GLOBAL PERSPECTIVE

Trump, emerging markets and globalisation 2.0

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Over the course of 2016, we at Lombard Odier Investment Managers felt confident to offer a positive view on emerging market bonds, currencies and equities for the first time in more than five years, following a punishing bear market.

We took our cue from the improving fundamentals that we saw, reversing many years of weakness; low market valuations; and what we considered to be the identifiable and manageable nature of the risks involved – China's imbalances and debt burden, and the strong US dollar. We recommended differentiating carefully in favour of quality and domestic demand, but essentially identified emerging markets as a rare value opportunity in an expensive world.[1]

Six months later, the fundamentals have continued to improve and the valuations have, if anything, pulled back the highs of the recent recovery. But one thing looks to have changed dramatically: the risk. The prospects for emerging markets look very different with President Trump in the White House.

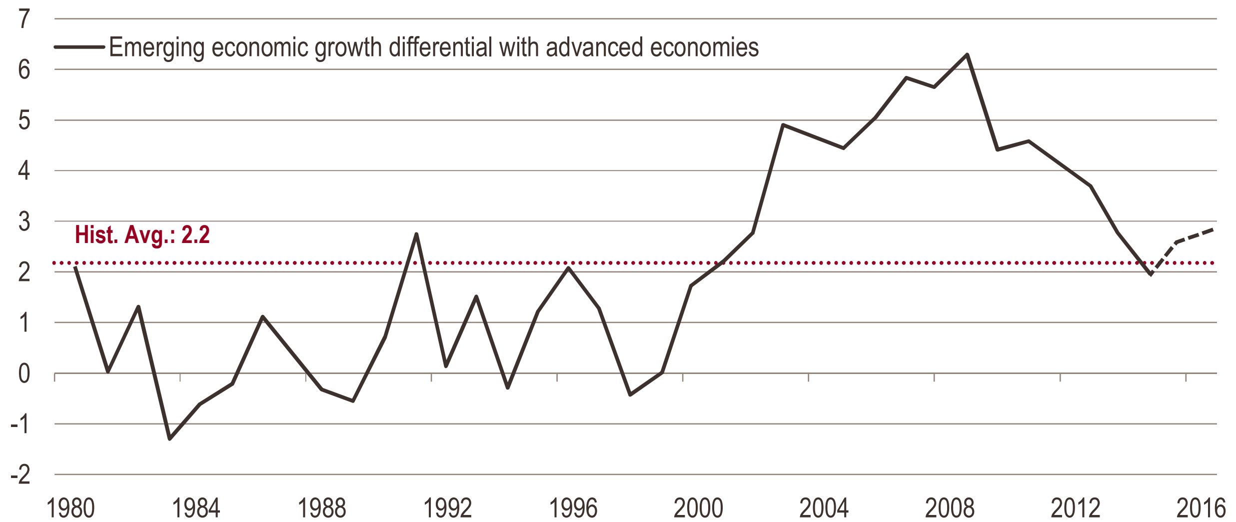
Here, the warnings tend to focus on two things: the potential for further strengthening of the US dollar, with its attendant risks of capital flight from the emerging world and balance-of-payments strains; and, especially, the impact of more aggressive US protectionism focussed specifically on China.

Taking the pulse of EM fundamentals

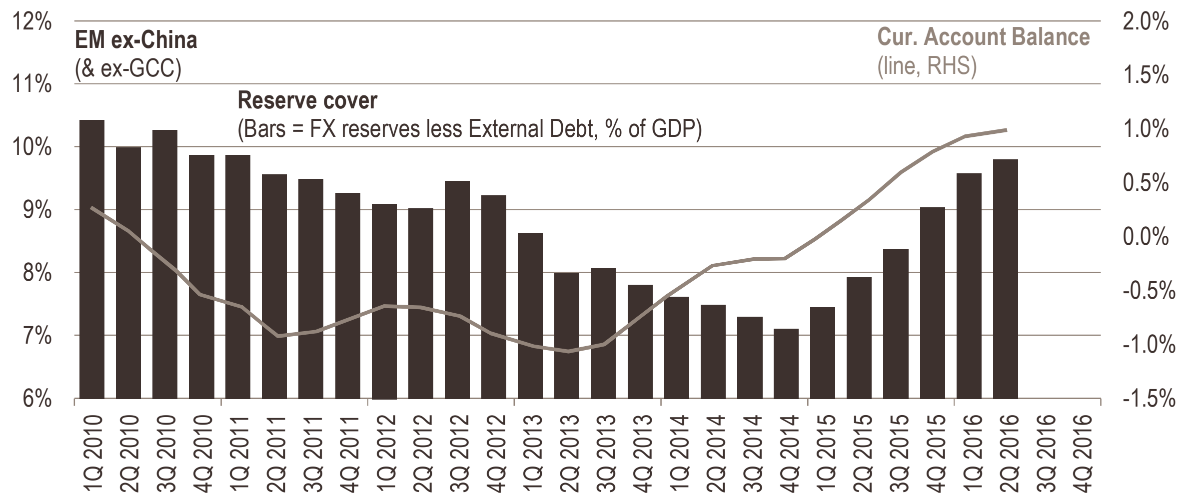
Overall, economic activity and external balances continue to improve in emerging markets, and valuations are still reminiscent of the aftermath of the 1997-98 crisis. The relative pricing of emerging and developed-market stocks is still at levels last seen in the early years of this century, yield differentials in hard-currency bonds remain at multi-year highs even after narrowing over the past six-to-nine months, and local currencies are still in early-stage recovery, building on current-account improvements and benign inflationary dynamics.

