Outlook for the emerging markets in 2017

The most positive surprise in 2016 has been provided by the financial assets of emerging countries, interrupting a bad patch that had lasted several years. Analysts are divided into those who believe this is only a temporary improvement and those who see a lasting turnaround. Both sides base their arguments on the conceptual framework of push and pull factors related to capital flows, which are certainly still very useful for analysing the performance of emerging markets. Pessimists believe the dominant factor will be the expected deterioration in global financial conditions, which will weaken the «push» of capital towards emerging assets. Optimists point to the improvement observed in these countries' macroeconomic situation over the last few quarters, which will «pull» capital towards them. These are obviously two opposing forces but their potential scope and how they will interact are not so clear: our assessment of the dynamics in operation leads us to opt for a moderately positive scenario.

2016 has been a veritable obstacle course for emerging assets, with fears regarding the Chinese economy in January, Brexit in June and Trump's victory in November, just to mention the most outstanding examples. Nevertheless the MSCI Emerging Markets index has recorded a 7% increase for the year so far, higher than the 2% achieved by the same index for the developed countries and in clear contrast with the drop of 17% suffered by the emerging bloc in 2015. In the bond market the spread for emerging bonds has narrowed by 30% since the peak reached in January, according to the global index produced by J. P. Morgan. Lastly, in the foreign exchange market, and in spite of some notable exceptions such as the Mexican peso and Turkish lira, 2016 has also been notable for the upward trend in emerging currencies. This overall positive performance has been supported both by push and pull factors. On the one hand, the search for yield by international investors, encouraged by the extremely accommodative tone of the G3 central banks, had a huge effect during the first half of the year whereas, since the summer, pull factors have started to play an increasingly important role thanks to signs of stabilisation in China and the improved situation in other important emerging economies (modest but enough to stand out in a context of weak growth by the developed bloc).[1]

Pessimists believe the most likely global financial climate in 2017 will be very hostile for the assets of developing countries, in particular for those with still excessive levels of debt.[2] They warn of two big risks in the external environment. The first comes from the normalisation of interest rates by the US Federal Reserve (Fed). This was already a cause for concern in the second half of 2015 when the Fed carried out its first interest rate hike after the Great Recession of 2008. That episode, together with doubts regarding the Chinese economy, hit emerging assets hard, a situation that lasted until February 2016. Normalisation is now very likely to occur in the near future,[3], arousing fears of a repetition of the events in 2015. In fact, some analysts are even resurrecting the taper tantrum of 2013 when the Fed announced its intention to reduce the rate of its asset purchase programme (QE), triggering huge turbulence in global markets: the yield on US 10-year bonds soared by more than 100 bps and numerous emerging markets saw a sharp and sudden deterioration in their financial conditions. Capital outflows, less liquidity, strong currency depreciation, a substantial increase in credit spreads and stock market losses were the main repercussions of that unexpected (verbal) first step towards normalising monetary policy in the US. These same effects have been seen in the past when the second factor worrying pessimists has come into play: an increase in global risk aversion. The three big episodes of 2016 mentioned above (China, Brexit and Trump) have been handled relatively successfully but, as yet, we cannot claim to have put them behind us. Moreover other sources of risk will emerge in 2017 that are substantial enough to cause an upswing in risk aversion, particularly the political uncertainty that could result from a very full electoral calendar in Europe.[4]

Optimists use five basic arguments to claim that the risks associated with a deterioration in the world's financial conditions will be manageable, predicting that emerging assets will be able to sustain the advances made in 2016. The first three arguments provide a direct response to the pessimists' concerns while the last two point to the current internal conditions of the emerging countries, which seem promising enough to attract investors.

Firstly, although it is true that the conditions are right for the Fed to gradually adjust interest rates, investors seem to have already taken this normalisation on board, unlike the surprise represented by the hints of tapering in 2013. An abrupt change in financial conditions is therefore less likely, providing emerging countries with more flexibility to adjust to a less accommodative global environment. Moreover, 2016 has shown us that the Fed tends to prefer to err on the side of caution, taking the trends in the external environment very much into account, to the extent of revising the pace at which it normalises the fed funds rate to ensure this does not destabilise international markets (especially in the case of possible systemic repercussions).

