Quarterly Market Letter

September 2019

The Hunt For Yield Is Still On In Emerging Markets

Macroeconomic Developments

- **EM environment** improved with the easing of the U.S. – China trade and European political tensions (no elections in Italy and no "non-deal Brexit") and confirmation of the ECB's QE. Trump is keeping twitter to a minimal, newswires report U.S. – China are negotiating an interim deal at the deputy level while plans remain for a high-level meeting in October. While the risk aversion scenario implies a soft tone in EM assets in the near term, DM yields reached new lows: UST yields fell to their lowest level since 2016, bonds yielding less than zero now make up more than a quarter of the investment-grade universe and bond yields should remain low for even longer. Hence, QE, which was supposed to be temporary, has become a 'permanent' debt monetization. Investors are assigning a higher probability to the 'secular stagnation' hypothesis of low growth/recession and disinflation. Thus continuing their search for yield, providing a buffer against downside risks to near-term EM performance.
- After the **U.S. Federal Reserve** cut interest rates for a second time this year in mid-September (and most likely again in October), emerging-market watchers shifted their focus to the trade war. The imposition of tariffs has hit growth in emerging markets, prompting EM authorities to cut rates massively. The big macro picture looks like one of secular stagnation for the major economies, with high debt levels that act as a drag on economic growth. The World Trade Organization reduced its global trade-growth forecast for 2019 to the weakest level in a decade, while the International Monetary Fund expects a more significant economic slowdown than it did three months ago.
- **Geopolitical threats:** Geopolitical shocks (drone attacks against Saudi oil facilities, the U.S. – Iran relationship) have hit business sentiment but are being tempered by a broad-based shift to easier policies. The U.S. House announced that it would officially launch an impeachment inquiry against Trump (even if the odds of an actual removal from office remain low). In the UK, the Brexit agenda has intensified. On the 70th anniversary of China, violent protests took place in Hong Kong. Meanwhile hope has increased for U.S. – China trade talks.
- **U.S. – China trade tensions**: The ever-escalating trade war between the U.S. and China has become a "new normal" in the international trade scene.[1] The U.S. and China

[1] Since January 2018, the U.S. average import tariffs on Chinese goods have risen from 3 to 23 percent. Meanwhile, China's retaliatory import tariffs on U.S. goods rose from 7 to 24 %.

are back to the discussion table in early October. The forecast is that all existing (and announced) tariffs will stay in place and that negotiations drag into next year. Incentives are aligned to come to some form of agreement between China and the U.S. Risks rise if this is not the case.

- For the U.S. 1) Companies' investment plans will continue to halt 2) Consumer confidence numbers in the U.S. may be affected 3) Markets may react negatively 4) A far-left U.S. presidential candidate could win (although there is little evidence yet that equity investors are getting concerned about the Elizabeth Warren risk factor).
- For China, the risk of no deal could mean 1) Deceleration will continue to weigh on growth, as roughly 30% of the economy is tied to trade 2) Hong Kong spillover 3) If Trump wins reelection, Chinese economic growth continues to slow given trade impasse from tough negotiation.

- There is an estimated $240 trillion of debt worldwide, roughly 240% of global GDP, and too much of this debt is denominated in dollars, due to the greenback's role as global reserve currency and the deep liquidity of U.S. capital markets.[2] This means the prospects for all asset classes have become a function of U.S. dollar liquidity and direction. If the dollar rises too much, the strain in the system increases: not only for U.S. exports, but also for the emerging market with its high dependence on USD funding and export machines. The strength of the U.S. dollar has also recently been shown to track global economic uncertainty indices. Increased uncertainty incentivizes investors to find safer havens and the U.S. dollar and U.S. debt markets have a traditional role in this regard. Additionally, relative changes in central bank balance sheets are also a driver of currency movements. When the Fed previously implemented its QE programs, the U.S. dollar depreciated but then recovered. A weaker USD could buy some time for the global markets, it would not offer a structural solution, but represents the easiest quick fix and the one likely to face the least political opposition.

