Emerging Markets Quarterly Outlook

FIRST QUARTER – 2018

THE SIGNAL & THE NOISE

Emerging Market (EM) equities rallied out of the gates in 2018, maintaining the robust and broad-based upward momentum that saw 2017 turn in the best year for the stocks from the group of 24 developing economies that comprise the MSCI Emerging Markets Index since 2009. After rising unabated by 10% over the first three weeks of the year (with 23 of the local markets in the index rising; Egypt the sole decliner) however, a long-awaited patch of turbulence hit what had become overly complacent global financial markets, and the EM index fully reversed course in just two weeks amidst indiscriminate selling of equities across markets. There has been some recovery since, that left stocks up for the quarter, albeit in the context of more volatility than has been seen in recent memory.

Importantly, this recent spasm in markets appears to be more noise than signal — it has been a fairly textbook correction followed by a return to more normal levels of market volatility after a period of abnormal calm, rather than an inflection point for the global bull market or economic expansion.

The uptick in volatility has not been predicated on a weakening in the economic backdrop nor was it due to indications of fundamental weakness at the company-level. Instead, it has largely been a function of swings in sentiment (the noise) driving deviations around the underlying trends which themselves are driven by fundamentals (the signal).

Growth Signals

While the mood in the market may have changed from the borderline euphoria that dominated three months ago, the macroeconomic outlook really has not.

Global growth closed last year on a strong note and the "hard" activity indicators and "soft" survey data are showing that the momentum has carried into 2018. The International Monetary Fund (IMF) revised up its forecast for global growth in both the current year and next with this projected pickup driven by a strengthening within the EM — the advance among Emerging and Developing economies is expected to accelerate to its best rate in five years as the unprecedented breadth of expansion (and continued recovery of Brazil and Russia from their recent recessions) offsets the impact of the continued managed moderation of growth in China.

This means that a requisite condition for a rollover into a true bear market is not present — the current macro outlook, not just in EM but across the globe, provides no indication that a recession is imminent and continued economic growth should bode well for earnings growth. Indeed, EM earnings have come in well against expanding margins, while expectations are being revised higher to boot (growth forecasts area currently sitting just above 20%).

In conjunction with the downdraft in markets, this has served to make stock valuations in EM, which were in middling territory to begin with, look even better relative to their own histories and in comparison to those in Developed Markets (DM) — the price-to-book ratio sits in line with its historical norms while the 20% discount for EM stocks based on forward earnings is wider than its longer-term average and suggests some mean reversion via outperformance may be in the offering to narrow the gap.

In addition, currency continues to provide a tailwind for EM performance. After the basket of EM currencies rallied 11% against the US dollar in 2017, there has been a further appreciation so far this year despite the added volatility and decline in risk appetite, and the relative economic performance differentials between EM and DM suggests that there may still be room for further appreciation — though, it is worth highlighting that should trade tensions (more on this below) spur concerns over the EM outlook, currencies would be the prime vector that investors use to express their nervousness.

The strengthening in EM currencies has carried positive implications above just what it means for returns as well. Specifically, strong currencies are disinflationary since they make the domestic cost of imported goods and services cheaper. This one factor is why even with the positive economic backdrop, inflation remains contained in EM — other factors include the increased credibility of policymakers and their adoption of inflation targeting regimes, as well as the improvement of net international financial positions and current account balances which have made EM less vulnerable to international liquidity conditions and helped to provide greater currency stability.

The benign inflationary pressures mean that EM monetary policymakers have not been pressured to follow their DM counterparts in shifting toward policy normalization. Central banks in Brazil, Chile, Colombia, Russia, and South Africa all cut rates in Q1 while those in Argentina, Czech Republic, Hungary, India, Korea, Taiwan, Thailand and Turkey remained on the sidelines.

All of this remains constructive for EM equities — as does the fact that global equity funds remain materially underweight EM despite these markets claiming an increasing share of global market capitalization, something that should support a resumption of solid inflows in EM. Non-resident portfolio flows into EM actually declined sharply in February, marking the first net outflow in more than a year.

Political Noise

Of course, while the economics remain constructive, EM are hardly without risk and as is typical in the region, they are political in nature.

Politics have traditionally been a strong influencer of EM equity performance, as market sentiment ebbs and flows as governments fall in and out of favour with a relatively high frequency. For example, the recent removal of Pedro Kuczynski from office in Peru makes him the 19th elected president in Latin America in the past 30 years to fail to complete his term. While more often than not governments tend to be just a source of noise and rarely fundamentally alter the underlying trajectory of an economy — there are obvious exceptions to this such as Nicolas Maduro in Venezuela, Jacob Zuma in South Africa and the Kirchners in Argentina to provide recent examples — the related cacophony can muddle the market signals in the short-run.

