From West to East

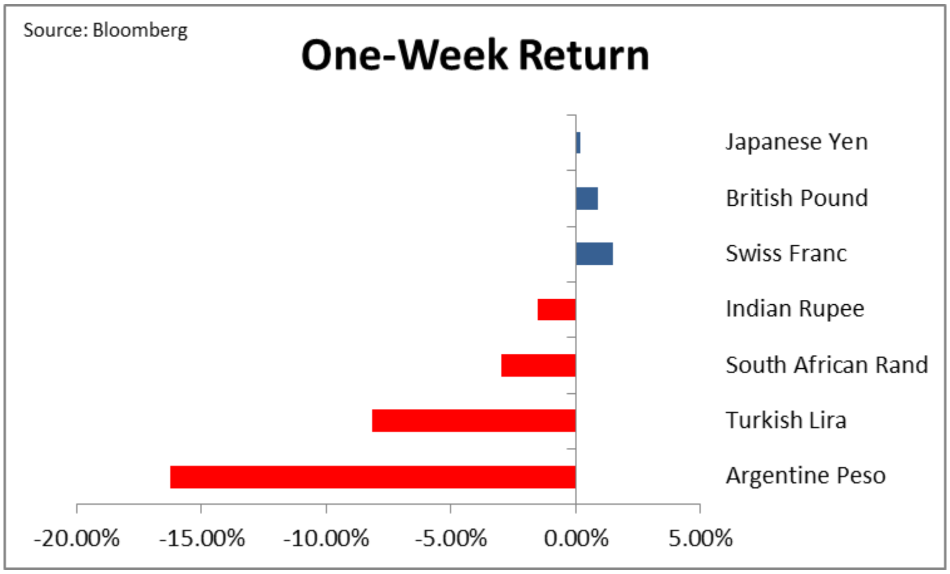
Weekly Investment View
2nd September, 2018

It is too soon to bet on a recovery in emerging markets

In 2008, 'decoupling' was a buzzword and much ink was spilled defending the ability developing nations had to divorce themselves from the troubles of the US and Europe. However, things proved not to be so simple. Every once in a while emerging markets do decouple, but not always in a positive way.
Last week had a bit of that flavor. The MSCI Emerging Markets Currency Index dropped 0.4% through Thursday while the broad dollar index was down 0.14%. In general, when the dollar rises, EM currencies drop and vice-versa – even though the dollar index is comprised mostly of currencies from the world's richest nations, such as the euro, the British pound and the Swiss franc.
Yet, even as the euro strengthened, pushing the Dollar Index down, the Chinese yuan, the Indian rupee, the South African rand, the Argentine peso and the Indonesian rupiah, were all either marking record lows or testing multi-year troughs. The move happened just as the NASDAQ, the S&P 500 and even the Dow Jones Industrials reached new highs.
The change is significant, especially given its timing. This year, until just a couple of weeks ago, the direction of the dollar had been highly correlated to the yuan, for instance. If the yuan devalued, the dollar strengthened, even though the Chinese currency is not featured in the Dollar Index. The strength of the US currency in its turn fed into the weakness of other EM currencies.
The fact that the greenback and developing currencies fell in tandem suggests a change of sentiment in the broader market.

"Risk should remain 'on', but it is better to stay out of emerging markets for now."

This is currently the position of the FAB Asset Allocation Committee (AAC). While the AAC continues to have a bullish stance overall towards risky assets such as equities, it also has reduced exposure to emerging markets debt and stocks.



There may be, however, a technical factor in the recent contagion which suggests some of the broad-based EM selling could soon pass. As it tried to stem the currency rout, the Turkish Central Bank limited the ability local banks had to trade hard currency options and forwards. Turkish lenders are the biggest providers of liquidity for foreigners trying to take a punt on the lira. Hence, suddenly, funds trying to hedge their positions in Turkey or even make a bet on the direction of the lira were left without the means to do so.
An imperfect option that some investors may have used is to instead short other liquid currencies of countries that have similar issues to Turkey. By betting on losses in other currencies, these investors sought to make up for part of their pain in Turkey, against which it is now very hard to hedge. That would partly explain why the South African rand and the Argentine peso followed the Turkish lira. Both countries have faced similar structural issues to Turkey's, namely nagging current account and fiscal deficits.
However, the 49.5% devaluation of the Argentine peso for the year-to-date will itself help reverse that issue. The recession that will follow this currency crisis is likely to reduce imports. Meanwhile, exports of agricultural products, soybeans in particular, will increase as Argentina is the third largest producer of the commodity and is likely to fulfill part of the Chinese demand that used to be met by the United States prior to the punitive tariffs, courtesy of President Donald Trump's trade war. Similar dynamics can be expected to play out elsewhere in EM.
The Indian rupee is a similar example. While the latest sell-off was initially triggered by a worse-than-expected trade deficit reported two weeks ago, oil prices are stabilizing and the 10.1% depreciation of the Indian currency for the year-to-date is likely to dampen imports.
The problem, however, is that once the ball starts rolling it can be very hard to stop. Investors may have shorted currencies of countries with similar issues to Turkey's as a hedge against their Turkish exposure, but while doing so, though, they appear to

