A brief update after market's turmoil in August

Sara Baliña / Sonsoles Castillo

Executive summary

- **A new outbreak of high volatility and risk aversion has rattled markets during the summer, especially Emerging Markets (EM), as investors have been relocating their positions towards safe-haven assets.**
  - Sharp corrections in equity markets since early July to the through (-6.7% globally, -16.3% in EM since 1 July), intense EM currency deprecations (above 10% on average) and higher risk premia (EMBI spreads above taper tantrum levels) define the recent episode of financial tensions. Commodity prices have plunged to levels of 2008-09.
  - Markets started to calm down in late August as China cut interest rates and its bank's reserve ratio and probably the strong correction run its course. It would however be premature to say that the episode is over.

- **China has been the trigger and the EM block is at the epicenter of this new bout**. Fears about the extent and nature of China's ongoing slowdown and the erratic and unexplained policy response from its authorities fuelled market uncertainty.
  - The interventions in the stock market, launching probes on stock market brokers, and the timing of the exchange-rate policy increased the perception of disorientation and thus the fear over the health of the Chinese economy and the ability of policy makers to face them.
  - Contagion to other EM, particularly in Asia and Latam, was magnified by the Fed's approaching lift-off, ongoing current cyclical weaknesses and political uncertainty in some major economies such as Brazil and Turkey.

- **How does this new episode affect the macroeconomic outlook? It will ultimately depend on how China's economy evolves.**

  (a) In our scenario of lower growth in China (growth rates at 6.0%- 6.5%), and lower commodity prices our baseline scenario changes…
  - It generates a downward bias to our GDP global forecasts weighted by worsened expectations mainly in EM, especially for the economies more dependent on China's demand -such as commodity producers- and/or foreign capital flows.
  - It will keep EM currencies more depreciated versus the dollar, bringing about higher inflation. Inflationary pressures from depreciations would prompt tighter monetary policies, i.e., a delay of previously expected rate cuts or sooner rate hikes.
  - It supports a more accommodative monetary policy stance in Developed Economies with the Fed pushing the lift-off beyond September and/or keeping the upward path more gradual after the first increase and the ECB would consider the extension or front-load of its QE.

  (b) If the current market turmoil continues and the Chinese Economy slows more dramatically the risk scenario would kick in with more serious consequences worldwide. To monitor very closely from China in the near future: (i) economic indicators, (ii) depreciation pressures over the renminbi and capital outflows and; (iii) policy strategy, including liquidation of foreign reserves and potential US Treasuries sell-off.

Market´s reaction: global risk-off mood, sharp rebound of financial volatility, collapse of commodity prices and EM underperformance

There has been a **strong flight to quality movement and a sharp rise of financial volatility** across the board since July. The VIX has picked levels of 2011 at 40 points and BBVA Research volatility indices reflect a broad increase, more intense in equity and FX markets.

In particular, as regards market moves since 1 July to the through a week ago, MSCI World lost almost 7%, with EM and China leading the corrections (-16% and -20% respectively). On average, EM currencies depreciated by 10%. Colombian peso, Russian ruble and Brazilian real registered the worst performance. With respect to bond markets, it is worth mentioning the rebound of spreads across the EM: Global EMBI increased by 70bp (+80bp in Asian region and +110bp in Latam). **In the last days, the financial pressures receded slightly**, with gains in equity markets close to 4% from the minimum levels and stabilization in currency and commodity markets (e.g. oil prices recovered by 5 USD to 47 USD per barrel).

The EM assets concentrate the recent sell-off, with investors readjusting their positions towards safe-haven assets (DM markets and, in particular, the Eurozone). China and Latam led the net capital outflows, mainly in the bond segment (it is worth mentioning the role of local retail investors in the correction of the Chinese equity market). However so far, **capital outflows are not alarming in comparison to other risk-aversion episodes such as 2013 *taper tantrum* or the 2008-09 crises.**

Widespread declines in the stock markets, significant EM currency depreciations (more abrupt in those countries more exposed to China) **and widening risk premia in EM and corporate bond are a warning that we could be facing an episode of global risk aversion with impact on global growth.**

Commodity markets are now with prices similar to 2008-2009 levels, and have overshot somewhat, as oil and metals prices have fallen more than what the current evolution of the macro scenario suggests. Oil prices have fallen around 20% since the end of July (from 53 USD to 43 USD per barrel of Brent oil) and copper has dropped by 10% since the end of July to around USD2.20/2.25 per pound.

