What makes Emerging Markets Fixed Income attractive – even under a Trump presidency?

REASONS TO BE CHEERFUL - FOR PROFESSIONAL INVESTORS – April 2017

Executive Summary

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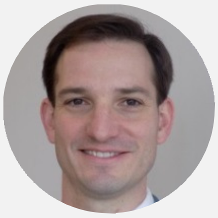

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HOW MUCH CAN TRUMP ACTUALLY DELIVER?

It has not gone unnoticed globally that Donald Trump is now in the White House of the United States of America. Love him or hate him, his Presidency and policies are likely to have implications that resonate around the world. As investors in Emerging Markets Fixed Income, the key question that we therefore currently have to address is how his plans may impact the emerging market countries in which we invest and, when building the exposures in our portfolios, we need to look at what he has been saying and what we think he may do.

Although it might seem that the damage he can do will be limited (many watchers of US politics are now saying that he has become impotent and that he will not be able to get any of his agenda accomplished without the support of Congress and without the broader mandate), we acknowledge that in recent political science analysis, many academics have shown that US Presidents are actually, counterintuitively, highly effective.

On average, 70% of what US Presidents promise during their election campaign, they deliver, and there is little deviation from this figure. The least effective President in modern history in the US, going back 100 years, still accomplished by the count in this political science analysis, over 50% of what was pledged on his campaign trail. We must therefore acknowledge that Trump has a formidable power to implement some of the most pungent policies that he has been proposing.

The common reaction to any analysis of his campaign rhetoric is that the outlook for emerging market countries is gloomy. However, there are, we believe, many reasons to counter this and that, arguably, for a number of countries the impact of a Trump Presidency will be benign, or in some cases, positive even and that the most negative implications will be localised to just two specific countries. It is on these that we will focus our disucssion initially.

TRUMP'S LIGHTENING RODS: MEXICO AND CHINA

In analysing his campaign rhetoric, with a view to emerging markets, the clearest themes that Trump seemed to enjoy telegraphing had to do with scapegoats, in particular, Mexico and China. Mexico, he claims, has stolen American jobs, and China, he believes, has stolen American growth. He has pledged to rectify this through some combination of relegation of free trade agreements, new tariffs on imports, and new deals that force these countries to reduce their manufacturing base.

Firstly, we will consider our risk case as relates to Mexico in more detail. Since Mexico is so wholly dependent on the US in terms of investment, consumption and trade, we believe that Trump has already triggered a recession in growth. Mexico's growth rate has petered out from a trend of about 3% over the last few years and, thanks mainly to the Twitter effect, is now entering a recession. The Twitter effect results in American companies not wanting to put a single Dollar in Mexico, for fear of being singled out by the new US President. Also, to the extent that they have production in Mexico, it is possible that they may even reduce those investment and hiring plans, already causing a growth impact on the country. Consequently, our risk view is that this Twitter effect is likely could cause a growth crisis as soon as the second half of this year.

From a growth crisis, it is then not hard to see how a balance-of-payments crisis might follow over the next two to three years. We do not even yet know what the new US administration will propose in terms of NAFTA renegotiation and tariffs specifically on Mexico, which will impair Mexico's already precarious current account balance and could tip the country into a balance-of-payments crisis.

Furthermore, this will likely be compounded by deportations from the US into Mexico, which will not only involve Mexicans, but all Central Americans who will be deported into Mexico, and we could likely see a labour and humanitarian crisis on top of the growth crisis. All this combined, the situation in Mexico and the outlook for the country thanks to the Trump administration is particularly poor.

We think also that Trump is bad for China. Even though China is in a much stronger economic situation than Mexico, China has been Trump's number one target for unfair trade for over 30 years, and we do not believe that he is likely to let up on this any time soon.

We expect that he will soon announce a policy specific to China which may have to do with tariffs or currency manipulation, and will probably involve a specific punishment for exports from China to the US that have value-add. This attack of China's exports by the new US administration will likely be the trigger of a growth downturn in China.