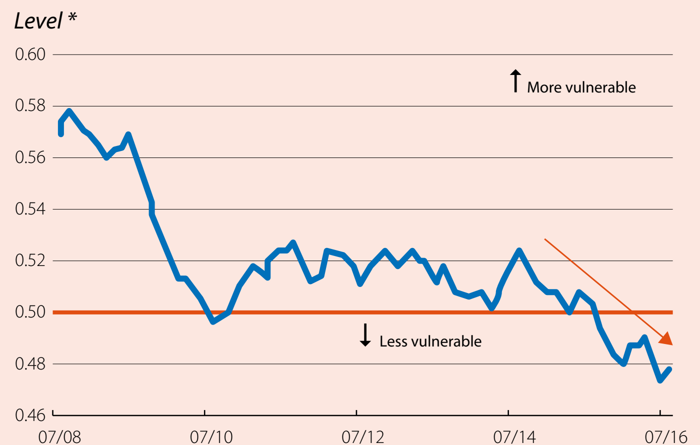
1. For more details, see the Focus «Stock markets in the emerging countries: the turn of domestic factors» in MR11/2016.
2. For more details, see the Focus «Emerging debt: a weak flank given the Fed's monetary normalisation» in MR11/2016.
3. For this issue, see the article «Monetary policy in 2017: a promising journey, but hurdles lie ahead» in this Dossier.
4. For more details, see the article «Politics and economics in 2017: an inseparable duo» in this Dossier.

Secondly, although it is true that political uncertainty can fuel nervousness at all latitudes, such a risk is higher in the developed countries. In this respect, investor reaction to Brexit is revealing as this resulted in a better performance for emerging assets in relative terms. In other words, Brexit showed that greater global risk aversion originating in the advanced countries does not always negatively affect, and can even boost, emerging financial markets. The stance taken by the Trump Administration in terms of its commercial policy perhaps represents the most likely risk factor for the emerging economies but we can expect the US Congress to be play a moderating role on this front, as well as on others.

Thirdly, and related to the previous two points, the vulnerability arising due to the likely deterioration in global financial conditions is now less than in 2013 or 2015 because international investors' exposure to emerging financial assets is much more limited than before. For example, data regarding the composition of western investment and pension fund portfolios show that, at present, emerging assets account for 12% of the total, very close to the minimum figure of 11% reached at the beginning of 2016 or after the Great Recession of 2009 (i.e. after the impact of the panic sell-off). On the other hand, just before the taper tantrum this figure was 17%, almost an all-time high. This leads us to believe that, even if global financial conditions deteriorate more sharply than expected, it should not result in disruptive events for the emerging markets.

Macroeconomic vulnerability of the emerging economies

*Level **



Note: ** Index from 0 to 1, where 0.50 is the historical median. This index reflects the economic fragility of the emerging countries based on key variables related to (i) macroeconomic stability (economic growth and inflation); (ii) the level of leveraging in the private sector (trend in credit, private debt and real interest rates); (iii) external imbalances (current account, reserves and exchange rate), and (iv) sovereign risk (fiscal balance and public debt).*
Source: *CaixaBank Research, based on data from Deutsche Bank.*

Fourthly, emerging financial assets are currently reasonably attractive in terms of price. First of all, different calculations of the equilibrium exchange rates suggest that the emerging currencies are mostly priced below their intrinsic value, with the P/E ratio close to 11.5 for the MSCI Emerging Markets index, lower than the 12.5 average recorded since early 1990. The situation is a little tighter in the bond market from a historical perspective, in line with the situation throughout the world due to the impact of unconventional policies implemented by central banks. The sovereign credit spread is almost 1 pp below its historical average since the end of the 1990s (although it is in the higher part of the range observed since 2009, the start of these unconventional policies).

Last, but by no means least, the improvement in the macroeconomic situation of most of the emerging economies in the last few years has made them more attractive and also resilient in the face of adverse financial conditions. Since mid-2014 the emerging countries have managed to substantially reduce their macroeconomic vulnerability (see the previous graph). Several studies have shown that the impact of a change in monetary policy by developed economies on the financial conditions of the emerging countries mainly depends on the underlying macroeconomic fundamentals of each country itself.[5] Similarly, other studies highlight the fact that, when these fundamentals are solid, they can substantially mitigate the negative effects of an upswing in global risk aversion.[6] Moreover, the importance of fundamentals per se has increased since the mid-2000s.[7] In other words, international investors increasingly discriminate between the different countries in the heterogeneous group of emerging economies (as could be seen during the taper tantrum).

In summary, pessimists are not wrong when they warn of the risks facing the emerging markets in 2017. These undoubtedly exist. But the counter-arguments put forward by optimists regarding the positioning of portfolios and investor expectations are convincing and encouraging. Ultimately, the slow but sure improvement observed in underlying economic fundamentals is crucial for the gains made in 2016 to continue in the coming year. Let us hope this is the case.

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5. See, for example, Santacreu, A. M. (2015), «The Economic Fundamentals of Emerging Market Volatility», Federal Reserve Bank of St. Louis, Economic Synopses, No. 2, 2015.
6. Yildirim, Z. (2016), «Global financial conditions and asset markets: Evidence from fragile emerging economies», Economic Modelling, Volume 57, September 2016, Pages 208-220.
7. Ahmed, S., Coulibaly, B. and Zlate, A. (2015), «International Financial Spillovers to Emerging Market Economies: How Important Are Economic Fundamentals?», Board of Governors of the Federal Reserve System, International Finance Discussion Papers 1.135, April.