# Quarterly Market Letter

June 2019

## *Summer Lull: Trade Truce, No Recession in Sight. Yet, As Growth Deceleration Continues, Investors Search For Yield.*

### Macroeconomic Developments

- **Trade war** “Top of Mind”: The outcome of the G20 meeting in Osaka in late June was viewed as positive. There was no immediate escalation of trade tension, but there is still no clear path towards a comprehensive deal. After an impasse that lasted for nearly two months, trade talks between China and the U.S. are scheduled to restart. The U.S. administration will hold off on raising tariffs to 25% on the remaining US$300 billion imports from China. Furthermore, both parties will roll back some non-tariff barriers (i.e., restrictions on high-tech exports by U.S. companies and sanctions against Huawei), and China will continue to purchase agricultural products from the U.S. All of these should reduce the risks of a world recession taking place in 2020.
- As far as the **Fed** is concerned, good economic data out of the U.S. as well as U.S. – China trade truce allows for some breathing space, in that it does not feel forced to ratify immediate market expectations of aggressive rate cuts.
- Rising political conflict and uncertainty has weighed on business sentiment and global capex, holding **GDP growth** to a below-trend pace in 2Q. The ongoing economic global slowdown (apparent in the lower global capex growth, the dip in manufacturing sentiment – flat PMIs –, and the lingering undershooting inflation) will likely remain in place and earnings growth will continue to slow down as we move forward. Major central banks have adopted a dovish shift in global monetary policy and are preparing to take action to counter this risk. All major central banks should be at zero interest rates and renewed QE in the not-so-distant future, but the Fed wants to resist moving in that direction too quickly.
- We see no **EM financial stress** so far due to the significant easing in global financial conditions in the past three months (10-year U.S. yields have fallen from +2.6% in April to +1.9% currently) that has come with the dovish message from the Fed and resulting slide in U.S. Treasury rates. The global economy looks fundamentally healthy. Balance sheets are very healthy for households and sufficiently so for corporates, and labor markets seem resilient.
- The environment of lower interest rates, and weaker USD, is supportive for high beta EMs.
- Global financial market sentiment improved after the U.S. and Mexico struck a deal, avoiding new tariffs on Mexico. Safe-haven assets declined, while risky assets saw a relief rally.

- U.S.: Despite the current U.S. – China truce, trade policy uncertainty will keep weighing on economic prospects.
- Fears of a sharp labor market slowdown have proven unfounded so far. Following the rebound in June, averages for nonfarm payroll growth are now back above the breakeven rate consistent with stable unemployment, although still below the 2018 pace. One challenge to this view is the slowdown in the manufacturing surveys, which has taken activity indicators down to below-trend.
- The U.S. is set to suffer the delayed effects of previous interest rate hikes and waning fiscal support. The slowdown in economic growth should eventually prompt the Fed to cut interest rates, particularly with underlying inflation muted (Core PCE inflation remains below 2%). Employment growth is still trending gradually lower but, with the stock market setting new records and trade talks with China back on (for now at least), the data support the view that Fed officials are marginally more likely to wait until September before loosening policy.
- **Currency wars**: The U.S. administration has shown its concern on the current strength of the dollar. President Trump can be expected to use tariffs-threats to deal with undervalued currencies.
- **Euro-zone growth** will remain sluggish and risks relating to Italy's fiscal position have increased. Meanwhile, hopes of a recovery of exports to China are likely to be disappointed as Chinese policy stimulus falls short of previous efforts.

## Global Drivers

### Commodities

**Oil upside is limited. WTI end-year range target $55-65/bbl.[1]**

Global oil is a positive, near-term technical momentum story supported by supply dynamics and geopolitical tensions. Decent world economic growth, a hawkish OPEC, a lingering Iranian quandary, and a collapsing Venezuela, are expected to continue supporting oil prices this year. The offset to positive supply dynamics may come later in the year from a possible continued weakening of global demand. The global economic slowdown is more pronounced now from last year, so the demand side of equilibrium will likely keep prices lower, longer term.

In the current economic climate, higher oil prices can be deflationary rather than inflationary and in the U.S., higher gasoline prices can hit US consumer confidence and put a dent in real disposable incomes.

**Copper and commodities are still trending lower.** Slowing demand for copper may be an indication of an economic slowdown or even recession ahead. The trend in commodities is important, as it serves as a measure of inflationary conditions. Right now, despite the Federal Reserve's rhetoric, it seems there is no inflation to be concerned about in the U.S.

