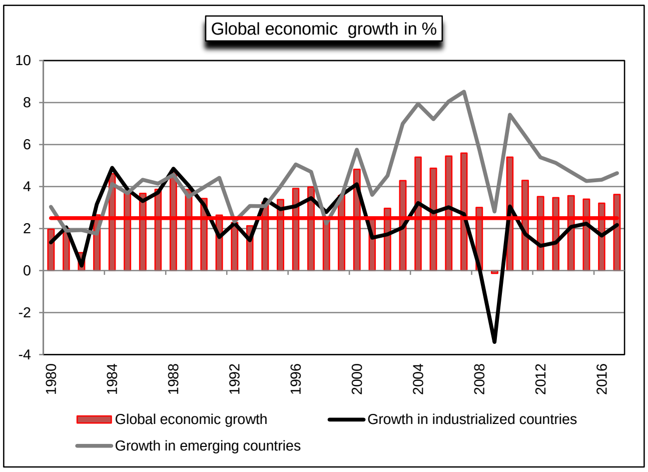
Outlook for 2018 (III): Growth in emerging countries accelerating

We dealt with the economic prospects for industrialized countries in the past two weeks. Now, we turn to the emerging countries in this third part of our outlook for 2018. Previous years saw a pattern of missed economic growth expectations, which was partly responsible for disappointing global momentum. But the tide has turned to the positive this year, and that will continue in 2018. We expect the emerging countries as a group to grow by more than 5% next year, their highest rate since 2013.

Since the 2008-2009 financial and economic crisis, the world economy has grown very unevenly and weakly compared with previous cycles. Instead of growth rates of 4%-5%, the world economy has expanded in the past years at just over 3%. The industrialized countries were mainly responsible for the slow growth at first. Later, misguided political developments in some emerging countries added to that and noticeably dampened growth. A collapse of commodity prices then intensified the negative effects in 2015. They hit bottom in spring 2016 and in most cases have significantly recovered since then. Parallel to that, economic prospects for emerging countries have also improved.



In its latest forecast, the International Monetary Fund (IMF) predicts that growth in the emerging countries will accelerate next year from 4.6% to 4.9%. However, it is notable that the IMF is generally very cautious in its outlook and points out many remaining risks. In our opinion, based on the strong economic momentum observed now, it is very likely that actual economic development in these countries in 2018 will turn out better than initially forecast, as it already has this year. Many forecasters are exercising caution mainly because their growth expectations were almost always too optimistic in the years after the financial crisis. By now, they have recognized the forecasting errors of the past and "learned" from them to make more cautious assessments (theory of adaptive expectations: previous forecasts are compared with actual results and new expectations take into account past mistakes). But this caution for 2018 is misguided. We expect economic growth of over 5% in the emerging countries.

China: Continuing solid growth despite weaker real estate market

Economic conditions have improved in almost all emerging countries in the past months. If the IMF forecasts are correct, economic output will decline this year in only 12 of the 154 countries classified as emerging markets compared with last year (among those affected, Venezuela is the largest). And the IMF forecasts a recession for only five of these countries in 2018. That is the lowest number since 1980. We consider it likely that economic growth in the emerging countries will accelerate further next year. A rate of just under 5% will be achieved in 2017, and the rate in 2018 should be higher than that. China, the world's second-largest national economy and by far the largest emerging country, is playing a decisive role in this development. This year, the Chinese economy will grow by 6.8% year-on-year and hence even somewhat more strongly than in 2016. That is primarily attributable to continuing strong domestic demand, but also to the recovery of export business due to the upswing of the world economy and global trade. Somewhat less economic momentum seems likely in 2018, mainly as a result of a weakening real estate market. After house prices shot up in 2016 in many cities, the Chinese government and central bank began deliberately braking the market earlier this year by tightening lending terms and limiting the possibilities of purchasing a (second) home. However, after the recent price declines, the reins might be loosened again somewhat next year, so economic growth should slow only moderately. The IMF forecasts a growth rate of 6.5% for 2018, and China has regularly grown somewhat more strongly than originally expected by the IMF in the past years. This could happen again in 2018.

