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EM: faster, higher, stronger?

There is little change to our growth expectations this quarter for the emerging markets. Domestic trajectories have largely played out as expected in this regard, though inflation has thrown up more surprises. China, it is true, did better than we had forecast in the first half of the year, but this looks to us to be the result of unsustainable stimulus, and a deceleration already appears to be underway. Higher-than-expected inflation has pushed back our rate cutting cycles in Russia and Brazil, but we still expect policy action this year. India too looks likely to engage in easing as current central bank governor Raghuram Rajan steps down in September, likely in favour of a more dovish appointee.

Overall we expect stronger growth going into 2017, despite the deceleration seen in China. Much of this comes from a recovery from recession in Russia and Brazil, though India also continues its steady march upwards as credit growth recovers and reform momentum helps encourage investment.

Table 3: Balance of probabilities by scenario outcome vs. baseline

% per annum	GDP			Inflation		
	2015	2016f	2017f	2015	2016f	2017f
China	6.9	6.4	6.2	1.5	2.0↓	2.0↑
Brazil	-3.8	-3.5	0.9	9.0	8.5↑	5.5↑
India	7.0	7.5	7.9	5.0	5.6↑	5.9↑
Russia	-3.7	-0.2↓	1.5	15.3	7.5↑	6.5↑

Source: Bloomberg, Thomson Datastream, Schroders Economics Group. Previous forecast from June 2016. Please note the forecast warning at the back of the document.

China: pace to flag after too strong a start

Stimulus has juiced growth for now…

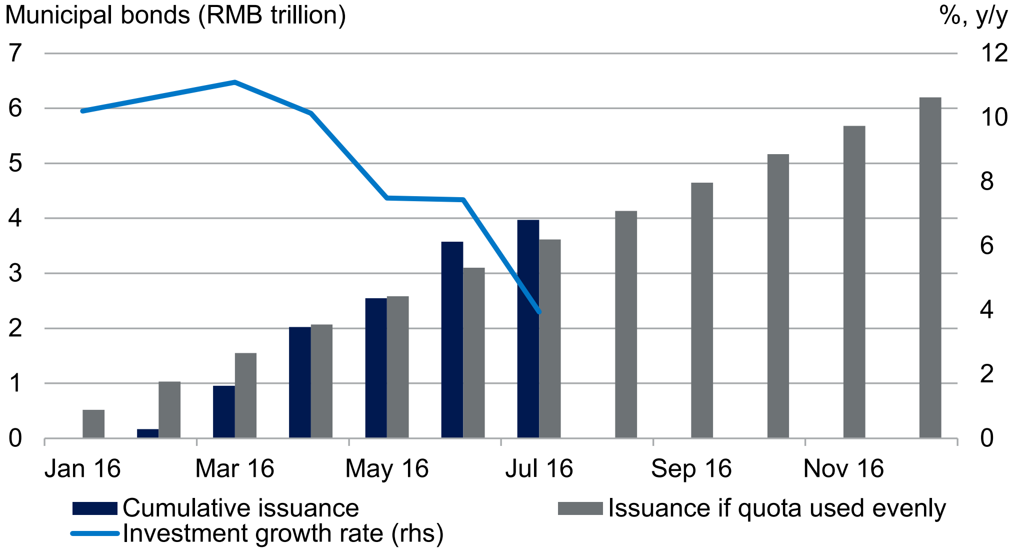
Chinese GDP growth was unchanged in the second quarter of the year, at 6.7% year-on-year, capping a strong first half of the year, and would suggest that stimulus efforts have successfully supported growth.

A sector breakdown of the data shows acceleration coming through the primary and secondary industries, or “old” China, with the tertiary sector (services) slowing marginally. This is counter to the narrative of a China transitioning to a new growth model and suggests that growth and stability for now trump the need to reform the economy. We would also note however that this time last year saw an outsize contribution from the services sector thanks to the equity market boom, so some payback was inevitable. Growth in services also continues to surpass that in manufacturing and other areas.

