October 2018

By Multi-Asset team

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Nikko Asset Management

EMERGING MARKETS QUARTERLY: NAVIGATING AN INFLECTION POINT

Q3 2018 Insights

The trade war between the US and China appears to be morphing into deeper and more protracted conflict as reflected in a recent speech by US Vice President Mike Pence, who criticised China not just for trade practices but more fundamentally for its broad political and economic model.

Clearly the speech was designed to appeal to the Republican base as mid-term elections approach, but grievances with China are increasingly finding bipartisan support on the belief that China has yet to become a "responsible stakeholder" – a term coined in 2005 by then-Deputy Secretary of State Robert Zoellick to describe how China ought to work with the US "to sustain the international system that enabled its success."

Calling it a new cold war may be early, but it is fair to say that a mutual distrust or at least increasingly divergent perspectives should not be underestimated and likely cannot be undone by a simple truce on the trade war. Global supply chains have already been disrupted by tariffs, and now disruptions look likely to persist – particularly in areas of technology deemed a national security interest.

Presidents Trump and Xi are due to meet at the G20 summit in Argentina in late November, but so far there is no apparent olive branch beyond the late-August US decision to limit new tariffs on USD200 billion of US imports to just 10% before they rise to 25% at the beginning of 2019, should a resolution not be found.

We still believe a deal is possible to avert the inevitable pain of a 25% tariff on both sides of the Pacific. However, the overall conflict looks set to continue through various channels which will likely have a long-lasting effect as globalisation remains in reverse.

The outlook for EM is complex. On one hand, global growth appears supported on the back of US fiscal stimulus and China's recent shift toward easing. On the other hand, the growth boost attributable US fiscal stimulus is beginning to wane while the US Federal Reserve (Fed) continues to tighten, and China easing has yet to transmit into the real economy.

Despite returning confidence in markets like Turkey and Argentina which formed the epicentre of EM stress early in the third quarter, financial conditions still remain overall tight across EM.

We had hoped growth momentum slowing in the US and returning elsewhere would ease dollar strength. However, China easing against US tightening, coupled with renewed European concerns in the form of Italy remaining defiant on fiscal budgets, continue to support the dollar.

EM is unambiguously cheap, but policies and their impact on the growth outlook will remain key determinants of earnings and therefore market direction. Over the remaining months of this year, we are keeping a close watch on three key signposts:

- *Tariffs:* We still believe some form of agreement is possible to avert the pain of a 25% tariff in 2019. Markets would clearly find relief on such an outcome, but the forces driving de-globalisation are likely to remain intact, which is a headwind for corporate earnings.
- *China credit impulse:* Deleveraging coupled with rising defaults have so far limited the transmission of China easing to credit expansion. The credit impulse remains negative where demand is so far not matching new offered supply. Given its capacity to control credit, we suspect China will make adjustments as necessary to lift the credit impulse.
- *Fed policy:* Tightening looks set to continue, though if equities continue to sell off, at some point the Fed will need to consider the negative wealth effect and perhaps a diminishing impact of the fiscal stimulus. Any move to downshift tightening would be a firm near-term positive. Nevertheless, the perceived inability of the US to fully normalise rates could ultimately be deemed a longer-term negative for risk appetite.

Asia growth eases, while valuations are attractive on earnings momentum

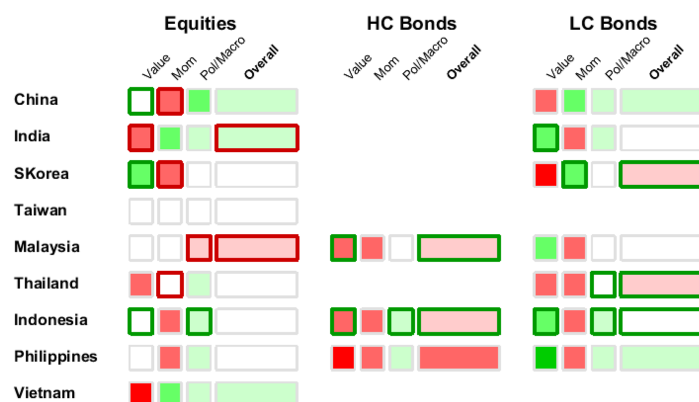
Momentum shifted negative both for China and South Korea equities on the back of trade wars, which are expected to reverberate across the Asia supply chain. In both cases, the momentum downgrade was offset by an uptick in valuations. Despite risk to the supply chain from trade wars, earnings and growth still look resilient.

India equities were downgraded in August due to rich valuations and a more challenging macro outlook. Equities subsequently corrected harshly driven by a major credit default (IL&FS) demonstrating that the banking system remains weak despite efforts to recapitalise and streamline bankruptcy laws. On balance, banks and credit services deserve caution, while service exporters (IT) may well reap the benefits of a weaker currency.

