Emerging Markets Can Trump US Policy Rhetoric

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Key points

■ We believe the consensus view of a Trump presidency translating into a blanket "stay clear of " investing in emerging markets is overly simplistic.

■ Our analysis of President Trump's proposed policy of trade protectionism suggests that the impact on emerging markets is more nuanced – the vulnerability of these markets is significantly lower today than it was five years ago; several emerging countries have strong domestic demand drivers and Trump policies like a weak US dollar regime could, in fact, be a positive for emerging markets.

The basic trade protectionism argument
An "America First" US trade policy can be viewed as one wherein America's external economic interdependencies are reduced and world GDP as a whole is impacted. Many asset allocators have focused purely on the adverse developed markets/emerging markets trade impact and have extrapolated this further to suggest that investing in developed markets (DM) and not emerging markets (EM) is the more prudent choice. In this piece, we examine the implications and practical implementation of an "America First" US trade policy.

Decrease in EM macroeconomic vulnerability and relative valuations
Most commentators view EM as a single homogeneous asset class with a single growth driver (US policy/interdependency). Our experience of investing in these markets for over 20+ years suggests otherwise. We believe that today EM are a heterogeneous group with a multitude of drivers beyond DM policies. Admittedly, historically there have been instances where emerging countries behaved as a monolith (the taper tantrum is an example in the recent past when correlations went close to one). However, our proprietary indicator of macroeconomic vulnerability that takes into account leading indicators of EM crises and vulnerability is at a multi-year low today. For example, the five countries with the largest current account deficit (CAD) have witnessed their CAD shrink from USD 290 billion in 2013 (4.3% of their aggregate GDP) to USD 90 billion (1.6% of their aggregate GDP) today. In such an environment when the macroeconomic health of EM as a whole is much stronger, their ability to withstand external pressures is fortified.

The opportunity to look more closely at EM also presents itself via the relative valuation of the asset class. Over the last five years, a rosier health assessment of EM has not translated into better market valuations. In fact, EM had a market cap of nearly 90% of the US in late 2010 through the latter part of 2011. Today, EM is valued at broadly 60% of the US market cap and relative valuations are at the same level as they were around 5 years ago. A recent paper1 written by GMO's Asset Allocation team also posits the currently attractive relative EM valuations.

Investors may have exaggerated the impact of a US-China trade war
Let's return to the DM/EM trade policy impact argument, and tackle the most widely cited EM country – China. It makes up, after all, 28% of the MSCI EM benchmark and the consensus view is that because its biggest trading partner is the US, it will be the most adversely impacted. However, it is worth pointing out that at the end of 2016, China had just 2.3% of GDP as trade surplus with the US, down from its peak of 5.2% of GDP in 2006; China's exports to the US are less than one-fifth of its total exports, and exports to the US translate into a mere 3.5% of China's GDP. Further, what is less wellknown is that in the first decade of the century, China used more than half (52%) of its trade surplus with the US to buy US treasuries, thus benefiting the US with a lower cost of capital.

Second, China has successfully made the transition from being an export-led economy to one in which over 50% of its GDP now comes from services. Third, for all the anxiety around China's burgeoning debt load, external debt as a percent of total debt at 13% of GDP is the lowest among all EM countries, and household debt at 43% is also low. This suggests that China still has the deep pockets to spend on infrastructure and other assets that boost productivity. It's worth recalling that during the 2008-09 financial crisis, China spent RMB¥ 4 trillion (around USD 600 billion) on a fiscal stimulus package that benefited the global economy. Fourth, our on-the-ground channel checks across China suggest that replicating an intricate network of producers and suppliers in an ecosystem built over two decades will be far from easy for the United

States. Manufacturing, in particular, requires an entire business ecosystem wherein the constituent parts are in relative proximity to each other. Finally, we cannot gloss over the adverse environmental impact that will be a by-product of any sort of increased manufacturing activity in the US. After nearly three decades of an aggressive “build now – clean later” approach, China appears to have succumbed to pressure to become a more responsible global environmental partner and has embarked on a multi-billion dollar program to limit factory pollution, clean its rivers, and better handle toxic waste.

Other emerging countries are also fairly resilient

Next, let’s take on the case of the US’s immediate trading neighbors, Brazil and Mexico. For Brazil, the biggest economic driver today is falling inflation in an economy that is gradually recovering from a deep recession. Concerns about protectionism should be limited as the US has a USD 4 billion trade surplus with Brazil, so it is not in the interest of the US to reduce trade there. As for Mexico, the peso has depreciated by 10% since the election and the real effective exchange rate is at a 26% discount relative to its 10-year average. We believe this indicates that the market has already priced in much of the potential fallout from a change in US trade policies.

The potential impact on service-based economies also seems contained. For example, in India, with a domestic savings rate at a high of 32% of GDP and with effective domestic policies in place, reliance on external savings is limited. Such favorable macro drivers enable the financial markets to look past much of the “externally” generated noise. This was evident after the recent demonetization (announced on the same day that President Trump won the US election) when we saw USD 15 billion of net inflows – almost 1% of GDP – into mutual funds in the short time span of three months.

Finally, how the US could practically compete on price with the likes of The Philippines and Vietnam remains a quandary. For instance, an entry-level Philippino BPO service center worker earns around $2.25 hour, which accounts for one-third of the US federal minimum wage.

Weak US dollar policy and higher US inflation benefits EM

Although US exchange rate policy continues to be debated within the Trump administration, on a few occasions (including via Twitter on January 17, 2017), President Trump has suggested he would pursue a weak USD policy. Such a policy could lead to relatively stronger EM currencies, which would in turn lead to higher inflation, positive equity fund flows, and, possibly, a virtuous cycle. In addition, President Trump’s fiscal policies could eventually stimulate aggregate demand and lead to higher inflation in the US. If equities in DM do well, there will be a likely spillover effect on EM equities.

Conclusion

We believe most asset allocators have reacted purely to the headline policy of “America First” and its requisite uptick in trade protectionism. We have argued that the practical implementation of such a policy raises several questions and that many emerging countries today are less reliant on trade with the US than is commonly believed. Countries such as China and India have resilient domestic drivers of growth. We believe the macroeconomic vulnerability of EM as a group is much lower today, and, if so, we are bound to see a marked performance divergence between countries and sectors that can do well irrespective of US policy. In fact, it’s been 1 month since President Trump took office, and just last week alone EM fund flows hit a 6-month high as $2.7 billion flowed into emerging equity markets and $1.3 billion was invested in emerging debt markets. In addition to improved economic health, with local stock indices in several countries like India, China, and Brazil hitting new highs, we anticipate emerging equity markets will continue do well.

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