EMERGING MARKETS OUTLOOK UPDATE

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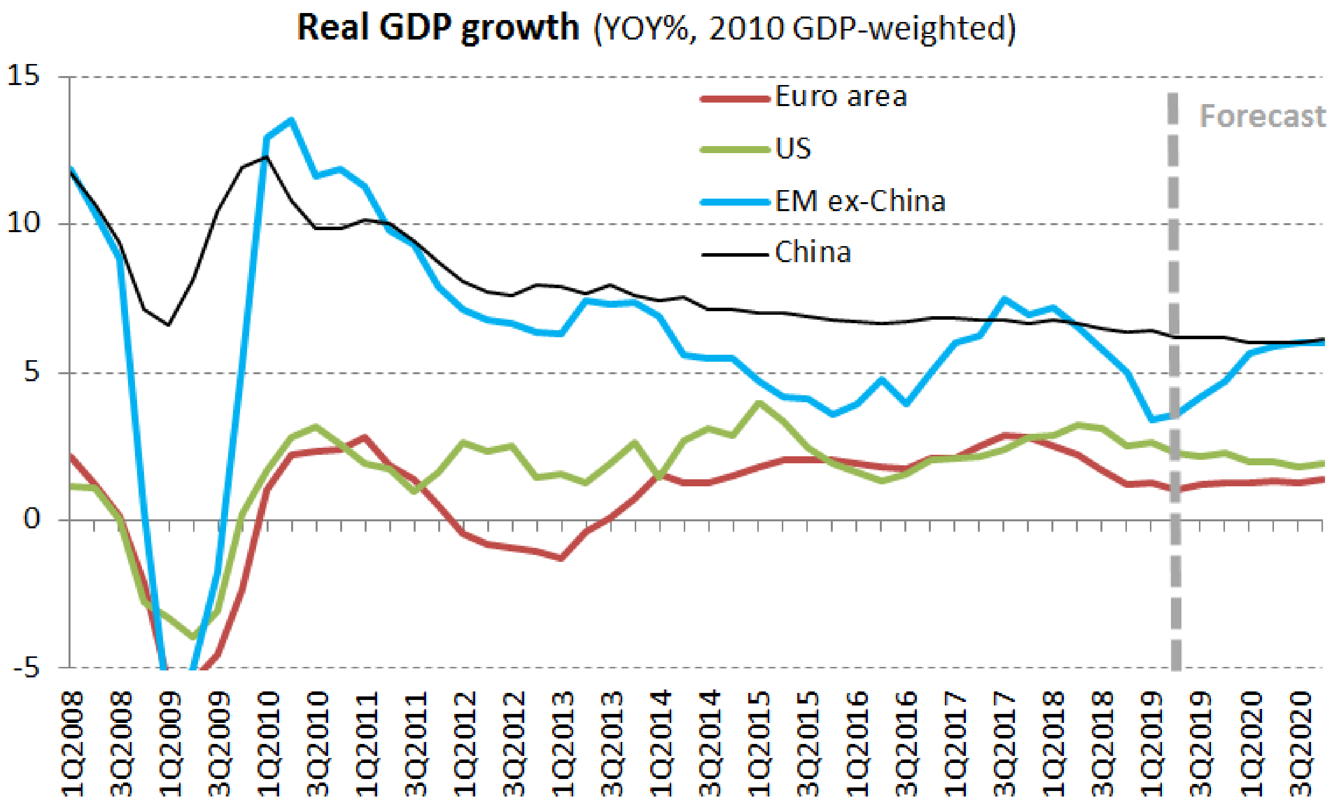
BNP PARIBAS
ASSET MANAGEMENT

The asset manager for a changing world

Agenda

- Intro – our macro team
- Backdrop
  - Synchronized slowdown in global growth…
  - …and how this is reflected in the global bond markets
  - US, Euro area and China
  - Trade and manufacturing sectors are hurting more than services and consumer, so far
  - Long term trends we don't believe will reverse: China slowdown and US-China trade war
  - EM growth outlook in the above context - fragile
- EM policy response:
  - easing for those who have the monetary and fiscal space. On the face of it, some space is there
    - EM inflation is generally low, historically record low in some (technology, rising debt burden, demographics)
    - EM nominal and real policy rates are still high vs DM …but closer look reveals thinner EM buffers
    - EM growth is low and potential growth has come down
    - Fiscal space is seriously constrained for some EM

Global slowdown. YTD a chorus of downgrades in growth forecasts

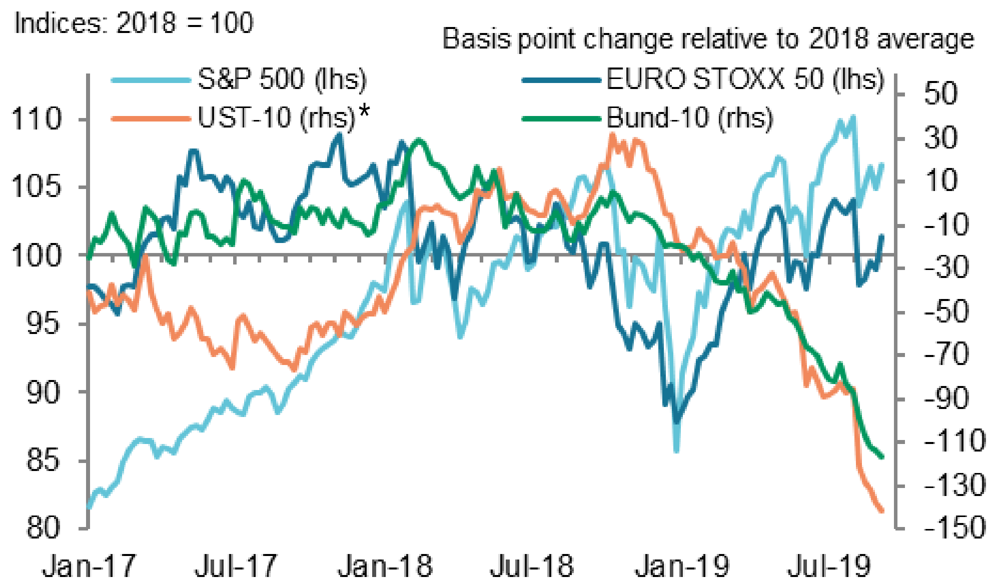


Source: JP Morgan, UBS, Bank of America, Goldman Sachs, Citigroup, Morgan Stanley, BNPP AM, Aug 2019

Markets update

- Bond market - bond yields have collapsed.
  - reflects both a fall in real yields and a decline in break-even inflation to near historic lows…
  - …which at face value suggest a near complete loss of confidence in the ability of DM central banks to deliver their inflation mandates
  - The yield curve is pricing in a substantial ease in global monetary policy, both in terms of rate cuts at the front end but also more asset purchases driving long end yields lower.
  - Flight to safe haven/quality - perception of large numbers of material downside risks lurking on the radar screen has likely triggered a flight to quality into an increasingly scarce asset class, driving yields on UST, Bunds and the like even lower.
  - The inversion of the yield curve slope has also spooked some investors, since the historical record suggests that there is a meaningful risk of recession in the near future when the curve inverts.

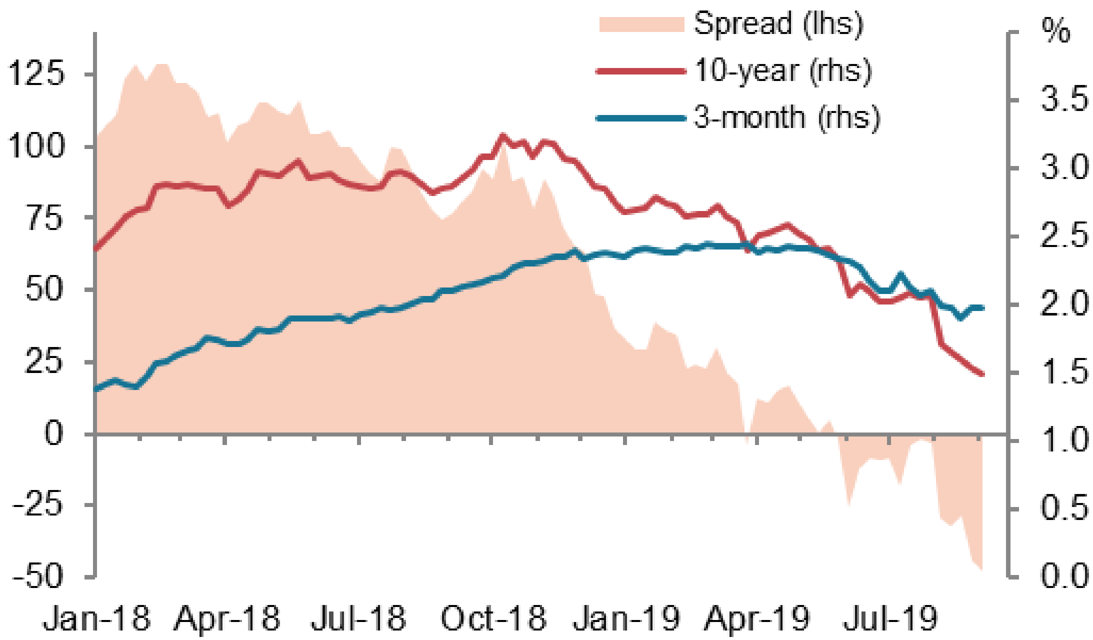
Equity and bond markets relative to 2018