…but we doubt it can be sustained

Looking at the higher frequency data, we would note that property investment slowed markedly in June, and further in July, and that investment generally has weakened considerably. Private sector investment (60% of the total) is now contracting, with investment growth reliant on the public sector. This has received a fillip over the last 12 months thanks to the new ability of local governments to issue municipal bonds, providing key financing. However, bond issuance began in May of 2015, and so the base now includes their impact: this May was the beginning of the investment slowdown. In addition, there is a bond issuance quota of RMB 6.2 trillion, and over 3.5 trillion in bonds were issued in the first half of the year. Last year, the quota seemed to act as a hard ceiling, and bank lending quotas also appear to place binding constraints on credit activity, so we think the same will be true this year. This implies a reduced pace of issuance for the second half, which will drag on investment at a time when even more public support is needed (chart 13).

Chart 13: Municipal bond issuance will have to slow despite weak investment



Source: Thomson Datastream, Deutsche Bank, Schroders Economics Group. 18 August 2016.

Still no hard landing as bank funding looks stable

Given the downturn in the data, it may seem an odd time for us to drop our scenario of a Chinese hard landing. However, this has more to do with the time horizon of our scenarios – they must be triggered within six months – than a view on our part that all is well in China. In the near term, the state has sufficient resources to contain any flare ups in the economy or financial system, where risks abound. In its recent Article IV report on China, the International Monetary Fund (IMF) estimated that "debt at risk" in the economy amounted to 15.5% of total loans, with the potential for losses equivalent to 7% of GDP. What is missing for the moment, however, is a trigger. Bank funding is largely stable and derived from household deposits (though reliance on interbank funding is growing), and strict capital controls trap funds in the system while also greatly limiting the entry of foreign money. Financial crises are typically triggered by a sudden stop of capital flows to the financial system. Given the composition of funding, we think this is very unlikely in the next six months. We would be less sanguine over the next three years.

Currency policy, as we have noted previously, retains a clear weakening bias. However, capital outflows seem to have reduced and markets appear unperturbed by the ongoing weakness of the renminbi. All of this makes a big devaluation less likely, and we expect further gradual depreciation over the foreseeable horizon.

Brazil: leaving the starting blocks

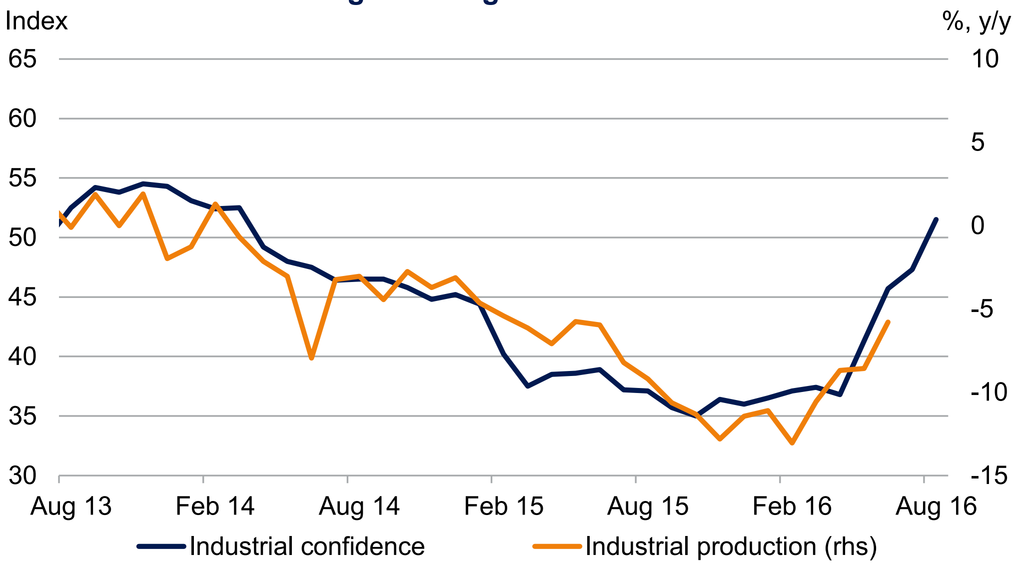
Growth is recovering in Brazil, from a very low base

High frequency data suggests a recovery of sorts is underway in Brazil, though it will still be a few quarters before we see positive growth. The PMIs have shown one of the sharpest turnarounds, though industrial production and retail sales have also reversed their decelerating trends. The improvement in the latter comes despite a labour market that is still shedding jobs.

