Emerging Markets – Vive La Difference! (long live the difference)

Summary

Emerging market assets were sold off significantly in 2018 on the back of both external and domestic factors.

Reversal in some of these influences coupled with attractive valuations led to an undifferentiated rally in EM assets towards the end of 2018.

The rally continued in 2019 but started showing signs of petering out in the month of February.

Has the rally gone too far? For some EM economies that have a valuation advantage and are backed by sound fundamentals, the rally could sustain.

However, various risks loom. Given that a number of important risk factors for the EMs are fairly well known, the <u>risk emerges from factors and events that are not yet priced in.</u>

The response to these uncertain risk events will unlikely be uniform across EM countries.

In a nutshell, we could see a differentiated rally across EMs. Countries with greater domestic resilience (such as India, Indonesia, Brazil) are likely to perform better than the rest.

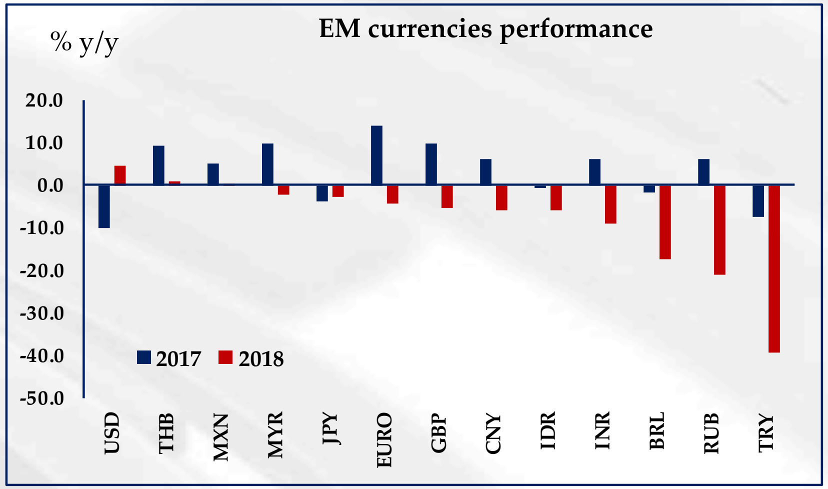
Emerging market assets fell significantly in 2018…..

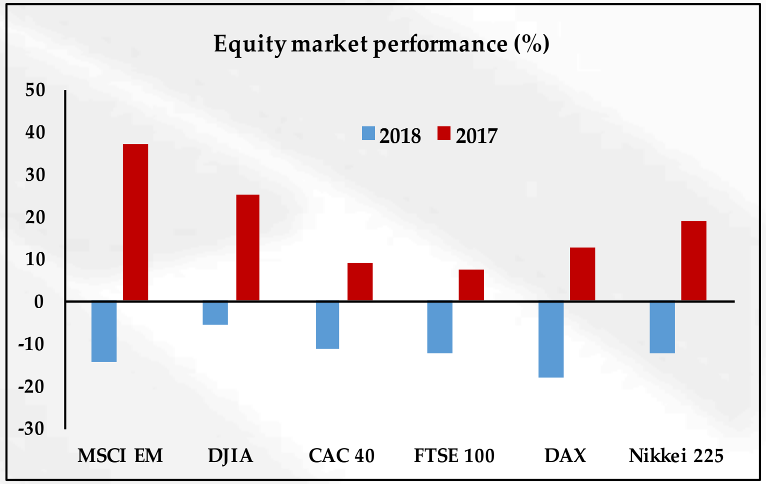
4 Factors that weighed on EM assets in 2018

1. Higher US yields and the USD on the back of ongoing Fed monetary tightening
2. Global risk-off sentiment fueled by the US's protectionist measures
3. Volatile oil prices
4. Country-specific turmoil in e.g. Turkey and Argentina

Total Return (%)		
Asset class	**2018**	**Over 3 years**
US Inv Grade Bonds (Bloomberg US Agg Bond)	0.0	2.1
TIPS (Bloomberg Treasury TIPS)	-1.3	2.1
iBoxx US Liquid High Yield corporate bond market)	-1.6	6.5
FTSE Emerging Markets Government Bond Index	-1.5	6.7
FTSE World Government Bond Index	-1.8	3.3
FTSE Russell Non-$ Corp	-6.0	3.0
Markit Global ex US High yield	-7.7	5.0
Commodities (Bloomberg Commodity)	-11.3	0.3

The Bloomberg US Aggregate Bond Index is a market capitalization-weighted index including treasury securities, Government agency bonds, Mortgage-backed bonds, Corporate bonds, and a small amount of foreign bonds traded in U.S. It excludes Municipal bonds, and Treasury Inflation-Protected Securities

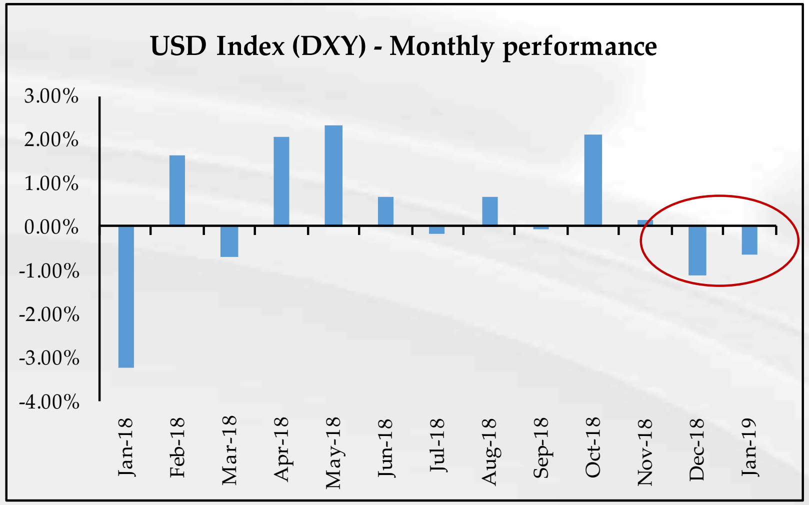




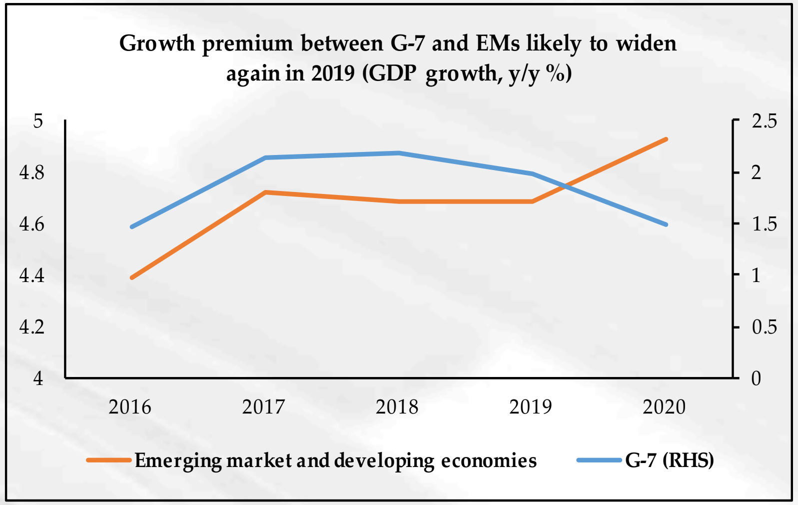
Source: Reuters, investing.com, media reports HDFC Bank

