Schroders

EM forecast update: Crumbling BRICs with a focus on China

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- **The situation has stagnated or deteriorated for the BRIC countries, with macro disappointments in China, and political concerns in Brazil and Russia. India alone has hinted at a brighter future, but upgrades will have to wait until promises become actions. We focus on China and the two areas generating the greatest concern at present are the financial and property sectors.**
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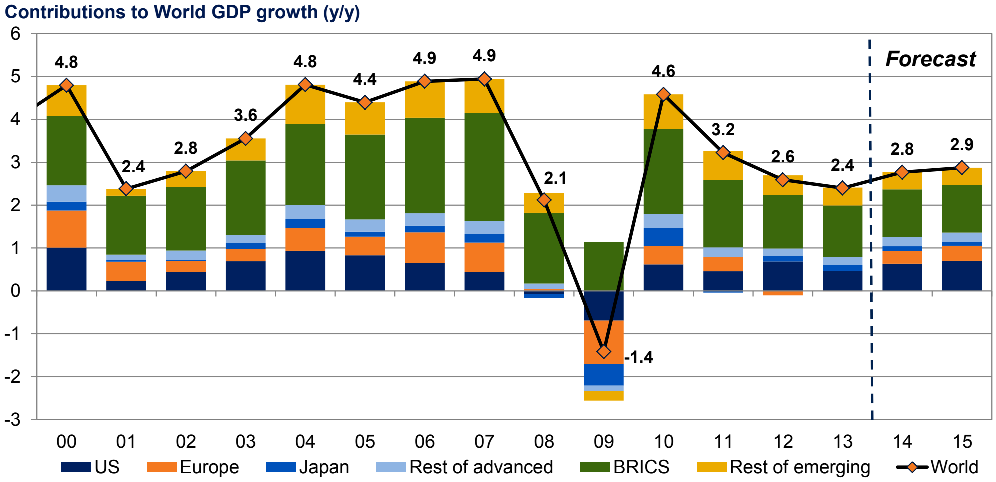
Views at a glance

- **A short summary of our main macro views and where we see the risks to the world economy.**

Chart: Global growth upswing intact



Source: Thomson Datastream, Schroders 28 May 2014 forecast. Previous forecast from February 2014. Please note the forecast warning at the back of the document.

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EM forecast update: crumbling BRICs and focus on China

Downwards revisions as macro disappoints and politics weighs on growth

We have revised our growth and inflation numbers for the BRIC economies and have either kept them constant or pushed them down on a mixture of macroeconomic and political deterioration. The political situation has improved in India but we are waiting for concrete policy signals before adjusting our growth expectations. With most tightening cycles concluded, our inflation outlook is also relatively unchanged for now.

Table 2: Summary of BRIC forecasts

% per annum	GDP			Inflation		
	2013	2014f	2015f	2013	2014f	2015f
China	7.7	7.1	6.8 ↓	2.6	2.7	3.1 ↑
Brazil	2.3	1.7 ↓	1.9 ↓	6.2	6.6 ↑	6.3 ↑
India	4.6	5.0	5.5	10.9	7.1	6.1
Russia	1.3	0.6 ↓	1.4 ↓	6.8	6.3	5.8

Source: Bloomberg, Thomson Datastream, Schroders. 28 May 2014. Previous forecast from February 2014. Please note the forecast warning at the back of the document.

China: property looks precarious

Chinese growth slowed as expected in Q1

The data has largely continued to deteriorate in China since our last forecast. First quarter GDP came in at 7.4% year-on-year, down from the 7.7% recorded in the final quarter of 2013. Other, higher frequency data has pointed to continued slowdown since then, though the latest flash PMI showed some stabilisation. All in all though we see little reason at this point to alter our below-consensus GDP call. The government remains reticent on major stimulus, and continues providing minor encouragements rather than driving in the spurs; the urbanisation plan has been accelerated, the railway budget increased, and assorted minor tax breaks implemented. While this will provide support to growth this year, it depletes the ammunition available later on. We originally expected growth to rebound slightly in 2015 as growth positive measures fed through – with these increasingly frontloaded we now think 2015 will weaken compared to this year. Growth of 6.8% is now forecast.

