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Emerging Markets

SPECIAL REPORT – 2019

BNY MELLON
INVESTMENT MANAGEMENT

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1. Mellon was formed on 31 January 2018, through the merger of The Boston Company and Standish into Mellon Capital. Effective 2 January 2019, the combined firm was renamed Mellon Investments Corporation.

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Introduction

Emerging markets (EM) made a strong start to 2019 after a tumultuous year which saw volatility swings heavily impact developing markets as diverse as Turkey and Argentina, driving some fund outflows from the EM sector.

Investors hoping for some sustained respite from last year's market squalls – which in May 2018 alone saw foreign investors pull some US$12.3bn from EM debt and equity markets[2] – initially looked to more dovish signals on interest rate rises by the US Federal Reserve (Fed) as a calming influence. Yet escalating global trade tensions, stoked by the ongoing Sino-US trade dispute, have since brought some renewed concerns and volatility to the market.

Nevertheless, there are encouraging grounds for optimism for EM investors. In its April 2019 economic outlook, the IMF noted the ongoing trade tensions, predicting global growth will slow from 3.6% in 2018 to 3.3% this year. However, it also said it expects to see gradual stabilisation in stressed EM economies such as Argentina this year. It also anticipates improved momentum for emerging markets and developing economies into 2020.[3]

An expanding EM universe also continues to offer strong pockets of opportunity for discerning investors willing to ride out the short term bouts of volatility common to developing markets. While geopolitical risk remains an ever present threat, some emerging markets can potentially offer compelling returns and a valuable means of diversification.

At a global level, 2019 will see a large number of EM elections which could help frame potential threats and opportunities for investors, while the outcome of international trade talks could also shape the wider investment outlook within the EM sector.

Against this backdrop, managers from across BNY Mellon Investment Management examine the latest developments within the broad EM investment landscape, exploring shifting political trends, broader trade and economic developments and some of the evolving risks and opportunities they present.

2. *Bloomberg*. Emerging Markets in May Saw Biggest Outflows in 18 Months. 05 June 2018.
3. IMF World Economic Outlook, April 2019.

A new world order?

Shifting trade patterns, as well as potential trade conflicts, are placing a renewed focus on emerging markets in an increasingly multi-track global economy. Here, managers from across BNY Mellon Investment Management consider this evolving landscape and ask whether, after a volatile 2018, emerging markets (EM) are returning to form.

After a turbulent 2018, investment interest has returned to emerging markets on the back of market gains. From the start of the year to 19 April 2019, the MSCI EM Index rose 13% in US dollar terms.[1] To an increasing number of investors, emerging markets, which look set to drive global growth in coming decades, have truly come of age.

According to forecasts by global consulting giant McKinsey, rapidly evolving technology, rising consumption from urbanisation and growing "south-south" trade between China and other emerging markets are key trends that will likely help them achieve stronger growth.[2]

The "south-south" trade alone saw an 11x increase between 1995 and 2016, according to the consultants. They also predict that over half the forecasted global consumption growth (expected to reach US$62 trillion by 2025, double its 2013 level) will come from emerging markets[3] led by countries such as China and India.

Yet, while emerging markets present many attractive opportunities to global investors, they also face wide ranging threats.

From short-term geopolitical events to more drawn out and lengthy political dramas such as the prolonged tussle over the leadership of Venezuela or the scope of Iran's nuclear programme, perceived geopolitical threats remain in the news and therefore on investors' minds. Trade conflict – especially with the US – has added to the perception of EM risks.

On the political front, more news will drive attention to emerging markets. In a busy year of elections, countries such as India, Indonesia, the Philippines, Thailand, Argentina, Nigeria, South Africa, Poland and Ukraine all go to the polls in 2019.

While few shocks are expected, Insight Investment portfolio manager Oliver Williams points out, all pose varying potential threats and opportunities.

TRADE THREATS

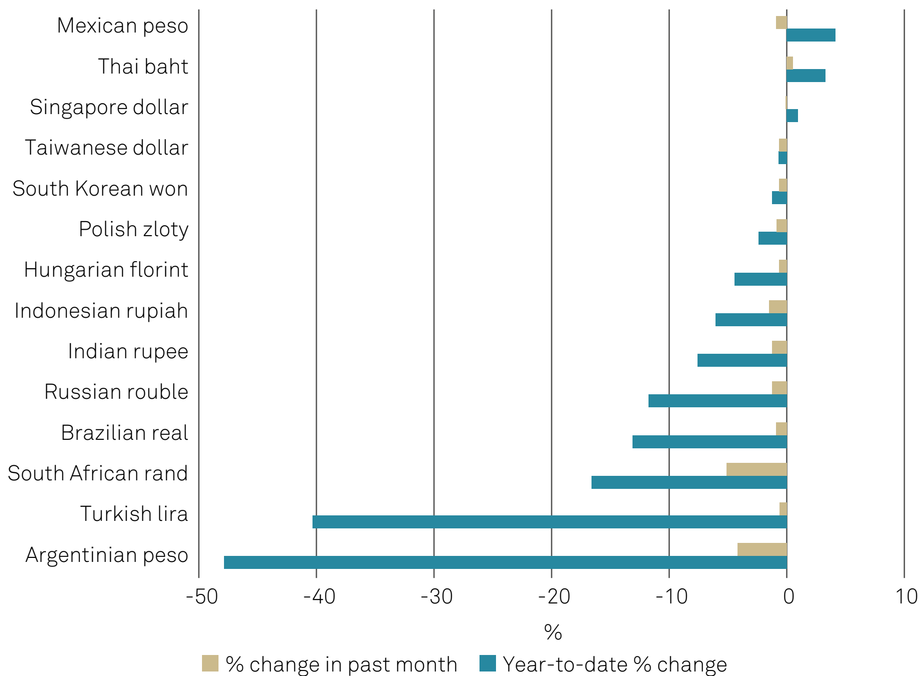
Beyond politics, many EMs can face significant currency risk. With much EM corporate debt denominated in US dollars, any significant strengthening in the greenback's value could have an impact on the economic health of issuers.

This dependency of some EM economies and their currencies was vividly illustrated in Turkey in 2018, when its lira currency lost more than 30% of its value against the US dollar at one stage, pushing its stock markets to drop 17% as Turkish inflation hit 18%.[4]

The crisis was in part inflamed by trade threats from US President Donald Trump who, at the time, said he had approved doubling tariffs on Turkish steel and aluminium.[5]

1. *Money Week*, Emerging markets bounce back. 19 April 2019.
2. *Mckinsey.* Outperformers: high-growth emerging economies and the companies that propel them. September 2018.
3. *Mckinsey.* Global growth, local roots: The shift toward emerging markets. August 2017.
4. *BBC*. Turkey lira crisis explained. 10 August 2018.
5. Ibid

EMERGING CURRENCIES VS US DOLLAR



Source: Thomson Reuters Datastream, data as at 05 September 2018.

Elsewhere, the Trump administration's aggressive trade stance – particularly levelled at China and Mexico – has triggered fears for both emerging markets and the wider global economy. Trump again ramped up China trade hostility in May, more than doubling tariffs on US$200bn of Chinese goods,[6] yet some analysts feel the effects of US tariffs and other measures may ultimately prove more nuanced than was widely anticipated.

Mellon research analyst Jack Encarnacao says: "All told, the US tariff regime (USTR) placed new tariffs on US$25bn worth of Chinese imports in 2018. Of that, US$50bn had 25% tariffs placed on them and US$20bn had 10% tariffs, with a possibility of an increase to 25% (as mooted in early May 2019). The tariffs were rolled out in phases. However, there have been, and will continue to be, lots of wrinkles in the process."

He goes on: "To our thinking, products, like smartphones, are among the highest-value Chinese products the US imports and have the lowest near-term risk of being disrupted by trade tensions."

The USTR in May published a new $30bn proposed tariff list that includes virtually every Chinese import, but that only marks the beginning of a process that has increasingly seen the carving out of high-value products.

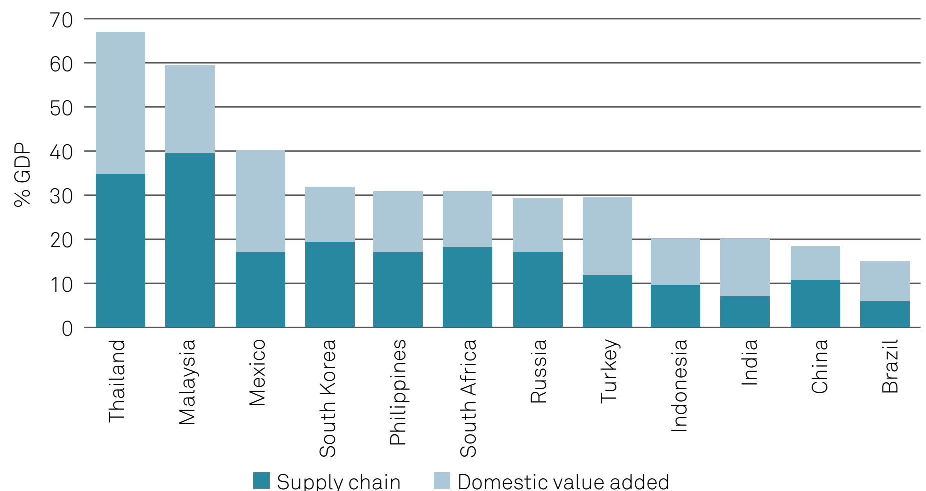
At an investment level, trade wars matter to global securities markets, increasing both uncertainty and volatility. After a particularly volatile 2018, however, some portfolio managers remain optimistic EMs can ride out any short-term uncertainty over wider trade issues to stabilise in the months ahead.

Commenting, Carl Shepherd, a fixed income portfolio manager at Newton Investment, says: "EMs are generally vulnerable to trade disputes as they are price takers in the sale of commodities in global markets. Trade disputes also increase uncertainty and thus make forecasting and planning more difficult and act as a drag on growth. Therefore, we can expect flight to quality tendencies in these situations."

He adds: "It does seem that some of the headwinds of 2018 are dissipating now or becoming tailwinds and we have seen a halt in US rate rises. While nobody can be 100% certain EMs are in recovery mode, this reversal of market expectations certainly, in our view, makes the case for investing in EM stronger and supportive of "carry" investing, especially as EM inflation remains mainly subdued."

