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INTERNATIONAL MARKETS
ARE BETTER TIMES COMING?

KEY TAKEAWAYS

1. The past two weeks have brought good news for those invested abroad.
2. The European Central Bank's growth projections are strong.
3. Foreign currencies have been gaining ground relative to the U.S. dollar.
4. Japan, New Zealand, Chile, And Colombia have recently beaten expectations.
5. We believe international markets continue to present attractive opportunities.

The last week has brought some good news for U.S. investors concerned about international markets. Previous weeks had seen capitals flowing back stateside, attracted both by a strong stock market and increasing interest rates. Investors were also unnerved by particular events in Turkey and Argentina, and, to a lesser extent, by political uncertainty in Brazil. As we have argued in the past, extrapolating what is going on in Turkey and Argentina to the rest of emerging markets has no factual base. The former became negligent in its managing of monetary policy, refusing to increase rates for reasons of political expediency. Its private sector has also accumulated high levels of foreign-currency debt, and the country's current-account deficit did little to bring calm to markets. The case of Argentina – still a frontier market according to MSCI, although that was supposed to change next year – is more complicated, with problems that can be traced back to decades of wrong policies. The current government is now attempting much-needed reforms, with the help of the IMF.

For those specifically fearing contagion, it is important to note that the most important countries in the MSCI Emerging Markets Index show a very different picture from Turkey, with either substantial current account surpluses or only minor – and thus manageable – deficits. Plus, their banking sectors and overall institutions are in much stronger shape than they were in the late 1990s, when the Asian crisis started in Thailand and quickly expanded, wreaking havoc on many emerging economies.

This paper presents a recap of the series of good news that have come from international markets during the last few weeks. We separate them by region, in an effort to make clear that there are still opportunities to be found in every major area around the world. In Europe, the ECB is finally confident enough that it will stop purchasing assets at the end of this year. In Asia, Japan, China, and even Turkey have surprised markets with recent data. Moreover, authorities seem to be willing to act in order to support growth. In Latin America and Australia, we also see positive signs, be in terms of investment, job creation, or inflation control. We argue that there is enough evidence for cautious optimism regarding the prospects of international markets, with opportunities in every major region.

I - Europe

1. United Kingdom

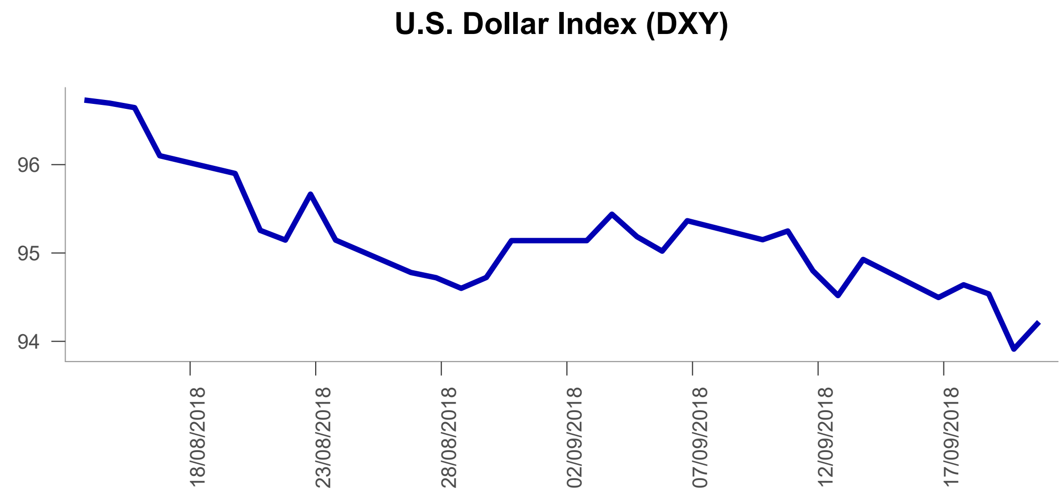
The pound reached its highest value against the dollar in 10 weeks on Thursday 9/20. This is the culmination of a series of positive events in September. First, wage growth remains strong in the country. Second, it was confirmed that Mark Carney, the governor of the Bank of England, will remain in his post for another year. And finally, markets are becoming optimistic about a Brexit deal finally being reached between the government and the European Union, despite the intra-party fighting that has cast doubts on the future of Prime Minister Theresa May's government. In our view, the Brexit-with-no-deal scenario (a.k.a. hard Brexit) is still possible, and this would probably alter the Bank of England's interest-rate policy for 2019. Hence, we remain cautious, but optimistic. We are especially watching the role Ireland might play as a mediator between the E.U. and the U.K.

