



Emerging Markets Quarterly – 2016/3

Since the Brexit vote, there has been a tremendous demand for emerging markets assets. Inflows into emerging markets funds have reached record highs during the third quarter of 2016. These assets could particularly benefit from the hunt for yield of the post-Brexit period because the fundamental situation and the external environment of these countries have improved. The external environment is much brighter compared to the beginning of the year: the hiking cycle of the Federal Reserve turns out to be very slow and commodity prices rebounded somewhat. In addition, China's economy has stabilised. Yet, recently a new external risk factor has emerged: Donald Trump. His foreign policy agenda would weaken the fundamentals of the emerging world. Moreover, the external environment would become more challenging as we predict a stronger US Dollar as well as a lower oil price after a Trump victory.

Growth – Slow recovery is materialising

Our long held view of a slow growth recovery in emerging markets is materialising. Growth of commodity exporters is recovering since the heavy weights Russia and Brazil are getting out of recession. We have been emphasising the slow nature of the recovery as several difficulties remain, such as the low level of commodity prices and political as well as structural issues. In Russia, the recovery is literally L-shaped (as opposed to V-shaped). Thus, the fall of the GDP level was followed by a stabilisation but not by a marked increase. In fact, the level of GDP has literally moved sideways over the last four quarters. As a result, the annual growth rate of economic activity indicators is back at zero but not (yet) in positive territory. The current recession has been ongoing for two years and is by far the longest downturn of the last twenty years. In Brazil, the recession is even more severe. GDP has fallen by 7.5% since end 2013. We also expect rather a L-shaped than a V-shaped recovery for Brazil, however, to a less extreme degree than in Russia. Moreover, the upside risk is that President Temer can implement some social security reforms and start to consolidate the fiscal debacle.

India – Slow recovery despite structural improvements

The approval of the Goods and Services Tax (GST) is a historical step for India. The tax harmonisation across states will create one common market within India and thereby greatly improve efficiency and lower bureaucracy. Moreover, confidence in the government's ability to turn things around increased. Prime Minister Modi

delivered his flagship reform. We are confident that the final steps will not pose major problems and that the GST can be implemented in 2017. Modi's government also approved other reforms such as the bankruptcy law or the easing of FDI restrictions. Moreover, it markedly increased infrastructure spending. We believe that the government will now concentrate on the implementation of these initiatives. Thus, we do not expect further reforms until the elections in 2019. Another area, which clearly improved over recent years, is macroeconomic stability. Inflation decreased from double-digit numbers to currently 5%-6% and the current account deficit shrank from 5% of GDP in late 2012 to less than 1% in mid-2016. In contrast, the fiscal consolidation has been slow. We fear that the consolidation will be slowed down yet again once the report of the committee reviewing the fiscal discipline will be published in October. Despite these fundamental improvements, growth should not accelerate rapidly as it takes time until the positive effects of the reforms unfold.

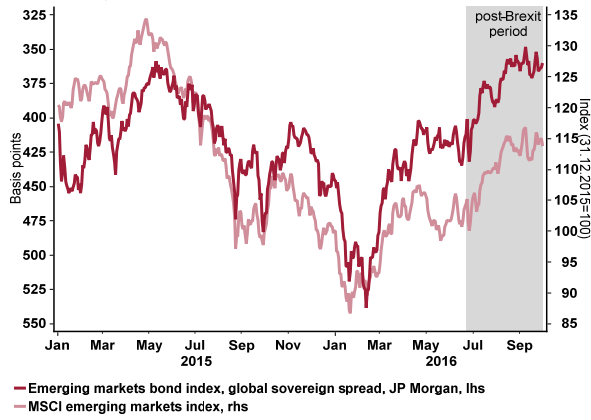
China – The government will attain its growth target

The government's GDP growth target for 2016 is 6.5%-7.0%. We have been of the view that even the lower bound is challenging. After the marked slowdown in 2015, the government launched substantial fiscal and monetary easing measures last year. They had the desired effect: Growth has stabilised. We have underestimated the length of this stabilisation period. However, we still believe that the current growth stabilisation is temporary and that it has aggravated imbalances as it is based on the "old-style" growth model. Moreover, the peak of the mini-cycle has been reached. In our view, the biggest risks are indebtedness, the currency and the fragile interplay between market forces and government interventions, which can cause policy mistakes.