.......but supporting factors started emerging at the turn of the year

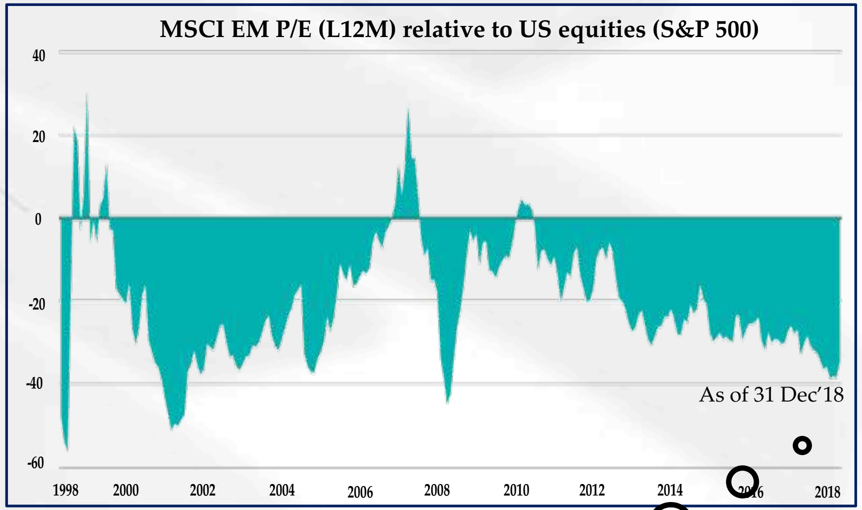
A "Dovish" Fed and a fading dollar rally



Growth premiums expected make a comeback …



…coupled with attractive valuations



MSCI EM Index was down to 11.8x trailing earnings, a discount of about 35% compared to US equities. This discount is wider than the 20 yr average, which is around 20%

Source: IMF, investing.com, MSCI, Lazard asset management & HDFC Bank

The outliers also started seeing favorable developments…

Argentina

1. IMF loaned the government $57.1 billion
2. Austerity plan (including a "zero deficit" budget)
3. To be incorporated into the MSCI EM Index in mid-2019

Turkey

1. Lira rebounded
2. CAD moved into positive territory in Q3 2018

Brazil

1. Economy re-accelerated while inflation declined in Q3 20018
2. Presidential election of Jair Bolsonaro - seen as pro reform and business

India/Indonesia

Net oil importer benefitted with easing in oil prices

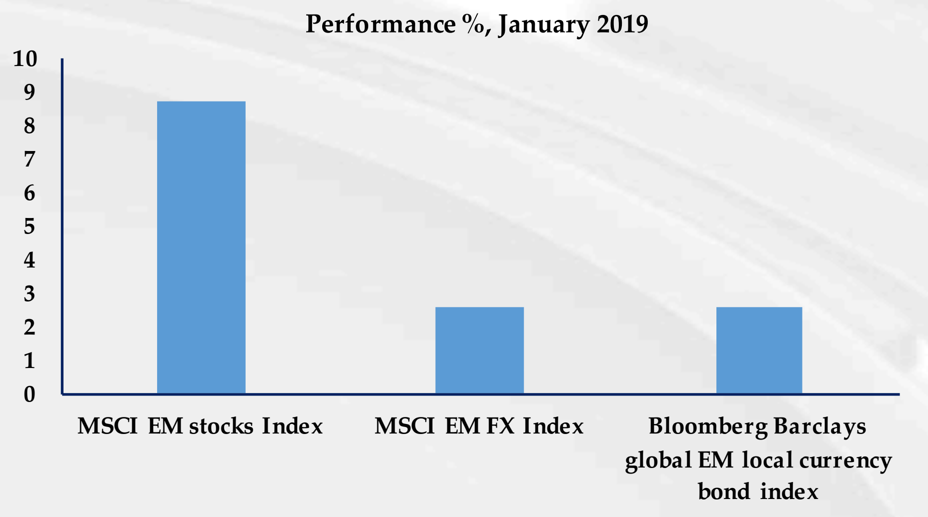
Russia

Some US sanctions on Russia were lifted at the end of 2018

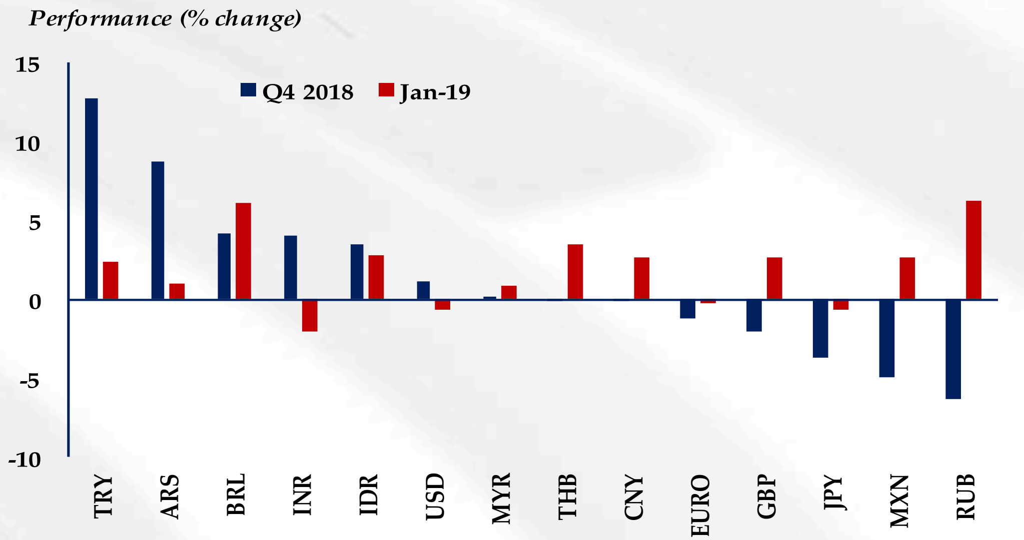
EMs saw an undifferentiated rally across regions and assets

Recovery started in 4Q and picked up pace (homogenously) in January 2019

- Local **EM currencies started bottoming in early September** as the US dollar stabilized.
- **Equities staged a recovery beginning in late October** as valuations became extremely cheap and flows returned to the asset class.
- **Debt markets began to recover in late November**, benefiting from the drop in treasury yields as the Fed appears closer to the end of its tightening cycle.
- The rally sustained in January 2019

