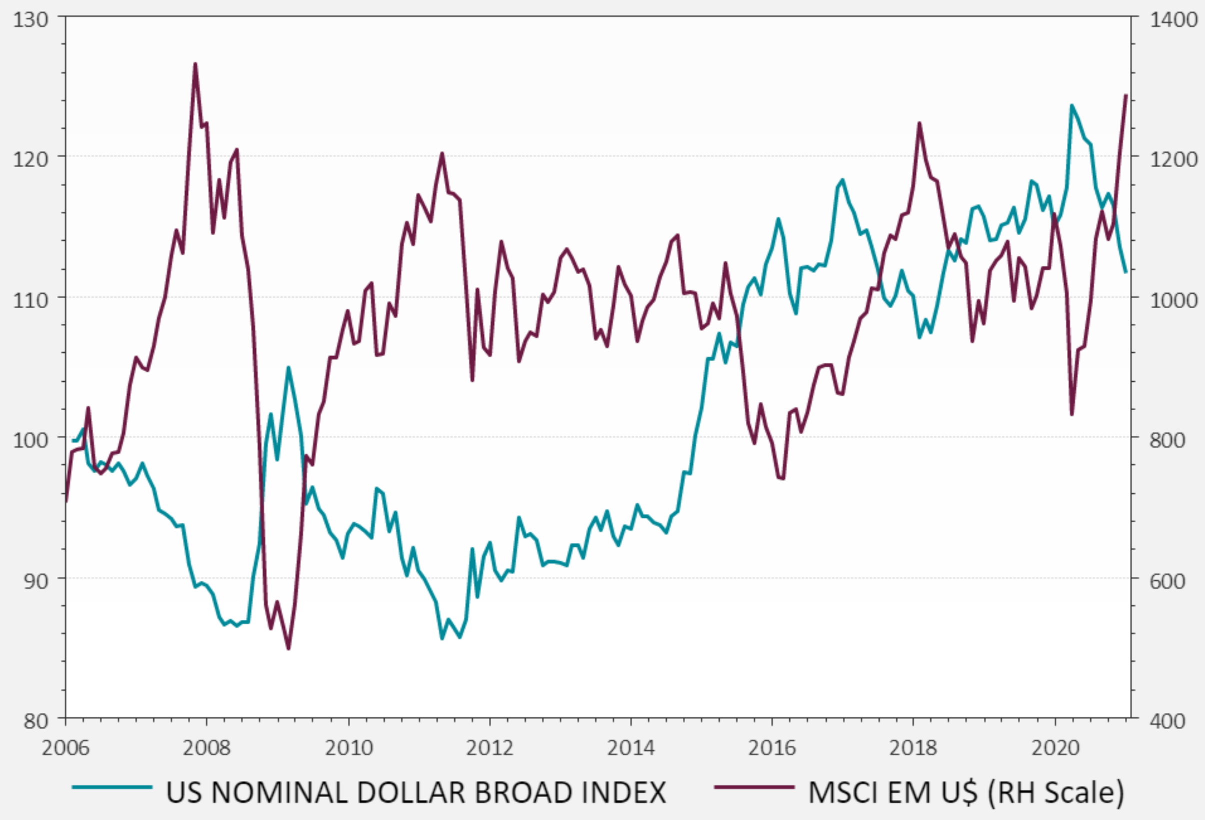
DECODING

Emerging markets: a call for 2021?

By Laetitia Baldeschi, Head of Strategy at CPR AM

Global growth will rebound in 2021, by around 5% after a contraction of more than 4% in 2020. The rebound momentum as it has been observed for a few weeks seems more favorable to emerging countries on the financial market. Several arguments can be put forward to explain this back in favor for investors and to forecast the rest of the year 2021. The latest data published by China, the depreciation of the US dollar, the recent evolution of the commodity prices are all pleading for this asset class.

