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April 2018

By Nikko Asset Management's Multi-Asset team

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Nikko Asset Management

EMERGING MARKETS QUARTERLY: TAKING VOLATILITY 'IN STRIDE'

Q1 2018 Insights

The market narrative changed abruptly over the quarter, from observing the "melt up" in January with exceptionally low volatility, to a massive spike in volatility in early February with markets remaining on edge ever since. What happened? Some blame it on "the machines" (a.k.a. systems traders) which was certainly partly true in the early days, but markets are increasingly pricing real uncertainty – from fears of inflation and trade wars to rising geopolitical tensions.

Volatility is not bad. In fact, it is often healthy as it shakes out excess leverage and weak hands to reveal better opportunities driven by fundamentals rather than excess liquidity. Of course, volatility is less desirable when joined by rising uncertainty that hampers economic activity. So far, we see uncertainty as relatively benign and growth therefore still intact.

Importantly, higher volatility remained mostly limited to the equity complex, and while the dollar strengthened marginally, emerging market (EM) currencies have stayed resilient even despite the run-up in US rates. Our base case is that conditions continue to remain supportive of EM risk.

It is possible that the threat of tariffs between the US and China could elevate to a trade war, but given the extent of the negative repercussions born by both countries, it is still very unlikely. Miscalculations can lead to mistakes, but so far the bluster and rhetoric still appear to be setting the stage for negotiations.

Growth eased in the first quarter, but driven more by the base effects from an aggressive restocking cycle that lasted into early last year. China has tightened, but in a measured way, mostly hindering speculative leverage while still allowing credit to flow into the real economy. Meanwhile, strong profits are feeding back into higher consumption importantly evidencing the gradual economic rebalance that is underway.

US Tax Reform, and perhaps stimulus later this year, is also supportive of global growth. Yes, the US recovery is "long in the tooth", but the restrained recovery to date coupled with still low levels of inflation help support the notion of a potentially extended economic cycle with less risk of overheating.

Of course, inflation surprise to the upside would cause the Federal Reserve (Fed) to shift to more aggressive tightening and change the outlook considerably, but this is not our base case despite record low unemployment. Inflation remains broadly moderate around the world, and it is difficult to imagine US inflation significantly breaking out on its own.

Our principle concern remains the gathering pace of stimulus withdrawal across the developed world. As the Fed continues to increase the pace of its balance sheet reduction coupled with the wind down of QE across the European Central Bank (ECB) and, to a lesser extent, the Bank of Japan (BOJ), financial conditions are likely to meaningfully tighten by the second half of 2018.

Typically, tighter financial conditions are associated with a stronger dollar which would be negative across EM, but flow dynamics suggest that the dollar can even still remain weak. An estimated USD3 trillion in outflows to the US and from Europe and China are just beginning to reverse. Unless US growth turns exceptional relative to other opportunities around the world, US net flows are still likely to remain outbound.

Ironically, while the US attempts to close its external deficits, funding fiscal has deficits become impossible without crowding out the private sector. Therefore, it seems a meaningful reduction in the balance of payment deficit is still unlikely, which is also helping to keep the dollar weak.

China launched the "petro yuan" just weeks ago, which is an early stage challenge to the petrodollar. Already, central banks are keeping fewer dollars in reserves, and increasing global trade settled in currencies other than the dollar means even fewer reserve dollars will be required in the future.

It may be too early to call the end of the dollar as the world's reserve currency, but even a gradual shift away suggests a weaker dollar, which remains supportive of EM.

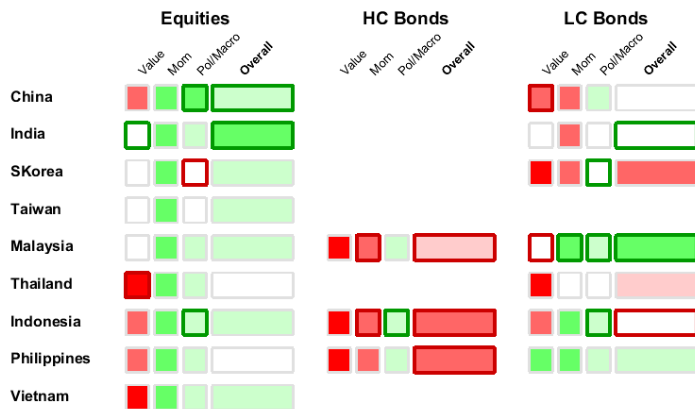
Asia still top growth story in spite of trade skirmish

