GUARDCAP

Emerging Markets Quarterly Outlook

FOURTH QUARTER – 2016

A CHANGE IN LEADERSHIP

Some of the gloss came off of the performance of EM equities in Q4, largely as result of the outcome of the U.S. presidential election. We must wait to see what Mr Trump's accession to the Oval Office means for EM in practice, but his rhetoric alone has increased the level of uncertainty about the outlook for the asset class and investors have priced this in accordingly. Not surprisingly, countries which are heavily dependent on the USA for exports and ex-patriot remittances, such as Mexico, took big hits, but they had plenty of company for other reasons. Unwelcome political developments and flaky macro-economics are no longer being tolerated to the degree they were previously. Turkey, which encapsulates both problems, was treated particularly harshly, as was the Philippines where the increasingly erratic leadership of President Duterte is the main issue. India's experiment in getting to grips with its underground economy - by removing high denomination banknotes from circulation - was not well received either. The one saving grace, at least for oil producers, has been the agreement between OPEC and key non-member partners with respect to output cuts. This reinforced the gathering change in leadership away from defensive sectors towards cyclicals. Russia and the Gulf states the main winners from this change in investor preference, meant that EMEA found itself in the unaccustomed position of being the best performing region over the quarter.

More noise than substance?

Even more than usual, EM is going to be very sensitive to developments in the USA in 2017. Doubtless there will be occasional sell-offs on the back of news announcements, but it is worth remembering that the historical record suggests that, as in DM, fundamentals drive the medium-term outlook. Fortunately, we are on familiar ground when it comes to what happens when the U.S. Federal Reserve (Fed) starts to tighten. EM equities can live with rate hikes provided that they don't happen too quickly and real rates don't rise too much as long as global growth holds up. Rising U.S. interest rates will not automatically trigger hikes in EM other than for countries with dollar pegs, such as the UAE. Countries with strong balance of payments and fiscal positions, like Korea, will follow independent monetary policies which may mean that they do nothing or, if appropriate, cut domestic rates. Countries with fragile economies will probably have to push up local benchmark rates even faster than the Fed if they are to contain downward currency pressure and rising inflationary expectations. We have already seen Mexico and Turkey react in that way, albeit without much success. The good news is that EM broadly is in better shape with respect to external buffers than it was at the time of the taper tantrum in 2013 and currencies are not conspicuously overvalued.

"...the good news is that EM broadly is in better shape ..."

However, growth, particularly in China, is slower than it was then and there are few levers available to boost domestic demand meaningfully. In these circumstances a Trump reflation package would be a bonus if it boosts EM export opportunities and doesn't trigger a more aggressive approach to monetary policy. However, even if one is delivered, EM is only likely to receive scraps due to the changing pattern of the U.S. economy, i.e. more spending on services, and the probable focus on infrastructure.

The new administration's actions with respect to trade policy, immigration policy and foreign affairs are potentially more alarming. International trade is already very weak, so ripping up trade agreements and using tariffs as an offensive weapon in negotiations, to say the least, will not be helpful. The Chinese leadership so far have kept their own council, but they must be expected to react very negatively to unilateral actions that would damage their country's interests. Other EM countries do not have the same clout, but they too are unlikely to be supine. If Mr Trump pushes too hard, it will be bad news for the world economy in general and even more so for EM exporters. Immigration control could also prove to be a thorny issue. Politics aside, implementing controls will be difficult given increasingly internationally integrated global production. Some EM industries, e.g. IT software providers, could face real problems. Stock prices have already fallen where this is a particular issue, but there is scope for more losses. Perhaps, the greatest danger comes from geo-political mishaps. Sabre-rattling always alarms investors, especially when it occurs in somewhere as potentially explosive as the South China Sea. Let's hope for the best.

Politics, politics, politics!

As we were reminded last year, it is not just American politics that can upset EM financial markets. Brexit and Mr Renzi's defeat in the recent Italian referendum briefly disturbed the prevailing equilibrium, but, as usual, it was local politics that really counted. Increasing voter dissatisfaction with corruption has become a powerful force that is dangerous to ignore. The Presidents of Brazil and Korea were impeached because of public outrage and leaders elsewhere are under strong pressure to change. Political turbulence is usually bad for confidence, but where it promises to improve economic policy-making it may be welcome. This was certainly the case in Brazil in 2016 which enjoyed spectacular returns despite being mired in recession and facing deep structural problems in its economy. This trend has further to run. If the leopard is willing to change his spots, this too can bring reward. Hungary has been on a roll for some time, largely because its authoritarian government has retreated from the more extreme populist features of its economic plan. Even Putin's Russia has quietly been pushing through market-friendly reforms, which has not gone unnoticed. It is, perhaps, ironic that EM governments are beginning to shift away from an interventionist approach to running their economies because of its inherent failings when DM politicians and electorates increasingly are beginning to see it as a solution to improving problems with respect to social inclusion.

In a relatively quiet electoral year, the most important planned political event in EM is likely to be in November when China's 19TH Communist Party National Congress meets to elect a new cadre of leaders.

It is widely thought that President Xi Jingping will use this as an opportunity to consolidate his power base. With his own men in key positions, he may become more assertive about the pace and direction of economic reform and more tolerant of short-term pain. This will be a positive. On the other hand, this more forward approach to policy making may well include international relations, and that may be more uncomfortable. As always, what happens in China is critical to the fortunes of EM, whereas what happens elsewhere may have a significant local impact but will only cause ripples in terms of the international arena.

