Testing Times

Sonja Gibbs
Senior Director
Global Capital Markets
Institute of International Finance
Waning global liquidity

G4 official policy rates

Central bank balance sheets

Source: national sources
Strongest U.S. growth in the rear-view mirror?

Purchasing managers’ indices—some signs of slower U.S. activity

Slowdown seen through 2019-20

Source: IIF, Bloomberg

Source: BEA, WSJ
Question marks over pace of policy tightening, implications of yield curve flattening

Correction after September payrolls, but markets and Fed still far apart

Very divided opinions on yield curve flattening

Source: IIF, Bloomberg
Markets vs. the Fed

What will the Fed Funds rate be in December 2018?
Percentage probabilities

What will the Fed Funds rate be in December 2019?
Percentage probabilities

Source: Bloomberg, Fed Funds futures prices
© FT
Hedging bets

Futures market positioning favors USD, U.S. equities...

...but net positions in U.S. Treasuries are at record shorts

Source: IIF, Bloomberg

Source: IIF, Bloomberg
Dollar path makes all the difference

How far can renewed USD strength go? What will be the Chinese reaction function?

Substantial correction across EM currency markets

Source: IIF, Bloomberg
How bad is EM contagion risk?

**EM FX correlations rising—but not to extremes**

*Average 90-day rolling correlation between percentage change in MSCI EM FX index & USD/local exchange rate*

**Inflation risk varies significantly across EMs**

Source: IIF, Bloomberg
EM fundamentals vary significantly

Rising external financing needs for many emerging markets

Source: IIF, World Bank. *external financing needs= current account deficit + amortization on medium to long-term external debt + short-term external debt

Emerging Markets: Reserve Adequacy

Source: IIF EM Scorecard
Vulnerabilities in EM bond markets

Risk aversion rising, but still a lot of differentiation among EMs

EMs with more non-resident bond ownership may be more vulnerable to a selloff

Global risk aversion, EMBIG spread, bps

Source: Haver, National Sources, IIF

foreign ownership, % of total LC government bonds

Source: IIF, Bloomberg
How cheap are EM equities?

Equity valuations have come down—but few markets look cheap

Higher corporate leverage, and higher debt service costs, are an issue for many SMEs

Source: IIF, Bloomberg

Source: IIF, Bloomberg
How long will the skew towards U.S. persist?

Remarkable shift in fund allocations towards U.S. stocks and bonds

Near-record fund underweights in EM equities, but EM bond positioning not far from “neutral”

Source: IIF, EPFR
Backdrop: U.S.-China trade tension

U.S.-China Trade Dispute Timeline: U.S. Actions

U.S.-China Trade Dispute Timeline: China Actions

Note: Only includes actions implemented or officially announced. Source: USITC, USTR, MOFCOM, IIF
U.S. vs. China—who has more at stake?

U.S. Exports to China (2017 values) and China’s Retaliatory Tariffs

- U.S. Exports to China Not Yet Targeted (approx. $20 bn) - mostly commercial aircraft/parts
- $6 bn Sec. 301 retaliation announced Aug. 3rd, effective TBD
- $3 bn Sec. 232 retaliation, effective April 2nd

U.S. Imports from China (2017 values) and U.S. Tariffs on China

- U.S. Imports from China Not Yet Targeted (approx. $267 bn) - mainly major consumer items such as cell phones, laptops, apparel
- $200 bn Sec. 301 tariffs announced July 10th, effective TBD
- $16 bn Sec. 301 tariffs, effective Aug. 23rd
- $34 bn Sec. 301 tariffs, effective July 6th
- $3 bn Sec. 232 tariffs, effective March 23rd

Source: MOFCOM, USITC, IIF
Unfinished business: NAFTA and Brexit

Trade between NAFTA members
Trade in goods in billions of US dollars

- US-Canada**
- Mexico-US*
- Canada-Mexico*

1994: North American Free Trade Agreement (NAFTA) takes effect

<table>
<thead>
<tr>
<th>Year</th>
<th>US-Canada</th>
<th>Mexico-US</th>
<th>Canada-Mexico</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Main export markets
2016: %

USA
- Canada 16%
- Mexico 14%
- China 9.2%
- Japan 4.9%
- Others 51.3%

CI
- USA 74%
- Japan 4.5%
- Others 15.1%
- Britain 2%
- Mexico 2.1%

Mexico
- USA 74%
- Canada 5.8%
- China 1.9%
- Japan 1.4%
- Others 15.5%

Sources: Mexican Economy Ministry, US Census Bureau, MIT Observatory of Economic Complexity

Post-Brexit trade options for the UK

- No deal with the European Union
  - Means no agreement at all
  - May take years to complete
  - Excludes financial services
  - Requires border controls between Ireland (EU) and N. Ireland (UK)

- No Brexit Remain in the EU after all
  - Single market
  - Customs union

- Single market with the EU
  - Must accept immigrants from single market countries
  - Must pay into EU budget and abide by European Court of Justice rulings
  - No Irish border controls