The main driver of this market reaction -more focused on countries more linked to China or to commodities- is **the uncertainty about China's economic growth.** (China accounts for 11% of world oil consumption, more than 55% of copper consumption and two thirds of iron). But the market turbulence has also affected countries exposed to higher foreign funding needs, such as Turkey, showing that the Fed lift off has also been a relevant factor.

Figure 3
Broad increase of financial volatility but less intense than in other risk episodes
VIX Index

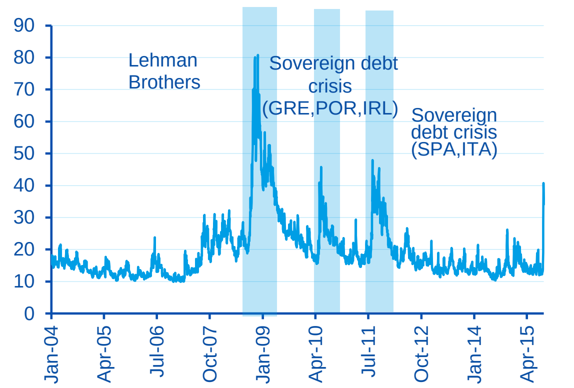


Figure 4
Sharp corrections in equity markets (-7% since July), more abrupt in China (-18%) and EM (-16%)
Stock market index (base 100= Jan15)

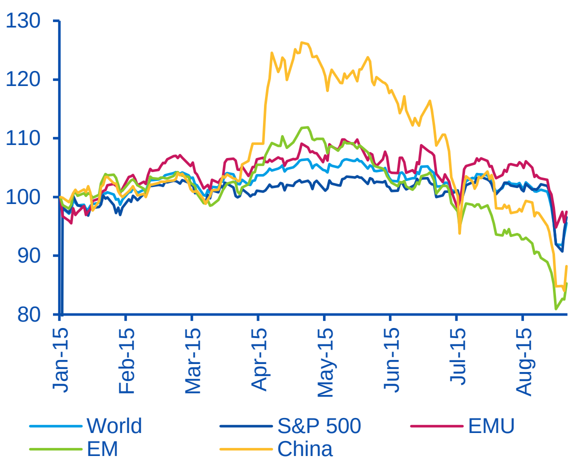


Figure 5
Intense EM currency depreciations and flight to quality to DM currencies
FX against the USD since July (%). Depreciations (+)

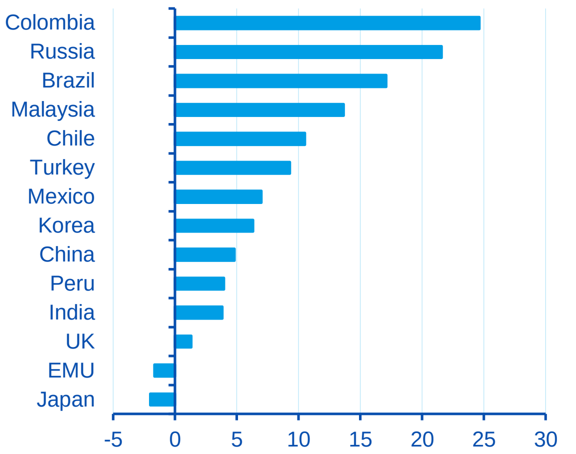


Figure 6
Commodity prices on the downward trend: oil prices have fallen around 30% since July
Commodity prices index (base 100= Jan15)

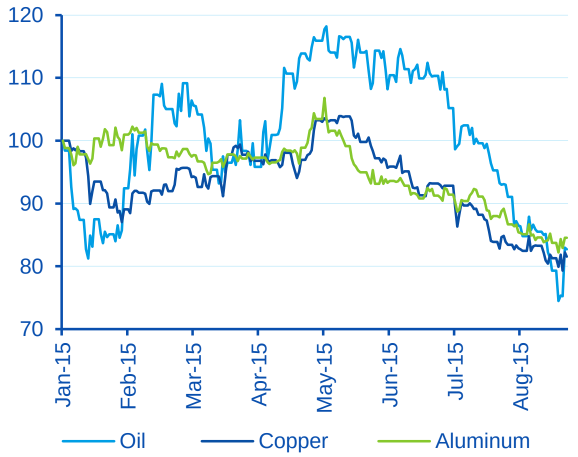


Figure 7
Contagion to EM bonds: EMBI spreads above taper tantrum levels; limited rebound in peripheral risk premia
EMBI spreads & EMU peripheral risk premium (bp)

