Rosa & Roubini ASSOCIATES

# MAKING SENSE OF *THIS* WORLD — *12 February 2018*

*R&R Weekly Column*
*By Brunello Rosa*

## Emerging Markets Remain Resilient in Global Market Shake-Up

As the market tries to settle after a week of elevated volatility and re-pricing of securities across the board,we would like to highlight the remarkable resilience of emerging markets in this turbulent context. If we look at MSCI indexes, emerging equity markets had outperformed DMs in the January 2018 rally (+7.5% versus 5.8%) and slightly underperformed DMs in the sell-off (-10.2% vs -8.8%, mirroring the re-widening of credit spreads), but their performance since the beginning of the year has been in line with the global index (-3.5%). At the time of the 2013 taper tantrum, the sell-off at the long end of the US yield curve sent shockwaves through the system that impacted mostly EMs, in particular the so-called Fragile Five economies (Turkey, Brazil, India, South Africa, Indonesia) which were most exposed because of their large current account deficits and external debt. On the other hand, in our recent analysis on EM currencies, we had already noted how EMs (including the Fragile Five) had repaired some of their domestic and external balance sheets, thus proving more resilient to the Fed's interest rate normalisation and potential dollar appreciation.

Our travel notes from Turkey (one of the most fragile economies from an external perspective, with a still-large C/A deficit) highlighted how the country's cyclical economic resilience was able to compensate the historical structural economic deficiencies, even within a complicated domestic political and international geopolitical environment. Our analysis on China in January discussed how the managed economic transition from an investment-driven to a consumption-led economy was likely to result in a gradual, if bumpy, slowdown, rather than a crash, thanks to a political system that had just renewed its confidence in the single-party system, and its supreme leader, President Xi, and how this would allow the Asian giant to weather not just a passing storm, but even a systemic crisis. More in general, during the recent sell-off, EMs have found resilience in a number of concurring factors, including: *first*, synchronised global growth will continue to exert a positive influence on EMs, most of which still depend on export to grow; *second*, the stabilisation of commodity prices in 2016-17 has also helped stabilise the EM business cycle; *third*, the build-up of foreign reserves and the shrinking of current account deficits have made most EMs less sensitive to sudden market reversals; *fourth*, the fact that the dollar index only appreciated 2.2% during the sell-off meant that EMs did not suffer massive currency outflows.

Going forward, assuming the US inflation scare does not intensify, investors cite still positive yield differential between DM (in particular US) rates and EM rates and the relative cheapness of EM versus DM equity on a P/E basis to justify continued search for opportunity in the EM fixed income and equity spaces. A worsening of the sell-off would most likely induce a re-thinking of this position, even if the impact on EM would likely be smaller than in 2013, considering better economic fundamentals. Clearly other structural risks exist that suggest cautiousness in EM exposure, such as a political cycle with elections in Mexico, Brazil, Russia and soon South Africa, the build-up of a large amount of corporate debt (often dollar-denominated), the potential fallout of protectionist measures from the US administration (e.g. stand-off of Nafta negotiations) and geopolitical risks in various parts of the world.

### *Our Recent Publications*

- *Turkey: Muddling Thorugh Macroeconomic and Geopolitical Challenges*, *by Rémi Bourgeot, 7 February 2018*
- *BoE Delivers Hawkish Inflation Report* *by Brunello Rosa,* 8 February *2018*
- *Italian Elections: Uncertainty and Complacency Abound* *by Brunello Rosa, 6 February 2018*

## The Week Ahead

***US - The 2019 fiscal plan will be unveiled on Monday 12 February*.** On Friday 9, the US Congress ended the government shutdown (the second this year) with a deal that secures government funding until March 23. The deal also sets the framework for the federal budget for the next two years. This week, January CPI data will be published in the US (*c:* 1.9% y-o-y; *p:* 2.1%).

***Germany - The agreement to form a government still requires approval by SPD members*.** On Wednesday 7, CDU and SPD reached an agreement to form a new coalition government. The SPD will get the finance and foreign ministries. However, the agreement needs to be validated on a mail ballot by the 464,000 SPD members. The results will be made public on March 4. This week, January CPI data will be published in Germany (*c:* 1.6% y-o-y; *p*: 1.6%).

***UK – Inflation data.*** After the BOE delivered a hawkish Inflation Report on Thursday 8 February, this week January inflation data will be published in the UK (*c:* 2.9% y-o-y; *p*: 3.0%).

***Oil prices will continue to be impacted by oversupply concerns.*** On Friday 9, Brent oil dropped to its lowest level of 2018 (USD/bbl. 62.8, -8.4% w-o-w), after EIA data showed that: *a)* US domestic oil production hit almost 10.3mn bpd, exceeding the prior record of 10.04m b/d, set in 1970; and *b)* US crude inventories increased by 1.9mn barrels w-o-w).

## The Quarter Ahead

***The absence of structural inflation will prevent an acceleration of the Fed's tightening cycle.*** As a result, in H1-2018 stocks are unlikely to experience a "bear market" *(a 20% fall from the 52-week high, over 300 days)* or a "market crash" *(a 10% fall in one day, or 40% from the 52-week high over 150 days).* The growth outlook remains positive both in the US and EZ, as suggested by the January US ISM non-manufacturing (*a:* 59.9; *c:* 56.5; *p:* 56.0) and EZ PMI (*a:* 58.8; *c:* 58.6; *p:* 58.6).

***Europe*** - A new Grand Coalition government (if approved by the SPD base) in Germany supported by French President Macron should be able to adopt some of the reforms needed to further the EZ integration process.

