Four Major Risks To EM Risky Assets

14 July 2021, Yvan Berthoux

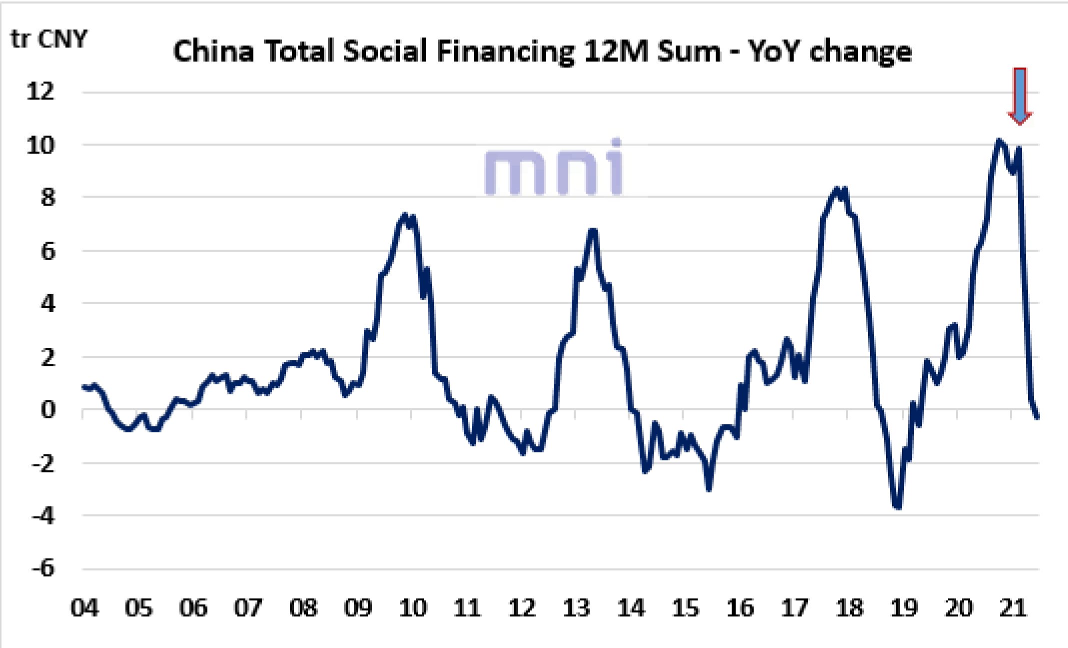
1. Contraction in Chinese liquidity

First, we have seen that the significant tightening in Chinese liquidity in the past few months has been weighing on domestic risk assets (i.e. tech stocks), but also global assets more recently such as copper, lumber and EM equities more broadly.

Despite the significant increase in aggregate financing in June (+3.67tr CNY vs. 2.89tr CNY expected and up from 1.92tr CNY the previous month), the annual change in the Total Social Financing (TSF) 12M Sum keeps falling.

Figure 1 shows that the annual change in China TSF 12M Sum (which we also refer tio as China 'liquidity') fell from over 10tr CNY in October 2020 to -0.2tr CNY in June 2021.

