HSBC Emerging Markets Index

Q2 2012

Dr. Murat Ulgen

Notwithstanding a deceleration, emerging economies remain resilient to yet another false dawn in the developed world

11 July 2012

Below-trend growth and easing price pressures offer room for stimulus

HSBC Emerging Markets Index moderates slightly to 53.0 in the second quarter from 53.6 in the first quarter. Despite this deceleration, activity remains resilient to yet another false dawn in the developed world.

It feels like déjà vu with developed world growth sputtering again following New Year optimism. In part this is owed to a deepening of the eurozone crisis in the second quarter of the year and all the financial, trade and confidence channel impacts that have reverberate across the world. U.S. activity has disappointed, prompting the FED to extend its monetary policy accommodation in the form of more 'operation twist'. U.K. activity remains depressed, while the non-eurozone countries in Europe are feeling the pinch as their main trading partner remains embroiled in a complex and intertwined sovereign-banking crisis. So, developed world growth is being revised down as has been the case in the last two years.

What is different this time though is a visible slowdown in emerging giants, the majority of the BRIC countries, too. Chinese growth, predominantly manufacturing output, has been softening for more than a year now, as a consequence of earlier quantitative tightening and weakness in eurozone demand. Brazil has lost a lot of steam in the second quarter. Meanwhile, India and Russia still expanded at a decent clip, although deceleration is quiet visible in both as well. Thus, the emerging world has grown at a below-trend pace pretty much for a year now.

The main drag on activity still remains the manufacturing sector. Whilst improving slightly from the first quarter of the year, the pace of expansion still remains considerably below pre-crisis averages. Chinese manufacturing output has been declining for the past four quarters, while Polish production fell for the first time since the global financial crisis. Brazil's manufacturing output also returned back to contraction after a short period of improvement in the first quarter. Other Asian producers also remain on a soft footing, as evident by Taiwan's and South Korea's subdued performances. New order growth has not changed too much in the second quarter but new export orders in manufacturing have now contracted for three quarters out of the past four. The biggest drop was in Poland, attesting to the challenges in the neighbourhood.

The services economy appears relatively immune. The pace of expansion is still markedly below pre-crisis averages and even slowed a bit in the second quarter, nonetheless business activity has remained more buoyant than in the manufacturing sector for more than a year now. As opposed to weak manufacturing output in China, services activity has actually picked up some steam in the second quarter. Mexico's service sector performance was healthy but both Brazil and Russia proved to be a drag on headline services activity vis-à-vis their contribution a quarter ago. It is also worth noting that the business expectations in services reached a two-year high, thanks to a major improvement in India.

Employment conditions remained unchanged from the previous quarter and seem fairly lacklustre. Job-shedding in the Chinese economy, for the first time since the global crisis, raises a yellow flag. It has actually been the case for a year in the manufacturing sector but the deterioration is now faster. Brazil's manufacturing sector is losing jobs again after a temporary respite in the first quarter, while Turkey maintains its stellar track record on job creation. Employment conditions in services are relatively better, but a far cry from the pre-crisis healthy jobs market.

The silver lining is the easing of price pressures on the back of a steep fall in oil and commodity prices. The input costs for emerging market businesses have retreated to the lowest levels since the global financial crisis. The marginal acceleration in service sector costs was more than offset by a moderation of manufacturing sector input prices. With decelerating activity and falling cost side pressures, output charges have also moderated in the second quarter. The rate of decline in China is the sharpest since the second quarter of 2009, which is true for both the manufacturing and services business lines. Price pressures still remain fairly acute in India, though.

The story in general resembles that of the first quarter. Notwithstanding a deceleration, emerging economies remain resilient to yet another false dawn in the developed world. That said, growth remains below trend and it is still not "business as usual" yet for the emerging nations. As such, softer growth and the inflation outlook offer room for policymakers to stimulate growth. China and Brazil have already been doing this. Policy rates and reserve requirements were slashed since early this year and HSBC expects more to come. Fiscal policy is regarded as a more indirect tool. China has taken some targeted fiscal measures on taxes, credit provision, etc. As it happens, the sovereign debt crisis in the eurozone makes governments more cautious about pulling the fiscal levers, although there are exceptions of running large budget deficits such as India.

It is a very precarious world. The recent eurozone summit at the end of June has delivered some rays of hopes, however the fiscally challenged periphery still has mountains of economic problems to climb. The eurozone still needs to lay down the foundations for deeper political and fiscal integration, while forging a banking union. That means, the drawn out nature of this crisis will continue to pose strong headwinds for the emerging economies, in particular to emerging Europe as the supply chain and banking systems are closely inter linked. The financial deleveraging and export trade channels are powerful undercurrents dragging down the economic performance of emerging markets.

That said, all these risks have been there for a long time now. This is the main difference from the Lehman crisis which caused a confidence shock of sort, catching businesses off guard with high inventories. This eurozone crisis has been in the making for a long while and emerging market growth remains resilient in the face of excessive external uncertainties. At the end of the day, they still have plenty of ammunition to deploy and they will.

Emerging nations have favourable demographics – broadly speaking – cleaner balance sheets and lower leverage. Financing costs have come tumbling down and access to international capital has become much easier. This is the moment for emerging nations to invest such low cost capital in productivity – boosting areas. The risk of misallocating capital and causing bubbles of sorts is clearly there, although the persistent growth differential with the West as well as resilience of economic activity argues that emerging markets are staying on the right track.

Dr. Murat Ulgen

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HSBC Emerging Markets Index

Manufacturing weakness contributes to below-trend expansion of emerging market output in Q2

Key findings:

- Service providers record sharper rise in output relative to goods producers
- New export orders down slightly
- Input price inflation eases to three-year low
- Service sector optimism the highest in 8 quarters

Emerging market output growth weakens in Q2

The Q2 EMI findings pointed to a slight softening of emerging market activity growth, with the HSBC Emerging Markets Index, a quarterly indicator derived from the monthly *PMI™* surveys, falling from 53.6 to 53.0. The rate of expansion in emerging market output (covering manufacturing and services) was solid, albeit weaker than the average for the past three years.

