



EMERGING MARKETS QUARTERLY: A FIRM REPRIEVE, FOR NOW

Q4 2018 Insights

Emerging markets (EM) slid from February through the year-end on the back of a stronger dollar, an escalating trade war and notably weaker growth in China. However, we see evidence that these previous headwinds may now be turning into tailwinds. While uncertainty remains, the outlook is certainly greatly improved, especially given attractive valuations.

Aggressive US Federal Reserve (Fed) tightening, coupled with a fiscal boost to growth, kept the dollar strong, which is invariably a broad headwind against EM assets. However, the fiscal boost is wearing off and the Fed has turned dovish, which suggests the tightening cycle may be coming to an end.

While equities continued to sell off through the year-end on a deteriorating growth outlook, EM currencies actually began to outperform the dollar beginning in late September.

Chart 1: Emerging equities versus currency



Source: Bloomberg, January 2019

Counterintuitively, the broad equity sell-off which finally enveloped the US beginning in early October might have been a positive for EM, as it was enough to cause the Fed to rethink its pace of tightening – not just in rates but also in balance sheet reduction. The sharp drop in US equities also

demonstrated that the US is not immune to the negative effects of rising tariffs, seeming to push Trump back to the table to get a deal done.

Our base case is that additional tariffs will be avoided but the trade war will grind on through other legal channels such as recent actions taken against Huawei. This is long-term negative for global trade, but positive for avoiding further tariffs that could weigh on growth and earnings.

Weak growth in China was clearly a drag on EM sentiment, and while authorities continue to tweak monetary and fiscal levers to preserve private sector growth without undoing important efforts to deleverage, the so-far weak transmission to growth is clearly making markets nervous.

While China may be more patient than markets to find quality growth, we do expect healthier growth to be achieved by the second or third quarter of 2019. It will have a different complexion that favours consumption over investment to leave commodities in a more normal range of demand, but this is positive for sustainability of long-term growth.

A weaker dollar, a truce on tariffs and returning growth to China are all firm positives for EM assets, but we remain concerned about liquidity conditions, given that central banks in the West continue to remove accommodative policy.

Just as Turkey and Argentina fell under stress during the summer months, we expect the markets will continue to test other imbalanced economies and companies that have been overly dependent on easy, cheap money. In this environment, sticking with quality assets remains critical.

Asia growth eases, while valuations are attractive on earnings momentum

North Asian equities were downgraded across the board. China moved to neutral for deteriorating growth and earnings momentum while Taiwan and South Korea were dropped to

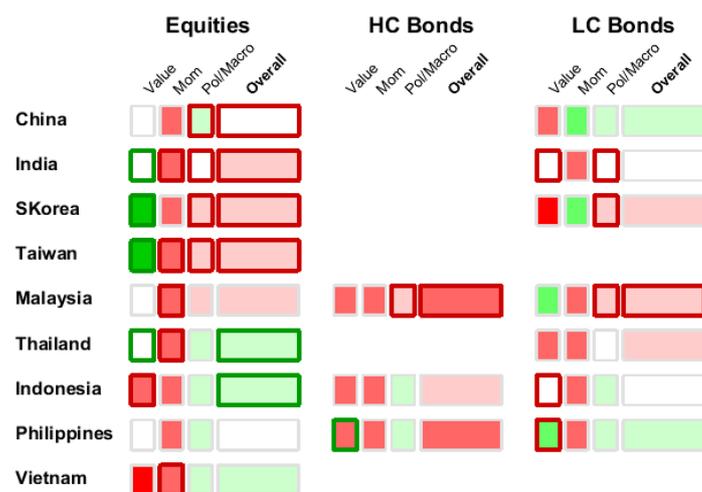
neutral-negative mainly on account of deteriorating demand for technology hardware for both servers and smartphones – which weigh heavily in these markets.

India was also downgraded for momentum shifting negative and deteriorating macro, though we note valuations are shifting to neutral after appearing expensive for some time. Macro has shifted from positive to neutral because of a high profile default among non-bank financial corporations which is likely to impede credit growth. Also, RBI governor Urjit Patel abruptly resigned amidst pressure by the Modi administration to compromise the central bank’s independence.

Malaysian bonds were downgraded for deteriorating fiscal dynamics, while elsewhere in the ASEAN region, Indonesian and Thai equities were upgraded on account of improving momentum and more attractive valuations, respectively. Overall, growth is proving to be resilient despite rate hikes while low inflation means the tightening cycle is likely coming to an end.