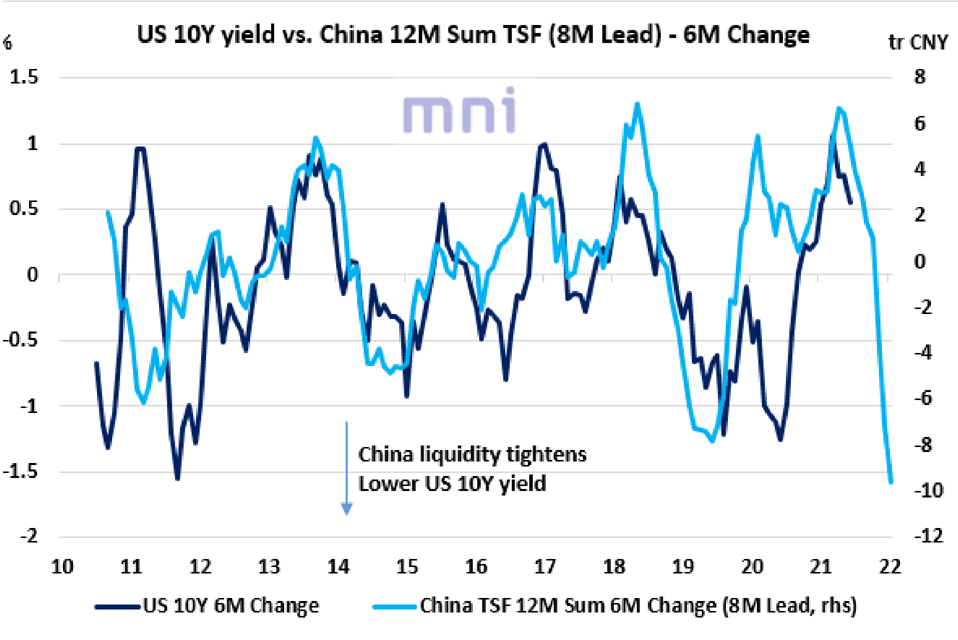
Figure 1



Source: Bloomberg/MNI

Figure 2 shows that the 6M change in China TSF 12M Sum has also nicely led the 6M change in US 10Y yields by 8 months; periods of significant contraction in Chinese liquidity have been associated with falling LT US bond yields.

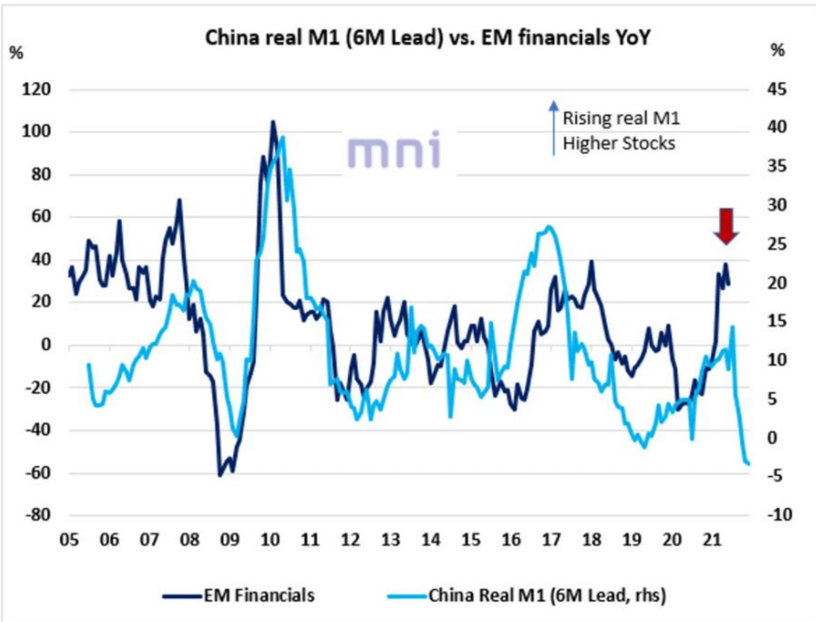
Figure 2



Source: Bloomberg/MNI

In addition, the rapid fall in China real money growth (M1) could also continue to weigh significantly on cyclical stocks in the coming months. Figure 3 shows that China real M1 has historically led EM financials by 6 months.

Figure 3



Source: Bloomberg/MNI

Last week, Chinese authorities responded to the recent tightening in financial conditions (strong CNY and weaker equities) by announcing a 50bps cut in the required reserve ratio. We will see if lower rates in China will be enough to stimulate asset prices and temporally weaken the CNY.

