

Daily Note

EM CONTAGION: CRISIS UPON CRISIS

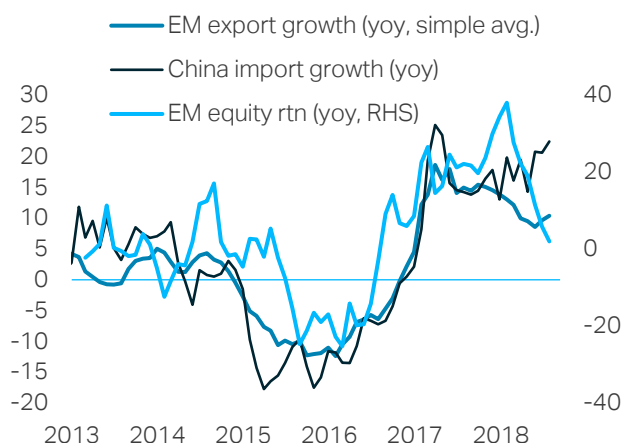
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- **Argentina, Turkey could be manageable, Brazil less so, China not at all**
- **EM crises, tighter liquidity and Trade War lead to correlated markets**
- **Negative feedback to DM will be via trade and China**

We maintain our strong negative view of overall EM risk. For several months our view has been that it is the cumulative impact that matters when assessing the effect on EM economies and markets of tighter global liquidity conditions, the escalating trade conflict between the US and China, and crises in Argentina and Turkey (see, for example, our 21 May [EM Watch](#), and more recently, 20 August [EM Watch](#)). These drivers are likely to intensify in the coming months.

What has changed is Brazil. The likelihood of a market friendly outcome in the 7 October Brazilian election first-round has receded (see our 4 September [EM Strategy Monthly](#)). With a month of campaigning ahead, the result is still far from certain, but opinion polls raise the spectre of a second-round run-off between a far-left and a far-right candidate. Such an event would shock markets out of their complacency about the prospect for essential fiscal reform.

Argentina and Turkey are relatively small EM economies – European banks are exposed, but not systemically so (see our 13 August [Europe Watch](#)). The scale of selling elsewhere by investors looking to cover losses in these markets is not negligible, particularly in dollar debt, but could likely be absorbed by wider EM. And the fallout for the global economy would be limited. By contrast, Brazil is an important market for EM investors in each of credit, equity and local debt. If crisis conditions do indeed develop, there will be significant contagion to wider EM.

Chart 1: China's import and EM export growth


Source: Bloomberg, TS Lombard.

Chart 2: Avg EM inter-country equity correlation


Source: Bloomberg, TS Lombard.

EM crises have so far had little impact on the global economy. Brazil could become a more challenging test of global investors' sentiment, but it is the escalating US-China trade conflict that poses the greatest threat to global growth. China's response could include a steep renminbi depreciation, which would cause a severe market dislocation (see our 4 September [Daily Note](#)).

The Trade War is about to enter what could be its most economically damaging stage yet.

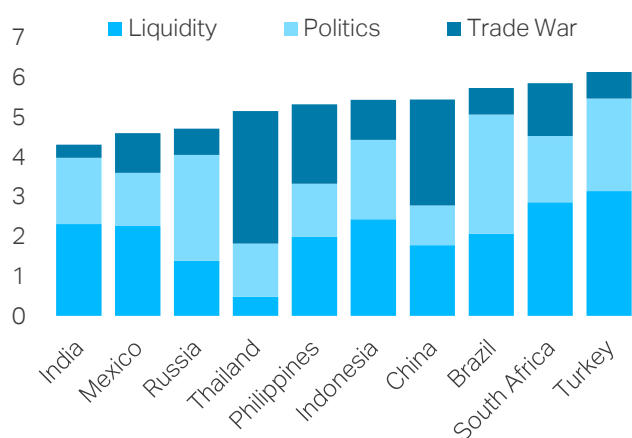
World trade growth is already declining. Lower EM export growth has led the fall in EM equities and will likely slip further, despite a recent boost from China's front-loading of imports (see Chart 1 and 28 August [EM Watch](#)). A phased implementation of US tariffs may yet delay the economic damage of the Trade War (see our 13 August [EM Watch](#)), but deep divisions remain and US political incentives favour a further ratcheting up of pressure.

Tighter liquidity conditions, politics and geopolitics, and the Trade War all contribute to rising correlation among EM assets (see Chart 2), increasing the challenge for EM investors aiming to achieve alpha via country selection. Economic fundamentals remain an important consideration. Our EM resilience score calculated using an approximate 75/25 weighting of current account balance and FX reserves to GDP has shown a broad correlation with markets under tightening liquidity conditions (see our 25 June [EM Watch](#)). In a recent analysis, we sought to quantify EM political and geopolitical risks (see our 30 July [EM Watch](#)). To these we add our assessment of Trade War impact, to construct an EM combined risk indicator (see Chart 3¹). We adjust our EM asset allocation views to take account of exposure to these risks (see Figure 1).

India and Mexico stand out as EM relative safe havens. India and Mexico are at the weak edge of the middle of the EM pack in terms of current account and FX reserves. Political risks in both centre on potential populist slippage, and in India on the chance of a weak government next year; risks appear contained in both in the short term. India is a closed economy and so less exposed to trade disruption, while the prospect of a US trade deal reduces Mexico's exposure.

Russia and Thailand are next best placed. Russia has strong fundamental resilience and limited Trade War exposure, but high geopolitical risk. The probability of new US sanctions is low, though non-negligible, but the worst-case impact could be severe (see our 6 August [EM Watch](#)). While Thailand has both strong resilience and stable short-term politics, but is deeply integrated with Asian manufacturing supply chains that face Trade War disruption.

Chart 3: EM combined risk factor



Source: Bloomberg, TS Lombard.

Figure 1: EM asset allocation

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

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

Source: TS Lombard.

¹The presentation of overall risk as an equal weighted sum of these factors is illustrative and ignores the fact that, at any given time, risk may be driven more by one factor than another, and that the factors themselves may be correlated.