Finance still a concern, but risks seem to be ebbing

The two areas generating the greatest concern at present are the financial and property sectors. Trust product defaults seem to have tailed away for now; bank analysts estimate that most (around 80%) issuers have successfully repaid or rolled over the products. However, risks remain, predominantly in the mining and coal sectors. There has been some liquidity support: interbank rates have fallen, and the reserve ratio requirement was cut for rural banks, but the People's Bank of China (PBoC) has maintained a hawkish tone in statements and insisted on the need for tighter liquidity. Credit growth, as measured by total social financing, continues to decelerate, taking investment with it. A financial crisis seems unlikely at present, however. As we said in the March Viewpoint, trust companies themselves are unable to create money, and have little to no securitisation and low leverage. A trust company failing, therefore, has limited direct impact on the financial system. The main concern is its impact on confidence, a full default could lead to a panicked rush out of the shadow financing system and a credit crunch.

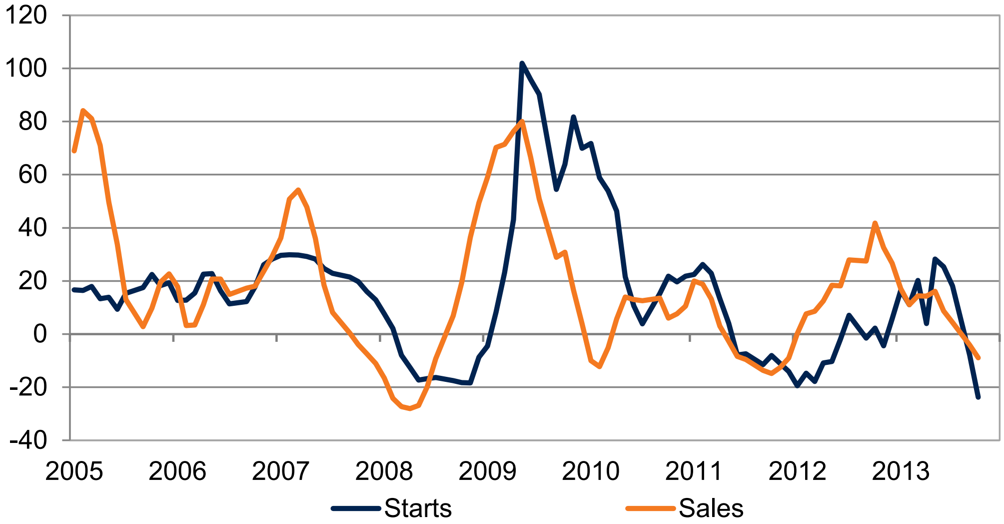
This, though, presupposes that defaults go unchecked. It seems extremely unlikely to us that the authorities will permit a large scale default in the near future. Though the imposition of minor losses in recent trust default cases shows a willingness to move in this direction, we expect a very gradual approach will be adopted to accustom Chinese investors to the concept of moral hazard. There is also a reputational risk; 84% of trust companies are backed by local governments and large financial institutions. Default by such a trust risks nurturing the idea that the government or bank associated with the product is also bankrupt, a loss of confidence of that kind would be devastating. Continued bailouts, with partial losses, seem likely.

Property sector in trouble…

The property sector, meanwhile, is effectively now in recession, with sales in their fourth month of contraction (chart 12). Price increases have slowed to just 0.1% month on month, their lowest since October 2012, though still rising 6.7% year on year. A slowdown in the sector matters because real estate accounted for 12.7% of GDP in 2013 (this compares to roughly 3% of GDP in the US). Further, land sales are a key source of government revenues, and property sector lending accounts for approximately 20% of bank loans. In an atmosphere of tighter credit, we think property investment will slow compared to last year. While government investment in affordable housing will help, it only accounts for 10-15% of real estate investment. Other measures, such as the easing of restrictions on property purchase, will also provide support, but not enough to reverse the slowdown.

Chart 12: The Chinese property sector is slowing

Residential floor space started and sold (sq. m, % y/y, 3mma)



