

## Emerging Markets Forecasts

October 2008 – Author: Mark Capstick, Fund Manager

### EMEA

#### Russia, Turkey and South Africa

##### Politics

###### *Russia*

A de facto political duopoly emerged since Medvedev's inauguration in May. The expectations that with time, Medvedev would gradually distance himself from Putin, lost much ground with the Russia-West conflict. The government is likely to continue present policies with selected interventions in 'strategically important' sectors. Financial market distress was met by a substantial rescue package from authorities (refinancing of corporate foreign debt, CBR crediting commercial banks without any collateral, compensation of losses on interbank loan market). S&P revised their outlook on Russia's rating to negative after the announcement of the recent rescue package, however, Moody's affirmed its positive outlook.

###### *Turkey*

Although animosity between the incumbent AKP and the secularists has not disappeared, the conclusion of the high profile court case this summer probably had the best possible outcome for the markets. The AKP remain in power, re-enforcing the markets' perception of democracy. However, the slim margin of victory and heavy penalties handed out should help to ensure that AKP concentrate on less politically controversial reform and more market friendly policy.

###### *South Africa*

Following the forced resignation of Mbeki, there is the potential for the political situation to deteriorate. Although Mbeki's resignation has had little effect on the currency to date, we have now entered a period of greater uncertainty. Jacob Zuma is currently implying a period of policy and party continuity, however, he was elected to the ANC leadership on the back of strong left wing union support. As the economy continues to slow, we can easily imagine a more populist approach. In the meantime, there is also the potential for the ANC to split into two parties ahead of the Presidential elections. Political risk is not fully priced into South African assets.

##### Inflation

###### *Russia*

Since 2006, Russia's economic growth has rested upon two legs: windfalls from rising oil prices and capital inflows from abroad. Both legs have contributed to high, above the potential, economic growth. This growth story seems to have come to an end in 3Q 2008, with a dramatic fall in oil prices from their peak levels and massive capital outflows from the Russian asset markets. Despite this, inflation is currently 15%. Growth will slow down to sustainable levels but is still supported by private consumption, which in turn is driven by high nominal wage and earnings growth, which will continue to keep prices at elevated levels.

### *Turkey*

The days of hyper-inflation in Turkey seem to be behind us following the establishment of an inflation targeting Central Bank. However, their credibility has been called into question in recent months following an increase in the top end of the inflation band for 2009 and 2010. Critics have suggested that the Central Bank have been under pressure from the government to adopt a more growth orientated monetary policy as economic activity in Turkey slows. This seems to be unfair criticism: we believe that adopting a more realistic short-term inflationary target could actually increase Central Bank credibility and future inflationary expectations if this target can be achieved. Turkey does not have the same problems with capacity utilisation and tightness in the labour market as many other EMEA countries. We believe that there is evidence that the slowing economy could mean that inflation in Turkey has peaked, and that the Central Bank will have room to loosen policy. The greatest risk to this scenario is a sharp fall in the value of the Lira, given the speed and impact of a weaker currency on inflation levels. However, given our benign global outlook, we will discount the potential for excessive downside pressure on the currency.

### *South Africa*

Inflation in South Africa is less benign. Inflation levels have exceeded market expectations almost every month for the past year, and given that inflation year on year has increased almost every month for the past five years, it is difficult to imagine that inflationary expectations will be curtailed easily. With demand for energy within South Africa running well above supply, it is likely that the government will have to increase the price that consumers pay for their electricity dramatically to encourage investment in this sector. Money markets are currently pricing in approximately 100bp of cuts in interest rates in 2009, which we feel may be a little aggressive. Although the headline inflation level will fall in January due to changes in the CPI basket, it will remain significantly above the top end of the Central Bank's target band. We believe that it would be a policy error for the Central Bank to cut rates into this current environment and hope that governor Mboweni will continue to remain focused on his inflation targeting objectives.

