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By Nikko Asset Management's Multi-Asset team

Nikko Asset Management

EMERGING MARKETS QUARTERLY: RECOVERY BROADENS BUT WITH POLICY RISK STILL ON THE HORIZON

Q1 2017 Insights

The Trump reflation trade may have lost some of its shine during the quarter, but any disappointment was more than overshadowed by strong global data as exports and production continued to gather pace. In fact, fading enthusiasm for Trump's ability to execute has arguably served as a tailwind for Emerging Market (EM) assets in the form of a weaker dollar and moderating long term rates.

Having passed the first anniversary since the market lows of early 2016, the recovery has proven more durable, both for the continued recovery in global demand and importantly for the rebound in commodities which has allowed for a broader, more synchronised global recovery.

Markets are now contemplating when and how central bankers will be taking the punch bowl away. The Federal Reserve (Fed) hiked rates for the third time in March and is now considering reducing its balance sheet later in the year, beginning the unwind of quantitative easing (QE). As the recovery spreads to Europe, the European Central Bank (ECB) is also considering some degree of tightening through higher rates and reduced QE purchases.

Typically, the early stages of tightening do not threaten a recovery, but the scale of unconventional policies utilised around the developed world make this time different. To be sure, central bankers will tread slowly and carefully to ensure that the recovery remains intact. However the financial system remains fragile, so the liquidity impact of any tightening will be an important watch point in the months to come.

Our base case is that the pace of tightening will remain moderate and the recovery intact keeping our asset hierarchies largely the same as Q4 2016.

Asian equities are now at the top of the hierarchy because valuations remain attractive on the back of improving price and earnings momentum.

Latin American (LatAm) local bonds fall just below Asian equities on the hierarchy as a result of a continued easing cycle and attractive real yields. Valuations, on the other hand, are marginally less attractive given the extent of the compression in inflation expectations. Equities in the region rank below local bonds as valuations are demanding relative to still disappointing economic growth.

Hard currency bonds rank in the middle of the hierarchy, favouring LatAm. EMEA generally ranks toward the bottom of the hierarchy across asset classes, though pockets of opportunities are present in Russia and Eastern Europe.

Asian local bonds remain at the bottom of the hierarchy as the easing cycle has ended and, while the US dollar and yield pressures have eased for the moment, valuations are stretched, leaving the asset class still vulnerable.

Asian bonds less attractive while equities still supported

Asia has benefitted from accelerating growth and easing financial conditions, in addition to a weaker dollar and easing treasury yields that had been a source of stress in Q4 2016. Significantly for China, easing conditions (coupled with new capital controls) helped to contain capital outflows, alleviating liquidity pressures across the region. While improved conditions have eased pressures on local bonds and led to several upgrades, the asset class generally remains expensive and vulnerable to further US tightening going forward. Equities, on the other hand, still benefit from improving earnings momentum, both from the recovery in global

demand as well as expected increases in consumption that typically follow a lift in profits.

Asset Class Scores

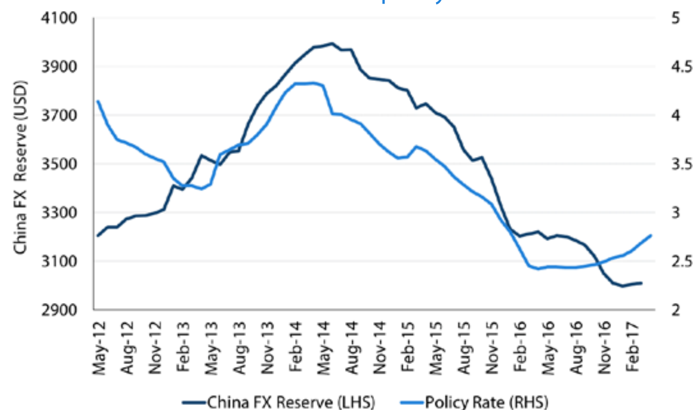
Score Summary: For each country and asset class, scores are represented by colours – white is neutral, green is positive and red is negative. The overall score is shown to the right with the underlying scores – value, momentum and political/macro – shown to the left. The border shows grey for no score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

Modest upgrades in local currency bonds

Local bonds were downgraded to the bottom of the hierarchy in Q4 2016 due to stretched valuations, rising inflation and tight liquidity conditions driven by rising treasury yields combined with a strong dollar.

China remains challenged by the so-called "impossible trinity", where it is impossible to manage its currency with an open capital while at the same time maintaining independent monetary policy. Policymakers have had to compromise, most recently through adding capital controls and lifting rates to match Fed tightening. As shown in Chart 1, FX reserves began to decline beginning in mid-2014 due to capital outflows, induced at least partly by China's efforts to cut its policy rate. However two recent rate hikes have helped to lend yield support in order to stem capital outflows and, in the process, stabilise FX reserves.