Same direction of travel, same old problems getting there

Production data from China during the last quarter finally started to improve in response to repeated small doses of monetary and fiscal stimulus. Accordingly, with an almost audible sigh of relief, the authorities are now looking to put reform back on top of the agenda. Nothing dramatic is likely to be announced prior to the Communist Party Congress. Nevertheless, officials have been busy and there has already been a subtle shift of emphasis about the sort of change that is being sought. In future, quality rather than quantity of production will be prioritised, which is likely to mean a greater focus on innovation and reducing capacity at the bottom end of the value-added chain. In keeping with the new theme of more socially acceptable urbanisation, environmental policies will be more strictly enforced which will make it more difficult for marginal industrial operations to keep going. Supplemented with some micro-economic tweaking, the net result of these initiatives should be a modest cut in current output from smokestack industries. This is not very exciting, but it definitely represents an improvement on previous industrial policy.

Somewhat more pressing will be the necessity of deflating the asset bubble in real estate. This has now been explicitly recognised, but rather than risk sending the economy into a tailspin by a general tightening of credit policy, the authorities have preferred to adopt a series of measures which target specific excesses, e.g. rising house prices in Tier 1 and 2 cities. Whether they will work or not is moot. Moreover, even if they do, the collateral damage could be painful. The rest of the economy is not strong enough to withstand a sharp downturn in the construction cycle and this could easily happen. Further, real estate developers remain highly geared in financial terms and their stretched balance sheets could become an unwelcome headache for the banking sector. This is not the only peril arising from too much leverage in the system. China's bond market has been taking a pummelling in recent months. Although prospective tightening in the U.S. has not helped, the roots of this problem lies in a reduction in domestic funding supply since August, against a background of highly leveraged investment vehicles. Painfully reminiscent of 2015's equity market crash, it looks as if both individuals and the banking system had used various shadowy means to increase exposure to excessive levels, only to be left high and dry when loose monetary conditions disappeared. With no alternative but to resort to bond sales to meet obligations, the result has been a rout. The government has already been forced to downsize recent issuance and the corporate bond market is also coming under pressure.

"...Lack of access to normal funding could become a significant problem for companies ..."

Lack of access to normal funding could become a significant problem for companies, the opposite of what was envisaged when the reform programme was announced. Unfortunately, it is not just bond buyers that have overindulged in terms of financial leverage. Despite having to be bailed out by government intervention in 2015, retail players and hedge funds have again been playing speculative games in the local A-share equity market. Merrill Lynch has estimated that the percentage of A-share positions with leverage has risen from 14% in June 2015 to 22% in Q3 2016. Further, there is probably a fair slice of additional leverage being used on top of this, largely financed by structured wealth management products and old fashioned borrowing. Not surprisingly, both retail and hedge fund investors have significantly raised the proportion of total equity that they hold since the bottom of the market, whereas controlling shareholders and other corporate entities have been correspondingly reducing theirs. No guesses as to which direction the smart money has been shifting. Although the financial regulators continue to close down various loopholes, there is already enough leverage in place to result in a major implosion should the market start to plunge again for any reason. Banks would be vulnerable to major losses should that occur and it would almost certainly mean that the government will be saddled with an even bigger bill for sorting out the ensuing mess than last time.

"...Major market crashes are not inevitable, but ..."

Major market crashes are not inevitable, but the distinct possibility that they might occur adds another complication to policy making. Prospects for the non-banking private sector may be looking up a little at the moment, but confidence remains fragile and attempts to deflate asset bubbles may well slow growth in the first half of next year even if catastrophe is avoided. If deceleration is too great, there will be strong political pressure for a new round of stimulus measures and to further delay reform implementation. Albeit reluctantly, the finance ministry and the central bank will probably yield to political expediency. Meanwhile, non-financial debt continues to pile up and has now reached 250% of GDP. The debt to GDP ratio looks set to increase to north of 300% by the end of the decade, which is worrying given that a disproportionate share of that debt sits on the balance sheets of those least able to pay it, e.g. primary producers and retailers. Another headache for the government is the continued flow of capital overseas. Yet more measures have been introduced to stem the tide, but so far they have not been particularly effective and all of them push in the opposite direction of opening up f/x and capital markets. Reserves are still massive but they are shrinking at an unacceptable pace. There is less protection than usual from the traditional current account surplus, which is now running at less than 3% of GDP. In these circumstances China cannot be regarded as a currency manipulator according to the usual criteria. Its de facto f/x policy will remain keeping the yuan steady against a trade-weighted basket of currencies, which may be a source of tension if the U.S. dollar is strong. All in all, although the share of consumption and services in the economy continues to creep gradually upwards, finding the path to delivering a modern balanced economy remains as difficult as ever for China's leaders.

Grinding Upwards

Given the background, forecasting what will happen to EM equities in the coming year is even more fraught than usual. However, based on the possibly heroic assumptions that nothing too much goes wrong with trade relations in the new U.S. political era and the Chinese economy stays on the rails, growth in EM is likely to prove a little stronger in 2017 than 2016, if only because recessions in natural resource dependent countries will ease. This should deliver double digit U.S. dollar earnings growth for the asset class. EM currently trades at around 12x 2017 consensus earnings, the discount to DM being at the upper end of the historical range. All things being equal, investors can reasonably hope for another year of decent if not spectacular returns. But the range of possible outcomes is inevitably wider than usual, even for volatile world of EM equities.