Top-down Trumps Bottom-up

Emerging markets are currently facing two fairly striking opposing forces, in particular, favourable top-down macro forces or factors, set against fairly weak/mixed bottom-up country stories.

Market Insight

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Published June 2017

Overall we are seeing the top-down factors over-weighing much more difficult and challenging bottom-up forces. At present, top-down forces are dominant but we believe this is unlikely to last. We are of the view that country specific stories will come to the fore with credit differentiation (alpha) rather than beta plays being the order of the day.

Top-down

Goldilocks global growth

Global growth data is still telling a story of a synchronised global reflation/recovery. Led by Chinese reflation from mid-2015, but coming in parallel with a sustained US recovery as balance sheet healing appears near complete. This is now being joined by new found confidence in Europe, helped by recent political wins for more mainstream forces, not least that of Emmanuel Macron in France.

Central banks still providing liquid refreshment

Despite the nascent and now seemingly well entrenched recovery, developed market central banks seem loathed to tighten aggressively. The Federal Reserve is tightening but at a pace which seems manageable – and less pressure therein now as the 'Trump bump' seems to be fading. On the latter, there are concerns that the chaos and political flux around the Trump presidency could act to break the US recovery, as 'soft' data converges with hard data.

Chinese authorities are beginning to tighten, but this seems more like marginal tinkering. China is content that the economy is growing at a robust pace to ensure no big negative surprises this side of the leadership change.

In Europe, we think the European Central Bank (ECB) still has its eye on domestic politics and the threat from populists after the shock of Brexit and the Trump victory. In our opinion, the ECB needs to ensure robust growth and job creation to help mainstream politicians counter the risk from the far-right, far-left and the anti-immigrant rant. Mainstream victories in the Dutch and French elections are encouraging, but we think the ECB will only begin to take its foot off the monetary gas when the German elections are done and dusted in September. Overall, there is still plenty of monetary stimulus. Interestingly, we are yet to see much evidence of a splurge in developed market investment/mergers & acquisitions, as companies in developed markets still seem cautious as to the durability of the recovery. This is leaving ample excess liquidity pumping around global markets and finding its way into risk assets, including emerging markets (EM).

Oil prices are in a sweet spot

Oil prices holding around a US$50 per barrel handle seems optimal both in terms of ensuring fiscal sustainability for oil companies, but also giving enough spare space/cash for consumers. Arguably oil prices around current levels are not high enough to breed complacency for oil companies, ensuring focus on fiscal and structural reform, but also not low enough to raise concern about budget and debt sustainability. We think that OPEC seems to be holding the line for the time-being in terms of production cuts.

Trump's protectionist desires seem to have been caged

While we started the year concerned around the protectionist impulses of President Trump, in reality his ambitions have been contained by hard economic reality (for example efforts to reform The North American Free Trade Agreement (NAFTA) have come up against the realisation that this will hurt US businesses and consumers through higher inflation) and by geopolitical needs (the need to cooperate with China to mitigate the threat from North Korea). There has been a lot of bluster and bluff but not much action – the US administration has appeared all too willing to cut deals and take any small and short term wins it can.

Geopolitical risks have been contained – so far

Fears that Trump would translate domestic policy failure into foreign military adventures have so far failed to come to fruition – aside from lobbing a few Tomahawk missiles at a near empty Syrian air base. In part it could be argued that his early difficulties over 'Flynngate' forced Trump to quickly hire and delegate policy to more experienced and cautious foreign affairs/military/security officials, including James Mattis/General McMaster and even Rex Tillerson. In many respects foreign policy under Trump has gone back to default GOP settings, with a return to more traditional bilateral allegiances with Saudi Arabia/Gulf Monarchies, Egypt, Turkey (perhaps) and Israel. A more transactional (literally) foreign policy agenda, based on military and trade relationships. Trump could so easily still move back outside the box, but early policy mishaps over Russia, the One-China policy and Israel-Palestinian relations have seen Trump look to minimise risks on the foreign policy front. Encouragingly, the US seems to be working and engaging with China over North Korea. Iran remains a potential flash-point, but the return of the US to the Gulf appears to have re-assured allies like Saudi Arabia, to feel less of a need to project their own force and encouragingly take more of a backseat and focus instead on managing oil prices (what they do best).

Under Trump, the vacuum left by the Obama administration is to a certain extent being filled, or at least partially. This is not disengagement, but rather the opposite, albeit under Trump the US is clearly not projecting US values, but US interests, mostly business/military strategic. Even on NATO, Trump's initial mixed, even hostile, commentary, is perhaps serving to focus other members on the failings of the organisation and on the need to make the organisation less reliant on the US strategic umbrella. This is maybe long overdue for an organisation which has been in decline for as much as a decade now or longer – and its decline has seen others, including Russia, step into the void.

