Weekly commentary

FOR PROFESSIONAL INVESTORS

What Trump means for EM assets

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Key takeaways

- We are taken aback by the indiscriminate selloff in emerging markets; we see this as ultimately a buying opportunity for many assets
- We see the majority of EM as relatively unaffected and cyclically more attractive
- Economies will adjust and prove resilient whatever the policy changes ahead

Full commentary

Growth is looking up, equities have surged, there is a promise of economic stimulus, inflation on the horizon, commodities rebounding, and the Federal Reserve (Fed) looks set to continue hiking.

The year is 2004, and emerging market assets are beginning to embark on a multi-year period of double-digit returns.

Despite jitters and uncertainties following a global financial crisis, contentious election, terrorist attacks, and geopolitical uncertainty, what mattered most in 2004 was the simple fact of global economic growth acceleration on the back of US stimulus. This environment proved more than sufficient to power emerging market (EM) returns. If the Fed hikes for the “right” reason -- growth -- then EM assets stand undeterred. As inflation takes hold, chasing capital into emerging economies, uncertainty gives way to confidence and a classic late-stage value and carry trade rally unfolds.

There are too many similarities to our current environment to count. We are in a late stage economic cycle, with long awaited hope for the fiscal lever, and inflation appears like dry kindling in search of a match. Following last week’s US election surprise, we remain bullish EM fixed income in the view that stimulative policies in the US will ultimately provide an engine of demand and reflation for global output.

Let me be clear: we do not endorse Trump’s ideas nor do we condone his bombastic rhetoric. But if we take his platform at face value, what do the President-elect’s foreign and trade policies mean for specific countries? Here we are nearing new ground. Never before has a new president campaigned on such specific and uninvited economic policies affecting such unsuspecting markets. In short, Trump has employed two lightning rods for his populist agenda with very different repercussions for each: Mexico and China.

In the case of Mexico, Trump has proposed three things: building a border wall financed by an embargo on worker remittances, the swift deportation of millions of Mexican workers, and withdrawal or negotiation of the US free trade agreement. These actions if carried out would drastically impair Mexico’s services and income positions, severely reduce Mexican production and export growth rates, and painfully weaken the country’s balance of payments position. The country could easily tip into a new tequila crisis, this time caused by -- instead of saved by -- the US. However unimaginable, these policies would have no direct dissipation into the South American economies of Brazil, Colombia and Peru; in fact those countries as commodities exporters stand to benefit enormously from potentially higher metals and energy prices and have little trade or financial linkages with Mexico. Manufactured exports to the US from South America are remarkably low, implying little to lose even if the US becomes broadly protectionist. In short, we see clear country selection implications here but no across-the-board rationale for Latin American asset weakness.

For the other lightening rod, China, Trump’s policy proposals include two themes: labelling the nation a currency manipulator and raising tariffs unilaterally. On the first of these, Trump’s goal is presumably to force a free float of the exchange rate -- something the Chinese have already moved toward and appear willing to embrace. This is not at all negative for the Chinese economy if managed properly, as by many metrics the RMB now ranks as one of the most overvalued currencies in the world. On the second proposal, the economic impact of import tariffs not only to China, but to much of industrialized Asia would be catastrophic. A sudden and steep tax on Chinese exports

This week’s market developments

Monday, November 14

- Eurozone Industrial Production growth decreased to -1.0% m.o.m. (s.a.) for September

Tuesday, November 15

- Eurozone GDP growth (prelim estimate) remained at 0.3% q.o.q. (s.a.) for Q3
- Germany GDP growth (prelim estimate) decreased to 0.2% q.o.q. (s.a.) for Q3
- UK CPI growth decreased to 0.1% m.o.m. (s.a.) for October
- UK Core CPI growth decreased to 1.2% m.o.m. (s.a.) for October
- US Retail Sales Advance growth increased to 0.8% m.o.m. for October

Wednesday, November 16

- US PPI Final Demand growth decreased to 0.0% m.o.m. (s.a.) for October
- US Industrial Production growth decreased to 0.0% m.o.m. (s.a.) for October

