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By Nikko Asset Management's Multi-Asset team

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Nikko Asset Management

EMERGING MARKETS QUARTERLY: RECOVERY INTACT WITH RISING DEVELOPED MARKET UNKNOWNS

Q4 2016 Insights

Donald Trump winning the US presidential election delivered a big surprise, defying poll predictions but ringing consistent with the wave of populism sweeping the developed world. First witnessed early last summer with the Brexit vote, the rise of populism remains a key risk in Europe, while the implications for the shift in US policy are more likely to be mixed.

US trade policy is likely to undergo a tectonic shift – on one hand viewed as a step backwards from globalisation, on the other, perhaps a rebalance of incentives for more sustainable long-term growth. Since 2008, policymakers have been attempting to induce demand through fresh credit, however if these new policies are successful, more investment for higher productivity is simply a better long-term growth solution.

There are many unknowns and risks in terms of execution, timing and implications for different emerging markets (EM), especially as President Trump has failed to temper his tough rhetoric since the election.

However, the base case is that President Trump's administration will adopt a pragmatic, transactional approach when adjusting trade agreements and creating incentive structures, while avoiding more aggressive tactics, such as tariffs, which risk leaving all economies worse off.

The anticipated change is already lifting confidence, and while President Trump ultimately intends to bring more production back to the US, it will take time leaving EM, which should be a near-term beneficiary of renewed global demand.

Longer term, new policies with changed incentives should drive global trade to a new equilibrium. If these policies succeed in adding to productivity, growth prospects should be better globally, not just in EM.

The immediate challenge of the policy shift is the accompanying strong US dollar and higher interest rates. Indeed, the high velocity re-pricing in the weeks that followed the US election weighed heavily on EM assets. However, as the pace softened and partly reversed towards year-end, EM assets mostly clawed back post-election losses.

On balance, provided the pace of yield and currency adjustment stays moderate, the macro fundamentals remain supportive of EM assets, though with some caution due to the changing landscape, which is reflected in several changes to our asset class hierarchies.

Already advanced in its easing cycle, the outlook for Asian local currency bonds is less promising in a rising yield and strong US dollar environment. This has lead to a significant downgrade and lands this asset class at the bottom of the hierarchy.

Conversely, LatAm local currency bonds remain at the top of the hierarchy as the easing cycle is just underway, with falling inflation and high real yields to buffer against rising US interest rates.

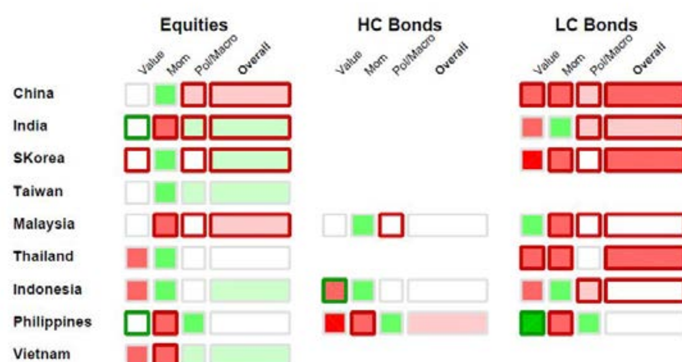
Asian equities remain near the top of the hierarchy, as earnings continue to improve and valuations appear attractive. LatAm equities rank below this, as valuations have grown rich in what is a challenging growth environment.

Hard currency bonds rank in the middle of the hierarchy, our preference being LatAm. EMEA ranks at the bottom of the hierarchy across most asset classes, with some pockets of opportunity.

Asian bonds less attractive while equities still supported

Asian prospects remain bright due to local reform efforts and improving global demand, but it remains exposed to the rise in US interest rates and a stronger US dollar. After a long easing cycle that saw an end to deflation in Q4 2016, local currency bonds are now more vulnerable to these changing dynamics. China remains most vulnerable, with capital outflows again putting acute pressure on both its currency and yields. However, policy remains accommodative across the region, which should allow earnings to continue their recovery on the back of normalising global demand.

