Investment Management Company Limited

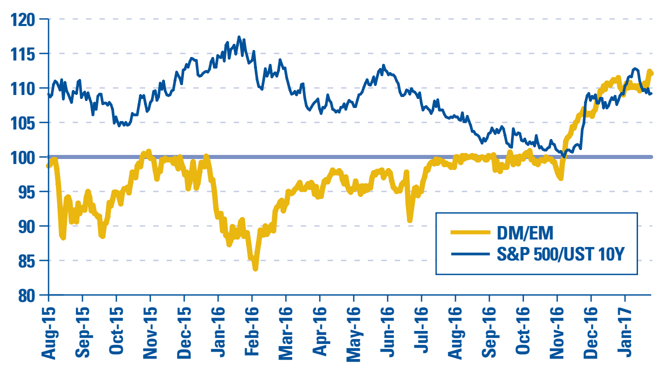
Emerging Markets Outlook

February 2017

Emerging Markets in Trump's World

Markets have taken the unexpected election victory of Donald Trump in their stride. The reaction following November 8, 2016 reinforced the tentative developments already underway since the summer and led to a 'double rotation', from bonds towards equities and from emerging markets (EM) to developed markets (DM). These shifts were motivated by an expectation of a renewed focus on (US) growth, notably via increased infrastructure spending and corporate tax cuts. Concerns over rising fiscal deficits and inflation drove the bonds sell-off, whereas fears of increased protectionism discouraged investors from emerging market holdings.

Chart 1: The Double Rotation*



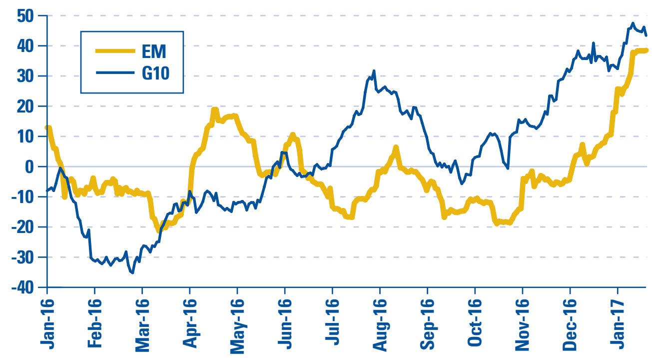
**100 = November 8, 2016*

Source: Bloomberg

But has it perhaps been too much too soon? Days before the inauguration and shortly thereafter, markets changed gear and reversed these initial moves. Since then, stock markets have resumed their rally, in a trading pattern reminiscent of the RoRo (risk on/risk off) pattern in the post-GFC period. Except that it is about growth and reflation this time (a 'GroGro' pattern).

It will be necessary to reassess the outlook for emerging markets under the new world order the Trump administration is seeking to establish. They will be impacted by the counteracting effects of changes in the policy mix, a more protectionist trade stance and rising commodity prices. But it is useful to lay out the baseline of what prospects for EM looked like before Donald Trump was elected.

Chart 2: Citi Economic Surprise Indices



Source: Bloomberg

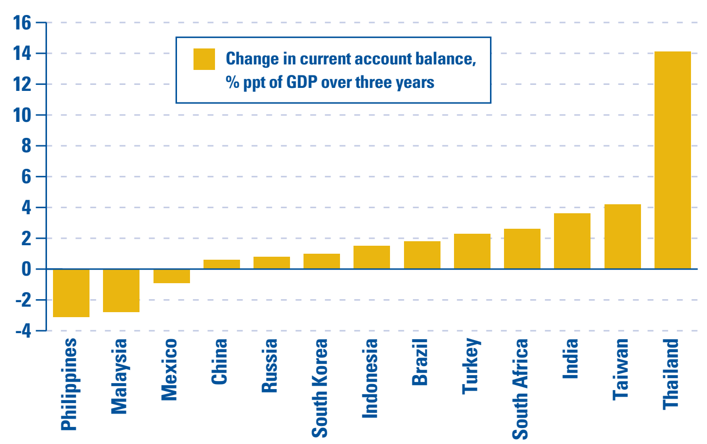
The World Before Trump

Before Donald Trump's election victory, prospects for emerging markets were considered to be on the mend, with growth, external balances and market indicators all improving.

Indeed, aggregate EM growth is expected to accelerate from an estimated 3.8% in 2016 to 4.6% in 2017, according to the Bloomberg poll of economic forecasters. This should also pull global growth up some 20bps, to 2.7% this year. Granted, part of this reflects the end of recessions in Brazil and Russia. But it remains nevertheless noteworthy against the backdrop of the steady deceleration of the large Indian and Chinese economies. The expected growth acceleration owes both to an improving environment for raw materials and to the counter-cyclical policies, both monetary and fiscal, many emerging market economies have been able to implement. In addition, more recent high frequency data releases also suggest greater underlying strength than markets expect (chart 2).

