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Top EM themes for 2016: EM finds its feet

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In this edition of the *Emerging Markets Analyst* we lay out the top macro and market themes that we think will dominate EM assets in 2016.

1. EM growth to pick up, even if not like in the old (your older brother's) days

2. After correcting imbalances, better prospects beyond

3. EM assets no longer expensive – will that be enough?

4. China's bumpy deceleration has further to run, CNY implications the most worrying

5. Commodity deflation – from oil to metals and bulks

6. Navigating curves: Steeper as we start, flatter as we go on

7. EM inflation picks up in a disinflationary world

8. Earn the 'good' carry, hedge the China (and CNY) risk

9. Systemic EM crises still only a tail event

10. Differentiate, differentiate, differentiate (this one is always part of an EM list)

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Top EM themes for 2016: EM finds its feet

1. EM growth to pick up, even if not like in the old (your older brother's) days

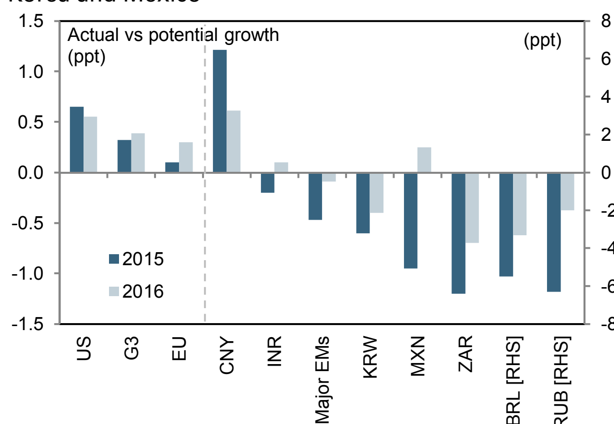
- Credit overhangs, lukewarm DMs point to continued below-trend EM growth.
- Some sequential improvement from smaller contractions in Russia, Brazil.
- India, Mexico, CEE should see strong growth in 2016 after a decent 2015.
- Still a tightrope walk, but 2016 could be the year when EM assets bottom.

Market issues: After six years of sequentially declining EM growth (2010-2015), our EM economists expect a pick-up in 2016. Among the BRICs, the continued slowing in China is likely to be offset to some extent by a sequential improvement in India, while in Russia we expect the contraction of late-2014 and 2015 to end finally in the fourth quarter of 2015, and even in Brazil the pace of contraction is likely to slow in 2016 relative to 2015 (Exhibit 1). In the rest of the EM, we expect robust growth rates in 2016 in Mexico and Central and Eastern Europe, specifically Poland and Hungary, with a more mixed picture in Asia.

Despite this pick-up, EM growth will remain at a below-trend pace as a number of global and local tailwinds that typically drive EM accelerations are going to be either neutral or outright headwinds. While the DM recovery has been better than the popular perception, with the Fed intent on gradually slowing the US expansion and Japan only just recovering from its technical recession in 2015, it is hard to see EMs moving to an above-trend pace by simply piggybacking off DM. We do expect Euro area growth to accelerate to an above-trend pace, which should help push the CEE economies to trend growth rates and beyond. But, aside from that, most EMs will face an external backdrop of relatively flat DM growth rates and higher US interest rates in 2016. 'Low-for-long' commodity prices mean there will be no tailwind for commodity producers either (although the headwinds in some cases may be less intense), and commodity importers – China and Korea are the prime examples – will continue to wrestle with large debt overhangs that will act as a brake on growth for several quarters (Exhibit 2). Credible cases of structural reforms that could boost EM growth are also few and far between, and even in India and Mexico the results have been disappointing.

Exhibit 1: A pick-up in EM growth in 2016, but still below-trend ...

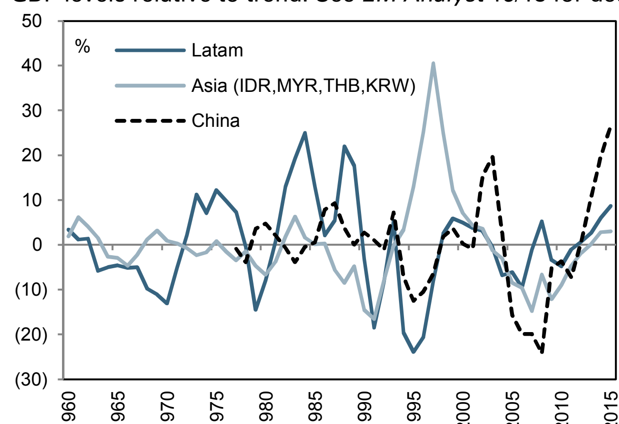
Major EMs include: Brazil, Russia, India, China, South Africa, Korea and Mexico



Source: Goldman Sachs Global Investment Research

Exhibit 2: ... as wide credit gaps in China and elsewhere weigh on activity

Credit gaps are defined as the difference between credit-to-GDP levels relative to trend. See *EM Analyst* 15/18 for details



Source: Haver Analytics, Goldman Sachs Global Investment Research

From an investment standpoint, the key issue is whether an improvement in growth will be enough, even when it is below trend. Given the widespread bearishness on EM, sluggish growth may help to limit the tail of possible downside scenarios, and therefore lower the required premium across EM assets, and 2016 could be the year EM assets put in a bottom and start to find their feet. We would expect more EM currencies to start exhibiting stability on a trade-weighted basis, even though some EM FX depreciation versus the USD is still likely. Likewise, a clearer indication of growth (and earnings) acceleration down the road would be necessary for EM equities to outperform DM markets strongly (rather than simply keeping pace with them).

2. After correcting imbalances, better prospects beyond

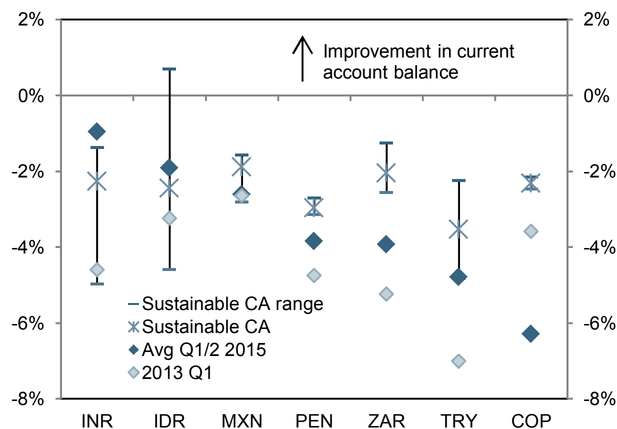
- Imbalances are correcting, but progress is uneven.
- Adjustments followed by better market performance: 2011/12 – PLN; 2013 – INR; 2014 – RUB; 2015 – BRL?
- External imbalance still an issue in COP, ZAR, TRY, MYR.
- Internal imbalance in CNY, KRW, THB, ILS.

Market issues: For about three years we have argued that EM economies needed to undertake an adjustment to regain external and internal balance, and that weaker currencies were an important part of that adjustment. These adjustments have progressed unevenly across EMs: on the external balance front, more adjustment is required in the cases of Colombia, South Africa and Turkey, where current account deficits are still substantial (Exhibit 3); on the internal balance front, where inflation is still significantly below target, we see the need for easier financial conditions in places like South Korea, Thailand, China and Israel. In all cases, our forecasts envisage significant further FX weakness.

While rebalancing has clearly been painful in the face of weaker global trade growth, lower commodity prices and a slowing China, a number of EMs have successfully rebalanced over the past few years, and it is important to acknowledge that. In that sense, we would part ways with the extreme pessimism that we sometimes encounter about the long-term prospects for EM assets with little scope for light at the end of the tunnel. We take a subtly different view: the required adjustment that many EMs are undergoing is painful in a macro and market sense, but on the other side there is the prospect of improved growth and better returns, even if it is not a rerun of the roaring 2000s. As Exhibit 4 shows, Poland (through 2011 and 2012), India (through 2013) and Russia (through 2014) have all undergone such adjustments. And, typically, after a painful bout of high real rates, soft growth and weaker currencies, they have tended to graduate towards more stable currencies (we forecast EUR/PLN at 4.10 in 12 months, $/INR at 67.5 and $/RUB at 66), with the prospect of better growth and continued equity market outperformance.