Thursday, November 17

- Eurozone CPI growth decreased to 0.2% m.o.m. (s.a.) for October
- US CPI growth increased to 0.4% m.o.m. (s.a.) for October

Friday, November 18

- US Leading Index growth decreased to 0.1% m.o.m. for October

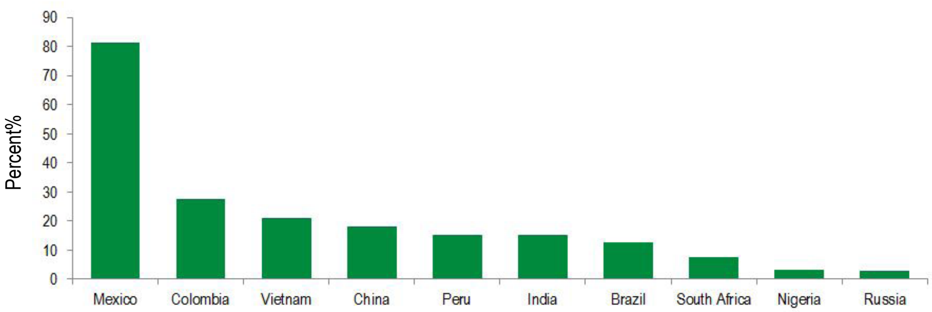
Source: Bloomberg, as of end November 21, 2016 would freeze Chinese manufacturing, disrupt the Asian supply chain, and potentially tip several economies into a severe downturn. If we step back, other EMs may actually benefit from this if their countries are not subject to the same punitive actions. Many producers already suffer from rising labor costs in China and tariffs could be the last straw for their decision to exit. Regional low cost producers such as Vietnam and India may receive jobs; other regions such as Africa and South America would welcome manufacturing investment. Here again, the story is more about country selection rather than cross-asset repricing.

In summary, we are taken aback by the indiscriminate selloff in emerging markets; we see this as ultimately a buying opportunity for many assets. Although we should expect negative headlines when Trump assumes office in January and policies are formalized, particularly of the lightening rod variety, we see the majority of EM as relatively unaffected and, at the end of the day, cyclically more attractive.

In investments, timing is everything, and we await the right entry point to implement this view. The current market environment in our estimation has unduly impacted credit spreads, which are historically mean reverting and insensitive to economic policy regimes. Volatility in currencies is more understandable given the move in US Treasuries and resetting of interest rate expectations; but ultimately we look for the cyclical entry point here as well. As in prior instances, in many markets, political noise is just that -- noise. We must remember that the world's institutions and linkages are stronger than one man and economies will adjust and prove resilient whatever the policy changes ahead.

Chart of the week

Exports to the United States (%)



Source: IMF Direction of Trades Statistics, 31/12/2015

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3m rate on December 2016 interest rates futures contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.53 %	December 14, 2016
ECB	-5 basis points	March 10, 2016	0.00 %	-0.17 %	December 8, 2016
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.06 %	December 20, 2016
BoE	-25 basis points	August 4, 2016	0.25 %	0.40 %	December 15, 2016

Source: Bloomberg

Next week's market developments

Tuesday, November 22

- US Existing Home Sales growth increased to 5,440,000 for October
- Eurozone Consumer Confidence (advance estimate) is expected to increase to -7.8 for November

Wednesday, November 23

- Markit Eurozone Manufacturing PMI (prelim estimate) is expected to decrease to 53.3 for November
- Markit Eurozone Services PMI (prelim estimate) is expected to remain at 53.3 for November
- US Durable Goods Orders (prelim estimate) is expected to increase to 1.8% m.o.m. (s.a.) for October
- Markit US Manufacturing PMI (prelim estimate) is expected to increase to 53.5 for November
- US New Home Sales growth is expected to decrease to 590,000 for October

Thursday, November 24

- Japan National CPI growth is expected to increase to 0.0% y.o.y.

Friday, November 25

- UK GDP growth (prelim estimate) is expected to remain at 0.5% q.o.q. for Q3

Source: Bloomberg, as of end November 21, 2016

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