From West to East

Weekly Investment View
16th September, 2018

EM assets have discounted trade war talk, but not its effects

Emerging market stocks seemed to catch a breath as the MSCI Emerging Markets Index rose 0.54% last week. Perhaps more heartening, the index did so on strong volume – usually something worth noting.

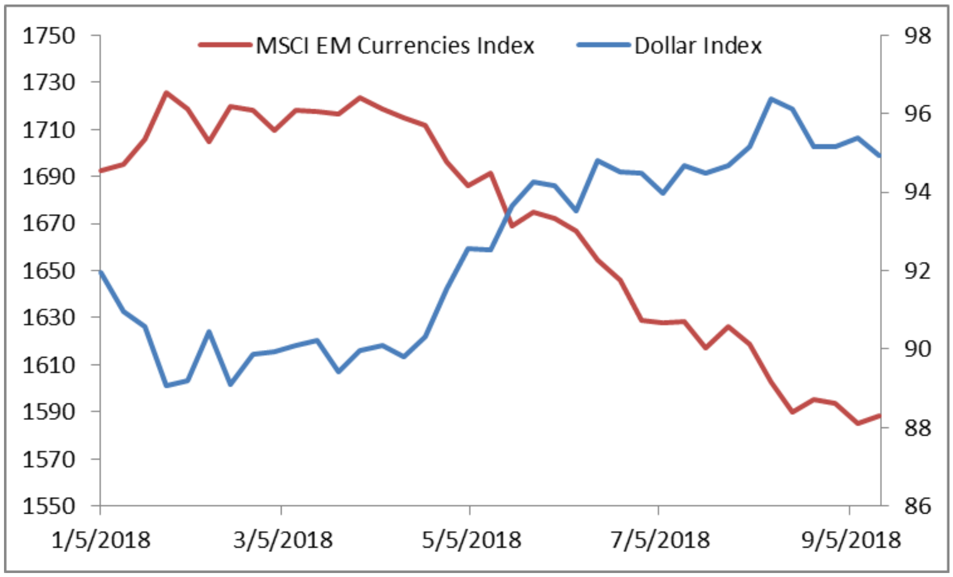
However, despite the positive tone, the underlying issues that prompted the 14.4% year-to-date drop in the MSCI EM Index remain intact. In fact, they may have become deeper. The strength of the US dollar remains little shaken. The dollar index ended the week down 0.46% but still at 94.927, just below the key 95.00 level and in a rising trend. More importantly, President Donald Trump's trade rhetoric remains as fiery as ever. Over the weekend, reports emerged suggesting the Trump Administration may announce new tariffs on US$200 billion of Chinese products, on top of the about US$50 billion targeted in July. The President has also indicated he is looking at penalizing the remainder of imports from China, bringing the total amount targeted to more than half a trillion dollars.

The Chinese yuan has depreciated 8.6% since April, when Mr. Trump made it clear tariffs would become a reality. That move has offset a significant portion of the up to 25% duties imposed on Chinese goods entering the US and has made them cheaper for buyers in other countries as well. The response of the rest of the world was a currency war of sorts, with other countries catching up with China and spurring a 5.7% rise in the US dollar index in the same period.

While the market is now accustomed to the rhetoric and has mostly discounted it, the actual effects of the trade war are only just starting to be felt and may, perhaps, not be fully priced.

The average monthly trade surplus for China has already dropped to US$24 billion this year from US$39 billion last year, and US$47 billion the year before. For an economy which is 80% driven by exports that is significant. The Chinese current account showed its first deficit in more than 20 years in the first quarter and barely made a surplus in the second quarter. Meanwhile, inflation accelerated to 2.3% in August from 1.9% in June.

The widening of the trade tariffs is only likely to exacerbate the pain in China. While some of the country's products will find new homes and American consumers will absorb part of the duties on products imported from Shanghai ports, over time this could dent the Chinese economy. In the US, it will translate into higher inflation, adding to the incentive for the US Federal Reserve to continue to increase interest rates. What those two elements together mean is more pain ahead for emerging markets and more US dollar strength.



"The economic impact of the trade war is yet to show in corporate profits."

One equity market which has suffered unduly this year has been Dubai. Last week saw it take another hit as engineering outfit Drake & Scull's management said it was considering whether to dissolve the company. The news added to the pressure on the local stock market, which ended the week down by 0.59%. The development comes just months after private equity fund Abraaj Capital filed for liquidation in the Cayman Islands.

The cases have increased investor uneasiness about the Dubai market and pushed valuations to very cheap levels. To be sure, there are reasons to be concerned about Dubai's economic health. Property markets are having difficulty breaking a multi-year slump. In August, the AE$1.97 billion in unit transactions represented a 57% drop compared to the same month a year earlier, and one of the lowest volumes in three years. That's significant, as real estate is a key part of the local economy. It may also not be a total coincidence. By making property more affordable, local authorities may be laying the ground for even stronger future growth in Dubai.

