

## Global overview

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In August, Emerging Market equities generally posted gains, amidst very benign conditions on the global stock markets. However, their performance still lagged well behind the gains registered on the developed markets. Similar to the situation in the industrialised countries, in recent months a relatively small group of companies in the Emerging Markets has recorded particularly robust price gains and these companies have consequently received an increasingly strong weighting in key stock indices. While these names are often trading at all-time highs, the vast majority of equities are still well below their old record highs and the price levels from the start of the year. On the one hand, this situation is a warning sign for a possible correction in the future. On the other hand, it implies that there are still many equities which are not overpriced, offering good earnings opportunities for investors in the quarters and years ahead. This latter group of equities mainly includes cyclical, smaller, and "old economy" enterprises. If and when there is such a rotation of favourites, it is highly likely that the Emerging Markets will enjoy above-average performance. In any case, from the current perspective, EM equities offer a significantly more attractive risk-reward profile compared to the USA over the long run. Now that the "decade of US equities" has come to an end, it is possible that a decade of the Emerging Markets (and possibly Europe as well) will soon start.

**Equity prices continue to rise in August, but market breadth declines substantially**

**Could a change in favourites on the stock markets be about to occur?**

In August, the global EM equity index rose by just over 2% (in USD). Price gains for the developed equity markets were almost three times as strong. One trend from the recent months continued: the price gains are increasingly concentrated in a smaller and smaller group of companies, in particular from the technology and communications sector, whose business is booming despite or perhaps because of the pandemic (or at least investors perceive this to be the case). As a result, their weighting in the equity indices is further increasing, triggering a positive feedback loop via passive investment vehicles such as ETFs, and momentum-based investment strategies, leading to further price increases for these shares. Interestingly enough, this is being observed not only in the developed markets, but also fundamentally for the Emerging Markets as well. The declining market breadth and strong signs of speculative exaggeration in the USA suggest the mounting possibility of a correction, in particular since the upcoming US presidential election may generate additional volatility. Experience shows that corrections on the stock market in the USA tend to have an impact on other markets, but this does not necessarily mean that the rally for the equity markets will come to an end. On the contrary, if this occurs in conjunction with a rotation of favourites it is possible that investors will start to focus on many more equities, which are not yet overpriced and have only participated in the recovery to a much more limited degree so far. In particular, this may include cyclical, smaller, and "old economy" enterprises.

**Long-term investment case for the Emerging Markets remains intact, but good selection is still important**

Many factors suggest that in such a scenario the Emerging Markets could perform much more strongly on the whole, ending the massive outperformance of the US stock market for a longer period of time. In such a case, taken as a whole, EM equities have a much better long-term risk-return profile compared to US equities, from the current vantage point. However, it is also very likely that not all of the Emerging Markets will benefit from this to the same degree, and naturally the same holds true for the various sectors. In such a scenario, active selection and willingness to depart from passive investments and major indices may be a profitable approach.

**“Textbook case” of the US dollar weakening with improvement in global economic conditions...**

In previous issues of *emreport*, we frequently discussed the role of US dollar as the “canary in a coal mine” and as a key factor that influences equities and bonds in the Emerging Markets. In this regard, it is remarkable that while the US dollar has continued to weaken in recent week, this development has mainly occurred vis-à-vis the euro and is less characteristic with regard to the EM currencies. The latter may be a factor explaining the sustained sub-average performance of EM equities, which is quite unusual in the case of a weaker dollar and broadly positive conditions on the global stock markets. At the same time, the partial USD weakness seen so far may be a warning sign that the global economic recovery is progressing much more slowly than the equity markets are currently discounting. In part, one aspect that may play a role in this is that the USA is able to operate with far greater fiscal and monetary leeway and is thus able to provide correspondingly larger stimulus for its own economy. However, the relevant limitations faced by many Emerging Markets may have a beneficial effect over the long run, as they force the affected countries and companies to reduce inefficiencies, bolster their balance sheets, and boost productivity. By contrast, in the past periods marked by massive state stimulus measures have often led to lower efficiency and misallocation of capital. In this regard, it should be emphasised that – to a large degree – the sub-average performance of the EM equity markets in the past decade was due to the lower, stagnating or even declining profitability of EM companies.

**... in particular, against the euro, but less versus EM currencies**

**Smaller budgetary leeway may offer opportunities for Emerging Markets over the long run**

**Vaccine for Covid-19 would be a game-changer, but does not look very realistic in large quantities for 2020**

Last but not least, a few words on the Covid-19 pandemic: clearly, a vaccine would be a game-changing development, but it is unlikely that large quantities will be available this year. At the same time, a return to widespread lockdowns does not look feasible, neither from a political nor from an economic perspective, and there are also clearly signs of fatigue about this subject on the markets and among the populace in many countries. As long as there are no dramatic, unforeseen developments, Covid-19 will likely become more and more part of everyday life and have increasingly less potential to trigger major movements in asset prices, up or down.

