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INVESTING IN EMERGING MARKET EQUITIES, EUROPE 2019

Developing and implementing strategies that balance risk and reward

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INVESTING IN EMERGING MARKET EQUITIES, EUROPE 2019

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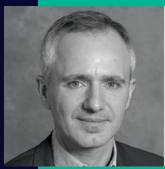

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1.1 ROUNDTABLE DEBATE

How is the tension between the US and China affecting the appetite for investing in Emerging Market equities - what are the global implications?

Moderator

Dominique Kistan,
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Chris Bates,
Associate Director,
FTSE Russell

POINTS OF DISCUSSION

- *Political tensions and economic impact*
- *Micro look at EM performance – who has been most affected?*
- *Drivers and impact of de-escalating trade tensions*
- *Looking to the future*

Dominique Kistan: What are the key pain points impacting Emerging Markets (EMs) as a result of the political tension between the US and China?

Zsoka Koczan: I will focus on what we call the EBRD regions, which refers to the former transition countries and the southern and eastern Mediterranean. This region roughly covers Estonia to Egypt and Morocco to Mongolia.

This is a region that is highly integrated: it has benefited from high FDI inflows and deep integration in global value chains in the early 2000's, before the global financial crisis.

Some of these countries, particularly in emerging Europe, are even more integrated, whether in terms of trade in intermediate goods or FDI inflows as a share of GDP, than many other EMs that we typically think of as participating in global value chains, like South Africa or Malaysia.

In recent years, as in other EMs, these flows have, however, been falling. FDI inflows have come down sharply since the global financial crisis and trade in intermediate goods has plateaued in this region.

Part of this reflects trade tensions which have increased uncertainty and reduced the value of offshoring production. However, it also reflects underlying structural changes, such as automation, which has reduced the importance of labour costs, and hence reduced the value of moving production to lower wage locations. Wage gaps between the EBRD regions - especially in emerging Europe - and advanced economies have also become narrower over time. Trade tensions have exacerbated these trends and brought these issues into the spotlight.

If these tensions remain confined to bilateral disputes, the effect on the EBDR region would be limited, but these countries would be affected by weaker global demand as a result of trade tensions.

Günther Schiendl: The issue this year has clearly been US interest rates and the US dollar versus emerging market currency movement. This, together with the political tension between China and US has led to a massive outflow of investments from the region. Specifically, emerging markets and Asian emerging markets.

> IT LOOKS TO ME TO BE A KIND OF NORMALISATION; WE WON'T GO BACK TO WHERE WE HAVE BEEN BEFORE, BUT A REAL SOLUTION ISN'T ON THE TABLE BECAUSE WE DON'T YET HAVE A COHERENT PICTURE

As an investor, on the equity side, we have attractive valuations for stocks in EM, but the point is that it will need a spark for investors to re-enter emerging market equities. It might be that right now the pendulum is turning with some signals on the trade front that the first sign of a deal is around the corner. Also, with the US dollar movement and the bond side there has been less turbulence because EM bond yields are attractive in comparison to developed market yields, so they have not been as affected as equities from the tension.

Whilst this is the financial impact there is a material impact as well. The longer trade tensions persist, the longer companies will wait with their investment and expansion programs. Ultimately, this will clearly have feed back into asset prices as well.

There has been an impact which has been felt for most of this year, but now there is some hope for a better situation in the future.

Chris Bates: It is all coming at a time when global growth and global trade have been slowing. Over the past year annual global growth in trade has dropped around 5% points and is in negative territory with half of this coming directly from the US and Asia Pacific region.

Clearly the impact of this trade dispute is visible in the data and for the open export driven economies, most of which are in the EM space and so rely on the US and China, they will also be caught in the crossfire.

This is coming at a time when there are also some more general structural concerns over EM, mainly for the high levels of US denominated debts within EM that haven't gone away yet.

We have also seen the overall financial conditions, particularly in the US, ease over the past year or so particularly with regards to interest rate expectations.

One area of pain has been the strength of the dollar relative to EM currencies. Given the high levels of US dominated debt in these countries, this could be something that flairs up.

The mood within markets seems to have improved somewhat recently and some expectation that a deal will be agreed in the next month or so but clearly there are structural concerns over EM as well.

Dominique: In your opinion, which EMs are being impacted most severely?

Chris: If we are talking about equity market performance then the obvious answer has been China who has performed reasonably well of late but has underperformed the wider EM index notably since mid 2018 - when trade tensions really came to the forefront as a key issue for markets.

We have seen the Chinese authorities responding with a devaluation of the RMB, which could well offset some of the impacts of the tariff.

From an equity market point of view, we can't just look at emerging markets as one market that is going in the same direction. This has been evident in the performance differentiation that has been seen within EM, and there have been fractures aside from the trade tension that have been driving underperformance or outperformance for individual countries within the EM space.

> "SLOWING GROWTH IN CHINA WILL LIKELY WEIGH ON CENTRAL ASIAN ECONOMIES THROUGH COMMODITY LINKS. IN GENERAL, COUNTRIES THAT ARE MORE INTEGRATED IN GLOBAL VALUE CHAINS AND ARE MORE OPEN WOULD BE MORE VULNERABLE"

Russia has performed very well this year and has had improving rhetoric over the sanctions and sensitivity to oil. Latin American performance has been driven more by domestic political concerns.

There have been a few winners emerging from this trade tension through trade diversion. For instance, with the slowdown in Chinese exports to the US there has been a partial offset by a boost in exports from other Asian countries with Bangladesh and Vietnam being winners. This has occurred in south America where, somewhat ironically, US imports from Mexico have increased significantly from some of the goods which the US has imposed tariffs on.

Zsoka: In terms of the slowing of global trade growth, this will weigh on the EBRD regions across the board. Some countries are more exposed to slowing growth in the eurozone, which has been revised down repeatedly. According to the IMF, it is now at the lowest level since 2013, and will affect countries in central Europe.

Slowing growth in China will likely weigh on central Asian economies through commodity links. In general, countries that are more integrated in global value chains and are more open would be more vulnerable.

So far, we have seen growth in central Europe and the Baltic states hold up; these countries continue to outperform comparable EMs at similar levels of development. This is mostly driven by strong domestic demand and wage growth. However, we do see high frequency indicators pointing to slowing industrial production here as well.

One of the factors that affects EMs in this region is weak governance, which weighs on valuations because it increases the risks for minority shareholders. It is also associated with lower stock market returns over time.

The EBRD countries started the 1990s with weaker governance than advanced economies, but improvements since then have been much larger. However, a gap continues to remain, and this is weighing on stock market valuations as well as growth. In a recent report we found large growth dividends of improving governance.

Günther: Somehow the Chinese equity market has been quite interesting. If you look at the local A shares market, with a ytd-Performance of about 20% which is about the same as the MCSI world index, one could have assumed that local Chinese companies would have been more affected from the trade situation but it turns out that the neighboring countries in Asia have been more affected than China. This is probably because of stimulus measures that the Chinese have taken.

For the other regions, Latin America is very much a local phenomenon and it seems to be that government functions are handed over from family to family. For Eastern and Central Europe, we don't necessarily refer to them as EM and haven't for some years as the development in these countries has been more in line with Europe. It would seem as though Chinas has held up better than expected.

Dominique: What potential outcomes can we anticipate given the current circumstances, and how are asset managers/owners preparing for these outcomes?

Günther: Right now, it seems to be a real worst-case outcome is off the table because Donald Trump has recognized that he needs a deal to keep his chances of a re-election intact. This is situation is much better than it was just a few weeks ago. Today we can't say whether we will have a solution to issues like high tech companies and intellectual knowledge, which have been at the center of Trumps motivation to start the trade war.

It looks to me to be a kind of normalisation; we won't go back to where we have been before, but a real solution isn't on the table because we don't yet have a coherent picture. Donald Trump is moving from one action to the other and whether these add up to a larger and more coherent picture remains to be seen. In any case, the situation is about to become less heated and I suppose this will lead a lot of asset flow back into the regions.

Another issue is that of sustainable finance within EM in Asia because there are structural developments that are interesting for investors. I would also assume that EM fixed income will be a major beneficiary just because of the global interest rate environment. More investors will move in and many who had been invested in EM bonds already but had moved out will likely re-enter this market.

Within EM bonds, we have the full spectrum from government bonds to investment grade corporates to corporate high yield bonds that are investable for investors. It is more a question now of their strategies or risk appetites as to how far up the risk spectrum they will go, but I believe in corporates and corporate high yield and feel that it is quite an interesting sub asset class.

Clearly, the exchange rate with US dollars as the EM currency is a major factor in whether investors are moving money or not.

Chris: It is fair to say that the mood has improved somewhat recently with expectations that a deal may be reached next month. EM have been a somewhat higher beta play on trade news and are likely to be a beneficiary if we do get some more positive news.