South Korean local currency (LC) bonds were upgraded with momentum shifting positive as rate hikes look unlikely due to the country's soft macro outlook including trade war concerns. While nominal rates in local terms look paltry (2.3% 10-year yield), hedged returns in USD are increasingly attractive given Fed rate hikes. Thailand LC bonds were similarly upgraded for relatively easy monetary policy and attractive hedged yields.

Malaysian equities were downgraded because of deteriorating growth prospects due to abandonment of infrastructure projects and the slowing stimulative effects of GST being reduced to zero. Malaysia hard currency (HC) was upgraded due to marginally improved valuations.

Asset Class Scores



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A new safe asset: China bonds

Asset allocators have struggled in 2018 with traditionally "safe" assets. Developed market (DM) bonds have not been exhibiting their normal safe characteristics as equities and DM bonds are increasingly selling off together.

Increasingly, China bonds looks like the safer asset relative to DM bonds – strongly outperforming DM peers over the last five years with performance further diverging in 2018.

Chart 1: China versus DM bond performance (local FX)

Source: Bloomberg, October 2018

China faces many challenges ahead, including deleveraging and now trade wars, but significant foreign buying suggests spreading confidence that Beijing can, in fact, navigate these difficult waters.

Chart 2: Foreign buying of China bonds

Source: Bloomberg, October 2018

Foreigners currently own only 2.3% of the third largest bond market in the world. As China bonds are due to be included in the Global Aggregate index beginning in April 2019, this should provide a crucial source of capital inflows to offset outflow pressures as China opens its capital account.

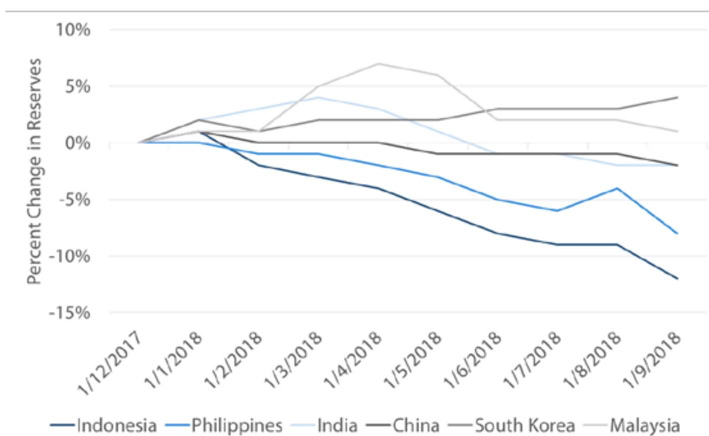
China is easing, which is weakening the currency at the margin, but a deeper devaluation is still highly unlikely given the much greater utility in keeping the currency stable to support foreign inflows to its bond and also equity markets.

FX reserves drain offers real yield gain

Portfolio outflows have been particularly acute for those countries with current account deficits including Indonesia,

India and the Philippines, reflected as a significant drain on FX reserves.

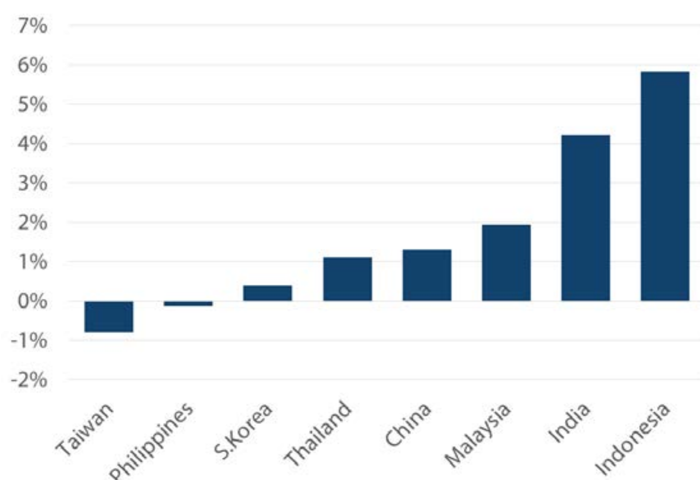
Chart 3: Asian change in FX reserves



Source: Bloomberg, September 2018

Central banks have raised rates to lend currency support as well as to adjust external deficits, but outside of the Philippines, inflation remains broadly at bay driving real yields to compelling levels in Indonesia and India.

Chart 4: Asia 10-year real yields



Source: Bloomberg, October 2018

While difficult external conditions may continue to weigh on Indonesia and India local currency bonds over the near term, high real yields and a benign inflation outlook should limit further downside. Both bonds are rated neutral for the current headwinds, but the return outlook is increasingly asymmetric in favour of upside as these pressures subside.

