

Six Hot Questions for Emerging Markets

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Key Insights

- **China:** Significant fears re-emerged in recent months about China's economy and, financial stability and their impact on the rest of the world. While China is facing bigger challenges, we still think Beijing could manage a soft-landing, although further slowdown is likely to come.
- **In the event a hard-landing materializes,** EMs as a whole would suffer badly, but impacts are expected to be diversified. Major metal commodity exporters in LATAM would likely suffer the most. Asia economies could suffer too, but net commodity importers should partially benefit from lower commodity prices. EMs in Eastern Europe may hold up better, given less direct links to China's economy and commodity prices.
- **Internal drivers: Monetary Policy.** The stance of Monetary Policy, according to the domestic conditions, is still accommodative; the EM output gap is open and inflation doesn't prevent cutting the rates. External factors such as Federal Reserve action could change the Monetary Policy stance for many EM countries. **Fiscal:** most of the EM countries are struggling to increase capex through public expenditure.
- **Macro Momentum:** EM macro Momentum is negative except for Hungary and Czech Republic. India is relatively better among BRICs, Brazil is the worst because of the ongoing deep recession and related fiscal issues.
- **External Vulnerability:** China remains the safest country, while Turkey is the most externally vulnerable country. India improved the most, while Malaysia deteriorated the most from Q1 15 to Q2 15.

While we recognize there are bigger challenges than several months ago, we still think Beijing could manage a soft-landing, although further slowdown is likely to come.

1. Is China Safely Converging Towards More Moderate Rates of Growth or is a Hard Landing Scenario Materializing?

Significant fears re-emerged over the last couple of months about the health of China's economy and its impact on the rest of the world. While we recognize there are bigger challenges than several months ago, we still think Beijing could manage a soft-landing, although further slowdown is likely to come.

What are the New Challenges?

Lack of communication about the country's reform of its currency regime in August triggered unexpected volatility in global financial markets. Despite recent clarifying from senior officials, worries remain as to whether policymakers will be able to manage a smooth transition by keeping capital outflows under control.

Meanwhile, investor confidence in Beijing's ability to manage economic transition has been seriously dampened by bad management of on-shore equity markets, with large-scale and controversial interventions in recent corrections.

There are also increasing doubts about the progress of structural reforms.

We expect the Renminbi to depreciate somewhat over the next couple of years, but the PBOC should be able to keep capital outflows reasonable.

Despite market volatility, reform measures have continued.

Continued disappointing data, together with the above concerns, have resulted in renewed fears about a hard-landing of China's economy in the near future.

Are they Manageable?

Although these concerns are sensible, we think the risks are still manageable. The stock market has much a smaller role in China's economy compared with other major countries. Meanwhile, it appears that Beijing is shifting its way of managing the equity market towards more market friendly measures.

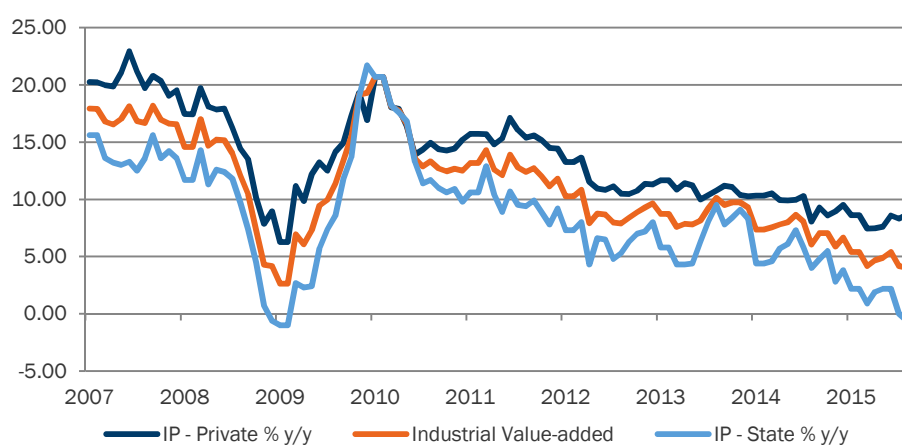
The country has one of the strongest Forex (FX) balance sheets among the major economies, as well as still effective capital controls. Fundamental inflows through trade surpluses and net Foreign Direct Investments (FDI) increased significantly over the past year. We expect RMB (Renminbi) to depreciate somewhat over the next couple of years, but the PBOC (People's Bank of China) should be able to keep capital outflows at reasonable levels.