Asset Class Scores



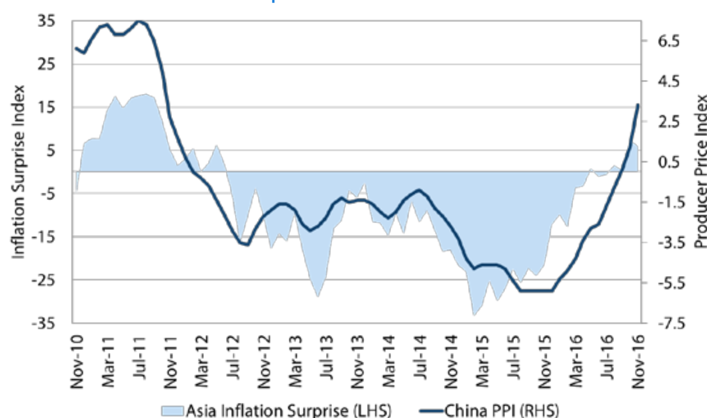
Score Summary: For each country and asset class, scores are represented by colours – white is neutral, green is positive and red is negative. The overall score is shown to the right with the underlying scores – value, momentum and political/macro – shown to the left. The border shows grey for no score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

Broad downgrade in local currency bonds

Modest inflation is returning to Asia, which while net positive for growth and earnings, means that the easing cycle has likely reached an end. Given stretched valuations and the jolt from rising US yields and the strong US dollar, momentum swung broadly negative. These deteriorating dynamics lead to a broad downgrade of the asset class, leaving it at the bottom of the hierarchy.

Inflation is returning, partly due to improving demand but mainly through support from commodity prices, which finally bottomed in January 2016, after declining more than 50 per cent since mid-2011. As shown in Chart 1, both the China Purchasing Price Index (PPI) and the Asia Inflation Surprise Index turned positive in Q4, after being negative since early 2012. Local yield dynamics are generally less favourable across the region, but with different country risks.

Chart 1: Asia Inflation Surprise versus China PPI



Source: Bloomberg 2017

A challenge for China has been the acceleration of capital outflows, which significantly weakened its currency in Q4. In effort to support the currency, authorities tightened capital controls and allowed yields to rise, which helped temper outflows. While policymakers managed an orderly devaluation for most of 2016, a strong US dollar and higher US yields remain a key risk for China's bond market.

Indian bonds have a different vulnerability, following the country's demonetisation in November. This long-term policy objective is laudable for tackling 'black money' and corruption, however the immediate impact has been deflationary.

This caused yields to compress quite substantially at first, before giving back some when the Reserve Bank of India failed to cut interest rates. Interest rates are quite compressed relative to history, leaving bonds exposed to returning inflation.

Indonesia and Malaysia are different to most of Asia, in that they are commodity exporters with higher real yields, and have likely completed their easing cycles. Despite supportive valuations, these countries are mainly exposed to market volatility, driven by high levels of foreign-owned debt.

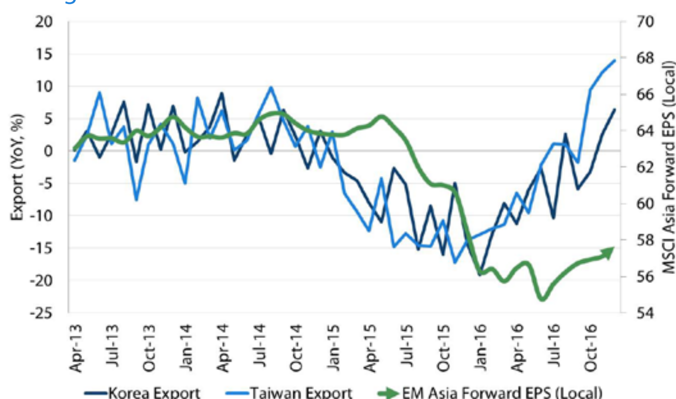
Local currency bonds sold off aggressively immediately following the US election, with Malaysia making matters worse by limiting the use of currency hedges. Both markets have since found support but were nevertheless downgraded, mostly for having reached the end of the easing cycle.

