UBP

UNION BANCAIRE PRIVÉE

INVESTOR INSIGHTS

Emerging Reflation

Monthly Report | December 2016

- *The outlook for Emerging Markets (EM) has changed with Donald Trump's election victory. The global growth outlook has improved but interest rate risk has increased.*
- *Despite this, EM countries have stabilized since commodity prices bottomed. Stimulus can come from fiscal / FX policy even if monetary policy is now constrained by capital flowing back to the G7.*
- *Bonds have performed well in 2016 but rising US long-term yields call for a more discerning asset allocation. Long-dated bonds should be replaced with shorter-dated, particularly corporate bonds.*
- *EM earnings have not revived as hoped for, but equities are still cheap. A small underweight in Asia and a tactical overweight in Russia are preferred. Cyclicals, financials, healthcare and exporters look good.*

Emerging markets (EM) have sold off modestly since the election of Donald Trump as US President-elect. Investors are trying hard to assess his impact and whether US interest rates will now rise faster than expected. As actual details of his proposed policies are patchy, periods of volatility are likely over the next few months. While some parts of the EM universe are now vulnerable to rising US interest rates, we believe that equities and short-dated corporate bonds will continue to offer appealing value in 2017. Longer-dated bonds may be vulnerable to inflation, but reflation is good for cyclically sensitive equities.

What has changed in EM…

Since September, the reasons for believing that EM countries have a better outlook have not changed much. Commodity prices are still rising and global growth forecasts have been revised upwards, particularly after the US election. A more nuanced view on policy is required though. Faster growth and higher inflation expectations globally mean less room to cut local interest rates while a combination of weaker currencies (already happening) and more fiscal measures (credit ratings permitting) should help EM countries to bolster growth.

Unlike September, when positives were mostly from inside EM themselves, two external developments have come to the fore. Long-term US interest rates have risen sharply and hurt returns in EM as some capital has returned to the US and Europe. There is also the threat of US trade tariffs or immigration restrictions. The first of these is having a direct impact on financial markets and could last for a while. It is far too early to tell how the second will play out.

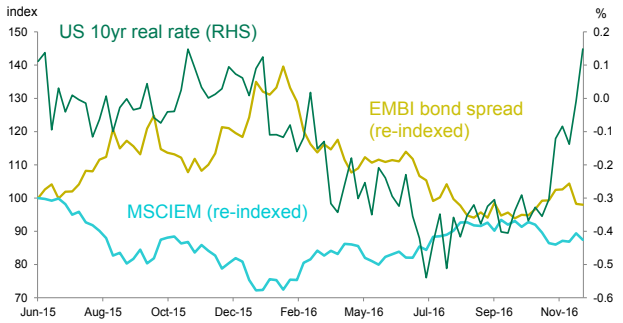
….. and what does it mean for investments?

The most sensitive EM asset classes to these US developments are longer-dated bonds and currencies of countries with financial markets that have particularly active foreign participation (page 4). Mexico stands out as the most vulnerable market in Latin America. In Asia, Indonesia and Malaysia have bond markets with large foreign participation. Turkey has the most sensitive market in Eastern Europe due to its large current account deficit. All will offer great value if post-election fears prove to be short-lived.

Nevertheless, from a tactical perspective long-dated sovereign bonds are expected to lose ground as US yields move higher. We prefer investment grade or high yielding emerging market sovereign and corporate bonds which are less sensitive to rising US bond yields and inflation. Moreover, spreads over US BBB-rated bonds still offer a substantial yield pick-up in US dollar terms.

Equities retain good value at these levels, particularly after EM currencies have sold off. Price-to-earnings and price-to-book discounts continue to compensate investors. Earnings disappointments in Asia favour a small underweight position. Attractive valuations, higher energy prices and the probability of an improved Russia-US relationship allow for a tactical overweight in Russian equities. Across EM we expect cyclicals, financials, exporters and healthcare to be the strongest performers.

US real rate moves & EM asset market response



As at 16 December 2016 Source: Bloomberg

- *Growth in emerging nations continues to benefit from higher commodity prices and a widening growth differential that makes them attractive investment destinations.*
- *Since the summer, interest rates cuts have continued. We expect that currency weakness and looser fiscal policy will be preferred to previously expected interest rate cuts in 2017.*
- *EM countries are much less sensitive to debt crises than 10-20 years ago but there is a risk of some trade-related volatility as President-elect Trump's period in office draws near.*

Since the summer EM central banks have continued to reduce interest rates and boost growth prospects. More fiscal stimulus from the US, a better growth outlook from Europe and signs of recovery even in Japan have all helped to push up commodity prices and prospects for global growth. This is commonly referred to as 'reflation'. At the same time, the recent rise in the US long-term interest rate has reversed the flow of foreign investment into EM and currencies have sold off as investors have converted their local currency-denominated assets and investments into US dollars.

