Global overview

Aside from a few exceptions, equity prices around the world dropped sharply in May. Escalation of the conflict between the USA and China and weaker economic data in many regions fuelled worries about a more significant downturn in global economic activity. In early June, prospects of rate cuts in the USA in the near future then resulted in a mild rebound for equity prices. Consequently, the relatively moderate to attractive valuations on many EM equity markets are balanced against the uncertainties related to an intensifying trade war. At the same time, there are some indications that the US dollar will be weaker in the months ahead. Bonds and equities in the emerging markets may be supported by this factor and by lower US bond yields. However, this outlook may be threatened by the risk of a military conflict between the USA and Iran, which has been mostly ignored on the markets so far.

Steep declines were seen on almost all equity and commodity markets in May. The MSCI EM index fell by more than 7%. The decline on the developed markets was not quite as strong, coming in at around 6%. China and the Asian stock markets were among the biggest losers, while Greece, Russia, and India actually posted gains against the trend. Escalation of the conflict between the USA and China and weaker economic data in many regions fuelled worries about a more significant downturn in global economic activity. Expectations of rate cuts in the USA in the near future then caused the equity markets to edge slightly higher again in early June, with EM bond markets also benefiting from this. From the end of May, strong gains were registered for emerging market bonds, both in hard currency and local currency terms. After US President Trump ratcheted up the conflict with China by issuing constant ultimatums and taking measures against China and Chinese companies far outside the realm of trade issues, the financial markets now appear to be reassessing the situation. Even for analysts who had recently been expecting to see a quick resolution to the conflict it seems more and more that a prolonged conflict with possible additional escalation is now the baseline scenario. It appears almost impossible to predict the exact course of events going forward. This is even more so the case as President Trump long ago explicitly stated on a number of occasions that higher uncertainty was part of his policy approach. Consequently, a (temporary) agreement in the trade conflict may paradoxically occur just when no one is expecting it. Nonetheless, a real solution to the rivalry for global hegemony does not seem to be a realistic outcome in the foreseeable future.
Thus, the underlying conflict between the USA and China will probably continue to accompany us for quite some time, especially since there is apparently a rather wide bipartisan consensus in Washington for imposing limitations on China. This negative factor is balanced against the moderate to attractive valuations of equities and the relatively good development of earnings in the corporate sector. Additional support for EM investors may come from the lower US yields and US dollar in the quarters ahead. Because the interest rate and growth outlook for the USA tend to suggest a weaker US dollar in the months ahead, along with the upcoming end to the Fed’s efforts to shrink its balance sheet (“quantitative tightening”).

However, these aspects would probably not matter too much if the dollar once again becomes popular as a “safe haven” in the event of escalation in the geopolitical realm. Moreover, the topic of Iran – which has mostly been ignored by the financial markets so far – also has a similar potential effect, and when this publication went to press there was a significant risk of escalation here. For some very influential circles in Saudi Arabia, Israel, and the USA, even the very draconian economic sanctions imposed by President Trump do not go far enough. If there is a military conflict with Iran, global risk sentiment and the global economic outlook will likely deteriorate sharply and the US dollar may then strengthen again as a “safe haven”.

As the latest economic data in China were once again on the weak side, it appears that additional fiscal and monetary policy stimulus measures are merely a matter of when and how much. In the second half of the year, this may have a positive economic impact, not only in China, but also in other emerging markets and in Europe. Thus, despite the negative factors and considerable uncertainty, there are also some optimistic aspects for the rest of the year.

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Country focus

China
Chinese exports edged higher in the past month, probably mostly due to early deliveries prior to the imposition of new US tariffs. On the other hand, there was a surprisingly strong decline in imports. May saw the lowest rate of industrial production growth since 2002. Private households’ propensity to consume remains low. There is mounting uncertainty in the corporate sector, due to the new tariffs and the drastic measures taken by Washington against leading Chinese tech sector companies. The wider application of punitive tariffs by the USA appears inevitable and will probably have a significant negative impact on Chinese economic growth. Depending on the scenario, GDP growth may be between 0.5% to 1.5% lower this year and next year. It is anticipated that Beijing will take additional monetary policy and fiscal countermeasures. Fundamentally speaking, it has enough "ammunition" to do so, but the trick will be to apply such measures moderately and very precisely, since they are always accompanied by numerous negative side effects. The focus will probably be on small and medium-sized companies and domestic consumption, while the authorities in Beijing want to avoid triggering a new boom in real estate or lending by the shadow banking sector. Food prices are also now joining the many headaches for the Chinese leadership. In April and May, prices for pork, fruit, and vegetables increased at rates well above 10% and sometime more than 20%. While this has a relatively limited impact on headline inflation from a purely statistical perspective, it may generate significant social and internal tensions in a situation which is already tense anyway.

