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## Protectionism May “Trump” Emerging Markets; The 3 C’s Revisited

In the 1<sup>st</sup> and 2<sup>nd</sup> quarters of 2016, we evolved from emerging market (EM) stock skeptics to believers. Our tactical bull case, as articulated in our *Weekly View* from 8/22/16, revolved primarily around what we termed the “3 Cs”: China economic stabilization, commodity prices bottoming, and central bank accommodation across the developed world.

Ahead of the US Presidential election, however, we tactically trimmed EM back in our RiverFront portfolios to a roughly neutral stance relative to our composite benchmarks, out of concerns that the market was not taking the potential of a Trump victory seriously enough. Subsequent to the election results, we further trimmed our EM exposure and now find ourselves underweight EM relative to our composite benchmarks. **What has caused the change in our tactical outlook on EM assets?**

If investors have learned anything in this tumultuous year, it’s to be prepared to rip up the script (as well as never to trust polling data, and not to underestimate the frustration of the electorate towards establishment politicians). What little we know about Trump’s economic plan suggests that it is built around three major tenets: (a) *major fiscal stimulus in the form of infrastructure spending (likely financed via large deficits)*, (b) *meaningful corporate tax reform*, and (c) *a very protectionist trade stance*. Taken at face value, Trump’s policies would appear to be pro-growth in the near-term and inflationary. This would help explain the behavior of developed market interest rates since the election, with a meaningful rise in the US 10-year Treasury yield to well above 2% and steepening of yield curves in the US and Europe. While this dynamic has largely been viewed as positive for risk assets across the developed world, the stiff cocktail of higher rates and protectionism may “trump” (sorry, bad joke) some if not all of the “3 C” tailwinds for emerging markets.

