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November 2020

MONTHLY AGENDA - THE EMERGING RECOVERY GETS A TICK

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Emerging from the crisis

The uncertainty of the US election has now faded; the narrative around an effective vaccine has turned more positive allowing thoughts to turn to re-opening strategies; and fiscal and monetary policy are still very supportive. The stars are aligned for a strong, synchronised, cyclical rebound in the global economy next year.

We believe emerging markets offer attractive risk-adjusted returns in this environment, particularly those that sit in the Asia region.

Synchronised recoveries are rare

Synchronised growth recoveries are not only rare they are particularly supportive for emerging markets.

Synchronous growth creates a positive feedback loop for emerging economies. With developed markets accounting for 60% of emerging-market exports, as import growth accelerates in the former, exports rise in the latter boosting income which in turn supports domestic consumption.

The last time we experienced a synchronised global recovery was in 2009. Stimulus following the Global Financial Crisis (GFC) boosted domestic demand in the major economies and created a boom in global trade.

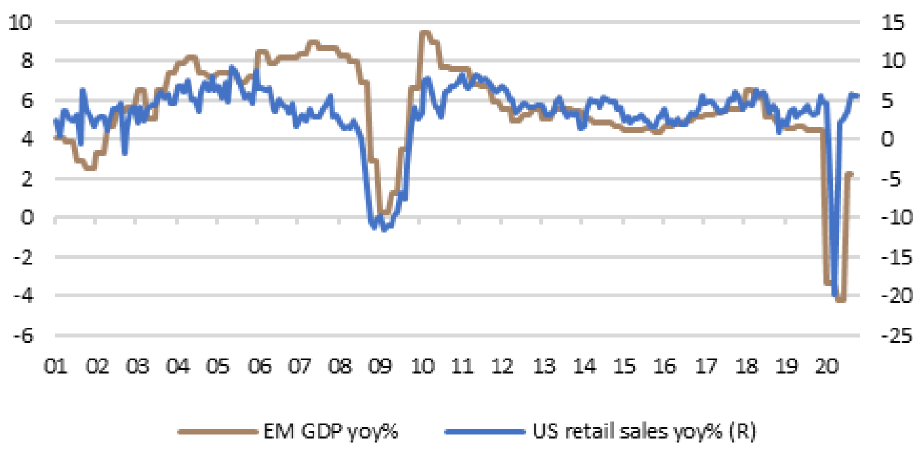
From the bottom in March 2009, the MSCI Emerging Markets Index rose 153% over a two-year period. This easily exceeded the MSCI World Index which rose 97% over the same period.

We expect this outperformance to once again be the case for three reasons.

First, another US fiscal stimulus package (the fourth) is expected to be released in early 2021. That, combined with considerable pent-up demand in the form of savings rates that are double normal levels, will boost US consumption activity. The availability of multiple vaccines will help unleash this pent-up demand and accelerate a return to normal for U.S. consumers.

As the chart below shows, emerging market growth tends to follow US consumer activity closely via the trade link.

Chart 1: Emerging market growth follows the US consumer



Source: Bloomberg

Second, Joe Biden is President-elect. His victory is seen as positive for emerging markets. With Biden there is the promise of a return to a rule-based world, which means fundamentals may start to reassert. It could also mean the U.S. will be more considered in its dealings with the EU and NAFTA, and become less hostile toward China.

Third, a subsidence of trade tensions and a recovery in global growth may lead to a weaker US dollar. A weaker US dollar has traditionally been positive for emerging markets given the fact that large amounts of their debt is denominated in US dollars. Weaker emerging market currencies push up debt/GDP ratios and reduce borrowers' ability to pay US dollar debt. That's especially dangerous for fragile, high-inflation economies like Argentina and Turkey.

Why Asian emerging markets?

The global recovery after the GFC was led by the emerging markets known as the BRIC economies – Brazil, Russia, India and China. This time around, we believe it will be the TICK economies that lead us out – Taiwan, India, China and Korea. These economies will likely benefit the most from a global re-opening next year having greater economic, financial and political stability than their peers.

In the scorecard below, we measure economic stability by comparing economic growth expectations for 2021. We measure financial stability by looking at the fiscal and current account balances of each economy and we proxy political stability by looking at the performance of the respective currencies over the past 12 months.

What is notable is the number of Asia economies at the top of the table.

