24 August 2018

Strategy

New 'fragile five' in emerging markets

A challenging year for emerging markets...

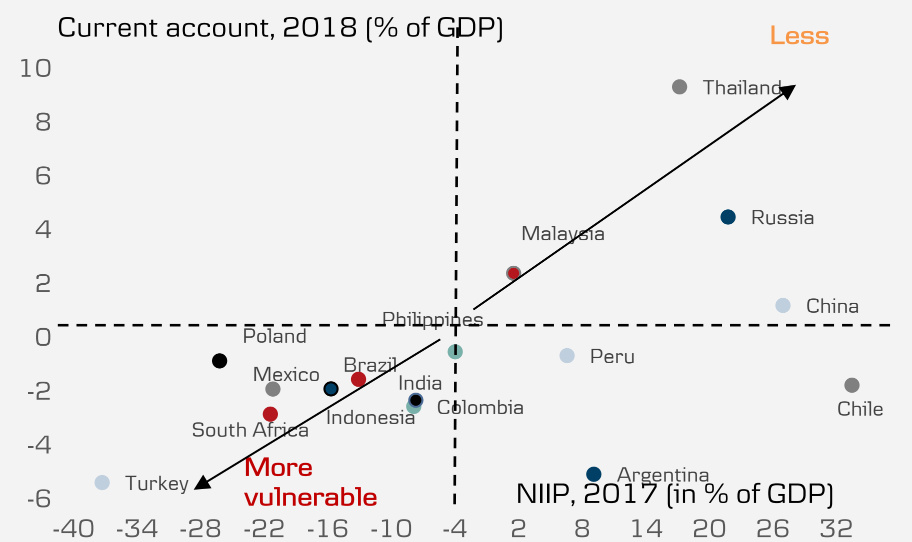
After a stellar run in 2017, it has been a difficult year for emerging markets so far in 2018. The nexus between a rising USD and US yields hit sentiment in the spring. The mood did not improve after the escalation of the trade dispute between the US and China in early summer. In addition, uncertainty about trade and geopolitical relations between the US and the rest of the world has been cast into doubt by the sanctions against Iran, Turkey and Russia. On Wednesday, South Africa felt the pressure when Trump tweeted his concerns regarding the land reforms being pursued in South Africa. This is introducing caution among EM investors about 'who is next'. As a result, EM stocks and bond prices have dropped.

...exposing a new set of fragile emerging markets

The rout in emerging markets began when former Fed Chair Ben Bernanke caused the so-called 'taper tantrum' in 2013, signalling tighter US monetary policy ahead. At that time, five countries stood out as particularly vulnerable: Brazil, India, Indonesia, South Africa and Turkey. These countries suffered from large current account deficits and internal political and economic challenges.

Given the bigger role of geopolitical risks (sanctions and trade disputes) apart from economic challenges, the countries hit this time share different characteristics.

Turkey is the most vulnerable major EM followed by South Africa...



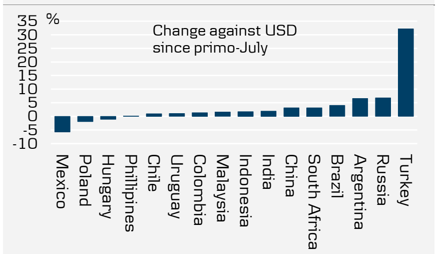
Note: NIIP is the net international investment position, which is gross external assets vs liabilities of the particular country. A negative number indicates a net foreign indebtedness, which makes a country more vulnerable to adverse global developments

Source: Danske Bank

Six global macro themes

- Emerging Market (EM) sentiment has been hit not only by rising USD and rates and the trade war, but also increased sanction risk from the US.
- The most vulnerable economies in EM at the moment are Turkey, Argentina, Russia, Brazil and South Africa.
- Contagion to other EMs should be limited unless Brazil escalates into a crisis.
- After failed trade talks between China-US, we expect an escalation in the trade war in early September, which could weigh further on EM sentiment

...and has been clearly hit hardest over the summer



Source: IFO, DG ECFIN, IHS Markit, Macrobond Financial

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In our view, the five most vulnerable EM countries at the moment are Argentina, Turkey, South Africa, Brazil and Russia.

- **Turkey**. Turkey is clearly an outlier when it comes to external vulnerability given its large negative net investment position and current account deficit. In addition, it has been hit by US sanctions over the detainment of the American pastor, along with weak central bank independence. We see continued pressure on the lira unless the central bank raises its interest rate by a significant margin and the US issue is resolved.

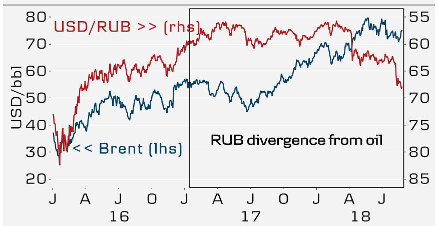
- **Argentina**. In complete contrast to Turkey, Argentina has sought helped from the IMF, which has agreed a comprehensive reform programme, including strengthening central bank independence, allowing exchange rate flexibility and fiscal adjustment. The authorities have shown significant commitment to the programme and the central bank has reacted vigilantly to eternal pressure, raising the central bank rate to 45%. We see upside for the ARS once EM sentiment improves.