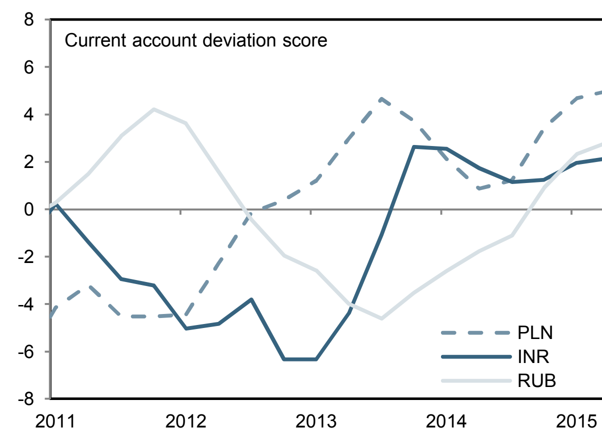
Even Brazil – the focus of much EM-related pessimism these days – has been going through an analogous painful macro and market adjustment in 2015, with real rates having moved to restrictive levels and a currency that is now at much more competitive levels. Given the additional political uncertainty in Brazil, it is notable that the depreciation in the real trade-weighted BRL over the past three years is not much more than for the AUD, another commodity currency that has needed to absorb the end of the commodity boom. While the potential for overshooting remains – especially if the political situation worsens dramatically – at 4.30 our $/BRL forecasts are now in line with the forwards.

Exhibit 3: Further external adjustment required in Colombia, South Africa and Turkey
Current account deficits relative to sustainable levels. See *EM Analyst 15/12 for details.*



Source: Goldman Sachs, Goldman Sachs Global Investment Research

Exhibit 4: Waves of adjustment: in Poland (2011-12), India (2013) and Russia (2014)
Higher absolute scores towards +/- 10 indicate increasing imbalance; 0 indicates balance



Source: Haver Analytics, Goldman Sachs Global Investment Research

3. EM assets no longer expensive – will that be enough?

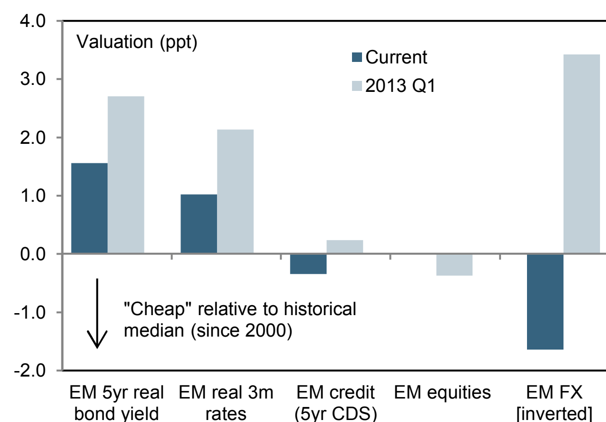
- EM assets have 'cheapened' after three years of underperformance.
- EM FX no longer 'expensive' relative to 'fair value' metrics on a broad basis.
- Rates, credit may need to adjust further.

Market issues: Going into the 'taper tantrum' in May 2013, in addition to challenging EM macro fundamentals, EM asset valuations were also 'expensive' (Exhibit 5). EM FX and local rates were at valuation levels that were 'rich' relative to their own histories as the EM carry trade that was already long in the tooth received one final added impetus from the Bank of Japan's decision to launch its QQE programme. The underperformance of EM assets since then has lowered valuations significantly. That reversal is most clear in the case of EM FX – which has moved from being the most stretched relative to our suite of fair value models, to being the EM asset class where valuations are probably the most supportive.

EM local rate valuations have also come down, but EM local rates are still low in a historical context. That is perhaps unsurprising given the fall in oil prices and the exceptionally low level of DM rates. That said, as those impulses fade and US rates start to normalise, EM rates may need to normalise and adjust higher as well. Likewise, EM credit and equity valuations are also not yet markedly 'cheap' relative to their own histories. But whereas EM credits have outperformed US HY credits of late, EM equities relative to US equities (or more broadly DM equities) have moved to decadal lows, and in the process have fallen modestly below fair-value.

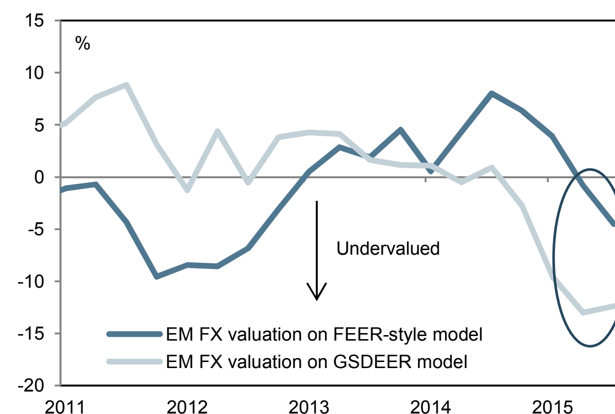
However, undemanding valuations by themselves are rarely enough to turn asset performance around. Better macro fundamentals, and especially stronger growth, are necessary ingredients for any sustainable rally in EM FX, equities and credit. That said, the fact that valuations are at more supportive levels is a testament to the adjustment that EM assets have achieved so far. And, looking into 2016, it is no longer obvious that EM FX is the weakest link among EM assets, and the risk-reward calculus of relative value opportunities within the EM FX complex should improve (Exhibit 6).

Exhibit 5: EM assets have cheapened …
EM FX uses GSDEER, EM equity uses 12m forward P/E



Source: Haver Analytics, FactSet, Goldman Sachs, Goldman Sachs Global Investment Research

Exhibit 6: … and EM FX most of all



Source: Goldman Sachs, Goldman Sachs Global Investment Research

4. China's bumpy deceleration has further to run, CNY implications the most worrying

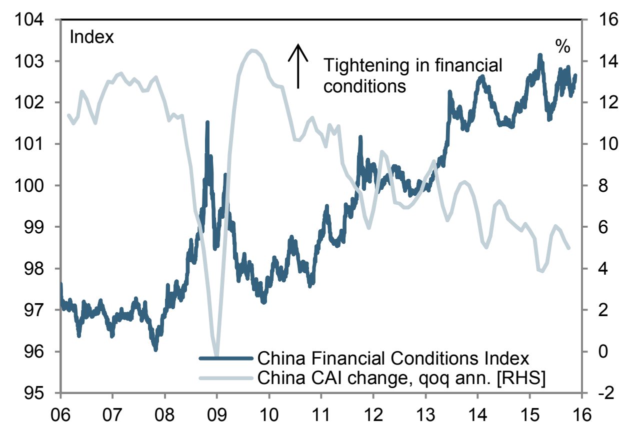
- The need to deleverage will keep China growth below trend; expect more easing.
- Outflows/anti-corruption measures limit effectiveness of monetary/fiscal stimulus.
- NJA/commodity exporters most exposed to slowing growth / CNY depreciation.

Market issues: We expect the bumpy deceleration in China's growth to extend into 2016, as policymakers wrestle with the aftermath of a massive debt build-up. But the slowing in China's growth trajectory is a pretty well flagged concern at this point, and we see a relatively low likelihood (below 20%) of a hard landing that takes Chinese activity run-rates to below 1% over the coming 12 months. If anything, our forecasts call for growth to improve a bit in the near term as activity recovers from prior shutdowns and is supported by a bout of fiscal spending and rate cuts.

So there are two distinct market issues. The first is whether the parts of EM that are further ahead in their rebalancing process can stabilise, even as China continues to slow. The domestic demand impulse from China is likely to remain weak on a protracted basis as policy supports become increasingly less effective – capital outflow pressures are keeping liquidity tight (Exhibit 7), anti-corruption measures are blunting the incentive of local governments to spend their fiscal allocations, and it is hard to see credit expansion drive growth higher on a sustainable basis. So, equities and credit in EMs for whom China is a major source of final demand may struggle to decouple from the slowdown there, and heading into 2016 we prefer EM equities more exposed to DM demand (Exhibit 8).

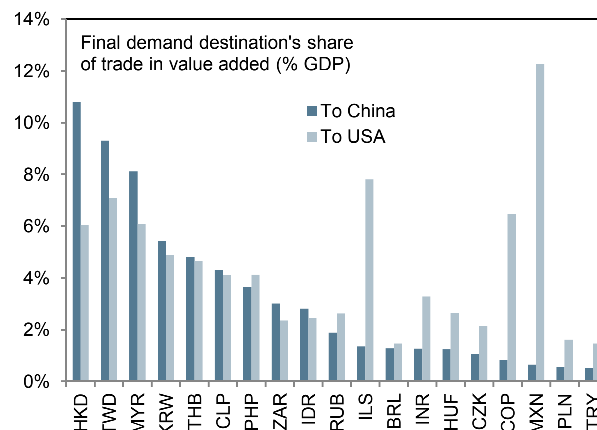
The second related issue is the potential for a significant depreciation of the CNY, which spills over into another leg lower across EM currencies. Given declining growth, there will be limited appetite to stomach significant further trade-weighted appreciation of the CNY through its tight USD peg, especially as it impedes policymakers' ability to deliver easier financial conditions. Hence, the combination of a stronger USD (driven by policy divergence among the G3) and a deceleration in Chinese growth pushes towards a shift in the way the CNY is managed, with more depreciation the likely outcome. In our view, the fallout from such a shift is the primary risk to the EM FX complex in 2016.