Currency depreciation preferred to recession

In the past this latter development would have been a warning sign. Fortunately, there is an important distinction between now and 10 or 20 years ago when EM central banks tried to stop currencies from falling as capital returned to home markets in the G7. Then, corporates owed large amounts to foreign creditors and many countries ran sizeable current account deficits. As capital left, EM countries didn't have the foreign reserves to offset selling of their own currencies. Currency depreciation rapidly increased the cost of servicing foreign debts and insolvency ensued.

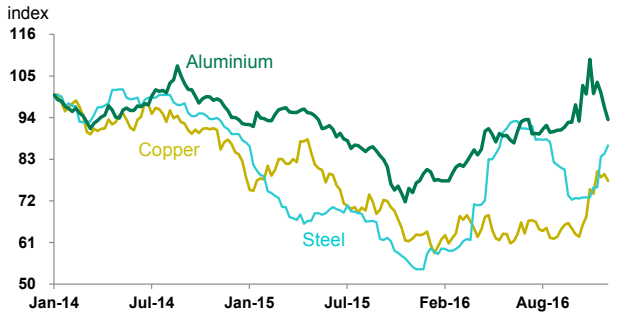
This time around, foreign reserve levels are higher and authorities have been more willing to allow currencies to take the strain of adjusting to a rising US dollar. The alternative would be either increased domestic interest rates or a tightening of fiscal policy. Both would risk pushing EM economies into recession.

Only two EM countries have tightened monetary policy since the summer (Mexico and Turkey). Both have extreme sensitivities to US politics and bond yields. For the remaining countries the outlook is more comfortable, provided that real US bond yields do not continue to rise rapidly from here. Commodity prices continuing to rise, commodity country growth forecasts being revised up and faster US growth are traditionally good for growth in Emerging Markets with large export sectors. EM countries still have better fiscal stimulus options than their G7 counterparts.

Protectionism is just a threat

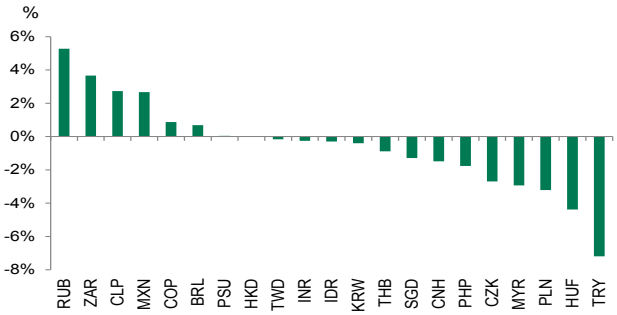
The big known unknown for Emerging Markets is protectionism (or US economic isolationism). President-elect Trump has withdrawn from the Trans-Pacific Partnership (TPP) which would have reduced tariff barriers across much of Asia Pacific (although China wasn't part of TPP). He has also threatened to raise tariffs, particularly against China. South East Asia and Korea are the most exposed to global trade. The larger EM countries are much less reliant on trade than commonly perceived.

Industrial metals prices



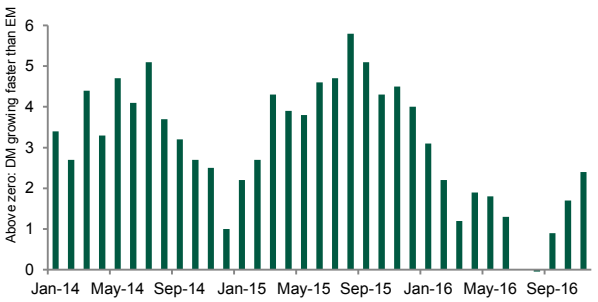
As at 16 December 2016 Source: Bloomberg

EM FX: One month change v US dollars



As at 16 December 2016 Source: Bloomberg

DM-EM PMI differential



As at 16 December 2016 Source: Bloomberg

FIXED INCOME

- *US inflation and rising long-term yields are a headwind for EM bonds with long maturities, even if economic growth momentum is rising.*
- *Emerging Market corporates with short-term maturities still represent good value as the spread over US benchmark BBB yields has widened.*
- *With only some exceptions, local currency government bonds are no longer supported by potential rate cuts and have increased embedded FX risk.*

Rising yields on US long-term government bonds are a headwind for hard currency EM bonds with longer maturities. Shorter-dated bonds are preferred as their prices are less sensitive to movements in US yields and inflation. Also, EM bonds denominated in local currencies are not favoured. The US dollar's recent appreciation will limit many of the cuts in EM interest rates that were expected at the end of October.