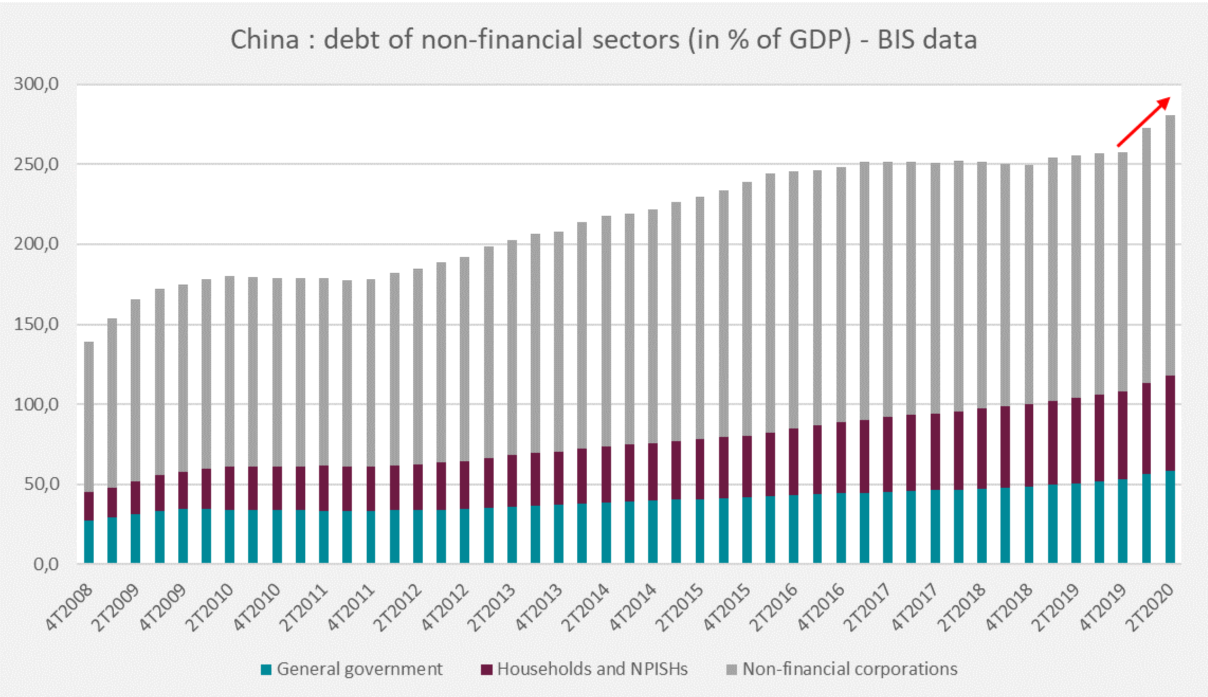
US dollar effective exchange rate and emerging markets