In an increasingly globalised world, US trade is not the only story. Across the globe, individual trade ties with near neighbours tend to be the most important for most countries. Some commentators believe regional emerging market clusters may actually benefit if Sino-US trade relations continue to sour, forcing China to trade more with neighbouring countries in the South East Asia region.[7]

EMERGING MARKET EXPORTS (% GDP)



Data as of 31 December 2018. Source: TS Lombard.

6. *BBC*. Trade war: Trump raises tariffs on $200bn of Chinese goods. 10 May 2019.
7. *FT*. Will the US-China trade war impact on global growth? 20 September 2018.

Whatever the outcome of the ongoing trade talks, China has its own plans to boost global trade and investment. It is now the world's largest producer, consumer and investor in renewable energy[8] and its ambitious and often controversial US$900bn One Belt One Road[9] initiative is designed to create other new markets for Chinese goods and services through a vast range of linking infrastructure projects.

RISING OPTIMISM

From an investment standpoint, by mid-2019, there appeared to be several reasons for optimism about EMs. The more dovish approach on interest rates adopted by the US Federal Reserve (Fed) earlier in the year provided a market fillip and, despite heightening Sino-US trade tensions in the first half of 2019, the sometimes wild gyrations markets witnessed in 2018—most notably in Turkey and Argentina—appear to have eased.

According to Lipper Alpha Insight, emerging market equity funds took in US$18.0bn in net new money for the year to April 2019—the third best quarterly net inflows ever. Much of this was on the back of news that the Fed was to ease its hawkish stance on raising interest rates.[10]

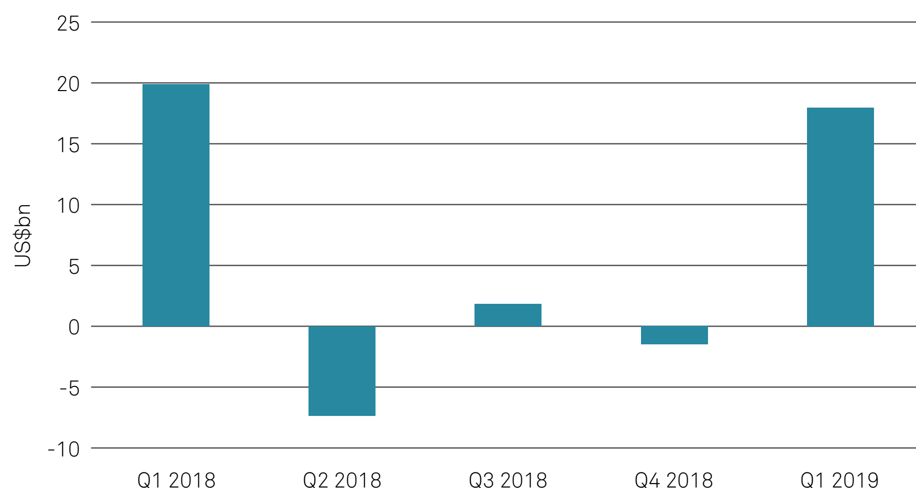
Despite some concerns over China trade and the health of its economy, Newton emerging and Asian equity team leader, Robert Marshall-Lee, continues to see opportunity in the market. "The MSCI China index has outperformed its European equivalent over three and five years, and now even over one year. In addition, the MSCI China index trades at a substantially lower forward price/earnings consensus multiple than the MSCI Europe index, demonstrating that outperformance has been driven largely by profit growth," he says.

"China offered up some fabulous stock opportunities in the latter part of 2018, which were quickly seized. We believe there are still some great opportunities in the Chinese market—particularly in the service sector."

Beyond China, Marshall-Lee sees a range of opportunities in markets as diverse as Nigeria, Pakistan and Vietnam, although he continues to believe some of the strongest potential is in a reforming India.

"We think India is still the most attractive emerging market on a five or 10-year view. Superficial equity valuations are higher but growth areas are also much higher on a sustained basis. India's underlying population growth is phenomenal and its credit penetration is very low, unlike most of the rest of the world. The Indian government has also laid the ground work for productivity growth for the next decade," he says.

EMERGING MARKET EQUITY FUND FLOWS Q1 2018 – Q1 2019*



Source: Lipper Alpha Insight as at 29 March 2019.
*Quarterly new flows of both mutual funds and ETFs in US$ bn.

While some investors remain concerned about a resurgence in EM volatility, Marshall-Lee feels it is unfair to judge these markets on a short-term basis. "When people look at 2018 in isolation they sometimes forget the fact that EMs did incredibly well the preceding year. We believe Europe has more impediments to growth than a number of emerging markets and it is worth remembering that Greece itself slipped into EM territory some years ago."

FIXED INCOME

Beyond equities, EM fixed income has also seen positive signs of growth in recent months. March saw the Bloomberg Barclays Emerging Market Local Currency Bond index reach near record highs amid broader signs of a nascent rally in emerging market debt.[11]

Insight Investment's Williams also points to growing opportunities in hard currency debt, including euro-denominated debt, and has noted a strong start to the year in the asset class.

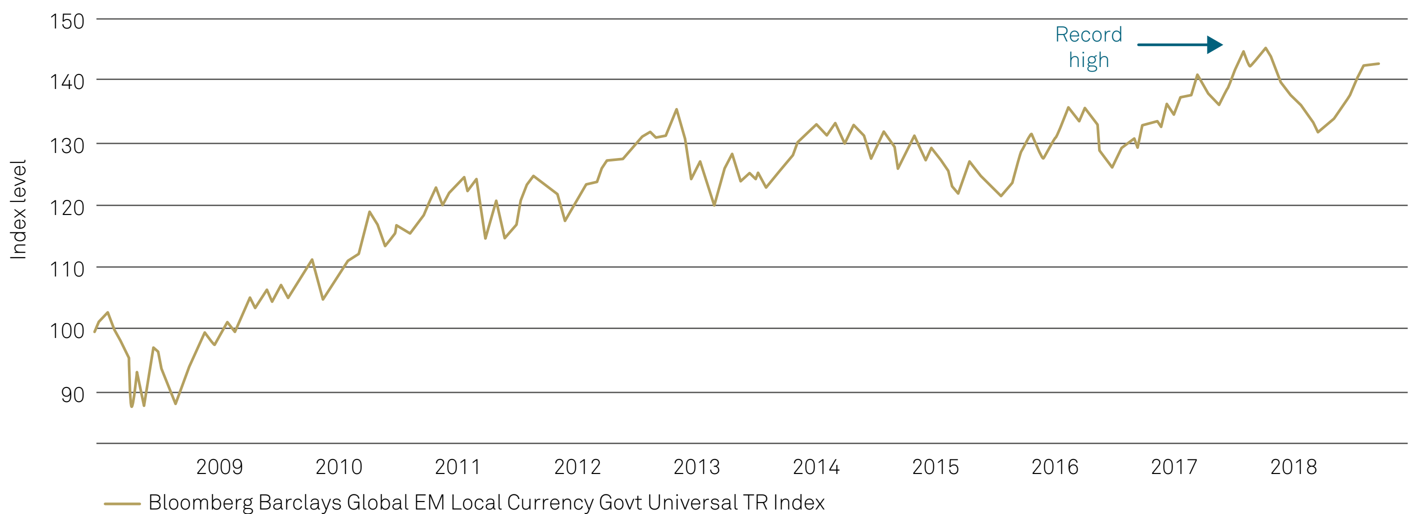
"EM hard currency assets have boasted a strongly positive return so far in 2019 (to April 30), thanks to the spread compression in a positive risk environment. Lower Treasury yields have also helped. Net issuance of hard currency debt has been a lot lower than in previous years and we have seen positive flows into the asset class this year. Overall, EM rates have had a positive start to the year. This is mainly thanks to the relatively high "carry" levels on the asset class," he says.

In terms of specific country opportunities, Newton's Shepherd believes Argentina offers good, if potentially risky, value, despite its reliance on IMF support and volatility. He is gloomier on Venezuela, which remains mired in political and economic strife but cites Ecuador as a potentially strong fixed income prospect.

"I believe that the brightest "star" in LatAm is Ecuador. Its government is starting from a very low base of expectations and still has a great amount of work to eventually shed the

8. *Copper Alliance*. Top 3 copper trends to watch in 2019. 1 February 2019.
9. The One Belt, One Road initiative is a major infrastructure-led scheme designed to enhance trade and incorporating a sea route linking southern China with East Africa and the Mediterranean and a series of overland corridors linking China with Europe. Source: Guardian. The $900bn question: what is the Belt and Road initiative? 12 May 2017.
10. *Refinitiv/Lipper Alpha Insight*. Emerging Markets Equity Funds Post Strong Q1 Fund Flows Results 29 March 2019.
11. *Bloomberg*. Emerging-Market Bonds Are Picking Up Steam. 17 March 2019.

EMERGING MARKET LOCAL CURRENCY BOND MARKET GAINS MOMENTUM



Source: Bloomberg as at 17 March 2019.

dollarisation in the economy. However, since Lenin Moreno became president in 2017 the country has made great strides in increasing transparency with regards to government financing," Shepherd says.

Mellon's head of emerging market debt Federico Garcia Zamora sees continuing value in oil-rich countries such as Russia, Kazakhstan and the Gulf states despite some geopolitical concerns.

"If you look at the pure economic fundamentals, Russia is getting stronger. It is building a growing external surplus, a growing fiscal surplus and the country is getting stronger. Inflation also appears to be peaking right now and should fall lower over time," he adds.

More broadly Garcia Zamora remains optimistic on EM debt through 2019 and beyond. "We think the global backdrop should be more constructive than last year given the current dovish shift by many major central banks," he says. "The EM debt universe is also extremely wide and many parts of the sector look cheap compared to other assets classes. Long-term charts of spreads show tight levels across asset classes. However, if you compare EMs versus other fixed income asset classes it compares favourably and we believe should perform well in the months ahead."

OUT OF AFRICA: THE BIRTH OF THE AFCFTA

Many emerging markets analysts see Africa as the final frontier for global investors and a continent potentially offering rich long-term prospects. Yet geopolitics, corruption, natural disasters and a lack of coherent, coordinated trading mechanisms have all helped stymie economic progress across disparate African states.

