

Major Country Developments March 2016

Overview

The European Central Bank warned that global growth is losing momentum and that persistently weak pricing pressures are a signal of poor global demand. Nevertheless, global risk assets rallied in recent weeks, encouraged by signs of policy changes in China and the U.S. Federal Reserve, and also by buoyancy in retail sales growth in the U.S. While the global economy is not in recession, there are clearer signs of a slowdown in global activity. The downward momentum seems to have gathered pace since the beginning of 2016. Global growth declined from 3.4% in late 2015 to 2.9% by the end of February. It is clear that advanced economies have slowed significantly since last November. The key change in February was a further decline in growth rate in the eurozone. This is a distinct change from the pattern in late 2015, when the eurozone was the strongest of the major advanced blocs. The change during January-February is evidenced by the German economy becoming markedly weaker. The latest estimates show eurozone growth currently at only 0.8%, compared to 2.3% in late 2015.

The extent of the slump in German growth is surprising, and is in sharp contrast to previous robustness of Germany's manufacturing sector. The overall estimate of German activity has dipped to only 0.2%, following a very weak survey of business expectations just released. There appears to be more signs of a generalized contraction in the rest of the German economy as both consumer confidence and services activity fell in February. European inflation continues to be lower than expectations. These are worrying trends for the European Central Bank, which is now almost certain to introduce another package of quantitative easing measures soon. Whether the next monetary stimulus will prove any more effective than previous doses is left to be seen.

Globally, a portfolio rebalancing is under way. The most important shift is in the perceived economic and financial prospects for emerging economies. Capital continues flowing out of emerging economies. These outflows

are driving the strong dollar. According to the World Bank about half of the 20 largest developing country stock markets experienced falls of 20% or more from their 2015 peaks. The currencies of commodity exporters (including Brazil, Indonesia, Russia, Malaysia and South Africa), and of big developing countries subject to rising political risks, fell to multiyear lows both against the U.S. dollar and in trade-weighted terms.

The volume of global high yield, non-investment grade debt, leveraged loans and collateralized loan obligations issued over the past four years totals about \$3.5 trillion according to the World Bank. Many loans have minimal covenant protection for lenders. Investors also increased duration, purchasing ultra-long dated bonds, whose prices are more sensitive to changes in interest rates. Petrobras the state-owned Brazilian oil company borrowed extensively in order to meet costs of developing offshore oilfields. In part, debt compensated for the company's inadequate operational cash flow reduced by artificially low domestic administered energy prices. In June 2015, Petrobras issued 100-year bonds yielding 8.45%. Investors purchased the long maturity convinced that there was minimal economic difference in risks between a 30-year and 100-year bond. Within three months of issuance, a combination of low commodity prices, concern about high debt levels, and an ongoing corruption scandal saw the bonds lose about 30% of their value.

Meanwhile, Brazil's largest iron ore producer Vale announced that its losses in the fourth quarter of last year widened to \$8.57 billion from a loss of \$2.12 billion in previous quarter. Over the full year the mining group suffered a loss of \$12.13 billion compared to net profit of \$457 million in the previous 12 months. The company blamed its poor results on impairment charges and a 47% depreciation of the Brazilian currency against the



By Byron Shoulton

dollar. Despite Brazil's macro-economic under performance, its foreign exchange reserves remain less impacted, finishing 2015 at a robust 7.7 times the external financing requirement, 1.8 times external short-term debt and 13.7 months worth of import cover. Not bad for a country in recession.

Saudi Arabia, the biggest producer in OPEC, has ruled out a cut in the nation's crude output, leaving U.S. shale to carry the burden of balancing the market. This places the U.S. shale industry in hunker down mode. The IMF warns that the effects of commodity price shocks go beyond the effect on budgets and growth or fears over a balance of payments crisis. The shocks can weaken banks in developing economies, and are depriving governments of revenue while depleting foreign exchange reserves in several countries. This raises the prospect of a commodity-driven financial crisis. The most important reason is the deteriorating performance of emerging economies-in cyclical and structural terms. Of the five BRICS (Brazil, Russia, India, China and South Africa), only India is experiencing a revival.

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The deterioration in fundamentals for oil-related emerging-market companies is clearly visible. With oil prices below \$40 per barrel, net debt levels in the sector will move higher and less cash flow will be available for debt reduction, even for what have so far been resilient oil producers. Reflecting this, the ratings trend for emerging-market debt turned decisively negative over the past year. Although not all emerging-market downgrades were directly related to oil, the oil sector represented \$180 billion of the \$190 billion of debt in that sector that experienced a change in credit rating in the past year. Meanwhile, lower oil prices are leading to a surge of new debt. As oil prices have fallen, financing needs for oil-dependent countries have increased. New bond issuance by oil-dependent nations in internation-

al capital markets rose from \$16 billion in 2013 to \$24 billion in 2015. This trend continues, with large new issuances expected in 2016 from the Middle East and Africa.

