GUARDIAN CAPITAL

Emerging Markets Quarterly Outlook

FIRST QUARTER – 2017

SO FAR, SO GOOD

Emerging Market equities have staged a spectacular recovery since their low point in January 2016 and the MSCI Emerging Market gross index is once again approaching the peaks of the trading range that has prevailed during the present decade. The advance, although still led by cyclicals, has broadened out from the commodity-led surge that prevailed in 2016. This appears to reflect increased optimism about the state of the global economy, to which the fortunes of EM equities remain strongly geared. The hike in interest rates delivered by the U.S. Federal Reserve did little to disturb the equanimity of investors, principally because the accompanying message assuaged fears of aggressive tightening. Recent economic data from EM has been mildly encouraging. Trade volumes, which have been unusually lacklustre for the past couple of years, are showing signs of improvement. Concern about Chinese growth has diminished. Recession-affected economies, such as Brazil and Russia, are beginning to slowly turn around. Most important of all, consensus earnings estimates are going up, with mid-teen percentage earnings growth for 2017 now in the cards. With the fastest pace seen in years, emerging markets will be outstripping developing markets for the second year in a row. At around 13x this year’s earnings, EM equities still offer a decent discount to their DM counterparts but are no longer bargain-basement prices.

Not all is rosy in EM. New corruption scandals continue to surface on a regular basis and old ones deepen, notably in Brazil and Korea. However, the financial markets now largely ignore them providing economic policy is pointing in the right direction. Investors are in a forgiving mood with respect to most other political issues too. Geopolitical spats, such as that between South Korea and China over a proposed missile defence system, barely cause a ripple. Unsavoury political developments in Turkey no longer have much impact on local financial markets. The list goes on and, whilst the details may vary by country, the key point is that investors have adjusted to higher levels of political uncertainty than would have been acceptable in the past. Even the statements of Mr Trump have lost their power to shock, as witnessed by the strong performance of Mexico so far this year.

Not surprisingly, the improvement in sentiment towards EM equities has led to a jump in international inflows to the asset class. These have not yet reached fever pitch, nor has total exposure reached previous highs. With the investment barometer pointing towards fair weather for the next few months, the present positive trend may well continue, subject to the odd bout of profit-taking. Protectionism and mishaps in China are the principal risks to this optimistic scenario.

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How vulnerable is EM to protectionism?

The expansion of global trade over the past few decades has been critical for the renaissance of EM economies, so the prospect of an outburst of U.S. protectionism was bound to set the alarm bells ringing. What will happen in practice is, of course, still highly uncertain. The market now appears to be taking the view that the reality will be less dreadful than Mr Trump's rhetorical vision. This is probably correct, but it is still worth considering what the possible damage might be. The main targets of any action will almost certainly be Mexico and China as they are the biggest beneficiaries of the outsourcing of U.S. manufacturing. Mexico is highly dependent on its links with the United States and it also enjoys a significant trade surplus with its NAFTA partner. China has less exposure relative to its GDP, but it is responsible for around half of the U.S. trade deficit.

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The U.S. enjoys huge economic leverage over Mexico: being its principal trading partner, its main supplier of capital and the source of remittances to the tune of 2.6% of GDP. It does not have the same advantages with respect to China. China's exports to the U.S. are equivalent to 4.2% of GDP, a little more than is the case for Germany but only a small fraction of Mexico's 27.7% ratio. Rather than being dependent on American capital to finance its growth, China has been a funder of U.S. sovereign debt and its diaspora remittances are miniscule. In addition to these two countries, other manufacturing centres in Asia, notably Korea, Malaysia, Thailand and Taiwan, are vulnerable to American protectionist restrictions as their exports to the U.S. are economically significant and they enjoy substantial trade surpluses. Europe, Middle East and Africa as well as South America, are unlikely to attract specific attention given the content of their export bundles and more balanced trade positions. The other area of contention is likely to be immigration controls. This a less critical issue, but Mexico again will be first in the firing line. Other countries that will be particularly unhappy with draconian measures because of their potential economic impact, are India with its big IT software services industry and the Philippines because of the negative impact on remittances. As tensions rise, the other area of concern is possible collateral damage in the form of reduced capital flows and the higher financing costs. Fragile countries in this respect still includes several of the usual suspects, e.g. South Africa and Turkey, but, fortunately, EM as a whole is in much better macro-economic shape than in 2013, the last time it was seriously tested.

