TS Lombard

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Economics / Politics / Markets

Daily Note

EM: CONFLICT, CRISES AND CONTAGION

Jon Harrison

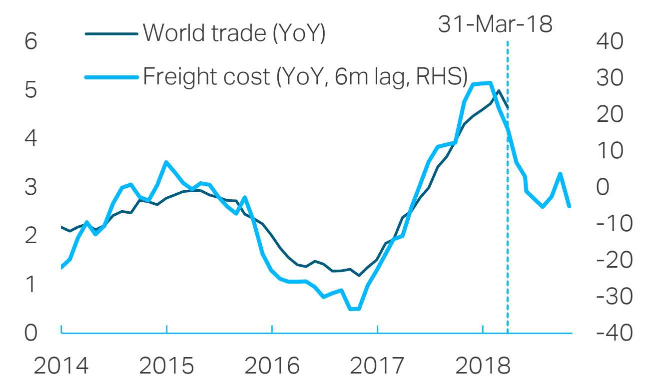
- **Unilateral US action threatens global trading order**
- **Brazil is following Turkey into economic crisis**
- **Contagion fear as investors look for next casualty**

The unilateral approach of the US administration raises the risk of further geopolitical tensions. The US decision to impose of tariffs on steel and aluminium imported from Mexico, Canada and the EU represents the most serious threat yet to the global trading order, while a settlement in the US-China trade conflict remains elusive. Mexico, Canada and the EU aim to launch retaliatory tariffs. China too threatens retaliation if the US goes ahead with planned tariffs later this month. On that front, no decision is likely until after the North Korea summit.

The growth of world trade volumes had started to decline even before this latest escalation. World trade data for March, released last week, showed a decline in the year-on-year growth of trade volumes for the first time since 2016 (see Chart 1). EM export growth has fallen over the past six months (see Chart 2). With no end to the global trade conflict in sight, a further decline in the world trade volumes, disruption to supply chains and a slowdown in EM exports appear likely.

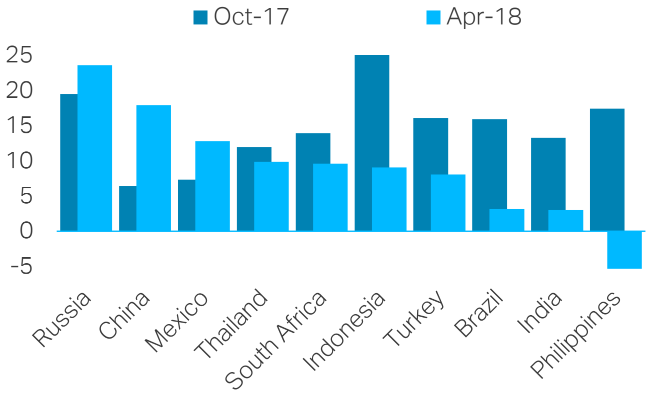
At the same time, Brazil is following Turkey into economic and market crisis. In our 21 May EM Watch, we highlighted the market turmoil in Turkey (and Argentina). The truckers' strike in Brazil has hit the economy and markets, and underlined the uncertainty surrounding the October election where no strong mainstream candidate has yet emerged. The crises in Turkey and Brazil stem from domestic events, but have been exacerbated by external conditions.

Chart 1: World trade vs freight cost



Source: CPB World Trade Monitor, Bloomberg, TS Lombard.

Export growth (yoy, 3 month ma)



Source: Bloomberg, TS Lombard.

Liquidity conditions raise fears of contagion. In our latest EM Strategy Monthly, Larry Brainard warns that liquidity-driven markets raise the risk of contagion. Our analysis of global liquidity suggests that, while the peak has past, there should be no abrupt tightening of financial conditions (see our 11 May Global Financial Trends). But there is a growing possibility that an extended period of risk aversion could precipitate a deeper tightening of financial conditions.