The EMI is based on 21 *PMI™ (Purchasing Managers' Index™)* surveys conducted across 16 emerging markets and provides the earliest and most reliable indication of economic trends.

Activity levels increased across both broad sectors covered by the EMI, with service providers again signalling a sharper rate of growth than goods producers. Although the fastest for a year, the pace of expansion in manufacturing output was only modest in Q2. Service sector firms meanwhile saw activity growth ease over the quarter, but remain solid nonetheless.

Brazil and China lead slowdown

Of the big-four emerging markets, a two-speed growth picture was evident in the second quarter of 2012. Activity growth eased in India and Russia, but rates held up relatively well compared to those seen for Brazil and China.

Brazilian private sector firms noted a marked moderation of activity growth in the second quarter, with the latest increase the weakest in the current three-quarter period of expansion. Meanwhile, China recorded only a modest expansion of business activity, despite growth accelerating to a one-year high. In both cases, manufacturing underperformance was the principal drag on activity.

Demand for goods produced by emerging market manufacturers on global markets continued to weaken in Q2, with new export business decreasing for a second successive quarter. Goods producers in Brazil and China noted declines in new export business over the quarter, while foreign order levels also fell in the Czech Republic, Poland (the sharpest in three years) and Taiwan.

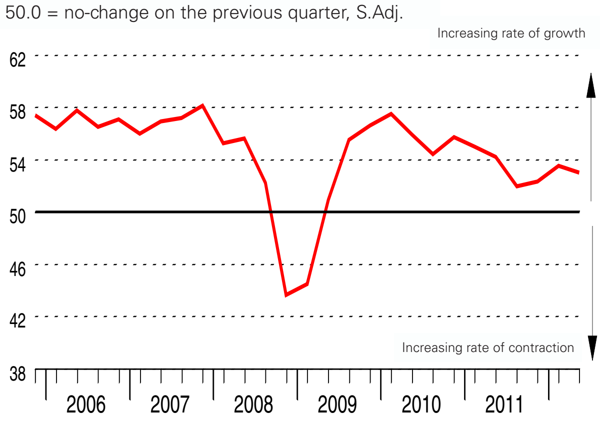
In contrast, India and Russia recorded growth of new export order intakes, while expansions were also seen in Turkey and South Korea.

Service sector growth remains below-trend

Service sector activity grew at a sub-par rate in the second quarter, with the overall expansion among the weakest recorded in the past three years. This reflected slower growth in Brazil (weakest in three quarters), India and Russia (slowest since Q1

EMI (all-sector output)

50.0 = no-change on the previous quarter, S.Adj.



BRIC (all-sector output)

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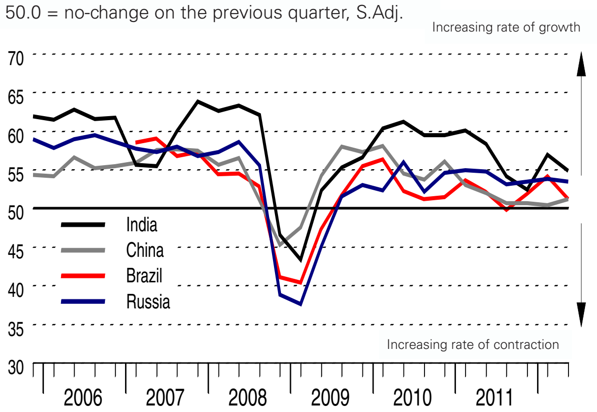

2011). China meanwhile recorded a solid expansion that was the strongest in one-and-a-half years.

Looking ahead, emerging market service providers remain confident about the one-year business outlook, with the degree of optimism the highest in two years. However, the extent of positive sentiment remains lower than in any quarter prior to the onset of the financial crisis.

Of the big-four emerging markets, service sector optimism was the strongest in Brazil, despite the extent of positive sentiment reaching a three-quarter low. Indian firms saw the strongest degree of optimism in 17 quarters, while service sector confidence in Russia was broadly in line with that seen in Q1. Meanwhile, service sector confidence in China improved to a five-quarter high, but remained down on the long-run trend.

Shorter delivery times; supplier capacity under little pressure

Muted growth of purchasing activity, in part reflecting lower output requirements, meant that the time taken by vendors to deliver inputs to goods producers shortened for the first time in three years. The Supplier Delivery Times Index, a useful gauge of the pressure being placed on supplier capacity, has posted above the neutral 50.0 threshold in only four other quarters since data were first compiled in Q2 2004.

Companies again reported a preference towards depletion of stocks of purchases in Q2, with holdings of pre-production goods falling for the fifth quarter running. Stocks of finished goods meanwhile were unchanged in Q2, marking the first quarter, in the series history, in which holdings of post-production goods have not fallen.

Input cost inflation eases to three-year low

EMI findings showed a moderation of input price inflation in the second quarter, largely reflective of a near-stabilisation of input costs faced by goods producers. Behind the weaker increase in average costs faced by manufacturers were reduced global prices for a variety of commodities and crude oil. Service providers, in contrast, saw a solid rise in input prices that was stronger than in Q1.

Goods producers lowered their output charges, on average, in response to weak demand conditions. Conversely, service sector firms continued to hike selling prices, extending the current period of higher charges to 12 quarters.

Spare capacity and economic uncertainty limit jobs growth

With new business growth remaining muted in Q2, companies found that capacity was little tested over the quarter, as signalled by a renewed decline in backlogs of work. Combined with increased global economic uncertainty emanating from the euro area debt crisis, emerging market companies remained hesitant with regards to hiring.