## Country focus



**Chinese exports surprisingly robust in August**

**Will the Chinese and US economies soon decouple?**

**China with a new economic strategy of "dual circulation"**

### China

China's exports were surprisingly positive for the previous month: very robust growth of 9.5% was recorded in August, the strongest in the last 18 months. China is profiting from the progress in recovery, economic reopening, and the easing of restrictions in the economies of its trading partners in particular. The significantly higher growth rate compared to overall growth in global trade implies that China continues to win market shares. By contrast, imports were weaker than anticipated, which is cause for some concern about developments in China's domestic economy. At the same time, more fiscal stimulus measures are in the pipeline, including investments in infrastructure. Thus, China will probably see significantly positive economic growth this year, whereas economic output in the rest of the world will contract to a larger or smaller degree.

In the meantime, the USA continues to escalate the conflict with China, repeatedly imposing new restrictions or sanctions on individual Chinese companies, and most recently President Trump spoke about mostly decoupling the economies of the two countries from one another. This is probably easier said than done. However, in Beijing the authorities have long been working to make China less vulnerable and reduce its dependencies. This is also the goal of the new economic model of China's Communist Party, known as "dual circulation". In this context, the country's domestic economy is seen as the main pillar of support, with the internal and external markets intended to mutually benefit each other. This would allow resilience to external shocks to be developed, while at the same time promoting further integration into the global economy. In Beijing's opinion, a "modern, efficient logistics system" is necessary for this, in light of the "difficult and complicated situation at home and abroad". Consequently, increased investment is likely in this field. At the same time, the door remains open for foreign capital, goods, and investments. Taking a long-term perspective, US companies may thus face the risk of losing their market position in China, in the event that the USA continues to ratchet up the confrontation with Beijing. Trump's aggressive policy against China appears to be an attempt to curb China's further rise, as long as the USA still has the means to do so. However, it looks like the USA no longer has the means to achieve this, if it ever had them at all.

Chinese mainland equities (A-shares) posted a gain of around 2.6% in August, while H-shares in Hong Kong suffered a mild decline (-0.5%).

### India

In August, India's equity market saw somewhat stronger gains than the EM average, with the markets hampered towards the end of the month by the renewed escalation of tensions on the Chinese-Indian border. Within the Indian equity market, in August cyclical stocks and those representing the "old economy" did much better than tech sector and telecommunications equities, in a remarkable contrast to the global trend. Net inflows of foreign capital into Indian equities reached a new single-month record at more than USD 6 bn. At the same time, Covid-19 infection rates in India continue to rise sharply and from April to June the economy contracted significantly more than most analysts had anticipated (shrinking by almost 24% compared to the same prior-year quarter). In absolute terms, India now has the 3rd highest number of Covid-19 fatalities in the world and the highest number of daily new infections,



**Record monthly inflow of foreign capital for Indian equities**

**Corporate results poor, but still well above analysts' expectations**

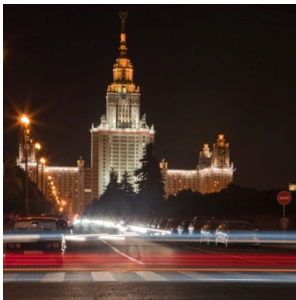


although – as is the case everywhere in the world – the mortality rate is falling tangibly.

Corporate results for the past quarter were the worst in a long time, but at the same time were far better than almost ever before compared to analysts' forecasts. Apparently, the analysts were overly pessimistic. At the same time, many companies appear to be weathering the crisis better than anticipated. All of the inflation figures were higher than expected, with a particularly strong increase in food prices. Nevertheless, it is unlikely that this will lead to any substantial tightening of monetary policy in the foreseeable future, since the priorities of the Indian central bank (along with almost all of the other central banks in the world) are elsewhere at the moment.

### Brazil

In August, Brazil's equity market was among the markets that deviated from the positive global trend in a negative direction, along with almost all of the other Latin American markets. The equity index dropped by nearly 4%, with non-resident investors also facing the effects of real depreciation (-5% versus USD) as a negative factor. At the same time, the economic data were actually not all that bad. Retail sales and industrial production saw improvements (+12.6% and +8.9% versus the previous month), while services continue to lag behind (unsurprisingly). The government's approach to budgetary discipline is a mounting concern for investors and analysts. Like most other countries, Brazil is working to counter the impacts of the Covid-19 pandemic with large-scale fiscal measures. Although President Bolsonaro is a staunch opponent of social benefits from the state, in light of the situation he authorised monthly transfers of around USD 110 to some 66 million Brazilians. As a result of this, his popularity has increased significantly. However, hardly any other large country like Brazil actually has so little room for fiscal measures of this nature. The question is whether and how government spending on this scale will (and can) be sustained?



**Russia surprises with world's first approval of a Covid-19 vaccine**

**Mysterious apparent poisoning of Russian opposition politician raises many questions**

### Russia

In August, Russia surprised the world with its approval of the world's first vaccine against the new coronavirus (SARS-CoV-2). While some Emerging Markets immediately announced their interest, the reaction in the West was mainly sceptical to negative. In particular, there was criticism about the lack of large-scale clinical studies and the question was raised as to how Russia was able to develop a vaccine so quickly. With regard to the former, Russia plans on carrying out these trials in the coming months, and with regard to the latter the research institutes involved explained that they had access to decades of past work in the field of vector vaccines.