Exhibit 7: China financial conditions have tightened even as growth has slowed



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 8: Asia and commodity producers most exposed to China slowdown



Source: OECD, Goldman Sachs Global Investment Research

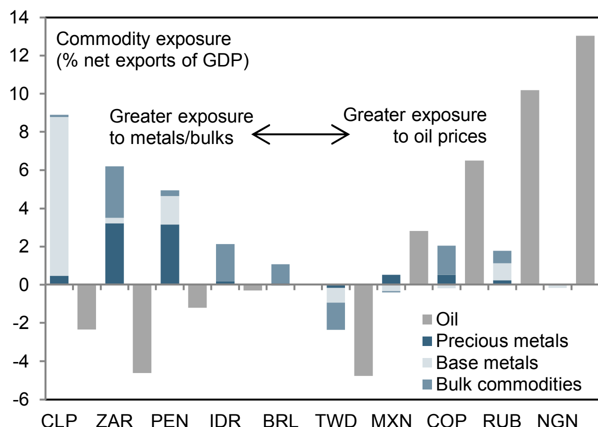
5. Commodity deflation – from oil to metals and bulks

- Limited further downside to oil prices, even if low for long.
- Greater downside in copper, iron ore, coal under central scenario.
- China growth rebalancing less hurtful for oil relative to metals.

Market issues: The collapse in oil prices resulting from the 'new oil order' spurred by Shale production has been one of the primary drivers of EM market moves through 2014 and 2015. The full effects of oil prices staying low (at around $45/bbl under our commodity team's central forecast) for long will continue to be felt for some time in oil-producing economies. However, at least among EMs (such as Russia and Mexico), where currencies have been allowed to move significantly and absorb the bulk of the terms-of-trade shock, the remaining adjustments to government and private-sector balances should be less immediately painful. Argentina may be the surprise winner of the 'new oil order' as the upcoming political transition paves the way for the exploitation of the 'Bakken of South America'. We are more concerned about places such as Nigeria, Saudi Arabia and Venezuela, where pegged exchange rates mean that the impact of the terms-of-trade shock is likely to fall more squarely on government fiscal balances (with risks to the sovereign credits), domestic household and corporates – and where, in the limit, the exchange rate peg may itself be at risk. Of course, pressures on both groups of EMs would increase in the event that oil prices fall further – to around $20/bbl if storage capacity is exhausted, as outlined by our Commodity team in their downside scenario.

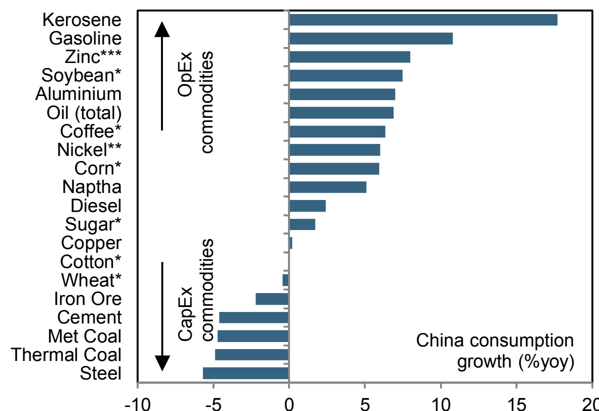
Going into 2016 we see greater downside in the metals and bulks part of the commodity complex: specifically, our end-2016 forecasts call for copper, iron ore, gold and coal to move roughly another 10% lower. From a market standpoint, therefore, currencies with relatively greater exposure to these metals – including the CLP, ZAR, PEN and IDR – should be relatively more vulnerable than the pure oil plays (Exhibit 9). The metals complex is also more exposed to China: even a growth-neutral rebalancing that sees consumption grow at the expense of fixed asset investment would be more supportive for oil demand than metals demand (Exhibit 10).

Exhibit 9: Commodity downdraft moves from oil to metals with differential EM impact
Precious metals: Gold, Silver; Base Metals: Aluminium, Copper, Nickel, Zinc, Lead; Bulk Commodities: Iron Ore, Coal



Source: UNCTAD, Goldman Sachs Global Investment Research

Exhibit 10: China rebalancing to benefit oil more than other commodities
2015 YTD



Source: IEA, Wood Mackenzie, CRU, CEIC, USDA, Goldman Sachs Global Investment Research
** Estimated 2015 annual consumption growth rate*
*** Calculated from apparent Stainless Steel demand*
**** Galvanised zinc production*

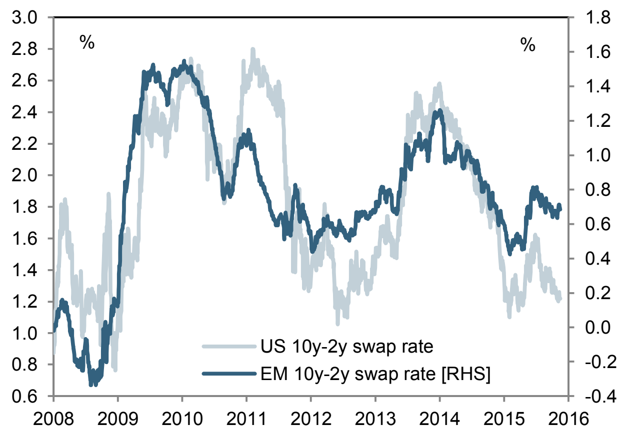
6. Navigating curves: Steeper as we start, flatter as we go on

- UST curve shape matters more than 'lift-off'.
- Pain for EM as term premium normalises after first hike ...
- ... which should give way to a more EM-friendly flattening.

Market issues: After several months of the now-familiar guessing game of when the Fed will raise rates, 'lift-off' looks set to take place at the December FOMC meeting. But, setting aside the 'sticker shock' from the first US rate hike in nearly a decade, given that EM assets have been absorbing US rate tightening for two years, the first hike may be less of a defining moment than is often assumed. Since the lapse of forward guidance and the first talk of tapering in early 2013, 2-year rates in the US have risen from about 25bp to around 1% currently.

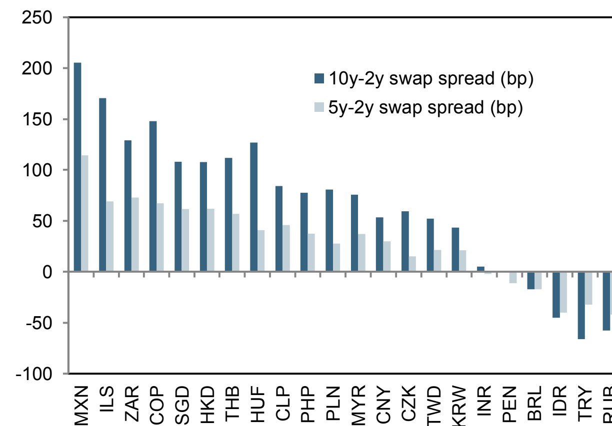
A far more important determinant of EM returns around 'lift-off' will be whether the Fed succeeds in delivering a 'dovish hike' so that the back end of the US curve remains broadly well behaved and a flattening ensues. The alternative is that the first hike shifts focus towards a potentially steep path of successive hikes (such as the 25bp hike per quarter path embodied in our US team's forecasts) and allows a rebuild in the term premium, especially if 'lift-off' comes alongside stronger US activity and a repricing of inflation expectations. Such a bear steepening would be much more painful for EM assets. EM curves did not flatten as aggressively as the G3 curves in the summer, but the average level of steepness in EM curves is not much higher currently than at the time of the 'taper tantrum' in 2013 (Exhibit 11). So long-end rates in EMs with flat curves could see the most pain, with currencies underperforming as well if the move extends. Among the low-yielders, CZK, PLN, HUF and MYR rates, and among the high-yielders, IDR and TRY may be most vulnerable (Exhibit 12). Curves in CEE (HUF, PLN, CZK) may be especially exposed if monetary policy authorities continue to add accommodation despite a reflationary macro-backdrop.

Exhibit 11: EM curves as flat as in early 2013 ahead of the taper tantrum …



Source: Goldman Sachs, Goldman Sachs Global Investment Research

Exhibit 12: … with flat curves most vulnerable to a US-led steepening



Source: Goldman Sachs, Goldman Sachs Global Investment Research

However, the continued bid for duration from the ECB and the BoJ – and we expect a further augmentation of quantitative easing by both central banks in coming months – should limit the degree of EM-unfriendly curve steepening. Moreover, as the tightening cycle progresses, we would expect the term structure to flatten – either because continued above-potential growth causes the market to price a faster pace of hikes at the front end, resulting in a bear-flattening, or because growth slows modestly and a bull-flattening ensues. The latter case, provided US growth does not slow too sharply, has historically been the most EM carry-trade friendly.

