MORNING BRIEFING
October 24, 2018

Geopolitics Matters

See the collection of the individual charts linked below.

(1) Panic Attack #62 isn't over just yet. (2) October has been a spooky month for stocks around the world, even in the US. (3) More geopolitical worries than usual unnerve investors. (4) Quadruple whammy for emerging markets: interest rates, the dollar, oil prices, and trade war. (5) Halloween and the mid-term elections will come and go. (6) Stocks are cheap in the US if economy continues to grow. (7) IMF report about global financial stability finds that current emerging markets crisis is relatively contained. (8) Our net capital flows proxy remains bullish for the dollar. (9) IMF sees relatively stable banking systems around the world. (10) Fed Chairman Powell says he isn't worrying about emerging market economies.

Global Stocks: Coupling. Since early February through late September, US stocks were on a tear, while stocks overseas were mostly stumbling (*Fig. 1*). US stocks decoupled from the rest of the world, supporting our preference for a Stay Home investment posture over the Go Global alternative.

So far this month, the US has coupled with the bearish sentiment overseas. In the past, I've observed that during bull markets, especially the latest one, geopolitical crises rarely matter. Instead, they create buying opportunities. However, this year, geopolitical issues have increasingly come to the fore as a concern for global stock investors.

US investors have been insulated by the strength of the US economy. The Trump tax cuts at the end of last year certainly helped to decouple the US from the rest of the world. However, the outperformance of the US economy pushed US interest rates higher and caused the dollar to soar. Both developments hurt emerging market economies, as we've discussed before and do further below.

In addition, Trump's sanctions on Iran boosted oil prices, which also are weighing on emerging market economies. In recent days, the outlook for oil prices has been complicated by the crisis over Saudi Arabia on mounting evidence that Crown Prince Mohammad bin Salman may have ordered the murder of a reporter.

Also complicating the geopolitical scene and weighing on global growth is Trump's escalating trade war with China. In the European Union (EU), Italy's new government is pushing for a budget that violates EU rules, and Brexit negotiations are going nowhere.

In the US, S&P 500 stocks have been hit hard this month, with downspins led by the cyclical ones that are most exposed to the global economy and geopolitical risk (*Fig. 2*). The 4% y/y increase in the trade-weighted dollar is another negative for these companies. Cyclical stocks of companies that do most of their business in the US, particularly those in housing-related businesses, have been getting hammered by rising interest rates as well.

An unnerving recent development is the caravan of illegal wannabe immigrants streaming through Mexico toward the US border. The issues raised could certainly impact the midterm congressional elections in the US—yet another source of uncertainty. Future political developments in some emerging economies—particularly Brazil, as we discussed last week—are also uncertain.

We know with certainty that Halloween is coming on October 31. The US midterm elections will be settled a few days later on November 6. The Fed may have to hold off on another rate hike in December if more signs of economic weakness emerge, as suggested by the cyclical stocks. In any event, S&P 500 revenues and earnings should continue to grow along with the economy next year, albeit at slower rates than this year.

Valuation multiples have dropped sharply this month, making stocks attractive. Joe and I still believe that October's selloff is Panic Attack #62 rather than the beginning of a bear market; we believe that the bull market will continue into next year. The next relief rally should be triggered by continued signs of economic growth combined with subdued inflation. That might provide some relief on the interest-rate outlook. There might be less relief in geopolitical tensions, especially between China and the US for the foreseeable future. Can't have everything.

Emerging Markets I: Capital Outflows. In its just-released October *Global Financial Stability Report* (*GFSR*), the International Monetary Fund (IMF) warned that a confluence of factors has started to drive capital out of emerging markets: the stronger dollar, tighter financial conditions, trade tensions, and political risks. Could these net capital outflows worsen and trigger a full-blown emerging market crisis?

They could worsen, Melissa and I believe after reviewing the 81-page report; however, we don't anticipate a widespread crisis among emerging market economies as a result. Rather, there could be country-specific problems that are exacerbated if interest rates continue to rise and the US dollar strengthens some more, as seem likely.

So our advice is: Be wary of emerging markets as a broad asset class, but don't count them all as equal. Pockets of opportunity may be found in countries that have demonstrated increased financial resilience since the 2008 crisis and relative political and policy stability.

