Emerging Markets and Trade Wars: Why Country Diversification Matters

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Speaker Key:

DP David Pett: Editor and Host, AGF Perspectives

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00:00:00	DP	[Music] Investors often consider emerging markets a singular thing, an it, not a they, but that doesn't do nearly enough justice to one of the most diverse investment themes out there. On this episode of the podcast, Kevin McCreadie, AGF CEO and Chief Investment Officer is joined by Regina Chi, Leader Portfolio Manager of AGF's Emerging Market Equity Strategies, to discuss the opportunities and risks of investing in the developing world today.
00:00:33		I'm your host, David Pett. Let's get into it. [Music]. I'm told that you guys both get up at ungodly time in the morning.
	KM	Yes, we have a bunch of early risers. I think the earliest one is a 4:09, I'm around 4:20, where are you?
	RC	Exactly 4:15 every day for the last 20-something years.
	KM	And Steve Way is somewhere in-between all that.
00:00:59	RC	He's 4:20 and he's in the office, first person to turn on the lights.
	DP	So, he's the first in and who's the next?
	RC	It's usually, I'm right behind him, beside Wyatt, then Jamie. So, a bunch of the global team members are in early.
	KM	And then down at end it's John and I on the trading side.
	DP	What's it been like to be an investor in emerging markets over the last couple of years?
00:01:29	KM	So, the last 2.5 years it's been, the main difference versus the previous business cycles, is really the trade wars. And it's not only impacted emerging markets, but it's also impacted

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		global markets in general. And that has been the key differentiator in terms of making considerations when you construct your portfolio, as well as picking stocks. And, as you know, the trade wars have been initiated by the US. That's caused enormous amount of uncertainty.
00:02:01		And it's not… It just hasn't impacted emerging markets. It's impacted developed markets as well, including Europe as well as Japan. So, that's definitely increased the risk premiums for markets.
	DP	And then, Kevin, from your perspective, how important have emerging markets become to the investment world?
00:02:27	KM	I'd go back to probably the mid-90s was really where the EM market really, in my mind, saw both the good and bad of what investor appetites were, right. You had the crisis in Thailand in '97, and it really burned, maybe, in some people's minds that, jeez, these really legitimate countries or developed markets, or had the liquidity. And I think that misnomer still even 20-odd years later, is still there for some investors.
00:02:58		And it's actually not the same set of countries or dynamics behind EM today as then, but yet I feel some investor's pain in the same. That it's a more volatile asset class that is subject to these currency crises, these crises that manifest themselves in these equity heartbreaks. And I actually look at where they are today. They probably have the makeup of them from an investor standpoint, it's probably more appealing and robust than some of the developed markets that we invest in.
00:03:32	RC	Yes, so that's a good point, Kevin, and if I set back, yes, the 2.5 years we've been impacted by trade uncertainty, but if you look beyond that, the last five years, there's been enormous change in the evolution of emerging markets. And it's mainly, the biggest change really happened in 2017 with the onset of digitalisation, and the digitalisation has allowed for a very strong pace of innovation, particularly in China.
00:04:01		And to Kevin's point, emerging markets used to be a commodity play where you had a third of the index in energy materials, and that has dropped significantly. And now, what's replaced that is information technology or technology in general, where that makes up over 30%. And so that's a huge positive structural change that's happened in the last five, six years.

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00:04:26	KM	Yes, and I think it's also the diversity of the sector makeup. To Regina's point, it's not the dominance tech that was non-existent 20-odd years ago, with a handful of a few countries and a few companies. But it's the breadth of them, and it's the middle-class-ation of those countries, as they all aspire to move up the chain. They demand more from healthcare systems, pharmaceuticals, consumer retail, consumer staples. And so, they look, on the surface, very different than they did 20 years ago.
00:04:56		So, as an asset class, I think it's something that is still a little bit misunderstood, but probably has some great opportunity, given some of the dynamics that are underneath those countries specifically.
	RC	Yes, and one thing that most investors don't appreciate is the fact that emerging markets have been able to leapfrog developed markets at such a fast pace, because of the fact that they don't have these heavy legacy businesses or technologies that's keeping them down.
00:05:27		They've been able to bypass bank terminals or bank branches, because they have been able to do Alipay or Tenpay through their phones. And as well as bypassing PCs altogether, because they're looking online with their smart phones, and so leapfrogging is a very big theme that's benefitted emerging markets.
	KM	And even if you go back into the early parts of the last decade, the adoption curve for phones, didn't start with a wired phone system.
00:05:58		It leapt right through cell phones and the idea of a cable, wired cable house to bring you TV has been jumped into streaming. So, I think there are whole ways that we look at those markets and say that they won't even adopt heavy infrastructure, like the developed world did for some of these things.
	DP	Kevin, you mentioned that some investors might have a misunderstanding about merging markets still. How does that manifest itself?
00:06:27	KM	So, every time we see an event on the news, whether it be some of the events in Latin America this year, with Venezuela, Argentina, even now Bolivia. People immediately react to, this

