

A Convergence of Fortune

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As the global economy keeps chugging along nicely, it may be hard to remember that this cycle began nearly a decade ago. It may be even harder still to recall that emerging markets (EM) were in a recession just a little over two years ago. But now, the economic picture has improved and emerging markets are converging with developed markets, driving strong, synchronised economic growth and EM outperformance (*Display 1*).

DISPLAY 1

Emerging markets: Moving more in line with developed markets

Emerging market returns as % of developed market returns



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AUTHOR



ANDREW HARMSTONE
Managing Director

Andrew is Lead Portfolio Manager for the Global Balanced Risk Control Strategy (GBaR). He joined Morgan Stanley in 2008 and has 37 years of relevant industry experience.

Emerging markets underperformed during the equity market sell-off in early February, when the MSCI World Index (USD) plunged 8.8% and the MSCI EM Index fell 10.2% (26 January 2018 to 9 February 2018). Yet, emerging markets had been more resilient than expected in the face of rising interest rates, which triggered the initial sell-off. And year-to-date, emerging market equities have outperformed (as of 12 March 2018). This represents a very different scenario from the one we experienced during the 2013 Taper Tantrum, when emerging market equities plummeted 15% following the US Federal Reserve's (Fed) announcement that it would begin tapering back its quantitative easing programme.¹

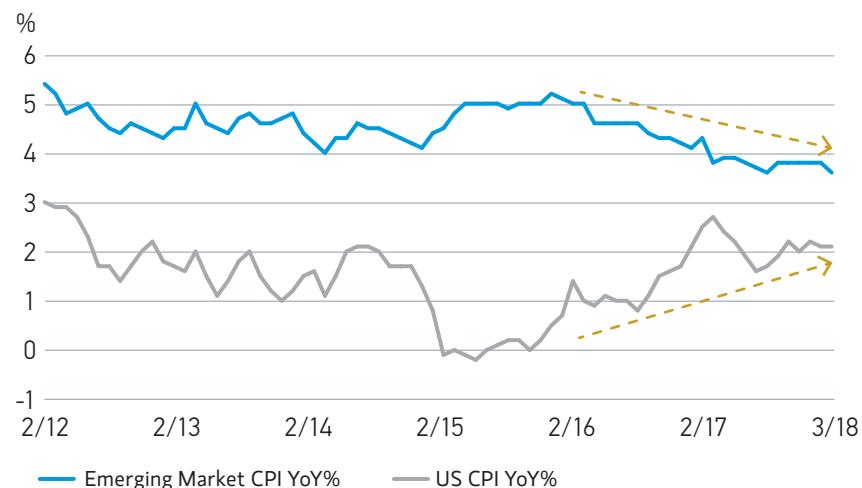
Underlying factors: Inflation and real yields

The year-over-year US consumer price index (CPI) has risen from zero-territory lows of 2015 to the 2% range. Over the same period, the emerging markets CPI has declined from highs in the 5% range to below 4%. At this point, both emerging and developed economies seem to be booming and their respective inflation pictures have converged towards the 2-4% range (*Display 2*).

Real yields in emerging markets, however, have been *diverging* from developed markets (*Display 3*). The real yield in the U.S. has seen a recent uptick, but its future direction will be clearer when the inflation picture comes into focus. What is clear is that US nominal rates are going up, real rates appear to be on the rise and inflation will potentially accelerate—which may prompt the Fed to raise rates sooner to compensate.