Equity outlook still positive on returning global demand

We believe the outlook for Asian equities remains positive, on the back of still reasonable valuations and an improving earnings outlook. While the pick-up in inflation may end further easing, policy remains accommodative with modest inflation supportive of increased demand. Most importantly, global demand continues to normalise, following the 2015 growth scare that had been a primary detractor from earnings.

As shown in Chart 2, export growth in South Korea and Taiwan has returned to normal levels following the severe downturn that began in early 2015, while forward 12-month earnings forecasts have also begun to move higher. Given the continued improvement in exports and the normal lag in earnings, we would expect further upward revisions if demand remains reasonably stable.

Chart 2: Korea and Taiwan Exports versus forward 12-month earnings



Source: Bloomberg 2017

While a strong US dollar and rising yields have tightened financial conditions, similar to 2015, two important differences are likely to keep growth intact this time. First, credit markets are much healthier, with commodities having likely bottomed in early 2016. Second, China continues to add stimulus, which has been a significant contributor to returning global demand.

These tailwinds so far seem sufficient to offset headwinds, like a strong US dollar and higher interest rate, in support of a continued recovery, which could start to gather momentum given the upcoming US fiscal stimulus. The primary risk to this scenario is with China. While high debt levels and continued credit expansion remains an important long-term risk, we remain most concerned about high capital outflows.

Drawing on reserves and lifting interest rates to support the currency amounts to significant tightening, which is bad for growth. Authorities are attempting to combat this with stimulus like dedicating savings to credit expansion rather than domestic consumption, which slows the economic rebalance.

Letting the currency float would seem a better option for China, but currency stability is now deemed to be a primary policy objective – to say nothing of the global blowback that such a move would have, and the likely retaliation from a Trump administration. China remains in a difficult position.

Chinese equities were downgraded for these rising macro political risks. Indian equities were downgraded for the near-term slowing due to the demonetisation, even though long-term prospects look brighter.

EMEA outlooks continue to diverge

Our outlook for EMEA continues to diverge, with continued improvements in Russia and Eastern Europe being offset by Turkey and South Africa, which are still struggling with structural imbalances and weak political capacity. Economic conditions in Europe are improving, but political risk nevertheless remains elevated. The numerous elections scheduled for 2017 means the rise of populism in Europe represents a threat to the EU. Turkey and South Africa remain most vulnerable given their dependence on EU funding. The economic spill over would be deeply negative across the region and likely to spread across EM.

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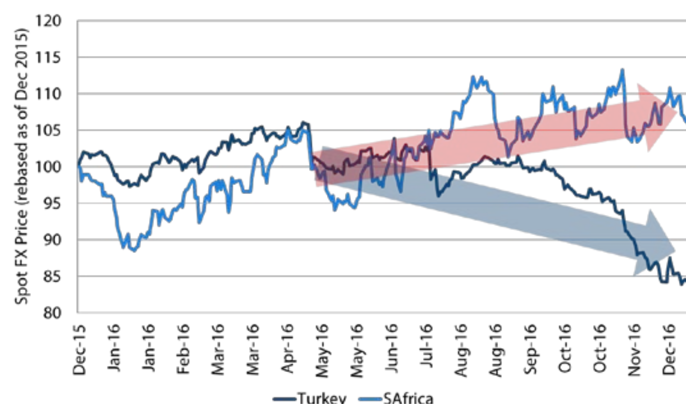
Different shades of rising political risk

Turkey and South Africa are EM standouts, given their external imbalances and political incapacity to reform past them. However, during Q4, their outlooks seemed to diverge quite markedly, reflected by the South African Rand strongly outperforming the Turkish Lira, as shown in Chart 3. Part of this divergence was driven by changing terms of trade, based on the direction of commodity prices, as well as the apparent direction of political momentum.

