



EM Comeback

Why a little convergence in global growth could be good for Emerging Markets

MACRO & MARKET VIEWS

Rising US growth outperformance has been a key feature of the macro environment in recent months. We think this is now turning as US growth is likely to moderate from the strong pace in the second quarter and converge somewhat with the rest of the world. We think this convergence creates the potential for a comeback in emerging market (EM) assets. More broadly, we prefer equities over credit and credit over rates.

KEY TAKEAWAYS

1. US exceptionalism has peaked.

We think the period of diverging growth rates—driven by strong US outperformance—is largely behind us. US growth benefitted from strong support from fiscal policy in the second quarter, which is likely to fade over time.

2. Interest rates are likely to remain near current levels into year-end.

We expect US interest rates to continue climbing over the longer term, but we see few catalysts for another significant move higher this year. With inflation rising gradually and US growth likely to moderate, we expect the Federal Reserve (Fed) to raise rates twice more in 2018, consistent with market pricing.

3. A challenging investment environment, but fertile for an EM comeback.

Trade tensions, political developments and the potential for a moderation in US growth raise the risk of a temporary pullback in equities later this year. However, we think US growth will remain above trend and economic fundamentals in most EM countries remain healthy, creating fertile ground for a comeback in EM assets.

Market Views

We prefer equity over credit, and credit over rates as we think the economic expansion will continue. We prefer EM relative to DM.

Moderate but positive returns in equities. Equities remain our preferred asset class but after the rebound in the US and given the likely future appreciation of the euro, we are less bullish on DM compared to our Mid-Year Outlook. We expect returns to be supported by the continued economic expansion and decent earnings growth.

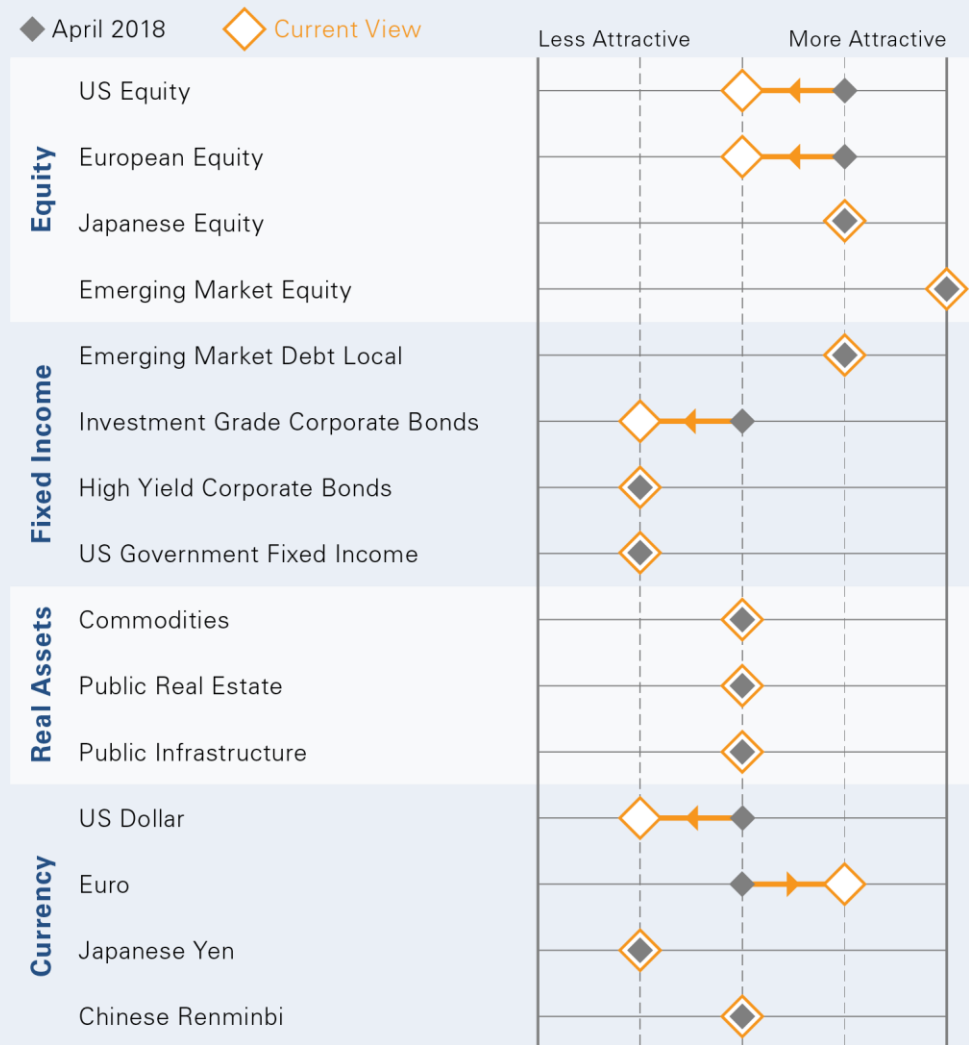
Bearish on government bonds. Strategically, we remain bearish on government bonds. We believe markets are underpricing the degree of Fed rate hikes over the next 12 months and more broadly underestimate the degree to which low bond yields have been driven by cyclical conditions rather than more secular forces. However, we think it will take time for the data to emerge to drive markets towards this view and more tactically we expect US 10 year yields to remain range-bound towards year-end.