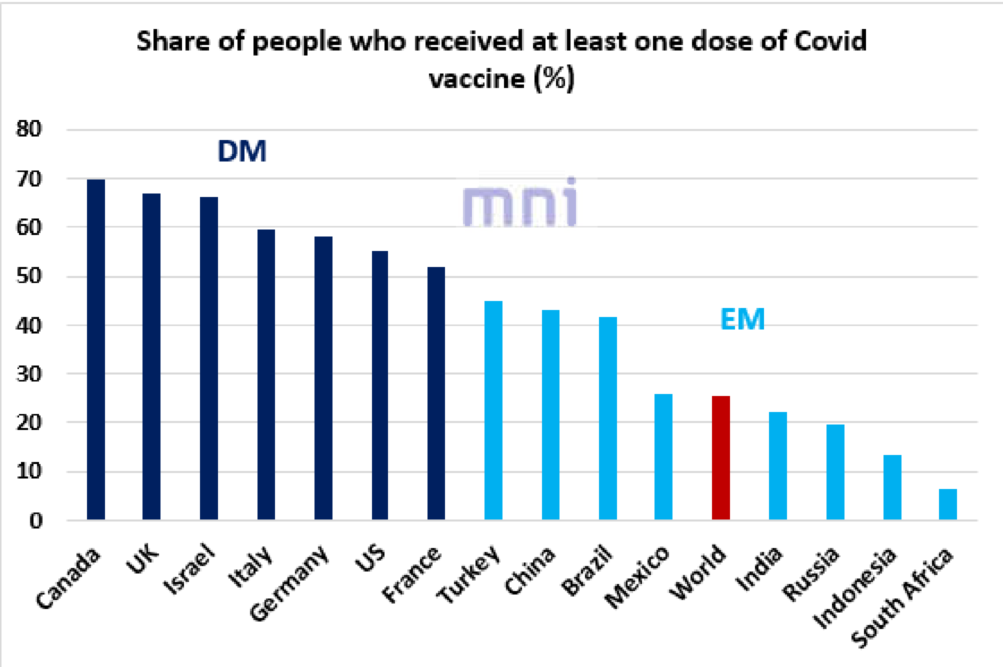
2. Rising uncertainty over the Delta variant

Given the slow pace of progress on vaccinations, the probability that governments will impose new social restrictions and even full national lockdowns has been rising sharply in recent weeks.

Lockdown policies will clearly start to weigh on growth expectations, and could start to severely impact EM assets in the medium term. As a reminder, real growth differentials have historically been a strong driver of currencies over time. Therefore, weaker growth in the EM world will tend to weaken EM currencies against major crosses (i.e. USD, EUR, JPY) and lead to higher price volatility in equity markets.

Figure 3 shows the strong divergence between DM and EM concerning the vaccination campaign. For instance, less than 20% of people have received at least one dose of the Covid vaccine in Russia, Indonesia and South Africa, while many developed markets are nearing the 70% threshold.