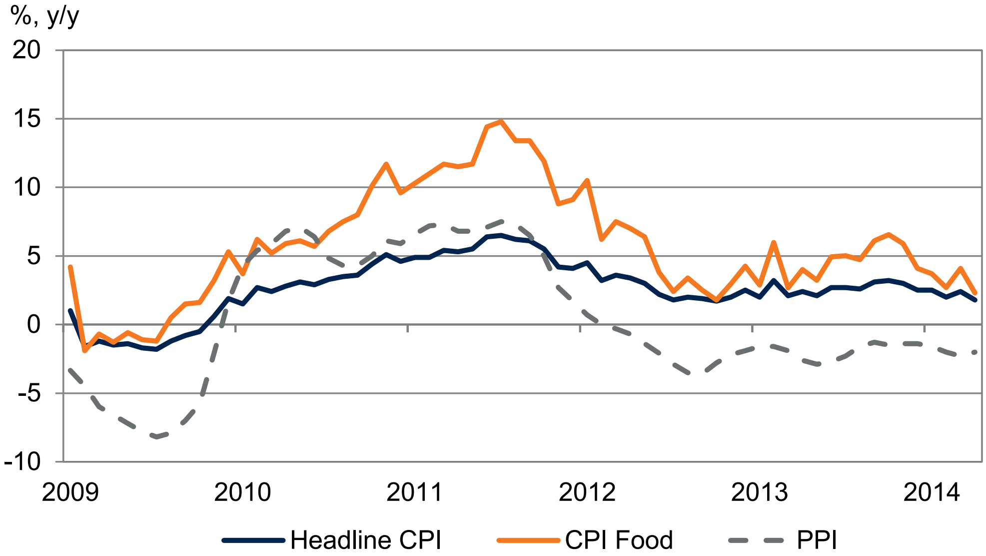
Source: Thomson Datastream, Schroders. 29 May 2014

… but a crisis is unlikely

However, while we see property acting as a drag on the economy, we do not think a Western style crisis is imminent. Mortgage loans are 14% of bank loans, and household debt is less than 25% of GDP. Reportedly only 10% of urban households have mortgage debt; combined with high deposit requirements (30% for the first house, 60% for the second, and 100% for the third), this looks a lower risk area than in the UK or US. Additionally, on a price to income basis, affordability has not markedly worsened because incomes have also been rising rapidly in China. The wealth effect is also much smaller; with mortgage equity withdrawal impossible in China, the impact of falling prices on consumption will be limited largely to its impact on confidence. Meanwhile, banks have strong buffers and, ultimately, state backing.

The broader concern about overall debt in the Chinese economy, estimated at around 230% of GDP, remains. The figure will continue to grow while total social financing growth outstrips nominal GDP growth (7.8% in Q1), which it seems set to do for some time yet. We do not think this will trigger a crisis but it will weigh on growth as increasing resources are dedicated to debt servicing.

Chart 13: Declining food prices have kept Chinese inflation contained



Source: Thomson Datastream, Schroders. 29 May 2014

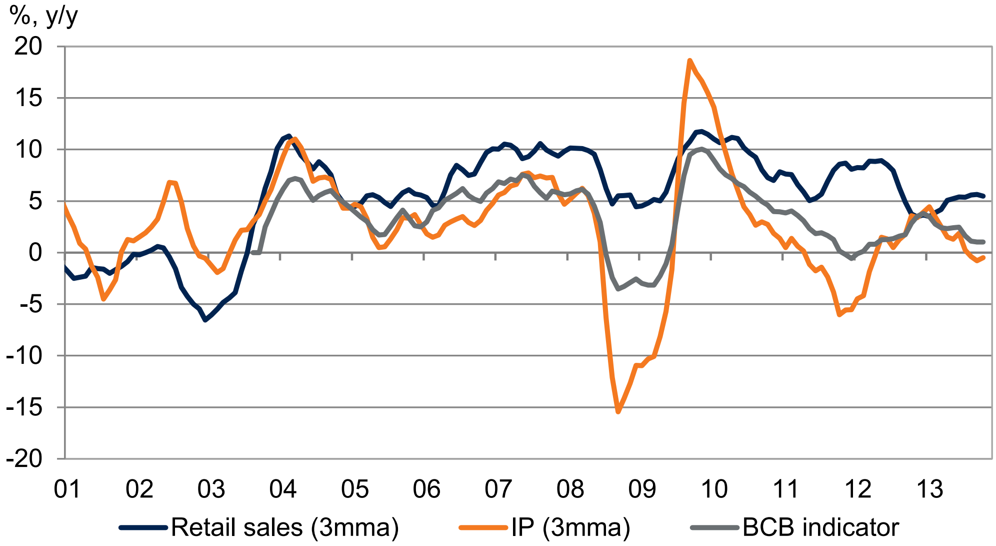
Pork prices should rebound and push up inflation

Inflation so far this year has been subdued (chart 13 above), slipping to an 18 month low of 1.8% in April as food inflation slowed dramatically. We do not expect this to persist, however, as it appears to be linked to the pork cycle. Losses at farms have resulted in a large contraction in capacity, which should push prices higher this year. Still, we think inflation will remain well below the 3.5% target, providing plenty of scope for monetary stimulus, should it be deemed necessary. We think a reserve ratio requirement cut is likely this year, potentially around the third quarter, as the PBoC looks to provide some support to banks, particularly in light of its stated desire to see mortgage lending eased.