## **Growth**

### *Russia*

GDP growth has moderated to a still high 7.5% y-o-y in 2Q 2008, but we expect more pronounced moderation to take place on the back of strong capital outflows, financial markets falls and the emerged liquidity crisis. In fact, tightening domestic and foreign credit conditions have already led to significant growth moderation in construction and manufacturing in 2Q. Production of construction materials has fallen in July/August y-o-y responding to weaker investment demand. Machine building has moderated its growth. Overall, the base for industrial growth has shrunk as a list of growing industries shortens. Inflation has also taken its toll, softening growth of consumer demand.

### *Turkey*

Turkish growth is slowing following a tightening monetary policy in recent months. However, recently PM Erdogan pledged his commitment to fiscal discipline and re-iterating his belief that trend growth can only improve through structural reform. The headline growth figure of just 1.9% was driven down primarily by a significant downturn in investment and private consumption growth, confirming the Central Bank's core view that aggregate demand conditions remain inherently non-inflationary, if not dis-inflationary. In the past, productivity gains have been helpful in improving Turkish resilience to global financial volatility, however, there is a threat to this equilibrium if structural reforms are not forthcoming.

### *South Africa*

In South Africa, consumption is going to continue to come under pressure due to high debt servicing costs, whilst investment also appears to be slowing, albeit from very high levels, with leading indicators suggesting a fall in investor confidence. The current account deficit at approximately 7.5% of GDP, which continues to be a concern given South Africa's dependence of short term portfolio flows rather than FDI to fund it. Given the lacklustre outlook for the South African economy, we expect a more populist approach to be taken by the Zuma led government.

## ASIA

### China and India

#### Politics

##### *China*

Politics is remarkably stable for a relatively poor country. Government and politics is outwardly consensual and the longevity of the Party allows policies to be slowly considered and implemented. The policy move towards a harmonious society should ensure a sustainable growth and social stability. In the long term, China's fundamentals are favourable given the large sized population, urbanisation trends and rising productivity trends. Good management will of course be required and at present, investors seem to be buying into the idea that the government can manage well. Main risks include the shortage of natural resources, inflationary pressures and the need for high speed growth to keep employment within acceptable levels.

##### *India*

Three more state elections are to be held before December which could set the tone for the next General Elections in April-May 2009. The nuclear deal, which was given up for dead, was revived in the nick of time and is awaiting the US Presidential sign-off; this will be a big positive for the Congress-led UPA Front. The Opposition is still fragmented. There is still no shape of a viable Third Front as suggested earlier in the year. The BJP led right-wing parties also do not have a formal coalition front ready for battle. This would take shape by the turn of the year and closer to the actual elections. Expect more action on this front in the months ahead.

#### Inflation and rates

##### *China*

China led Asia with the start of falling inflation cycle and we expect this to continue. Although still strong, growth will slow and this will allow rates to become more accommodative. Following the recent cut in lending rate of 27bp and a reduction in Reserve Requirement Ratio (RRR) of 100 bp, we expect PBOC to further ease monetary policy via interest rates, the RRR and loan quotas. China joined the rest of the developed world with concerted interest rate cuts that were made with an aim towards calming global markets. The PBOC eased rates by their typical 27bp, while the other cuts in rates from other central banks were 50bp.

### *India*

Inflation has likely peaked or could peak off by end of the year. A decline in commodity prices would reduce pressure on inflation allowing the RBI to cut interest rates by Q1 or Q2CY09, thus reviving domestic private consumption. Inflation is perched at 12% and will drop off once the impact of agriculture output, lower commodity prices globally and crude price impact with a lag. A high base effect from Jan-Feb 2009 will also play an important role in tempering inflation leading to a more accommodating Central Bank in 2009. Growth in bank credit has moderated sharply to just above 20%. Expect credit growth to stabilise here.

### **Growth**

#### *China*

We expect China to grow between 9-10% in 2008 and 7-9% in 2009, a slow down from the double digit growth enjoyed in the past several years, led by a significant reduction in export growth and in investment by real estate (22.3% of the total investment) and manufacturing (33% of the total investment) sectors as well as, to a lesser extent, the wealth effect from falling stock market and property prices. The majority of the slow down will be felt in the coastal areas which are hit hard by the decline in export and house prices. The inland provinces will fare better. The slow down, however, will be partially offset by the expected government's stimulus programme including potential tax cuts, infrastructure reconstruction (roads, bridges, dams), agriculture, railway and environmental facilities and easing in the monetary policy.