Inflation – Broad-based decline across regions

One of the consequences of the commodity price shock was a rapid increase of inflation for commodity producers. The depreciation of exchange rates caused a rise of inflation as imports became more expensive. The effects were biggest in Latin America, Russia and Indonesia. Since a one-time depreciation only has a temporary impact, inflation has reversed and declined over the last months for most commodity producers. In addition, inflation is stable in the commodity importing regions of Eastern Europe and Asia. This general downturn of inflation provides room for monetary easing.

Emerging markets assets – A clear beneficiary of the hunt for yield after the Brexit vote



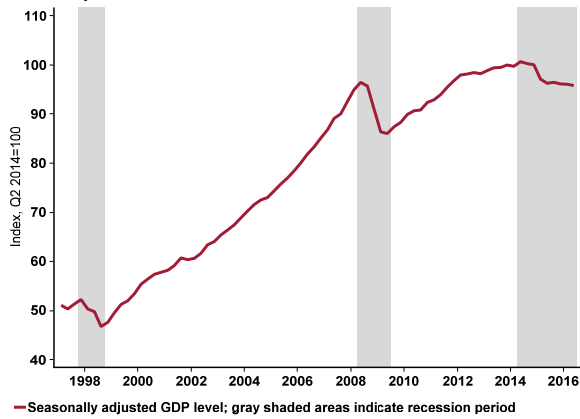
Source: **Macrobond**

Growth – Commodity exporters are finally recovering



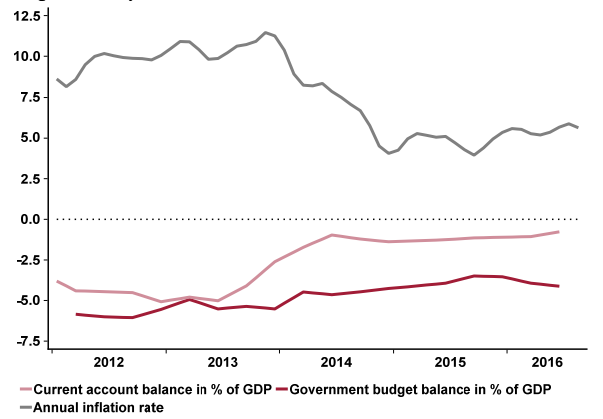
Source: **Macrobond**

Russia – Literally a L-shaped, and hence very slow, recovery



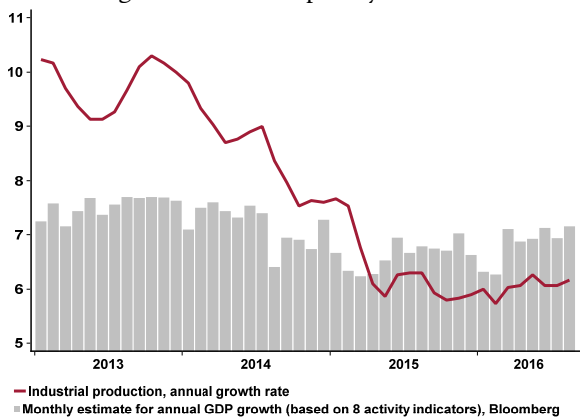
Source: **Macrobond**

India – Inflation and current account deficit clearly improved, yet, fiscal consolidation is still slow



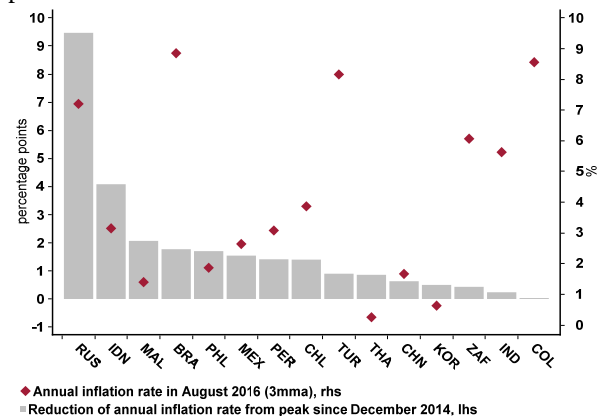
Source: **Macrobond**

China – Easing measures successfully stabilised economic growth on a temporary basis



Source: **Macrobond**

Inflation – Broad-based decline of inflation provides room for rate cuts



Source: **Macrobond**

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