LOM OFFSHORE FINANCIAL SERVICES

Monthly Global Market Commentary
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While the Fed Fumbles, Look at Emerging Markets
By Bryan Dooley

Despite market turbulence, the Fed decided to go ahead with the fourth rate hike of the year, while reducing expectations for next year to two hikes. All risky assets prices declined after the rate decision, as investors fear that higher interest rate will be a burden to economic growth. As the Fed contemplates its new reality and U.S. markets struggle to regain balance, we think Emerging Markets are worth a look at these levels.

It seems fitting that 2018 was the year of the Dog in the Chinese Zodiac. Most asset classes fared poorly this year as investors hit the panic button, but the pain has been particularly acute in the emerging market (EM) sector. Notwithstanding a few weeks of recent relative outperformance, EM's as a whole have dramatically underperformed the broader averages this year. For example, while the S&P 500 stock index has declined by 8% year-to-date, the MSCI emerging market stock index is down 15.6%, representing underperformance of 7.6% as of this writing.

To a large extent, 2018 has been a perfect storm against the EM's. The strengthening greenback, rising trade war tensions, geopolitical upheaval and collapsing oil prices have been major headwinds. China, by far the largest of the EM countries, has lately been the whipping boy of American politicians and the clear target of Trump's aggressive trade negotiations. Looming uncertainties over trade policies and growth have curtailed business investment creating poor sentiment for investors. Also, China and the other EM's are experiencing slower rates of GDP growth than they have enjoyed in the past.

Despite modestly decelerating growth in the world's second largest economy, economists expect China's gross domestic product (GDP) to advance at a rate of about 6.6% in 2018 and 6.2% in 2019, more than double the rate expected for the developed world as a whole using Bloomberg consensus data. Next year, aggregate emerging market GDP is expected to advance at a rate of 4.7%, compared to 2.1% for developed countries, as forecasted by the International Monetary Fund (IMF).

Beyond the raw GDP growth statistics, people in the EM countries are getting richer and the trend towards a rising middle class continues to provide a unique investment opportunity. According to the IMF, emerging markets are expected to represent 58% of the world's middle-class population by 2030, up from just 27% in 2009. China and India's middle class are expected to reach nearly 800 million people and will eventually represent two of the top three largest middle-class populations in the world by 2020. A growing middle class typically helps fuel economic growth. For example, on November 11, online sales during China's Singles Day totaled $42.4 billion, a 27% increase over last year. Consumer spending in areas such as clothing, electronics, entertainment are a good indication of where the economy is heading.

Front and center in the debate over EM's attractiveness is an apparent push away from globalization and towards greater nationalism, at least with respect to the U.S. Underscoring Trump's trade war is his commitment to bringing manufacturing back to America and away from the many countries which have greatly benefitted from outsourced American production over the few past decades.

A central question for the future, may be: Can the EM's prosper on their own? Indeed, China's Belt and Road initiative appears to have the country heading in this direction. China has spent over $4 trillion in building out its global infrastructure across 60 different countries as a means for distributing its products globally, and P.S.: America is not one of these destinations.
Looking at the EM's stock markets as a group, the median price-earnings (P/E) ratio on forward earnings is approximately 11.5 times. This ratio compares to approximately 16.5 times for the U.S. S&P 500 index. Trading at a thirty percent discount to the S&P, EM's are currently priced at relatively cheap levels. EM's have historically traded below U.S. P/E ratios but the current discount represents a discount of about ten percent discount to the median over the past decade.

One issue holding back Chinese shares has likely been inconsistent profit performance. Chinese corporate earnings experienced almost no growth between 2012 and 2016. However, earnings did begin to ramp up in 2017 and have remained solid throughout 2018. Corporate earnings are expected to accelerate from 13.4% growth this year to 14.2% in 2019 according to MSCI data and some analysts believe drivers of that growth still have a long way to run. China has many levers to pull in the direction of stimulating their economy and companies able to tap into the growing consumer spending that accompanies rising incomes have the most to gain.

