Risk Management Continues – Dollar Strength, Turkey and Emerging Markets

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Last week emerging markets continued to break down through important technical support (see *Weekly Chart*), and we elected to bring some more of our stock exposure back to the U.S. While we have reduced developed international several times in the last few months in our Advantage balanced portfolios, we had not reduced emerging markets (EM) this year until last week. We did not anticipate the magnitude of the weakness in EM currencies versus the dollar. We have responded by reducing EM equity weightings to be roughly neutral to our baseline benchmarks, while we assess whether the widespread selling of EM has created an opportunity for investors in certain countries or regions.

THE CASE FOR AND AGAINST EMERGING MARKETS:

The **optimistic case** for emerging markets starts with the idea of structural underrepresentation of its stock markets relative to superior long-term growth prospects for some of its major economies. According to the International Monetary Fund (IMF), emerging and developing economies account for almost 60% of the world's GDP. However, EM stock market capitalization is currently only around 10% of the world's equity market cap. If EM's relative economic impact continues to grow long-term, it seems logical that EM as a percentage of world equity market cap will likely grow over time as well. We believe this longer-term case justifies a strategic weighting, especially in portfolios with longer time horizons. A few examples include:

- **China**, the largest EM country, has economic growth rates that have slowed in the last 5 years, but remain at levels (6-7%) that are more than double the rate in developed markets. We anticipate China's recent growth rate is sustainable, even as they transition from an export driven economy to a more consumer driven economy. This growth will be needed to service China's growing debt levels. China has recently moved from a restrictive government policy designed to slow the housing market, to a more growth-oriented one in response to the trade/tariff dispute with the U.S.
- **India** has greater growth potential due to its superior demographics, but has structural impediments embedded in its social/political structure which impede that growth potential. Over time we anticipate some of these barriers to be lessened as they have in other developing economies that have matured. Nonetheless, despite these impediments India too has achieved faster growth.
- **The rest of EM feeds off the growth in China**. Asian regions like Korea and Taiwan provide high quality manufacturing and financing, and southeastern Asia offers alternative sources manufacturing as China moves upmarket. Latin America and Africa supply raw materials to the voracious demands of China's expanding infrastructure at home and abroad.

EM is also highly levered to economic trends in major developed countries. The slow but steady recovery in developed economies over the last couple of years has helped set into motion a positive corporate earnings cycle across emerging markets. EM equities have put together double-digit earnings-per-share (EPS) growth each year since 2016, a trend that still appears on track for 2018 *(source: Thomson Reuters Datastream, /I/B/E/S)*.

The pessimistic case is more tactical. Emerging markets are sensitive to the direction of the dollar, and this can be self-fulfilling since many EM countries borrow in dollars. Dollar strength makes the debt more expensive and potentially difficult to pay off, which can cause the interest rate to rise and currencies to fall as investors demand a better rate to offset additional risks. During periods of dollar strength, the weaker links in the EM chain often run into

