

GLOBAL EMERGING MARKETS: POSSIBLE IMPACTS FROM A TRUMP PRESIDENCY

Executive Summary

- The major effects on Emerging Markets (EM) of a Trump presidency are trade protectionism and a realignment of US geopolitical alliances.
- On trade, Trump is unlikely to reach the point of imposing tariffs, but will likely use threatening rhetoric to achieve some results.
- Russia stands the most to gain geopolitically, with sanctions likely eased in 2017.
- The US relationship with China is the most critical to watch with the potential for damaging tit for tat tariffs and geopolitical manoeuvring as China looks to take advantage of a shift away from the Trans-Pacific Partnership to cement its regional power.

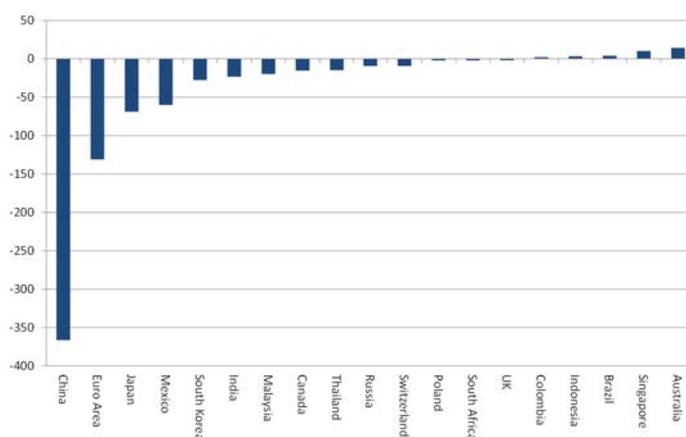
Trade Protectionism

In the election campaign, Trump had a seven-point plan on trade:

- Withdraw from the Trans-Pacific Partnership negotiations.
- Appoint tough and smart trade negotiators to fight on behalf of American workers.
- Direct the Secretary of Commerce to identify every violation of trade agreements.
- Renegotiate the North American Free Trade Agreement (NAFTA) and withdraw if no improvement is made.
- Instruct the Treasury Secretary to label China a currency manipulator.
- Instruct the US Trade Representative to bring trade cases against China, both in the US and at the WTO.
- Use every lawful Presidential power to remedy trade disputes if China does not halt illegal activities, including the theft of American trade secrets.

Clearly, China stands out as the most exposed to this threat. China exports about \$500bn of goods to the US each year, and the annualized trade deficit between the US and China stands at well over \$300bn. The designation of currency manipulator derives from the 1988 Customs Bill, under which the US Treasury Department is required to review each of the major trading partners of the US, and determine if they are manipulating their currencies in order to gain an unfair trade advantage. Trump has stated that China is a 'manipulator, grand master level' and that he intends to impose 45% tariffs on Chinese goods.

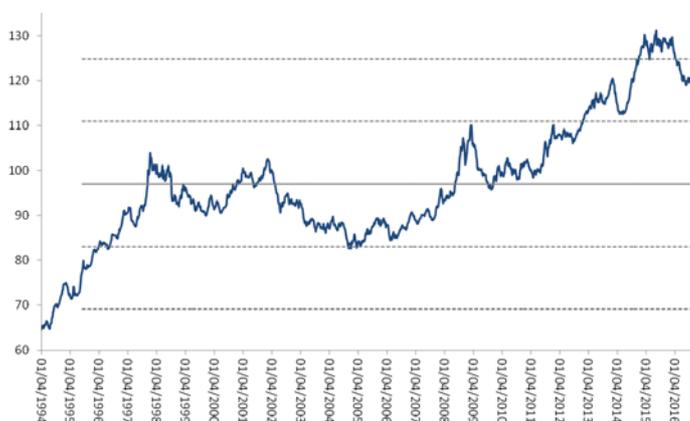
US Trade Balance by Market 2015 (\$bn)



Source: Bloomberg

Although China does have a significant trade surplus with the US, it is actually difficult to argue that they are manipulating their currency weaker at this moment. The trade surplus is countered by sizeable capital outflows, and Chinese FX reserves are in decline, indicating from this perspective, that the Chinese authorities are potentially holding the value of the currency at a higher level than it should be. Examining the currency on a real effective exchange rate basis (adjusted for inflation vs. a basket of trading partners), the value of the currency has appreciated significantly over recent decades, driven primarily by higher inflation in China relative to developed markets. Even after some recent weakening, as the authorities moved to target a basket exchange rate, the currency is still over one standard deviation above its long term average.

