Quarterly Market Letter

March 2019

"Risk On" Is Back. Market No Longer Pessimistic, But Rather Skeptical

Macroeconomic Developments

- The last few months of 2018 saw fears of the start of Global Financial Crisis 2.0. The sharp downward momentum in global industry and year-end financial market turbulence, compelled the FOMC to reverse course and adopt a "dovish" stance, making an abrupt turn from what the markets regarded as a hawkish stance late last year. In the end, the dovish Fed, Chinese credit expansion and further accommodation from other central banks, including the ECB, managed to calm things down. The mood of the financial markets changed, but it remains nervous.

- The U.S. yield curve inverted, allegedly predicting a recession. However, the entire range of the curve is not yet inverted. Investors are currently trying to assess whether a part-inversion is sufficient to trigger a recession, or just equates with a benign slowdown. The NY Fed gives roughly a 25% probability of a U.S. recession within 12 months, based on what happens to the 3 month-10 year spread. Curve inversions also align closely with peaks in U.S. equity markets. This probability is the highest since 2008. The Fed futures market is giving an increased probability to a 25bp rate cut at the end of this year. What is likely is that the Fed may cut rates sooner given its new-found flexibility and swiftness in changing its policy position. Now that the Fed hikes are off the table and the Fed can afford to be patient, **EM funding conditions won't be as tight as before. However, we see some risk of complacency if the U.S. economy and inflation pick up, even if temporarily.**

- **There seem to be too much bullishness in Treasuries**: the real 10-year Treasury yield is at 0.55%, which is below the levels seen during the 2007-2008 crisis. In the Eurozone, the real 10-year yield is negative and the German 10-year bund yield is approximately zero. Lower real yields are a sign of slower economic growth and low levels of real interest rates are associated with lower potential GDP growth, i.e. secular stagnation. As far as the FOMC is concerned, there is undoubtedly a "high bar" to raising interest rates, as Jerome Powell is highlighting concerns about slower global growth, in addition to slower domestic growth as the U.S. fiscal stimulus fades through the course of this year. Congressional deadlock rules out any further fiscal stimulus, and the debt ceiling issue is likely to return as a potential source of market volatility later in the summer. U.S. – China trade talks are progressing with the two sides aiming to achieve a deal by late April. Combined with the Fed pivot and China's tilt to fiscal ease, global financial conditions have eased. Importantly, early-year demand indicators for both the U.S. and China have printed modestly stronger than expectations. China is one of the keys for stabilization after mid-year. It is encouraging that monetary stimulus appears to be gaining traction and should be followed by a pickup in growth. If China improves, it will help EU since China is the EU's second largest export market, which accounts for roughly 50% of EU GDP.

- EM central banks continue their dovish tilt. The soft patch in global growth is being countered by a broad based global shift to easier monetary policy.

- **Green New Deal**: The likelihood of another recession; the constraints on conventional monetary policy; the threat of deflation and the need to fund the transition to a low-carbon economy all point in the same direction: a much bigger role for fiscal policy. The Modern Monetary Theory (MMT) turns the post-1970s orthodoxy on its head. It says a government that issues its own currency cannot go bust. There is no need for people to be unemployed because they can be put to work through higher public spending financed by the central bank. Under MMT, full employment is the main goal of policy and the central bank is subservient to the finance ministry. The attraction is obvious: MMT can be used to offer job guarantees and to fund the Green New Deal. The fact that Trump is unbothered by the size of the U.S. budget deficit makes MMT an easier political sell. Donald Trump has shown he does not care too much for central bank independence and believes in growing the economy first and worrying about the deficit later.

- The outlook for EU Banks still doesn't look good. The ECB has recognized that the economic downturn in the Eurozone is deeper than previously thought, hence it announced another round of targeted longer-term refinancing operations (TLTROs). Just adding liquidity to the banking system does not necessarily push inflation expectations up or necessarily encourage banks to lend, especially if debt-burdened borrowers have little appetite to add to their debt.

- The U.S. is asking Europe not to join the Silk and Belt road and Huawei´s 5G. If Trump plays hardball regarding auto imports, that could start a wedge between the U.S. and Europe, and make cooperation on these issues more difficult.

