EMERGING MARKETS

MEXICO'S MOMENT

In the spotlight, the country shows its resilience

Dr. Ricardo Adrogué is the Head of Emerging Markets Debt at Barings. The group manages strategies covering the full spectrum of EM debt, including local currency, sovereign hard currency and corporate bonds. Utilizing an investment framework that combines fundamental credit analysis and macroeconomic forecasts, Dr. Adrogué and team aim to build high-conviction portfolios across a universe of more than 75 countries covered.

Understanding U.S.-Mexico relations

Defying past market forecasts, Mexico's peso has been a top performer among emerging markets this year, appreciating by 11% against the U.S. dollar, while yields on 10-year dated bonds have edged down by around 40 basis points. In part, these improvements have been underpinned by signs that the hard-line immigration and trade policies mooted by President Trump may, in practice, be less far-reaching than expected. Positively, several senior cabinet members have struck a conciliatory tone on bilateral issues related to immigration, trade and security.

Relations with the U.S. are only part of the story, however. We believe the credible policymaking by President Peña Nieto's administration and the Central Bank will sustain Mexico's macroeconomic stability and sovereign creditworthiness, even if trade relations begin to worsen with its northern neighbor.

A balanced view on trade and migration

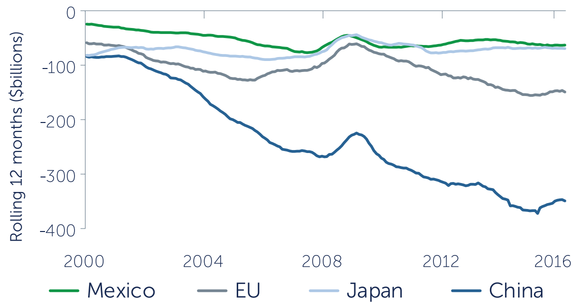
Given the interdependent and mutually beneficial relationship between the U.S. and Mexico, the shift in tone has helped to allay concerns on both sides of the border. In addition to cultural, security and immigration issues, the deep economic ties between the two countries cannot be understated.

Trade with Mexico supports 6 million jobs in the U.S., according to the U.S. Chamber of Commerce, while export receipts total over $200 billion. Indeed, Mexican consumers' propensity to consume U.S. goods is 10 times that of Asian consumers, with agricultural states being key beneficiaries of this demand.

In turn, Mexico's exports to the U.S. surpass imports, giving the country a trade surplus of $56 billion. This has been a notable issue for President Trump. However, Mexico accounts for less than 10% of the U.S. trade deficit, significantly less than either the EU or China. And when considering that Mexicans spend upwards of $25 billion in U.S. border towns and run a shortfall on the services account, the U.S. deficit with Mexico, broadly defined, is small to non-existent.

Similarly, net migration to the U.S. from Mexico is zero to negative, with migration south now exceeding that north. And while an estimated 12 million Mexicans live in the U.S., half of whom are undocumented, around 3 million have been deported over the past 12 years. In short, numbers today are lower than a decade ago and continue to fall.

U.S. TRADE BALANCES



Source: IMF/WEO. As of January 2017.

Negotiating NAFTA

Mexico and the U.S. have a more balanced trade and migration relationship than first meets the eye. This interdependence as well as that for other areas such as security should grant Mexico more bargaining power than one initially might expect. Understandably, we view this as a good position to be in as NAFTA member countries move to renegotiate the accord, probably in May and it is in all countries' interests to conclude in 2017.

Overall, President Peña Nieto's strategy has been to appease the U.S. administration and to unite Mexico. Specifically on NAFTA, his government will only agree to a better deal for Mexico, nothing less. Without improvements, Mexico is comfortable reverting to WTO rules on trade with the U.S.

Among the improvements needed are the inclusion of previously uncovered sectors—i.e. energy, telecoms, e-commerce—and better dispute resolution mechanisms. Part of the renegotiation process includes a consultation between the central government and domestic constituencies affected by NAFTA. This should allow domestic interests currently vested in NAFTA to influence the U.S. position and increase the chances of an acceptable outcome for all parties. Mexico will be fine with a stricter rules-of-origin requirement, but will not accept tariffs, quotas, or other restrictive trade measures.

Policy credibility

Peña Nieto's growth-centered policy agenda aims to lower barriers to competition, advance structural reforms, and strengthen the rule of law. Fiscal management has been respectable. The public sector borrowing requirement was 2.9% of GDP in 2016 with targets of 2.7% and 2.5% for 2017 and 2018, respectively. Given fiscal flexibility elsewhere and potential Central Bank valuation gains from a weaker peso, the 2017 target appears somewhat conservative.

On monetary policy, the Central Bank has credible policies for managing inflation. The 50 basis point hike (higher than the expected 25bp) in February and 25bp hike in March underscores its willingness to increase rates, even as growth slows. Ultimately, on trade, the monetary authorities believe exchange rate adjustments will help sustain export competitiveness. Imported inflationary pressures have so far been muted, though there is some pass through to fuel prices, while risks to financial stability appear limited with many U.S. dollar liabilities in the system naturally hedged.

Summary and outlook

Looking at risks related to trade, fiscal and monetary policy, we think, on balance, that Mexico will be more resilient than many might expect. We would, however, highlight some downside risk related to elections in July 2018. Currently, the leading candidate is the left-leaning populist Andrés Manual López Obrador, known as AMLO. In the meantime, three gubernatorial races in mid-2017 may provide insight into next year's elections, which we will monitor closely. Notwithstanding this, we believe the investment case for Mexico remains attractive on a risk-reward basis.