Economic growth is likely to slow further in the next couple of years, but this should be not surprising, as it is a result of structural transition. So far, the slowdown has been largely within property-linked industries, including mining and heavy sectors. The export sector is also suffering, but this largely reflects weakness in global demand. In contrast, consumption-linked, private sector and services seem to be resilient. There is no sign yet that the labour market is in significant difficulty.

The policy stance remains supportive on both the monetary and fiscal sides. New efforts at the central government level over the last few months should help to offset weakness in local government spending over the next few quarters. Moreover, space for further easing remains.

More importantly, the reform direction seems unchanged. Despite market volatility, broad reform measures have continued, including further interest rate liberalization (nearly finished), a constructive SOE (Stated Owned Enterprises) reform plan, and further steps on basic medical insurance and rural lands. Looking ahead, we expect to see softer growth, but the risk of a hard landing remains limited.

Figure 1. China Industrial Production – Structural Slowdown Rather than Broad Hard-Landing



Sources: CEIC, Pioneer Investments, as of Sep 2015

Among EMs, those in Asia and Latam with close trade links with China would suffer the most from a China slowdown

2. Which Countries are More Exposed to the Risk of a Chinese Hard Landing?

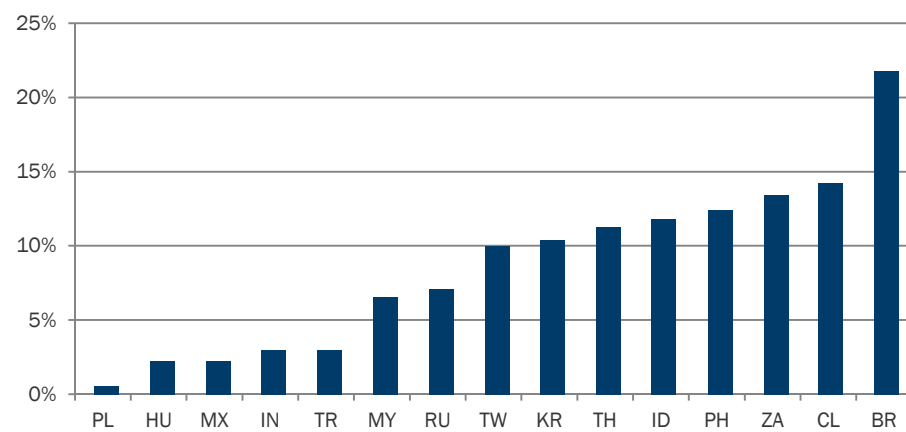
Although we continue to believe the risk of a Chinese hard landing is limited, it is worth performing a stress test in the event such risks materialise.

A sharp and broader slowdown, or a hard landing, would directly hit those countries whose exports to China are based on final demand (rather than being reshipped elsewhere). Among EMs, those in Asia and Latam with close trade links with China would suffer the most.

That said, the impacts would be different for different types of exports.

- Major metal exporters would likely suffer the most. Not only based on declining exports to China, but also potential lower commodity prices would further damage their current account balance, currency and financial stability.
- Agriculture commodity exporters could hold up better, given China's solid demand in certain agricultural goods.
- Most Asian economies, while highly exposed to China demand, could benefit from lower commodity prices, as large importers.

Figure 2. Share of Exports of Final Goods to China (As Percentage of Total Exports and GDP)



Source: Citigroup, Pioneer Investments, as of September 2015.

In a hard landing scenario, the external financial stability of an economy would also be seriously tested.

3. Given Lackluster Global Trade, How are the Domestic Drivers such as Monetary and Fiscal Policies Working?

Global Trade picked up in June, moving from -0.1% YoY in May to 2.6% YoY. However, it has remained on a downward trend over the last year, and we have accordingly revised down our expectations for 2015 from around 4% to around 2%. The case that we presented at the beginning of the year, when we said that external demand would not be supportive of economic growth in the EM universe, has been more and more confirmed by the data.

