Possible U.S. election implications for emerging markets: Down but not out?

In brief

- Emerging market (EM) assets have suffered in the wake of the Trump presidential victory and the Republican sweep of Congress.

- Since Nov. 8, EM equities are down -3.6% in local currency, EM USD sovereign bonds are down -4.0% and EM currencies are down -4.0% versus the dollar.

- Investors should remember that there is still much uncertainty around Mr. Trump’s policies, and thus should not overreact until there is more clarity around political appointments and specific policy proposals.

- The impact on EM will depend on the policy mix that is ultimately implemented, in particular whether only more pro-growth aspects of the agenda are emphasized or whether more restrictive trade and immigration policies are prioritized as well.

- Lastly, the size of pro-growth measures implemented will also dictate the extent of pressure on U.S. yields and the U.S. dollar, and thus how many headwinds EM faces from external macro factors once again.

Thinking through a lot of unknowns

In this bulletin, we consider some potential policies of a Trump administration and their possible effects on U.S. asset performance, and thus some implications for emerging market economies and markets.
Weak global trade volumes have been a challenge for EM

PRO-GROWTH AGENDA

Mr. Trump’s agenda includes several items that are likely to boost U.S. growth, such as an increase in government spending, tax cuts and less regulation. A lift in U.S. economic growth could have a positive impact on the global economy, including EM, as increased U.S. demand could mean increased imports from the rest of the world. Over the past few years, EM growth has been suffering from, amongst other things, weak global trade volumes due to subdued demand from the developed world (Exhibit 1). Thus, a boost in U.S. demand could have positive ripples across the world. However, this global effect will depend on how restrictive Mr. Trump’s trade policy ultimately is.

RESTRICTIVE TRADE POLICY

During his campaign, Mr. Trump spoke about canceling or renegotiating trade deals (such as NAFTA and the Trans-Pacific Partnership), as well as imposing large tariffs on imports from trading partners such as China and Mexico. A scenario of very restrictive trade policies could be very harmful to countries whose economies depend a lot on trade, and in particular, trade with the U.S. These countries could see large decreases in their exports, with a negative effect on their economic growth. One of the most exposed EM countries is Mexico, where exports represent 33% of GDP and exports to the U.S. alone make up 27% of GDP. Other EM countries could also suffer from decreased trade with the U.S., such as big export powerhouses in Asia like Korea, whose exports to the U.S. represent 5% of GDP (Exhibit 2).

KNOCK-ON EFFECTS FROM PROTECTIONISM

Beyond the near-term hit to EM exports to the U.S., a scenario of very restrictive U.S. trade policy would also have other knock-on effects for EM exporters. These would include less foreign direct investment in EM from U.S. companies that choose to move operations back to the U.S. (or choose not to expand production overseas); a negative hit to EM consumer and business confidence given the uncertainty around trade policy, negatively affecting domestic demand; and the potential for a shift in local politics toward more protectionist and nationalistic candidates in upcoming EM elections (such as Mexico’s presidential election in 2018).

IMMIGRATION POLICY OVERHAUL

Another campaign promise of Mr. Trump’s involved being much tougher on illegal immigration, including building a wall along the Mexican border paid for by
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Mexico. Questions arise as to how the wall would be paid for, with proposals including the freezing or taxing of remittances of Mexican workers in the U.S. Remittances to Mexico are very closely tied to Mexican household confidence and domestic consumption, thus this policy and uncertainty around it are another negative for the Mexican economy. In addition, a scenario in which the U.S. engages in large deportations of immigrants would add further support to more nationalistic candidates in upcoming elections in regions with a lot of immigrants to the U.S., such as Mexico and Central America.

HIGHER YIELDS

The potential for a policy mix that involves mostly just the pro-growth aspects of the agenda has led to an increase in expectations for U.S. growth, inflation, Fed hikes and debt issuance. This has resulted in a quick jump in U.S. Treasury yields, steepening the yield curve. The possibility of a shift from monetary to fiscal policy in other DM countries as well has caused yields to trend higher in many DM countries. This global rise in yields lessens the appeal for EM fixed income for those investors that had moved into EMD over the past few months purely for the search for yield alone. Demand from yield hungry DM investors was expected to be a key source of support for EMD spreads to continue moving lower despite already being at long-term averages (Exhibit 3). Going forward, investors will need to be much more selective, focusing on countries and companies that are actually improving their balance sheets, as there is likely to be much more dispersion in performance.