Whilst it is true that China has reoriented a large proportion of their economy away from the need for exports, this reorientation is as yet incomplete and China does still rely heavily on exports for growth, and mostly to the US. The US is still China's number one export market. Additionally, of course, as many have noted, there is also a risk of a trade war with China that would have a lose-lose implication as far as global growth.

We therefore concede upfront that Trump is bad for Mexico and is bad for China.

REASONS TO BE CHEERFUL

Having looked at the rather ominous implications of a Trump Presidency on Mexico and China, it is now important that we broaden our horizons and consider the other 70 emerging market countries in which we invest. Here, we find many reasons to be cheerful and there is plenty of evidence that the majority of countries could actually benefit from the Trump administration.

Considering commodity exporting sectors in emerging markets, countries like Brazil, Argentina, Colombia, Peru, specifically in South America, we see a very strong case that these regions will benefit from higher terms of trade and from reflationary policies in the US that have already increased the value of commodities prices in the market since the day of the election.

As US demand grows through Trump's fiscal expansionary policies, we think that these countries could benefit indirectly from an acceleration in global growth. These countries, specifically in South America, have very low value-added content to their manufacturing exports, and very few of those exports go to the US. We therefore do not see them as a target of any sort of trade policy by the new US administration.

Also, surprisingly, many may not appreciate that these countries have very low immigration to the US. Most of the immigration to the US from Latin America comes from Central America, not from South America. Hence there is no second round effect from the immigration policies either.

Looking further afield, the other region that we think particularly picks up due to Trump are the high-growth Asian countries. There is a group of countries in Asia that are already growing faster than China. These countries include Vietnam, India, Indonesia and the Philippines and we have noted for some time that they have been benefitting from China's loss of competitiveness on a trend basis.

In other words, as China becomes more expensive to produce because of labour costs, because of regulations in China and because of the currency, these countries have benefitted by essentially stealing manufacturing output market share from China. If Trump singles out China in his tariff policy, making it even more expensive for China to produce, we see that simply accelerating the migration of activity from China to South Asia, to the high-growth Asian countries.

So, very broadly, we have covered two very large regions in which we invest with a number of opportunities where we think Trump is actually positive in terms of the long-term growth for these countries. Although we do not want to overstate the case, our view since after the election in November, has been that Trump is not altogether bad for emerging markets – Trump is actually good for emerging markets, although this is a nuanced call and we do acknowledge that some specific countries will be significantly hurt.

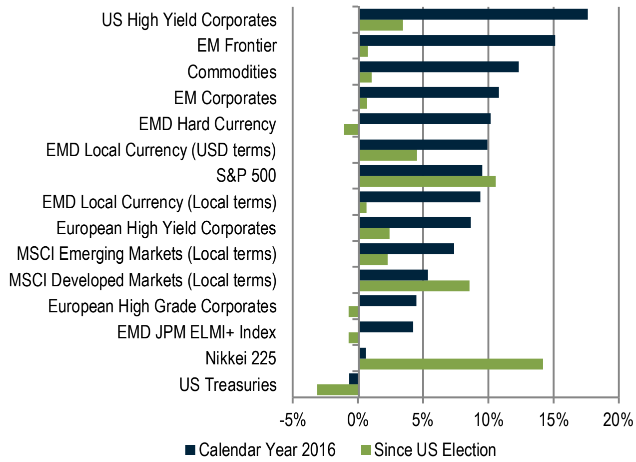
EMERGING MARKET DEBT PERFORMANCE SINCE TRUMP

Historically, US high yield corporates and emerging market US dollar bonds are comparable asset classes in that they have similar risk and similar return profiles.

2016, however, presented a different picture. US high yield returned 17% over the year and was the best performing asset class in fixed income whilst emerging market bonds lagged behind. Even though their performance was good, with returns of over 10% in US dollars, they fell shy of the 17% achieved by US high yield corporates, reflecting a valuation gap that has opened between spreads in corporate and emerging market bonds.