Latest data showed that emerging market jobs growth was subdued at the headline level. This not only reflected a renewed decline in manufacturing employment, but also a relatively muted pace of job creation across the service sector. China was the only one of the big-four emerging markets to record a decline in employment overall, with the fall the first in 13 quarters.

Orders and exports

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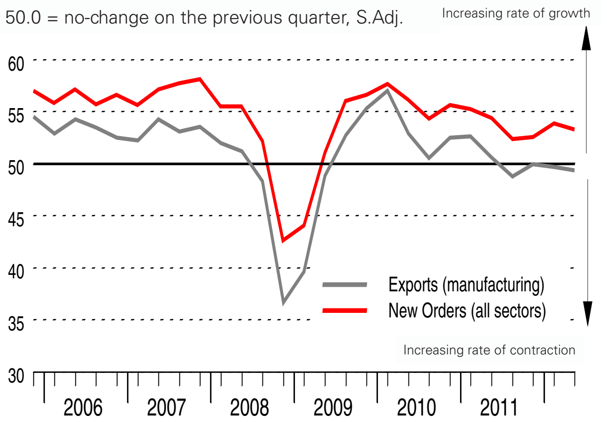

Employment and backlogs of work

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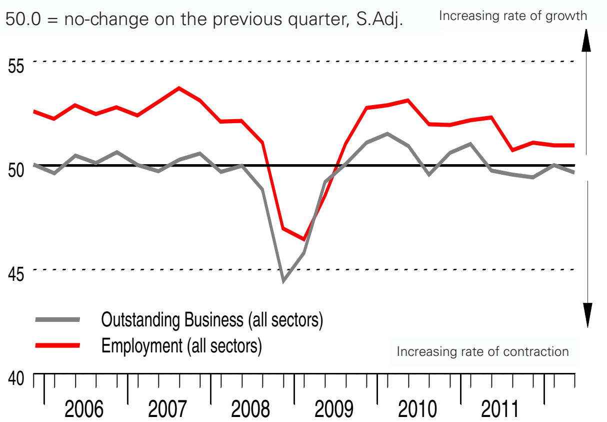

Input and output prices

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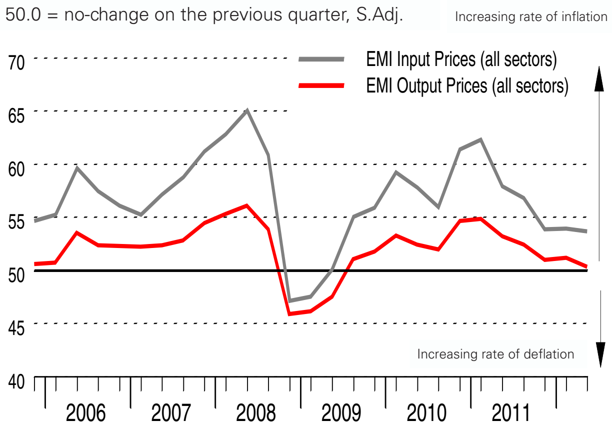


Output

Growth of emerging market output remains below-trend in Q2

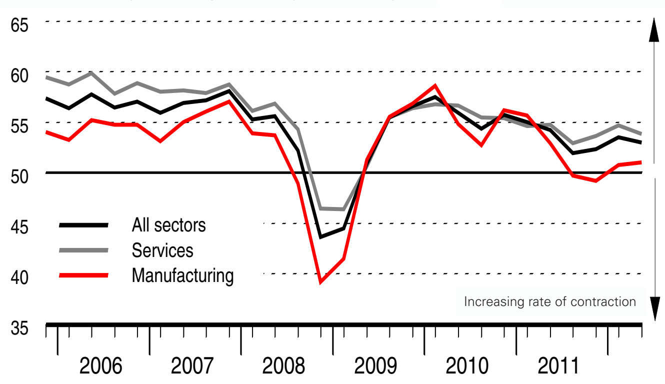
Emerging market output (covering manufacturing and services) increased again in the second quarter of 2012, extending the current period of growth to 13 quarters. Although solid, the rate of expansion was among the weakest recorded in the post-crisis period to date.

Service providers continued to report a sharper expansion of business activity relative to goods producers. Growth of manufacturing output remained only modest, despite picking up to a one-year high. Meanwhile, service sector firms again saw below-trend activity growth in the second quarter.

Of the big-four emerging markets, India was the best performer in terms of total output, followed by Russia. Rates of activity growth in China and Brazil (the latter, the lowest in three quarters) remained muted in comparison.

Output by sector

50.0 = no-change on the previous quarter, S.Adj.



Output in BRIC countries (all sectors)

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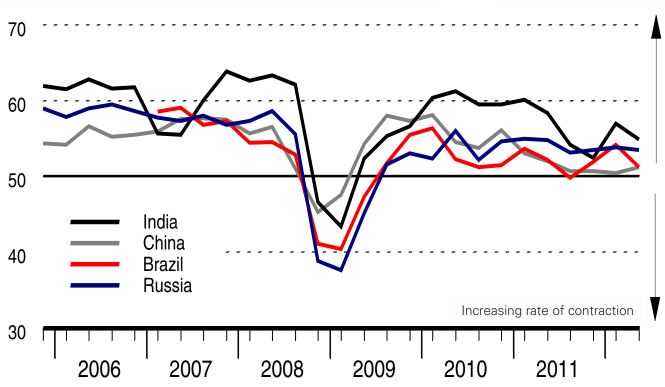

New Business

India main driver of total new order growth in Q2

Emerging market companies reported a solid expansion of incoming new business during Q2 2012. New order levels have now risen continuously for 13 successive quarters. The rate of new business growth was nonetheless weaker than in Q1 and below the long-run series average.

There was again differences by broad sector. Goods producers recorded only a marginal expansion of new order intakes during the quarter, while service providers noted a solid increase in new business overall.