There is, however, little evidence so far of a broader EM contagion, though also little doubt that investors are searching for the next market to be hit. Our analysis of inter-country correlation among EM equity markets shows that, while correlations rose markedly during the taper tantrum and ahead of the first Fed rate hike in 2015, there has been no such increase in correlation during the current bout of EM risk aversion (see Chart 3). The limited scale of retaliation against the US offers hope that a Trade War will be avoided. So far, there is value in distinguishing the resilient EM economies from the more vulnerable; but the deepening crisis in Brazil raises the risk that others will follow. India and the Philippines may be next in the firing line.

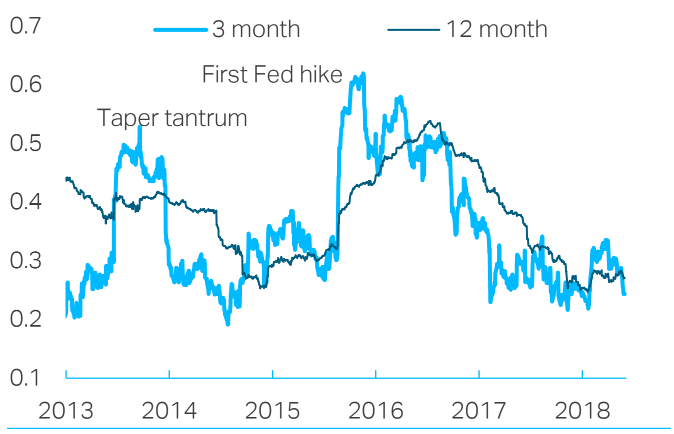
We maintain our moderate negative overall view of EM risk. A stronger dollar and higher US Treasury yields will continue to weigh on EM assets, while the soft patch in the Eurozone has removed an important driver of global growth. It is the prospect of an escalating trade conflict, however, that poses the greatest threat to EM (see our EM asset allocation heatmap).

China is likely to remain a relative safe haven among EM economies, even as gradually tightening monetary policy limits the potential for gains on local debt. Inflationary pressure are rising in India, despite the timely arrival of the monsoon. Rising fiscal risks will weigh on investor sentiment as central and state governments increase spending in an effort to boost rural support ahead of key state and national elections.

In Russia, the direction of travel of sanctions risk is now positive. The new government line-up unveiled last month sets the stage for tax and pension reforms and bodes well for the continuation of orthodox policymaking. In Brazil, last week's truckers' strike underlined the risks to the economy and markets, and has accelerated the collapse in support for the current administration, thereby strengthening the hand of populist outsiders.

Falling inflation and sound fiscal policy should support Mexican local debt and sovereign credit, but it is NAFTA that will drive the short term outlook. It will be left to the next administration to continue the negotiations: AMLO will likely take a more nationalist approach. In Indonesia, the renewed commitment of Bank Indonesia to manage the risks to inflation will boost sentiment.

Chart 3: Avg EM inter-country correlation



Source: Bloomberg, TS Lombard.

EM Asset Allocation View

	Equities ($)	Currencies	Local rates	Credit ($)	Scale
Risk	-1				
Asset class	+1	-1 (0)	-1	+1	
Relative country views					
China	+1	+1	-1	n/a	+2
Brazil	-2 (-1)	-1 (0)	-1 (+1)	-1 (+1)	+1
India	-1	-1	-1	n/a	0
Russia	+1 (-1)	+1 (0)	+1 (0)	+1 (-1)	-1
Mexico	0 (+1)	0 (+1)	+1	+1	-2
Indonesia	+1 (-1)	+1 (-1)	+1 (-1)	0 (-1)	
Philippines	-1	-1	-1	-1	Last month in brackets
Thailand	+1	+1	+1 (0)	n/a	
South Africa	+1	+1	+1	+1 (+2)	
Turkey	-1 (+1)	-2 (-1)	-1 (+1)	-1	

The scores of our relative country views sum to zero in each column