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TREMORS: EM Investors Brace for Potential U.S. Policy Shift

How much of emerging markets performance hangs on what happens in the United States? The short answer: It depends. For example, "the economies of Asia are driven increasingly by domestic demand, high savings rates, high investment rates and increased productivity," said Teresa Kong, a fixed income portfolio manager with Matthews Asia. "Nominal GDP growth across the world, and particularly in Asia, will drive corporate profitability, corporate earnings and equity markets in the region."

"Historically, growth in emerging markets has been driven by a set of factors that we think are increasingly less relevant," added Sara Moreno, a managing director and emerging markets portfolio manager with Jennison Associates. "Those were yield compression, lower interest rates and commodity-driven export growth led by a boom in infrastructure spending in China." She believes that today, returns in emerging markets are increasingly dependent on internal growth drivers and productivity improvements within individual economies.

That said, emerging markets (EM) are not totally insulated from what happens in the U.S. But one has to be very careful in drawing inferences from general trends, and Matthews Asia's Kong cautioned against trying to distill very complex market dynamics down to one or two variables.

"It would be overly simplistic to just look at the dollar, for example, and assume that a strong dollar is bad for Asia, or say that rising interest rates are bad for Asia," Kong said. "The truth is far more complex than that." She noted that the last time the U.S. transitioned to an inflationary economic expansion with rising rates was in the years from 2003 to 2007. During that period, EM credit spreads tightened and the "demand pull" coming from a stable, growing U.S. economy helped emerging markets do well.

DIFFERENT IMPLICATIONS

As for the dollar, different strong-dollar scenarios would have very different implications for EM economies. If U.S. growth is strong and the Federal Reserve is raising rates at a gradual and anticipated pace — driving dollar strength — that could be a positive for emerging markets, according to Sarah Orvin, a portfolio manager with Eaton Vance Management.

"But you could also see dollar strength if inflation is allowed to run a little hot and suddenly the Fed has to catch up," she said. "You could envision a scenario where growth maybe isn't doing as well as expected, but rates need to respond to higher inflation. That could also drive dollar strength, but that scenario would not be positive for EM."

The possibility of higher-than-expected inflation is not out of the question, given trade restrictions being floated by U.S. President Donald Trump and Washington policymakers, among other factors.

Ricardo Adrogué, head of emerging markets debt at Barings, pointed out that using tariffs and other trade restrictions to bring manufacturing jobs back to the U.S. could

> “Country-specific factors are going to matter even more in driving returns. So it’s important to look at each country on a bottom-up basis, rather than as a monolithic EM as a whole.”
>
> Sarah Orvin | Portfolio manager | Eaton Vance Management

end up shifting resources toward sectors in which the U.S. is less productive compared to the rest of the world, such as manufacturing, and away from sectors where the U.S. runs a trade surplus and is more productive than the rest of the world, like the financial and services sectors.

“That could result in an overall reduction in productivity while stoking domestic inflationary pressures,” he said. “That potentially could result in a more restrictive monetary policy because, all else being equal, inflation would be higher with such policies.”

IMPACT OF U.S. POLICIES

“Stepping back, we have almost as much uncertainty now as we did the day after the election in terms of what policies to expect from the new U.S. administration,” said Cathy Hepworth, a managing director and sovereign strategist for PGIM Fixed Income. “The perception is, at least, that any new policies will be growth-positive. And we already saw positive growth coming out of most emerging market countries even before the Nov. 8 election.”

The Mexican peso is up 10% this year

She noted that EM currencies — including a basket of higher-yielding currencies where there has been fundamental improvement in the underlying economies — have done quite well since the election. In that group she pointed to the Brazilian real, Russian ruble and Mexican peso. “In fact, since January of this year the peso is up about 10%,” Hepworth said. “And generally speaking, select EM local bonds have also performed quite well.”

But what can investors expect from Washington? The jury is still out.

“We don’t know yet how any new policies will be implemented,” said Ashutosh Sinha, emerging markets portfolio manager at Morgan Stanley Investment Management. “But whether it’s border taxes or tariffs, or some other restrictions, any of those could cause disarray, particularly in export-oriented economies.”

If U.S. rate hikes are more dramatic than expected, he would also expect a “shakeout” in EM, because the organic growth story is not as strong as it was in previous decades. And there is no telling what U.S. growth numbers will ultimately look like. But if for some reason that growth disappoints, some EM economies could take a hit.

GLOBALIZATION FALLING

“Aggregate growth rates are still higher and the aggregate valuations are still lower in emerging markets,” Sinha said. “But all the forces that are working in the world, like demographics, deglobalization and slowing global trade, make one think that the old model of growth for EM is not going to be repeated. You can no longer export your way to success, because globalization has been falling. That was happening even before the U.S. election gave us the potential for very different policies coming from Washington.”

Barings’ Adrogué noted that China runs the largest trade surplus with the U.S. (in U.S. dollar terms), followed by Mexico. So those two countries may be most vulnerable to trade restrictions or lack of growth in the U.S. While one finds many open economies in emerging Europe, those countries trade mostly with the eurozone, so the impact from U.S. policies would be indirect at best. The world’s least-affected region might be Latin America.

“Latin America’s economies don’t actually trade much with the U.S., the exception being Mexico,” Adrogué said. “And broadly speaking, the trade that Latin America does with the U.S. is focused on commodities.”

“Investors should be flexible in their thinking as they seek to adapt to whatever is coming from D.C.,” said Eaton Vance’s Orvin. “Country-specific factors are going to matter even more in driving returns. So it’s important to look at each country on a bottom-up basis, rather than as a monolithic EM as a whole.”

