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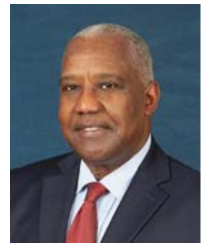
Major Country Developments December 2016



By Byron Shoulton

Overview

The U.S. election victory of President-elect Trump caught the world by surprise. The President-elect has announced the ushering in of a "new industrial revolution" and promises sweeping changes to trade policy, infrastructure, military spending and national security. In addition, the new Administration proposes steep tax cuts to businesses and the removal of numerous regulations that are believed to be stifling growth prospects. The relationship between the U.S. and several key global economies including China, Russia, Japan, South Korea, Mexico, et al, will be under review.

Independent analysis suggests that a boost in spending on public infrastructure and improving education would help relieve some of the burden on the U.S. central bank to support the economy. There is speculation that Congress could push through fiscal expansion after years of budgetary restraint. Advisers to the incoming Administration have been discussing a major stimulus package as one way to deliver on promises to generate millions of jobs and lift GDP growth to 4% or higher.

It is felt that the Federal Reserve would look favorably to the idea of more fiscal stimulus to the U.S. economy as this would lift potential output. However, the Fed is said to be in a wait-and -see mode, as they watch to see what Congress will actually end up agreeing to on fiscal policy. The economy is close to full employment with the unemployment rate currently at 4.6%. Despite the U.S. economy approaching the Fed's employment and inflation targets, the country has not experienced a robust recovery. Unease with the economy reflects a number of longer-term challenges. Prominent among those challenges are low equilibrium interest rates and sluggish productivity growth in the U.S. and abroad.

The U.S. financial sector is looking favorably to the new Administration enabling an easier operating environment, with lower taxes, lighter regulations and an end to rock bottom interest rates that have hurt lending margins. U.S. banking stocks jumped 20% since the election on expectations that more bank friendly rules will ensue.

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Regarding the North American Free Trade Agreement (NAFTA) which includes the U.S., Canada and Mexico, it now appears that the Trump Administration aims to push for substantial changes to existing rules governing trade between the three countries (instead of an abrupt U.S. withdrawal from the Agreement). Among some likely changes would be special tariffs or other barriers to reduce the U.S. trade deficit with Mexico and new taxes that would hit U.S. firms that move production from the U.S. to Mexico. In addition, there are indications that the U.S. would seek removal of a NAFTA provision that allows Mexican and Canadian companies to challenge U.S. regulations outside the court system.

Advisers to candidate Trump are advocating restructuring of the rules of global trade - a system that has underpinned growth, but also cost the U.S. manufacturing jobs. The question is how much of the promised changes made in the campaign will become reality.

Longstanding disputes between the U.S. and its neighbors – including country-of-origin labels for beef and Canada's softwood lumber products – could be addressed in a revised NAFTA. The stakes are high. The U.S. imported and exported a total of $1.1 trillion in merchandise to and from Canada and Mexico last year, compared with about $700 billion with the European Union and $600 billion with China.

Furthermore, Canada and Mexico are intertwined with the U.S. in a complex system of supply chains, with some components crossing borders more than once before the final product is sold to consumers. Breaking up NAFTA would upend numerous industries, and the biggest victim would be Mexico, which promotes itself as a platform offering global manufacturers duty-free access to the U.S.

Meanwhile, the U.S. economy is in improving health, adding an average of 180,000 jobs per month, while the unemployment rate fell to 4.6% and worker productivity improved by 2.3%. Household spending has remained resilient and the construction and housing markets have strengthened.

Emerging markets

Since the U.S. election, emerging markets have sold-off sharply, with currency and equity markets in Mexico, Indonesia and Malaysia being particularly hard hit. However, emerging market fundamentals are actually in much better shape than three years ago, with real yield spreads over the U.S. significantly higher than they were back then, and commodity prices experiencing upside pressure. From all indications emerging market economies look set to pick-up pace, but the recovery will be slow and painful.

As usual, economic performance across emerging markets varies from one country to the next. For example, India, Indonesia and Chile have experienced flagging growth over the past few months, but they remain in an upswing phase of their economic cycle and will gain momentum from structural economic reforms over a multi-year horizon. Meanwhile, the commodity exporters and reform laggards such as South Africa, Brazil and Russia are only just emerging from economic troughs. Oil exporting countries are suffering severely depleted government budgets and debt issuance in being ramped up as a consequence.