- Parliament rejected the Brexit Withdrawal Agreement again. There continues to be an effective cross-party majority against a “no deal” option. However, no majority has yet been found for any other specific Brexit end state. For example, a desirable customs union between the UK and the EU and an amendment that provides Parliament with more say in future trade negotiations. The "no deal" option, leaves downside risks to Sterling in place. Donald Tusk has asked for an extension for mid-2019. The balance of risks around Brexit outcomes is tilted towards a softer, more orderly departure. Public support for Brexit is currently below 50% so another vote would keep the UK in. The choice is parliament voting to override the June 2016 decision, or trying to have another vote. Either way a hard Brexit seems unlikely.

Global Drivers

Global Growth

Growth is likely to stabilize around current levels, before gradually recovering through the course of 2019.

There are two key drivers: The U.S. consumer and China. The increase in U.S. tariffs has imposed costs upon the U.S. consumer. U.S. consumer spending, which accounts for 70% of the U.S. economy is unlikely to provide growth leadership. As a result, we are counting on Chinese pump priming. This might take some months to come through, though increases in the price of base metals are encouraging. Furthermore, U.S. tariffs on China might remain in place for some time to ensure compliance with any U.S. – China trade deal that might be signed. The outlook for both the U.S. consumer and China suggest that the economic landscape points (certainly for the medium-term) to moderate rates of economic growth, but also subdued inflationary pressures. This suggests downward pressure on sovereign bond yields in the major economies and persistent low levels of real yields. A global slowdown is more or less priced into markets, though the consensus view amongst investors is that there will not be a global recession. Apart from the U.S. – China trade dispute, which looks as though some form of agreement can be reached, there are reasons for becoming more positive on the global growth outlook, reflecting a more accommodative policy from the major central banks.

The U.S. – China trade dispute resolution would lift a major negative off the global outlook. As a result, the downturn in the global economic cycle might soon be bottoming out.

Healthy macroeconomic fundamentals, still-accommodative monetary policy, and building fiscal supports should allow for global GDP outcome expansion that will reach its 10th

With global debt-GDP at a record high, the availability of fiscal space to sponsor a sustained economic recovery is clearly limited.

U.S. Monetary Policy

Fed's dovish turn key factor limiting recession risk this year. USD strength has not abated despite the dovish Fed influence.

The Fed signaled a pause following its December rate hike and FOMC's latest interest rate projections rule out any rate hikes for the rest of the year. However, the 2019, 2020 and 2021 median dots of the dot plot were revised significantly downward, suggesting this hiking cycle may be complete. Additionally, Chairman Jerome Powell announced that the Fed's balance sheet run-off will decelerate in May and conclude in September of this year, suggesting the end of the quantitative tightening process.

The FOMC meeting confirmed an accommodative shift in the Fed's reaction function. Despite a projection of unemployment rates below NAIRU (Non-Accelerating Inflation Rate of Unemployment), the Fed is not projecting rate hikes or rising inflation this year.

Guidance of a prolonged pause and an earlier end to balance sheet normalization has contributed to a flatter yield curve. We continue to view consensus expectations as too high.

The bond market is saying is that Fed dovishness is too little too late. Market-based measures of inflation expectations are falling. This implies an increase in the real fed funds rate (and real rates generally) and it also explains why the Fed has been quick to signal an abrupt end to the intended tightening this year, as the real fed funds rate would become even tighter. Lower real yields and lower inflation expectations in response to the Fed's shift in policy implies that the market believes there is a negative growth shock taking place. The fact is that as U.S. unemployment falls, an increase in inflation has been absent. The Fed likely thinks there is no need to be restrictive in this situation.

So what is next for the Fed? It is interesting to note that President Trump's nominee for the Fed, Stephen Moore, said in a New York Times interview that he favors a 50bp cut in the fed funds rate and argues that the September and December rate hikes were a mistake. President Trump will be glad to hear that. However, Jerome Powell has done a U-turn, which at least shows policy flexibility.

The neutral or equilibrium real yield estimates, termed R-Star by the Fed, is currently about 0.75%. Add in the targeted inflation rate of 2%, and you end up with the neutral nominal rate of 2.75% which is the rate expected by the FOMC in the longer-run.

