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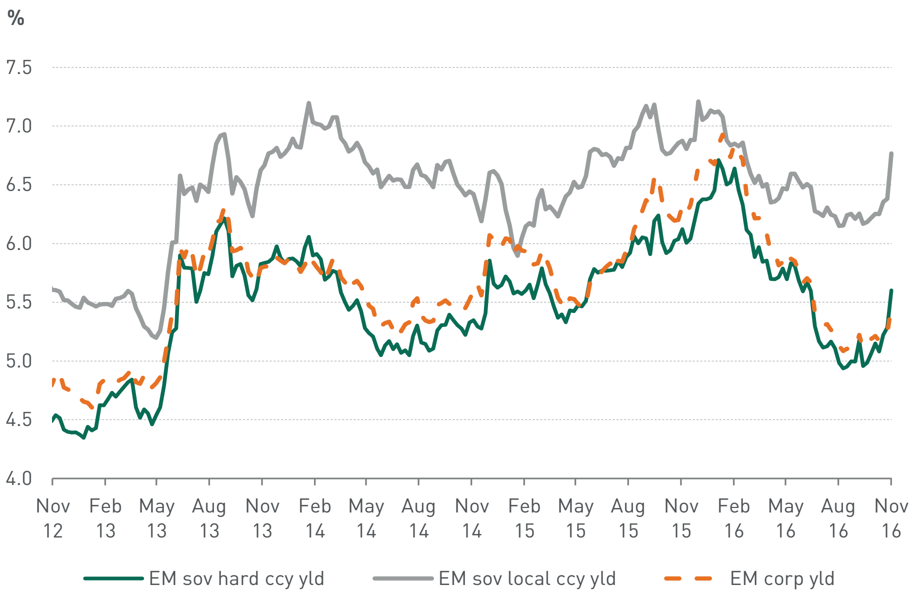
Trump Surprise Just Another Test for EM: Continued Resilience Unlikely to be Derailed

The unexpected election of Donald Trump as the 45th US president has sent Treasury yields higher and strengthened the dollar. However, risk assets – including emerging market (EM) currencies – have weakened materially, offering investors an opportunity to revisit winners and losers from 2016. Policy uncertainty may delay the market's return to viewing EM markets more positively, but the aggressive repricing of local yields and currencies over the last week means valuations are now considerably more attractive than before the US presidential election.

EM yields were quick to re-price a new reality



Source: Bloomberg, JP Morgan, PineBridge Investments, 11 November 2016

EM currencies sold off aggressively – some more than others

Source: Bloomberg, JP Morgan EM FX Index as of 21 November 2016

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The global macro picture has not changed materially since the election, although we would argue that Trump's promises of tax cuts and increased infrastructure spending have amplified pre-election optimism about slightly stronger global growth and higher US inflation prospects. The latter had convinced the market that the Federal Reserve would raise interest rates in December.

What to expect when you don't know what you're expecting

So far, the market has emphasized the positive parts of Trump's victory speech, which appeared somewhat conciliatory. There was little mention of trade protectionism, which would generally be considered more negative for emerging markets. Yet EM currencies have weakened significantly over the last week, in part due to increased risk aversion and in part due to a broadly stronger US dollar. Exchange rates in most EM countries are considered undervalued on a historical basis, but the currency weakness has had a limited effect on EM inflation, given structurally lower growth, allowing central banks to control their own monetary policy and earn credibility with investors.

As with any election, there are winners and losers. EM vulnerability to the yet-to-be clarified policies of the newly-elected president will depend on the countries' trade openness, level of remittances from the US, sensitivity to financial outflows, and, in local markets, foreign ownership of government bonds. Mexico, Malaysia, and, to a lesser extent, Indonesia, where foreigners own 40%-60% of the market, stand out. On the other end of the spectrum are Russia, Brazil, India, and Peru. Geopolitics aside, Russia has limited direct trade exposure to the US, a high policy rate, a conservative central bank, and a healthy current account surplus. Brazil is largely a closed economy with significant reform potential, a small current account deficit, and a high policy rate. The stories are similar in India and Peru, where the latter should also benefit from higher prices for copper, which is important for infrastructure. With all the uncertainty and varying national circumstances, this is hardly written in stone, but it might indicate what to expect.

Overreacting markets create opportunities

In the bigger picture, Trump's victory has also created policy uncertainty, and the renewed focus on a potential breakup of Europe, given a number of important elections next year, may intensify in December. Likewise, the prospect of looser US fiscal policy and tighter monetary policy could extend the recent trend of higher US yields and a stronger US dollar. However, it is at these times – when markets overreact to potential risks – that emerging market valuations become most attractive and the risks and rewards become more evident.

The Federal Open Market Committee (FOMC) has given us reason to believe that it will take into account global risks, and should Trump's policies dampen the economic outlook or should financial conditions become too tight, the Fed will refrain from raising interest rates too fast. Likewise, the European Central Bank and the Bank of Japan are unlikely to be able to remove policy accommodation in the current environment. EM economies may benefit from the improved US growth perspective and potential rise in commodity prices – particularly for metals – with some already cheering the yet-to-be clarified infrastructure plans.

The other side of the coin is the risk of the Fed becoming more hawkish and fears of European election surprises having a detrimental impact on market confidence, both of which could delay investors' return to emerging markets. However, with other risks in play last year – Fed tightening, the oil price collapse, and China's perceived economic troubles – emerging markets proved their resilience and we expect them to rise to the challenge yet again.