have unleashed negative momentum that has become a self-fulfilling prophecy. That helps explain why the Reserve Bank of India seems to have gone missing in the recent rupee sell-off. The central bank could have been expected to intervene in the currency given that devaluation in this case almost certainly translates into higher inflation, something that the RBI needs to combat. However, if it attempted to intervene when a barrage of foreign investors were against it, it would probably burn reserves without making any significant dent in the downward momentum of the currency. Argentina is the perfect example — the central bank's decision to hike rates to a world high of 60% last week did not stem the rout in the peso. Hence, it makes sense for the RBI to wait for when the intervention can be more effective, as painful as that may be.

"The sell-off in the Indian rupee, the Argentine peso and the South African rand may have been partly driven by Turkey, but it has now gained its own momentum."

The issue here, however is the currency, not the nation itself. Even as the Indian rupee touched a record low, the Sensex Index remained near the all-time high it hit on Tuesday. While the rally has been mostly driven by a half-dozen stocks, there were reports of buying by foreigners, in an indication that investors remain bullish on India's companies. Perhaps to confirm that, last week Mumbai reported that the economy expanded 8.2% in the second quarter, making it the fastest growing major nation in the world.
To be sure, the Sensex now trades at 20.7 times expected earnings for 2018, far above the 16.6 average of the past ten years, though still below the 23.3 times high reached in January. Still, with some of the largest components deriving revenues in dollars, there may be room for analysts to revise their earnings estimates up, which could boost the index even further.
Gains in Indian stocks should also be viewed relatively. The Sensex may be up 13.5% this year in local currency terms, but once the conversion to dollars is factored in, the index has only gained 2.2%. That is a far cry from the 8.5% year-to-date rally staged by the S&P 500 index.
Furthermore, the stage is set for US stocks to potentially rally still further.
Many of President Trump's recent regulatory changes are creating an environment in which it makes sense to invest in the US if a company is targeting that market. The corporate tax cuts earlier this year, for instance, rendered obsolete the argument of seeking a low tax country to be global headquarters for an American corporation. The policy of trade tariffs changes the calculation for companies that seek to produce in low-cost countries to export into the US.
Perhaps the latest victory on that front happened last week amid negotiations between the US and Mexico for a new trade agreement that could partly replace the current North American Free Trade Agreement (NAFTA). Mexico agreed to a minimum national content of 75% for products that it exports to the US under preferential terms, higher than the 66% previously required. Furthermore, a significant percentage of that national content also has to be produced by workers who make at least US$16/hour. That is more than three times the Mexican minimum wage of US$4.6/hour.
The move reduces Mexico's labor cost advantage. It also sets a template for the concessions the US will require from other trade partners. As a result, the argument of establishing production in low labor cost areas becomes even less meaningful and further spurs companies that sell to Americans to establish US manufacturing.
The host of incentives to invest in the US – or, in some cases restrictions against not doing so – is likely to continue to fuel the American economy, which recorded a 4.2% annualized rate of expansion in the second quarter, its fastest pace since 2014. While there are signs that this clip is unlikely to be sustained for the remainder of the year, all the moves by the Trump administration have set the scene for sustained economic growth at least until the next presidential election in 2020.

"Strong economic growth continues to favor US stocks, particularly sectors that are less exposed to exports."

That would ordinarily suggest further dollar strength and interest rate hikes by the Federal Reserve. However, as last week evidenced, the greenback is beginning to falter and as the EM uncertainty affects other parts of the globe there could soon be an argument for the Fed to slow down its rate hikes.
Some of the drivers of the dollar weakness may be removed this week, and a rebound is likely. The British pound rallied last week amid news that the European Union was willing to be more accommodative with the UK in its exit from the bloc. That changed toward the end of the week as Brussels realized that any indication that leaving the group can be done with minimal pain could prompt Hungarians and Italians, for instance, to reconsider their membership.
As chatter of a break-up of the European Union intensified, so did the tough talk against Brexiters. The result is likely to impact both the British pound and the euro — both of which are key components of the dollar index — and cause the greenback to regain some ground lost in the past two weeks.
As for the Fed, Richard Clarida was confirmed by the US Senate last week and is now clear to take his post as Vice-Chairman at the central bank. The Columbia scholar is known to defend that the neutral interest rate for the US is probably closer to 2% instead of the 4% view previously held among members of the rate-setting committee. He may therefore push the Fed into a more dovish stance after an expected hike in its September meeting.

INVESTMENT SUMMARY: The Saudi Tadawul Index lost 4.2% in August as news that Saudi Aramco's IPO would be delayed dampened excitement in that market. The Dubai Financial Market General Index suffered in tandem, bringing its valuation to seven times 2019 earnings, near the lowest on a one-year forward basis since 2012.

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