The Intelligence Report

Our views on the latest investment events - FOR PROFESSIONAL INVESTORS - 3 July 2017

Overview

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The outsized market reaction last Wednesday to European Central Bank President Mario Draghi's rather anodyne comments on the stance of ECB policy neatly illustrated the continuing heightened sensitivity of asset prices to perceived shifts in central bank policy. We were not surprised by Draghi's comments – he has already signalled that tapering is likely – but we were surprised that markets were surprised. Clearly the threat of tapering has become a little more credible to investors recently. We return to this theme of central bank credibility in the first of our articles, in which Cedric Scholtes and Daniel Morris examine the large divergence between market expectations of Federal Reserve policy, and the Federal Reserve governor's own views of future federal fund rates – the so called "dot plot". The markets do not believe that the Fed will raise rates as much over the next few years as they themselves are telling us that they expect to do. Cedric and Daniel review possible explanations for this divergence, and draw some tentative conclusions about possible investment implications.

Emerging markets are a regular theme in our Intelligence Report editions. This year's outperformance of EM equities has been notable. Even more notable has been the significant outperformance of EM IT, which has rallied 38% so far this year to become the largest single sector in the MSCI Emerging Markets Index. Guillermo Felices and Lydia Rangapanaiken analyze this phenomenon, identifying four key drivers, and drawing some conclusions about the longer term potential of this secular theme.

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Mind the gap

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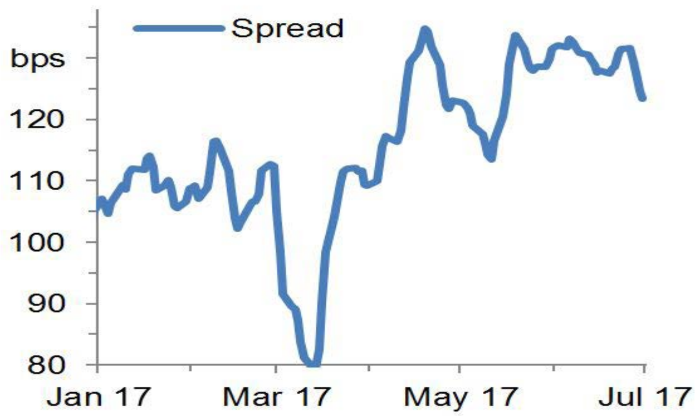
The gap between the US Federal Reserve's (Fed's) projection for its policy rate at the end of 2019 and what the futures market has priced remains very wide (see Figure 1). Not only do investors clearly not believe the Fed will increase its policy rate as much as it says it will, they are becoming increasingly pessimistic. The gap, however, must disappear between now and December 2019. So why is the gap so wide and what are the implications for investors of the inevitable closing?

Figure 1. Difference between December 2019 fed funds rate 'dot plot' median and futures



Data as at 30 June 2017. Sources: US Federal Reserve, Bloomberg, BNP Paribas Asset Management

The main explanation for the divergence is that the two parties are operating under different belief systems, or more flippantly, they live on two different planets — the Fed is from Mars, investors are from Venus. The primary framework for the Fed is the Philips Curve, which states that as the unemployment rate falls wages will rise since employers will be forced to offer higher salaries to attract workers. The market, on the other hand, is looking at how low inflation (both realized and expected) compares to the Fed's target of 2%, and concludes that the Fed will hike rates only a little as there is simply no need. The Fed's dual mandate is the lowest level of unemployment compatible with stable prices, and the current interest rate level seems to be adequate to achieve that aim.