Of course, an important factor is where we are in the US election cycle. Despite the tough rhetoric on trade from Donald Trump, there is an election next year so he will be cognisant of seeing consumers getting hit with higher prices, as companies pass on some of the higher tariffs. He won't want to see manufacturers in areas where he has built up support in the US, getting hit by margin squeezes so on this basis, he will want to see some sort of resolution or truce even if it is a short term one, because it will impact his chances of re-election.

One major positive is that these trade tensions have come at a time when financial conditions globally are relatively loose. Central Banks are getting into their monetary toolboxes once again and the looser financial conditions in the US will mean good news for EM. If the dollar does remain under control and the decline in developed market interest rates will help to pull EM yields lower as well. This accommodative monetary backdrop should support general economic growth in EM going forward despite the uncertainty over the drag from the trade tension.

Zsoka: From a long-term perspective, trade tensions in the EBRD regions have highlighted vulnerabilities of some countries. These economies are highly integrated in regional value chains. However so far, we have only seen limited learning associated with this. As countries participate in global value chains, they can learn from their suppliers, customers and competitors. This could allow them to move up the value chain to produce higher value-added components domestically, deepen their domestic supply chain capabilities and domestic supplier markets.

> "One area of pain has been the strength of the dollar relative to EM currencies. Given the high levels of US dominated debt in these countries, this could be something that flairs up"

In the EBDR regions, despite the countries' deep integration in global value chains, we have seen very little learning so far. Reliance on imported inputs has been broadly constant: foreign value added remains high, and large multinational enterprises remain dominant, especially in some sectors which are important drivers of growth. For instance, in car manufacturing, foreign value-added accounts for almost 40% of countries' exports.

The trade tensions have revealed these vulnerabilities. Limited learning from global value chains, high reliance on foreign companies, relatively limited spillovers to the rest of the economy, and shallow domestic supply markets could raise questions about the sustainability of the growth models of these countries, which have served them well so far, but may not be sustainable in the future.

Dominique: What are your prescriptions for the future?

Günther: Investment wise, fixed income in EM and sustainable finance in developing Asia are part of a global trend. Essentially, it is being led out of Europe with the European Union sustainable finance initiative which is about ESG and climate risk disclosure, reporting, Paris climate goal alignment and transition strategies etc.

On a physical basis, it is obvious that the major cities in China need to do something against pollution. I feel that globally politicians realize that we need to do something now or in the immediate future about climate change, so new climate policies and new initiatives will be created.

There will be new industries forming, such as renewable energy, the connection between I.T and sustainability both regionally and globally, which will provide potential for financial growth and be an essential contribution to the climate.

This will be a period of fundamentally rethinking investment strategies. I expect that investors will start to reconsider either exiting coal or oil industries and other heavy contributors to green house gas emission, but even more so investors will start looking into the new growth potential of renewable and sustainable industries. Asia and China urgently need to develop in this area, so we will be increasingly looking out for this. We can expect more green bond issuances and China is one of the top three countries in the world in terms of green bond issues. The other area is around the interest rate deferential that makes many EM or even frontier market bonds high attractive.

Chris: Given where we have seen developed market interest rates heading means that this hunt for yield is likely to continue, which many EM - China in particular - could benefit from.

For the near term, the worst-case scenario is off the table. A tail risk whether this is merely the tip of the iceberg in terms of the deeper deterioration in China US relations is something that hasn't been priced in yet and could be difficult to try to quantify.

One area that is in the firing line is the technology sector where we have already seen warning shots across the bow over the past year given the huge influence of the sector, not only in the US market but also the Chinese market and the wider EM landscape as well.

Zsoka: To follow up on the importance of the technology sector - this has revealed how vulnerable some of the EBRD economies are. I mentioned relatively limited learning and the high reliance on foreign enterprises earlier; furthermore, this is a region where growth has been relatively innovation light. When it comes to recreating supply chains domestically, economies with higher innovation capabilities, better management practices, stronger governance and larger domestic markets will have the upper hand in the long run.

The EBRD economies would face major challenges in a context of restrictions on transfers of technologies across borders, given their relatively modest innovation levels, as well as relatively weak governance.

Dominique: Thank you all for sharing your thoughts on this topic.

“GIVEN WHERE WE HAVE SEEN DEVELOPED MARKET INTEREST RATES HEADING MEANS THAT THIS HUNT FOR YIELD IS LIKELY TO CONTINUE, WHICH MANY EM - CHINA IN PARTICULAR - COULD BENEFIT FROM”

1.2 WHITEPAPER

Tension, Tariffs and Trade Wars
The role of China in emerging markets

Penny Pan,
Director- Project Management,
FTSE Russell

Relations between the US and China have been volatile recently. The world has watched—and the markets have reacted—as the two countries have imposed billions of dollars in tariffs on each other's goods over the past year.

Despite growing US-China tensions, China remains the world's second largest economy, making its prominence in emerging markets (EM) investment difficult to ignore. And for index providers such as FTSE Russell who are looking to reflect its global presence in their EM indices, China introduces a new type of tension—the complex task of determining which China equities to include.

The process for including China in EM indices starts with taking a step back and defining emerging markets more broadly. Many investors associate a country's index classification solely with its economy, where a country is classified as developed, emerging or frontier on the basis of its relative economic wealth. But while the strength of a country's economy is important, it represents just one of many index classification considerations.

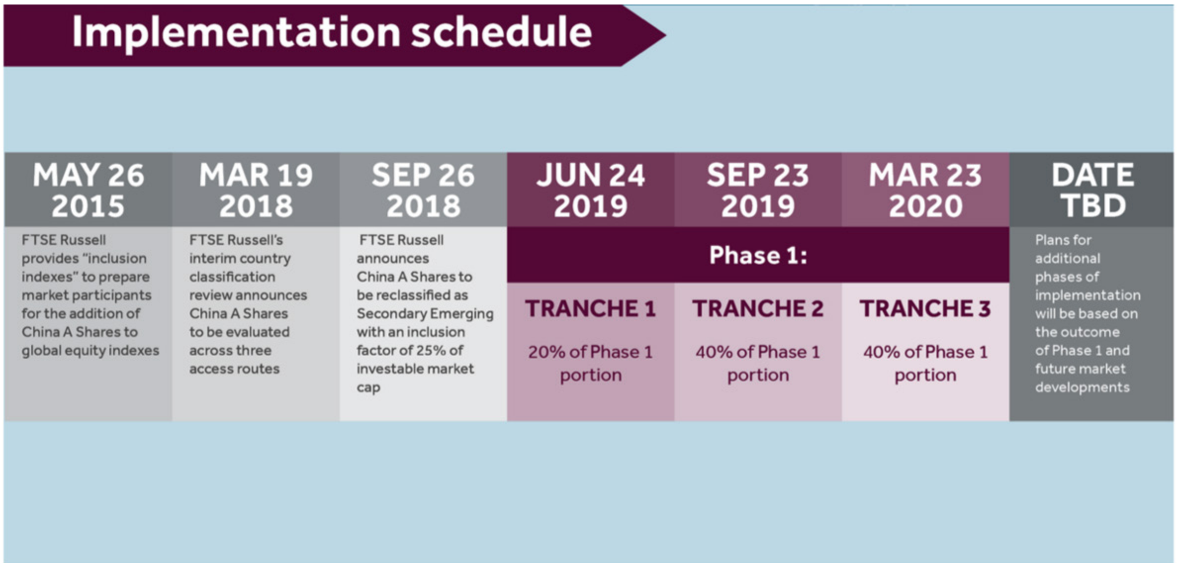
For example, FTSE Equity Country Classification framework assesses a total 21 of relevant objective criteria. These considerations are designed to gauge whether the country's market infrastructure, regulatory environment and investment processes can cope with the increased activity that would occur if it joined a leading global EM index. As a result of applying such a broad and diverse set of criteria, the countries FTSE Russell classifies as emerging are from an economic perspective, a relatively eclectic set of markets.

However, when it comes to capital market infrastructure, countries classified as emerging have far more commonality than differences. Notably, FTSE Russell announced in September 2018 that China A Shares available via the Northbound Stock Connect program—the mainstream equity class in that country—met the criteria to be included in its global equity indexes, the FTSE Global Equity Index Series (FTSE GEIS), as a Secondary Emerging market. When China A Shares are compared with their emerging index peer group, there is great similarity with respect to key criteria like investment access, market regulation, foreign exchange mechanisms, the settlement process and competition in the broker and custodial arenas.

The rising prominence of China A Shares in global markets is what prompted FTSE Russell to evaluate this market against its equity country classification process—and to conclude it was time to include large, mid and small cap China A Shares in its global indices. The decision to include China A Shares small caps is a particularly noteworthy one, as FTSE Russell is the only major index provider opting to phase them into its global indices.