*UST-10 : US 10 Year Treasury

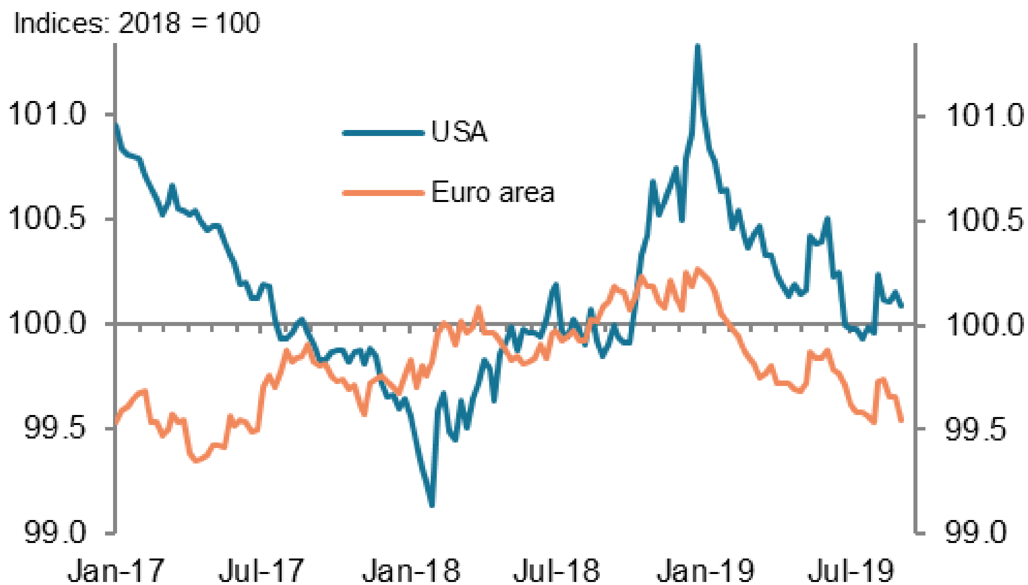
Source : Bloomberg, Factset, as of September 4, 2019

US Yield Curve Inversion



Source : Bloomberg, Factset, as of September 4, 2019

Financial conditions indices

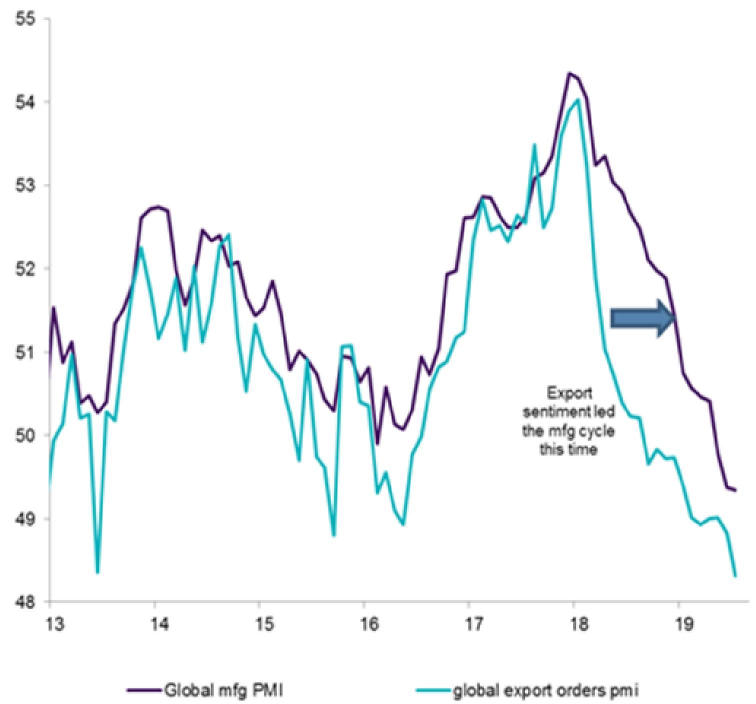


Source : Bloomberg, Factset, as of September 4, 2019

Export sentiment has been a drag on the overall cycle

Figure 2: Global manufacturing PMI and export orders

Source: Bloomberg, Haver, Markit, NWM



Manufacturing survey data are soft

- Regional breakdown of manufacturing surveys looks mixed in August, with some tentative signs of stabilisation in North Asia and Eastern Europe

Manufacturing PMI - Headline

	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19
Russia	50.9	50.1	52.8	51.8	49.8	48.6	49.3	49.1
Turkey	44.2	46.4	47.2	46.8	45.3	47.9	46.7	48.0
Poland	48.2	47.6	48.7	49.0	48.8	48.4	47.4	48.8
S. Africa	49.9	46.2	45.0	47.2	45.4	46.2	52.1	45.7
Israel	47.9	49.6	52.2	51.9	50.4	52.7	52.2	52.2
Czech	49.0	48.6	47.3	46.6	46.6	45.9	43.1	44.9
Hungary	54.6	55.5	52.4	54.8	57.5	54.0	51.2	52.6
Brazil	52.7	53.4	52.8	51.5	50.2	51.0	49.9	52.5
Mexico	50.9	52.6	49.8	50.1	50.0	49.2	49.8	49.0
India	53.9	54.3	52.6	51.8	52.7	52.1	52.5	51.4
S. Korea	48.3	47.2	48.8	50.2	48.4	47.5	47.3	49.0
Indonesia	49.9	50.1	51.2	50.4	51.6	50.6	49.6	49.0
Thailand	50.2	49.9	50.3	51.0	50.7	50.6	50.3	50.0
Malaysia	47.9	47.6	47.2	49.4	48.8	47.8	47.6	47.4
Taiwan	47.5	46.3	49.0	48.2	48.4	45.5	48.1	47.9
Vietnam	51.9	51.2	51.9	52.5	52.0	52.5	52.6	51.4
Singapore	50.7	50.4	50.8	50.3	49.9	49.6	49.8	
China (Caixin)	48.3	49.9	50.8	50.2	50.2	49.4	49.9	50.4
China (NBS)	49.5	49.2	50.5	50.1	49.4	49.4	49.7	49.5
US (Markit)	54.9	53.0	52.4	52.6	50.5	50.7	50.4	
US (ISM)	56.6	54.2	55.3	52.8	52.1	51.7	51.2	
Euro Area	50.5	49.3	47.5	47.9	47.7	47.6	46.5	47.0

contracting and getting worse
contracting but improving
expanding but getting worse
expanding and improving

Source : Haver, as of September 4, 2019

Export sentiment has been a drag on the overall cycle

- In terms of the forward leading indicator for external demand, new export orders surveys for Vietnam, Mexico and Brazil are expanding when everywhere else isn't looking good.... Evidence of benefit from trade diversion?

Manufacturing PMI - New export orders

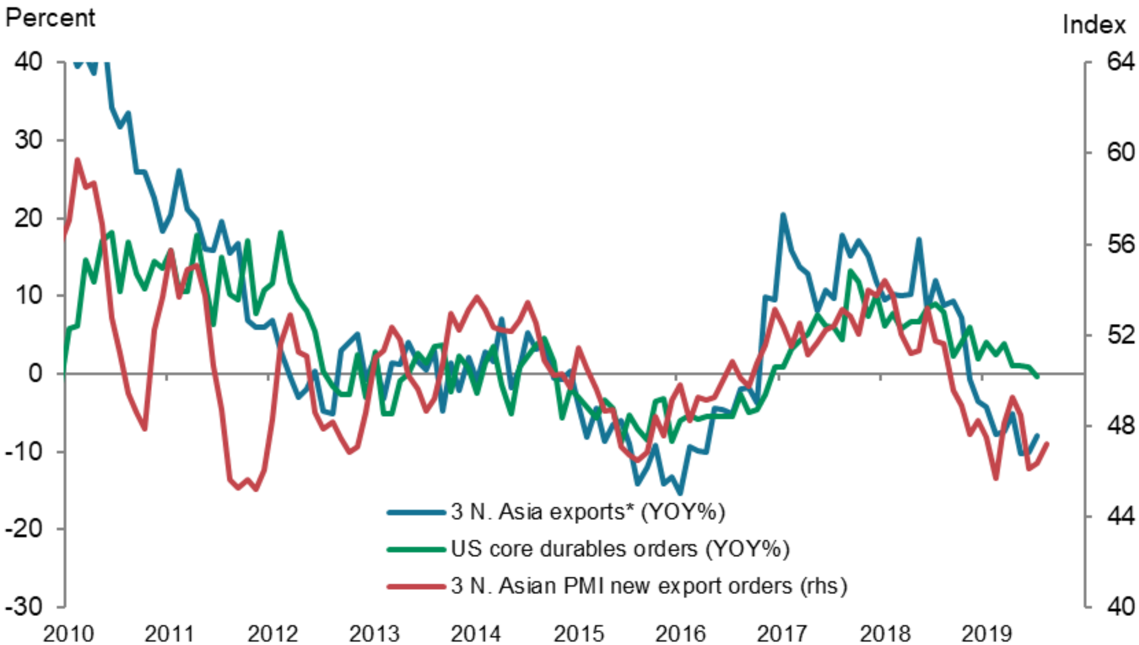
	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19
Russia	49.0	47.3	48.7	50.0	48.9	48.4	48.3	44.8
Turkey	49.8	50.3	49.2	47.5	45.8	50.6	50.0	49.2
Poland	43.7	43.9	43.5	44.0	46.2	47.1	47.0	47.6
Israel	45.3	51.4	47.5	46.3	46.7	48.5	45.0	
Czech	48.3	46.9	42.0	44.1	44.7	41.5	40.2	38.9
Brazil	46.0	48.5	49.1	48.1	48.2	45.8	47.1	50.3
Mexico	50.0	53.4	50.7	49.4	50.7	49.3	49.8	50.5
India	52.6	53.6	53.2	53.3	53.6	52.8	52.1	51.8
S. Korea	48.7	46.2	46.8	49.5	47.5	47.4	45.5	48.6
Indonesia	48.0	48.0	48.6	50.7	50.1	50.3	52.5	47.2
Thailand	50.3	50.4	49.4	50.1	51.1	53.2	51.7	49.3
Malaysia	49.2	48.1	48.8	50.6	48.5	48.3	50.6	50.0
Taiwan	43.6	41.0	47.1	48.1	47.9	41.2	43.7	43.2
Vietnam	52.7	51.3	54.8	54.1	53.4	52.2	51.3	51.9
Singapore	50.7	50.4	50.9	50.6	50.4	50.2	50.3	49.9
China (Caixin)	50.4	49.4	50.2	49.1	50.4	49.5	49.9	48.2
China (NBS)	46.9	45.2	47.1	49.2	46.5	46.3	46.9	47.2
US (Markit)	51.0	51.2	50.6	50.8	49.1	51.4	49.2	45.8
US (ISM)	51.8	52.8	51.7	49.5	51.0	50.5	48.1	43.3
Euro Area	48.5	46.4	44.8	45.9	47.0	46.6	44.2	45.8

contracting and getting worse
contracting but improving
expanding but getting worse
expanding and improving