- **Brexit:** The Brexit deadline is upcoming as is a likely election. Risks of a damaging no-deal Brexit remain elevated. Boris loses a battle, not yet the war. PM Johnson is pressing to hold a "people versus the Parliament" general election, and polls currently point to an outright majority for the Conservative Party. However, opposition parties appear increasingly likely to delay an election until November, facilitated by the EU agreeing to extend Article 50 to January. Given Johnson's commitment to "no deal if necessary" is not in doubt, a November election would force the PM to resign if he wishes to avoid requesting an extension.

Global Drivers

Global Liquidity

A total of 16 central banks have cut rates in 3Q19 and even more cuts are expected in 4Q19. Although the U.S. economy and China's exports continue to look healthy, world growth continues to gradually decelerate (strong USD, weak commodities). Hence, given the absence of inflationary pressures, in response to concerns on growth and geopolitical headwinds, interest rates are falling most everywhere. In particular,

[2] Saxo Bank

the Fed and ECB are set up for a renewed QE and confirmation of rate cuts. The Fed is expected to cut FFs another 25bp, along with a downward revision in its dot plot projections. The ECB announced an open-ended QE, easing further by year-end, and the BoE cutting rates in 1Q20. The FOMC is also likely to cut the interest rate on excess reserves (IOER) and announce Permanent Open Market Operations (POMOs, alternatively QE-lite) as a way of increasing banks' excess reserves and, in turn, mitigating the dollar repo liquidity squeeze.

USD/CNY

USD/CNY moved above 7 during August, taking a toll on risk assets. President Trump has voiced increasing concern that a strong dollar is damaging U.S. competitiveness. And after the U.S. decision to label China a "currency manipulator", currency has become another front in the U.S. – China trade war. If the yuan falls significantly further against the dollar, it could spread to other countries and lead to further deterioration of the global economy. If the yuan continues to slide, commodity exporters will be the most negatively impacted. However, USD-CNY looks capped at just below 7.10 unless there is another round of tariff escalation.

Commodities

Oil prices spiked following an attack on a Saudi oil refinery on September 14th, but the rise in prices proved to be short-lived. Slower global growth has weakened the outlook for commodity demand, although supply constraints should limit the downside to prices. Metals supply is constrained by a lack of mining investment in recent years, while significant cuts by OPEC and geopolitical developments are impacting oil supply. Trade tensions, weather and African swine flu have impacted the supply-side for many agricultural commodities.

EM Investment Outlook

Potential rebound in appetite for EM risk. A looser monetary policy among major central banks may push investors toward riskier assets over the rest of the year. Expectations of further Fed rate cuts boosts bond buying.

The hunt for yield is still on in emerging markets. There has been a recovery in emerging market sentiment thanks to 'goodwill' gestures from both China and the U.S. ahead of the upcoming trade talks in early October. Following China's announcement of exemptions to tariffs on imports from the U.S., President Trump announced that the U.S. would delay the next round of tariffs from October 1st to October 15th.

The appetite for EM risk, in particular local currency, could improve further in the near term given (1) a more supportive global liquidity and monetary policy backdrop, (2) a stable CNY, and (3) light positioning in EM assets.

As global growth slows, trade tensions escalate, geopolitical risks fester and central banks pivot to lower rates, there had been a flight to safe haven assets, including gold. Although the direction of global growth is pointing downward, but investors still have to find higher yields somewhere.

Global growth is likely to remain below potential as the stall in business spending is projected to spill over to consumers through labor market softening. Generally healthy private sector fundamentals (limited household leverage, manageable interest burdens, solid income gains, lack of over-extended durables spending) and active policy support are expected to contain the drags. This environment lends credibility to the "secular stagnation/Japanification" hypothesis (as seen with 2-10 year inversion of the UST yield curve and negative rates in Europe and Japan). That is why investors in the fixed income realm continue their search for yield/spread. Conversely, equities remain more attached to tariff/trade war rumors and tweets, Brexit, geo-politics and other news.