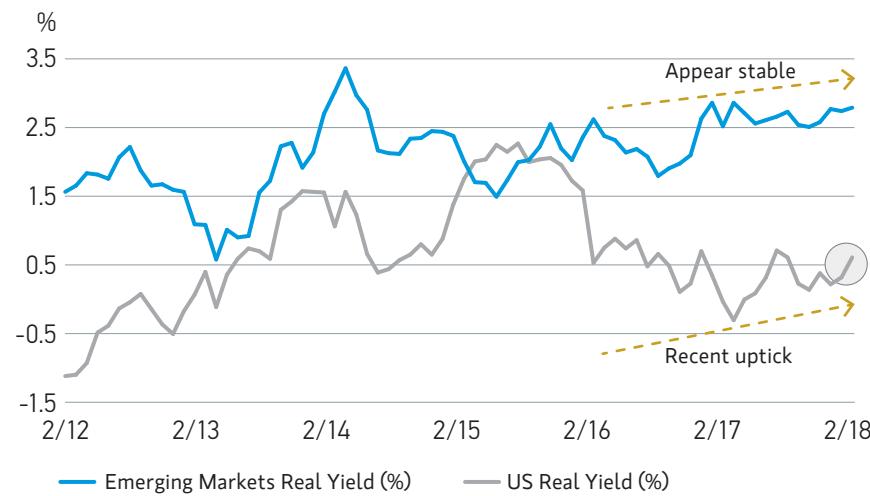
In emerging markets, real yields have been reasonably stable in recent months (*Display 3*). Some emerging markets have started lowering rates, with others only just beginning to follow, reflecting

DISPLAY 2 Inflation differential has narrowed



Source: Haver. Data as of 12 March 2018.

DISPLAY 3 Real yields have diverged



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¹ Source: Morningstar

the fact that they are at an earlier stage in the cycle. In contrast developed markets are moving towards tightening monetary policy.

Although both developed and emerging economies are economically strong now, the outlook is brightening in emerging markets, many of which are in an earlier part of the cycle than developed markets. This may explain why emerging market equities have trended upward in terms of relative performance versus developed world equities (*Display 1*).

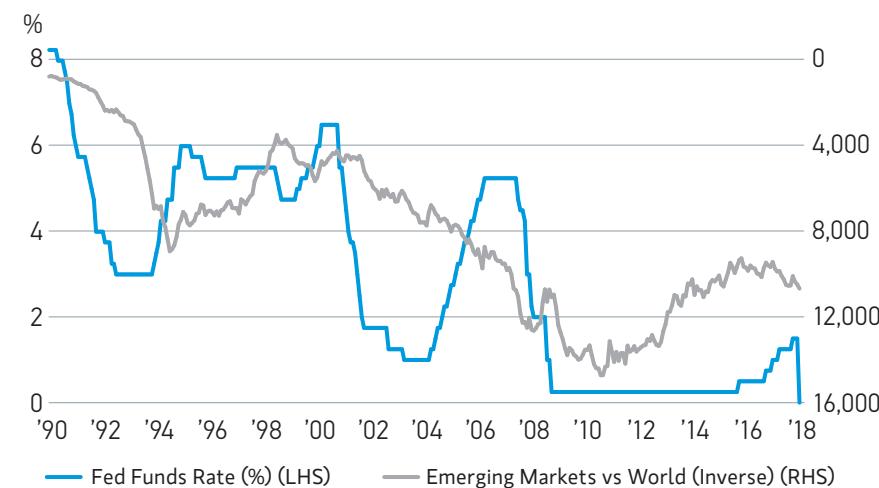
The Taper Tantrum: No repeat likely

Many investors may be wondering whether we will see a repeat of 2013's Taper Tantrum. We think that it's unlikely to occur for two reasons.

- First, there is no clear relationship between Fed rate hikes and emerging market equities performance versus world equities (*Display 4*). Generally, we see no reason to assume that emerging markets' performance will suffer on account of rising rates. In fact, emerging market equities appear more sensitive to the U.S. dollar than they do to rate hike cycles and the US dollar has been trending sideways since the start of the year.
- Second, emerging markets are currently offering investors a healthy risk premium versus developed markets. If we look at the real interest rate differential between emerging market ex-China and the US during 2013's Temper Tantrum, we can see that the real yield differential was minimal, offering very little premium versus US debt (*Display 5*). This low premium made emerging markets vulnerable to a rate rise. Today's much healthier risk premium is in the 2% range and should offer some cushion against external shocks and support flows into emerging market risk assets.

