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By Nikko Asset Management's Multi Asset team

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Nikko Asset Management

EMERGING MARKETS QUARTERLY: MACROPOLITICAL RISKS CONTINUE TO DOMINATE

Q4 2015 Insights

In early 2016, hedge fund Nevsky Capital decided to call it quits after 15 years of successful asset management. One of the reasons for the closure is that since the global financial crisis (GFC), emerging markets (EMs) are breaking away from the transparent 'Washington Consensus' model and are now prone to much less predictable nationalistic policies.

'Washington Consensus' describes the tenets of sound economic policy, which were broadly adopted in the 1990s following multiple currency crises and laid the foundation for almost a decade of growth and prosperity across EMs. During this extended period of stability, EM investing was quietly folded under the wing of traditional bottom-up security selection. The efficacy of this approach has been severely challenged since the GFC, where re-emerging macro and political risks have essentially overwhelmed micro risks.

Investing in EMs has clearly become more difficult, but where there are challenges, Nikko Asset Management's Multi-Asset team believes there are also opportunities. In this inaugural quarterly report, we summarise our current views on EMs and where we are seeing the main challenges and opportunities.

Navigating the divergence in EM outlook and performance

The GFC spread economic pain unevenly, severely testing the strength and resolve of political structures and institutions globally. Unsurprisingly, the varied success in navigating the turbulence led to a substantial divergence in outlook as well as market performance. Whereas investors used to view EMs as a generic play on global growth, current outlooks are contingent on the ability of individual EMs to adapt to a world of slower economic growth.

Commodity prices have collapsed, presenting enormous headwinds in Latin America but equal tail winds in Asia. All EMs are adjusting, but with vastly different macro exposures and political capacity to navigate the adjustment. These unique dynamics must be understood at the country level, while the underlying asset classes provide the means of expressing views and allocating risk.

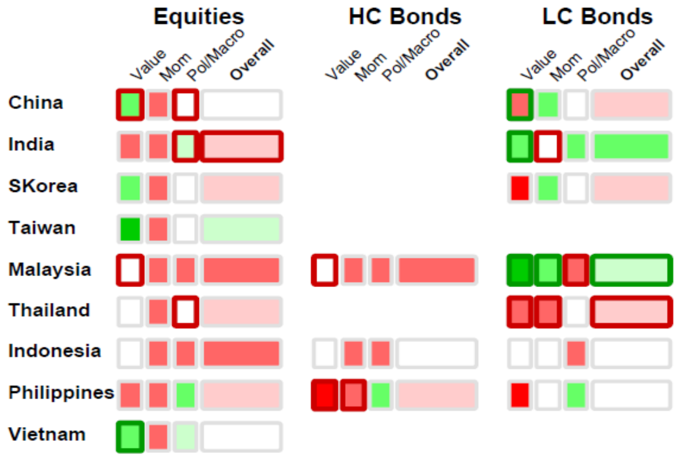
EMs are ideally suited for our team's top-down multi-asset investment framework, which combines valuation, macro and momentum across all asset classes and geographies. We supplement the framework with an evaluation of external macro vulnerabilities and political capacity. Given the complexity and importance of understanding political capacity, we have partnered with Eurasia Group, a leader in political risk research, to tightly integrate their expert views into our research process.

Asia remains at the top of our hierarchy, followed by EMEA and lastly Latin America. While each country is unique, regions share characteristics – e.g. Latin America is mainly an exporter and Asia chiefly an importer of commodities. Among asset classes, hard currency bonds remain at the top of the hierarchy, followed by local currency bonds and lastly equities. We are conservatively positioned while overweight cash and, with respect to local currency bonds, we are selectively hedged against currency risk.

Asia benefiting from falling commodity prices and significant reforms

Asia remains at the top of our regional hierarchy, benefiting from falling commodity prices and an ambitious reform agenda to support growth and earnings. However, growth has disappointed so far mainly as a function of slowing exports, while local demand has yet to fill the gap. More recently, local demand is also feeling the weight of corporate deleveraging that is a headwind to the growth outlook.

