Schroders
Economic and Strategy Viewpoint

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The global upswing and the EM rally

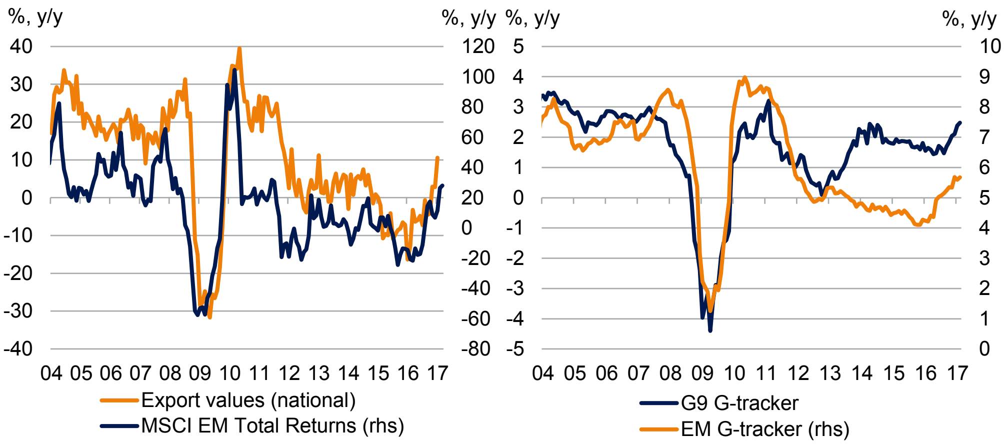
- Trade and EM equities have risen together in 2017, but we do not believe the upswing is secular. Instead, it looks like a cyclical bounce which will likely fade as we move into the second half of the year.

The global upswing and the EM rally

A positive start to 2017 after Trump turbulence in November

2017 has started strongly, with growth seemingly healthy and global trade feeling the benefits. This has coincided with a revival in equity markets, particularly in emerging markets (EM). We have written before about the importance of trade to EM, and a reminder of the relationship can be seen in chart 1. With exports a large part of the growth model in many EM economies, and certainly a large part of the equity indices, a pick up in trade boosts earnings and feeds through to overall equity performance. Trade performance is also important because it has historically been a way for EM to lever its own growth on the back of activity in developed markets, as reflected by our in-house growth trackers. Since the crisis, however, EM growth has slumped relative to DM growth, though it is still higher in absolute terms. We believe this is a result of the slump in trade visible over the same period.

Chart 1: Exports matter to EM equities and economic growth



Source: Thomson Datastream, Schroders Economics Group. 23 March 2017.

The turnaround in trade has greatly helped EM equity performance and economic activity, and would warrant great optimism if one were able to argue that trade could return to its pre-crisis growth rates of around 20%. This would imply a return to the 'good old days' of higher EM activity and equity returns.

Can trade momentum persist or even strengthen?

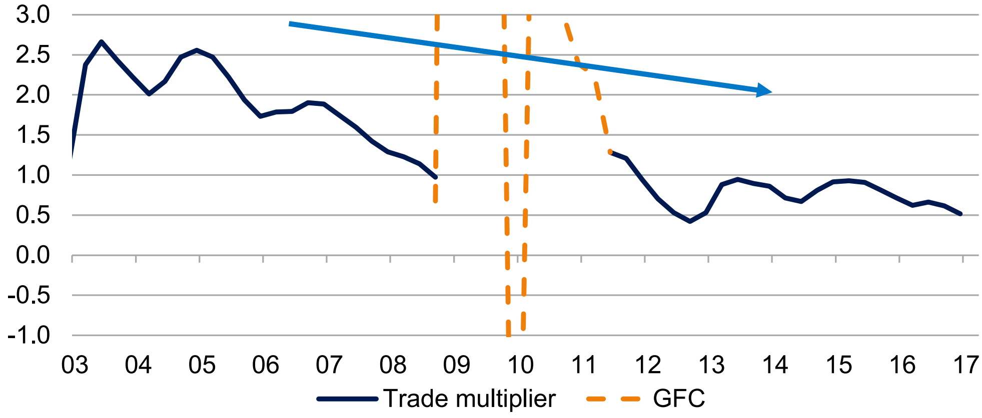
In assessing whether such a utopia can be attained, the first question we ask is why we have seen the recent improvement in trade. Key is whether the gains seen are simply a result of higher global growth, or whether there has been a structural change, such that for a given level of global activity, trade is higher today than in the past. That is, whether the trade multiplier has risen.