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		is just like it was two decades ago. And the reality is, EM is a pretty deep place to invest, in terms of number of countries today, it's 26. Probably back in the 90s, you're probably dealing with half that number. So, again, you have more choices. You don't have to invest in those countries.
00:06:54		So, I think the investor mentality still harkens back to a very different looking, and not valid, set of countries today, that versus where they were in the 90s, when some of those things were problematic. They still are problematic at a country level, but I think that you have a pretty broad place to be able to fish, to be able to get rid of some of that negative effect, if you wanted.
	RC	Yes, I've always said that emerging markets is not a homogeneous zone. And I like to say that you can't buy a plane ticket to emerging markets or to EM.
00:07:28		There are 26 countries, as Kevin mentioned, and each of those regions, whether that's Latin America, Asia, Eastern Europe, they're all generating different rates of growth, different CPI. And so that gives us the opportunity of stock picking across different regions and sectors. And we believe that emerging markets is incredibly cheap right now, trading near close to a 30% discount to developed markets, where the growth rate is 2.5 times higher than developed markets.
00:08:02	KM	Yes, growth rates, I think, in the end this year are probably going to be still north of four, and the developed markets, with the malaise in Europe right now, and the slow down that we're seeing in the US. If you put the developed markets together, they may be one in change. So again, very dramatic difference in their growth rates. But I'll come back to something else you said about the 26 countries, and I think this is where it pays to be truly active, to be able to make specific country decisions, versus where you would end access and have to own some of those problems.
00:08:33		Some of those countries you wouldn't want to invest in. If you're buying in, you're actually going to have to own them, whereas we can make truly active decisions based upon our knowledge about where to pick and choose to make those investments. But I do think it's the breadth of those that you have that's different today. And I think there's, as Regina said, I think the growth rates look pretty good, relative to what you can buy in the developed world today, at multiples that we

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		haven't seen in the developed world for quite some time.
00:08:58	RC	If I can add to that, we fundamentally believe that country matters in emerging market, and picking the right country stock market is important, so that you can avoid country markets like Argentina where you've had a huge blow up in the Argentina peso, as well as Venezuela. And so ultimately, we're trying to buy countries that will be relative outperformers, by having a disciplined process with that country allocation framework.
	DP	And it doesn't take a huge overweight or underweight in that regard, to make a big difference on a portfolio.
00:09:31	RC	Yes, we've been able to generate alpha by picking the right countries, and we think it could be a very good distinct second source of alpha generation for us. And to your point, you don't need to make dramatic bets to generate that relative outperformance.
	DP	And yet, you need to get the big players in this space right, I would guess. The Chinas, the Indias of the world. Maybe we can talk a little bit about china.
00:10:00	RC	Sure, so absolutely. Emerging markets is made up about 73% with Asia, so you need to get China, India, South Korea, right. India's about 8% of the index and South Korea is a double-digit exposure as well. So, we believe we know Asia well, particularly China, and to that end, this China trade war has been a detractor for its own economy, but also for global economy.
00:10:29		But we're hoping that there will be a trade truce soon, hopefully by the end of this year, with some sort of roll backs. And that should coincide nicely with bottoming PMIs globally.
	KM	I think the trade war thing has had probably a pretty great impact around the world. It's not just been impacting the EM. EM's probably more correlated to China, because traditionally it has sourced a lot of materials, a lot of technology from those Asian countries specifically.
00:10:59		So, as China has weakened, it's had some impact to those economies and those markets, and that's what you've seen reflected in the lag on EM this year, relative to some of the developed indices market returns. I think if you go back to it though, China is still probably the largest source of growth, for