Chart 1: China FX Reserves versus policy rate



Source: Bloomberg 2017

China local bonds were lifted one notch on the back of more attractive valuations. However, while liquidity conditions have improved, the tightening bias leaves bond yields still vulnerable. As the Fed continues to tighten later this year in addition to a potential reduction in its balance sheet, China will likely have to tighten as well to mitigate capital outflows.

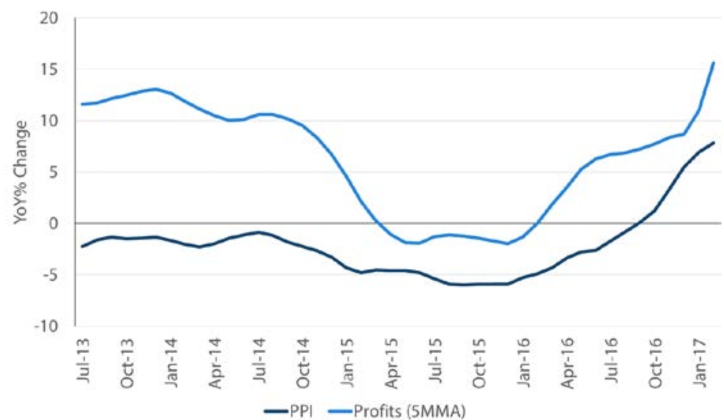
Indonesian and Malaysian local bonds were also both upgraded as improving liquidity conditions lifted the macro political scores. Malaysian bonds also showed better value. While large external debt exposure still leaves these countries vulnerable to sudden outflows, high real yields serve as a buffer given that inflation remains moderate.

Equity earnings outlook is well supported

Asian equities are the top performing EM asset year to date, on the back of normalising trade, higher profits and an improving consumer outlook. While China tightened mildly to match the Fed, policy remains accommodative and liquidity conditions have eased.

China equities were upgraded due to improving liquidity conditions and a better earnings outlook. The pick-up in producer prices is particularly positive for China. As shown in Chart 2, the pick-up in PPI is directly linked to increased industrial profits. This is "old China" growth but, given efforts to restructure the supply side of production, the quality of growth is improving. Higher profits are starting to lift wage growth and therefore consumption, which is a key objective of China reforms.

Chart 2: Producer prices versus industrial profits



Source: Bloomberg 2017

Malaysian equities were also upgraded as a result of an improvement in earnings outlook. Having lagged most of the region partly due to a relatively weak banking sector, a combination of fiscal stimulus and improving credit growth is finally translating to demand improvement reflected in better earnings.

Philippine equities were downgraded for a combination of rising political risk and eventual tightening as inflation pressures return. Economic growth has remained among the highest in the region, and although the growth outlook is still positive, President Duterte's erratic behaviour is starting to have a negative impact as reflected most recently through a decrease in foreign direct investment.

EMEA political risk continues to rise

Political risk continues to rise in the region. South Africa was the epicentre in Q1, where an impromptu cabinet reshuffle, including the removal of the highly respected Finance Minister, caused both S&P and Fitch to downgrade the country's debt to "junk". Elsewhere in the region, a shift in the Syrian conflict once again elevated tensions between Russia and the US. As Turkey nears its constitutional referendum, either outcome is basically negative for any reform agenda. Of course, the coming French election is another source of potential political stress and EMEA remains vulnerable should there be a deemed negative populist outcome. Despite high and rising political risks, we do see opportunities in Russia and Eastern Europe.

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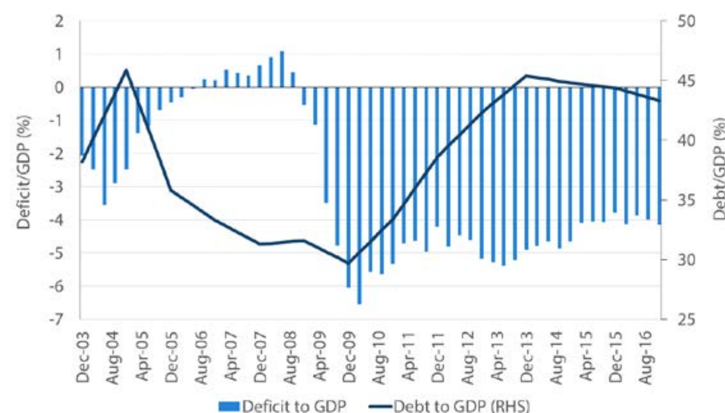
South Africa: when strong institutions are compromised

Rising risk appetite globally had seen significant flows to South African in the chase for yield despite high political instability and relatively weak fundamentals. Encouraged by positive momentum, investors grew ever more sanguine and depressed the political risk premium, even though the ground reality suggested they do just the opposite. In such situations it is not unusual to occasionally get slapped in the face with a sudden repricing of risk, as was the case in South Africa at the end of the last quarter.

