Quarterly Market Letter

September 2018

EM Fundamentals Hold, but U.S. Complacency Lurks

Executive Summary

- As we pass the tenth anniversary of the global financial crisis (GFC) this month, focus has increased on the likely source of the next crisis. A substantial amount of healing has taken place since the GFC with global labor market slack being eaten up and inflation on track to pre-crisis norms. Legacy costs, such as higher costs of debt and the already high levels of indebtness, have been material and challenge the upward trend in the U.S. economic cycle. Despite the normalization of unemployment and inflation, there has been a significant loss of income over the past decade and debt has increased significantly, in both DM public and EM corporate sectors.
- Global growth momentum is holding up at high activity levels, but there is growing evidence of a global liquidity drawdown.
- The S&P 500 posted a new record high in September. The glowing headlines are making the majority of investors complacent since they expect the trend of good news to continue.
- We feel more comfortable about China. The coverage of trade wars may be rising, but that is not translating into fears of slower Chinese growth.
- As real U.S. interest rates and the dollar have risen, investors have been pulling money from emerging markets. An EM crisis seems unlikely. Even if the Fed's interest normalization could affect valuations, EM assets have already incorporated some embedded cushion.
- Oil prices: the risks remain skewed to the upside, given geopolitical tensions among oil producers.
- EM FX: the dollar should remain strong, as U.S. monetary policy tightens liquidity for overseas borrowers. The rally in the dollar has pressured EM currencies, bond prices, and equities. Since its high in April, the JP Morgan Emerging Market Currency Index has fallen by more than 12%, while the Turkish Lira has plummeted and the Indian Rupee has plumbed a record low after falling more than 13% against the Dollar in 2018. The Argentine Peso was the worst: YTD it depreciated more than 50%, followed only by the TRY. Dollar positioning suggests the dollar would be vulnerable if Trump tweeted that he wanted a weaker USD. Long positions are almost as large as in January 2017.
- The combination of a weaker currency and higher inflation has forced a growing number of EM central banks to increase interest rates. The number of EM central banks that are tightening their policy is the highest since 2011, which will slow EM growth in 2019. The countries that have a current account deficit

are more vulnerable. This is one of the reasons why some of the weakest currencies in 2018 have been Argentina, Turkey, Indonesia, India, and South Africa. EM bond yields have increased in response to rate hikes by the Federal Reserve, weaker currencies and higher inflation. Furthermore, we are detecting vulnerabilities in the Philippines.

Macroeconomic Developments

- **The U.S. has experienced better growth** than the Eurozone and Japan. The impact of Trump's trade tactics, including a strong dollar, has yet to take effect. The Fed has little choice but to keep going with another 100bps tightening; 2019 will reveal what's being sown. The rate hike was widely expected at September FOMC meeting, and implicit in the dot plot is a flat terminal funds rate of 3.25-3.5%. It reinforces the expectation of quarterly hikes through the end of 2019, with risks tilted to the upside for the Fed Funds rate.

- **Further escalation in trade tensions.** Uncertainties over U.S. – China trade tensions still dominate market sentiment. The "Made in China 2025" initiative[1] is at the center of the dispute. As expected, the U.S. announced the next round of tariffs on roughly $200 billion worth of Chinese products, to take effect on September 24th at a rate of 10%, rising to 25% in 2019. Trump reiterated: "if China takes retaliatory action against our farmers or other industries, we will immediately pursue phase three, which is tariffs on approximately $267 billion of additional imports." The measures announced to date looks set to push up U.S. core PCE inflation by around 0.1pp, and about 0.2% if the next round of China tariffs materializes.

- **China confirmed its retaliatory tariffs** on $60 billion worth of U.S. products, effective September 24th, covering over 5,000 tariff lines. China is robust enough to counter U.S. challenges and continue its managed deleveraging, thanks to its current account surplus and large FX reserves. Reflecting the lower initial tariff rate imposed by the U.S., China's rate will range from 5%-10%[2].