Important to differentiate between trade values and volumes

On a related note, it would be helpful to remove the impact of prices. Chart 1, above, shows a sharp decline in trade values from 2014 into early 2016, chiefly reflecting the impact of collapsing commodity prices which in turn fed through to other tradable goods. Today, the base effect of such low prices means that in year on year terms, trade values could increase even absent a large increase in demand.

Consequently, when looking at the trade multiplier, we use trade volumes rather than values, and examine its relationship with global real GDP. We show this in chart 2. The downward trend is immediately apparent, and that it has persisted through the upturn in trade values seen in late 2016 is discouraging for anyone hoping for a secular improvement in trade. What this implies is that the improvement we have seen to date in trade values is entirely a result of higher prices and stronger global growth.

Chart 2: The trade multiplier is historically weak



Source: Thomson Datastream, Schroders Economics Group. 23 March 2017.

We do not expect a rapid rebound in the trade multiplier…

We have written in the past about the likely outlook for the trade multiplier. In a 2016 note[1], we identified some of the major headwinds: in particular the lasting impact of the global financial crisis (GFC), and the end of globalisation. We concluded that: "it seems unlikely that many of the headwinds identified will fade. The impact of the GFC, based on IMF research, is set to linger for several years more at least. It is also difficult to see globalisation finding new legs; China is transitioning to a consumption led economy and moving up the production value chain. We would need a similarly large economy to go through a similar process of integration into global supply chains, and the only candidates are India or Africa. India is the closer of the two but faces significant challenges and appears to lack the desire to become a manufacturing powerhouse. A five to ten year wait seems likely, at the very least." The recent switch to protectionist posturing reinforces this conclusion, in our view.

…so trade growth needs global reflation

So if trade will not be revived by the multiplier effect in the immediate future, we are left to rely on global growth or inflation to drive the value recovery further. This seems an unlikely prospect; while we do forecast a mild acceleration in both global growth (from 2.6% in 2016 to 2.9% in 2017, and to 3% in 2018) and inflation (to 2.7% this year from 2% last year, though slipping back slightly to 2.4% in 2018), this is not enough of an increase in either metric to return us to pre-crisis levels of trade growth. Growth and inflation before the crisis averaged over 3% and the trade multiplier was much higher too. More likely then is that the trade recovery hits a ceiling at levels not dissimilar to where we are today. This does not preclude further EM performance, but drivers will have to be sought elsewhere, perhaps in higher productivity and economic reform.

Identifying the engine

If a secular trade recovery is not on the cards, that implies the current improvement must only be cyclical. Received wisdom is that the global improvement in asset markets is part of a "Trumpflation" trade, and therefore driven by the US. However, China has already been engaged in stimulus (it helps when there is a streamlined legislative process) so perhaps the credit should be more evenly apportioned.

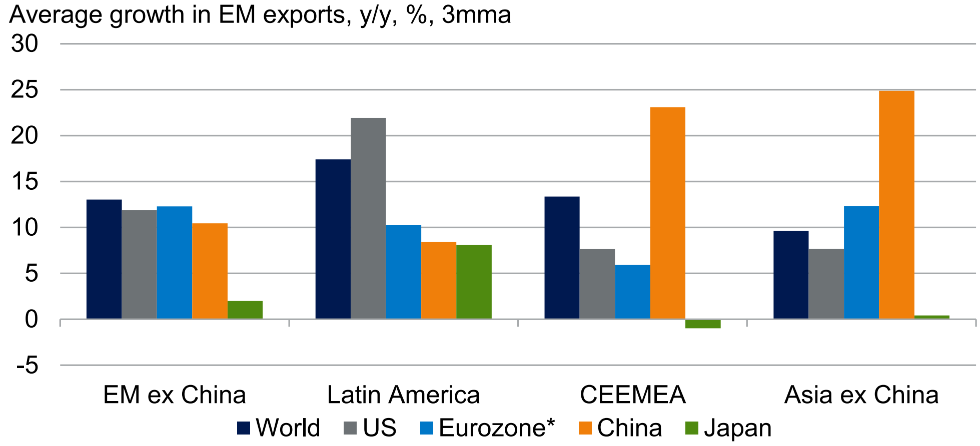
Reflation is not as US centric as imagined