- **Russia** does not have similar weak economic fundamentals as the other countries. However, two new sets of harsh US sanctions announced in early August have cast doubt on the future trajectory of the Russian economy and financial sector, weighing on the RUB, which could fall by more than 10% following the implementation of US sanctions (see our take here: *Flash Comment - Russian rouble: warning shots of US sanctions 'bill from hell'*).

- **Brazil**. BRL has come under pressure in recent days following election polls showing a sizeable lead for imprisoned former president Lula ahead of the presidential elections in early October. Even though Brazilian courts have so far ruled out the possibility of the former president running formally, investors fear that public opinion could override this decision. The key concern in Brazil involves the dire public debt dynamics with a gross public debt-to-GDP of 90% of GDP and a budget deficit of close to 8.5% of GDP. The likely absence of fiscal adjustment in the event of a Lula presidency could quickly lead to sizeable market pressures on Brazil. Our base case is that Lula will not be allowed to run for presidency and that a conservative candidate will win: however, BRL volatility in the run-up to the elections will be high.

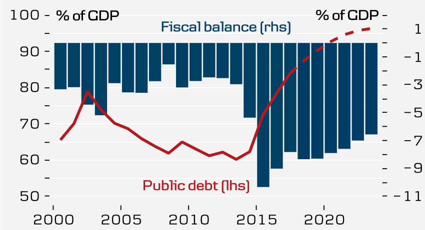
- **South Africa**. The South African economy has been hit by a slight contagion from Turkey given it also has weak external indicators. Furthermore, the prospect of a controversial land reform has triggered criticism from US President Trump this week, raising the risk of future US sanctions similar to those seen against Turkey. In contrast to Turkey, SA has an independent central bank and ministry of finance. Nevertheless, ZAR could remain under pressure until relations with the US are clarified.

Due to worsening sanctions risk, the RUB has not gained with higher oil prices



Source: Bloomberg, Macrobond Financial and Danske Bank

Dire fiscal metrics in Brazil

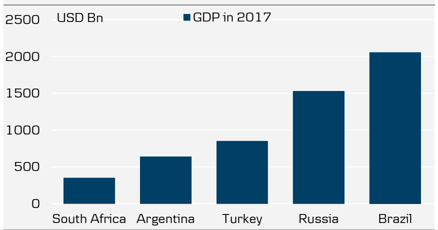


Source: IMF WEO April 2018, Danske Bank

Contagion to other EMs limited unless Brazil derails into crisis

We think that the contagion from the crisis in Turkey should be fairly limited in the rest of the EM given the limited size of the economy. In the case of a fully-fledged loss of market confidence in Brazil in the (unlikely) event of former president Lula coming back to power, the contagion risk to other EMs (notably in Latin America) would be sizable, as well as global risk sentiment given the size of the Brazilian economy and the exposures of the global financial institutions.

A crisis in Brazil would have significant knock-on effects on other EM and global risk sentiment



Source: IMF WEO April 2018, Danske Bank

...but escalation of China-US trade dispute likely to weigh on EM sentiment near term

This week saw further deterioration in the trade dispute between the world's two biggest economies as they both imposed tariffs on USD16bn of imports from each other. This was widely expected. At the same time, low-level talks between the two countries failed to make progress to formally launch new trade negotiations. We are sceptical about the outlook for such a deal, as Trump feels he has the upper hand due to the strong performance of the US economy and China is unlikely to give in to US demands to shed key parts of its 2025 strategy. Hence, we see further escalation of the trade war as likely after 5 September, when the deadline for public hearing in the US of tariffs on another USD200bn of imports from China passes. This will particularly weigh on China and other Asian countries, aside from hitting global risk sentiment.

Financial views

Asset class	Main factors
Equities	
Positive on 3-12 month horizon.	Fundamentals still support equities on a 3-12M horizon. However, despite strong earnings, higher risk premium is expected in the short run, among other things due to trade tensions
Bond market	
German/Scandi yields – stbale for now, higher in 12M	Strong forward guidance from the ECB. Core inflation remains muted. Range trading for Bunds for the rest of 2018. Still higher in 2018.
EUR 2Y10Y steeper, USD 2Y10Y flatter	The ECB keeps a tight leash on the short end of the curve but 10Y higher as US has an impact. Mainly steeper in 2019.
US-euro spread – short-end to widen further	The spread in the short-end is set to widen further as the Fed continues to hike.
Peripheral spreads – tightening (Italy special case)	ECB forward guidance, better fundamentals, an improved political picture (ex. latly) and rating upgrades to lead to renewed tightening after reccent wideing. Italy remains a special case.
FX & commodities	
EUR/USD – lower for longer... but not forever	In a range around 1.15 in 0-3M as USD carry and political risks weigh but supported longer term by valuation and ECB 'normalisation'.
EUR/GBP – gradually lower over the medium term	Brexit uncertainty dominates now but GBP should strengthen on 6-12M on Brexit clarification and Bank of England rate hikes.
USD/JPY – higher eventually	US yields decisive near term with political uncertainty as a significant downside risk. Longer term higher on Fed-Bank of Japan divergence.
EUR/SEK – volatile near term and sticky above 10 for long	Volatile near term and SEK-negatives remain due to lower growth, subdued inflation and too aggressive Riksbank pricing.
EUR/NOK – set to move lower but near-term headwinds	Positive on NOK on valuation, relative growth, positoning, terms of trade, the global outlook and Norges Bank initiating a hiking cycle.
Oil price – range bound rest of the year	OPEC increasing output and escalation of trade war has increased near-term downside risks.

Source: Danske Bank

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