EMEA regaining its footing

Turkey and South Africa assets were both downgraded for rising political risk, though recent developments have helped to restore confidence – particularly in Turkey for its returns to orthodox policy including a 625 basis point rate hike with a plan (albeit short on details) for a fiscal adjustment.

Prior to the rate hike, President Erdogan lashed out at the US and markets in general for punishing his alternative view of economics and policy. Since then, the president has capitulated on all fronts – at least for now – which markets are not surprisingly rewarding.

More relief is likely to be on the way given the recent release of American pastor Andrew Brunson whose detention for alleged terrorist activity had been the catalyst for US sanctions and tariffs against Turkey.

Inflation rose to 24.5% in September, and with the policy rate only at 24%, the central bank will need to stay vigilant. The devil will be in the details of the fiscal plan and management of the teetering banking system that is struggling against extremely tight liquidity and rising non-performing loans. The imminent economic adjustment and recession will be brutal.

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South Africa: a fine line against junk

President Cyril Ramaphosa walks a fine line, delicately pushing populist policy (just enough) to maintain support amongst his increasingly divided African National Congress (ANC) party for the upcoming 2019 elections while at the same time building a high-quality economic team to put the country back on a fiscally sustainable path.

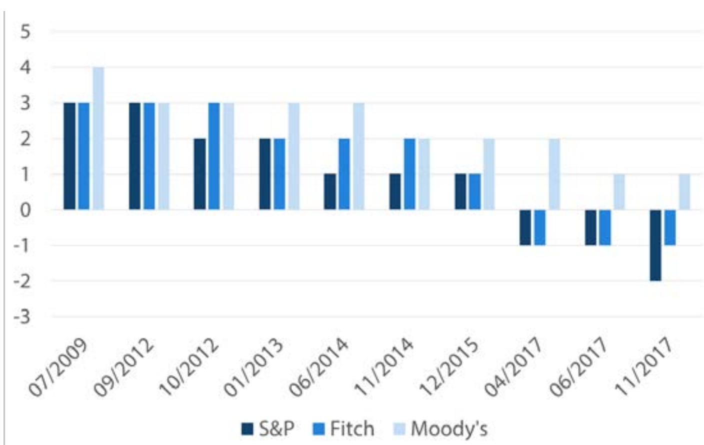
Appealing to all stakeholders has not been easy and at times humiliating, such as when Trump tweeted against the proposed constitutional amendment for land expropriation without compensation – a policy that Ramaphosa ultimately is likely to water down following the 2019 elections.

The economy officially entered recession in the second quarter as GDP contracted by 0.7%. Fortunately, inflation moderated allowing the central bank to keep rates steady at 6.5% while a modest stimulus package is hoped to lift the economy while not being too rich to risk further fiscal slippage.

Markets were heartened by the appointment of Tito Mboweni as the country's fifth finance minister in less than three years. However, the reprieve was short-lived given his recent acknowledgement of near-term fiscal slippage.

All eyes are now on Moody's, which is the only ratings agency holdout for not downgrading the country's debt to junk.

Chart 5: South Africa credit rating relative to junk



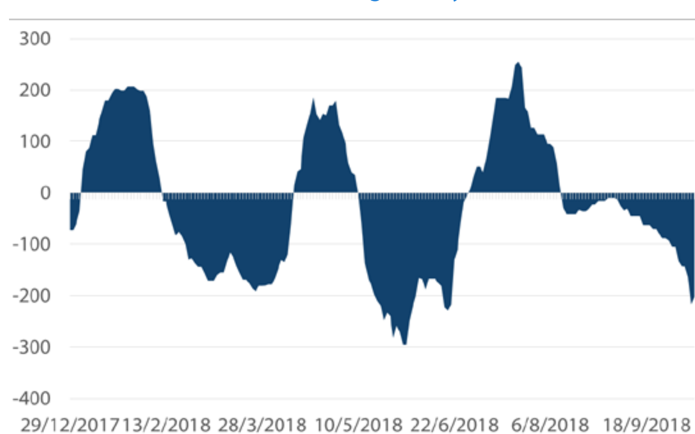
Source: Bloomberg, October 2018

The Moody's decision remains crucial, simply because a decision to downgrade would lead to the removal of the country's bonds from the WGBI index, which would drive significant capital outflows.

Russia sanctions rollercoaster

President Trump called for more sanctions against Russia on further evidence of Russia's connection with the Skripal poisoning in the UK and election tampering at home. The relentless call for new sanctions has taken a toll in the form of investment outflows, as shown in Chart 6 where Russia ETF outflows have been accelerating.

Chart 6: VanEck Russia ETF, rolling 30-day flows



Source: Bloomberg, October 2018

On the brighter side, additional sanctions likely averted the passage of a far more punishing sanctions bill being pushed through Congress, partly driven by Trump's (less than stellar) performance in Helsinki.