Brazil: politics and drought undermine growth outlook

First quarter GDP had not been published at the time of writing, but weaker high frequency data reinforce our negative view of the Brazilian economy. The central bank's GDP proxy, industrial production and to a lesser extent retail sales have been trending down this year (chart 14). Car sales are also nearing five year lows - they fell 16% year on year in March. Consumer credit demand is also slowing, as higher interest rates, lower consumer confidence and high inflation erode consumer demand.

Chart 14: Macro indicators point to a slowdown in Brazil



Source: Thomson Datastream, Schroders. 29 May 2014.

Falling ratings for Dilma have cheered investors

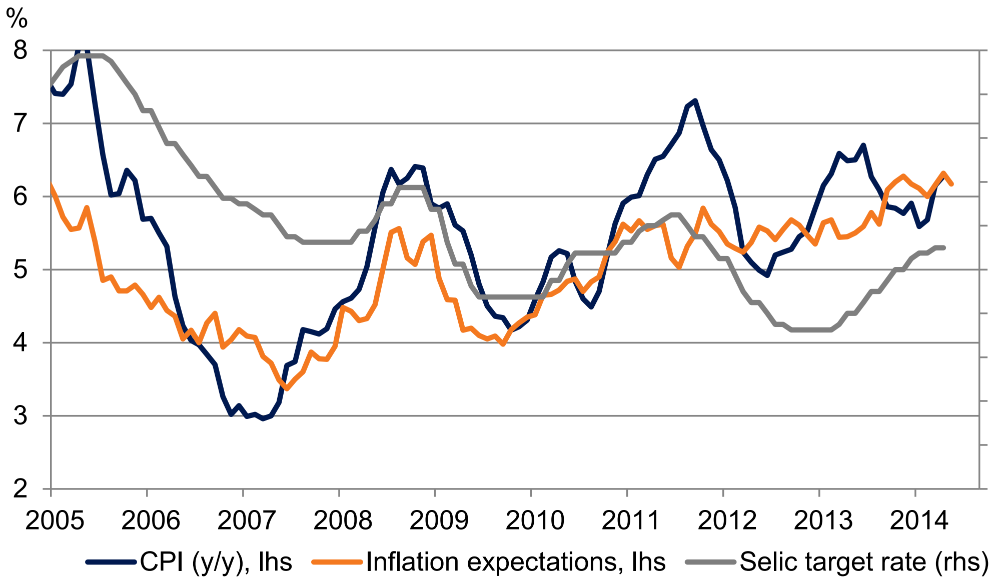
Political uncertainty has increased since our last forecast, with the incumbent Dilma falling in approval polls, increasing the chances of a second round. Markets have been cheering Dilma's fall, on hopes that it implies a more business friendly candidate will triumph in October. However, she remains the clear frontrunner for now, and in any case whoever wins will have substantial challenges; there will be no instant turnaround. The boost to investor sentiment would be helpful but a number of bottlenecks will take legislation and time to resolve. Until then, Dilma seems to be resorting to populism to shore up her vote; her government has increased welfare payments by 10% and provided additional capital injections to the development bank to maintain credit expansion (further undermining the shaky fiscal position). All this implies sharper cuts post-election and motivates our 2015 growth downgrade. Also affecting our growth outlook is the impact of the recent drought, which has continued almost unabated since we mentioned it in February's forecast. Depleted reservoirs have seen increasing use of high cost thermoelectric plants (for which fuel must be imported) rather than hydroelectric. This has resulted in a number of firms in the metals and chemicals industries reducing production and selling excess power on the spot market instead, where the price is at the government-fixed ceiling. Local media reports a number of firms are struggling to operate with electricity costs at this level.