#### *India*

GDP growth is likely to be tempered thanks mainly to slower growth in services and chiefly industrial production. Agriculture growth is expected to hold steady above 4% thanks to good rainfall again this year. GDP likely to sustain between 7-8% as domestic consumption and infrastructure build-out in India are expected to be key LT growth-drivers. In the short term, factors such as high inflation and interest rates have impacted growth leading to a cyclical slow-down. Government has sacrificed growth in its fight against inflation in 2008. The economy could bottom out by end of 2008 or early 2009 leading to a recovery from the middle of 2009.

## LATAM

### Brazil and Mexico

### **Politics**

#### *Brazil*

At present, the coalition is pretty stable and seems to be in a reasonably constructive mood. However, we have seen increasing meddling in private sector areas, e.g. bank tax hikes "if you make too much money we'll tax you". Few signs of serious vigour to attack high tax rates - this is resolutely a tax and spend administration. Lula can't run again in 2010 so expect the market to begin to focus on a likely successor - there isn't one at present in the PT. With economy booming, real wages growing and social programmes (Bolsa Familia) boosting lower incomes, we are unlikely to see PT risk this with big reform agenda.

### *Mexico*

Calderon has shown himself to be pretty effective at getting things done (fiscal reform) and has moved the debate on energy reform forward. There is the possible upside of energy reform in 2008, measures to free PEMEX from some of its tax burden to increase its CAPEX are not controversial, but the issue of allowing foreign equity participation in offshore fields is very divisive. PEMEX has huge unexplored deepwater acreage, but lacks deepwater expertise that a Statoil or Petrobras could bring. We'd expect a watered down reform avoiding the latter issue. It may be possible to circumvent constitutional ownership of oil via production contracts that would interest foreign partners.

### **Inflation**

#### *Brazil*

The most recent inflation figures in Brazil have improved; this can be attributed to lower food inflation. A key development for Brazil, given that food makes up over 22% of the consumer price basket. Nevertheless, the short-run improvement in headline CPI inflation has not been accompanied by a similar movement in core CPI inflation. It is unlikely that the latest inflation reads will end the Central Bank's monetary tightening cycle, as aggregate demand continues to push capacity utilization to very high levels. Besides the pressure on prices coming from economic activity, high levels reached by headline inflation over the last 12 months have sustained market inflation expectation above the target, increasing both inflation persistence and its medium-term trend.

#### *Mexico*

Annual inflation stood at 5.5% in September and should hover around those levels in the next few months, due to lagged effects of the commodity price shocks. Uncertainty about inflation pressures in 2009 have subsided on the back of the recent drop in commodity prices. Inflation should peak in the fourth quarter and converge to the official inflation target by the end of 2009. With the moderating trend in inflation, the central bank can remain in its long-term policy pause and even be provided with scope to cut rates if economic activity slows further.

### **Growth**

#### *Brazil*

Recent GDP data has shown that economic activity was growing strongly and above its potential level. Brazilian GDP has grown on a 6.5% annualized rate, accelerating from a 3.4% in the first-quarter of 2008. On the demand side, the main contribution for this strong growth was investment growth. Looking forward, we expect that ongoing monetary tightening will produce some economic slowdown. In particular, we should see signs of deceleration in the coming releases of industrial production. Continued intensification in international market turmoil should produce a faster deceleration in economic activity, probably driven by lower results in investment and net exports.

#### *Mexico*

Most recent economic reports indicate that the Mexican economy stalled in the first half of the year and that the rebound will take longer than anticipated. Slowing growth is largely explained by the softening in the non-manufacturing sector and confirms the deceleration in domestic demand, which in turn justifies recent downward revisions to growth. We estimate full-year 2008 real GDP growth at 2% and 3% in 2009, but downside risks have increased, particularly for 2009.