- While trade tensions rise elsewhere, the U.S. president and Japan's Prime Minister Abe agreed to negotiate a Trade Agreement of Goods (TAG), which will focus on the reduction of tax rates on agricultural products within the limits determined in the TPP11 (Trans-Pacific Partnership). It will also focus on seeking more access to the Japanese auto market for the U.S., who agreed not to impose tariffs on auto imports from Japan until negotiations are completed. The main risk to this negotiation is that it is limited and unlikely to materially reduce Japan's bilateral trade surplus with the US. As a result, auto tariffs could come back on the table even if an agreement is reached.

[1] Online. https://en.wikipedia.org/wiki/Made_in_China_2025

[2] Goldman Sachs: a "severe" trade war results in the S&P500 index dropping 25% (to 2200), generating over USD 6tn in market cap losses if the U.S. imposes 10% tariffs on all imports.

- A modest downgrade in Eurozone GDP growth forecasts for this year and next was matched by ECB hopes of a pick-up in core CPI inflation. As far as market expectations are concerned, the ECB expects to end its bond purchases at the end of next year, and the market expects the first rate hike in the fourth quarter of 2019.
- The next few weeks will be critical for European politics. Time is running out for the Brexit negotiations and the EU summit produced no breakthrough. We still believe that a deal will be reached, but key disagreements persist, most importantly over the Irish border. More immediately, the European Commission likely will reject the budget, and Italy will be vulnerable to rating downgrades. Downside risks are a weaker Euro and pressure to European peripheral bonds. The absence of fiscal union means that the Eurozone remains vulnerable to periodic debt and banking crises, with Italy now the main potential risk. The Italian 10-year bond yield rose to 3.45% though the 10-year BTP-bund spread is still some distance from the 500bp spread that occurred during the 2011 Eurozone debt and banking crisis.

Global Drivers

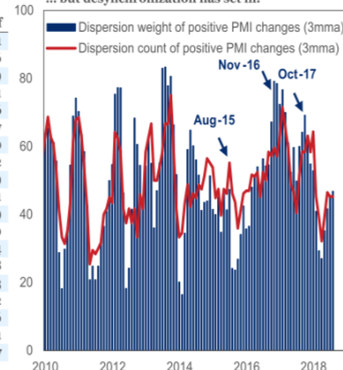
Global Growth

The latest batch of Chinese economic activity indicators for August presented a mixed picture, with fixed investment growth at a record low, while industrial production grew at a steady 6.1%. Chinese credit supply actually increased in the latest month and suggests that economic activity should benefit at some point.

Global growth is stable, ...

Change y/y (%)	2016	2017	2018f	2019f
Mature Markets	**1.6**	**2.2**	**2.3**	**2.1**
United States	1.6	2.2	2.9	2.6
Euro Area	1.8	2.4	2.1	1.9
Japan	1.0	1.7	1.2	1.1
Emerging Markets	**4.2**	**4.7**	**4.5**	**4.6**
Latin America	-1.3	1.2	0.6	1.7
Argentina	-1.8	2.9	-2.4	-1.0
Brazil	-3.5	1.0	1.1	2.2
EM Europe	1.6	4.0	2.9	1.9
Russia	-0.2	1.5	2.0	2.1
Turkey	3.2	7.4	3.0	-0.9
EM Asia	6.3	6.3	6.3	6.0
China	6.7	6.9	6.6	6.4
India	7.9	6.2	7.6	6.8
Africa/Middle East	2.9	1.4	1.5	2.3
South Africa	0.6	1.3	0.3	1.2
Saudi Arabia	1.7	-0.9	2.2	2.6
World	**2.6**	**3.2**	**3.2**	**3.1**
World (PPP weights)	**3.1**	**3.7**	**3.7**	**3.7**

Source: IIF



U.S. Monetary Policy

Inflation is at target, the unemployment rate is below target and falling, and yet the Fed Funds rate remains 100bp below the Fed's estimate of its neutral level. Most FOMC participants now agree that the Fed has some catching up to do, as the Fed Funds rate heads to 3.4% by end-2020. There is always the possibility that the Fed has to suspend its plans to tighten U.S. monetary policy should an escalation in the global trade war spill over into the U.S. economy and puncture the upward trend in U.S. equities.