Overall, ASEAN has proven defensive against North Asia, which has been pressured both by trade wars and a downturn in the technology hardware cycle.

Asset Class Scores



Score Summary: For each country and asset class, scores are represented by colours – white is neutral, green is positive and red is negative. The overall score is shown to the right with the underlying scores – value, momentum and political/macro – shown to the left. The border shows grey for no score change, while green shows positive and red negative.

The asset classes mentioned herein are a reflection of the portfolio manager’s current view of the investment strategies taken on behalf of the portfolio managed. These comments should not be constituted as an investment research or recommendation advice. Any prediction, projection or forecast on sectors, the economy and/or the market trends is not necessarily indicative of their future state or likely performances.

China growth down but not out

The China government has perhaps never been as tested in its resolve to stay the course in its commitment to deleveraging and reducing systemic risks. Through its harsh squeeze on shadow banking, it at first appeared that mainly speculation was being taken out of the market, but the real economy is now clearly impacted with banks keeping credit tight. Efforts to push credit to the real economy have so far disappointed,

owing to concerns about record defaults and uncertainty surrounding the trade war with the US.

Despite efforts to stimulate the economy, including cuts to reserve requirements, encouraging banks to lend to SMEs and broad tax cuts, credit creation has continued to deteriorate. This is reflected by declining money supply (M1) that is back down to the dark days of early 2015. However, there is some evidence of new loan issuance in December, so perhaps the tide is turning.

Chart 2: China money supply (M1)



Source: Bloomberg, January 2018

Add to this a downturn in China trade at least partly attributable to front-loading in anticipation of rising tariffs, a relatively weak consumer and a tepid property market, and the outlook is far from promising.

Nevertheless, staying the course on reforms is the right move for long-term sustainability. Our base case is that through the fine tuning of monetary and fiscal policy, quality growth will return in Q2 or Q3, but with negative data flow until then.

Not surprisingly, China equity markets, and A-shares in particular, have sold off harshly on the back of poor growth data and trade war uncertainty. But given the turning tides in the dollar, China growth and a trade war resolution, extreme valuations currently present a compelling buying opportunity.

Chart 3: China A-shares (CSI 300) forward price-to-earnings



Source: Bloomberg, October 2018

Favour ASEAN growth over North Asia tech

The extended technology hardware sector had a particularly difficult Q4 with the semiconductor index down about 16%, which was a deep drag on performance for chipmakers in Taiwan and South Korea. The pullback is partly for falling server demand – some attributable to less appeal for mining falling cryptocurrencies – but mostly for the slowdown in demand for smartphones, Apple in particular, as consumers await bigger leaps in technology such as 5G and folding screens.

Chart 4: Philadelphia Stock Exchange Semiconductor Index



Source: Bloomberg, January 2019

The tech cycle ebbs and flows and while we still see long-term opportunities in hardware related to cloud computing, artificial intelligence, the Internet of Things and next generation smartphones, ASEAN presents a more interesting near-term opportunity as a function of attractive valuations and still-healthy growth that is likely to pick up as monetary tightening nears completion.

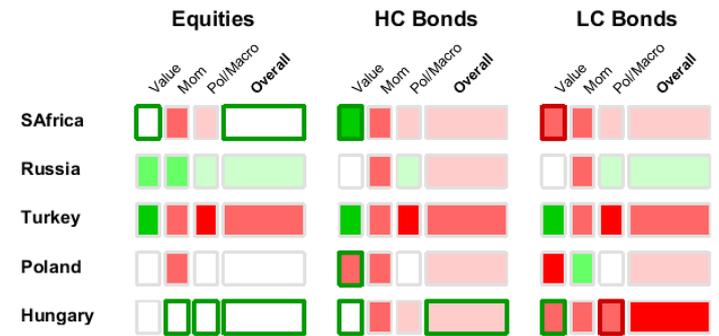
EMEA still mixed

Turkey and South Africa are on a better course, but political instability is very much still in play with any number of catalysts on the horizon that could cause markets to further discount such risks accordingly.

Central and eastern Europe remain surprisingly resilient as most data point to overheating – particularly in Romania and Hungary – but so far markets have not particularly discounted this rising risk given that growth remains attractive and inflation has not yet reached dangerous levels.