China and Taiwan both rate highly with balance-sheet strength, solid economic fundamentals and political stability. South Korea is next, reflecting a productive and innovative economy, a stable political climate and a robust balance sheet.

India scores well on the basis of its growth outlook but a deterioration in its fiscal balance due to sizeable COVID-stimulus weights on its overall score.

Chart 2: Emerging market scorecard

	Score	Fiscal Deficit (% GDP)	Current Account Deficit (% GDP)	2021 Economic Growth (%)	Currency Change (last 12mths %)
Taiwan		-2.1%	10.5%	3.3%	6.6%
China		-2.8%	0.7%	8.2%	5.8%
Philippines		-4.7%	-0.7%	7.0%	5.0%
Korea		-4.3%	3.7%	2.6%	3.8%
Thailand		-4.8%	5.6%	4.5%	0.1%
Malaysia		-4.8%	1.9%	7.0%	0.7%
Poland		-7.6%	2.6%	4.7%	1.8%
Indonesia		-4.7%	-2.1%	5.6%	-0.3%
Chile		-3.8%	-2.1%	6.0%	-1.8%
Peru		-4.5%	-0.6%	10.1%	-7.6%
India		-7.9%	-0.3%	8.9%	-3.9%
Saudi Arabia		-7.3%	-1.0%	3.8%	0.0%
Mexico		-2.6%	0.4%	4.1%	-6.5%
Egypt		-6.8%	-3.7%	4.6%	-3.0%
Russia		1.2%	2.5%	3.5%	-16.6%
Colombia		-5.8%	-2.8%	3.5%	-8.8%
South Africa		-13.9%	-0.9%	2.2%	-5.5%
Brazil		-8.5%	-0.9%	3.5%	-22.7%
Turkey		-4.8%	-2.8%	4.5%	-29.3%

Source: Bloomberg, Escala

Turkey, Brazil and South Africa are at the bottom of the ladder driven largely by poor institutional robustness, an unstable political structure, and weak balance sheets.

The Turkish lira has been the worst performing emerging market currency this year as foreign capital has flowed out of the economy in response to poor macroeconomic management and political instability. The Turkish Government has attempted to support the currency by spending some of its foreign exchange reserves.

Foreign exchange can act as a cushion for those emerging markets that rely of foreign capital inflows to drive growth. It can be used by governments as back-up funds in the event of foreign capital flight. Such was the case during the Asian

Financial Crisis in 1997. Since then, most Asian economies maintain large foreign exchange reserves as part of their risk management strategy.

Taiwan

Taiwan in known for its manufacture of semiconductors and is home to Taiwan Semiconductor Manufacturing Company (TSMC), the world's largest manufacturer of semiconductors. Tailwinds present before COVID, fuelled by the transition to 5G, data centre expansion, and high-powered computing, have become gale force post-COVID.

From a macroeconomic standpoint, Taiwan is well positioned. Taiwan's September quarter GDP report came in stronger than expected with a significant rebound in domestic consumption. This was supported by stabilizing consumer sentiment upon successful COVID-19 containment, an improving labour market and government measures to boost consumer spending and domestic tourism. Taiwan's industrial production topped expectations in September, led by broad-based gains across machinery and equipment, base metals, and chemical material production. The total value of factory output reached an all-time high.

Consistent with this, Taiwan's export orders are booming with August data registering the highest increase since January 2018. Orders from the U.S., China and Europe all recorded double-digit growth.

India

India's daily COVID case numbers peaked in the middle of September and have since been on a downward trajectory. Coordination between the central and state governments on COVID, and fairly successful policy responses in areas such as contact tracing and production of protective clothing for medical staff, suggest India has the technical capability to lift lockdowns and keep them lifted in large areas where the pandemic is not especially severe.

India's COVID stimulus of INR20 trillion (about 10% of GDP) was large and highly targeted with liquidity injections, cash transfers to migrant workers and loans to small business. This has been followed by reforms such as expanding the small firms umbrella and a suspension of duties and taxes on exports to offset infrastructure inefficiencies.

India's industrial production growth turned positive in September for the first time in seven months, aided by the further easing of lockdown measures and low inventory levels.

The government has announced fresh policy measures to support the economy - largely focused on the manufacturing sector. Together with previous structural reforms, the new policy measures should encourage increased investment in the manufacturing sector and point to a sustainable recovery over the medium-term.