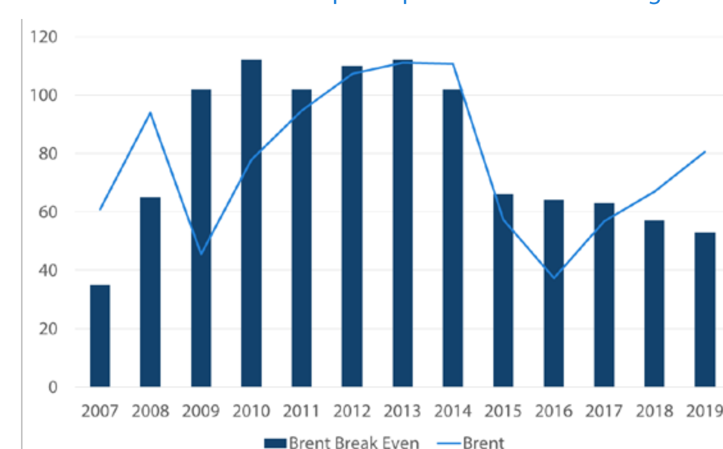
Meanwhile, the Mueller investigation goes on, but his investigation team is shrinking as agents have been redeployed back to prior posts. To date, there is no evident smoking gun to suggest collusion, but the findings will be important to determine the potential for further sanctions.

Meanwhile, Trump has found some success in at least shifting some of the sovereign interference narrative from Russia to China.

We have long held the view that Russian economic policy is a firm positive – both for monetary and fiscal restraint which is quite different than the boom and bust cycles that followed the price of oil for the last several decades.

Today, the price of oil has continued to rise while fiscal restraint has reduced the required price of oil to USD53 per barrel to meet fiscal targets. Meanwhile, growth continues to pick up on the back of more investment, so Russia appears reasonably well-insulated against the sanctions' onslaught.

Chart 7: Price of oil versus required price to meet fiscal target



Source: Bloomberg, October 2018

LatAm commodity kick and political hope

Positive political developments and China stimulus lent support to LatAm assets on the prospect of commodity demand. Importantly, Mexico and Canada separately closed trade deals with the US, rebranded as USMCA which is much the same as NAFTA, though with a protectionist tone.

Brazil local currency bonds were downgraded for downshifting momentum, though they have since seen respite as markets judged Jair Bolsonaro's win in the first round of the presidential election as a better outcome than the PT's alternative candidate.

Chile equities were downgraded for deteriorating momentum and valuations. Equities followed copper up from early September but have since broken down again to new lows despite relatively resilient growth. Still, equities are expensive, tax cuts did not materialise and monetary tightening is likely to start later in the year as inflation is projected to pick up.

Argentina equities were downgraded because of rising inflation and an increasingly harsh economic adjustment ahead.

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Argentina back from the brink

President Mauricio Macri made the mistake of disclosing a deal with the IMF to front-load 2019 disbursements when, in fact, no deal at been struck, leading to a currency meltdown in late August.

Chart 8: Argentina Peso

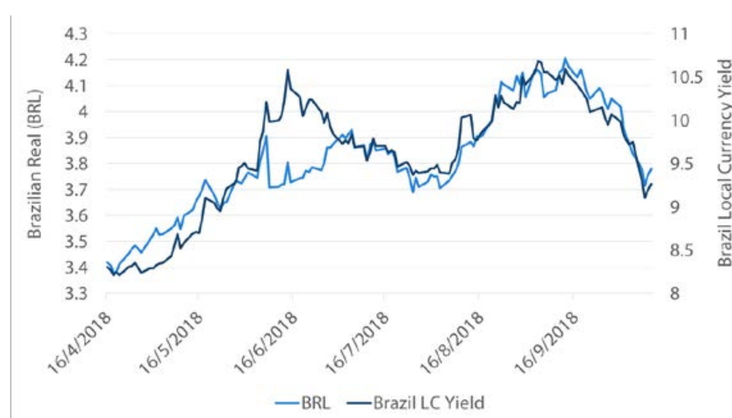
Source: Bloomberg, October 2018

Returning to the IMF (so quickly) required a much deeper fiscal adjustment which has since restored market confidence. While numerous economic and political hurdles remain, so far the projected fiscal adjustment looks credible.

Brazil near-term election relief

Brazil LC was downgraded due to momentum shifting negative against challenged valuations and macro politics. However, like other EM markets stressed during the summer months (and consequently oversold), the first round of the Presidential election favouring Bolsonaro over the hard-left alternative was enough to offer near-term relief. Bond yields compressed and the currency strengthened, but we still see many challenges ahead that do not warrant an upgrade at this time.

Chart 9: Brazil local bonds and currency (BRL)



Source: Bloomberg 2018

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