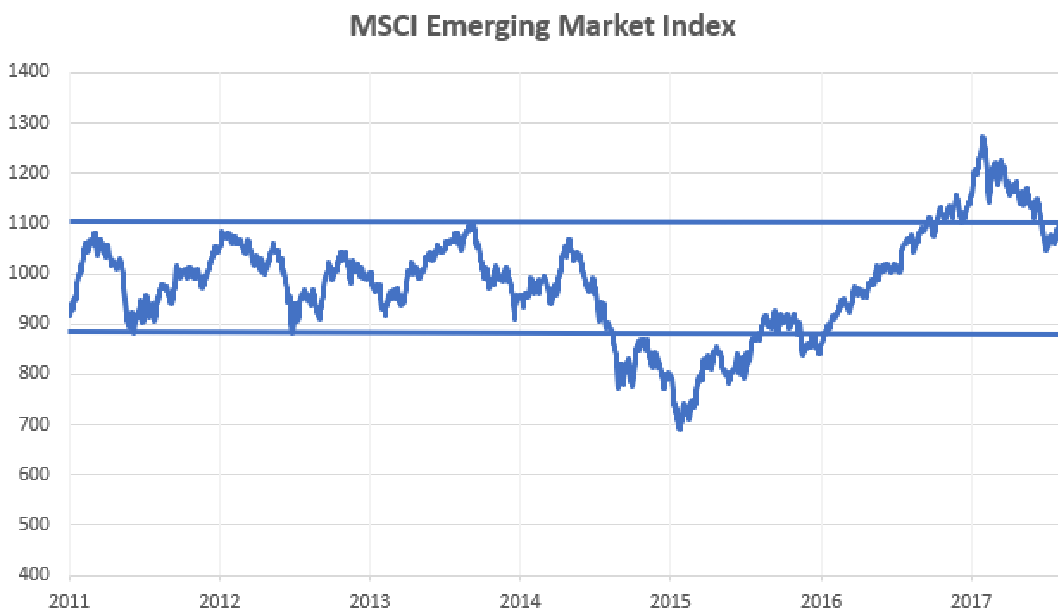
trouble. This time it is Turkey that has become the weakest link. Through the same mechanism, a weak dollar leads to a virtuous cycle of stronger local currencies and lower interest rates leading to higher stock markets, such as was seen in 2017. Currently the USD cycle is working against EM.

FOCUS ON TURKEY, AND THE RISK OF DEFAULT: A Turkish default may now be inevitable. Over the next 12 months Turkey needs to raise over $60 billion in dollars and euros to make principal and interest payments, and now that their problems are well understood, no one is likely to lend them the money. With their giant trade deficit, Turkey will have difficulty generating currency from trade – in fact, they will actually need to borrow even more. Their recent dispute with Trump over a political prisoner, combined with Turkish President Tayyip Erdogan's questionable economic policies, means that the IMF, a typical lender of last resort, may not provide assistance. Germany and Europe have meaningful incentive to help Turkey given their trading relationship. However, without external help it may only be a matter of time before Turkey runs out of cash and defaults. The prospect of a default from a major economy and NATO member is currently rattling markets around the world.

TURKEY MAY BE AN ISOLATED CASE: We do not believe that issues in Turkey have vastly broader analogs across all of EM. The 'doom loop' vulnerability for an emerging market is usually a function of high amounts of debt denominated in foreign currency, a large current account deficit, a lack of foreign currency reserves, and an incompetent central bank. With the exceptions of Argentina and South Africa, EM countries (especially in Asia) appear less exposed to these risks than they were during the EM meltdowns of the mid-to-late 1990s. However, we believe additional EM currency weakness could continue in the short term, until there is a de-escalation of trade tensions or more dovish rhetoric from the U.S. Federal Reserve.

EM TECHNICAL PICTURE - TREND NOW DOWN: Emerging markets, as represented in the chart below by the MSCI EM Index traded in a range from 900 to 1100 from 2011 to 2014, suffered a nasty bear market which bottomed in August of 2016 before recovering rapidly through January of this year. We thought the index would find support at the top of the old range (1100), but it has not and for now the trend is clearly down.

THE WEEKLY CHART: BACK IN THE OLD TRADING RANGE



Source: RiverFront, Factset. Past performance is no guarantee of future results. You cannot invest directly in an index.

BOTTOM LINE: Despite our long-term preference for international stocks, we acknowledge that trade tensions combined with rising U.S. interest rates and a strong U.S. dollar remain meaningful headwinds. We would note that the major difference between this and other down years for international is that earnings growth is still expected to be positive for both developed and emerging markets this year. We think that will matter after the dust settles and so we will be looking for the right opportunity to reinvest.

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In a rising interest rate environment, the value of fixed-income securities generally declines.

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Index Definitions:

MSCI Emerging Markets Index is an equity index that captures large and mid cap representation across 24 emerging markets (EM) countries.

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