Trump’s latest public ultimatums to China and his clearly quite extreme demands also make it more difficult for the government in Beijing to reach a (temporary) compromise with the USA. It appears that the Chinese are slowly realising that ultimately no deal at all may be better than agreeing to a bad deal. At the same time, efforts are being made to avoid any possible accusations in relation to the currency, even though the depreciation pressure on the yuan is quite obvious, despite the strict limitations on capital transactions. There are indications that the level of 7 yuan per dollar will not hold forever, especially since a weaker yuan can offset some of the punitive tariffs.

It hardly came as a surprise that China’s equity market was one of the main losers in May. A-shares fell by around 6%, with losses for H-shares in Hong Kong even amounting to around 10%.

India
The equity index in Mumbai bucked the global trend in May to advance 2% and hit a new record high. Hence, the index showed a positive, albeit relatively modest, reaction to the unexpectedly clear election victory for incumbent PM Modi and his Hindu-nationalist BJP. There are probably several reasons for this. Basically speaking, a victory had been anticipated. In addition, there was negative geopolitical news (trade war), relatively high stock valuations, and declining earnings forecasts, along with weaker economic data (industrial production, purchasing managers’ indices). After his impressive election win, Modi now needs to produce results in the economic sphere. During his first term in office, he only delivered on some of the things that he had generously promised to the voters. At 5.8%, Indian economic growth during the fourth quarter of fiscal 2018/2019 was far weaker than had been generally anticipated.
Instead of the millions of promised new jobs, the rate of unemployment in 2018 was at the highest level in the last 45 years, in part due to the sustained strong population growth in India. It was thus no accident that Modi’s latest election campaign focused mainly on Hindu-nationalist issues and foreign policy successes. In early June, the central bank reacted to the weaker economic data by lowering the key rate by 0.25% to 5.75%, marking the lowest level in the last nine years.

**Brazil**

Brazil’s economy contracted by 0.2% in the first quarter, in part due to weaker agricultural performance. Hence, the country is at risk of slipping into recession. In just three months, growth forecasts for 2019 have already been halved from 2.5% to about 1.25%. Unemployment remains very high at over 12%, and even according to the government this figure hardly captures the true extent of the problems on the labour market.

In the domestic arena, the approval ratings of far-right President Bolsonaro’s government are falling rapidly. Even many of his supporters in the business world appear to be increasingly disillusioned about the failure to progress with reforms and the President’s obvious lack of interest in economic issues. Hundreds of thousands of students, teachers, and parents demonstrated in more than 200 cities against the planned massive cuts to education spending and the massive intervention by the President in the autonomy of universities and schools. In response, Bolsonaro mobilised his supporters for a counter-demonstration and to put pressure on the parliament. Right now, Justice Minister Moro is coming under increasing scrutiny. As the lead judge, he was a key figure in the trial of ex-President Lula da Silva. Mobile phone conversations, chats, videos, and other documents released by “Intercept” appear to indicate that the trial of Lula was politically motivated and violated legal norms. Apparently, the state prosecution and judge made a coordinated effort to convict Lula, to incarcerate him, and to prevent his likely re-election. Moro criticised the publications as “selective” and “distorting” and did not recognise any unlawful conduct, but interestingly enough neither he nor the prosecution team contested the authenticity of the documents and footage which was presented. So far, Bolsonaro has stood behind his justice minister, which is hardly surprising. In light of the new revelations, the Supreme Court now wishes to consider Lula’s previously rejected appeal for release.

Despite the domestic political turbulence, the equity index in Sao Paolo bucked the global trend and posted an increase of almost one percent in May.

**Russia**

In its latest country report, the World Bank once again lowered its 2019 growth forecast for Russia, this time to 1.2%. However, the same correction of 0.3% was applied for the global economy as a whole, and it left its forecast for Russian growth in 2020 and 2021 at 1.8%. That said, these forecasts do not yet include the effects of the ambitious, very detailed investment programme currently proposed by the Russian government with a value of USD 400 bn, distributed over six years. Western economists in particular doubt that the objectives of this programme can be achieved. Critics point out that the role of the state in the economy will become even larger as a result, instead of providing more room for private enterprises.
Russia has a detailed, very ambitious six-year economic programme

Role of the state continues to increase, out of necessity

Significant fiscal leeway, thanks to conservative monetary and fiscal policy

Equity index in Moscow at an all-time high, despite falling oil prices

Others pointed out that the government really does not have many other options right now. Because due to the Western sanctions and the geopolitical situation, it was completely uncertain whether and to what extent Russian private firms (let alone foreign ones) would react to state incentives, even though their involvement would be necessary and welcome. At any rate, President Putin wants to boost the contribution of small and medium-sized enterprises to economic output from 20% to 40%, which most analysts currently see as being unrealistic.