She expects the dollar to gradually strengthen but does not see that as a negative for EM debt. Over the past year, valuations have moved significantly, particularly in credit spreads. Such moves, Orvin believes, need to be seen in the context of fundamental stories throughout EM, irrespective of what’s happening in the U.S. •

GLOBAL DISCONNECT:
Will EM Cut Rates While the Fed Hikes?

Emerging markets — and investors — are entering uncharted waters.

For the past 15 years, emerging markets have been gaining monetary independence from the United States. That is, one should no longer expect local interest rates in emerging markets to follow the exact same path as U.S. rates.

"We have never been in a U.S. rate-hiking cycle under the current global conditions of floating currencies and independent central banks with inflation-targeting frameworks," said Ricardo Adrogué, head of emerging markets debt at Barings. "This will be an important test for a lot of countries that now have truly floating currencies, and we are positioning portfolios accordingly."

Adrogué believes that the U.S. could end up raising rates more than the market expects. But that may not translate into significantly higher interest rates across emerging markets.

Why not?

"In a lot of EM countries, the economic cycle is out of sync with that of the U.S.," he said, "and may become even more so if we see the new administration follow through with anti-trade policies."

And rate increases in the United States do not necessarily lead to falling prices across all bonds, especially emerging market bonds. In fact, rising U.S. rates may require investors to rethink their typical principles, or heuristic views, on bond investing, according to Teresa Kong, a fixed-income manager with Matthews Asia.

Investors are taught that U.S. Treasuries represent the risk-free rate, and that risky assets are securities such as emerging market and high-yield bonds. Yet in a rising interest rate environment, the bonds with the most duration risk are U.S. Treasury bonds.

"By contrast, emerging market bonds often have the least exposure to U.S. interest rates, because they derive a lot more of their return from credit spreads and currency movements," Kong said.

"There is often a misperception in terms of what happens in emerging markets when the Fed is hiking," said Cathy Hepworth, a managing director and sovereign strategist for PGIM Fixed Income. "During past hiking cycles, on a one- or three-year forward-looking basis, EM debt has delivered positive returns.

"The Fed normalizing or hiking doesn't necessarily mean EM spreads have to sell off," she said. "Our view is that 10-year and 30-year U.S. Treasury yields will likely be range-bound, curves will flatten, and credit spreads, in general, will tighten."

Kong, of Matthews Asia, said that when U.S. interest rates rise, the first question EM investors should ask is whether their bonds are denominated in dollars. If the bonds are not denominated in U.S. dollars, the question becomes: Are the interest rates of other regimes rising in tandem with the U.S., or are they marching to the beat of their own drum?

Even as the Federal Reserve hikes rates, central banks across emerging markets will likely be cutting rates, with the exception being emerging Europe, according to Barings' Adrogué. He pointed to Malaysia, which has been lifted by steady U.S. growth but could be hurt by U.S. anti-trade policies. In such a scenario, slower growth in the Malaysian economy could see rates cut from current levels.

Indonesia — where the economic cycle is out of sync with that of the U.S. — has already started cutting rates. South Africa has seen slow economic growth and extremely low credit growth for the past several years. Dramatic adjustments to its current account and currency have stabilized in the last year, potentially pointing to the start of a rate-cutting cycle. And across Latin America — from Brazil to Argentina to Colombia — central banks are more concerned with their own inflation targets, growth priorities and currency issues than they are with Fed policy.

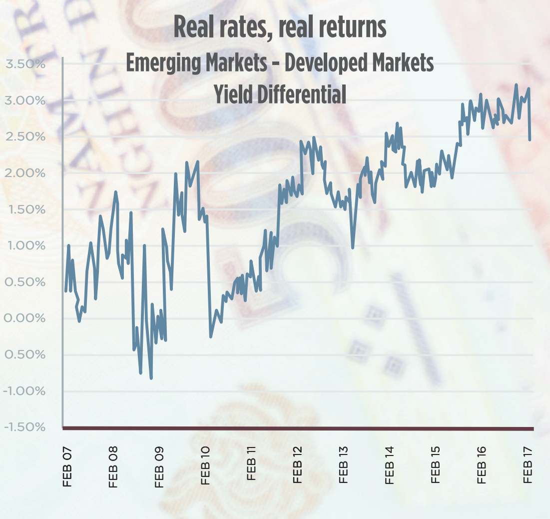
"Local rates are where we see the most value right now," said Sarah Orvin, a portfolio manager with Eaton Vance Management. "Emerging market real rates as compared to real rates in developed markets are near a 10-year high." (See chart.)

She pointed to Russia as an example of favorable rate dynamics. Russia's current account surplus was halved in 2016 as oil prices plunged. Policymakers took appropriate action to realign the economy toward what they saw as a new fundamental value for oil, building a budget that balances with oil at $40 a barrel.

"Monetary policymakers also increased interest rates substantially and have committed to keeping them quite high until they feel that inflation is back on a sustainable footing," Orvin said. "With Russia's benchmark interest rate at 10% and inflation at 5%, that real rate is quite attractive and we'd expect to see some rate cuts from Russia in the future."

Fed rate hikes may pose the most problems for countries that have taken on large amounts of hard-currency debt. Ghana is a good example, according to Orvin. In the context of lower U.S. rates, many countries came to market and issued bonds in dollars but subsequently were lax about fiscal policy. Ghana, with a debt-to-GDP ratio of 74%, has shown an inability to reform and will likely have to refinance its debt at higher rates at some point.