Populist fiscal policy is making the central bank's job harder

We suspect the central bank must be increasingly frustrated by the refusal of government policy to truly co-operate in containing inflation, which remains close to the upper band of the target range despite the 375 bps of rate hikes since the start of 2013 (chart 15). Inflation is, of course, a backward looking indicator, but worryingly inflation expectations remain elevated as well, suggesting the problem is likely to persist. Despite this, the central bank opted to keep rates on hold at 11% at its latest policy meeting. Though the accompanying statement suggested further hikes would be considered, it seems likely that we will have to wait until after the elections now for rates to increase again. Despite this, inflation pressures look set to remain elevated in 2015, in part due to the ongoing need for high cost thermoelectric plants to stay online, and in part due to the inevitable increase in regulated prices, which have been suppressed in the run up to the election.

Chart 15: Brazilian inflation persists, despite tight monetary policy

Modi's mandate is positive for reform hopes



Source: Thomson Datastream, Schroders. 29 May 2014

India: election positive, but wait and see

India's electorate returned Modi's BJP with 282 seats, granting them a majority and a stronger mandate than many had expected. There had been a risk that results would disappoint and that the optimism of recent months would sour. Instead, the count surprised to the upside, giving investors a fresh injection of hope.

The inbox for the new government is a busy one. There is an investment bottleneck to clear, fiscal consolidation will be important, and central bank governor Rajan is keen to move to inflation targeting. Longer term, inefficiencies in the land and labour markets must be addressed, and the tricky issue of foreign investment resolved. A majority for the BJP greatly reduces the need for compromise, and could mean we see reforms pushed through. However, the BJP-led government will still have to negotiate with state governments and the upper house of parliament. State governments could prove particularly obstructive. In all though, this election result is a positive one for the Indian economy. Still, we will have to wait until July's budget for our first real taste of where policy will go. Consequently we feel it is too soon to revise our growth outlook for India on the back of the election results.

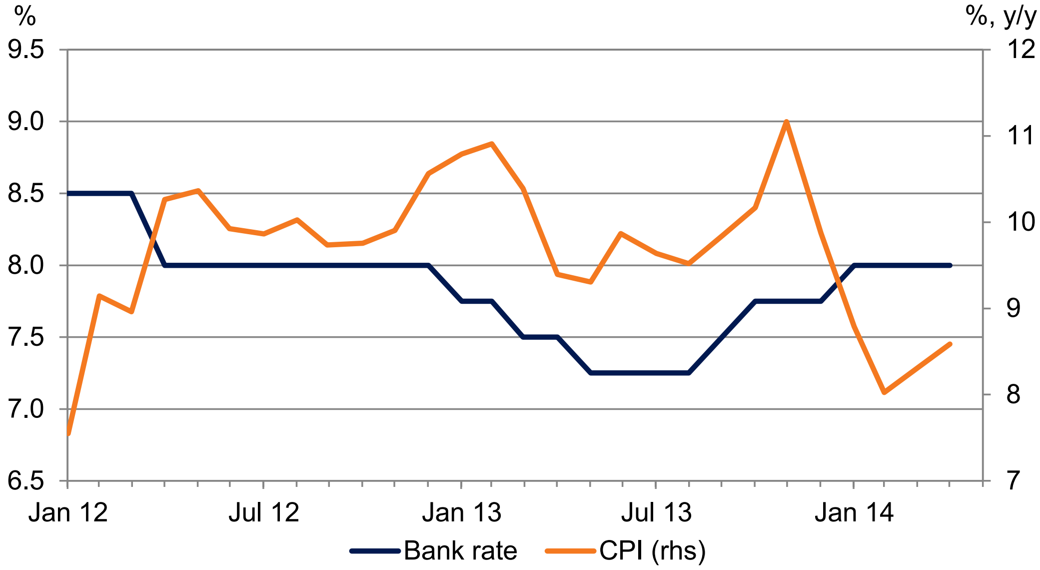
Higher frequency data in the first quarter was weak, with industrial production and exports contracting, not helped by a strengthening rupee. The tighter monetary policy used to stabilise the rupee is likely hindering growth, especially when India's banks are seeing rising bad debt and so becoming more reluctant to lend.

On the monetary policy front, governor Rajan's crusade against inflation continues, with policy remaining tight despite deteriorating growth indicators. Inflation has bounced back slightly after initial successes (chart 16) This acceleration was driven mainly by food price inflation; core CPI was unchanged at 7.8%. There are increased upside risks to our inflation forecast as a result, particularly with the possibility of an El Nino weather system this year. Policy will have to remain tight.

Chart 16: Indian inflation down but not out

Uncertainty and sanctions

generating headwinds for Russian growth



Source: Thomson Datastream, Schroders. 29 May 2014.