JP Morgan China Real Effective Exchange Rate (CPI Based)



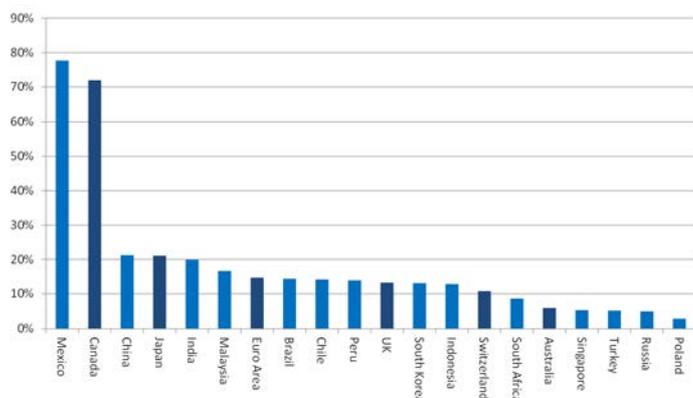
Source: JP Morgan / Bloomberg. Dotted lines are standard deviations from long term average

China is already facing a difficult year in 2017, as the effects of previous stimulus policies on housing, infrastructure and autos diminish. Moreover, at the 19th National Congress in the autumn, the majority of the current Standing Committee of the Communist Party is expected to retire, making this National Congress particularly sensitive to political issues. The threat of trade tariffs could potentially be used to attempt to pressure the Chinese authorities to relax rules on investment, and open up more areas of the economy to foreign firms.

It is also possible that Trump may be able to secure an agreement on intellectual property rights and cyber security. These issues could potentially be a way for Trump to declare a political victory, without resorting to the imposition of tariffs, which would have a widespread inflationary impact in the US. If tariffs were to be imposed on China, the most likely scenario would be that the Chinese authorities would engineer a significant depreciation, potentially bring the return of the currency wars and even higher US countervailing duties.

Globally, if we examine which countries are most exposed to the US in proportion to their overall exports the picture changes:

Exports to US as a % of Total Exports



Source: Bloomberg

Mexico is the clear worry amongst emerging markets, with close to 80% of its exports headed to the US. Trump has stated that he intends to renegotiate NAFTA (and withdraw if a successful renegotiation isn't possible), build a wall along the Mexican border (notably, there are already walls in several major sections), impose a tax on remittance flows back to Mexico, and also to deport millions of Mexicans who are currently working illegally in the US. Although these create popular media headlines in some parts of the US, the reality is, not surprisingly, very complex.

The supply chain between the US and Mexico is extremely integrated, and manufactured goods can actually cross multiple times between the US and Mexican borders before the product is finished. The Mexican Ministry of the Economy estimate that around 40% of the cost of Mexican exports is actually accrued in the US. This level of integration makes it very difficult to impose tariffs on Mexican goods without significant costs to the US manufacturing industry. Whether Trump is willing to allow these costs in order to shift production back to the US is the key question, but it seems that he may be.

Regarding border control, Trump may be able to achieve progress in a way which will allow him to present a successful policy, with minimal economic damage. One proposal being put forward by several Republicans in the US House of Representatives is to increase significantly the number of federal agents patrolling the border, and extending fences along some areas of the border. If such measures were to greatly reduce illegal immigration, this would likely be welcomed by all who supported Trump during the election and, although the Mexican government has stated that it will not in any way pay for a border wall, some contribution towards additional border controls may be more palatable.

Deporting Mexican migrants on a large scale will also cause economic problems, and much stricter enforcement of existing policies might be sufficient to achieve Trump's goals. Notably, immigration trends have changed in recent years, with more Mexicans now leaving the US to return home than headed to the US. With Trump, it is quite likely that this trend will accelerate, and we could see Mexico look for ways to appease Trump in ways that can be presented as a political win domestically. For example, a program to help those returning from the US and fleeing the new American political backdrop could be positively spun for politicians on both sides of the border.

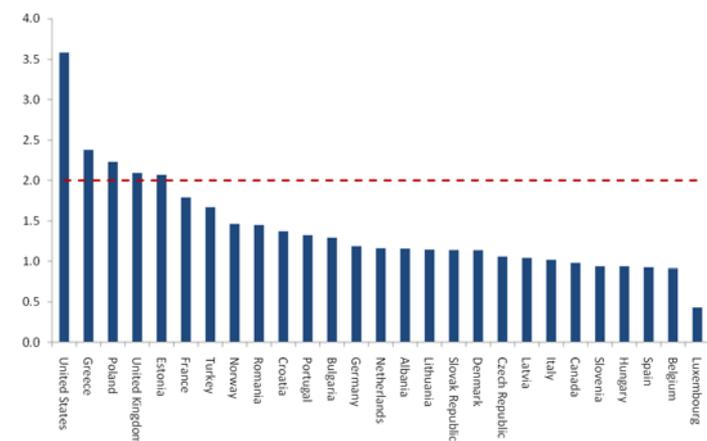
In Asia, if the Trans-Pacific Partnership is abandoned, the likely winner is China, and Asian nations will pivot towards increasing trade with China. China was not part of the Trans-Pacific Partnership, as the agreement was largely an attempt to counter China's growing world influence. China has already indicated that it will use a regional summit in Peru to propose an Asia Pacific free trade area. If the US does shift to a more protectionist stance, however, the Chinese economy is likely to face severe headwinds, curbing its demand for imports from the rest of Asia. This could, in turn, incentivise Chinese authorities to provide greater fiscal stimulus to boost consumption, as strategically this could be a key moment for China to cement its role in the region.