"That's going to be problematic unless they're able to change their policy mix," Orvin said. "It's these kinds of situations that bear close monitoring and a generous degree of caution." •

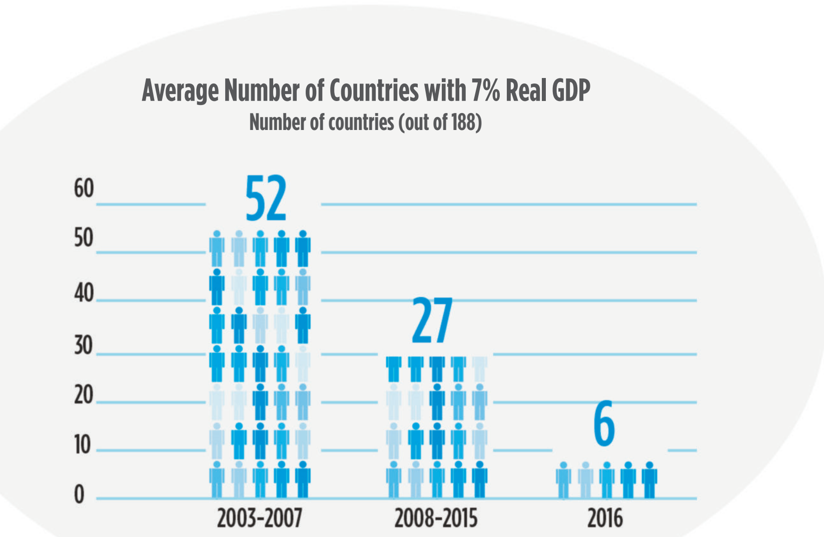


As of March 17, 2017
Source: Eaton Vance, Bloomberg, JPMorgan. Real yields are calculated as nominal yield minus most recent quarter YoY CPI percent change.

In Emerging Markets,

Emerging markets had a strong run before the Great Recession, and last year they managed to regain some of their prior glow. But now what?

"Between 2002 and 2007, the EM story was broad-based organic growth," said Ashutosh Sinha, an emerging markets portfolio manager at Morgan Stanley Investment Management. "There were approximately 50 countries growing at 7% or more, thanks to simultaneous tailwinds." Among those tailwinds was the big commodities boom, he said, led by capital investments from China.



Source: MSIM, IMF, Haver Analytics, as of Dec. 31, 2016

"But now, look forward through the next five to 10 years and try to visualize how those key drivers are going to pan out," Sinha said. "After a period of very low growth, we saw a pickup in 2016 when EM equities were up 10%-11%. But broad-based, top-line growth is unlikely to return because the tailwinds are no longer there."

Still, he doesn't believe the EM story is over. It just won't feature the all-encompassing growth seen in the decade prior to 2007. "There will be pockets of growth in a low-growth world," Sinha said. "But investors have to be just as selective in EM as they are in developed markets."

For EM, the definition of "rapid growth" has to be revised down. Poorer countries (those with per-capita income of about $5,000) like the Philippines, Indonesia, India and even frontier markets such as Pakistan and Vietnam, may grow at 5%. Middle-income countries (those with an income of $5,000 to $15,000) in Eastern Europe and Latin America may grow at 3% to 4%. And higher-income countries (with income of more than $15,000) such as Taiwan and South Korea may grow at 2% to 3%.

"The opportunity, compared to the U.S., Europe and Japan, is still better," Sinha said. "Given the size of these populations, the runway for growth is huge. We look for companies that have a dominant market position and pricing power, and are clever about launching products that adapt to the growing and evolving tastes of new consumers."

While consumption-based tailwinds won't power every company in every country, Robert J. Horrocks, chief investment officer and portfolio manager for Matthews Asia, sees enormous opportunities coming from EM consumers' appetite for basic lifestyle comforts that Western consumers take for granted — owning one's own home, a first car, maybe a second car, family holidays, home furnishings and household goods. In the industrial space, as wages rise, he sees tailwinds behind automation technologies such as sensors, and in the health-care space, pharmaceuticals and hospital-based medical technology may also benefit from rising incomes and consumer spending.

Morgan Stanley Investment Management's Sinha argued that consumer upgrades to premium branded products and discretionary spending on lifestyle products, such as cosmetics, fashion, travel accessories, and even insurance and health care, can spur growth in specific niches that is two, three, or even four times GDP.

NO SUBSTITUTE FOR BOTTOM-UP ANALYSIS

When it comes to emerging market sovereign debt, a similar principle of selectivity should be applied, as country-specific factors are likely to drive returns for the medium and long term, according to Sarah Orvin, a portfolio manager with Eaton Vance Management.

"First of all, thinking of EM debt as just a handful of the biggest countries in the index makes it very difficult to add value," she said. There just aren't enough opportunities, according to Orvin, whose team covers more than 100 countries

a Rising Tide Lifts Some Boats

across emerging and frontier markets.

"One of our favorite local markets for the past few years has been Serbia," she said. "Assets issued in Serbian dinar are not present in the benchmark, but have been outperforming the benchmark."

Serbia has come a long way since the break up of Yugoslavia. Today, most political actors in the country advocate liberalizing their markets and joining the EU. The tail risks in terms of politics have narrowed considerably. Serbia has sold off many state-owned assets and undertaken wide-scale macroeconomic reforms.

"The fiscal deficit has been cut from almost 7% of GDP in 2014 to 1 ½% of GDP in 2016," Orvin said. "At the same time, Serbia has been regaining growth, which is forecast to hit 3% in 2017. We think that's achievable."

Poland, Hungary, Croatia and Romania are also growing relatively strongly. And the Dominican Republic is another example of an off-benchmark local market with stable politics, decent growth, and a currency that predictably depreciates about 3% to 5% a year. But with interest rates hovering around 10%, Dominican local debt can still deliver a healthy return, Orvin said.

