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Current capital market report | **Emerging Markets**

Global overview

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The uptrend on the equity markets lost momentum in July. While US equities still benefited from hopes of interest rate cuts, persistent economic worries in most other regions provided headwinds. At the end of the month, the US Fed disappointed the high-flying expectations of the majority of market participants. The equity markets responded with losses nearly everywhere. The strong US dollar (the currency climbed to a new multi-year high immediately after the rate cut in the USA), the surprising announcement of new punitive tariffs by Donald Trump, and the breach of the 7 yuan per US dollar mark reinforced the downward trend in the initial days of August. The bond markets in the emerging economies, on the other hand, remained very solid. In contrast to the equity markets, they are profiting from continuing capital inflows. We will likely continue to see price fluctuations in the coming weeks, but there are still many signs pointing to an economic upturn in the second half of the year.

EM equities slightly weaker overall in July; bonds still in demand among international investors

In the equities segment, July was characterised by consolidation ahead of the central bank meetings in Europe and the USA at the end of the month. The MSCI EM index fell slightly (by around 1.7%), while the developed markets posted a marginal gain thanks to US equities. As is often the case, there were some divergent movements within the Emerging Markets. In Turkey, for example, stock prices and the currency bucked the EM trend with substantial gains, while the Indian market was particularly weak. With regard to capital inflows, the trend of the last few months continues: EM equities are still suffering from outflows, while bonds remain in high demand among international investors.

Fed cuts interest rates as expected, but surprises markets by indicating move is not start of lengthy rate cutting cycle

What was likely the most important event in July happened at the very end of the month: As expected, the US Fed lowered the target range for the fed funds rate by 0.25% to 1.75% to 2%. However, the associated commentary surprised virtually every market participant and observer. Fed Chairman Powell explicitly explained that this rate cut is in no way intended as the beginning of a new, lengthy rate cutting cycle. This was tantamount to a cold shower for the financial markets, which in some cases had already priced in three to four rate cuts for the coming 12 months. The Fed's announcement that it would end its balance sheet tapering two months earlier than previously indicated did nothing to improve sentiment, either.

Dollar appreciates after rate cut

The dollar climbed to a new multi-year high immediately following the interest rate decision, but has since retreated somewhat again. It will likely take a few weeks to see whether a new upward shift will materialise for the currency. It is widely known that a stronger dollar is generally negative for Emerging Market investments. Added to this is the fact that an overly strong US dollar makes it difficult for the central banks in the emerging economies to loosen their monetary policy.

Trump surprises with announcements of new import tariffs against China: Is this addressed at Beijing or the Fed?

Yuan falls below 7 yuan per dollar mark for first time since 2008

Is this the start of a currency war?

The US data situation did not supply the Fed chairman with all that many arguments to justify the rate cut. Thus, it was hardly surprising that international risks, and the trade conflict in particular, were a major focus. President Trump immediately reacted to the rate cut, which was much too late and too low in his opinion, with a new attack on the central bank. And as if he intends to force the Fed into additional rate cuts by escalating the trade conflict, he surprised everyone by announcing new punitive tariffs to the tune of roughly 300 billion dollars on the Chinese imports that were not yet subject to sanctions. At the beginning of August, the Chinese yuan broke through the 7 yuan per dollar mark for the first time since 2008. As a result, the currencies are increasingly becoming the focus of attention again as potential battlefields in the economic war. It is entirely possible that Trump will also take targeted measures to weaken the dollar sooner or later. Because this would fall to the Department of the Treasury, it would not require the approval of Congress or the Fed.

For the moment, however, such a scenario does not yet appear to be imminent, especially because Beijing has stabilised the yuan at the 7 mark for the time being. As an anti-cyclical currency, the dollar should depreciate anyway as soon as global economic growth picks up again. From this perspective, Trump's desire for a weaker dollar would be much better served by refraining from constantly igniting new fires for the global economy rather than inadvertently pushing the US currency higher again and again with his actions and statements.

The "hard" economic data still do not indicate a real recovery of the global economy at this point. However, there are increasing signs that the Chinese stimulus is gradually finding its way into the real economy. This could have a positive impact on Asia and Europe in particular further down the road. Rate cuts in the USA and numerous emerging economies should also start to show their effects in the coming months.

Country focus

China

The initial impact of China's stimulus measures is slowly starting to show despite the countervailing effects resulting from Beijing's "clean-up" efforts in the financial sector and the increasingly detrimental trade conflict. Construction activity on the part of real estate companies already bottomed out about a year ago and is now enjoying solid growth again. The demand for steel and cement is picking up considerably. Lower inventories in the automotive sector could lead to increased auto production again in the coming months. Infrastructure investments by local and regional governments are also expected to increase. Do not expect any miracles to come from the latter, however, as the financing situation of the local governments will simply not allow for this (anymore). As encouraging as some indicators for the coming months appear right now, the current conditions are still quite gloomy. While developments are mixed with regard to consumer data, investments in capital goods remain very weak, which is hardly surprising given the uncertainties related to the trade war.