We moved then to analyse the ability of domestic drivers to engineer sustainable growth for these countries, specifically Monetary and Fiscal policies.

According to our analysis, monetary policy within the EM universe needs to remain on the accommodative side, but since the beginning of the year the easing room in many countries has narrowed.

Monetary Policy

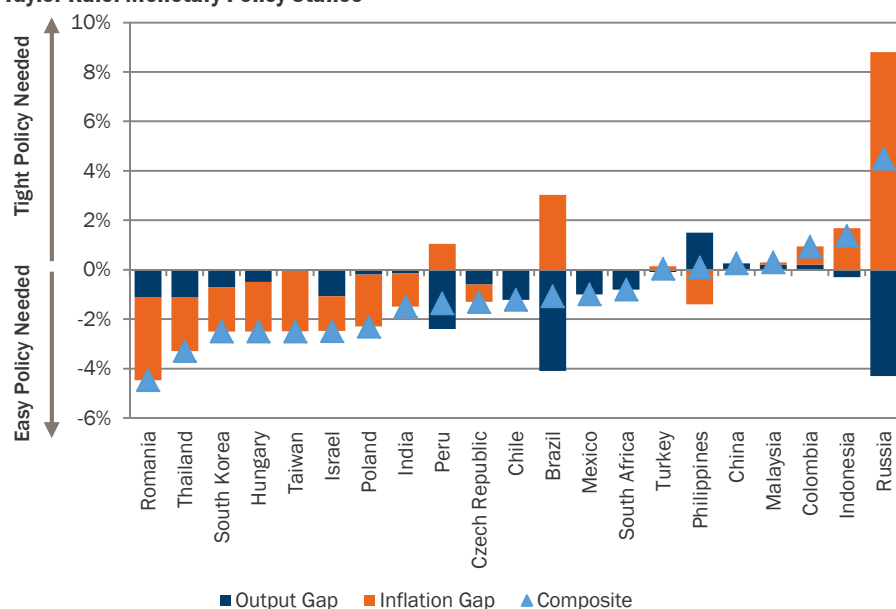
According to our internal Taylor Rules¹, monetary policy within the EM universe needs to remain on the accommodative side. Most of the countries are growing at rates below their potential and inflation is rarely a constraint to cutting policy rates, indeed it is generally well below the Central Bank target. The few exceptions in that regard are Russia, Indonesia and Colombia where high inflation rates are calling for higher policy rates. In Brazil, the high inflation is not enough to offset the need for easing created by the economic cycle, as the country is in deep recession.

Recently, the RBI (Reserve Bank of India) surprised with a 50 bps, stronger action than expected. A cut by 25 bps was in the pipeline, but the Federal Reserve's cautious stance provided a tailwind for the move. The domestic conditions in India remain supportive of an accommodative stance. Our Taylor Rule is calling for a further 75 bps of rate cuts.

In the near term, we expect a wait and see mood, depending on the Federal Reserve's actions and the inflation outlook.

Figure 3. EM Taylor Rules

Taylor Rule: Monetary Policy Stance



Source: Pioneer Investments, as of 29th of September 2015. Output gap is the difference between actual GDP and potential GDP. Inflation gap is the difference between actual inflation and Central Bank target. Composite summarizes the contribution coming from output and inflation gap.

It's worth noting a couple of additional considerations:

- Since the beginning of the year, the easing room in many countries has narrowed, because the Monetary Authorities have cut the rates and the inflation rate has bottomed.
- While the Federal Reserve didn't hike rates in September, we are still in an environment where it is expected to do so in the near future. For many of the EM countries (e.g. Mexico), that's enough to offset any will to engage in easing, regardless of domestic economic conditions.

¹ Our version of the monetary-policy rule proposed by John B. Taylor and aiming at calculating the change in the nominal interest rate that a central bank should apply as a result of changes in inflation, output or other economic factors in order to foster price stability and full employment.

