Disruption Outlook: Trade War & Tariffs

Disruptive Forces in Investing

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Anu Rajakumar: In early 2019, investor concerns regarding an impending U.S./China trade deal and a global growth slowdown rattled emerging markets, and year to date, the region still continues to underperform developed markets. As uncertainty around these negotiations continue to unfold, how should investors be allocating to emerging markets in their portfolio? My name is Anu Rajakumar, and on today's episode of Disruptive Forces, we continue our discussion around political disruption, specifically the trade war on tariffs, and how that is affecting the investment behavior of both companies and investors. To share thoughts on this important topic is Conrad Saldanha, Senior Portfolio Manager of Neuberger Berman's Emerging Markets Equity Team. Thanks for being here today, Conrad.

Conrad Saldanha: Thank you Anu.

Anu: So let's jump into the U.S./China trade war and what that means for emerging market companies. In the first half of 2019, the U.S. imported less than $230 billion worth of goods from China, down 10 percent from a year earlier. So maybe if you can just start with giving us a lay of the land of where we are today and talk broadly about how the shift is affected emerging markets.

Conrad: Sure Anu. When we look at the global growth environment, it has been tepid, anemic, slow, if you want to put any of those words to it. When I look at emerging markets in of itself, growth has decelerated, and to talk about China itself, growth has been slowing down for a little while. Obviously, there's a big base effect that we'll talk about, but also in terms of the mix, the shift from fixed asset investment, much more towards consumption and consumption-oriented economy. So my view is that while trade has not helped in the near-term and maybe impacts the recovery, we've been in this slower growth environment globally and across emerging markets coming off a higher base effect. Keeping in mind that that rates are lower, inflation is lower, and thus you're seeing a nominal GDP decelerating, and nominal GDP as much more as an important driver for emerging market growth, especially when you look at companies, and that's what we look at. When we look at fundamentals of companies, earnings growth has been decelerating. In fact, we started the year of full consensus looking for eight percent earnings growth. We're probably going to end up in that range of four percent for earnings per share growth this year for emerging markets on a consensus basis. And that's relative to developed markets that somewhere in that range of zero to two percent. Now, what has helped globally has been lower rates factoring into the multiples or higher multiples, much more so in developed markets than they have been in emerging markets. But I feel optimistic that there are pockets of domestic demand, whether it's in technology spending this year, off a lower base last year. It's in financials and the financial sector, in emerging markets that the higher quality ones, in particular, whether it's in India, it's in Russia, that continue to drive growth, and you're seeing that in the earnings of those companies.

Anu: So now do you see this as a continued threat to the space, this trade war concern?

Conrad: I continue to see the trade war as being an additional factor that is handicapping growth and I'll just reiterate that the growth slowdown, was one that we expected previously. We continue to see it, transpiring and I think the trade issues prolong that recovery in the global growth cycle. If I think across EM and how that impacts EM, I think a lot of EM is not really export oriented. We had, call it the 2000s and the late 2000s where it was, the Chinese, absorption of commodities for the fixed asset investment that pulled a lot of EM up that were more commodity exporters such as Brazil. However, EM has been a lot more about domestic demand, in the current environment. Plus looking forward and I think that count needs to be a growth engine for EM. However, the scarcity of growth remains an overriding issue, globally for us. There are pockets that we think are more interesting. Whether it's the technology spending, that ultimately caters to the consumer globally, there are pockets of financial, businesses that are more consumption oriented that continue to grow quite nicely. Especially in an environment where rates are as subdued. We're seeing over half of the world in a negative rate environment, that's creating an opportunity for EM to stimulate, both on a monetary basis as well as fiscal, which plays into, again, the domestic side of emerging markets in my view.

Anu: And where specifically in EM have you seen those pockets of opportunity? You mentioned tech spending and financials. Any examples you can give there?

Conrad: Sure. When I look at technology spend, last year there was a slowdown driven by memory prices, we've seen a recovery off that and if you look – specially at accelerating the fourth quarter of last year, having spent the summer last year in Asia, there was a massive decline in Capex and still a Capex hasn't fully recovered because of the whole trade uncertainty. So if you ask me to sum it up, what has really been impacted, by the trade issues has definitely been the capital spending element of it. While consumers are still holding up the Capex has been

withheld due to just the uncertainty of how these trade policies would transpire. But more on the positive side in terms of growth, technology when you're looking at it whether it's the spending coming through in terms of smartphones. I think where it is much more about China trying to be more self-reliant. You're seeing a lot more spending transpiring, the likes of China Mobile are really accelerating out the 5G spend and by default, they are spending a lot more of their Capex with Huawei. Subsequent to the trade issues and the dispute that the U.S. has had with Huawei, so you're seeing a lot more being recycled domestically and China, rapidly progressing towards maintaining their self-sufficiency both in semi-conductors and in software which are two areas that they rely heavily on the U.S. in particular.

