ROTHKO

MONDRIAN INVESTMENT PARTNERS LIMITED

Buy EM: Saw-Toothed Growth Path to Continue

Quarter 1, 2019

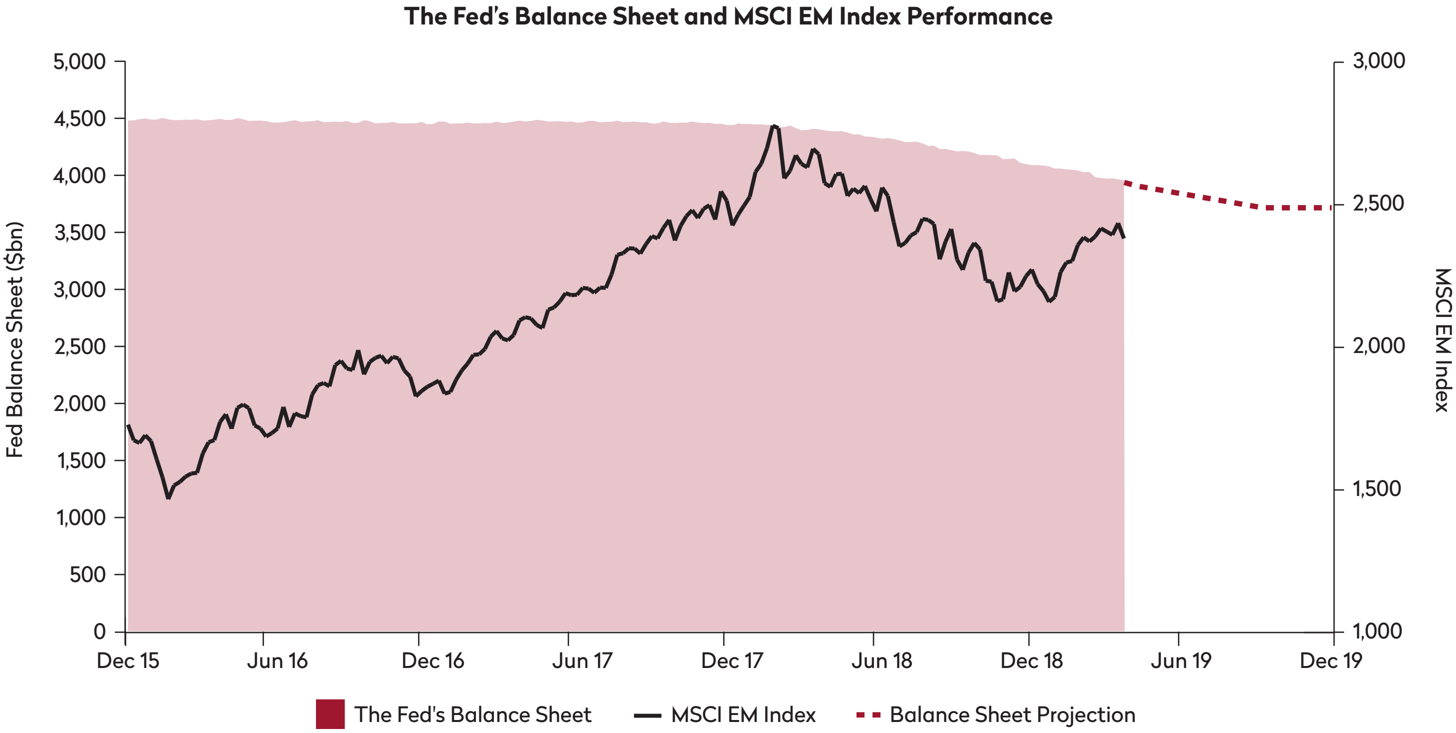
Rothko's outlook:

- **Policy errors trap the Fed into a more benign tightening cycle**
- **Emerging Markets have generally accommodative financial conditions**
- **China's monetary headroom and domestic growth potential will continue to confound the bears**
- **Looking beyond the headline noise, the EM "saw-toothed" growth path will endure**
- **It is a good time to allocate to an EM strategy that can participate on the upside, but more importantly, defend on the downside**

The Fed: Errors and Insularity

The emerging world is still heavily influenced by the global supply of US dollars, something controlled by one of the most insular and error prone institutions in the global financial system; the Federal Reserve. The ebb and flow of US$s are important enough to warrant China's reluctance to open its capital account while presenting weaker EMs with fundamental challenges since quantitative tightening (QT) began at the end of 2017. However, for EM this turns out not to have been as bad as it had seemed (see Exhibit 1). The Fed, fresh from its latest policy errors (having contracted too fast in 2018 (as we predicted in our *Q2 2018* note), prompting a pause on rates and an announced intention to stop asset sales), is now caught between the risk of hurting US growth and stoking US inflation — a straitjacket that helps EM.

Exhibit 1: The Fed's Straitjacket Boosts EM



Source: The Federal Reserve, MSCI & Rothko Investment Strategies.