President Zuma has always been basically a disaster, but been mostly kept in check by strong institutions and his desire not to upset markets too much in his effort to retain the country's investment grade status. But Zuma has grown increasingly strident recently. Last month he sacked well-respected Finance Minister Pravin Gordhan who had maintained credibility with international investors with regards to fiscal discipline. His departure leaves the Ministry of Finance fairly compromised. Both S&P and Fitch quickly downgrade the credit rating to junk.

For South Africa, the primary macro risk is the high level of sovereign debt. Returning growth and fiscal prudence had helped to reduce fiscal deficits to a more sustainable path as shown in Chart 3, but fiscal slippage seems likely given the move and Zuma's propensity to play the political system that is largely built on patronage.

Chart 3: South Africa Debt to GDP versus Fiscal Deficit to GDP



Source: Bloomberg 2017

So far, there are no signs of contagion, but the event will be an important one to follow. The key risk is that if all the agencies downgrade to junk, Zuma may feel that he has less to lose and, in the process, allow for greater fiscal slippage than markets currently fear. So far, he seems safe in power, though there are members of his African National Congress (ANC) party seeking a "vote of no confidence". Rising political risk caused a downgrade for hard currencies bonds, but marginally offset by improving earnings support for equities and expectations of rate cuts to support local bonds. All South African assets continue to score negative.

Russia local currency bond upgraded

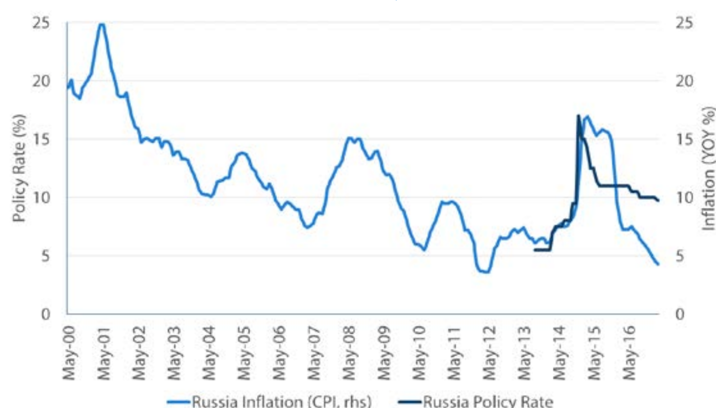
Despite rising tensions with the US, Russia local bonds were upgraded for an improving macro political outlook that can continue to compress bond yields. The risk premium associated with Russian assets has remained structurally high and, historically, for good reason as political risk has always remained high, investment low and the economy structurally dependent on energy with little reform hope of ever diversifying. However, recent policy changes suggest not only a better growth outlook, but also scope for the sovereign risk premium to compress.

The key shift in Russia is economic policy, aimed to improve investment and slowly diversify away from its sole dependence on energy exports. Since the fall of the Soviet Union, investment had been significantly impeded by a high degree of uncertainty driven by poor policy, which basically allowed energy volatility to bleed into the economy with high levels of inflation. Recent policy changes are designed to reduce this uncertainty.

In late 2014, in the midst of crashing oil prices and recently inflicted sanctions relating to the Ukraine conflict, Russia made the bold move to free float its currency, ending two decades of exchange rate controls. The currency now relies on interest rate policy to target inflation and derivatively reduce currency volatility. As shown in Chart 4, policy has been effective – first taking control of the 2015 inflation ramp that peaked at 17% and now keeping rates relatively high at 10% with inflation

declining now to 4.3% in March, a short distance from achieving its 4% target.

Chart 4: Russia Inflation versus Policy Rate



Source: Bloomberg 2017

The central bank also sought to clean up the banking system, using tough monetary policy to force poorly managed, undercapitalised banks to either close or merge with healthier larger ones. At the same time, companies heavily dependent on international credit markets were forced to deleverage. Overall, the banking system is much healthier and dependence of foreign credit much reduced.

In February, changes in fiscal policy were announced, including consolidation to reduce deficits while incentivising investment to further decouple the economy's dependence on energy. Starting in 2020, fiscal spending will be limited to revenues collected up to USD40-50/bbl oil prices, using the excess to fund tax breaks that incentivise badly needed investment in oil fields where output has been plunging. Tighter monetary and fiscal policy suggest some degree of near-term pain, but we can expect long-term gains in the form of less uncertainty, higher investment and higher productivity with less dependence on energy. Despite potentially rising political tensions, macro improvements and likely rate cuts still justify the upgrade to local bonds.

Hungary local currency bonds downgraded

In Q4 of 2016, Hungary local bonds were downgraded due to overly loose fiscal policy coupled with rising inflationary pressures. Momentum slipped to negative this past quarter, driving a further downgrade.