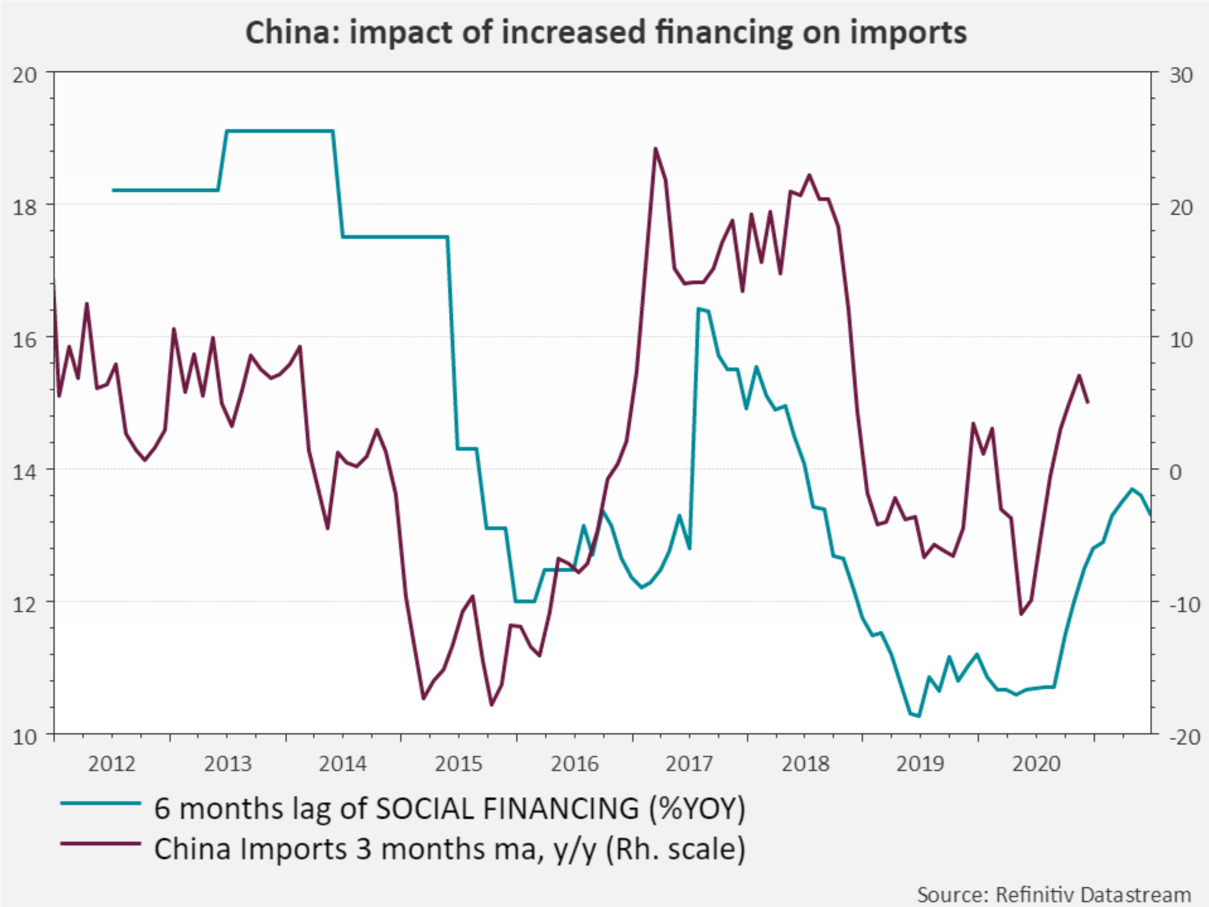
Source: Refinitiv Datastream

Indeed, the Chinese data are very impressive. Activity in China was buoyant in December, as GDP growth reached 6.5% yoy in Q4, a level unexpected after the shock experienced by China in the first quarter. In total, GDP will have grown by 2.3% over the year as a whole, with China probably being the only G20 country showing positive GDP growth in 2020. The rebound is the consequence of the particularly dynamic industrial sector at the end of the year, with production up 7.3% year on year. External demand to China remains very strong. China literally flooded the world with so-called "covid" products (masks, medical equipment but also computers…) even though the first confinement had closed or disorganized the global industrial fabric. At the end of 2020, the industrial capacity utilization rate has largely recovered to its pre-crisis level at 78%, admittedly still with strong sectoral disparities.