Turning point in credit approaching. Given the positive backdrop from corporate fundamentals and the macro environment, we think it is too early to position for a significant widening in spreads. We are approaching the point in the economic cycle when credit spreads have historically started to turn but we think that is unlikely to be a 2018 event.

Range bound oil prices as base case. Escalating supply disruptions have increased the risk that oil prices spike significantly higher. However, our base case remains a more range bound environment (\$60-80/bbl for WTI) – OPEC supply cuts are likely to provide a floor for oil prices, while political pressure from consumer nations mitigates the probability of sustained move higher. In base metals, we are positive from these levels – Chinese policy support and global cyclical tailwinds should drive a rebound. In precious metals, we expect real rates and the USD to be the main drivers in the medium term.

US dollar strength likely to fade. We think the strength of the US dollar has been driven by growth divergence and as that turns we would expect the strength to start to fade. We are particularly bullish on EM currencies vs the dollar, given the substantial valuation gap that has reemerged after the EM sell-off.

Source: GSAM. As of September 2018



INVESTMENT THEMES

EM Comeback

We expect some moderation in US growth and continued consolidation in the long-end of US rates to be important aspects of the macro environment towards year-end. We think concerns about trade and EM contagion are overdone. We expect this macro environment to drive a comeback in EM assets after their recent underperformance.

From growth divergence since the spring...

In our mid-year Investment Outlook, we highlighted 1) upside risks to the US and Japanese growth outlook; 2) downside risks for Europe and China; and 3) reduced interest rate risk after the sharp rise in rates earlier in the year. Together we thought these developments created a better balance of risks. Since then, the S&P 500 reached a new high and the US printed a very strong 4.2% growth in the second quarter. At the same time, we have seen weaker data in Europe and in China which, together with trade tensions, renewed market concerns about the Chinese growth outlook. In EM outside of China, growth has been weaker than we expected which, in addition to several country-specific risks, has caused significant underperformance in EM assets against our expectations.

...to renewed growth convergence...

We now think this exceptional period of US outperformance is largely behind us. The US benefitted from strong fiscal policy support in the second quarter, which is likely to fade over time. Meanwhile, growth in Europe appears to be stabilising at a lower but more sustainable level than we saw late last year. The recovery in Japan, which had been more muted than we expected, is gradually continuing. In China, policy support has been firm in the face of weaker data and risks from trade, which we think will eventually generate a period of positive surprises. Outside of China, most EM countries have healthy economic fundamentals and should benefit from US growth. In our view, the weakness in EM assets reflects country-specific challenges rather than a broad EM crisis ([click here for more](#)), and the bigger picture is one of global growth converging at healthy levels after a period defined by US exceptionalism.

...and continued consolidation of long end US rates

In the spring, we thought interest rate risk would return later this year after a period of consolidation in long-term rates. However, that consolidation now looks likely to continue until around the turn of the year. The market is pricing approximately 45 basis points of additional Fed rate hikes in 2018, suggesting markets will not be surprised if the Fed delivers the two hikes we expect. At the same time, inflation has been slow to firm, with the acceleration in year-over-year numbers this year largely reflecting base effects. With gradual inflation and a likely moderation in US growth, we think the Fed will want to keep its options open by waiting—at least until the run-up to the December meeting—to signal a more aggressive pace of rate hikes in 2019. We see plenty of signs of firming inflation, but we think it will take time before inflation becomes strong enough to impact monetary policy more significantly.

A challenging investment landscape to navigate...

We think the investment environment will remain challenging to navigate and we continue to favor a dynamic approach to investment. Trade and geopolitics are likely to be a continued source of volatility, and moderation in US growth could well lead to a temporary sell-off in US equities. We also worry about Italy's budget negotiations and the outlook for Italian growth. Despite these challenges, we think continued economic expansion and decent earnings growth will leave developed market (DM) equities higher by year-end. That said, we are less bullish on DM equities than we were in our mid-year Investment Outlook as equities have recovered significantly. Also, while this update focuses on the rest of 2018, as we move into 2019 the risk to US growth becomes more nuanced as Fed policy continues to tighten while the impact of fiscal stimulus moderates further. This will be a key focus for our 2019 Investment Outlook.

...but fertile for an EM Comeback

We think the recent US economic outperformance, combined with softer growth in many other economies, has been an underappreciated factor behind asset performance in general in recent months and EM underperformance in particular. We therefore see the shift to convergence—with US growth moderating while other economies stabilize—as significant. We think EM assets will be the clearest beneficiary, supported by our view that market fears of trade tensions and EM contagion are likely to prove overdone. More generally, we would also expect the US dollar strength to start to fade.