### Trade War

Perhaps the biggest obstacle to a trade deal being struck, is the renewed U.S. demand for China to curtail various aspects of its industrial policy. Given the central role Made in China 2025 plays in its domestic growth plans and the Belt

[1] RVX Asset Management Internal Estimates

and Road Initiative plays in its foreign policies, it is hard to see China conceding on this issue.

For the U.S., the 2020 election is on the horizon and Trump is feeling vulnerable of losing his industrial support in key swing states. For China, a series of important anniversaries (the most important being the 70-year anniversary of the People's Republic of China on October 1st) is likely to lift nationalistic spirits and make concessions to the U.S. all the more difficult.

### U.S. Monetary Policy

**Good economic data out of the U.S. dampens hope of rate cuts. Data is consistent with a continued slowdown in economic growth, but not weak enough to convince the Fed to cut interest rates immediately.**

The Federal Reserve has opted to leave monetary policy unchanged, but as widely expected (and forewarned by Fed Chair Jerome Powell), has adopted a more dovish stance. The Fed believes "uncertainties about the outlook have increased," which mean the FOMC will be "closely monitoring the implications of incoming information and will act as appropriate to sustain the expansion." The current economic situation has been downgraded from one that was "solid" in May to one that is "moderate" today. This is largely down to "soft" business investment, which is enough to offset the fact consumer spending "appears to have picked up". Yet they have actually revised up their 2020 GDP growth forecast to 2% and lowered their prediction for unemployment. Meanwhile, market-based measures of inflation "have declined" and they have lowered their near-term forecast profile, but have headline and core inflation returning to target next year.

The market has taken this as a signal that a July 25bp rate cut is virtually a done deal with more to come, however, we are uncertain. We continue to look for two rate cuts in 2H19 and favor September and December.

## EM Investment Outlook

Good economic data out of the U.S. dampens the hope of short-term rate cuts, but policy easing within EM is still gaining momentum. The MSCI EM Equity Index has returned just above its 200-day moving average indicating a sign of improving sentiment toward EM markets.

While macro risks remain to the downside as business sentiment and global capex have been adversely impacted by trade uncertainty, there is a case to be made for investment strategy to turn more cyclical as central bank easing becomes more synchronized.

The current environment of dovish central banks and globally depressed yields naturally pushes capital flows into EM. For EM bond funds, these positive push factors appear to more than offset concerns about global and EM growth.

The equity market is trending up for now, but the bond and commodity markets seem not to agree:

- The bond market is sending a message of decelerating GDP growth and inflation and the need to cut rates to avoid a recession. It's beginning to look like a very late economic cycle.
- The Fed seems to begin to understand the message, but equity investors seem to be underestimating the importance of (1) the timing and (2) the size of the rate cut. Both are extremely important, if we are attempting to avoid a recession. Whether the market is getting ahead of itself remains a question.

- The S&P 500 and the Treasury bond market cannot both be right. If the FOMC lowers the funds rate by 0.75% or more by mid 2020, it would be because the economy and corporate earnings are going to be weaker and rate cuts alone will not be enough to save the day. If the economy proves more resilient than forecast, then the FOMC won't be lowering rates as much as bond or equity investors are currently expecting.

EM local rates are being pulled by opposing forces – policy easing vs. slowdown concerns reinforced by U.S. curve inversion. There is a debate about the validity of U.S. curve inversion as a signaling tool for a U.S. recession. However, the underlying signal of a late economic cycle is a potent one and curve inversion is spreading across EM too.

We believe the risk premium in EM local bond curves is not too low and there may be a case for incrementally turning more constructive on duration in certain EM high yielders, especially in markets where expectations of policy easing could intensify.

## Emerging Market Equities

### Investment Summary

While the 2nd quarter of 2019 was positive for emerging market equities, the asset class did relatively underperform both U.S. and international developed markets. The MSCI Emerging Market Index (net) was up 0.61%[2] for the quarter vs. the S&P 500 return of 3.78%[3] and the MSCI EAFE (net) return of 3.68%[2]. From a country standpoint, top performers included Russia, Brazil, and South Africa. China, Hong Kong, and South Korea were the worst performers for the quarter.

From a sector standpoint, Financials, Consumer Staples, and Energy were the top performers. Communication Services, Health Care, and Consumer Discretionary underperformed. The MSCI EM Value Index outperformed the MSCI EM Growth Index for the quarter with a +0.97%[2] (net) return vs. +0.26% (net)[2].