- Free trade deal with the EU
  - Revert to World Trade Organisation rules
  - Takes longer to complete
  - Excludes financial services
  - Requires border controls between Ireland (EU) and N. Ireland (UK)

- Customs union with the EU
  - No border controls
  - UK cannot make bilateral free trade deals with 3rd countries
  - Excludes financial services

Examples:
- Germany: Member of the EU
- South Korea: Prioritises sovereignty and immigration control over close economic ties
- Turkey: Common external tariff on imports
- Norway, Iceland: Free movement of goods, services, investments and people

© AFP
Warning signals for EM bond markets

Appetite for EM carry trades are at 5-year low

Source: IIF, Bloomberg
A closer look at EM portfolio flows

China—an asset class of its own?

Total Net Portfolio Flows

USD billion, cumulative non-res portfolio flows

USD billion; monthly flows through August 2018


Source: National sources, Bloomberg, IIF.
Total Non-Resident Capital Flows to EMs

Non-Resident Capital Flows to EMs and EM-DM Growth Differential

$ billion

IIF Forecast

EM-DM Growth Differential, rhs
EM (ex-China)
China

EM (ex-China)
Massive increase in global debt

Rising global debt stock

Higher corporate leverage—not only in EMs

Source: IIF Global Debt Monitor.
Higher debt levels across emerging markets

China deleveraging?

<table>
<thead>
<tr>
<th>China</th>
<th>Pakistan</th>
<th>Argentina</th>
<th>Russia</th>
<th>Kenya</th>
<th>Ghana</th>
<th>Ukraine</th>
<th>Mexico</th>
<th>Greece</th>
<th>Turkey</th>
<th>Egypt</th>
<th>South Africa</th>
<th>Poland</th>
<th>Czech Republic</th>
<th>UAE</th>
<th>Brazil</th>
</tr>
</thead>
<tbody>
<tr>
<td>Households</td>
<td>Non-fin. corporates</td>
<td>Government</td>
<td>Fin. corporates</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0</td>
<td>50</td>
<td>100</td>
<td>150</td>
<td>200</td>
<td>250</td>
<td>300</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: IIF Global Debt Monitor.

Distribution of EM debt by sector

Source: IIF Global Debt Monitor.
Shift away from EM FX debt

Growth in the EM debt universe

Big drop in FX issuance in recent months

Source: IIF Global Debt Monitor.

Source: IIF Global Debt Monitor.
Debt-related vulnerabilities

Reliance on variable rate corporate bonds

% of outstanding international bonds, shaded bars represent mature markets

Financial corporates
Non-financial corporates

FX-Denominated EM Debt, by sector

Source: IIF Global Debt Monitor.
Turkey
Near-term outlook

September 2018

Ugras Ulku, Deputy Head of EM Europe
The TRY is Undervalued.

The TRY is now significantly undervalued.
Undervalued TRY will fuel external imbalance adjustment.

Huge real devaluation since 2013.
Large Devaluations

Median GDP falls 7-10 percent, the current account swing into surplus.
High frequency growth indicators

Credit impulse has turned negative, weighing on growth in 2018H2.
EXTERNAL IMBALANCE ADJUSTMENT HAS STARTED.

Preliminary high frequency data suggests that the current account deficit turned to surplus in August while net capital inflows shifted to outflows.

Source: Haver, IIF. *July-August
The adjustment will come mostly from imports.

With the weaker TRY shifting demand away from imports while boosting exports, the current account deficit should narrow sharply in 2019.

Source: Haver, IIF.
Capital outflows weigh on growth.

Abrupt TRY depreciation is contractionary through deteriorated confidence, reduced profits, and weaker corporate balance sheets.

Source: Haver, IIF. * July-August
NEGATIVE OUTPUT GAP SHOULD HELP INFLATION TO EASE IN 2019.

If sustained, the TRY’s 20% depreciation since July will likely push the 12-month headline inflation to 22% in early 2019.
Challenging inflation outlook led to a tighter monetary stance.

Tighter monetary stance has helped attract portfolio capital inflows, lowering long-term interest rates.

Source: Haver.
Tighter fiscal stance seems needed to further improve investor confidence.

The widening in the fiscal deficit during January-July was mainly driven by a pre-election surge in capital spending from a year earlier.

Source: Haver.
NEAR-TERM OUTLOOK

• External balance
  • If sustained, undervalued TRY should lead to a sharp adjustment in the current account deficit in 2019.

• Growth
  • Capital outflows will likely lead to a decline in output during 2018H2-2019Q1 before the recovery starts in 2019Q2.

• Inflation
  • With overheating no longer the concern, large negative output gap should help inflation to ease in 2019.

• Policies
  • With economy slowing and unemployment rising, maintaining a tight policy stance might be challenging ahead of the local government elections in March 2019.