Second quarter GDP data is not yet available, but first quarter growth improved on the back of government spending, net exports, and investment. Government spending is unlikely to be much of a driver given planned austerity, and this boost at least partially reflects the attempts by the outgoing president Dilma Rousseff to shore up support with largesse for her base. The contribution of net exports, boosted almost entirely by improved export performance, can be attributed to the weaker currency and lower unit labour costs. This should persist for most of the third quarter, after which the currency impact will begin to fade, particularly given the strength we have seen in the real and concomitant increase in unit labour costs.

Perhaps most interesting though is the performance of investment. Though still contracting, it was much less of a drag than in the fourth quarter of 2015. When we also consider a rebound in business confidence witnessed in survey data, we could conclude that the formation of a new government has returned investment confidence to the economy. If this narrative is correct, the revival is somewhat hostage to further political developments. On this front, it is encouraging that the impeachment of Rousseff looks to be on track, with a strong majority seemingly in President Temer's camp. Business confidence surveys show the revival in sentiment has extended, reaching levels last seen in early 2014. This bodes well for further investment and industrial performance (chart 14), as does the interest taken by assorted foreign investors in Brazilian assets.

Chart 14: Confidence surges amongst Brazil's industrialists



Source: Thomson Datastream, Schroders Economics Group. 18 August 2016.

Some encouraging political news, but risks are rising

There are risks, however. President Temer and his government have been linked to the ongoing corruption scandal at Petrobras, which has metastasised also to Eletrobras. There is a chance this undermines Temer's government as it undermined Rousseff's, weakening its ability to implement reform. In addition, a number of reforms have already seen dilution. This might just be electoral calculation ahead of local elections in October, but investors would do well to keep one eye on developments here as a signal of the government's commitment to reform.

In terms of monetary policy, the central bank under new governor Ilan Goldfajn has been forced into a more hawkish position than might have been anticipated given Goldfajn's dovish commentary prior to taking the role. Inflation has proven stickier than expected, making a rate cut difficult to justify. Our own inflation forecast has been revised up on the stubbornness of inflation this year, and we have both pushed out and reduced the rate cutting cycle, with 75bps of cuts this year at most.

Russia: still fighting to compete

The Russian economy contracted 0.6% year-on-year in the second quarter of 2016, in line with our forecast but a better performance than expected by the market. The number is also an improvement on the first quarter reading of a 1.2% contraction.

As this is an advance reading, there is no breakdown available so the drivers of the improved performance can only be inferred from higher frequency data. Industrial production has expanded throughout the quarter in year-on-year terms as it recovers from low levels. This has likely been helped in part by a weaker currency; exports are on an improving path, though still down year-on-year. Retail sales are still anaemic, with the consumer facing headwinds of high unemployment, so consumption is unlikely to have been particularly strong.