Historically, the U.S. yield curve has inverted ahead of every single recession. The U.S. yield curve inversion is an added risk to EM equities, but one that does not require urgent actions. Investors should not be in a hurry to reduce EM equities, as back-testing data indicate that MSCI EM has peaked with 1-2 years of lag to this indicator. EM's share of global mutual funds' assets under management is only 7.3% vs historical average allocation of 9.2%.[3]

In regards to equities, expectations of looser monetary policy have boosted cyclical equities in 2019 so far in both mature and emerging markets.

Emerging Market Equities

3Q 2019 Synopsis

The 3rd quarter of 2019 was negative for emerging market equities, as the asset class relatively underperformed both U.S. and international developed markets. The MSCI Emerging Market Index (net) was down -4.25%[4] for the quarter vs. the S&P 500 return of +1.70%[5] and the MSCI EAFE (net) return of -1.07%.[4] The portfolio outperformed the MSCI EM Index with a return of -3.12% for the quarter and continued to maintain its overall YTD outperformance on both relative and absolute terms.

Attribution

Of the +1.03% of outperformance of the portfolio against the MSCI EM Index for the quarter, the main drivers by sector were:

- **Underweight to Financials: +1.30%**
    - Portfolio weight of 11.7% vs. index weight of 24.7%.
    - Uncertainty around the direction of global interest rates and signs of deflationary pressures in the global economy led to a downturn in the sector.
    - The top performer was National Bank of Greece (+11%).
- **Underweight to Materials: +0.84%**
    - Portfolio weight of 5% vs. index weight of 7.3%.
    - While the overall sector was negative for the month, precious metals stocks were outperformers.
    - The key outperformer was South Africa-based Harmony Gold (+25.1%).

From a country standpoint, the main drivers were the:

- **Overweight to Thailand: 0.5%**
    - Portfolio weight of 6.7% vs. index weight of 2.9%.
    - Thailand was seen as a safe haven during a volatile quarter for EM equities.
    - The top performer was Thai Beverage (+4.3%).

[3] JP Morgan

[4] MSCI

[5] Bloomberg

- **Overweight to South Africa: +0.5%**
    - Portfolio weight of 7.6% vs. index weight of 5.4%.
    - The key outperformer was South Africa-based Harmony Gold (+25.1%).

From a stock-specific standpoint, the key outperformers were Harmony Gold (+25.1%), China Oilfield Services (+20.8%), and Taiwan Semiconductor (+19.5%). Underperformers were China-based Anton Oilfield Services (-24.6%), China-based iQiyi (-21.9%), and South Africa-based Sasol (-20.5%).

Market Outlook

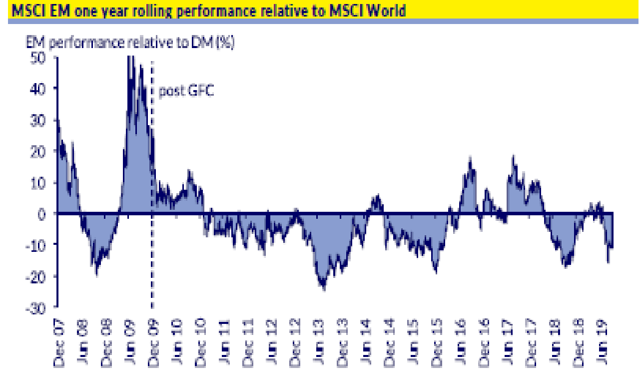
News flow around U.S. – China trade sanctions continue to dominate market sentiment in 3Q, as do worries on further weakening of global growth expectations as a result of a protracted conflict. Both sides have much to lose if a deal does not get done, and both sides have faced a weakened negotiating position over the past quarter: China with recent unrest in Hong Kong and the U.S. with potential impeachment proceedings. The trade war has also not seen the intended effect that the U.S. originally wanted; instead of a narrowing of the trade deficit with China, it has actually widened since 2018. As a result, we would expect a makeshift deal to take place in the near-term that would enable all parties to save face.

3Q also saw the U.S. Fed cutting interest rates, the first cut since 2008. The Fed appears to be acting out of concerns on the knock-on effects of the trade war and the impact of slowing global growth on the U.S. economy. Chairman Powell's comment on a 'mid-cycle adjustment' disappointed markets, as consensus had formed over further rate cuts to year-end. Amidst this backdrop, the International Monetary Fund cut its forecast for global growth to 3.0% for 2019, down from the last forecast of 3.2% in July.