[1] Salman Ahmed, "Emerging Markets: Last Refuge in a Low-Return Desert?" (September 2016).

FIGURE 1 – ECONOMIC ACTIVITY AND EXTERNAL BALANCES CONTINUE TO RECOVER



Source: IMF, Bloomberg. Past performance is not a guarantee of future results.



Source: Bloomberg, IMF, Goldman Sachs, national sources.

So how about those Trump-related risks? Let's start with the US dollar before we move on to the headline-grabbing warnings about the unravelling of global trade.

Dollar risk: overstated for now

In fact, a lot of the fear around a sharply stronger dollar is based upon expectations of what might happen in response to protectionism. If companies close down manufacturing facilities overseas and relocate them in the US to avoid the impact of new tariffs and taxes on their supply chains, that would generate demand for US dollars and, all else being equal, push the currency up against its emerging-market peers.

These operations take time, however. Until these relocations take place, the most likely outcome is a slowdown in domestic US economic activity combined with an inflationary effect from lower supply of overseas manufactured goods, and tariffs and taxes on those that continue to be imported. That would create a dilemma for the Federal Reserve – and ultimately it is the path of interest rates that is likely to have the most profound impact on the dollar.

Recent "Fedspeak" has been marginally more hawkish in response to the prospect of tax reform and fiscal stimulus from the new administration, but official statements remain noncommittal. Like everybody else at the moment, the Fed is dealing with expectations rather than reality: we believe it is likely to err on the side of caution until it gets more clarity on the new administration's policies. President Trump would like to see US nominal GDP growth at 4% per annum, too, and that's another reason to let the economy run slightly hotter and the dollar slightly weaker than would otherwise be the case.

Policy clarity won't come until late 2017 or 2018 at the earliest, and we believe the impact of physical capital returning to US shores probably wouldn't feed through for another year or so after that – which suggests to us that a sharp dollar rally is unlikely in the shorter term.

Protectionism risk: China will take the lead in "Globalisation 2.0"

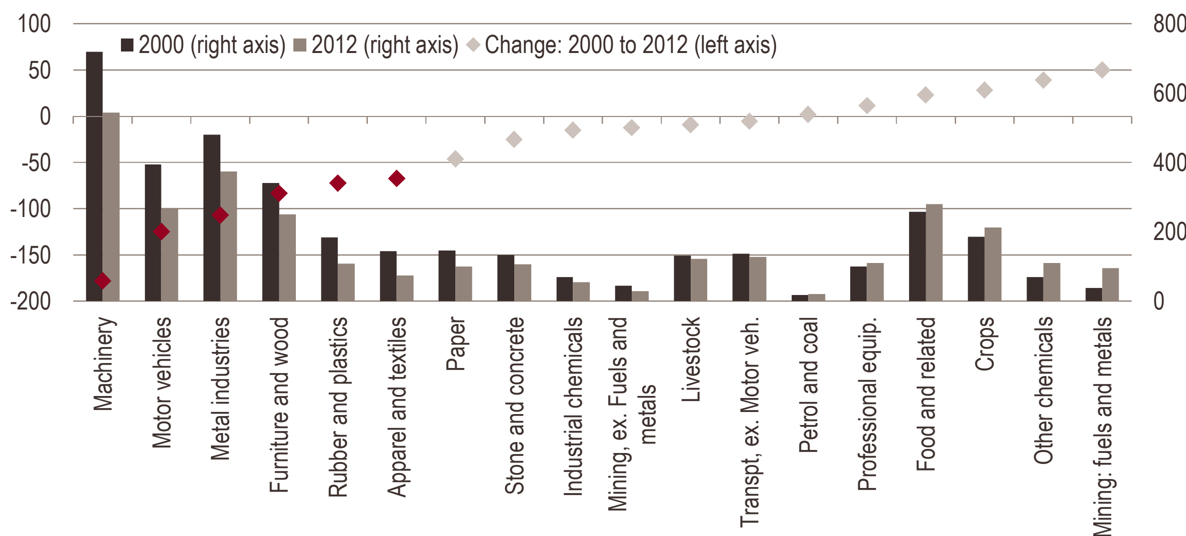
The threat of protectionism to global trade flows feels more clear-cut, especially as trade volumes are finally showing signs of a fragile recovery from the multi-year stagnation experienced on the back of low commodity prices and the China slowdown.