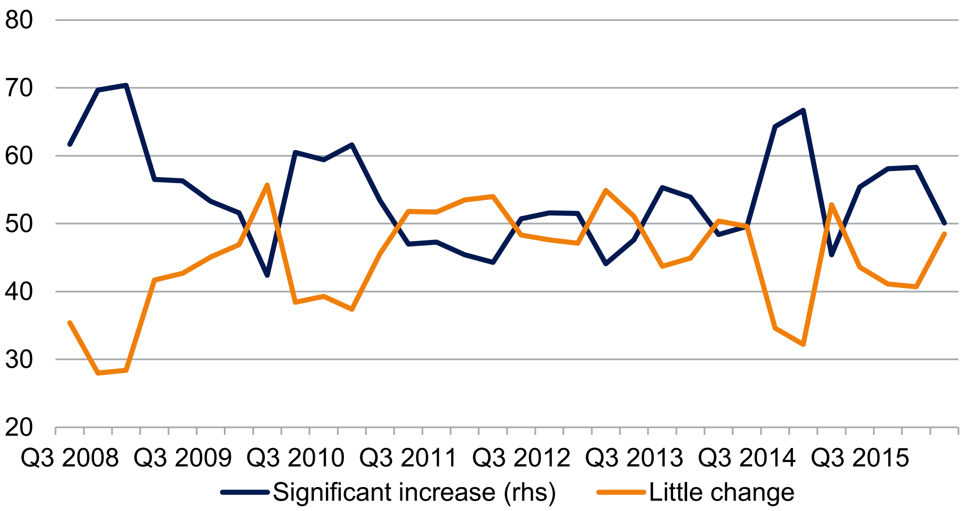
Growth should continue to recover, but to a low ceiling

The outlook from here remains one of gradual recovery, recent oil price weakness notwithstanding. We expect positive year-on-year growth by Q4, and a positive overall growth performance in 2017, though still muted. The worst of the oil price crash effects may be over, but Russia's economy needs to address structural imbalances if it is going to grow strongly in a world of cheaper oil. The economy is also going to face fiscal headwinds given the balanced budget goal, which requires fiscal consolidation of around 4% of GDP by 2020. The planned rate of reduction has been a cut to the deficit of 1% of GDP each year, with presidential elections in early 2018 likely weighing against more aggressive consolidation.

The weakness in oil in July and early August generated some renewed currency weakness. The central bank has also mentioned that inflation expectations remain more elevated than they would like (chart 15), while wage growth is also a concern. We think there is still scope for 50–100bps of cuts this year provided the oil price firms, given lower indexation in regulated tariffs this year which will reduce the inflationary impact from regulated prices

Chart 15: Inflation expectations keep Russian central bank's finger off trigger

Expectations on inflation (% of respondents)



Source: Thomson Datastream, Schroders Economics Group. 18 August 2016.

India: another hurdle finally cleared

Reform progress is a relief

After a decade of waiting, India has finally passed a bill clearing the way for the implementation of a unified Goods and Services Tax (GST). This may sound dry, but when one considers that until this point India has been less of a "single common market" than the European Union, the implications seem much more significant.

By unifying tax rates across goods and services, removing taxes on the movement of goods and shifting the basis of taxation to consumption rather than production, the GST should remove a wide range of distortions and inefficiencies, benefiting investment, growth, and tax revenues in the medium to long run.

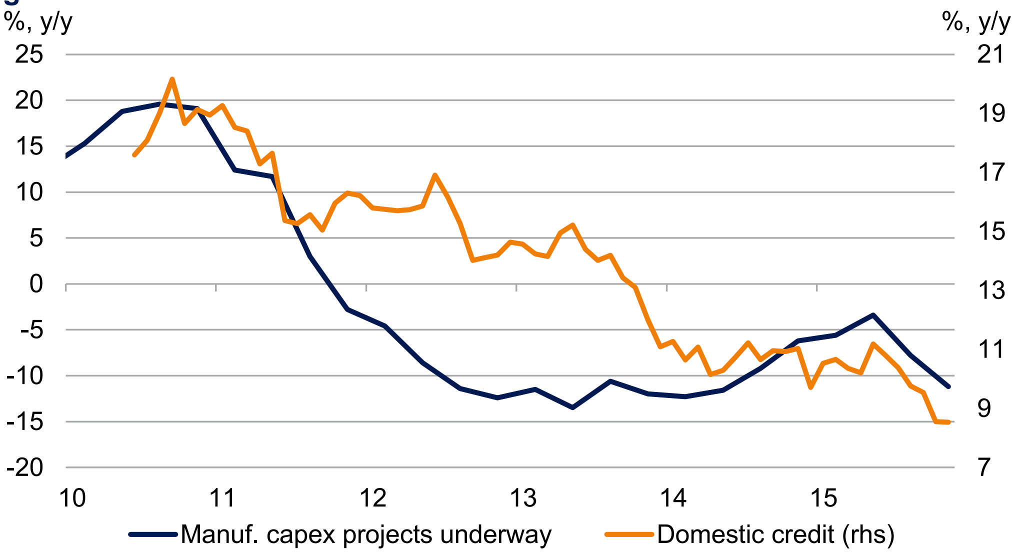
However, implementation could be messy; the GST will reduce taxes for manufacturers but increase them for service producers. This has potential inflationary impacts and a negative hit to growth in the short run, if manufacturers do not pass this reduction on, but service providers pass on their tax increase.