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		a country its size, in the world. It's the number two economy, that's growing 6%. Just think about the absolute amount of growth, not in percentage terms, but dollar terms, that that represents in a given year.
00:11:31		So, even if it were to slow from 6% to 5.5, well, the headline would be there. There's still a lot of incremental absolute dollars that [unclear] put to work.
	RC	But that's the source of the problem, that China is the second largest economy in the world. It's surpassed Japan as the second largest, in 2010, and so here we are, like you say, it's growing 6%. The US is growing at, what, 2%, 1.9% by the end of this year.
00:12:01		And that growth deferential is allowing China to reach US levels, and some economists have been estimating that China could surpass the United States by 2030, 2035.
	KM	Yes, so I think that, back to the issue which is, China is important to the EM story, but I will tell you different than 20 years ago. China is important to the world's story.
00:12:30		It's important to what's happening in Germany with autos, so as China weakens a little bit, or these tariffs create uncertainty around the world, corporate CEOs don't buy CAPEX. They don't know what the rules are going to be around which goods are going to be tariffed and when. They pull back, and that uncertainty starts to create market dislocations, as we've seen throughout the year. Every time there's been rumours of a trade breakdown, you've seen the markets sell of every time there's been rumours that there is a trade deal at hand, with China.
00:12:58		You've seen the markets buy into that and rally. And I think I agree with Regina, we will get something. The timing of a trade deal and what it looks like is still uncertain. As we sit here today, in mid-November, late-November-ish, it looks like there's be a trade truce for sure, of some sort. Meaning some of the tariffs get pulled back, some amount of agricultural goods will be purchased, but not sure you really get the, what was once envisioned, a full two part trade deal which deals with the bigger, longer term issue, as China does develop at this pace.
00:13:33		To become a technology leader, where there's IP theft and the ability to enforce IP copyright and patents becomes really

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		the secondary trade issue, that's longer term to deal with. And I don't think we'll see that in the near term. But I think it gets played out. I think the markets will price it in, as they have. If there is a negative side that shows up in the next couple of months, the market will react the same way.
00:14:02		But we ultimately think we get something done. It benefits both the US, China, and therefore, by extension, the emerging markets.
	DP	Does one country benefit more than the other, from a truce or…?
	KM	We may disagree on this. I think that the Chinese can probably withstand this more, and can run at this longer, given the fact that they're economy is fairly closed, they have many levers to pull, in terms of whether it be reserve, ration requirements, cutting rates, fiscal policy they can deploy, which [unclear] have not, such as tax cuts.
00:14:36		Whereas, to the US, which is really running a pretty large budget deficit now. You're looking at a trillion dollars. The ability to stimulate the economy with fiscal policy is pretty tapped. Interest rates here won't save you if you don't get a trade deal. You've had three cuts by the Fed so far. So, I think if you had to say, for me, who gets hurt by a longer prolonged war here, it's got to be the US.
00:15:06		I don't think that there's any amount of rate cuts that could trump, no pun intended, this tariff and trade war.
	RC	So, I agree with you, Kevin, that China will be able to manage this way, and will be able to withstand a longer trade war if it persists. And that's because it is a managed economy, and you have a lifetime leader as a president.
00:15:30		Whereas in the United States, you have election cycles, and China has stimulated quite aggressively already, by cutting various tax rates, VAT tax rates, the household consumption. They've also been lowering interest rates, and their currency has been depreciating, which is helping the export market. And so, they'll continue to stimulate to help their domestic economy.
00:15:55		The one thing I do worry about longer term is that, if this trade war is on pause, but we still have this tech war on technology leadership, then the pace of innovation for China could slow.

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		And so that pace of innovation, whether it's through IP theft or their own organic innovation, that would be negative longer term, if they have… If they are not able to gain access to trade journals, for example, get access to universities.
00:16:30		And so far, the US is trying to do that, and so that's the negative case on the longer-term perspective for China, but we'll see. I think it's going to be fluid.
	DP	Is that potential damage baked in already though, given this has been in the process for a while now.
	KM	Yes, I think they're starting to see winners and losers in this already, and the longer it goes on, that gets magnified.
00:16:58		So, let's flip a coin to the US for a second. Clear loser is US farmers. Bankruptcy, rates in the US farm belt are sky rocketing, as the pressure on these… On prices have really hurt. You've seen the US manufacturing sector, the auto sector, the US consumer, one would argue, as a pay up for intermediate goods. Especially if this next batch of tariffs comes in after the holidays. Then it's real consumer goods and the consumer will bear the brunt of this.
00:17:28		If they don't and they basically say, we're not paying up for those goods, then the manufacturer or the companies that sell them will, in the form of discounting, which will go against their profits. So, there has been, in my mind, some already, winners and losers. And if you look at corporate CEO and CFO surveys, the uncertainty presented by not knowing what that future is, is showing up in a lack of confidence, which I think, if that's sustained, probably is the thing that maybe pushing and tipping the economy over.
00:17:59		Because we're not certain what the rules are, you're not going to be really comfortable making a big investment in any of these areas that are related to this. So, I'd say some clear headwinds on the US, and I can flip that coin back to the EM world and say where the winners are. I look at some of the countries in Asia that were US companies, to get out of the way of this, have moved their supply chains from China and moved them to Vietnam or other places in South-East Asia, where you're seeing pretty decent growth now.
00:18:33		So, some beneficiary in the short-term there for EM, to the detriment, obviously, of China in the longer term, but I think, again, how you look at this is, the longer it goes, I think it's