Moreover, the strengthening of the pound is not an isolated event. We have seen the won, the rupiah, and the baht, among others, recover against the dollar lately. In fact, the value of the U.S. Dollar Index, which measures the value of the greenback against a basket of the most important foreign currencies, has been declining notoriously in the past few weeks (figure 1). U.S. investors in international markets need to remember that they are, in practice, short on the dollar. This means that when the dollar becomes weaker, the dollar returns to their foreign investments go up. A weaker dollar is good news for those who have invested in foreign markets.

Figure 1

THE VALUE OF THE U.S. DOLLAR INDEX SHOWS HOW THE DOLLAR HAS RECEDED (AUGUST 14TH WAS THIS YEAR'S PEAK)

Source: Innealta Capital using data from Bloomberg. The graph shows values between 8/14/2018 and 9/21/2018.



2. Euro area

The European Central Bank (ECB) finally announced this week the end of the quantitative easing program in the euro area, worth approximately EUR 2.5 trillion. Specifically, monthly asset purchases will be reduced by 50% starting in October (EUR 30 billion to EUR 15 billion), with the idea of ending them in December. The ECB chairman, Mario Draghi, had already anticipated this in June. Just a few months back, markets would have reacted very negatively to such news, deeming purchases by the central bank as absolutely necessary to shore up prices, avoid a deflationary spiral, and prevent interest rates – especially in Southern Europe – from abruptly increasing and halting the recovery. Consequently, the announcement serves as proof not only of the bank's confidence in the euro area's growth potential, but also the degree to which markets share the same belief.

Meaning

At the core of this announcement is the belief by the ECB that the output gap in the euro area has shrunk to the point where bond purchases need to be cut. In plain English, this means that growth is estimated to be above potential. An example of this: receding unemployment across different countries. Then the question becomes: if the ECB is not needed anymore to support prices, where will the boost come from? The ECB stated that rising wages, partly coming from labor shortages, would push up prices. Increased government spending will help, as well. The euro area is still below the ECB's inflation target of 2%.

The bank's balance sheet should not start shrinking soon, however: it will only stop growing. Combined with very low rates, this accommodative monetary policy will help support growth across the continent. Thus, the ECB is not about to pull the plug abruptly.

External threats

Tariffs are now the main concern. However, the "truce" agreed between the European Commission and the Trump administration at the end of July has helped to cool things down. In fact, the negotiations could end with even more trade between the E.U. and the U.S., as both parties will work on an agreement towards zero tariffs and the removal of all trade barriers for non-auto industrial goods. As for Turkey's woes affecting European banks, the latter are much better capitalized than they were in 2008. Furthermore, they have access to cheap funds from the ECB.

II - Asia

1. China

Analysts continue to track the evolution of trade tensions between China and the United States. President Trump announced new tariffs – of 10% – on another $200 billion worth of Chinese imports last Monday (9/17), which will increase to 25% at year-end. More tariffs were threatened if China retaliated. The impact of previous tariffs is already starting to be felt on both sides, not exclusively in China. Companies like Apple and Ford have made explicit statements about the negative consequences tariffs will have on their business. In fact, the dollar lost ground on Monday (9/17) as the market deemed very likely that the new tariffs would be announced soon (as they were, that very day, after the U.S. markets had closed).

Far from what many would believe, the trade deficit with China has actually increased this year. As of July, it had grown 10% relative to the same period in 2017, reaching ~$233.5 billion.

Beyond tariffs, we believe there have been some recent developments that we consider important when assessing the current state of the Chinese economy:

- Industrial production grew in August, while unemployment fell.
- Monetary and fiscal policies have been shoring up the economy, and are expected to continue to do so.
- For example, with more spending on infrastructure, decreasing reserve requirements for banks (seeking to boost credit), and putting its plans to curb corporate debt on hold.
- The government has signaled it will remain very focused on growth.
- Moreover, negotiations between the U.S. Treasury Secretary and his Chinese counterpart – regarding trade – are expected to resume soon.
- There is only a limited amount of products on which the U.S. can slap additional tariffs, and those that have been spared so far include the most sensitive ones for American consumers (so the political cost of levying a tariff on them is higher, which should serve as an incentive to negotiate).

2. Turkey

On September 13th, the central bank took action – finally – and raised rates drastically, from 17.75% to 24%. The main goal was to defend its ailing currency, which has lost ~40% of its value this year. Markets responded and the lira climbed ~6% that day. This will definitely help assuage fears that local companies indebted in dollars could soon face problems. But more importantly, it will restore confidence in the central bank's independence from the government, specifically the president, who had explicitly advocated for lower rates, even in the face of a plummeting lira. A country like Turkey, with a considerable current account deficit, needs and will continue to need external funding, so this signal matters greatly. What's more, a few European banks with significant exposure to Turkey (BBVA, ING, Unicredit, BNP Paribas) saw their shares appreciate in the aftermath.