The passage of the legislation is positive for sentiment; investors had become somewhat jaded on the Indian reform story as Modi's government became bogged down in the same mess of vested interests and political inertia that has plagued successive governments. That the Bharatiya Janata Party (BJP) can cooperate with the opposition Congress party to enact important legislation, and that it has built support in the upper house, improves the policy outlook and could encourage foreign direct investment and portfolio inflows. Some caution is warranted; the GST was in the interest of a range of parties in a way that other reform legislation may not be.

A boost to investment sentiment is sorely needed in India, given the performance of the private sector in this regard. According to HSBC, private sector investment contracted 1.4% in the 2016 fiscal year. Accounting for 75% of investment demand, this has a significant impact on headline investment growth despite strong public spending. Credit growth has also been weak, and may explain some of the softness (chart 16). A planned bank recapitalisation and clean up should shore up credit support from 2017. Budgeted public capital expenditure also remains strong, and can have a beneficial crowding in effect on private investment.

Banking sector needs recapitalisation and reform to support growth

Chart 16: "Make in India" campaign struggling in face of weak credit growth



Source: Thomson Datastream, Schroders Economics Group. 18 August 2016.

We think a change in policy stance is likely from the central bank in Q3. Central bank governor Rajan is stepping down, and his replacement is likely to be more dovish. We modestly revise up our inflation expectations to reflect this probability, though the adoption of an official inflation target should provide some constraints. Rajan opted not to extend his term amidst fierce criticism from senior figures in the ruling party, suggesting that whoever is appointed to replace him will be more in tune with government thinking. This could mean looser policy in the form of rate cuts, but also acquiescing to the mooted use of central bank cash reserves to recapitalise troubled lenders, a move opposed by Rajan. An eye must be kept on the inflationary consequences.

