

# A silver lining

Trump's election clouds outlook for Emerging Market assets

By CESAR PEREZ RUIZ

**E**MERGING Market (EM) economies continue to face structural challenges, but the risk-reward balance for investment has been turning more favourable, thanks to a more-gradual-than-anticipated pace of US monetary policy tightening, a stabilisation of Chinese economic growth, a pick-up in nominal GDP (gross domestic product) growth – supporting corporate earnings – and a recovery in commodities prices.

Against this, EM economies stand to be among the big losers from Donald Trump's election as US president, if it results in increased protectionism, but the distance between president and candidate Trump will be key, and remains uncertain.

The structural drivers behind EM weakness have not changed much: high debt, slowing growth and China's gradual economic rebalancing. Despite this, four key trends favour Asian and EM equities at present. First, although uncertainty over Fed policy has increased following Mr Trump's election win, US monetary tightening still appears likely to be less aggressive than anticipated at the start of this year – we forecast a 25 basis point rate rise in December, followed by just two more rises in 2017.

Second, there has been a short-term pick-up in economic activity in China, a key driver for wider EM. We forecast real GDP growth of 6.7 per cent in 2016, with fixed asset investment a key driver, particularly in the property sector – although we anticipate a slowdown to 6.2 per cent in 2017 as property investment slackens.

Many heavy industries, from steel and glass makers to construction machinery, have seen a notable rebound in activity. Household consumption also remains resilient, with growth in retail sales stabilising at over 10 per cent year-on-year (y-o-y) in Q3, and car sales rising 26 per cent in September 2016 compared to a year earlier.

Third, although global real GDP growth remains muted, nominal GDP is picking up globally as pricing pressures re-emerge, notably in China. The Chinese producer price index (PPI), which measures the price of industrial products, saw positive y-o-y change in September for the first time in over four years.

Nominal GDP growth tends to be closely correlated to earnings growth, so this trend bodes well for EM corporate earnings. What is more, nominal GDP growth above the bank lending rate, as is currently the case in China, also helps companies to pay down debt, following a sharp rise in EM corporate leverage in recent years.

Finally, commodity prices have recovered somewhat this year, providing some respite to EM commodities producers. Following the US election, the November OPEC (Organization of the Petroleum Exporting Countries) meeting is another key date for EM economies – agreement on supply cuts would put a firmer floor under oil prices.

## Protectionism

Against this, EM assets risk being among the big losers from Mr Trump's election, if it results in increased protectionism – at a time when EM economies' export-oriented growth models have already been under strain. Mr Trump has promised a tougher stance on trade policy. He opposes the Trans-Pacific Partnership (TPP) and favours renegotiating the North American Free Trade Agreement (Nafta).

He has also promised to declare China a currency manipulator and called for high tariffs on goods sold by China or Mexico. EM countries with large trade surpluses with the US, such as Mexico, look most vulnerable. However, president Trump could yet prove much more moderate than candidate Trump in this area.

We like the dynamics of EM hard-currency assets, especially as we have seen a lot of Chinese developers paying down their

dollar debt. We are less positive on EM local-currency assets, because we expect the US dollar to strengthen. Moreover, EMs still need credit growth to come down: Credit growth in most EM countries is still higher than nominal GDP growth. Overall, the rally in EM assets looks to have run ahead of fundamentals, and a period of consolidation is likely.

Structurally, the outlook for broad EM appears mixed. The end of the commodity "super cycle" as China's growth gradually slows will likely continue to impose adjustment on commodity-exporting countries until demand and supply find a new equilibrium. The impact may be felt most severely by EM economies in Latin America, which are now highly dependent on commodity exports.

Much of the damage in terms of commodity price deflation has probably been done – a further sharp drop in prices looks unlikely. But the pace at which commodity-exporting EMs reach a new equilibrium will depend heavily on the speed of their supply-side adjustment.

Meanwhile, some other EM countries with favourable demographics and the right policies could surprise on the upside. India and Indonesia could be two bright spots. With favourable demographics and reform-minded leaders, the growth outlook for the two economies is quite positive in the medium term, while accommodative monetary policies could boost growth in the near term.

We are cautious on Thailand, given concerns about politics following the death of the king, and the Philippines, given eroding rule of law. The Philippines' seeming shift out of the US orbit and towards a closer relationship with China also emphasises that the balance of power in Asia could change in unexpected directions in the coming years: Geopolitics will be a key risk to watch. ▣

Cesar Perez Ruiz is Chief Investment Officer, Pictet Wealth Management