Russia may be rounding the bend to at least find a pause in the relentless escalation of sanctions. Washington now appears more focused on China as a source of potential wrongdoing on which there is bipartisan support. Despite remaining a geopolitical pariah, we still like owning Russian risk for its particularly strong macro fundamentals.

Asset Class Scores



Score Summary: For each country and asset class, scores are represented by colours – white is neutral, green is positive and red is negative. The overall score is shown to the right with the underlying scores – value, momentum and political/macro – shown to the left. The border shows grey for no score change, while green shows positive and red negative.

The asset classes mentioned herein are a reflection of the portfolio manager’s current view of the investment strategies taken on behalf of the portfolio managed. These comments should not be constituted as an investment research or recommendation advice. Any prediction, projection or forecast on sectors, the economy and/or the market trends is not necessarily indicative of their future state or likely performances.

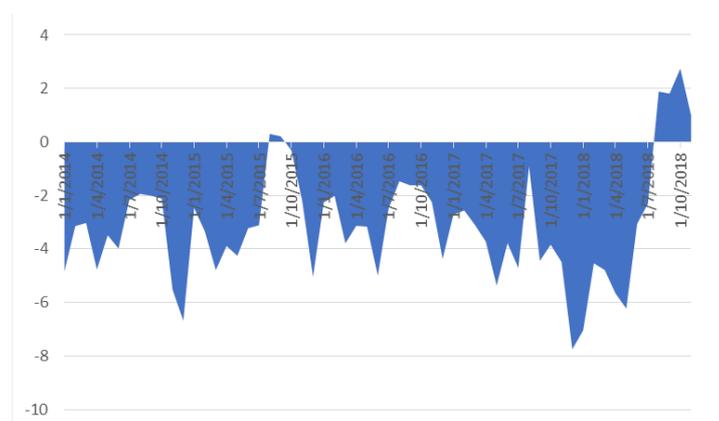
Turkey adjustment in process, but with high risk

Turkey has done much to win the support of markets since the dark days of last August when political risk was firmly on the rise – President Erdogan defying the US by detaining the American pastor on terror-related charges while suggesting that rates needed to be cut (not lifted) to contain inflation.

These events triggered a deep sell-off – the currency, in particular – but weeks later the central bank capitulated with a firm (orthodox) lift in rates while authorities decided to let the pastor go to at least partially restore relations with the US. In October, after the grisly murder of Saudi journalist Khashoggi at the Saudi embassy in Turkey, President Erdogan seemed to find leverage on Saudi Arabia that at least for now may have offered a further backstop to stability.

The rate hike and other adjustments have helped to curtail the country’s most nagging imbalance – the current account deficit. In fact, the current account has shifted from deficit to surplus since August as domestic demand has collapsed.

Chart 5: Turkey’s current account balance



Source: Bloomberg, January 2019

Clearly, the shift to orthodox policy and the external adjustment have been a strong tailwind for Turkish assets, but political risk is far from removed. President Erdogan remains committed toward consolidating his power and pushing an unfriendly market agenda.

Already, since the US had decided to withdraw its troops from Syria, it appears that Erdogan is likely to test the US's resolve to protect the Kurds that is certainly not in keeping with his agenda. We suspect volatility will remain elevated.

US pivoting focus from Russia to China?

The worst seems over as far as the barrage of escalating sanctions by the US against Russia from alleged election tampering to the Skripal poisoning in the UK. Robert Mueller's yet-to-be disclosed findings from his investigation may still include evidence of collusion between the Trump administration and the Russians to take the 2016 US Presidential election, but the possibility seems increasingly remote as time wears on and the appetite for punishment is turning from Russia to China where both parties can agree.

Meanwhile, Russian assets still benefit from passable growth and a very healthy external position – a return to twin surpluses (2.7% budget surplus and 7% current account surplus) – owing to strong policies that have withstood quite significant declines in oil prices. Over 2018, the biggest risk was the threat of further sanctions, and if this threat gradually dissipates – as we think it will – Russian assets have scope to further re-rate to the upside.

