GUARDCAP

Emerging Markets Quarterly Outlook

THIRD QUARTER – 2018

MARKETS GIVETH AND MARKETS TAKETH AWAY

Emerging Market (EM) equities surged out of the gates to start 2018, adding to their outperformance relative to their Developed Market (DM) peers over the previous two years. That euphoria, however, quickly faded as a confluence of factors — chief among them being the strengthening US dollar that resulted from American monetary and trade policy shifts — weighed on investor sentiment and sent EM stocks into free fall.

With the negative performance in September, the MSCI Emerging Markets Index has now declined in seven of the last eight months and consequently seen its margin of victory over DM equities since 2016 completely evaporate — the index is now down 9.5% on a year-to-date basis (-7.5% total return) and has sunk back into its post-2011 trend range.

The pain this year has been felt broadly across the EM complex. Of the 24 regional markets that make up the MSCI Emerging Markets Index, two-thirds are in negative territory for the year and three-quarters of those have clocked in returns of -10% or worse. Moreover, the Philippines, South Africa, Greece, and Turkey are all down in excess of 20% — Turkey has actually seen its stock market's value cut almost in half this year thanks to its domestic crisis, a feat matched by also-crisis-stricken Argentina, which is slated to join the benchmark EM index next May.

Looking for the Light at the End of the Tunnel

Against the darkness that has covered EM, however, there are some flickers of light.

The pace of the selloff in the EM moderated in Q3 and the declines were more selective in a sign that concerns over broad, systematic issues throughout the region have ebbed — in contrast to Q2 when 22 of the MSCI Emerging Markets index component countries posted declines in US dollar terms, just 10 moved lower over the last three months with the laggards being those regions with elevated country-specific risks (the worst performer in Q3 was Turkey while China was among the biggest losers). Indeed, investor sentiment on the region has turned for the better of late, with EM recently seeing positive fund inflows again — though it more resembles a trickle than a tidal wave.

A main reason for this shift is that investors have started to take notice of opportunities within EM. One consequence of the indiscriminate drop in equity prices has been that the grouping has become attractive from a valuation perspective. With the broad EM index trading at 12x forward earnings, it is in line with its own historical averages while its 40% discount relative to DM stocks is at an extreme. The price-to-book ratio, the most useful valuation gauge for EM, at 1.6x is in middling territory at a time when the rising return on equity for the group justifies a rising multiple. Finally, the 2.7% percent dividend yield on offer exceeds what is available in DM and rivals what is available in bond markets, pointing to opportunities for income pickup as well.

Of course, the argument is always that sometimes something is cheap for a reason — and in this case, skepticism about the general health of EM economies and the sustainability of their continued expansion remains heightened.

Containing Crises

First of all, this year has shown markets how fundamental weaknesses within the region can be exposed, and raised the spectre of EM crises past. The firming of the US dollar in response to concerns that the Federal Reserve would adopt a more aggressive approach to policy setting in order to stave off inflation put pressure on those foreign borrowers that issued bonds in greenbacks since the attendant weakening in their own domestic currencies made those debt servicing costs more onerous. This is particularly the case within EM where many of these countries find themselves having to issue foreign currency denominated bonds to attract investors otherwise concerned about currency risks.

Turkey and Argentina especially find themselves under intense strain thanks to their high foreign currency-denominated debt loads and limited foreign exchange reserves, not to mention their gaping current account deficits that require a persistent inflow of foreign funds. But while it has been the case in the past that a crisis in one EM economy can create crises in others, the current situation has little in common with the Asian currency crisis of 1998 or fallouts from 2013’s “taper tantrum”.

Most EM economies (with the notable exceptions of Turkey and Argentina) have taken steps over the last two decades to increase currency reserves, decrease current account deficits, and to reduce their dependence on foreign funds. For the foreign currency debt that does exist, it is generally longer dated, particularly for corporates (which are also typically less financially leveraged than in previous eras), which means that vulnerabilities are less likely to be exacerbated near-term by principal payments coming due. As well, the general stability of the financial systems

in the region are more sound than when previous calamities hit given that EM banks, as elsewhere, are now better capitalised. All of these shifts serve to mitigate the risks of a small crisis spilling over borders to become a large one.

Moreover, the Turkish economy is relatively small (accounting for 1% of global output) with limited significance outside its own borders (it buys just 1% of global traded goods and operates outside of the European Union and Eurozone); Argentina is even less integral to the global economic machine, accounting for less than 1% of world GDP and only about a third of a percent of trade. There are risks for European banks holding Turkish loans (predominantly Spanish and Italian banks), but they are far from a threat to their solvency, let alone of a scale that could cause systematic issues that would affect the fundamental strength of the global economy as a whole.

Trading Fire

The other major concern facing EM economies is the protectionist trade policy stance being taken by the White House that has resulted in the persistent threat of a global trade war.

Despite what some people may think, trade wars are neither good nor are they easy to win — they are typically lose-lose scenarios, with consumers ultimately bearing the bulk of the burden via higher prices.