Source : Haver, as of September 4, 2019

North Asia is underperforming the US

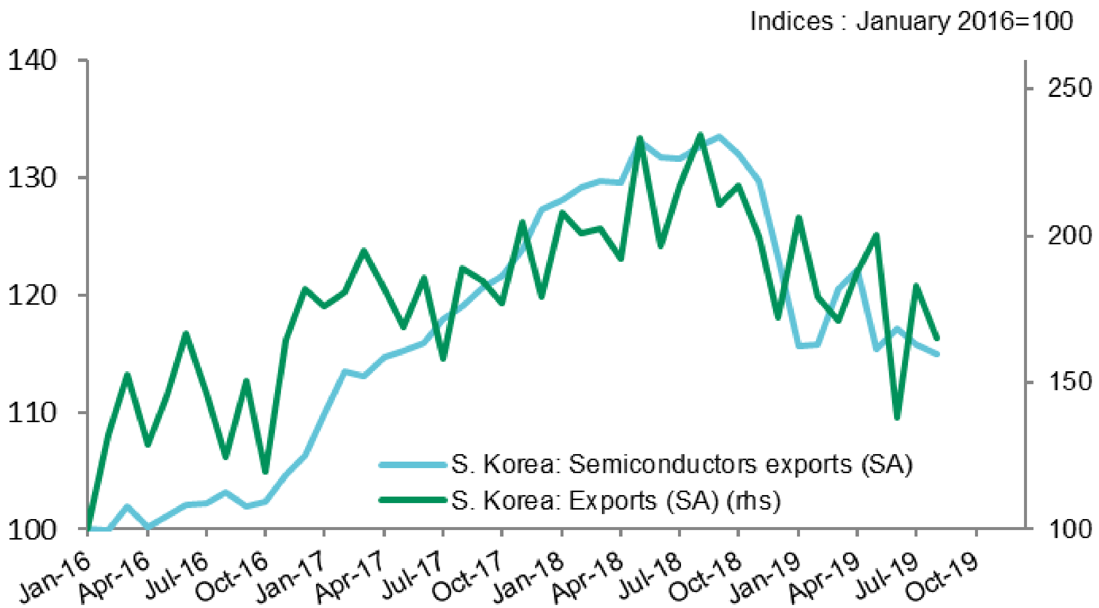
- North Asian forward-looking indicator of the new export orders PMI sub-index has ticked up again in August but remains in the contractionary territory, implying no big turn around for North Asian exporters
- Recent re-escalation in the US-China trade war doesn't bode well for the sentiment and activity in this part of the world going forward



** Sum of S. Korea, Taiwan, Singapore exports. Ex-oil exports for Singapore*
Source : Haver, as of September 3, 2019

Spot light on South Korean exports

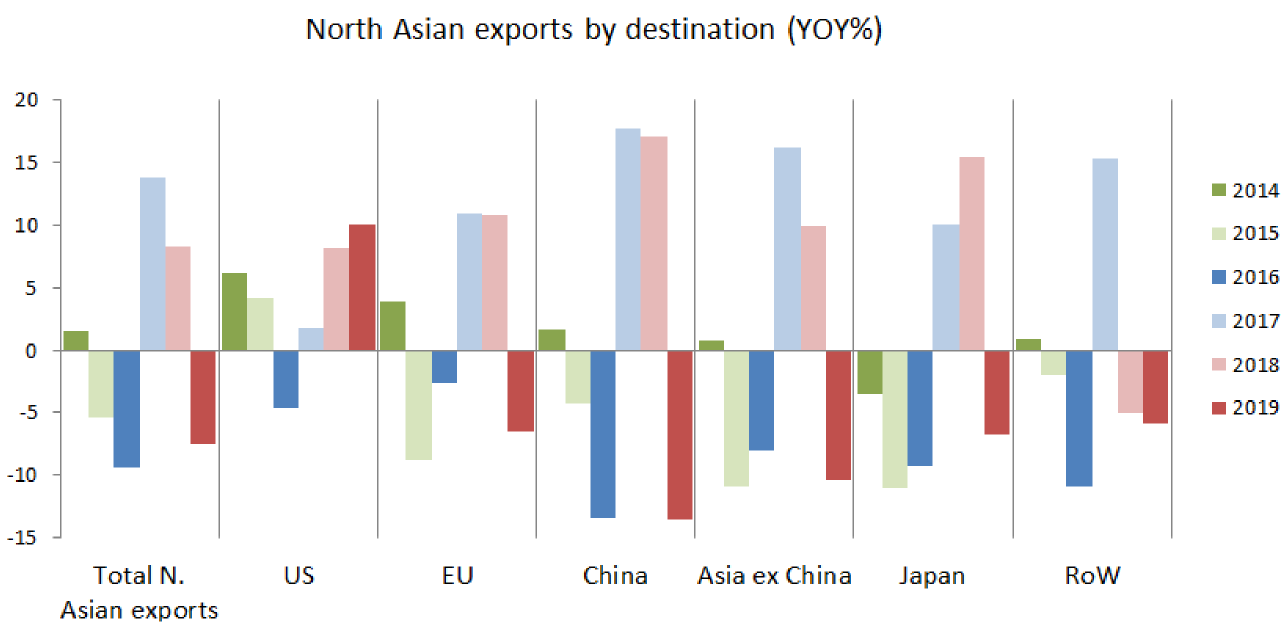
- As a result, North Asian neighbours (such as South Korea, with exposure to US-China trade war, semiconductors down cycle and softer demand from core DM markets) continue to suffer – no recovery in exports, as of August: “core” exports (ex ships and semiconductors) are zigzagging around but no convincing turn around in trend – still downward



Source : Haver, as of September 3, 2019

Messages from the North Asian exports: not very optimistic

- Based on YTD trade data, North Asian exports went to the US instead of China, which, prior to trade wars, has been the top destination in terms of exports growth for North Asia
- Overall exports growth out of North Asia remains weak across the board, which is consistent with the elevated inventory to shipment ratios seen across South Korea and Taiwan.

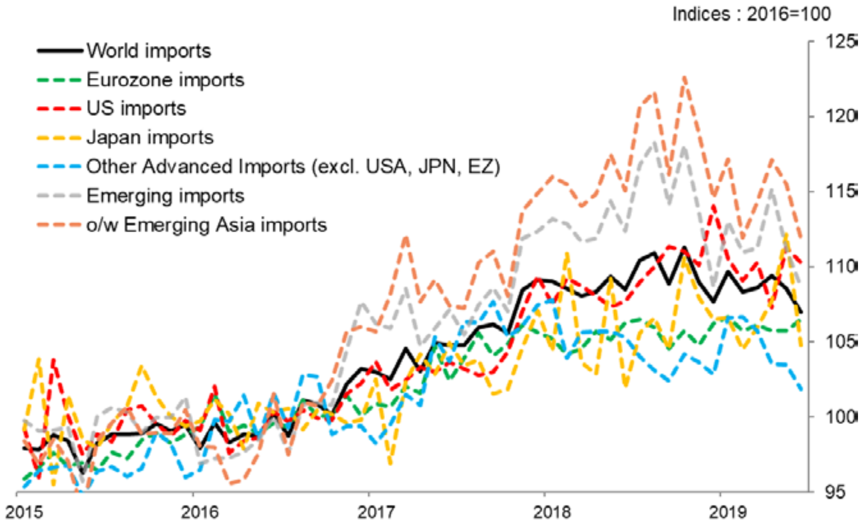


- YOY% = Korea + Taiwan + Sing, Jan-Jun for all years

World Trade

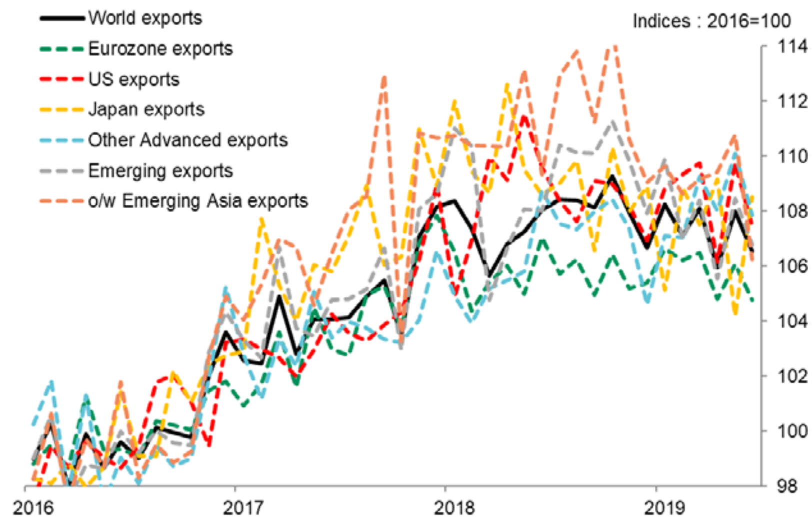
- World trade was down 1.4% on the month in June with both import and export volumes data slowing
- Both imports and exports were down on the month in the advanced economies, driven primarily by US (imports down 1% and exports down 2%) and weak Japan numbers for imports (close to -7%)
- The data in EM were also down on the month, particularly imports slowdown was mainly driven by Latam (almost -10% after a sharp rise the two previous months) and EM Asia (-3%)