The underperformance of emerging market local currency bonds was even more pronounced in 2016 as they returned less than 10% over the year. Since the election, the valuation gap has grown. US high-yield corporate bonds, and corporate bonds, generally, have had positive returns. Since the day of the election, US high-yield corporate bonds are up about 3% but emerging market hard currency bonds have posted negative returns, meaning that it is cheaper to buy the index now than it was before the election. This is intuitive since it represents the fact that the market has decided that Trump is bad for emerging markets, without understanding the nuances that he is bad, yes, for some countries, but really, for most, he is not.

Returns Across Asset Classes for 2016 and Since US Election



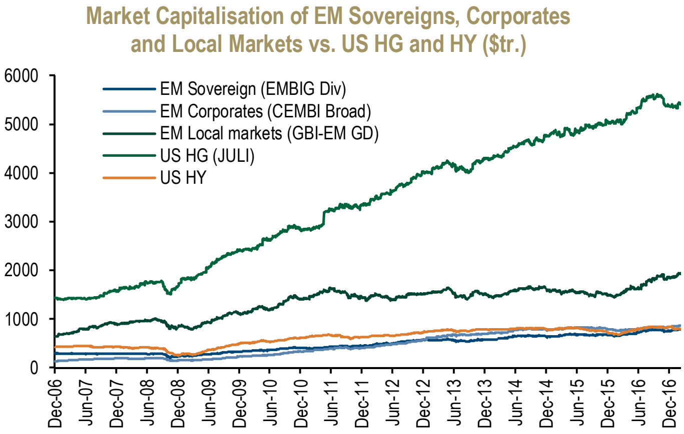
Source: BNP Paribas, Bloomberg, JP Morgan, 10th March 2017
Since US election shows 8th November 2016 to 9th March 2017. Past performance is not a guide to future performance.

INFLECTION POINT – WHY EMD NOW?

In local currency emerging market bonds, the underperformance from 2016 continued into early 2017 but since then we have passed an important inflection point. Year to date, as at the end of March 2017, local currency emerging market debt, as measured by JP Morgan GBI-EM GD, is up over 6.50%. We have anticipated this outperformance since December and have been advocating that now may the time to buy local currency emerging market debt. The reasons for this are not only that the yields are high, but because the interest rates have risen since the election (we believe as an irrational reaction to Trump) and because of the currencies that we think are poised to outperform.

In other words, we think that the US Dollar cycle is over, and that the currency will weaken from here. Reflationary policies will increase the US current account and, as the Fed hiking plan is now well underway, there is little surprise left from Fed policy. This is already beginning to play out. We have seen an important turn in emerging market currencies over the last couple of months and we think there is much room for this to continue. For emerging market local debt to catch up with high-yield bonds, we could have another ten percentage points of rally, and we think that this is a reasonable expectation for the rest of this year.

In addition to the yields, rates and currency positioning, we also believe that there is scope for significant growth of the asset class. Considering the total market cap of the various emerging market and global bond segments, emerging market bonds are still much smaller in terms of market cap than their US corporate equivalent. If we compare US high-grade bonds, which now have a total market cap of about five trillion, or US high-yield corporate bonds which have a total market cap approaching one trillion, we are still looking at emerging market sovereign debt that is smaller than that. There are less emerging market dollar bonds than there are US high-yield corporate bonds.



Source: JP Morgan, February 2017

Furthermore, in local markets, even though both the size and the liquidity have increased, we still see a total market cap of only about two trillion. Additionally, the reallocation of investors into emerging markets over the last year has been weak; despite headlines to the contrary about investors buying emerging market bonds again, the data shows that this has in fact been a very weak allocation and there has not been much in the way of flows into the asset class; rising from 10.5% to just 11.5% over the last year, relative to a peak of 18% in 2011. From 2011 to 2016, we saw a seven percentage point drop in investor allocations to emerging markets, from 18% down to 10.5%, and this has only slightly reversed over the last year.

