A tale of two business cycles
By Jan Dehn

Developed economies continue to grow slower than before their 2008/2009 crisis despite hyper-easy monetary policies and very expansionary fiscal policies. By contrast, Emerging Markets (EM) economies are experiencing accelerating growth without the help from Quantitative Easing (QE), ultra-low interest rates and tremendous fiscal stimulus. EM economies are in normal business cycles and experiencing an upswing, which will spread to domestic demand as capital flows back to the asset class. EM central banks will hike rates in order to contain inflation expectations. Hence, the Korean rate hike last week is a harbinger of things to come. In the coming years we expect EM central banks, not their counterparts in developed economies, to lead the global rate hiking cycle. We expect EM central banks to hike sooner, faster and eventually by more than developed market central banks against a backdrop of stronger growth. This is a tale of two business cycles – a normal one in EM and an abnormal one in developed economies – and it bodes well for EM currencies.

Emerging Markets

Though modest in size and couched in dovish language, the Bank of Korea’s 25bps rate hike of the policy rate to 1.5% is an indication of things to come across the wider EM universe. The undisputed consensus in financial markets today is that the US Fed will lead the global hiking cycle. However, this consensus is likely to be proven wrong, in our opinion. Instead, we think EM central banks will lead the global hiking cycle and that developed market central banks will be hard pressed to match the pace of hikes. In turn, this will have negative implication for developed market currencies.

There are material differences in the business cycle dynamics of EM countries and developed market countries. Developed economies are stuck in so-called ‘new normal’ business cycles characterised by substantially reduced trend growth rates relative to past trend growth rates. Their central banks are also seriously constrained in terms of their abilities to normalise rates on account of overvalued asset prices and inadequate tools to ease in case of recession. By contrast, EM countries are experiencing perfectly normal business cycle dynamics and look set to experience major upicks in growth in 2018 as domestic demand kicks in on the back of the resumption of inflows to EM’s local markets.
Why have EM countries and developed countries become stuck with such different business cycle dynamics? The main reason is that developed economies face structural problems, while EM economies have mainly been in the grip of a cyclical downturn, which is now rapidly dissipating. Consider each in turn:

The developed market crisis of 2008/2009 was a debt and banking crisis. Developed economies reached the crisis point after decades of poor regulation and accumulation of debt. They responded to the crisis almost exclusively by easing monetary policies to an unprecedented degree, but neglected entirely to fix their underlying structural problems. In fact, the problems have arguably been compounded by the accumulation of even more debt and the creation of huge asset bubbles. These policies created a positive mood in financial markets, but the refusal to reform and the lack of investment, private and public, have contributed to a steady decline in productivity and rising income inequality, which is now leading to ever more protectionist and populist government policies. This does not bode well for future economic prospects in developed economies. Moreover, as the most stimulatory phase of monetary policy comes to an end, the drag on very indebted economies may well increase and the risk of serious instability in overbought financial markets increases.

EM’s business cycles are distinctly different. Most importantly, EM countries are generally not burdened by the same structural constraints, which dog developed economies. The sharp decelerations in EM growth rates during the QE years from 2010-2015 was distinctly cyclical in nature and largely out of the control of EM governments. Specifically, the primary reason for slower EM growth was massive capital flight over a sustained period as global asset allocators withdrew about a third of their allocations to EM in favour of chasing returns in the QE sponsored stock and bond markets in the developed world. EM economies were severely finance constrained even before these inflows, which therefore severely tightened credit conditions in EM economies. Of course, the outflows also materially raised local bond yields. In fact, on no fewer than three occasions were local currency government bonds yields pushed higher than 7.2%, which is a higher yield than the average yield of 7%, which prevailed between 2003 and 2007, when the Fed funds rate reached 5.25%. It is quite remarkable to contemplate that in the middle of the largest easing episode in world monetary history EM countries were in effect forced to price in a full normalisation of US monetary policy in their local bond markets solely due to investor behaviour.

Be that as it may, the economic consequences of dramatically tighter financial conditions were classic. EM experienced a cyclical downturn of the type, which all normal countries undergo when real rates rise and credit conditions tighten. The silver lining is that such downturns ultimately cure themselves. Prices and wages decline and currencies adjust, and soon real exchange rates become competitive enough to enable exports to rise. As employment and incomes rise with growing activity in the export sectors, soon domestic demand begins to pick up as well until eventually the economy returns to full employment at the same trend growth rate, which prevailed before the downturn.