Fiscal Policy

At this point in the fiscal year, for most EM countries it's possible to assess how the fiscal balances are going with respect to the expectations the Governments put in their budgets at the beginning of the year. We ran an analysis with the aim of identifying the countries willing to allow their fiscal positions to deteriorate in order to boost or sustain their economic growth. We declared as "winners" those without the intertemporal budget constraints of high Government Debt as percentage of GDP. Colombia, Philippines, Russia, Indonesia and Chile were among these countries and, more recently, South Korea and Turkey joined the group as tentatively supporting the economy through the fiscal channel.

Notwithstanding the fiscal consolidation embarked upon in India, that country has already used 70% of its budget in the first 4 months of the fiscal year and is running capex expenditure faster than the run rate. Sometime towards the end of the year the Fiscal Deficit target will be again in the spotlight. India has the room to meet its target via a serious program of public assets dismissal.

Russia and Brazil's fiscal position has deteriorated sharply because of the deep recession they are experiencing and the low price level for the commodities they export. However, Russia has a low Government Debt and is using its Reserve Fund to fund its deficit, which allows it to spend in support of growth. That state of affairs can't last many years and, indeed, they are currently debating in their budget law definition as to how to replenish their Reserve Fund by changing the threshold of the Oil Price in excess of which they will transfer money to the fund. At the opposite end, Brazil has a very high and increasing Government Debt, and the Fiscal Consolidation goals declared at the beginning of the year have been derailed, leaving the country on the edge of a fiscal crisis.

Russia and Brazil deteriorated sharply their fiscal position because of the deep recession they are passing through and the low level of commodities prices that they export.

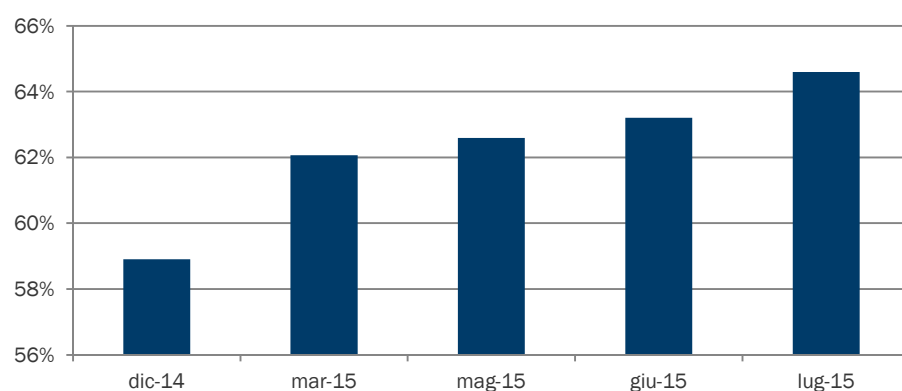
In Brazil, it has become more and more clear that implementing painful fiscal reforms in a country strongly hit by a deep recession is quite unrealistic and the Government Debt has been quickly rising.

4. Is Brazil on the Edge of a Debt Crisis?

At the end of August, a draft for the next fiscal year budget balance was circulated with a Primary Fiscal Deficit target of 0.34% as percentage of GDP in 2016 and around -0.2% in 2015. That was the catalyzing event in bringing to the attention of investors what was happening in Brazil.

Less than one year ago, President Dilma Rousseff took a brave and correct decision in appointing a fiscal hawk, Levy, as Ministry of Finance, recognizing that Brazil needed to embark on a fiscal consolidation phase before returning to sustainable growth. Unfortunately, it has become more and more clear that implementing such painful fiscal reforms in a country strongly hit by a deep recession was quite unrealistic, and the Government Debt has been rising rapidly.

Figure 4. General Government Gross Debt as Percentage of GDP



Source: Central Bank do Brazil, Pioneer Investments, as of July, 2015

After reducing their fiscal target several times during the year, the Cabinet in August announced a Primary Fiscal Deficit for the current and following years. Since then the Cabinet has started to negotiate with Congress measures to fix the fiscal situation and to approve a Budget Law that includes a positive number as the Primary Fiscal Balance target for next year.

The second catalyst has been the downgrading of Brazil's credit outlook by the S&P rating agency. The rating agencies have been saying that a precondition to keeping Investment Grade status was a positive Primary Balance. S&P moved quite early in downgrading the outlook, on the conclusion that Brazil will not be able, for many reasons, to properly fix its fiscal situation in the short term.