Additionally, on Thursday 9/20, the government finally came to terms with economic reality. It reduced its growth projections for the coming years, and it increased its inflation forecast. The Minister of Finance predicted GDP growth of 3.8% for 2018 (down from the previous 5.5% estimation), and 2.3% for 2019. Although lower than before, they are still high and ambitious rates; but they pale when compared to the 7.4% expansion in 2017. Inflation for this year is expected to be 20.8%, and 15.9% in 2019. Beyond these projections, the government estimates an increase in the primary budget surplus (by cutting TRY 60 billion in spending, roughly $9.5 billion at current rates), meaning the government will not go out of its way to stimulate activity. In any case, analysts expected more details, yet we believe we have at least seen enough to be confident that the worst part of the storm has passed. The country has realized that the credit-fueled growth path it had embarked on during the last decade and a half is unsustainable. Turkey's next step should be to focus on the health of its banks: non-performing loans could bring the country back to the brink.

In any case, investors should keep in mind the limited ability Turkey has to affect international markets as a whole: its economy does not even account for 1% of the MSCI Emerging Markets Index.

3. Japan

The news from Japan on the political front have been good, with Prime Minister Shinzo Abe winning the election to remain at the helm of the governing Liberal Democratic Party. The fact that he narrowly won was welcomed by markets, for it will force him to focus on reforms. Moreover, the Japanese economy has beaten expectations lately:

- Economic growth for the second quarter surprised markets, with the fastest expansion since Q1 of 2016.
- The economy grew at an annualized rate of 3% between April and June.
- This happened even as trade tensions and some natural disasters had cast doubts on economic performance.
- Capital expenditures were the main driver of growth, pointing to a strong desire by businesses to invest.

III - Latin America

1. Colombia

Net foreign investment to Colombia reached $1.237 billion in August, an increase of almost 67% relative to the same month in 2017. The main driver was the oil industry, according to data provided by the Central Bank of Colombia on Monday (9/17). At the end of August, foreign direct investment was up 33.2% year-on-year. Lower political uncertainty (after the presidential election was decided in favor of a market-friendly candidate, who is now in office) has been quoted as one the reasons behind the increase.

Why is Colombia attractive?

Colombia is Latin America's fourth-largest economy, and its government has forecast GDP growth of 2.7% in 2018. Last year ended with a disappointing 1.8% growth rate. Some analysts are worried about Colombia's current account deficit (3.5% of GDP at the end of Q1), which is higher than that of many other emerging economies. In particular, they fear contagion from distressed countries like Turkey and Argentina. In our view, it is a mistake to focus on just one variable in order to assess the desirability of a holding. For example, Colombian companies show reasonable levels of debt, with a substantial portion of capital coming from domestic investors. Investment has also remained strong, as shown before. Furthermore, the government has successfully met its deficit targets, even in the face of decreasing oil revenues. This discipline, coupled with an administration that investors can trust, is a source of certainty. What's more, the central bank has been able to achieve its inflation target (2% to 4%), therefore anchoring inflation expectations. On the worrying side, we can point to increasing levels of public debt: gross public debt was 45% of GDP at the end of 2017 – unchanged since 2016 and still far from Brazil's 74% (data from Cepal, a UN regional commission). Also, some important reforms are yet to be enacted, especially those that will help the government meet its fiscal-deficit targets.

Thus, we see a country with judicious fiscal and monetary policies, where investment is growing, and where the administration reassures markets. In other words, we see it as an investment opportunity.

2. Chile

Commodities are very important to a wide array of emerging economies. Chile is no exception. Specifically, the price of copper is of great concern for Chile: this commodity represents between 45% and 50% of the country's exports (and it used to be more when the price was higher). Renewed trade tensions were expected to hit the price, given that China is a significant buyer. That had been the case in previous months, with a decrease of 18% since the year's peak in June. But even after new tariffs were announced on 9/17, the price went up 2.44% the following day in London. We can interpret this as proof that markets had already internalized the new tariffs. Moreover, extra investment on infrastructure may be helping to offset the expected reduction in Chinese demand.

Growth picking up

The good news had started in July, when it was announced that the IMACEC index (highly correlated with GDP, published monthly) showed a growth of 4.9% in June (best performance for June since 2012). GDP growth for the first semester was 4.8%. The low base of comparison helped, but still the numbers were considered a positive surprise.