FTSE Russell's decision to include small caps is about achieving an accurate representation of the China A Shares market. The 2014 launch of the Shanghai-Hong Kong Stock Connect scheme and the 2016 addition of a similar program connecting Shenzhen and Hong Kong significantly eased access to China equities for international investors. A broad range of China A Shares—not only large cap and mid cap but also small cap stocks—are available under the Stock Connect scheme. As such, including China A Share small caps makes for a more comprehensive representation of the China A Shares opportunity set.

While the case for including China A Shares in EM indices has been made evident through a rigorous and transparent classification process, the task of doing so is complex. Index changes of this magnitude are a significant undertaking and require several steps to ensure the market is prepared to absorb such a sizeable shift in assets. To assist index trackers in efficiently replicating the underlying benchmark change, FTSE Russell designed Phase 1 of its China A Shares implementation plan to be spread over three separate tranches. This initial phase of inclusion is based on 25% of each security's investability weight, with the first tranche implemented on June 24, 2019 and the final slated for March 23, 2020.



The implementation plan also involves seeking market feedback after each tranche is implemented. This gives FTSE Russell the ability to evaluate how well the market is absorbing the additional securities before proceeding with the next tranche.

With the first two tranches of Phase 1 China A Shares implementation in the rearview, the FTSE Russell Emerging Index has already begun its transformation. The first two tranches only represented 60% of Phase 1, but nonetheless resulted in the addition of 1,082 China A Shares to the FTSE Emerging All Cap Index, representing investable market capitalisation of over $324.7 billion.

While these numbers are not insignificant, it is important to note that 40% of Phase 1 implementation still remains. Once this phase is completed in March 2020, China A Shares representing over $300 billion in investable market capitalisation will have been added. As shown below, the addition of these shares will impact China's country weight across FTSE Russell's EM indices, although the level of impact depends on the specific index. For example, the FTSE Emerging Index (which includes large and mid-cap stocks) is projected to see its China weight increase from 34.6% to 37.0%, while the FTSE Emerging Small Cap Index is projected to see its China weight jump from 17.5% to 22.7% after Phase 1 is completed.

Comparison of China's current and projected weight after Phase 1 completion

	FTSE Global All Cap	FTSE All-World	FTSE All-World ex US	FTSE Emerging All Cap	FTSE Emerging	FTSE Emerging Small Cap	FTSE Asia Pacific
China's weight as of March 29, 2019 (did not yet include A Shares)	3.3%	3.5%	7.7%	33.1%	34.6%	17.5%	17.4%
Projected weight of China A Shares after completion of Phase 1	0.6%	0.6%	1.3%	5.8%	5.7%	6.8%	3.0%
Projected weight of China after completion of Phase 1 (includes A, B, H, N Shares and P, Red, S Chips)	3.8%	4.0%	8.8%	35.8%	37.3%	20.9%	18.5%

Source: FTSE Russell. Projected weights are for March 23, 2020 using prices and constituents as of September20, 2019. Please see the end for important legal disclosures.

Looking ahead, it is important to keep in mind that Phase 1 is just the beginning of the process. FTSE Russell will base the timing and size of additional phases of China A shares implementation on the outcome of Phase 1 and future market developments. Specific questions could include: whether the size of the next phase should be based on any increase to the quota sizes; whether Phase 1 should be repeated (i.e., taking the total inclusion factor to 50%); whether stocks outside of Stock Connect routes should be included. But regardless of how additional implementation phases unfold, FTSE Russell expects China's share of its EM indices to continue to grow, with the ultimate potential to dwarf other EM countries.

China A Shares included in FTSE Global All Cap Index - September 23, 2019

	Number of Stocks	Number of Stocks as % of China A Total	Full Market Cap (USDb)	Full Market Cap as % of China A Total	Net Market Cap* (USDb)	Net Market Cap* as % of China A Total
Shanghai Stock Exchange	**480**	**44.4%**	**3,657.2**	**63.8%**	**195.5**	**60.2%**
Large Cap	182	16.8%	3,069.6	53.5%	159.2	49.0%
Mid Cap	169	15.6%	406.6	7.1%	24.6	7.6%
Small Cap	129	11.9%	181.0	3.2%	11.7	3.6%
Shenzhen Stock Exchange	**602**	**55.6%**	**2,075.3**	**36.2%**	**129.2**	**39.8%**
Large Cap	120	11.1%	1,197.1	20.9%	72.3	22.3%
Mid Cap	245	22.6%	540.3	9.4%	34.0	10.5%
Small Cap	237	21.9%	338.0	5.9%	22.9	7.1%
Total	**1,082**	**100.0%**	**5,732.5**	**100.0%**	**324.7**	**100.0%**

Source: FTSE Russell, based on closing prices as at September 20, 2019
* Net market cap takes into consideration free float and foreign ownership restrictions and the 25% inclusion factor for Phase 1.

As shown, according to FTSE Russell's research China shares could in time form half of all stocks in FTSE Emerging Markets, with A Shares, and ex A Shares (B, H, N, P, Red and S Chips). So, while US-China tensions, trade wars and tariffs continue to play out on the global stage, China's prominence in EM investments continues to rise—a concurrent trend that has already begun to reshape EM indices.

1.3 INTERVIEW

Evaluating the impact of strength of the dollar on Emerging Markets from a macro and micro perspective

Interviewer

Dominique Kistan,
Content Producer,
Clear Path Analysis

Interviewee

James Jackson,
Senior Equity Manager
Researcher, Aon Hewitt

SUMMARY

- *Relationship between EMs, the dollar and commodity prices*
- *Balancing macro and micro perspectives*
- *Benefits of a heterogenous approach to EMs*
- *Importance of active investment approach to EMs*
- *Global growth, integration and comparisons with developed markets*

Dominique Kistan: From a macro perspective, how has the strength of the dollar impacted Emerging Market Equities?

James Jackson: At a headline level, it is widely recognized that a strong dollar is bad for EM in aggregate, and you can track the performance of a strong dollar versus EM underperformance to developed markets quite nicely.

There are three main reasons for this. One reason for this is that a strong dollar will impact countries who have high levels of dollar denominated debt, and the costs to service this debt will become more expensive in local currency.

Secondly, the attractiveness of the EM asset class would reduce in dollar terms, which would potentially increase capital flight away from EMs.

A third reason which doesn't always hold, but generally commodity prices can be impacted as international markets price commodities in dollars, and the strong dollar would make commodities more expensive for other countries. With less demand the price of commodities will fall. With a number of EMs being commodity exporters, this will hurt them from this angle.

However, not all EMs are affected the same, the countries that would be most affected by a stronger dollar would be those with high levels of foreign debt, currency account deficits, external funding challenges or if the commodity linkage is there, commodity exporters. The countries that are most exposed at the moment are places like Turkey, South Africa, and from the commodity perspective, countries like Brazil and Chile both have a high proportion of commodity exports. Whereas on the flip side, a country like India is a commodity importer, so they could benefit on a relative basis.

This is why we advocate an active approach to EM, so that you have the ability to potentially down weight some of the less attractive markets if the macro is unappealing, or if there are signs of dollar weakness there are markets that would be stronger relative beneficiaries.

There are of course other drivers to EM than the US dollar. The influence of commodities within EM is less than it used to be. If you look at the EM MSCI index and go back 6-7 years, roughly 30% of the index was directly linked to commodities / energy. Whereas, now it is much less - around half that figure - and in its place there are more domestically orientated industries.

There are also countries such as Russia, who is quite isolated from the global economy at present, so the incremental dollar direction has mattered less. There are also areas such as China A-shares, or companies listed and domiciled in mainland China, which have had completely different drivers to the incremental dollar direction. So, whilst dollar strength and weakness are important, there are many other factors to consider.

> IF THIS PORTFOLIO MANAGER HAS A HOMOGENOUS VIEW TO EM, THEN YOU WILL MOST LIKELY MISS OUT ON OPPORTUNITIES THAT COULD BE BENEFICIAL TO A GLOBAL PORTFOLIO

Dominique: What are the benefits of evaluating investments in EMs from a micro perspective?

James: We look at many EM managers, and subsequently recommend our preferred picks to clients. Evaluating EMs on a micro or bottom up basis is critical. By this I mean not just looking at the macro, or top down of Emerging Markets, but considering the companies that you could invest in within those countries. For all the managers that we look at, few, if any, would just look at the macro or have a purely top down approach. Even if you have a manager who is more tilted towards top down or macro, you still need a stock selection approach.

Both macro and micro views impact stock returns within EM, so arguably an approach that can capture both, will be able to capture more alpha drivers and ways of outperforming the market.

The importance of micro can even be perceived as an extension to the dollar discussion, with a different impact at the company level. A market like Brazil tends to react negatively to a strong dollar, but it also has some export companies within its index whose revenues are in dollars, but their costs are in local reals. So, these companies can actually do well in a stronger dollar environment. Also, Brazil at the country level has a lot of foreign currency reserves, but some of the big companies within the index have been very debt laden in foreign denominated debt, so there are company differences.