In chart 3 we look at export growth in the recent November to January period for EM as a whole and each region, splitting out export growth by trade partner. While the US has been the clear driver for Latin America, China is the dominant force in CEEMEA and Asia ex China. Additionally, February trade data shows a big pick up in Latin American exports to China, but without data for the matching

[1]Global Market Perspective, Q3 2016 http://www.schroders.co.uk/en/uk/tp/economics2/global-market-perspective2/q3-2016/

period in the US and Europe a comparison will have to wait. In any event, China has undeniably had a major role to play in the recent pick up in trade. The eurozone and especially Japan seem less crucial to the story.

Chart 3: Who should we thank for recent gains?



Source: Thomson Datastream, Schroders Economics Group. 23 March 2017. *Exports to Eurozone from Hungary and Poland based on December data, and some individual country data not available for each EM region exporting to Eurozone.

China has played a big part in the trade recovery

If this growth and trade story is reliant on US and Chinese demand, rather than a secular theme, the next question is how long it is going to last.

How long can this engine drive trade?

In our last forecast update[2] we wrote that the revival in activity in the second half of 2016 was "largely driven by a combination of stronger consumer spending and an inventory cycle", particularly in the US. Looking ahead, however, we warned that the inventory building cycle could face headwinds after the first quarter of this year, with inventories in better balance with output. Although we do see a chance of some support for growth in the second quarter, we still expect the inventory cycle to fade. On the consumer side we continue to see headwinds, as inflation erodes real incomes and weighs on consumer spending. Taken together, this suggests that the impetus lent to trade by the US will begin to fade in the second half of 2017.

Both the US and China are enjoying cyclical upswings which will likely fade soon

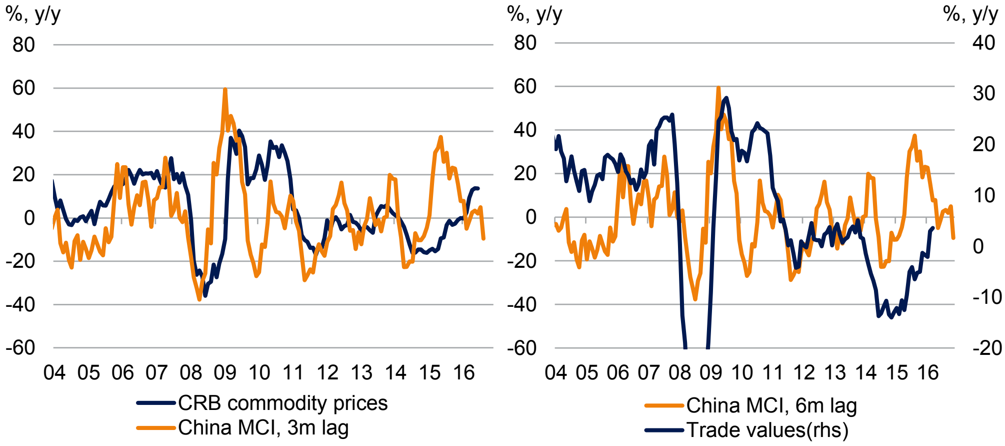
As to China, we expect the economy as a whole to slow marginally this year, with a bigger slowdown pencilled in for 2018. Against such a backdrop it is difficult to argue the economy can continue to deliver the current level of support for global trade. China's contribution so far has come on the back of policy stimulus, both monetary and fiscal. The impact of monetary policy in particular tends to be lagged.

