Lazard
Perspectives

New Rules of Engagement: Emerging Markets in a Trump Era

The new US administration's desire to change the rules of engagement with other nations should present a new set of hurdles—and opportunities—in the emerging markets, particularly China and Mexico. However, as legal limits are considered, and as the second- and third-order effects of trade tariffs and immigration decisions become more apparent, analysts across our emerging markets equity platform believe it becomes likely that some of the administration's more controversial proposals may be softened.

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ASSET MANAGEMENT

Following Donald Trump's surprise victory, fundamental US policy assumptions have been challenged and markets globally have reacted differently. US equity futures pointed immediately lower the night of his win, but stock indices have since recovered to test new highs. The US dollar is also experiencing a period of renewed strength and US Treasury bonds have sold off, with the yield on the 10-year note climbing to 2.4% as of this writing. We believe these indicators portray an optimistic economic direction for the United States.

As the president-elect prepares to boost infrastructure spending, cut taxes, and loosen regulation, US inflation and nominal interest rates are expected to rise. Along with this, uncertainty relating to specific policies and the composition of the cabinet have created a sense of insecurity among emerging markets investors. November marked the largest developing markets outflow since June 2013 as about $24 billion left the asset class ($8 billion from equities and $16 billion from debt securities).[1] Emerging markets equities lost 5%, currencies 3%, and external debt 4% that month.[2] Although emerging markets equities trimmed their gains in the fourth quarter of 2016, they still finished with their first annual gain since 2012.

Time will tell if the president-elect will continue to emphasize protectionism and the sovereignty of nations. We think it is likely that some of his more controversial proposals will be watered down for pragmatic reasons, including some relating to the economic interdependence between the United States and its trading partners, many of which are emerging markets.

We believe that emerging markets investors remain most concerned with Trump's protectionist statements on trade (specifically, higher tariffs) and immigration. Here we discuss the practical considerations that could lead his team to soften its stated stance on these subjects, and how emerging markets might react to this administration's foreign policy. We expect that countries and companies will seek to leverage their strengths and reposition themselves in a new playing field.

Trade: A Two-Way Street

The United States maintains free trade agreements with 20 countries, with China and Mexico its largest and third-largest trade partners, respectively. In 2015 alone, total two-way trade with these countries was valued at $598 billion and $531 billion, respectively.[3] In the weeks following the election, the Trump team has discussed the use of traditional trade barriers, enforcement cases, tariffs, and even a destination-based cash-flow tax, similar to a value-added tax. While China and Mexico, along with other countries in the emerging markets, will undoubtedly feel the effects of such trade policies, the United States has just as much to lose from any potential trade disruption or trade war. In 2015, nearly 16% of total US exports of goods, $236 billion worth, were bound for Mexico alone, while 8%, or $116 billion worth, went to China.[4]

Retaliation from these countries could have negative consequences for the US economy. What is more, by imposing tariffs on certain trading partners, we believe Trump will, in effect, implement a regressive tax on poorer Americans as they may be forced to pay more for imported goods, such as clothing, electronics, and automobiles.

As president, Trump can easily impose tariffs on other nations—to a certain extent. His decisions could be contested based on differing legal interpretations, however. While the president of the United States has the ability to apply broad-based tariffs on all imports of up to 15%, the tariffs would expire after 150 days without Congressional approval.[5]

Under the Trade Expansion Act of 1962, the president can impose tariffs with no specified upper limits on select goods unilaterally. Should a national emergency or state of war be declared, the president has the authority to regulate all forms of international commerce as well as freeze and potentially seize foreign-owned assets of all kinds.[6] Under this scenario, the president would likely face numerous legal challenges from those US firms that have been negatively affected.

Supply Chain Complexities

One of Trump's campaign positions involves convincing Apple to manufacture many of its products in the United States. The benefits of such an approach are difficult to quantify. In manufacturing its iPhone, for example, Apple sources components from as many as 28 countries, including memory chips from Korean suppliers, displays from Japanese suppliers, and glass and radio-frequency parts from US suppliers. It also uses Taiwanese companies to assemble the handsets in China. The strength of Asia's electronics supply chain coupled with the region's large and cheap labor pool gives countries like China the ability to quickly ramp up, or dial back, production. Imposing a high tariff on Chinese imports could cause production to move from China to lower-cost Asian neighbors, such as Vietnam.