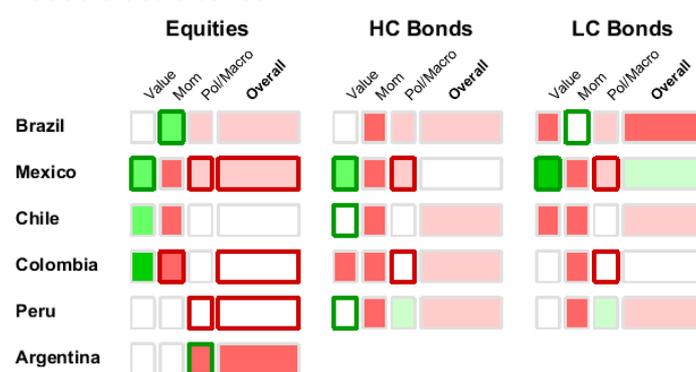
LatAm politics continue on the mend

Political prospects may be diverging between Brazil and Mexico, but markets seemed to have overshoot the relative sense of optimism and pessimism, respectively. Brazil is seeking to reform while Mexico is leaning left, but the trajectories are early and far from the outcomes that markets are pricing.

Brazil equities were upgraded to neutral as a function of momentum shifting positive while valuations are still reasonably attractive against decent earnings prospects. Mexican assets were left flat as deteriorating politics is being offset by increasingly compelling valuations.

Colombia equities were downgraded to neutral for momentum shifting negative though we note valuations remain among the most compelling in the region. Peru equities were also downgraded to neutral for weaker growth, both in investment and consumption.

Asset Class Scores



Score Summary: For each country and asset class, scores are represented by colours – white is neutral, green is positive and red is negative. The overall score is shown to the right with the underlying scores – value, momentum and political/macro – shown to the left. The border shows grey for no score change, while green shows positive and red negative.

The asset classes mentioned herein are a reflection of the portfolio manager's current view of the investment strategies taken on behalf of the portfolio managed. These comments should not be constituted as an investment research or recommendation advice. Any prediction, projection or forecast on sectors, the economy and/or the market trends is not necessarily indicative of their future state or likely performances.

Markets continue to cheer for Bolsonaro

Jair Bolsonaro was inaugurated on 1 January as President of Brazil with a surprisingly high approval rating of 75%. His popularity remains a critical measure of the weight of his mandate as he prepares to push what should be a very unpopular reform agenda including pension reform.

Markets seem to be mapping his popularity directly to the probability of his success, but it is important to remember that two prior presidents (Rousseff and Temer) were unable to get the job done.

Under these prior administrations, it was argued that Congress would push difficult reforms through on the back of an unpopular President who would serve as a scapegoat. So far, the populace is cheering Bolsonaro as a function of leaving the old and corrupt guard, but will his popularity be sustained as voters recognise that reforms are due to take benefits away?

It is far from clear, and therefore, we cast a bit more doubt on the smooth passage of a reform agenda that will necessarily inflict a painful adjustment against the broad populace. We still like the Brazil story, but we keep a very watchful eye on various signposts to distinguish hope from what can be assured.

Mexican bonds appear attractive

Back in July, it was well-anticipated that leftist Andrés Manuel López Obrador (AMLO) would win the Presidential election, so it was a much bigger surprise how badly markets were punished after the election.

Bond yields blew out nearly 150 basis points (bps) from the election through late November on a stream of news that AMLO was (not surprisingly) delivering on his promised agenda – from cancelling the new airport to reversing elements of energy reform. Yes, the path to execution might

have been smoother with a more market-friendly touch, but the market “surprise” to the downside seemed excessive.

Chart 6: Mexico local currency bond yields



Source: Bloomberg 2018

Currently, Brazil bonds yield about 40bps more than the Mexican equivalent which is quite unusual given the vast difference in current credit quality. Note, Brazil yields averaged over 250bps over Mexico over the last year and 525bps over five years. We like Mexico over Brazil for the strong optionality to the upside should there be any shift in sentiment to cause the spread to diverge to more normal levels.

Important Information

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association.

United Kingdom and rest of Europe: This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules).

This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

United States: This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. This publication has not been reviewed by the Monetary Authority of Singapore. Nikko Asset Management Asia Limited is a regulated entity in Singapore.

Hong Kong: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed institution in Hong Kong.

Australia: Nikko AM Limited ABN 99 003 376 252 (**Nikko AM Australia**) is responsible for the distribution of this information in Australia. **Nikko AM Australia** holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice.

New Zealand: Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme, the Nikko AM NZ Wholesale Investment Scheme and the Nikko AM KiwiSaver Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website: www.nikkoam.co.nz).

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis of a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the

rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Bank group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document neither constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree 80/98), nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.