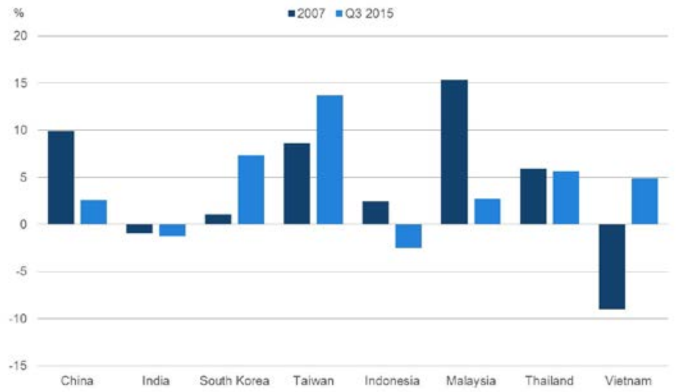
Asset Class Scores



Score Summary: For each country and asset class, scores are represented by colours where white is neutral and progressive shades of green are positive and red is negative. The overall score is shown to the right with the underlying scores – value, momentum and political/macro – shown to the left. The border shows gray for no score change this quarter, green shows positive and red negative.

One key area of stability for the region is that Asia remains a net saver despite the slowdown in exports. Chart 1 compares current accounts as a percentage of GDP across the region in 2007 (before the GFC) and currently. India and Indonesia have relatively small deficit positions, while the rest of the region has maintained healthy surpluses, which is a significant advantage in a world of slow growth and tightening liquidity.

Chart 1: Asia current accounts as % of GDP



Source: Bloomberg 2015

Despite excess savings, currencies remain under pressure due to net capital outflows that exceed these savings. Also known as the "carry unwind", the dynamic partly led to China's devaluation back in August. Since the devaluation, outflows have accelerated, requiring China to use currency reserves to temper volatility. Reserves remain adequate to continue this support for some time, but this also squeezes bank liquidity and therefore tightens monetary conditions.

China can partly offset the squeeze through easing elsewhere – such as reducing reserve requirements where it maintains significant dry powder – but, fiscally, China is largely hamstrung, having already accumulated high levels of debt since the GFC. Outside of China, the risks linked to China's devaluation and broader EM capital outflows vary. North Asia, in particular, is threatened by increased competition from China. More broadly, strains in Asia are at least partly buffered by savings and relative ability to ease.

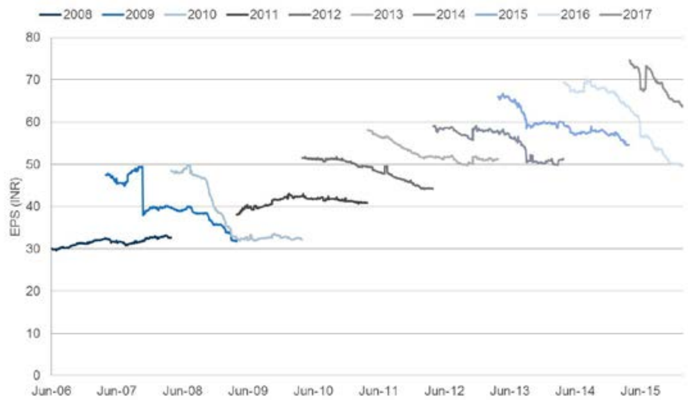
Summary of score changes for Asia over the quarter

India Equities downgraded to neutral-negative

India is the global poster child for growth potential, with the slow wheels of democracy pushing for investment to improve productivity across its 1.2 billion citizens. The 'Modi revolution' is real; while his party's defeats in Delhi and Bihar threaten to crimp reform momentum, markets have arguably already priced for the upside that has yet to materialise. Equities are expensive, and we have grown uncomfortable with momentum slipping to negative while earnings have yet to fully deliver on the macro story.