Schroder Economics Group: Views at a glance

Macro summary – September 2016

Key points

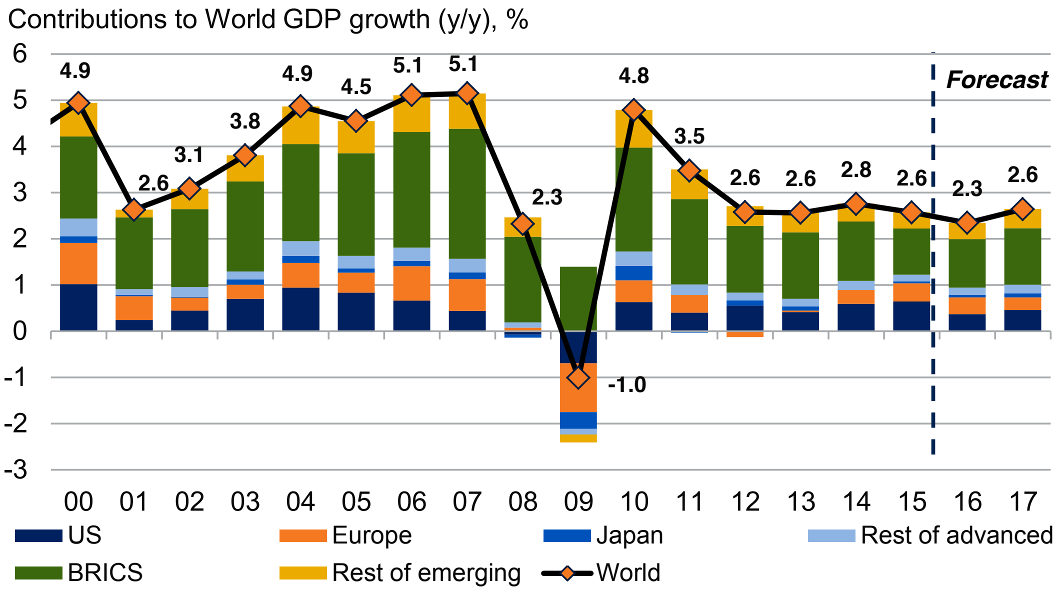
Baseline

- We have trimmed our global growth forecast at 2.3% for 2016 as a result of downgrades to the US and Europe. For 2017, our forecasts are little changed, with growth strengthening modestly as a result of more stable emerging market activity. Global inflation rises modestly as a result of the recovery in oil prices.
- The US Fed is expected to raise rates in December by 25 bps, so taking fed funds to 0.75% by end year. With inflation rising, further rate increases are expected in 2017 to 1.25% by end year, with the Fed moving cautiously on concerns about its impact on the rest of the world and the strength of domestic recovery.
- UK to slow sharply following Brexit vote. The initial shock will cause business investment to fall, eventually leading to lower employment and wage growth. By 2017, the household sector will also feel the impact, but the economy narrowly avoids recession. The pound has fallen sharply which will result in higher inflation, but there are further downside risks to the currency. The BoE cut rates in August, and is likely to cut again to 0.1% in November. QE has also been expanded, but the BoE may need to extend purchases until the end of 2017.
- Eurozone recovery continues in 2016, but at a marginally slower pace owing to the Brexit shock. It is likely to slow further in 2017 as inflation starts to rise, eating into the real disposable income of households. Inflation is still too low, and so the ECB is to cut rates further with the deposit rate falling to -0.5% by the end of the year where it stays through 2017. QE is likely to be extended to the end of 2017.
- Japanese growth now forecast at 0.7% this year and inflation at -0.1%. Following the strengthening of the yen, the BoJ cuts rates and adds more QE over the forecast period. Easier fiscal policy provides a temporary boost to growth is eased in 2016 and the consumption tax hike pushed out from the end of 2016 and into 2017.
- Emerging economies benefit from modest advanced economy demand growth and firmer commodity prices, but tighter US monetary policy weighs on activity. Concerns over China's growth to persist, further fiscal support and easing from the PBoC is expected.

Risks

- Risks skewed towards weaker growth on fears of secular stagnation, Brexit impact on Europe and a US recession. Inflationary risks stem from an increase in tariffs on trade, a significant wage acceleration in the US, or a global push toward reflation by policymakers.

Chart: World GDP forecast



Source: Thomson Datastream, Schroders Economics Group, August 2016 forecast. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2015	2016		Prev.	Consensus	2017		Prev.	Consensus
World	100	2.6	2.3	↓	(2.5)	2.3	2.6		(2.6)	2.7
Advanced*	62.9	1.9	1.5	↓	(1.7)	1.5	1.6	↑	(1.5)	1.7
US	24.9	2.6	1.5	↓	(2.0)	1.5	1.8	↑	(1.7)	2.3
Eurozone	19.2	1.6	1.5	↓	(1.6)	1.5	1.3		(1.3)	1.3
Germany	5.5	1.4	1.7	↓	(1.8)	1.6	1.7		(1.7)	1.2
UK	4.2	2.2	1.7	↑	(1.6)	1.6	0.6	↓	(0.8)	0.6
Japan	6.6	0.6	0.7	↑	(0.6)	0.5	1.4	↑	(0.9)	0.8
Total Emerging**	37.1	3.6	3.8		(3.8)	3.8	4.4		(4.4)	4.4
BRICs	23.8	4.2	4.4		(4.4)	4.5	5.1		(5.1)	5.1
China	14.8	6.9	6.4		(6.4)	6.6	6.2		(6.2)	6.3