As labor accounts for only a small part of the iPhone's overall production cost, relocating manufacturing activity to the United States does not guarantee economic benefits to US workers. The phone's cost to consumers in the United States and elsewhere will potentially also be inflated by higher US labor costs and component shipping, not to mention the potential costs of building new factories and training US workers.

Trade with China

The president-elect has stated a willingness to slap a 45% tariff on imported Chinese goods and label China a currency manipulator for suppressing the value of the renminbi to boost its exports. In our view, the ability of the United States to impose such a tariff and the benefits of doing so are questionable. Based upon our research, China currently only satisfies one of three criteria set by the US Department of the Treasury to determine if a country is, in fact, a foreign currency manipulator (Exhibit 1): it currently maintains a trade surplus of greater than $20 billion. Although China may have satisfied the current account surplus criteria in the past, as of October 2016 it did not.

US trade protectionism and tariffs could put further pressure on the already-weakening renminbi, which has sunk to an 8-1/2 year low due to a strengthening dollar and capital outflows. Chinese authorities have drawn on their war chest of foreign currency reserves to support the renminbi as it approaches the 7 CNY per USD threshold. After peaking at nearly $4 trillion in mid-2014, China's reserves are now closer to $3 trillion (Exhibit 2), which has led to tighter government controls on capital outflows and increased scrutiny of overseas investment projects. Chinese officials will have to decide whether it is more important to continue to support the renminbi at the expense of China's reserves, or whether they should prioritize the reserve level and allow market forces to determine the level of the currency. Another large currency devaluation by the central bank could strengthen Trump's depiction of China as a currency manipulator. It would also likely cause other Asian countries to depreciate their currencies, resulting in a domino effect across the region.

Although China is likely to feel the effects of weaker trade under a Trump presidency, it may benefit from US withdrawal from the 12-nation Trans-Pacific Partnership (TPP) as it was previously excluded from the scuttled deal. (Trump has pledged to withdraw from this pact within his first 100 days in office in favor of a focus on bilateral trade agreements.) With its share of global GDP surging from 4% in 2000 to 15% in 2015 (Exhibit 3), China is positioning itself to assume a greater role in promoting regional and global trade agreements and the free flow of investment. At the Asia Pacific Economic Cooperation summit in November, President Xi Jinping offered China's answer to the TPP, the Regional Comprehensive Economic Partnership (RCEP), which intentionally excludes the United States, and spoke of broadening the Free Trade Area of the Asia-Pacific. Although the RCEP may not be as ambitious as the TPP in reducing nearly 18,000 tariffs and trade barriers, it is the only major Asian trade deal that is up for negotiation.[7]

China has already surpassed the United States as South America's largest trading partner and has pledged to increase trade to $500 billion and foreign direct investment to $250 billion by 2025. President Xi has opened the possibility for Latin American to join China's "One Belt, One Road" program, a modern version of the Silk Road linking Asia to Europe. Although it now relies less on demand for commodities than during the boom years, China remains committed to strengthening economic ties with Latin America and across Asia.

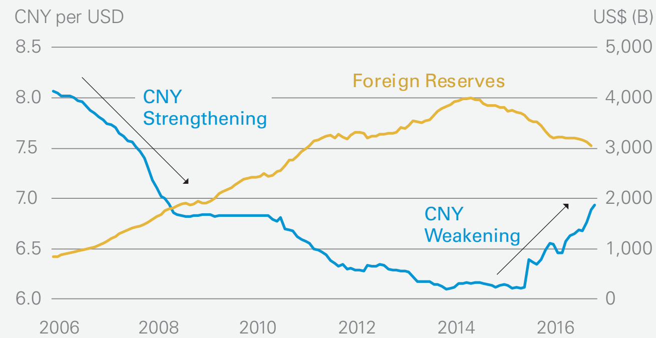
Exhibit 1
Rules Exist to Identify Currency Manipulators

