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The Global Economy is "Just Right" for EM growth

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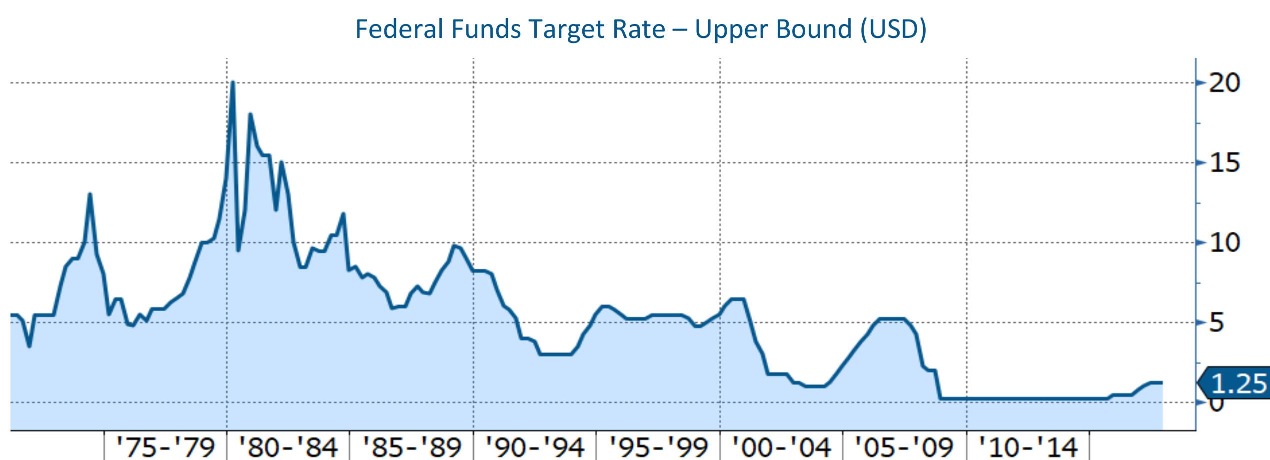
Twenty years since the collapse of the Thai *baht*, nine years since U.S. interest rates dropped to zero, three years since oil prices plummeted, and almost two years since China's stock market crash, the Emerging Markets (EM) are now poised for growth. The same factors that contributed to these periods of volatility now combine to create the ideal conditions for EM: the U.S. dollar, U.S. interest rates, oil prices and China's growth. Examining each of these factors and their effects explains why we at Cartica believe the outlook for EM looks "just right."

U.S. Interest Rates Remain Low

Unexpected changes in U.S. interest rate policy were behind many bouts of EM volatility over the latter half of the twentieth century. Most attribute the series of Latin American defaults in the late 1980s to Paul Volcker's aggressive policy of tightening the U.S. money supply in response to persistent double-digit inflation.[1] A more recent example is the rates-driven EM selloff of 2013 following then-Chairman Bernanke's announcement of the Fed's plans to taper.

Today we find ourselves in a significantly different scenario: U.S. interest rates are low and despite more hawkish rhetoric, the Fed is likely to tread cautiously as it proceeds. What's more, the current cycle of rate hikes has been long and gradual. It was almost two years ago in December 2015 that the Fed hiked rates for the first time in almost a decade. Since that first hike, the policy rate increased 25bps three additional times over the span of two years. This very patient approach reflects the Fed's weighting of risks; they seem more concerned by the risk of hiking rates too quickly than by the risk of keeping rates too low for too long. The nomination of Jerome Powell for Fed chair signals continuity in this approach. While this calculation of risks could change over time, it seems unlikely to over the short-term horizon as inflation remains persistently low.



Source: Bloomberg.

