KEY TAKEAWAY

Manufacturing activity in emerging economies softened in May, after the positive trends in earlier months. Factory output in China and Taiwan expanded at a slower pace when compared to the previous months, while output in Russia declined for the first time in nearly two years.

Equity Prices Decline On Concerns Of Higher External Debt Levels, Political Risks

Emerging market equity prices declined in May as investors became more concerned about external debt loads of select countries and worsening political risks. Markets in Latin America declined the most, followed by Africa and Europe. Brazil was among the worst performers as its currency weakened and the government's ability to implement policies was tested by a trucker's strike that paralyzed the country. In Europe, the central bank in Turkey had to raise its benchmark rate to prevent further currency weakness. In Asia, Malaysia was hurt by the unexpected results of its national elections while Korea declined on fears about tighter government regulations on businesses. Among the major markets, China and Russia ended the month with moderate gains.

Manufacturing activity in emerging economies softened in May, after the positive trends in earlier months. Factory output in China and Taiwan expanded at a slower pace when compared to the previous months, while output in Russia declined for the first time in nearly two years. Weak trends continued in Korea while the recovery in factory activity in Brazil faded in May. Several of the emerging countries, including China, Korea and Russia, reported lower employment in the manufacturing sector. Services activity in China was relatively unchanged from the previous month while India reported a decline. On the positive side, services sector unemployment increased in most countries except Brazil. Crude oil prices continued to trend higher while prices of most industrial metals remained elevated.

NEAR-TERM OUTLOOK

Emerging market investors have become uneasy about the growing external risks that could lead to currency volatility and reduced capital inflows. The recent equity price correction in Latin America and select Asian markets indicates that investors are becoming more cautious about the higher costs to service their external debt when global interest rates harden. Some countries like Turkey have allowed their current account deficits to balloon and haven't shown the willingness to address the weakness. As their currencies came under pressure, the central banks in these countries have had to hike interest rates and intervene to stabilize the currency markets. Some investors worry that the problems could spread to other markets, especially if U.S. rates rise more than expected or if political risks worsen. Nevertheless, it should be noted that several of the emerging economies, including China and India, are growing at a robust pace and have sufficient currency reserves. The current account deficits of several countries have narrowed in recent years, while relatively low inflation gives central banks more policy flexibility. Domestic demand has been growing in several of these countries and they have become less reliant on external demand for goods and services.

Worsening trade disputes is another risk facing emerging markets as they could weaken the ongoing recovery in global trade volumes. After the U.S. administration announced additional import duties in

February, responses from other countries were more measured. Threats of even more restrictions and tariffs have erased the hopes of an early settlement. The aggressive renegotiation of trade treaties such as NAFTA have worsened the uncertainties. If these disputes prolong, businesses will be reluctant to make capital investments. Yet, it is more likely that all sides will gradually come to an agreement under the existing dispute settlement framework of the World Trade Organization (WTO).