### Outlook

Emerging market equities continue to swing on news flow related to the potential for a U.S. – China trade war. May was especially volatile as tensions escalated, but June saw a return to normalcy as both sides showed progress in talks leading up to the G20 meeting at the end of June. Longer-term, trade negotiations may just be the first volley in a broader economic, trade, technological, and geopolitical realignment of power between the U.S. and China.

*If the conflict escalates from here*, a further decoupling of the Chinese and American economies is possible, including a dismantling of the supply chains both countries depend on heavily. 60% of all goods imported into the U.S. from China are made by non-Chinese companies.

[2] MSCI
[3] Bloomberg

These companies will either have to absorb the tariff increase or pass it along to U.S. consumers (or a combination of both). These companies may also get into the cross-hairs of Chinese regulators, who may make it especially difficult for U.S. companies (Apple, Starbucks, Boeing etc.) to do business in China.

The anti-Japan sentiment in China during the Senkaku Islands dispute in 2012 and the anti-South Korea sentiment during the THADD standoff in 2016-17 did considerable damage to the equities of Japanese and South Korean multinationals that were operating in China. Depending on the manufacturing base and percentage of profits from their Chinese operations, the equities of some multinationals may decline accordingly.

We would expect China to accelerate plans to become more self-sufficient in semiconductors, given the news flow around Huawei. Domestic-oriented sectors in China should be fairly insulated and may even benefit from increased government stimulus. In the meantime, Korean companies such as Samsung may stand to benefit from being a non-U.S. supplier. Southeast Asia may benefit as multinationals may look to new countries to circumvent the trade war; Vietnam and Thailand could be an especially attractive destination for new factories. In other regions, Brazil and Argentina's grain exporters may stand to benefit, for example, as new trading partners.

Given the timing of U.S. elections in late 2020, China may decide to play the long game to see if the current U.S. administration gets re-elected. China has a 'national team' of state-owned enterprises, banks, and brokerages that are ready to step in to backstop the equity and currency markets. China also has no opposition party and a friendly media apparatus. In recent speeches, President Xi has alluded to a new 'Long March', invoking a time of hardship and austerity for the Chinese people. The Long March refers to a grueling 4,000-mile journey taken by the Chinese Communist Party in 1934 as they fled the Nationalist Army under Chiang Kai-shek. When they regrouped and reclaimed China in 1949, the Long March became a key inflection point in the Party's history. Xi seems to be preparing the population for the potential of a protracted trade conflict with the U.S. As this plays out, defensive sectors and more value-oriented investments in EM have a higher chance of long-term outperformance.

*If the conflict de-escalates from here*, there should be a healthy rebound in EM equities and relative outperformance for Chinese equities, and especially names tied to the manufacturing sector. Chinese technology names should also outperform given increased risk appetites, and energy names should rebound given increased global growth assumptions. Regardless, our base line assumption is that an interim trade deal gets done before year-end, giving both sides the opportunity to save face and please internal constituents. Given U.S. elections in late 2020, a deal would also give the current U.S. administration a positive talking point during campaign season. We would assume if the rhetoric starts to impact the stock market or the real economy in a negative way, the U.S. will back off. Aside from tariff-related issues, we see reasons why any further Chinese currency depreciation would likely be limited and gradual. So far, the evidence shows that China has been lowering rates and depreciating the yuan from 6.3 to 6.82 vs the dollar, allegedly to partially offset the negative consequences of potential U.S. tariffs on their exports. We believe that the end-2016 level of 6.96 could be the maximum that the PBoC allows it to go, as they should defend the currency prior to the 7 level.

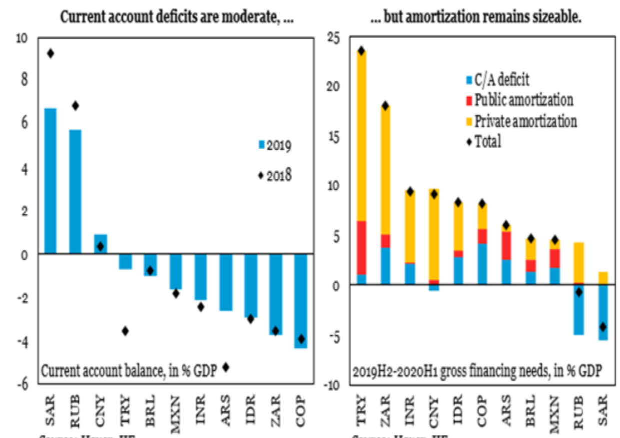
From a portfolio standpoint, we are maintaining our increased exposure to technology stocks (both in the Communication Services and Information Technology sector), as valuations continue to be attractive relative to the companies' fundamentals and earnings power. We would expect China to ease regulatory burdens in 2H 2019, which would help overall sentiment. We also remain overweight in the Energy sector as increased tensions between the U.S. and Iran, as well as recent skirmishes in the Strait of Hormuz, should lead to an uptick in prices in the near-term.