Of course, a major area of concern is the final outcome of the ongoing trade war between the U.S. and China. Investors are wary of the recent U.S.-China trade truce outlined at the G-20 meeting in Argentina for several reasons, including a lack of apparent agreement on details and a new hardline U.S. negotiator.

However, there is reason to believe we get a workable deal in the near future. As long-time investment strategist and Blackstone Group Vice Chairman, Byron Wein, pointed out in a recent CNBC interview: “China and the U.S. both need a deal.. and when both sides of a negotiation come to the table looking for a positive outcome, you usually get one.” Personally, I believe President Trump is first and foremost a dealmaker who desperately needs an agreement to bolster his increasingly tenuous grip on Washington and to have a shot at a second presidential term.

Some of the more constructive commentary from both China and the White House in recent days may be pointing in this direction. China is already talking about reducing its U.S. automobile import tariffs, cracking down on intellectual property theft and is already buying U.S. agricultural products once again.

In any event, China has an agenda which will not be as export dependent in the future. Selling to the country’s own middle class while economically annexing neighboring countries looks to be their longer-term strategy. Clearly, exports have become a much smaller part of the country’s GDP growth. Over 70% of China’s GDP growth for the first three quarters of this year came from consumption rather than exports or government spending as they have in the past.

Meanwhile, retail sales in India are expected to almost double from $600 billion to $1 trillion by 2020. The rise may be driven by improving incomes, digital innovation and mobile wallets in the e-commerce sector. Likewise, Brazil’s economic outlook has been improving since its October presidential election.

Emerging markets selectively offer value at these levels and as an asset class have historically been a good portfolio diversifier. However, investors must be willing to accept a higher-than-average degree of volatility as geopolitical uncertainties are likely to persist.

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Stock Market Performance

	12/24/18	W-o-W	M-o-M	Y-o-Y
DJIA	22,282	-5.6%	-8.3%	-10.0%
S&P 500	2,417	-5.1%	-8.2%	-9.9%
MSCI World	1,835	-4.1%	-7.1%	-12.6%
S&P/TSX	13,935	-3.0%	-7.2%	-13.8%
BSX	1,940	-6.6%	-14.8%	-12.0%
FTSE100	6,686	-1.3%	-3.8%	-11.9%
DAX	10,634	-1.3%	-5.0%	-18.7%
CAC	4,626	-3.6%	-6.5%	-13.8%
Nikkei	20,166	-6.2%	-6.8%	-11.9%
Hang Seng	25,651	-1.7%	-1.1%	-13.3%
Shanghai	2,527	-2.7%	-2.0%	-23.4%

Key Rates and Prices

Currencies	12/24/18	Month ago	Year ago
EUR	$1.14	$1.13	$1.19
GBP	$1.27	$1.28	$1.34
JPY	¥110.52	¥112.96	¥113.29
CAD	$0.74	$0.76	$0.79
CHF	$1.01	$1.00	$1.01
AUD	$0.71	$0.72	$0.77
Fixed Income			
3M LIBOR	2.82	2.69	1.69
3M Treasury Bill	2.39	2.40	1.33
2Yr Treasury Note	2.62	2.81	1.89
10Yr Treasury Note	2.77	3.04	2.48
Fed Funds Rate	2.50	2.25	1.50
Commodities			
Gold/oz.	1,264.68	1,223.19	1,275.25
Silver/oz.	14.70	14.28	16.39
Copper/lb.	2.72	2.82	3.23
Oil	44.94	50.42	58.47

Global Economic Calendar (December 24th — December 28th)

Mon: Chicago Fed National Activity Index (US)
Tues: HOLIDAY
Wed: Redbook (US); Industrial Profits (CN); S&P Corelogic Case-Shiller HPI (US)
Thurs: Jobless Claims (US); Money Supply (US); New Home Sales (US); Farm Prices (US); Unemployment Rate (JP)
Fri: Baker-Huges Rig Count (US); EIA Petroleum Status Report (US); EIA Natural Gas Report (US)