One initiative designed to boost trade and investment across the continent is the African Continental Free Trade Agreement. Signed in Rwanda in March 2018, the agreement was the first step in what many hope will be the creation of an African Continental Free Trade Area (AfCFTA). This could, in turn, become one of the widest free trade blocs in the world. Its architects hope to create a single continental market for goods and services, with free movement of business people and investments.

In April, the Gambia became the 22nd country to ratify the agreement and while Nigeria has so far refused to follow suit, fearing it could undermine local manufacturers and entrepreneurs,[12] other African nations remain optimistic the area can gain real momentum.

Newton's Shepherd says: "There are already several currency unions in west Africa collectively using the CFA franc,[13] so I don't see why this cooperation couldn't stretch to a free trade area. I believe its creation would be hugely significant. A free trade area would mean a minimum quality or standard of transaction would be necessary in this area."

He goes on: "This would usually be initiated by the larger and more sophisticated markets such as South Africa which is already able to meet normal global standards. This will naturally force compliance and improvements within the more undeveloped nations and could pull up the quality of transactions. This would help investors garner greater information on trade and inevitably improve the quality of economic forecasting and hopefully kick start a virtuous cycle of greater transparency for the continent."

KEY POINTS

- Strong investment inflows have returned to emerging markets.
- Trade disputes prove unsettling for investors.
- A busy EM election year lies ahead.

12. *Africanews.com*. Nigeria's Buhari explains failure to sign continental free trade agreement. 23 March 2018.
13. The CFA franc is the name for two African currencies – the West African franc and the Central African franc.

The end of an acronym

Whatever happened to the BRICs? For Newton's emerging markets team, the brief life and death of the formerly ubiquitous acronym says everything about how emerging markets have evolved.

Investors looking for present-day proof of the persistence of change might consider the fate of a once in-vogue acronym from the world of investment, that of BRICS, denoting the economies of Brazil, Russia, India and China.[1]

Devised in 2001 by Goldman Sachs chief economist Jim O'Neill, it came to prominence in the decade that followed, its popularity fuelled by the assumption those four emerging countries would play an increasingly dominant role in the global economy. With some 40% of the world's population and 25% of the world's land mass, the thinking was easy to understand.[2] As the commodities super-cycle took off, the world, in theory, was the BRICs' oyster.

Yet fast forward two decades and BRICS is now an almost neglected term. China and India's story may still be at the heart of the global economic narrative, but Brazil, Russia and South Africa? Not so much. So, what happened to BRICS and what does their fate tell us about the way emerging market economies have transformed in the past two decades?

For Newton's emerging markets team, the changing fortunes of the BRICS nations tell us everything we need to know about the speed of change in developing countries. As long-term investors they are first-hand witnesses to how once-frontier, high growth economies have evolved and matured over that time.

"If you think back two decades, emerging markets represented less than 5% of the global equity universe," says the team.

"Today, the market cap of the MSCI Emerging Markets Index is somewhere in the region of US$4 trillion, representing about 10% of world market capitalisation.[3] That's a huge change."

And yet, says team member and portfolio manager Zoe Kan, many investors still find it hard to view emerging markets as anything other than high risk, high growth. In Asia, in particular, this means managers are often under intense pressure to chase short-term investment strategies regardless of the long-term outlook while at the same time being blind to other opportunities such as the potential for income.

FOCUS ON QUALITY

A focus on quality, defensive names offering a steadier, less volatile investment journey over a broader horizon, may help investors enjoy more reliable portfolio returns, thanks to the compounding power of dividends.

Not so long ago this might have presented a challenge, but today the universe of EM dividend payers has increased, especially in Asia. "I'm enjoying the evolution of the market," says Kan. "We've witnessed governance improve across the board and, as a consequence of that, we're also seeing a broader, more diversified list of companies offering sustainable income."

Partly this is demand driven. Take South Korea, for example. In 1960, with a GDP

1. South Africa was added to the rubric later in the decade.
2. *MSCI*: 'The future of emerging markets', April 2019. https://www.msci.com/www/research-paper/the-future-of-emerging-markets/01323047429.
3. Source: Ibid, using the MSCI Emerging Markets Index as a proxy.
4. *Harvard Business Review*: 'How Innovative Companies Help Frontier Markets Grow', 19 February 2019.

> In China, the State's ability to engineer a soft landing following the global financial crisis and the subsequent debt-fuelled expansion of the economy have seen it outpace its peers.

per capita of US$155 it was one of the poorest countries in Asia.[4]

Unquestionably a 'frontier' economy. Today, with a nearly 14% weighting on the MSCI Emerging Market Index it finds itself on the cusp of promotion to the developed market index – a poster child if ever there was one for the power of transformation.

Accompanying this growth, however, has been a greying of the workforce and by 2050 South Korea is expected to have one of the world's oldest populations. "In the next few decades we're going to see more and more emerging market countries facing the same demographic pressures we're facing in the West," says Kan. "And – just like in the developed world – that means an increasing need for dividend-paying companies.

As an example of the kind of investments with the potential to take up this mantle, Kan points to Real Estate Investment Trusts (REITs), in particular those operating in the retail sector. "The emerging market consumer services sector has experienced spectacular growth in recent decades as rising prosperity fosters the growth of an emerging market middle class. REITs, with their focus on dividends, can be a defensively positioned way for investors to access this growth."

WHAT'S IN A NAME?

So, nearly two decades on, what did happen to the BRICS? Really, it was a tale of divergence, according to Newton's emerging markets team. The US tightening its monetary policy in 2013 didn't help: it sparked capital flight from EM assets and into Treasuries – but also made life difficult for holders of dollar-denominated debt, more so for those, such as India and Brazil, lacking sizeable foreign exchange reserves.

Later, geopolitical events were also to play a part. For Russia, the Ukraine conflict and the annexation of Crimea sparked off international sanctions. For Brazil, the so-called 'carwash' scandal and the impeachment of then President Dilma Rousseff also did much to tarnish a once-progressive image.

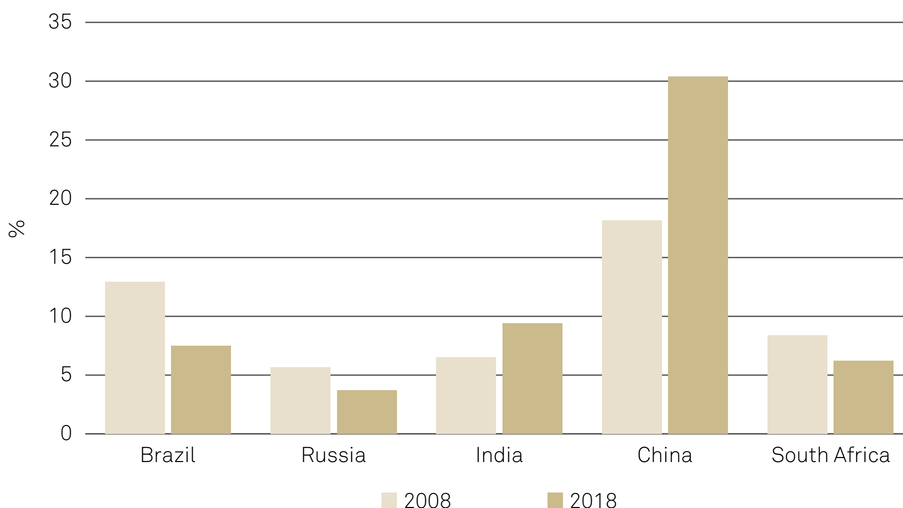
In contrast, India and China have continued their upward trajectory. India's election of Prime Minister Narendra Modi ushered in an era of free market reform which boosted the country's international credibility and foreign investment.

In China, the State's ability to engineer a soft landing following the global financial crisis and the subsequent debt-fuelled expansion of the economy have seen it outpace its peers.

The make-up of the MSCI Emerging Markets Index reflects that divergence. Brazil's weight on the index has fallen from 13% (in US dollar terms) in 2008 when BRICs were all the rage to just 7.5% today.[5] Russia and South Africa have experienced similar declines. In contrast, India's weighting has increased from 6.5% to 9.4%.[6]

Meanwhile, China has become the undisputed heavyweight in the room, accounting for an increasingly large weighting Index of its own. What a difference a decade makes.

COUNTRY WEIGHTING ON THE MSCI EMERGING MARKETS INDEX (US$ TERMS), 2008 VERSUS 2018



Source: BNY Mellon as at 31 December 2018.

KEY POINTS

- The once common BRICS acronym has faded from use as once-frontier, high growth economies have evolved and matured.
- The universe of EM dividend payers has also increased.
- The changing make-up of the MSCI Emerging Markets Index reflects growing emerging market divergence.

5. Source: *BNY Mellon*, MSCI, as at 31 December 2018.
6. Ibid.

The Asian century

China's rise to economic and political pre-eminence could pose a challenge to developed market liberal democracies, argues Shamik Dhar, chief economist at BNY Mellon Investment Management.

When it comes to China's long march to superpower status, Shamik Dhar likes to quote Zhou Enlai. In a 1972 interview, the then Chinese premier was asked about the impact of 1789's French Revolution. "Too early to say," he replied.

For Dhar, chief economist with BNY Mellon Investment Management, the quote, apocryphal though it may be, says everything about China's mindset in its transformation from emerging market status. "It's easy to forget the multi-millennia of history underpinning China's claim to great nation status," he says. "In the West, we're used to a set of assumptions dating back to the Enlightenment and carried through the Pax Britannica or, more recently, the Pax Americana.[1] The message from China is different: those 250 years – which encompassed the French Revolution and witnessed the birth and triumph of Western liberal democracies – are really just a blip. Many of those ideas and assumptions we take for granted are up for grabs as China reasserts its 'natural' economic and political pre-eminence on the world stage."

But it's not just China. Dhar notes how the coming decades will likely see a wholesale reshuffling of the current order as countries at the top of the economic pack fall behind their emerging market counterparts. In just 11 years from now, according to one set of estimates, the US will have dropped from being the world's first to third largest economy.[2] In its place China will take top slot followed by India. Likewise, Indonesia, Brazil, and Egypt will leapfrog some more developed market counterparts with only Japan and Germany, of the current incumbents, still holding on to a place in the top 10. The same estimates suggest Asia's GDP could account for around 35% of the global total by 2030, up from 28% in 2018 and 20% in 2010.