Criteria for a Currency Manipulator	Does China Satisfy Criteria?
Large bilateral trade surplus greater than $20 billion	Yes
Current account surplus greater than 3% of GDP	No
Net purchases of foreign currency totaling at least 2% of an economy's GDP over a period of 12 months	No

As of October 2016

Source: CLSA, US Department of the Treasury – Section 701 of the Trade Facilitation and Trade Enforcement Act

Exhibit 2
China Is Deploying Reserves to Support Its Currency

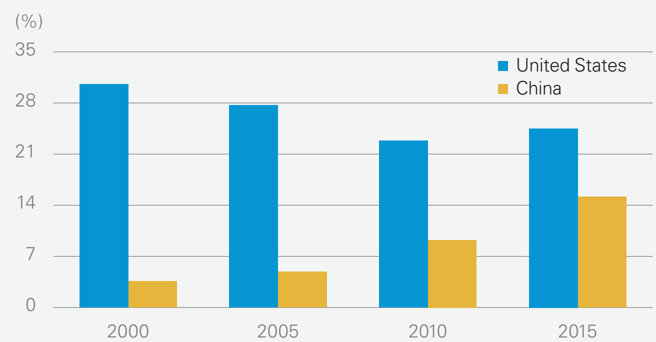


As of November 2016

Source: Haver Analytics, People's Bank of China, State Administration of Foreign Exchange

Exhibit 3
China Is Gaining Prominence in World Trade

Share of Global GDP



As of October 2016

Source: Haver Analytics, International Monetary Fund

At 19 cases, the United States has the most trade disputes with China at the World Trade Organization (WTO). Under the WTO safeguard agreement, Trump can impose temporary tariffs on certain Chinese products, which will most likely be the products currently under dispute (these include steel, aluminum, and coal). A decision to impose additional tariffs outside the WTO's scope would violate the existing trade agreement with China, which will likely cause China to retaliate by cancelling its US-bound exports and substituting its imports of US goods with those from other countries.[8]

While the United States tends to import Chinese-made mass-market consumer products, China typically imports US goods of higher value, such as aircraft, oilseed, and autos. In 2015, for instance, China bought $15 billion worth of aircraft and $11 billion of soybeans from the United States.[9] China also has clout in the form of its significant and growing US business investments (it contributed $5 billion of foreign direct investment in 2015[10]) and its ownership of $1.16 trillion worth of US Treasury securities.[11] It may balk at future purchases of Treasuries should it find itself in a trade war with the United States.

Any reduction in Chinese exports to the United States could trigger more fiscal policy support from the Chinese government to stabilize its domestic growth. Any potential trade shock could also accelerate China's reform and economic rebalancing process, causing China to speed up its transition away from low-end manufacturing exports.

US tariffs on Chinese goods could create negative ripples to other Asian economies due to supply chain linkages between China and these countries. Parts of developed and developing Asia could suffer, given that Japan and Korea are major suppliers of electronics components used in finished Chinese goods.

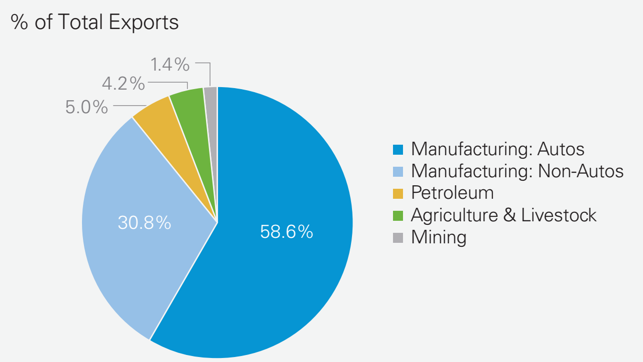
Trump's focus on bringing back jobs to the United States could also hurt some Asian economies to the extent that his policies impede the growth of the business process outsourcing (BPO) sector. Globalization and lower barriers to trade have intensified the demand for BPO services, with the Philippines and India the biggest beneficiaries. The sector is a source of employment for a large and growing portion of the local workforce in contact centers, back office services, data transcription, animation, software development, engineering development, and game development. In the Philippines, for example, revenues from the BPO sector are expected to surpass remittances ($26 billion in 2015) in the coming years.