The so-called taper tantrum in 2013, when the Federal Reserve signalled a wind down of its quantitative easing purchases, provided a wake-up call to many emerging market economies whose growth had become dependent on liquidity-driven capital inflows and whose current account deficits had expanded with rising domestic consumption. The threat of a sudden reversal of capital flows prompted policymakers to adopt corrective measures and, as a result, current account deficits have narrowed and surpluses increased (chart 3). The key exceptions are Malaysia, which suffered from lower oil revenues, and the Philippines, where a boost to capital goods imports nearly eliminated its sizeable external surplus.

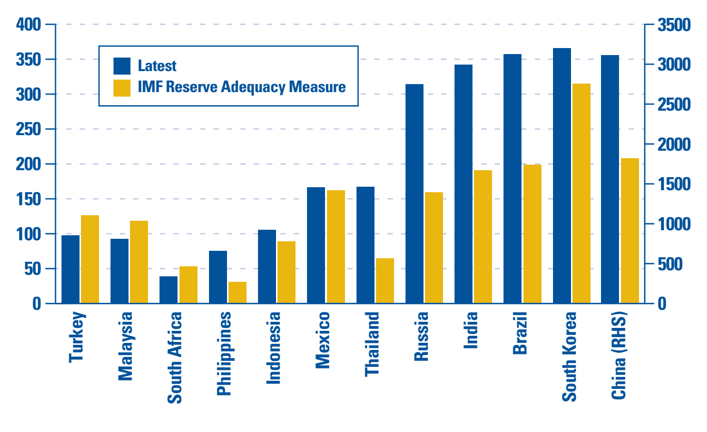
Chart 3: EM Current Account Balances



Source: Bloomberg

The improved flow dynamics also resulted in improved national balance sheets: even though international reserves have come off their peak (mostly on account of China's reserve drop from roughly $4 trn to $3 trn), most economies exceed the IMF's reserve adequacy measure (based on a composite metric including import coverage and reserves to short-term debt, while also accounting for the country's FX regime, risk of resident outflows, rollover risks and the opportunity cost of holding reserves). Only three countries (Malaysia, Turkey and South Africa) fall below their 'required' reserves and one – Mexico – is roughly equal.

Chart 4: International Reserve Adequacy ($bn)



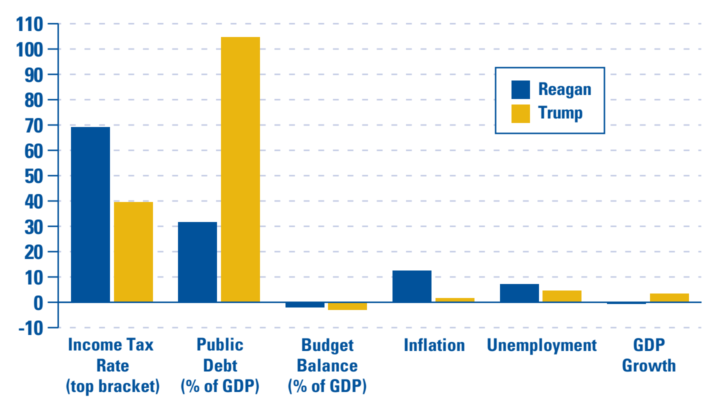
Source: IMF

Investor positioning has also left emerging markets less vulnerable to a negative capital account shock ('sudden reversal') than previously. Amidst widespread financial sector 'de-risking', net capital flows to emerging markets have dwindled in the past three years. The impact of any outflow would thus be more muted. At the same time, equity prices are less stretched than virtually any other global asset class. On a 10-year basis, global equity markets are above their period average (and near their high in the case of the US), with a similar situation in credit markets. On the other hand, EM equity markets (and to some extent EM local rates markets) stand out with price levels below their long-run average. In P/E terms, EMs are roughly at the average 30% discount to DMs they have held over the past 15 years.

Enter Donald Trump

In assessing the prospects for the incoming Trump administration, a comparison is often made with the Reagan administration, which started in 1981. Similar to Trump, Ronald Reagan had a background in entertainment, although he also had some political experience as governor of California. Significantly, both presidents promised large cuts in personal and corporate income tax rates. Yet, both the initial conditions and the policies each president inherited were strikingly different. Reagan faced a top marginal income tax rate of 69% and a fiscal deficit of just 2.1% of GDP, while the economy was in recession and inflation was running high ('stagflation'). By contrast, the current top household income tax rate is 40%, the fiscal deficit at 3.1% of GDP, the economy close to full employment and inflation low.