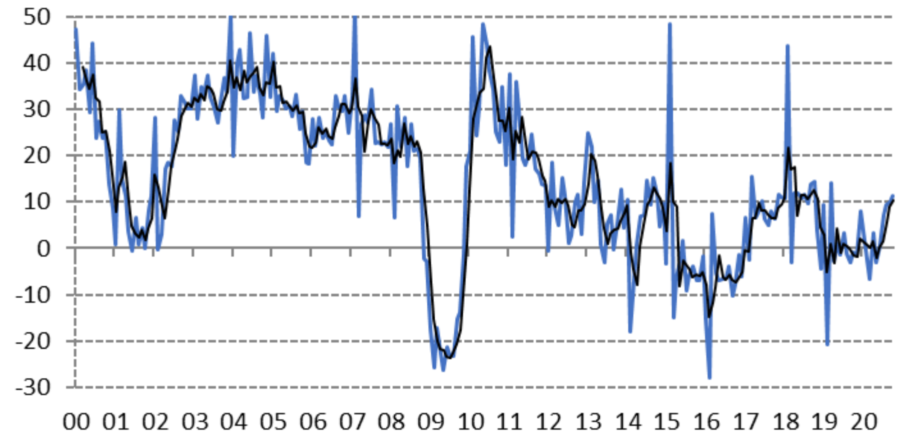
China

China' exports are surging, so much so that freight congestion is building. China Railway Express reported for the ten months to October cargo volume from China to Europe jumped 50% from a year ago. More than 10,000 freight trains have made the China-to-Europe run, an 80% increase from a year earlier. Capacity is now running above 98%.

Overall, Chinese exports are growing at the fastest pace since March 2019. Exports to major trading partners, including the United States, the European Union and the rest of Asia, all grew strongly. Meanwhile shipments of medical goods and electronic goods continue to power the Chinese economy.

Despite the escalating trade tensions, Chinese exports to Australia rose 16.6% from a year earlier, while imports from Australia rose 6.6%.

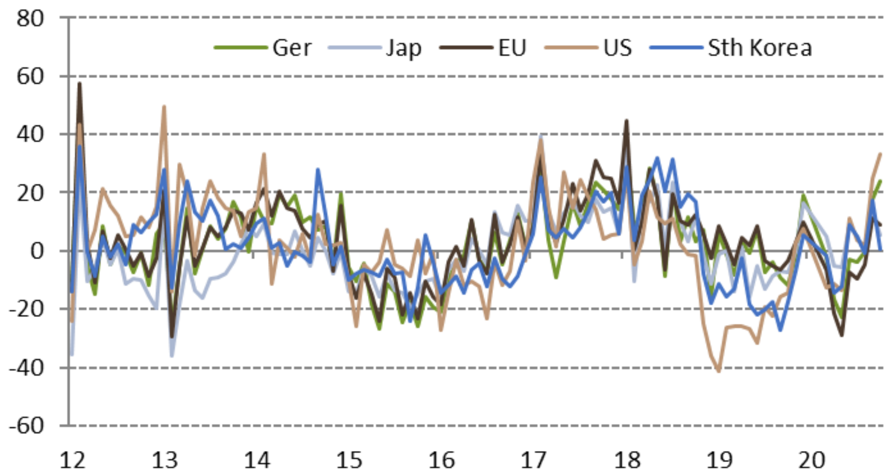
Chart 3: Chinese exports (yoy%)



Source: Bloomberg

Chinese consumer demand now appears to have recovered from the hit it took during the pandemic. This is reflected in the strength in imports from its major trading partners. Imports from Germany are growing at their fastest pace since April 2018 while imports from the US are the highest since February 2017.

Chart 4: Chinese import partners (yoy%)



Source: Bloomberg

Reflecting the strength in the Chinese economy, commodity prices are rising. Iron ore prices are up 31% year-to-date for example.

Geopolitical risks are a more potent headwind for China. Regulatory and legislative actions aimed at China's internet companies in the U.S. and India remain.

Korea

Being one of just a handful of countries that managed to escape the coronavirus carnage, South Korea is heading into next year in better shape than most. A strong public health response and aggressive stimulus have helped limit the economic damage from the crisis.

The rebound in 3Q GDP was driven by a 15.6% quarterly surge in exports as the easing of global lockdowns helped to release pent-up demand. The data so far suggest the recovery in external demand is continuing into the fourth quarter, led by sustained strength in semiconductor shipments - underscoring the importance of the tech sector in driving the rebound in the Asia region. The broadening recovery in China to include consumption - the destination of about a quarter of South Korea's overseas sales - should also lend continued support to exports.