Higher volatility has touched all risk assets and Asia is no exception. Technology sold off in sympathy with the US, even though regulatory risk is much less. Earnings remain strong and recent weakness likely offers better entry points in the sector. We do see Trump ultimately winning some concessions in trade negotiations, but it is unlikely to meaningfully impact tech given its policy importance across the region.

Growth has slowed somewhat, but mostly owing to a strong base effect. China growth surprised to the upside in Q1, though Q2 is likely to ease as authorities continue to crackdown on shadow banking and overall redirecting its growth objective from quantity to quality.

The Belt and Road Initiative (BRI) is taking shape with significant investment in places like Malaysia providing a further tailwind to local growth. The region still benefits from fiscal reforms supporting infrastructure investment, and now with high levels of inbound foreign direct investment (FDI) from China and improving local credit conditions, growth potential is broadening.

Asset Class Scores



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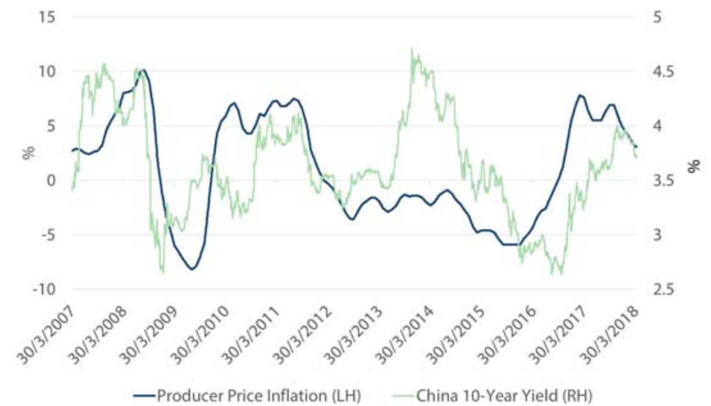
Opening of the China bond market

In March, it was announced that the Global Aggregate Bond Index will include China bonds, starting in April 2019. The weight will scale to ~5.5% by the end of 2020, making its weight the 4th largest in the index. This adds at least USD100 billion of passive investment which could easily grow north of USD250 billion as active investors join the mix and other indexes consider adding an allocation to China as well.

China bonds currently rate expensive based on our valuation metrics, but this is mainly because inflation rates remaining quite compressed relative to history. During 2017, the Purchasing Price Index (PPI) lifted quite significantly both for the pickup in demand as well as aggressive supply side reforms. Bond yields followed, but as PPI has begun to ease in second half, so have the pressures on bond yields, leading to compression as shown in Chart 1.

Chart 1: China yields compress with falling inflation



Source: Bloomberg 2017

In fact, during the US inflation scare in early 2018 causing US Treasury (UST) yields to blow out, China bonds were among very few sovereign markets in the world where yields actually compressed over the same period. Are China bonds the new safe haven asset? It is too early to say, but given the positive spread to developed market (DM) equivalents, which is now challenged in its unwind of exceptionally easy policy, investors are certainly taking note.

China 10Y bonds yield 3.7%, roughly 200 basis points (bps) better than the Global Aggregate Index and 100bps above USTs. The relative yield advantage, coupled with benign inflation dynamics and impending technical inflows due to its index inclusion, make for an increasingly compelling investment story.

Technology shows value relative to global peers

In 2017, industrial profits benefited from a rising PPI and are likely to compress somewhat as PPI falls, but this is only with respect to "old China" industries. Importantly, healthy industrial profits are typically followed by higher wages and increased consumption, which is a tailwind for technology.

The rising middle class is comprised mainly of millennials that consume the lion's share of technology services, usually through smartphones, which we see reflected in robust earnings growth across the sector. In Chart 2 (next page), we compare technology earnings within EM (mostly located in Asia) against the US, Europe and Japan.