DISPLAY 4

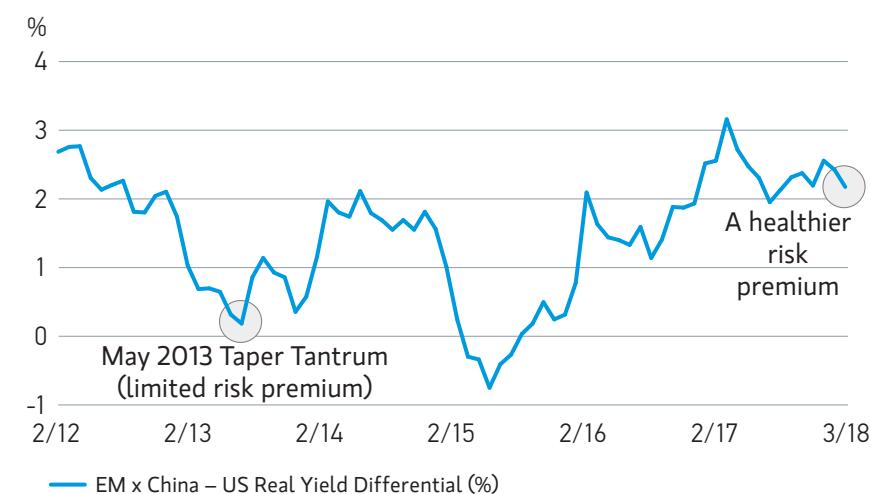
No clear link between US rate policy and emerging market equities



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DISPLAY 5

Today's higher risk premium provides some cushion



Source: Haver. Data as of 12 March 2018.

DISPLAY 6

Equity valuations are creeping higher but not yet expensive

Emerging market equity valuations



Global equity valuations



Source: IBES. Data as of 12 March 2018. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions

Emerging market valuations have room to rise

Valuations for emerging market equities have been slowly creeping higher, as have those for equities worldwide (*Display 6*). As investors increase their appetites for risk, valuations often continue to rise until they become meaningfully expensive. With both emerging and developed markets trading near historical norms and not yet expensive, we think more gains are possible.

Earnings growth has been quite strong on average across the globe, and we do not yet see a case for a reversal of this trend. The pendulum, however, will eventually swing and emerging markets could come out ahead when it does: Lower-trending inflation and stable real yields (*Displays 2 & 3*) present a strong case for relative strength in emerging markets as the global economy works through its cycle.

Tariffs, tiffs and tweets

The markets reacted negatively to President Trump's unexpected announcement on 8 March, accompanied by tweets, that he would impose import tariffs on steel and aluminium. The general implication of a trade war creates significant risk for emerging markets such as South Korea and Taiwan, which are particularly sensitive to a trade war because of their high export revenue.

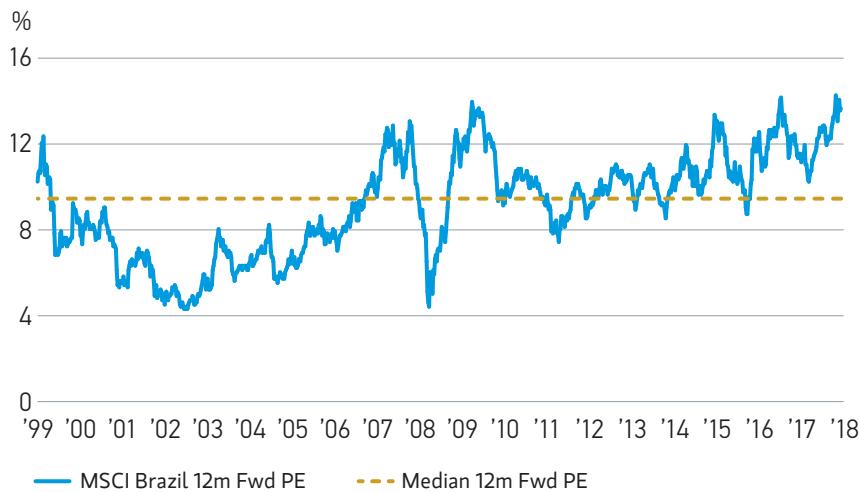
On 22 March, President Trump imposed 25% tariffs on up to USD \$60 billion in annual Chinese imports following his administration's conclusion that Beijing has unfairly acquired US intellectual property. Meanwhile, China's Ministry of Commerce announced its own planned tariffs on 23 March, for roughly USD \$3 billion in imports.²