Anu: So what about ramifications for global supply chains? Maybe even countries outside of the U.S. and China. What's the impact there?

Conrad: For global supply chains, I think there are two sides of it or if I have to bifurcate it, one would be the higher value technology supply chain. And the other one I would call it more the basic commoditized lower value. I would put textiles, into that bucket. For the higher value technology elements, my view is that there will be a certain amount of displacement of, U.S. technology companies favoring, I would call it Taiwanese companies, Japanese and the German companies. And you're seeing that transpire as we speak. Taiwanese, obviously with TSMC being the fab of choice, globally, you are seeing acceleration and displacement. We're seeing a shift even in the likes of Sunny Optical, they continue to see a benefit of that spend even though there have been changes in mix and whether it's Huawei versus Samsung being their largest customer, they've been innovative in terms of filling that void. There's definitely a shift happening in that regard. If I move to the lower value-added items, I think China has figured out several years back that they are not going to get wealthy as an economy or wealthier selling lower value items. The labor arbitrage that was significant has narrowed and so they've been moving more up the technology front here if you will. Some of that displacement has already happened, whether it's Vietnam, Bangladesh, trying to look for cheaper, labor arbitrage that has been transpiring and my guess is that's accelerating right now but that's something that China has been cognizant about, offshoring if you will. Now, in the meantime, you might see a little bit more of re-labeling but over the long-term, I would say that the smaller countries cannot fully displace China from a scale standpoint. And what, a billion-odd people, billion two or billion three plus can do in terms of manufacturing the efficiency, the productivity we are fed, the logistics that they put in place, cannot fully be displaced by the Vietnams of the world. Otherwise, you'll end up in a situation of a boom bust scenario where inflation really accelerates and takes out that arbitrage. But I think it's a cognizant move by China. And in the meantime, you might see a little bit more relabeling and more Capex going into these areas. Ultimately, the answer will probably lay in automation that helps productivity and the offshoring out of China.

Anu: And so how about the Brazils, Russia, India, what's the impact been on the Brit countries that are not China here?

Conrad: The Brit countries, as an acronym might be punchy. As an investment, acronym, it makes less sense and what I'm pleased about is the divergent opportunities set, and people not lumping them altogether because EM is a heterogeneous asset class. And you've seen that, what's transpiring in China hasn't affected really Brazil, Russia and India where there are different dynamics underlying those economies. And you're seeing a lot more of the domestic side, pulling through, in terms of growth, in terms of mix of the market. For instance, Russia is the best performing market, north of 30 percent this year, in terms of U.S. dollar returns in itself. And that's been driven by good, solid earnings growth in that market. We came off the sanctions last year and Russia seems to have a nice hedge where if oil prices decline, the ruble declines and it gets more competitive, on a ruble basis and importantly, on a dollar basis for energy. For Brazil, it's been about reform and that's what void the market more than just the whole commodity complex and trading together. India's got its own dynamics of big domestic opportunities set. It has been sluggish but it has less to do with the global trade cycle. Obviously, it's not helpful, but I think it's the liquidity bonanza that transpired after the demonetization. You're seeing the opposite end of that spectrum, now there's a liquidity tightness and trying to get Capex to come back domestically is one of the factors. And more importantly, it's getting domestic demand, especially in rural India to drive the economy is something that's been slower. But it's got its own trajectory and based on the lower, global, growth and inflation dynamics, there's been more room to stimulate in places like India to get that domestic demand growing again.

Anu: Right. It sounds like lots of pockets of opportunities, outside this big political issue that is still unresolved. So back to the U.S. and China, in terms of consumer confidence, it appears that both have been quite strong, both in the U.S. and China. Do you see that changing going forward?

Conrad: I think that's the last bastian of growth and dependable growth that we've seen. In the U.S., I think importantly, you've seen a wealth effect. So yes, unemployment is at low levels but the wealth affect has driven, consumption and kept it at an elevated level. While I'm not a specialist on the U.S., we live here, we see it every day. And I think that's been a positive driver and I cannot see that changing, in an environment where rates continue to be low and supportive. So that's definitely a positive engine that continues to motor the global economy. In China, I think similarly you've seen, consumption that is void by a strong domestic stock market with the China A shares up north of 30 percent. This year, one of the best performing stock markets, albeit coming off of a tougher year last year of trade and tightening policies domestically, obviously the policies do play a sentiment factor in China. We have to keep an eye out on both prices, right. And where you've seen a swine flu impact, what does that mean in terms of disposable income, that's potentially a wild card. But I think the worst of that is potentially, behind us. But we continue to see strong growth in ecommerce sales if you look at ecommerce overall growing in the high teen's year on year. November 11th is their singles day sale for Alibaba reported, a 26 percent year-on-year sales growth which is a phenomenal number.