Trade with Mexico

While campaigning, Trump stated intentions to exit or, at the very least, renegotiate the North American Free Trade Agreement (NAFTA), which eliminates tariffs and governs trade between the United States, Mexico, and Canada. Should he fail to renegotiate terms, as president he will have the authority to withdraw the United States from NAFTA with six months' notice. He has also not ruled out attempting to tax remittances to Mexico to finance the cost of building a partition between the countries. Leading up to Election Day, the Mexican peso closely tracked Trump's poll rankings. Between Election Day and year-end, the peso weakened by 13%, reaching a record low and causing the central bank to respond with a 0.50% rate increase.

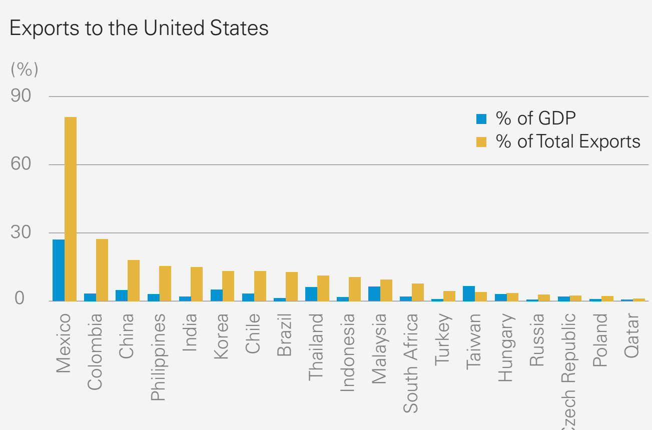
Though difficult to quantify, the economic impact on Mexico will depend on how quickly trade tensions escalate between both countries as manufactured products are Mexico's main export, accounting for nearly 90% of its total exports (Exhibit 4).[12] US exports represent more than 25% of Mexico's GDP and account for 80% of its total exports (Exhibit 5). With NAFTA's future in doubt, it will now be even more important for President Enrique Peña Nieto, whose approval rating has fallen to record lows, to promote parts of the Mexican economy that do not rely on

Exhibit 4
Manufactured Goods Account for Nearly All Mexican Exports



As of November 2016
Source: Haver Analytics, National Institute of Statistics and Geography (INEGI)

Exhibit 5
Mexico Faces the Greatest Threat from US Tariffs



As of November 2016
Source: Haver Analytics, central banks, national statistics agencies

NAFTA prior to general elections being held in 2018, such as the energy sector. Although structural reforms in Mexico's energy and education sectors have yet to significantly boost economic activity, they will be crucial to attract private sector capital and increase the competitiveness and efficiency of Mexican businesses (see *Latin America: An Update on Reforms*).

The Trump team has focused on narrowing the $60.7 billion trade deficit the United States maintains with Mexico by levying tariffs and trade barriers. However, Mexico could counter with its own retaliatory tariffs that would be just as disruptive to many US-based companies with complex supply chains that run through Mexico. Mexican officials have stated that they are willing to modernize NAFTA, including adding rules on e-commerce, but are hesitant to agree to export quotas and tariffs. To prepare for any trade disruptions with the United States, Mexico could look to add to its 40 existing trade deals with other countries and may even sign on to a smaller version of TPP or another regional trade agreement.

Immigration: Changing Labor Dynamics

The nomination of Alabama Senator Jeff Sessions to Attorney General suggests that Trump may follow through on his immigration proposals, including deporting many of the 11 million undocumented immigrants, with a focus on the 2–3 million people with criminal records. While Trump has vowed to terminate President Obama's two executive amnesties for illegal immigrants, Sessions has publicly opposed all illegal immigration as well as certain forms of legal immigration, including H-1B visas for skilled professionals.

Although Trump's immigration reform has focused on Mexico, Central America is thought to be the bigger source of migrants to the United States in recent years.[13] Notwithstanding the humanitarian considerations, an influx of displaced workers could destabilize Central American economies by worsening already high unemployment rates and wiping out millions of dollars in remittances, which are a large and stable source of foreign currency earnings, especially in El Salvador, Guatemala, and Honduras.[14] Remittances for these three Central American countries represent approximately 13% of their combined GDP, compared to the $25 billion in remittances Mexico received in 2015, or less than 3% of Mexico's GDP (Exhibit 6).[15] Trump has promised to cut off remittances to Mexico if it does not make a one-time payment of $5 billion–$10 billion to finance the construction of a partition along the US–Mexico border.[16] Other pledges include impounding all remittance payments from illegal wages and hiking fees on temporary visas and border-crossing cards.

