Investment Strategy Note

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Downgrading Emerging Market equities to neutral

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- **Within our asset allocation we have a long-standing underweight recommendation on equities. However, within the equity asset class, we implemented a tactical overweight call on June 29 on EM equities, believing that they could outperform in the aftermath of the UK's Brexit vote**
- **EM equities have rallied 10% during this time, outperforming developed market equities by 3.9% (in US dollars)**
- **We now believe that increasing policy uncertainty in the US as well as rising political risk in the world's largest economy will act as near-term headwinds for EM**

US-centric headwinds to Trump EM tailwinds

Recent global equity market weakness has not been caused only by the potential for a US interest rate hike in our view. Rather, it is the deliberation over an interest rate hike in the context of weak and weakening economic growth that is causing concern. The problem for the Federal Reserve is that 7 years into the recovery from the 2008-09 recession, policy rates remain close to zero. Typically a return to economic growth (following a recession) would go hand in hand with a return to policy "normality", i.e. interest rates would rise. This has not happened on this occasion, all the while, US economic growth has been slowing. The choices for the Fed now are to hike and risk pushing the economy into recession only to later be able to cut, or to leave rates at current levels but risk having no room for cutting when the recession does eventually arrive. This uncertainty we believe will weigh on risk assets in the coming months.

In addition to this, with US presidential elections only 7 weeks away, uncertainty as to the outcome is also likely to weigh on risk appetite. For EM the biggest risk we think comes from a rise in protectionism or anti-globalisation in the event of a Donald Trump victory. Protectionism has been on the rise long before this presidential campaign started. The 2008-09 global financial crisis appears to have been the catalyst, we wrote about this in a note on 9 June 2016 **(see link here)**. However, we expect the protectionist trend to accelerate faster under a Trump presidency given his frequent and open critiques of the NAFTA, TTP and TTIP trade deals. For EM this would represent a major headwind, given that EM exports to the US and Europe have already slowed drastically in recent years.

This risk will most immediately be expressed via EM currencies. It is striking to note that the Mexican peso recently hit an all-time low against the US dollar. Having fallen 14% in 2015 it has lost another 13% so far in 2016. While it is understandable that Mexico will likely be impacted the most by the outcome of the US presidential election, other emerging markets will not remain unaffected, and yet some EM currencies remain up substantially vs. the US dollar year-to-date (South African rand, Brazilian real for example). This poses quite a big risk in our view.

Overall, although some of the positive underpinnings for EM equities such as cheap valuations and under-ownership by global funds remain, these are likely to be Trumped in the near-term (pun intended) by US-centric risks. As such, we take profit on our tactical overweight recommendation on EM equities, downgrading them to neutral from overweight.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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