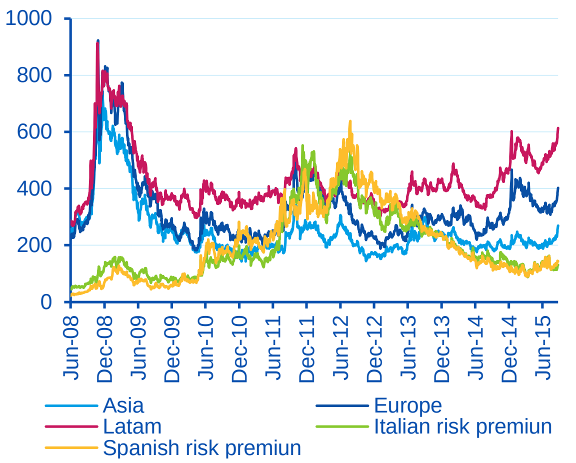


Figure 8
Latam and China lead the net capital outflows from EM
Cumulative net capital outflows (equity&bonds) since July (% of total AUM)

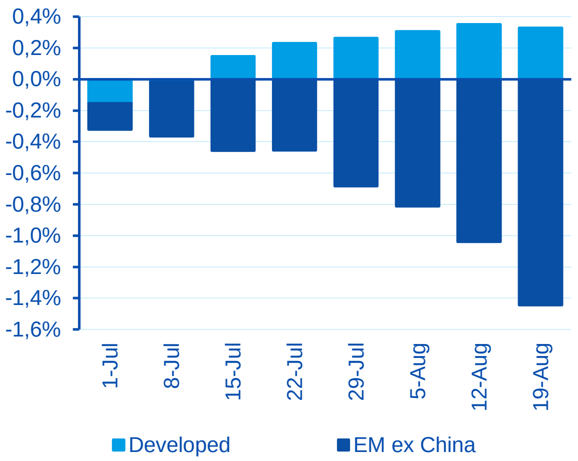
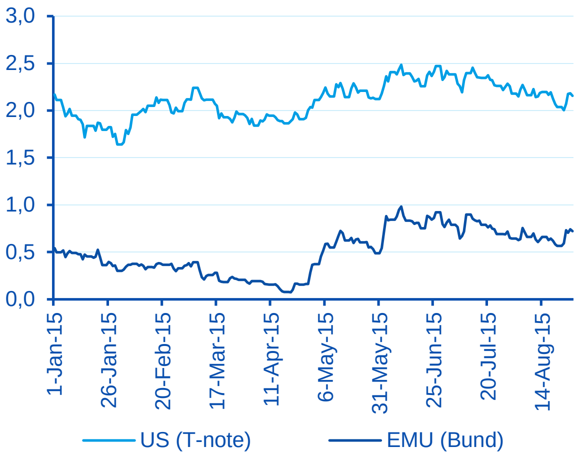
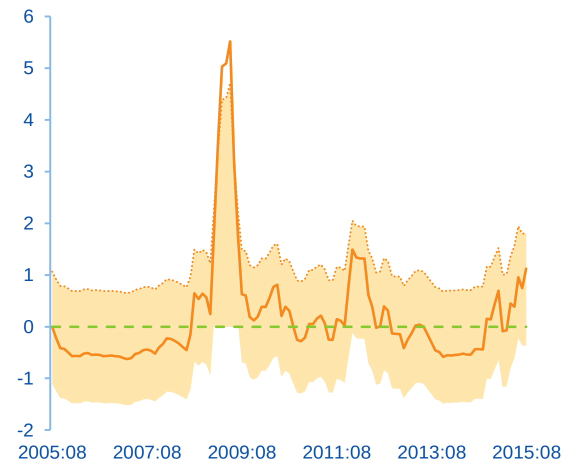


Figure 9
Flight to quality: downside pressures on DM sovereign yields
T-note and Bund (sovereign yields), %



