is commonly assumed; consider that the bulk of emerging markets GDP is manufacturing orientated (Asia and Europe). Not only that, over 70% of equity market capitalisation in emerging markets is in net commodity importers ; one would expect rising commodity prices to be bad for emerging markets as a whole. This reinforces our view that chart 10 is showing

you three series highly correlated with global risk.

Not time to buy just yet, but 2016 could still be the year

So really, that looks to be it. There is at best only a weak fundamental story; most of the recent move in emerging markets looks to have been driven by sentiment alone (including the political story in Brazil), with the improvement in risk appetite coming at a time when aggregate emerging market valuations look attractive and investors have been waiting for an opportunity to re-enter the asset class. On this point, our view would be that the apparent cheapness in emerging market equities emanates from areas like commodities and Chinese financials, which all have potentially serious balance sheet issues, so the scope for rerating is limited. Arguably, anything you want to buy in EM already looks fair value, if not expensive. So, answering the question of whether you should be buying emerging markets right now, the answer is: only if you're positive about the direction of risk appetite. We have already laid out our view in the global section of this Viewpoint: at this stage it is difficult to make the case for an acceleration beyond the current pick-up, and building expectations of Federal Reserve rate hikes (we expect two this year, in a more hawkish tilt than the market) will likely see US dollar appreciation.

So, if now is not a good time to re-enter emerging markets, when would be? Returning to our earlier point on the importance of trade, a revival in emerging market exports would be one key trigger. But as we discussed, a significant long term revival seems unlikely given the structural change in trade. Volumes will likely remain muted given this structural change and our expectations on global growth. Trade values, on the other hand, should stage a short recovery later this year: around H2 assuming a flat commodity price profile, as base effects drop out of the comparison. Were commodity prices to pick up before then, we should see a more rapid pick-up in EM performance. Again, given our views on China, we think this is fairly unlikely. Summarising then, when do we buy EM? Soon, but not yet.

Schroder Economics Group: Views at a glance

Macro summary – April 2016

Key points

Baseline

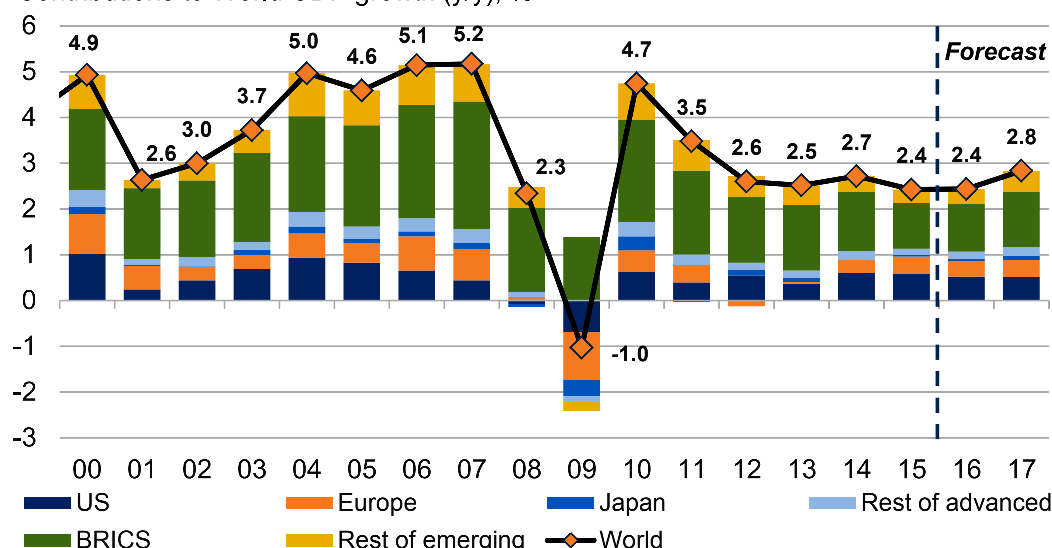
- We trimmed our global growth forecast in February to 2.4% for 2016 led by downgrades to the US, Japan and emerging markets. The inflation forecast for 2016 was also reduced for the advanced economies to reflect the lower oil price profile. Emerging market inflation is, however, higher as a result of currency depreciation and administered price hikes. For 2017, our forecasts were little changed, with growth strengthening modestly as a result of more stable emerging market activity.
- The US Fed is expected to raise rates in June and December by 25 bps, so taking fed funds to 1% by end year. Further increases in 2017 to 1.5% by end year, but this is a flatter profile than before to reflect lower inflation and concerns about global activity.
- UK recovery to continue, but to moderate as a result of Brexit uncertainty and the resumption of austerity. Interest rate normalisation to begin with first rate rise in November 2016. BoE to move cautiously, hiking 25 bps in November, peaking at around 1% in February 2017 when weaker activity will force a pause.
- Eurozone recovery continues in 2016, but does not accelerate as tailwinds fade and the external environment drags on growth. Inflation to turn positive again in 2016 and rise modestly into 2017. ECB to cut rates further with the deposit rate falling to -0.5% by the end of the year where it stays through 2017.
- Japanese growth now forecast at 0.8% this year (previously 1.1%) and inflation reduced to 0.4%. The BoJ responds with further rate cuts, taking policy rates to -0.25% by end 2016.
- Emerging economies benefit from modest advanced economy growth, but tighter US monetary policy weighs on activity, while commodity weakness will continue to hinder big producers. Concerns over China's growth to persist, further fiscal support and easing from the PBoC is expected.