Part of this is due to demographics – but look beyond the forecasts of population growth and the facts on the ground suggest the Asian century is already underway. In 2005, for instance, only three of the world's 10 busiest deep water ports were in China. Just a decade later, seven of the top 10 were located there – with nine of the total in the Asia Pacific region.[3]

The same holds true of air travel and air freight. Says Dhar: "People of a certain age might recall how Heathrow, Charles De Gaulle or JFK were once marketed as the world's busiest airports. This no longer holds true. Today, if you're looking for a list of the world's busiest airports

EMERGING MARKETS IN NUMBERS: LEAVING THE WEST BEHIND

- By 2050, Africa is expected to be home to 2.6 billion people, while India is billed to become the world's most populous country by 2025. In contrast, the rapidly greying populations in the developed world, particularly in Europe and Japan, will act as a brake on economic growth.

  Source: (Population Reference Bureau): '2018 World Population Data Sheet', 24 August 2018).

- Today, eight out of 10 of the world's busiest international flight routes are in the Asia Pacific region.

  Source: (OAG.com) (the Official Airline Guide), 12 April 2019.

- In 2017 China overtook the US as the largest importer of crude oil.

  (Source: CEIC Data, OPEC, accessed 2 May 2019).

- In 2016, nine of the world's 20 busiest shipping container ports were located in China. Fifteen of the top-20 were located in the Asia Pacific region.

  (Source: World Shipping Council, annual volume by 20-foot equivalent units (TEUs). Accessed 2 May 2019.).

1. The *Pax Britannica* was the period of relative peace between the end of the Napoleonic Wars and the First World War facilitated by the Royal Navy's dominance of global shipping lanes. Pax Americana refers to a similar period of relative peace following World War Two built on US military hegemony.
2. *Business Insider*: 'The US could lose its crown as the world's most powerful economy as soon as next year, and it's unlikely to ever get it back', 10 January 2019. (Calculations based on GDP output after adjusting for purchasing power parity).
3. Source: *World Shipping Council*, annual volume by 20-foot equivalent units (TEUs). Accessed 2 May 2019.

you wouldn't look to Europe or the US: they're almost entirely in Asia."

In the corporate sphere too recent changes are hard to ignore. Each year, Fortune's Global 500 report ranks the world's largest companies by revenue. In 2008, US and European names dominated the list with only three Chinese companies in the top 100. A decade later and that dominance has retreated, with the number of European companies in the top-100 falling from 51 to 25 and the number of Chinese names rising from three to 21.[4]

For Dhar, the implications of this change are momentous – and he points to a wholesale repositioning in the locus of global production and consumption, not least in the commodities space, as one likely consequence.

"Consider the question of energy production," he says. "In 2017 China supplanted the US as the world's largest importer of crude oil. Yes, the growth in the shale industry, which made the US less reliant on imports, has had an impact – but it still points to a reshuffling of the deck and an upending of the established order."

As with commodities, so with goods and services. Dhar notes how over the past three decades the growth of developing countries and their emergence as the workshops of the world have lifted millions of people out of poverty. But, as we move on to the next stage of global growth, that paradigm – of emerging markets being the factories and developed markets being the consumers – will likely fall away.

"Instead, I think we'll move to a position where a country like China is the factory, consumer and services provider to the world," he says. "That's a very different proposition, not just economically but politically too."

UNSETTLING IMPLICATIONS

It's here, in the realm of geopolitics, that Dhar believes the most profound and unsettling consequences of China's emergence are likely to be felt. He highlights how the approach since the days of Kissinger and Nixon has been to bring China into the international fold, using the economic architecture created immediately after the Second World War. But that strategy has largely failed, he says, not least because China has managed to sidestep the spirit if not the law of the World Trade Organisation. But he believes the legacy of the Global Financial Crisis (GFC) has also played a part.

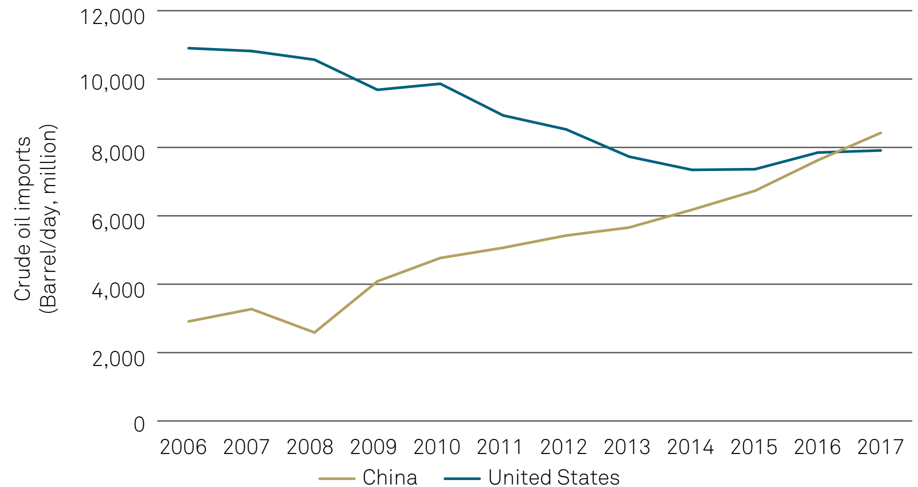
In a post-GFC world the mood music has changed and this in turn has emboldened China in its view that the classic Western liberal model is not the only game in town.

"Right now, the West is having a collective crisis of confidence" says Dhar. "The US is aware of that – and it goes some way to explain the current efforts to renegotiate longstanding conventions in trade."

For the future, investors might question whether China's rise will be at the expense of other leading nations and if this can happen without conflict. Here, again, Dhar adopts a long-term view.

"From a historical perspective I'd argue it's impossible for economic relations between countries to change as dramatically as they have done between China and the US without some kind of reset in the political relationship too. But I also suspect those 'liberal norms' – which form the foundations of Western democracies – are still the best way to meet people's aspirations, regardless of where they live. If we are talking about lessons from history that seems to be a≈crucial one: time and again, rising economic prosperity has sparked demand for greater freedoms, including religious freedom, freedom of assembly and freedom of expression. In that sense, for all its claims to historical gravitas, I suspect China may still be in the early stages of a much longer journey."

INFLEXION POINT: US/CHINA CRUDE OIL IMPORTS (BARRELS/DAY, MILLION)



Source: CEIC Data, OPEC, accessed 2 May 2019.

KEY POINTS

- China looks poised to become the world's largest economy, soon.
- An economic reset between China and the US could prompt a major shift in political relations.
- The global financial crisis has placed a real strain on the post-Second World War economic and political settlement.

4. Source: *Fortune*: 'Global 500', 19 July 2018.

Turning green

Electric vehicles and surging interest in green energy are fuelling new demand for commodities, much to the potential benefit of emerging markets. Mellon portfolio manager Robin Wehbé outlines the changing shape of commodities' supply and demand dynamics.

Copper has witnessed a step-up in demand thanks to the electrification of virtually everything these days. But supply, which largely comes from emerging markets, may create a challenging picture for the commodity in the short-term, says Mellon portfolio manager Robin Wehbé. In the past, the metal was mostly associated with housing and construction but today demand for copper is shifting in line with the move away from fossil fuels, he says.

Trends such as the rise of electric vehicles (EVs) and the increase in demand for renewable energy, in which copper is a key conductor in areas like wind turbines, are adding to global demand for the red metal. This widespread need is a potential income boon for the countries that mine it, like Chile (the world's largest copper producing country), Peru, Mexico and Indonesia. While Chile has six of the 10 largest copper mines in the world, Indonesia's Grasberg mine has the world's single largest known gold reserve and the second largest copper reserve.[1] However, in order to keep up output, the Grasberg open-pit mine has begun mining underground as well, Wehbé says. As a result, production at the mine is falling as it transitions, dampening supply and influencing global pricing. In January the Indonesian government warned production from the Grasberg mine would fall by 85% this year.[2]

On the back of supply-led volatility concerns as well as trade war fears, the price of copper fell by some 20% (in US dollar terms) in 2018 but as Bloomberg reported in April last year, investors, traders and mining executives remained bullish about its long-term prospects.[3] In 2019, to 8 May, the metal rose by around 5% in US dollar terms.[4]

Copper is not the only metal feeling the effects of the green energy movement, Wehbé says, noting many commodities are beneficiaries of the growing adoption of renewables and accompanying technological advancements. Metals such as nickel, lithium and cobalt are essential components in battery technologies. While mining in such commodities are global, emerging markets such as Russia, Argentina, China and the Democratic Republic of Congo, have a dominant position, he notes.

However, Wehbé says despite the move to "green" alternatives, "brown" energy remains dominant the opportunities in oil remain intact, thanks in part to subsidies and price-fixing in emerging markets such as Brazil and India. While demand for crude oil has been affected by increased adoption of EVs, this doesn't mean demand has stalled. "The stone age didn't end because of a lack of stones," he comments.

With regards to the investment outlook for metals, Wehbé believes there are select opportunities despite short-term uncertainty thanks to trade tensions and creeping investor wariness of a market downturn. However, on a longer term view as brown energy becomes more expensive and as green becomes an increasingly mainstream substitute, commodities linked to next-generation energy will likely experience a tail-wind, he adds.

While highlighting the attractive opportunities related to next generation energy, Wehbé also notes mining remains an industrial activity that can impact the environment and present safety complications. "There can also be

DID YOU KNOW?

A single car can have up to six kilometres of copper wiring. While most cars use internal combustion engines that require up to 23 kg of copper, hybrid electric vehicles (EV) can use 40 kg of copper, a plug-in hybrid electric vehicle can use 60 kg of copper while a typical battery EV uses 83 kg.

Source: *Mining.com*. Copper demand from EVs to be 9x higher by 2027. 12 June 2017.

1. *Mining Technology. Grasberg Open Pit.* https://www.mining-technology.com/projects/grasbergopenpit/.
2. *Mining.com.* Exports from world's second-largest copper mine to drop 85%. 9 January 2019.
3. *Bloomberg*. Copper supply woes on show with world no.2 mine output to halve. April 2018.
4. *Macrotrends.net*. Accessed 9 May 2019.