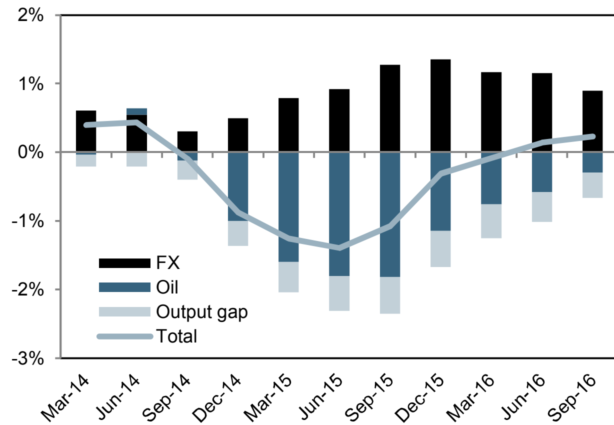
7. EM inflation picks up in a disinflationary world

- The disinflationary impulse from lower oil prices will fade in 2016.
- Inflation will rise, but stay low in ‘low-flation’ group (TWD, THB, KRW, CNY, ILS).
- Higher inflation will complicate policy choice in TRY, ZAR, INR.
- Inflation should ease sharply in Russia, more gradually in Brazil.

Market issues: ‘Low-flation’ and the fight against it played a big role in markets in 2015, and we end the year with inflation estimates at their lows across major DMs and several EM economies. As we work through the remaining slack in the G3 economies, and with most EMs still growing below trend, 2016 should be another year with low inflation rates. But the intense disinflationary impulse from lower oil prices over the past year is likely to fade gradually over the coming year (Exhibit 13). Indeed, for several EMs, the lagged effects of the large currency depreciations of 2015 will add a positive impulse to headline inflation in 2016. In parts of Asia, in particular, we expect a severe El Niño to boost agricultural prices and food price inflation may also be part of the mix for a period of time. As these developments unfold, it is certainly possible to envisage bouts of interest rate volatility as markets worry – for the first time in several years – about the possibility of central banks falling behind the curve.

Exhibit 13: Disinflationary impulse from oil to fade in 2016

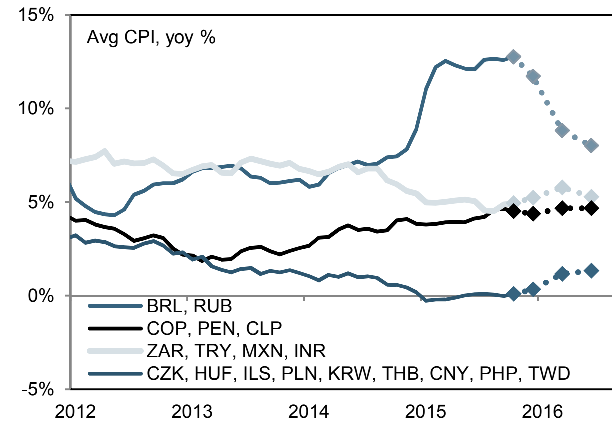
Model-implied effects of FX, oil prices and output gaps on average EM inflation



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 14: The 'squeezed middle' – Turkey, South Africa, and India – will likely see inflation pressures come back

See *EMW* 15/16 for details



Source: Haver Analytics, Goldman Sachs Global Investment Research

Those concerns are likely to be most acute among a 'squeezed middle' of EMs where inflation starts moving higher from levels that are not especially low to start with: risks are most conspicuous in Turkey, where the momentum of core inflation is already running in double-digits, followed by South Africa and India, where policymakers will need to strike a difficult balance between supporting growth and keeping inflation in check (Exhibit 14). EMs in Latin America are at the front line of that balancing act, with rate hikes already delivered in Chile, Colombia and Peru (and more to come in the coming months), and Mexico having indicated a desire to move soon after the Fed.

The sequential uptick in inflation is likely to come from much lower levels in much of Asia. This suggests that in EMs such as Korea, Taiwan, Thailand, China, and even Israel, the challenges of 'low-flation' will continue to argue for more easing, and we would be inclined to fade any back-ups in rates in these markets. The CEE economies are prime candidates to exit 'low-flation' given the prospect of a second year of above-trend growth, which may raise questions about the EUR/CZK peg and the merits of further easing in Hungary.

Russia is likely to see the biggest disinflation of all – from 15.7% currently to 4% by the end of 2016 – and our economists expect 500bp of cuts in Russia by mid-2016. Even in Brazil, the deep economic contraction should start to weigh on inflation, although rate cuts here are more likely to be a story for the second half of 2016. In our view, it would be premature for the central bank to rush into a sharp easing cycle after waging a hard battle against inflation and inflation expectations, but the opportunity to receive local rates may come earlier as the market front-runs that move. That is also likely to be the cue for considering long positions in Brazilian equities, as we expect to see growth bottoming out midway through the year.

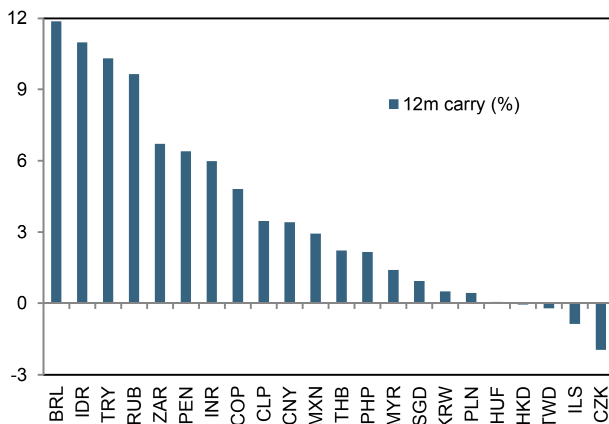
8. Earn the 'good' carry, hedge the China (and CNY) risk

- FX carry opportunities in EMs that have adjusted imbalances (INR, RUB, MXN).
- US steepening, oil downside and CNY devaluation are the main potholes to avoid.
- CNY devaluation hedges include (i) long $/CNH, (ii) long $/KRW and/or $/MYR, or (iii) short commodity currencies (such as CLP)

Market issues: Under our baseline global macro and market outlook, it is possible to envisage better performance for EM assets relative to the past few years. A modest pick-up in EM growth – even taking account of a deceleration in China, still broadly low inflation and a Fed that is only likely to move at a measured pace – should make for a macro backdrop where earning EM carry is less risky than in previous years, especially among the 'good' EM stories where imbalances have been corrected and valuations are supportive (Exhibit 15). The INR remains top of that list, but the RUB also offers a good opportunity under our central forecast of limited further oil price downside. Among the lower yielders, the MXN should also offer stable carry in a world with flat oil prices, and we continue to see the PLN supported by the improving growth dynamic in Europe relative to Asia or the US. Funding these EM currency longs out of the EUR, where we continue to forecast further downside, still looks attractive. But, provided our baseline view plays out, stability versus the USD also looks within reach in 2016.

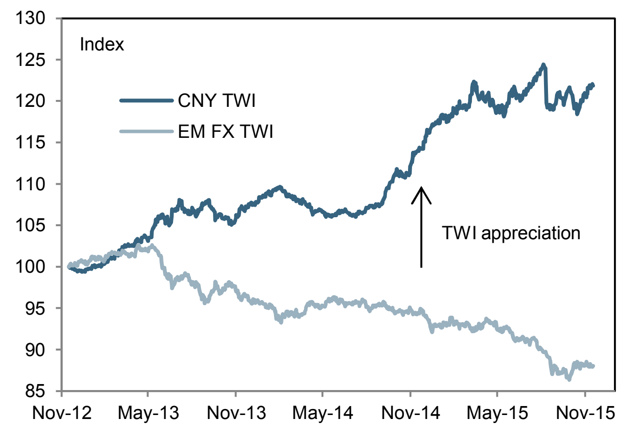
The challenge with such a strategy is that there are still at least three downside risks that can derail any constructive EM FX view. First, oil prices that undershoot towards a downside scenario of $20/bbl as storage capacity is exhausted are likely to put the entire EM complex under pressure. Second, it is easy to imagine how strong data can thwart the FOMC's desire to deliver a 'dovish hike' in December. And, third, as China's bumpy deceleration extends, the risks of a substantial (10%+) depreciation are likely to grow, posing a threat to the entire EM FX complex. Thus, even though we think EM FX will finally find a bottom in 2016, trading a constructive EM FX view is likely to prove a choppy and often frustrating endeavour, with a premium on avoiding these potholes.