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		negative for everybody.
	RC	So, the supply chain diversion has been happening, even for Chinese companies, with production in China. They've been moving, to Kevin's point, to Vietnam, Indonesia, Thailand.
00:19:00		And now India has made it incredibly attractive to invest in their home market, with lower tax rates. So, that's nothing new. It's accelerated a bit, but that's certainly helping spur very strong positive regionalisation within Asia. And so, while China might slow a little bit, but be really steady, it's certainly going to help the other countries to finally be able to grow domestically, with higher CAPEX.
00:19:31	KM	Yes, in some ways though, the Trump administration's desire to have those jobs come back to the US is never going to happen. Those jobs or those supply chains have moved to South-East Asia, as we've said. They're not going back to China either. So, in both cases, the loser there longer term is going to be the US and China around that, because of some of these issues, for sure.
	DP	So, with everything that we've talked about, are we going to get a trade deal any time soon, beyond this truce or phase one or whatever we're calling it these days?
00:20:03	KM	Yes, my own view is phase one is a truce, right. I don't think phase one… Phase one is essentially unwinding some of the current tariffs at some pacing, not immediately, but over some period of time, in exchange for getting agricultural goods. I think there are other things out there [unclear] prevent potentially though, that getting done. In the near term, I think this situation in Hong Kong is getting more volatile by the day.
00:20:29		Were the Chinese to take a heavy hand there I think that would be seen as a negative around the world, to a trade deal. I think there would be bipartisan support in the US Congress, about not giving China an easy path on trade here after that, if that were to happen. So, I think that's out there, for sure, as an issue. I think for the Chinese, I think they look at the current administration and not sure that they're getting into a fair negotiation.
00:20:59		Part of it is, let's wait this thing out and see who is going to be the nominee to run against Trump, and they'll know that by the spring, right, so we're not that far off. And say, yes, maybe if it's Joe Biden, is he a better one to negotiate with? If it's

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		Elizabeth Warren, probably not. She's going to go after human rights in any kind of a trade deal, and that probably reverts them back to Trump. So, there are things out there that probably, in both parties' minds, that would gate an immediate signing of a deal, as much as everyone would like one.
00:21:31	RC	It would be a mistake if China doesn't do something sooner than later, because their internal dynamics had been softening, there's no doubt about that. So, for him… For Xi Jinping to wait until spring would be a mistake, in my opinion. And the bottom line is that Trump's support has been very strong, despite all the impeachment issues.
00:21:57		And the Democratic Party is very [unclear]. You have Warren and Sanders and then Biden, and then all of a sudden you have Bloomberg coming into play, as an independent. So, if I were China, I would try to get something done sooner than later.
	KM	Yes, I just think that this is… If this was easy, we would have dealt with it already, and so the fact that we're here now, and you can correlate the market when the market started going sideways to down last year, it was solely around this issue.
00:22:27		And related to, what was the Fed going to do to help with this issue. When the market has recovered, it's been on the prospect of there was going to be a deal this year. And the Fed was going to be at their back to help, and so, I think that we're sitting here, and there's been a lot of positives built back in, and I hope they get it done, but I think there's a lot more work in that, potentially.
	DP	Yes, so Regina, the thing that I always look at, and if I looked at EM as a stock, and I said, you trade at this multiple, which is pretty attractive vis-à-vis it's history, and vis-à-vis the developed world.
00:23:01		And the growth rate that you achieve, as we said earlier, probably economies are growing north of four. What is it that people fear that keeps them from investing in EM?
	RC	Well, more recently it's all been about the US China Trade War, the headline risk has really prevented investors to get really bullish on emerging markets. And so, if we get that behind us, then I think we have strong momentum in emerging markets.