Risks

- Risks skewed towards deflation on fears of China hard landing, currency wars and a US recession. The risk that Fed rate hikes lead to widespread EM defaults would also push the world economy in a deflationary direction. Inflationary risks stem from a significant wage acceleration in the US, or a global push toward reflation by policymakers. Finally, an agreement between Saudi Arabia and Russia could limit oil supply, leading to a jump in inflation and a hit to consumer spending.

Chart: World GDP forecast

Contributions to World GDP growth (y/y), %



Source: Thomson Datastream, Schroders Economics Group, February 2016 forecast. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2015	2016		*Prev.*	Consensus	2017		*Prev.*	Consensus
World	100	2.4	2.4	↓	*(2.6)*	2.4	2.8		*(2.8)*	2.9
Advanced*	62.4	1.8	1.7	↓	*(1.9)*	1.8	1.9		*(1.9)*	1.9
US	24.7	2.4	2.1	↓	*(2.4)*	2.1	2.1		*(2.1)*	2.4
Eurozone	19.0	1.5	1.4	↓	*(1.5)*	1.5	1.6		*(1.6)*	1.7
Germany	5.5	1.4	1.6	↓	*(1.7)*	1.6	2.1		*(2.1)*	1.5
UK	4.2	2.2	1.9		*(1.9)*	2.0	1.6		*(1.6)*	2.2
Japan	6.5	0.5	0.8	↓	*(1.1)*	0.7	1.4	↓	*(1.5)*	0.6
Total Emerging**	37.6	3.4	3.6	↓	*(3.9)*	3.5	4.4	↑	*(4.2)*	4.3
BRICs	23.6	4.2	4.4	↓	*(4.6)*	4.3	5.2		*(5.2)*	5.0
China	14.7	6.9	6.3		*(6.3)*	6.4	6.2		*(6.2)*	6.2

Inflation CPI

y/y%	Wt (%)	2015	2016		*Prev.*	Consensus	2017		*Prev.*	Consensus
World	100	3.0	3.9	↑	*(3.7)*	4.2	3.7	↓	*(3.9)*	3.6
Advanced*	62.4	0.2	1.0	↓	*(1.4)*	0.8	2.0	↑	*(1.9)*	1.8
US	24.7	0.1	1.2	↓	*(1.6)*	1.3	2.3	↑	*(2.1)*	2.2
Eurozone	19.0	0.0	0.7	↓	*(1.3)*	0.3	1.6		*(1.6)*	1.4
Germany	5.5	0.1	0.9	↓	*(1.5)*	0.5	1.8	↑	*(1.6)*	1.6
UK	4.2	0.1	0.8	↓	*(1.3)*	0.7	2.0	↓	*(2.2)*	1.8
Japan	6.5	0.8	0.4	↓	*(1.0)*	0.0	1.8		*(1.8)*	1.6
Total Emerging**	37.6	7.6	8.7	↑	*(7.4)*	9.7	6.7	↓	*(7.3)*	6.7
BRICs	23.6	4.5	3.8	↑	*(3.6)*	3.5	3.5	↑	*(3.4)*	3.2
China	14.7	1.5	1.9		*(1.9)*	1.5	2.1		*(2.1)*	1.7