Exhibit 15: Selective exposure to 'good' EM carry where imbalances have adjusted ...



Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 16: ... but hedge the CNY depreciation risk which will exacerbate the depreciation in EM FX



Source: Goldman Sachs, Goldman Sachs Global Investment Research

Consequently, it makes sense to consider direct and indirect hedges to these risks. Of the three risks, in the first two cases there are at least some automatic stabilisers. A sharp oil price undershoot should cause shale oil supply to fall, limiting the duration of any undershoot. Similarly, if financial conditions tighten sharply around the FOMC hike, the Fed is more likely to slow down its pace of future rate increases. We worry most, therefore, about the risks of a sharp CNY depreciation over the course of the next 12 months as the SDR decision fades into memory (Exhibit 16). This can be hedged directly through $/CNH upside, where the forwards currently price only a small depreciation over the next 12 months, reflecting in part the still strong trade balance and ample reserve cushion which should allow policymakers to move at a time and pace of their choosing. That said, capital outflows have been eroding the reserve cushion in recent months, and periodic official interventions through the forward book may actually provide attractive entry points for setting hedges. Alternately, exposure to upside in parts of $/NJA (for example, a basket of $/KRW and $/MYR), where carry costs are low, or commodity currencies (such as $/CLP) should be part of any portfolio with a constructive EM FX view.

9. Systemic EM crises still only a tail event

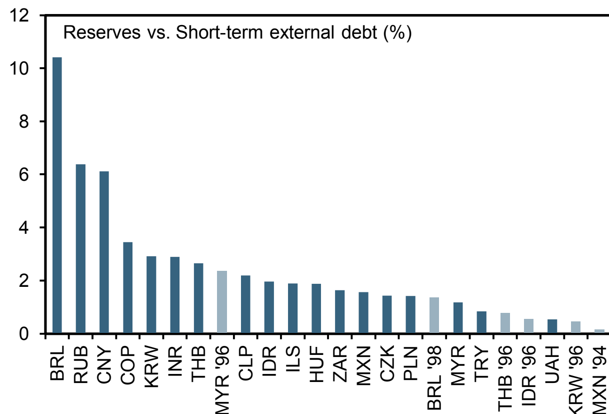
- EM bank underperformance likely, but the bar for sovereign crises is much higher.
- Sovereign external positions healthier on the whole.
- Institutional capacity to navigate a long period of poor growth is the weak link.

Market issues: EM fragilities and an impending Fed hike are reminiscent of EM crises past. However, we believe (to use a clichéd phrase) this time will be different. The 1980s and 1990s were punctuated by EM crises involving external debt: simplifying enormously, this typically involved a reliance on external funding, pegged exchange rates and open capital accounts. As the cost of external funding increased, the pegs were vulnerable to self-fulfilling episodes of panic, since foreign currency reserves were lower than short-term external debt; and the ensuing FX depreciation exacerbated capital outflow and led to dramatic hits to balance sheets as investors worried about an unsustainable burden of debt denominated in foreign currency.

We have argued that a repeat of such crises is unlikely because the setup is very different today, given that (1) most EM currencies are not pegged, which has allowed for a gradual but still substantial adjustment in EM currencies; (2) EM reserves are much larger relative to short-term external debt (Exhibit 17); (3) the rate path of the Fed during this hiking cycle is likely to be less sharp than in past cycles, putting less pressure on EM rates markets. We have already noted that the adjustment in EM current accounts has now been under way for two years. This is in stark contrast to past EM crises, which occurred when current account deficits were typically at their peak; this, in turn, should provide an ongoing cushion against EM pressures.

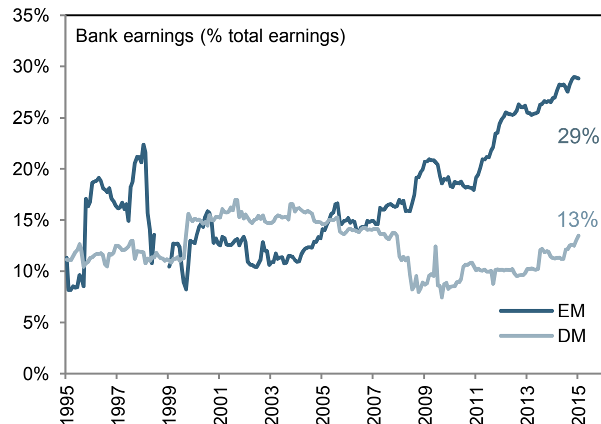
The nature of the current EM challenge is different, and is primarily focused on navigating a poor growth outlook. Stretched leverage ratios remain a key headwind and not just in China: credit gaps are also wide in South-East Asia, Turkey and Brazil. With much of that debt denominated in local currency in this cycle, EM banks may see further underperformance and require recapitalisation as corporate and household credit deteriorates in line with weak growth and higher rates. The starting point is also stretched, as the share of EM banks in overall corporate profits has risen sharply from an average of 15% over the past 20 years to nearly 30% currently (Exhibit 18). We would also not be surprised to see pockets of corporate distress where external borrowing has been substantial, especially in the commodity investment sector.

Exhibit 17: EM external balance sheets in better shape than previous crisis episodes



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 18: EM bank profits vulnerable to slower growth and a downturn in the credit cycle



Source: FactSet, Goldman Sachs Global Investment Research

The real risk of a systemic EM crisis stems from a different source – the ability of institutions across EM to navigate a prolonged period of weak growth coinciding with adverse shocks. Venezuela may move even closer to hyperinflation and/or default in 2016 without external help, but even more 'mainstream' EMs such as Brazil, Malaysia and Turkey are seeing currency and sovereign CDS underperformance as markets worry about institutional fragilities and the ability to manage the cycle effectively. Bouts of volatility are possible in Asia too, with general elections in Korea and Taiwan, a political transition in Thailand and the retirement of the highly experienced BNM governor Zeti in Malaysia. It is possible that worries around some of these shifts will escalate to critical levels in the year ahead, but we do not think a broad-based EM crisis is inevitable or even likely unless some of these political/institutional risks worsen across the EM landscape, including and especially in China.

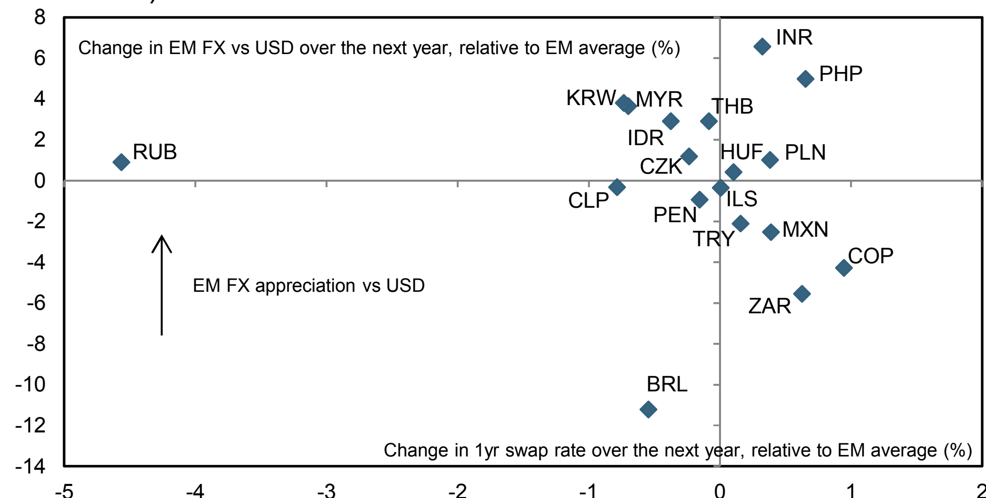
10. Differentiate, differentiate, differentiate (this one is always part of an EM list)

- Excessive deficits, slow growth will continue to weigh on FX in BRL, ZAR, COP.
- RUB, KRW (and eventually BRL) are friendly environments for lower rates.
- Strong projected growth creates room for FX outperformance in INR, PLN, PHP.

Market issues: In addition to global macro factors, domestic macroeconomic imbalances have driven much of the asset market differentiation across EMs in 2015 and, as we look into 2016, the disparate combinations of growth, inflation and current account gaps will continue to differentiate performance across EM FX and rates. We have developed a framework that allows us to estimate, for each EM, the impact of these three impulses on both the FX and rates markets in the year ahead. Based on this, we can identify three sets of conclusions (Exhibit 19):

First, we see the clearest scope for currency underperformance in BRL, ZAR and COP, where still large external deficits and moderate-to-weak real GDP growth will push towards currency weakness. In COP and ZAR, relatively firm headline inflation should also push towards higher front-end rates. Brazil is likely to enter 2016 at a very high level of inflation, but here we expect weak growth and the prospect of lower inflation to push towards lower BRL rates as the year progresses.