Russia is vulnerable to financial sanctions

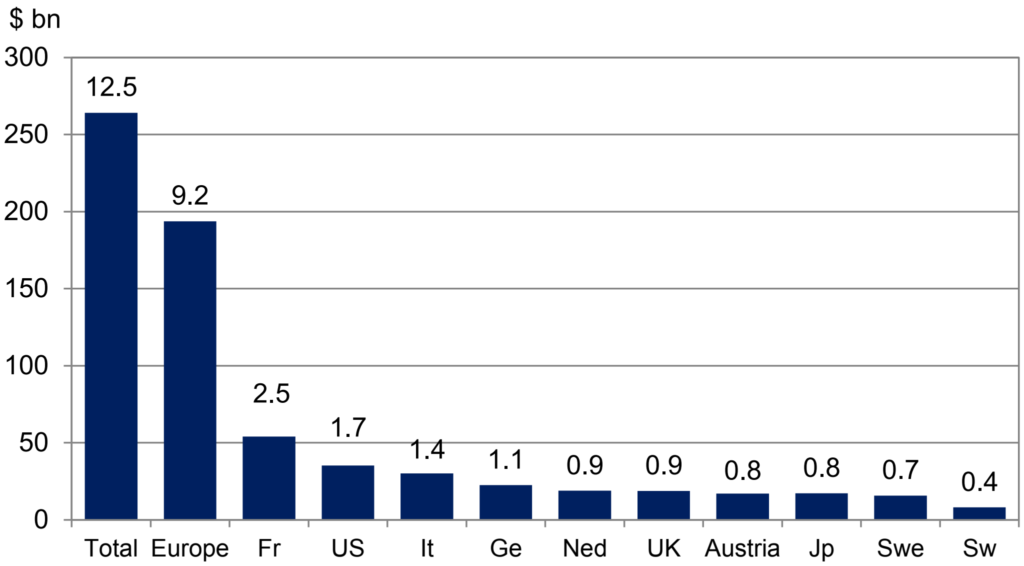
Russia: Ukraine unsettles the bear

Our growth forecast for Russia has seen a significant downgrade following events in Ukraine, which were yet to transpire at the time of our last forecast update. Though sanctions have not been broad based as yet, there is already evidence of an economic impact; Russian GDP grew by 0.9% year on year in the first quarter. This marked a sharp fall from the 2.0% growth recorded in the fourth quarter of 2013.

Higher frequency data suggests the slowdown has been driven by lower investment spending. Consumer spending has slowed too, but has held up reasonably well in comparison. Meanwhile, PMI data points to ongoing contraction in manufacturing and services. It is not much of a stretch to argue that uncertainty arising from escalating tensions in Ukraine contributed to reluctance to invest. If the situation in Ukraine is not resolved, we would expect Russia's GDP numbers to continue to worsen throughout the year. Further sanctions are being discussed and the economic damage from extant sanctions and general uncertainty will build over time. As it stands the second quarter already looks likely to disappoint, and will probably put Russia into recession.

Although it is not our base case, particularly as tensions seem to be easing, we should also consider the possibility of Iranian style sanctions. The scope for economic damage then becomes far greater. Chart 17 shows foreign bank claims on Russia in absolute terms and as a share of Russian GDP. The withdrawal of finance equivalent to 12.5% of GDP would be difficult to brush off.

Chart 17: Foreign bank claims on Russia



Source: BIS, IMF, Schroders. 29 May 2014. Figures above columns denote bank claims as a share of Russian GDP

The slowdown will worsen policymaker headaches – presumably already throbbing from sanctions and political pressure – as inflation remains high. Rates have already been hiked in response to this and currency weakness, but there will be increasing policy conflict if the political situation does not improve. The easing of tensions though has seen the ruble strengthen, for now, so the inflation spike could prove temporary.