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While the global growth environment remains fragile, commodity prices are set to rise gradually in 2017, debt servicing burdens among emerging markets remain generally high, and in most cases, economic reform is happening at a sluggish pace. Emerging markets are slowly recovering following extremely uncertain times over the last few years. Among the various key themes expected to play out over the coming quarters the following are worth noting:

- Mexico and China could be impacted negatively under the Trump presidency, while Russia seems likely to benefit given the president-elect's declaration that he'd like to have better relations with that country.

- Lower-income, reform-oriented economies such as India and Indonesia appear set to outperform within the emerging market sphere in the year ahead.

- Commodity exporters will gain ground from rising commodity prices, although the recovery will be slow.

- Russian assets are likely to outperform on account of rising oil prices, the possibility of loosening of sanctions and a possible rapprochement with the incoming U.S. Administration.

- The Mexican peso has weakened but could eventually gain ground if the country is able to ease tensions with the Trump Administration. Mexico is highly dependent on the U.S. for trade and will suffer greatly if more protectionist trade policies are introduced. Moreover, a crackdown on undocumented immigrants could cause remittance flows to Mexico to collapse.
- Corporate debt levels have surged across emerging markets and pose a risk to growth. That includes China, India and South Africa. On the other hand, countries such as Russia, Turkey and Brazil have seen some deleveraging in recent months.

Europe

The European Central bank is being urged to reassess its monthly asset-purchase program and not continue on its present course. Instead, the ECB would fund a wave of new infrastructure spending across the continent. By shifting from the purchase on bonds issued by the various European national and supranational organizations, to injecting funds directly into the economy, the consensus view is that the latter approach would have a greater impact on economic growth.

In the U.K. negotiators are confident that they can secure a good agreement with the European Union in the face of the Brexit vote. From London's perspective, it is facing a 27-country block that remains economically fragile, worried about security, under populist assault and divided over the crisis of legitimacy facing its central EU institutions. While the British aggressively seek preferred access to the single-market (which it voted to leave), negotiators argue that Britain has in its favor the fruits of decades of economic integration and near-irreplaceable contributions to common European interests.

Many agree the British have leverage. The big question is how to effectively use that leverage and whether or not it will be enough to prevail against a mindset that aims to preserve the existing EU. This requires taking a tough stand in negotiations with an ex-member who voluntarily chooses to leave the union. Without a strong pushback in negotiating future ties with the U.K., the EU would be making it easier for other members to exit the economic block and single market without having to consider tough consequences.

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Brazil

The Brazilian currency (real) is likely to remain well below its latest highs over the short-term in light of turbulence in foreign exchange markets. Given the currency's strong rally since January 2016, further depreciation is likely. The expectation is for the real to strengthen modestly in 2017 with continued central bank support and the likelihood of rising commodity prices.

The victory of President-elect Trump has driven a sell-off of emerging market currencies, given expectations that the new Administration will boost spending and pursue protectionist trade policies, which could lead to inflation, rising interest rates and a slowdown in global trade. Given the threat of the U.S. imposing tariffs on China, the expectation is that the Chinese currency RMB is at risk of a large depreciation. Weakness in the RMB will likely feed through to volatility in the Brazilian real, as China is Brazil's single most important export market, accounting for 18.6% of exports.

The real recently broke through BRL3.36:US$1. Although uncertainty over policy adds to further currency volatility, rising interest rates will support the real. Inflation remains in a firm downward trend, falling to 7.8%, and is projected to hit a low of 6.8% for the full year. Meanwhile, interest rates remain elevated at 14% and short-term interest rate futures have risen.

The Brazilian central bank is expected to continue to intervene in exchange markets to forestall more substantial depreciation of the currency. Recently, the central bank halted sales of reverse foreign exchange swaps, which it had pursued over the last year in order to slow the currency's appreciation. It resumed auctions of standard foreign exchange swaps, which are equivalent to selling dollars on the futures market. According the central bank's president the intention is to support the unit using all tools at its disposal.

