EM jitters amidst strong fundamentals

- Investors less confident on outlook amidst uneven global growth
- EM risks counterbalanced by solid fundamentals
- KSA and Russia propose crude production increase
- Fed upbeat on US growth signals more hikes to come

Recent developments pointing to narrower, US-led, global growth and rising geopolitical risks have weighed on investor sentiment, kept risk assets range-bound, boosted the US Dollar and put pressure on emerging markets. Although we remain still constructive about the state of the global economy and hold the view that the second half of the year should see improvements in non-US activity, data releases must be closely watched and non-US fundamentals will have to pick up soon to avoid a revision to our base case.

Uneven global growth and geopolitical tensions take toll on risk assets

Last week, business confidence disappointed in Europe, UK and Japan, adding to the woes of lower than expected inflation reported previously. This increases the burden on the US economy to sustain the current expansion, is likely to further boost the dollar in the short term and makes the path of Fed policy increasingly divergent from that of other major central banks.

The lack of a clear resolution to US-Chinese trade conflicts, uncertainty surrounding US-North Korea talks and the emergence of a populist government in Italy are not helping either. Investors sought shelter in gold and the Japanese Yen, which both appreciated for the week.

No EM crisis, no positive catalyst either

EM assets, which have recently underperformed DM counterparts, are feeling the brunt of tighter financial conditions primarily caused by rising US yields and a stronger dollar. In spite of rising investor concerns, EM fundamentals remain solid as compared even to more recent past. Foreign exchange reserves ex China for the main EM countries were above $3tn in April, up from less than $2tn in 2009, giving developing nations firepower to support their currencies. Although the total US Dollar debt of EM countries has tripled since 2007, it is also true that many EM exporting nations get dollar revenue which partially offsets currency risk.

Improvements in non-US growth, which would make US strength less exceptional and help rein in the dollar, would generate renewed confidence in the outlook for the global economy and the EM nations. While there is currently no EM crisis, EM assets in the short term could continue to drift lower amidst lack of positive catalysts.

Selective approach to EM assets required

The KSA and Russia are amongst the few equity EMs in the green so far in 2018. Both countries are oil exporters with low debt-to-GDP levels. In the current jittery environment marked by rising crude prices EM oil-exporting countries, or the ones with large foreign exchange reserves and low debt levels, are likely to fare better than oil importers, or countries with low foreign exchange reserves and high debt to GDP ratios. High oil prices have taken their toll on the current account deficit of an oil-importer like India, which had enjoyed prices at $50/bbl only one year back. Inflation is ticking up and so are transport costs for the vast distribution network of Indian goods, the growing consumption of which is the backbone of India’s economic growth rate of +7 percent. In India a large number of corporates boasts earnings growth above 20%, as well as high ROE’s, an edge in a volatile world where balance-sheet quality is the discerning factor.

Investors are advised to take a very selective approach within EM and pick preferably stories of domestic strength. India is one of these stories, which we still support, both in terms of equity and bond assets.

EM bonds are appealing at current valuations, following a 100bps yield repricing. In particular, on a historical
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Crude prices retreat on supply increase announcement

Comments by Energy Ministers in Saudi Arabia and Russia point to a possible easing of oil production curbs in the second half of the year. Production cuts combined with a tight crude market could negatively impact global economic activity, a concern which spurred the US and China to exercise pressure on OPEC countries to increase supply. This caused a sharp drop in Brent and WTI prices, as well as in the net long exposure of large speculators.

Crude gains should be capped in the short term, and the announced intention to expand production should limit Brent upside beyond $80/bbl. Crude is unlikely to slump either, as market conditions remain tight and the increase in supply is partially counterbalanced by lower production both in Iran and Venezuela.

US Fed leans dovish – policy shift or cautiously optimistic?
The May Fed minutes delivered a dovish message, suggesting tolerance for a temporary inflation overshoot, while at the same time reiterating that another rate hike is warranted "soon" and the pace of hikes should remain "gradual". This is compatible with a June policy move, but gives little visibility as to whether one or two more should be expected this year. Fed officials remained optimistic about the outlook for growth and showed increased confidence in that for inflation, moving "close to 2 percent".

The immediate reaction post the release of the minutes was a mild steepening of the yield curve, which has otherwise been flattening throughout this monetary cycle. A flattening curve points to a slowdown in the economy, which eventually will happen, orchestrated by the Fed via policy tightening. Although many investors dread the event of an inverted curve, likely to occur sometime in 2019 and harbinger of a recession, history reminds us that considerable time may lapse, even a year, between inversion and the onset of a recession. Currently global growth remains above trend and set to expand at 3.8 percent in 2018, as per latest consensus forecasts.

Privacy constraints limiting tech upside

Netflix has become as valuable as Walt Disney and Comcast, as investors remain faithful to the FAANGs. These disruptive technology and internet firms continue to power the US indices. Worries persist about the disproportionate gains of the FAANG stocks of Facebook, Amazon, Apple, Netflix and Google. Netflix is up 83% this year and trades at a whopping 105X forward earnings. The expected long-term earnings growth of 47% is the reason why investors keep betting on the stock.

Facebook had managed to convince US end-users that they should have no worries about their privacy or sharing of data. In Europe however, Facebook is subject to the stringent new privacy law labelled GDPR “General Data Protection Regulation”, which became effective on 25th May, forcing companies to change how they gather and handle information. It defines new rights for individuals and responsibilities for companies. This has led to a huge cut down on the free marketing by companies thorough spam mails and use of data gathered from apps and internet sites.

Italian populist government raises political risks in Europe

Italian Government Bonds (BTPs) sold off to yield 100bps above Spanish counterparts on heightened political risks, following the rise to power of populist parties in Italy. The populist coalition is euro-sceptic and discussed tax and basic income reforms which would significantly boost the country’s debt-to-GDP ratio, already at 130%.

The reforms, unaffordable given the Italian debt burden, are likely to be toned down, unless the new coalition looks for a direct confrontation with EU partners, who were recently given reassurance on public debt reduction and compliance with euro area rules by the previous government. What seems to be more uncertain is whether the anti-EU stance will prevail, with threats to leave the euro area in order to seek concessions from European partners.

The success of Italian politics will ultimately be decided by the leadership’s ability to boost economic growth and productivity, rather than by conflicts with Brussels, which will undermine investor confidence and deepen Italian woes.

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