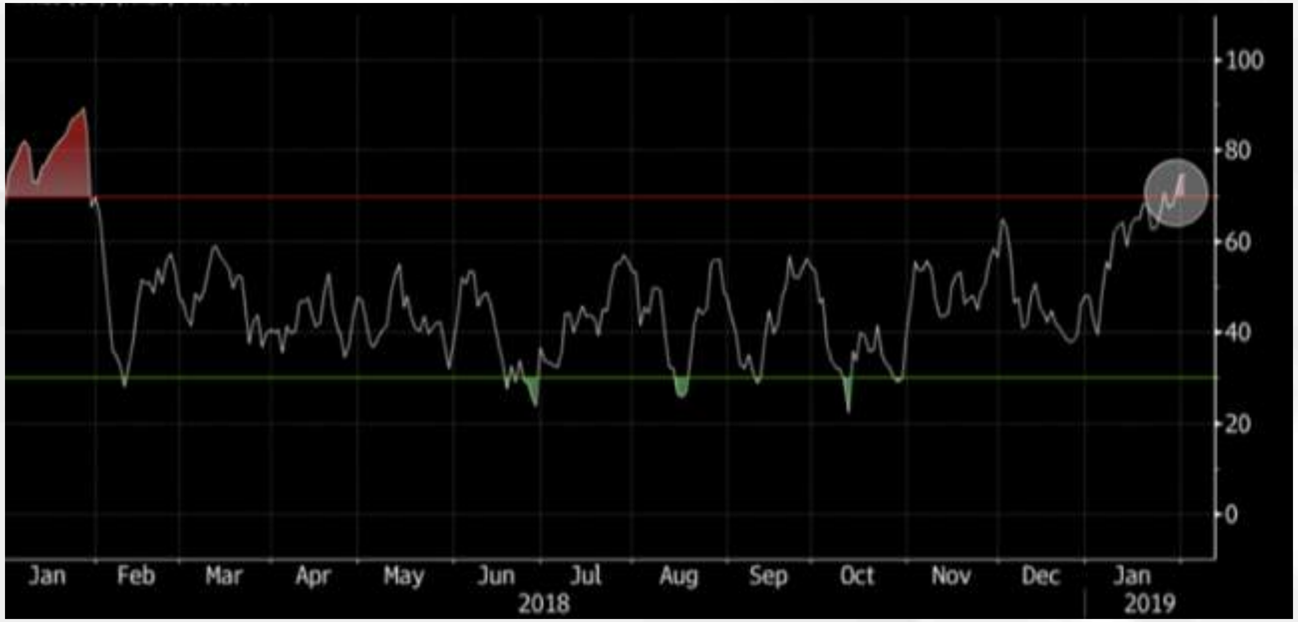


EM currencies performance



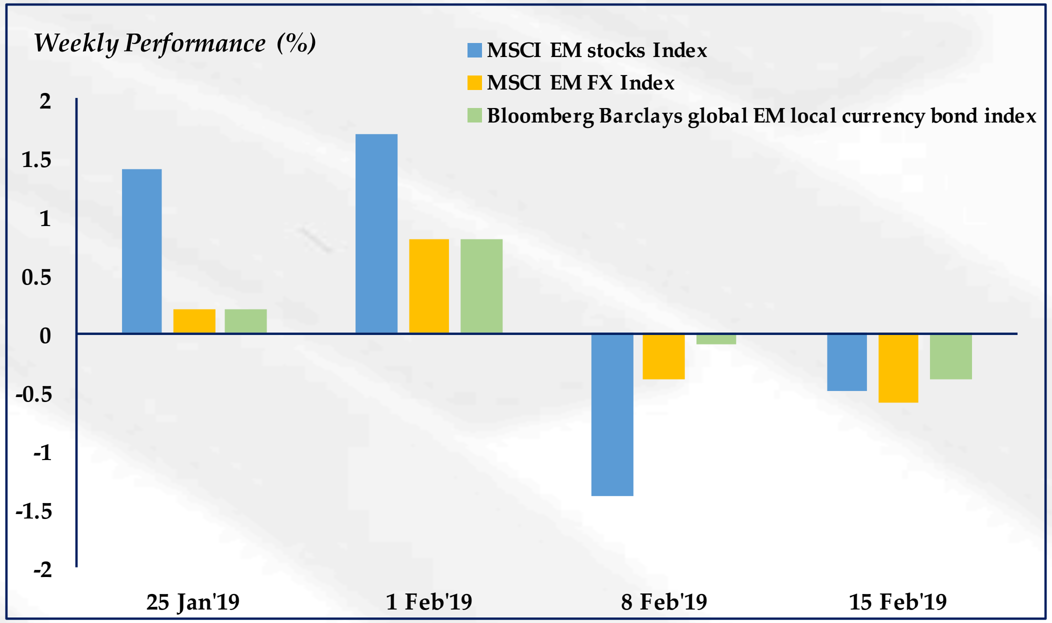
The big question: Has the rally gone too far?

EM stocks in overbought territory!



The Relative Strength Index (RSI) is a momentum oscillator that measures the speed and change of price movements. The RSI oscillates between zero and 100. Traditionally the RSI is considered overbought when above 70 and oversold when below 30.

Other asset classes also pulled back in February

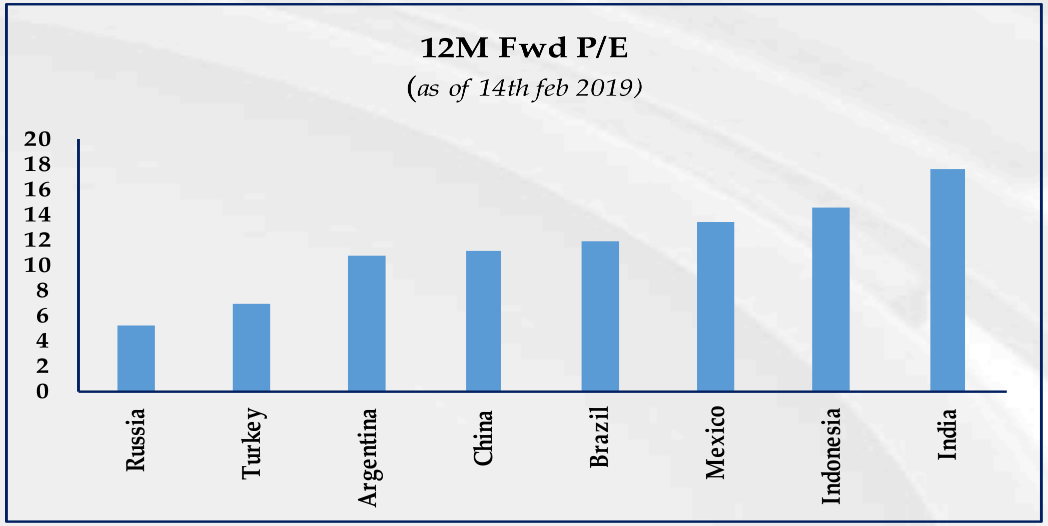


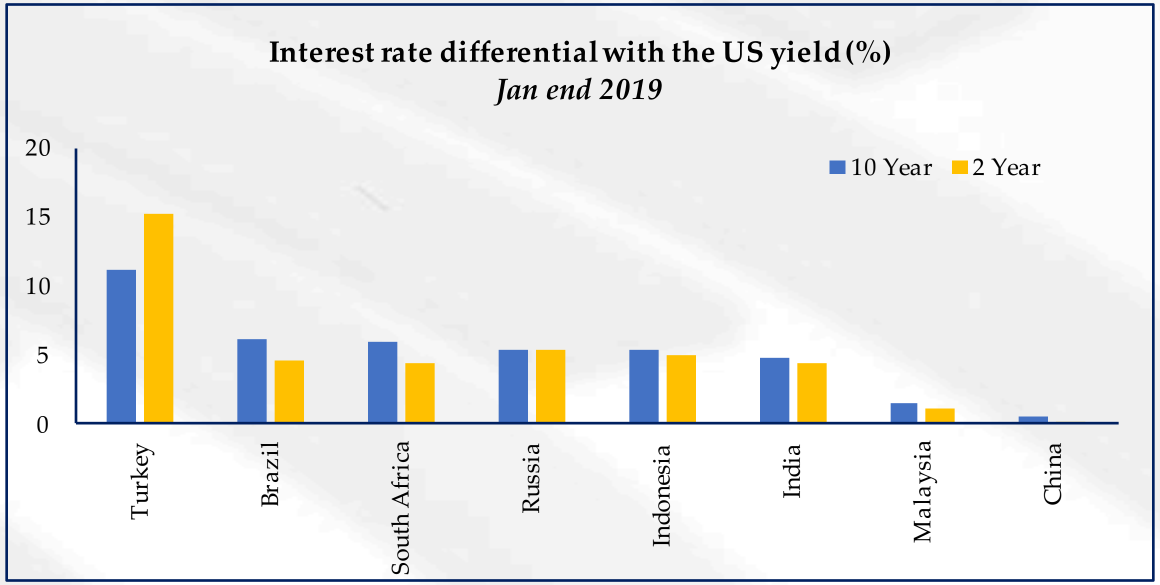
However despite the run-up some EMs attractive as a pure "value plays".....