"Dubai's stock market's future looks rosier than its recent past; investors looking backward may miss the opportunities ahead."

In fact, this may be the traditional case of buying when 'there is blood on the street'. Brent crude prices, which have a heavy influence on economic growth in the United Arab Emirates, have been steady between US$70/barrel and US$80/barrel, for one. **And while there is a risk that global demand could suffer from the economic slowdown in emerging markets, which account for most of the growth in demand for fossil fuels, the supply picture is still not supportive of lower crude prices either.** There are two reasons to believe that demand will continue to outpace supply: OPEC and US shale oil production.

After the period of very low prices in 2016, the oil-producing nations group has learned that it needs to stick together and has been much better at keeping to quotas. Furthermore, two key producers, Venezuela and Nigeria, are seeing dwindling output amid political issues, while Libya's production has been regularly disrupted by clashes with local militia. As for the US, thanks to shale oil it is again one of the world's largest producers of oil, pumping a record 11 million barrels a day. That level, however, has plateaued and there are increasing signs that productivity in shale extraction is dropping. Apparently, the easier-to-access shale oil has already been tapped and now it becomes increasingly more expensive and complicated to tap additional barrels. Hence, it should not surprise investors if US output starts to drop from here. This helps balance a potential fall in demand from emerging markets and suggests the US$65-US$90/barrel trading range the FAB Asset Allocation Committee expects for oil this year should remain intact.

That is hardly good news for India, which has seen its current account suffer as a result of higher oil prices as it imports a lot of the commodity. Last week, the country released trade data showing imports outpaced exports by US$17.4 billion, one of the worst prints for the measure in the past six years.

When India released the July data, it helped trigger a sell-off in the rupee that eventually snowballed into the 3.5% depreciation the currency suffered in August, which added to another 1% depreciation in the first week of September. Last week saw some reprieve to the selling, starting on Wednesday, when news began to come out that the government was preparing a package of measures to stem the drop in the rupee. Investors were expecting, perhaps, a new foreign currency non-resident deposit scheme similar to the one that was introduced in September 2013 and helped the rupee recover 12.5% in nine months.

The measures announced on Friday afternoon, however, did not include the foreign currency non-resident deposit scheme. Instead, the government reduced taxes on investments in rupee-denominated foreign bonds, eased limits on foreign ownership of local corporate bonds and relaxed restrictions on overseas borrowings for Indian companies. While the measures help to increase the inflow of dollars and relieve pressure on corporations, they are unlikely to yield the kind of immediate and significant results that the foreign currency non-resident deposit scheme may have offered.

"India's regulatory upset added to the trade deficit unveiled after trading hours on Friday set the stage for a potential resumption of the rupee depreciation."

Anyone wishing to see the costs of building market expectations and not meeting them needs only to look at Turkey. The Turkish lira had dropped 41.2% this year until last Monday, much of the move having happened since President Recep Tayyip Erdogan was reelected in June, after which the central bank failed to deliver a strong – and widely expected – rate hike. Global investors seemed to view the inaction as a result of Mr. Erdogan' criticism against raising interest rates.

The opposite reaction happened last week, when the central bank delivered a larger-than-expected 625 basis points rate hike on Thursday, prompting a 4.3% appreciation of the currency that day. However, it is unclear whether 24% interest rates will be enough to stem the currency depreciation, simply because Turkey's underlying issues continue in place. Mr. Erdogan is not helping either, as he went on to criticize the central bank's decision the next day, saying that he was being "patient", but that his patience would soon run out.

The central bank may not have had the luxury of patience. Turkey burned through US$10 billion of its reserves between 3rd August and 7th September, according to the latest central bank data. Turkey imports about US$19 billion of goods a month, so the current US$70 billion is enough to pay for less than four months of foreign products and services. Turkey has logged an average trade deficit of US$6.7 billion a month this year, which means its reserves get it through less than a year of trade. In such a situation, the country needs foreign investors to buy its assets to compensate for the trade losses, but the opposite has happened. Eventually, economic recession and currency depreciation are likely to correct the trade imbalance. Until then, however, investors can expect a lot more volatility. And while the rate hike may help slow down the depreciation of the currency, the examples of Argentina, India and Indonesia suggest it may not be enough to stop it.

"The Turkish lira's drop could slow down but is unlikely to reverse course at this stage."

INVESTMENT SUMMARY: US stocks continue to prove one of the best investments this year, in line with the FAB AAC's recommendations. The S&P500 Index ended the week 1.16% up, bringing its year-to-date gains to 8.7%. The NASDAQ 100 Index, similarly, rose 1.55% last week and is up 18% so far this year. The AAC has remained bullish of technology stocks throughout the year.

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