An ancillary point here is that when we look at managers, it is important that managers can look across all of the opportunities that are within a country. There are some EM countries where the benchmark composition or stock market capitalization is very concentrated in only a handful of companies. For instance, in Brazil, around 60% of their index is made up from about 8 organizations and you get a similar pattern across a number of countries. These large stocks are also often banks, commodity companies, or perceived proxies for the country macro, so are arguably more exposed to external factors, such as the global liquidity or the dollar.

Therefore, a smaller manager or someone who is able to look down the market cap spectrum may be able to find a few more opportunities in a wider variety of industries. These opportunities may contain more domestic companies or have some slightly different drivers to navigate some of these external factors, whether it be associated trade or the dollar.

We do see managers who primarily focus on bottom up and who have less focus on macro, but this has ramifications too. If you invest purely on a micro basis you could be attracted to great companies that are in poor macro exposed countries i.e. a good house on a bad street. This might mean that whilst the company is doing great in local currency terms with good growth, operations and performance but the dollar return that you get as an investor may be poor. If this is your approach, you may have to be patient and wait for an extended period for the macro effects to diminish, and positive company fundamentals to prevail.

Having perspective of macro is imperative, there are some managers who use it as an alpha driver and return seeking objective, but it is fine if you use it as a risk control as well complementing bottom up stock selection.

Dominique: What are the dangers of a homogenous approach to Emerging Market Equity investments?

James: EMs are often presumed to be volatile with vulnerable currencies, weak governance, focused on manufacturing and heavy industry but with higher growth.

Many of our clients will invest in a global equity fund, which is one portfolio manager or portfolio management team who will be tasked with picking the best companies from around the world. If this portfolio manager has a homogenous view to EM, then you will most likely miss out on opportunities that could be beneficial to a global portfolio.

Whilst EMs are certainly more integrated into the world now, there are still diversification benefits to be had from EM to developed markets with some differentiated return drivers. They are also some great companies. Some might be surprised to hear that there are some world leading technology companies who are steps ahead of some of the large US, well known technology companies.

The other angle is that if an investor wants to make a dedicated allocation to EM. This homogenous impression is probably a nod towards a desire to invest passively. If everything is the same, why would you pay to have an active approach to EM. But the reality is that there is a lot of variation within EMs; with different valuations, growth rates, stages of economic development, demographic profiles, levels of political stability etc. The components of EM don't move in lock step, so there is an opportunity for an active manager to benefit from this as they move. If they are treated as a single risk proxy block, then you are probably going to miss value parts of it and overpay for growth in other parts as well.

One example of the benefit of an active approach would be that if you look at Brazil who had several years of relative underperformance compared to the broader index up until 2016.There was a very poor macro situation a lot of political issues and a corruption scandal. Hope came into the market in 2016 with political change, commodity prices rose, and the market rallied significantly. If you were a passive investor, you would have largely ended up where you started, so you would have underperformed and then benefitted in the upswing. If you were an active manager who was able to moderately underweight this market through the difficulties and then allocate more when there was an upswing, there would have been a lot of excess performance that could have been harnessed.

Dominique: How essential is it to evaluate emerging market investments in relation to developed markets?

James: Within EM there are different degrees of integration into the global economy, but the reality is that many EM companies are very entwined to the global economy. If you were to take your smart phone out and look at it, if it was not a brand from Korea or China the components of it almost certainly are from an Emerging Market, so it is naïve to not consider EM companies in the context of developed market competitors.

Most EMs are not closed to just domestic competition, so understanding the global competition is vital to understanding the prospects of many EM companies. It might also be that the developed market company who is operating in the EM is the more compelling investment case.

If this happens, we are open to an EM manager investing in a developed market listed company, as long as the underlying revenues from that company are coming from an EM, and sometimes it does make more sense to do this. An example of this would be that there are quite a few subsidiaries of developed market companies in the consumer staples sector that are listed in EM, and these tend to trade on very expensive valuations. Part of this is because there is a scarcity factor, as within EM there aren't as many companies with the same characteristics as these companies. Whereas, the parent company who is listed in the developed market world doesn't have that same scarcity issue because there are more comparable companies. Resultantly often the parent trades on a much more attractive valuation, so we are certainly open to the manager allocating to the cheaper counterpart. This also gives you a bit more breadth in the opportunity set and gives you a bit more potential diversification versus a stricter approach.

Dominique: Thank you for sharing your thoughts on this topic.

SECTION 2

BALANCING RISK AND REWARD

2.1 WHITEPAPER

Maximising the potential of Emerging Market opportunities over the long-term through market cycles and sector evolution

2.2 INTERVIEW

Striking the balance between political volatility and attractive asset prices: does increased volatility produce more attractive opportunities?

2.1 WHITEPAPER

Maximising the potential of Emerging Market opportunities over the long-term through market cycles and sector evolution

Eugene Nivorozhkin,
Associate Professor in Finance, University College London

Over the last decades Emerging Markets (EM) have been steadily becoming a strategic investment in global asset allocations. The broad consensus is that their importance is also likely to increase over time. The dominant argument evolves around the investable universe of EM exchanges that is still modest in comparison to the size of their economies. Based on purchasing power parity adjusted exchange rates, EM account for 59% of the global GDP and for 74% of global GDP growth. EM also represent 40% of global economic activity based on the origination of listed companies' revenues. Nevertheless, as EM continue to liberalise, broaden and deepen to reflect their economic growth drivers, they still account only for 20% of global total market capitalisation, which drops to 12%, if free float adjusted market capitalisation is used. EM's market capitalization to GDP ratio, a measure of the market depth, has also been much lower comparing to the developed markets historically - currently standing at 90%, compared to 118% for developed markets.

The pervasive argument in the investment community is that EM's underlying characteristics and market microstructure makes them significantly inefficient relative to developed markets. Greater volatility of EM is stressed to be a driving force for more frequent deviations of prices from underlying fundamentals, providing investors with the potential for significant alpha generation, much more so than in developed markets.

With the increase popularity of factor investing and smart beta strategies it is interesting to check the relative performance of emerging and developed markets using a robust and reliable set of internationally accepted market indices. We start by exploring four individual factor returns and compare them between EM and Developed Markets (DM) and then proceed with performance comparison of indexes tracking the performance of all four factors.

The Size Factor captures the tendency of small-cap stocks to outperform bigger companies over the long run. The size premium has been part of institutional investing for decades. In the past few years, it has become a building block of many factor-based indexes. The MSCI Equal Weighted indexes underweights large-cap stocks and overweights mid-cap stocks relative to its parent index resulting in a low size bias exposure. In the last 15 years (October 2004-October 2019), MSCI EM Equal Weighted Index delivered a slightly inferior annualised returns relative to MSCI World Equal Weighted Index (5.2% vs 5.4%) (see Figure 1). During the period, the EM index underperformed the underlying parent index MSCI EM by 15 percentage points, while DM index outperformed the underlying parent index MSCI World by 1 percentage points. The average difference between the annual performance of an equal weighted index and a parent index was 0.69 percentage points for DM index and only 0.06 percentage points for EM index (in the period 2005-2018). The 3-, 5, and 10-year Sharpe ratios were consistently higher for the equal weighted DM indexes than EM indexes. The Sharpe ratios of the equal weighted indexes were also consistently lower than the Sharp ratios of the underlying parent index in both groups.

The Value Factor is based on the notion that cheaply priced stocks outperform pricier stocks in the long term. The MSCI Enhanced Value Index applies three valuation ratio descriptors on a sector relative basis: (1) Forward price to earnings (Fwd P/E); Enterprise value/operating cash flows (EV/CFO); and (3) Price to book value (P/B).

In the last 15 years (October 2004-October 2019), MSCI EM Enhanced Value Index delivered 8.7% annualised returns, compared to 5.3% delivered by MSCI World Enhanced Value Index (see Figure 1). During the period, the EM index outperformed the underlying parent index MSCI EM by 114 percentage points, while DM index outperformed the underlying parent index MSCI World only by 5 percentage points. The average difference between the annual performance of a value enhanced index and a parent index was 0.4 percentage points for DM indexes and 2.4 percentage points for EM indexes. The 3-, 5-, and 10-year Sharpe ratios were consistently higher for the DM indexes than EM indexes. The Sharpe ratios of the value enhanced index was lower than the Sharp ratios of the underlying parent index for DM. For EM, the 5-year Sharpe ratio of EM index was slightly higher than that of the underlying parent index and the 10-year Sharpe ratios were equal.