This is particularly relevant now as EM are currently experiencing a heavy slate of elections, which provide the potential for heightened uncertainty in financial markets.

Russia (where Vladimir Putin was awarded another six-year term as President in March amidst increased scrutiny from the West that has resulted in sanctions and the expulsion of diplomats) and China (where Xi Jinping was granted a second term as President in October and saw his power consolidated and extended indefinitely by the National People's Congress in March) caused no stir in the marketplace.

Elsewhere, the recent tilt toward business-friendly governments has been well received — Cyril Ramaphosa assuming the leadership of the African National Congress in South Africa and taking over as President with Jacob Zuma finally stepping down; Sebastián Piñera's presidential victory in Chile; and the strong performance of Iván Duque's centre-right Centro Democrático party in the Colombian parliamentary election, which bodes well for the impending presidential election in May.

On the other hand, upcoming elections in Mexico (July) and Brazil (October) come with ample risks with populist candidates currently polling strongly. The re-election of Eurosceptic Viktor Orban in the April Hungarian parliamentary elections comes at a tense time in terms of the country's relations with the European Union, but the continuation of the Fidesz party's economic policies at least should support growth in the central European manufacturing hub.

Does This Mean War?

While the elections have not factored hugely into markets, politics — even though they do not stem from the region — have indeed been a driver of volatility through the rising potential for a trade war.

The opening salvo in these escalating trade tensions was the move by the US Administration to implement import tariffs on steel and aluminum imports in February. While these tariffs are more noise than anything, given that they have a narrower scope than first feared — the likes of Mexico, South Korea, Argentina and Brazil are exempt, while China and Russia export only a small share of these commodities stateside — the signal here is clear: the US is adopting a more protectionist approach to its trade policy no matter how questionable it may be, to try to protect industries where the train has already left the station.

The US also subsequently announced that it was introducing tariffs on tech-heavy imports from China in response to its view that America was suffering losses due to illegal technological transfers to the world's second largest economy. Importantly here as well, though, the direct impact is still fairly muted — the coverage is $50 billion worth of Chinese exports and at a rate of up to 25%, which compares to the 45% rate touted by the US President on the campaign trail. While not insignificant, this is a drop in the bucket for

China — the nation had a trade surplus with the US totalling $375 billion in 2017 on $506 billion worth of exports — and is unlikely to have a material impact on its growth prospects.

Again, though, the concern is the signal being sent and what the fallout would be should tensions escalate. Despite what the American President may think, trade wars are neither good nor are they easy to win and that is especially the case with respect to a formidable adversary such as China.

While China's economy is roughly twice as exposed to trade as the US, it has reduced its dependence on exports over the last decade (exports represent just 20% of China's GDP, which compares to 37% 10 years ago) and its domestic economy is still big enough to likely absorb the brunt of any hit.

As well, China's 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 US — as well as the fact that China is a funder of US sovereign debt (it is the largest foreign holder of US Treasuries, owning $1.2 trillion or 8% of all marketable securities) at time when the U.S. is upping its bond issuance to fund its fiscal initiatives, give it powerful weapons.

But a trade war between the world's two largest economies would likely have many other countries caught in the crossfire, multiplying the magnitude of negative economic spillovers globally. This is particularly the case among EM, which are more dependent on exports to and investment from the US as a driver of growth than their DM counterparts and have comparatively limited leverage for negotiations.

China, for its part, has retaliated to the US moves by first announcing tariffs of its own of 15% to 25% on US exports totalling just $3 billion, and following up with a more aggressive tariff plan targeting $50 billion of key American imports (including planes, cars, chemicals, soybeans and beef).

The question now is to what degree tensions will further escalate — we have a tentative idea here, with the American President suggesting looking into targeting another $100 billion worth of imports.

Neither country has an interest in engaging in a prolonged spat, but neither do the leaders want to be seen as capitulating. There have been indications of a willingness to negotiate and there should be enough wiggle room to come up with a face-saving agreement before the tariffs actually come into effect.

While there are obvious risks to this agreeable outcome, solace can be taken in the fact that despite earlier hardline stances from the US about NAFTA, negotiations there have apparently made material progress of late (most notable is the US dropping its auto content demands) which is a plus for Mexico, while the US and South Korea also recently agreed to a revised trade pact.

In other words, there is seemingly a desire to reach agreements and there is hope for the sabre rattling representing nothing but noise rather than a signal of a seismic shift in how international trade relations are managed. Of course, however, history shows that EM assets typically overreact to negative global macroeconomic news, and should negotiations fail, there is no reason to expect that this time would be different.