While some reversal of the "EM long" trade might happen, valuation catching up and carry-trade will still hold for some markets

As of Jan 31, 2019	Div yield %	P/E	P/E Fwd	P/BV
MSCI EM	2.76	12.77	11.44	1.61
MSCI ACWI	2.61	16.45	14.07	2.19
MSCI World	2.59	17.12	14.52	2.3

- *The MSCI ACWI (All Country World Index) is a market capitalization weighted index capturing large and mid cap representation across 23 Developed Markets (DM) and 24 Emerging Markets.*
- *The MSCI World Index captures large and mid cap representation across 23 Developed Markets (DM) countries*

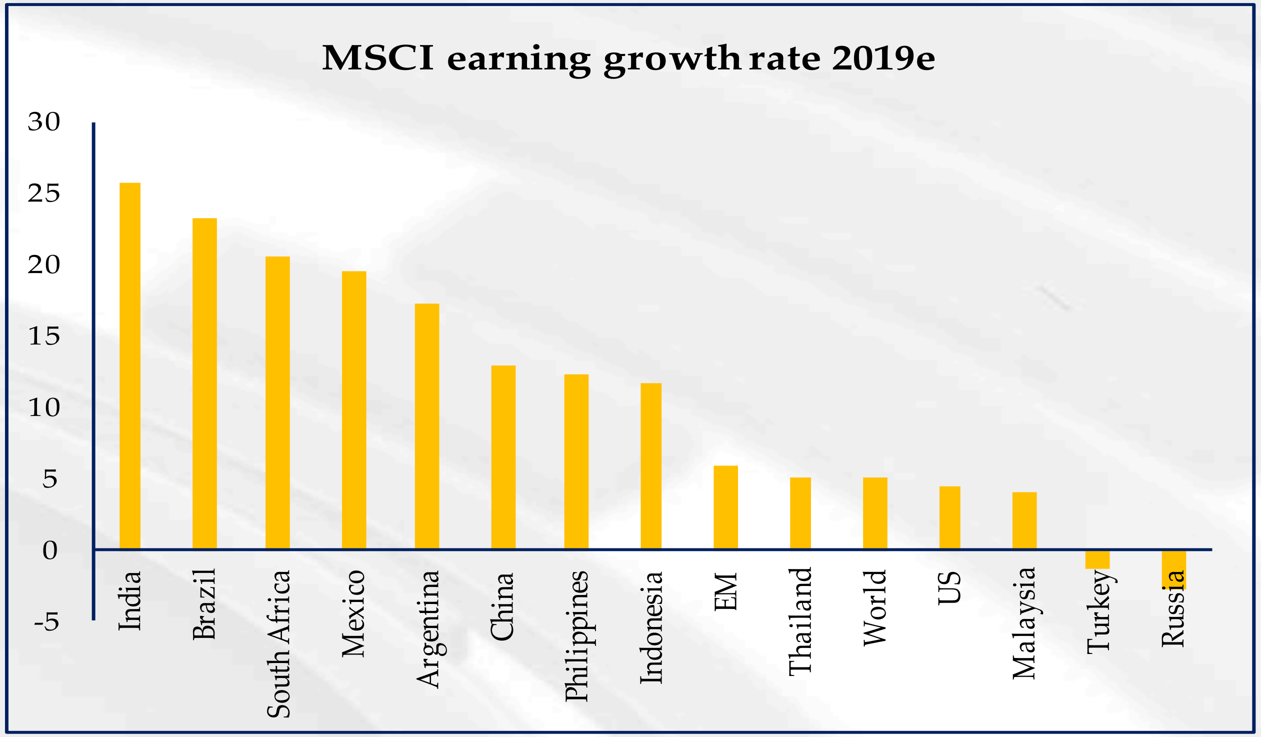




Source: MSCI, investing.com, Yardeni Research & HDFC Bank

……with some markets backed by potentially greater growth opportunities

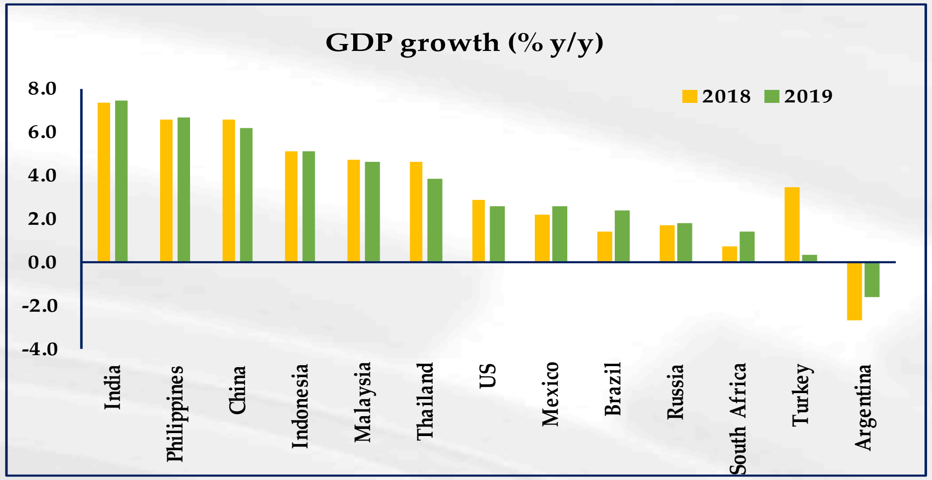
In 2019, EM earnings growth is likely to outpace growth for the US and the world



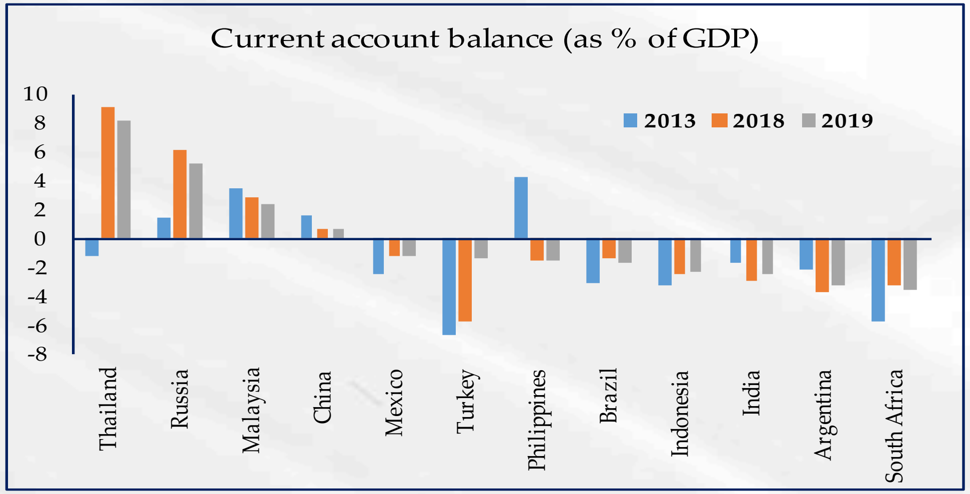
Source: *Charles Schwab, MSCI* , Yardeni Research & HDFC Bank