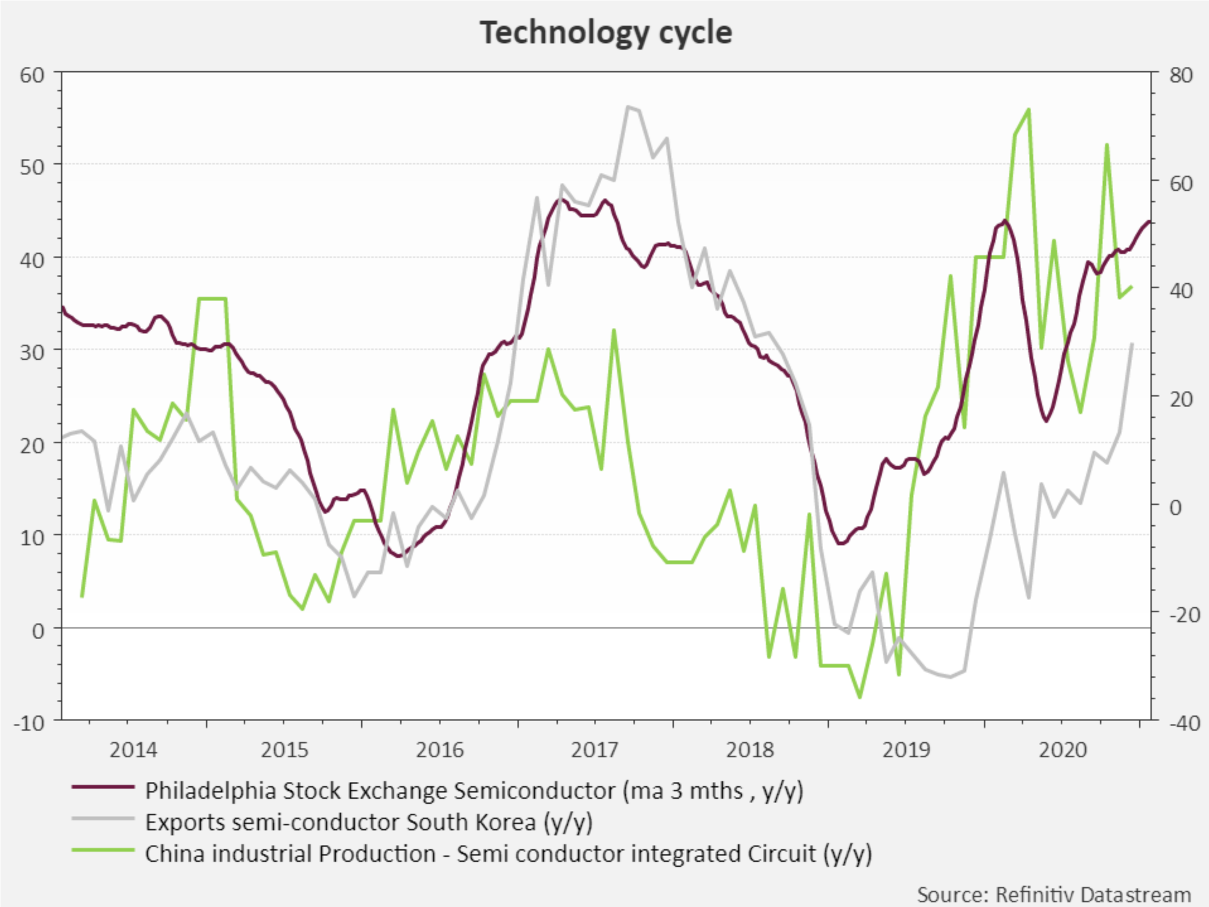
The authorities' political choices to support and then revive the economy are reflected today in growth which still appears unbalanced, recovering the shortcomings observed after the financial crisis of 2008. The choice was made to relaunch in priority industrial activity, by the channel of the large state-owned enterprises, whose productivity remains much lower than that of the private enterprises, by refocusing on external demand. **Structural rebalancing policies were largely put on hold during 2020.** This is reflected in the relative weakness of the rebound in household consumption, with fiscal support having been particularly modest, unlike what we have been able to observe in developed countries or even in Brazil**.** Social protection remains inadequate, with in particular the most limited unemployment coverage covering only a third of the urban working population, and a fifth of migrants. According to the IMF, in the first quarter of 2020, only 10% of the 23 million unemployed received benefits. **The two essential points to watch over the coming quarters will therefore be the restoration of the level of employment allowing a return to dynamic domestic consumption and the development of private debt in the country.** Indeed, the other perverse effect of the nature of the support policy put in place by the authorities is the increase in corporate debt leverage, after several quarters of stabilization (graph). The multiplication at the end of 2020 of announcements of corporate defaults confirms our fears in this area.