Short duration preferred over long

Since the declaration of Donald Trump's election victory on 9 November 10-year US government bonds yields have risen by 0.70% to stand at 2.56%. The JP Morgan EMBI Diversified global bond spread over US BBB-rated benchmark bonds has risen from 354 basis points (bps) on 9 November to 368bps. The 5-year average is 349bps and the 10-year 363bps. EM debt is not expensive; neither is it cheap.

From here, UBP believes the probability of US yields moving higher is greater than the chance that they will fall. Trump's ambitious proposal of new spending and tax cuts will probably be financed by issuing new treasury bonds. As US labour markets are close to full employment this new fiscal programme may add to the already quickening pace of US inflation via faster growth.

Unless Trumps' fiscal stimulus package is smaller than expected, or inflation fails to rise further, the risk remains that long-term US bond yields move higher than their current level (they yielded 1.85% on 8 November). Even if global growth is unchanged, this prospect of rising US yields makes EM bonds with shorter maturities a better risk-reward allocation.

Note also that the charts to the right show that high yielding corporate bonds have not sold off as much as investment grade bonds since early November. EM corporate bonds have shorter maturities on average than sovereigns and EM high yield bonds have shorter maturities on average than investment grade corporates. Higher yielding corporate and sovereign bonds with short maturities should at least form part of an EM fixed income portfolio.

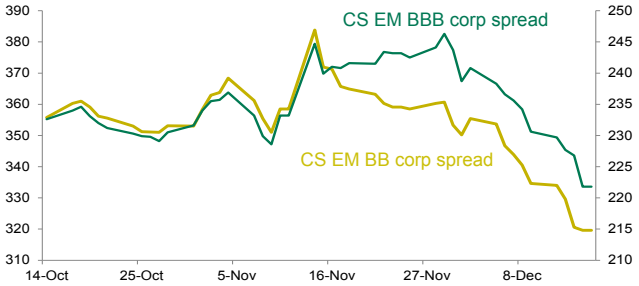
Local currency bonds have FX risk

A number of countries in Emerging Markets have room to cut interest rates modestly, for example India, but options are now limited. As was the case during the sell-off in 2013, the risk to local government bonds is greatest in countries with large current account deficits and high external debts (e.g. Turkey). Short-term interest rates, adjusted for inflation, are above 1% in many EM countries, but cutting them now will increase the prospect of further depreciation and currency losses for bond investors.

Local currency-denominated bonds will be good value when currencies bottom, and markets stabilize, but that isn't the case yet.

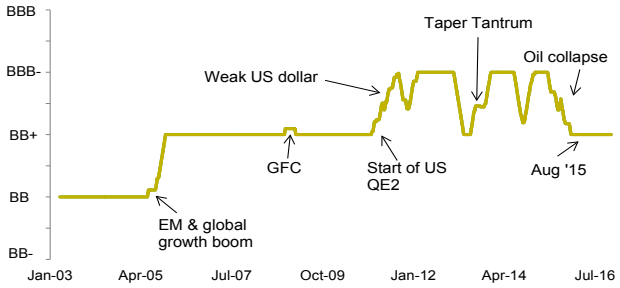
The final chart shows the markets with the highest amount of foreign participation in local interest rate markets. Such markets would be vulnerable to a big increase in interest rates if developed market investors were to sell up quickly. The exposure of most of Asia and the larger EM nations is actually quite small.

US Election effect: EM corp bonds



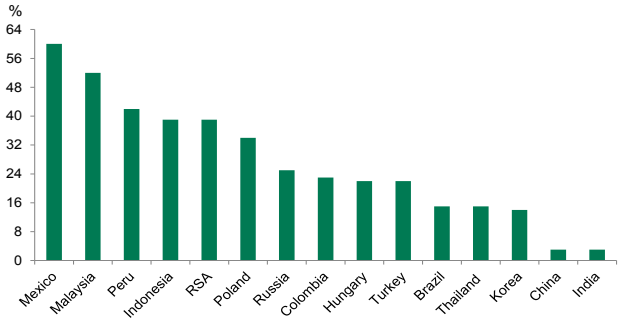
As at 16 December 2016 Source: Thomson Datastream

JP Morgan EMBIG index - average S&P rating



As at 23 November 2016 Source: Goldman Sachs

Foreign holdings: EM bond markets



As at 16 December 2016 Source: Bank of America Merrill Lynch

EQUITIES

- *While inflation requires bond investors to manage their positions more carefully, a revival of inflation from low levels is positive for equities. It improves corporate pricing power.*
- *Equities in EM are still trading at substantial discounts to developed markets with a similar return on equity (ROE). This removes the need to trim exposure and allows for additions when markets stabilize.*
- *EM earnings have not revived as hoped for, but equities are still cheap. A small underweight in Asia and a tactical overweight in Russia are preferred. Cyclicals, financials, healthcare and exporters look good.*