Of the largest emerging markets, India recorded the strongest rise in new orders, albeit at a weaker pace than in the first quarter. Rates of total new business growth in Brazil (slowest in three quarters) and China were only modest and marginal respectively. Russia meanwhile saw a solid expansion.

New business by sector

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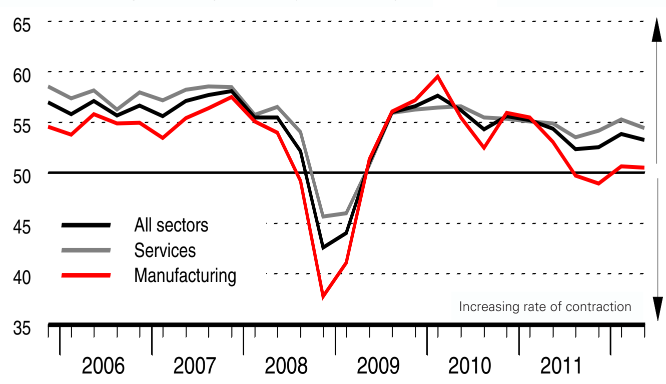

New business in BRIC countries (all sectors)

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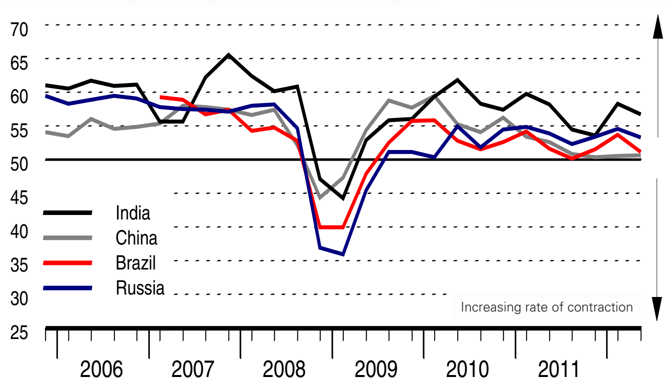

Outstanding Business

Marginal rate of backlog depletion recorded in the second quarter

Backlogs of work across the emerging world decreased in the second quarter, following no change in Q1. Although only slight, the overall decrease in work-in-hand (but not yet completed) suggests that capacity at firms' units was little tested over the quarter.

Manufacturers reported no difference in the level of business outstanding for the second successive quarter, while service providers noted a marginal decline. This followed no change in the first quarter.

India was the only one of the big-four emerging markets to record a rise in backlogs of work (covering manufacturing and services), while China registered no change. Lower levels of work-in-hand were recorded in Brazil (renewed decline) and Russia (weakest drop since Q1 2011).

Outstanding business by sector

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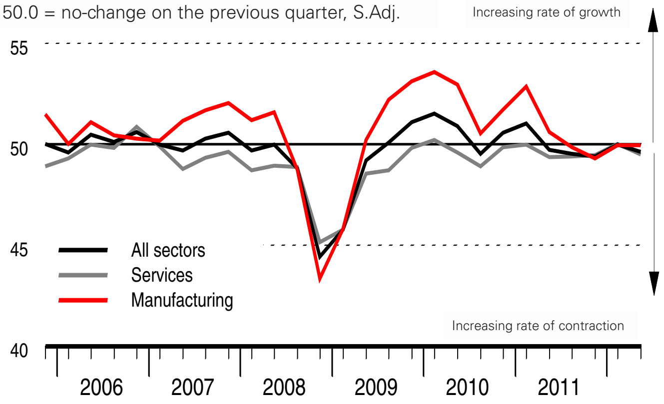

Outstanding business in BRIC countries (all sectors)

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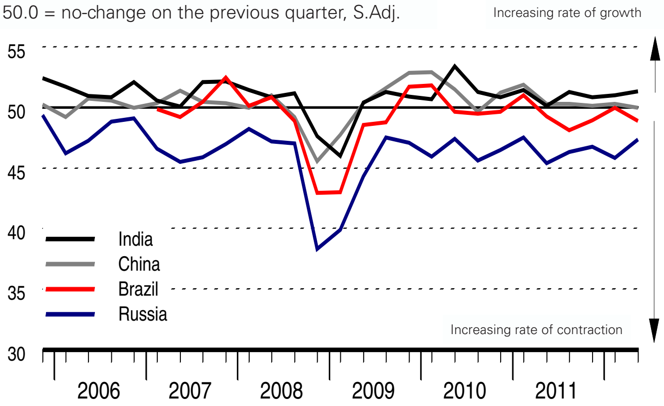

Employment

Job shedding in manufacturing weighs on employment growth overall

Emerging market companies added to their staff numbers for the twelfth successive quarter in Q2. Jobs growth held steady at a modest rate overall, but remained down on the long-run trend for the series.

Jobs continued to be created in the service sector, with the pace of employment growth remaining moderate. In contrast, latest data highlighted a renewed decline in manufacturing employment during the second quarter. The overall reduction was only marginal, however.

Of the largest emerging markets, only China saw a reduction in staff numbers – the first in 13 quarters. India recorded the strongest rise in total employment for a year, although the rate of job creation was weaker than the pace of hiring by firms operating in Brazil and Russia.