Before reviewing the IMF's worry list for emerging markets, let's review recent related developments:

(1) *Flows have turned negative*. Foreign portfolio flows (i.e., net nonresident purchases of emerging market stocks and bonds) turned negative in mid-April. (See the *GFSR* Figure 1.10, panel 1.) Emerging market stock and bond mutual funds had experienced strong inflows in 2017 and early 2018. Since then, about $35 billion has poured out of these funds, according to the *GFSR*.

Yet the outflows from emerging market investment funds so far have not been as severe as in past emerging market crises. Previous episodes, such as the 2013 taper tantrum and the 2015 China devaluation, resulted in about $60 billion in outflows each, measured from peak to trough. However, the *GFSR* stated: "In the event of a sharp deterioration in global risk sentiment, portfolio outflows could intensify." Nevertheless, "overall vulnerabilities in emerging market economies remain moderate compared with historical levels," the report said.

(2) *The drivers are region-specific.* The IMF report noted that, so far, the spillovers across emerging markets have been "relatively contained and idiosyncratic factors explained much of the outsized asset price moves." The initial pressure was seen across countries with "large external vulnerabilities" and "weaknesses in policy frameworks," such as Argentina and Turkey. As the US dollar gained strength and US long-term yields rose, those countries experienced sharper currency depreciation and widening of external credit spreads than their peers.

Market selling pressures then shifted mostly to Asian emerging market equities amid heightened trade tensions. During August, homegrown political risks drove selling pressure in select emerging market countries, including Brazil, Turkey, and South Africa. (See Figure 1.10, panel 2 and panel 3 in the *GFSR*.)

(3) *Outflows & the stronger dollar correlate*. Debbie and I have our own homegrown monthly proxy for international capital flows, calculated as the 12-month change in non-gold international reserves minus the 12-month sum of the merchandise trade surplus with the US. The world outside the US experienced increasingly large net outflows during the 2015 global growth recession. They diminished in size during 2016 and 2017 as the global economy recovered until they were close to zero in early 2018. They've mounted again this year through August (*Fig. 3*). Leading the way over this period was our proxy for Chinese net capital outflows (*Fig. 4*).

Not surprisingly, our proxy is highly correlated with the y/y percent change in the US dollar. It remains bullish for the greenback.

Emerging Markets II: Could It Get Worse? The IMF has no shortage of reasons why there could be more pain for emerging market assets ahead. Consider these, outlined in the *GFSR*:

(1) *US monetary tightening to exacerbate outflows*. Actual outflows have been greater than the IMF expected as a result of US monetary policy normalization. "Retail outflows have been sizable and inflows from institutional investors have slowed considerably." (See *GFSR*'s Figure 1.15, panel 1.) The IMF figures that there "could be a further drag on portfolio flows of about $10 billion by the end of 2019, in addition to a realized impact so far of an estimated $20 billion." Further, as a result of the Fed's balance-sheet normalization, a "deterioration in external factors could lead to a $50 billion reduction of inflows in 2018, which will ease only modestly to an additional $40 billion in 2019." (See the *GFSR*'s Figure 1.15, panel 2.)

Under a worst-case scenario analysis, "medium-term debt outflows could reach 0.6 percent of the combined GDP of emerging market economies (excluding China), on par with the outflows seen during the global financial crisis." However, the IMF's analysis suggests that this is highly unlikely to occur. It could become more probable if there were a spike in risk aversion and a corresponding "sharp reversal of portfolio debt flows."

(2) *Rise in external, public-, and private-sector debt*. Easy financial conditions since the 2008 financial crisis have led "to a sharp rise in external borrowing, with external debt increasing much faster than exports in many emerging markets." The *GFSR* noted that a "combination of high external debt and relatively weak reserve coverage levels would make a country particularly vulnerable to external shocks."

Further, the share of emerging market countries (excluding China) with high public debt relative to the aggregate GDP of emerging markets has more than doubled since 2008. In the private sector, high leverage has stretched nonfinancial firms so that the debt-repayment capacity of firms in some economies is at risk. Although the median debt at risk has declined recently across regions, it remains elevated for countries in regions such as Latin America and in emerging Asia. Some countries have strong reserve buffers, however, which may increase their resilience to external shocks.

(3) *Investor base shift to nonbank, domestic*. The mix of funds flowing into emerging markets has changed. But it's hard to tell whether that could worsen capital outflows on a broad scale. Before the 2008 crisis, financing to emerging markets was mostly bank-related. Now portfolio investors provide more cash to emerging markets than banks do, making emerging markets more vulnerable to

withdrawals of foreign cash. Bank lending tends to be longer term and less volatile than portfolio investing.

