Current capital market report on the Emerging Markets

emreport

Global overview

EM equity markets are suffering from higher inflation, rate hikes and pressure on many companies' profit margins

Developments on the stock markets in the Emerging Markets (EM) were varied in April. While the underlying trend was rather weak in Latin America and Asia especially, Eastern Europe stood out with some very handsome gains. Most of the EM in Asia and Latin America were thus unable to keep up with the sustained good performance seen on the US stock markets. Basically, the negative factors were the same ones seen in the previous weeks and months: rising rates of inflation, more threats of interest rate hikes or actual central bank moves to increase rates (leading to worries about a sharp slowdown in growth in the EM) and high commodity prices. The last factor is a double-bladed sword for the EM: while commodity exporters are profiting massively, the rising material and commodity costs are already having a tangible negative impact on profit margins for many EM companies.

Over the medium term, the USA is at risk of losing its highest credit rating – financial markets and the government are (still) unimpressed by this however

With the speed that is typical on the markets these days, investors' attention shifted away from the nuclear accident in Japan as soon as it became clear that no further escalation of the situation was expected. In light of the sometimes blundering information policy of the operator TEPCO and the Japanese government, a healthy portion of scepticism is called for in relation to any news of success however. Nevertheless, for the financial markets, the biggest (and most unquantifiable) risk for the Japanese equity market is no longer a major topic for the time being. Of course, over the medium to long term, the main problem continues to be Japan's enormous public debt. In this regard, however, there will not probably be any acute risks over the short term, as this factor will likely unfold its impact over the coming years. Consequently, it does not currently play a role for most investors, who take an increasingly short-term perspective on things. The same holds true in relation to the creditworthiness of the USA, but to a more limited degree. The rating agency S&P has even gone as far as issuing a warning about the risk of the USA losing its top notch AAA rating in the years ahead. Ultimately, the markets showed no significant reaction to this however. Of course, generally speaking, this raises some interesting questions: if the USA, the world superpower and holder of the world's reserve currency, loses its highest-level rating, then what will be left that deserves the highest rating and what will the highest rating mean then anyway? And how long can the US dollar continue to function as the world's reserve currency if the creditworthiness of the issuer is increasingly questionable? This last aspect seems to be a key factor behind the rapid increases in the price of gold and silver. Precious metals are becoming more and more respected again as currency around the world, in particular in the Emerging Markets such as China and India.

For the US central bank, the weakening dollar obviously does not seem to be a problem, and certainly not a result of its extremely loose monetary policy. At the eagerly awaited press conference, Fed chief Bernanke at least announced that the current programme for purchasing government bonds (QE 2) would come to an end around mid-year. At the same time, he

adjusted the economic forecasts slightly downwards. For the foreseeable future it does not look like there will be any hikes in interest rates in the USA.

The EM economies in Asia and Latin America remained on track for growth on the whole, and GDP and industrial production levels are now well higher than the level from before the onset of the global economic and financial crisis. At the same time, however, the pace of growth has slowed sharply in some countries. Economies in Central and Eastern Europe also continue to recover. Employment is picking up thanks to an upturn in industrial production driven by vigorous external demand. In general, slight declines in price levels have been seen recently, after a period of inflationary pressure earlier in the year due to rising food prices. The overall outlook for the CEE currencies is still positive – foreign trade and the prospects of rising interest rates should provide more support as well.

Country focus

China

China's monetary authorities hike interest rates more, as the growth outlook weakens slightly but remains very robust

Just a few months ago, many were worried about the Chinese economy overheating, but now there are mounting worries that the central bank's policies will slam the brakes too hard on economic activity. The last round of purchasing managers' index data was the weakest in the last six years and since the beginning of the year the official growth projection has been adjusted down by around one percentage point from almost 10% to the current figure of 8.8%. Of course, this still represents a very quick pace of growth. Nevertheless, it remains to be seen whether inflation will ease starting from mid-year, in line with the projections and hopes. If not, there may be more rate hikes, which would further dampen economic activity.