Figure 4



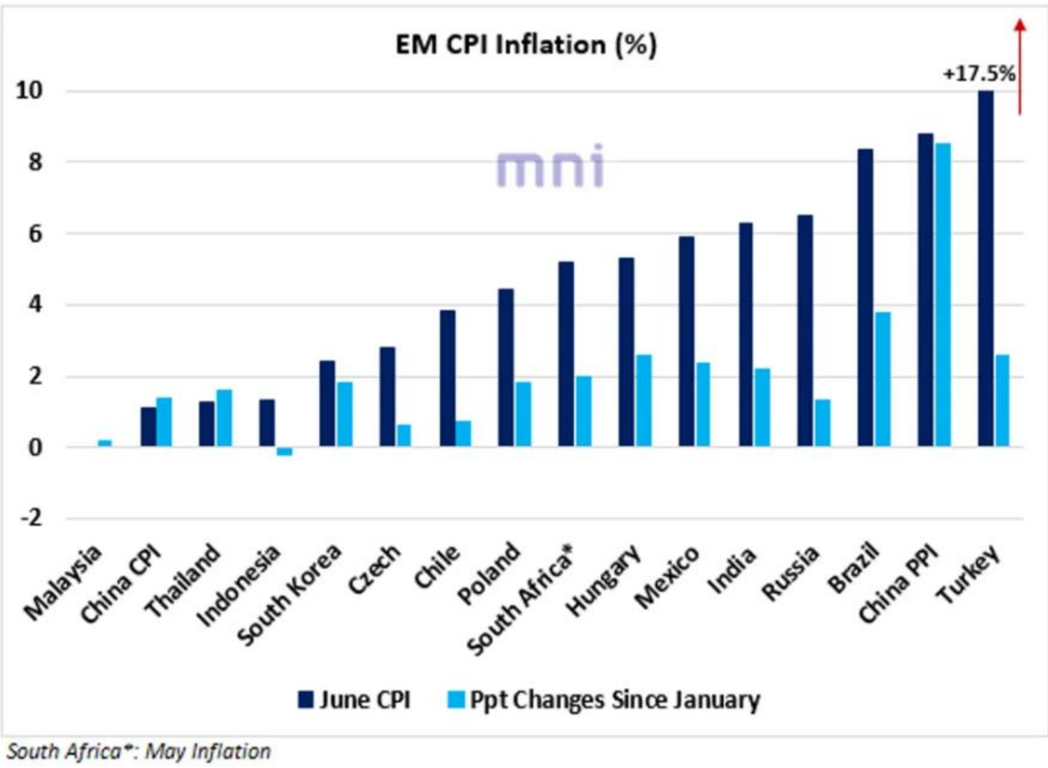
Source: ourworldindata/MNI

3. Rising political instability

Lower growth expectations combined with rising inflationary pressures (figure 5) are putting EM central banks in a difficult position. While some EM central banks have already started a tightening cycle in 2021 to curb the inflationary pressures (CBRT, CBR, CBB and more recently CNB and NBH), others are keeping interest rates steady in order to stimulate the economic recovery (figure 6). For instance, NBP left its benchmark rate unchanged last week at 0.1% with Governor Glapinski once again confirming on Friday that inflation is currently driven by supply shocks and that there is no risk of overheating in Poland.

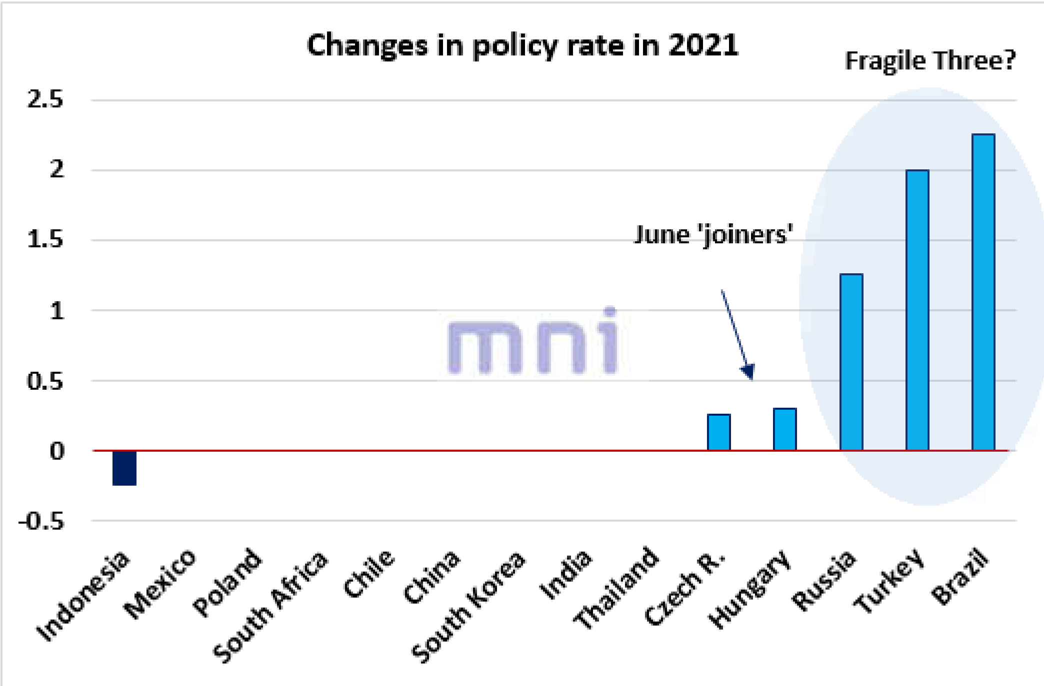
Another interesting case to watch in the coming weeks is South Africa; on one hand, inflationary pressures have been rising, with CPI inflation surging by 5.2% YoY in May, but on the other hand, political uncertainty has skyrocketed amid the Zuma riots and growth expectations are likely to be revised lower in the near term. In addition, riots could fuel the spread of Covid infections in the coming weeks, raising the probability of a renewed period of lockdown. SARB will be in a critical position in the coming months if inflation continues to accelerate.