Chart 4 shows the correlation between lagged monetary conditions in China (the MCI) and global commodity prices and trade values. Clearly, China is not the sole driver of either variable, but the MCI often demonstrates predictive power in calling turning points in advance. Looking ahead, this implies a downturn lies in store unless an offset can be delivered elsewhere. At the very least, China can not be counted on to provide the tailwind enjoyed over the last 12 months.

The conclusion then is that with Chinese support already fading and the US inventory cycle nearing its end, global trade is likely to rollover, at least in value terms, in the second half of 2017. The implication of chart 4 is that this will take EM equities with it.

[2] Schroders Economic and Strategy Viewpoint, March 2017 http://www.schroders.co.uk/en/uk/tp/economics2/economic-and-strategy-viewpoint/march-2017/

Chart 4: Monetary conditions in China matter for commodities and trade



Source: Bloomberg, Thomson Datastream, Schroders Economics Group. 24 March 2017. The monetary conditions index (MCI) is constructed by Bloomberg and consists of real interest rates, total loan growth and the real effective exchange rate.

One hope, however, lies in signs of improving capital expenditure in Germany and Japan. Read optimistically, this might be taken as a sign that those economies are picking up the growth baton from the US and China, which could allow some further global trade gains. We do have some concerns that capital expenditures may only be rising because corporates are misreading the US and Chinese inventory cycles as secular changes in demand. Let us take a positive view, though, and say that it is a separate story. It seems likely that the EM beneficiaries would change. Historically, Eurozone investment has been more strongly correlated with exports to the region from EMEA and Asia than with exports from Latin America, who have so far benefitted from stronger US and Chinese demand. Asia also benefits most from a Japanese revival. So if we do see a rotation in growth leadership from the US and China to Germany and Japan, relative underperformance of Latin America seems a likely result. While surveys would suggest an increase in US capital expenditures is also imminent, we have found less of a relationship between such expenditure and EM exports. Instead, it is US consumer spending, particularly on durable goods, that seems to support emerging market exporters.