Growth, not inflation, governs the Fed´s monetary policy. The more important question is when the Fed stops raising rates. Lining Powell's path to higher policy rates has been the intention of getting them back into line with the pace of real growth, regardless of whether inflation comes along or not.

High Commodity Prices

The oil market is in the hands of global politics. Oil prices remain elevated, and the impact of Hurricane Florence adds to worries of supply disruptions. The catalysts for this last rally appear clear: Iran exports have declined faster than expected, OPEC failed to deliver a commitment to increase production, while global growth (especially EM) expectations are stabilizing and China restocking is occurring. The market mood looks too pessimistic, but China's

managed deleveraging process and the EM woes constrain the fundamental support. Production from other OPEC producers and Russia are offsetting losses out of Iran so far. Thus, another supply catalyst beyond Iran (geopolitical tensions in the Middle East) would be needed for prices to break to the upside. The Iran embargo is unlikely to cause a supply shortage and we expect Brent crude oil prices to remain relatively stable in the $70-80/bbl range till end of 2019. EIA expects Brent spot prices will average $73/b in 2018 and $74/b in 2019[3].

EM Investment Outlook

EM looks oversold, but volatility is not over.

Despite good news on economic growth and a strong corporate earnings season, the market remained constrained, but there is not much of a contagion effect from Turkey and Argentina. Risk aversion on persistent trade climate has also weighed on EM equity valuations. According to the IIF, despite a sharp drop in portfolio flows, 2018 should see broadly stable non-resident capital flows to EM of over $1.1 trillion, just slightly lower than last year´s number.

On a valuation basis Emerging Market equities looks cheap, especially when compared to the U.S. The forward Price/Earnings ratio for the U.S. is 17.0, and only 10.9 for EM, which implies that EM is selling at a 35% discount to the U.S. The 29% discount to Developed Market equities in general is not much more than the historical 22% discount. The primary reason for investors allocating into EM is premium growth. Since the taper tantrum, EM macro fundamentals such as current accounts, reliance on portfolio flows and real credit growth have improved. EM EPS are also forecast to post premium growth over DM.

As expected, the rally in the dollar has pressured EM currencies, bond prices, and equities. Some EM economies face pressure in terms of poor macro fundamentals, such as high inflation, high twin deficits, exposure to dollar-denominated debt, and reliance on external funding (Turkey has external financing needs over the next 12 months of USD $240 billion). The sizable decline in EM currencies is pushing up inflation.

Risks

1. **Trade war escalation:** deeper and more prolonged conflict. Growing possibility that the U.S. – China trade war enters Phase III in 2019, resulting in tariffs on all +$500 billion of imports from China. Although China is likely to deliver policy supports, downside risks to 2019 China growth are increasing. The renminbi could weaken beyond 7, as China's current account moves into deficit and tariffs hit trade and GDP growth.
2. **Complacency?** The longest post-WW2 U.S. expansion: with the S&P 500 posting a new record high in September, healthy economic growth, optimism and confidence, it is only natural for investors to expect the good times to keep rolling. But, the U.S. economy could slow more than expected in 2019, and likely result in a **15% to 20% correction in U.S. equities**. Even though Emerging Markets are cheaper than an expensive U.S. market, if the U.S. falls, FM and EM will go down, just maybe less.
3. **Dwindling QE exposes EM macro fragilities.** The Federal Reserve is planning on increasing the federal funds rate once more in 2018 and 3 times in 2019. A decade following the Lehman crisis, the after-effects on the economy and the financial