Schroder Economics Group: Views at a glance

Macro summary – May 2014

Key points

Baseline

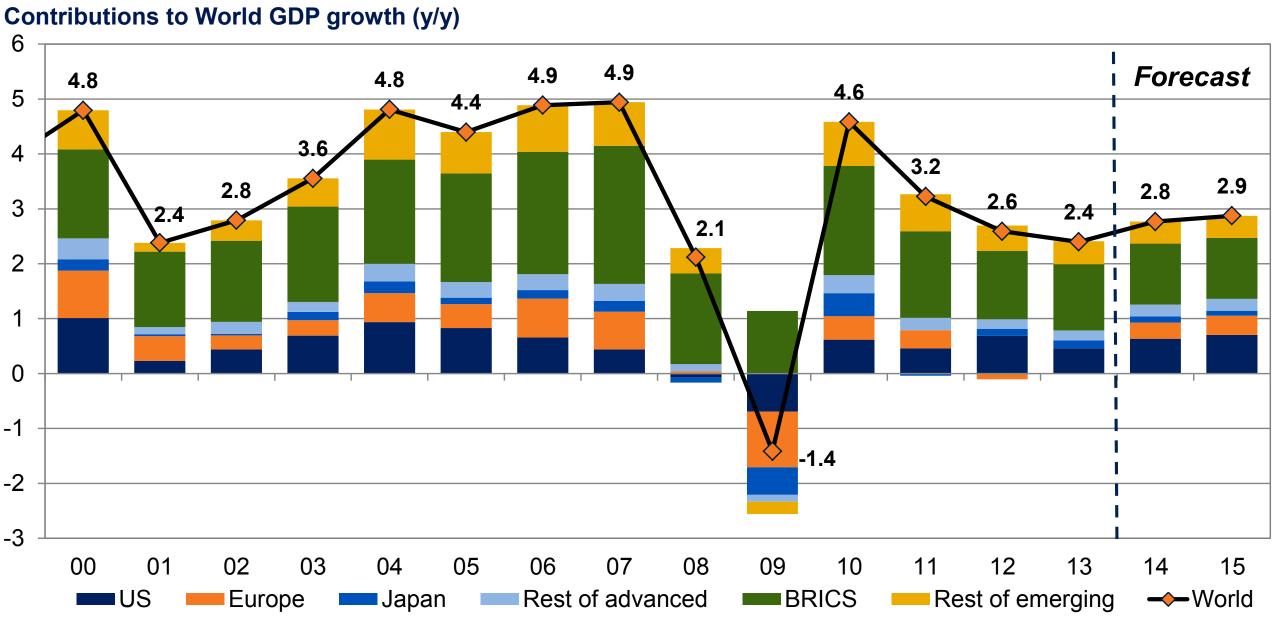
- World economy on track for modest recovery as monetary stimulus feeds through and fiscal headwinds fade in 2014. Inflation to remain well contained.
- US to rebound in q2 after weather related dip in q1. Economy beginning to normalise as banks return to health and private sector re-leverages. Unemployment to fall faster than Fed expects and central bank to complete tapering of asset purchases by October 2014. First rate rise expected in q3 2015.
- UK recovery to be sustained by robust housing and consumer demand whilst economic slack should limit the pick up in inflation. Growth likely to moderate next year with general election and resumption of austerity. Interest rates to rise in August 2015.

- Eurozone recovery becomes more established as fiscal austerity and credit conditions ease in 2014. Low inflation likely to prompt ECB to cut rates and take measures to reduce the cost of credit, otherwise on hold through 2015. Deflation to be avoided, but possibility of QE in response to deflation fears.
- "Abenomics" achieving good results so far, but Japan faces significant challenges to eliminate deflation and repair its fiscal position. Bank of Japan to step up asset purchases as growth and inflation fall back in 2014 and 2015.
- US leading Japan and Europe (excluding UK). De-synchronised cycle implies divergence in monetary policy with the Fed eventually tightening ahead of others and a stronger USD.
- Tighter US monetary policy weighs on emerging economies. Region to benefit from advanced country cyclical upswing, but China growth downshifting as past tailwinds (strong external demand, weak USD and falling global rates) go into reverse and the authorities seek to deleverage the economy. Deflationary for world economy, especially commodity producers (e.g. Latin America).

Risks

- Risks are still skewed towards deflation, but are more balanced than in the past. Principal downside risk is a China financial crisis triggered by defaults in the shadow banking system. Some danger of inflation if capacity proves tighter than expected whilst upside risk is a return of animal spirits and a G7 boom (see page 17 for details).