Chart 3: Turkish Lira versus South African Rand



Source: Bloomberg 2017

South Africa maintains strong institutions, with the important exception of its Executive branch, where President Zuma, in our view, has been a disaster. The recently-perceived 'silver lining' has been his loss of popularity, which lead to a 'no confidence' vote by his own ANC party in November. While he survived the vote, this shift in momentum against Zuma was apparently enough for S&P to give South Africa the benefit of the doubt and not downgrade its debt to 'junk' during its

December review. There is little to suggest that politics in South Africa is on the mend, so a future downgrade still seems likely.

In contrast, political momentum in Turkey has continued to deteriorate following the failed coup back in July. President Erdogan used the event as an opportunity to remove the opposition and, in the process, remove any reasonable hope for reform that would put Turkey back on a sustainable economic path. Despite the Q4 rebound, European banks have continued to lose appetite for wholesale funding to Turkish banks, removing a crucial deficit-funding source that threatens a harsh economic adjustment.

Despite the market's re-pricing of political risk, we continue to rank the assets of both countries at the bottom of the hierarchy. Concerns for Turkey are unfolding as originally feared, while South Africa still requires a material catalyst to suggest an improved outlook.

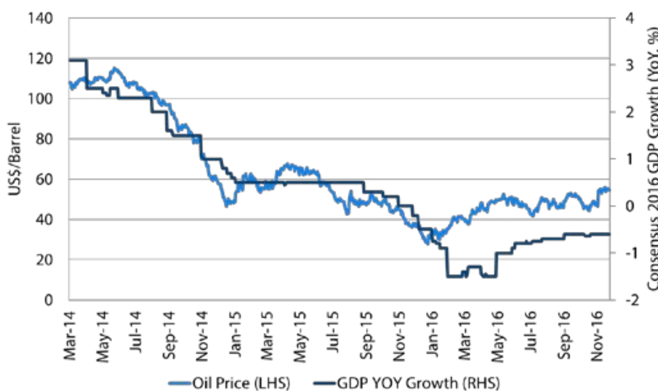
Russia equities upgraded

Russia is currently in the strange position of being under siege, with the US intelligence community levelling charges that it was President Putin himself that directed hacks designed to sway the US election. Despite this, President Trump remains intent on resetting US/Russian relations.

While threats of retaliation from the Obama administration would normally indicate that political risk is on the rise, much of the current strain seems likely to be reversed.

Macro politics were upgraded for better earnings and an improved outlook, including the recent OPEC agreement designed to support oil prices. Oil prices tend to support Russia's economy naturally, as shown in Chart 4. Longer term, improved relations with the US could lend additional tailwinds in the form of sanctions relief.

Chart 4: Oil Price versus Russia GDP Growth



Source: Bloomberg 2017

Hungary bonds downgraded

Over the last few years, Hungary has realised the benefits of more business-friendly policies, which have been a direct contributor to earnings improvements. The government recently announced plans to raise the minimum wage by 15 per cent, proposing to offset the additional cost by cutting the corporate tax rate to 9 per cent, which would be the lowest in the EU. Equities would be expected to benefit from these pro-growth policies, but they are inflationary and potentially fiscally imprudent, which could lead to a downgrade both in local and hard currency bonds.

LatAm easing gathers pace though growth still disappoints

LatAm local currency bonds remain at the top of the hierarchy, given their attractive valuations, positive momentum and the fact that policymakers are just beginning an easing cycle. Mexico, on the other hand, is tightening but remains attractive based on its valuations. This is despite negative momentum and rising interest rates, which have been mainly driven by market fear around the implications of a Trump administration. Hard currency bonds in the region are preferred over EMEA. Equities appear attractive, outside of Brazil and Mexico, where valuations are stretched against still weak growth.