We would not be surprised if there are further short-term cuts to these global growth estimates. Economic data from many regions remain weak, and many parts of the developed world are also experiencing deflationary forces. India, one of the bellwethers for global growth, has been quietly ratcheting down GDP growth expectations from 5.5% to 5%. Europe has also seen a downturn in manufacturing data, and sentiment has been influenced by the uncertainty around Brexit negotiations.

While it may seem counter-intuitive, we believe that now is a great time to be looking at EM equities specifically because of this backdrop. First of all, EM have significant underperformed its developed counterparts since the Global Financial Crisis of the past decade, and especially since the U.S. has escalated the potential of a trade war since last year. As a result, relative valuations are the most attractive we have seen in years. This implies that the market has already priced in a very negative environment and not much has to go right from here for EM to begin outperforming. From a policy standpoint, EM central banks also have more room to cut and could begin a multi-year easing cycle that would be positive for equities.

MSCI EM one year rolling performance relative to MSCI World



Note: Rolling 1-year USD total return, EM minus DM. Source: CLSA, Factset

We also believe that political risk is somewhat lower than EM in aggregate than in developed markets, specifically due to Brexit and political instability in the U.S. With the exception of Argentina in 4Q, very few large elections loom in the horizon. Over the past year, India, Indonesia, and Brazil all had elections that were net positives for its equity markets. Administrations in China, Russia, and South Korea are entrenched for the near future. The wildcard will be the Chinese administration facing its toughest crisis to date in Hong Kong.

From a country standpoint, Brazil has been quietly pushing through much-needed pension reform through its notoriously difficult legislative process, and we expect its equity market to respond accordingly. Greece has been emerging from a decade-long recession and has attracted high-than-expected foreign capital flows into its debt and equity markets. The Philippines and Vietnam both show some of the highest GDP growth rates in the world, which should continue given recent changes to the global supply chain.

From a sector standpoint, we continue to overweight Energy. It has been our long-held thesis that the markets are under-appreciating the geopolitical risks around industry spare capacity, and the recent attack on Saudi Aramco's facility has confirmed this fear. We do not see a de-escalation here, especially as the U.S. has been maintaining a hawkish stance against Iran. We are also 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. The underperformance of Chinese technology names relative to its U.S. peers has especially been striking; we believe this is due to correct given strong earnings growth from the former and increased regulatory worries around the latter. 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 over time.

From a risk standpoint, we are monitoring the news that the U.S. administration is looking into potential capital controls on Chinese equities listed in the U.S., either through a forced delisting of Chinese ADRs from U.S. exchanges and indices or limits on how much U.S. investors are able to own of these securities. While the timing and magnitude of these potential actions are unknown, the threat itself adds an extra layer of uncertainty to U.S.-listed Chinese ADRs. We believe such actions could be extremely harmful to U.S. investors, as they would lose access to many innovative companies that are at the leading edge of many important global trends: artificial intelligence, quantum computing, autonomous driving, and the convergence of 5G technology with IOT (Internet of Things), to name a few. Chinese companies have significantly outspent global peers in research and development, and we are seeing the fruits of it in recent company results. Chinese tech companies, for example, have some of the highest earnings growth rates in our investment universe. It would be difficult to find global replacements for this growth, especially given the increased risk of a slowdown in developed markets.

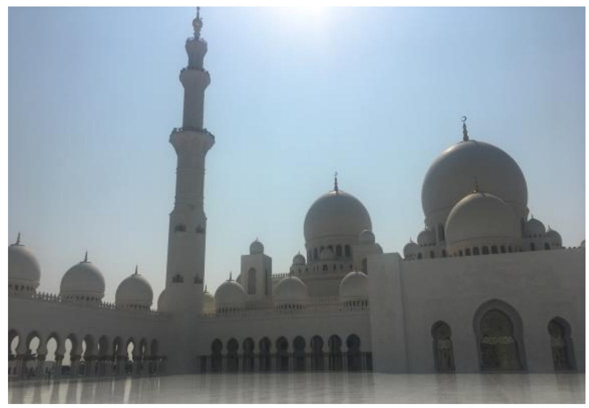
Travelogue

Given our longstanding adage that we should not commit capital to countries where we are unwilling to visit, we recently completed research trips to Hong Kong, mainland China, and the United Arab Emirates.