The quality factor is described in academic literature as capturing companies with durable business models and sustainable competitive advantages. The MSCI Quality Index employs three fundamental variables to capture the quality factor: (1) Return on equity - which shows how effectively a company uses investments to generate earnings growth; (2) Debt to equity - a measure of company leverage; and (3) Earnings variability - how smooth earnings growth has been. In the last 15 years (October 2004-October 2019), MSCI EM Quality Index delivered 9% annualised returns, compared to 8.4% delivered by MSCI World Quality Index (see Figure 1). During the period, the EM index outperformed the underlying parent index MSCI EM by 128 percentage points, while DM index outperformed the underlying parent index MSCI World by 123 percentage points. The average difference between the annual performance of a value enhanced index and a parent index was 1.9 percentage points for DM index and 1.98 percentage points for EM index. The 3-, 5-, and 10-year Sharpe ratios were consistently higher for the DM indexes than EM indexes. The Sharpe ratios of the DM quality index were higher than the Sharp ratios of the underlying parent index for DM, while for the EM index only the 3-year Sharpe ration was higher than that of the underlying parent index.

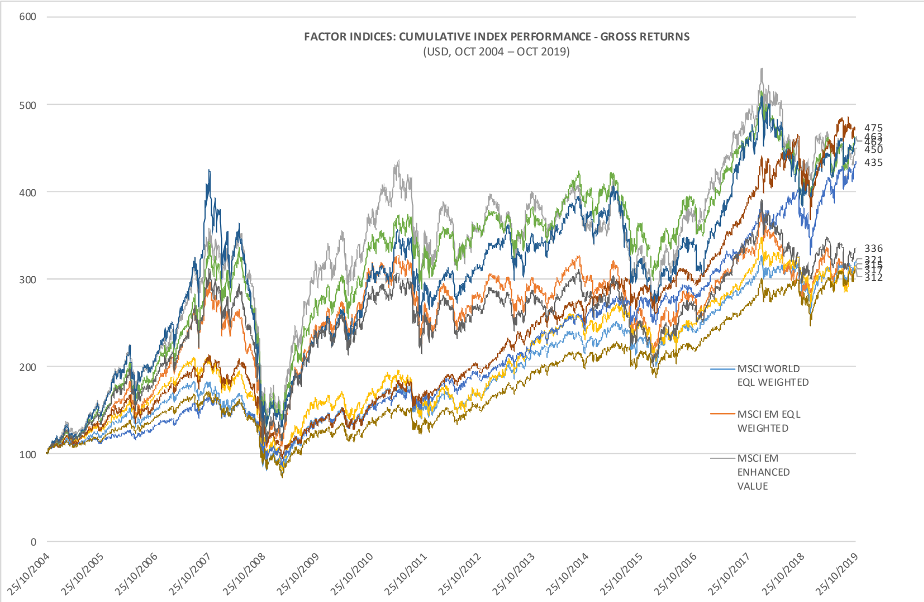
The momentum factor refers to the tendency of winning stocks to continue performing well in the near-term. The MSCI Momentum Index measures: (1) Risk-adjusted excess return - that which exceeds the benchmark - for 6-month periods; (2) Risk-adjusted excess return - that which exceeds the benchmark - for 12-month periods.

In the last 15 years (October 2004-October 2019), MSCI EM Momentum Index delivered 10.7% annualised returns, compared to 10.9% delivered by MSCI World Momentum Index (see Figure 1). During the period, the EM index outperformed the underlying parent index MSCI EM by 126 percentage points, while DM index outperformed the underlying parent index MSCI World by 163 percentage points. The average difference between the annual performance of a value enhanced index and a parent index was 3.21 percentage points for DM index and 2.40 percentage points for EM index. The 3-, 5-, and 10-year Sharpe ratios were consistently higher for the DM indexes than EM indexes. The Sharpe ratios of the momentum indexes were higher than the Sharp ratios of the underlying parent index in both groups.

MSCI Diversified Multiple-Factor Indexes use the Barra product risk tools to construct indexes that track the performance of four factors considered earlier – Value, Momentum, Quality and Low Size. It is argued that these factors provided higher return than the overall market, while the index construction allows to keep risk at the level of an underlying parent index. Among other things, the indexes allow investors to active while keeping risk at the level of an underlying parent index. Hence, the multiple-factor indexes significantly diversify the risk characteristics of the corresponding single-factor indexes. In the last 15 years (October 2004-October 2019), MSCI Diversified Multiple-Factor Index delivered 9% annualised returns, compared to 8% delivered by MSCI World Diversified Multiple-Factor Index (see Figure 1). Nevertheless, the DM index outperformed the EM index over 3- and 5-year time horizons. During the period, the EM index outperformed the underlying parent index MSCI EM by 463 percentage points, while DM index outperformed the underlying parent index MSCI World by 419 percentage points. The average difference between the annual performance of a value enhanced index and a parent index was 2.63 percentage points for DM index and 2.66 percentage points for EM index. The 3-, 5, and 10-year Sharpe ratios were consistently higher for the DM indexes than EM indexes. Only the 10-year Sharpe ratio was higher than the Sharp ratios of the underlying parent index for DM, while only the 3-year Sharpe ratio was lower the one of the underlying parent index for EM.

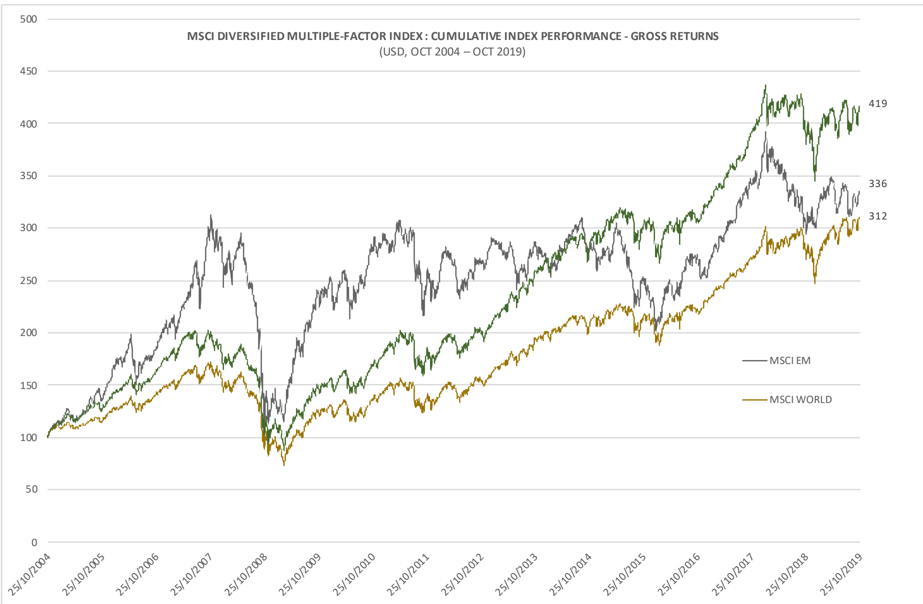
The presented analysis confirms the conventional wisdom that allocating part of an investor's portfolio to emerging markets equities could add value to a global equity portfolio. It also highlights the benefits of allocating to factors in both emerging and developed markets. The evidence with respect to the relative performance of multi-factor strategies in developed and emerging markets is mixed and varies depending on the sub-period considered. The improvements in the efficiency of emerging markets over time and decline in volatility of returns relative to developed markets clearly limits alfa opportunities and presents active portfolio managers with new challenges. Emerging markets tend to be more heterogenous than developed markets, as they comprise a huge array of economies all at various stages of development and maturity with different capital market structures. With many different currencies, political frameworks and policy stances emerging markets is a complex, diverse, evolving and relatively inefficient market universe. More dynamic and volatile nature of emerging markets compared to developed markets leads to a different balance of price and volatility drivers. While stock research and selection are key for all portfolio managers, 'Top Down' factors, such as country, industry and currency can be disproportionately important in driving prices and hence the alpha opportunity in the emerging markets

Figure 1



Source: Thomson Reuters Datastream

Figure 2



Source: Thomson Reuters Datastream

2.2 INTERVIEW

Striking the balance between political volatility and attractive asset prices: does increased volatility produce more attractive opportunities?

Interviewer

Dominique Kistan,
Content Producer,
Clear Path Analysis

Interviewee

Egon Vavrek,
Director, APG Asset Management

SUMMARY

- *Impact of political volatility and emerging market economies*
- *Understanding and managing risk*
- *Mispricing*
- *Taking on excessive risk*

Dominique Kistan: How would you describe the relationship between political volatility and EM asset prices?

Egon Vavrek: The relationship undeniably exists, so I would agree with the thesis that political volatility can have an impact on emerging market asset pricing. If you look at the past two decades' emerging market capital flow, we see clear evidence that EM become part of mainstream investment portfolios. During that period, many emerging market economies went through political and economic hardship, those periods were providing a good opportunity to collect more evidence.

Dominique: What are the key points of political volatility that do affect these asset prices? What has been the impact of EM coming into the mainstream?