If Chinese growth has weaknesses, it has a significant spillover effect on the rest of the world and more particularly on emerging countries. This is obviously a desired political and geostrategic role and the launch of the Comprehensive Regional Economic Partnership (RCEP) between 15 Asian countries representing 30% of world GDP is part of this dynamic**.** This agreement creates a free trade area in Pacific Asia and should ultimately result in increased trade between these countries. Furthermore, and this must be taken into account, the weight of China in the exports of some emerging countries outside the Asia zone is also very important. This is particularly the case of Brazil, which accounts for 18% of its exports with China or Chile, for which China represents 26% of exports. As soon as China revives, it can be seen in partner countries!

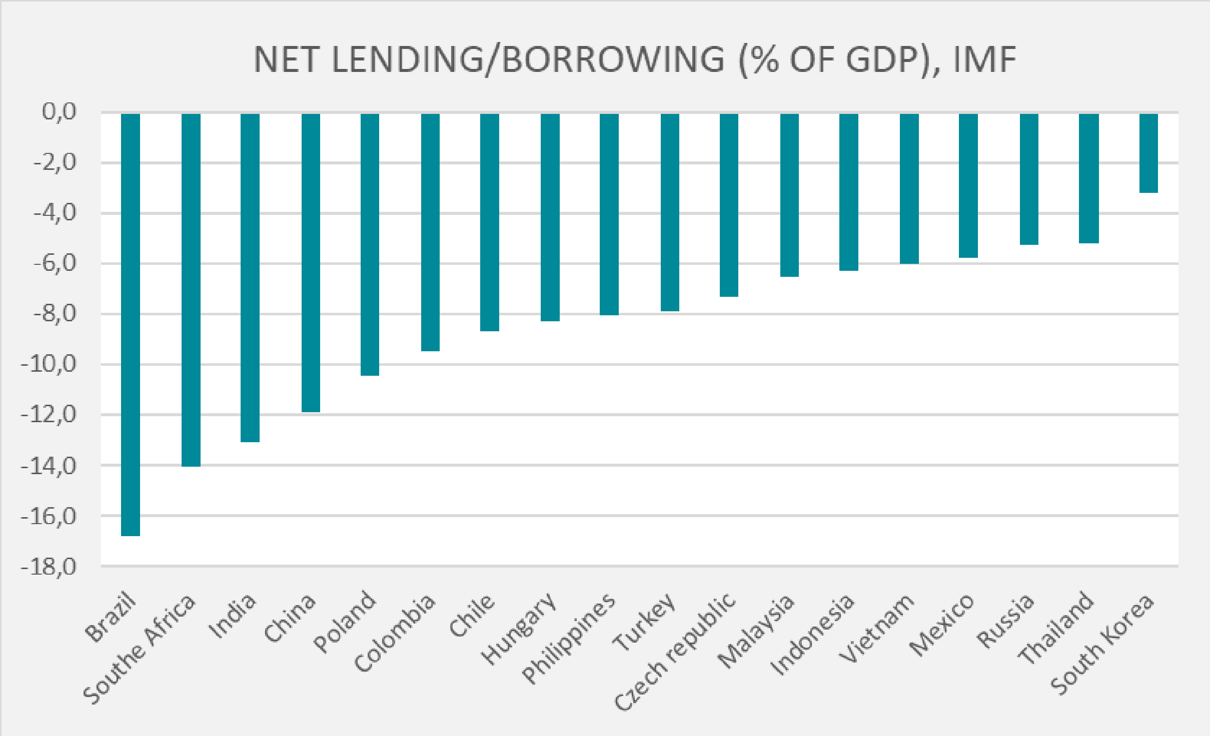


Geographical proximity and greater commercial integration, but also, and this is important, better management of the health crisis made these Asian stock markets the first to rebound if we, of course, exclude the weakest economies, ie the most sensitive to tourism and transport (Thailand, Malaysia and the Philippines) but also India. An industrial specialization in semiconductors and more generally in the high technology sector was an additional driver, as in Taiwan or South Korea. Given the dynamics of Chinese demand in this specific sector and the political priorities displayed in this area, the trend could continue for some time.



