Daily Note

EMS LEADING WORLD SLOWDOWN

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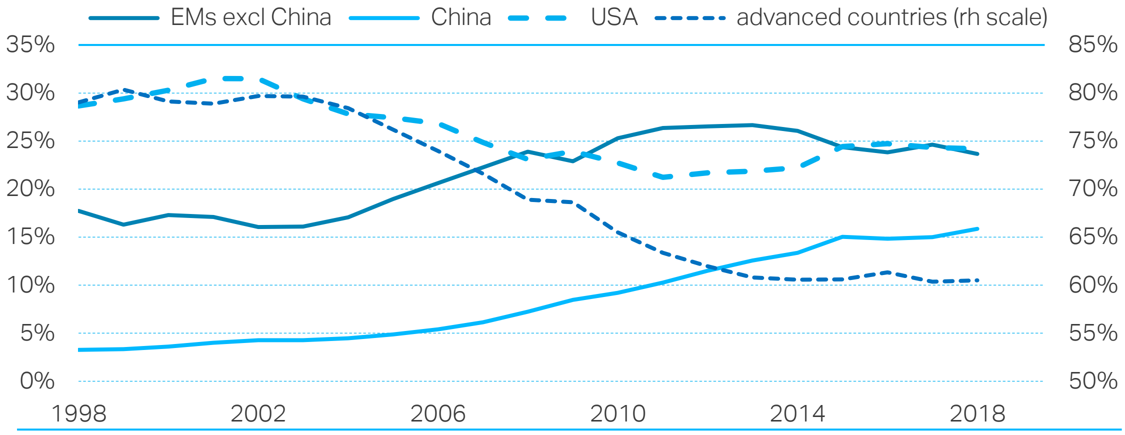
- **EMs are now 40% of world, current-dollar GDP and are leading the slowdown**
- **Rising dollar and falling yuan => imports and debts cost more, exports are hurt**
- **Japan and Germany both saw falling real GDP in Q3 - US to slow down next**

Share of world GDP in current US$, %



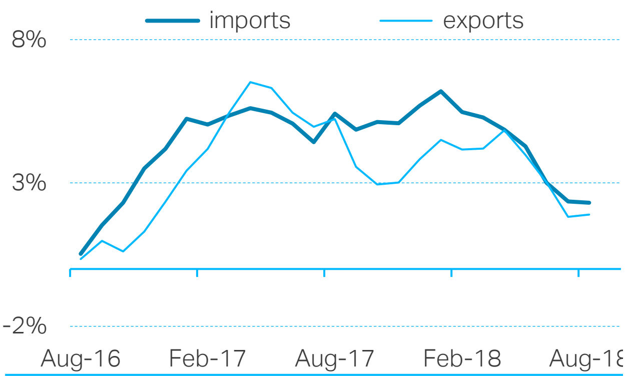
Source: IMF, TS Lombard

Emerging markets now account for about 40% of world GDP, measured in current dollars, versus half that at the turn of the century. While this has been true since about 2013-14, for the first time they are moving largely together, and acting as a chief motivator of the world economy. The basic force has been the following dichotomy: the rising dollar means imports (and debts) cost more, while the fall in the Chinese yuan has hurt export competitiveness.

Real FX rates, PPI-based

Source: Datastream, JP Morgan, TS Lombard

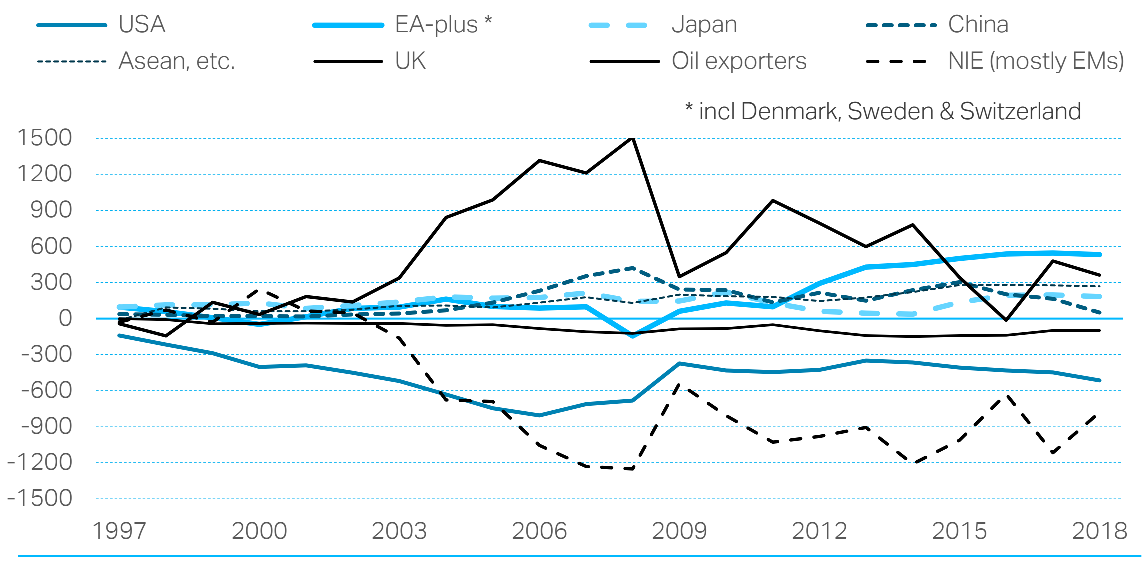
World trade volumes, 6-mths/6-mths
% change, saar



Source: Datastream, TS Lombard

Both the US dollar and China's yuan were overvalued by long-term standards in 2016-17, but the gradual appreciation of the yuan alongside US domestic recovery from the 2015 slowdown created positive conditions for world trade growth and the competitiveness of EMs (as well as the weaker advanced countries such as Italy and Japan). The dollar started to appreciate in the spring owing to re-emergence of interest-rate differentials as a driver of FX rates – in 2017 current accounts had been dominant. But the escalation of trade war concerns from May onward drove up the dollar much further, and sank the yuan.

Current account balances incl EMs, $ billion IMF forecasts for 2018



Source: IMF, TS Lombard

China's economy was already slowing in mid-2018, responding to tighter monetary conditions, as the authorities concerned themselves with rising debt/income ratios. Faced with more expensive dollars – and oil prices until recently – non-oil EMs have been the most exposed. The chart above shows them within 'NIE' (not included elsewhere) which includes Australasia and Canada, whose combined deficits have been about $100 billion. So the non-oil EMs have been running deficits of around $800 billion for the past dozen years. The large raft of debt this entails is now costing more – just as dollar deposits offer positive real returns for the first time since the financial crisis, making EM paper less attractive. Debt problems as well as deficits makes their problems much worse than those of savings-glut countries like Japan, Asian Tigers and the EA.

The advanced country slowdown that showed up with real Q3 GDP declines of 0.3% in Japan and 0.2% in Germany. Now, finally, it is liable to spill over to the US. Real US exports fell in Q3, as did housing, while business capex only gained marginally. Only a sharp drop in personal saving and a jump in inventories prevented real growth retreating markedly. Our view of trade-war geopolitics is that it will continue to enforce further yuan/dollar depreciation, perhaps to 7.40 by end-2019. This means the dollar rises further, probably sharply slowing the US economy.

To be sure, some will gain from trade war. Brazil is exporting more soya as China restricts its imports from the US. ASEAN countries, India and Bangladesh may gain as Chinese products are re-routed to the US through countries deemed friendly by the US – production facilities may also be relocated. But in general the dichotomy of a rising dollar and falling yuan means the pain is being spread worldwide. The slowdown has already started, and could last through 2019.