Chart 5: Starting Conditions at the Trump and Reagan Presidencies (%)



Source: Bloomberg, Tax Foundation

The Reagan tax reform was designed to be revenue-neutral by raising capital gains rates, scaling back investment incentives and increasing corporate tax collection. It simplified the tax code by taxing ordinary and capital gains income at the same rate and by eliminating industry-specific shelter provisions. In contrast, the Trump proposal creates sheltering opportunities by reducing to 15% the tax rate on any income that can be characterised as corporate income. And whereas Reagan promised an impetus to growth from lower taxation that would raise tax revenue and thereby reduce the deficit (the infamous 'Laffer Curve'), Trump's policies are set to lead to wider deficits as he simultaneously promises to ramp up spending. Coming at a time when the economy is already recovering swiftly (3.5% saar in Q3, 1.9% in Q4), with wages and commodity prices rising, any successful boost to growth is set to raise inflation and accelerate the Fed's monetary tightening cycle. The Reagan era experience also demonstrated that rates can rise long before any fiscal stimulus is delivered to the economy. Tighter monetary conditions in turn can negate some of these positive effects, acting as a powerful headwind to equities, and reverberate across the globe.

Higher Rates & Stronger Dollar

Indeed, the Fed in December raised its median forecast from two to three rate increases in 2017 on account of the likelihood of a more expansionary policy stance. The combination of looser fiscal policy and tighter monetary policy has put upward pressure on the US dollar, which appreciated by 5.4% in nominal effective terms from November 8, 2016 through January 11, 2017. Mooted border adjustment taxes, tariffs or other protectionist measures could lead to further dollar appreciation as long as markets maintain their bullish view on the new administration. However, in the medium term, a reduction in US trade openness would eventually depress the equilibrium exchange rate. Indeed, souring sentiment towards Trump's policies recently has led to a weaker dollar, with gains since the election having halved since the January 11 peak.

Higher US interest rates and a stronger US dollar have a negative effect on emerging markets, all else equal. While non-commodity exports become (temporarily) cheaper, the cost of servicing external, dollar-denominated debt increases. But EMs are now in a better position than at previous such junctures. Government debt burdens have fallen across EM over the past decades: aside from Venezuela and Argentina, the highest government debt ratios are 10-15% of GDP and household debt ratios are even lower. By contrast, most of the foreign currency debt is now owed by corporations (75-80%), rather than households or banks. This has the advantage that corporates are better able to shield themselves from adverse FX moves (by hedging their exposure) and also means that debt is often in loan form, which is easier to roll-over or refinance than bond debt.

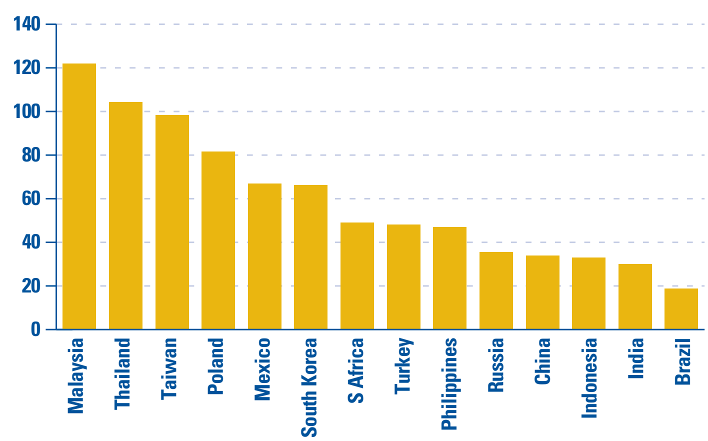
The highly developed economies of Hong Kong, Singapore and Taiwan aside, USD debt is below 50% of GDP in most emerging markets (Venezuela being the most notable exception) and below 25% of GDP in many. In general, cross-border liabilities to US banks are highest for Latin America, where they represent 35% of total external financing, followed by Asia (5% of total) and even less in Emerging Europe. Morgan Stanley estimate that some $300 bn matures in USD debt in each of the next three years, but excluding Hong Kong, Singapore, Korea and China this amount falls to roughly half. Outside this list, only a few have debt payments exceeding $10 bn per year: Mexico, Russia, India, Brazil and Turkey. Turkey is also the key country in which the majority of external debt is owed not by corporates but by financial entities. Capital flow disruptions may also affect direct investment, which provides over 25% of USD financing for Latin America according to Citigroup.