Digging a little deeper, using Institute of International Finance data and separating bonds and equities, emerging market bond allocations look even weaker. They remain below the long-term average of 12%, standing now at only about 11.5%, and only just slightly up from the cycle low of 11% that we reached at the beginning of 2016. So again, not only have reallocations been weak but they are also below long-term averages.

As a result, there is no evidence that investors have become overallocated to emerging market investments and we therefore believe that there is ample room for this market to expand over time as more investors commit themselves to the asset class and we think that we are back on track for that reallocation to occur over the coming years.

HOW STRONG ARE THE FUNDAMENTALS?

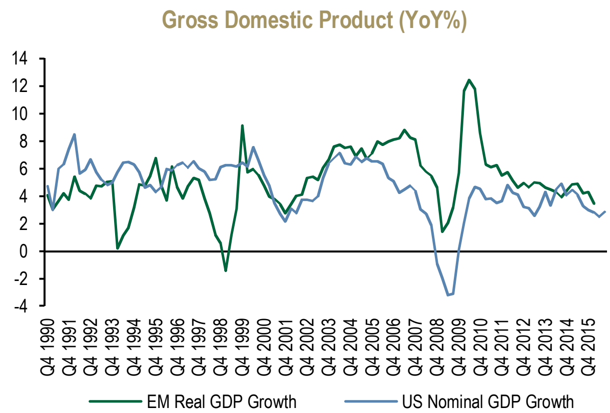
Taking a step back, it is also worth considering how strong emerging markets are on their fundamentals, before and irrespective of Trump. There are four generic factors that we can consider when analysing the fundamental health of a country; competitiveness, which we measure through real, effective exchange rates; external vulnerabilities, for which we look at the current account deficit; productivity, for which we proxy with GDP growth; and monetary or macroeconomic management, which we proxy with inflation in a country.

Taking a naïve view of the last ten years, across the 15 largest countries in the JP Morgan EMBI GD benchmark, compared to their ten-year average, surprisingly, almost all of these countries look better across these four indicators than they have over the last ten years, on average. In fact, if we look at all 15 countries using the four indicators, 62% of them are better than their ten-year long-term average, and half of those are better than a two-standard deviation outcome. This implies that not only are these countries better than they have been in ten years, but they are significantly better than they have been in ten years.

Not surprisingly, of these indicators, it is the external vulnerabilities which remain the weak points and where we have the most concern. The current account deficits remain in some specific markets. These are the countries that we think, from a fundamental structural basis, have an incomplete adjustment to the new economic reality. However, we think that this adjustment is ongoing and we see, by and large, organic evidence that emerging markets are healthier than they have been in several years.

Taking a forward view, we also stick to a very clear notion that as goes the US, so goes emerging markets. The US economic cycle has been robust and we can see inflation ticking up notably there, a trend we expect to continue given that the new policies likely to be enacted by Donald Trump, including tax reform, net fiscal spending, labour market changes, changes to immigration and increase in tariffs on imports, are all inflationary policies.

Hence, a core part of our view is that, going forward, the US will experience a period of much higher inflation and this is important because, historically, over the last 30 years, there has been an irrefutable correlation between US inflation and emerging markets growth. Whilst this is not entirely intuitive, it does make sense on a number of levels. If we think about US inflation as causing higher transactions in the short term, inflation begets short-term growth and that growth gets exported to emerging markets. Considering that the source of that growth over the past 20 years has been fiscal impetus, fiscal stimulus is often exported almost immediately into demand for emerging market products.



Source: IMF IFS, 22/02/2017

From a portfolio allocation perspective, a search for carry that is often engendered by a higher inflationary environment, pushes capital into emerging markets and other high-carry asset classes, and that often comes directly from US investors. The pickup in US inflation, we believe very strongly, will cause an acceleration in demand for emerging markets and consequently for emerging markets growth.