US tech earnings have shown relatively steady growth over the last seven years. EM tech earnings, on the other hand, have experienced a downdraft in 2015, but have picked up considerably since early 2016, nearly catching up to US levels.

Chart 2: Technology Earnings around the world

Source: Bloomberg 2017

While EM technology earnings growth remains quite robust, valuations are comparatively cheap at 14x forward earnings versus 18x in the US. Given rising regulatory risk in the US due to Facebook's recent accidental leak and misuse of personal data, EM technology could well have an earnings advantage over the US going forward.

Other Asian points of interest

- ***Inflation still benign:*** the Philippines may have to hike rates later this year, but overall inflationary pressures remain benign across the region including India, allowing policy to remain broadly easy.
- ***India Bank fraud:*** A revealed USD2 billion fraud at Punjab bank was a major setback to bank optimism following the USD32 billion bank recapitalisation announced in late 2017. Investors are concerned for what other frauds may emerge and the risk to credit growth, but the aggressive sell-off in banks seems overdone.
- ***India Bond weakness:*** The rise in India bonds yields has been blamed on fiscal slippage, a widening current account deficit and inflation risk which has yet to really emerge. FDI is healthy at USD42 billion to fund the external deficit, but just barely. Bond yields seem to exaggerate the risk, partly owing to its small investor base, depending too much on banks to soak up supply. Bringing insurance companies into the mix and lifting foreign caps would be useful steps to ease yield pressures.
- ***China government reorganisation:*** Government agencies have been streamlined with targeted authority to meet government objectives, including tackling systemic risks and in shifting the focus from growth quantity to quality. We expect the squeeze on shadow banking to continue.
- ***China bank profits grow:*** Bank lending is picking up, helping to partly offset the pain from the shadow banking squeeze. Supply side reforms and returning industrial profits is helping to bring back confidence in bank balance sheets, helping valuations to rerate.
- ***China launches "petro yuan":*** A new futures market was introduced to trade oil contracts in Yuan, exchangeable directly to gold, which is a long-term potential threat to the petro dollar, though these are early days.

EMEA: trading places in political risk

EMEA remains a mixed region with a notably improved political outlook for South Africa, while Russia remains the geopolitical pariah, recently slammed with the most aggressive sanctions since the end of the Cold War. Eastern Europe continues with strong growth with still elevated EU tensions, while Turkey's imbalances continue to slide as it overheats with high inflation and a significantly widening current account deficit.

South Africa scores were lifted across the board for a much improved political environment. Russia scores are staying put for now, but we continue to watch the situation closely, less so for the impact of recent sanctions but rather the potential for tensions to escalate even further.

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Russia strong fundamentals vexed by rising geopolitical tensions, again

Russia had broadly remained a favourite EM market both for its attractive valuations and favourable macro fundamentals, including still supportive oil prices. Inflation is low, real yields are attractive, and the economy continues to recover on the back of not just higher oil prices, but improving consumption and investment that have broadly lifted earnings.

While Mueller's investigation of Trump for "Russian collusion" seemed to dissipate, other sources of geopolitical tensions were on the rise. In March, the US determined that Russia cyber operations had infiltrated US infrastructure, which was soon followed by an attempted murder on UK soil of a former double-agent and his daughter by a nerve agent, believed to be perpetrated by Russian operatives.

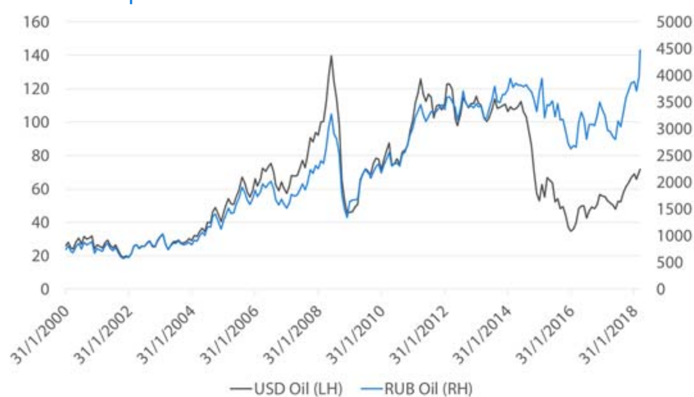
In early April, the US Treasury announced new sanctions against Russian oligarchs and companies, which are the most aggressive to date. Russian markets tumbled – the worst declines since the Ukraine incursion back in 2014.