Employment by sector

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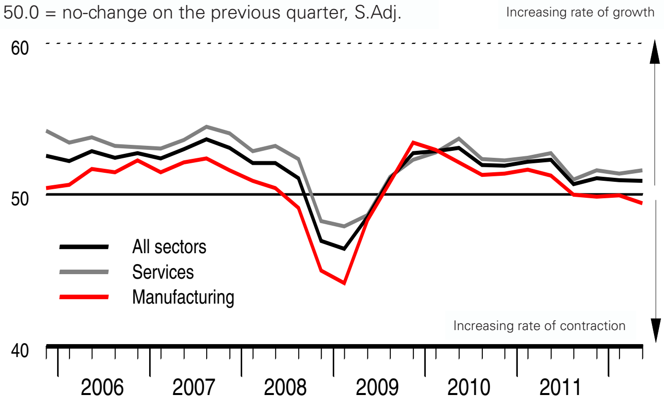

Employment in BRIC countries (all sectors)

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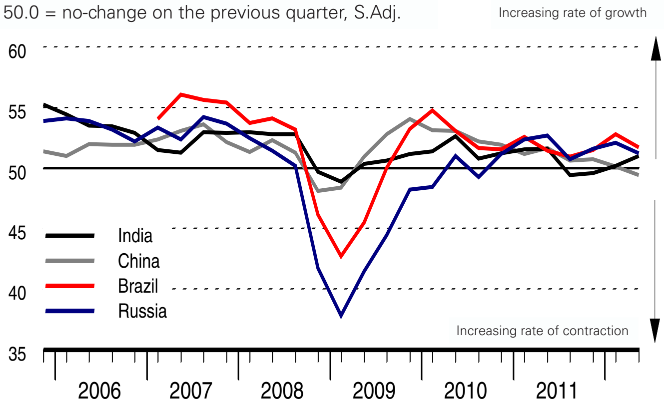

Input Prices

Input cost inflation hits three-year low; price pressures remain subdued in China

EMI findings showed a further rise in average costs faced by emerging market companies in Q2. However, the rate of input price inflation was the weakest in three years.

The moderation of input price pressures at the composite level mainly reflected a slower rate of increase in average costs faced by goods producers. The pace of inflation eased to near-stabilisation in Q2; the weakest in three years. In contrast, service providers saw a solid rise in overall costs, with the rate of inflation picking up to the fastest in three quarters.

Input cost inflation remained strong in India, with the pace of increase the highest since Q3 2011. Russian firms meanwhile reported the weakest rise in input costs for three years, while inflation held steady at a solid rate in Brazil. Average costs were broadly unchanged in China.

Input prices by sector

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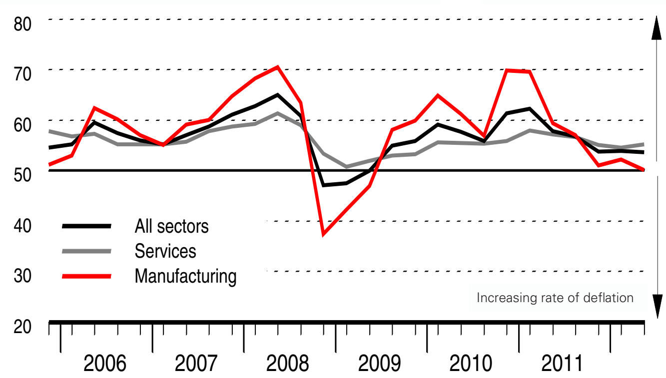

Input prices in BRIC countries (all sectors)

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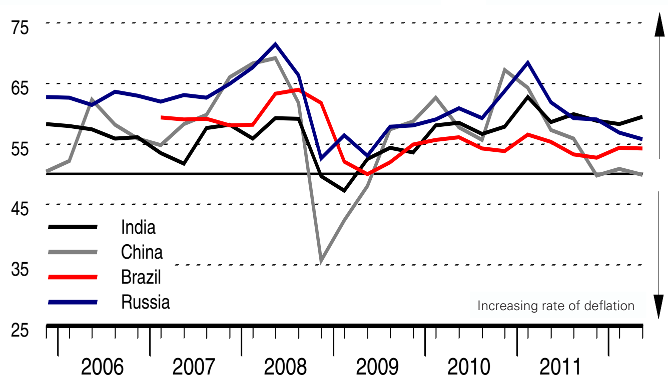

Output Prices

Output charges rise to the weakest extent in three years

The rate of output price inflation eased to the weakest in three years during Q2 2012, largely reflecting a moderation of input price pressures.

Manufacturers again reduced their output prices in the second quarter, as firms passed on lower input costs to clients through decreased factory gate charges. The latest decline in average tariffs was the third in as many quarters, and the sharpest in three years. In the service sector, output charges increased on average, albeit at a modest rate that was the weakest in ten quarters.

China was the only one of the largest emerging markets to record a decrease in output prices, with the pace of decline the sharpest since Q2 2009. India again recorded the sharpest rise in average tariffs.

Output prices by sector

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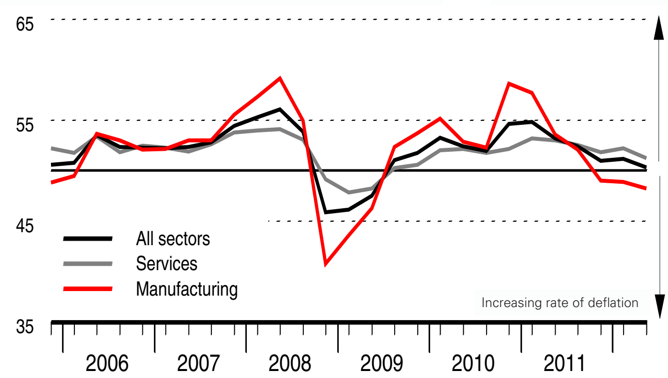

Output prices in BRIC countries (all sectors)

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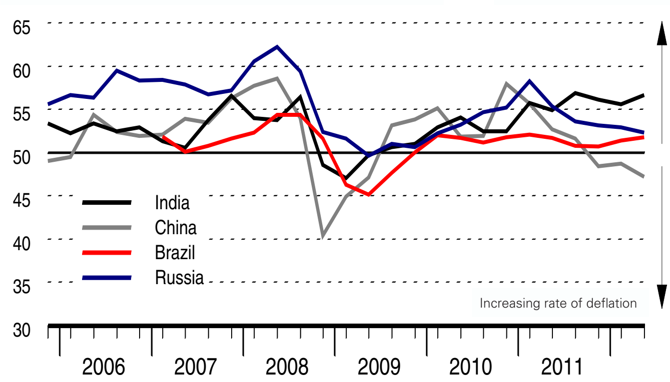

New Export Orders

New export orders fall for second successive quarter

Foreign demand for goods produced by emerging markets manufacturing firms fell during Q2 2012, with new export business decreasing for a second quarter in a row. Although sharper than in Q1, the rate of decline in new export orders was still marginal.