AN ESG PERSPECTIVE

Insight Investment senior ESG analyst Joshua Kendall outlines why environmental and social factors can play a vital role in mining-related emerging market debt analysis and selection.

While positive on the opportunities that exist in new energy-related commodities, from an ESG point of view, the safety aspects of commodities warrant analysis, says Insight's Joshua Kendall. "Due diligence on a company's policies and practices are essential to identify and potentially avoid the worst performers. This requires research and dialogue with management to understand how they manage risk – something that is often difficult to achieve using traditional company analysis."

This analysis also needs to be multi-layered, says Kendall. A company may look attractive: exposed to growth areas in minerals (such as those tied to new technology areas), with the right ESG and sustainability policies in place and a good health and safety track record. Even so, dig beneath the surface and its operations might feature governance and political risks.

As an example of this he cites cobalt, a much sought-after metal because of its use in lithium-ion batteries, where supply is concentrated in the volatile Democratic Republic of Congo.

"High-level policies are one thing but analysts have to go into the minutiae and look at what is happening on (and under) the ground," he says. "Every miner also has different products and some are more dangerous, with regards to the extraction processes, than others."

This is what can make engagement with miners difficult. While investment managers can engage on a company's policies, making sure they are not cutting corners in areas like health and safety for example, they are less able to do anything about the country-specific risks that a company might face because of the location of its assets.

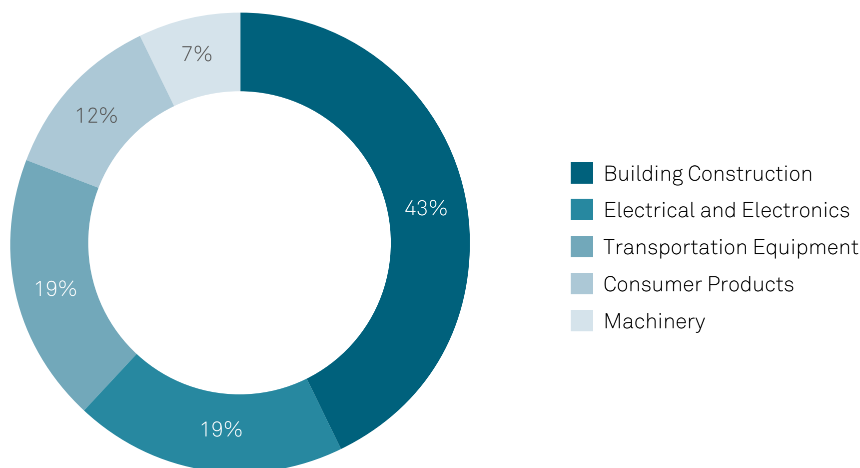
"While developed market mining companies might be seen as more attractive from an ESG perspective because of relatively higher levels of accountability, greater awareness of sustainability issues and better health-and-safety track records, these companies still largely operate in emerging market countries and in areas that might have unsustainable practices," Kendall concludes.

concerns around complicated political regimes, not to mention local labour challenges such as safety standards.

"These issues are complex and should not be taken casually. Even disaggregating risk by political regimes can be tricky. One might think it obvious to avoid emerging market economies in mining exposure. However, some of the most financially costly mining/commodity related accidents in the past decade occurred in the west."

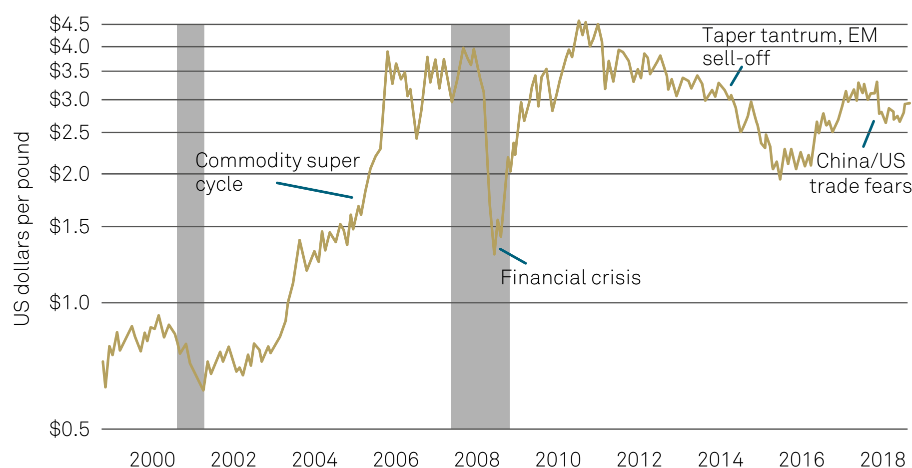
He cites the West Virginia coal mine disaster in 2010[5]; which was also the year of the Deepwater Horizon oil rig explosion in the Gulf of Mexico (41 miles off the coast of Louisiana).[6] Careful analysis is warranted, he adds.

USES OF COPPER IN THE UNITED STATES DURING 2017



Source: *United States Geological Survey Mineral Commodity Summary for 2018, BNY Mellon Investment Management.*

COPPER PRICE OVER 10 YEARS TO 8 MAY 2019



Source: *Macrotrends.com*. 8 May 2019.

KEY POINTS

- Electric vehicles and surging interest in green energy is fuelling new demand for commodities.
- Rising copper demand can be a boon for emerging markets which produce it.
- ESG factors can play a vital role in mining-related emerging market debt analysis and selection.

5. *NPR* – The Two Way. Coal Company To Pay More Than $200 Million In W. Va. Disaster. 6 December 2011.
6. https://www.britannica.com/event/Deepwater-Horizon-oil-spill.

The politics of change

Mellon portfolio manager Federico Garcia Zamora and senior sovereign analyst Alejandro Martinez Cruz assess what the recent political shift across several leading Latin American nations might mean for wider investment in the LatAm region.

Shifting political affiliations, voter disillusionment, the constant news flow of corruption scandals and, in some cases, rising poverty and violence have helped shift the geopolitical dial across some of the biggest and most economically important Latin American (LatAm) markets. Voters desperate for change have been increasingly drawn to self-styled "outsiders" who claim to operate above and beyond the political mainstream.

With Mauricio Macri in Argentina and Jair Bolsanaro in Brazil, the list of reform-minded leaders elected in Latin America is growing, and the current crop of leaders has marked a distinctively rightward shift in the politics of several key Latin American markets.

Yet for all this, LatAm is far from the homogenous market or geopolitical base that outsiders sometimes assume. In stark contrast with Brazil, Argentina and Colombia, Mexico chose to elect Andrés Manuel López Obrador as its first left leaning president since 1982, pointing to both a more volatile and nuanced regional political picture where both left and right historically attract strong support.

Mellon senior sovereign analyst Alejandro Martinez Cruz says: "Left-leaning governments enjoyed a strong period of support over the last 20 years and were initially buoyed by rising commodity prices, which allowed them to look at more redistributive programmes."

"Governments in these countries expanded their economies during the commodity boom of the early 2000s, but when commodity prices fell, they were caught out. In some cases, revenues dropped by 30-40%. These governments found they had too little time to adjust their budgets to both this and a strengthening US dollar and quickly faced widening deficits at a time when their currencies were also depreciating. As if this wasn't bad enough, major corruption scandals started to emerge in countries such as Brazil against a wider backdrop of social and economic unrest in other countries like Venezuela."

Against this backdrop, a mood for change has swept across markets such as Argentina and Brazil, ushering in a new breed of leaders, pledging conservative reform via so-called market-friendly economic policies expected to boost investment opportunities.

Yet, in some cases, voters are finding there are no easy answers to their economic problems. Argentina is a case in point. Last year the country was forced to rely on an emergency US$57bn loan from the International Monetary Fund (IMF) as the value of its peso currency plummeted more than 45% against the US dollar while inflation and interest rates soared to over 25%.[1]

Argentinian President Mauricio Macri was elected in 2015 on the promise of providing renewed stability and sustainable market-friendly policies to revive a slumbering national economy.[2] Upon assuming office, his economic team immediately set about reforming Argentina's economy by dismantling capital controls, allowing the currency to float freely and settling a long-standing dispute with creditors.

Yet, despite initiating a reform process with some promising results, including a return to the international bond market with a record-breaking US$16.5bn dollar-denominated issuance,[3] Macri soon found his government back in crisis management mode. His reform efforts will be further tested in October this year when Argentina goes to the polls in what Mellon's head of emerging markets debt Federico Garcia Zamora expects will be both a protracted and tight election.

In Brazil, many hopes are pinned on ambitious social security and pension reforms. Yet, for all Bolsonaro's impressive election win, Brazilian politics remains highly fragmented, with 25 parties represented in its Congress and a president who does not have the power to ignore its wishes. However, Martinez Cruz remains optimistic Brazil can help drive recovery under Bolsonaro and new economic minister Paulo Guedes.

1. *CNBC*. Argentina's central bank hikes rates to 60% as the currency collapses. 30 August 2018.
2. *BBC*. Argentina – the crisis in six charts. 09 September 2018.
3. *Wall Street Journal*. Argentina returns to global debt markets with US$16.5bn bond sale. 19 April 2018.

TRADING PLACES: WHICH WAY NEXT FOR MERCOSUR?

The Latin American trade grouping Mercosur is one of the world's largest trading blocs. Formed of Argentina, Brazil, Paraguay, Uruguay and Venezuela, the US$2.9 trillion[4] grouping dwarfs LatAm's second biggest trade bloc, the Pacific Alliance, which includes Peru, Mexico, Colombia and Chile.

In theory, it should be a regional trading powerhouse creating abundant trade and investment opportunities. Yet, despite building significant agreements on pensions, tourism and migration, it has been accused of being a political club[5] forged by now largely defunct left wing political regimes in the region and failing to live up to its promise.