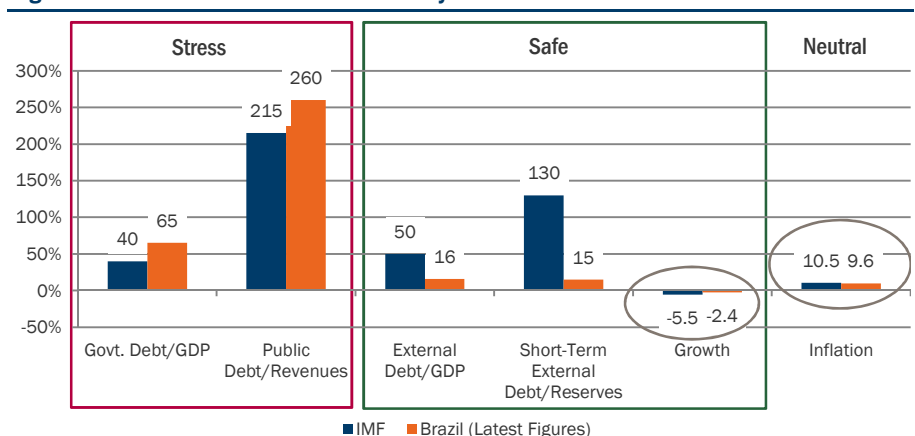
What is the current state of affairs?

- The economic conditions remain awful: the economy is in a deep recession (-2.6% YoY in Q2 2015) and inflation is still high (9.5% YoY in August), notwithstanding the aggressive hawkish stance of the Central Bank. The perspectives are not rosy. The Central Bank kept a wait and see attitude with regard to Monetary Policy: they are supposed to be at the peak of the hiking cycle but it remains to be evaluated given the impact of the strong currency depreciation (-32% since the beginning of the year) on imported inflation and inflation expectations. In the meantime, the Central Bank is very active in programs aiming to defend the currency, via FX swaps.
- The stability conditions are poor. On the political side, there is the risk/hope of an impeachment of the President. Many believe that a political change at the top could unblock the dialogue between the Cabinet and Congress, easing the decision-making process in economic and fiscal policy matters. On the external vulnerability side, Brazil remains in a neutral position in the EM rank: thanks to the FX swaps mentioned earlier, in the short term they have a safe buffer in terms of Reserves and External Debt as percentage of GDP is low.

Despite weak economic and stability conditions previously mentioned, a debt crisis is unlikely to happen in the short term.

Despite weak economic and stability conditions, a debt crisis is unlikely to happen in the short term. Comparing main economic indicators with the IMF thresholds used to assess the probability of a default scenario, provides evidence of a less alarming environment. Stress signals come from excessive Government Debt/ GDP and Public Debt/Reserves ratios. Inflation is an element to watch as it could spike as a consequence of excessive currency depreciation. External position and GDP growth indicators are in a safer position.

Figure 5. Thresholds to Measure Probability of Default



Source: IMF paper <https://www.imf.org/external/pubs/ft/scr/2012/cr12192.pdf>. Bloomberg, CEIC, Pioneer Investments. Data as of 30th September 2015

Note: Growth is 2015 consensus estimate

Overall, the macro momentum in EM is negative but in Hungary and Czech Republic. Brazil has the worst macro momentum due to deteriorating domestic growth dynamics and deteriorating fiscal dynamics.