Chart 2 shows the evolution of earnings estimates and so far 2016 remains disappointing. However, bonds still score positive for attractive valuations and positive macro fundamentals. Reforms and falling oil prices have significantly curbed inflation, with still tight policy offering ample leeway to ease.

Chart 2: India earnings estimates



Source: Bloomberg 2015

Local currency bond downgrade for Thailand and upgrade for Malaysia

SE Asia's macro dynamics are varied, but mainly stable on a relative basis, sometimes triggering market volatility when perceptions of rising 'political risk' come to the fore. Malaysia and Thailand frequently make the headlines in this regard, but despite often vociferous political wrangling, most interested parties gravitate to the status quo to keep economic growth intact.

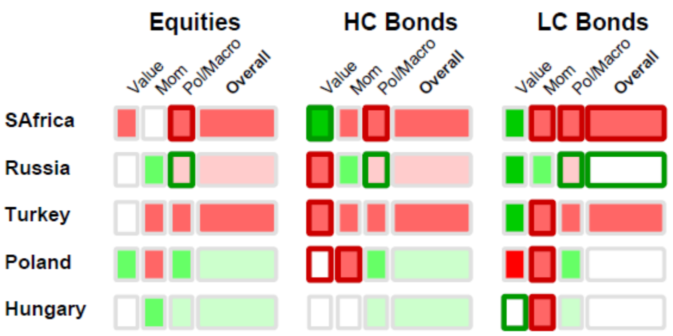
Malaysia remained in the spotlight for the second half of 2015 with many believing that the so-called '1MDB' scandal would lead to the ousting of Prime Minister Najib Razak. In Q4, the investigation's momentum dissipated, helping to return stability to local bonds with more attractive valuations and improving momentum to support the score upgrade.

In Thailand, while the political-macro score remained neutral, both valuation and momentum turned negative supporting a downgrade of local bonds.

Eastern Europe, Middle East & Africa (EMEA) is a mixed bag

EMEA ranks below Asia in the hierarchy but ahead of Latin America, basically due to its mixed bag of themes with very different opportunities and risks. As commodity exporters, Russia and South Africa are similarly exposed to the decline in commodities as Latin America, but with very different macro-political risks. As an oil importer, Turkey benefits from declining oil prices but remains exposed to high levels of private sector debt, significant external imbalances and lack of political capacity to properly adjust. Poland and Hungary have worryingly high levels of external debt, but political capacity is high and so far significant progress has been made to adjust external imbalances and reduce external debt.

Asset Class Scores



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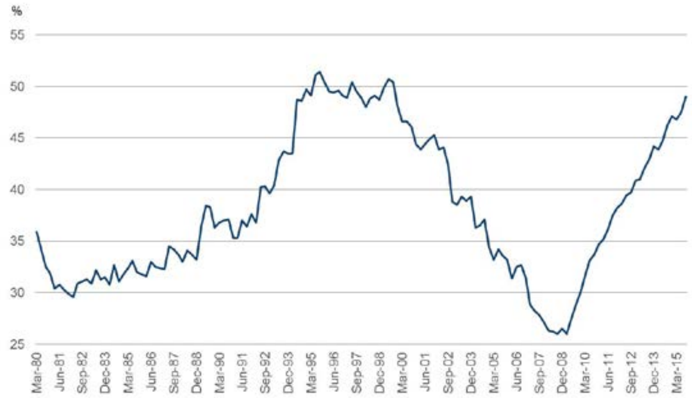
Summary of score changes for EMEA over the quarter

South Africa local bonds downgraded to negative

When Jacob Zuma was elected president in late 2007, many feared his populist leanings would damage the hard fought macro stability achieved over the prior decade. However, strong institutions, including the Ministry of Finance and the Judiciary, largely kept policy in check. This changed in December when Zuma crossed the line, ousting well-respected Finance Minister Nene to replace him with an unknown – ostensibly to take control of government finances. Markets punished the decision causing Zuma to reverse course and replace the position with a market-trusted veteran, but the damage to credibility was already done.