South Korea's makers of electric-car batteries, solar panels, wind power plants and hydrogen fuel-cell vehicles will also likely benefit from having Joe Biden in the White House given his $2 trillion green plan.

Regional trade boost

Following the recent signing of the worlds' largest trade deal, the Regional Comprehensive Economic Partnership (RCEP), we expect to see the rise of regional economic centres, where supply-chains get re-distributed and growing demand from large economies like China or India fuels growth in other developing countries nearby.

Supply-chains have been significantly disrupted already over the past couple of years. Two years ago, for example, 80% of Christmas tree lights sold in the US came from China. In the first 10 months of 2020, just 25% came from China as the trade war took effect. Vietnam was a beneficiary taking up a 44% share this year while the Philippines took 16%.

Put this together with strong domestic consumption driven by a rising middle class and the tilt towards growth industries, and we can see a compelling case for exposure to Asian emerging market economies.

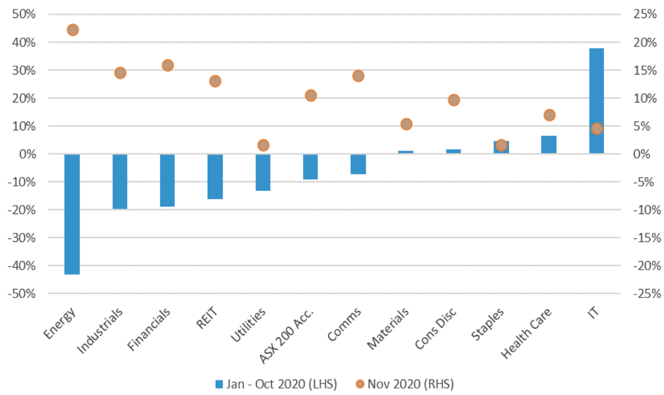
The importance of being active

While the case for emerging markets for investors seeking growth and diversification is strong currently, being discerning is critical. Passive funds that track industry benchmarks contain a significant amount of unrewarded risk.

The recent crisis highlights the importance of investing in high-quality names, that are located in countries with sound balance sheets, and stable political and economic structures.

Active management and an awareness corporate governance is paramount to guarding against fraud, false information disclosure, malicious transfer of assets, misappropriation of funds and other illegal activities that tend to be more evident in emerging markets than in other jurisdictions.

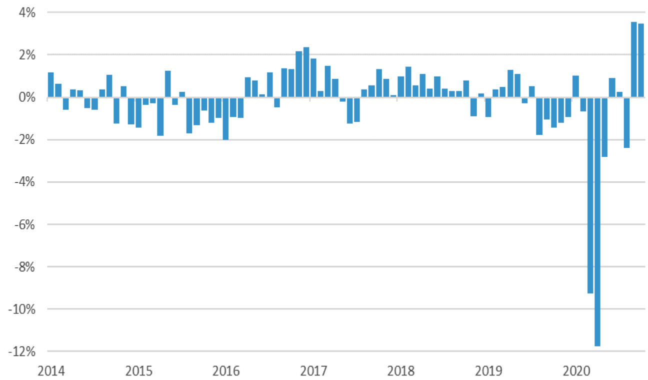
Chart 5: ASX 200 sector performance



Source: IRESS

The ASX 200 Accumulation Index has gained more than 10% in the first three weeks of November, turning around the poor performance of the second half of October. While greater certainty has followed the US election, positive developments on the vaccine front has seen a sharp jump in share prices across the board. The sectors leading the way this month are generally those that had performed poorly in the first ten months of the year, with many of these more heavily impacted by COVID-related restrictions. The energy sector has recorded the strongest performance this month, up more than 20%, while the IT sector is up just 5%.