[1] https://www.federalreservehistory.org/essays/recession_of_1981_82

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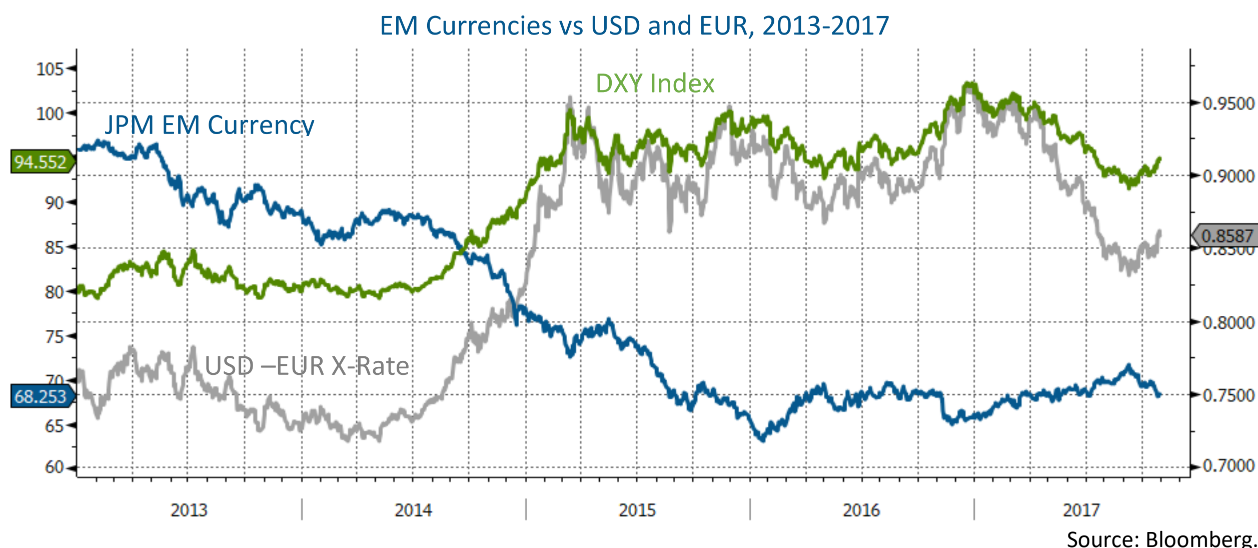
Complimenting the benign U.S. rate environment, global liquidity is plentiful and is likely to remain so. The ECB and the BOJ together have injected $2trn in liquidity so far this year and there are close to $10trn in negative interest rate bonds outstanding. This will ensure that foreign capital continues to flow into higher-yielding EM countries, even as the U.S. moves to gradually increase rates.

U.S. Dollar Weakening Continues

Dollar weakness has historically been a boon for EM. While overall the USD has weakened since the start of this year, we have seen it strengthen some recently. We believe this strengthening is a temporary blip, brought about by a more hawkish tone from the Fed, hopes of a Trump tax plan and geopolitical threats. The fundamentals that support USD weakness have not changed; while the U.S. drove the economic cycle over the last 6 to 7 years, that trend has shifted. The improving growth prospects in EM, Japan and the EU will continue to drive capital flows, boosting these countries' currencies relative to the dollar and prolonging the positive environment for EM assets.

EM Currencies vs USD and EUR, 2013-2017



Source: Bloomberg.

Oil Remains Range-bound

Oil has been confined to the $40-55 range for the past 18 months and while recently Brent has increased to the low $60s, this is likely because of the late summer hurricanes in the US, OPEC production cuts, the Kurdish referendum and the anti-corruption crackdown in Saudi Arabia. With shale as the new swing producer, we doubt that oil prices will return to the $100 range seen pre-2015. This is important as it is periods of instability in oil prices- with prices either rising to extreme highs or lows- that tend to hurt EM most.

Volatility in oil prices have varying effects across EM countries. Following the 2014 fall in oil prices, several EMs suffered terms of trade shocks that hurt their currencies and current accounts. These macroeconomic adjustments have now cycled through the system, and most EMs now find themselves with more fairly-valued currencies, manageable current account balances and adequate foreign exchange reserves. Some net importers of oil, such as India and Indonesia, have taken the opportunity to liberalize fuel prices and remove subsidies. Over the last few years, Mexico has taken steps to privatize formerly state-owned oil giant Petroleos Mexicanos (Pemex) helping to lower its government's