LatAM is easing though growth still disappoints

LatAm dynamics remain largely the same. Despite a marginal deterioration in valuations, declining inflation has been supporting rate cuts to keep local currency bonds at the top of the hierarchy. Relatively high real yields still remain supportive, but the margin for further rate compression is becoming more limited as the easing cycle advances. The dynamics for Mexico are quite different from the rest of LatAm. The country is on a tightening path, but has benefitted from a significant relief rally this quarter given that Trump policy threats have proven much softer than his rhetoric. Equities remain below Asia on the hierarchy as we still believe earnings estimates are aggressive and could fall short given disappointments in economic growth.

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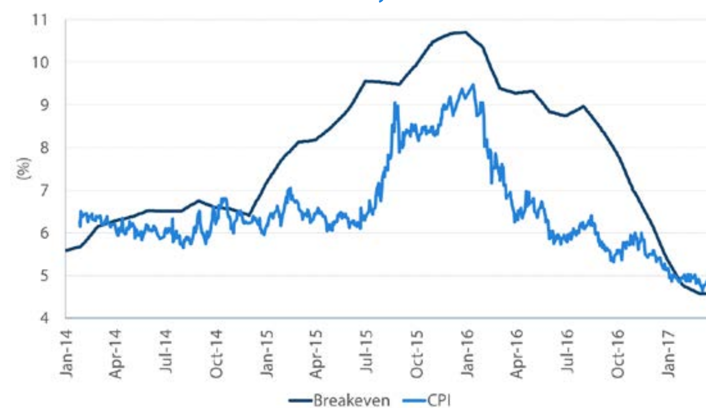
Brazil local bonds stretched on valuations

Brazil assets have had a good run, narrowly avoiding a crisis last year by convincing markets that renewed efforts to reform could bring the country's fiscal dynamics back to a sustainable path. Clearly, the rebound in commodities helped lend credibility while President Temer continues to push reforms to contain expenditures. Inflation is falling and the central bank is cutting rates aggressively, but the high levels of debt and unemployment have so far impeded a broader recovery. High real yields and an ongoing easing cycle lend support to local bonds, but valuation was downgraded mainly on account of the collapse in inflation expectations. As shown in Chart 5, inflation has collapsed to 4.6%, well below historical averages as a result of weak growth coupled with the pass through of currency strength. These conditions are likely transitory, yet breakevens are pricings only slightly higher inflation (4.8%) over the next 10 years – an unlikely scenario if growth recovers.

Chart 5: Brazil inflation versus 10-year Breakeven



Source: Bloomberg 2017

If growth continues to disappoint, the assumptions for fiscal revenue will have to be adjusted. At some point, despite reform efforts to fix the fiscal account, markets may again question the sustainability of it. This could trigger another

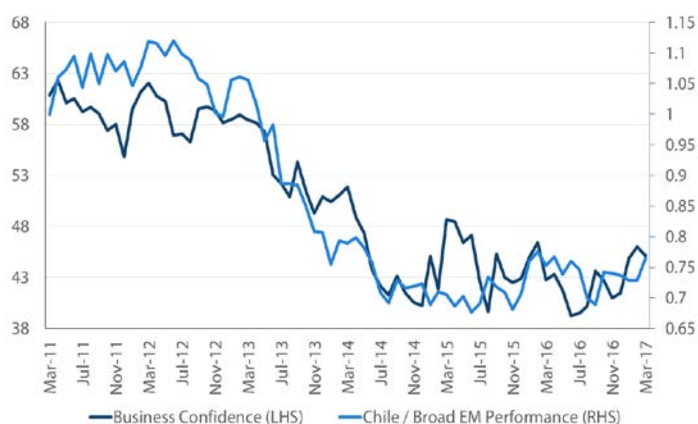
bout of risk aversion. We are not there yet, but the risk is real and important to watch.

Chilean equities and local bonds downgraded for valuations

Both Chilean equities and local bonds were downgraded due to rich valuations, at least partly driven by a run-up in price driven by a more upbeat view on the upcoming presidential elections to be held in November 2017.

Economically, Chile is one of the more advanced and diversified economies in the region despite its relatively high dependence on commodity exports. Since 2013, business confidence has deteriorated, dragging down the relative performance of Chile equities compared to the broad EM (as shown in Chart 6). Populist President Bachelet has pushed through a number of business-unfriendly policies, but her declining popularity and inability to push forward more populous policies has helped to stabilise confidence. The presidential election coming later this year is returning hope of more business-friendly policies, which has given a boost to asset prices.

Chart 6: Chile Business Confidence versus excess performance over EM



Source: Bloomberg 2017

For the moment, there are reasons to be optimistic, but we will wait for better macro political visibility to justify the more expensive valuations.

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