Notably, however: “[D]ifferent types of nonbank investors (such as pension funds, insurance companies, and mutual funds) have different risk appetites and investment mandates.” Recent years have seen rising emerging market investing via mutual funds and ETFs, which may be more sensitive to global financial conditions. Additionally, opportunistic global funds that have highly concentrated positions in markets could “suddenly shift their allocations.”

Yet a 10/15 *WSJ* article titled “Emerging-Markets Selloffs: This One Is Different” noted that emerging markets are less vulnerable to withdrawals of foreign cash now than before the 2008 crisis. “In 2017, overseas capital flows to emerging markets equaled 4.35% of gross domestic product compared with almost 9.00% in 2007, according to the Institute of International Finance [IIF],” observed the article. Foreign investors play a larger role in Latin America and emerging Europe than they do in Asia.

(4) *Banks stronger, but not bullet proof*. Regarding global bank stability, here’s the bottom line: “Banks have strengthened their balance sheets since the global financial crisis: they now have higher levels of capital and more liquidity in aggregate. But weaknesses in the global banking system are still apparent. Increasing debt in the household and corporate sectors has left banks in some countries exposed to borrowers with high debt-service burdens. The combination of some highly indebted sovereigns and bank holdings of government bonds risks reigniting the sovereign bank nexus. In addition, some banks are exposed to opaque and illiquid assets, or are reliant on foreign currency funding.”

Emerging Markets III: Fed’s View. Fed Chairman Jerome Powell believes the concern over emerging markets is overblown. Some observers agree with him that, on balance, emerging markets will be able to handle a gradual rise in US interest rates; others disagree. Some considerations with bearing on the question include:

(1) *One-two interest-rate, dollar punch*. Emerging markets could be particularly vulnerable to greater outflows if investors grow increasingly wary of leverage in these countries, as discussed above. Sentiment toward these regions could further sour if investors perceive emerging markets as especially sensitive to US monetary tightening. As US interest rates rise, there could be greater demand for US fixed-income assets and a flow away from emerging markets, all else being equal.

Further, emerging markets may experience a one-two punch as interest rates push the demand for dollars up. Emerging markets’ dollar-denominated debt composes a significant portion of emerging markets debt outstanding. A rising dollar makes it more expensive to service that debt.

(2) *Commodity prices or the Fed?* In his 5/8 speech, “Monetary Policy Influences on Global Financial Conditions and International Capital Flows,” Powell stated: “Since the Fed is the central bank of the world's largest economy and issuer of the world’s most widely used reserve currency, it is to be expected that the Fed's policy actions will spill over to other economies.”

But he doesn’t attribute the brisk capital inflows to emerging markets seen in most years since the financial crisis primarily to the Fed’s monetary stimulus but to rising commodity prices and growth in those regions. So the reverse scenario—capital outflows from emerging markets—would not be expected to result from the Fed’s tightening, he reasoned.

Powell is right about the relationship between emerging markets and commodity prices. The Emerging Markets MSCI stock price index (in dollars) has been highly correlated with the CRB raw industrials spot price index (*Fig. 5*). Commodity prices have held up relatively well in the face of the recent strength of the dollar. If they continue to do so as the Fed continues to normalize, then Powell might be right not to worry too much about the fragility of emerging markets.

Following a sharp decline during 2015, the Emerging Markets MSCI stock price index bottomed on January 21, 2016, then soared 65.5% in local currency and 84.9% in US dollars through January 26, 2018 (*Fig. 6*). Since then through Monday's close, the former is down 17.2%, while the latter is down 22.8%. Over the same two periods, the Emerging Markets MSCI currency index rose 22.1%, and then it fell 7.3% (*Fig. 7*).

Here is the ytd performance derby of the major MSCI global stock market indexes in local currencies through Monday's close: US (3.0%), All Country World (-2.1), Japan (-5.9), UK (-8.4), EMU (-8.6), and Emerging Markets (-10.5) (*Fig. 8*).

(3) *Emerging markets are not equal*. Counter to Powell's relaxed view, the September 2018 *BIS Quarterly Review* stated: "In all major emerging market regions, the growth of US dollar-denominated credit has outpaced that in other foreign currencies. The high share of dollar borrowing foreshadows risks that could [materialize] in the case of a persistent dollar appreciation." However, the report noted that "dollar exposures in emerging market economies vary substantially across countries and sectors."