The recent trade agreement between the US, Canada and Mexico relieves some of the stress on the most exposed countries — exports to the US account for nearly a third of Mexican produced goods and almost a one-fifth of those made in Canada — and shows some willingness to step back from the brink. That said, the US Administration continues to be stuck in a stalemate in terms of its negotiations with China, whose $375 billion trade surplus with the US makes them the main target of the President's ire.

To date, the US has implemented tariffs on nearly $250 billion worth of imports from China and the President is currently threatening tariffs on an additional $250 billion which would increase coverage to the full amount for goods shipped to the US. China has responded with retaliatory tariffs on just over $100 billion of goods imported from the US and pledged further actions if necessary — and while there is limited scope for further import levies, additional non-tariff barriers that impact US companies trying to do business in the Middle Kingdom, such as licensing and permit delays, are on the table.

It is worth highlighting that despite the large dollar figures being thrown around, the size of the direct hit to the world's two largest economies will be a fraction of that notional value and as such, the tariffs are unlikely to actually have a material impact on trajectory for growth in these economies. For example, if blanket tariffs of 25% were able to fully reduce China's $500 billion worth of exports to the US by one-quarter, that would translate to a hit of less than 1% of the country's output at a time when it is still expected to grow in excess of 6%. The potential economic hit, while not nothing, is relatively manageable given the increasing heft of China's domestic economy and policymakers' long-term focus and willingness to provide support despite structural issues related to elevated debt loads in the country.

Moreover, China's place at the centre of the global supply chain means that the tariffs on its exports do not fully impact its own producers — nearly a third of the value-added of China's exports originates from a foreign market. In fact, the US is actually the second largest contributor (behind Japan) to the value-added in China's exports stateside, meaning that American firms are impacted by the tariffs even barring retaliatory actions. Of course, as share of GDP, the hit to the US from this channel is marginal, but there would be more significant reverberations felt through Southeast Asia — namely in Taiwan, Malaysia, Korea and Singapore — and EM commodity producers such as Saudi Arabia and Chile.

Similarly, America is the fourth-largest source of imports to China (the main goods shipped are aerospace products, agricultural goods, motor vehicles and increasingly oil & gas; China is the US' third largest export destination behind Canada and Mexico) and could find itself among the collateral damage from any tariff-induced decline in Chinese demand — again, though, the most vulnerable areas are those smaller export-sensitive economies in Southeast Asia that rely heavily on Chinese demand.

The important question now is to what degree do trade tension escalate further from here? The persistent threat of an intensifying and widening trade war creates uncertainty in the marketplace that weighs on confidence and restricts activity as businesses and consumers hold back on spending decisions — something that can provide a significant drag on growth, particularly among the EM where countries tend to be more export-oriented and dependent on foreign investment.

Ideally, there is some sort of compromise that can see China bring its various anti-competitive practices closer to international norms. Such concessions, however, are not politically desirable and Chinese president Xi Jinping is reluctant to lose face in a showdown with his American counterpart. That means the squabble could run and run at increasing cost to trade (and growth) going forward — instigating a trade war is evidently the simple part; getting out of one on terms that are politically acceptable to both sides is decidedly more difficult.

Weathering the Storm

Despite the challenging environment, economic momentum largely remains in place in EM and the world more generally for now, aside from the obvious exceptions such as Turkey and Argentina. Global demand remains firm, though subject to some modest downward revision, which means that trade flows are not going to grind to a complete halt. While central banks in DM are increasingly moving toward normalizing monetary policy, EM policymakers (namely those in China) find themselves with some scope to provide support for their domestic economies and global financial conditions still remain benign. Against this, EM corporate profits have managed to hold up fairly well — though there have been downward revisions here of late as well, earnings growth is still forecast to exceed 10% for the current year and next. This all suggest that the international business cycle still has some life in it yet, which could mean that EM assets could still see their usual late phase rally when market risk sentiment recovers.

All figures are in USD, unless otherwise stated. This document includes information concerning financial markets that was developed at a particular point in time. This information is subject to change at any time, without notice, and without update. This commentary may also include forward looking statements concerning anticipated results, circumstances, and expectations regarding future events. Forward-looking statements require assumptions to be made and are, therefore, subject to inherent risks and uncertainties. There is significant risk that predictions and other forward looking statements will not prove to be accurate. Investing involves risk. Equity markets are volatile and will increase and decrease in response to economic, political, regulatory and other developments. The risks and potential rewards are usually greater for small companies and companies located in emerging markets. Diversification may not protect against market risk and loss of principal may result. Certain information contained in this document has been obtained from external parties which we believe to be reliable, however we cannot guarantee its accuracy. This presentation is for general purposes only and does not constitute investment, legal, accounting, tax advice or a recommendation to buy, sell or hold a security. It is only intended for the audience to whom it has been distributed and may not be reproduced or redistributed without the consent of Guardian Capital LP or GuardCap Asset Management Limited. GuardCap Asset Management Limited is an indirect, wholly-owned subsidiary of Guardian Capital Group Limited which is a publicly traded firm listed on the Toronto Stock Exchange. For further information on Guardian Capital LP or GuardCap Asset Management Limited, please visit www.guardiancapitallp.com or www.guardcap.co.uk.