Besides offering value quite a few EMs promise improved fundamentals

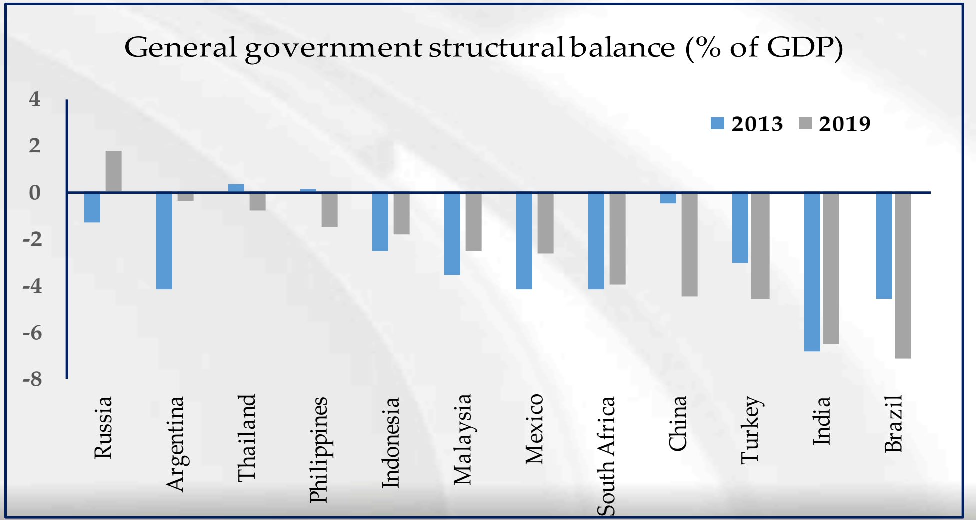
Despite moderation, in 2018 EMs still outpaced developed markets. This trend is expected to continue in 2019



Some of these countries maintained stronger balance sheets than did during the "taper tantrum"



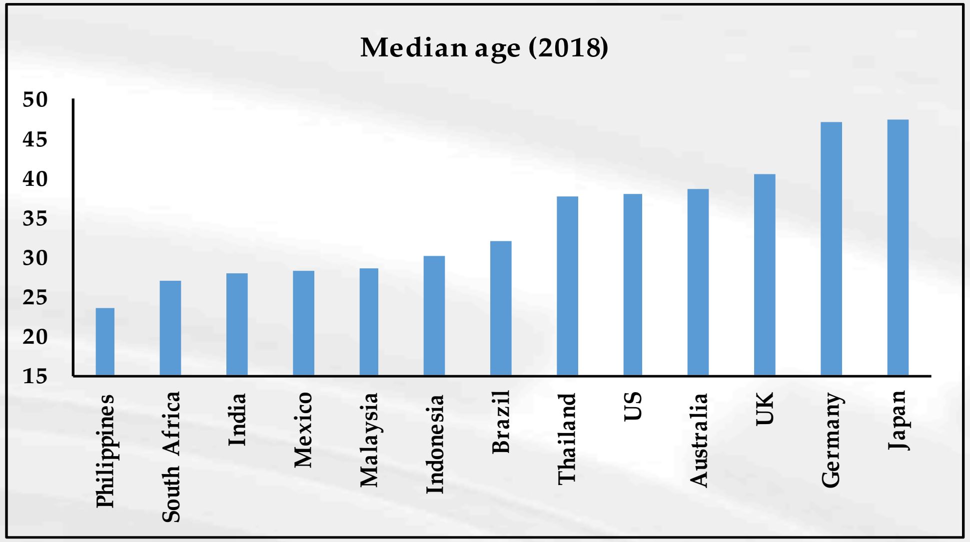
And barring for few, fiscal deficits remain in a better shape than were in 2013, setting these markets up for solid growth, as the headwinds subside



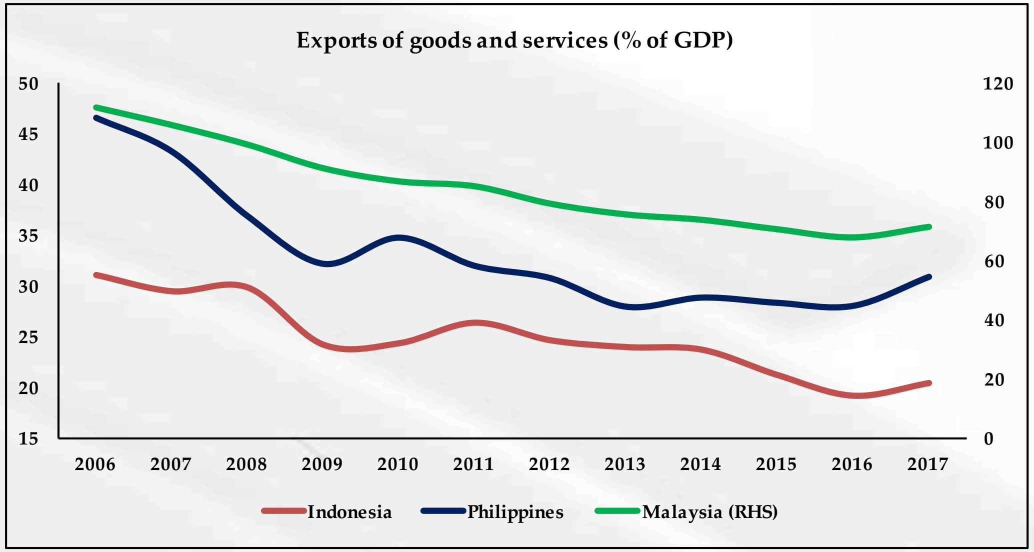
Source: *IMF* & HDFC Bank

Other structural factors support a selective long EM trade

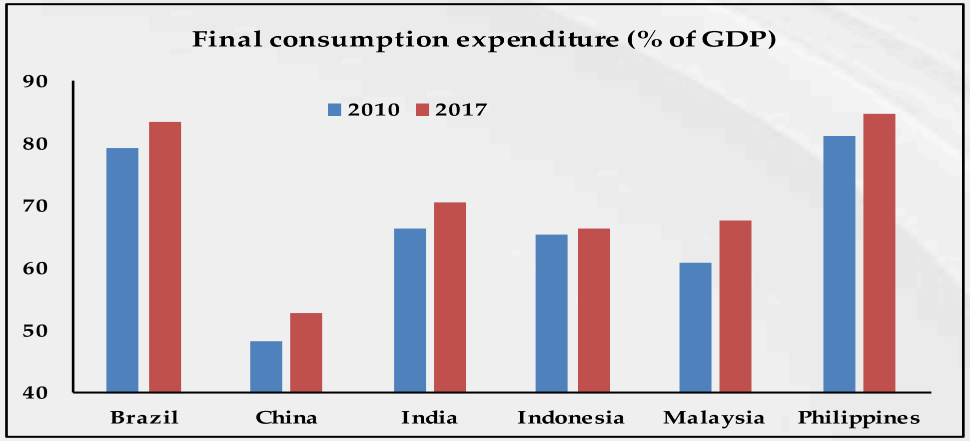
Many emerging markets have favorable demographics



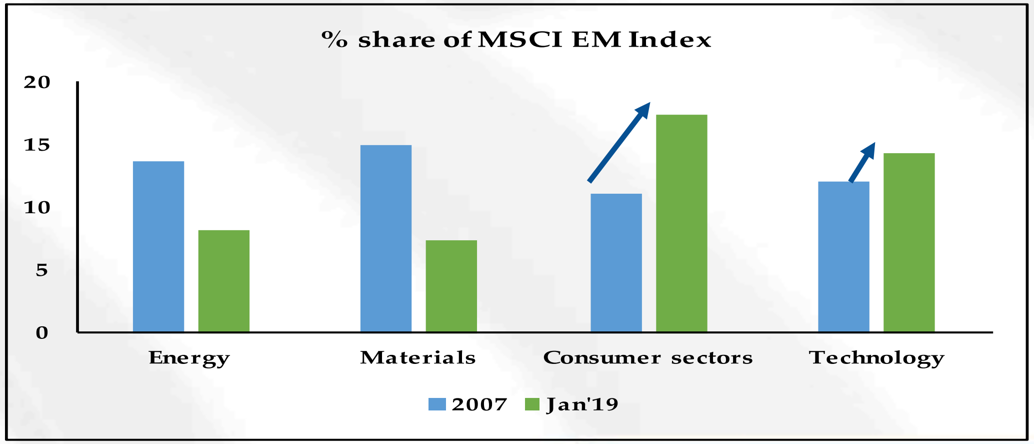
…with the share of exports in their economies trending lower