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00:23:31		Emerging markets actually, in the fourth quarter, is outperforming developed markets as we speak. So, I think that template is there, and if we do get bottoming PMIs and resumption of growth, then emerging markets will be able to play on that, right. It always has been. But besides that, we're focused on fundamentals, so volatility has always been present in emerging market.
00:23:58		And you always have one or two countries that are in turmoil. For example, this year it's been Venezuela again, or Argentina, but since we're looking for high quality companies with a fundamental catalyst, and companies that are in a rate of return above this classic capital. We look past these turbulent periods, because we are investing in these companies for the long term.
	DP	So, are there any headlines out there that would keep you from investing? Take Latin America, there's a lot of noise going on in Latin America, where you put blinders on the headlines, if you will, and try to just dig into the fundamentals. There's nothing out there that says I couldn't do it right now?
00:24:37	RC	We stick to the fundamentals, and we do look to our country allocation model to see what would be screening for us. I just mentioned that Argentina might look attractive now, after a plus 60% drop in the stock market in the last 18 months. But we'll review the situation and see if there are high quality stocks that are screening for us.
00:25:03		But the bottom line is that a lot of our companies that we own in China, don't have exposure directly to the China US Trade War, and so that's where I'm very comfortable with our investment thesis. And so, we're confident that our individual catalyst, company catalyst, will play out.
	KM	So, a lot of it still has China in the name, when we think about EM, not in the name, but in our dialog, right.
00:25:30		And so, China, between the traditional H shares, that we all can invest in, the A share market, which is the local market, and you throw Taiwan in the mix, right. It's probably now, within the index, something that looks closing in on 40% of the universe, right. Is there a world do you ever see developing where people say I want my EM, excluding China, and they want to bolt China on discretely to that, so they can control the weight?

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00:25:58	RC	So, we haven't seen that directly, but we're hearing about greater interest in pure A share listed portfolios. And we're hearing that from the institutional side, because the A share market, the local Shanghai, Shenzhen markets are very distinct. Very largely, very retail driven, and so you can get very strong relative returns. The possibility for active management is very high there, because the markets within the Shanghai Index, as well as the Shenzhen Exchange are very inefficient.
00:26:35	DP	What opportunities are you seeing outside of China right now?
	RC	I really like Brazil. Brazil, right now, [unclear] has been, in terms of total return, is in line with the benchmark, and it really hasn't outperformed. But the set up is really strong for 2020. They just recently passed their pension reform, and even with an alt-right president like Bolsonaro, he's been able to pursue very business friendly role forms.
00:27:02		So, beyond pension reform, we could potentially get tax reform, administrator reforms, and that's going to allow Brazil to just be a much more efficient as an economy. It's the most amount of structural forms that I've seen in any given year, like Brazil. So, we're very positive on Brazil. We think that economic growth will be actually higher than expected, especially going from 2020 to 2021.
00:27:30		And so, the pace of acceleration should be solid, in our opinion.
	DP	From an asset allocation perspective, how much weight should be put into emerging markets?
	KM	So, I think there's a lot of work that needs to be done. We're seeing some of our institutional investors really look at EM in a different lens today, given the liquidity there, that's much higher than it was 20 years ago. Given the breadth of countries you can invest in vis-à-vis 20 years ago.
00:27:57		And the weight that people would say, again, in that period of time, it was not uncommon to have large investors say, I can only have 10%. We see investors today, high teens, 20%. So, I think there's a lot of rethinking that has to go on, given the opportunity set that is very different today. The liquidity issues, as I said, that we saw 20 years ago don't really show themselves today. So, I think that that asset class, for many

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		investors, should be much higher than where it traditionally was. So, think high teens versus that 10% band.
00:28:27		You know, in our own case, within our own balance portfolio set today, we've had a fair allocation to EM this year. We're over weighted. It's one of the largest over weights we've got in the portfolio, which reflects the diversity it gives us within our set of equity asset classes. But also, the [unclear] evaluation and the growth rates.
	RC	So, the EM makes up about 40% of the world economy today, and by 2035, I believe, according to the World Bank, it's going to represent 60%.
00:28:59		So, that's a large percentage of the world economy, and yet there's an under allocation to the asset class. And the only way to get it is buying it directly. Buying directly through emerging markets. Not through global multinationals, for example. [Music].
	DP	And with that, I'd like to thank Regina for chatting with us, and Kevin. Until next time, when Greg Valliere, AGF's Chief US Policy Strategist, joins the podcast with his take on the US election and rise of populist politics around the world. [Music].
00:29:30		[Music]. This podcast is for informational purposes only, and is prepared by AGF. It is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or adopt any investment strategy.
00:30:01		The views and opinions expressed in this podcast are based upon information available as at the publication date, and are subject to change. The opinions provided are those of the speakers, and not necessarily those of AGF, its subsidiaries or any of its affiliated companies. Reliance upon information in this material is at the sole discretion of the listener. The information provided is neither tax nor legal advice, and investors are expected to obtain professional investment advice.
00:30:30		Any discussion of performance is historical, is not indicative of, nor does it guarantee future results, and there can be no assurance comparable results will be achieved in the future.
00:30:41		[End].