Figure 5



Source: Bloomberg/MNI

Figure 6



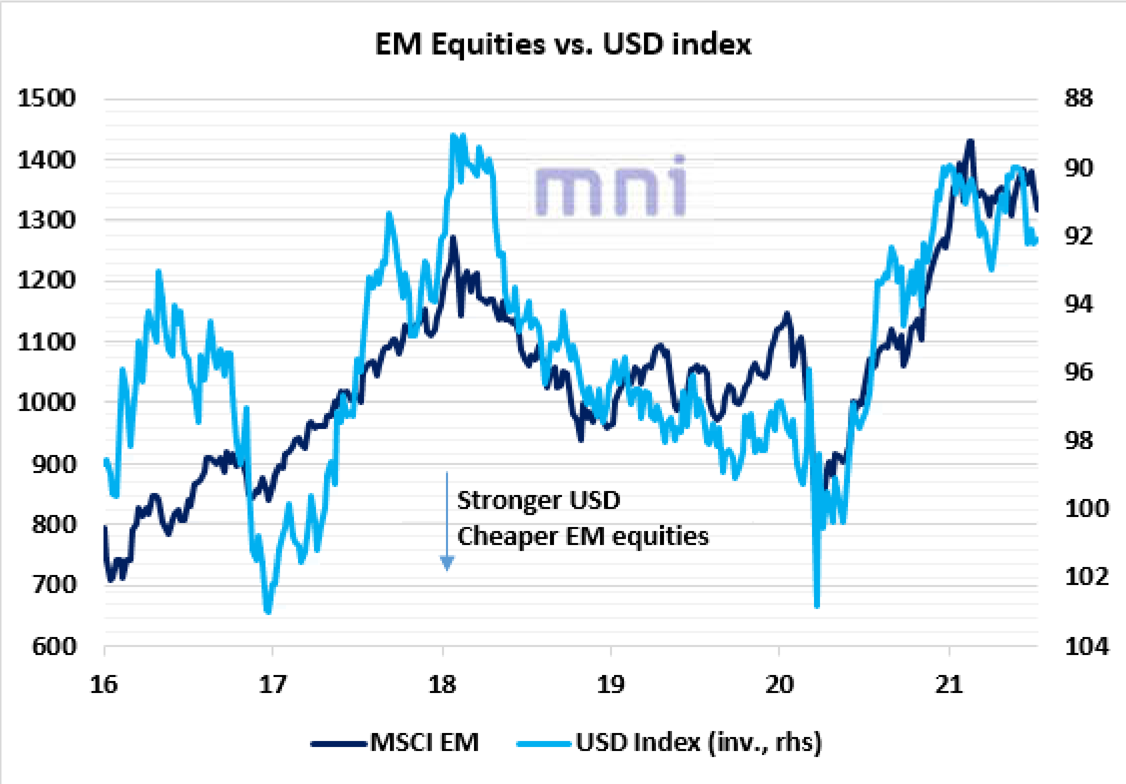
Source: Bloomberg/MNI

4. A rising US Dollar

Rising political uncertainty, lower growth expectations and a contraction of Chinese liquidity could all lead to a higher US Dollar in the near term, which is typically a net negative for EM risky assets such as equities.

Figure 7 shows the strong co-movement between the US Dollar and EM equities over time; periods of USD weakness are generally associated with EM equity strength (and vice versa).

Figure 7



Source: Bloomberg/MNI