Anu: Unbelievable. Right.

Conrad: It's absolutely stunning. And you think of, ecommerce expenditure situation in China, 21 percent and, you know, adding a point and a half every year, they're taking more and more shares. So I think that does look, steady growth driver. Obviously for China, the mix of retail is smaller or consumption is smaller in the basket versus the U.S., where it's 70 percent. China is hovering in that 45, 50 percent range. Obviously measuring that number is not as accurate but it remains a strong and powerful, growth engine, though being hand strung by fixed asset investment and the debt levels in China. And that's why overall growth, I would clarify, is softer in China and potentially could be for a little bit, coming off of very high base and a big economy that it is right now. And you're in the teens trillions GDP. It's a tougher number to support especially when the debt levels are elevated on the corporate sector.

Anu: Now, the Hong Kong protests have been increasing in intensity in recent weeks. How have these protests had an effect on the U.S./China trade deal, if at all?

Conrad: Anu, I'm a little conflicted in that respect, should that encourage China to strike a deal and have a positive signaling impact, or does it mean that China's so preoccupied they do not want to be rushed into a trade deal? And obviously this is happening while the phase one negotiations on. I think it's from the U.S. standpoint, I think it's less of an issue for the President. Probably more an issue for Congress in terms of further concessions in the trade negotiations. We'll have to see how this pans out. It is obviously a very fluid situation. It's rather challenging. However, we have to see what the impact is more fundamentally for companies, especially for the China listed companies in Hong Kong, as well as the Hong Kong businesses. It is obviously have any impact on the growth aspect of Hong Kong near term, but also structurally. Does it move more capital out of Hong Kong and more to China to the mainland, which was already transpiring? And that's something that structural we need to keep an eye out for.

Anu: Conrad, we're still a long way away from the U.S. election in November 2020, but I'd love to get your thoughts on how you think the impact of the trade negotiations may change in the event that we see a Democratic candidate get elected to the U.S. presidency.

Conrad: Anu, it is early, and it's probably a difficult call at this time. But knowing the way the Democrats are also reacting to China and seemed to take an even harder line, surprisingly, my view is they might soften, they might change once they get elected. So we'll have to see how that transpires, but obviously as of right now, it seems to be an equally tough spot. I think what makes me feel good about emerging markets is that it may not be as contentious, even if I take it to the whole international even developed markets route, that it may not be as contentious as it is right now. There will probably be less tweets to have to deal with and the fatigue of that on a daily basis, but I think importantly, it'll come down to the policies that the next president has in the U.S., and how much does that stimulate the domestic economy versus how much does it have a negative wealth impact as well. And that could have an impact on the stock market as well as on consumer and sentiment of the consumer, which is supporting this economy, which is very important. Which leads me to the final point is that what does that mean for the carry trade that has worked so well in terms of the U.S. bond market, the U.S. equity market, and the dollar. And if that tide turns, does that bode favorably in my mind, it could be a positive backdrop for EM and that carry trade moving across to emerging markets.

Anu: I think as we wrap up here, we've been hearing about these trade talks for months and months now, I think investors are dealing with a set amount of fatigue from this issue. Conrad, I'd love to, as we wrap up here, for you to just discuss what investors should think about as these negotiations continue to unfold? What are your key takeaways that folks should be aware of?

Conrad: Sure Anu. I think a few of the two takeaways from my standpoint that we are in a slower growth environment, and frustratingly, when you see the tweets come out, the U.S. seems to react positively. EM is still in a bit of a funk, and that reflects a bigger fear factor in emerging markets versus the greed, I would call it, in the U.S. So that bifurcation leads me to think that EM, yes, it's undervalued, but what really drives it? And it comes down to two factors. One is when I look at rates in in EM, there's more flexibility on both the monetary side as well as fiscal while the currencies are holding. So that gives me a positive bias to emerging markets, and you could potentially see multiples rerate. Secondly is earnings, and that's very important. This year, as I alluded to earlier, consensus was looking for eight percent earnings growth. We're ending up at somewhere in the range of four percent. Next year I think is a little optimistic for consensus coming in at about 14 percent. Even if we clip closer to that seven to eight percent would be a nice number along with some amount of rerating for emerging markets, which drives me to a positive bias on a relative basis for emerging markets.

Anu: Conrad, I appreciate your thoughts today on this complex and changing topic, and I encourage our listeners to subscribe to Conrad's regular commentaries on emerging markets to keep apprised of his views. Thank you again.

Conrad: Thanks Anu.

Anu: As a reminder, this is the second of a three-part series on the theme of political disruptions affecting the investment landscape. So we're looking forward to releasing the last one in a couple of weeks' time. So keep an eye out for in your Apple podcasts or Google podcast app. For previous episodes as well as more information about our firm and offerings please visit www.nb.com/disruptive forces.

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