Import Volume YoY



Source : Haver, as of September 2, 2019

Export Volume YoY

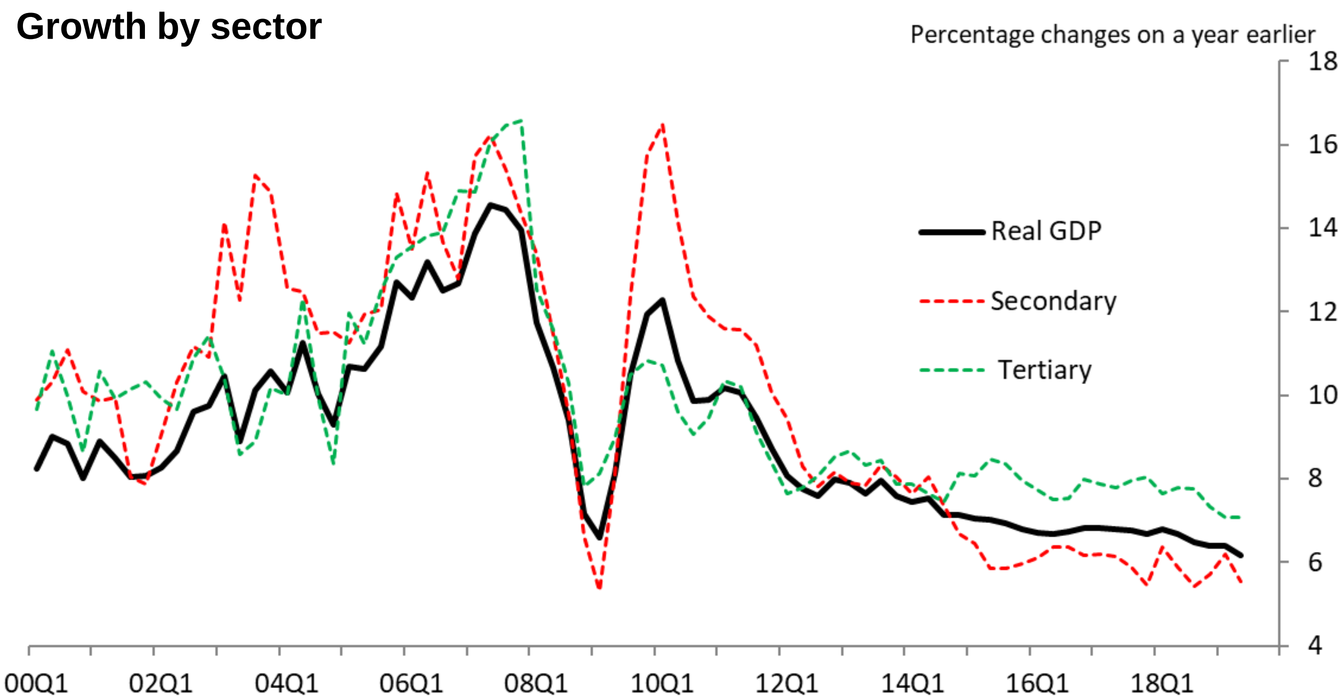


Source : Haver, as of September 2, 2019

China

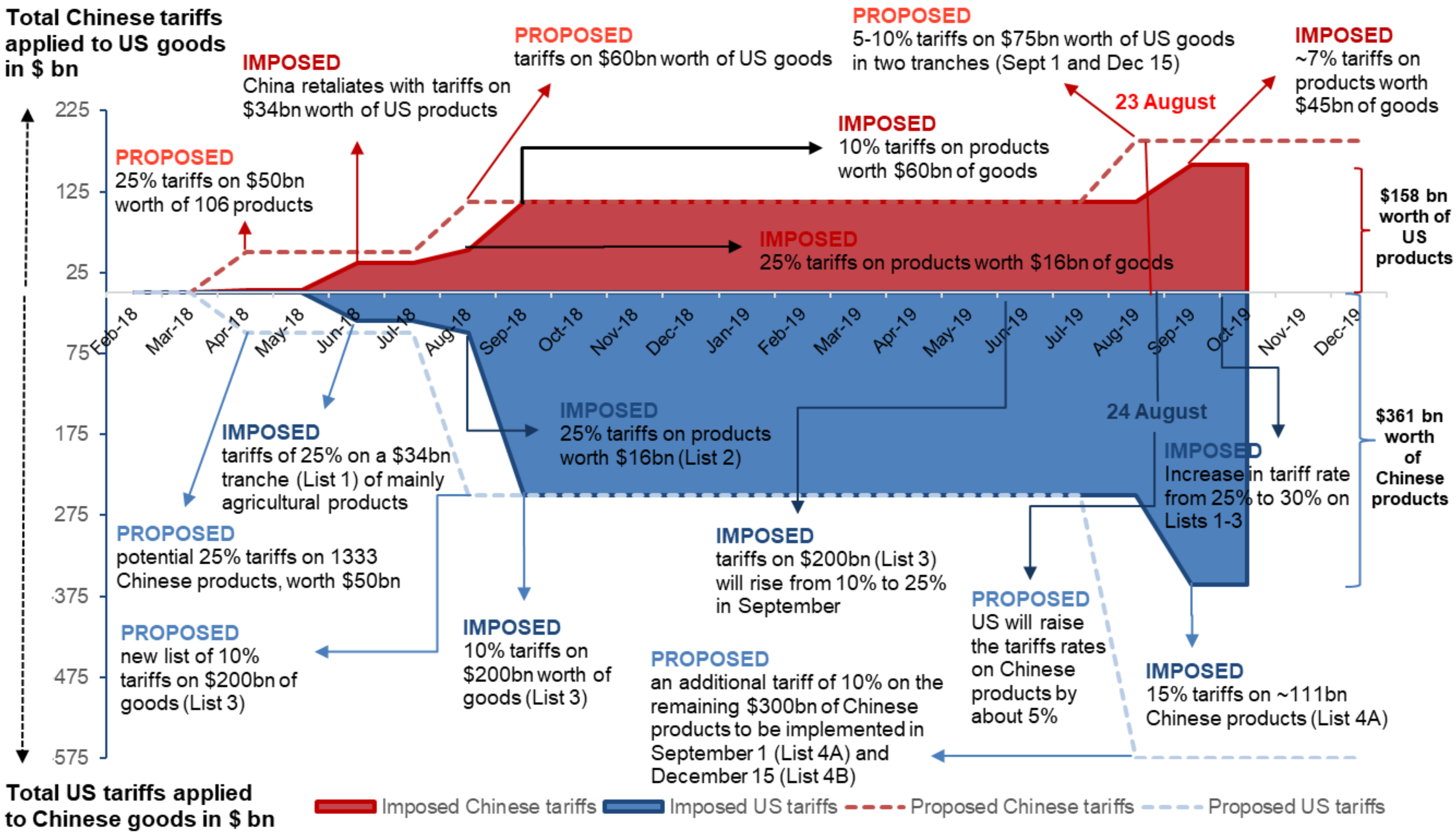
- Much anticipated trough in the current cycle is yet to materialize
- focus remains on the inevitable drag from the tariffs
- however, the underlying slowdown in domestic demand is likely as important in our view
  - both in terms of the trajectory of growth and explaining the weakness in global manufacturing and trade – that is, it is not just the fact that China is importing less because it is exporting less to the US, it is also the case that China is importing less because it is consuming and investing less.
- Lines of defence so far:
  - On the monetary front, PBOC is likely to deliver additional RRR cuts while looking for ways to improve policy transmission to private corporate sector and SMEs.
  - On the fiscal front, moderate fiscal expansion will continue, funded by issuance of local government special bonds while fiscal spending will continue to be targeted at the new/emerging industries and infrastructure investment, not the highly leveraged state sector. Further VAT tax cuts, corporate income tax cuts and fee reductions to boost the private spending are also on the table. The expected impact on growth should be moderately positive, consistent with the shift in policy objectives, with a greater importance attached to financial stability objectives as opposed to single-minded focus on maximizing growth.
  - RMB = PBOC probably don't want it that much weaker, to protect the services sector with FX debt
  - Current account (via imports contraction). Evidence: North Asia (South Korea, Taiwan) and Europe (Germany) exports and manufacturing sector are hurting
- Bottom line: growth will remain on the downtrend

The unobserved slowdown



- Starting 2014, transition away from production/investment to services/consumption already implies reduced demand for imports from the rest of the world
- The latest numbers show a very modest decline in Chinese GDP growth
- The question is how much faster is the actual slowdown and is it disproportionately concentrated in the secondary or tertiary sector

US-China Trade War Timeline



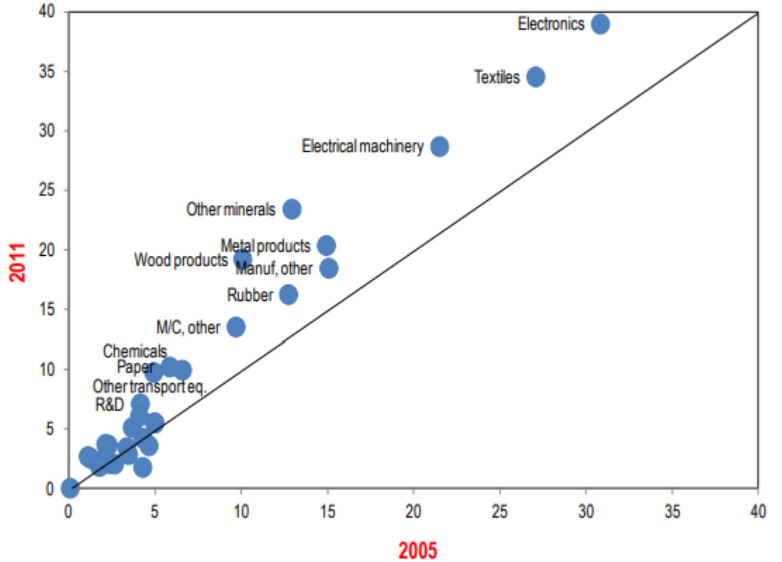
Source : United States Trade Representative (USTR), as of September 2, 2019

China place in GVCs

- China's backward linkages now range between 15–40% of the global share in c.10 large GVCs, suggesting that spillovers to upstream economies transmitted through China are now even larger than before

China's Backward Linkages in GVCs: 2005 vs. 2011

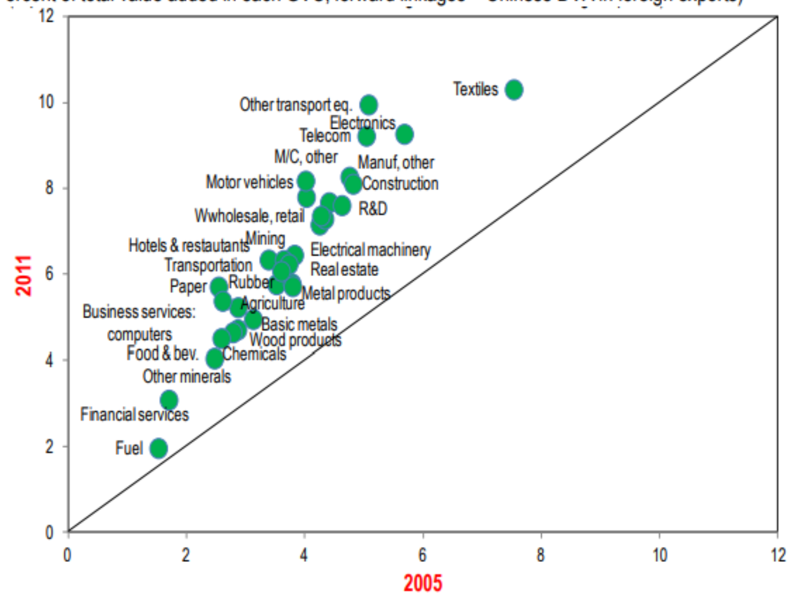
(Percent of total value added in each GVC; backward linkages = import content in Chinese exports)



Source: OECD-WTO TiVA database.