Since the GFC, 'temporary' stimulus has morphed to chronic deficits. Growth failed to adequately recover and, on the back of rising debt servicing costs, South Africa is increasingly at risk of slipping into a debt trap. Chart 3 shows the debt-to-GDP ratio quickly approaching mid-1990 levels when South African bonds were rated junk (BB). Currently, the bonds are still rated one notch above junk (BBB-) with a negative outlook. While new reforms could still beat the debt trap and perhaps still will, the prospect for such reforms are becoming increasingly elusive. Local bond valuations remain attractive, but negative momentum and deteriorating macro-political fundamentals support a downgrade to negative.

Chart 3: South Africa debt to GDP ratio

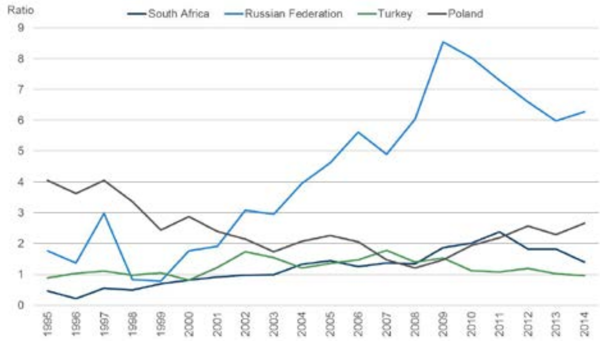


Source: Bloomberg 2015

Russian local bonds upgraded to neutral

Few countries have been in the geopolitical spotlight like Russia. Crashing oil prices, coupled with severe sanctions imposed during the Ukraine crisis, brought about the perfect economic storm. Russia was priced to collapse in early 2015. However, the currency adjustment and currency reserves ultimately proved to be an adequate buffer to prevent default. Chart 4 compares coverage ratios of reserves in the region to external short-term debt. A high coverage ratio effectively allowed Russia to roll corporate debt that otherwise would have gone into default.

Chart 4: Reserves / short-term external debt



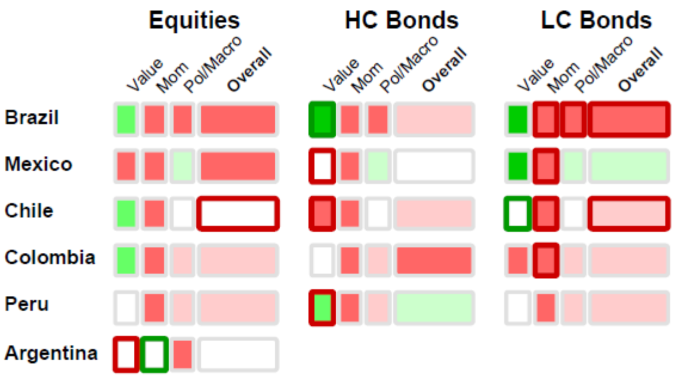
Source: IMF 2015

More recently, sources of political risk have abated. Some months ago, the Ukraine crisis threatened to escalate, bringing further sanctions. But military resources were redirected from Ukraine to Syria allowing the former to settle into a more desirable frozen conflict while efforts to stabilise the latter brought Western support. The change in military course not only avoids prospects for further sanctions but paves the way for existing sanctions to eventually be lifted. Local bonds were upgraded to neutral, based on attractive valuations, positive momentum and improving macro-political fundamentals.

Latin America faces headwinds of commodity price declines

Latin America ranks at the bottom of our hierarchy, mainly for the macro-political stresses caused by the headwinds of commodity price declines. Brazil currently faces particularly high economic and political stress. Mexico sits on the opposite end of the spectrum. Although it is also suffering from falling oil prices, this is more than compensated for by a very strong macroeconomic and political foundation, where significant reforms promise growth dividends into the future.