Commodity Prices

Prices rebounded, benefiting EMHY.

Commodities rallied through the first quarter. Investors are now debating the likelihood of a U.S. recession. Crude led most of this rally, primarily due to U.S. sanctions against Iran and Venezuela as well as OPEC-led supply cuts overshadowing concerns over a slowing global economy. Gold prices, which have remained top of mind for investors since the Fed pause, slid due to a stronger dollar.

The glass half full: commodity markets should arguably suffer the most direct pass-through from the global economic growth slowdown. Yet, despite the state of the global economy and the slowdown in China's growth trajectory, fundamentals in many markets remain sound, supply is disciplined, and the global monetary U-turn is likely to appease concerns that central banks were inevitably driving the global economy into a recession.

Oil: Spotlight on Iran and Venezuela. Global oil demand to remain solid at the same pace as 2018.

This year's oil price strength is part political (OPEC+) and part structural (slower U.S. supply growth). OPEC+'s decision to push their meeting in June supports the thesis of tighter supply in H1.

Iran and Venezuela represent the biggest upside risks to the oil market outlook for 2019. Importantly, when it comes to increasing output to make up for supply disruptions, Saudi Arabia is unlikely to intervene proactively, as it did in 2018. We expect Brent to trade in a $62-75 range over the next 12 months, and $55-69 for WTI[1]. Global economic and oil demand growth is expected to continue to be solid.

On the supply side, non-OPEC growth – led by the U.S. – is projected to be very strong, far exceeding global demand growth, however, this should be offset by aggressive OPEC+ supply cuts.

EM Investment Outlook

We continue to be selective, preferring higher yielding shorter-dated bonds in solvent non-investment grade names.

Investors seem to be skeptical of both the bear and bull case. The risk aversion mood among investors eased somewhat but caution remained as fears of a deceleration in advanced

[1] RVX Asset Management Internal Estimates

economies, coupled with uncertainty surrounding trade issues and Brexit, lingered.

The global backdrop for EM economies deteriorated over the past year, however some factors are changing: (1) Growth in developed economies has halved in the past year, but China and the U.S. are showing incipient recoveries; (2) Global and EM financial conditions tightened last year, but central banks are loosening monetary policies; (3) Commodity prices are rebounding; and (4) The risk of a 'trade war' is subsiding.

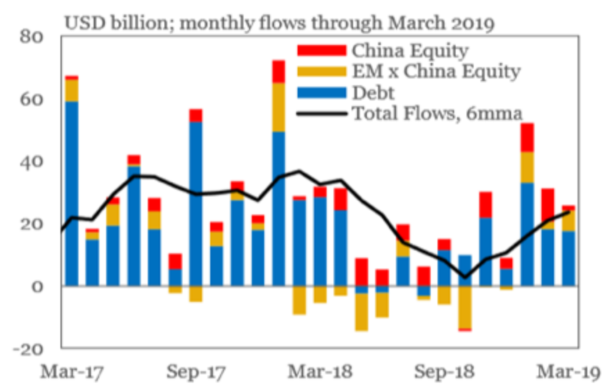
EM headwinds have lessened due to the change in Fed policy, as it allows EM policy rates to remain lower for longer. With the U.S. Federal Reserve pledging to be "patient" in future rate hikes, emerging markets should do better this year.

At the end of last year, investors were in a deep state of pessimism. Recession and trade war fears abounded and global equities had fallen through the year. Investors had increased their cash positions at the expense of equities and were underweight a broad range of risky assets. Economic troubles in Argentina and Turkey, as well as the Fed tightening monetary policy, had caused a selloff in several EM currencies. Some EM stock indexes also saw steep declines. Rising interest rates stateside make it harder for emerging economies to service their U.S – dollar debt. Those markets, however, should turn around this year.

Strong Underlying Fundamentals

Too much pessimism is still priced into equities. The 12-month trailing PE multiple for MSCI ACWI World is roughly 17%, which is 20% lower than at the start of 2018[2]. This de-rating is the result of a reassessment of the growth expectations in the last 15 months, as views moved from "goldilocks" to "imminent recession". Those expectations look too pessimistic given corporate earnings are at all-time highs, and margins are high and growing. Companies are investing; not just buying their own stock. This stems from the fact that corporates have a lot of cash on their balance sheets still which is a signal of confidence in future growth.