Exhibit 19: Imbalance-driven pressures in the year ahead: towards weaker FX in BRL, ZAR, COP; lower rates in RUB, KRW (and eventually BRL); and stronger FX in INR, PLN, and PHP
Model estimates of growth, inflation and current account-driven pressures on rates and FX.
See *EM Analyst 15/15* for details.



Source: Haver Analytics, Goldman Sachs Global Investment Research

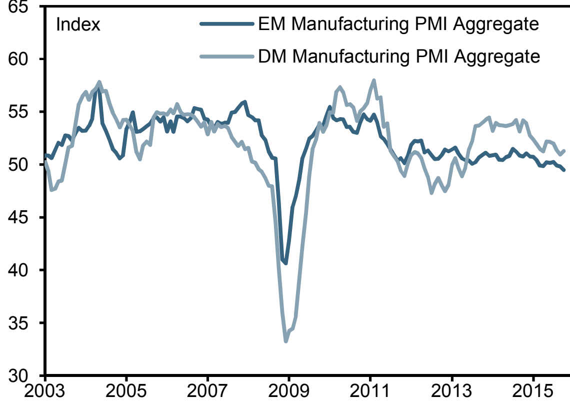
Second, Russia faces the strongest pressure for lower front-end rates, and the profile of recovering growth and a strong external balance argues for relative stability in the currency. Apart from Russia, our model estimates suggest that pressure for lower front-end rates will be felt most clearly in South Korea, given that growth is below trend and inflation is still well below target despite the pick-up we expect. Our economists have pencilled in 50bp of cuts in Korea; but, given weak exports and a capital outflow package in train, we also expect significant currency weakness as part of the easing in financial conditions.

Third, three countries make it into the quadrant with appreciation pressure in FX and upward pressure on rates: India, the Philippines and Poland. The common thread is balanced external accounts, strong projected growth and a pick-up in inflation. That said, it is hard to see policy rates being hiked in Poland given the upcoming change to the MPC in 2016Q1, so EUR/PLN downside (or PLN/HUF upside) may be a better way to position for the domestic macro impulses here. In India, we expect these dynamics to bring the rate-cutting cycle to an end for now; however, given the prospect of an outperforming currency, it remains a prime candidate for earning ‘good’ EM carry.

This report is a collaborative effort of the authors named, drawing on their areas of expertise.

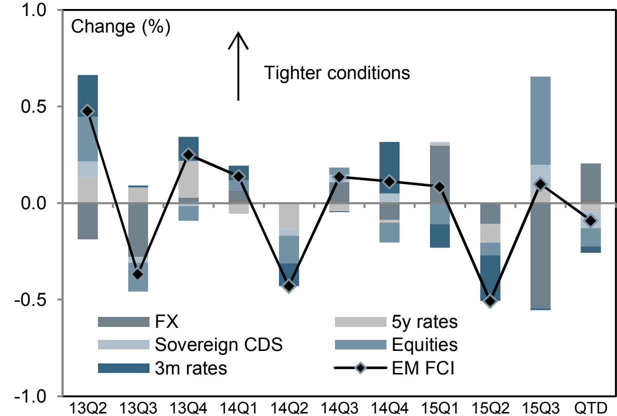
EM macro and markets snapshot

EM and DM Manufacturing PMI
SA, 50+ = Expansion



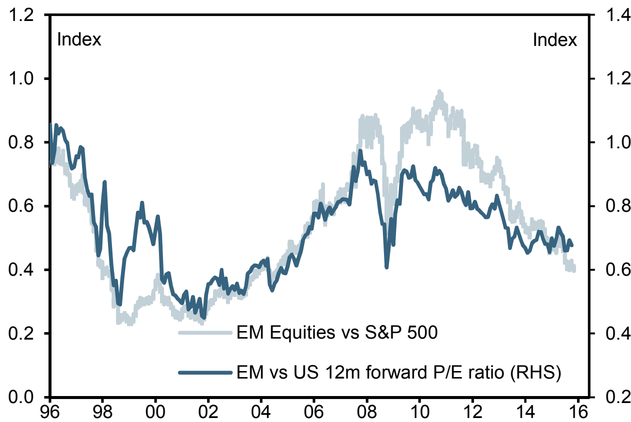
Source: Haver Analytics, Goldman Sachs Global Investment Research.

EM Financial Conditions
For details of construction see *EM Macro Daily*, July 22, 2014



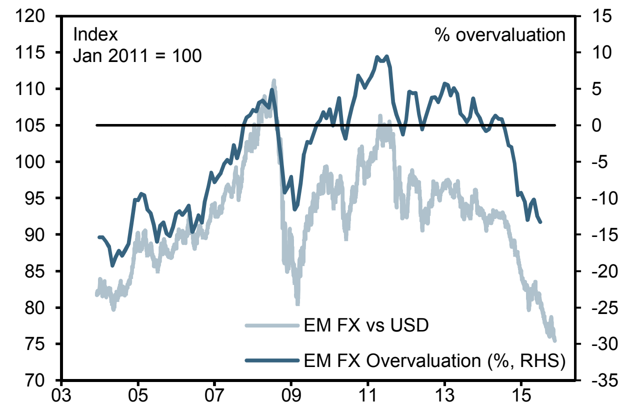
Source: Goldman Sachs, Goldman Sachs Global Investment Research.

EM Equities versus US



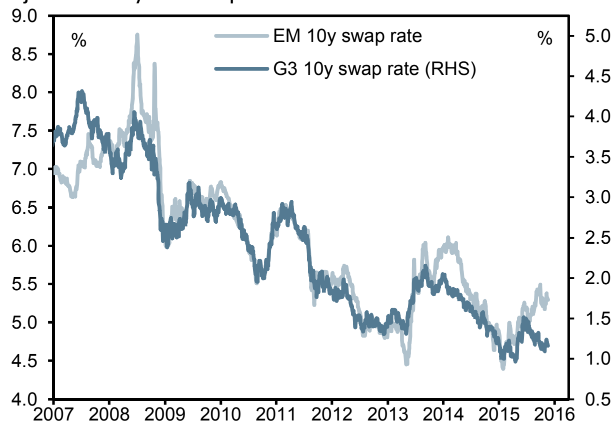
Source: MSCI, Goldman Sachs Global Investment Research.

EM FX versus USD and EM FX overvaluation
Major EMs, overvaluation calculated using GSDEER values



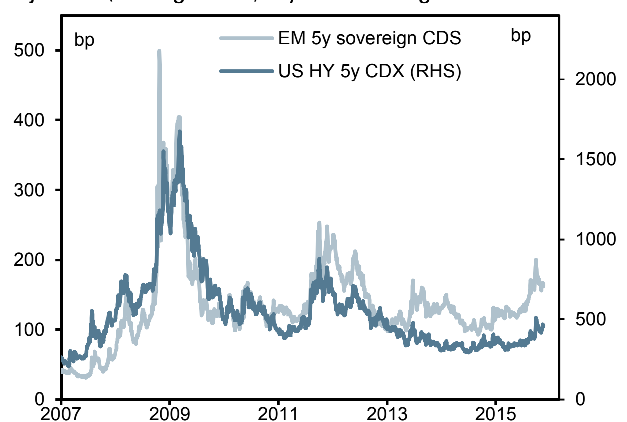
Source: Goldman Sachs, Goldman Sachs Global Investment Research.

EM versus G3 10-year rates
Major EM 10-year swap rates



Source: Goldman Sachs, Goldman Sachs Global Investment Research.

EM sovereign CDS versus US HY CDX
Major EM (ex-Argentina) 5-year sovereign CDS



Source: Goldman Sachs, Goldman Sachs Global Investment Research.