China's Forward Linkages in GVCs: 2005 vs. 2011

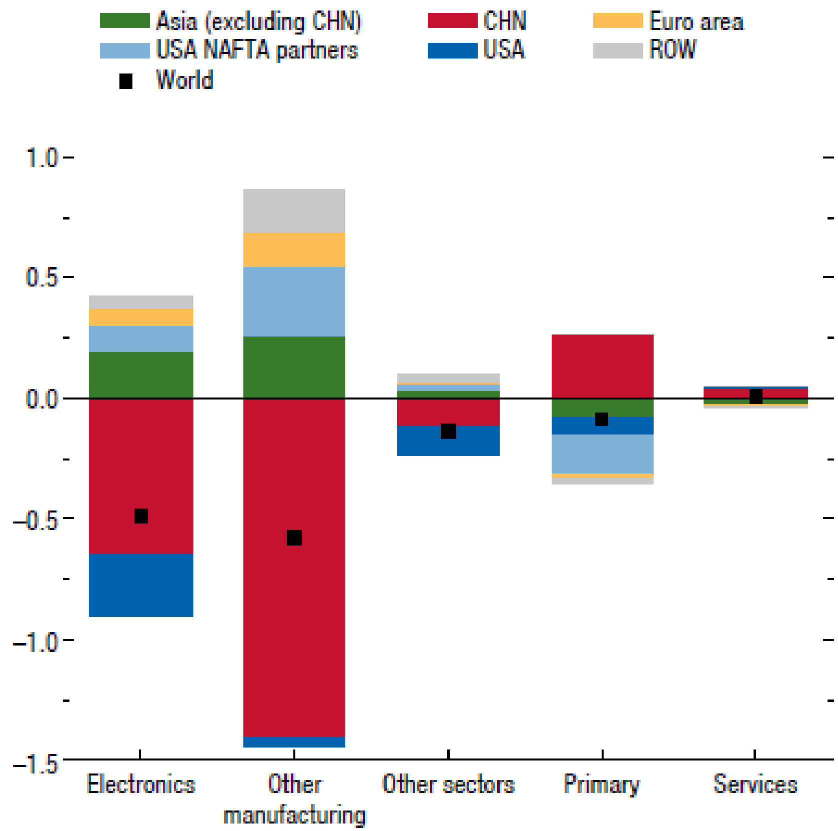
(Percent of total value added in each GVC; forward linkages = Chinese DVA in foreign exports)



Trade war hurts China more than the US

- IMF simulation of bilateral trade war, which leads to a 25-30% reduction in trade flows in the short run and 30-70% in the long run
- GDP losses of 0.3-0.6% for US and 0.5-1.5% for China (given larger share of exports in GDP)
- Impact concentrated in manufacturing (esp. electronics)
- Trade diversion benefits regional producers ~ e.g., NAFTA partners for the US market
- China estimated to move from 1st to 4th in exporter to US in electronics and machinery (share halves)

Impact of 25% increase in tariffs on US-CHN trade

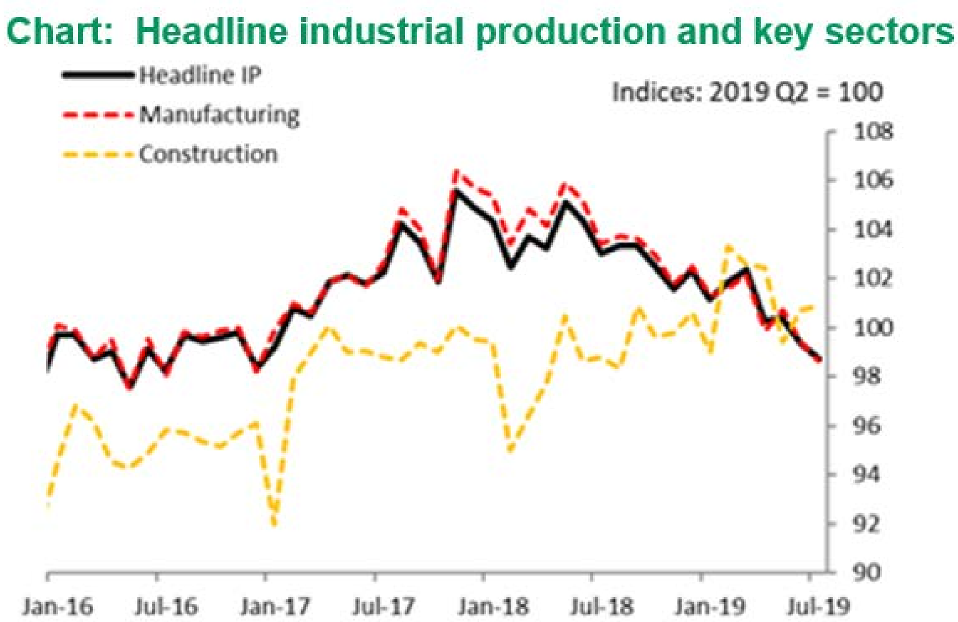


Source: IMF calculations using the model in Caliendo and others (2017).
Note: NAFTA = North American Free Trade Agreement; ROW = rest of the world.
Data labels use International Organization for Standardization (ISO) country codes.

Euro area

- The macro data have been disappointing.
- Growth has slowed but the pain has been concentrated in the sectors that are typically exposed to world trade like manufacturing and the countries that are most exposed to those sectors like Germany.
- The outlook for domestic demand in the Eurozone is more reassuring – with low interest rates, solid disposable income growth and reasonably healthy balance sheets. However, the increased threat of trade tensions, weakness in external demand that likely has its origin in the deceleration of demand in China and geo-political risk on the Eurozone’s doorstep (Brexit) all suggests that this drag from net trade might persist for some time.
- Moreover, underlying inflation remains stuck far below the ECB’s target. The central bank has responded and looks set to announce a package of measures at its September meeting.
- There is fresh talk of fiscal stimulus at the national and supranational level but a game-changing fiscal reset still seems some way off. In particular, the German government still seems unpersuaded of the case for removing the constitutional requirement for balanced budgets.
- Meanwhile, we are facing a parliamentary showdown in the United Kingdom over Brexit in the next couple of weeks, with MPs opposed to leaving without a deal forced to make their move with Parliament set to be in recess between mid-September and mid-October and the UK set to leave the EU without a deal at the end of October.

Germany – manufacturing still contracting



Source : Haver Analytics, as of September 9, 2019

US

- Growth has slowed since 2018 but remained above trend in the first half of 2019
- as with Europe, what weakness there is in the data is predominantly in the manufacturing sector.
- escalation of trade tensions by the Trump Administration has no doubt weighed on corporate sentiment but the outlook for near-term growth still remains reasonable – not least given the significant ease in financial conditions since the start of the year.
- inflation has disappointed and the Federal Reserve has increasingly become concerned about the absence of any meaningful pass-through from a tight labour market into stronger domestically generated inflation and the perceived risks to growth. The Federal Reserve quickly discarded the patience narrative that it adopted earlier this year when the Fed retreated from its plan to gradually raise rates in 2019.
- The Fed has already cut rates once, is likely to do so again in September and may well cut further before the end of the year, under pressure from the market and the President.
- The President is not (yet) backing down from his protectionist agenda, but we are sceptical that he can win major concessions from the Chinese and we are concerned that ECB stimulus might prompt him to open up a new front in the trade war: on the EU.
- The collateral damage of trade wars on his electoral prospects might then prompt an attempt to inject fresh fiscal stimulus in the economy – a possibility which seems largely discounted by the market.

Emerging markets ex-China

- disappointing growth in the first half of 2019,
- the outlook for 2019 H2 remains extremely fragile.
  - EM is confronted by
    - the combination of the ongoing malaise in domestic demand in China (see slowing Asian data, be it Japanese machinery or Indonesian coal exports)
    - multiple trade wars – not only US-China but also Japan-South Korea –
    - and a multitude of geo-political risks (Hong Kong, Iran, Brexit) putting downward pressure on demand via the confidence, investment, supply chain and trade channels, and thereby likely postponing the timing of the recovery.

    - In terms of the policy reaction, no recovery in economic activity and mostly benign inflationary pressures across most of emerging market economies domestically and easing by developed markets central banks externally suggest there is scope for more front-loaded/aggressive easing response from the emerging markets central banks. To this point, in the past 3 months, we had India, Russia, Turkey, South Africa, Brazil, South Korea, Indonesia, Malaysia, Chile and Philippines central banks cutting policy rates, joined by Mexico, Peru, and Thailand in the last month.