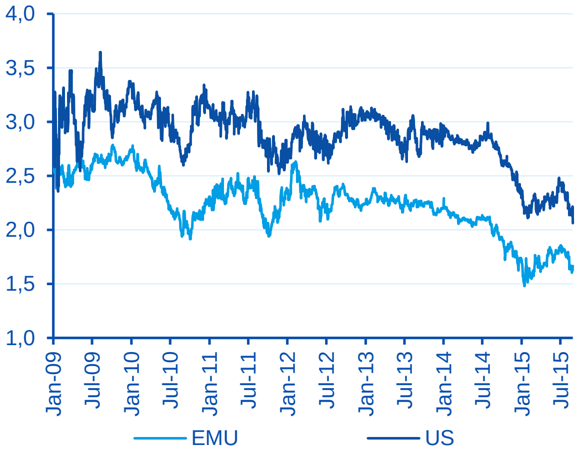
Source: BBVA Research, Bloomberg

Figure 10
BBVA Research Safe Haven Indicator
Represents the median of the selected safe haven components in portfolio flows, risk premia and FX data (based on BBVA DFM/FAVAR Model)



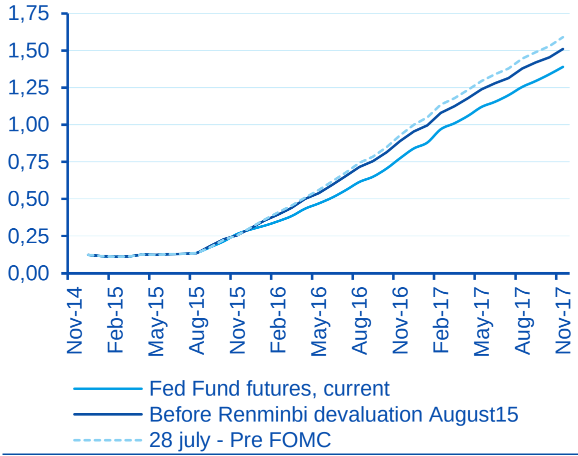
Source: BBVA Research

Figure 11
Long-term market's inflation expectations in US and EMU come back to January levels
Inflation Breakeven (5Y5Y), %



Source: BBVA Research, Bloomberg

Figure 12
Market delays the Fed normalization
Market expectations for *fed funds* (%)



Source: BBVA Research, Bloomberg

Macro & policy background

Doubts about the magnitude of the economic slowdown in China, with implications on its ability to decelerate gradually towards rates closer to 6% while it rebalances its growth pattern, have been exacerbated by erratic decisions from authorities ranging from the reaction to the stock market crash back in July (see Global Economic outlook 3Q15) to the surprising and ill-explained decision of the PBoC to devalue the renminbi. This decision, taken in mid-August (the currency only depreciated from levels of 6.20 to 6.38 USD/CNY when the real effective exchange rate has appreciated by 10% since early 2014) **raised doubts about the cyclical position of the economy**.

The recent decision to cut its repo interest rate (-25bp) and RRR (-50bp) is more "business as usual", but there are increasing doubts at present as regards whether they are intervening in offshore currency markets to keep the currency stable. Other Asian countries (e.g. Vietnam, Kazakhstan) with dollar-pegs have already reacted to Chinese decision on FX forcing a depreciation of their currencies.

This scenario of lower growth in China, compounded with the **correlated deceleration in other emerging economies** (especially in Latin America) and rising political and geopolitical risks in big EM countries such as Brazil, Russia and Turkey (but not in India or Mexico), has brought back instability to financial markets during the summer and has raised the downside risks to the global economic recovery.

This happens in a context of weak domestic demand across the board, loss of confidence favoured by political tensions in some countries (such as Brazil or Turkey) and, in general, doubts about the ability of governments to adopt reforms to reactivate growth in the current bleak economic environment-.

All this represents a differential feature of this episode respect to recent episodes of risk aversion: **Emerging Markets are now at the epicentre**. This does not mean that it will have little impact on developed countries as **growth can also slow down** in a context of lower external demand (slowing global trade continues to intensify led by falling trade in Asia) and only gradual domestic spending increase; but so far, so good.

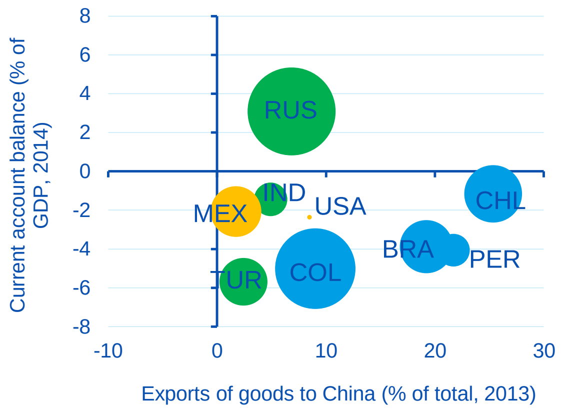
In the **US**, a better than expected GDP growth balance for H115 (including the upward revision for 2Q15 to 3.7%) and the labour market strength give support to recovery although the resilience of the consumption continues to be the key to offset the potential negative effects of lower exports and energy output. In the **Eurozone**, while the economic recovery continues and the agreement between Greece and its creditors reduces institutional instability, the political uncertainty underpinning the snap elections is a fact that is worth highlighting as well as the tightening of financial conditions mainly as result of the euro effective appreciation.