After Trump was elected, we argued that we more likely to see "trade stagnation" than "trade reversal" under the new administration. As recently as mid-January it appeared that President-elect Trump was focusing his rhetoric on his fiscal campaign promises rather than on trade and immigration.[2]

Well, a month is a long time in politics. Rhetoric and action have both stepped up: alongside formally abandoning the already-defunct US engagement with the Trans-Pacific Partnership (TPP), we have seen unusually aggressive statements directed at traditional allies and trading partners, calls to "speed up" a renegotiation of the North American Free Trade Agreement (NAFTA), threats to impose border taxes on corporations, and an expressed preference for bilateral over multilateral trade agreements.

To be clear, we would still regard this as threatening trade stagnation rather than outright reversal: the latter would be characterised by a blanket tariff which morphs into capital war between the US and China, for example. This is not imminent, in our view, not least because China holds a lot of US debt, meaning such a development would be potentially very damaging to the US. Instead, we expect President Trump's administration to deploy a sector-specific approach to populist trade protectionism rather than pursuing an overarching confrontation, as that would respond specifically to the jobs concerns of working-age white males without college degrees in "swing states" (Figure 2), while lessening the risk of an asymmetric response from China that spirals beyond trade.

FIGURE 2 – US "SWING STATES" HAVE SEEN SUBSTANTIAL JOB LOSSES IN TRADE-SENSITIVE INDUSTRIES
EMPLOYMENT (IN THOUSANDS) OF WHITE, WORKING-AGE MALES WITHOUT A 4-YEAR COLLEGE DEGREE LIVING IN 16 US "SWING STATES"



Source: Goldman Sachs, IPUMS-USA.

[2] Salman Ahmed, "Trump Testing Our View of the World" (November 2016); Salman Ahmed & Jan Straatman, "From 2016 to 2017: A Quantum Leap?" (January 2017).

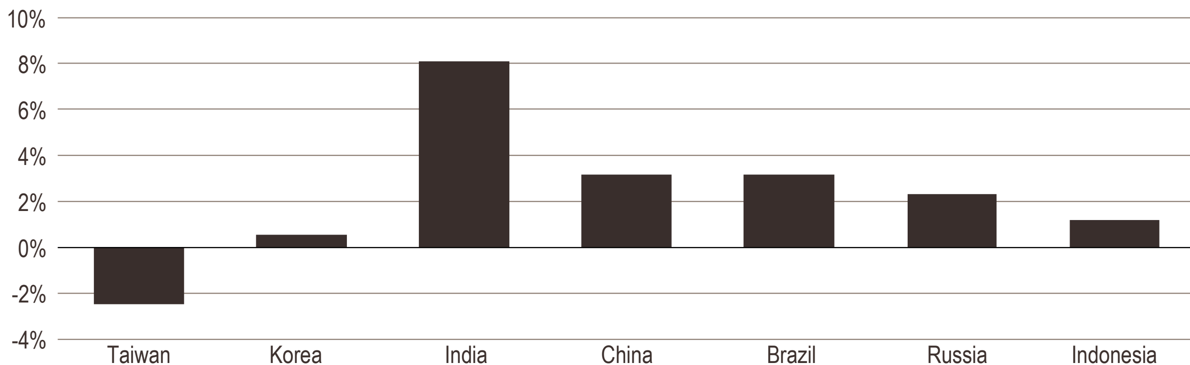
Furthermore, much of the fear associated with the US retreating from global trade rests upon a rather "old" view of what the emerging world does in today's global economy. Its source of catch-up growth is no longer simply massive real-asset investment, on the one hand, and high-volume manufacturing of cheap goods for rich western consumers, on the other. The next stage of growth will be centred on domestic demand – and, crucially, on intra-emerging market dynamics, in our view.