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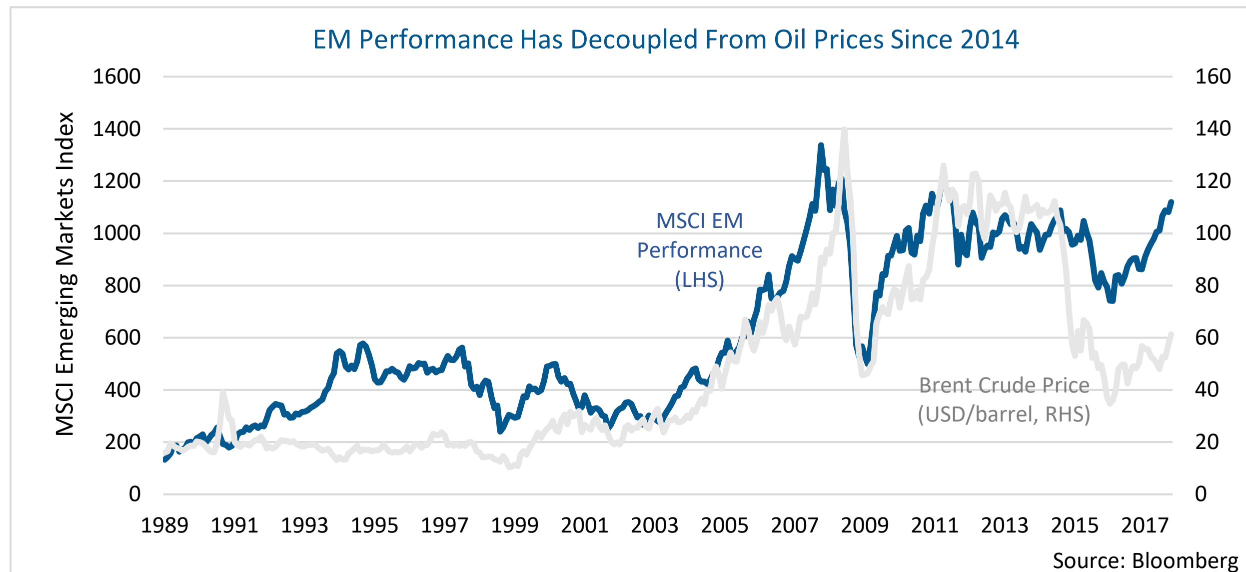
dependency on oil-related tax revenues. In the first half of this year, emerging market stocks rose over 16%, while crude oil was down 14%. While this partly reflects the higher weightings of both Asia (which is less dependent on oil) and technology stocks in the index, it also may reflect the increased resiliency of some of the large EM countries to fluctuations in the oil market.



China Continues to Drive Global Growth

Over most of the history of foreign investment in EM, the U.S. set the pace of global interest rates and was also the main driver of global growth. This resulted in a self-balancing business cycle with a single country reacting when its economy got too hot or too cold. This paradigm no longer holds. China is now responsible for global growth, while the U.S. continues to set global interest rates. With two global actors now influencing the business cycle, growth across regions has synchronized for the first time since 2008. The U.S. is now in the third longest economic expansion of its history, inflation remains benign, and volatility has been at an all-time low across asset classes over the last seven months.

While concerns remain over the build-up of credit and excesses in the Chinese property sector, the third quarter GDP estimate came in at 6.9%, which represents the second consecutive quarter of near 7% percent growth. The stimulus of late 2015 and early 2016 have largely been effective, and recent steps to strengthen the more productive private sector by directing credit to small businesses are positive signs. For the rest of EM, this prolonged period of stimulus and state-led development in China has led to significant tailwinds as President Xi's appetite for massive domestic infrastructure projects means greater demand for EM imports. As the government returns following the 19th Party Congress, we can expect further consolidation of President Xi's power, which likely means more of the same going forward. Overall in EM, domestic fundamentals continue to improve: EM GDP grew at its fastest pace since early 2013 in August at 4.8% yoy,[2] exports rose to a 5-year high in Q1, and aggregate Inflation at a 5-year low. All of this together suggests that we could be in for a prolonged bull market in EM.

[2] Capital Economics, "EM GDP growth at multi-year high in August;" October 30, 2017.

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Risks to Our Outlook

So what could trigger a change to this rosy outlook? The most likely risks are **(1)** a prolonged period of USD strength, **(2)** a reversal in the direction of global liquidity, or **(3)** a collapse in China's growth.

However, the EM of today are different from the EM of yesteryear. Even if these triggers were to play out, most EM country's external vulnerability has decreased substantially since 2008. During the more recent period of the 2013 Taper Tantrum, ten out of twenty-four EMs ran a current account deficit over 3%. Today there are only three – Colombia, Egypt and Turkey. With stronger balance sheets, floating exchange rates and large stockpiles of FX reserves, EM countries are more insulated now from external shocks and have deeper arsenals of weapons with which to fight macro headwinds. This last point highlights the importance of macro analysis when investing in EM. As EM economies have matured, there has also been growing differentiation between countries and within the markets of each country. While some sectors may be poised to directly benefit from the Goldilocks economy, others will be less affected.

At Cartica we believe that both country and company differentiation are essential to identifying the most attractive risk-adjusted return across EM. We approach each investment as if it were an onion, peeling back the different layers of risk to find the intersection of macro tailwinds and strong company fundamentals. With a focus on active ownership of emerging markets companies, we seek to unlock long-term growth in our investments by partnering with management teams, boards, and shareholders to drive positive governance and operational changes.

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