There could also be further geopolitical ramifications surrounding disputed islands in the South China Sea if China feels threatened and isolated. North Korea is another critical issue here, with recent missile tests a serious concern for the US. This will likely be a growing source of tensions between the US and China, which has already led to sanctions being imposed by the US on some Chinese companies and could easily lead to many more of such, thus, raising the possibility of retaliation by both China and North Korea. Whether China seems willing to take great risks by supporting North Korea under this scenario, and whether Trump is willing to take great risks to prevent North Korea from becoming a nuclear power, will be key to watch, as such may occur quite quickly.

Geopolitics

European nations, with Central and Eastern Europe in particular, have relied on the US for its military security since the end of the Second World War. At this present time, if Europe was left to its own devices, its security would certainly be compromised. There are only a handful of EU countries that fulfil NATO's defence spending obligations, i.e. committing to at least 2% of GDP towards military spending, those are Greece, Poland, Estonia and the UK. As such, the US support for NATO's budget over the years has been very significant, and last year, the US defence expenditure effectively represented around 70% of the defence spending of the Alliance as a whole (including direct and indirect funding).

NATO Member Defence Spending in % of GDP 2015 vs 2% Commitment



Source: NATO

Given that one of Trump's election promises was to end this "free-rider" phenomena by the European countries, either Europeans will decide to contribute more funds or the future of NATO and its policy path will shift significantly. Some even take a more alarming view, suggesting the risk of the US pulling out of NATO membership could become a reality. We do not, however, concur with this view.

On other issues, at this stage, it is uncertain what direction Trump's foreign policy takes. His election promises do cause some market concern, partially because their implementation is not well-defined. During his long and controversial election campaign, he often claimed that he is prepared to destroy ISIS by "bombing the sh*t out of 'em", at the same time as being

opposed involvement in the long protracted conflicts in far off lands. He also often suggested that South Korea and Japan might wish to develop their own nuclear capabilities to guarantee security in the region (particularly with respect to recent nuclear tests by North Korea).

On a number of occasions, he also showed admiration for Putin and spoke respectfully of Russia's army of hackers. The potential warming of ties with Russia could have quite significant ramifications, not only for security in Europe, but could also have a significant impact on the geopolitical situation in the Middle East. In the end, however, Trump's relations with Russia will likely be limited to "frenemy" status, as it was prior to the Ukraine crisis, with clear cooperation on ISIS and global terrorism. In our view, in no way will Trump ever prioritize Russia over long-standing NATO allies, while not provoking Russia in Ukraine or insulting it as an inferior power.

As for the Middle East, his isolationist approach could result in a de-escalation of the US's involvement in Syria, allowing Assad, heavily armed by both Russia and Iran, to turn the tide in fighting against ISIS and let him recoup the country without further US involvement. This would likely be seen as another victory for Russia by re-establishing its long standing allegiance in the country and preserving some Russian influence in Middle East.

Lastly, closer bilateral ties with Russia could also result in the easing or expiration of economic sanctions, first imposed by the US Department of the Treasury in March 2014. This move would likely be well received by the likes of Italy, Greece and Hungary who have opposed the European sanctions in the first place, in time perhaps leading to the full removal of sanctions by the EU, too.

One area that could cause tensions will be that President Trump is likely to emphasize the rule of law, freedom of speech and the press in every country. Both the Philippines and Turkey are two countries which could find themselves faced with a US that is less concerned about historical ties. President Duterte has recently stated that he wants an end to joint military exercises with the US within two years, so an end to the Mutual Defence Treaty with the Philippines may be a step that the Trump may be much more willing to contemplate.

On the positive side, for Turkey, one of Trump's advisors, General Michael Flynn has argued that the US should extradite Gulen, the cleric blamed by Turkish President Erdogan for the attempted coup against him. Any moves in that direction would certainly be positive for Turkish, US relations, but basic democratic freedoms will continue to be an impediment to relations, not only with the US but also with the EU.

Iran will be another focus point. During his election campaign Trump promised to tear up the Iran nuclear agreement which saw the US remove sanctions from the country. This agreement, however, has already been signed into international law by the United Nations Security Council, which makes it unlikely that Europe would follow any moves to impose fresh sanctions as long as Iran continues to satisfy its side of the deal.

Conclusion

Trump's election will likely bring major changes in the US position on various issues, and at this stage uncertainty is high. The markets worst fears are unlikely to be realised, however, as Trump should be able to achieve sufficient success to claim victory without resorting to trade tariffs or military action. However, the geopolitical landscape will likely have to change so much that major conflicts could occur. Much will depend on how soon countries decide to adapt to the new US reality.

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