This is already happening. Since 2010, internal domestic dynamics in key emerging countries have generally been a stronger driver of growth compared to trade. Since 2000 emerging markets' exports to advanced economies have fallen from 80% of total exports to 60% – which means that the proportion of intra-emerging market trade has doubled (Figure 3).[3]

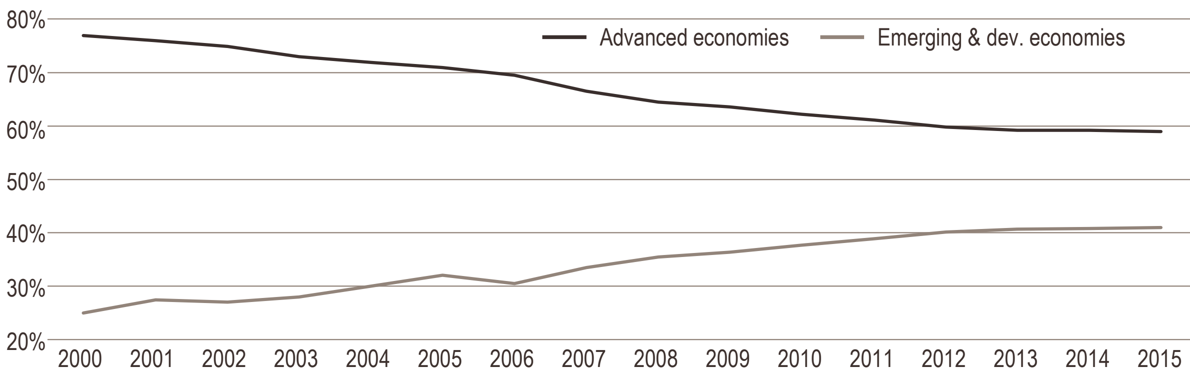
Nonetheless, this trend, which represents the next great step in the globalisation process, is still in its infancy. It's easy to forget the "globalisation" achieved simply by connecting eastern and western China, in terms of the markets that are linked together and opened up. This is the thinking behind the Silk Road Economic Belt and the Maritime Silk Road – the so-called "One Belt, One Road" infrastructure development initiative – proposed by China in 2013 to connect with the rest of Eurasia. The vision is transformational for global trade patterns, stimulating domestic demand across these regions, especially as the necessary infrastructure is deployed

FIGURE 3 – THE EMERGING WORLD IS REBALANCING TOWARDS DOMESTIC DEMAND

CHANGE IN WEIGHT OF DOMESTIC SPENDING (AS % OF GDP OVER 2010 TO 2015)



DESTINATION FOR EM EXPORTS (AS % OF TOTAL EXPORTS)



Sources: National sources, IMF. Data as at 31 December 2015

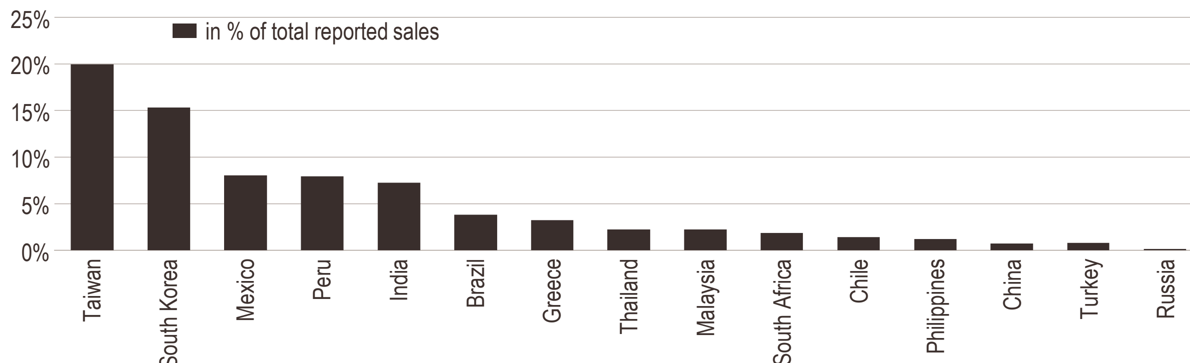
This is not to say that there are not some emerging-market sectors – and indeed entire economies – that are more at risk from this transformation than others. There should be no surprise that Figure 4 shows semiconductors in Taiwan and Korea, and auto parts in Mexico, are among the vulnerable.