Egon: Political volatility most likely existed even before EM become mainstream asset class in the last 20-30 years, but in the early years most of the exposure was felt by fixed income side of investments, as most are exposed to these dynamics. Increased presence of passive investment vehicles likely amplified the volatility, as it become easier to move large amount of capital and have direct market impact.

Dominique: What are the additional risks that investing in EMs entails?

Egon: The reality is that policies and the politics that influence macro-economic policies are firmly in place all around the world. One of the most recent examples is that the current president of the United States is criticizing the FED's monetary policies and the ECB is spending tangible amount of time debating whether fiscal stimulus can be part of the monetary tools set or not.

The increased political volatility globally is not really an EM story any longer, but rather a global reality. However, the biggest impact on asset prices is still coming from EM because the reach of these policies is much deeper, due to the short period of time that market economy has had to mature. Additionally, lack of full balance-and-checks and independent protection of those institutions will have sudden and tangible market implications.

If you look over the past few years, we have had experiences from the sanction starting out in Russia, currency crisis in Turkey and Argentina. All of which have indicated that the magnitude of the political and macro-economic events can define asset prices in a very sharp way.

This is the main reason that we are directed to EM overall, because this kind of volatility for a long duration asset owner offer a compelling investment opportunity. If we have the capacity to understand the risks clearly and try to tilt the portfolio towards countries and assets that are mispriced, we can take advantage of sharp market reactions. We have evidence that some of the cases a situation seems to be blown out of proportion and the country seems to be over-penalized. As we are a long duration asset owner, we have the privilege of being able to deploy capital during these periods of crisis.

Dominique: How do you evaluate your risks?

Egon: There are a few very clearly defined macro risk proxies for equity investors that are serving us very well when we are carrying

> “THE INCREASED POLITICAL VOLATILITY GLOBALLY IS NOT REALLY AN EM STORY ANY LONGER, BUT RATHER A GLOBAL REALITY”

out our first assessment on a country. Usually we are looking at hard currency pricing of different bond issuances or different CDS of single assets levels. Spreads are mainly credit driven tools, but these usually serve as a very good starting point when we are defining what kinds of risk factors visible.

For our direct equity product, we have a separate team who handle the macro assessment on single country level and running much more systematic and comprehensive risk assessment. The process is to build a country model, which focuses on different economic drivers, i.e. labour productivity, unemployment, demographics, disposable income trend, credit penetration systems etc.

This process will provide us with a firm macro-economic view on the country, which can be used to define whether the country is on the right or wrong path.

Dominique: Are these data points based on previous trends i.e. the way that politics have unfolded in the past and the way that they have impacted EM equities?

Egon: In the past, we have known countries that have been seen a 'basket-case' as they failed to address their macro-economic imbalances or funding/capital shortfalls (e.g. Argentina or Turkey). Argentina is probably the most notorious defaulter in the past century, so those facts are would be in the back of our minds.

We still try to judge a single investment so we would drill down to a single bond issuance or equity investment and look at what are the prevailing risks. We are aiming to define whether there is anything left on the table for a long-term investor i.e. are there any quality long-term investment opportunity out there that we could be involved with?

Equally, it could be that this overarching environment that was very poor in the past will constant continue to prevail and it's unlikely that even quality assets will offer some return to our stakeholders, because they cannot compensate for those shortfalls ('a great house in a bad neighbourhood'). Most of those companies are performing better than regional peers but if you look at it from a hard currency perspective, they still prove to be unattractive investments. This is driven by the fact that the over currency depreciation has penalized our hard currency return, despite the underlying focus on management and asset quality.

This is the biggest factor that we are observing when it comes to political risk and volatility. It is an area where you really have to roll up your sleeves and make sure that you are making a full assessment of a country. You need to make sure that you are able to handle the micro reality, whilst you are embedding most of the macro numbers in that process in order to come to a solid and holistic view as to whether it is a good investment or not.

Dominique: Is there a particular strategy that enables you to mitigate risk when investing in Emerging Market equities?

Egon: If you were looking at mispricing, for a very large western European headquartered companies and a western listed consumer companies, big part of the revenue is generated in EM. If you look at the revenue split, we don't recognize that the company's issuance has been priced either on the bond or equity sides to any of those risks.

If we are looking at similar operators, such as any of the beverage or consumer staples companies listed in emerging markets. They may be operating with the same metrics and geographies, they may be priced more aggressively, as risks are more prominent from investors' perspective. The biggest differentiation that we can do as a long duration asset owner is to look at the difference between these two areas.

One of the most curious facts is coming from Russia, as a large state-owned company is trading at new highs in dollar terms since sanctions were imposed in 2014. It is visible how much hard work went in on the management side to become more shareholder friendly, improve capital allocation, despite weak commodity and oil prices.

You could have taken advantage of this mispricing in Russia in 2014, if your mandate allowed it. But it would have required a large amount of attention in the following 4-5 years to assure that management delivers on promises.

Dominique: Does the cautious behaviour of many investors produce better prices for those who are willing to take on riskier bets?

Egon: We see many of the big global macro driven houses which are in trouble, because they took on too much risk. With this knowledge it is difficult to make an assessment on whether the cautious or riskier approaches are beneficial.

You must be flexible and follow the markets very closely. It is easy to say that taking excessive risk doesn't pay off, but in other parts of the world with the high concentration of passive flow, sometimes asset allocators will fully remove capital from countries who may have been in the headlines for the wrong reasons. This is where fundamental investors can come in and take advantage of the volatility because most of it is being driven by technical issues.

If a country or company moving to sub-investment grade with their bond issuance, we know that a few asset managers are prevented by their mandates to be exposed to that market, so you know that there will be an artificial supply of that issuance. Not because anything new happened to the country (probably most of the structural weaknesses already priced in), but because most of the investors are prevented holding those assets.

The same to index trackers when an index setter agency removes a country from its index. We experienced the same dynamics when a new country was added to one of the MSCI equity indices. There was a huge run off because passive flow was coming into the country to track the global and EM universe at the peak for the indices and no one was doing any honest assessment on political, geopolitical or macro-economic risks of the country.

Alternatively, you can take advantage and invest in a more contrarian manner, because there is a technical explanation for why the market behaved in this way.

We also have many defining factors in how we handle EM asset exposure, which is coming from our sustainability and geopolitical risk. We make sure that we have a strong and prudent process in place, as it is difficult to handle highly volatile countries where they have a poor practice. For example, human rights, bribery, money laundering, etc. These sometimes filter down directly into political or macro-economic activity and reality. We have our policy in place as most of the time, these factors give us a good indication as to when upcoming volatility can be visible in these markets.

Dominique: Thank you for sharing your thoughts on this topic.

SECTION 3

THE BUSINESS GROWTH CYCLE

3.1 WHITEPAPER

The implication of China's business cycle on the rest of EM and the global economy

3.2 INTERVIEW

Discussing tax burdens for foreign investors and whether reducing them can facilitate capital markets and equity growth in Emerging Markets

3.1 WHITEPAPER

The implication of China's business cycle on the rest of EM and the global economy

Nafez Zouk,
Emerging Markets Macro Strategist, Oxford Economics

China isn't to the world, and to emerging markets (EM) in particular, what it used to be. Decades of stellar investment-fuelled growth have made China a key facet of the global economy, underpinned by the extensive linkages of cross-country demand for commodities, goods, FDI, and technology.

More pertinently, however, China has been the provider of marginal growth – and, indeed, the shock absorber of last resort – at times when the world has needed it the most. During the 2008 global financial crisis, China's massive stimulus package of nearly 20% of GDP meant that the global economy was able to recover much faster than would otherwise have been the case. And EMs in particular were able to continue enjoying the commodity boom that would go on to last a few more years. Even during the 2015-16 downturn which coincided with a fall of oil prices to a low of $28 per barrel, China's aggressive stimulus managed to pull the economy out of the doldrums and pave the way for the coordinated 'goldilocks' environment of global growth that underpinned the stellar asset returns of 2017.

The past 18 months, however, paint a starkly different picture. The slowdown in the global economy, driven in part by the rise of protectionism and trade uncertainty, has coincided with a slowdown in Chinese growth as well. China's real GDP growth in Q3 fell below 6% for the first time in 30 years. But this, in our view, is China's new normal and a reflection of key structural changes underway in its economy. Our forecast is for Chinese growth to continue moderating, falling to 5.7% in 2020.

Is China not coming to the rescue this time?

Against this backdrop, expectations that China would rehash substantial stimulus measures from its 2008 and 2015-16 playbooks were running high when signs of faltering growth emerged in late 2017. But the aggressive stimulus measures that the world economy had grown used to did not materialise. Crucially, we see little scope that they will.