Manufacturers in Brazil and China recorded further declines in new export business, extending current sequences of reduction to five and two quarters respectively. Meanwhile, Poland and the Czech Republic recorded the sharpest drops in foreign order levels in three years.

In contrast, Russian goods producers recorded the steepest rise in new export work since Q1 2011. Indian manufacturers meanwhile noted a third successive quarter of new export order growth.

New export orders (manufacturing)

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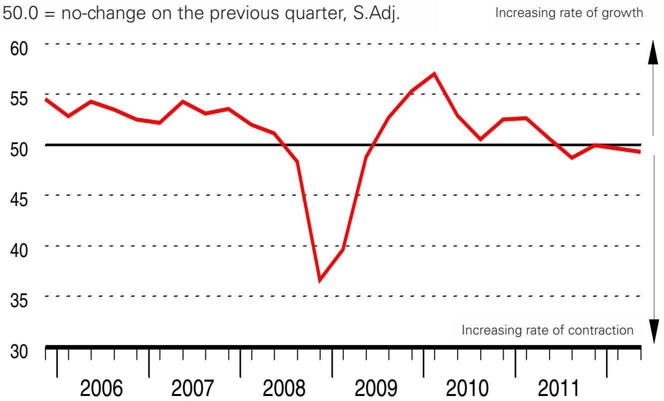

New export orders in BRIC countries (manufacturing)

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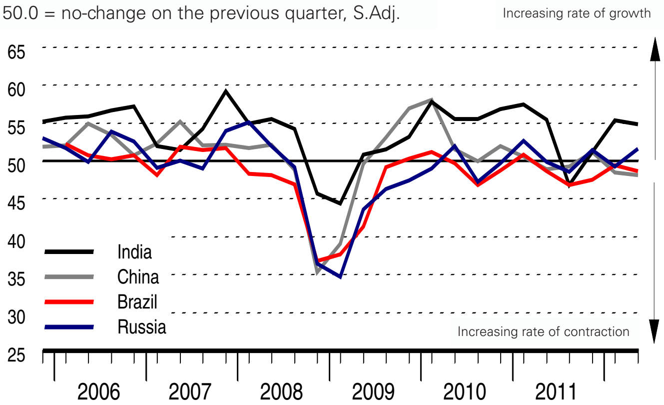

Quantity of Purchases

Purchasing rises for first time in three quarters, albeit marginally

Emerging market manufacturers reported a rise in purchasing activity during Q2, ending a two-quarter period of decline. However, the rate at which firms acquired additional inputs was only marginal.

Of the largest emerging markets, China recorded a marginal decline in input buying, while firms in Brazil noted a renewed reduction. India saw marked, albeit weaker, growth of purchasing during the quarter. Russia meanwhile recorded a solid expansion overall.

Polish goods producers recorded a marked decrease in the amount of inputs purchased over the quarter; the fastest in three years. In contrast, South Korean, Taiwanese and Turkish manufacturing firms noted growth of purchasing. Expansions were also seen in Saudi Arabia and the UAE.

Quantity of purchases (manufacturing)

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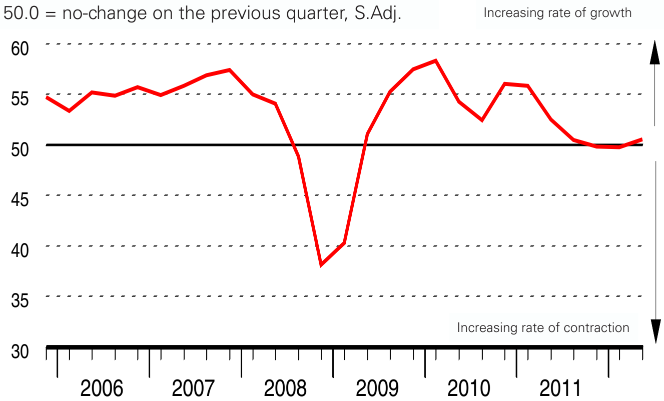

Quantity of purchases in BRIC countries (manufacturing)

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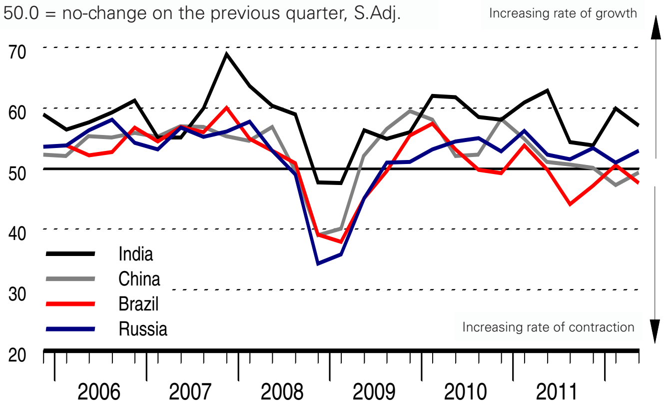

Stocks of Finished Goods

Stock levels unchanged in Q2

Q2 marked the first quarter, in the series history, in which stocks of finished goods across the emerging world have not fallen. Holdings of post-production goods at emerging market firms remained unchanged overall. Moreover, the index measuring trends in post-production inventories has risen for three successive quarters.

Stock levels rose in China (joint-highest since the start of the series), India (rate of accumulation among the sharpest on record), Singapore and Taiwan.