In Russia, the government is lining up seven major state companies, including Aeroflot, Alrosa, a diamond mine, and Rosneft, for potential privatization. The Russian authorities have also invited 28 foreign banks to participate in an upcoming government bond issue [the first of its kind since Russia annexed Crimea from Ukraine]. The U.S. Departments of State and Treasury have pressured U.S. banks not to participate as this would indirectly undercut the spirit of existing economic sanctions imposed against certain Russian interests.

In Kazakhstan where the economy is suffering from low oil prices, the government is projecting that future development be based on oil at \$20 per barrel. There is already a plan for a massive privatization program, which will include major state industries, gas, coal, the national airline, railway and some 700 enterprises to be partially or completely privatized.

As oil prices have fallen to new lows, markets are demanding ever-larger premiums for buying emerging-market debt. Risk premiums for such debt are now at their highest since 2011. There is a particular close correlation between the interest rate premium commanded by emerging-market bonds and the oil price. That's because around 26% of the \$1.4 trillion in emerging-market debt is directly oil-dependent, including oil and gas companies in several countries

and sovereign issuers with significant oil exports. These include Middle East producers, Russia and former Soviet countries; Angola, Nigeria and Gabon in Sub-Saharan Africa; Venezuela, Colombia, Mexico and Ecuador in Latin America, and Malaysia in Asia. Meanwhile, miners across the globe continue to write-down the value of their assets as fears grow over the impact of China's slowdown and its demand for raw materials. The likelihood increases of greater consolidation of assets among leading energy, mineral and mining producers as competitive forces influence the joining of hands to increase efficiencies and secure future market share.

USA

The core strengths of the U.S. economy are expected to reassert themselves and could lead to gross domestic growth of 2.6%-3% in 2016. As Federal Reserve policy-makers consider risks to U.S. growth, weak inflation has signaled lowered economic expectations. Amid this year's market turmoil and worries about emerging market growth, officials continue to debate the growth outlook. Since lifting interest rates for the first time since 2006, the Fed has appeared increasingly wary of following with additional increases too soon, preferring to hold fire and assess what damage -if any- the tightening of financial conditions and the slowdown in China will do to U.S. growth. The Fed confronts a mixed picture, with the U.S. economy continuing to register steady growth and consistent new job creation, even as the outlook dims overseas, with emerging market growth particularly shaky. Revised figures confirmed that the U.S. economy grew more rapidly than previously estimated in the fourth quarter of 2015, while inflation picked up along with household spending. Some independent projections see U.S. GDP growth surpassing 2% in the first quarter 2016 and moving toward 3% for the full year.

For more than a year, American oil producers found a way to keep pumping despite the biggest slide in crude prices in 12 years. Several U.S. drilling companies released their latest projections which suggest that a change is beginning to take place. Some companies expect oil and natural gas production to fall between 11% and 15% this year. Fewer companies expect production volumes to grow by 10%, while others are pulling back and slashing capital spending budgets in an attempt to hoard cash and ensure they can meet debt payments. Meanwhile, the oil glut is expected to last well into 2017. The surprising resilience of U.S. producers has been a key factor in the 70% slide in crude prices over the past 20 months, with operators cutting costs and squeezing more oil out of fewer wells to stave off reckoning. The expectation is for a shakeout in the U.S. oil and gas market where many highly leveraged companies will be forced to declare bankruptcy. Focus remains on talks among oil producing nations about freezing output while expectations are that U.S. produc-

tion will keep falling.

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While export-oriented sectors of the U.S. economy have been hit by the global turmoil amid a strong dollar that makes American made goods more expensive overseas, the U.S. has performed well thanks to a recovering job market and cheap energy prices that have bolstered consumers' spending power. Only about 13% of U.S. output comes from exports; consumer spending still accounts for more than two-thirds of U.S. GDP.

Even the riskiest part of the U.S. corporate-bond market appears to be staging a comeback, marking an upswing in investor confidence following a turbulent start to the year. Returns on junk bonds, debt issued by heavily indebted companies that carry low credit ratings turned positive since mid-February, reversing a sharp selloff at the beginning of the year. Still, this recovery continues to be long and drawn out. Among U.S. manufacturers, only 46% expressed optimism about the U.S. economy. The longer the drag from global growth remains in place, the more likelihood that the U.S. economy is negatively impacted.