Schroder Economics Group: Views at a glance

Macro summary – April 2017

Key points

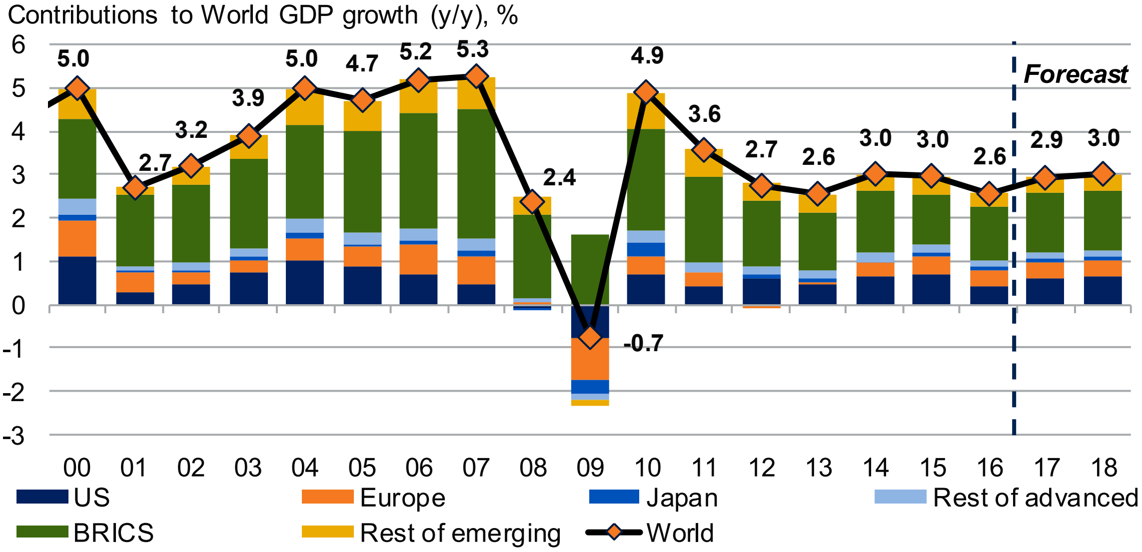
Baseline

- Global growth is expected to come in at 2.9% in 2017 (after 2.6% in 2016) led by the advanced economies whilst inflation rises to 2.7% (from 2% in 2016) largely due to higher oil prices. This checks activity in 2017H2, but global growth of 3% is still expected in 2018 boosted by fiscal loosening in the US, and as inflation falls back helping to support consumer demand globally.
- The US Fed is expected to raise rates three times in 2017 taking fed funds to 1.5% by end year. With growth strengthening and core inflation rising, tightening is expected to continue in 2018 with three rate hikes taking the policy rate to 2.25% by end year.
- UK to slow in 2017. Inflation is set to rise sharply due to the fall in the pound, which will reduce disposable income of households and encourage cuts in spending. Investment is already weak, and has started to impact employment. The BoE is expected to remain on hold, constrained by the higher inflation. Growth remains below trend in 2018 causing unemployment to rise.
- Eurozone growth is set to ease in 2017 as a temporary rise in inflation constrains household spending. Political uncertainty will also weigh on business investment, though we assume the establishment holds on to power. The outlook for 2018 is more promising as inflation falls back, and external performance is boosted by better growth elsewhere. The ECB should keep interest rates on hold, but will quicken tapering of QE in 2018.
- Japanese growth forecast at 1.6% in 2017 and inflation at 1.1% supported by looser fiscal policy and a weaker yen. No further rate cuts from the BoJ, but more QQE is expected as the central bank targets zero yield for the 10 year government bond.
- Emerging economies benefit from modest advanced economy demand growth and firmer commodity prices, but tighter US monetary policy weighs on activity. Concerns over China's growth to persist, further fiscal support and easing from the PBoC is expected.

Risks

- Risks skewed towards stagflation on fears of protectionism, deflationary risks stem from political risk in Europe and a US recession (via China dumps Treasuries). Reflationary risks stem from more aggressive Trump policy on fiscal policy.

Chart: World GDP forecast



Source: Thomson Datastream, Schroders Economics Group, February 2017 forecast. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2016	2017		Prev.	Consensus	2018		Prev.	Consensus
World	100	2.6	2.9	↑	(2.8)	2.9	3.0		(3.0)	2.9
Advanced*	62.6	1.6	1.9	↑	(1.7)	1.9	2.0		(2.0)	1.9
US	27.0	1.6	2.3	↑	(1.9)	2.2	2.4	↓	(2.5)	2.4
Eurozone	17.4	1.7	1.5	↑	(1.2)	1.6	1.8		(1.8)	1.5
Germany	5.1	1.8	1.6	↑	(1.4)	1.4	2.0	↑	(1.9)	1.6
UK	4.3	2.0	1.7	↑	(1.4)	1.7	1.7	↑	(1.5)	1.3
Japan	6.2	1.0	1.6	↑	(1.4)	1.2	1.0	↑	(0.9)	1.0
Total Emerging**	37.4	4.2	4.6	↓	(4.7)	4.5	4.6	↓	(4.7)	4.7
BRICs	24.2	5.1	5.6	↑	(5.5)	5.5	5.6	↑	(5.5)	5.5
China	16.4	6.7	6.6	↑	(6.5)	6.5	6.2		(6.2)	6.2