[3] Online. https://www.eia.gov/outlooks/steo/

system persist. Economic growth in the major economies has been slow to recover. **Global debt is at a record high.** As U.S. interest rates continue to rise, there is growing concern that debt service and refinancing may become more difficult for vulnerable borrowers, particularly for hard currency debt. U.S. fiscal expansion is already resulting in trillion-dollar budget deficits (the August deficit was the highest deficit for the month on record) and a sharp escalation in the federal debt-GDP ratio to above 100%. The most significant tailwind for equities for years has been central bank Quantitative Easing programs that pushed trillions of dollars of liquidity into the global financial system. Although the Federal Reserve suspended its QE program in 2014, the European Central Bank (ECB) and the Bank of Japan (BOJ) increased their QE programs. Even after the Federal Reserve began shrinking its balance sheet in October 2017, the QE programs by the ECB and BOJ vastly exceeded the Fed's cutbacks so the global central bank balance sheet kept expanding. Importantly the year-over-year rate of change in the expansion of the central bank balance sheet in 2018 slowed materially, and with the exception of the U.S., has had an impact on global equity markets. In October, the Fed is increasing the runoff of its balance from $40 billion a month to $50 billion and the ECB is lowering its purchases from $30 billion to $15 billion, and is expected to stop its purchases altogether in January 2019. Although the BOJ has made no formal announcement, it has progressively lowered its monthly purchases so far in 2018. For years the rising tide of central bank Quantitative Easing lifted all boats. In 2018 the tide began to recede and the loss of added liquidity has become apparent in global equity and bond markets.

Equity Investment Outlook

Emerging Markets

For most of the year, currency volatility led by a strengthening U.S. dollar, political upheavals, higher energy prices, and fears of a global trade war has led to increased uncertainty in emerging markets. The third quarter was no different, as emerging market equities underperformed both U.S. and international developed markets. The MSCI Emerging Market Index (gross) was down -0.95%[4] for the quarter vs. the S&P 500 return of 7.20%[5] and the MSCI EAFE (gross) return of 1.42%[4].

From a country standpoint, Turkey, Greece, and South Africa were the worst performers for the quarter. Both Turkey and South Africa saw significant currency volatility, while Greece was hit with increased worries around its banking system. Top performers included the smaller countries of Hungary and Qatar, both beneficiaries of higher oil prices. Thailand, increasingly seen as a safe-haven during emerging market downturns, was also an outperformer.

From a sector standpoint, Energy, Materials, and Industrials were the strongest performers while Consumer Discretionary, Communication Services, and Health Care were the worst. The MSCI EM Value Index significantly outperformed the MSCI EM Growth Index for the quarter with

[4] MSCI

[5] Bloomberg

a +3.68%[4] return vs. -5.32%[4], due to the much higher Energy weight in the Value index.

Within our sector positioning, we began the quarter with a very low weight (5.3%) in Information Technology. By the end of the quarter, we had increased our weight to 11.5% through a combination of new purchases and adding to existing positions. While we are still under the MSCI EM Index weight of 26.9%[6] at the end of the quarter, we continue to look for new ideas in this sector. We have learned over the years to never let a good crisis go to waste, and the recent market volatility has given us an opportunity to buy many world-class companies at considerable discounts to their long-term intrinsic values. We have also maintained our overweight in the Energy sector, where we are now at 14% of the portfolio. The next quarter should see a continued support for energy prices, especially as rhetoric around Iran sanctions heat up. While spare capacity remains tight, the prolonged economic and humanitarian crisis in Venezuela, as well as renewed volatility in Libya and Nigeria may continue to worry markets.

From a country standpoint, we have increased allocations to Malaysia and South Korea, with the former showing stability after a surprise election result last quarter and the latter increasing economic ties with North Korea. Mainly because of worries around a looming trade war, the last quarter also saw underperformance in Chinese equities. We remain comfortable with our China positioning, and as mentioned in prior commentaries, a lot of our names in China are either domestic-demand oriented companies or companies in the energy sector. We have very little exposure to companies that may be directly impacted in the short-term by increased trade rhetoric.