Exhibit 1. Net Non-Resident Portfolio Inflows to EMs



Source: Haver, IIF

The EM asset class is developing a deeper and wider base of dedicated investors. EM funds have been sticky. Recent inflows into Chinese equities account for a large part of positive non-resident portfolio flows into EM stocks and bonds this quarter.

Exhibit 4. ... and shows a clear trend towards China.

Source: Haver, IIF

[2] Societe Generale

Geopolitical Risks

- The 2019 Outlook is focused on protection. The U.S. President Trump signed an order declaring U.S. recognition of the Golan Heights as Israeli territory (Israel captured Golan Heights from Syria in 1967). Iran, Syria, Russia and Turkey criticized the U.S. decision. Britain and France also shared their objections. The U.S. Golan Height decision marked an inflexion point in the region. The international community declared their rejection to U.S. recognition of Israeli sovereignty over Golan.
- Russia increased its support of Maduro. Russia deployed 100 Russian army personnel and 35 tons of military equipment to Caracas, Venezuela. Moscow has sent military units to Venezuela and said they would stay as long as necessary. The U.S. is considering further sanctions against the Maduro administration to limit financial institutions to process transactions inside the country including SWIFT access to government financial institutions.
- The U.S. has put pressure on North Korea. After the Trump-Kim summit failed, the U.S. issued a new sanction which shows more military strength against Chinese aspirations in South China Sea. The U.S. Army has sent two naval vessels to Taiwan Strait to show its growing interest in checking Chinese ambition in the region. South Korean President Moon Jae-in and U.S. President Trump will meet in Washington on April 11th to discuss the North Korea dispute. North Korea is considering suspending nuclear talks with the U.S.

Emerging Market Equities

Investment Summary

While the 1st 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 9.92%[3] for the quarter vs. the S&P 500 return of 13.07%[4] and the MSCI EAFE (net) return of 9.98%[3]. From a country standpoint, top performers included China, Taiwan, and Brazil. Qatar, Turkey, and Poland were the worst performers for the quarter.

From a sector standpoint, Consumer Discretionary, Financials, and Information Technology were the top performers. Defensive areas such as Health Care, Utilities and Consumer Staples underperformed. The MSCI EM Value Index underperformed the MSCI EM Growth Index for the quarter with a 7.83%[3] (net) return vs. 10.53%[3] (net).

Outlook

1Q earnings season is mostly behind us, and our portfolio companies have generally met or beat street expectations. We have always believed earnings growth in EM should command at least an equal multiple to their developed market peers, as we have seen less financial engineering among EM companies to derive earnings in recent results.

Energy prices, a key swing factor in emerging markets, have rebounded YTD given recent OPEC and Russia compliance on production cuts, and political instability around key producers Venezuela, Libya, and Nigeria. Another factor that would create upside risk include slower US shale growth and the unwinding of hedging

[3] MSCI
[4] Bloomberg

activity that impacted the sector in 4Q 2018. Stock performance within the sector has lagged the underlying commodity's price performance, which we have also encountered in prior rallies. Market participants are generally underweight the sector and given the magnitude of the price drop in 4Q 2018, consensus has not formed yet that the recent rally has staying power. Regardless, nothing has changed our fundamental view and we even added to our positions during last quarter's selloff.

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 its regulatory activity in the sector in 2019, especially in the crucial gaming segment.

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, which may also mean that a buying opportunity arises later in the year. Key priorities for our 2Q research docket are coincidentally areas where we have a large underweight: more work on undervalued opportunities in India (especially given potential volatility around upcoming elections) and the banking industry in South Korea. The latter has some of the cheapest valuations in the EM asset class, but a lack of growth and clear catalysts have kept investors away. As we have invested in the sector in the past and are familiar with the companies, recent news flow that Korean banks may be interested in growing outside of Korea has piqued our curiosity.