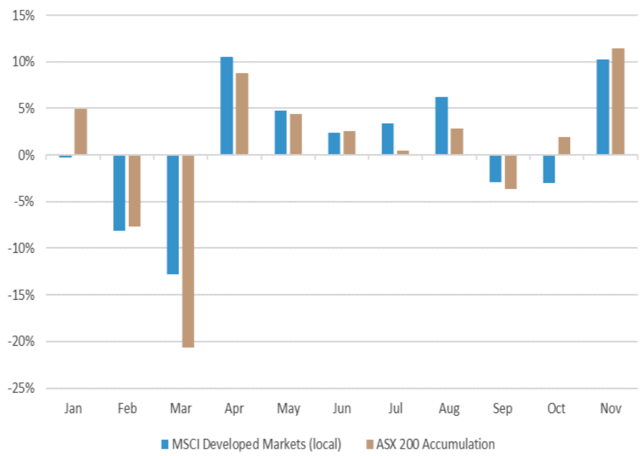
Chart 6: ASX 200 monthly EPS revisions turn positive



Source: Bloomberg

With a supportive backdrop of fiscal stimulus, easing monetary policy and falling COVID cases, the ASX 200 recorded another solid month of positive earnings revisions in October. Forward earnings were upgraded by 3.5% for a second successive month, with the last two months the strongest in several years.

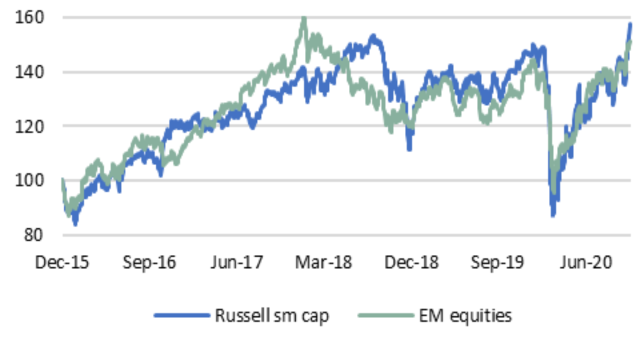
Chart 7: Australian equities start to outperform
(monthly % change)



Source: Bloomberg

The improved earnings environment has also translated into better relative performance for the Australian equity market. In the seven-month period from the beginning of March, the ASX 200 Accumulation Index lagged developed markets in all but one month. However, this turned in October, with the ASX 200 outperforming by 5% for the month, while the domestic market has also generated stronger returns in the early part of November.

Chart 8: Emerging markets and small caps
(Index: 31/12/15=100)



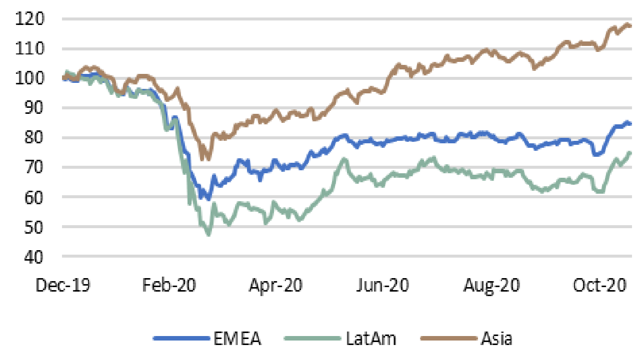
Source: Bloomberg

Small cap companies managed to extend their rally this month, hitting all-time highs. That bodes well for emerging market assets, given the small-cap gauge has moved closely with the MSCI Emerging Market Index.

Granted, surging virus counts in the U.S. and elsewhere and more lockdowns could leave investors jittery. However, Treasury yields also moved lower in reflection of Fed Chair Powell's hint that the Fed will stick to its guns on stimulus and keep a lid on bond yields.

Combined with the retreat in the US dollar, that's a setup that can help shore up sentiment for emerging markets.

Chart 9: Emerging market region – Asia shines
(Index 31/12/19=100)



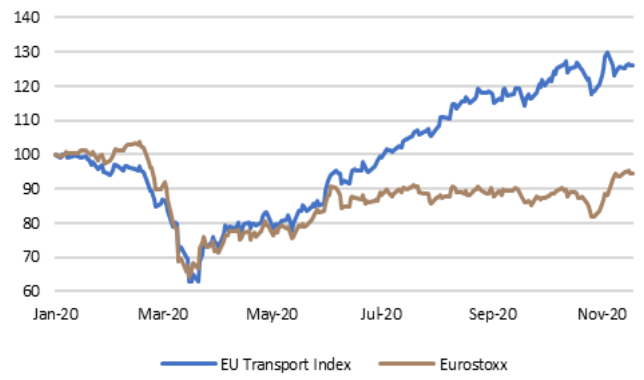
Source: Bloomberg

Finding a vaccine is one thing. The ability to distribute it efficiently and fund it easily is another.