Many factors are at play. Chinese authorities have made a clear pivot away from a focus on growth to one on financial stability. As a result, their policy actions have been constrained by concerns over the health of bank and corporate balance sheets, the sustainability of the real estate sector, and, more recently, by US trade tensions, all the while contending with increasing fiscal deficits and a debt overhang in the corporate sector.

Therefore, the authorities in China have satisfied themselves with relatively minor stimulus measures – cutting taxes, lowering reserve requirements, and allowing local governments to issue more debt. More recently, the PBoC tweaked its interest rate framework, and even lowered its new benchmark Prime Loan rate by 5bp. But the monetary transmission mechanism has been impaired for a while now. And the heavy guns have not been brought out.

Consider Beijing's options. The authorities could boost the real estate sector, as they did in 2015, incentivizing mortgage lending to fuel a construction boom. But they are now much more concerned with financial stability and would be loath to see an unsustainable rise in house prices, or an excess supply of housing stock. Instead, growth in housing starts has moderated this year, with little signs of a pick-up in 2020.

Beijing could also pursue a previously tried and tested strategy of increasing infrastructure spending. Previous rounds of spending on large projects has provided a boost not only to the domestic economy, but to a large swathe of EMs whose commodity and mineral exports are fodder for China's construction industry. But again, with local governments already shouldering large debt repayment burdens (and reduced tax revenues), there is little appetite in Beijing for them to take on additional debt.

Moreover, the impact of monetary easing has not filtered through to the real economy as expected, partly because the demand for credit remains low. Corporate default rates are rising, and a highly leveraged corporate sector (with record amounts of dollar-denominated debt) would rather pay down its debt than invest in productive capacity. Meanwhile, a unit of debt generates less growth than it used to. Little wonder why the authorities have turned their attention to financial stability. A crackdown on shadow banking and has been a key reason behind the fall in credit growth since mid-2017.

That leaves the onus on Chinese consumers, which have become the biggest source demand. Indeed, a key plank of the authorities' long-term strategic plan is to shift China's economy towards becoming consumer led. But that will take a long time. Household income is still a relatively low share of the overall pie. Moreover, Chinese consumers still save a large share of their incomes, thanks in part to the absence of social safety nets, which means their marginal propensity to spend any windfall from any tax cuts is low.

Countering this relatively bleak picture, are two silver linings. First are the emerging signs that the signing of a "phase one" deal between the US and China could lead to a truce until the US election in November 2020. After many bouts of excessive optimism this year, the bar has been set so low that just a rolling back of some tariffs, coupled with the concessions made by both sides, could be enough to boost sentiment.

Second, there are signs that China may be preparing for another round of stimulus measures by the end of the year. But even then, expectations for a substantial package are low. The government's tolerance for slower growth has risen. Thus, we expect it to remain relatively restrained in terms of applying policy stimulus. The world and EM are going to have to get used to that.

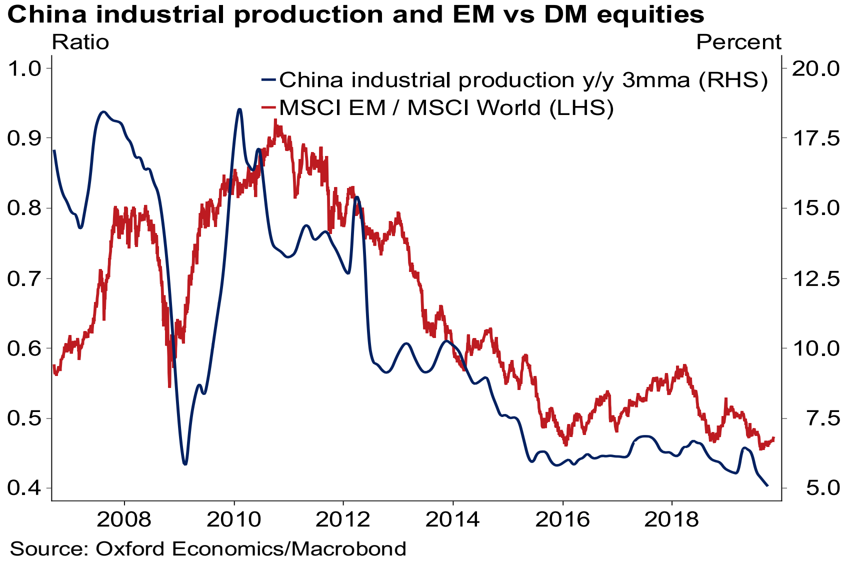
The inability, or rather, unwillingness, of China to stimulate its economy, an extent commensurate with previous episodes of faltering world growth has reduced international spill-overs. This is one reason why global growth has continued to deteriorate over the past year, and why that weakness has been concentrated in the manufacturing sector. The auto sector-driven contraction in German industrial output is a case in point. The slowdown in Chinese demand has also contributed to the slump in prices of commodities, minerals, and basic metals.

For emerging markets, the implications are more structural in nature. In the past decades, export-led growth has been the model of choice for many EMs seeking to take advantage of China's stellar rise. In practical terms, this has translated into China becoming the largest trading partner of the vast majority of EMs, particularly those exporting commodities. Permanently lower demand from China will challenge EMs to find alternative sources of growth.

A new normal for EM assets?

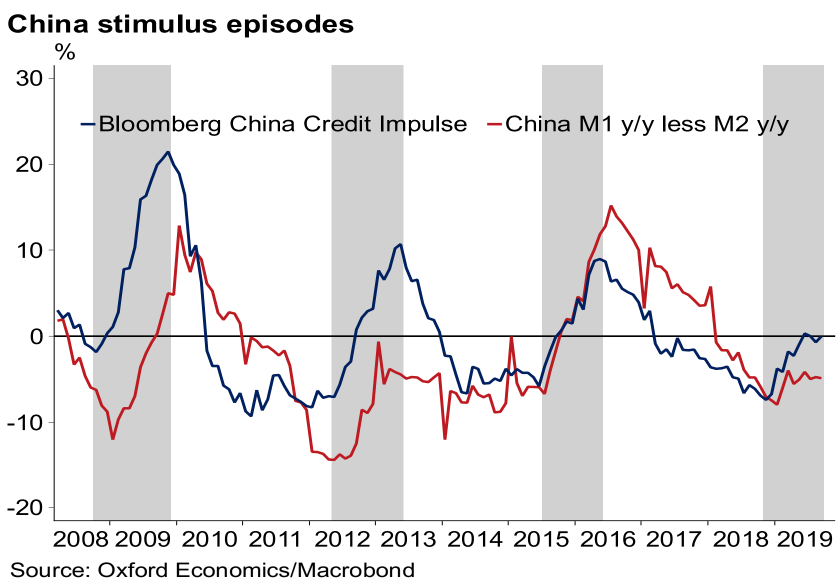
For EM investors, a new, non-China centric normal will be a tricky environment to navigate. China's sheer size in most investable indices means many EM investors will have a hard time ignoring China. Those that can will find it difficult to escape the exposure, both direct and indirect, that EM asset classes have to China.

Historically, the outperformance of EM risk assets, notably equities, has largely relied on the Chinese industrial sector holding up. But imports and the troika of industrial production, retail sales and fixed asset investment have been disappointing. And, as noted above, policy-easing measures undertaken so far this year (tax cuts, monetary easing, RRR cuts) have so far had little success in turning the tide of the growth slowdown underway since the end of 2017.



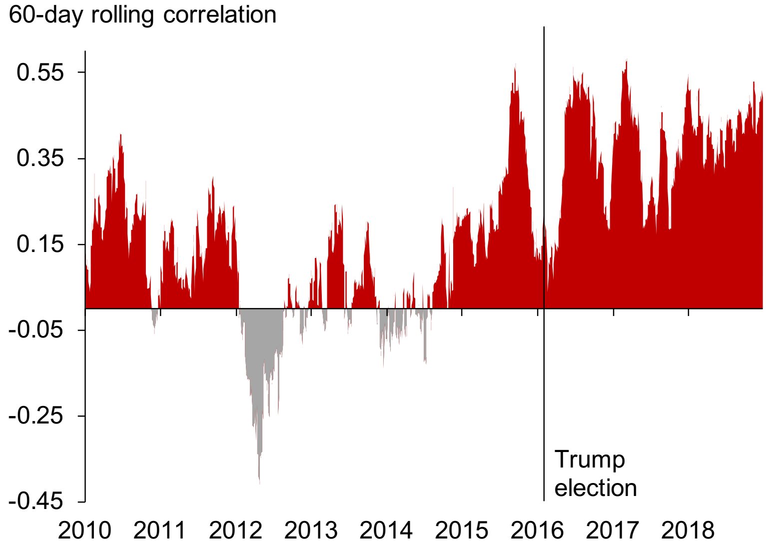
Normally, we would have expected the recovery in China's credit impulse – a reliable leading indicator of the global manufacturing and trade cycle – to cushion the impact of the slowdown and boost risky assets. But conditions are very different this time. Over the last decade, the global trade cycle has followed the trajectory of China's credit cycle. But there are two significant qualifications this time – (1) China's stimulus is much less focused on the property market, global spill-overs are much smaller and (2) trade tensions – not just US-China, but also Japan-Korea and US-Europe – counter the favourable effects of China's fiscal expansion.