…. while that of consumption is on the rise



Evolving sector dominance



Source: World Bank, MSCI, World population review and HDFC Bank

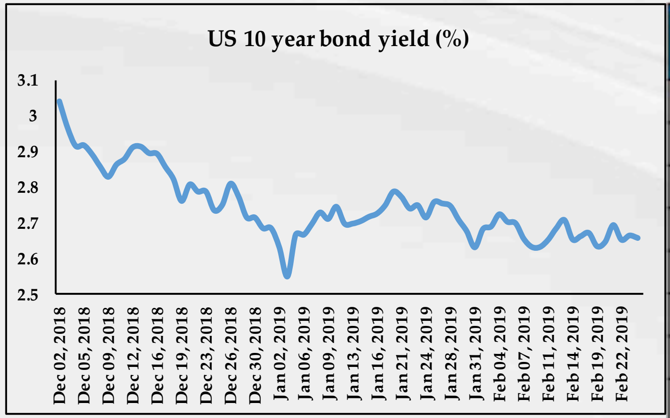
But risks bear monitoring!

Given that a number of important risk factors for the EMs are fairly well known, the risk emerges from what is already priced in by the markets and what is not. However, these uncertain risk events will likely have a differentiated impact across EM countries. Thus we are not short on EMs as an asset class and across-the board dips could be buying opportunities in select markets

1. A "less dovish" Fed and continued dollar strength

The Fed

- **What is priced in?** Ours's and market's base case is that the Fed will likely remain on hold in 2019 with a slight chance of a rate cut in 2020.
- **Risk:** A "less dovish" stance by the Fed than what is anticipated by the markets or further rate hikes could lead to repricing of assets and diversion of funds away from EMs



US Fed Expectations

"3 rate hikes in 2019" to "Rates on hold"

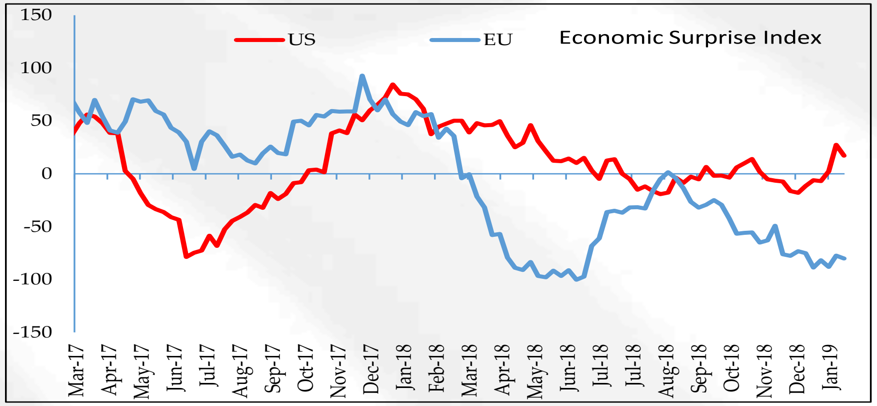
Meeting Date	Implied Rate	Basis Points
20-Mar-19	2.398	-0.1
1-May-19	2.398	-0.1
19-Jun-19	2.403	0.4
31-Jul-19	2.408	0.9
18-Sep-19	2.408	0.9
30-Oct-19	2.41	1.1
11-Dec-19	2.387	-1.2
29-Jan-20	2.282	-11.7

US Dollar

What is priced in? A slowdown in the US economy is largely priced in. **What remains uncertain at the moment is the pace of moderation relative to other economies.**

Our base case –Economic performance in both the Euro zone and China could be relatively more disappointing than the US. Consequently, the pace of downside in the USD is likely to be moderate. **Our base case assumes that the DXY stay broadly unchanged for the most part of the year.**

Risk - If US growth vis-à-vis other key economies surprises on the upside, we could see renewed strength in the dollar which would be EM negative at least temporarily

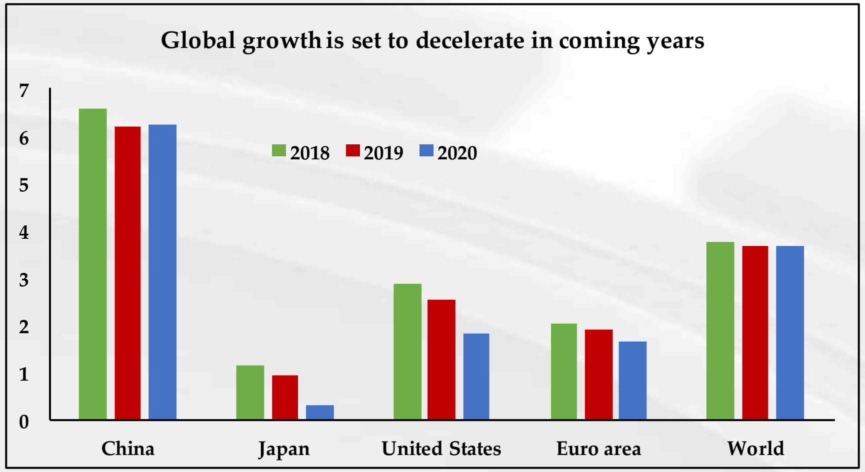


Source: Reuters, US Fed and HDFC Bank

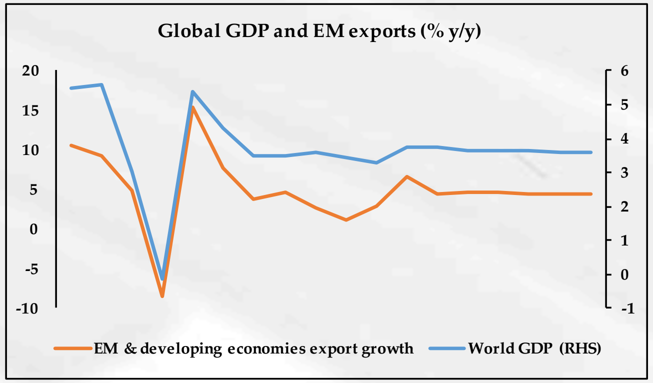
2. Sharper than anticipated deceleration in global growth

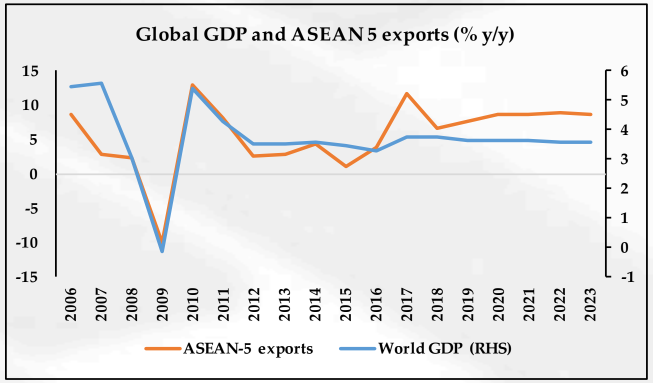
- Emerging markets remain vulnerable to the pace of growth of the global economy in 2019, most notably through the exports channel among others.
- Markets are pricing in a moderated but synchronized slowdown in global growth.
- A steeper correction, therefore, may lead to "risk-off" sentiment and affect some EM countries more than others – for instance emerging Europe remain highly sensitive to German growth.