This is the exact recovery dynamic currently underway in most EM countries. Cast a quick glance at the Snippets section below and over the past couple of months – there is a lot of strong economic data coming out of EM these days. The business cycle is most advanced in Asia, but Eastern European countries are not far behind and Latin America and Africa look set to follow suit over the next couple of years. Most EM economies began to experience quite strong export-led recovery in early 2016, which is why the EM-developed market growth differential began to pick up in favour of EM some two years ago. The year 2018 looks set to usher in the next phase of EM growth, namely domestic demand-led growth. Credit conditions are continuing to ease on the back of a resumption of capital flows into EM’s local markets, which have been supremely the best performing bond and stocks markets in the world over the last two years. Notice that the resumption of domestic demand implies a material uptick in EM growth rates, since domestic demand is nearly three times larger than exports as a share of EM GDP.

Central banks in EM and developed economies also face very different constraints and priorities. EM central banks can be relied upon to respond to the pickup in domestic demand in a prudent manner. Their central objective is to ensure that inflation expectations remain well anchored. Stronger consumption and investment will begin to put upwards pressure on the prices of non-tradeable goods and services, which are naturally limited in supply. Capital inflows to EM are also strongly associated with higher inflation despite short-term deflationary FX pass-through effects that operate via the prices of tradeable goods and services in CPI indices. EM central banks are very likely to hike at the first signs of inflation and they have strong political backing for doing so. After all, EM populations are not exactly replete with inflation hedges, so their tolerance for accelerating prices is very low indeed. That does not mean that rate hikes will be draconian. At roughly 3.5% yoy, the average index weighted EM inflation rate is still materially lower than its long-term average, but we expect inflation to gradually drift back up towards 5% by 2021 and EM central banks will want to be ahead of this move.

Unlike their cousins in EM, developed market central banks do not have healthy positive real policy rates with plenty of room to cut in the event of downturns. Also, their financial markets are in bubble territory after years of QE policies. The economic and financial risks associated with hiking rates are therefore much higher. The
primary concerns of developed market central bankers will therefore, continue to be to avoid pricking
distended asset bubbles and/or triggering recessions.

These differences in the nature of business cycles and central bank objectives in EM and in developed
countries implies that the pace, speed and extent of rate hikes in EM will ultimately be greater than in
developed economies. In other words, EM will lead the global hiking cycle, not the developed economies. The
notion that EM countries will lead the global hiking cycle is not consensus as markets continue to obsess
about US Fed hikes. Our view is that developed market central banks, including the Fed, will in fact be
seriously challenged to match the pace of EM rate hikes over the next couple of years as EM growth picks up
in earnest. Indeed, even if inflation eventually resumes in developed economies, central banks may still opt on
the side of easier policies in order to protect growth and avoid asset price collapses.

The implications for currencies are clear: the outlook for developed market currencies, including the US Dollar
continues to look bearish. The combination of stronger growth and more aggressive paths for policy rates in
EM are powerful drivers of currencies and should enhance the attractiveness of EM currencies. This is why
we think the trend of higher EM currencies versus the Dollar, which began two years ago will continue for
several more years from a low starting point.

- **Brazil**: Real GDP growth accelerated sharply to 1.4% yoy in Q3 2017 from 0.4% yoy in Q2 2017. The primary
  fiscal balance also went into a surplus to the tune of BRL 4.8bn in October versus BRL 4.1bn expected. This
  resulted in lower public sector debt: 50.7% of GDP down from 50.9% of GDP in September. It also means
  that the 12-month trade surplus declined slightly to USD 66.5bn in November from USD 67.7bn in October.

- **Mexico**: Alejandro Dias de Leon replaced Agustin Carstens as Mexico's next Central Bank Governor. Former
  Finance Minister Jose Antonio Meade will run for President for the ruling PRI party and PEMEX’s former CEO
  Gonzalez Annaya will be Mexico’s new Finance Minister. The quality of senior economic officials across the
  entire civil service in Mexico is consistently high. Economic policies will not change. Hence, these transitions
  should not be market moving, in our view. Exports grew at a rate of 7.7% yoy in October versus 4.7% yoy in
  September and remittances from overseas workers in October were 19% higher than in the same month
during the year prior.

- **South Africa**: Deputy President Cyril Ramaphosa appears to be leading the race for the job of ANC leader
  against Zuma-candidate Nkosazana Dlamini-Zuma. However, not all votes have been counted yet and the race
  is tight. David Mabuza of Mpumalanga province may yet emerge as kingmaker. Producer prices inflation was
  0.7% mom in October, in line with expectations. The government announced that it will cut spending by USD
  1.8bn over the next three years. The trade balance was much stronger than expected in October (ZAR 4.6bn
  in surplus versus an expected deficit of ZAR 5.5bn). Manufacturing PMI increased from 47.8 in October to
  48.6 in November.