We continue to be generally underweight more defensive sectors such as Consumer Staples and Utilities, which is a byproduct of our fundamental, bottom-up process. We would expect further relative underperformance in these areas, especially as trade war concerns abate. Key priorities for our 3Q research docket are in countries where we have little exposure: India, Brazil, and Russia.

From a macro standpoint, the recent downtrend in U.S. interest rates and the outperformance of gold and other commodities may portend a weakening of the U.S. dollar in the near future. The 10-year U.S. Treasury yield briefly dipped below the Fed Funds rate in 2Q, which has been a fairly reliable recession indicator over the last few decades. Given the overvaluation of U.S. equities vs. emerging market counterparts, we would expect these negative U.S. macro indicators to be a relative tailwind for emerging market equities.

## Country Updates

**Large current account deficits remain in South Africa and Colombia; other EMs have moderated their deficits, but still face sizable external debt amortization.**



Source: Haver, IIF    Source: Haver, IIF

### China (MW)

**Tariffs to continue to weigh on growth. PBoC is on easing path, but will not rush.**

Despite a truce in the China – U.S. trade tensions, after the G20 summit, existing tariffs will continue to weigh on growth. Combined with the latest weaker economic data readings, this calls for further policy stimulus to mitigate the headwinds.

China is committed to maintaining 6% economic growth rate and likely will respond to any slowing with further easing. Cutting reserve ratios and pushing banks to lend more to the private sector will likely be the primary tools.

### Brazil (MW)

**Pension overhaul enters a key stage. A lower selic rate is contingent on pension reform approval. Political tensions are lessening.**

Social security reform is at a crucial phase. Overall, there seems to be general support for the reform in Congress, so the chances of SSR passage before the July 18th recess are high. The COPOM should start the easing cycle depending on the speed of the approval of the SSR. Aside from pension reforms and privatizations, anchored inflation expectations, strong external accounts, as well as the recent softening in the data also make the case for lower rates from a macro perspective.

The Mercosur/EU agreement shows that the liberalization agenda is starting to materialize. The agreement underscores that Brazil is truly shifting away from its historically closed trade positioning. Terms are still to be disclosed, but agriculture, materials, and industrials most likely winners. According to initial information, the EU will lift tariffs on agricultural/commodity products from Mercosur. Beef, sugar and ethanol should benefit from special trade conditions. Other sectors that could benefit are materials and industrials. Sectors that could face greater competition are automakers, apparel and beverages. The European Union is Mercosur's second largest trade partner, with over $90B in traded values in 2018, representing 18% of total Brazilian exports.[4]

### Mexico (MW)

**Tariffs increases off the table by now. Growth outlook is weakening amid policy uncertainty and Pemex fragility.**

Trump suspended the 5% Mexican tariff, a short-term relief in trade tension. President Trump's high stakes gamble of incremental tariff increases on Mexican goods to the U.S. was taken off the table after the Mexican government committed to some actions to stem the flow of Central American migrants to the United States. Despite the deal, the threat of new tariff is not completely off the cards.

Consensus growth forecasts have been revised downward to 1.2%5[4] in 2019 and 1.7%[4] in 2020, respectively.

Fitch's downgrade of the sovereign and Pemex, and Moody's outlook change for both from stable to negative.

### Argentina (UW)

**Tight race heading into the August primaries. Electoral risks fuel the potential for volatility, but this seems largely priced in.**

The peso stabilized, and financial assets rallied. Retrenchment of imports has improved the trade balance. Imminent general elections are scheduled for October 27th. Polls point to the presidential election being decided in a runoff in November; August primaries could shed more light. Macro stability appears to increase support for President Macri; we think policy framework can withstand shocks. Kirchner surprisingly opted to run as vice presidential candidate on the same ticket as Fernandez in May, in an apparent appeal to more moderates in the country.