At the end of August, an apparent poison attack on Russian opposition politician Navalny generated headlines and new diplomatic tensions. As per his wishes and at the invitation of the German federal government, Navalny was quickly flown to Germany for treatment. As of our editorial deadline, no evidence had been presented on the possible perpetrators of the alleged attack. While Russian doctors found no signs of poisoning or similar substances, Germany announced that Navalny had undoubtedly been attacked with a poison from the Novichok family of chemical warfare agents. While it was unclear who was behind this, German Chancellor Merkel nevertheless raised the prospect of new sanctions against Russia. Even measures involving the almost complete Nordstream 2 pipeline are being considered. It is questionable, however, whether such sanctions will be imposed,

**Equity market relaxed so far**

as Germany in particular stands to profit significantly from this natural gas pipeline. It is also unclear what motive Russia's leadership might have had for such an attack, since Navalny has little influence on the domestic political situation. Despite a recognition level of around 50%, for many years he has only received 1%-5% of votes at the national level in independent surveys. At the same time, there is the risk of further deterioration in relations between Russia and the West. So far, the Russian financial markets have reacted nonchalantly to the developments. The Moscow stock index gained around 2% in August.

**Russian economy showing signs of stabilisation**

There are signs of stabilisation and recovery in the economy. In July, the year-on-year decline in economic output was not as bad as in June, and the purchasing managers' index for manufacturing returned to expansionary territory in August, with a reading of 51.1 points. This development was mainly due to rising production and increasing new orders.

**Turkey wants to redraw the borders in the Mediterranean and is emphasising its claims with military threats****Turkey**

In recent weeks, Turkey has been in the headlines with its provocative statements directed at Greece, Cyprus, and the EU. On the one hand, this involves potential oil and gas deposits in the Mediterranean Sea, where Turkey views the current borders as unjustified and wishes to change them, unilaterally if necessary. Apparently, Turkey may even be willing to use military force to do so. On the other hand, President Erdogan is using the nationalist sabre-rattling politics in international affairs to distract attention from domestic political and economic difficulties. Due to the pandemic, Turkey has been hit very hard by the massive downturn in tourism. This is reflected both in domestic economic conditions and in FX revenues; and the need for a constant flow of external capital has long since been the Achilles' heel of the Turkish economy. Consequently, the lira has been under pressure for quite some time now, and even though the Turkish economics minister is painting a very optimistic picture for next year, the situation right now is far from great. That said, the rhetoric about changing borders in the Mediterranean should not be given too much weight. Both Turkey and Greece should be interested in a negotiated settlement and, in principle, both should be capable of reaching one. As any compromise solution for Turkey would represent an improvement compared to the current situation, it should be relatively easy for President Erdogan to score political points in this regard. In any case, exploiting any possible oil and gas deposits in this region is probably not high on Turkey's list of priorities at the moment. Because in August, Turkish politicians announced the largest discovery of natural gas deposits in the country's history, in the Black Sea, which is not without controversy itself. The deposit allegedly has around 320 billion cubic metres of gas and could cover some of Turkish gas demand as early as 2023. On the one hand, this would be a positive development for Turkey's balance of payments, due to lower gas imports, and on the other hand it would strengthen the country's hand when it comes to negotiations with gas suppliers. Analysts, however, are sceptical and note that hard and fast statements on the volumes that can actually be produced cannot even be made at this point in time, and that the time and costs needed to access the reserves are still unclear. By way of comparison, they cite a nearby natural gas discovery by Romania eight years ago, which still has not been brought fully into production.

**Large gas discovery in the Black Sea: production slated to begin as early as 2023, with possibly very positive effects for the Turkish economy**

Running counter to the global trend, the Turkish equity market slumped in August. The stock index in Istanbul lost about 4%, with the situation compounded by the roughly 5% lira depreciation.

### CE3 – Poland, Czechia, Hungary

Retail sales and industrial production continued to recover in Poland and were better than generally expected in July. Both indicators rose versus the same month of the previous year. The situation was different in the Czech Republic, where retail sales and industrial production were both well lower than the corresponding figures for July 2019. In all three of these countries, the inflation rate was around 3% in the past period. The Hungarian central bank noted weaker growth in the second quarter compared to the original expectations, and the finance ministry announced additional fiscal measures to support the economy in the second half of the year. These measures may push Hungary's budget deficit for 2020 to 7%-9% of GDP.

The Czech Republic has suffered severe setbacks in containing Covid-19, with record-setting numbers of new cases every day, which now exceed the comparable figures from April. Starting from September 1st, the country has introduced a mask requirement for all public transportation and public buildings. In Hungary, the government wants to minimise the risks of a new surge in cases. From September 1st, it closed the country's borders and reactivated border controls, which were already instituted when the pandemic broke out in March/April.

The equity markets in the region moved broadly in line with the general trend for the Emerging Markets in August. The indices in Poland and the Czech Republic posted gains of 2.3% and 2.4% respectively, while Hungary only managed a small increase of a half a percent.

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