First signs of an upturn in the coming months, but current data remain weak for now

At the beginning of August, the central bank fixed the yuan above the mostly psychologically important mark of 7 yuan per US dollar for the first time since 2008. It is difficult to say whether this is the first sign that the central bank is giving in to the depreciation pressure or a warning shot from Beijing directed at the USA. Contrary to the claims made in Trump's recent tweets, Beijing has been actively combating the depreciation of the yuan for quite some time. From this perspective, China has indeed been manipulating its currency for a long while, but in a completely different direction than Trump is insinuating. In light of this, it is downright absurd that Washington officially classified China as a currency manipulator just a day after its currency broke through the 7 mark. Is this twisting of the facts a calculated move? In the era of Trump, it is nearly impossible to know for sure.

USA officially classifies China as "currency manipulator"

In the midst of all this, the protests in Hong Kong are creating additional concerns for the leaders in Beijing. The protests were originally intended to voice opposition to a new extradition agreement between Hong Kong and the Chinese mainland, but have since become a general protest movement against Hong Kong's government and against Beijing. Whether and to what extent the flames are being fanned by hidden Western influences as claimed by China's leadership is nearly impossible to assess at the moment. In any case, this comes at a very inconvenient time for Beijing and especially for President Xi. Chinese equities suffered losses in line with the Emerging Market trend in July. Prices fell by 1.5% to 2% on the mainland and in Hong Kong.

Protests spread in Hong Kong

India

India's market was one of the weaker performers among the emerging economies in July. The index comprising the biggest Indian equities lost around 5%. Stock prices for small and medium-sized enterprises declined by 10% or more in many cases. Several elements in the new government's budget proposal apparently contributed to this or at the very least created a bit of uncertainty on the market. Foreign investors pulled roughly 1.6 billion dollars out of the equity market, but over one billion dollars flowed into Indian bonds at the same time. The latter asset class posted significant gains, and yields dropped considerably. The markets are expecting another interest rate cut in August, which would be the fourth cut in a row. The inflation rate appears to leave plenty of room for the central bank to make such a

India's economic motor increasingly sputtering – one million jobs at risk in automotive sector

move, and the economy could certainly benefit from lower interest rates. After all, nearly all of the economic data have been weaker of late.
Some 200,000 jobs have been lost in the automotive industry alone recently and there are fears within the sector that it will lose up to a million jobs. The only truly positive development of late was the increased rainfall, which ensured that this year's monsoon is no longer 20–30% behind the multi-year average, but "only" 10%.

Modi government escalates situation in Kashmir and revokes state's special constitutional status

At the same time, the Indian government dramatically escalated the situation in the region of Kashmir at the beginning of August, including with air strikes on the Pakistani side of the Line of Control. Pakistan reported the use of illegal cluster bombs and attacks on civilian targets and asked the global community to mediate in the conflict. Prime Minister Modi revoked the partial autonomy of the Muslim-majority state of Jammu and Kashmir that has been constitutionally guaranteed for 70 years and quickly had the associated law passed by his parliamentary majority. The government in New Delhi is apparently playing with the idea of dividing the state into two parts. There was no discernible reason for the military escalation. It appears that the extreme Hindu nationalist BJP government, now freed of any limitations that may have been imposed by a coalition partner, wants to create a fait accompli in Kashmir as quickly as possible. It is possible that the region will be forcibly colonised in order to establish a Hindu majority. At the same time, the escalation in Kashmir – much the same as during the election campaign – serves as a distraction from the lacklustre overall economic performance in recent years and the current misery. At the end of the day, these developments are not really surprising if one considers the Hindu chauvinistic change of course that has occurred in India since Modi took office in 2014. However, it is likely that hardly anyone expected him to take such aggressive actions only a few weeks after being re-elected. These events triggered shock waves throughout the region and have the potential to grow into a highly combustible open conflict between two nuclear powers. In light of this, the reaction on the equity market and the FX market (the country's currency depreciated by 6% after the constitutional amendment) has been very moderate so far.

Indian's actions could have incalculable consequences throughout the region and beyond

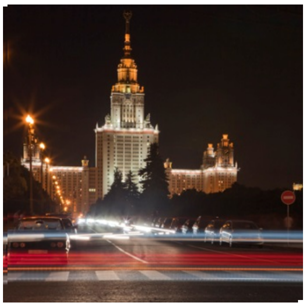
Brazil

Rate cut by the central bank

The Brazilian central bank lowered the key rate by 0.5% to 6%, more than had been expected by many observers, in order to give the still floundering economy a boost. There were tentative signs of a slight upturn in May/June, but only on a very selective basis and not by any means across the entire economy. Inflation is currently about a whole percentage point below the central bank's target, providing room for looser monetary policy. The market expects at least one more rate cut to 5.5% by the end of the year.