In any case, recent credit data does not suggest that a credit surge on par with previous slowdowns (2015, 2011- 12, 2008-09) is underway. Shadow banking contributes a much smaller share than previously to total social financing, and a significant part of the increase in bank credit this year is previously off-balance-sheet loans migrating to banks' balance sheets. Unsurprisingly in that light, estimates of China's credit impulse have been rolling over again after a pick-up earlier in the year.



Emerging market currencies have been caught up in the US-China trade tensions. The continued strength of the dollar during the Fed's policy rate cuts this year has kept the headwinds facing EM currencies strong, making EM FX the weakest link in the investment thesis for EM. Although the dollar reigns King when it comes to guiding the portfolio flows to and from EM, a new player has recently emerged on stage – the CNY. We calculate that, since Trump's election, in other words, since the start of the US-China trade tensions, the correlation between EM currencies and the CNY has risen to above 0.5 (from an average of 0.1 in previous years). As a result, EM currencies have had to, in addition to a strong dollar, contend with a weaker CNY, particularly since it breached the psychologically important level of 7/$ to absorb the impact of sanctions.

EM FX and CNY correlation



Source : Oxford Economics/Bloomberg

But there are some green shoots. Leading indicators of economic activity in EM, such as PMI indices, have turned expansionary over the past few months, providing some momentum for a turnaround in EM currencies. And if the recent truce holds, we might be set for a year where EM currencies will be less of a drag on EM local-currency bond total returns.

In this environment, differentiation will be key. Not all EMs are created equal. Some will benefit from China's slowdown and trade tensions with the US – Taiwan and Mexico are a case in point. Both have managed to capture some market share from China and increase exports to the US. Vietnam has become the country of choice for relocation of supply chains away from the Chinese mainland. Thailand has managed to continue attracting inflows, despite the regional trade tensions.

Other EM, particularly those like Turkey and India who have traditionally had large current account deficits in part due to large oil import bills, will benefit from the lower oil prices that result from decreased Chinese demand.

Some will fare less well. Many exporters of key commodities, like Chile and South Africa, will have to deal with permanently altered terms-of-trade, keeping up the pressures on their currencies and dampening their investment outlooks.

Other headwinds facing EM will gradually fade. US macro fundamentals suggest a weaker trajectory for the dollar. That, coupled with lower rates core rates and falling EM bond yields, will provide a strong anchor for EM assets to perform well. EM equity valuations are cheap on aggregate, and low and well-anchored inflation in EM means policy rates can continue to fall.

What's clear, however, is that era in which Chinese demand lifts all EM boats is waning. As that tide retreats, an investment framework that differentiates EM by their China exposure will not be the only requirement for investors. Equally important will be a country-specific assessment of ability of each economy, or cluster of economies, to reinvent themselves in this new normal.

3.2 INTERVIEW

Discussing tax burdens for foreign investors and whether reducing them can facilitate capital markets and equity growth in Emerging Markets

Interviewer

Dominique Kistan, Content Producer, Clear Path Analysis

Interviewee

Diego Martinez Burzaco, Market Research and Private Banking, MB Global Capital

SUMMARY

- *Impact of tax on capital markets and country*
- *Government strategy*
- *Developing domestic capital market*
- *Relationship between capital market and economic development*

Dominique Kistan: What are the key pain points surrounding tax burdens for foreign investors?

Diego Martinez Burzaco: We must consider taxes from several angles. When you are looking at foreign capitals to EM, foreign capitals are looking for good returns and limited risks. If you are tax burdened or have tax issues to consider, perhaps you are adding risk, which means that you will require higher expected returns for your investors.

I feel that taxes are not the perfect way to seduce this capital in order to remain long term within EM. What taxes do is limit the period holding of investors in EM and these sorts of things are not very good for the entire development of capital markets and the development of the country.

Dominique: How do you do you address the challenge of limited holdings within EM?

Diego: Based on my experience in Argentina, there was initial confidence about the new government in 2016 and the only capital inflow that we had seen was short term capital. Then, a year later, the government set a new tax on investments and this discouraged capital inflows.

We can also see similar experiences through several EM not only in Latin America but also in Europe and Asia. What governments tried to do with these kinds of taxes is to have more fiscal income in the short term, but for the mid and long-term perspective this was very damaging and hurt the economies and capital market development.

Capital wants to get the higher return as much as possible with the lowest tax rate. So, in this environment, it is unwise for countries to apply new taxes to capital investment when trying to get new capital inflow. This could hurt economic prospective mainly in those countries who have fiscal deficits. As capital moves freely, it looks for better conditions with market friendly governments than those who want to create and use taxes for capital.

Dominique: To what extent are tax burdens a deterrent for foreign investors to invest in EMs?

Diego: When you entice capital inflows, you are not only attractive short-term capital but also mid-term capital. In countries where the rules are changing all the time, capital doesn't feel comfortable so they will look for a short-term return and then will move on.

For those governments who think with a more long-term strategy in mind and who give both capital fiscal incentives as well as tax incentives, they can enjoy not only the short-term financial investments but also the mid-term investments which are linked to the real economy not just the financial economy.

This is the main challenge that several governments within EM face nowadays, as they must change or set economic policies for the mid-term perspective.

When you are only focused on the short-term perspective you may enjoy capital inflow, but it may only be for several months and then you will have to deal with the outflows. This could negatively impact your economic prospective, as well as your currency against the dollar and the euro.

Dominique: Is this something that the Argentinian government is doing at the moment?

Diego: In Argentina we had general elections last Sunday (October 27th) where the society chose the opposition candidate, and the market friendly government that is leaving next December lost an important opportunity to entice capital. Not only the foreign capital, but also the domestic capital that is allocated abroad.

They couldn't manage the unstable rules for investments that had taken place during the last decade in Argentina. When they encouraged capital inflow to the country a year later, they set a tax on financial investment that discouraged both foreign and domestic capital that came from abroad and capital outflowed again.

This is the key issue of what was wrong with this government and it was committed across several governments in all of Latin America. They didn't want to carry out the strong reforms that the economy requires, and they fell in love with the short capital inflow and then when the outflows occurred, the economic vulnerability appeared again. Therefore, Latin American economies are much more volatile compared to European EM.

Diego: In countries where there is a lack of credibility, they will need to time to convince investors that things will be different. You can't promise and then move back to older policies that not only hurt investors but also the domestic capital markets. In countries where credibility is very low, they will require more time than in those countries where they are more respectful about the investment flows and have rules that prevail over the coming years.

There is no magic here but just a long-term strategy that should be implemented by the government without taking care who the ruling party is at that moment, capital should be respected as a key institution in order to develop your capital market.

Dominique: To what extent would reductions in tax burdens facilitate capital markets and equity growth in EMs?

Diego: Capital markets should be the main institution in order to drive the savings into real economy investments.

If you can't link savings and investing, then you will encounter short-term constraints, and this could not produce economic development.

There is a very real relationship between the development of local capital markets and the economic development in Argentina, so capital markets should play a central role in the development that any country wants to achieve in the long term.

> "In countries where the rules are changing all the time, capital doesn't feel comfortable so they will look for a short-term return and then will move on"

Dominique: What would the benefits of reducing tax burdens for foreign investors be?

Diego: If you reduce that tax burden, it will develop domestic capital market, which is crucial when looking for economic development. If you look at the statistics, you can find a developed economy with an undeveloped capital market. There is a correlation there and if you are looking for the economic and development growth in that country you should make the strong effort to develop capital markets.

One of the factors that can drive this is reducing tax burdens for capital outflows and domestic capital that is allocated abroad. You should incentivise that capital so that countries develop their capital markets, because for the capital to stay it needs rules. If you change the rules frequently, you will see that short-term capital will be the only capital that will come into your country and this causes damage when they leave again.

Dominique: It is about creating an environment where the capital stays in the country for long, as opposed to taking a shorter view?

Dominique: Do you have any final thoughts?

Diego: I have been working in investments for 18 years and I see similar behaviors in many Latin American economies around what capital markets should mean to the prosperity of their societies. If you have a prejudgment of the role of capital markets and your opinion is negatively biased, you will never understand the link between savings and investments.

You should analyze and evaluate this relationship without any kind of political judgement as this is a fact that shows that there is a strong relationship between the growth of capital markets and the economic development. There are several examples around the world and within the EM economies, we should try and imitate what several developed economies have done in the past as this is the key for them to also achieve development.

Dominique: Thank you for sharing your thoughts on this topic.

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