The Fed's case

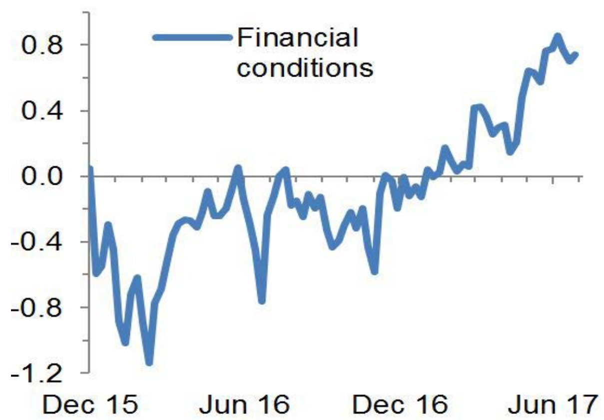
The Fed believes that the dramatic decline in the unemployment rate over the last several years must inevitably lead to higher wages. Until now, however, that has not been the case. Unemployment in the US has fallen from a peak of 10% in 2009 to just 4.3% today, but the rate of wage growth has not increased. Average hourly earnings growth has actually declined over the last few months, from 2.8% year-on-year in February to 2.5% in May, even as the unemployment rate has dropped by 40 basis points. This lack of wage growth when unemployment is falling is what is meant when economists say the Philips Curve is flat compared to what history and theory suggest it should be. For example, from 2005 to 2006, the unemployment rate dropped from 5.2% to 4.5% while the annual rate of wage growth rose from 2.6% to 4.1%.

The primary explanation for the current flat curve is that the level of unemployment that triggers a rise in wages is not constant. Evidently a level below 5% was enough in 2007 but it is not today. The challenge for central bankers is that economists can only estimate the threshold level (called the NAIRU, for Non-Accelerating Inflation Rate of Unemployment). It is only clear what this level is once wage inflation actually begins to accelerate. The Fed believes that the key level is not far from the current unemployment rate and that higher inflation will soon appear, hence the decision two weeks ago to hike the fed funds rate by another 25 basis points. Japan, however, illustrates that NAIRU could be even lower. Unemployment there has fallen to 2.8% while wages have deflated by 0.3%.

There is another reason the Fed believes that inflation will continue to rise and that its forecasted hikes in the policy rate are necessary. US GDP is expected to grow at 2.2% this year, faster than the estimated potential growth rate of the economy of about 1.9%. The Fed believes that this above-trend growth has largely closed the output gap in the US (that is, the amount of spare productive capacity in the economy) and that this must inevitably generate inflationary pressures, separate from what is happening in the labour market.

Even with the 100 basis points increase in the policy rate since December 2015, overall financial conditions in the economy — taking into account not only policy rates but other factors such as longer-term interest rates, the dollar and the level of the stock market — are looser today than they were 18 months ago (see Figure 2). Finally, the Fed would prefer to 'normalise' rates, i.e. achieve a return to real yields closer to the long-run average of 2%; they are less than 50 basis points today. The concern is that abnormally low real rates could inflate bubbles in the equity or commercial real estate markets.

Figure 2. Financial conditions



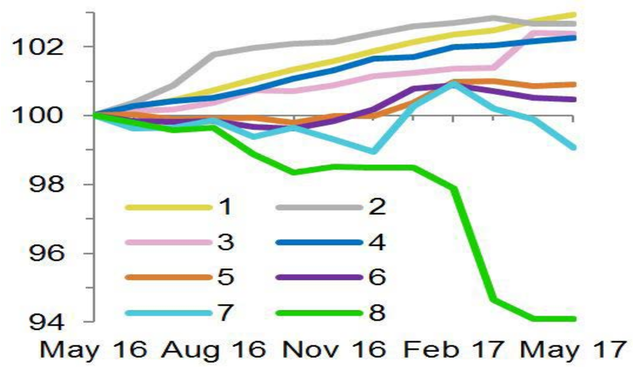
Data as at 30 June 2017. Note: A positive value indicates accommodative financial conditions, while a negative value indicates tighter financial conditions relative to pre-crisis norms. Sources: Bloomberg, BNP Paribas Asset Management

The market's view

The market is more sceptical that inflation will rise much from its current level. Inflation swaps forecast an inflation rate of just 2.2% over the next five to 10 years compared to 2.8% before the Global Financial Crisis (GFC). One reason forecasts are low is that realised inflation has continued to weaken despite above-trend GDP growth and low unemployment. The core Consumer Price Index (CPI), which excludes volatile food and energy prices, has dropped from 2.3% year-on-year growth in January 2017 to 1.7% in May, while the core Personal Consumption Expenditures Index has fallen from 1.8% to 1.6%.

There are two reasons, however, to believe that this weakness may be transitory. First, many of the components of the core CPI have continued to rise at a rate closer to the Fed's 2% target (see Figure 3).

