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Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

The curious strength of emerging economies, etc.

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1. Overview Macroeconomic and Financial Risks (Trends & Topics)

 # The curious strength of emerging economies (Tsuyoshi Oyama, Partner/Head of Center for Risk Management Strategy (CRMS) at Deloitte Touche Tohmatsu LLC/Deloitte Asia Pacific Risk and Capital Management Leader)

All around the globe stock prices remain sky-high. Particularly in the US, we are seeing historically high stock prices continue to climb. Even in Japan, stock prices have attained a twenty one year high level of JPY 21,000. The strong global economy, in particular the US economy, is one of the reasons for the current bull market, but so also is the fact that prices have not yet shown any sign of rising in the US. In fact, although the central banks of developed nations (excluding Japan) continue along the path of monetary policy normalization, long term interest rates have risen only slightly. This shows us the large gap between the central banks and the market on the view of the future path of interest rates (or price increases). Should the market’s view remain unchanged, we can expect high stock prices to continue.

In this environment, emerging economies also continue to hold their healthy condition. Foreign demand remains dependably strong and resource prices hold firm. In addition, monetary easing from the past underpins relatively strong domestic demand. Finally, while it is noticeable that the trend in slight rises in interest rates of developed countries has depressed exchange rates in some emerging economies, we have yet to see a country contend with worrisomely large capital outflows.

What is peculiar is that even in countries with noticeable political instability, the macro economy alone resists depressionary forces and stock prices remain remarkably high. South Africa is an excellent example - President

Zuma's position is being shaken by scandal but the country has managed to dodge a recession and stocks are instead rising. In Turkey, while President Erdoğan further consolidates his power in the state, the country is also celebrating its continued economic growth – a reversal of an earlier, if brief, downward trend. Finally in Brazil, where President Temer's approval rating has dropped to 5%, the economy has only just returned to positive growth and stock prices are on an upward trend.

As a reason for this de-synchronization between economics and politics, we can offer an assumption: these countries are in the process of establishing a "stable economic institutional setting", one which is not overly influenced by politics. Particularly important to this is the independence of central banks. In both South Africa and Turkey, central banks kept the policy rate unchanged because of rising consumer prices in spite of pressure from politicians to lower it. In a similar vein, in addition to a new autonomy of the central bank enshrined by a constitutional amendment in Brazil, the government also placed a cap on the budget deficit. Consequently, Brazil has established an institutional setting that will not easily lose investor trust even if the stance of the government is slightly shaken up.

Given that the current high global stock prices and continued capital inflows into emerging economies are much owed to the strong risk-on trend of developed countries, this situation could easily be reversed once some supporting factors behind this aggressive market stance fade out. Supposing that US FRB Chair Yellen's prediction of price rises turns out to be correct, this is likely to push up interest rates strongly and then put strong downward pressures on global high stock prices. Should this come to pass, we will be asking once more whether or not the sound and stable economic institutional setting of emerging economies are able to protect their economies from this kind of risk-off tsunami.