For 3Q, the main worry for emerging market equities was the possibility of increased systemic risk in the form of currency contagion, as the quarter saw major declines in the Turkish lira, Brazilian real, South African rand, and the Indonesian rupiah. While equity prices were volatile as a result, the MSCI EM index finished only down -0.95%[7] for the quarter, which we would attribute to the counterbalancing positive effect of an increase in oil prices in many emerging market countries. Of the countries mentioned above, we are most interested in new ideas inside Brazil, where an upcoming election will be an important catalyst for very inexpensive equity valuations. We maintained our holdings in Indonesia and South Africa and even increased our weights in some Indonesian companies that were hit the hardest during the quarter. We are still not interested in Turkish equities and would prefer to wait on the sidelines until we see the magnitude of the upcoming recession and, more importantly, a sound policy framework around a cleanup of the banking sector. This is the third major crisis we have experienced in Turkey (the other two were in 1994 and 2001), and each time the market only rebounded after credible policies were announced to recapitalize the banks and clean up non-performing loans.

For 4Q, key risks will include ripple effects from a potential further devaluation of the Chinese renminbi, a near-term spike in oil prices that would cause fiscal pressure for countries that are net oil importers, rising global interest rates, election uncertainty (Brazil elections and U.S. midterms), and geopolitical risk (escalation of U.S. – Iran and U.S. – China tensions). Recent EM underperformance relative to U.S. equities

[6] MSCI EM Fact Sheet, 9/30/2018

[7] MSCI

has been the worst we have seen in many years. The rise in U.S. interest rates, a growing realization that the fiscal situation in the U.S. has deteriorated, and the potential for a U.S. mid-term election outcome that creates political gridlock all may help with a reversal of the recent EM underperformance.

Country Updates

China (Structural MW, Tactical UW)

Sovereign solvency is out of the question. Nonetheless, corporate defaults should continue to emerge.

China's economy is facing headwinds from the government's deleveraging efforts as well as from the trade conflict with the U.S. In order to mitigate the impact on the economy, the authorities have implemented targeted stimulus measures, which may not be enough to stabilize growth. Measures of growth such as electricity consumption, rail freight volume and bank lending, paint a picture of stability despite trade rhetoric.

The focus is on dollar-denominated debt corporate China has sold in recent years and, critically, how much of it will fall due next year and in 2020. Most of it comes from property companies that haven't hedged the currency.

China had its first current account deficit in 20 years. The trade war is accelerating a structural shift in the current account. In the near term, however, strong U.S. import demand suggests China's current account surplus will persist. Thus far, there is no evidence from the August data that the bilateral U.S. – China surplus is contracting. Assuming Trump's full tariff implementation on U.S.$450 billion of imports within six to nine months, China's current account will fall into a U.S. $50 billion deficit and the yuan could depreciate to beyond 7 by mid-2019. Many Chinese exporters have received orders until December 2018 but not beyond then. It appears U.S. buyers are waiting for the details of the expected tariff announcements before committing to 2019 purchases. Such behavior raises the prospect of rushed front-loading following the announcement of the second round of tariffs. Exports could then show stronger growth in Q4 2018 before falling sharply in Q1 2019.

FX reserves fell modestly in August, but are still strong. Large FX reserves provide strong buffers against shock events.

A wide range of regulatory reforms have reduced financial sector risks: shadow bank credit continues to contract, but at a slower pace (as regulators pulled back a little bit on "financial delevering") while bond issuance also accelerated. As a result, total social financing growth – a measure of broad credit growth – is stabilizing. The authorities' goal is "structural deleveraging," i.e. bringing shadow bank financing back onto the balance sheets of the commercial banks.

Argentina (Spec MW, Structural Sell)

Default averted until 2020.

The USD vs Peso moved to a peak of more than 40 from less than 20 in March. The IMF pledged a $50 billion aid package in June. When this record aid program didn't arrest the decline in the Argentine Peso, the IMF increased it to $57.4 billion through 2021 on September 26th. It is the largest loan to a single country in the IMF's history. Interest rates have soared to 60%, inflation is approaching 40%, and Argentina is headed for a deep recession. Country risk (measured by the EMBI) reached the highest level since January 2015, to later decreased back upon the announcement of a second IMF deal,

whereby Argentina will receive an extra US $7.1 billion. This means its entire credit line with the IMF will amount to US $57.1 billion. Export taxes were re-introduced and so primary deficit and money base growth will be zero. As per the IMF, "the combined effect of the fewer needs of financing for 2019 and 2020, plus the expedited disbursement and increase of funds provided by the IMF reduces and ensures the Treasury's sovereign debt program."