The Chinese equity market has not been able to follow the positive performance of the US markets and booked a mild decline in LCY terms in April. Investors are clearly still sceptical about the development of corporate earnings and profit margins. The IT sector held up best.

India

Sharp rate hikes by the Indian central bank

In India, the central bank decided on a surprisingly strong rate hike of another 0.50%, admitting that it had underestimated the inflation dynamics. Banking stocks and carmakers came in for more pressure as a result, due to the ensuing gloomier growth outlook. The reporting season on the annual results of Indian companies was mixed. Several companies fell short of expectations and suffered sharp declines in stock prices as a result. In particular, many releases on profit margins were disappointing and reflected the generally intense pressures on costs, especially in consumer goods.

Brazil

Growth slowing down, but persistently high inflation is hampering prices of Brazilian stocks

In Brazil, the economic data point to a significant slowdown in growth. For 2011, a growth rate of just 4% is now anticipated and the latest purchasing managers' index reading was just over the 50-point mark, which separates expansion from contraction. At the same time, inflation remains stubborn and has forced the central bank to raise interest rates by another 25bp again, bringing the key rate to 12%. Market consensus is looking for a key rate of 12.5% at the end of the year. Due to worries about further appreciation of the Brazilian real, the central bank had recently opted for "alternative measures" to curb lending growth, rather than interest rate hikes. For example, inflows of capital were to be checked with more taxes and other measures, and in order to reduce growth in lending, the minimum reserve rates for banks were increased, in particular on short-term car loans and payroll loans. The desired results, however, have not been seen for the most part.

The equity market in Brazil came under pressure in April again, due to the gloomier growth outlook, worries about inflation and fears of rate hikes. Along with residential builders and real estate companies, sharp losses were booked for cyclical sectors in particular, such as steel producers. As in the previous month, telecom shares held up relatively well. Thanks to their low valuations and the persistent inflation, these stocks are becoming more and more interesting, as their earnings tend to increase in line with the broader rise in price levels. In terms of the Bovespa index, the upside potential for the equity market looks limited for the time being.

Russia

Investors are reserved on Russian stocks despite more increases in oil prices

Inflationary pressure has only eased minimally in Russia. At the end of April, the central bank raised the key rate to the current level of 8.25%, in a move which took many market participants by surprise. The stronger rouble (versus the US dollar) also helps to dampen inflation. The rouble has mainly appreciated on the back of the rising oil prices in recent months. On the whole, yields on Russian bonds hardly changed in month-on-month terms.

Russia's stock market developed weaker than the other markets in the region during April. Several new stock issues hampered performance and the price gains seen in recent months prompted investors to a more cautious approach. Most market players are sceptical as to whether oil prices can remain so high and are thus taking a more reserved view of oil stocks. Additionally, new rumours about new taxes on the oil industry also impeded the market. Gas stocks showed the best price performance in April, whereas steel and banks were weak.

Turkey

Turkish C/A deficit still looks problematic – inflation appears under control for now, but risks from commodity prices remain

With a gain of 9.2% yoy, Turkey's economic growth in 2010 was significantly higher than generally anticipated. Although the year-on-year rate of inflation is currently on a strong downward trend, this is not part of a sustainable disinflationary trend. Turkey's dependency on commodity imports and the very robust, sustained domestic demand continue to be factors which pose a significant threat to long-term price stability. The central bank's latest inflation forecast for Q2 2011 was published at the end of April and featured an increase in inflation expectations, in particular due to the higher oil price. In April, the central bank left the key rates unchanged in line with expectations, after having lowered rates twice in the previous months. In order to help alleviate the imbalance in foreign trade, however, the minimum reserve rates for banks were raised. The Turkish lira continues to be the weakest currency in the region, which is perfectly fine with the country's central bank. In the first two months of the year, there were intense increases in yields on Turkish LCY bonds, but in April yields moved on a downward trend overall. If the current world market developments in oil and food prices continue, the outlook for inflation in Turkey could deteriorate very quickly again. In turn, this could prompt a response by the central bank, but also create the potential for a stronger currency again as a result.