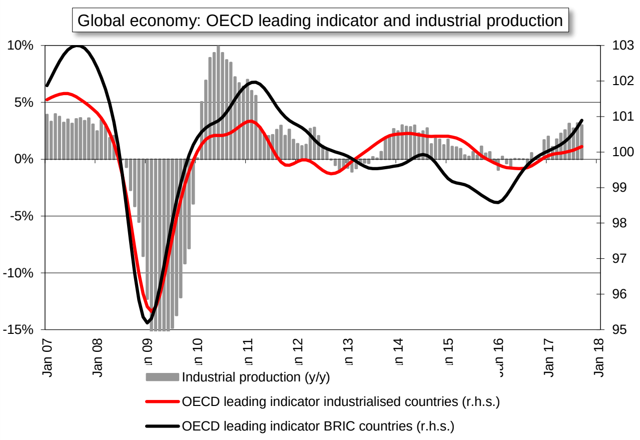
India: Economic policy reforms make for temporary uncertainty

In the other three big emerging markets, India, Brazil, and Russia, economic growth is likely to accelerate in the coming year. Growth has been slowed in India this year by the government's action to demonetize large banknotes at the end of 2016 and the "big" tax reform at mid-year, which introduced a new single tax to replace hundreds of existing levies. Uncertainties associated with these measures have proven an impediment to capital investment this year. However, the planning risks for corporate spending should gradually recede, thus allowing the Indian economy to grow by more than 7% again in 2018. But a certain risk remains that capital investment might continue to be weak, if business confidence in the Modi government's economic policies should be substantially damaged.

Russia and Brazil: Stimulus from continuing commodity price recovery and loose monetary policy

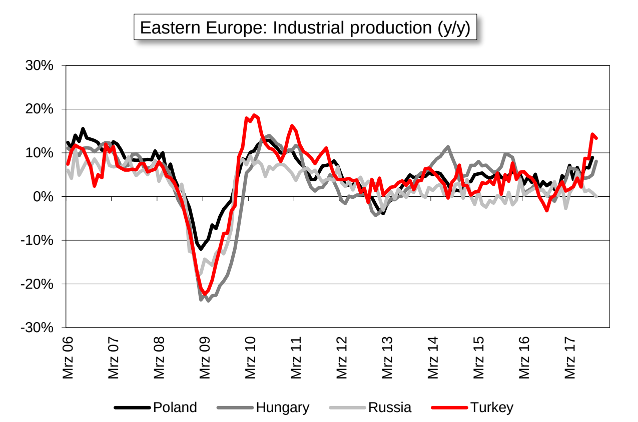
As principal beneficiaries of the ongoing commodity price recovery, Russia and Brazil will continue to catch up economically next year after deep recessions in 2015 and 2016.

In contrast to the IMF, which forecasts somewhat weaker economic momentum for the two countries next year, we expect accelerated GDP growth of at least 2% for each. In both countries, exports are now growing at about 20% year-on-year. Declining unemployment and simultaneously falling inflation rates are increasing consumer purchasing power, so greater growth impetus will come from domestic demand in both countries next year. Moreover, the more expansionary monetary policy of the Russian and Brazilian central banks is supporting growth. The Russian central bank has lowered interest rates this year by 175 basis points, and the Brazilian central bank has done the same by no less than 625 basis points.



Eastern Europe: Finally back on growth track after long lean period

Growth prospects have improved in all three major emerging regions, Asia, Latin America, and Eastern Europe. China is the most important trading partner for the Asian emerging markets, so they track the current economic situation in that country. A similar picture may be found in Latin America. Because of its geographical proximity, the US economy is an important factor, but the influence of commodity prices on the economy is even more dominant. For countries like Brazil, Chile, and Peru, the prices of iron ore, copper, and nickel play a crucial role in whether the economic situation improves or worsens. China now accounts for more than 50% of global demand for the most important industrial metals, so its influence on many Latin American economies is enormous.



The situation looks different in Eastern Europe. A close economic connection with Western Europe is crucial for the economic outlook of these countries going forward. Even though the political situation in some parts of Eastern Europe (mainly the south) deserves critical scrutiny, the economy in most of the region's countries has strongly recovered. The European Bank for Reconstruction and Development (EBRD) has just revised its growth forecasts sharply upward for Turkey, Latvia, Slovenia, Estonia, Rumania, and Poland. If the Chinese economy should develop less strongly than we expect, that would have direct negative effects on many countries in Asia and Latin America. Eastern Europe, on the other hand, would be relatively immune, as long as a new crisis does not arise in Western Europe. Growing exports to the euro zone and domestic demand stimulated by higher wages can shelter Eastern Europe, at least for some time, from the negative consequences of an unexpected economic weak spell in China.