Viewed through the lens of valuations and macro fundamentals, Russia still remains attractive. The most important distinction between the Ukraine incursion and

going back even further to the Georgian incursion in 2008, these events that similarly slammed Russian assets also coincided with deep declines in oil prices. Today, this is not the case, as oil prices are the highest they've been since the deep declines of 2014.

Importantly, since Russia moved to free float its currency back in 2014, the Ruble has served as a natural stabiliser to changing oil prices. As shown in Chart 3, in Ruble terms, the price of oil has never been higher, which directly transmits to higher earnings and an improved fiscal account. The pass through to inflation is relatively nominal, determined to lift CPI just 1% for a 10% drop in the currency. March CPI measured just 2.4%, comfortably below the 4% target rate.

Chart 3: Oil price in Ruble versus Dollar



Source: Bloomberg 2017

GDP growth had been forecasted at 1.7%, which is likely to be crimped, but not so much in consumption which is the main driver of growth. The primary risk is to investment, given elevated uncertainty and the rising cost of external financing.

Given the fiscal consolidation occurring in 2017, there is room to stimulate if required. All things considered, Russia looks unlikely to slip back into recession. As equities trade at just 5.3x forward earnings – a more than 20% discount to its historical average of 6.9x – there is considerable upside potential.

The bigger risk on the near-term horizon is the conflict in Syria, where the US, the UK and France initiated a major strike in retaliation for the government's use of chemical weapons. Russia is still backing Assad, so these highly fluid (and dangerous) events bear a very close watch.

South Africa upgrade

Last quarter, we reported Cyril Ramaphosa's election as the new head of the African National Congress (ANC) Party and as the country's new President, finally dethroning the terribly corrupt Jacob Zuma. Markets repriced quickly given Ramaphosa's support for business and proposed anti-corruption initiative and, as it turns out, justifiably given his positive actions to date.

Ramaphosa submitted a credible budget plan to close the fiscal deficit by 2022, helping to stave off the looming Moody's downgrade that threatened to push South Africa bonds out of the World Government Bond Index (WGBI), a very large and passively tracked fixed income index, which could have triggered enormous capital outflows.

Former Finance Minister (and highly regarded) Pravin Gordhan was named the new Minister for Public Enterprises, aiming to take on the financial mismanagement of state-owned enterprises (SOEs), giving further credence to Ramaphosa fiscally prudent objectives and overall desire to push positive reforms.

Former President Jacob Zuma is now being brought up on charges of corruption, which is an important (and symbolic) step in kicking off the anti-corruption campaign.

South Africa has yet to be fixed, but it is on the mend currently assisted by the tailwinds of global growth and commodity support. Should growth slow materially, the fiscal trajectory would be at risk requiring more painful reforms.

Turkey turning more fragile, again

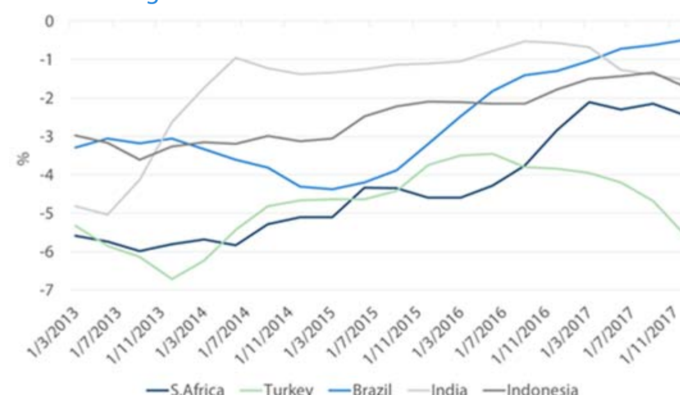
Turkey is once again standing out for its vulnerabilities in the form of high inflation and its sliding current account deficit. While CPI eased to 10.2% in March 2018 from a 13.0% peak touched back in November 2017, inflationary pressures still remain high with CPI levels expected to remain between 10% and 10.5% over 2018, with risk to the upside.