***China - Later in the year it will let the CNY weaken.*** Year-to-date, China has allowed its currency to appreciate against the USD (3.1% y-t-d to USD/CNY 6.303 as of February 9). The move has probably been induced by US President Trump's allegations on China's "*unfair trade policies*". The appreciation will impact exports negatively, but it will also reduce the cost to repay USD-denominated debt for Chinese firms. Later in the year, China is likely to let its currency depreciate by allowing limited amounts of capital to flow out of the country.

***Saudi Arabia - The government collected more than USD 100bn (15% of GDP, as estimated by Fitch's) in corruption settlements.*** The additional revenues will provide additional fiscal space to the government. The net impact of the anti-corruption campaign on the economy will depend on: *a)* how the additional revenues are utilized; and *b)* the impact on the investment climate. In the oil sector, rising US output, which might surpass Saudi Arabia's and Russia's, will probably offset the production cuts led by the Opec and Russia, adding downward pressure on prices.

## Last Week's Review

***US - Stocks suffered a large decline.*** In the trading week ending on February 9, global markets continued to experience losses. The S&P500 and the DJIA were close to a correction (*a fall of 10% from the 52-week high over a single week*), as they ended the week with losses of 7.5% and 5.2% w-o-w respectively (down 11.1% and 9.1% from their January 26 record-high). As stocks fell, volatility spiked: the VIX reached its highest weekly close (29.1) since October 2011. The USD appreciated by 1.7% w-o-w, closing the week at EUR/USD 1.225.

***Brazil - On Wednesday 7, the BCB lowered its benchmark rate to a historic low of 6.75%.*** The BCB cut the policy rate by 25 bps to boost growth, taking advantage from falling inflation (2.9% y-o-y in January 2018, compared to 5.4% in January 2017).

***Turkey - January y-o-y inflation decelerated to 10.4%*** (*p:* 11.9%). However, the decline in inflation is unlikely to be permanent, and, therefore, the CBRT is not expected to reduce rates.

***Pablo Gallego Cuervo*** *and* ***Renata Bossini*** *contributed to this Viewsletter. The picture in the front page comes from this website.*

## Abbreviations, Acronyms and Definitions

| | |
|---|---|
| *a* | *Actual* |
| *bn* | *Billion* |
| *BCB* | *Central Bank of Brazil* |
| *BoE* | *Bank of England* |
| *BoJ* | *Bank of Japan* |
| *bpd* | *Barrels per day* |
| *bps* | *Basis points* |
| *c* | *Consensus* |
| *CB* | *Central bank* |
| *CBK* | *Central Bank of Kuwait* |
| *CBO* | *US Congressional Budget Office* |
| *CBR* | *Central Bank of the Russian Federation* |
| *CBRT* | *Central Bank of the Republic of Turkey* |
| *CDU* | *Christian Democratic Union of Germany* |
| *CNY* | *Chinese Yuan* |
| *CPI* | *Consumer Price Index* |
| *CSU* | *Christian Social Union in Bavaria* |
| *DFMGI* | *Dubai Financial Market General Index* |
| *DJIA* | *Dow Jones Industrial Average Index* |
| *d-o-d* | *Day-on-day* |
| *DXY* | *US Dollar Index* |
| *EC* | *European Council* |
| *ECB* | *European Central Bank* |
| *EIA* | *US Energy Information Agency* |
| *EM* | *Emerging Markets* |
| *EP* | *European Parliament* |
| *EUR* | *Euro* |
| *EZ* | *Eurozone* |
| *Fed* | *US Federal Reserve* |
| *FOMC* | *US Federal Open Market Committee* |
| *FRB* | *US Federal Reserve Board* |
| *FX* | *Foreign exchange* |
| *GCC* | *Gulf Cooperation Council* |
| *GBP* | *British pound* |
| *GDP* | *Gross domestic product* |
| *GOP* | *Grand Old Party (US Republican Party)* |
| *IMF* | *International Monetary Fund* |
| *IPO* | *Initial public offering* |
| *JPY* | *Japanese yen* |
| *k* | *thousand* |
| *m-o-m* | *Month-on-month* |
| *mn* | *Million* |
| *MPM* | *Monetary Policy Meeting* |
| *M5S* | *Five Star Movement* |
| *OECD* | *The Organization for Economic Cooperation and Development* |
| *Opec* | *Organization of Petroleum Exporting Countries* |
| *P* | *Previous* |
| *PCE* | *Personal Consumption Expenditures* |
| *PM* | *Prime minister* |
| *PMI* | *Purchasing managers' index* |
| *pps* | *Percentage points* |
| *QE* | *Quantitative easing* |
| *q-o-q* | *Quarter on quarter* |
| *SHCOMP* | *Shanghai Stock Exchange Composite Index* |
| *SPD* | *Social Democratic Party of Germany* |
| *tb/d* | *Thousand barrels per day* |
| *tn* | *Trillion* |
| *TRY* | *Turkish Lira* |
| *UAE* | *United Arab Emirates* |
| *UK* | *United Kingdom* |
| *US* | *United States* |
| *USD* | *United States Dollar* |
| *USD/bbl. .* | *USD per barrel* |
| *UST* | *US Treasury bills/bonds* |
| *VAT* | *Value added tax* |
| *VIX* | *Chicago Board Options Exchange Volatility Index* |
| *w-o-w* | *Week-on-week* |
| *y-o-y* | *Year-on-year* |
| *y-t-d* | *Year-to-date* |
| *YPG* | *People's Protection Units* |

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***Analyst Certification**: We, Brunello Rosa and Nouriel Roubini, hereby certify that all the views expressed in this report reflect our personal opinion, which has not been influenced by considerations of Rosa&Roubini Associates's business, nor by personal or client relationships. We also certify that no part of our compensation was, is or will be, directly or indirectly, related to the views expressed in this report.*