Figure 3. Core CPI components

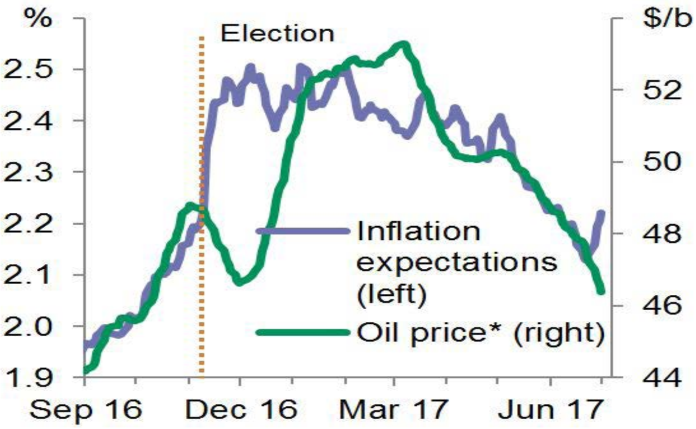


Data as at 31 May 2017. Note: Components: 1) Housing, 2) medical care, 3) other goods and services, 4) education, 5) recreation, 6) transport, 7) apparel, 8) communication. Sources: BEA, BNP Paribas Asset Management

Half of the components are rising at a 2% rate and two others have been at that pace over the last six months. The two notably weak categories, apparel and telecommunications, may continue to weigh on inflation (both have been declining for years) but at a much slower pace than recently. The Fed is mindful that in 2003-2004, core inflation was also temporarily low when the economy was near full employment. Low inflation then was used as a justification for not raising rates more aggressively, but in retrospect that policy contributed to the mortgage crisis in the US.

The steep decline in oil prices since February is the other reason to believe inflation expectations may recover. Prices jumped last November when the Organization of the Petroleum Exporting Countries (OPEC) announced plans to cut production, but the effect has waned as US shale oil production increased and along with doubts about the ability of the cartel to maintain the agreement. Crude oil prices had fallen 22% (based on the benchmark WTI (West Texas Intermediate)) through last week and this decline has been mirrored in falling inflation expectations (see Figure 4). If oil prices were to stabilise or rise from here (and a weakening dollar suggests they might), inflation expectations would likely do the same.

Figure 4. Oil prices and inflation expectations



*Data as at 30 June 2017. Sources: Bloomberg, BNP Paribas Asset Management

There are other drivers of low inflation, however, that could prove to be more persistent. Globalization, exemplified by China's accession to the World Trade Organisation, has helped drive down prices around the world. Not only have goods prices fallen, but falling telecommunications prices have led overall services prices to decline as well. For example, call centres in India are much cheaper to staff than in Indiana. While trade has slowed since the GFC, pressure on goods and services prices are likely to remain intense. The internet looks set to continue to disrupt industries, generally leading to lower prices (Amazon's acquisition of Whole Foods is just the latest example). Commodity prices are unlikely to rise significantly as China's growth rate slows and it becomes more of a services-led and less a manufacturing-oriented economy.

Investment implications

Depending on what one believes is the reason for low inflation expectations, there are different investment implications. If one believes that the Fed's inflation target is no longer credible because the Central Bank has failed for years to meet its 2% objective, then eventually the Fed would have to acknowledge that its forecasts for policy rates are unrealistic and the 'dots' would move lower. Not only would the Fed not raise rates as much as it has projected, it could even be forced to reverse the rate increases it has already put in place. If this scenario is accurate, the recommendation would be to invest in longer-dated US Treasuries as yields should decline once the Fed capitulates.

Alternatively, the level of future inflation suggested by TIPS (Treasury Inflation-Protected Securities) could be consistent with a belief that the Fed will in fact hike rates as forecasted but that the result will be low inflation. In this case, one would want to be short 2-year Treasury notes as the yield is likely to rise as the Fed continues to increase policy rates. Conversely, the current yield on 2-year Treasury notes would be correct if the Fed does not tighten further, but inflation expectations should rise as the market foresees Fed policy easing. In this case, the better investment would be break-even inflation.