The economy shrank almost 6% in the first quarter yoy and the unemployment rate topped 10% amid an economic crisis that began last year with the peso plunging against the dollar. The country's 12-month inflation rate reached 57.3% in May. 1Q current account deficit wider than expected at USD $3.8bn.[6]

There is no agreement from the ruling coalition on whether moving forward with structural reform immediately after starting a second term

[4] European Commission, ec.europa.eu

[5] JP Morgan

[6] The National Institute of Statistics and Censuses (INDEC) indec.gov.ar

is the best political strategy. The opposition has stressed its commitment to honoring Argentina debt obligations. There is bipartisan consensus on the need to change the terms of Argentina's agreement with the IMF.

### Turkey (UW)

**Erdogan “controls” monetary policy now. Replacement of CBT Governor broke the positive mood from the end of election uncertainty and Trump and Erdogan meeting at the G20.**

Turkey’s lira declined after Mr. Cetinkaya was relieved of his duty as CBRT, allegedly upon refusal to cut rates. Mr. Uysal took over the post. However, with hefty rate-cuts already priced in and the high yields on offer, the fallout has been relatively contained. This could lead to a faster pace of rate cuts in 2019 or, to the introduction of unorthodox measures.

Domestic political risks had improved significantly with the end of Istanbul´s election saga and improved sentiment on the S-400 dispute, but cannot be ignored completely, with regards to the new political party establishment by Babacan/Gul. Also, despite the positive sentiment after the Trump-Erdogan meeting at the G20, there is still ambiguity with regards to S-400, and the July 31st deadline by the U.S. for Turkey to cancel its S-400 purchase is nearing, so the risk of potential U.S. sanctions is not completely off the table.

Inflation is falling to the mid-teens, giving room to rate cuts. Q2 data showed renewed economic weakness, prompting policymakers to announce easing measures. Yet, bank balance sheets are constrained and the budget deficit has already widened.

Moody's downgrades Turkey's sovereign to B1/Negative: The downgrade reflects Moody's view that the risk of a Balance of Payments crisis continues to rise, and with it the risk of a government default. Turkey's credit strengths are its large diversified economy and still-moderate levels of government debt. However, Turkey may require $40 billion to $90 billion to avoid a sovereign default should it be frozen out of international borrowing markets, according to Reuters.

The European Union leaders threatened sanctions against Turkey as a fight escalated over offshore energy reserves in the eastern Mediterranean. The unprecedented EU move came as Turkish President Recep Tayyip Erdogan already faced the imminent threat of U.S. sanctions over Ankara’s planned purchase of a Russian missile-defense system. Turkey began drilling activities in May just west of Cyprus, drawing rebukes from the EU and the U.S.

### South Africa (UW)

**New cabinet is a sign of push for reform. Critical policy issue: Eskom.**

President Ramaphosa has cut the number of ministers in his cabinet to 28 from 36, merging several departments. Mboweni returns as finance minister, while Pravin Gordhan retains leadership of public enterprises. Local financial markets have rallied on the news.

South African GDP contracted in Q1. And while things probably improved more recently, sharp divides within the government suggest that President Cyril Ramaphosa is unlikely to push through the reforms that many investors had expected.

### India (Safe Haven OW)

**Modi Wins. Positive momentum. Now What?**

As the euphoria from India Prime Minister Narendra Modi’s landslide election win fades, the focus shifts back to the nation's economic fundamentals.

Budget deficit target at 3.3% of GDP.  The lack of counter-cyclical fiscal action owes in large part to the already-large imbalance, with total public sector borrowing at 8% – 9% of GDP. With fiscal policy sidelined, the onus of support falls on monetary policy. Risks are skewed toward more easing than expected given the growth slowdown.

### Pakistan (UW)

**IMF approves $6 billion package as government applies shock therapy**

The IMF approved funding for $6b to support reducing public debt while expanding social spending. The IMF expects Pakistan to maintain a "flexible, market-determined exchange rate to restore competitiveness and rebuild official reserves."

Pakistan's government, under Prime Minister Imran Khan, had for months resisted requesting help from the IMF, preferring to try to fill its funding gaps with money from regional allies, but in April, Mr. Khan switched gears. He replaced his finance minister, central bank chief and the head of the tax collection authority and instituted a reform plan that will include improving tax collection by one-third, raising tax rates, curbing government spending and increasing gas and electricity prices.

Growth will nosedive and inflation will spike, the government says. Middle-class voters who are Mr. Khan's political base will be hit hard. But he is betting that the economy stabilizes quickly. For Mr. Khan, it is better to deliver a short, sharp shock to the economy than endure the three years of austerity more typical of an IMF program, his aides said—a period that would take Pakistan to the cusp of the next election.

**We thank you for your continued support.**

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