Operating profitability in Emerging Markets declined for much of the period from 2010 to 2015, but has started to rebound toward normal G7 levels. Return on Equity (ROE) of 10% in Emerging Markets is comparable to much of the G7 but the price-to-earnings (PE) and price-to-book (PB) discounts to G7 equities are steep. Whereas US equities are priced at 19 times 2017 earnings, Emerging Markets are at 14 times: a 26% discount. Nevertheless, equity markets have declined since bond yields rose in November.

Depreciation has added to value

Unlike their fixed income counterparts the vast majority of equity exposure in Emerging Markets is in local currency terms. This has amplified the downside momentum to equity markets, but equally has now made them much cheaper. Unlike bonds, equity markets respond positively to rising inflation, at least until the point when central banks start to raise interest rates quickly to slow growth.

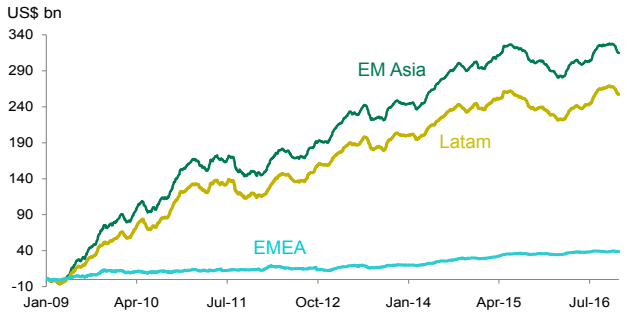
Why are the PE and PB discounts important? The charts to the right show how much financial analysts have been adjusting their forecasts for earnings per share growth over the next twelve months. While earnings were revised upwards in the first half of the year, revisions have either stalled over the summer or only gone up in Latin America where the influence of Brazil is huge. Rising commodity prices and falling inflation are at last starting to be reflected in better growth prospects.

Much of the gains in EM equity over the middle half of 2016 were from prices rising more quickly than earnings. The failure of earnings to revive has encouraged the withdrawal of capital since US yields started to rise. But it doesn't diminish the appeal of this asset class. Earnings growth is not expected to revive in Asia for 3-6 months so a small underweight is preferred. By contrast, however, the potential for improved Russia-US relations, deep relative valuations and increased energy prices justify taking a tactical overweight in Russian equities. EM is not a uniform asset class.

Sectoral options

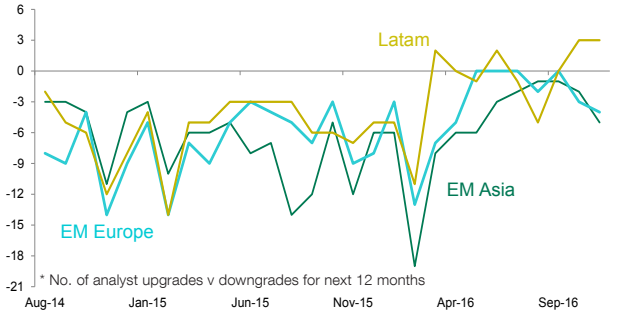
In sector terms, the return of inflation improves the outlook for those parts of an economy which benefit from improved growth prospects, the potential for bank lending rates to increase faster than deposit rates and also for household incomes to increase. These sectors are cyclicals, financials and healthcare. The latter is not heavily represented in EM but an overweight on G7 corporates will apply to those in EM too. Exporters should benefit from G7 growth and weaker currencies.

Cumulative Inflows to EM equities (net)



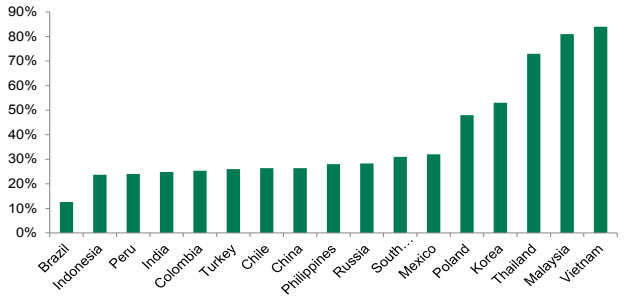
As at 25 November 2016 Source: JP Morgan

EM: Earnings revision ratios



As at 20 November 2016 Source: Bloomberg

EM: Exports % GDP



As at 16 December 2016 Source: National Sources

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