FOCUS · Stock markets in the emerging countries: the turn of domestic factors

The main index representing the emerging stock markets recorded a 16% rise between January and October this year in spite of the dramatic fall observed in the first month of the year. This figure contrasts with the meagre 3% gain in developed stock markets. Numerous voices have doubted this resurgence in emerging stock markets with the main argument that the Federal Reserve (Fed) will soon restart its interest rate hikes. There is no doubt that this is a fundamental factor but it is not the only one nor necessarily the most important.

When examining the trends in emerging equity markets, and in order to understand the dynamics of the capital flows towards these countries in general, it is very useful to distinguish between two types of determining factors. On the one hand, push factors: forces of global scope that cause an impact from outside the emerging markets, such as global risk aversion or interest rate levels in developed economies. On the other hand there are pull factors: those attributes of the emerging countries that affect investor decisions, such as macroeconomic fundamentals and geopolitical risks.

At the beginning of the year, both push and pull factors combined to hit emerging assets hard. The rise in global risk aversion fuelled by renewed doubts regarding China's economy was the main trigger for widespread stock market losses which were particularly pronounced in the emerging economies. This was further aggravated by the fact that such markets were already facing an adverse external environment since the Fed had begun to normalise interest rates in December 2015; all this within a worryingly fragile context in terms of the economies and internal policies of several emblematic countries such as Brazil, South Africa and Turkey.

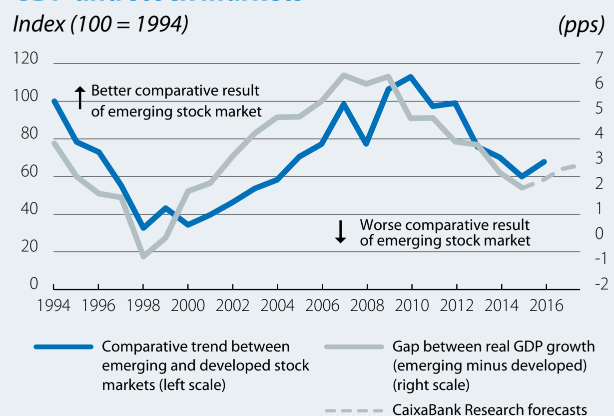
Since then, the sharp gains made by emerging stock markets have mainly been supported by push factors. On the one hand, the Fed has reconsidered its plans to raise interest rates. At the end of 2015 it was intending to carry out four hikes of 0.25 points in 2016 and several more in 2017, while now it is only considering one more hike before the year ends and just two or three next year. This more accommodative monetary tone has fuelled a phenomenon known as the «search for yield». In fact, the prospect of an environment of low and even negative interest rates for a prolonged period of time is good news for emerging assets since a substantial reduction in risk-free yields makes riskier assets more attractive. The solid recovery in commodity prices during these months, in particular the 80% rise in oil, has also been an important support for emerging equity.

These two tailwinds are now easing and are unlikely to continue driving the emerging stock markets with the same intensity. Certainly the expectations now being revealed by investors regarding the Fed's hikes (and also regarding the ECB's bond purchases) are unlikely to err on the side of caution and such an extra boost seems improbable. In fact, the opposite scenario is beginning to appear: faster than expected interest rate hikes in the US, which could be motivated by an upswing in inflation and would result in a notable rise in long-term interest rates in developed countries and strong appreciation of the dollar; a recipe for capital outflows and stock market losses in the emerging economies. Nonetheless, this risk is low at present and a scenario of slow rises is more plausible, so that the search for yield should continue to moderately benefit emerging stock markets, at least in the short term.

Beyond the fluctuations which will surely appear as a result of the Fed's actions, or any outbreaks of risk aversion for economic reasons (doubt still hover over China) or political reasons (there is a very full electoral agenda worldwide), the outlook for the emerging stock markets now depends on pull factors and these are moderately positive. The relative improvement in growth for the emerging bloc compared with the developed economies should act as the driving force for the emerging stock markets (see the graph). In any case, selectivity seems crucial, even more than ever as the emerging markets constitute an increasingly less homogeneous bloc, as shown by the contrast between the economic strength of several emerging countries (in particular India and Indonesia) and the uncertainty that still hovers over the future of other developing countries (such as Brazil, Turkey and Russia).

Emerging and developed countries: GDP and stock markets

Index (100 = 1994) *(pps)*



Note: *The figure for the comparative trend between emerging and developed stock markets in 2016 corresponds to the value at 25 October 2016.*
Source: *CaixaBank Research, based on Bloomberg data.*