Russia certainly has fiscal leeway and not just because they want to push back against the protracted sanctions and economic warfare of the USA and its allies. Russia has currency reserves equivalent to almost USD 500 bn, an extremely low level of gross public debt amounting to 13% of GDP, and has been pursuing a very conservative monetary and fiscal policy. The flip side of this in the past has been seen in weak economic growth, stagnating incomes, and inadequate investment in infrastructure, education, and healthcare. The intention is to now gradually reduce these shortfalls, to halve poverty, and to significantly increase life expectancy. It remains uncertain, however, when and to what extent the Russian central bank will be willing to loosen its monetary policy, which many observers view as being far too tight. There certainly would be leeway to lower interest rates at least. In conjunction with the attractive and sometimes very attractive valuations and the rising corporate earnings, all of this should continue to provide support for the Russian equity market. In May, this market moved against the downward global trend to hit a new all-time high (+3%). Even the sharp drop in oil prices in June has so far been unable to stop the upward trend on the Moscow stock exchange.

Turkey

According to official data, in Q1 2019 Turkey’s economy grew at a rate of around 1.3% compared to Q4 2018. From a purely statistical point of view, Turkey thus exited the recession (following contraction in economic output in Q3 and Q4 2018). But it appears possible that the Turkish economy may quickly fall back again. Consumer confidence is at the lowest level since 2008, structural problems in the economy remain unresolved, and the lira is still under pressure. The modest recovery in Q1 was apparently more related to fiscal stimulus in the run-up to the municipal elections, rather than to any real stabilisation of economic performance. In light of the stubbornly high inflation and persistent depreciation pressure on the currency, the central bank has not yet been able to lower the key interest rate again. It remains at the very high level of 24%. At the same time, Turkey is insisting on purchasing the Russian S-400 air defence system, even though the USA is applying massive pressure to prevent this. If the USA imposes sanctions on Turkey because of this, the government in Ankara has stated that it is prepared to take retaliatory measures.

The Turkish equity market dropped almost 5% in May. As a result, it performed better than the average for the emerging markets, moving on a trend that was seen for almost all of the European emerging markets.

Greece

Greece’s equity market was the big winner in May, with another gain of more than 7%. The rally on the stock market was spearheaded by banking equities. In the European parliamentary elections, PM Tsipras’ Syriza party only came in second, more than 9% behind the conservative Nea Dimokratia.
Syriza also suffered heavy defeats in the municipal elections in Greece, which took place at the same time. Tsipras had explicitly characterised the elections as a vote of confidence on his government. It probably came as cold comfort to him that the far-right party “Golden Dawn” lost massive support among voters. In response to the results, Tsipras rescheduled the general elections slated for October to the 7th of July. Unless there is a political miracle, it appears there will be a changing of the political guard in Athens at that point.

**CE3 – Poland, Czech Republic, Hungary**

The latest economic data in Poland were significantly better. Retail sales and industrial production both posted robust gains, while inflation remained unchanged at around 2.2% yoy. In the European elections, the incumbent PiS part was clearly the strongest force, taking more than 45% of the votes.

Economic data were rather mixed in the Czech Republic last month. On the whole, they still point to strong economic performance, paired with elevated but recently modestly declining inflation (2.8% versus the previous figure of 3%). In the European parliamentary elections, PM Babis’ ANO party came out on top with 21% of the support, while the social-democratic coalition partner will no longer be represented in the EU parliament.

In Hungary, industrial production and retail sales still look strong, but inflation continued to rise, advancing to 3.9% yoy in April (from 3.7% in March), which is well higher than the central bank’s 3% target. In the EU elections, PM Orban’s Fidesz party scored an impressive victory. Together with their allies, the Christian Democrats, they took more than 52% of the votes and performed especially well in the poorest regions. In his statement, Orban viewed this as a clear vote in favour of changes in Brussels.

The equity markets in the three countries were all impacted by the negative global trend in May, but suffered smaller losses than the global average, with Poland down 4.1%, the Czech Republic down 2.3%, and Hungary down 3.8%.

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