- **Philippines**: The Senate approved a tax reform. A version of the tax reform has already been passed in the
  House of Representatives. The two bills will now be reconciled. Revenues will rise by about 1% of GDP and
  there will be a temporary increase in inflation due to fuel excise duties and other taxes.

**Snippets:**

- **Argentina**: Moody’s raised Argentina sovereign debt rating by one notch to B2 from B3 with stable outlook.
  Industrial production firmed to a solid pace of 4.4% yoy in October compared to 2.3% yoy in September.

- **Chile**: Manufacturing production accelerated to a pace of 0.6% yoy in October from -1.4% yoy in September.

- **China**: The official PMI manufacturing index increased to 51.8 in November from 5.6 in October. This
  was better than expected (51.4). New orders rose strongly and prices declined. The Caixin manufacturing PMI
  moderated slightly to 50.8 in November from 51 in October.

- **Egypt**: The government imposed a 1% fee on portfolio inflows in order to discourage excessive appreciation
  of the currency. There was no change in the fee charged for investors wishing to pull money out of Egypt.

- **Hong Kong**: The rate of growth of retail sales moderated to 3.9% yoy in October from 5.7% yoy in
  September.

- **India**: The real economy was 6.3% greater in Q3 2017 than in the same quarter of 2016, which was a
  significant step up from 5.7% yoy growth in Q2 2017. Manufacturing PMI accelerated sharply to 52.6 in
  November from 50.3 in October.

- **Indonesia**: The November rate of CPI inflation was lower than expected at 3.3% yoy versus a market
  consensus of 3.4% yoy.

- **Kenya**: Incumbent Uhuru Kenyatta was sworn in as President of Kenya. The country remains divided after
  controversial elections.

- **Malaysia**: The fiscal deficit year to date was lower than at the same point last year. The deficit stood at
  MYR 37.2bn versus MYR 37.5bn at this point in 2016.
Emerging Markets

- **Peru:** Headline inflation dropped to 1.54% yoy in November from 2.04% yoy in October. The central bank’s target inflation rate is 2.00%.
- **Poland:** The rate of real GDP growth in Q3 2017 was 4.9% yoy versus 4.5% yoy expected and yoy CPI inflation in November was 2.5% versus 2.3% expected.
- **Qatar:** FX reserves increased to USD 17.1bn in October from USD 16.5bn in September.
- **South Korea:** Industrial production temporarily declined (-1.1% mom) due to holiday-related day count distortions. Exports expanded at a rate of 9.6% yoy in November from 7.1% yoy in October. Manufacturing PMI firmed to 51.2 in November from 50.2 in October.
- **Sri Lanka:** The rate of CPI inflation declined to 7.6% yoy in November from 7.8% yoy in October.
- **Taiwan:** Still on fire. The manufacturing PMI surged to 56.3 in November from 53.6 in October.
- **Thailand:** Both consumption and investment were strong in October. Imports and tourism related export revenues also picked up strongly. The CPI inflation rate increased to 0.99% yoy from 0.86% yoy previously versus an expectation of 1.00% yoy.
- **Turkey:** The rate of CPI inflation reached a 13-year high of 12.98% yoy in November versus 12.5% expected as the central bank continues to take orders from President Erdogan, who believes that higher interest rates cause inflation.
- **Venezuela:** Energy Minister Manuel Quevedo said that PDVSA will continue to service debt. Coupon payments are late due to difficulties in processing payments following the imposition of US financial sector sanctions.

Global backdrop

The US remains by far the most important source of uncertainty in global financial markets. Ignoring unanswered questions regarding US intentions in North Korea and the Middle East, there are currently at least four sources of uncertainty emanating from the US.