FX stability remains uncertain. The BCRA established a corridor with ARS 34 and 44 per US dollar, as a 3% monthly deval. Inflation targets have been scraped and the main tool will be monetary aggregates. Guido Sandleris, the new governor, signals more coordination between Treasury and the BCRA and less ad-hoc intervention. We expect currency markets to remain sensitive as uncertainty increases ahead of presidential elections next year.

Brazil (MW)

Political stability following elections should underpin a relief rally in November even regardless of who wins the election.

The preconditions for an upgrade would be to rebalance public sector debt dynamics and boost potential GDP growth. The economic rebound has remained disappointing, for both, sales and employment. An indicator of the poor health of the economy is the falling demand for new consumer loans. Likewise, the number of consumers with past-due debts increased for the 11th consecutive month in August and nearly 63 million Brazilians have debts in arrears. With unemployment still at 12.3%, demand for credit is likely to remain weak, and bad debt levels should remain high. Market forecasts seem too optimistic and will likely lead to disappointment. Consensus real GDP growth expectations for 2019 and 2020 are both at 2.5%. The market appears to be discounting a significant improvement in the relative profitability of Brazilian assets, but we are skeptical. As a proportion of Bovespa market capitalization, non-resident ownership stands at 50%, up from 46% in the last twelve months.

A USD/BRL 4 appears more consistent with the rest of EM, and Brazil's carry trade at 900bps is the most attractive among mainstream EM, and is at the highest level in 12 years.

Turkey (Spec MW, Structural UW)

Raised interest rates stabilized the TRY.

The economy is already slowing down and showing positive external results during the last two months. The undervalued currency rebalanced its economy away from consumption and debt, towards exports and (eventually) investment.

The government published its three-year macro and fiscal framework, called the New Economic Plan (NEP) envisaging slower growth in 2019-2020, and gradual improvement in the external shortfall, as well as a degree of fiscal consolidation next year. Public debt is hovers around 30% of GDP.

The story has changed dramatically from what it was. The Turkey of the past was a Euro convergence play, a key NATO ally, and a fast growing nationalist democracy. Today, it is none of those things.

India (UW)

Rupee weakens again despite government's patchwork measures. The IMF warned that India cannot reliably count on global financial market flows to fund a current account gap wider than 3% of GDP.

Panic over the falling rupee is starting to grip Indian policymakers. This was evident by the list

of measures that Finance Minister Arun Jaitley announced in September to curb the widening current account deficit, such as cutting down “non-necessary” imports and removing the 20% exposure limit on investments by foreign portfolio investors in debt to a single corporate group. The government also eased rules for manufacturing firms borrowing from overseas as well as for banks raising rupee-denominated overseas bonds, and said it will review mandatory hedging conditions for infrastructure loans through external commercial borrowings.

India is the world’s third largest importer of oil and relies on oil imports for 80% of its oil consumption. Its economy and central bank is dealing with the double whammy of a weak currency and the 23% increase in oil prices in 2018. When adjusted for the decline in the Rupee and rise in oil, India is paying 40% more for oil than when 2018 began.

Economic Affairs Secretary Subhash Chandra Garg said that the measures will have an impact of USD $8–10 billion, but they appeared like patchwork. Details on how exactly the government will curb imports were unclear, but restrictions on gold, mobile phones and other high-end electronic goods are possible. Apart from the elevated oil prices that are expanding the CAD, non-oil import growth too has been high, leading to concerns of a structural widening of the trade gap.

Jaitley also reiterated the government’s commitment to stick to its FY19 fiscal deficit target of 3.3% of GDP, but we remain wary of fiscal slippages in the current political environment with key state elections due at the end of 2018 and the next national elections scheduled for April–May 2019. The rupee weakness is exacerbating inflationary pressures already taking root in the economy, and the government faces the tricky choice of either cutting excise duties on fuel and risking fiscal slippage, or allowing inflation to climb.

We thank you for your continued support.

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