The focus from many Chinese companies, especially in the technology sector, was "import substitution" i.e. substituting what is currently imported in their supply chain from the U.S. with their own manufactured components or chips, thus becoming more self-sufficient over time. We witnessed some of the protests in Hong Kong: there is no easy solution, as the goals of the protesters and the Chinese government are diametrically opposed. The Hong Kong economy has been suffering from lack of Chinese tourists and less activity overall, which is impacting services demand. We also visited the Hong Kong /China "Greater Bay" region, an ambitious plan to link Shenzhen (the Chinese equivalent of Silicon Valley), Macau (Las Vegas), Hengqin Island (Orlando) and Hong Kong (New York City) and have them all accessible to each other within an hour.

Hengqin Island, which is connected by a bridge to Macau, is especially interesting as a master-planned tourist and leisure destination designed to support overflow from Macau. It is a pet project of President Xi, is three times the size of Macau and already has many amusement parks and the largest aquarium in the world. As Macau is primarily for gaming, it is running out of space and does not have enough hotel rooms to meet demand. China has identified Hengqin Island as a solution, which is a five-minute ride over a bridge and is considered part of mainland China. As several larger resorts are being built, Hengqin Island should support Macau for years to come as well as serve as its own tourist destination.

We also visited with many Middle Eastern companies while attending a conference in the UAE. The implications of the recent attack on the Saudi Aramco oil facilities was a key topic, with consensus that heightened volatility and increased risk around global energy supply lines are here to stay. The recent protests in Egypt against alleged corruption in the Sisi administration was also heavily discussed, as the Egyptian equity markets have been a bright spot in the region and may correct in the near-term if the protests continue. On the positive side, the recent inclusion of Saudi Arabia in the MSCI EM Index this year (with an eventual large index weight assigned to the potential IPO of Saudi Aramco) and the potential inclusion of Kuwait in the MSCI EM Index next year, all are indicators of renewed foreign interest in this region.



The primary focus for our research docket in 4Q will be new names from these visits, as well as new ideas in Latin America. Based on our initial screening results, there may be some attractive company-specific opportunities in Latin America that investors are presently under-appreciating.

Country Updates

China (UW)

Data may continue to show economic weakening, but there are signs of stabilization too.

Following the slight improvement in the official manufacturing PMI for September, the private gauge is expected to show it stayed above the 50 level. Services PMI, one of the remaining bright spots in the economy, is forecast to have held up.

China's foreign-currency holdings fell last month to $3.1 trillion, the lowest level since February, the central bank said on its website.

Argentina (UW)

Government introduced capital controls in the FX market, announces intent to re-profile debt.

Argentine primary elections were held on August 11th. Opposition candidate, Alberto Fernandez, won by a surprising 16% difference, shocking financial markets and leading to an increase in the country's risk premium and a peso selloff. Following difficulties in rolling over short term maturities and a depletion in reserves, authorities announced their desire to engage in a 'voluntary' re-profiling of external and local law bonds and the imposition of capital controls and ask for more favorable IMF repayment terms.

Given the upcoming election on October 27th, any discussion of external and local law bonds will likely need to wait until a new government is in place.

Fernandez said that the country would meet its obligations in full if given time to revive growth and that Argentina should be able to replicate Uruguay´s voluntary debt renegotiations in 2003, which is widely seen as a positive model.

MSCI opens consultation on "replicability" of Argentina Index and "appropriateness" of its EM status. Consultation after imposition of capital controls by government, closing on Dec. 13th with results on or before Dec 31st. If reclassification takes place, likely to happen in 1-2Q 2020.

Peru (MW)

Constitutional crisis boosts political uncertainty, raises depreciation risk.