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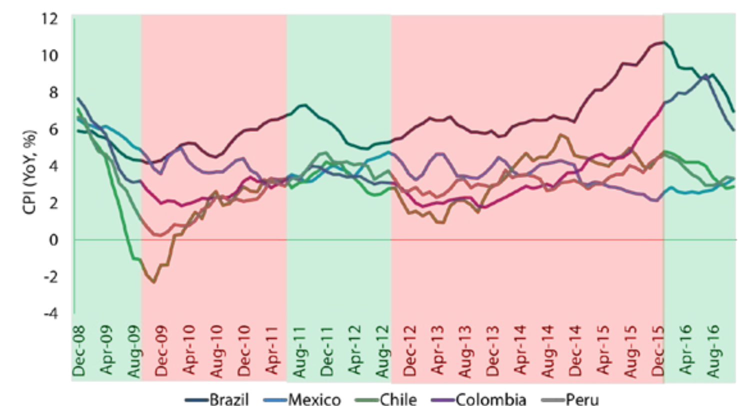
High real yields and interest rate cuts favour local currency bonds

Local currency bonds remain in a sweet spot for rising real yields, due to falling inflation and a rate easing cycle that is just beginning. As shown in Chart 5, inflation peaked across the region in early 2017 (shown in green), as weak demand surpassed the inflationary pressure of weak currencies. Demand is now improving but there is still a wide output gap that is keeping inflationary pressures at bay, and strengthening currencies that are adding further to disinflation.

Chart 5: LatAm Inflation: Consumer Price Index

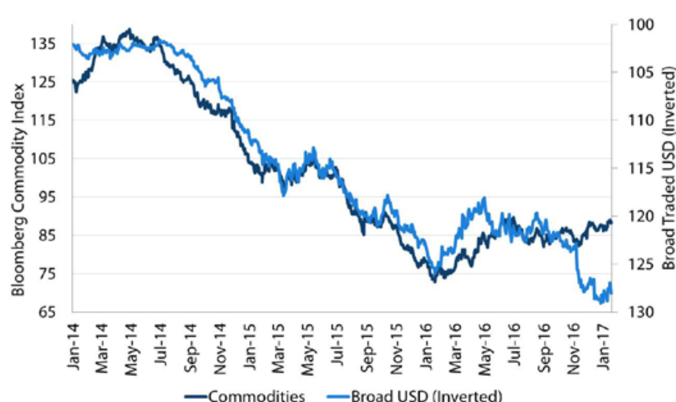


Source: Bloomberg 2017.

Mexico, of course, is the regional outlier for rising inflation – partly for demand pressures, having suffered less during the downturn, but mainly for its weak currency, which is driven largely by fear of a Trump administration's policies. Though new US policies are likely to weigh on future growth prospects for Mexico, the country remains one of the strongest credits in EM, with now strong value support.

There are two main risks to local currency bonds. First, while politics have improved across the region, execution risk remains high – particularly in Brazil, where political risk is again on the rise, which could undermine the anticipated fast pace of fiscal reforms. Second, US dollar strength weighs on commodity prices, as shown in Chart 6. While commodities have held up quite well despite the continued US dollar rally, continued resilience is not necessarily assured.

Chart 6: Commodities versus US dollar



Source: Bloomberg 2017

Equities expensive

Equities in Brazil and Mexico, which weigh most heavily in the region in terms of size, appear to be expensive and seem to have ambitious earnings estimates. Despite significant macro improvements, we remain cautious due to concerns that earnings may not be delivered on the basis of several headwinds:

- Earnings estimates suggest a V-shape recovery, implying a commodity recovery that could exceed still weak levels of global demand.
- Debt levels remain high, with sizable US dollar-denominated debt potentially weighing heavier given recent strength.
- The economic recovery has so far disappointed, with analysts perhaps underestimating the debt burden impact and overestimating the near-term effect of reforms and interest rate cuts.

On balance, despite positive momentum and improving macro conditions, we remain cautious on valuations and earnings, preferring smaller equity markets in the region where valuations look attractive.

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