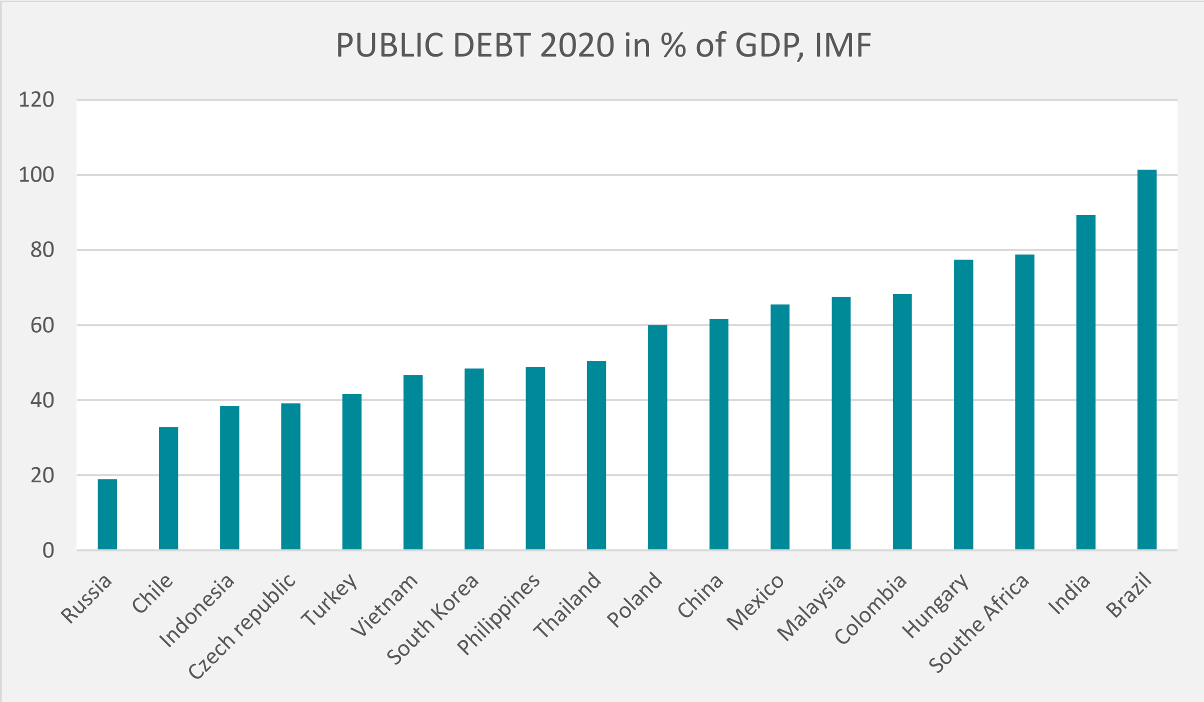
A call for Latam?

Latin America has been severely affected by the pandemic, but the arrival of vaccines should be a factor for accelerating the recovery in this area. **The region's high sensitivity to commodity demand puts it at the forefront of the rebound phase, especially as the stock markets of these countries have suffered greatly over the past year and are therefore very late**. **Several specific factors can be put forward to reinforce this conviction of a potential rebound at least in the first half of the year.** In Brazil, the authorities have made the choice (costly in terms of public finances, reaching 8 percentage points of GDP) to put in place income support measures, particularly for the most vulnerable. This minimum income policy coupled with job protection or increased compensation for job loss has enabled consumption to rebound rapidly, unlike what we have seen in China, for example ...