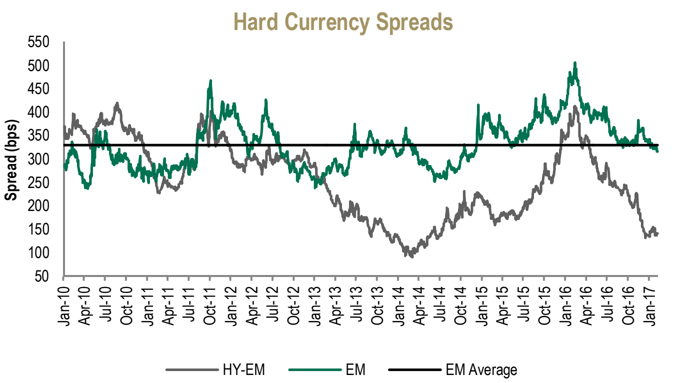
MARKET OUTLOOK

When we think about the asset allocation between the different types of securities that you can buy, hard currency emerging market bonds, local currency emerging market bonds or other emerging market assets, we consider the different macro risk factors that most directly affect these segments.

Looking initially at bonds denominated in US Dollars from a high level, there are two components that contribute to their return. The first comes from US treasuries and the other from spreads. This explains why these bonds behave like high-yield corporate bonds with very similar volatility and returns historically. However, there is far greater diversification in terms of country risk from the sovereign debt of emerging markets. Additionally, as we discussed earlier in this piece, we know that these bonds have underperformed significantly since the election.

We generally see spreads as fairly valued across all spread products. However, we see spreads as cheap in emerging markets, when considering their relative value to other spread asset classes. Spreads of high yield global corporate bonds over emerging market sovereign bonds have recently hit their tightest levels of the last ten years. These levels have only been hit once previously in this time, at the beginning of 2014. This spread is of about 100 basis points.

That is only an additional 100 basis point pickup if you are in high-yield global bonds relative to emerging market sovereign bonds and it is worth bearing in mind that emerging market bonds are half investment grade, making it really not a fair comparison. This is the tightest valuation that we have seen in some time, and that valuation has come down from 400 basis points to 100 basis points over the last year. It is our view that this will reverse and that this reversal will come through the outperformance of emerging market dollar bonds in a broad bond market rally environment. So, our expectation is that we will see further spread compression and the outperformance of emerging market dollar bonds from here.



Source: BNP Paribas, Bloomberg, February 2017

That said, we think the more interesting segment currently is in local markets and emerging market debt denominated in local currencies. The factors that drive the returns of the local currency markets are growth, the US dollar cycle and interest rates in local emerging markets.

One of the interesting by-products of Trump's reflationary policies is that the trades that are affected in markets with low inflation are very different to the trades that are affected in markets with high inflation. If we look across emerging markets at countries like Korea, Poland, the Czech Republic, Thailand and Israel, these are countries that have inflation that looks a lot like US inflation. Where it has been very, very low, it is now beginning to rise. We think Trump's reflationary policies mean inflation will rise even faster in these low yielding markets.

In contrast, the very high interest rate markets like Brazil, Indonesia, Russia, Columbia and South Africa – and now we can add Argentina to this list – will benefit from the search for yield that comes in an inflationary environment and the fact that investors will head back into high yielding markets for return. So here we find an interesting dichotomy between high yielding emerging markets and low yielding emerging markets. It is the high yielding segments in emerging markets about which we are the most excited and have the greatest expectations for outperformance.

We do recognise, however, that there is higher volatility in these markets and that the returns depend acutely on the cycle of currencies and particularly the US Dollar cycle. However, given the underperformance of local market bonds over the last few years, we believe that they are poised to outperform on a multiyear basis. Furthermore, there is not much additional volatility when compared to global corporate bonds or US Dollar-based sovereign emerging market bonds.

In currencies themselves, there's been a valuation opportunity created by the difference between commodities prices – a generic basket of commodities prices is up about 10% since the US election – and EM currencies which, until recently, were trading weaker than they had before the US election. Currencies have now come back over the last eight weeks, but we see much more room for them to go to close the valuation gap in terms of trade. Going forward, we think the underperformance of local currency versus hard currency is over and this is where we would be the strongest advocates of investment.

DISCLAIMER