The economy has been running on a sugar high of fiscal stimulus which is due to decline given high real yields and stretched bank loan-to-deposit ratios. Meanwhile, rising imports prices of oil and a curious demand for gold have caused the current account to slip quite badly.

The so-called "fragile 5" was damaged by heavy capital outflows back in 2013 during the taper tantrum, which was mainly attributable to large current account deficits shown in Chart 4. Most of the 5 have improved their positions through a combination of reforms and macro support – except Turkey.

The rise in volatility coupled with the continued withdrawal of stimulus by developed market threatens another liquidity squeeze leaving Turkey at risk in funding its external deficit. The recent slide in the currency seems to reflect this rising risk.

Chart 4: "Fragile 5" current account deficits



Source: Bloomberg 2017

LatAm shifting leadership

Latin America (LatAm) benefits from still supportive demand for its commodity exports coupled with better politics and gradual economic improvement. Levels of debt are still high, arguably hampering demand but declining servicing costs is repairing balance sheets while helping to lift earnings.

Investment is picking up in Chile on returning business confidence following the election of President Pinera, while even Mexico is turning more upbeat as the US has made important concessions that increase the likelihood of a NAFTA deal closing before the Mexico presidential election in July.

Brazil is still sits with high levels of uncertainty concerning the upcoming Presidential election in October. It's a coin toss but, nevertheless, markets are giving the benefit of the doubt. Inflation remains low, though real yields are compressed relative to history, providing little cushion if the election outlook starts to sour.

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Mexico benefits from less uncertainty

The US shifted strategy, focusing its attention on Trade with respect to China and, in the process, allowing for certain concessions with respect to NAFTA and increasing its likely passage – probably before the Presidential election in July.

Andrés Manuel López Obrador (AMLO) is likely to win the upcoming Presidential election, and still poses risk in his left-leaning policies, but the hope is that, as a career politician having served as the Head of Government of Mexico City in the early 2000s, he is more likely to remain pragmatic in catering to his populist base while ultimately keeping prudent policies in place to support growth.

CPI has declined to 5% in March from a 6.8% peak back in December. Inflation should continue to ease as growth remains weak and a stronger peso passes through even more disinflation. Monetary easing can be expected despite the Fed's continued tightening.

The economy remains sluggish, though with NAFTA uncertainty lifting and rate cuts on the horizon, the outlook for Mexico appears brighter.

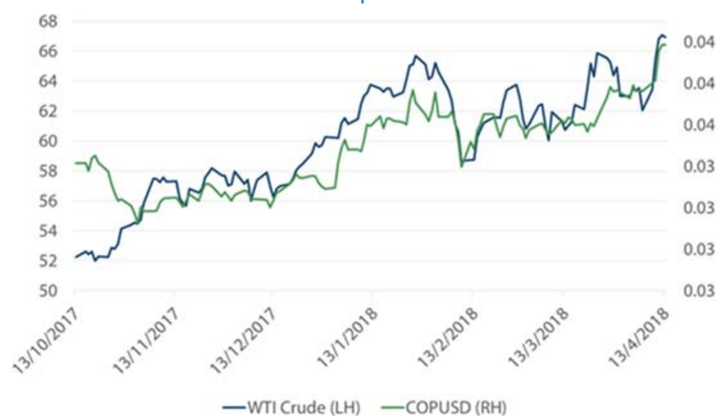
Argentina's stubborn inflation & deep drought

Argentina is more challenged of late, as inflation remains stubbornly high and the government has been less successful than hoped in negotiating labour contracts. Meanwhile, the country has suffered its worst drought in 20 years, dragging the current account down to -6%. The economy continues to rebalance on the back of many positive reforms, but still high inflation, slower growth and a deepening current account deficit remain headwinds for now.

Colombian Peso remaining oil play

As the Russian Ruble decouples from oil given its geopolitical turmoil, the Colombia Peso may be the beneficiary, perhaps taking some of Russia's flows as a means of gaining alternative exposure to continued oil strength.

Chart 5: Chilean Economic Perception Index



Source: Bloomberg 2017

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