5. How's the Macro Momentum Within the EM?

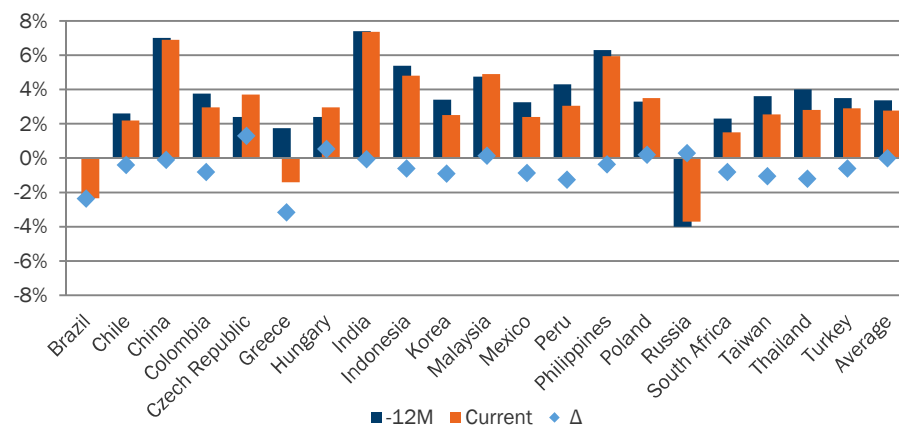
Overall, the macro momentum in EM² is negative except for Hungary and Czech Republic. Brazil has the worst macro momentum due to deteriorating domestic growth and fiscal dynamics.

On a regional perspective, EEMEA (Eastern Europe, Middle East, and Africa) has better macro momentum compared to other regions mainly due to improving growth forecasts in Poland, Czech Republic and Hungary. Russia and Greece have the less appealing momentum in the region due to public finance conditions: the Russian fiscal balance is under stress due to diminished oil revenues, while skewed public debt in Greece is still taking its toll on growth.

Growth momentum in Asia is low due to worsening growth forecasts for external dependent economies such as Korea and Taiwan. India and Philippines remained the least effected economies within Asia due to improving inflation dynamics and relatively stable fiscal balances.

Figure 6. 2015 GDP Growth Forecast

2015 GDP Growth Forecast



Source: Ceic, Bloomberg, Pioneer Investments, as of September 2015

The sharp drop in global resource prices has resulted in lowered growth forecasts for Latin American commodity exporting economies. Within Latam, Mexico has the better macro momentum due to still favorable fiscal dynamics along with an improving inflation outlook.

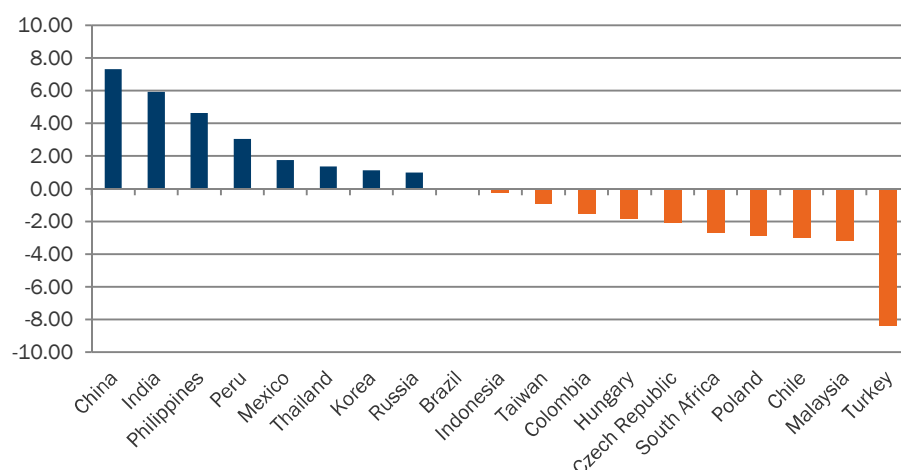
6. IIF the Fed is Indeed Delaying its Decision on the Policy Rate, Which Countries are Most Vulnerable in the EM Universe?

Notwithstanding the Federal Reserve's failure to act in September, a near-term intervention by the US Central Bank is still our main case (December is the most likely horizon). We updated our External Vulnerability Index with most of the Q2 2015 figures, in order to rank the EM Universe in terms of external vulnerability.

² The score measures the macroeconomic momentum among the EMs. The growth momentum has measured with the latest six months changes in GDP forecasts. Related to the demand side, we have the internal demand (Private consumption and Investments) and external demand (exports) as momentum measures and with respect their position versus their growth trend. Public finance momentum has measured with changes in government debt over one year and fiscal balance dynamics through the current fiscal year. The three months forward inflation expectations have measured versus the Central Banks target. Lastly, the gap between real policy rates and real GDP growth for next three months measures the liquidity conditions in each economy.

In term of external vulnerability, China remains the safest country externally wise, while Turkey keeps the riskiest position.