We are encouraged by the healthy rebound in emerging markets YTD and would expect this outperformance to continue for 2Q. Worries about a protracted trade battle between the US and China seems to have abated, and our base scenario is an agreement amenable to both sides. We would expect the Chinese equity rally to continue, as recent economic data has been positive. While market participants are discussing the ramifications of the inverted yield curve in the US for emerging markets, we believe it is too early to call for a potential EM slowdown. EM had already been underperforming the US since the aftermath of the global financial crisis in 2009, while fundamentals in EM have been relatively improving over the last few years. In summary, EM continues to hold favorable characteristics vs. developed counterparts, currency issues generally seem to be in the rear-view mirror, new areas of opportunity include India and South Korea, and upside risks appear to outweigh downside risks going into 2Q.

Country Updates

Turkey (UW)

Looking shaky once again. Contraction in domestic demand deepens. The lira under pressure.

The old problem of high FX debt has not gone away and the economy has slipped into a recession. The prospect of political unrest amid a global backdrop of economic slowdown, trade wars, and sanctions may translate into renewed volatility.

<u>Local elections:</u> The AK Party of Turkish President Erdogan with his allies has secured the majority of municipalities. AKP vote share was down in the capital and Istanbul. Istanbul mayoral vote may provide a catalyst for widespread political

unrest. Meanwhile, portfolio flow metrics reveal an acceleration of capital outflows has occurred since the start of March. Export growth remains in double-digit territory, while imports fell at a faster pace. Balance of payments suggests a V-shaped recovery. The current account shortfall is at 2.8% of GDP. Net portfolio inflows recorded a recent high, largely on the back of new external debt issuance by the government. The private sector, meanwhile, continued de-leveraging. In an environment characterized by deteriorating asset quality (non-performing loan ratio rose to 4.0% in January from 2.9% a year ago), banking sector de-leveraging makes it difficult to envision a quick turnaround in activity, especially private sector investment[5].

Strained relationship with the U.S.: 2018 saw the imposition (and later lifting) of sanctions by the U.S. on Turkish government officials. Although the direct issue was resolved, tensions remain high due to Turkey and the U.S. being on competing sides of the Syria conflict; the continuing residence of an Erdogan critics in the U.S., and the recent purchase by Erdogan of a Russian missile defense system. Any one of these points of contention could escalate into new sanctions.

TRY: The recent drop in the CBRT's FX reserves is causing concern that the government is using the proceeds of its Eurobond issuance to defend the currency. Vulnerabilities such as limited reserves and domestic dollarization are in the spotlight again. With investor confidence falling, keeping the Lira stable will involve either further use of reserves, pushing up yields to punitive levels or incentivizing locals to de-dollarize. The first couple of options are costly to sustain in the medium term and using administrative measures to de-dollarize is likely to further erode confidence among domestic and foreign investors. The latest developments mean that the near-term path of the currency has become difficult to predict, but the risks of a sharp depreciation are becoming more front-loaded.

Ukraine (MW)

Outsider Zelenskiy virtual winner. Cautious, but positive on election result.

Given that Zelenskiy has a lead of more than 14 points and would take the majority of votes from Tymoshenko, Boyko, Smeshko, Lyashko and Hrytsenko, his chances to be the next president are even larger than exit polls indicated. Main actors will shift their focus towards parliamentary elections on October 27th. Zelensky's party appears to be the likely winner, followed by Fatherland of Tymoshenko and Petro Poroshenko Bloc. Zelenskiy will try to avoid any alliances in his attempt to portray himself as the anti-system candidate, but appearance of new faces could contract his advantage. However, polls already indicate a fragmented parliament so alliances are likely to be unavoidable.

Real GDP grew by 3.5% YoY in Q4-2018. This took annual growth in 2018 to a seven year high of 3.3%[6].

Argentina (UW)

Election risk remains. The external adjustment continues to unfold.

Argentina's presidential elections (first round October 27th) will be competitive, with FX and inflation the critical factors determining President Macri's reelection. The aggressive policy tightening as per the IMF deal, makes the

[5] HSBC

[6] State Statistis Service of Ukraine (SSSU)

macro story quite vulnerable, with the balance of risks still leaning to the downside. Trade balance improvement continues to be persistent as imports plunge (down -21.9% oya), while exported volumes (up 6.7% oya) have started to recover[6]. International reserves, however, have not recovered. Capital flight continues. Private sector asset purchases tend to accelerate in July during election years. Treasury's FX sales starting in mid-April should provide some respite, alleviating the pressure on the exchange rate.

