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IMF-meetings in Washington: positive outlook for emerging markets

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The following points reflect my impressions at the presentations that I attended at the IMF-meetings in Washington from 12 to 15 October 2017.

Positive inflows into emerging market assets expected to continue in 2018

Total emerging markets-flows are still in the early stages of their comeback. 2017 saw a record USD 110bn in inflows. We expect the volume to exceed this number in 2018. US pension funds (as the biggest pool of funds in the USA) are still underweighted in the global emerging markets (GEM). The positive effects from the pressure created by the inflow are stronger than the negatives ones deriving from the G-3 central banks' tightening mood. Within the asset class, market participants expect emerging markets equities to benefit the most (mainly Latin American equities and countries like Brazil and Argentina in particular).

Global emerging markets are still going through an improving macroeconomic trend. For example, average current account deficits have halved in the past four years.

In the presentations given, no major sell-off of commodities was expected. The estimated bandwidth of the oil price (WTI USD/bbl) for the coming years is USD 50 to 60.

What also supports emerging markets is the fact that many local central banks are still biased towards easing monetary measures. That is to say that further interest rate cuts can be expected for 2018.

Venezuela is expected to deliver on loan payments that will be falling due throughout the rest of this year, but the looming debt restructuring will be quite complicated and prolonged.

Risks for GEM investors are more related to the US

There is a paradigm shift in global relations. Emerging markets nowadays harbour fewer idiosyncratic risks. Key threats to global financial stability are more tied to the USA. For example, the carrot and stick approach pursued by Trump’s administration is really more of a stick and rather less of a carrot approach.

There is a wider use of sanctions (Russia, Venezuela, Iran, North Korea, maybe Chinese banks) and a greater bias towards protectionism (Nafta “renegotiation”, car imports, etc.).

On Nafta: the Trump administration has indicated its preference for leaving, but the final decision may be passed to Congress, which could be seen as a silver lining for compromise. A US withdrawal could cost Mexico 0.6% of GDP.

Optimism towards Europe – China is currently not the focus

The pessimism towards Europe over the past few years has turned into astonishing optimism. Brexit is seen as a non-systemic, localised UK problem. Also, the political momentum in Italy is not seen as a manifest systemic threat. 18 out of 19 countries are growing above potential.

China is not dominating the discussion about risk. That being said, perhaps a certain degree of risk that the country might not be able to maintain growth could be looming on the horizon; also, US sanctions against Chinese banks doing business with North Korea can possibly trigger capital outflows. Trump’s visit to China towards the end of the year may mitigate the latter risk.

Turkey is still a carry trade[1]. The higher risk profile is compensated by high interest rates. Frontier Markets (e. g. countries like Egypt, Sri Lanka, Ukraine or Kazakhstan) are attractive from a risk-return profile.

[1] A carry trade is a strategy in which an investor sells a certain currency with a relatively low interest rate (such as Euro or USD) and uses the funds to purchase a different currency yielding a higher interest rate (such as Turkish lira).

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