Armed forces side with the president, boosting his chances of victory.

The crisis erupted after President Martin Vizcarra called on Congress to pass a law to depoliticize the selection of judges for the Constitutional Tribunal, which interprets the constitution. The measure was a "confidence vote," meaning that if it was rejected, Vizcarra said he would be able to dissolve the legislature. Congress delayed the confidence vote, but went ahead and appointed a new judge to the tribunal. Hours later, Vizcarra dissolved Congress, which then voted to declare the presidency vacant for incompetence and to suspend Vizcarra for a year. Mercedes Araoz, Vizcarra's vice president, accepted the presidency, but as demonstrations began on the streets of Lima, top officials of the armed forces met with Vizcarra and declared their allegiance to him.

Under Peruvian rules, once Congress is dissolved, it is replaced by a "Permanent Commission" of top members from each party. The Permanent Commission can't legislate, but can only act as an oversight body to ensure the continued functioning of the democratic system. The hydrocarbons bill will have to await the installation of a new Congress next year.

Brazil (MW)

Economic activity remains challenged. Privatizations to keep investors´ interest.

Data on the Brazilian economy continues to show a very slow recovery. Well behaved inflation dynamics allowed a 50 bps cut from the COPOM, putting rates at a new historical low of 5.5%, with more cuts to come. The social security reform is almost done and the new Telecom Law should allow for new investments in the sector.

Mexico (UW)

Easing bias supports the market, but activity continues to falter.

Activity continues to disappoint. Disinflation remains, with the headline coming in at 3%. While core remains unchanged, Banxico went ahead with a 25 bps cut. The federal government presented the 2020 budget proposal, showing a marginal increase of the debt burden from 45.3% to 45.6%, oil production of 1.95 mbpd and a primary surplus of 0.7%.[6]

Current account deficit fell considerably during the first half of 2019 in comparison with the same period of the previous year. This was mainly due to the bigger surplus in the non-oil goods balance.

Egypt (UW)

Protests and a vulnerable EGP.

Egypt's central bank trimmed its key interest rates by 100 basis points on Sept. 26th, its second cut in as many months, after inflation fell further and as central banks globally ease monetary policy.

The current account deficit widened USD 2.2bn in 2018/19 but robust tourism revenues and record export earnings saw the pace of deterioration slow in the final quarter. FDI remained weak, falling to its lowest level since 2014.

Turkey (MW)

Positive macro data releases. The economy recovered and beat forecasts in 2Q19, as GVT prioritizes growth. Lira to outperform in the near-term, but the medium-term outlook remains challenging.

Since the June local election re-run in Istanbul, sentiment has improved and markets have turned cautiously optimistic, allowing the central bank to act more decisively. Inflation decreasing faster than expected. The Central Bank took an aggressive easing approach, cutting the rates by 750bps in the past two months - albeit strongly pressured by Erdogan. Sanction fears regarding the purchase of anti-aircraft missiles from Russia has eased, although remains. Sovereign debt remains low and FX reserves appear sufficiently large to cover external debt repayments.[7] On the other hand, fiscal deficit has significantly increased to 4.0% of GDP.[6]

The government published its three-year macro and fiscal framework, called the New Economic Plan (NEP). The government envisages a very strong rebound in growth to 5% next year but does not expect acceleration in inflation or a sharp widening in the external shortfall, even though these imbalances have historically accompanied high growth rates in Turkey.[6]

With two potential political formations competing with the AKP, political tensions are likely to remain high and there is an increased risk of elections being held before 2023 (general and presidential elections need to be held simultaneously under the constitution). Still, the 10pp fall in President Erdogan's approval rate to 44% in less than a year should reduce the likelihood of earlier elections, at least until the economy recovers on stronger footing.

[6] Credit Suisse

[7] https://twitter.com/IIF/status/1175111187580821505?s=20

Vietnam (OW)

Growth expanding at 7%+, benefiting from trade redirection.

Thanks to strong and sustained FDI inflows, manufacturing capacity has expanded, contributing to strong export performance. In particular, Vietnam's exports to the U.S. jumped sharply this year.

We thank you for your continued support.

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