Asia has already shown it has the capacity to curb the spread of the virus. Debt-to-GDP levels for 2021 in Asian countries such as China and Indonesia are projected to be lower than their peers in the developing world, based on projections by Moody's Investors Service. India is an exception in the region.

Meanwhile, Brazil and Colombia in Latin America will still be in a challenging situation as they are already hampered by relatively higher debt-to GDP ratios.

Chart 10: EU freight operators profit from Silk Road
(Index 01/03/20 = 100)



Source: Bloomberg

The New Silk Road that would link seaborne and rail freight routes from China to Europe is facing severe congestion as China replaces the U.S. as the EU's top trading partner. From January to July, EU imports from China increased 5% while imports from the U.S. dropped 12%, according to data from Eurostat.

As a result, Chinese companies are literally detouring around the high cost of using ships and aircraft. Instead they're turning to trains and European freight and logistics operators to move their products to the EU.

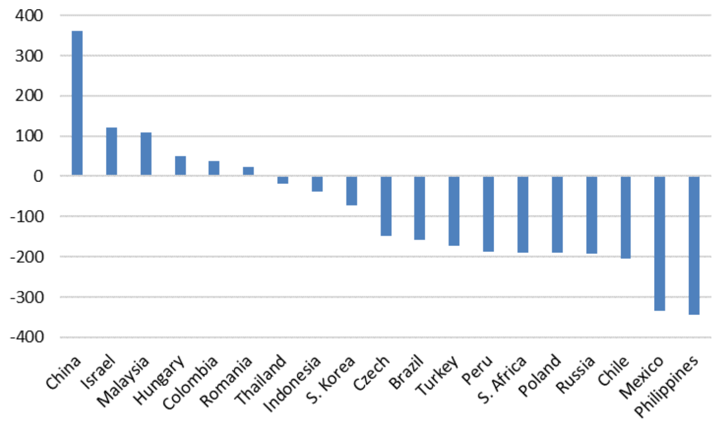
Chart 11: US yield curve steepening

Source: Bloomberg

While Covid-19 continues to spread across the US, neither the stock market nor the yield curve are signalling a material slowdown. Cyclical stocks continue to outperform defensive sectors. The yield curve is comfortably positively slopped.

Both reflect the optimism towards vaccines and belief that any near-term downside risks will be offset by renewed monetary and fiscal support.

Chart 12: **Change in 2-year teal yields (bpts)**

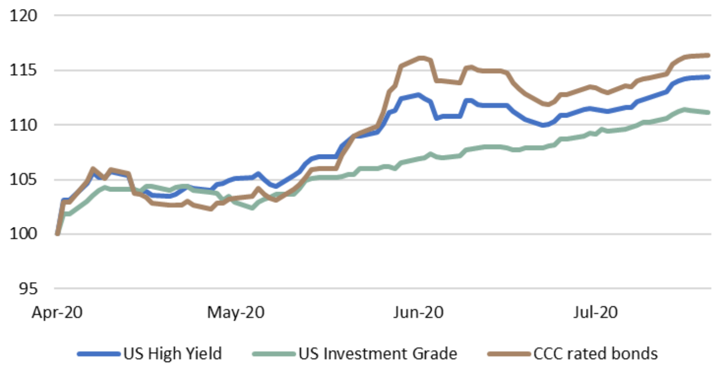


Source: Bloomberg

Over the past year, two-year real yields have fallen in 13 of 19 emerging markets, with the Philippines (down 344 bps) and Mexico (down 333 bps) exhibiting the fastest pace of decline. By comparison, just six economies have seen two-year real yields rise over the past year, with China (up 362 bps) witnessing the greatest increase among EM peers.

More than developed markets, emerging markets have been relying on monetary policy to stimulate growth. Of the 247 rate cuts this year, just 17 came from developed market central banks.