Foreign Policy: Bucking Convention

US foreign policy under a Trump administration remains uncertain. Trump has conveyed a tougher stance to US allies in Europe and has taken a more assertive tone with China, while setting a warmer one with Russia.

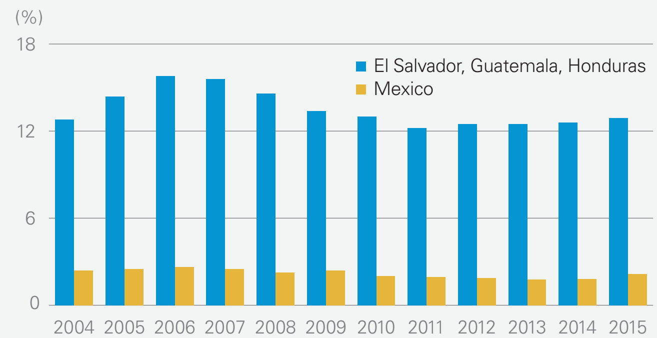
Central and eastern European countries are waiting for the president-elect to clarify his position on the North Atlantic Treaty Organization (NATO), a political and military alliance meant to safeguard the freedom and security of its 28 members. Trump has openly criticized those member nations who are not meeting the 2% target for defense spending and has suggested that US involvement could be conditional on member countries satisfying this target. He has not clearly confirmed whether as president he will honor Article 5 of NATO's charter, which obligates the United States to defend the Baltic states, Estonia, Latvia, and Lithuania, in the event of a Russian military invasion. Should the United States withdraw its support for NATO, regional leaders may form a Central European alliance to combat potential Russian encroachment, which could add uncertainty to the region.

Russian equities, which were already on the rebound, climbed further after the election on the prospect of a reset in US relations and the possibility of a lifting or easing of sanctions on Russia. Trump has repeatedly praised President Vladimir Putin, reiterating the benefit of having a working relationship with Russia. This is already causing friction with members of the Republican-controlled Congress. Following the announcement by the Obama administration of a new round of sanctions against Russia for

Exhibit 6

Limits on Remittances Will Have a Greater Impact on Central American Economies

Annual Remittances (% of GDP)



As of October 2016

Source: Haver Analytics, central banks

its alleged intimidation of American diplomats and its alleged influence on the presidential election, Putin, against the advice of his foreign minister, did not impose retaliatory sanctions. It appears Putin is operating in anticipation of a friendlier incoming administration. The appointment of Exxon Mobil's chief executive Rex Tillerson as Secretary of State could accelerate the lifting of sanctions as Tillerson opposed US sanctions on Russia in 2014, is the recipient of the Kremlin's Order of Friendship, and worked to secure various joint ventures with Russian oil company Rosneft. In his nationally televised State of the Union address, Putin expressed hope for both countries to normalize ties and cooperate in Syria. Though fragile, the recently brokered ceasefire in Syria could pave the way for a working relationship between the United States and Russia for coordinated military action exclusively against the Islamic State.

Trump has explicitly questioned whether the United States should continue to observe Beijing's "One China" policy, which calls for reunification with Taiwan, without first discussing with China its currency policy, trade tariffs, or military build-up in the South China Sea. We think it is likely that President Xi and President-elect Trump will continue to assert strength and respond to the other's political moves, thus adding tension to the US–China relationship.

A further unknown is Trump's policy on the Iran nuclear deal, where Iran has agreed to dismantle and limit parts of its nuclear program in exchange for looser sanctions. He has repeatedly referred to the deal as a "disaster," promising to reverse it even as the European Union, Russia, and China recently reaffirmed their "resolute commitment" to the deal. Should the United States withdraw its support, its coordination with these countries on the war in Syria—particularly Russia—could become extremely difficult. Notably, China could increase its trade with, and investment in, Iran to weaken US influence in the Middle East, particularly if the One China policy is not recognized by the United States.