We believe the current weakness in inflation results from factors that are likely to persist for months or even years to come. However, over 2018 and 2019, we see inflation gently recovering as tightness in the labour market drives up wages. The longer-term risk is from a US recession, which is certainly possible over the next three to five years. If a recession arrives before the Fed has been able to raise policy rates much higher, it could find its ability to stimulate the economy is limited as it could subsequently only cut rates so far. As inflation expectations would fall yet further in a recession, there is a risk that they could collapse entirely as investors would not believe the Fed had the tools to regenerate inflation, which is arguably the issue the Bank of Japan faces today. Current low levels of inflation thus appear to reflect not only the disinflationary forces affecting the US economy today, but fears for the future.

The rise of the emerging market IT sector

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Emerging market (EM) equities have been one of the strongest-performing asset classes so far this year, with total returns of close to 20%. However, this performance masks the stellar performance of the EM IT sector, which has returned close to 38% year-to-date. The IT Sub-Index is now the biggest weight in the Morgan Stanley Capital International (MSCI) EM Index (c.25%) and includes providers of IT services as well as intermediate and end-product manufacturers. We explore the rise of the sector, its fundamental drivers and some investment implications.

The EM IT sector is the largest in the MSCI EM index following a robust performance since 2012

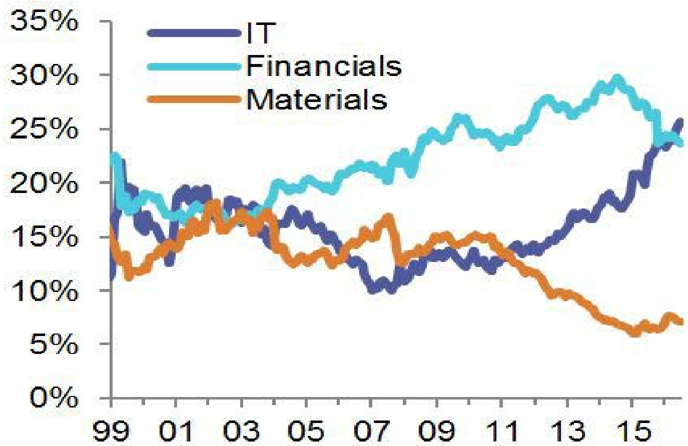
One of the emerging market success stories so far this year has been the outperformance of the EM IT equity sector, which has returned close to 38% year-to-date following a total return of 18% in 2016. However, the sector's outperformance stretches much further back. Since January 2013, the IT sub-index has returned 84% compared with only a 4% total return for the EM MSCI. This is even more remarkable considering that almost all the companies in the sector are based in Asia, meaning that the sector defied the significant GDP growth slowdown in China from 2011 to 2015 (Figure 1).

Figure 1. EM IT sector has outperformed the EM MSCI Index since 2013, despite China's slowdown

Sources: Bloomberg and BNP Paribas Asset Management, as of 29/06/2017

The IT sector's performance has been so consistently strong that it is now the largest weight in the MSCI EM index, overcoming two historical heavyweights: financials and materials (Figure 2).

Figure 2. EM IT is now the largest sector in the MSCI EM Index



Sources: Thomson Reuters and BNP Paribas Asset Management, as of 29/06/2017

Despite the sector's weight increase, it has only 75 companies in the MSCI EM Index, which is fewer than the number in five other EM sectors: financials, industrials, materials, consumer discretionary and consumer staples. Furthermore, the IT sector has a large company bias, with the biggest ten accounting for around 20% of the MSCI EM index. These include three types of businesses: intermediate input producers (semi-conductors, e.g. Taiwan Semiconductor Company), electronics goods producers (e.g. Samsung) and IT services (e.g. Alibaba and Tencent).

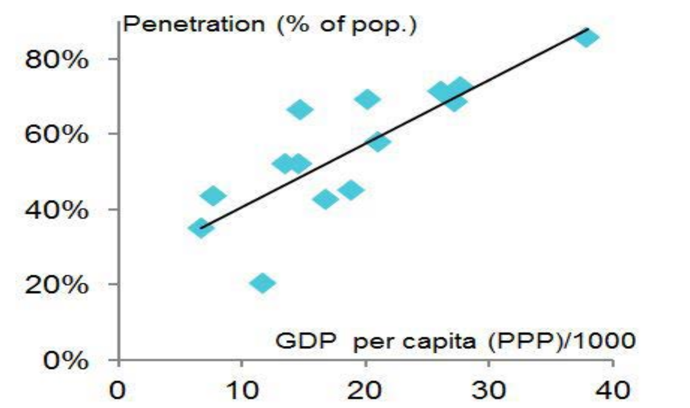
Some EM IT drivers are here to stay

We have identified four principal factors currently supporting companies in the EM IT sector:

