MARKET VIEW
Emerging markets

MARCH 2017

> "Having fallen out of grace in late 2016 and early 2017, emerging equities and debt have been among the best performers in their respective asset classes as of 15 March"

Since Donald Trump's election as president of the United States, research and views have been very divided on emerging markets. And, in general, negative views have carried the day.
On the one hand, many agreed that the macroeconomic situation and microeconomic fundamentals were in the process of improving and that 2017 would hold some positive surprises in store. On the other hand, the utmost caution was in order, given the threats to launch trade "reprisals" against a number of emerging economies.
All in all, having fallen out of grace in late 2016 and early 2017, emerging equities and debt have been among the best performers in their respective asset classes, with gains of 8.8% and 1.75% respectively, as of 15 March and in euros. Where does the consensus stand now?

AN IMPROVED MACROECONOMIC OUTLOOK DESPITE WIDE DISPARITIES

For the first time in several years, the consensus has revised its growth forecasts for the BRICSs(1),to 5.4% for 2017, far higher than the 4.75% growth of 2016.
This shift is being driven by Brazil and Russia, which are now emerging from recession. Also noteworthy is that demonetisation did not have the disastrous impact on the Indian economy that was expected (including by us) and that the local macroeconomic situation has been a positive surprise.
Trends have also diverged in inflation. It continues to recede in Latin America but is accelerating in Asia, and is rebounding the most in central and eastern Europe. Mexico, India and Russia are exceptions in their respective regions.
Each central bank is acting in accordance with the cycle of its own local economy, but all of them are also somewhat conservative and even hawkish. Perhaps the only exception is the Brazilian central bank, with its clear easing policy. Since the deceleration of inflation was recognised as certain and sustainable, last autumn, the Selic(2) rate has been cut by 200 bps. This has come with a sharp reduction in the current account deficit over the past 18 months, as well as a set of reforms to stabilise and reduce public deficits, including over the long term.
The macroeconomic environment has thus been a healthy breeding ground for good performances for emerging sovereign debt. But it was still necessary for trade war risks to vanish or at least to see their probability of occurrence sharply reduced.

CLEAR CHOICES IN PRIORITISING US REFORMS, BUT STILL LOTS OF AMBIGUITY

A review of all of Trump's proposals during his campaign, particularly his domestic reforms (US corporate tax reform) and his aggressive trade policy against countries like China and Mexico, had highlighted the difficulty of waging all his battles simultaneously, as no indication was provided during the campaign of the future US administration's priorities. Some clarity now seems to have emerged, and the priority seems to have been given to domestic reforms.

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(1) Brazil, Russia, India, China and South Africa
(2) Brazilian money-market rate

ODDO BHF ASSET MANAGEMENT

> *In some countries we are also seeing a positive shift in political momentum.*

Republican tax experts in Congress are preparing a major reform that will include a reduction in the corporate tax rate but may also include export tax breaks, import taxes, the non-deductibility of interest costs and the option of depreciating productive investments over just one year, with all of this meant to remain close to tax neutrality. This will clearly be a huge undertaking loaded with pitfalls.

Meanwhile, we have seen a number of signs of easing in tensions between the United States and its trade partners who had been its main targets. There is now talk of opening negotiations with Mexico and Canada, and no longer any talk of a unilateral withdrawal from NAFTA(3). Regarding China, regular contacts have been agreed to, to avoid "misunderstood decisions" and even to set up a summit meeting between Xi and Trump.

Of course, there are still some sticking points between the two great powers, such as in the Yellow Seat or at the WTO, but the baseline scenario is now a non-aggression pact and the avoidance of a trade war. Keep in mind, as well, that based on US Treasury criteria, it would be hard to accuse China of manipulating its exchange rate. Meanwhile, China is trying to not depreciate its exchange rate excessively, which is consistent with its policy of stemming capital outflows.

In some countries we are also seeing a positive shift in political momentum. In India, for example, Modi's victory in elections in Uttar Pradesh (despite losses in other states) has bolstered his standing on the national level and made him the favourite in the next general elections. On the other hand, tensions have seldom been so high with Pakistan. In Brazil, Temer has undertaken major reforms, which he has thus far managed to get through Congress.

In April, a pension reform will be put to a vote for the purpose of boosting public finances. But Temer is not an elected president – he replaced Dilma Roussef – and his legitimacy is extremely shaky. In Korea many investors believe that the finalisation of the impeachment of the president and the arrest of Samsung's CEO were steps in the right direction in terms of governance and the *chaebols*(4). Regarding China, we are not among those overwrought investors, given that, in the run-up to the 19th Party Congress this autumn, officials will try to rein in volatility in China's economy and its financial markets while continuing the process of creative destruction in various sectors.

(3) North American Free Trade Agreement
(4) Korean corporate conglomerates in various sectors that maintain cross shareholdings.

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> *"Can one really steer completely clear of markets accounting for 58% of the world's GDP?"*

THIS MAY BE THE START OF A TURNAROUND IN MICROECONOMIC INDICATORS

The positive trend in political risks has led emerging market equity prices back to their levels prevailing before the US elections, albeit to varying degrees from one country to another. Most local indices are now trading at near their five-year highs. Is this a reason to steer clear of these countries?
Not necessarily, considering that:

- These markets are emerging from three or four years of derating justified by drastic leveraging, shrinking margins, mixed trends in sales and profits, and the lack of progress in governance (setting aside the various crackdowns on corruption in Brazil, Korea, India, and elsewhere).
- Valuations are far below those of developed economies, particularly in price/book value terms (1.6 vs. 2.3).

So further gains in emerging equities will require a recovery in results, shored up balance sheets and improved governance, and there have been positive signs in the last three months on margins, debt/EBITDA ratios, and sales. And (proper) treatment of minority shareholders is increasingly taken on board by company managers in emerging markets.
We might add that most emerging market currencies are still undervalued, which makes those markets even more attractive for euro- and USD-based investors.

In conclusion, what are the risks? The main one is probably a radical change in US trade policy. A steep drop in oil prices – and industrial metals – is another risk. And, obviously, a US recession would hit asset values – corporate and sovereign bonds and equities – in these countries directly and significantly. For the moment, we don't believe any of these three scenarios are very likely. The major risk could ultimately be a combination of "a little of all three". But can one steer completely clear of markets accounting for 58% of the world's GDP (in PPP terms, and 38% in current USD) and (according to the World Bank) one third of its of its market capitalisation?

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