Economic forecasts

Real GDP (% change, yoy)

	94-01	02-09	10	11	12	13	14	15 (f)	16 (f)
Aggregates									
World	2.3	3.7	5.4	4.2	3.2	3.2	3.3	3.2	3.5
Emerging Markets	3.8	6.9	8.3	7.0	5.4	5.4	4.7	4.4	4.9
Developed Markets	3.0	1.6	3.1	1.7	1.2	1.1	1.9	2.0	2.0
G3									
USA	3.7	1.6	2.5	1.6	2.2	1.5	2.4	2.4	2.2
Euro area	2.6	1.0	2.0	1.7	-0.8	-0.2	0.9	1.5	1.7
Japan	0.9	0.4	4.7	-0.5	1.7	1.6	-0.1	0.6	1.0
Asia									
China	9.4	10.8	10.6	9.5	7.7	7.7	7.3	6.9	6.4
Hong Kong	2.8	4.2	6.8	4.9	1.5	3.1	2.5	2.3	1.6
India	5.7	7.7	9.3	7.7	4.8	6.4	7.1	7.4	7.8
Indonesia	3.1	5.5	6.4	6.2	6.0	5.6	5.0	4.8	5.2
Malaysia	5.5	4.8	7.5	5.3	5.5	4.7	6.0	5.0	4.7
Philippines	3.8	4.8	7.6	3.7	6.7	7.1	6.1	5.6	6.1
Singapore	6.2	5.6	-1.0	0.0	3.4	4.4	2.9	2.0	2.3
South Korea	5.7	4.0	6.5	3.7	2.3	3.0	3.3	2.7	2.9
Taiwan	5.1	3.9	10.6	3.8	2.1	2.2	3.8	0.7	1.9
Thailand	3.1	4.4	7.5	0.8	7.3	2.8	0.9	2.8	2.9
Latin America									
Argentina	1.5	4.5	9.5	8.4	0.8	2.9	0.5	1.7	1.1
Brazil	2.7	3.5	7.6	3.9	1.8	2.7	0.1	-3.2	-1.6
Chile	5.2	4.1	5.8	5.8	5.5	4.2	1.9	2.1	2.5
Colombia	2.3	4.4	4.0	6.6	4.0	4.9	4.6	3.0	2.8
Mexico	3.2	1.8	5.1	4.0	4.0	1.4	2.1	2.3	2.8
Peru	4.3	5.8	8.5	6.5	6.0	5.8	2.4	2.6	3.6
Venezuela	1.0	4.1	-1.5	4.2	5.6	1.3	-4.0	-8.2	-4.6
CEEMEA									
Czech Republic	2.6	3.4	2.1	2.0	-0.8	-0.5	2.0	4.5	2.7
Hungary	3.6	1.9	0.8	1.8	-1.7	2.0	3.6	2.6	2.6
Israel	4.6	3.4	5.5	5.0	2.9	3.3	2.6	2.4	3.1
Nigeria	2.7	10.1	7.8	4.9	4.3	5.4	6.3	3.1	3.6
Poland	4.9	4.2	3.6	4.9	1.9	1.7	3.3	3.6	3.4
Romania	-0.3	5.0	-0.8	1.1	0.6	3.4	2.8	3.8	5.2
Russia	3.9	4.9	4.5	4.2	3.5	1.3	0.6	-3.5	1.5
South Africa	2.9	3.6	3.0	3.2	2.2	2.2	1.5	1.4	1.7
Turkey	2.3	4.6	9.2	8.8	2.1	4.2	2.9	3.5	3.0
Ukraine	0.0	4.2	3.9	5.4	0.4	-0.1	-6.5	-11.2	1.0

Consumer Prices (% change, yoy)

	94-01	02-09	10	11	12	13	14	15 (f)	16 (f)
Aggregates									
World	4.1	3.7	3.5	4.6	3.5	3.4	3.7	3.1	2.9
Emerging Markets	7.7	6.3	5.8	6.7	5.1	5.6	5.9	6.0	4.5
Developed Markets	2.0	2.0	1.6	2.7	2.0	1.4	1.3	0.3	1.4
G3									
USA	2.6	2.4	1.6	3.1	2.1	1.5	1.6	0.2	1.8
Euro area	1.9	2.1	1.6	2.7	2.5	1.4	0.4	0.1	1.1
Japan	0.2	-0.1	-0.7	-0.3	0.0	0.4	2.8	0.7	0.3
Asia									
China	6.4	2.2	3.3	5.4	2.7	2.6	2.0	1.4	1.5
Hong Kong	2.9	0.5	2.3	5.3	4.1	4.3	4.4	3.0	3.0
India	-	5.9	10.3	9.6	9.7	10.7	6.6	4.8	5.1
Indonesia	15.8	8.7	5.1	5.3	4.0	6.4	6.4	6.4	5.5
Malaysia	3.0	2.4	1.7	3.2	1.7	2.1	3.1	2.2	3.7
Philippines	7.0	5.2	4.1	4.7	3.2	2.9	4.2	1.4	2.8
Singapore	1.3	1.6	2.8	5.2	4.6	2.4	1.0	-0.4	1.1
South Korea	4.4	3.1	2.9	4.0	2.2	1.3	1.3	0.7	1.9
Taiwan	1.9	1.1	1.0	1.4	1.9	0.8	1.2	-0.3	1.2
Thailand	4.2	2.7	3.3	3.8	3.0	2.2	1.9	-0.8	2.0
Latin America									
Argentina	0.3	11.0	10.5	9.8	10.0	10.6	21.4	15.7	19.8
Brazil	273.3	6.9	5.0	6.6	5.4	6.2	6.3	8.9	7.4
Chile	6.2	3.4	1.4	3.3	3.0	1.9	4.4	4.4	3.9
Colombia	16.0	5.7	2.3	3.4	3.2	2.0	2.9	4.9	5.5
Mexico	18.2	4.5	4.2	3.4	4.1	3.8	4.0	2.8	3.6
Peru	8.9	2.5	1.5	3.4	3.7	2.8	3.2	3.5	3.7
Venezuela	44.8	22.6	28.2	26.1	21.3	40.0	61.8	99.5	125.9
CEEMEA									
Czech Republic	7.2	2.4	1.5	1.9	3.3	1.4	0.4	0.4	1.2
Hungary	16.5	5.3	4.9	3.9	5.7	1.7	-0.2	-0.1	2.2
Israel	7.0	2.2	2.7	3.5	1.7	1.5	0.5	-0.6	0.6
Nigeria	13.0	12.3	13.8	10.9	12.2	8.5	8.0	9.1	10.8
Poland	16.4	2.5	2.6	4.3	3.7	0.9	0.0	-0.9	1.2
Romania	0.0	7.6	6.1	5.8	3.3	4.0	1.1	-0.6	-0.7
Russia	90.4	12.3	6.9	8.5	5.1	6.6	7.8	15.1	5.9
South Africa	4.8	6.3	3.5	6.1	5.7	5.4	5.3	5.6	6.7
Turkey	71.0	15.6	8.6	6.5	8.9	7.5	8.9	7.6	7.8
Ukraine	12.3	11.5	9.4	8.0	0.6	-0.3	12.1	49.9	23.9

Current Account (% GDP)

	94-01	02-09	10	11	12	13	14	15 (f)	16 (f)
G3									
USA	-2.4	-4.7	-3.0	-3.0	-2.9	-2.4	-2.2	-2.4	-2.8
Euro area	-0.8	0.0	0.3	0.2	1.3	2.0	2.4	3.2	3.0
Japan	2.3	3.5	4.0	2.2	1.0	0.8	0.5	3.4	3.7
Asia									
China	1.7	5.9	3.9	1.8	2.5	1.6	2.1	2.8	2.1
Hong Kong	1.1	10.8	7.0	5.6	1.6	1.5	1.9	4.5	5.4
India	-1.0	-0.6	-3.3	-3.4	-5.0	-2.6	-1.4	-0.9	-1.5
Indonesia	0.8	1.8	0.7	0.2	-2.7	-3.2	-3.1	-2.1	-2.6
Malaysia	2.2	13.2	10.1	10.9	5.1	3.4	4.3	2.9	2.4
Philippines	-3.3	2.7	3.7	2.5	2.6	4.2	3.7	3.8	4.0
Singapore	16.0	19.8	23.6	22.0	17.2	17.9	19.1	22.9	20.8
South Korea	1.8	1.8	2.9	2.3	4.5	6.1	6.3	8.0	7.5
Taiwan	3.1	7.9	9.3	9.0	10.7	11.7	12.4	14.4	14.1
Thailand	1.4	2.3	2.9	2.5	-0.4	-1.2	3.7	6.4	4.9
Latin America									
Argentina	-3.3	3.5	-0.3	-0.7	-0.2	-0.7	-1.1	-1.6	-1.0
Brazil	-3.3	0.1	-2.1	-2.0	-2.2	-3.4	-4.4	-3.9	-2.8
Chile	-3.0	1.2	1.7	-1.2	-3.6	-3.7	-1.2	-1.1	-1.5
Colombia	-3.2	-1.7	-3.0	-2.9	-3.1	-3.3	-5.2	-6.1	-4.2
Mexico	-2.8	-1.3	-0.5	-1.1	-1.4	-2.4	-1.9	-2.8	-2.6
Peru	-5.1	-0.3	-2.4	-1.9	-2.7	-4.2	-4.0	-3.8	-2.8
Venezuela	4.4	10.7	3.7	7.7	2.9	1.5	2.0	-2.0	-1.3
CEEMEA									
Czech Republic	-3.7	-3.3	-3.6	-2.1	-1.6	-0.5	0.6	1.0	-0.5
Hungary	-7.2	-6.5	0.3	0.7	1.8	4.0	2.3	3.5	1.3
Israel	-2.4	2.3	3.5	2.6	1.7	2.9	3.7	3.0	3.0
Nigeria	1.3	10.3	3.9	3.0	4.1	3.9	0.2	-2.6	-1.9
Poland	-6.0	-4.3	-5.4	-5.2	-3.7	-1.3	-2.0	-0.4	-1.2
Romania	-1.6	-7.9	-5.1	-4.9	-4.8	-1.1	-0.5	-2.1	-4.6
Russia	6.2	7.9	4.4	5.1	3.6	1.7	2.9	5.0	3.8
South Africa	-0.6	-3.1	-1.5	-2.2	-5.0	-5.8	-5.5	-3.9	-4.5
Turkey	-0.5	-3.8	-6.2	-9.6	-6.2	-7.8	-5.8	-4.6	-3.9
Ukraine	3.7	1.6	-2.2	-6.3	-8.1	-9.0	-3.5	-0.8	-0.5