The correction in commodity prices, this time mostly due to a demand-side shock, generates **downward pressures on inflation rates in DM** in a context of tepid improvement in domestic demand. The currency appreciations also ease price pressures through lower import prices.

As a consequence, and **as regards monetary policy**, the US cyclical position (in particular, the labour market) supports the start of the interest rate normalization in September, as we contemplate in our baseline scenario. However, (i) the deterioration in EM economic outlook, (ii) the downside pressures on inflation caused by the on-going USD appreciation and correction in oil prices, (iii) the impact of the recent stock market adjustment on household's financial wealth and (iv) the uncertainty about the next steps in China (and other Asian countries) on foreign exchange **could delay a bit the first interest rate hike by Fed** in a decade or lead them to stop for a while after the first rate hike, instead of starting a gradual path. Recent remarks by NY Fed's Dudley (tightening monetary policy as early as September seemed "less compelling to me than it was a few weeks ago") has further reduce the probability of liftoff to 25% by Sept and 50% by Dec (according to Fed funds futures).

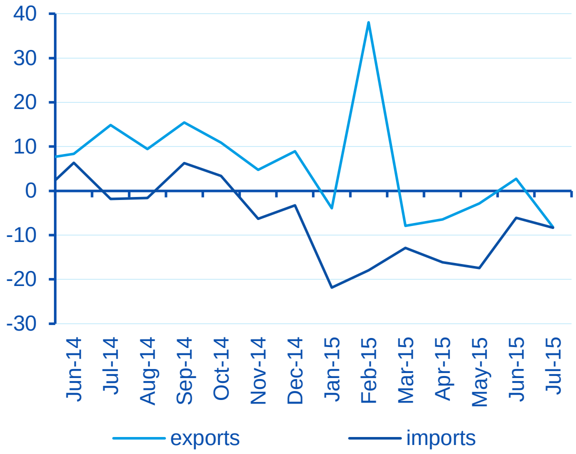
As for the **ECB**, Peter Praet highlighted the risk of low inflation ("developments in the world economy and in commodity markets have increased the downside risk of achieving the sustainable inflation path toward 2%") as well as alluded to the flexibility of the current QE program. However, Vice-President Constancio remains more cautious. At the next week monetary policy meeting, **inflation staff's projections are expected to be revised slightly downwards and accompanied by a dovish tone**.

Figure 1
Exposure to China and foreign funding needs*
* Size of bubble: magnitude of currency depreciation against USD since May15



Source: BBVA Research, UNCTAD, IMF

Figure 2
Chinese external demand (volume of exports and imports of goods, YoY change, %)



Source: BBVA Research, Haver

Potential implications of the recent economic events

What does the future hold for China?

- As long as macroeconomic data continues to point south, or policy makers continue touching policy tools erratically (will additional capital controls be considered?; How strong is and will continue to be the FX intervention in the market to hold the currency stable?), markets will remain understandably fearful about China's deceleration. **The lack of a clear communication strategy by local authorities may be enough to trigger renewed tensions.** Eventually, however, everything will boil down to whether the economy is able to grow at around 6%-6.5% in the next year and a half, as we expect, or will decelerate further.
- Even in case growth stabilizes, **the market will adjust the asset valuations to a new environment of lower growth and higher policy challenges in the EM block**. Volatility will remain high and uneven as the scenario for China clears out, but the high liquidity in developed markets, the good financial situation of bank's balance sheets in developed countries and room of manoeuvre slowing the pace of monetary policy normalization can keep volatility more contained than in August.
- **Scenarios of significant lower growth in China and thus in a whole set of EM would be much more challenging**. **They would probably require agreements among countries (brokered by the IMF) not to say EM currencies loose, and the approval of facility credit lines or even rescue programs to some EM countries. Admittedly, this would also bring about delays in monetary policy normalization in the US and the UK and more QE action in the ECB, and Japan.**

Assuming that growth in China stabilizes but at slightly lower levels than expected before (between 6 and 6.5% in the next year and a half according our estimations):

i. We **revise down our oil price forecast** by around 10% in 2015, 14% in 2016 and 11% in 2017 relative to July's (also on account of excess supply as a result of a sustained increase in inventories and a surprisingly resilient US shale oil industry). This means an average Brent price of 54 USD in 2015 and 59 USD in 2016. In the long-run, we still anticipate prices at 80 USD/b (Brent) but with a slower convergence from current prices.

ii. **We have a downside bias from our current growth forecast, mainly in the EM block**. Commodity producer countries would suffer the most due to lowered expectations in commodity prices.