Chart: World GDP forecast



Source: Thomson Datastream, Schroders 28 May 2014 forecast. Previous forecast from November 2013. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2013	2014		Prev.	Consensus	2015		Prev.	Consensus
World	100	2.4	2.8	↓	(3.0)	2.8	2.9	↓	(3.1)	3.2
Advanced*	64.4	1.2	1.9	↓	(2.1)	1.9	2.1	↓	(2.2)	2.3
US	24.7	1.9	2.6	↓	(3.0)	2.5	2.9	↓	(3.0)	3.1
Eurozone	18.6	-0.4	1.0	↓	(1.1)	1.1	1.4		(1.4)	1.4
Germany	5.2	0.5	2.2	↑	(1.9)	1.9	2.3	↑	(2.2)	2.0
UK	3.8	1.7	2.9	↑	(2.6)	2.9	2.4	↑	(2.1)	2.5
Japan	9.1	1.6	1.2	↓	(1.4)	1.3	1.0	↓	(1.3)	1.3
Total Emerging**	35.6	4.6	4.2	↓	(4.4)	4.3	4.3	↓	(4.6)	4.8
BRICs	21.8	5.5	5.1	↓	(5.3)	5.2	5.1	↓	(5.6)	5.4
China	12.5	7.7	7.1		(7.1)	7.3	6.8	↓	(7.3)	7.2

Inflation CPI

y/y%	Wt (%)	2013	2014		Prev.	Consensus	2015		Prev.	Consensus
World	100	2.6	3.0	↑	(2.8)	3.0	3.1	↑	(2.8)	3.0
Advanced*	64.4	1.3	1.5	↑	(1.4)	1.6	1.6	↑	(1.5)	1.7
US	24.7	1.5	1.8	↑	(1.5)	1.8	1.9	↑	(1.4)	1.9
Eurozone	18.6	1.3	0.9	↑	(0.8)	0.8	1.2		(1.2)	1.3
Germany	5.2	1.6	1.3		(1.3)	1.3	2.0	↑	(1.7)	1.9
UK	3.8	2.6	1.9	↓	(2.3)	1.9	2.2	↓	(2.7)	2.0
Japan	9.1	0.1	2.0	↑	(1.9)	2.6	1.6	↑	(1.5)	1.8
Total Emerging**	35.6	4.9	5.7	↑	(5.4)	5.6	5.6	↑	(5.3)	5.3
BRICs	21.8	4.7	4.4	↑	(4.3)	4.3	4.4	↑	(4.1)	4.3
China	12.5	2.6	2.7		(2.7)	2.5	3.1	↑	(2.9)	3.0

Interest rates

% (Month of Dec)	Current	2013	2014		Prev.	Market	2015		Prev.	Market
US	0.25	0.25	0.25		(0.25)	0.26	0.75	↑	(0.50)	0.92
UK	0.50	0.50	0.50		(0.50)	0.72	1.00	↑	(0.50)	1.58
Eurozone	0.25	0.25	0.10		(0.10)	0.21	0.10		(0.10)	0.30
Japan	0.10	0.10	0.10		(0.10)	0.19	0.10		(0.10)	0.19
China	6.00	6.00	6.00		(6.00)	-	6.00		(6.00)	-

Other monetary policy

(Over year or by Dec)	Current	2013	2014		Prev.		2015		Prev.
US QE ($Bn)	4227	4033	4443		(4443)		4443		(4443)
UK QE (£Bn)	375	375	375		(375)		375		(375)
JP QE (¥Tn)	241	224	295		-		383		-
China RRR (%)	20.00	20.00	19.50	↓	20.00		19.50	↓	20.00

Key variables

FX	Current	2013	2014		Prev.	Y/Y(%)	2015		Prev.	Y/Y(%)
USD/GBP	1.68	1.61	1.68	↑	(1.63)	4.3	1.63	↑	(1.55)	-3.0
USD/EUR	1.37	1.34	1.35	↑	(1.34)	0.7	1.30	↑	(1.27)	-3.7
JPY/USD	101.5	100.0	105.0	↓	(110)	5.0	110.0	↓	(120)	4.8
GBP/EUR	0.81	0.83	0.80	↓	(0.82)	-3.5	0.80	↓	(0.82)	-0.7
RMB/USD	6.23	6.10	6.18	↑	(6.00)	1.3	6.10	↑	(5.95)	-1.3
Commodities										
Brent Crude	111.1	109.0	108.3	↑	(108)	-0.7	103.7	↑	(103)	-4.3

Source: Schroders, Thomson Datastream, Consensus Economics, May 2014
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Please note the forecast warning at the back of the document.
Market data as at 16/05/2014
Previous forecast refers to November 2013

* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, Sweden, Switzerland, United Kingdom, United States.

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

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