Chart 13: US credit rally lead by CCC rated bonds
(Index: 04/08/20=100)



Source: Bloomberg

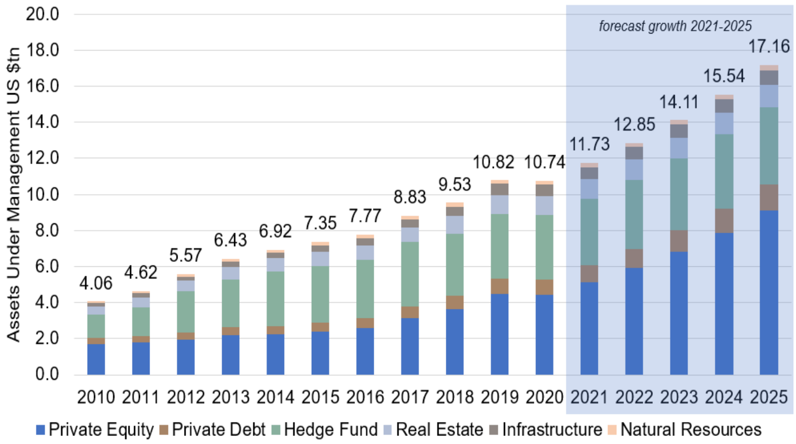
The rally in US credit markets has been led by the lowest rated (CCC) bonds. This reflects the decision by the US Federal Reserve to purchase lower grade bonds as part of its quantitative easing program.

In a rare public disagreement, U.S. Treasury Secretary Mnuchin requested that emergency Fed stimulus programs be allowed to expire as scheduled on Dec. 31. Fed Chair Powell immediately objected to the instruction.

Market participants had expected another extension given the economic impact of a recent surge in COVID-19 cases. The measures had helped everything from junk to high-grade debt rally since the spring, reversing one of the worst sell-offs since the GFC.

Alternatives

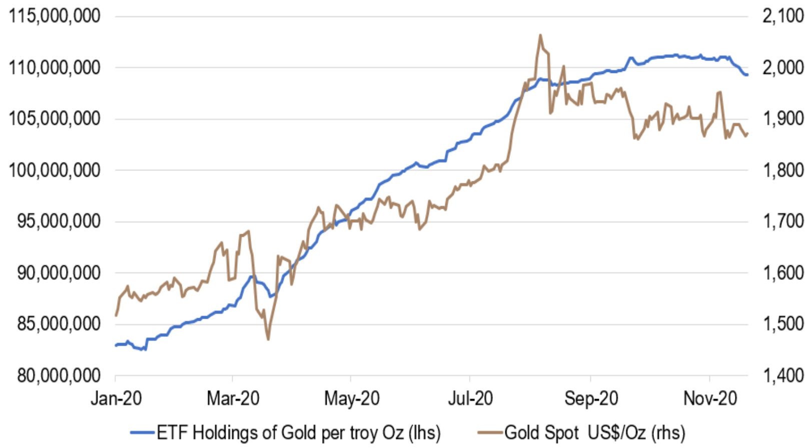
Chart 14: Alternatives forecast to grow 60% through 2025



Source: Preqin

Alternatives total asset under management are forecast to grow by 60%, or 9.8% annualised equivalent rate, taking total assets to US$17.16tn by 2025. Private equity and private debt are expected to see the biggest increase in assets with growth rates of 15.6%p.a. and 11.4%p.a. respectively. As investors increasingly look beyond public markets for attractive returns private equity's total share of alternatives is expected to grow from 41% currently to 53% in 2025. Asia-Pacific is expected to see the bulk of private market growth given the lower current penetration and higher forecasted GDP growth for the region attracting more private market managers to the region.

Chart 15: Year to date rally in gold stalls



Source: Bloomberg

Positive developments on numerous COVID-19 vaccines along with short-term delays to future rounds of fiscal stimulus has stalled the strong year to date run in gold as investors look to lock in profits on spot prices that are up 23% year to date. The pace of inflows into gold ETFs has also levelled off in recent weeks following a 37% increase in allocations to gold ETFs this year. Investors in the yellow metal will be looking for any further weakness in the USD and clarity around timing and size of fiscal stimulus packages to act as support for spot prices in the near term. Citi have a 2021 base case price target of $2,100 whilst the bull case price target is $2,325.

Chart 16: Retail A-REIT gains on vaccine news

Source: Bloomberg

The shift away from bricks and mortar retail to online ecommerce has seen demand for warehouses and distribution centres increase significantly, the ASX 300 Industrial A-REIT Index is up 35% year to date on the back of this trend. On the other hand, it is no surprise to see the ASX 300 Retail A-REIT has been one of the worst performing sectors of the Australian market with the index down 54% at its lowest point in March. The recent positive news on the vaccine front has however provided a relief rally for cyclically exposed sectors with the Retail A-REIT Index and Office A-REIT Index up 25% and 13% respectively since the beginning of November.

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