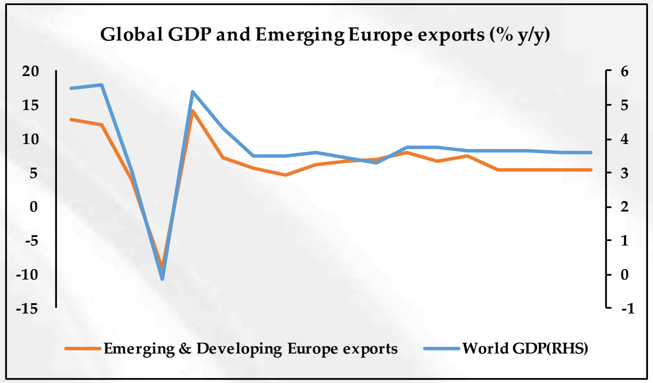
Synchronized slowdown

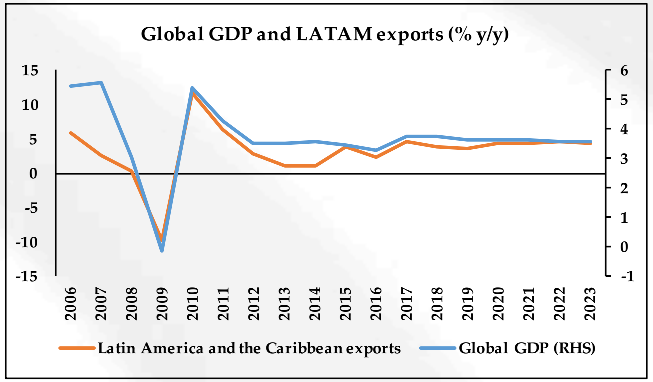


Global growth & EM exports







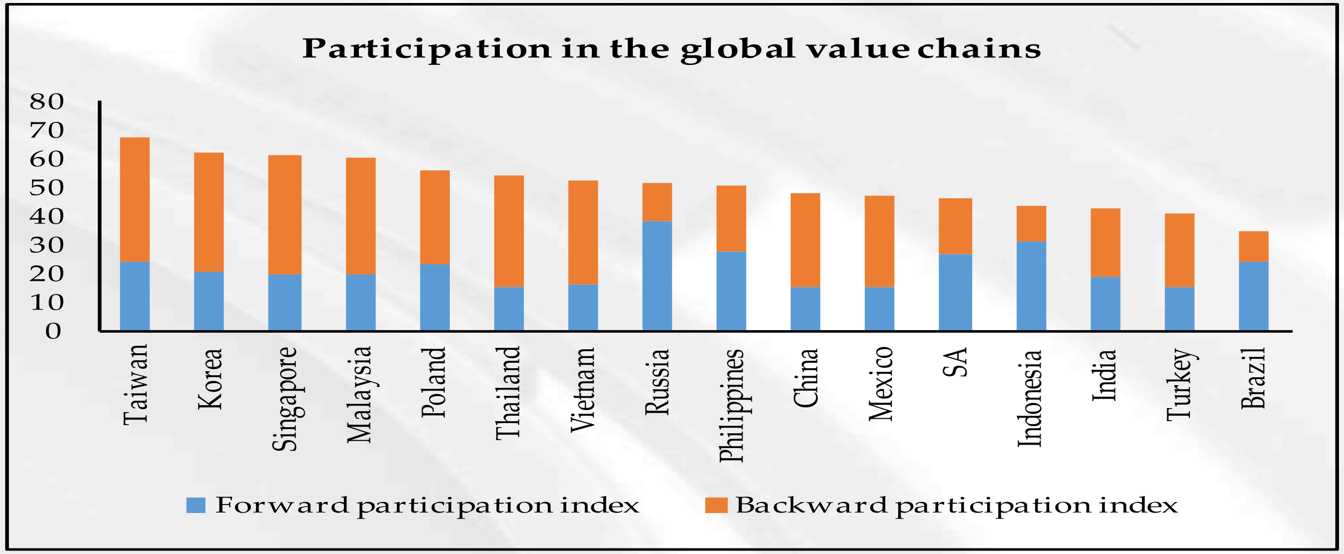


Source: IMF and HDFC Bank

3. Escalation in trade tariffs

- **At the moment, markets are not pricing in any further escalation in US-China trade war.**
- *US decision to extend the March-1, 2019 deadline to increase U.S. tariffs on Chinese goods from 10% to 25% on $200 billion worth of Chinese imports into the US has provided relief to EM assets.*
- **Risk, however, still persists of any potential increase in tension between the US and China until a final agreement is reached**
- **Potential tariff hikes on European automakers may also make the markets jittery.**
- **Impact on trade will be differentiated across EM countries contingent upon how inter linked their supply chains are.**

While stakes for a trade war remains high, EMs will not be affected equally



Note: *As defined by OECD-WTO, the Global Value Chains (GVC) participation index is composed of two components reflecting the upstream and downstream links in the chain. Forward participation to GVCs corresponds to the indicator "Domestic value added sent to third economies". Backward participation to GVCs refers to the "Foreign value added content of exports"*

Source: BofA Merrill Lynch Global Research, WTO and HDFC Bank

There is a brighter side to it as well!

Trade diversions, as a consequence of tariff hikes in selected countries, could benefit other countries that have a similar export mix. For instance,

- Producers of agricultural goods in Argentina and Brazil benefitted from Chinese tariffs on US soybeans.
- With higher tariffs on China, US companies could buy semiconductor parts from Malaysia, data storage units from Thailand, or ready made garments from India.
- **Reallocations in terms of foreign direct investments** - markets in Southeast Asia or Latin America might benefit as manufacturing destinations with geographical advantage and competitive labor costs.

Asia's winners in the US-China trade war: A report by the Economist Intelligence Unit

	Strong benefits	Mild benefits	Disruption
Information and communications technology	Malaysia Vietnam	India Indonesia Thailand	Philippines Japan Singapore South Korea Taiwan
Automotive	Thailand Malaysia	India Indonesia Philippines Vietnam	Japan South Korea Taiwan Singapore
Readymade garments	Bangladesh Vietnam India	Sri lanka Pakistan	Indonesia Cambodia Myanmar

Source: Economist Intelligence Unit and HDFC Bank

4. Chinese stimulus fails to cushion the economy

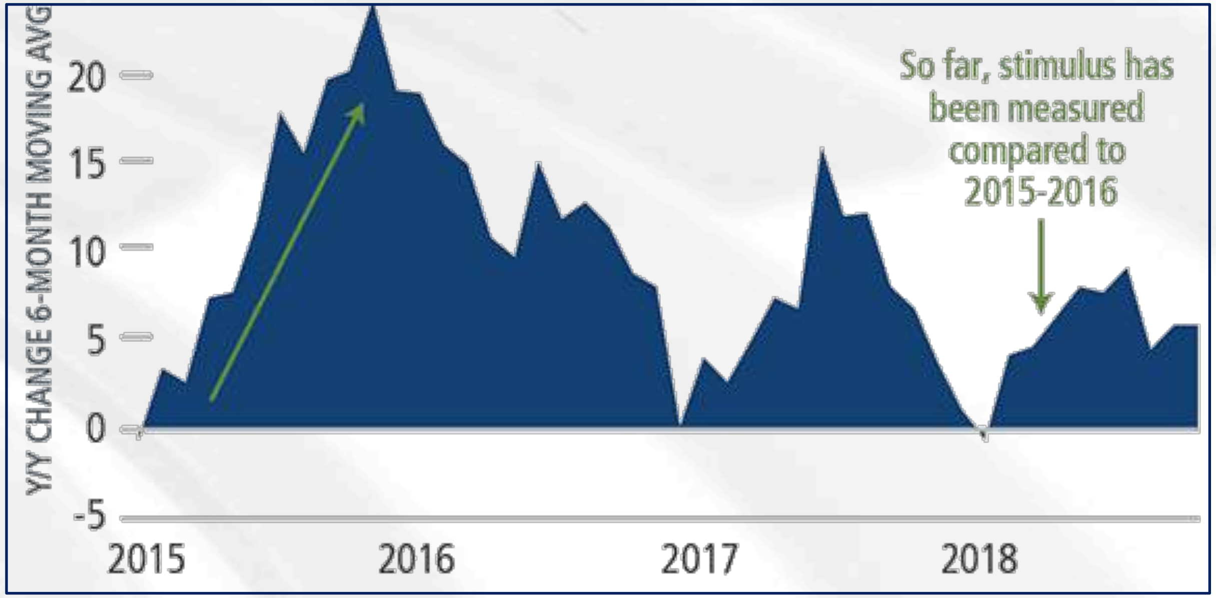
China's slowdown - the most important variable to emerging markets' performance in 2019