Emerging markets ex-China activity data – forecast

2019

EM real GDP growth is expected around 4.0% vs 4.5% YOY in previous update

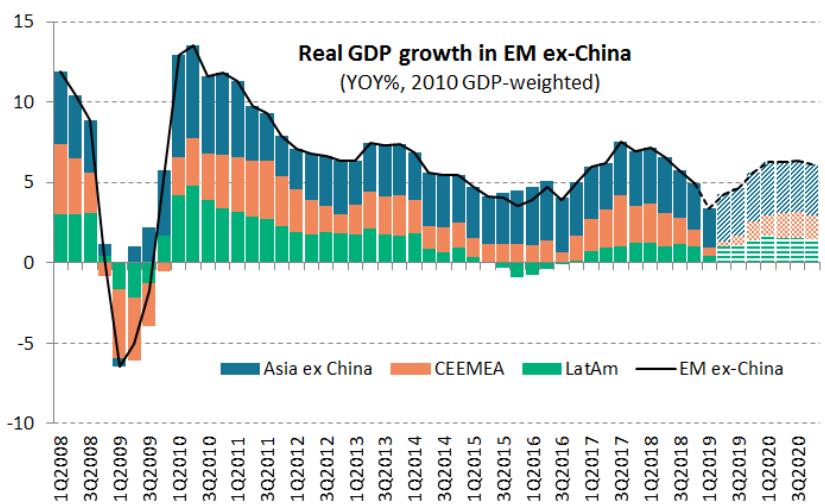
- Downward revisions led by Turkey (-0.8%), Mexico (-0.6%) and Brazil (-0.5%).
- Rest of EM were revised down by 0.2%. S. Korea by -0.1%
- Unchanged for Indonesia
- 2018 GDP growth stood at 6.1%, so we are looking at pretty sharp slowdown in YOY% terms.

2020

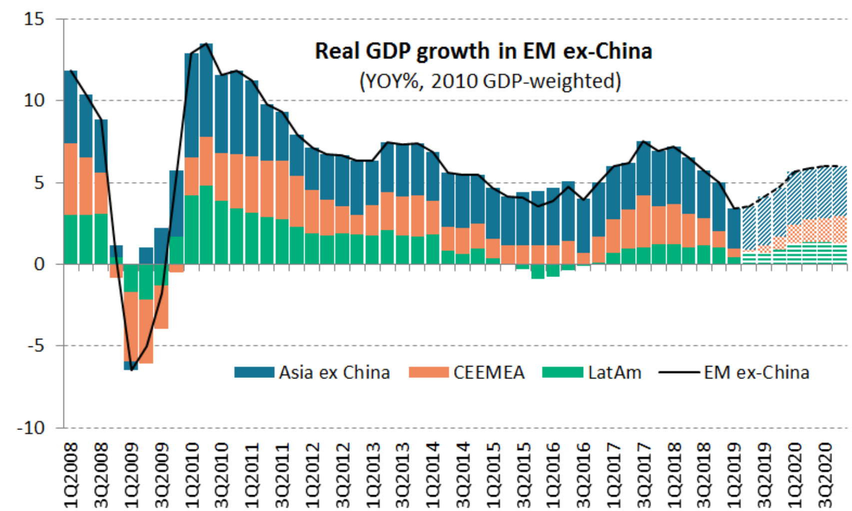
5.9% vs 6.3% YOY in previous update

- Downward revisions led by Turkey (-0.6%), Brazil, Mexico and S. Africa (all by -0.3%).

Previous forecast (June)

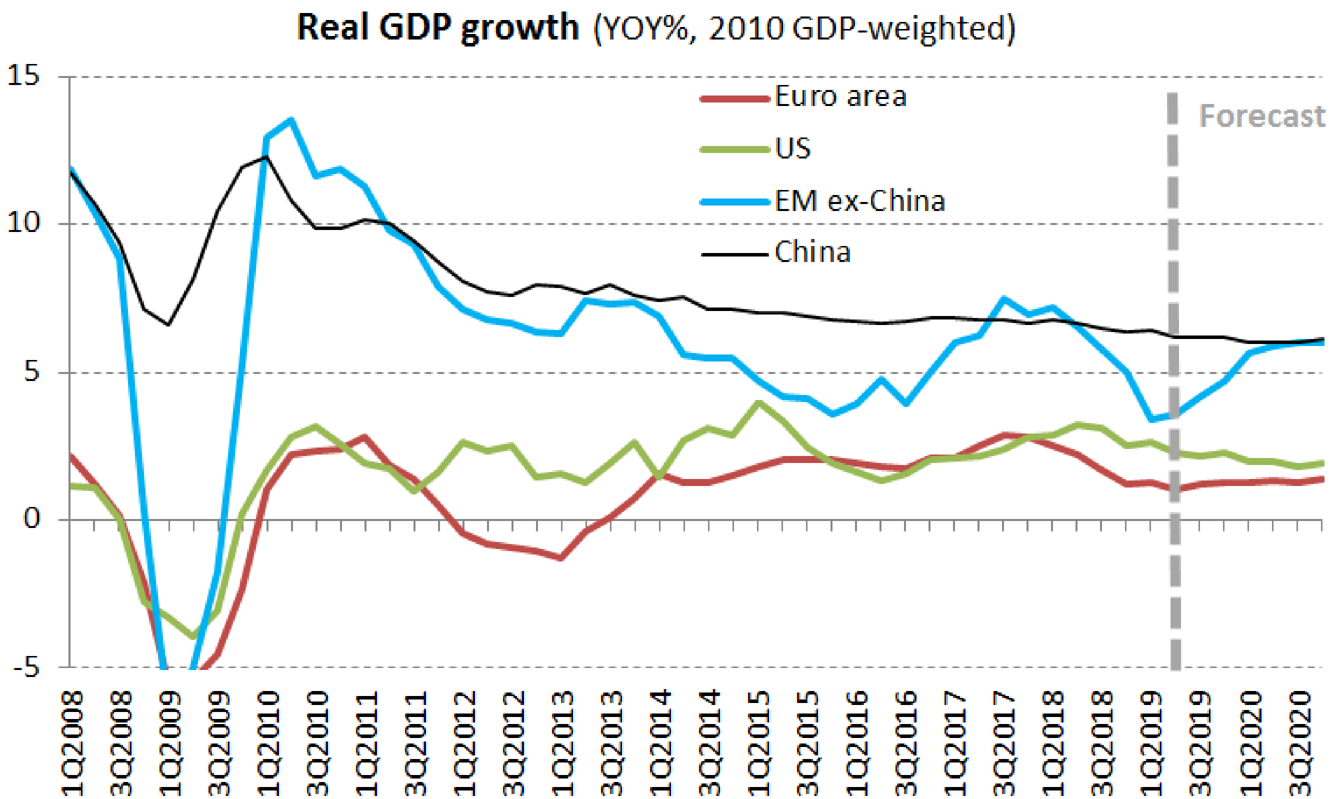


New forecast (August)



Forecasts are based on "smart consensus" (Citi, GS, MS, UBS and JPM survey)

Growth Forecasts Revisions : YTD a chorus of downgrades



Source: JP Morgan, UBS, Bank of America, Goldman Sachs, Citigroup, Morgan Stanley, BNPP AM, Aug 2019

Growth Forecasts Revisions : a chorus of downgrades

Real GDP growth (YOY%)

		Brazil	Russia	India	S. Africa	Turkey	Mexico	Colombia	S. Korea	Indonesia	China	US	Euro area
Actual	1Q2018	1.2	1.8	8.0	1.6	7.1	2.2	2.6	2.9	5.1	6.8	2.9	2.5
	2Q2018	0.9	2.0	7.9	0.7	5.0	1.5	2.4	2.9	5.3	6.7	3.2	2.2
	3Q2018	1.3	2.1	7.1	0.5	1.8	2.5	2.6	1.9	5.2	6.5	3.1	1.7
	4Q2018	1.1	2.9	6.6	0.1	-3.0	1.6	2.7	3.0	5.2	6.4	2.5	1.2
	1Q2019	0.4	0.5	5.8	-0.1	-2.8	0.1	2.3	1.6	5.1	6.4	2.7	1.2
Forecast	2Q2019	0.7	0.9	6.0	0.8	-4.7	0.6	3.1	2.1	5.0	6.2	2.3	1.1
(as of 2 Aug 2019)	3Q2019	0.7	1.2	6.6	0.7	-3.1	0.4	3.1	2.2	4.9	6.2	2.2	1.3
	4Q2019	1.1	1.5	7.0	0.7	-1.3	0.6	2.8	2.1	4.9	6.2	2.3	1.4
	1Q2020	1.7	2.2	7.1	2.0	-0.8	1.8	3.3	3.2	5.0	6.0	2.0	1.3
	2Q2020	2.1	2.0	7.1	1.2	1.6	1.4	3.3	2.5	5.1	6.0	2.0	1.4
	3Q2020	2.0	2.1	7.3	0.9	2.5	1.5	2.9	2.1	5.1	6.0	1.8	1.4
	4Q2020	2.0	2.2	7.2	1.0	3.0	1.4	3.0	1.8	5.1	6.1	1.9	1.3
Actual	2018	1.1	2.2	7.4	0.7	2.7	2.0	2.6	2.7	5.2	6.6	2.9	1.9
Forecast	2019	0.7	1.0	6.3	0.5	-3.0	0.4	2.8	2.0	5.0	6.2	2.3	1.2
	2020	2.0	2.1	7.2	1.3	1.6	1.5	3.1	2.4	5.1	6.0	1.9	1.4

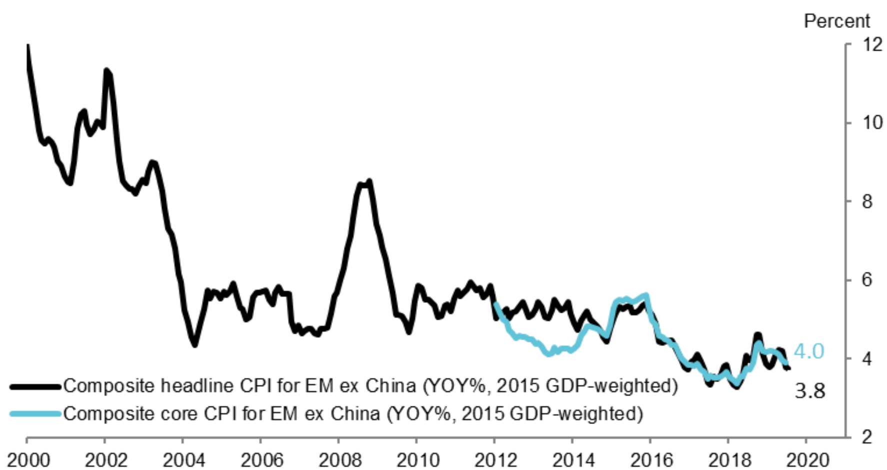
Revisions compared to June-19 forecasts:

