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Record Turnout With Emerging Markets in Focus

By Eric Fine, Portfolio Manager

Portfolio Manager Eric Fine and members of his team, participated in the latest annual meeting of the International Monetary Fund (IMF). Here are some of the key takeaways:

Investors were generally bullish, and there was a record turnout. Investors favored sectors such as emerging markets (EM) local debt and EM equities, and the acknowledged risks were viewed as distant. Recession risk was viewed as low; U.S. Treasury yields were expected to remain low; oil prices were viewed as range-bound ($40 to $60 per barrel); there were less concerns about trading liquidity; most expected China to not have a crisis, but simply lower growth; a Clinton victory was widely expected; and Europe was a festering problem but not a crisis.

Our reaction: This is probably bearish for the market. Last spring, investor sentiment was bearish and the market rallied. Also, investors seemed fatigued with worrying about risks that have not exploded yet, even around Brexit.

Europe was viewed negatively by both the official and investor participants; pessimism is at a new low and is a broadly held sentiment. Their fiscal rules are not being applied, banking issues are being postponed/muddled, and the politics are problematic (but not disastrous, France's right wing party leader Marine LePen is viewed as a distraction). Deutsche Bank is almost unanimously viewed as something that would be sorted out either by a small fine by the U.S. Department of Justice (DOJ), a new capital injection from a private investor, or ultimately a government bailout that would not be a crisis-like moment.

Our reaction: Virtually no one seemed to recognize that the problems with Deutsche Bank started well before the DOJ requested a $14 billion settlement related to the bank's mortgage lending practices which contributed to the 2008 financial crisis. The idea that there is a risk to the bank's derivatives issues seemed alien to everyone we spoke to. On politics, though, we are open to the idea that anti-EU sentiment festers.

Investors saw China as storing up problems for the future, but not facing a crisis in the next few years. Capital controls were seen as working. Overall, China barely got a mention.

Our reaction: That could be right. The real issue is the external environment – weaker global demand, higher U.S. interest rates (or risk yields generally) – and its impact on a levered China. Also, there are hints that capital flight is resuming. The key point is that a benign outcome seems to be the consensus view, so adverse news would be a surprise to this consensus.

Emerging markets were viewed more favorably than developed markets (DM), mainly because DM looked worse and EM has been through the wringer a few times already. DM central banks were viewed as maintaining lower interest rates "forever".

Our reaction: At some point, weak DM growth will simply be negative, and DM risks generally have a more meaningful impact on EM than isolated crises within EM. The major central banks will likely have less ability to stimulate in the future. In particular, lower rates may not result in a weaker U.S. dollar the next time around.

The theme of DM central banks taking on less of the burden/ passing the baton to fiscal remained intact. The Bank of England said what it has done is sufficient, the European Central Bank is trying to move beyond quantitative easing (QE), the Federal Reserve is likely hiking in December, and the Bank of Japan wants to reduce asset purchases. There will not necessarily be balance sheet reductions, but the market may be complacent in thinking that balance sheets will automatically increase at the first hint of weakness. It was noted by the official sector that it is harder to show populations that policies have helped people.

Our reaction: We agree. Although the market seems to have this view, it may not be doing much about it, as any serious end to QE policies would have a potentially dramatic impact on all asset prices.

No talk of global economic recovery. The only change is "inclusive growth", meaning more redistribution of a shrinking pie. No green shoots.[1] People do not have commodity price forecasts because the standard error is huge. Commodity price forecasts used to be central to growth forecasts. After eight years of QE, there is no baseline that is conventional. Many acknowledged the lack of credit experience within the industry as QE has been the prevailing backdrop for many people's entire careers. It was also noted that weak U.S. growth should eventually mean a stronger U.S. dollar, not the weaker one as it has been generating recently.

Our reaction: We agree.

Trade protection sentiment will likely persist after the U.S. election. There is a lot that can be done with executive power. It appears U.S. authorities will be harsh on currency manipulation and ready to implement sanctions.

Our reaction: We agree.

Talk of stimulating growth through fiscal policy is just a distraction as you cannot get it through the legislature. Many felt the International Monetary Fund (IMF) looks lame by calling for fiscal stimulus from those who they say can afford it, and hearing "no". Germany will be heading the next G-20 summit in 2017 and it appears to be motivated to avoid any discussion of using fiscal policy to boost global growth at this time.

Our reaction: We agree.

Latin America was a popular topic. Brazil, Argentina, and Peru were all viewed as already having gone through crisis. Finance Ministers in Brazil and Peru presented reform plans that addressed the key economic issues facing their countries and were viewed as credible by investors. Argentina was given a pass, as investors were willing to overlook the government's reliance on central bank financing. Mexico was largely absent from discussions, in contrast to the excitement over its reform program in previous years, which is now seen as a major disappointment.

Our reaction: If the external environment is bad it could hurt LATAM. Also, DM problems have the biggest impact on EM. We are disappointed in the drift of Argentine fiscal policy, and are unimpressed with Mexican growth and some aspects of their policy. Nonetheless, we do generally respect the reform programs in a number of countries including Brazil, Peru, Indonesia, and to some extent, Russia.

[1]Green shoots is a term used colloquially to indicate signs of economic recovery during an economic downturn.

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