High hopes of creating a European Union (EU) style arrangement in LatAm have tended to give way to a fractured indiscipline in a grouping whose members have, at times, appeared to openly flout agreed rules.[6]

In a major sign of political fracturing, in 2012 Mercosur hit Paraguay with a one year suspension from the group after the suspension of its then president, Fernando Lugo. Venezuela was later suspended indefinitely after much internal debate when its president, Nicolás Maduro, decided to push ahead with an election for an all-powerful constituent assembly.[7]

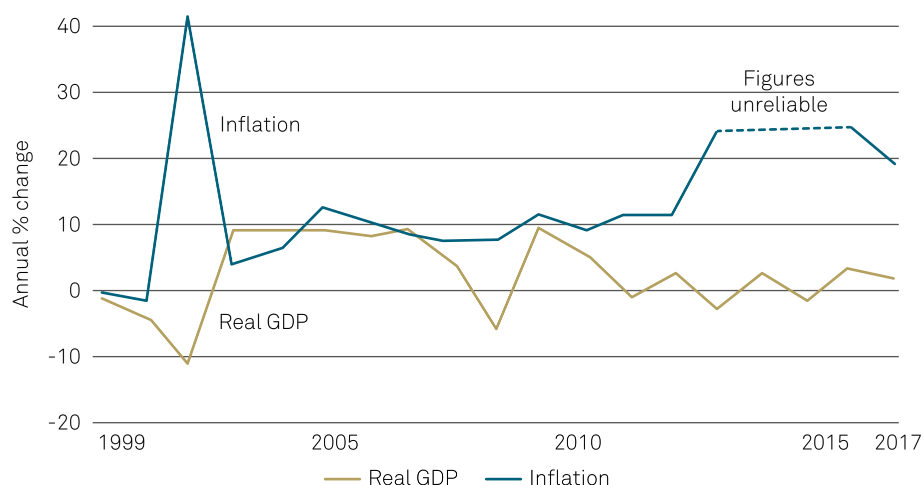
Since then, efforts to forge external trade links with the EU have gathered some momentum, yet the election of sceptical new political leaders in Argentina and Brazil could signal an uncertain future for the trade grouping.

Martinez Cruz says, "These leaders represent two of its biggest members and both seem to feel the bloc is not working. With both leaders pledging to discuss its future, we may even see the end of Mercosur or the creation of a new entity or grouping."

KEY POINTS

- Reform-minded leaders now run Argentina, Brazil and Colombia.
- Chile is benefiting from global copper demand.
- Regional trading bloc Mercosur could be set for change.

ARGENTINA GDP AND INFLATION



Source: *IMF/BBC*. 09 September 2018.

Elsewhere in LatAm, Martinez Cruz sees investment potential in some of the more politically stable countries such as Colombia, Peru, Chile and Panama. Garcia Zamora has a particularly positive outlook on Chile, whose economy is what he describes as comparatively strong and underpinned partly by its impressive metals and mineral wealth.

"Growth is rebounding in Chile and it is one of the largest copper producers in a world where copper demand continues to grow. The Chilean peso has a high sensitivity to the copper price and could also benefit from any growth rebound outside the US in the second half of this year," he says.

Garcia Zamora does, however, have some serious doubts about the Mexican economy. The face-off between the US Trump administration and Mexican government on border security and Trump's much touted wall is just one factor troubling markets. Yet, according to Garcia Zamora, a bigger threat may lie in the economic policies of the Lopez Obrador administration itself.

"Shifting government policy could slow private investment over the next few years and this will likely mean structurally lower growth in the long term and structurally higher inflation. In the short term, the Lopez Obrador administration has been a bit more pragmatic than we initially feared but his longer-term policies may prove detrimental. As just one example, raising the minimum wage way above productivity gains in Mexico will likely lead to an increase in inflation," he says.

Venezuela also appears a real concern for investors and an area many are avoiding. The oil rich nation has the potential to be an economic star in the region, yet it remains blighted by political unrest and mismanagement. Martinez Cruz points to≈a growing exodus of Venezuelans from the country, with neighbouring Colombia particularly hard hit by an influx of often desperate refugees.

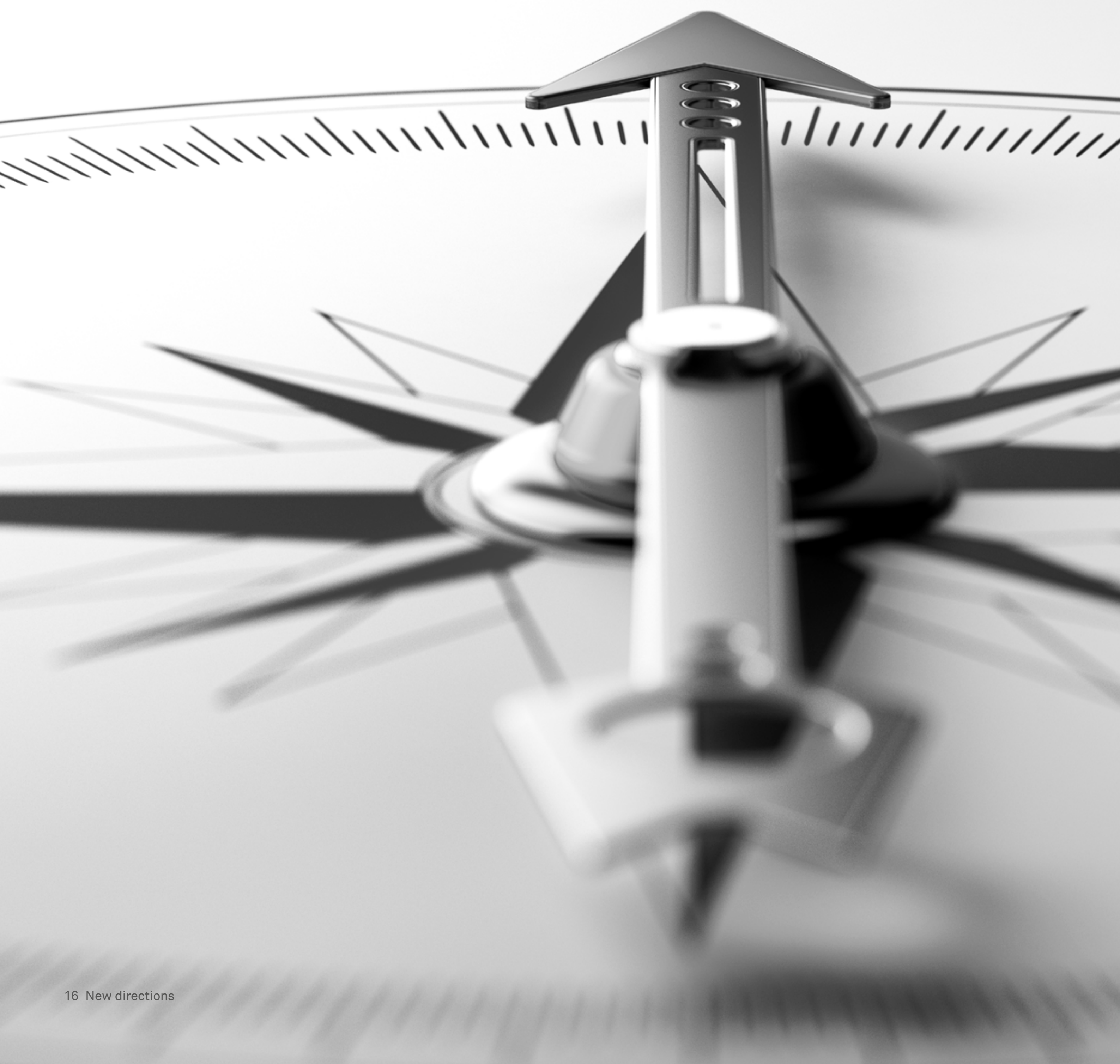
Yet, for all the disparate political picture across LatAm, both Martinez Cruz and Garcia Zamora continue to see strong potential opportunity for investors willing to accept the risk and reward dynamics of the region.

"LatAm has a long tradition of political instability and highly indebted, highly leveraged countries and investors must make a careful calculation on whether they are making the kind of returns to justify the level of risk they are taking. That said, we still see a lot of value in markets such as Brazil and, selectively, across the region. In general, LatAm also tends to pay a premium over other emerging markets in regions such as Asia," Martinez Cruz concludes.

4. Council on foreign relations. Mercosur: South America's Fractious Trade Bloc. 10 September 2018.
5. *The Economist*. Mercosur's missed boat. 12 May 2016.
6. Ibid.
7. *FT*. Venezuela suspended from South American trade bloc. 05 August 2017.

New directions

The Brazilian election of Jair Bolsonaro as president prompted a mixed reaction world-wide. Now, many are asking if his government can truly address Brazil's political and economic malaise. ARX chief economist, Solange Srour, considers some possible changes and challenges ahead.



The new year saw a new government in Brazil. After the collapse of the left-leaning and ultimately doomed presidency of Dilma Rousseff and her successor Michel Temer, Brazil has taken a sharp shift to the right.

Bolsonaro, a former paratrooper, won the 2018 election in what many analysts saw as a backlash against corruption and crime. Brazil's so-called "car wash" scandal – involving illegal payments of more than US$5bn to company executives and political parties[1] – has cast a long shadow over politics in the country and generated a deep mistrust of politicians among some voters, ARX chief economist, Solange Srour comments.

Bolsonaro's appeal was based on his pitch as a political outsider, unsullied by involvement in corruption, though critics point out he has technically been involved in politics for over 20 years. His ultimate success will likely depend on his economic record. The so-called "Trump of the tropics", favours a market-friendly approach and a reduction of state intervention in the economy.

To this end he has appointed former fund manager Paulo Guedes as economic minister. In turn, Guedes has pledged to end years of failed state intervention and introduce radical free market reforms.[2]

Key to the Bolsonaro regime's proposed reforms will be a social security and pension bill designed to save over one trillion reals (US$254bn) over a 10 year period by establishing a minimum retirement age and limiting access to some social security programmes.[3] Yet this still needs to overcome a series of legislative hurdles to become law.

MARKET REFORM

Srour, speaking in April 2019, said she believes that despite the potential challenges ahead, Bolsonaro's platform offers the chance to invigorate the Brazilian economy and improve investment prospects in the country.

"The approval of social security reform could be the first of several positive measures– such as tax reform and anti-bureaucracy measures – that could contribute to a more optimistic scenario for investors. During this period, we believe demand will pick up. In this scenario, we could also see some local currency appreciation in the short term."