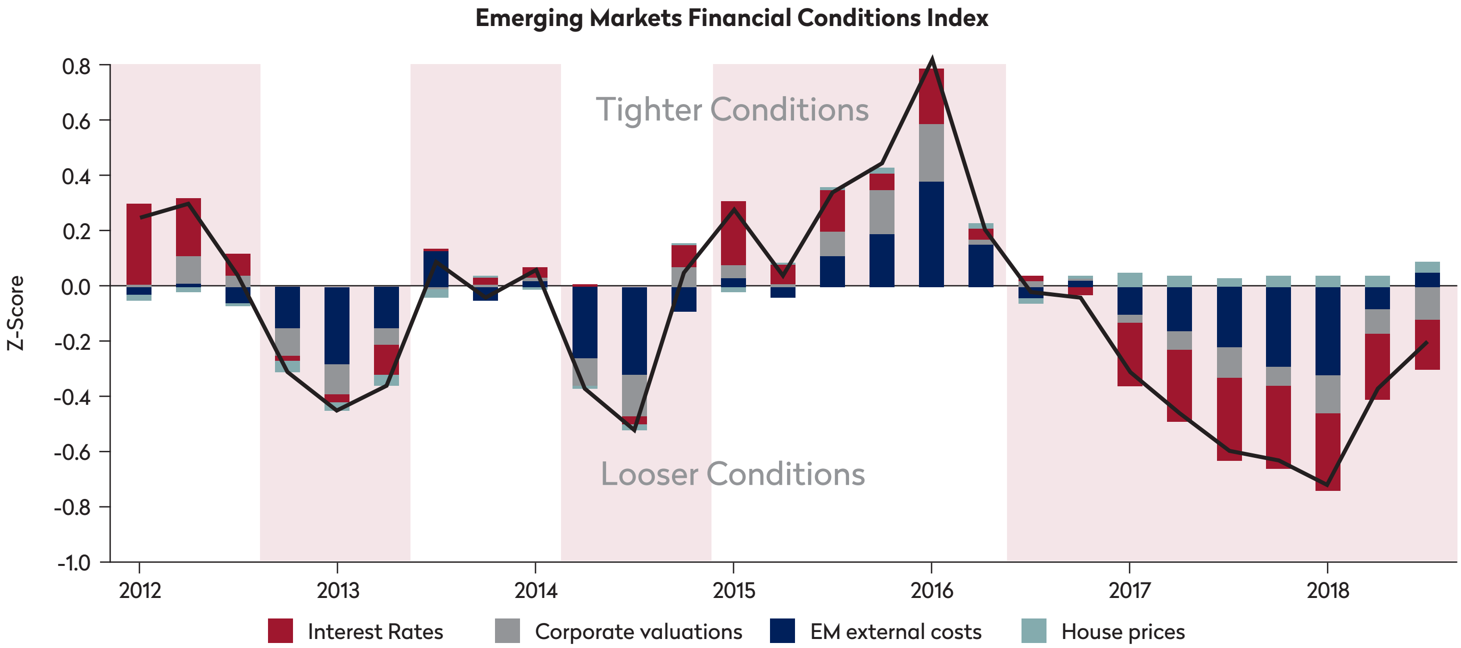
Saw_Toothed_Growth_Q119

EM Monetary Conditions, Generally Still Accommodative

Looking beyond the trade war headline-noise, financial conditions are still relatively accommodative across most EMs (see Exhibit 2). Combine this with the Fed's paralysis, we expect both these forces to at least partly offset global growth concerns and to materially benefit EM.

While the weakest EMs (particularly Turkey and Argentina) have seen currency defending rate hikes, more stable markets find themselves in a decent condition that should enable them to weather any possible slowdown in global growth and maintain a "saw-toothed" growth path.

Exhibit 2: Financial Conditions Still Expansionary in EM



Source: The IMF.
Note: The chart above is based on a sample of countries including Argentina, Brazil, Chile, Colombia, Egypt, Hungary, India, Indonesia, Kazakhstan, Lebanon, Malaysia, Mexico, Nigeria, Peru, the Philippines, Poland, Russia, South Africa, Turkey, and Ukraine. Values less than zero represent financial conditions that are loose relative to the historical average of 1996 or the earliest data available through 2018.

China Bears: In the Cold Again

As we noted in our *Q2 2018* note, Chinese FX reserve levels are the canary in the coal mine, and right now reserves are flat and all is just fine. China has had very mixed management of its economy which has emboldened the bears but the shadow banking purge continues to be offset by accommodative conditions competently. Yes, debt has reached eye watering levels domestically but the fact remains that the Chinese mainly owe themselves this money and control their own capital account. While MSCI and others have gifted the Communist Party with hard currency inflows, China continues to keep its capital account closed (don't be fooled by the apparent openness of the Stock Connect scheme, see our *Q2 2018* note).

The worst of Chinese economic mismanagement will be shown, in the fullness of time to be the chronic overinvestment in infrastructure "to nowhere" and poor and badly sited real estate. The lack of middle income escape-velocity is also likely (and bear in mind, holding China below this escape velocity is a key strategic aim of the US in trade negotiations) and the pull of balance-sheet recession a concern too. However, none of this will matter in the longer term simply because of China's unprecedented growth engine. 1.4bn people, aspiring to wealth, education and longevity, facilitated by a completely and utterly unscrupulous government. The China bears will be in the cold for some time to come.

Smoothing a Saw-Toothed Growth Path

Rothko is not alone in its opinion that EM will continue to follow a "saw-toothed" growth path. But, how can investors best accrue growth while enduring the characteristic shocks and volatility of EM? Defensive, return characteristics are the key. While many point to MinVol factor strategies as the answer, we have major concerns over the reliance on factors and price correlations (see our *Factor Strategies Living Beyond Their Means* note). Instead, we believe in defensiveness that can be derived from a systematically applied investment approach with a consistent focus on fundamentally-driven, income-oriented value. Rothko offers such a strategy and has produced such defensiveness since our inception in 2013. We believe now is the time to allocate to EM and we believe Rothko's ability to participate in market upside but defend on the downside are the key characteristics investors should be aiming to gain exposure to.

Disclosure

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Mondrian Investment Partners Limited | Fifth Floor, 10 Gresham Street, London EC2V 7JD, UK | London +44 207 477 7000 | Philadelphia +1 215 825 4500 | www.mondrian.com

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