In contrast, inventory levels decreased in Brazil (third decline in as many quarters), the Czech Republic (sharpest of all emerging markets), Poland, Russia, Turkey and South Korea.

Stocks of finished goods (manufacturing)

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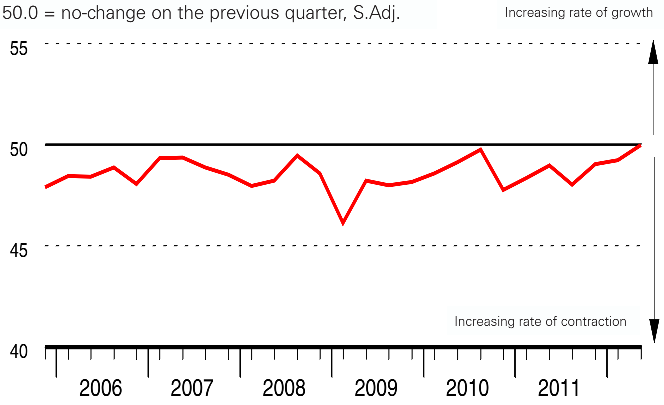

Stocks of finished goods in BRIC countries (manufacturing)

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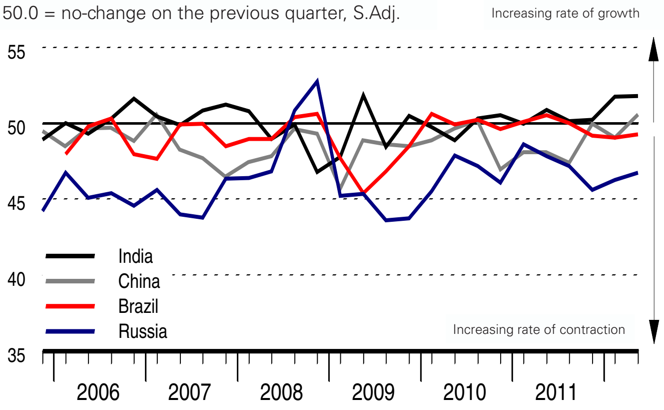

Stocks of Purchases

Holdings of pre-production goods fall at weakest rate for a year

Stocks of pre-production goods decreased for a fifth successive quarter in Q2, largely in response to muted growth of purchasing. The rate of decline was only marginal, however, and the weakest for a year.

Rates of stock depletion were broadly similar in Brazil, China and Russia. The Czech Republic meanwhile recorded the sharpest decrease in inventory levels of all emerging markets, followed by Poland.

India, on the other hand, recorded a rise in holdings of pre-production goods. However, the rate of expansion eased sharply to the weakest in the current 13-quarter period of growth. Higher stock levels were also recorded in Singapore and Taiwan.

Stocks of purchases (manufacturing)

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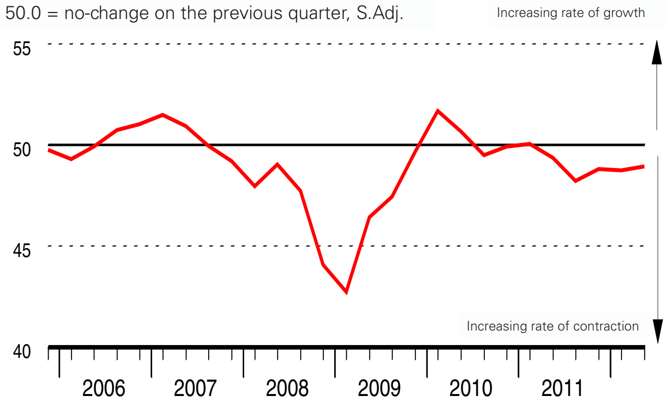

Stocks of purchases in BRIC countries (manufacturing)

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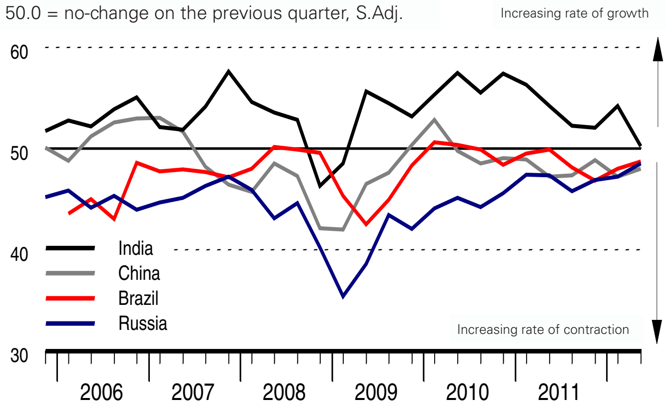

Suppliers' Delivery Times

Shorter lead times signalled for first time in three years

The average time taken by vendors to deliver inputs to emerging market goods producers shortened for the first time in three years, suggesting little pressure was placed on supplier capacity over the quarter. The index measuring trends in vendor performance has posted above the neutral 50.0 threshold, signalling lead time shortening, in only four other quarters since data were first compiled in Q2 2004.

Shorter lead times were recorded in China (first improvement in three years), India, Taiwan and South Korea. In contrast, average vendor performance deteriorated in Brazil, Poland, Russia and Turkey.