- The ongoing synchronised global recovery is boosting demand for IT services, electronics and intermediate goods
- Low EM labour costs and the capacity to adopt new technologies / innovate continue to favour intermediate and final goods being manufactured in EM
- Demand for IT services, intermediate goods and electronics benefits from sheer size of Asia's population. For instance, compare China and India's combined population of approximately 2.5 billion with around 320 million in the US
- Rising EM income per capita supports internet penetration and therefore the use of electronics and internet-related industries

In our view, the importance of these drivers will evolve over time. The synchronised global recovery may hit a cyclical peak. Population growth will likely slow in China and labour costs should continue to rise in the region. However, none of these is likely to happen anytime soon. Indeed, some factors like rising income per capital should continue to provide a significant structural underpinning for internet penetration and hence the earnings prospects of IT services firms (Figure 3).

Figure 3. Internet penetration vs GDP per capita

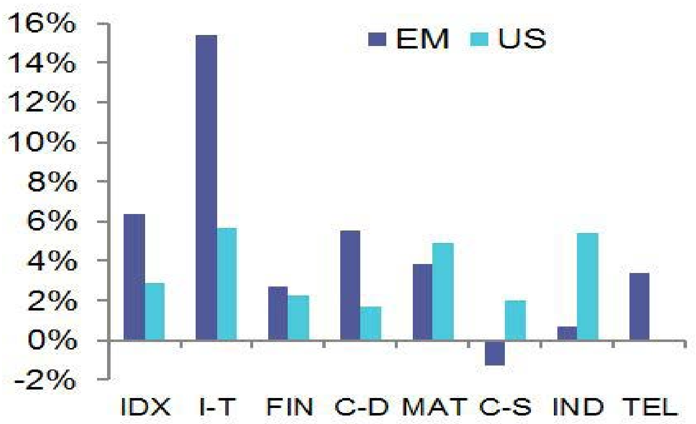


Sources: Bloomberg and BNP Paribas Asset Management, as of 29/06/2017

Is the bullish investment scenario already priced in?

The rally in the IT sector over the past few months hasn't just been driven by animal spirits relating to the drivers described above, it also reflects an acceleration in earnings growth that started in early 2016. This has in turn fuelled consensus earnings prospects. Indeed, consensus earnings momentum (measured as the three-month change in Bloomberg earnings expectations) is currently materially stronger than in other EM sectors and the US (Figure 4).

Figure 4. IT EM earnings momentum is strong vs. other sectors and vs. the US



Note: IDX = MSCI, I-T = Information Technology, FIN = Financials, C-D = Consumer Discretionary, MAT = Materials, C-S = Consumer Staples, IND = Industrials, TEL = Telecommunication Services. Sources: Bloomberg and BNP Paribas Asset Management, as of 29/06/2017

Prices have broadly caught up with this earnings momentum already, so the upbeat earnings outlook appears to be largely priced in. As a result, valuations have also risen for the sector. Twelve-month-forward price/earnings ratios, for instance, are close to the top of their post-crisis range, at around 15x, and although they are higher than EM as a whole (c.12x), they are still cheaper than for the US IT sector (c.18x).

Asset allocation implications: Wait for pull-backs before adding to EM IT

To sum up, we see the development of the EM IT sector as being structurally based and having long-term potential. EM Asia equities, and therefore EM IT, are already the biggest allocation in our Parvest Emerging Market multi-asset income fund. Valuations are not particularly expensive vs. the US, but they are not cheap either, whether historically or relative to other EM sectors. However, the rally appears to us to be over-extended so we would rather wait for a pull-back before adding to our current allocation. We have already flagged risks on the horizon, such as China's fading credit stimulus and tighter monetary/financial conditions in the developed world. If these shocks materialise and reflect cyclical/temporary adjustments, then we will continue to favour adding exposure to the structural EM IT story.

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