Pension reform clears first important hurdle

The controversial social reform was resoundingly approved by the lower house in an initial vote with much more support and considerably fewer changes than had been expected. Although the package of laws still has many hurdles to clear, it appears that the most important stage has been completed for now. The stock index in Sao Paolo bucked the Emerging Markets trend in July, posting a gain of just under 1%. The Brazilian real also appreciated against the dollar.



Russia's economy is growing, but at a relatively weak pace

Minister disagrees with central bank about lending

Interest rate cut by Russian central bank

Russia

Both real wages and industrial production have picked up a bit again in Russia recently. According to the Ministry of Economic Development, the economy grew by 0.7% yoy in June. At the same time, Minister Oreshkin warned of the negative consequences of consumer loan growth, which he feels is too high. Oreshkin said that this threatens to create a type of bubble that could throw Russia into a recession in 2021 at the latest and that too much money is being lent to consumers. In his view, this will reduce the availability of loans for investments in the economy. According to Oreshkin, the central bank is not doing enough to curtail consumer loans, a notion that is of course flatly rejected by the central bank. Russian Central Bank governor Elvira Nabiullina does not at all believe that a bubble is forming and on the contrary said that consumer loans are providing important support for Russia's economic growth, which is not very strong to begin with. She also stated that a reduction of consumer loans would by no means lead to higher lending to companies. Consumer loan growth is indeed nearly twice as high as the growth rate for corporate loans. However, the main obstacle for corporate investments is not excessive financing costs, but the much too slow and inadequate implementation of long-planned reforms by the government. These reforms would improve the economic climate in general. It appears that the majority of analysts share the central bank's opinion and see the minister's statements as an attempt to cover up failures by the government by pointing the finger at the central bank. At the end of July, the central bank lowered the key rate from 7.5% to 7.25%, stating that the falling inflation leaves room for a rate cut. At the same time, the central bank warned of weaker economic growth than originally projected.
The Moscow equity index declined by roughly 1% in July after reaching a new all-time high in June. With a gain of over 30%, the Russian equity market remains one of the top performers this year. The rouble also still looks very robust.

Currency and equities recover in July

Surprisingly high rate cut by the central bank

Risk of new conflict with the EU regarding Cyprus

Turkey

July saw a marked recovery on the Turkish equity market and for the Turkish lira. The stock index in Istanbul rose by more than 6%, and the lira appreciated by a similar amount. One of the key factors behind these developments was apparently the sharp decline in inflation, which dropped to 15.7% in June, a full three percentage points lower than in May. At the end of July, the central bank responded with a hefty rate cut from 24% to 19.75%, as President Erdogan had been demanding for quite some time. This was significantly higher than the markets had expected. The sacking of the central bank governor by President Erdogan at the beginning of the month likely had something to do with this. However, the economic data are not yet showing a drastic improvement thus far. Sentiment among consumers and businesses deteriorated again and capacity utilisation continues to decline.
At the same time, Turkey is drilling for oil and gas just off the coast of Cyprus under the protection of Turkish warships, despite protests by Cyprus and threats of sanctions by the EU. According to Ankara, these are naturally Turkish waters. The country also remains unimpressed by the threat of American sanctions. Two of a total of five Russian S-400 air defence systems arrived in Turkey in July. Admittedly, the suggestion by US Secretary of State Pompeo that Turkey could still avoid sanctions by not activating the two flight defence systems, which cost over 2 billion dollars, does seem a bit absurd.

Greece

Kyriakos Mitsotakis from the conservative New Democracy party was sworn in as the prime minister of Greece. Thanks to Greek election law, he can rely on an absolute majority in parliament despite the fact that only just under 40% of voters cast their ballots for his party. There were no major surprises during the presentation of his new government. Greece's equity market posted a gain of nearly 4% in July.

CE3 – Poland, Czech Republic, Hungary

Poland's inflation rate once again saw an unexpectedly high increase to 2.9% yoy in June after coming in at 2.6% yoy the month before. Although retail sales registered robust growth again, they fell short of the expectations and displayed less momentum than in the previous months.

In contrast to Poland, inflation in Czechia declined somewhat again in June. At 2.7%, however, it is still well above the central bank's target of 2%.

Czech Senate votes to impeach President Zeman

The opposition-controlled Senate, which is the upper house of the Czech parliament, voted in favour of impeaching President Zeman for allegedly violating the constitution. Among other violations, he is accused of unconstitutionally rejecting the nomination of numerous ministers. In order for the impeachment process to move forward, however, 60% of the representatives in the lower house would have to vote in favour of the motion, which is very unlikely based on the current situation.

Much like in Czechia, inflation has also retreated in Hungary recently. The most recent reading of 3.4% yoy (after 3.9% yoy the previous month) takes some of the pressure off the central bank, which is targeting an inflation rate of 3%. Accordingly, the monetary authorities also left interest rates unchanged. They expect a slight decline in both inflation and economic growth over the course of the rest of the year and next year.

The equity markets in Hungary and Czechia each posted gains of just over 1% in July, while prices in Warsaw fell by roughly 2%.

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