Despite Bolsonaro's authoritarian image, Srour points out he will still need to navigate the Brazilian Congress, negotiate and, where necessary, reach political compromise on key economic and financial measures.

She adds: "Ultimately we believe the social security and pension reforms will be approved. We think Congress has a lot of vested interest in pushing through the reforms, although we are likely to see some demonstrations on the streets against this. Next year, we will have municipal elections in Brazil so it is in the interest of politicians to approve the reforms sooner rather than later.

"Despite his early anti-political rhetoric, Bolsonaro is trying to talk with other parties in order to have a better relationship with Congress. We are optimistic, and yet cautious at the same time, that reforms will progress."

At a wider level Bolsonaro hopes to open up the relatively closed Brazilian economy through wider external trade links, eliminating what he sees as unfair trade practises and uncertainty for trade flows.[4]

According to Srour, any major attempts to liberalise Brazilian trade are, however, dependent on the government successfully introducing domestic reform.

"Technically, the opening of the Brazilian economy and reductions in trade tariffs don't need the approval of Congress and the president can change a lot. That said, government will most likely take a cautious approach and wait until social security reforms have been made before opening the economy to wider international competition."

While unemployment is currently riding high in Brazil, Srour points to manageable inflation and lower interest rates – at around 6.5%[5] – than at historic levels (Brazilian interest rates hit 45% in 1999[6]) as more positive indicators which could give Bolsonaro a platform to build on.

"After many years of questionable political decisions we believe proved detrimental to our economic fundamentals, Brazil now seems headed in the right direction and the government has a genuinely reforming agenda. From an investment standpoint, we think equities have the most to gain right now. The Brazilian people have been very cautious about growth prospects but we do see some renewed optimism likely to encourage equity investment.

> "Despite his early anti-political rhetoric, Bolsonaro is trying to talk with other parties in order to have a better relationship with Congress. We are optimistic and yet cautious at the same time that reforms will progress."
>
> **Solange Srour, ARX**

"Once the social security reform is approved it will likely open other measures which will be very important for Brazil to grow. We have a positive view on Brazil and are optimistic but also accept there is always scope for political and market turbulence because of the necessary negotiations between the Congress and the Brazilian government."

KEY POINTS

- New government has a so-called market-friendly agenda.
- Major social security reforms planned.
- High Brazilian unemployment but interest rates and inflation lower.

1. *Guardian*. Operation Car Wash: Is this the biggest corruption scandal in history? 01 June 2017.
2. *FT*. Brazil economy minister vows return of 'order' in sweeping reforms. 10 February 2019.
3. *Bloomberg*. Brazil Pension Bill Set to Advance With First Congress Vote. 23 April 2019.
4. *FT*. Brazil's Jair Bolsonaro pledges to open up economy. 22 January 2019.
5. *Bloomberg*. Brazil Holds Key Rate at 6.50% and Signals No Cuts in Sight. 08 May 2019.
6. *Trading Economics*.Brazil interest rate. 09 May 2019.

Beyond the headlines

The growing depth and breadth of the emerging market debt (EMD) universe is increasingly blurring the differentiation between 'emerging' and 'developed' markets. By Colm McDonagh, head of emerging market debt at Insight Investment.

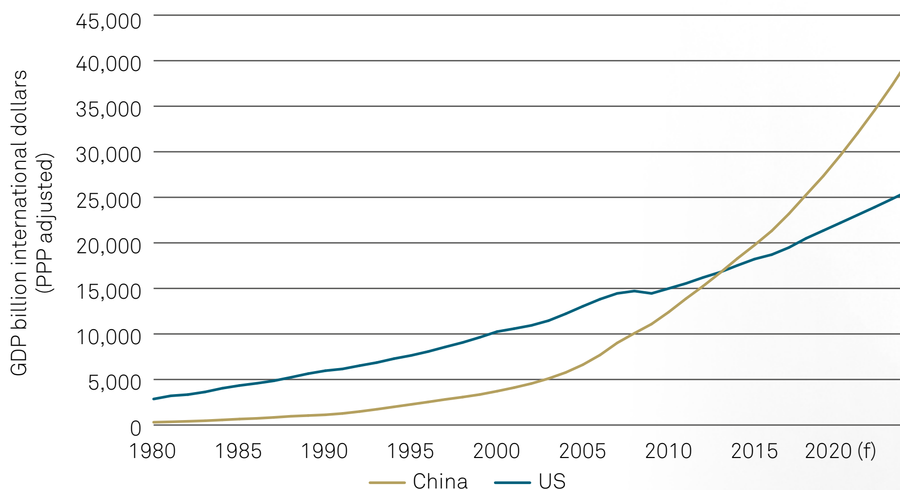
When investors think about emerging markets there is a tendency for them to focus on whatever developing country is hitting the news headlines at the time; and those headlines are often negative.

As a result, investing in emerging markets is often associated with assets at the higher end of the risk spectrum. This is compounded by a history of investors attempting to tactically allocate to emerging markets, entering the asset class just as the cycle peaks rather than looking for longer term returns. Some emerging markets do carry political risk and can be highly volatile, but the asset class is broad and the differentiation between 'emerging' and 'developed' has become increasingly blurred over time.

One of the most notable examples of such blurring is China. Radical reforms implemented in the 1990s allowed private sector growth to flourish and in the following decades China has become one of the most important economies in the world. On a purchasing-power-parity (PPP) adjusted basis, the Chinese economy is now larger than the US economy, although it still ranks second in nominal terms.

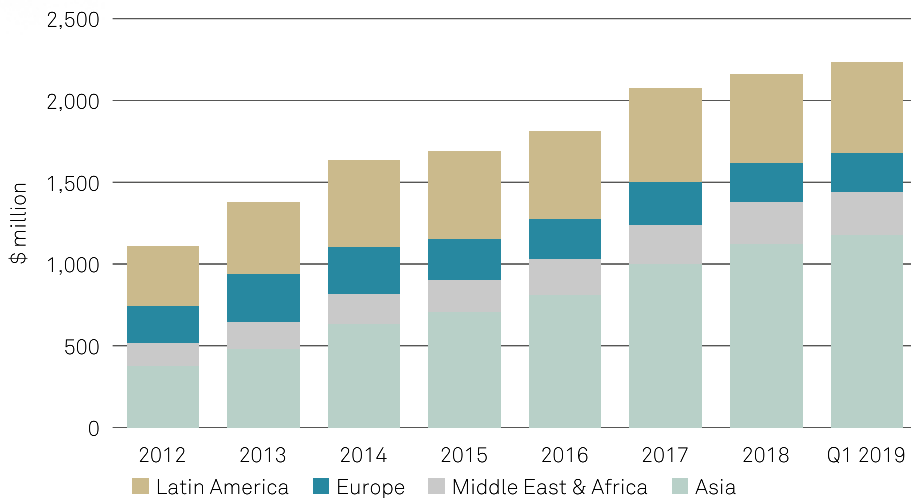
As emerging economies have grown, in aggregate surpassing the size of their developed counterparts, so the structure of debt markets in those countries has

CHINA – WORLD'S LARGEST ECONOMY IN PPP* TERMS



Source: *IMF*. Data as at 30 April 2019. *Purchasing power parity.

EM CORPORATE DEBT MARKET GROWTH



Source: JP Morgan. Data as at end March 2019.

also evolved, deepening and increasingly supported by local investor bases. Until recently mainstream bond indices had largely ignored these changes, but this has now started to change. In April, Chinese government debt was added to the Bloomberg Barclays Global Aggregate Index, with the country's index weight incrementally being increased over a 20-month period to make up approximately 6% of the index. Barclays estimates this will lead to an average of US$5.5bn in inflows to the Chinese bond market in every month of the implementation period, purely from index tracking funds alone.

The response from more active investors is unclear, but with credit rating agency Standard and Poor's rating Chinese sovereign debt at A+ and Italian sovereign debt at a much lower BBB, China may prove of interest for those looking to reduce their political risk via an 'emerging' investment.

So when examined more closely, the attraction of emerging market bonds can be far more compelling than many assume, yet investment still needs to be considered in the context of the wide spectrum of credit qualities available in the asset class.

CORPORATE DEBT GROWTH

Emerging market corporate debt has grown to well in excess of US$2 trillion in outstanding nominal value, effectively creating an entirely new asset class, as issuers have shifted away from bank lending and into capital markets. Emerging market corporate debt is largely denominated in US dollars and the average credit rating is now typically BBB.[1] It also offers a yield premium to comparably rated developed market corporate debt.

The growth in emerging market corporate debt has been driven largely by Asian issuers, but a growing number of Middle Eastern issuers have entered the market in recent years. For example, Saudi Aramco, the world's largest oil and gas company, issued US$12bn of debt in April 2019 and attracted orders of over US$100bn, making it one of the most oversubscribed debt offerings in history.

When considering these points, an investor may start to question the relevance of the 'emerging' tagline in the modern world and instead choose to focus on analysing the markets and companies that the asset class envelopes at an individual level. But, from an investment standpoint, one consideration we would highlight is the aspect of currency risk.

From a credit point of view it is far better for an emerging market government to issue debt in their own currency, as they can more easily devalue their currency as a release valve to manage external market shocks. In our view this requires a tactical approach to currency investment to prevent what can appear to be attractive local market interest rates from simply acting as compensation for holding a depreciating currency.

CONCLUSION

Emerging market debt can be seen as three distinct asset classes, covering rates, credit and currency. The correlation between individual markets is weakening over time, driven by differences in credit quality, policy execution and investor base, with locally based investors now playing a dominant role in some markets.

Returns from local currency investments can, potentially, be significantly different than returns for hard currency investments and currency exposures need to be carefully managed. The 'emerging' world can offer opportunities to diversify US dollar corporate debt holdings but also for those looking for high income, albeit more volatile, local currency debt.

KEY POINTS

- The EMD universe is broadening in depth and complexity.
- EM corporate debt has grown to well in excess of US$2 trillion in outstanding nominal value.
- China's presence in bond indices is expected to influence future investment flows.

1. *Insight Investment* as of January 2019.

Friend or foe?

As Sino-US trade tensions continue to unsettle markets, what implications do they hold for emerging markets (EM) and global investors? Here, investment specialists from Newton Investment Management, Insight Investment, Mellon and Walter Scott consider the evolving trade and investment landscape.