Fall in China's growth is largely priced in. Markets expect the Chinese economy to start recovering in H2 2019 as the stimulus measures already announced (and expected to be buffered up) by the government start to make an impact. **Thus we are betting on a 6 per cent plus growth for 2019**

A sharper than anticipated slowdown despite the stimulus is what could spook the markets.

GDP growth decelerated sharply in 2H 2018 raising fears among investors

China government spending growth: Past vs Present



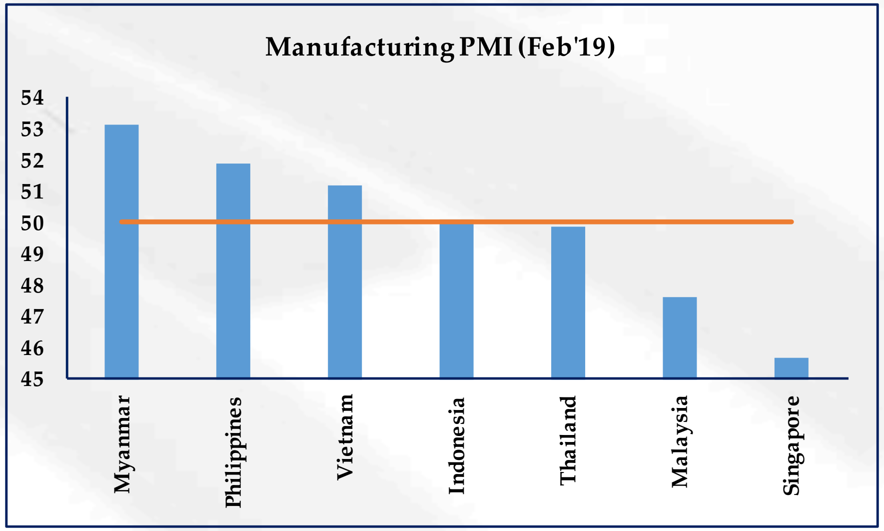
Source: Bloomberg, investing.com, Macrobond and HDFC Bank

Impact on EMs to vary across countries depending on their exposure to China.

The impact is likely to come through two channels – 1) direct impact - trade/manufacturing channel and 2) "sentiment" effect– making all EM economies a blanket case

Spillover implications of China's slowdown for international trade – *An IMF study*

ASEAN has started to feel the heat - headline PMI edged down to 49.6 in February, from 49.7 in January, to signal the first back-to-back monthly deterioration in business conditions for over two years.



Source: Bloomberg, investing.com, IHS Markit and HDFC Bank

5. Volatile commodity prices

- **Oil –** Volatility expected to continue in 2019 as well but prices expected to stabilize around $65/bbl – slowing global demand, record production of U.S. shale oil and political uncertainty likely to cap prices. **A sharp spike up or a drastic fall back in prices as was seen in 2018 could impact EMs though selectively.**

- **Metals –** prices to remain broadly unchanged in 2019. China's environmental policies, tariff negotiations between the US and China, and Chinese policy responses aimed at stimulating the economy are the key determining factors

Historically estimated commodity price impact on EM current accounts (% of GDP)

	Current account sensitivity to 10% price decline		
	Food	Energy	Metals
Brazil	-0.3	0.0	-0.2
Mexico	0.1	-0.1	0.0
Colombia	0.0	-0.9	0.0
Chile	-0.3	0.6	-1.7
Peru	0.2	0.0	-0.8
Argentina	-0.8	0.1	0.0
Venezuela	0.3	-2.1	-0.1
Russia	0.2	-1.7	-0.1
Turkey	-0.1	0.7	0.2
South Africa	0.0	0.5	-0.8
Poland	0.2	0.4	0.0
Hungary	-0.3	0.6	0.2
India	-0.1	0.6	0.1
Indonesia	-0.2	0.1	0.0
Malaysia	-0.3	-0.6	0.3
Thailand	-0.5	1.2	0.5

Source: Credit Suisse, Oxford Economics and HDFC Bank

6. Political risk: EM elections in focus

2019 political calendar is set to be very busy with general elections in several key EMs, especially Asia, where India, Indonesia, the Philippines, and Thailand will hold polls. Sub-Saharan Africa's two biggest economies, Nigeria and South Africa, will hold elections as will Greece, Poland, and Ukraine in Europe.

While markets expect continuity of the current political dispensation in upcoming elections in some of these key economies, risk in the form of populist rhetoric that may delay/reverse the reform process looms.

Major election in 2019				
Country	Month	Event	Prospect of continuity of government	Reform outlook
Nigeria	February	General election		
Thailand	March	General election		
Ukraine	March	General election		
Indonesia	April	General election		
India	April-May	General election		
Philippines	May	Mid-term election		
South Africa	May	General election		
Greece	October	General election		
Argentina	October	General election		
Poland	November	General election		
Green = positive, yellow = neutral, red =negative				

Source: Fitch solutions and HDFC Bank

HDFC BANK
We understand your world

In a nutshell – Differentiation is the way to play the EM theme!

Countries with greater domestic resilience to external shocks are likely to outperform

Brazil

Market friendly government

Attractive valuations and yield differentials

High earning prospects

Indonesia

5% + GDP growth prospects

Massive infrastructure investment

Competitive advantage in resource-based industries

Risks - Crude oil prices, elections and relatively higher valuations

India

Growth outperformer with 7%+ GDP growth

Better macro fundamentals among peers

Risks - Crude oil prices, elections and relatively higher valuations

Russia

Attractive valuations

Growth gradually improving along with other macro economic variables

Further sanctions remain the biggest risk

Thailand

Democratically-elected government in upcoming elections

Likely to benefit from US-China trade war

Massive infrastructure development - $50 bn Eastern Economic Corridor

Risk - Unattractive valuations and yield differentials

Malaysia

Sentiments improved after the unpopular administration of Prime Minister Najib Razak was replaced in 2018 elections

Likely to benefit from the US-China trade war

Domestic infrastructure investment

Sound macros

Higher oil prices could provide a fillip

Some of the other countries such as Turkey and Argentina which were massively sold off last year could see bouts of rally purely driven by attractive valuations. However, these economies remain highly vulnerable to external shocks given their macros.

HDFC Bank Treasury economics research team

Abheek Barua
Chief Economist
Phone number: +91 (0) 124-4664305
Email ID: abheek.barua@hdfcbank.com

Tushar Arora,
Senior Economist
Phone number: +91(0)124-4664338
Email ID: tushar.arora@hdfcbank.com

Tanvi Garg,
Economist
Phone number: +91 (0) 124-4664354
Email ID: tanvi.garg@hdfcbank.com

Sakshi Gupta,
Economist
Phone number: +91 (0) 124-4664372
Email ID: sakshi.gupta3@hdfcbank.com