Emerging Markets Commentary

Trade speculation dominated Emerging Markets headlines in March. US President Donald Trump announced plans to levy 25% tariffs on about $50 billion worth of imports from China as well as adopt new restrictions on Chinese investment in the US. China responded to steel and aluminum tariffs announced earlier with tariffs of its own, ranging from 15-25% on about $3 billion in US goods. The actions have sparked fears of a damaging trade war between the largest economies in the world. However, the announced tariffs' economic impact is small when scaled properly. For example, potential US tariffs on Chinese exports would amount to 0.62% of exports or about 0.12% of Chinese GDP. Similarly, Chinese tariffs on US imports would equal about 0.029% of Chinese imports and 0.0053% of Chinese GDP. While tariffs are a mild negative and the possibility of a trade war always exists, we don't believe one is probable yet.

In China, President Xi Jinping made headlines, as the Communist Party proposed removing a constitutional clause that limits the president to two terms, raising the possibility Xi could remain in power indefinitely. This isn't an unexpected shock as rumblings about Xi consolidating political power have long existed—intensifying since last year's 19th Party Congress. While analysts debate the potential positives (e.g., less uncertainty) and negatives (e.g., removal of any semblance of checks and balances), this isn't a major deviation in political behavior for China. From an investing perspective, this is a continuation of the status quo. While Xi's power-grab could have long-term sociological consequences, the investment impact is likely limited for now. Through all the trade and political worries, EM economies like China continue expanding. China's combined January-February data remained in line with long-running trends. Overall, China's economy seemingly remains healthy even as the government takes steps to slow down credit availability.

Elsewhere in Asia, a South Korean appeals court reduced and suspended the prison sentence of Samsung head Jay Y. Lee. Lee received a five-year jail term last August for bribery, and many believed the government was taking a tougher stance against corporate malfeasance and political corruption. Economically, Korea remains an integral link in the global tech supply chain—and Korean equities have proven political drama and geopolitical tension won't slow them down. Though reforms would likely benefit the country in the long run, they aren't required for equities to rise.

In late January, a Brazilian appeals court upheld the corruption conviction of former President Luiz Inácio Lula da Silva (better known as Lula), hurting his chances to run for the presidency this year. Though many experts attribute Brazilian equity market outperformance to the apparent resolution of the political drama, improving economic fundamentals are likely playing more of a role. While the Brazilian economy is benefiting from the tailwinds powering the global expansion, it also remains reliant on commodity prices, which still face headwinds from the global supply glut.

Mexico, Latin America's second-largest economy, grew 1.0% q/q (1.8% y/y) in Q4, rebounding from Q3's -0.3% contraction as the effects of September's earthquake faded. For the year, Mexico grew 2.1%, slower than 2016's 2.9%, though government spending cuts and a fall in oil and gas production were the primary culprits. The services sector grew 1.2% q/q (2.6% y/y), a sign that Mexico's burgeoning consumer class is faring well. Though political events like a July presidential election and ongoing NAFTA negotiations may weigh on sentiment, Mexico is doing better than widely appreciated, setting up a low bar for reality to exceed.

In South Africa, President Jacob Zuma formally resigned from office. Zuma currently faces 783 counts of alleged fraud and corruption related to a 1990s arms deal along with additional allegations of corruption tied to his relationship with the prominent Gupta family. Zuma's African National Congress (ANC) Party drove his resignation after officially voting to order him out. New ANC leader Cyril Ramaphosa replaced Zuma, and while some experts see the successor as a reformer, it will likely be difficult for him to pass meaningful change—especially with the ANC relatively fractured and simultaneously pursuing more populist measures like amending the constitution to allow land expropriation. South Africa's economy faces some headwinds from the global commodity supply glut, so unless Ramaphosa executes an extensive reform agenda, South Africa will likely underperform relative to other Emerging Markets.

A banking scandal emerged in India, adding another headwind toward the country. Punjab National Bank, the country's second-largest state-run lender, accused two jewelry groups of colluding with bank employees in a fraud amounting to more than $2 billion. The government has responded by launching an investigation and announcing plans to set up a new body to oversee auditors. While the direct fallout has limited broader impact, the controversy has hurt sentiment and sparked concerns of other potential hidden risks in the banking system. The Financials scandal is the latest issue weighing on sentiment toward India. Recent protectionist measures (e.g., the introduction of capital gains tax and Indian equity exchanges no longer providing data outside the country) have worried investors, and the Modi government doesn't have any additional major economic reforms on the horizon.

Outlook:

Trade tensions—particularly between China and the US—have spurred concerns of a trade war between the world's two-largest economies. However, we believe these fears are overblown. Current tariffs lack the scale to meaningfully dent the global economy, and harsh rhetoric has given way to more moderate actions. Moreover, while high-profile trade spats garner the most attention, the world has been moving toward freer trade, with big agreements reached across Developed, Emerging and even Frontier Markets. While the synchronised global expansion is benefiting most economies, not all Emerging Markets (EM) will likely benefit to the same degree. Though many treat EM as one cohesive bloc, individual nations' economic and political drivers vary. In our view, economies that are trade-oriented and have growing services sectors and consumer classes are better positioned to perform than those reliant on commodity prices. We believe investors who take a selective approach to Emerging Markets can find opportunities.

Sources*: FactSet, Instituto Nacional de Estadistica y Geografia, National Bureau of Statistics, Oxford Economics, FactSet, MSCI India Index return with net dividends in USD, MSCI Emerging Markets Index return with net dividends in USD, National Bureau of Statistics of China.*

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