We would finally add that in Europe, the combination of Brexit and a Trump victory, have made it clear to continental Europeans what they don't want, and they have returned to the fold of mainstream centrist/liberal parties/candidates in the Netherlands, France and also likely in Germany. We are tempted to write herein that 'Trump has saved Europe', albeit from something all too like himself.

Bottom-up

Brazil

Just when investors were turning more constructive, the Temer scandal surfaced, raising concern over the sustainability of structural reforms. We believe this agenda is still critically important for spurring a growth/rebound to ensure that the country grows out of its deteriorating public finance/debt problems. Growth and pension reforms are crucial to this and with uncertainty over the future of incumbent President Temer, these must now be in doubt.

Mexico

Has perhaps managed to fend off the worst protectionist impulses around a border adjusted tax (BAT) from the US, but the outcome might well be 'contagion' from the Trump effect into its own political scene, with a more populist agenda in the run up to its own elections.

Turkey

In our opinion, the strong growth/reform story seemed to go off the tracks in 2013, and Erdogan has struggled to bring things back as he has faced an increasingly difficult domestic, foreign affairs and security setting. Arguably he has not helped matters by his own often unorthodox economic policy impulses – against the interest rate lobby, and reining in the independence of the Central Bank of the Republic of Turkey (CBRT) – and also by playing the nationalist card to the detriment of relations with the EU and traditional allies in the West. Turkey has some well-known vulnerabilities – the wide current account deficit and large external financing requirement. But also key strengths – robust public finances, strong banks and favourable demographics. But, we believe that Erdogan needs to go back to the successful pro-business policies of the Justice and Development Party (AKP) for the period 2002- 2013, if he is going to win the 2019 elections. We are not sure at present if the pro-business/national agenda fits that well and seems still to be keeping local and foreign investors on the sidelines.

South Africa

Internal battles over the succession to President Zuma are keeping political risks elevated, weighing down on growth and investment and keeping many investors on the side-lines. Well known structural vulnerabilities are not being addressed, while the country still remains vulnerable to deteriorating public finances and ratings downgrades.

Russia

Russia's balance sheet is strong, but the economy fails to produce meaningful growth, and stagnation remains the dominant theme. This likely reflects deep structural weaknesses which the Putin regime continuously fails to address – these relate to the weak business environment (corruption, bureaucracy, red tape, rule of law and protection of property rights). We would argue that the power vertical is at the centre of the problems – and reform means Putin releasing control which seems unlikely. Meanwhile, Putin's continued geopolitical battle with the West we think just continues to deter foreign and domestic investment.

Ukraine

Lot has been achieved on the reform front over the past three years – fiscal/balance of payments adjustment, energy sector reform, National Bank of Ukraine/FX/monetary reform, and the economy is now growing. But lots more needs to be done, including difficult pension and land reform and still very little has been done on really delivering on the number one problem in Ukraine which is the anti-corruption agenda. Meanwhile, the Donbas situation in the east still needs to be resolved, while relations with Russia remain tortuous and still a clear and present danger.

Venezuela

Venezuela appears to be in a spiral of decline, but with the Madura regime is surprising everyone in terms of its ability to survive. However, there seems little chance of a meaningful economic improvement until there is real political change.

Egypt

Multilateral and bilateral bail-outs are providing some hope (buying time for reform), but the structural problems are deep seated. They relate to underlying political, social and security risks/tensions which make addressing key economic vulnerabilities that much more difficult, and particularly the weak state of public finances and banks. Recent exchange rate reform offers some hope of improvement.

India

India seems to be a ray of hope in EM space, with the Modi administration finally making some significant progress on the reform front with the demonetisation/Aadhaar card reform, goods and services tax introduction offering a real hope of a step change in public finances, and opening the way for improved public administration and investment in key bottlenecks such as infrastructure, education, public housing, etc. The weak state of the banking sector, land and labour market reform though are now structural impediments to development which need addressing, albeit the question is has Modi the political will to do this before the next elections.

Central and Eastern Europe

Has some better growth/reform stories, driven by earlier balance sheet cleansing in the period after the Global Financial Crisis, but now also by the improving growth outlook for core Europe. Poland, Hungary, Romania, Croatia and Serbia are all seeing growth step up a gear. But I guess the regional concern is the rise of more populist/illiberal forces and movements – for example, Orban in Hungary and Kaczynski in Poland, and looking further afield and out in terms of time dimensions the impact of the weakening EU accession anchor in the Balkans, Turkey and Ukraine. How will this impact on regional peace, stability and prosperity? Recent events in Macedonia have revealed the vulnerabilities.

China

Probably fits into both the top-down and bottom-up view. The top-down story is that the fiscal/monetary stimulus from mid-2015 onwards seems to be keeping real GDP growth elevated, buying time through the leadership change to year end, and likely enough for the global growth/reflation trade to sustain this year. Beyond that the question marks remain as to whether the Chinese authorities have the means to bring about the rebalancing of the Chinese economy, and deleverage gently. In our opinion, they certainly still have a strong enough balance sheet to cushion the impact, but are the problems just building.