Share prices on the Istanbul stock exchange trended higher in April. Apparently, it was domestic investors who were mainly interested in buying. The increase in prices, however, can primarily be seen as a reaction to the previous sub-average performance by Turkish stocks. Over the short and medium term, there are hardly any triggers in sight for sustained increases in share prices, and thus we do not expect to see any major gains in Turkey for the time being.

Poland

Inflation keeps rising in Poland – strongest equity market in the region in April

Poland's economy continues to look robust, with real growth of 4.4% in 2010. One of the main growth drivers was domestic demand. The latest retail sales data and the industrial sales figures reflect more unbroken strong growth in year-on-year terms. Inflation rose to 4.3% (annual rate), and thus exceeded the central bank's target even more than previously and was above market participants' expectations as well. This means that more rate hikes by the central bank are likely during the course of the year. Gains were registered for Polish government bonds and the zloty was the strongest currency in the region in April.

The Polish stock index continued its positive performance from March and posted a gain of 3.4% in LCY terms – for EUR-based investors the gain was even stronger at almost 6% thanks to the appreciation of PLN. With this, Poland was one of the most robust equity markets in the region in April. In contrast to March, Polish banking stocks saw sub-average performance, whereas oil&gas shares posted strong gains.

Czech Republic

Strong export business – weak domestic conditions

Unemployment has hardly dropped since the crisis

One of the most striking aspects in the Czech Republic continues to be the discrepancy between accelerating economic growth last year on the one hand and persistently weak private consumption on the other. On the whole, the Czech economy has bounced back quite strongly from the levels seen during the crisis, supported by robust external demand, especially from Germany. Exports and imports are growing at high year-on-year rates, and industrial production is at a much higher level. But so far the upturn does not seem to be having a broader impact on the domestic economy. Retail sales are only improving slowly from the crisis levels, which is undoubtedly due to the persistently high rate of unemployment. Unemployment has hardly dropped from the high levels seen during the global economic and financial crisis. Inflation, on the other hand, has been surprisingly benign recently, dropping to an annual rate of 1.7% and thus remaining in the central bank's comfort zone. From the perspective of price stability, this is certainly a positive development, but at the same time it underlines the impression of weak domestic conditions. Yields on Czech bonds dropped in April and together with the firmer Czech koruna this resulted in quite positive performance for EUR-based investors.

A mild gain of around 1.5% was registered for the Czech equity market in April, but this market still limped behind the performance of most regional peers yet again. The utility CEZ and the oil company Unipetrol stood out.

Hungary

Controversial amendments to the Constitution passed in Hungary

Surprisingly strong rise in inflation undermines hopes of any cuts in interest rates

Hungary's economy grew at a rate of 1.9% in 2010, thanks mainly to higher exports, whilst domestic demand remained slack. Hungary is thus also mainly profiting from external demand, which is reflected in the robust trade balance amongst other things. The forint was slightly stronger against the euro in April. Hungarian bonds were also able to post gains and yields fell over the month. Over the long term, the level of Hungarian yields still looks attractive. Nevertheless, prices will remain volatile, particularly in light of the ongoing questions about the new government's reform plans. Constitutional amendments were passed in April which in the future set a ceiling of 50% of GDP for public debt (currently, of course the debt ratio is just over 80%) and a change in the process of nominating members of the Fiscal Council. At its last meeting in April, Hungary's central bank left interest rates unchanged at 6% again. Since March, the composition of the monetary policy council is new, as four of the seven members were replaced. Many market participants expected less upward pressure on key rates as a result, and some were even looking for rate cuts during the rest of the year, as long as inflation subsides in H2 2011. But annual inflation surprised negatively in April again and this means that monetary policy easing is less likely in the months to come.

The Hungarian stock market remains on its positive trend seen since the beginning of the year and managed a gain of almost 5% in local currency terms, driven by the index heavyweights OTP and MOL, whereas the rather defensive pharmaceutical names saw prices fall.

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