Inflation CPI

y/y%	Wt (%)	2015	2016		Prev.	Consensus	2017		Prev.	Consensus
World	100	1.8	2.2		(2.2)	2.0	2.5		(2.5)	2.4
Advanced*	62.9	0.2	0.9	↓	(1.0)	0.7	1.7	↓	(1.8)	1.7
US	24.9	0.1	1.5	↓	(1.7)	1.2	2.3	↑	(2.1)	2.3
Eurozone	19.2	0.0	0.3	↓	(0.6)	0.3	1.0	↓	(1.4)	1.3
Germany	5.5	0.1	0.5		(0.5)	0.5	1.7		(1.7)	1.5
UK	4.2	0.0	1.0	↓	(1.2)	0.7	2.6	↑	(2.5)	2.4
Japan	6.6	0.8	-0.1		(-0.1)	-0.1	1.2	↑	(0.8)	0.6
Total Emerging**	37.1	4.4	4.4	↑	(4.3)	4.2	3.8	↑	(3.7)	3.6
BRICs	23.8	4.5	4.0	↑	(3.9)	3.7	3.5	↑	(3.4)	3.2
China	14.8	1.4	2.0	↓	(2.2)	2.0	2.0		(2.0)	2.0

Interest rates

% (Month of Dec)	Current	2015	2016		Prev.	Market	2017		Prev.	Market
US	0.50	0.50	0.75		(0.75)	0.92	1.25		(1.25)	1.07
UK	0.25	0.50	0.10	↓	(0.25)	0.25	0.10	↓	(0.25)	0.23
Eurozone (Refi)	0.00	0.05	0.00		(0.00)	-0.34	0.00		(0.00)	0.23
Eurozone (Depo)	-0.40	-0.30	-0.50		-		-0.50			
Japan	-0.10	0.10	-0.30	↓	(-0.10)	0.02	-0.40	↓	(-0.10)	-0.04
China	4.35	4.35	3.50		(3.50)	-	3.00		(3.00)	-

Other monetary policy

(Over year or by Dec)	Current	2015	2016		Prev.		2017		Prev.
US QE ($Bn)	4466	4487	4475	↓	(4496)		4493	↓	(4514)
EZ QE (€Bn)	203	652	1552	↑	(1548)		2512	↑	(1788)
UK QE (£Bn)	375	375	438	↑	(375)		565	↑	(375)
JP QE (¥Tn)	433	383	453	↑	(436)		493	↑	(476)
China RRR (%)	17.00	17.50	15.00		15.00		13.00		13.00

Key variables

FX (Month of Dec)	Current	2015	2016		Prev.	Y/Y(%)	2017		Prev.	Y/Y(%)
USD/GBP	1.30	1.47	1.25		(1.25)	-15.2	1.20	↓	(1.25)	-4.0
USD/EUR	1.12	1.09	1.06		(1.06)	-2.4	1.04	↓	(1.06)	-1.9
JPY/USD	101.3	120.3	100		(100)	-16.9	105	↓	(110)	5.0
GBP/EUR	0.86	0.74	0.85		(0.85)	15.1	0.87	↑	(0.85)	2.2
RMB/USD	6.64	6.49	6.85		(6.85)	5.5	7.15		(7.15)	4.4
Commodities (over year)										
Brent Crude	45.9	52.7	43.4	↓	(46.1)	-17.7	47.5	↓	(51.8)	9.5