Asset Class Scores



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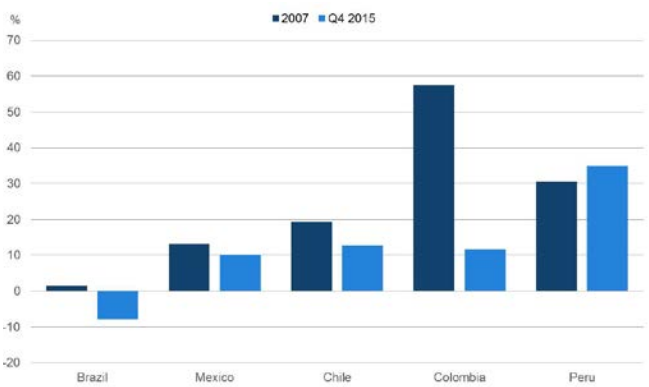
Terms-of-trade is a helpful lens to understand the relative stress on different economies in the region. Chart 5 compares the change in terms-of-trade from the commodities peak in 2007 to the current situation. Through 2007, terms-of-trade (unsurprisingly) improved across the region as commodities prices climbed, although just barely for Brazil since it was still a net oil importer at the time. Through 2015, Brazil slipped into negative territory while gains achieved by the rest of Latin America through 2007 have remained largely intact. Latin America is still vulnerable to further commodity adjustments, but it is important to recognise these structural gains that extend beyond simple commodity exposure.

Chart 5: Latin America terms of trade



Source: Bloomberg 2015

Valuations are broadly cheap, with the exception of Mexican equities, but the earnings collapse and enormous macroeconomic headwinds offer no visible near-term respite. At some point, there will be a significant buying opportunity, but we are not there yet and, therefore, Latin America remains at the bottom of the equity hierarchy.

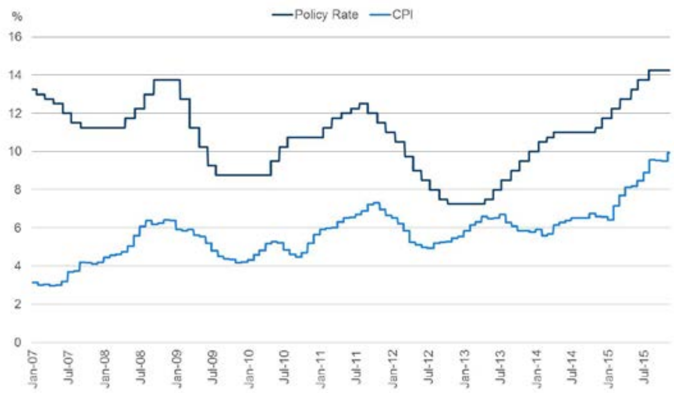
Summary of score changes for Latin America over the quarter

Brazil local bonds downgraded to negative

Political turmoil has engulfed Brazil over the past two years. The situation continues to deteriorate with the deepening political corruption scandal that threatens to derail an extremely painful (but necessary) fiscal adjustment. Importantly, despite threats of President Rousseff's impeachment and the stepping down of Financial Minister Levy, most in positions of power are aligned with the status quo, preferring someone else to do the dirty work to correct the economy to ensure better election prospects in 2018. Brazil has the resources and ability to solve its problems, but the main risk is hitting an economic wall in the process of haggling over the means of execution.

The fiscal adjustment remains challenged but, importantly, tight monetary policy is likely to keep inflation in check. As Chart 6 shows, while inflation has continued to inch up to nearly 10%, the policy rate is already at 14.25% providing a high real yield. The consensus forecast still projects a policy rate below 14% by Q2 2016 and below 13.5% by Q3 2016.

Chart 6: Brazilian policy rate versus inflation (CPI)



Source: Bloomberg 2015

Bond valuations are compelling, particularly in view of the potential for easing. However, as the corruption scandal escalates and the likelihood of impeachment increases, the risks of economic error are significant, supporting an overall score downgrade.

Important Information