### THE 3 C’S REVISITED – THE POTENTIAL IMPACT OF A TRUMP PRESIDENCY ON EM

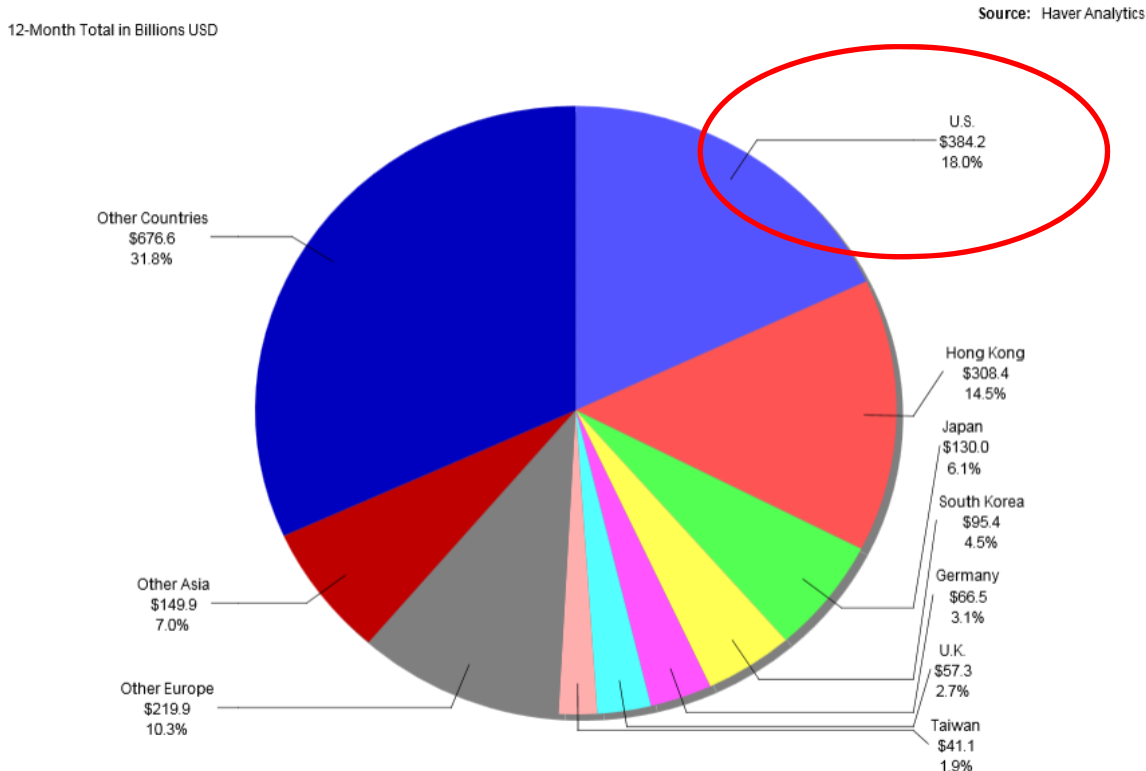
- China: Economic stabilization threatened by Trump’s stance on trade.** While China’s economy, stock market, and currency all stabilized in 2016, we acknowledge that China is clearly in the crosshairs of Trump’s protectionist rhetoric, and that the US executive branch has wide discretion on trade (see our recently published *Strategic View* from 11/09/16 for more detail on this). A trade war and resulting lower global trade would likely have a negative consequence for all of EM, but an outsized effect on China, the largest EM exporter and equity market by far. This is in part due to China’s reliance on exports to the US (see Chart of the Week, next page), as well as the fact that China is a more logical political target in our opinion than NAFTA nations like Canada. Unfortunately, we believe that as China’s economy goes, so goes much of Asia and EM.
- Central banks: Rising US interest rates represent tightening financial conditions and potential risks for EM currencies and economies.** Conventional wisdom ahead of the election suggested a Trump victory would lead to a risk-off flight to safety in US Treasuries. However, just the opposite has happened, we believe due to the market’s acute post-election focus on the inflationary tendencies of Trump’s policies. In practical terms, a spike up in rates means that US financial conditions have tightened, even without an increase in policy rates by the Fed. This has immediate negative implications for EM, as EM currencies had been helped in 2016 by a dovish Fed and declining long-term rates in the US. If US rates continue to move higher, we are concerned that this would put EM currency stability at risk, and it may create stress fractures in US-denominated EM risk asset prices. These risks would increase if inflation materializes faster than expected, causing the currently dovish Fed to turn more hawkish and pushing the US dollar higher.
- Commodity price impact: mixed signals here.** A Trump cabinet that deregulates and promotes American sources of energy may increase supply and thus exert downward pressure to oil prices; this is a potential negative for EM given the historical positive correlation between oil prices and EM equity performance. However, a potential offset may be the positive effect of Trump’s pro-growth/inflation policies on metals prices. This may mean that, over time, certain EM markets’ economies may move in divergent directions, and may necessitate a more targeted approach to security selection in EM.

Note: much has been made in the last few days about the potential effects of Trump’s policies when, frankly, no one really knows what he will actually be willing and able to accomplish. Trump’s reputation as unpredictable and his complicated relationship with his own party makes it difficult to predict what the final policy implementation will look like. The positive long-term mean-reversion potential in EM stocks and inexpensive currency valuations in some markets suggest that the opportunity in EM may still exist in certain regions, especially if Trump’s protectionist leanings turn out to be more stump rhetoric than reality.

We will be watching inflation expectations, interest rates, and body language from the Trump camp in the months to come for clues as to whether the recent drop is an opportunity in EM or a “falling knife” to be avoided, but for now we’re prepared to watch from the sidelines. In our view, investors need to continue to expect the unexpected and be prepared to rip up the script again as we head towards an uncertain 2017.

**CHART OF THE WEEK: CHINESE ECONOMY HIGHLY DEPENDENT ON US EXPORTS**

China Goods Exports By Country/Region



IE15451

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High-yield securities (including junk bonds) are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities. In a rising interest rate environment, the value of fixed-income securities generally declines.

Using a currency hedge or a currency hedged product does not insulate the portfolio against losses.

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