China

China's foreign trade contracted much faster than expected in February, the latest sign of weakening global trade and lethargic domestic commodity demand as the country's economy slows. Exports fell 25.4% from a year earlier in dollar terms, the worst one-month decline since early 2009 and down from the 11.2% drop in January. Imports fell 13.8%, trimming losses after an 18.8% fall in January. China's trade surplus narrowed to \$32.6 billion in February from an all-time

high of \$63.3 billion in January.

The currency, the renminbi, has stabilized over the past two months. Foreign exchange reserves data indicate capital outflow pressure eased in February as the renminbi stabilized, but many companies and investors remain pessimistic about the Chinese currency. Ongoing market turmoil has reduced investor confidence in China's economy. However, the challenges facing China are not amenable to any quick technocratic fixes. The economy is unbalanced, with high savings rates, wastefully high investment rates and high debt.

Measures considered by Chinese policymakers tasked with tackling slower growth and loss of investor confidence include allowing capital outflows for investment purposes, a big depreciation of the currency and allowing a re-emergence of large current account surpluses. China pursues a multi-level approach of policy adjustments and regulatory changes in financial markets aimed at moderating capital flight, allowing for investment inflows and eventually hoping to guarantee the legitimate movement of capital in and out of the country. The balancing act is to avoid solutions that could threaten internal stability or increase risks to the global economy. Beijing is resisting the pressure to move capital abroad: gross foreign currency reserves have fallen by \$660 billion (17%) since June 2014.

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Yet, if outflows were to continue at current levels the authorities would have to tighten controls, which would undermine reforms; or let the exchange rate slump, which would have a destabilizing effect on the world economy. Beijing now appears eager to attract more foreign capital into its bond market, with debt supply expected to rise as the world's second-largest economy widens its fiscal deficit over the next few years. Beijing announced that it is loosening restrictions that had

previously made it hard for most large foreign funds to participate in China's \$7.5 trillion domestic bond market. The move is being greeted as a significant step in the continuing liberalization of China's financial markets.

China has experimented with allowing foreign investors into its bond market for several years. Large sovereign investors such as central banks and sovereign-wealth funds are already able to buy Chinese bonds easily. However, foreign ownership of Chinese government debt has stagnated at close to 2% of the market, according to data from the central bank. That could now rise to 8%-10% over the next five years, with inflows into China's bond market from abroad potentially reaching \$46 billion this year.

Chinese companies, whose debt currently accounts for around 10% of the country's bond market, are looking to shift away from their current heavy reliance on bank lending. With the stock market still volatile, companies will likely be relying more on bond issuance. China's bond market grew 35% last year and the continued rapid pace at which debt is to grow may explain the Chinese central bank's unusually sudden opening up of the market. In recent weeks, Beijing already loosened and simplified some regulations on existing quotas for foreign investment. For the government and companies, the advantage of opening up bond investments to a wider pool of capital is clear. With more demand for their debt, their cost of borrowing could fall.

Globally, trillions of dollars of developed-market government bonds from Japan to Europe are trading below 1%, with some dipping into negative territory. Meanwhile, the yield on benchmark Chinese government bonds is now just under 3%: bond yields move in the opposite direction of their prices. Still, these yields have already fallen from around 5% in 2013, as domestic investors have piled into these safe-haven assets. Major international fund managers will likely seek assurances about the ease with which they could move money into and out of China given the country's capital controls. There continues to be broader concerns about Chinese economic policy-making. Recent shifts in China's foreign-currency policy have spooked markets this year.

Fund managers abroad will be cautious, seeking greater clarity on China's currency policy as evaluation of the risks of investing heavily in China's bond market continues.

Africa

Years of recent rapid economic growth across Africa fueled hopes of a prosperous new era. To many, the world's poorest continent was finally emerging, with economies that would lessen its dependence on global demand for Africa's raw resources. As China's economy slows and its once insatiable appetite for commodities seems to wane, many African economies are feeling the effects. The slowdown in China is curbing the rate of growth in several African economies. Projections for the continent have been sharply cut. Credit rating agencies have downgraded or lowered their outlook on commodity exporters like Angola, Ghana, Mozambique and Zambia, which were high on the list for international investors until just over a year ago.

The consensus is that many African countries failed to take advantage of the boom years to carry out long-term changes to their economies. They failed to deal with some of the biggest obstacles to sustained growth, like the severe lack of electricity across the continent; and to spur industries that would create long term jobs. Since the start of this year, the outlook has grown grimmer, especially in its two biggest economies, Nigeria and South Africa. Their currencies fell to record lows as China, Africa's biggest trading partner, announced that imports from Africa plummeted 40% in 2015.

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In South Africa, where a chronic shortage of power has constrained the economy, unemployment hovers at around 25%. Many expect South Africa, Africa's most

advanced and diversified economy, to slide into a recession this year. South Africa is Africa's biggest exporter of iron ore to China and is currently suffering from a slump in mining, as well as in other sectors like manufacturing and agriculture.