Selectivity, based on bottom-up analysis, is especially important for EM corporate debt, and in that process, investors have to be careful about imputing risk to corporates based on their country of domicile. Over time, the performance of the business itself, as reflected in such measures as cash flows and enterprise value, drives the performance of corporate bonds, according to Ricardo Adrogué, head of emerging markets debt at Barings. But currently he sees a top-down bias against EM corporates that he calls a "country ceiling."

"A lot of very solid emerging market corporates are being re-rated downward because they happen to reside in countries that are rated below investment grade," Adrogué said. "Based on their balance sheets, business models, cash flows, enterprise value and the like, we believe that many EM corporates should be rated investment grade on a stand-alone basis. But because they are in Russia, or Brazil, rating agencies perceive a higher risk of default, based on the creditworthiness of those countries."

He argued that the re-rating creates price distortions, with the market effectively pricing many EM corporates more aggressively than the countries in which they operate. In fact, Adrogué believes such corporates are actually better risks than the countries in which they are located, and the rating agencies are overestimating the default risk of countries such as Russia or Brazil, which he sees as very low.

"That's part of the reason why EM corporates look slightly tight or expensive compared to the sovereigns," he said. "And in any case, one cannot compare EM sovereign and EM corporate indexes, because they are so different — the latter has a much shorter duration and much less embedded Treasury risk."

CURRENCIES CHEAP. OR ARE THEY?

According to most metrics, emerging market currencies look cheap from a valuation perspective. But one has to ask what the right metrics are. Having suffered over the past several years, currency investors may be wondering how to face the unfolding opportunity.

> There will be pockets of growth in a low-growth world. But investors have to be just as selective in EM as they are in developed markets.
>
> **Ashutosh Sinha | Emerging markets portfolio manager**
> **Morgan Stanley Investment Management**

Adrogué cautioned against focusing on momentum or whether the carry is high or low, and suggested that bottom-up, country-by-country metrics, such as export competitiveness — whether a country is gaining market share and the export sector is growing — are more appropriate. “Those kinds of parameters are most indicative of currency competitiveness, independent of currency momentum or carry,” he said.

Though emerging currencies have rallied, Adrogué said investors can still find value in just about every region of the world, including Asia, where he cited Malaysia and Thailand, Latin America (Mexico, Colombia), and even parts of Africa (South Africa).

EMERGING MARKETS — A TURNAROUND STORY

“If we look at where overall index spreads are, based on bottom-up, relative-value analysis, emerging market sovereign debt is close to its five-year average whereas U.S. BBB-rated investment-grade and U.S. high-yield bond spreads are both through their five-year averages,” said Cathy Hepworth, a managing director and sovereign strategist for PGIM Fixed Income. “So if you are comfortable with the pace of Fed rate increases and expect spreads to tighten, in that context, EM spreads look attractive relative to other credit markets. If you dig even deeper, looking at individual countries and where they are trading relative to the rest of the group, a cohort of issuers stands out.”

Brazil was a huge success story last year, with many issuers looking cheap given what they offered. Hepworth considers Brazil a double-B credit that arguably is stabilizing. After next year’s elections, Brazil may even be considered an improving credit. And there are quasi-sovereign issuers in Brazil she believes offer solid value because they trade very cheap to the sovereign.

Similarly, the credit story in Mexico has deteriorated over the past couple of years. But Hepworth said that Mexico has not deteriorated nearly to the extent priced in by investors — in spreads, currency or local bonds. “We think that there is good value in Mexico, in both sovereign and quasi-sovereign issues,” she said. “In 2017, certain Mexican assets may deliver the same kind of comeback performance that Brazil turned in last year, although arguably Mexico did not sell off as much as Brazil.”

As for EM equity valuations, Horrocks of Matthews Asia said he believes they look reasonable in a global context. “On a cyclically adjusted price-to-earnings basis, Asia is now cheaper than Europe and much cheaper than the U.S.,” he said. “Developed market equities are trading ever higher, even while the prospect for long-term earnings growth deteriorates. You have the opposite happening in Asia, where profits as a percentage of GDP are close to all-time lows, and the market is trading at a discount. In our view, equity markets have been factoring in short-term news flow, and not long-term growth fundamentals.”

After years of underperformance — and a shot of uncertainty from the U.S. presidential election — emerging markets may have begun to bounce back.

“Yes, as emerging markets equity investors, we care about what happens in the U.S., but our strategy focuses on identifying bottom-up, organic growth stories,” said Sara Moreno, a managing director and emerging markets equity portfolio manager with Jennison Associates. “And the stable macro environments we are seeing across emerging markets can make that growth case even stronger.”

What does one look for? Factors including responsible fiscal and monetary policies, wage growth, infrastructure investment, low inflation, urbanization, a growing middle class and manageable levels of debt.

“In emerging markets,” Moreno said, “all these productivity factors tease out some very compelling stories indeed.” •