In Mexico, the authorities have used the fiscal policy with great caution. On the other hand, they were able to rely on significant monetary easing, which could continue if inflation remains under control in the coming months. The other support came, although it was not so obvious of a noticeable increase in remittances from Mexicans living in the United States, benefiting from fiscal aid. The expected US stimulus plans will undoubtedly have an impact on the Mexican economy, with flows to the United States accounting for 80% of Mexican exports. The political appeasement linked to the change of administration in Washington will also be a positive point for this market (the peso suffered under the Trump presidency). Another country that could benefit from the economic context is the Chile. This country is a very important producer of copper, an essential raw material for products resulting from new technologies, and the development of 5G, as well as that of electric vehicles, which makes Chile an essential partner.

But we must remain cautious: risks are present and could reappear in the second part of the year. Indeed, with the expected rebound in activity, linked in particular to the generalization of vaccination but also to ultra-accommodating economic policies, investors could anticipate an "overheating" which would therefore be accompanied by a rise in rates in the anticipation of the start of a gradual process of monetary normalization**.** This environment would undoubtedly be the signal for highlighting the levels of debt accumulated during the health crisis and rekindled concerns about the ability to repay debts, private and public. Such a context is always more difficult for emerging countries, whose access to market financing at a reasonable cost is always less assured. Brazil has a very high public debt that is close to 100% of the GDP. Already, the fact that long-term rates stayed almost at the level of 2019 during the crisis period with a central bank key rate falling to its historic low (2%) suggests a strong sensitivity of the markets to this theme. Mexico will be less concerned but must deal with some governance issues, in particular, in terms of the independence of public agencies and control institutions, which could damage its reputation and again weigh on the rating of rating agencies. Chile, which experienced many social and political problems in 2019, is not immune to a resurgence of social tensions.



In this context, being integrated with the European Union can constitute a clear advantage for the countries of emerging Europe, which will benefit for their part from the restart of the euro zone and in particular from the German industrial dynamic. **The results of the health crisis are not completely negative. One of its benefits is the reduction of current imbalances for many countries. This will also be one of the selection criteria that will need to be taken into account in assessing the strength of the country. Thus, as always in the emerging world, after an initial craze, the selective approach will gain the upper hand with the gradual normalization of economies expected for the second part of the year**.

In this approach, we have cross-checked a set of criteria for assessing the macroeconomic situation, the political situation but also the structural specificities of emerging countries with more microeconomic elements such as the composition, valuation and profit outlook of the stock markets for countries present in the MSCI Emerging in order to compose the optimal portfolio of our GEAR Emerging fund. The following ranking emerges: we favor the Chinese and Taiwanese markets, followed by Korea, Indonesia, Brazil, Chile, the Czech Republic and Poland to a lesser extent. We are neutral in terms of country risk on Mexico, Colombia, Malaysia, Thailand and Hungary. We are a little more cautious about the weightings of India, the Philippines and Russia, but are significantly underweight South Africa and Turkey, which in our view have many weaknesses.

Written on January 25th,2021

Information:

All comments and analyses reflect CPR AM's view of market conditions and its evolution, according to information known at the time. As a result of the simplified nature of the information contained in this document, that information is necessarily partial and incomplete and shall not be considered as having any contractual value.

This document has not been drafted in compliance with the regulatory requirements aiming at promoting the independence of financial analysis or investment research. CPRAM is therefore not bound by the prohibition to conclude transactions of the financial instruments mentioned in this document. Any projections, valuations and statistical analyses herein are provided to assist the recipient in the evaluation of the matters described herein. Such projections, valuations and analyses may be based on subjective assessments and assumptions and may use one among alternative methodologies that produce different results. Accordingly, such projections, valuations and statistical analyses should not be viewed as facts and should not be relied upon as an accurate prediction of future events.

CPR ASSET MANAGEMENT, limited company with a capital of € 53 445 705 - Portfolio management company authorized by the AMF n° GP 01-056 - 90 boulevard Pasteur, 75015 Paris - France – 399 392 141 RCS Paris.

cpr-am.com **@CPR _AM** **cpr-asset-management**