The first is President Donald Trump’s tax cut, which the Senate passed last week. The bill will now have to be reconciled with the House version before Trump signs it into law. The ‘Let them eat cake’ tax cut is worth about USD 1.5tn, or 8% of US GDP. It is funded by debt. Hence, it is most accurately understood as a giant exercise in inter- and intra-generational income redistribution. The benefits accrue mainly to wealthy business owners today, while the costs are picked up by the general public, who will be paying for this tax cut (and the interest required to service the associated increase in public debt) via general taxation in future years. The other purpose of the bill is to provide fiscal stimulus in a bid to reduce the risk of recession as the Fed gradually moves towards tighter monetary policies. Congress Republicans face a tough challenge retaining their seats in elections next year and Trump faces re-election in November 2020. Still, we think the macroeconomic impact of the tax cut will be small for several reasons. First, the consumption effect of the tax cut will be minor, because the benefits will accrue mainly to corporates and owners of stock, that is, rich people, who have lower spending propensities than lower income groups. Most ordinary Americans will only benefit via some positive wealth effect via their 401K accounts. Second, the investment impact will also be small, since US companies could already, if they so choose, invest more than they are already doing, regardless of the tax regime. Third, as New York Fed Chairman Bill Dudley said, the US economy has already reached full employment, so this is not the best time to stimulate demand. In conclusion, once the initial impact on stock markets has been priced in the impact may ultimately prove disappointing. In fact, since the corporate tax cut is mainly financed by debt it will ultimately lower US productivity and hence r* (the FOMC members’ expectation for where the fed funds rate will converge in the long run), which is dovish from a monetary policy perspective.¹

The second source of uncertainty relates to the scandal surrounding alleged ties between the Trump Campaign and Russia. US stocks and the Dollar took a dive on Friday and US bonds rallied after former national security advisor Michael Flynn pleaded guilty to charges of lying to federal agents. The guilty plea led to speculation that he has struck a deal with the Muller inquiry, which will reveal even closer ties between the Trump Campaign and the Russians than have previously been known. Flynn’s insight clearly increases the odds that US President Donald Trump could be impeached, although impeachment itself does not appear to be imminent or even a certainty.

Third, the US government is running out of money. House Republicans have announced a plan to extend funding of the federal government by two weeks to avoid a shutdown by 8 December. Our expectation is the Congress will also take steps to increase funding for the government beyond this short extension, but clearly this is not a risk-free situation.

¹ For more details on the negative relationship between government debt and productivity in the US see “The DM savings glut,” The Emerging View, 1 November 2017.
Finally, the US is delving further into protectionism. Last week the Trump Administration announced duties on aluminium sheet and tool chests from China. The protectionist measures had not been prompted by US industrial lobbying, so these measures should be seen as a clear manifestation of the Trump Administration’s outright preference for protectionist policies. The goods in question happen to be a very small part of Chinese exports, so there will not be any macroeconomic consequences for China. However, the measures will obviously distort the US domestic prices for the goods in question, which will favour uncompetitive US producers, while at the same time raising price for US consumers. Hence, like all protectionist measures these will make everyone in America weaker with the sole exception of the few rent seekers, whose influence with the Trump administration means they can now continue to produce inefficiently at the expense of the wider American public.

In other news, US real GDP growth was marginally stronger than expected in Q3 2017 at 3.3% qoq saar, but weaker trade, inventory, manufacturing as well as personal income and spending data for the month of October now point to materially softer growth in Q4 2017. At 1.45% yoy, core PCE was marginally higher than expected (1.40%) in the month of October, but still significantly below the Fed’s 2% target. The softer spending numbers for October are more meaningful than the marginally higher inflation print, in our view. In the Eurozone, the rate of unemployment declined to 8.8% in October versus 8.9% expected, while core inflation was lower than expected (0.9% yoy versus 1.0% yoy expected). German inflation, however, was higher than expected (1.8% yoy versus 1.7% yoy expected), but not by enough to push the Eurozone inflation rate higher. OPEC agreed with Russia to extend supply cuts until the end of 2018, which provided support from oil, which has been rising recently on stronger growth numbers, especially in EM countries.

### Benchmark performance

<table>
<thead>
<tr>
<th>Emerging Markets</th>
<th>Month to date</th>
<th>Year to date</th>
<th>1 year</th>
<th>3 years</th>
<th>5 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSCI EM</td>
<td>-0.43%</td>
<td>32.39%</td>
<td>33.39%</td>
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<td>Shanghai Composite</td>
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<td>EM FX Spot</td>
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Continued overleaf
### Benchmark performance

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<tr>
<th>Global Backdrop</th>
<th>Month to date</th>
<th>Year to date</th>
<th>1 year</th>
<th>3 years</th>
<th>5 years</th>
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<tr>
<td>S&amp;P 500</td>
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<td>-19.05%</td>
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<td>DXY Index*</td>
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<td>USDJPY</td>
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<td>Gold spot</td>
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<td>10.48%</td>
<td>8.78%</td>
<td>5.62%</td>
<td>-25.00%</td>
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*VIX Index = Chicago Board Options Exchange SPX Volatility Index.  
*DXY Index = The Dollar Index.  
*CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.


Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.