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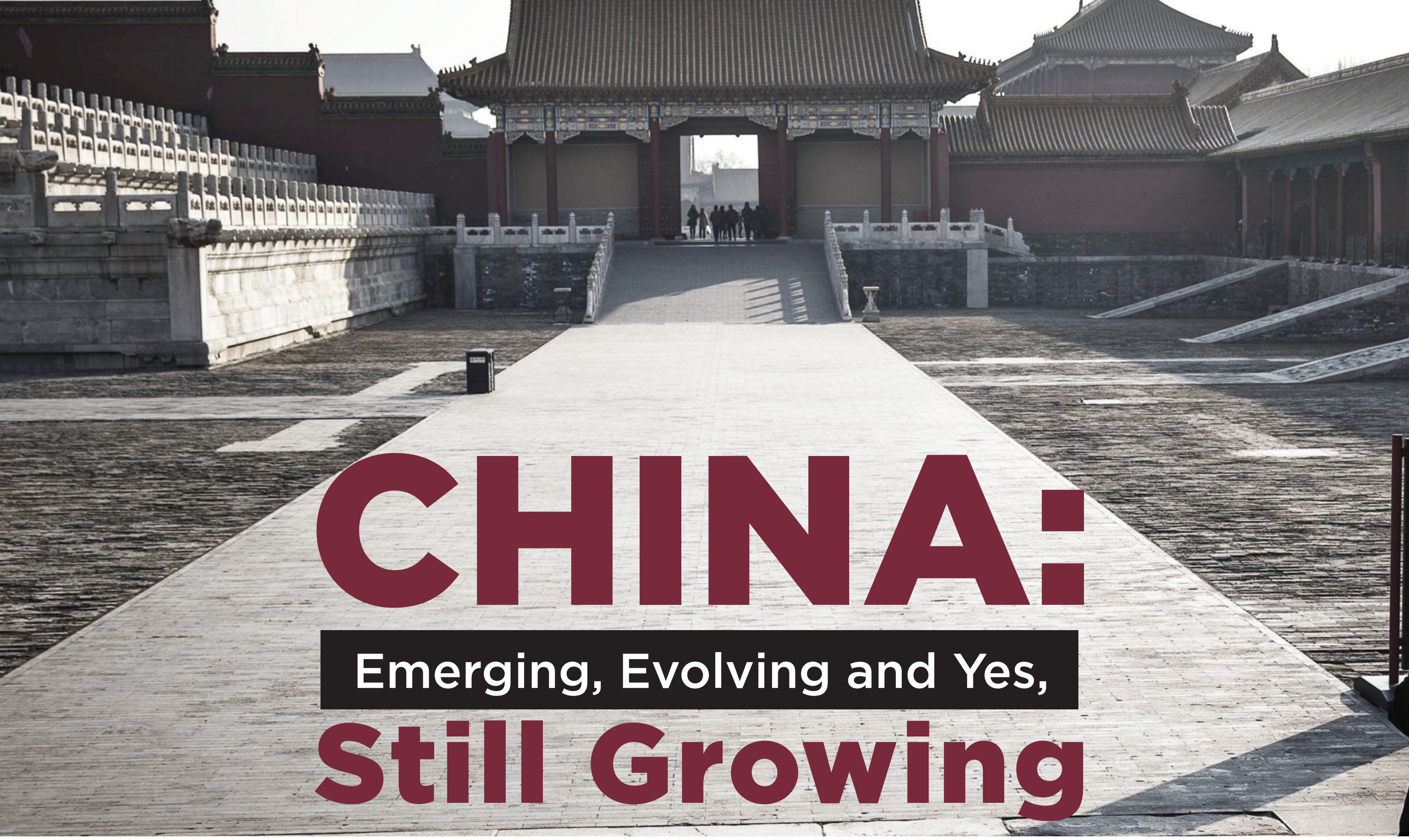


CHINA: Emerging, Evolving and Yes, Still Growing

China is no longer emerging markets investors' chief concern. But it's not because China is any less of a worry. Investors are just preoccupied with U.S. policy issues.

"It's maybe the third question we get, or the third issue investors care about, after policy expectations for the new U.S. administration and the Fed," said Cathy Hepworth, a managing director and sovereign strategist for PGIM Fixed Income. "But China still matters a great deal because it comprises a significant part of overall global growth. It matters if China grows at 6 ½% or 2%. It's going to matter for the rest of the world."

A chief concern of EM investors last year was the potential for a rapid slowdown in economic growth. But China delivered a growth surprise, and continues to issue positive data as its economy shifts toward services and consumption.

The growth surprise in 2016 owed mostly to China's stimulus measures, according to Hepworth, and PGIM Fixed Income's base case for 2017, and probably 2018, is a steady continuation of growth.

"We believe stability is such a key focus for Chinese leaders that they will take whatever measures are necessary to make sure that growth doesn't fall dramatically," she said.

"The things to pay attention to in China, more than the overall growth rate, are the composition and sources of growth," said Sara Moreno, a managing director and emerging markets portfolio manager with Jennison Associates. "The shift from fixed-asset investment to a consumption-driven economy is generating some very interesting opportunities."

Domestic factors to consider include an aging labor force, rapidly rising wages and rising imports that are no longer limited to commodities. What's more, China is now creating export opportunities for goods and services from other emerging countries. And China's investment profile is growing as it exports capital to the rest of the world: to Africa, Asia and even Latin America.

"We care about the pace of growth," Moreno said. "But what we focus more on are the composition of growth, the quality of growth and the sustainability of growth. A slower but more sustainable China would be very positive for EM equities and certainly global equities."

THE COMPOSITION OF GROWTH

"Look, China is not Brazil," said Ashutosh Sinha, an emerging markets portfolio manager at Morgan Stanley Investment Management. "China is still growing, compared to negative growth in Brazil. But different components of the Chinese economy are growing at vastly different rates."

The story in China today is more about specific growth niches in services, technology, health care and consumer products. For example, the beer industry has very low margins, but as it consolidates, margins continue to move higher, according to Sinha.

"Focusing on companies that benefit from consolidation within the beer industry may be a way to exploit growing consumer demand," he said. "The same is true of travel and tourism."

China reported approximately 10 million outbound tourists in 2000, a number that swelled to 122 million in 2016 and is expected to hit 150 million by 2020. Such demographic shifts point the way to lifestyle plays such as luggage. Half of the luggage market is unorganized or divided among smaller unbranded names, especially in EM, according to Sinha. And the combined appetite for travel and upscale branded goods may present a compelling growth story in a slowing economy. Sinha makes the same point about personal care products, where specific pockets, such as hair care or cosmetics, may offer stronger growth than the category overall.