U.S. DOLLAR STRENGTH

The possibility of higher growth and higher yields in the U.S. would provide support to a stronger dollar. However, a policy mix that involved more restrictive trade could stem the dollar’s appreciation somewhat. The direction of the dollar is crucial for EM asset performance (Exhibit 4), as dollar stability allows foreign investors to feel more comfortable returning to local EM assets and also provides room for local central banks to cut rates in an effort to boost tepid growth. A scenario where the dollar continues to strengthen considerably against EM currencies would be one that could see the re-emergence of outflows from EM assets and local central banks that are forced to hold off on rate cuts (or even hike rates) despite U.S. dollar strength is generally a headwind for EM assets.

EXHIBIT 3: CORPORATE AND SOVEREIGN EMD SPREADS
USD-DENOMINATED DEBT, PERCENTAGE POINTS OVER TREASURY

<table>
<thead>
<tr>
<th></th>
<th>Average</th>
<th>Latest</th>
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<tbody>
<tr>
<td>EM sovereigns</td>
<td>3.4%</td>
<td>3.6%</td>
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<tr>
<td>EM corporates</td>
<td>3.8%</td>
<td>3.1%</td>
</tr>
</tbody>
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EXHIBIT 4: DM vs. EM PERFORMANCE AND THE U.S. DOLLAR
MSCI THE WORLD/ MSCI EM, JANUARY 2016 = 1

Source: MSCI, FactSet, Bloomberg, J.P. Morgan Asset Management; data are as of November 18, 2016.
weak local growth in order to deal with inflation. This would be particularly challenging for EM countries that still have large current account deficits (and thus are very dependent on foreign inflows), as well as countries that have limited scope to cut interest rates or provide fiscal stimulus in an effort to stimulate growth.

THE EMERGING MARKETS GROWTH ALPHA

Beyond merely the search for yield, a key support for EM asset performance this year and beyond is the improved prospect for EM growth in comparison to DM growth. EM will tend to grow faster than DM, but the key question for EM performance relative to DM is “how much faster?” For the first time since the peak in commodity prices a few years ago, expectations for EM growth began to consistently move up, at the same time that expectations for DM growth turned down (Exhibit 5). As a result, the “EM growth alpha” returned, suggesting the rebound in EM assets this year was sustainable. The key question now is to what extent does more restrictive trade policy (or the uncertainty around it) plus less space for monetary easing, caused by outflows and a stronger dollar, result in a reversal in this trend.

Investment implications

The impact on EM of Trump’s victory and the Republican sweep will largely depend on what policies are implemented. A focus on the pro-growth only aspects of the agenda, such as fiscal expansion and deregulation, can help improve U.S. growth, with positive implications for global growth as a whole. However, a policy mix that also involves very restrictive trade and immigration policies could have negative direct and indirect effects on EM growth, especially for countries with closer ties to the U.S. The impact on EM will also depend on the extent to which pro-growth measures are implemented in practice. A substantial tax and infrastructure program could justify the increase in U.S. growth, inflation and interest rate expectations, and thus the related increase in U.S. yields and the U.S. dollar. This would make the external environment more challenging for EM once again compared to before the U.S. election.

This would increase the burden of proof for EM countries to deliver on promised reforms and higher economic and earnings growth. As a result, investors will need to be selective when investing in EM equities and debt in 2017, as the tide may no longer lift all boats equally.

A lot is still uncertain, thus volatility is likely to remain more elevated for EM assets compared to earlier this year; however, investors should be wary of overreacting before getting more clarity on U.S. policy over the next few weeks and months.

THINGS TO WATCH

Presidential appointments:
In order to gauge the direction of a Trump administration’s trade and immigration policies, it will
be important to watch key appointments over the next few weeks, such as Treasury Secretary, Secretary of Commerce, U.S. Trade Representative, Secretary of State and Secretary of Homeland Security.

**Tax and infrastructure bills:**
In order to assess whether the Treasury and FX markets were correct to expect higher growth and higher inflation in the U.S., it will be crucial to watch the tax and infrastructure spending bills that are ultimately proposed in the first few months of Trump’s presidency.

**Federal Reserve statement and press conference:**
In order to discern whether the Fed’s view of the economy has changed, and thus whether we can expect a more hawkish turn of policy over the next few years, it will be crucial to watch the statement and press conference at the December 14 meeting. This will help us gauge the extent of further upward pressure on the U.S. dollar and U.S. yields.