Conclusion

While the uncertainty of a Trump presidency has weighed on emerging markets, particularly on the subject of trade protectionism, immigration, and foreign policy, the general consensus across our emerging markets equity platform is that some of Trump's most controversial proposals will be tempered. As a result, expectations of higher inflation and tighter monetary policy in the United States due to the president-elect's pro-growth stance may also be exaggerated. Although a sharp increase in US interest rates would be challenging for emerging markets as a whole, we believe many of these countries can withstand gradual US interest rate hikes, keeping in mind that these also reflect a certain measure of confidence in global growth prospects, which is favorable for emerging markets.

Our emerging markets equity teams each have a unique investment goal and philosophy, which grants them different worldviews. They agree that the developing world is in better financial health with regard to current account balances, foreign currency reserves, and fiscal positions than during the taper tantrum in 2013. Commodity prices, in particular for oil, have also improved since early 2016. The November 2016 OPEC agreement to cut 1.2 million barrels per day from global oil production is encouraging and should support emerging markets sentiment, particularly for commodity exporters. Inflation continues to fall in most countries, creating room for more accommodative central bank policy, and real interest rates for the most part remain considerably higher in emerging markets than in developed markets.

Returns on equity have been on the decline since 2011 but may have recently reached a bottom on a combination of improving capital discipline and select austerity measures among emerging markets companies. A revival of capital spending in the United States via a Trump infrastructure plan could provide a demand boost to the emerging markets. Even prior to the US election result, negative earnings revisions have been slowing among emerging markets companies and earnings are being revised higher in some cases. In addition, the GDP growth premium that emerging markets maintain over developed markets is expected to increase in the coming years.

Policy developments will have to be closely monitored and investors should be prepared to adjust their analysis as warranted. Should President-elect Trump decide to pursue a more isolationist strategy, certain countries in the emerging markets are likely to experience more volatility and economic weakness. However, if he is more pragmatic in his approach, recognizing that trade wars can hurt the United States as much as its trading partners, the overall "Trump effect" is likely to result in better growth prospects for the United States and the emerging markets.

About Us

Lazard's Emerging Markets Equity platform has been at the forefront of emerging markets investing for nearly thirty years. We specialize in different investment disciplines and offer emerging markets solutions that capture the benefits of our exceptional access to company managements and firmwide research collaboration.

This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

Notes

1 As of November 2016. Institute of International Finance.

2 Emerging markets equities as represented by the MSCI Emerging Markets Index, currencies by the J.P. Morgan Emerging Local Markets Index Plus, and external debt by the J.P. Morgan EMBI Global Diversified Index.

3 Office of the United States Trade Representative: Free Trade Agreements (https://ustr.gov/trade-agreements/free-trade-agreements)

4 Census Bureau, Haver Analytics

5 Section 122 of the Trade Act of 1974

6 Peterson Institute for International Economics: Assessing Trade Agendas in the US Presidential Campaign, September 2016

7 http://www.wsj.com/articles/china-touts-its-own-trade-pact-as-u-s-backed-one-withers-1479811275

8 UBS China Economic Comment, *The Impact of a Trump Victory on China*, 10 November 2016

9 Office of the United States Trade Representative: The People's Republic of China

10 Bureau of Economic Analysis, Foreign Direct Investment in the United States: Financial transactions without current-cost adjustment

11 CLSA Greed & Fear, *Down Under Extended*, 1 December 2016

12 As of 2015. INEGI, Haver Analytics

13 http://www.pewresearch.org/fact-tank/2016/11/03/5-facts-about-illegal-immigration-in-the-u-s/

14 http://www.nytimes.com/2016/11/17/world/americas/mexico-immigrants-trump-deportations.html

15 *Mexican Consumer Stocks: Post-election Performance and Outlook*, UBS, 9 November 2016

16 https://www.washingtonpost.com/politics/trump-would-seek-to-block-money-transfers-to-force-mexico-to-fund-border-wall/2016/04/05/c0196314-fa7c-11e5-80e4-c381214de1a3_story.html

Important Information

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