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Brazil has continued to advance fiscal reforms through its legislature, which should mitigate price pressures and support needed investment. A government spending cap amendment has continued to move easily through Congress, gaining Senate approval while municipal election gains by President Temer's coalition has given momentum to his push for needed pension reforms. Brazil's fiscal shortfall will narrow modestly in 2017. Recovering economic activity will support revenues, while expenditure growth will be constrained. The consensus is for a modest economic recovery in 2017 of just under 1% GDP growth.

Turkey

Turkey's central bank raised interest rates for the first time in three years, as pressure mounted on emerging markets in the wake of the U.S. election results. The central bank's decision to respond to the weakening lira by increasing the repo rate 50 basis points to 8% came despite a call by Turkey's President to cut rates instead. The Turkish lira has been plunging in the wake of the Trump victory and the expectation that fiscal stimulus rather than ultra-low interest rates will be the preferred policy tool going forward in the U.S. The Turkish central bank's move could begin a series of rate increases in Turkey and elsewhere amid prospects of an increase in U.S. rates after the decades-long decline. This shift would partly reflect the incoming U.S. Administration's plan to boost U.S. growth by fiscal rather than monetary stimulus. Such a change in financial conditions - widely anticipated by bond markets - would have consequences on emerging markets that have grown used to the abundant availability of relatively cheap money. In what was its first round of monetary tightening since a decision in early 2014, the Turkish central bank also increased the overnight borrowing rate by 0.25% to 8.5%.

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Turkey's political turbulence has chipped away at growth, consumer spending and the lira, as President Erdogan has threatened a referendum to call off the accession talks with the EU while purging political opponents from the Turkish workplace and institutions. The country's large external vulnerabilities [strong reliance on foreign capital inflows to finance its current account deficits] suggest significant further interest rate hikes are ahead. President Erdogan indicated his opposition to the rate increase and called on lenders to reduce interest rates to spur growth, employment, investment and competition.

Turkish unemployment is currently above 11%. The president is also urging citizens to push back by stocking up on liras and gold instead of buying dollars.

Separately, the European Parliament voted to suspend EU membership talks with Turkey. That move reflects the EU's hardening stance toward Ankara and in particular toward a President who is perceived as autocratic and increasingly in violation of human rights of many Turkish citizens.

China

China's foreign exchange reserves fell [for the fifth consecutive month] by $70 billion in November as the country's central bank burnt through more reserves in its battle to the defend the renminbi from greater depreciation on the back of accelerating capital outflows. Reserves at the People's Bank of China fell to $3.051 trillion, a decline of 2.2% from the previous month – and the largest drop since a 3% fall in January. The prediction is that Beijing will continue tightening capital controls via measures that European and U.S. businesses say have disrupted their operations. Recently introduced measures to curb capital outflows have begun to interfere with foreign business in China. Several European businesses have been unable to remit dividends because of the new foreign exchange controls which the EU Chamber of Commerce in Beijing contends is disruptive. U.S. companies have added their voice to mounting criticism of capital controls, sighting added burden of approval requirements and the potential for the new measures to hamper companies' ability to move money overseas.

The monthly foreign exchange outflows point to difficulty for Chinese policymakers who have sought to combat the currency's softening against the dollar by selling the U.S. currency from the central bank's foreign exchange reserves. The renminbi has been among the better-performing emerging markets currencies in the wake of the U.S. November presidential election. Yet it is down 6.1% since January. That weakness has helped drive outflows. In the first ten months of 2016, capital outflows from China rose to $530 billion.

Finally, a confrontational trade policy between the U.S. and China could result in the Trump Administration declaring China a 'currency manipulator' with the risk that increased tariffs could spark a trade war. The Chinese may be willing to head off such an outcome by engaging the incoming Administration early and privately negotiating mutually beneficial agreements.

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FCIA's Deals Of the Month

Bank Policy: Coverage of $15,000,000 one year trade financing, Turkey

Facultative Reinsurance: Single Buyer Non-Cancelable Limit Policy: $30 million import finance in mining sector, 5 year tenor, LATAM

What is Trade Credit Insurance?

If you are a company selling products or services on credit terms, or a financial institution financing those sales, you are providing trade credit. When you provide trade credit, non-payment by your buyer or borrower is always a possibility. FCIA's Trade Credit Insurance products protect you against loss resulting from that non-payment.