A capital markets expert offers insight based on TAC ECONOMICS research.

The Market Insight

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Writer and commentator David Wigan offers his thoughts on the key trends revealed by TAC ECONOMICS quantitative models and insight.

Emerging markets – three red flags

Not the most pleasant times in emerging markets. Rising U.S. interest rates, a stronger dollar, and diminishing international liquidity have created headwinds, which are being reinforced by increasing tariffs between China and the U.S. and talk of trade wars. TAC economists predict rising risks at least up to mid-2019. Political uncertainties in some countries (Brazil, Turkey), meanwhile, increase the likelihood of speculative attacks on local currencies in those countries and their key trading partners. Already growth is slowing and TAC predicts it will continue to do so, reaching 4% in the first quarter of 2020, compared with 5% in Q1 2018.

Three key factors are likely to dictate EM fortunes over the next six or so quarters: the impact of protectionism, commodity prices and China.

Protectionism. The period 1995 to 2010 was marked by a spectacular expansion of international trade, fuelled by the emergence of China, declining tariffs and the impact of globalisation on supply chains. In the past decade, these drivers have weakened, and in their place has emerged a rising focus on restrictive trade policies, culminating in the recent antagonistic period. The Trump administration says that multilateral rules have offered "free rides" to some countries, and in particular China. "Making America Great Again" arguably encapsulates the idea that others have inhibited natural U.S. leadership. The ultimate impact of this dynamic is likely to be contingent on whether it remains restricted mainly to the China-U.S. relationship, or contaminates trade relations around the world. Of course, the impact is likely to be greater in the event of cyclical economic reversal.

Commodity prices. With several countries unable to contribute, or restricted in their contribution, to global oil production, it's not surprising that the price of oil has risen, particularly with global growth remaining robust. TAC non-linear models suggest the potential for spikes at or close to 90$/bl (Brent) and a floor at 65$/bl for most of the period ahead. However, new pipeline facilities in the U.S., expected from February-March 2019, are expected to help supply overtake demand, particularly when the U.S. cycle reverts and China slows. Prices at that point are likely to decline rapidly, with Brent falling to around 50$/bl in early 2020 and dropping to 55-65$/bl in the second half of next year.

China. Chinese government policy broadly may be interpreted to have four objectives: rebalancing economic growth, supporting China's role as an economic powerhouse, achieving world-power status, and retaining the dominance of a single-party rule.

Against this background, China's recent economic data is unhelpful. The economy grew 6.5 percent in the third quarter from a year earlier, below an expected 6.6 percent rate, and slower than 6.7 percent in the second quarter. At the same time Chinese authorities are trying to navigate challenges. Trade war fears have sparked a blistering selloff in domestic stock markets and a steep decline in the value of the yuan.

The likely weakening of President Xi's power within the Chinese leadership and the assessment of the potential impact of U.S. trade restrictions have led to modest reflationary policies. This has been mostly through central bank liquidity injections in the interbank market and the subsequent decline in SHIBOR interest rates.

Still, TAC predicts continuing slowing growth to 6% in the first half of 2019 and then further still going into 2020. This would be associated with a further 5%-10% depreciation of the CNY against USD, i.e., a total 15%-20% depreciation over the "overvalued" level of USD/CNY 6.30 in March 2018.

Trade, Oil and China: Three EM bellwethers that deserve attention in the months ahead.

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TAC ECONOMICS team is available for any economic, financial, technical questions and requests at the following e-mail address: hotline@taceconomics.com

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Tel +33 (0)299 39 31 40
Web: www.taceconomics.com