Brazil (MW)

Higher political tension and falling confidence raise concerns about the pace of economic recovery. A considerable part of the reform story seems already priced in, so disappointment looks possible.

The pension reform will likely prove difficult to pass but privatization should sustain momentum. The economy continues to underperform due to high real interest rates.

There is a lot of willingness to pass the reform, but risks are asymmetrical toward a worse than expected outcome. Recent polls have indicated that about half of the population supports social security reform. The president of the Constitution and Justice Committee (CCJ) in the Lower House delayed the schedule for the vote on the Pension Reform proposal in the committee to April 17th.

Brazil has solid external accounts; debt is stable at 54.4% of GDP while gross debt 77.4%[6]. Capital flows rebounded in early 2019: portfolio investment registered the second consecutive monthly surplus, of U.S. $4.0bn, mainly driven by fixed income investment[6].

Mexico (UW)

Economy lackluster as rates too high. MXN vulnerable. Pemex cheap.

1Q GDP growth disappointingly slow, forecast is at 0.8%[7]. Investment remains sluggish. Trade data shows externally-driven sectors are likely to lag. Elevated risk premia in Mexican assets amid policy uncertainty that have led to credit downgrades to the state-owned company Pemex, and even put at risk the sovereign rating.

Fitch said it sees contingent liabilities as a risk to Mexico's public finances. Government support measures for state-owned oil company Pemex have a minor impact on public finances and suggest the sovereign is concerned about protecting its own credit profile. Yet, they are insufficient to allow the company to invest enough to stabilize oil production. Further support is likely, including the use of stabilization funds.

China (MW)

Easing measures show signs of activity recovery. Good progress of China – U.S. negotiation. There are still risks, particularly on the external side, given still weak global growth.

Chinese equities are back in bull-market territory. The economy is stabilizing after a slowdown in the end of 2018. The success in curbing the shadow banking system provided policy makers the flexibility to loosen monetary policy through lowering the required reserve ratio for banks. March PMI readings surprised on the upside, with both the manufacturing and non-manufacturing gauges rising to six-month highs, partly driven by normalization after the Chinese New Year holidays. There are also signs that the ongoing private sector-focused easing is

[7] JP Morgan (DW March 29)

helping to improve business confidence and activity.

All this implies less negative repercussions from the debt stability perspective. Corporate debt has fallen to 128% of GDP in 2018 from 134% in 2017[8]. However, household debt is growing rapidly, mainly due to an increase in mortgage debt. A plus point is that China's external debt is low, at about 10% of GDP.

CNY: As trade talks with the U.S. progress, Chinese policy-makers will continue to prioritize currency stability. The CNY has been appreciating against the US dollar over the past few months.

For the Chinese authorities, the challenge of securing sustainable growth has to be balanced by deleveraging the economy's debt burden in the corporate sector. More recently, the PBoC has encouraged an expansion in credit as growth takes priority over deleveraging. At some point, the short-term credit cycle will be tightened but the authorities are far from doing that. The Chinese authorities have not faced any pressures on the exchange rate, which has been remarkably stable against the U.S. dollar. This satisfies the demands of the White House and U.S. Treasury, which are both keen to ensure that China does not implement a currency devaluation. It is also in China's interest that it stabilizes the currency rather than export a loss of competitiveness to their Asian trading partners by letting their currencies appreciate.

Thailand (UW)

The election does not have much of an impact on growth in the short term. Domestic demand can cushion the weakness in external demand.

With 94% of votes counted, it appears no party or presumed coalition has achieved outright majority in the lower house, as expected. Assuming military-appointed senators vote with the pro-military coalition, Prime Minister Prayut is likely to be re-appointed. This suggests a degree of policy continuity, but the possible lack of a lower house majority might complicate policymaking. If all neutral parties join the pro-Prayut coalition, a narrow majority may be formed, which would likely be seen as a market-friendly outcome. Meanwhile, the Future Forward Party, which came in third, is facing legal challenges. The results will not be officially announced until after the King's Coronation sometime in May.

[8] Bruegel.Org

We thank you for your continued support.

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