Interest rates

% (Month of Dec)	Current	2015	2016		*Prev.*	Market	2017		*Prev.*	Market
US	0.50	0.50	1.00	↓	*(1.25)*	0.83	1.50	↓	*(2.00)*	1.07
UK	0.50	0.50	0.75	↓	*(1.00)*	0.65	1.00	↓	*(1.25)*	0.83
Eurozone (Refi)	0.00	0.05	0.05		*(0.05)*	-0.30	0.05	↓	*(0.25)*	0.83
Eurozone (Depo)	-0.40	-0.30	-0.50		*-*		-0.50			
Japan	-0.10	0.10	-0.25	↓	*(0.10)*	0.01	-0.50	↓	*(0.10)*	0.01
China	4.35	4.35	3.50		*(3.50)*	-	3.00		*(3.00)*	-

Other monetary policy

(Over year or by Dec)	Current	2015	2016		*Prev.*	2017		*Prev.*
US QE ($Bn)	4487	4487	4505	↓	*(4507)*	4523	↓	*(4525)*
EZ QE (€Bn)	159	652	1372	↑	*(1369)*	1732	↑	*(1369)*
UK QE (£Bn)	375	375	375		*(375)*	375		*(375)*
JP QE (¥Tn)	383	383	400	↓	*(404)*	400	↓	*(404)*
China RRR (%)	17.50	17.50	15.00		*15.00*	13.00		*13.00*

Key variables

FX (Month of Dec)	Current	2015	2016		*Prev.*	Y/Y(%)	2017		*Prev.*	Y/Y(%)
USD/GBP	1.44	1.47	1.43	↓	*(1.50)*	-3.0	1.40	↓	*(1.50)*	-2.1
USD/EUR	1.14	1.09	1.08	↑	*(1.02)*	-0.6	1.04	↑	*(1.02)*	-3.7
JPY/USD	112.5	120.3	115	↓	*(120)*	-4.4	120	↑	*(115)*	4.3
GBP/EUR	0.79	0.74	0.76	↑	*(0.68)*	2.5	0.74	↑	*(0.68)*	-1.6
RMB/USD	6.48	6.49	6.80	↑	*(6.60)*	4.7	7.00	↑	*(6.80)*	2.9
Commodities (over year)										
Brent Crude	39.8	52.7	35.7	↓	*(48)*	-32.3	41.9	↓	*(43)*	17.6

Source: Schroders, Thomson Datastream, Consensus Economics, March 2016
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 30/03/2016
Previous forecast refers to November 2015

* **Advanced markets**: Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.

** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

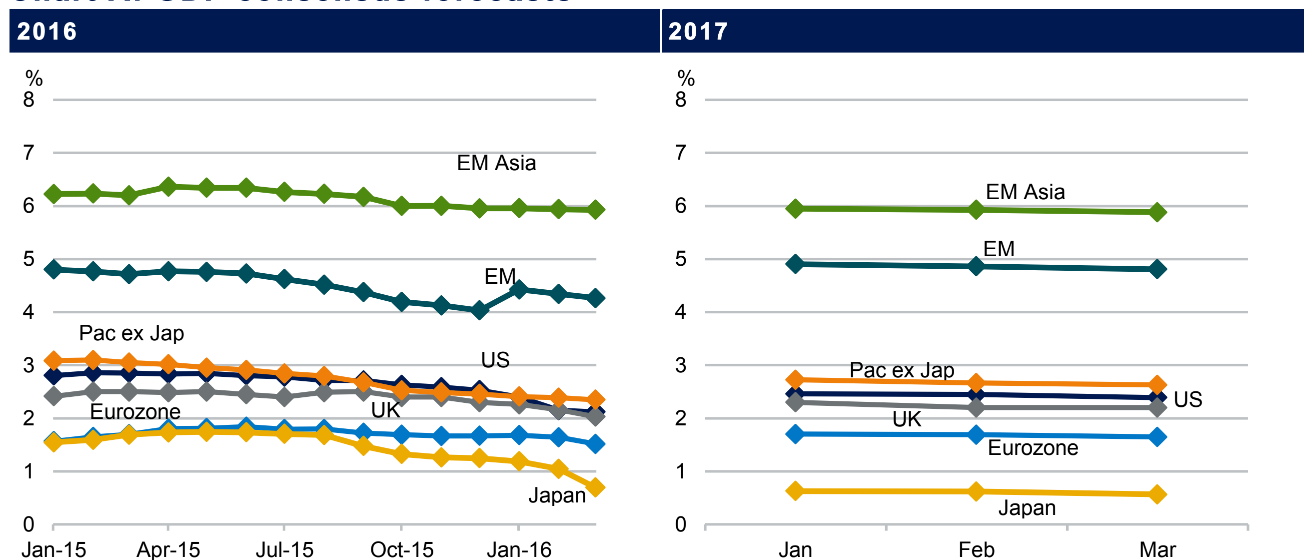
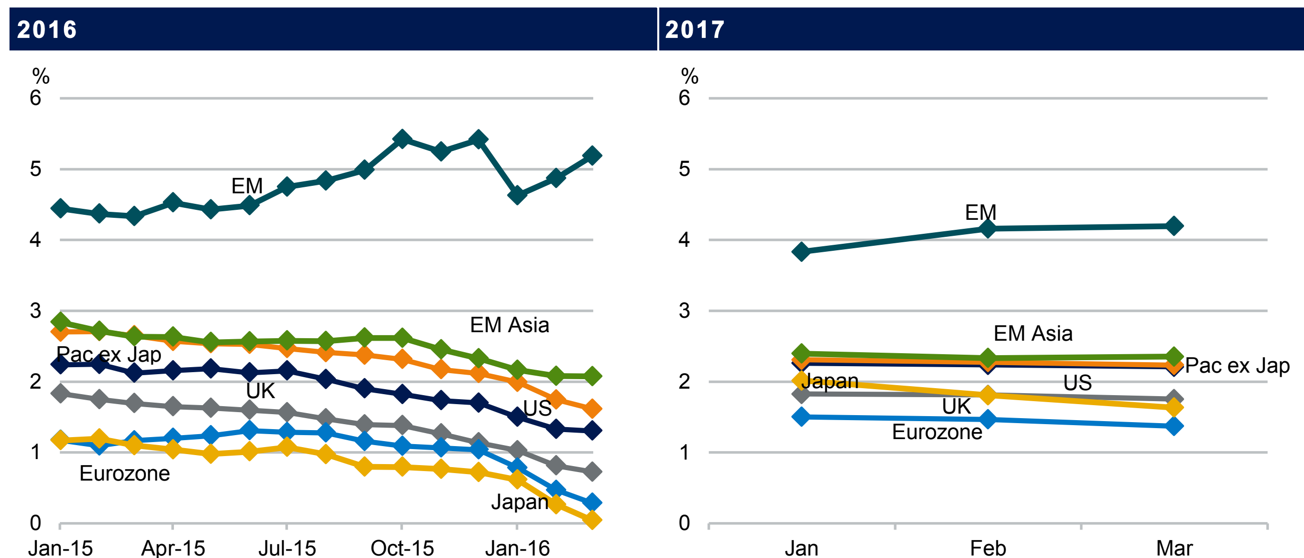


Chart B: Inflation consensus forecasts



Source: Consensus Economics (March 2016), Schroders

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand

Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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