Inflation CPI

y/y%	Wt (%)	2016	2017		Prev.	Consensus	2018		Prev.	Consensus
World	100	2.0	2.7	↑	(2.4)	2.6	2.4	↑	(2.3)	2.4
Advanced*	62.6	0.7	2.0	↑	(1.7)	2.0	1.5		(1.5)	1.9
US	27.0	1.3	2.6	↑	(2.0)	2.5	2.3		(2.3)	2.3
Eurozone	17.4	0.2	1.6	↑	(1.3)	1.7	0.9		(0.9)	1.4
Germany	5.1	0.4	2.0	↑	(1.3)	1.8	1.3	↑	(0.8)	1.7
UK	4.3	0.7	2.9		(2.9)	2.6	2.2	↑	(1.9)	2.7
Japan	6.2	-0.1	1.1	↑	(0.8)	0.7	1.1	↑	(0.9)	1.0
Total Emerging**	37.4	4.1	3.8	↑	(3.7)	3.6	3.8	↑	(3.6)	3.3
BRICs	24.2	3.6	3.3		(3.3)	2.9	3.3	↑	(3.2)	2.8
China	16.4	2.0	2.5	↑	(2.3)	2.1	2.3	↑	(2.2)	2.0

Interest rates

% (Month of Dec)	Current	2016	2017		Prev.	Market	2018		Prev.	Market
US	1.00	0.75	1.50	↑	(1.25)	1.55	2.25		(2.25)	2.01
UK	0.25	0.25	0.25		(0.25)	0.50	0.25		(0.25)	0.71
Eurozone (Refi)	0.00	0.00	0.00		(0.00)	-0.22	0.00		(0.00)	0.00
Eurozone (Depo)	-0.40	-0.40	-0.40		(-0.50)		-0.40	↑	(-0.50)	
Japan	-0.10	-0.10	-0.10		(-0.10)	0.06	-0.10		(-0.10)	0.08
China	4.35	4.35	4.00	↑	(3.50)	-	3.50		(3.50)	-

Other monetary policy

(Over year or by Dec)	Current	2016	2017		Prev.		2018		Prev.
US QE ($Bn)	4451	4451	4451	↑	(4430)		4354	↓	(4412)
EZ QE (€Bn)	1481	1481	2261	↓	(2416)		2591	↑	(2516)
UK QE (£Bn)	423	423	444		(444)		445		(445)
JP QE (¥Tn)	476	476	556	↑	(547)		676	↑	(667)
China RRR (%)	17.00	17.00	16.50	↑	16.00		16.00		16.00

Key variables

FX (Month of Dec)	Current	2016	2017		Prev.	Y/Y(%)	2018		Prev.	Y/Y(%)
USD/GBP	1.25	1.24	1.22	↑	(1.20)	-1.3	1.20	↑	(1.12)	-1.6
USD/EUR	1.08	1.05	1.04	↑	(1.00)	-1.4	1.01	↑	(0.95)	-2.9
JPY/USD	111.1	116.6	114	↑	(112)	-2.3	116	↑	(115)	1.8
GBP/EUR	0.87	0.85	0.85	↑	(0.83)	-0.1	0.84	↓	(0.85)	-1.3
RMB/USD	6.89	6.95	7.10	↓	(7.15)	2.2	7.40	↓	(7.50)	4.2
Commodities (over year)										
Brent Crude	50.7	45.9	56.5	↑	(50.1)	23.1	56.2	↑	(53.0)	-0.4

Source: Schroders, Thomson Datastream, Consensus Economics, March 2017
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 24/03/2017
Previous forecast refers to November 2016
* **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, 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