Macro Outlook Summary

Growth

We expect the global economic expansion to continue, but importantly we think the period of strong US economic outperformance and the associated divergence in regional growth rates is now behind us and we expect renewed convergence. The trajectory for EM economies has been a particular concern for markets. We think the broad policy support in China may create a period of upside surprises. In EM outside of China, we believe the reversal of a number of idiosyncratic drags on growth together with the still early stage nature of the recovery in several EM economies could lift overall growth.

Inflation

We do not expect a rapid acceleration in developed-market inflation. In the US, the labor market is tight enough that we are likely to see a gradual firming of inflation. A faster rise has the potential to be disruptive but it is not our core scenario. In Europe, we expect inflation to be more muted and for any surprises to have relatively little market impact given the still large undershoot relative to target.

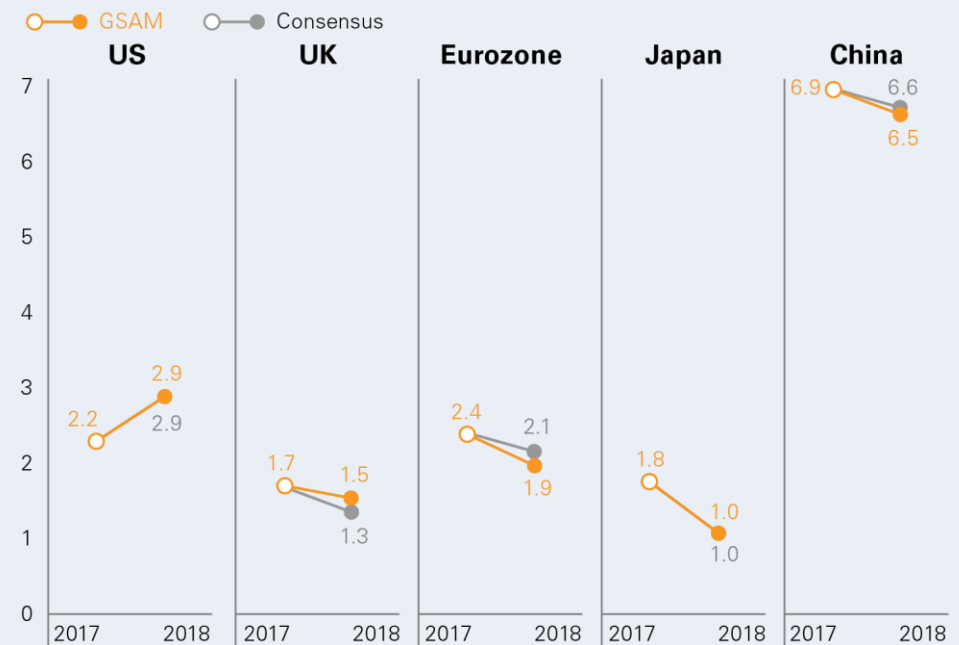
Monetary Policy

We expect the Fed to continue its quarterly hiking path for now. This is largely priced until the end of this year, and therefore we expect limited market impact in 2018. In Europe, we expect the first rate hike in the second half of 2019, most likely in the fourth quarter. In Japan, we think the current monetary policy stance will continue for the foreseeable future and that the debate in markets is overestimating the risk of a shift in policy.

Politics

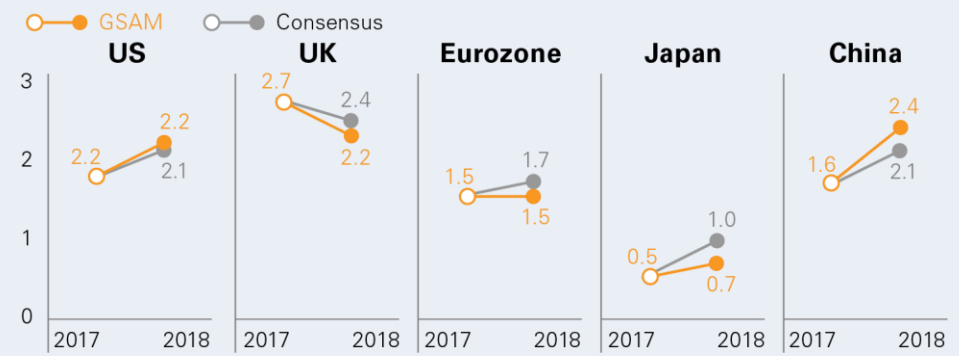
In our view, markets are overly worried about the economic impact of trade tensions and the potential for EM contagion. We think these concerns could fade this year, providing support for a comeback in EM assets. Geopolitical risks remain and domestic politics have also become more nuanced, with Italian budget negotiations and US mid-term elections providing potential catalysts for a pick-up in volatility.

Growth Forecast



Source: GSAM, Bloomberg. As of November 2017

Inflation Forecast



Source: GSAM, Bloomberg. As of November 2017

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