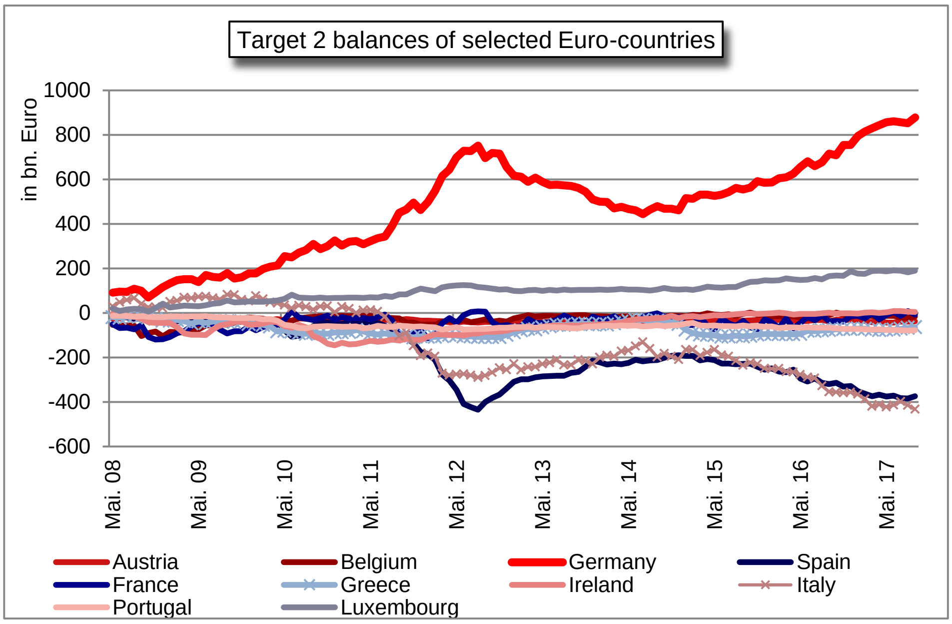
To investors, this means that both stocks and bonds from emerging countries are and will remain an interesting option for one's portfolio. But in view of the good economic situation, the stock markets in the industrialized countries also still have more price potential. We do not find bonds from those countries attractive except in isolated cases. Now that we have expounded our detailed economic outlook for the world economy in three parts, we will present the specific recommendations that follow from in it in the next two weeks. We will then also publish our concrete price targets for the stock markets and our interest rate and exchange rate forecasts.

Weekly outlook for December 4-8, 2017

	July	Aug.	Sept.	Oct.	Nov.	Dec.	Release
DE: PMI, services, final	53.1	53.5	55.6	54.7	54.9		December 5
DE: New orders, m/m	-0.4%	4.1%	1.0%	-0.2%			December 6
DE: New orders, y/y	5.2%	8.5%	9.5%	6.0%			December 6
DE: Industrial production, m/m	-0.1%	2.6%	-1.6%	0.8%			December 7
DE: Industrial production, y/y	4.1%	4.5%	3.5%	4.4%			December 7
DE: Exports, m/m	0.5%	2.0%	-0.4%	0.3%			December 8
DE: Exports, y/y	8.0%	7.5%	7.7%	7.3%			December 8
DE: Imports, m/m	1.8%	0.8%	-1.0%	0.2%			December 8
DE: Imports, y/y	9.6%	8.4%	7.5%	6.5%			December 8
EUR19: Sentix	28.3	27.7	28.2	29.7	34.0	32.0	December 4
EUR19: Producer prices m/m	0.0%	0.3%	0.6%	0.2%			December 4
EUR19: Producer prices y/y	2.0%	2.5%	2.9%	2.4%			December 4
EUR19: PMI, services, final	55.4	54.7	55.8	55.0	56.2		December 5
EUR19: Retail sales, m/m	0.0%	-0.1%	0.7%	0.4%			December 5

MMWB estimates in red

Chart of the Week: A toast to the next 10 years



The second generation of the Trans-European Automated Real-time Gross Settlement Express Transfer System (Target2) celebrated its tenth anniversary on November 19 – a good opportunity for us to reflect. Target2 is a platform used to settle cross-border payment transactions among the central banks of the euro area countries. Without wishing to go into detail, we may observe that a country's having a negative balance means a net outflow of money from that country. At the same time, a negative balance also means that the country, or its central bank, has net payables to the Eurosystem, and a positive balance that the country has net receivables. Germany has been the country with the highest receivables since Target2 was established. There can be different reasons for such Target2 balances, and capital flight is one of the most important. That became particularly clear during the European debt crisis in 2012. While capital flowed out of Spain, Greece, and Italy, among others, huge negative balances accumulated in those countries. Since a large part of the capital migrated to Germany, its receivables increased to EUR 750 billion at the peak of the crisis. As the crisis subsided, some of the capital found its way back to the countries from which it came, and the Target2 balances shrank. The balances thus seem to be very suitable as crisis indicators. The current rise of such balances to new record highs is therefore a cause for concern. Germany's balances are about to reach the one-trillion threshold. However, there is reason to doubt that the cause here is also capital flight from periphery countries. A different explanation is closely connected with the ECB's bond purchase program and is therefore technical in nature. Regardless of the exact cause, however, the increased balance poses considerable financial risks for Germany. It is very unlikely, for example, that Italy would pay its Target2 debts of nearly EUR 400 billion if it were to leave the euro system. Ultimately, this means that Germany is sitting on a big mountain of at least doubtful receivables, since it is not clear what part the ECB could or would be willing to settle in a crisis.