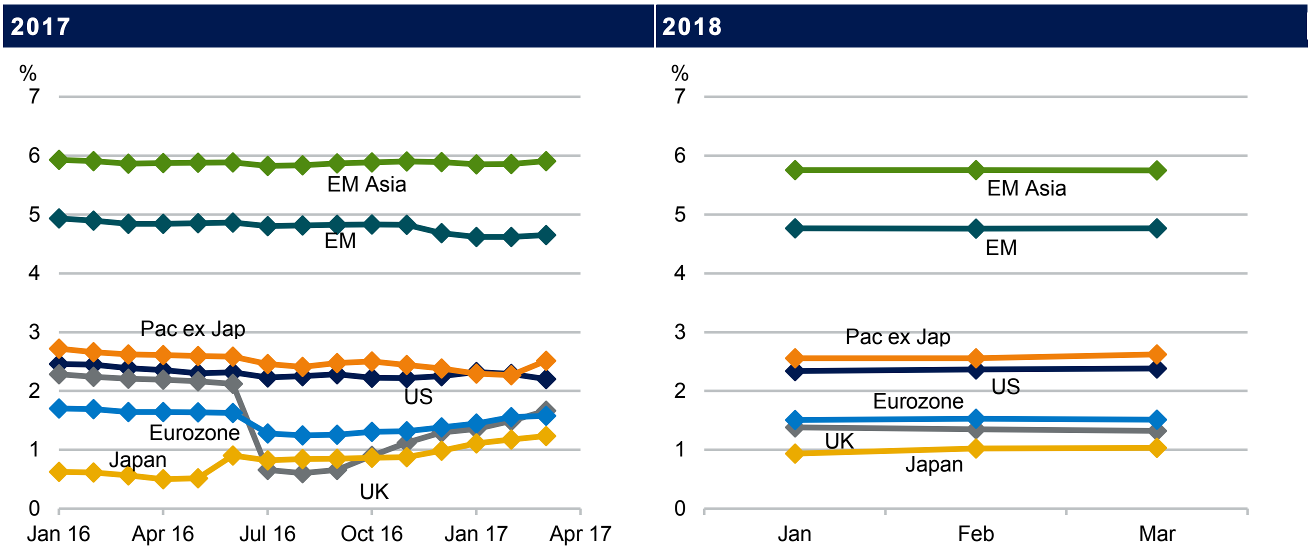
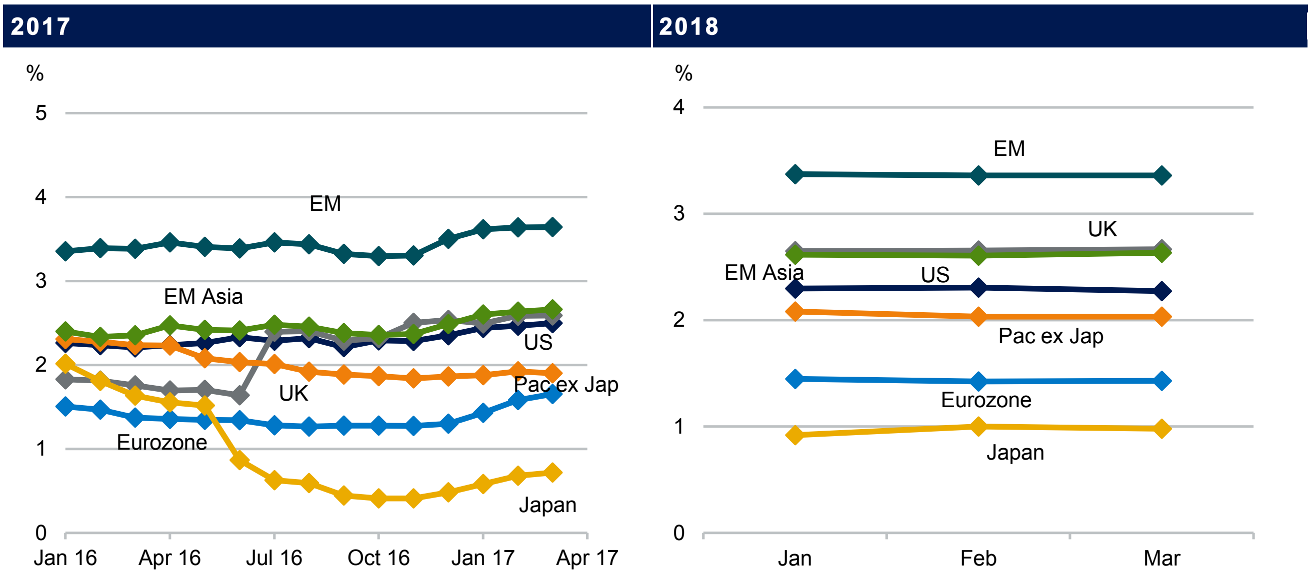


Chart B: Inflation consensus forecasts



Source: Consensus Economics (March 2017), 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.