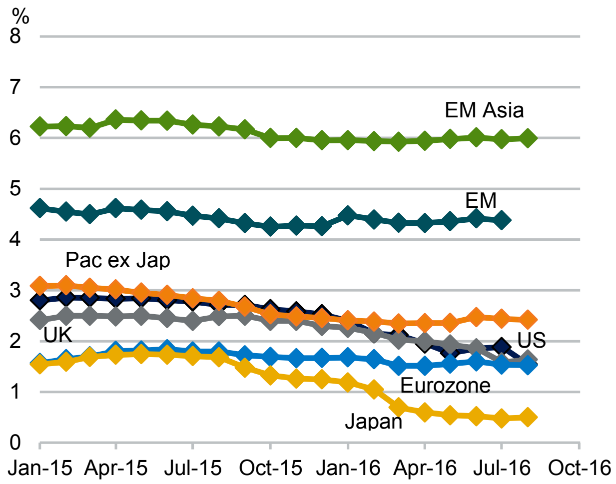
Source: Schroders, Thomson Datastream, Consensus Economics, August 2016
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 11/08/2016
Previous forecast refers to June 2016
* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.
** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia,

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

2016	2017



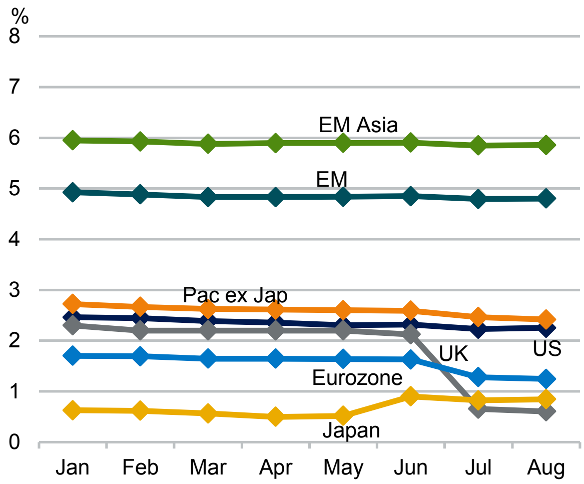
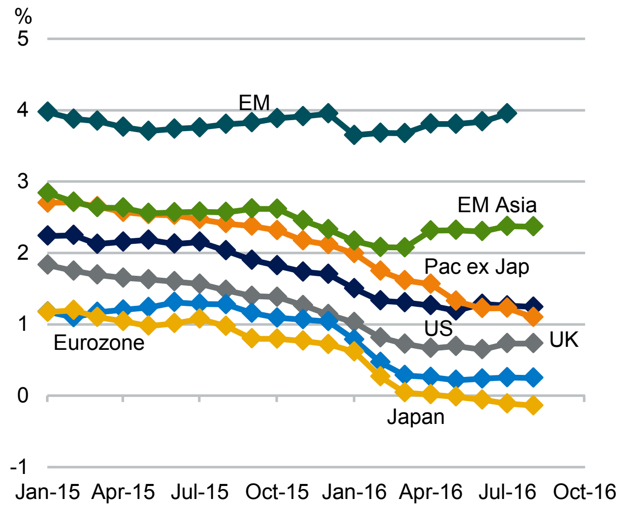
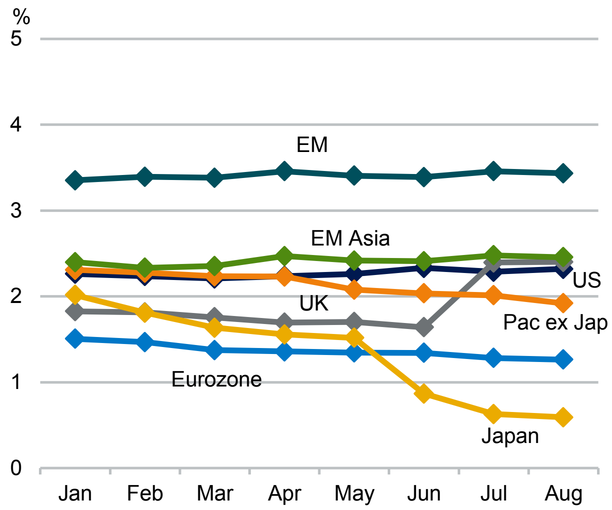


Chart B: Inflation consensus forecasts

2016	2017





Source: Consensus Economics (August 2016), Schroders.

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.

Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.