Powell also pointed out in his May speech that not all emerging markets are created equal: Some have already revealed stress fractures because of the rising US interest rates and US dollar. Others may continue to weather the storm. We think that among the latter could be Asian emerging markets that stand to benefit as production moves to them out of China if Trump continues to escalate his trade war with the country.

CALENDARS

US. Wed: C-PMI, M-PMI, and NM-PMI Flash Estimates 54.1/55.5/54.0, New Home Sales 625k, FHFA Home Price Index 0.3%, MBA Mortgage Applications, EIA Petroleum Status Report, Beige Book, Bostic, Mester, Bullard. **Thurs:** Durable Goods Orders Total, Ex Transportation, and Core Capital Goods -1.5%/0.4%/0.5%, Advance Merchandise Trade Balance -$74.7b, Kansas City Fed Manufacturing Index, Jobless Claims 212k, Pending Home Sales 0.0%, EIA Natural Gas Report, Clarida, Mester. (Econoday estimates)

Global. Wed: Eurozone C-PMI, M-PMI, and NM-PMI Flash Estimates 53.9/53.0/54.5, Germany C-PMI, M-PMI, NM-PMI Flash Estimates 54.8/53.4/55.5, France C-PMI, M-PMI, and NM-PI Flash Estimates 53.9/52.4/54.7, BOC Rate Decision 1.75%. **Thurs:** Germany Ifo Business Climate, Current Assessment, and Expectations Indexes, ECB Rate Decision 0.00%, ECB Marginal Lending Facility & Deposit Facility Rates 0.25%/-0.4%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q3 Earnings Season Monitor (*link*): With over 22% of S&P 500 companies finished reporting earnings and revenues for Q3-2018, the y/y revenue and earnings growth metrics remain very strong compared to Q2's stellar results, but companies are recording a smaller revenue and earnings surprise beat. We're not seeing signs of a sharp slowdown. Of the 111 companies in the S&P 500 that have reported through mid-day Tuesday, 80% exceeded industry analysts' earnings estimates by an average of 4.2%; they have averaged a y/y earnings gain of 24.1%. On the revenue side, 63% of companies beat their Q3 sales estimates so far, with results coming in 0.5% above forecast and 7.9% higher than a year earlier. At the same point during the Q2-2018 reporting period, a higher percentage of companies (84%) in the S&P 500 had beaten consensus earnings estimates by a higher 6.1%, and earnings were up a higher 27.5% y/y. With respect to revenues, a much higher 74% had exceeded revenue forecasts at this point in the Q2 season by a higher 1.5%, and sales rose a greater 10.7% y/y. Q3 earnings results are higher y/y for 93% of companies, vs a slightly higher 94% at the same point in Q2, and Q3 revenues are higher y/y for 84% vs a greater 91% a quarter ago. These figures will begin to change markedly as more Q3-2018 results are reported throughout the coming weeks. The early results on revenues are very encouraging, particularly the percentage of companies growing revenues y/y. Q3-2018 should mark the ninth straight quarter of positive y/y earnings growth and among the highest growth quarters since Q4-2010; y/y revenue growth should be positive for a tenth straight quarter, with its pace slowing somewhat but remaining well above the historical trend. The strong results are mostly due to lower tax rates and improved business conditions, but cost pressures and global growth concerns are increasing.

US ECONOMIC INDICATORS

Regional M-PMIs (*link*): The three Fed districts that have reported on manufacturing activity for October so far—Philadelphia, New York, and Richmond—showed factories continue to hum. We average the composite, orders, and employment measures as data become available. The composite index decelerated to 19.4 this month after accelerating from 20.5 to 23.6 last month; it's not far from last October's peak of 24.3—which was the best reading since mid-2004. New York's composite index (21.1 from 19.0) accelerated slightly, while Richmond's (15 from 24) slowed; Philadelphia's (to 22.2 from 22.9) virtually matched September's robust pace. The new orders gauge (20.6 from 24.0) showed slower, though still robust, growth—averaging 21.8 the past six months. Orders growth in the New York (22.5 from 16.5) region improved, while billings in the Philly (19.3 from 21.4) and Richmond (20 from 34) areas slowed, though remained at elevated levels. The employment measure (15.8 from 15.6) reveals job gains effectively matched September's pace, as manufacturers in the Philly (19.5 from 17.6) and Richmond (19 from 16) regions hired at a faster rate and those in New York (9.0 from 13.3) hired at slower pace this month.

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