Stretched valuations are snapping back

EM corporates have outperformed the rest of the EM debt asset class, as is typical when markets dislocate after a significant event and risk assets sell off. Initially, EM corporate spreads actually tightened, outperforming US Treasuries, and even when US Treasuries stabilized, the spread widening in EM corporates remained modest. This slight repricing is actually welcome. Before the US election, valuations were looking rather stretched, and the back-up in yields is providing a more attractive entry level, particularly in investment grade. The trajectory of EM corporate fundamentals has gradually improved through 2016 and the majority – about 63% of our coverage universe – has a stable credit trend, about 24% is negative, and 13% are positive. The third-quarter results season in Asia and Europe, the Middle East, and Africa (EMEA) has been more or less in line with expectations. And Latin American corporates have, at the margin, beaten estimates. So overall it's "steady as she goes."

Corporates continue to hold the line

The longer term fundamental outlook into 2017 is also stable and we expect EM corporate defaults to remain subdued, outperforming US high yield bonds. The market volatility after the US elections has had an impact on the technical position because in the near term we are likely to see less supply and issuance (excluding Asia), which will provide positive support. On the flip side, we are watching carefully for any repatriation out of the asset class, but given that the bulk of the investor base is institutional, we are not expecting any material changes. Overall, EM corporates have so far proven once again to be the defensive component of the EM debt asset class, and we expect that to remain the case for the foreseeable future.

As always, timing the market is an impossible task and there is still significant uncertainty about what a Trump presidency means in practice. Still, there is no denying that value is returning to EM after this year's hunt for yield pushed EM bond prices higher, resulting in double-digit returns.

Emerging markets should remain on asset allocators' radar

Back in September, after the summer bond rally, we updated our return projections for various EM asset classes over the next 12 months and got only -1% to 2%. Not great for emerging markets, but perhaps unsurprising after nearly 11%-16% year-to-date. Two months and a 60-basis-point bump in US Treasury yields later, the picture has changed. We are looking for 5%-7% returns across pretty much all of our markets. With high expected returns in investment grade, our allocation framework suggests an overweight in sovereign and corporate IG bonds and an underweight in local currency.

Is EM a screaming buy? Perhaps not, but very few investors are brave enough to buy when it is. After all, how many listened to us in January, when expected returns were near double-digits? At the current levels, investors are getting decent compensation for EM risk and should consider increasing positions.

Scenario analysis and total return expectations (12-month forward-looking)

Market pricing here

	20%	10%	50%	15%	5%
Probability ▶	20%	10%	50%	15%	5%
Scenarios ▶	"Armageddon"	"Bear on a Leash"	"Cruise Along"	"Bright Future"	"Fly High"
Growth Trend	Global slowdown China shock	Global slowdown EM growth <4% China growth 6%	Stable EM growth at 4-4.5% China 6-6.5%, US 2-2.5% and EU at 1.5%	Faster growth: EM growth >4.5%, China >6.5%, US> 2.5%, EU>2%	Faster growth: EM growth >4.5%, China >6.5%, US > 2.5%, EU>2%
Inflation Path	Lower/deflation	Lower/deflation	Stable to lower inflation in EM, low inflation in DM	Inflation edging higher	Higher inflation (US > 3%)
G3 Central Bank Policies	Perception of imminent US rate hike/potential policy mistake	Fed delaying hikes, more policy stimulus from other central banks	2 Fed hikes in 12 months, more policy stimulus from other central banks	US monetary policy normalisation	Accelerated US normalisation
Fiscal Lever in the Policy Toolkit	Countercyclical fiscal policies/reforms in selective EM	Fiscal stimulus/structural reforms in selective EM	Fiscal stimulus/structural reforms in selective EM	Fiscal stimulus/more structural reforms	More reforms
Commodities	Lower	Lower	Stable (oil price $40-50bbl)	Slightly higher	Higher

Macro Scenarios Translated Into Total Return Forecasts - 12-month View

	Probability	UST Move (10Y @ 2.21%)	EM Sov Hard Ccy	EM Sov Hard Ccy - IG	EM Sov Hard Ccy - HY	EM Local Currency	EM Corporates	EM Corp IG	EM Corp HY
Armageddon	20	-146 bps	4.1	6.5	1.4	-11.1	3.2	6.0	-1.1
Bear on a Leash	10	-71 bps	9.5	11.8	7.1	15.0	6.5	8.2	4.0
Cruise Along	50	-21 bps	7.6	7.6	7.7	14.2	6.3	6.3	6.2
Bright Future	15	29 bps	7.6	5.0	10.5	2.5	6.0	5.2	7.2
Fly High	5	104 bps	2.0	-3.1	7.7	5.9	1.6	-1.1	5.8
Total	**100**	**-37 bps**	**6.8**	**6.9**	**6.8**	**7.0**	**5.4**	**5.9**	**4.7**

Source: PineBridge Investments, as of 15 November 2016. For illustrative purposes only. We are not soliciting or recommending any action based on this material. Forecasts are by the EM Debt team and are subject to change without any notice. Any views represent the opinion of the manager and are subject to change.

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MULTI-ASSET | FIXED INCOME | EQUITIES | ALTERNATIVES