Like the currencies of many commodity-exporting nations, South Africa's rand has declined sharply in recent months because of the global fall in raw material prices and also because of poor government policies. The weak rand will make it more painful for South Africa, which is experiencing the worst drought in a generation and is usually an exporter of agricultural products, to import corn, the nation's staple. Imports in general will be more expensive for South African businesses and consumers in the year ahead.

Higher food prices and import costs could pose a challenge to the sitting government. President Jacob Zuma of the African National Congress is expected to face serious challenges in municipal elections due later this year, given rising public anger over income inequality, high prices, high unemployment, poor living standards, rampant corruption and a weak economy.

Nigeria, Africa's largest economy and oil producer, is reeling from the crash in crude prices at the same time as the government faces the threat of Boko Haram, the Islamic extremist group that has long terrorized the nation. With oil accounting for more than 80% of government revenue, the government may also lack resources to quell potential unrest in the Niger Delta, the source of the country's oil.

Nigeria's currency, the naira, collapsed to record lows in February after the central bank placed restrictions on the sale of the U.S. dollar to protect the shrinking foreign exchange reserves. The exchange rate fell to about 300 naira to the dollar in the black market, down from 240 early in the month. Weakening currencies will make it harder for Nigeria [and other African governments to repay China for loans used to build large infrastructure projects. The tumbling naira and China's downturn are also reverberating across the private sector, negatively affecting large and small enterprises.

Companies importing paper products, tires and a host of intermediate and finished products from China are reporting that the restrictions now placed on the dollar are making it difficult for them to place orders with Chinese suppliers. Nigeria, which remains dependent on oil, has experienced growth in other sectors in the past decade. A rising middle class has led to the emergence of Western-style shopping malls. A booming entertainment industry helped Nigeria overtake South Africa as the continent's largest economy in 2014. Nigeria is already in discussions with the World Bank and other institutions about borrowing billions to plug a \$15 billion budget deficit left by falling oil revenues.

The slump in economic activity is exposing Africa's growing vulnerability to changes taking place in China. It has served to tamp down heady talk of 'Africa rising', a catchphrase that symbolized the continent's recent fortunes. Growing consumer demand and an emerging middle class, while real in many African countries are insufficient to offset a fall in the continent's main economic driver of growth, which remains commodities.

While commodity exporters like Angola and Zambia have been hit hard by China's slowdown, other countries are showing greater resilience. Countries such as Kenya and Ethiopia, which were forced to diversify their economies, in part because of their dearth of commodities, will probably continue to enjoy robust growth. Zambia, whose economy depends on copper exports, has suffered from waning demand from China and a drop in copper prices. Mines have closed and thousands of jobs have been lost in recent months. Critics say Zambia could have taken advantage during the boom by negotiating better terms with Chinese companies, including securing technological transfers or more employment for infrastructure projects.

Zambia used revenue from copper to increase the salaries of civil servants but did not invest in potential growth industries, like tourism and agriculture. Some argue that large infrastructure projects were wasted opportunities that failed to lead to sustainable economic development. Critics opine that Chinese investments

should have been steered toward building infrastructure that furthered regional integration and trade. More countries will seek IMF support. Requests for bailouts are possible in Angola and Gabon.

In South Sudan warring factions are battling for control of that country's dwindling oil production in a sign that both sides have given up on faltering peace talks, and are instead seeking a military and economic stranglehold over the cash-strapped country. Oil companies in South Sudan have evacuated non-essential staff from fields in Upper Nile state, following renewed heavy fighting in Malakal the regional capital. Malakal lies about 300 miles from the fields that pump the bulk of the country's crude. Oil production was hit in December when rebel fighters took control of Unity state, the other oil-rich region. Oil executives worry that rebel forces will move beyond Malakal and encircle oil fields to gain leverage. Officials estimate that oil output has fallen by around 40%, forcing regular buyers of South Sudan crude to seek alternatives.

In January the Chinese Premier met with African leaders in a summit and pledged \$60 billion in future development assistance to the continent, promising to support Africa's goal of "achieving development and prosperity". While some leaders heaped praise on China, the impact of China's downturn and its growing trade imbalance with Africa speaks volumes. In 2015 China exported \$102 billion to Africa but imported only \$67 billion from the continent.

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FCIA's Deals Of the Month

Multibuyer Pay-As-You-Go Policy:

supporting \$18,000,000 of exports in food products obtained for risk mitigation purposes, Far East & North America

Single Buyer, Non-Cancelable Limit Policy:

coverage on \$25,000,000 limit in packaging industry, USA