Trade Relations a Flashpoint

Trade represents a particular area of concern for emerging markets as many economies remain export-driven. From the US point of view, China maintains the largest bilateral surplus, followed by Mexico and, to a lesser extent, India. While it is thus not surprising that the Trump administration has zeroed in on the former two countries, it may yet realize that trade restrictions cut both ways and invite retaliation. So far, China has not figured prominently among the flurry of tweets and executive orders, even though President Trump threatened on the campaign trail to label it a 'currency manipulator' and impose a 45% import tariff. It is not yet clear, whether Donald Trump - uncharacteristically - swerved from his campaign promises or whether he is simply awaiting the confirmation of his State and Treasury Secretaries. Either way, the combative approach of Chief Strategist Steve Bannon suggests that at least trade litigation through the WTO, which has been used in the past, will be ramped up and tensions will be left to escalate (he recently spoke of a likely 'war with China within the next five years').

While there is still a lack of clarity as to what exactly will come to pass, recent actions and appointments suggest that President Trump does not intend to deviate from his campaign pledges or moderate his stance on core issues. Increased protectionism and the disruptions that can cause to global supply chains is thus the biggest risk for emerging markets in the medium term. In the case of Asia, it also risks exacerbating the problem of excess capacity. A silver lining is the potential increase in intra-EM trade as a result, exemplified by the fact that China has overtaken the US as Brazil's largest trading partner.

Chart 6: EM Trade (% of GDP)



Source: Bloomberg

Robust Commodity Prices Provide Support

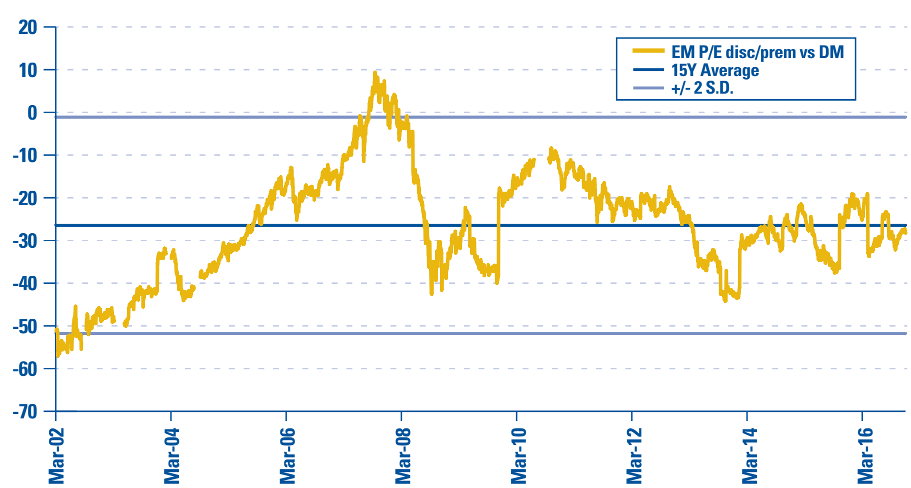
One key upside for emerging markets stems from the stabilization in commodity prices which began in 2015. After a year-long consolidation period, raw materials prices picked up through 2016 and gained additional momentum after Trump's election victory. On the expectation that the new administration would kick off a substantial infrastructure investment program, copper prices soared 20% since the election, a boon to exporters such as Chile and Peru. Conversely, the 23% increase in the oil price over the same period (reflecting OPEC and non-OPEC agreements on production cuts), buoys countries such as Russia and Malaysia (while hurting some importers).

Summary

The policies of the Trump administration have the potential to derail emerging markets. The beneficial effect of any increase in US demand, if it occurs, could be offset by rising inflation and tighter monetary conditions. A potential boost to EM exports from weaker exchange rates could be negated by more restrictive trade policies. The net effect of these counteracting forces remains ambiguous at the moment and will vary by region and country. Only the strengthening in commodities is a clear positive in the aggregate (albeit with regional variations) as flows of raw materials are unlikely to be disrupted.

Against this backdrop, the strengthening of fundamentals, improving growth prospects and light investor positioning infuse emerging markets with a degree of protection against negative shocks. In addition, EM equities have appreciated much less than other equity markets in 2016, let alone credit markets, and stand just below their 10-year price average. In P/E terms, the EM/DM ratio is also close to the long term average. This adds a further element of resilience to emerging market exposure.

Chart 7: EM Discount to DM



Source: Bloomberg

Michael Hart and Lyndon Barreto, CFA, February 2017

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