Figure 7. EM External Vulnerability



Source: Ceic, Bloomberg, Central Banks, BIS, Pioneer Investments, as of September 2015. Vulnerability index takes into consideration various indicators among which Current Account/GDP, Foreign Direct Investments/GDP, External Debt/GDP, Forex Reserves/Short Term External Debt.

The top and bottom positions have not changed in comparison with the previous update (three months ago): China remains the safest country with respect to external factors, while Turkey keeps the riskiest position. The big effort embarked by India in terms of adjusting balances is clearly visible in the above table, where India has gained the second-ranking position. Among the so called fragile five, India is the only country to have made significant forward strides. We can't say that the country is fully safe should there be a disorderly exit from QE by the Federal Reserve. Brazil's position improved on the narrowing of the CA in the latest months, due to a sharp fall of imports (weakness in demand) and a strong currency devaluation (around 30% since the beginning of the year). Malaysia, on the opposite end of the scale, has declined in rank because of the deterioration of its CA (while remaining in surplus it has decreased at 2.7% of GDP).

Conclusions

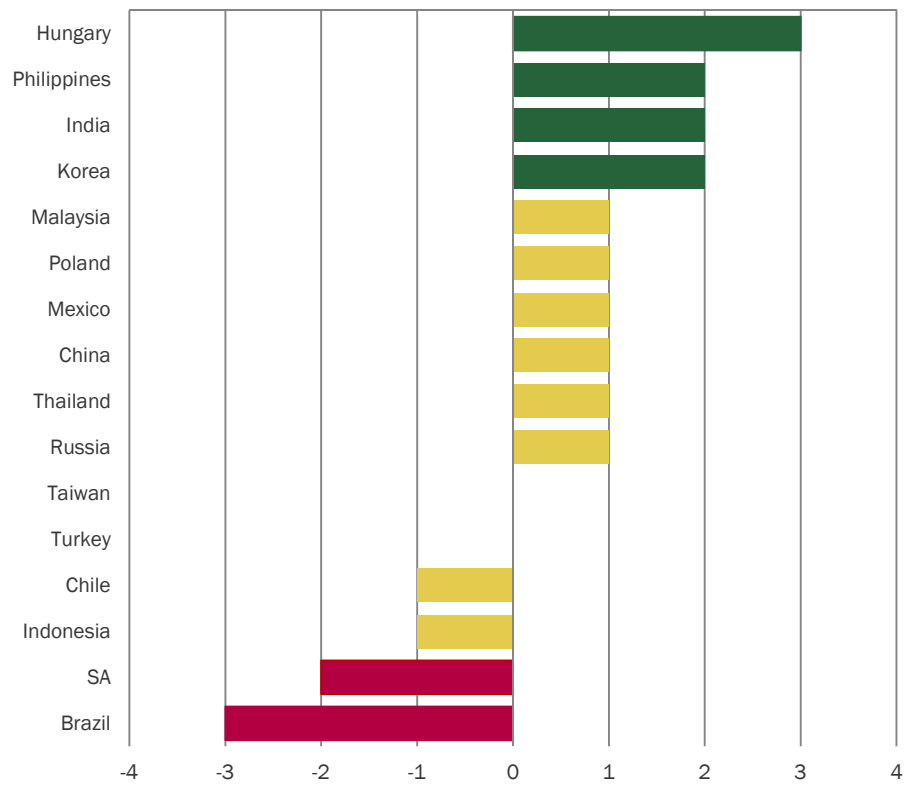
We assessed the outlook for each EM economy, applying the assumptions detailed in this document and that are shaping our main scenario:

- China -a manageable slowdown
- Fiscal and Monetary stance
- External Vulnerability
- Macro Momentum

The chart below summarizes our conclusions, ranking the different EM countries. The rank was built by assigning a value of +1, 0 and -1 to each parameter depending on whether the country exhibited a positive, neutral or negative response, respectively. These values were then added together in order to obtain a comprehensive score for each country.

Brazil and South Africa are the least appealing countries in the AM universe, while at the opposite end a number of Asian economies along with Hungary are the best positioned.

Figure 8. EM Rank



Source: Pioneer Investments, as of September 30, 2015

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