This scenario would shore up the depreciatory forces that we have witnessed in EM, especially among commodity exporters. Its policy makers would be confronted to a monetary-policy dilemma: maintaining support to the economic cycle via low interest rates and/or currency depreciations or endorsing the Fed's monetary policy to limit further capital outflows and inflation pressures.

At such crossroad, **we expect that market-oriented countries in EM would mostly respond in accordance to their inflation-targeting regime**, letting their currencies depreciate as long as the accompanying domestic slowdown offset the inflationary pressures.

In **China**, **the PBoC could strengthen its scheme of monetary stimulus** through new rate cuts, additional injections of liquidity and/or allowing a gradual depreciation of the renminbi. The use of fiscal stimulus is also on the table. **Latam** and **Turkey** will face a combination of cyclical deterioration, upward pressure on inflation (from the pass-through caused by the currency depreciations) and capital outflows. As a result, a somewhat **tighter path of interest rates relative to those anticipated so far seems feasible**.

Save-heaven effect should remain high (low interest rates) in the markets, punishing EM financial assets. The weakness of EM currencies could continue taking into account also recent developments in the renminbi, being more intense for countries with flexible exchange rates, large export shares to China and/or a similar trade structures (e.g. Brazil, Colombia and Chile).

In developed economies, deflationary pressures would be met with a more accommodative monetary policy stance: with the Fed delaying its lift-off even further (and/or further reducing the expected rate at which to tighten thereafter) while the ECB may end up prolonging its QE in this scenario. Overall, developed central banks will continue to ensure easy monetary conditions maintaining or strengthening current liquidity programs (ECB and BoJ) and delaying or making more gradual the path of rate hikes (Fed and BoE).

After the recent swings in the euro-dollar (hitting the 1.17 to later revert to 1.12), we see the 1.17 level as an outlier and the result of illiquid markets mixed with a sudden liquidation of leveraged positions that favoured the euro and the yen (given their recent role as funding currencies). Looking forward, we expect a slightly stronger euro as markets price-in a more cautious Fed (not necessarily with respect to the lift-off, but also with respect to the tightening cycle). Our forecasts point a relatively stable average of **1.10 for the euro-dollar**, trending slightly up in the second half of 2016. Swings around such an average would be contained within a 1.07-1.14 range, with pressures to the lower end during the first quarter of 2016. It is worth noticing that under this baseline scenario, we assume that any significant appreciation of the euro would be effectively offset by an active ECB (through either the extension or a frontloading of its current QE strategy).

Summary of projections: Baseline scenario (Jul-15)

Gross domestic product (annual average,YoY)

Jul-15	**2013**	**2014**	**2015**	**2016**
United States	2.2	2.4	2.5	2.8
Eurozone	-0.3	0.9	1.5	1.9
Spain	-1.2	1.4	3.2	2.7
LatAm *	2.5	0.8	0.3	1.2
Eagles **	5.6	5.2	4.8	5.2
Emerging Asia	7.0	6.8	6.6	6.4
China	7.7	7.3	6.7	6.2
World	3.4	3.4	3.4	3.8

Inflation (annual average, YoY)

Jul-15	**2013**	**2014**	**2015**	**2016**
United States	1.5	1.6	0.5	1.8
Eurozone	1.4	0.4	0.3	1.3
Spain	1.4	-0.2	-0.2	1.3
LatAm *	9.2	12.6	15.7	26.3
Eagles **	5.2	4.6	4.9	4.3
Emerging Asia	4.8	3.7	3.0	3.3
China	2.6	2.1	1.6	2.0
World	4.2	3.9	3.9	5.0

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela

** Bangladesh, Brazil, China, India, Indonesia, Iraq, Mexico, Nigeria, Pakistan, Philippines, Russia, Saudi Arabia, Thailand and Turkey

Source: BBVA Research and IMF

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