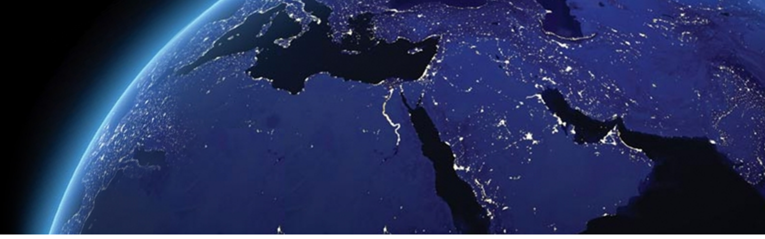


Emerging Markets

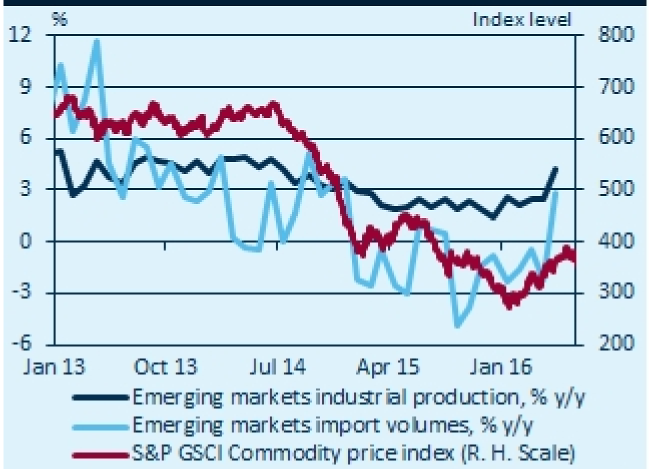
Emerging safe havens?

Emerging market (EM) investors have seen a turbulent 2016, marked by substantial political risk yet significant market improvement. An attempted coup in Turkey, political power grab in Brazil, and ongoing turmoil in the Middle East and South China Sea have complicated the political outlook for many of the largest emerging markets but done little to dissuade investors searching for yield. Although the growth outlook remains tepid, EM assets have shown substantial resilience to global events, in some respects even benefiting from political uncertainty in the developed world. From a fundamental perspective, **emerging markets are now benefitting from two significant changes over the first seven months of 2016: a marked improvement in commodity prices and a significant change to the outlook for Fed policy**. Both factors were primary causes of EM weakness over 2015. The fall in commodity prices from mid-2014 had a larger-than-expected negative impact on EM demand. Besides the obvious negative impact on the domestic economy of commodity exporters, depressed import demand and weaker financial flows from commodity producers impacted countries that were otherwise expected to benefit. Secondly, Fed rate hike expectations caused considerable tightening of financial conditions in EM. Fast forward to now and commodity prices are rebounding and Fed hike expectations are drastically reduced.

As a result, many of the largest EM economies saw fundamental improvement from Q1 to Q2. After a very weak first quarter, where official growth registered 4.9% quarter-on-quarter annualised, Chinese activity rebounded strongly at the end of Q2. The biggest thorn in China's side was the rising dollar and outflow pressures. Once the Fed signalled this hiking cycle would be slower and the terminal rate would be lower, outflow pressures subsided and currency pressure dissipated. China's policy combination of monetary easing, government spending and quasi-fiscal stimulus also worked to improve house prices and production figures. **Despite exacerbating long-term imbalances, the view that policymakers are using the necessary tools to stabilise growth has caused a general improvement in EM risk sentiment**. Elsewhere, it appears the worst is behind us – economic growth has troughed in most major commodity exporters; EM trade and production figures have begun to improve (see Chart 10); and financial flows into EM continued apace.

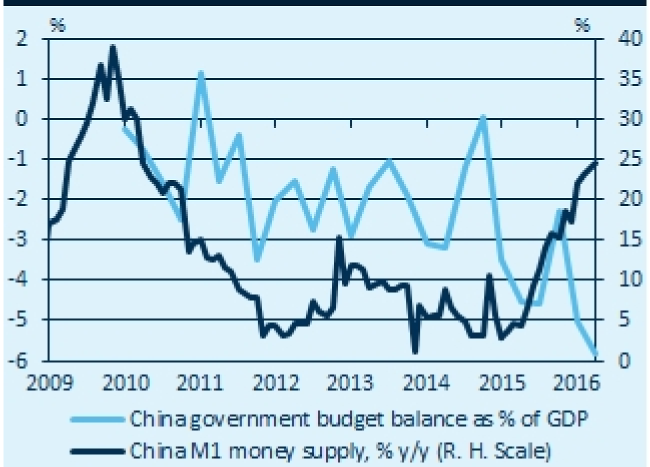
Looking forward, it is hard to see scope for much improvement in macro data or EM balance sheets; that said, the combination of accommodative Fed policy and commodity price stabilisation undoubtedly limits the downside potential. We see Chinese growth moderating over the second half of this year, as the current mini-cycle comes to an end and policymakers have dwindling room for additional stimulus. Sky-high M1 growth and record fiscal deficits (see Chart 11) point to easing momentum having peaked. It's difficult to know exactly why M1 figures are so high but it signals an economy with significant liquidity and few avenues to productively spend it. We think Indian growth will stay stable at current levels, and that the tailwinds created by the Seventh Pay Commission and a healthy monsoon will be offset by slowing private investment and weak credit growth.

Chart 10: Tracking commodities



Source: CPB, Datastream, Bloomberg (as of 30 June 2016)

Chart 11: Awash in cash



Source: CRBC, Datastream, Haver (as of June 2016)