Policy Rates (%, eop)

	94-01	02-09	10	11	12	13	13	15 (f)	16 (f)
G3									
USA	5.0	2.3	0.2	0.1	0.2	0.1	0.1	0.4	1.4
Euro area	3.7	2.5	1.0	1.0	0.8	0.3	0.1	0.1	0.1
Japan	0.5	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Asia									
China	-	2.0	3.8	3.9	3.2	5.3	4.4	2.0	1.5
Hong Kong	-	-	-	-	-	-	-	-	-
India	-	5.6	6.3	8.5	8.0	7.8	8.0	6.8	6.8
Indonesia	16.1	9.4	6.5	6.0	5.8	7.5	7.8	7.5	7.0
Malaysia	-	3.0	2.8	3.0	3.0	3.0	3.3	3.3	3.3
Philippines	-	5.0	4.0	4.5	3.5	3.5	4.0	4.0	4.3
Singapore	-	-	-	-	-	-	-	-	-
South Korea	-	3.6	2.5	3.3	2.8	2.5	2.0	1.5	1.3
Taiwan	2.1	2.7	1.6	1.9	1.9	1.9	1.9	1.6	1.5
Thailand	1.9	-	2.0	3.3	2.8	2.3	2.0	1.5	1.3
Latin America									
Argentina	-	-	-	-	-	-	-	-	-
Brazil	17.4	15.5	10.8	11.0	7.3	10.0	11.8	14.3	13.3
Chile	5.8	4.0	3.3	5.3	5.0	4.5	3.0	3.5	4.0
Colombia	10.3	6.9	3.0	4.8	4.3	3.3	4.5	5.8	5.5
Mexico	14.2	7.2	4.5	4.5	4.5	3.5	3.0	3.3	4.0
Peru	7.3	3.7	3.0	4.3	4.3	4.0	3.5	3.8	4.3
Venezuela	-	-	-	-	-	-	-	-	-
CEEMEA									
Czech Republic	9.0	2.3	0.8	0.8	0.1	0.1	0.1	0.1	0.1
Hungary	17.7	8.5	5.8	7.0	5.8	3.0	2.1	1.4	1.4
Israel	12.3	4.4	2.0	2.8	2.0	1.0	0.3	0.1	0.5
Nigeria	-	9.7	6.3	12.0	12.0	12.0	13.0	13.0	11.0
Poland	11.5	5.1	3.5	4.5	4.3	2.5	2.0	1.5	1.5
Romania	-	8.0	10.3	8.0	6.3	6.0	5.3	4.0	2.8
Russia	-	69.2	5.0	5.3	5.5	5.5	17.0	10.0	6.0
South Africa	11.2	9.3	5.5	5.5	5.0	5.0	5.8	6.3	7.0
Turkey	-	14.2	6.5	5.8	5.5	4.5	8.3	7.5	12.0
Ukraine	-	-	-	-	-	-	-	-	-

Source: Goldman Sachs, Goldman Sachs Global Investment Research.

EM FX Forecasts and Forwards

		3-Month Horizon		6-Month Horizon		12-Month Horizon		Long-term Forecasts		
	Current	Forward	Forecast	Forward	Forecast	Forward	Forecast	2016 (f)	2017 (f)	GSDEER
DM										
EUR/$	1.06	1.07	1.02	1.07	1.00	1.08	0.95	0.80	0.80	1.20
$/JPY	124	123	122	123	125	122	130	140	140	108
£/$	1.52	1.52	1.48	1.52	1.49	1.53	1.46	1.40	1.40	1.43
$/CAD	1.33	1.33	1.32	1.33	1.35	1.33	1.40	1.40	1.40	1.21
NZD/$	0.65	0.64	0.68	0.64	0.64	0.63	0.62	0.63	0.63	0.63
AUD/$	0.71	0.71	0.69	0.70	0.67	0.70	0.67	0.70	0.70	0.74
EMEA										
$/CZK	25.38	25.28	26.76	25.16	27.30	24.87	28.74	32.50	31.88	19.55
$/HUF	291	292	309	292	322	291	342	406	406	246
$/PLN	3.99	4.00	4.12	4.00	4.15	4.01	4.32	5.13	5.13	2.98
$/RON	4.17	4.18	4.31	4.18	4.35	4.18	4.53	5.11	4.91	-
$/RUB	65.03	66.78	67.00	68.31	66.00	71.31	66.00	67.52	67.52	47.07
$/UAH	23.51	25.20	24.00	26.15	27.00	26.75	30.00	36.00	40.00	-
$/TRY	2.87	2.94	3.00	3.02	3.30	3.16	3.55	3.60	3.60	2.70
$/ILS	3.90	3.90	4.10	3.89	4.15	3.87	4.25	4.30	4.30	4.04
$/ZAR	14.16	14.40	14.60	14.62	14.90	15.12	15.30	15.33	16.37	7.46
$/NGN	199	213	200	226	200	249	240	230	245	-
Americas										
$/ARS	9.63	16.50	10.51	17.00	11.60	19.00	14.18	15.83	17.25	4.66
$/BRL	3.79	3.90	4.00	4.01	4.15	4.23	4.30	4.52	4.74	3.22
$/MXN	16.76	16.87	17.00	16.98	16.75	17.24	16.75	17.25	17.50	14.95
$/CLP	716	723	720	729	740	740	740	739	753	508
$/PEN	3.36	3.41	3.38	3.47	3.40	3.57	3.50	3.54	3.61	3.11
$/COP	3093	3120	3000	3156	3150	3222	3300	3399	3467	2193
$/VEF	6.29	-	6.30	-	9.90	-	12.60	23.50	28.20	13.44
Asia										
$/CNY	6.39	6.48	6.45	6.53	6.50	6.61	6.60	6.80	6.80	6.66
$/HKD	7.75	7.75	7.85	7.75	7.85	7.75	7.85	7.80	7.80	6.90
$/INR	66.17	67.10	66.50	68.14	67.00	70.15	67.50	67.00	68.00	75.64
$/KRW	1168	1171	1200	1173	1230	1173	1300	1300	1300	1242
$/MYR	4.35	4.37	4.60	4.39	4.65	4.43	4.70	4.40	4.40	2.84
$/SGD	1.42	1.43	1.44	1.43	1.46	1.44	1.50	1.49	1.48	1.18
$/TWD	32.76	32.77	33.00	32.75	33.50	32.74	34.50	34.00	34.00	23.97
$/THB	35.96	36.20	39.00	36.41	39.00	36.80	40.00	40.00	40.00	35.48
$/IDR	13840	14280	14400	14670	14600	15460	14700	14700	14700	12854
$/PHP	47.20	47.52	48.00	47.77	49.00	48.21	49.00	49.00	49.00	58.92
Euro Crosses										
EUR/CHF	1.09	1.08	0.98	1.08	0.96	1.08	0.95	1.10	1.10	1.40
EUR/CZK	27.02	26.97	27.30	26.91	27.30	26.80	27.30	26.00	25.50	23.39
EUR/HUF	310	311	315	312	322	314	325	325	325	294
EUR/PLN	4.25	4.27	4.20	4.28	4.15	4.32	4.10	4.10	4.10	3.56
EUR/RON	4.44	4.46	4.40	4.47	4.35	4.50	4.30	4.09	3.93	-
EUR/RUB	69.24	71.26	68.34	73.08	66.00	76.84	62.70	54.02	54.02	56.33

Close – November 18, 2015. Source: Goldman Sachs, Goldman Sachs Global Investment Research.

Disclosure Appendix

Reg AC

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