The type and degree of pain suffered will depend on the nature of proposed measures. These may include abandoning existing free trade agreements, tariffs, obstructive regulation and border or other corporate tax changes. Any of the above would be harmful, but unilateral measures, such as the 45% tariff on imports from China suggested by Mr Trump, would be particularly harsh on the countries targeted. Arbitrary measures will invite retaliation and in any trade war, China would be a formidable adversary. Not only would it be able to withstand the economic shock better than most countries, its position at the centre of the global supply chain and its importance to American multinationals, which have sunk five times more capital into China than Chinese companies have into the U.S., give it powerful weapons. Beggar-thy-neighbour policies would also damage U.S. geo-political interests in Asia at a delicate time. The administration, hopefully, will settle for negotiating a series of concessions rather than pursue unilateral radical policies that, in the robotic age, will not deliver the American middle class jobs promised. If it chooses the latter, not only will it face political and legal challenges at home, it will also find it difficult to prove its case with respect to currency manipulation or to stay within WTO rules. With luck, reason will prevail, but if it does not, EM will be in for a rough ride.

All quiet on the eastern front?

The improvement in China's economic momentum evident towards the close of last year, has continued into 2017. Gains appear to be becoming more broad-based and wholesale prices have begun to rise. Economists have begun to increase growth forecasts and they are no longer fretting about the consequences of sustained disinflation. All of this is music to the ears of the government in what will be a big political year. The 6.5% official growth target should be achievable without Herculean levels of stimulus, so once again reform can be top of the agenda. The Central Leading Group for Financial and Economic Affairs, chaired by President Xi, laid down the immediate priorities at the end of February: reducing excess capacity by closing zombie companies, improving systemic financial risk controls, deflating the house price bubble and cutting the prices and fees set by monopolies. Laudable goals, but can they be delivered without upsetting the economic apple cart? Probably not if progress is to be meaningful.

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In the run up to the Communist Party National Congress President Xi is unlikely to be in the mood to risk triggering a sharp slowdown, so a slew of relatively minor tweaks to policy rather than radical changes appears to be the likely formula for most of the year. A quick look at the possibly painful consequences of decisive action reveals why this will be the case. Closing active industrial producers, rather than counting already idled capacity as a reduction, will ratchet up unemployment and crystalize bad debt. The former will not be popular with affected workers and the banks are still not in a position to face up to reality. The five-yearly Finance Work Conference, which is due to sit later this year, will be key to setting long-term financial sector strategy, but it is unlikely to discover the alchemist's stone whereby deleveraging can be delivered quickly without threatening to cut credit excessively. With the impact of last year's fiscal stimulus already beginning to fade, clamping down too hard on property developers could threaten economic expansion and, as in the past, there could be a threat to financial stability if property prices decline sharply. At present, it is unclear precisely what taking on the monopolies means. However, as any meaningful action is likely to hurt powerful state-owened enterprises (SOEs), the President may wish to consolidate political control before starting a major campaign.

Given their importance to the economy, the way in which SOEs are reformed is an important consideration for investors. Ideally, markets will become open to private sector companies and they will be able to compete on a level playing field. Unfortunately, it does not seem that this is going to happen. Instead, there will be a reduction in SOE numbers through relevant mergers, but the new national champions will largely retain their previous privileges. In the past, culling SOEs has not delivered much improvement in return on capital, but there could be significant gains this time, albeit from a very low base. This is because of the introduction of management incentive schemes tied to profitability. The government has a genuine interest in seeing higher earnings as these would enable rising dividend payments to overstretched state coffers. Another initiative is that state-owned investment companies will be encouraged to take equity stakes in fast growing private companies. This looks suspiciously like expanding state control rather than reducing it. The sop to a few lucky private companies is that they will be able to take minority stakes in sectors previously not open to them. The overall mix should benefit national economic performance in the medium term, but the dilution of the profit motive, in favour of promoting government objectives over a wider front, will disadvantage private investors in the long term.

Although the immediate economic outlook in China is a bit sunnier than it has been for a couple of years, this is likely to prove a temporary interlude. President Xi implicitly acknowledged this when he recently stated that China is able to tolerate growth below 6.5% if meeting the target comes with excessive risk. We will probably have to wait until the aforementioned National Congress to see if this means promoting reform that begins to bite. The government cannot wait forever to rebalance the economy sustainably, but rising to the challenge will almost certainly mean growth that disappoints financial market expectations. Unfortunately, procrastination will lead to a worse outcome in the long-term.