The financial sector, on the other hand, is one area where investors may want to exercise caution. China's debt-to-GDP ratio has at least doubled in the last 10 years, and with so many loans now on Chinese banks' books, there is much debate over the true number of the banks' non-performing loans.

"Make whatever assumptions you want, but no one really knows," Sinha said. Banks are a large part of the benchmark, and they look very cheap, trading at seven or eight times earnings. But Sinha asks, "What are the true earnings? We know the 'p' but we don't know the 'e.'" For that reason he said he is not overly concerned about looking for "cheap" stocks.

"I'd rather look for certainty of the 'e,' the quality of the company, and the growth pocket in which it is positioned — whether that pocket is resilient and sustainable," he said. "I don't mind paying a higher 'p' to buy a stock like that."

parts of the economy," he said. "The Chinese learned a lot from our mistakes in the U.S. The vast majority of new homebuyers in China put down 30% cash, more than the government-mandated 20%, and 90% of new homes in China are sold to owner-occupiers rather than investors."

Rothman also took issue with fearsome headlines about Chinese "ghost cities." The typical pattern with such places is that they look ghostly when constructed, but within a couple of years they are full, he said. When 60 Minutes visited the "ghost city" of Zhengzhou in 2014, the subway had not opened yet.

"I went back two years later and found the city full up," Rothman said. "The subway had finally opened, and Zhengzhou was a thriving busy place where I spent most of the day sitting in traffic."

> We believe stability is such a key focus for Chinese leaders that they will take whatever measures are necessary to make sure that growth doesn't fall dramatically. **Cathy Hepworth | Managing director and sovereign strategist | PGIM Fixed Income**

THE CHANGING CHINA STORY

One of the biggest misconceptions about China — after the notion that it's still an export- and commodity-driven economy — is the idea that U.S.-China trade has been bad for the U.S. In fact, China has been the No. 1 importer of U.S. agricultural products since 2011, and agricultural exports to China have increased more than 125% over the last 10 years, according to Andy Rothman, an investment strategist and China specialist with Matthews Asia.

"Boeing, over the last five years, has delivered more aircraft to China than to the United States," he said. "And China is now the biggest market for General Motors. Since China joined the World Trade Organization 15 years ago, exports to China are up 500%, compared to a 90% increase in the rest of the world."

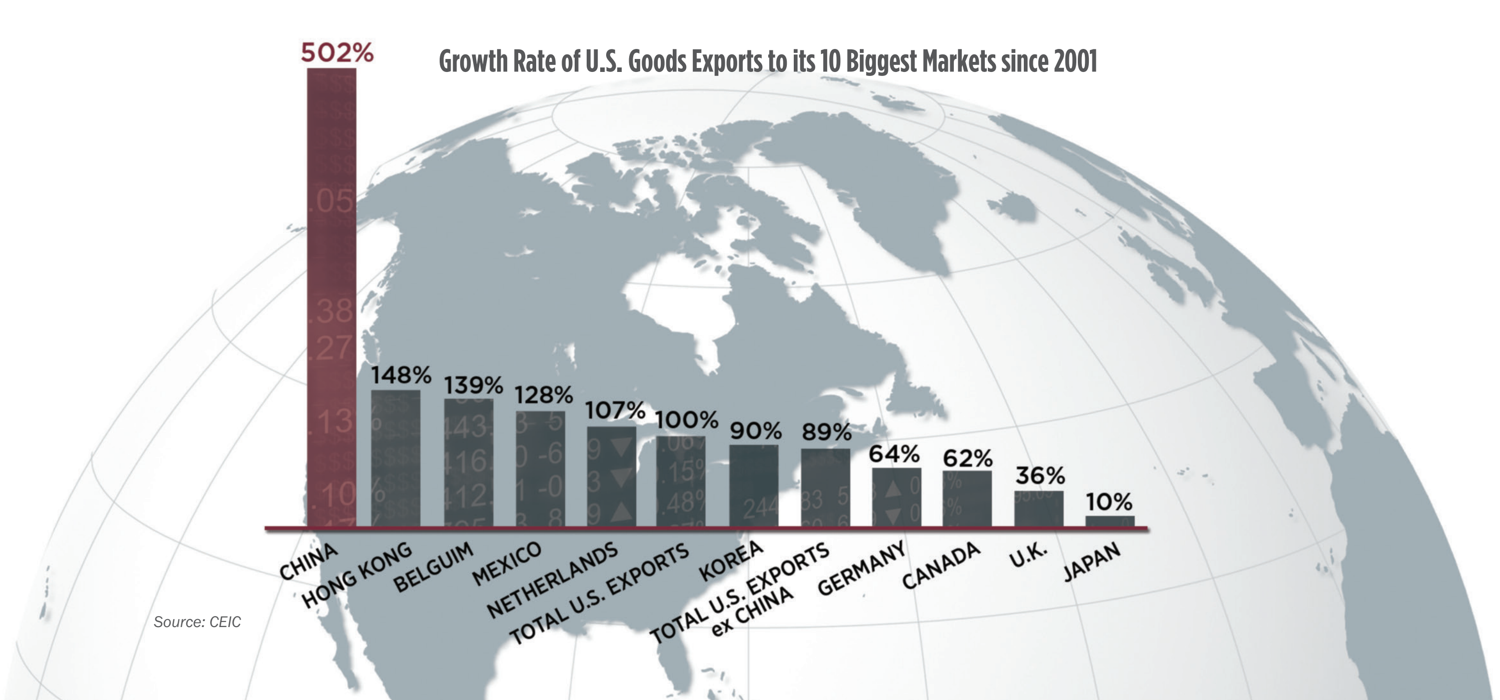
Another misconception, Rothman said, is the idea that China's property market is in the midst of a bubble. "I would argue that the housing market in China is one of the strongest

He added that the state of the banking sector is also misunderstood.