Forecast	2019	-0.5	-0.2	-0.2	-0.2	-0.8	-0.6	-0.2	-0.1	0.0	-0.2	-0.3	-0.1
	2020	-0.3	0.1	-0.2	-0.3	-0.6	-0.3	-0.2	-0.2	-0.1	-0.1	-0.1	0.0

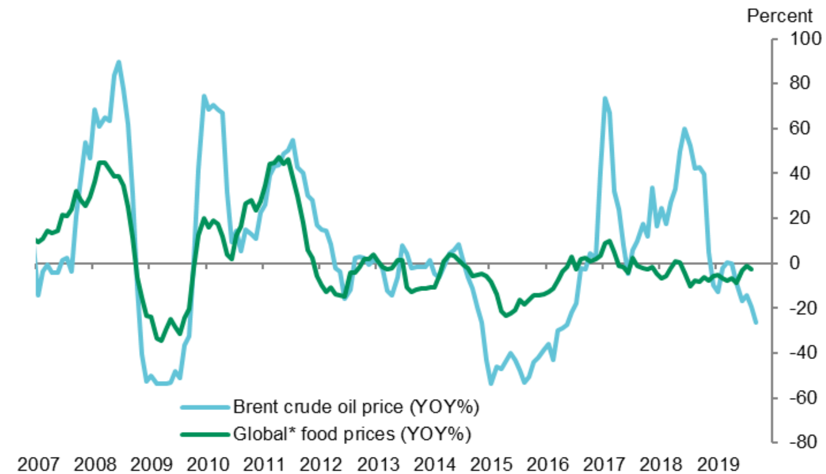
Source: JP Morgan, UBS, Bank of America, Goldman Sachs, Citigroup, Morgan Stanley, BNPP AM, Aug 2019

EM inflation

- Our aggregate EM headline inflation measure was steady to 3.8% YOY in July, remaining close to historically low levels. Core inflation ticked up, to 4.0% YOY from 3.9% in June
- Decline in both global food and oil prices in August is supportive for keeping the non-core component of inflation well behaved (normally larger chunk of the inflation basket in Emerging Markets compared to Developed Markets)



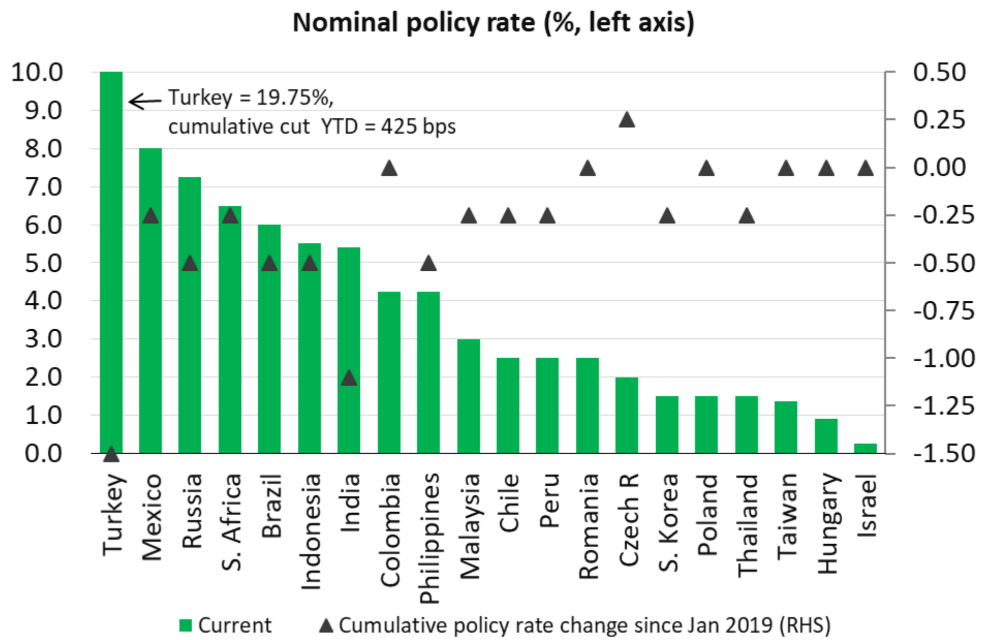
Source: Haver, as of September 3, 2019
EM CPI universe: Brazil, Mexico, Colombia, Chile, Peru, Uruguay, India, S. Korea, Indonesia, Thailand, Malaysia, Singapore, Hong Kong, Russia, Turkey, Poland, S. Africa, Israel, Czech Republic, Romania, Hungary



* Global food prices are calculated by taking average of YOY% changes in UN FAO food price index, Bloomberg agriculture index, and CRB food index
Source : Haver, as of September 3, 2019

EM policy rates - lower

- In terms of the policy reaction, no recovery in economic activity and mostly benign inflationary pressures across most of emerging market economies domestically and easing by developed markets central banks externally suggest there is scope for more aggressive easing response from the emerging markets central banks
- To this point, in the past 3 months, we had India, Russia, Turkey, South Africa, Brazil, South Korea, Indonesia, Malaysia, Chile and Philippines central banks cutting policy rates, joined by Mexico, Peru, and Thailand in the last month



Source : Haver, as of September 3, 2019

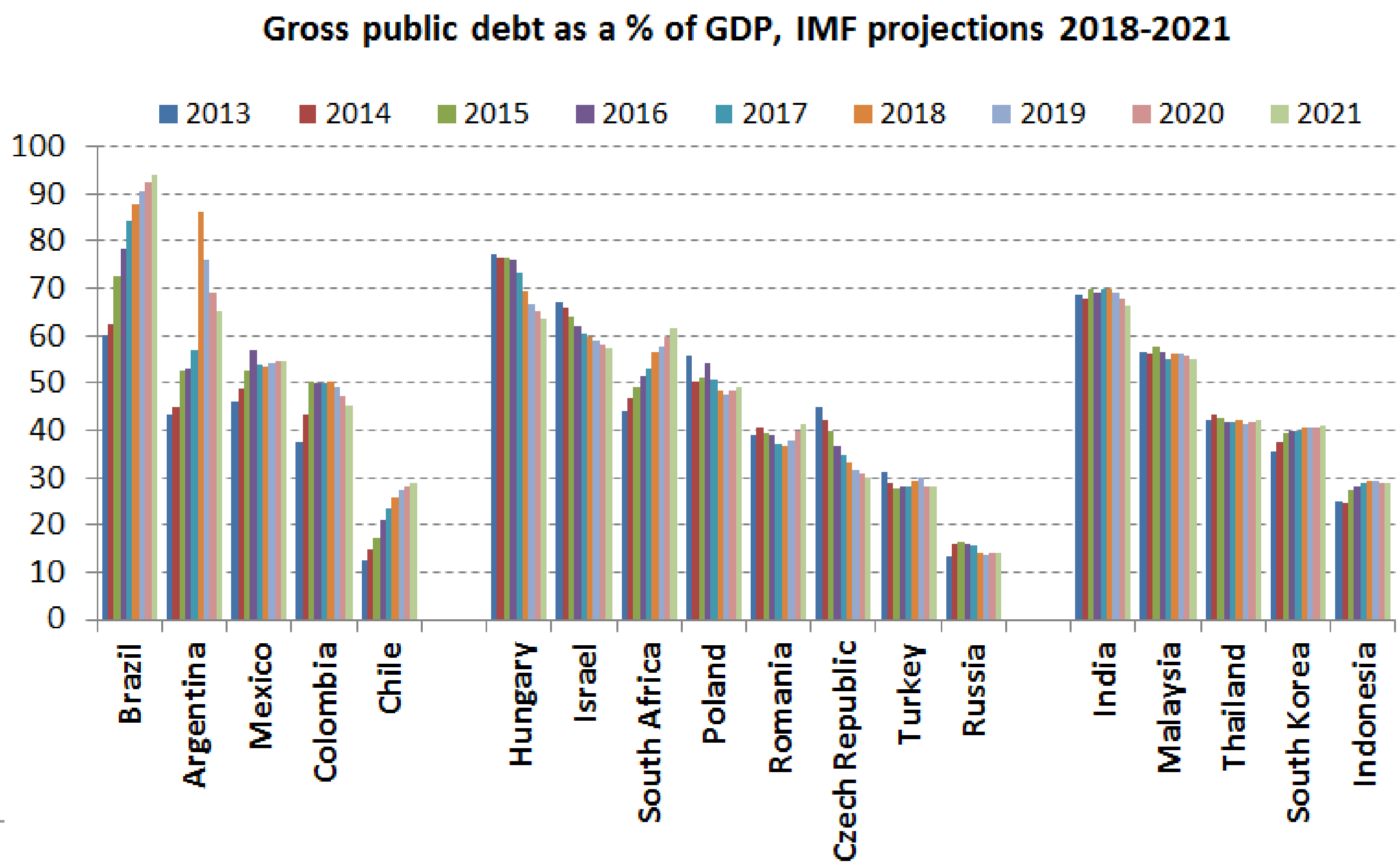
EM rates tend to sell off at times of recession worries…

…and DM CBs easing (see 2008 below)…
so I will not talk about extreme stress scenarios today

Yellow line: JP Morgan GBI-EM Global Div Composite (yield to maturity, weighted duration is ~6 years)
White line: 5 year US Treasury bond