Robert Marshall-Lee
Investment leader emerging and Asian equity team, Newton Investment Management

Colm McDonagh
Head of EM fixed income, Insight Investment

Aninda Mitra
Global sovereign analyst, Mellon

Trevor Holder
Portfolio manager fixed income, Newton

WALTER SCOTT

How can China best resolve its ongoing trade dispute with the US and what political/economic implications does this hold for wider emerging markets trade? How damaging is this dispute for other emerging markets and wider EM investment?

Marshall-Lee: Over the past 12 months we have seen a huge amount of market fear over China. However, when considering the negative 2018 performance of China's equity market, it's worth bearing in mind its strong performance in 2016 and 2017. Investors still have attractive entry points for many of the best Chinese companies and concerns over trade wars and previously tight monetary policy have actually created some buying opportunities in the market in companies with sustained multi-year growth prospects, irrespective of the trade tensions.

The previous devaluation of the Chinese currency against the dollar had offset much of the reduced competitiveness caused by any increased tariffs. While trade disputes are of concern, markets are actually very good at correcting their negative impacts.

However, if draconian tariffs are sustained, this could reprice many products for the US consumer, which could help fuel broader inflation leading to higher interest rates, harming all asset prices and the service economy that supports most employment and wealth in the US economy. It would be extremely expensive to onshore such supply chains, so this is not feasible in the short term and would be unlikely to offset the negative effect.

McDonagh: The US has a number of goals here. It wants to narrow the imbalance of trade between the US and China, with China committing to buying more from the US. It wants China to open its economy to greater foreign investment, including state owned enterprises and it wants to see the enforcement of intellectual property rights, with current rules that force foreign investors to share intellectual property with Chinese partners removed. China may compromise on some of these issues and a commitment to increase imports from the US over time and easier access to Chinese markets are likely to be agreed. A compromise on intellectual property may, however, be more nuanced.

China has already started the process of improving intellectual property laws. But, in the longer term China is reliant on its "Made in China 2025" strategy – to shift its manufacturing base up the value chain and away from producing low value goods. It's important to remember that for both sides this is not just about trade, but also about longer term political goals as China grows in power and the US attempts to protect its dominant position on the world stage.

The broader impact on emerging markets is complex. If the dispute is resolved then investors may become more optimistic about the outlook for global growth, but the US may simply escalate disputes elsewhere, shifting the impact towards emerging markets in other regions such as Eastern Europe.

Holder: Escalating US-Sino trade tensions will likely see Beijing cushion the domestic economy with further policy stimulus alongside renminbi depreciation. China had already offered concessions in a number of areas, including intellectual property rights, market access (e.g. autos and financials) and preferential imports. A "deal" would broadly boost investment confidence, but for wider emerging markets, the consequences of various means of narrowing the bilateral trade deficit are somewhat uneven. For example, China potentially increasing soya bean imports from the US would be negative for Latin America producers, such as Brazil and Argentina. Meanwhile, higher US energy imports would be security sensitive for Beijing and come at the expense of exports from the Middle East and Venezuela. Small open economies are particularly exposed to supply chain disruption, however, any shift in multinationals' manufacturing away from the mainland should ultimately be to the relative benefit of other skilled/low-cost emerging markets, such as Vietnam or Mexico.

Irrespective of Beijing's conspicuous de-emphasis, China's state-backed industrial upgrading will endure as a source of geopolitical tension and an impediment to comprehensive and lasting US-Sino agreement. Post deal oversight remains a further key issue, with China sensitive to any perceived infringements of its sovereignty, while the US requires sufficient leverage to ensure China keeps its promises. Tariffs are one of few available tools in this respect, hence any deal would still likely entail some level of US duties on China's exports.

Despite the recent escalation of tensions, both sides remain engaged in dialogue, but the timeframe of any possible deal has been pushed back at best, risking a more protracted period of EM currency and financial market volatility at a time when global growth is already subdued.

Mitra: China depends more on exports to the US than the other way around. It is poised to sustain future current account deficits, regardless of whether the trade dispute is "resolved" or if it deteriorates further amid heightened mutual recrimination.

This is because a "resolution" as is widely expected by the market consists of China raising its imports from the US without a countervailing or timely reduction of imports from elsewhere. On the other hand, a "deterioration," which is the less expected scenario, and is still not priced in by the markets, would comprise higher tariff rates by the US across a much broader base of goods imported from China; and a retaliation by the Chinese side could encompass even higher tariff rates, or an outright boycott of US goods – such as mobile phones – manufactured in China.

Our central scenario is for a "standstill" in the Sino-US trade relationship with both sides agreeing to not escalate the base or the rate of tariffs beyond current levels.

However, a reversal of recent increases in tariff rates and worsening technology-related disputes seems distant. Tariff rate reductions to ex-ante levels will need more time as they would depend on a track record of enforcement and the sustainability of additional bilateral agreements in areas such as the treatment of intellectual property rights and a reduction of the bilateral trade imbalance, which is currently heavily in China's favour.

The materialisation of a standstill in the trade relationship should ease investor sentiment somewhat. But heightened uncertainty around Sino-US trade is a net negative for other countries insofar as there is a lingering risk of a bad outcome which could slow GDP growth at one or both of the world's two leading growth engines.

Highly open and trade-dependent economies, such as those in East Asia, are particularly exposed, though other EMs could actually gain, over time, as global manufacturing centered on production and shipments from China begin to diversify.

The Walter Scott team: The resolution of the Sino-US trade dispute remains unpredictable. The highest likelihood is that logic will prevail as both sides have too much to lose. However, whatever the case, the inescapable reality is that the US and China are major economic rivals. Companies that are globally diversified, flexible, i.e. can adapt as rules change, and have a sustainable competitive advantage (no hiding behind tariff barriers or an unsustainable cost advantage) may be better placed to avoid some of the corresponding economic ructions.

Generally, anything that is negative for China's economy will create collateral damage for its Asian neighbours, but it can also positively impact some of China's manufacturing rivals e.g. in South East Asia. Furthermore, some of the trade potentially lost with the US will be replaced by increased trade within Asia and other EM countries.

How much progress is China making in its shift from a manufacturing-led to service sector-led economy? What implications does this hold for global trade and what opportunities is it creating for global investors?

Marshall-Lee: There has been a huge shift from manufacturing to services in China in recent years and the economy continues to transition from growth, driven by fixed-asset investment, to consumption-focused growth, particularly through consumer services. This is led by private enterprises that are run with a profit motive and tend to be less capital intensive, unlike the fixed asset boom, which was dominated by state banks funnelling credit into other state-owned entities and property developers.

With the fixed-asset intensity of the economy declining, GDP growth is likely to continue to slow, however the quality of growth is set to improve. A slower rate of GDP should not, in our view, hinder the consumer-facing areas of the economy particularly, as the labour share of GDP increases and because many service industries are still quite nascent.

Consumption-focused growth will spur on tertiary industries that represent a growing share of GDP and dominate the growth contribution. Additionally, policy changes bode well for service sectors, such as education, healthcare, insurance and internet-based businesses.

McDonagh: China is certainly making a lot of progress but despite reforms, state owned enterprises are still overly benefiting from government support and are too geared towards the manufacturing sector. China has long seen the need to attract global investors and has been in the process of opening its capital account for some time; the recent trade dispute is likely to accelerate that process. A new round of partial privatisations could increase the opportunities for global investors to participate in the China story over the medium term. China is likely to continue to play an important role in global manufacturing, but an often overlooked aspect of its growing service economy is the role of tourism. Outflows from Chinese tourists are now a significant counterbalance to the Chinese trade surplus.

Holder: China's economy is now far more domestically orientated with exports less than 20% of GDP, while services constitute more than half of the economy. That said, China's nominal GDP growth and macro cycle remains highly correlated with the profitability of basic industries, the credit impulse and the property market.

Recent central government stimulus in response to last year's economic downturn entailed increased support for consumption, but in the event of a sharp growth slowdown, infrastructure investment remains Beijing's higher multiplier lever of choice to stabilise output.

A shift towards greater consumption is also reflected in the shrinking of China's current account surplus, which is seeing Beijing increasingly look to global capital markets for funding.

The opening of China's capital markets will offer return and diversification opportunities for global bond investors, given relatively attractive yields and historically low correlation with other major markets – aided by low foreign ownership. Longer-term, however, these capital inflows could contribute to a more volatile renminbi and relatively higher risk premia for other EM sovereign index constituents.

Mitra: China has been rebalancing away from exports and investment for some time now as its share in global exports has peaked and as it also seeks to curb its reliance on the increasingly less efficient utilisation of credit. Domestic services, underpinned by more market-based funding, have played a key role in driving activity and economic growth and this is reflected in the rise of China's financial services, real estate, insurance and tech companies.

The authorities now seem to be prioritising sustained increases in domestic consumption to overcome what could amount to sustained trade headwinds. Recent steps to cut the VAT tax rate, heighten allowable tax deductions for households/individuals, and lower corporations' pension contributions toward employee accounts, point to an effort to strengthen the consumption dynamic.

Additionally, China's domestic savings, especially at its household sector, have begun falling steadily alongside its weakening demographics – and this also restricts the ability to mount large-scale investment-led stimulus.

The main implication of these trends is that the Chinese authorities' efforts to boost domestic demand through tax cuts and infusion of liquidity will shore up growth gradually, or at least limit downside risks.

The Walter Scott Team: China is making rapid progress in shifting its economy to value-added manufacturing and services, with the country aiming to be in the vanguard of the digital economy. We are likely to see trade flows adjust accordingly, as the nature of what is traded, and patterns of capital investment, change as a result. Opportunities lie, for instance, in selling capital goods such as automation equipment, and service expertise, (financial services as an example), into China to facilitate its economic transition. Manufacturers will be focused less on 'lowest cost' to determine the location of facilities, as proximity to the customer, speed to market, access to talent, and supply chain cluster effects become increasingly important considerations. Additionally, as the economy develops, we cannot ignore the increasing affluence of the Chinese consumer, whose appetite for personal goods has a wide-ranging impact on companies across the world.

> “China has been rebalancing away from exports and investment for some time now as its share in global exports has peaked and as it also seeks to curb its reliance on the increasingly less efficient utilisation of credit.”
>
> Aninda Mitra, Mellon

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