After the Great Recession, approximately 20 million Chinese workers lost their jobs in a very short period of time. In response, the government brought forward the construction schedule for infrastructure and asked banks to finance it.

"In response, the state directed state-controlled banks to lend money to state-controlled companies to build state-directed public infrastructure," he said. "That's the majority of Chinese debt. There's no private participation. Therefore the government has the luxury of controlling the timing and structure of how this debt gets unwound."

Rothman argued that the resolution of China's debt problem is underway, though it will take five to seven years to play out. And it will likely result in slower growth, increased volatility and pressure on Chinese bank profitability. "But it's unlikely to result in a crisis or a liquidity squeeze in the banking system," he said. •



Source: CEIC

The Truth About LEVERAGE

You should be terrified. On the other hand, maybe you shouldn't be. Headlines scream about the threat that leverage poses to emerging markets. At the same time, Japan has a debt-to-GDP ratio of 300%. In the United States, it's 200%. So what are investors to make of the bad rap emerging markets get on the issue of leverage?

"You can't generalize the threat on a regional level," said Sarah Orvin, a portfolio manager with Eaton Vance Management. "We think it's all very country-specific, and it's really important to understand not just the headline information, but also do the deep-dive research required to fully understand the debt situation in specific countries."

Asia, for example, is generally associated with lower debt levels, and it's not a region that Orvin is much concerned about — overall. That doesn't mean that all of Asia is in the clear. "You look at a place like Mongolia and see a significant debt problem," she said.

Orvin isn't much worried about Eastern Europe, either, given its recent strong growth and declining overall debt levels. Public and private balance sheets have been deleveraging since the beginning of the financial crisis in 2008, and many Eastern European countries look better on a debt basis than they did just a few years ago.

Then again, there is Turkey.

"We think that in Turkey specifically, the ability to roll over corporate debt is going to depend a lot on government policy and how credible it is," she said, "because corporate bond returns are going to be driven mostly by country factors at the end of the day."

Turkey has "taken a bit of a beating over the past year," Orvin said. The currency has cheapened, which is one reason why local markets there look attractive. But rates have also been adjusted higher to counteract the falling currency, which she described as an appropriate policy move. The ultimate effect on corporate debt, however, is unclear and bears watching. And it all supports her contention that blanket statements about leverage are meaningless — true understanding only comes from a deep dive into the circumstances of each country.

"We have seen heavy borrowing in the emerging markets' corporate sector," said Ricardo Adrogué, head of emerging markets debt at Barings. "And three years ago the IMF put out a report saying that big corporates had borrowed beyond acceptable limits and were about to go under. Here it is three years later and corporates didn't go under. Some went bankrupt. Some did extremely well. So clearly that wasn't a good limit."

Adrogué said that, theoretically at least, there is no limit to leverage. Research into the subject has failed to reach a reliable conclusion about which specific levels of leverage are risky and which are not. "The range is so wide as to be meaningless," he said. "We just don't know what level of leverage any given country can hold. Is it the Japan debt-to-GDP limit of 300%? Or maybe the U.S. limit, closer to 200%? Or is it the Argentina limit of 30% of GDP?"

As for emerging markets, overall domestic leverage started declining about a year ago. According to Adrogué, the process of deleveraging supports his argument that central bankers in emerging markets — especially those who hiked rates aggressively, as in Brazil — have a lot of room to cut interest rates.

Brazil is a good example of the added burden emerging markets bear when it comes to perceptions of leverage. "In terms of private debt, Brazil was for a time overleveraged, but the servicing of that debt is becoming manageable again," said Sara Moreno, a managing director and emerging markets portfolio manager with Jennison Associates. "These are cycles that any economy goes through. Emerging markets are no different from developed markets in terms of the basic features of the business cycle."

Rather than looking simply at overall debt levels, PGIM Fixed Income's sovereign strategist, Cathy Hepworth, said she pays more attention to the trajectory of debt. In that vein, she is somewhat concerned about specific countries such as Brazil and China. "But when we look across emerging markets, we do not currently see trends in government external debt that should raise alarm bells," she said.

> We have seen heavy borrowing in the emerging markets' corporate sector.
>
> Ricardo Adrogué
> Head of emerging markets debt | Barings

One of the best arguments against the "leverage crisis" headlines is Singapore. Investors rarely, if ever, complain about debt levels in Singapore, even though they are among the highest in the world. "People don't complain because they understand that Singapore is a financial center," said Robert J. Horrocks, chief investment officer at Matthews Asia. "Those debt levels are very consistent with the underlying structure of the economy."

A sober appraisal of the issue shows that problematic levels of debt are coming from a few specific pockets, not across the board. One of those, indeed, is the largest EM economy, China, and the concern is over economic tail risk.

"China needs between $4 and $5 of new debt to generate $1 of GDP growth," said Ashutosh Sinha, an emerging markets portfolio manager at Morgan Stanley Investment Management. "That situation is not dissimilar to what happened in Japan, and the result will likely be the same — lower growth."

Latin America is often the target of criticism, but debt levels there are reasonable in comparison to China, as well as to developed markets. "Is there an opportunity for people to borrow and build homes and take mortgages and buy cars in Mexico?" Sinha asked. "Yes. Are there similar opportunities in markets like the Philippines and Indonesia, and even in India, which has a higher overall level of debt to GDP? I think yes." •

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