Suppliers' delivery times (manufacturing)

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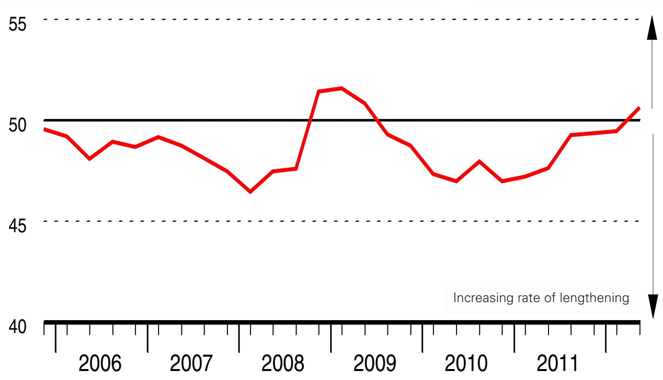

Suppliers' delivery times in BRIC countries (manufacturing)

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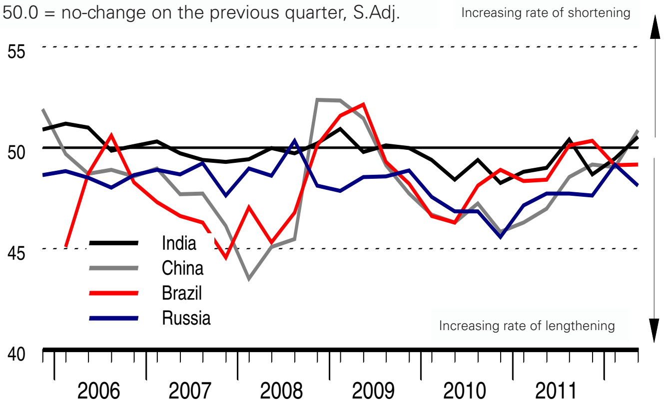


Business Expectations

Service sector optimism the highest in two years

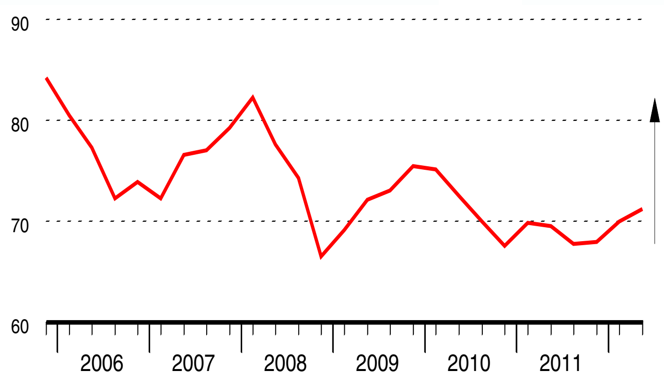
When questioned about the prospects for activity at their units over the next 12 months, emerging market service sector firms again expressed optimism regarding the business outlook. Although below-trend, the degree of positive sentiment was the strongest in two years.

Business confidence remained the strongest among Brazilian service providers in Q2, despite the extent of positive sentiment reaching a three-quarter low. Service sector confidence in Russia was broadly in line with that seen in the first quarter, while Indian firms saw the strongest degree of optimism in 17 quarters.

Service sector confidence in China improved to a five-quarter high, but remained down on the long-run trend.

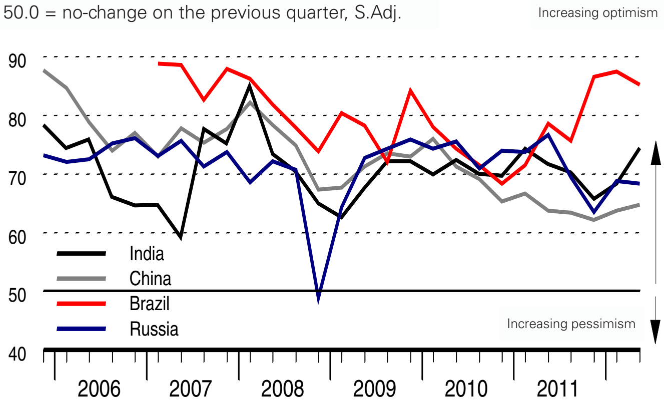
Business expectations (services)

50.0 = no-change on the previous quarter, S.Adj.



Business expectations in BRIC countries (services)

50.0 = no-change on the previous quarter, S.Adj.



Background Information

The Survey

The HSBC Emerging Markets Index (EMI) is a weighted composite indicator derived from national *Purchasing Managers' Index™ (PMI™)* surveys in the emerging markets of Czech Republic, Hong Kong, Israel, Mexico, Poland, Singapore, South Africa, South Korea, Taiwan, Turkey, UAE, Saudi Arabia and the increasingly important BRIC economies of Brazil, Russia, India and China. These surveys collectively track business conditions in over 5,800 reporting companies.

The *Purchasing Managers' Index™ (PMI™)* surveys on which the EMI is based have become the most closely-watched business surveys in the world, with an unmatched reputation for accurately anticipating official data. The survey data are collected using identical methods in all countries, with survey panels stratified geographically and by International Standard Industrial Classification (ISIC) group, based on contributions to GDP.

Survey responses reflect the change, if any, in the current month compared to the previous month based on data collected mid-month. For each of the indicators, a 'diffusion' index is produced, which reflects the percentage of positive responses plus a half of those responding 'the same'. Diffusion indexes have the properties of leading indicators and are convenient summary measures showing the prevailing direction of change. An index reading above 50 indicates an overall increase in that variable, below 50 an overall decrease. All data are seasonally adjusted.

Data collected at the national level for manufacturing and services are then weighted together according to relative contributions to national or regional GDP to produce indicators at the national whole economy or aggregate emerging market level.

Data Sources

Country/ Region	Producer:
Brazil	Markit
Russia	Markit
India	Markit
China	Markit
South Korea	Markit
Taiwan	Markit
Hong Kong	Markit
South Africa	BER
Singapore	SIPMM
Israel	IPLMA
Turkey	Markit
Poland	Markit
Czech Republic	Markit
Mexico	IMEF
UAE	Markit
Saudi Arabia	Markit

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About Markit Economics

Markit Economics is a specialist compiler of business surveys and economic indices, including the *Purchasing Managers' Index™ (PMI™)* series, which is now available for 32 countries and also for key regions including the Eurozone. The PMIs have become the most closely watched business surveys in the world, favoured by central banks, financial markets and business decision makers for their ability to provide up-to-date, accurate and often unique monthly indicators of economic trends.

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