Clearly, business models based on exporting to the US will need to adapt to the new world of intra-emerging market trade. This probably would have been necessary anyway, but voter anger from the US "Rust Belt" makes it more urgent.

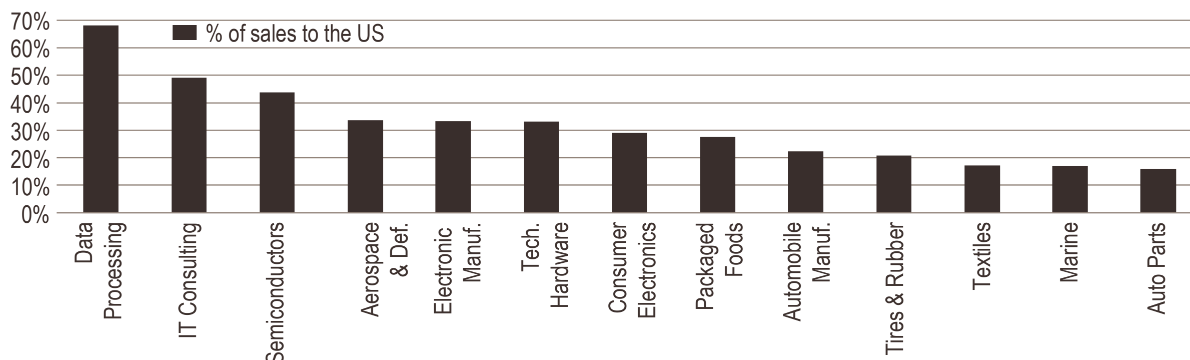
[3] See LOIM, "Rethink Your Emerging Market Equity Exposure" (November 2016).

By the same token, the election of President Trump simply reinforces the principles that have been underpinning our approach to emerging-market investing for some time: focusing on quality companies and strong countries, where domestic demand is an important driver of growth, in order to capture long-term trends. This also facilitates long-term holdings in non-crowded positions - vital in an environment of fractured market liquidity, especially when it comes to fixed-income investing.

FIGURE 4 – COUNTRIES AND SECTORS THAT COULD BE AT RISK IF THE US RETREATS FROM GLOBAL TRADE
SALES EXPOSURE TO THE US OF LISTED COMPANIES BY COUNTRY (2015)



SALES EXPOSURE TO THE US OF EMERGING MARKET SUB-INDUSTRIES (2015)



Source: Bloomberg, LOIM, company reports, data as at end of December 2015.

The "super trends" have not changed, but accelerated

Ultimately, then, the gap left behind in the event that the US seriously retreats from global trade are likely to be country- and sector-specific, in our view, and should be put into perspective against the much bigger implications of "Globalisation 2.0." The emerging world is stepping into that gap, led by China and a more connected Eurasia through initiatives such as "One Belt, One Road," and a re-negotiated TPP that goes ahead without the US.

When you change your view of the world in this way, the end-game risk is not US protectionism or a strong US dollar at all. Rather, it is the risk of is a balance-of-payments or other financial accident in China. Again, the fundamentals that we described back in September last year have not changed, and they certainly have not deteriorated.[4]

China's external debt position is exceptionally strong and a healthy level of inflation has been returning on the back of ongoing stimulus, both of which should help to contain the well-known problems that the banking system has with non-performing loans while the authorities gradually work them out, in our view. In addition, 2017 is an important year, politically: the 19th National Congress scheduled for the autumn could influence Chinese policy makers to prioritise domestic economic stability over external-sector priorities. Already we see that the risks of capital outflows are being severely blunted by heavy use of capital controls by the Chinese authorities.

[4] Salman Ahmed, "Emerging Markets: Last Refuge in a Low-Return Desert?" (September 2016).

All in all, we expect a “trade stagnation” environment to prevail, allowing emerging market assets to climb the current “wall of worry,” and splitting the investment world into distinct winners and losers. This should offer significant scope for differentiation when it comes to equity or fixed income investing.

In the event that the US picks a very confrontational stance towards China, leading to an asymmetric response from the world’s second largest economy, we see downside risks to current asset pricing. Even then, however, we still expect the advent of “Globalisation 2.0” – a series of structural, regional developments that help facilitate growth based on domestic demand. The emerging world is quitting the workshop of the rich, developed countries; it is becoming rich itself; it is consuming more of what it makes itself; and it is moving into the driving seat of trade and globalisation. The vote that was cast on 8 November 2016 may well have accelerated that trend.

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