Stock marktes	As of 01.12.2017 11:33	Change versus 24.11.2017 -1 week	31.10.2017 -1 month	31.08.2017 -3 months	30.12.2016 YTD
Dow Jones	24272	3,0%	3,8%	10,6%	22,8%
S&P 500	2648	1,7%	2,8%	7,1%	18,3%
Nasdaq	6874	-0,2%	2,2%	6,9%	27,7%
DAX	12886	-1,3%	-2,6%	6,9%	12,2%
MDAX	26744	0,2%	0,3%	8,4%	20,5%
TecDAX	2498	-2,8%	-1,8%	9,0%	37,9%
EuroStoxx 50	3540	-1,2%	-3,7%	3,5%	7,6%
Stoxx 50	3141	-0,9%	-2,6%	3,3%	4,3%
SMI (Swiss Market Index)	9296	-0,3%	0,6%	4,2%	13,1%
Nikkei 225	22819	1,2%	3,7%	16,1%	19,4%
Brasilien BOVESPA	71971	-2,9%	-3,1%	1,6%	19,5%
Russland RTS	1129	-3,2%	1,4%	3,0%	-2,1%
Indien BSE 30	32833	-2,5%	-1,1%	3,5%	23,3%
China Shanghai Composite	3318	-1,1%	-2,2%	-1,3%	6,9%
MSCI Welt (in €)	2077	0,6%	-0,3%	5,3%	5,0%
MSCI Emerging Markets (in €)	1121	-3,1%	-2,1%	2,3%	15,1%
Bond markets					
Bund-Future	163,14	28	39	-194	-101
Bobl-Future	131,72	7	-6	-142	-191
Schatz-Future	112,23	2	-4	-4	-6
3 Monats Euribor	-0,33	0	0	0	-1
3M Euribor Future, Dec 2017	-0,33	0	0	0	0
3 Monats $ Libor	1,48	1	10	16	48
Fed Funds Future, Dec 2017	1,29	0	2	9	0
10 year US Treasuries	2,38	4	0	26	-7
10 year Bunds	0,34	-3	-3	5	13
10 year JGB	0,03	0	-3	3	-1
10 year Swiss Government	-0,14	-2	-7	0	6
US Treas 10Y Performance	580,51	-0,5%	-0,2%	-1,9%	1,9%
Bund 10Y Performance	613,52	0,0%	0,0%	0,0%	0,7%
REX Performance Index	482,90	-0,1%	-0,2%	-0,3%	-0,5%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,69	1	6	1	2
IBOXX BBB, €	1,17	0	5	-11	-33
ML US High Yield	6,17	3	15	8	-28
JPM EMBI+, Index	831	0,0%	-0,8%	-1,1%	7,6%
Convertible Bonds, Exane 25	7381	0,0%	0,2%	3,3%	6,7%
Commodities					
CRB Spot Index	429,43	-0,8%	0,4%	-1,5%	1,5%
MG Base Metal Index	338,33	-2,8%	-1,8%	-0,9%	20,9%
Crude oil Brent	63,31	-0,4%	3,6%	21,0%	11,6%
Gold	1276,70	-0,9%	0,6%	-3,0%	10,3%
Silver	16,33	-4,0%	-2,0%	-7,1%	1,7%
Aluminium	2034,00	-3,9%	-5,0%	-3,1%	19,4%
Copper	6735,00	-3,5%	-1,2%	-0,4%	21,9%
Iron ore	63,36	1,3%	5,1%	-15,6%	-20,6%
Freight rates Baltic Dry Index	1578	8,2%	3,7%	33,3%	64,2%
Currencies					
EUR/ USD	1,1907	0,3%	2,3%	0,7%	13,0%
EUR/ GBP	0,8821	-1,3%	0,6%	-4,4%	3,3%
EUR/ JPY	133,85	1,2%	1,4%	2,3%	8,5%
EUR/ CHF	1,1708	0,5%	0,7%	2,3%	9,0%
USD/ CNY	6,6070	0,0%	-0,4%	0,2%	-5,0%
USD/ JPY	112,54	0,9%	-1,0%	2,3%	-3,7%
USD/ GBP	0,74	-1,0%	-1,6%	-4,5%	-8,4%

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