The implications of a global trade war for emerging markets are unclear at this time. If other market players take action and retaliate, emerging markets could suffer from negative sentiment and a variety of country- and sector-specific issues. President Trump created further uncertainty around the issue by announcing the US would temporarily exempt Brazil, the European Union (EU), Australia, Argentina, and South Korea from the tariffs.

Country specifics matter

Our analysis has thus far referred to emerging markets in aggregate. But within emerging markets, there are significant variations in economic drivers, market valuations and risk factors. Here, we highlight some of the more noteworthy differences:

² Source: Ministry of Commerce People's Republic of China; <http://english.mofcom.gov.cn/article/newsrelease/policyreleasing/201803/20180302723376.shtml>

DISPLAY 7**Brazil: On the verge of overheating?**

Source: IBES. Data as of 12 March 2018.

LATIN AMERICA

Driven by Brazil, Latin America is generally expensive. Brazil's PE is in the 96th percentile of its 20-year history (Display 7). This raises caution from a valuation standpoint, despite an improving economy and stabilising political scene, given the declining likelihood of a populist-left government.

Upcoming elections in Mexico (in July) and Brazil (October) are likely to increase market volatility. Also, Mexican equities are still very sensitive to North American Free Trade Agreement (NAFTA) negotiations and trade policy discussions in general. Macro trends between these two major Latin American countries have been vastly divergent: Brazil's inflation has been declining steadily since 2016 while until recently Mexico's inflation was moving sharply higher.

EMERGING ASIA

The increasing hawkishness of the US on trade protectionism will pose a headwind for Asia given its high sensitivity to trade. President Trump's announcement of tariffs on Chinese imports will further strengthen headwinds. A full-fledged trade confrontation would damage all parties involved. The level of uncertainty is high and any material sanctions imposed by the US, as well as subsequent retaliatory measures from other countries, could negatively affect the equity performance of the region. In addition, we view China's growth rate as a crucial factor to monitor this year.

Overall, globally we believe the effect of tariff actions will be limited and that the global economy will continue to grow, with emerging markets having the best prospects. Market volatility may be largely dependent on President Trump's negotiating strategy. His actions and tactics tend to grab headlines, since he's

typically aggressive about his positions at first, and then tends to pull back to a more reasonable stance.

FIXED INCOME: LOCAL IS PREFERABLE TO HARD CURRENCY

Within emerging markets' fixed income, we prefer local over hard currency. Any interest rate increases in the U.S. would put downward pressure on hard currency and because still-high real yields, in our opinion, will tend to help protect local emerging market currencies from rapid depreciation.

Emerging markets: Beneficiaries of the convergence of fortunes

Our case for emerging markets is a relative one. We remain positive on global equities in general.

President Trump's hard-hitting and unpredictable negotiating tactics tend to rattle markets. After taking an initial tough stance, though, he has been known to ultimately settle on more reasonable terms. The uncertainty caused by this erratic style is likely to fuel volatility in the financial markets.

Emerging markets though, may benefit from greater momentum and a smoother path in the form of declining inflation and interest rate trends. This likely stems from the fact that they are at an earlier stage of the economic cycle than developed markets.

There are plenty of idiosyncratic risks in the emerging markets, yet the aggregate economic picture looks promising. Many investors with vivid memories of the Taper Tantrum may be wondering if it makes sense to invest in emerging markets while the Fed is tightening. Given reasonable valuations, healthy risk premiums and stable inflation, we believe the answer is yes.

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