Fiscal policy space? Yes for some, but pockets of weakness

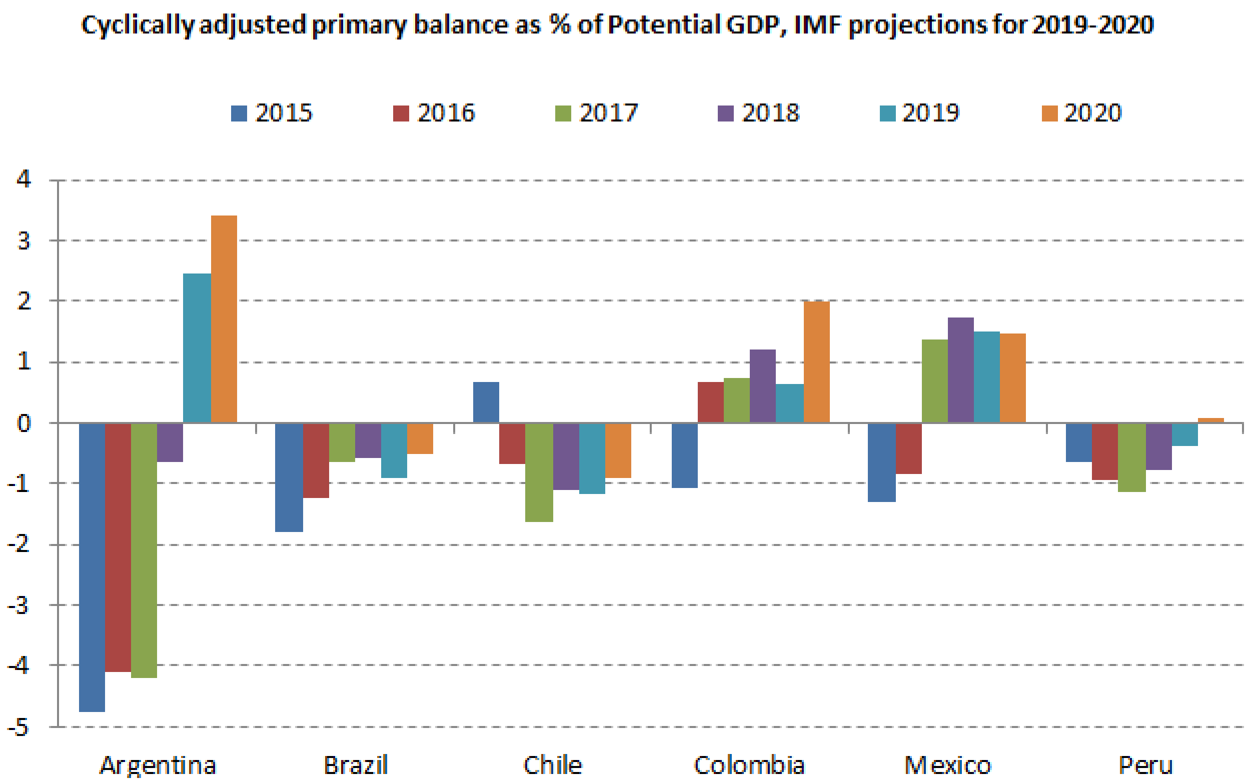
- **Asia** is the one region in EM where public debt is relatively low and nominal growth is well above the average interest rate on government debt, meaning Asia has very favorable public debt dynamics (i.e., it can run small deficits and still have stable debt to GDP due to g>r)



Fiscal space

Not much room for fiscal easing in LatAm.

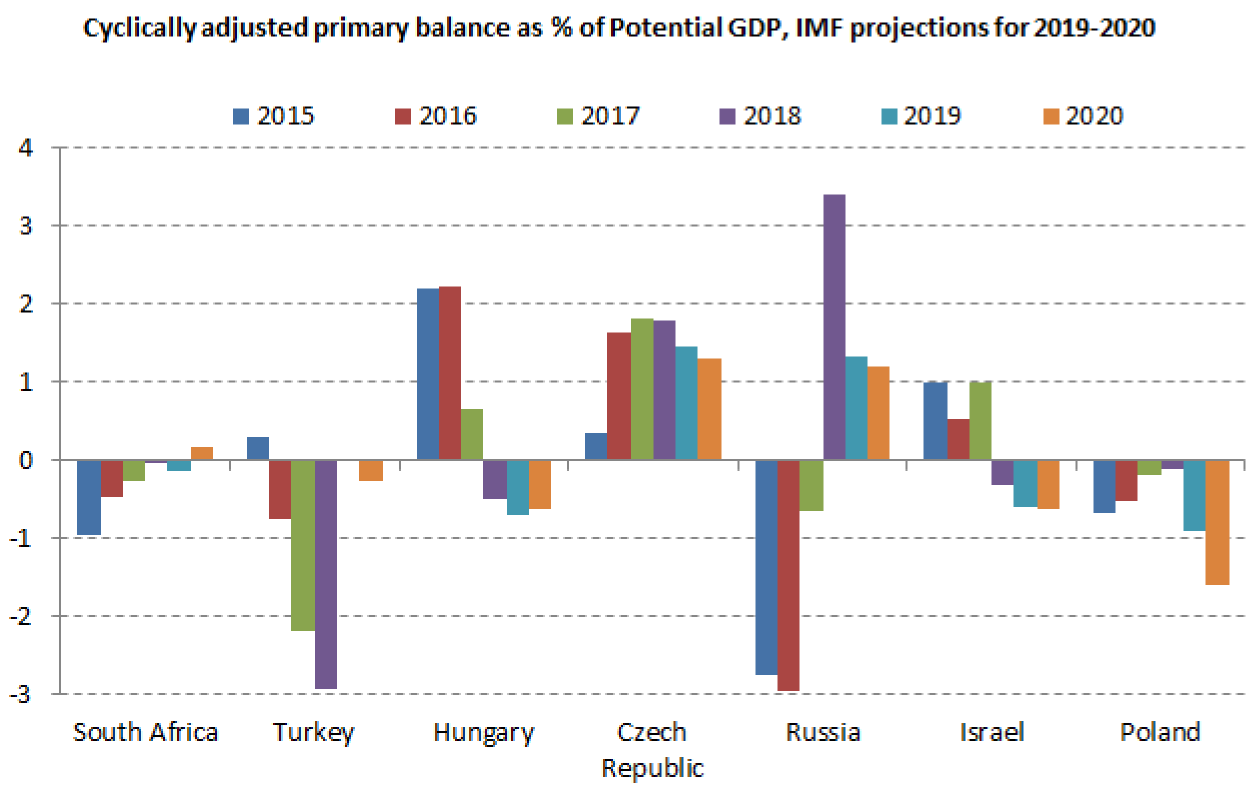
Mexico has inherited better fiscal from previous administration so in theory could do more but fiscal space is at risk from Pemex debt coming on to sovereign balance sheet...



Fiscal space

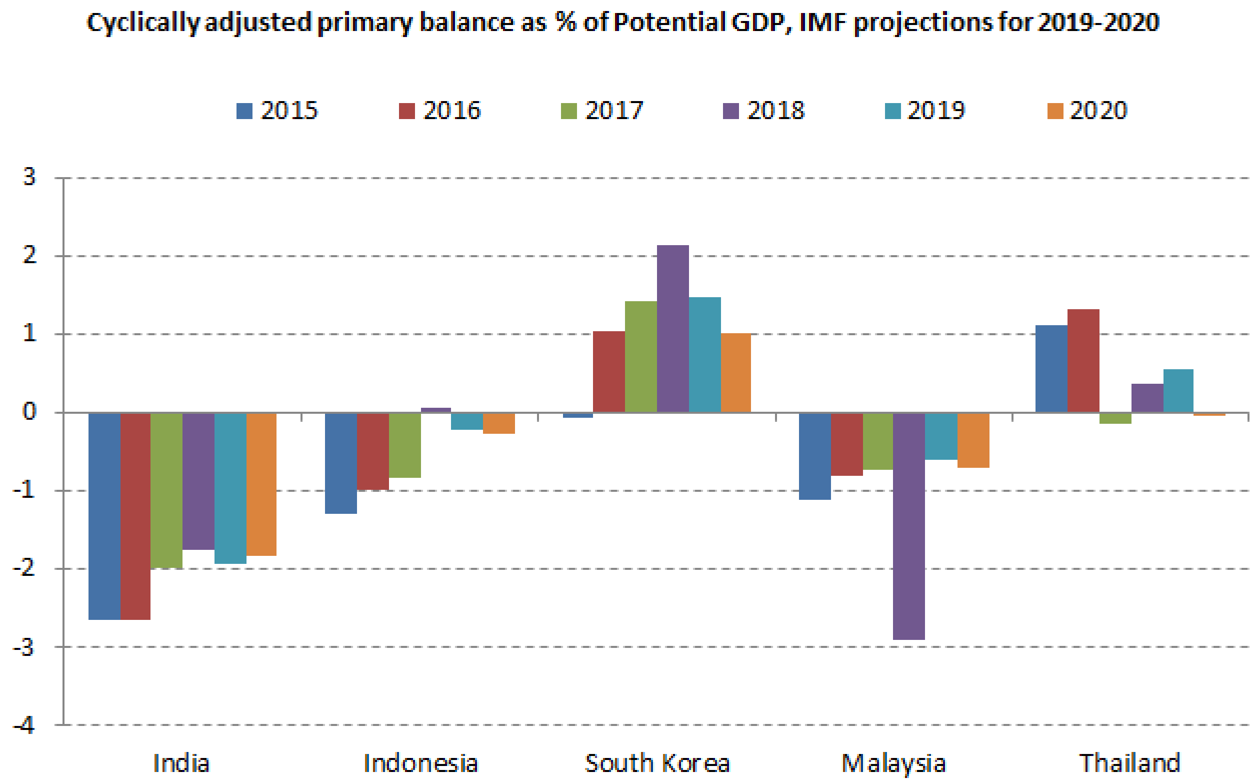
Russia – note that sharp consolidation starting 2017 vs stock of low debt. It's expected to roll out fiscal stimulus next year.

Turkey and Poland have come out with the fiscal packages this year.



Fiscal space

Aside from India and Malaysia, the rest are expected to do more starting with S. Korea and Thailand.



To recap...

- “synchronised” global slowdown, but no recession
- DM central banks reaction – dovish
- EM contagion risk from external slowdown is via exports + capex
- EM CBs follow suit
- EM easing space: monetary + fiscal, but how much is there?

On the face of it, some space is there:

- EM inflation is generally low
- EM nominal and real policy rates are high vs DM

…but closer look reveals thinner EM buffers

- EM growth is low, potential growth has come down
- Fiscal space is seriously constrained for some EM

Bottom line

In an “orderly” slowdown, some EM will have room to ease

But in case of a recession, knee jerk reaction for EM rates is higher