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Insight

Buoyant emerging markets face a testing 2018

Big risks are stronger US dollar and a China slowdown that hits global demand

INSIGHT
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Emerging markets this year have been driven by the winds of a co-ordinated recovery in economic growth, with trade growing strongly, corporate earnings robust and interest rates low on average across the emerging market universe.

But whether that environment will propel another year of strong gains for EM assets is another question. The big risks include the potential for a stronger US dollar and a China economic slowdown that could hit global demand for resources, several analysts say.

"The year 2018 may well be the toughest test yet for EM assets since the 2013 taper tantrum," says David Hauner, head of economics for eastern Europe, Middle East and Africa at Bank of America Merrill Lynch in London.

"The clear and present danger is the combination of US monetary tightening and fiscal stimulus, which could conspire to push US nominal and real yields higher," Mr Hauner adds.

During the 2013 taper tantrum, EM assets were clobbered by a surge in US Treasury bond yields brought about by the Federal Reserve signalling a desire to reduce the amount of money being pumped into the financial system.

The concern now, say Mr Hauner and other analysts, is that the proposed US tax reforms — if adopted — could trigger a resurgence in corporate capital flooding back to the US, thereby driving up the US dollar's value. When the dollar appreciates against EM currencies, funds tend to flow out of EM assets and gravitate towards their dollar-denominated counterparts.

However, opinion is divided on how the proposed US tax reform may play out. Arvind Rajan, head of global and macro at PGIM Fixed Income, a fund with $695bn in assets under management, says he does not expect the reforms to prompt a drastic change in US monetary policy as the Fed's preferred price gauge remains well below 2 per cent.

> 'The danger is a combination of US monetary tightening and stimulus'

"The passage of the tax bill would marginally increase the number of hikes that we should expect but I don't expect the Fed to strike out in an entirely different direction," he says.

The other main cloud hanging over the generally encouraging outlook for EMs is China's economic slowdown. Consensus Economics, a private group that polls economists' projections, forecasts China's GDP growth next year to moderate to 6.4 per cent, down from the official 6.9 per cent posted in the second quarter of this year. "Growth momentum [in China] has started to ease since the third quarter and we believe the slowdown is likely to be a sustained trend in 2018," says Shen Jianguang, chief economist at Mizuho Securities in Asia. "This is mainly the result of policy tightening, including financial deleveraging, anti-pollution controls and new curbs on the over-heated housing market."

China's slowdown is likely to be expressed mainly in a cooling of its real estate market, with October numbers showing a significant ebbing of growth momentum in property investment, new home starts and sales. Nevertheless, consumer spending is likely to remain strong next year as incomes continue to surge and the younger generation's willingness to consume stays buoyant.

So if both of the big risks for EMs —the Fed and a Chinese slowdown — remain contained, investors may feel liberated enough to concentrate on other more positive narratives, say analysts. "Basically, market turbulence in the first half of the year should be seen as a buying opportunity for emerging markets," Mr Hauner says.

Chief among these during 2017 has been a strong corporate earnings picture. Earnings per share (EPS) growth of the companies in the MSCI EM index —the leading benchmark for EM equities — are on course to rise 22.4 per cent this year, according to BofA figures.

BofA is predicting EPS growth to moderate to 12.7 per cent next year, still a robust performance in spite of the slowdown from this year. India, South Africa, China, Indonesia and Chile are among predicted outperformers next year, the investment bank says. In terms of industry sector, earnings are expected to be strongest in consumer discretionary, healthcare and information technology.

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