

Are You Missing Out on Emerging Markets?

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Last week I spoke with Jared Dillian, editor of the Daily Dirtnap, and Caesar Maasry, Head of Emerging Market (EM) Equity Strategy at Goldman Sachs International, about their thoughts regarding opportunities in emerging markets, including the Federal Reserve (Fed) influence on price action, and potential catalysts for a turnaround in EM.

Fed's Inaction, EM's Reprieve Dillian believes that the Fed is trapped and will be unable to raise rates until 2017. The Fed delayed the decision to hike rates at its September meeting due to reservations concerning long-term inflation expectations as well as critical uncertainty stemming from the global growth outlook. Dillian pointed to Fed chairman Janet Yellen's background as a labor economist and how deeply she cares about the unemployed, which may cause her to lean toward the dovish side. In addition, from a political perspective, the Fed's Board of Governors comprises seven people. Two spots are currently vacant, and since the other five were appointed by President Obama, Dillian believes they are democrats. Given that we are entering an election year, Dillian believes these Fed governors want to see a Democrat elected to the White House and would not want to hike rates and possibly send the economy into recession ahead of the election. Dillian is bullish on emerging markets and commodities. Based on his trader background, he feels there was a period of maximum pessimism there, which we are starting to see reverse. He sees the reflation trade back on for the foreseeable future and currently likes gold and silver as a result.

Good and Bad EM Markets: Brazil at a Crossroads While Dillian wants to avoid Russia, he really likes Brazil. He considers it very difficult to short the currency with a 14% carry, adding that Brazil's political situation is precarious, with President Rousseff's approval ratings at an all-time low of 8%—he thinks it's unlikely she'll get to serve out her second term. Dillian pointed to the free market protests that occurred six to eight weeks ago in Brazil—where 2 million people were in the streets, chanting, “Less Marx, more Mises,” signaling potentially massive change and support for the capitalist model. Maasry discussed Brazil's current macro picture by stating that the country's commodity, current account and credit imbalance put it at a crossroads. Even though its debt to gross domestic product (GDP) stands at 60%—it is Brazil's increase in total credit that has been high—leading to questions about debt sustainability. This is also apparent in the way earnings growth has been abnormally robust among Brazilian financials—driven mostly by credit growth—while the broad markets have seen flat to shrinking earnings. Maasry believes that Brazil's catalyst for a turnaround is likely to be fiscal consolidation.

India a Bright Star The reformist nature of India's government has set it apart from the rest of the EM pack. Dillian thinks the recent photo of Prime Minister Narendra Modi walking down the street with Mark Zuckerberg and Sheryl Sandberg in Silicon Valley summarizes his business savvy. Dillian sees Modi as a unique combination and analogue of Ronald Reagan and Paul Volcker in 1982 (before the major bull market started in the U.S.). In addition, India has demographics on its side: with a young population and the potential for infrastructure spending in the trillions of dollars. Dillian says the one pushback he receives on

India is that people say “I was just in India. Haven’t you seen it?” implying that there are still underdeveloped areas in the country. He has a catchphrase: Your best investments are “tank trades,” which are places that you really only want to visit in a tank. **China’s Potential for Quantitative Easing (QE)** Many have forecast that China is likely to step up its stimulus in the near future. Many of the country’s prior policy actions were designed to engineer a wealth effect by stimulating consumption through a stronger stock market and credit extension. According to Maasry, the issue with credit in China is lack of demand. Furthermore, China has already seen a large rise in credit, particularly on the corporate and local government side. In light of this, Maasry believes any QE efforts by China would likely circumvent additional pressure on the government’s balance sheets. Maasry also believes we are unlikely to see a credit crisis-type blowout in China, given that the government owns the major banks that hold the most debt. We are more likely to see a slow unwind and a gradual reform process that could take years to play out. Both Dillian and Maasry were encouraged by China’s substantial ammunition to create more accommodative markets. **EM Currencies Driving Performance** Maasry believes that the Fed’s tightening cycle looms on the horizon, which puts pressure on EM currency depreciation rather than appreciation. He also believes that if China were to devalue, a number of currencies would respond in kind to maintain their competitiveness. All considered, valuations in EM currencies remain very attractive and could suggest an interesting opportunity once the dust settles. **Where to Focus in EM?** Maasry likes countries that are more leveraged toward growth in the developed markets, such as Korea and Taiwan, as well as domestic-growth countries such as India.

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