Tax reform bill

Finally, in August the government unveiled its much-anticipated tax reform, eagerly awaited by the private sector. The plan will effectively reduce tax rates for corporations, and undo at least part of the reform passed during the previous administration, which was heavily criticized by the business community for raising taxes and making the system more confusing. The IMF, in a report released this week (9/20), praised the proposed new tax legislation and other reforms the new administration has been pushing. Moreover, the IMF increased its growth projection for the Chilean economy in 2018, from 3.4% to 4%, in line with what the central bank is currently forecasting (between 4% and 4.5%).

IV - New Zealand and Australia

New Zealand

GDP rose by 1% during Q2, the strongest quarterly growth rate in two years. Agriculture was the main contributor, expanding 4.1%. Exports were also strong, but investment disappointed. These numbers beat expectations and led to an appreciation of the currency.

Australia

Jobs growth in the economy's highest-paying sectors was 9% year-on-year in the three months to August, the highest since 2006. Unemployment currently stands at a six-year low. Additionally, the Commonwealth Bank of Australia (CBA) Business Sales indicator released in September showed that private sales, that is, spending, has now been growing for 26 consecutive months.

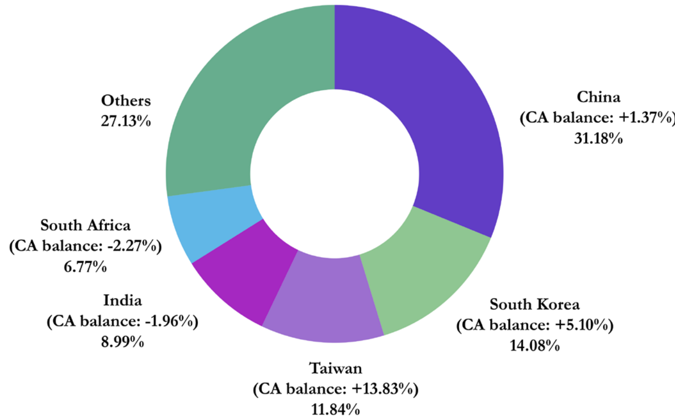
Conclusion

Despite the concerns brought about by the crises in Argentina and Turkey, recent data strongly support the thesis that many opportunities for investment still exist within the international space. Even more, within every region we can find economies whose perspectives going forward look very solid and strong, with great potential to continue growing. In our view, this represents an opportunity for investors who can distinguish between winners and losers in the international landscape, especially in light of the stark differences we see even at the regional level. It is also key to separate the causes behind a country's temporary underperformance: for example, short-term political uncertainty has to be dealt with very differently than deep macroeconomic imbalances. For those fearing contagion and a repeat of the Asian crisis of the late 1990s, they should realize how much stronger the financial systems of the region are now, and how much better their current-account balances are (see figure 2). In fact, the countries with the largest weights in the MSCI Emerging Market Index have solid current-account balances (measured as a percentage of GDP). A weighted average of current account balances across the countries in the index yields a surplus of more than 2.5% of GDP.

Figure 2

THE MOST IMPORTANT COUNTRIES IN THE MSCI EM INDEX HAVE CURRENT ACCOUNT SURPLUSES OR MANAGEABLE DEFICITS

Source: Innealta Capital using data from MSCI and from the IMF's World Economic Outlook (April 2018 report). Data for current account balances is as of the end of 2017.



We remain optimistic about the existence of targeted opportunities within the international space. We believe the data support the fact that there are localized investment opportunities in every region. Some countries have recently shown strong signs regarding variables like investment, job creation, or economic growth. The latter is inevitably tied to earnings in the long run, presenting investors with a vehicle to overperform.

Last revised: September 21st, 2018.

Important information

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The **MSCI Emerging Markets Index** *is designed to represent the performance of large- and mid-cap securities in 24 Emerging Markets. As of March 2018 it had more than 830 constituents and covered approximately 85% of the free float-adjusted market capitalization in each country.*

The **U.S. Dollar Index** *(USDX, DXY, DX) is a measure of the value of the U.S. dollar relative to the value of a basket of currencies of the majority of the U.S.'s most significant trading partners. This index is similar to other trade-weighted indexes, which also use the exchange rates from the same major currencies.*

IMACEC *(Índice Mensual de Actividad Económica or Monthly Index of Economic Activity) is a monthly indicator released by the Central Bank of Chile, which is highly correlated to GDP, covering more than 90% of the total activities included in the estimation of quarterly GDP. It is the best predictor of quarterly GDP estimates. The index compiles weighted information on production from all the sectors in the economy, and follows the same methodology of the National Accounting System.*

The U.S. Bureau of Economic Analysis defines the **current account** *as one that "records exports and imports of goods and services, receipts and payments of income on assets, and unilateral transfers (net gifts to other countries)."*

036-INN-9/25/2018