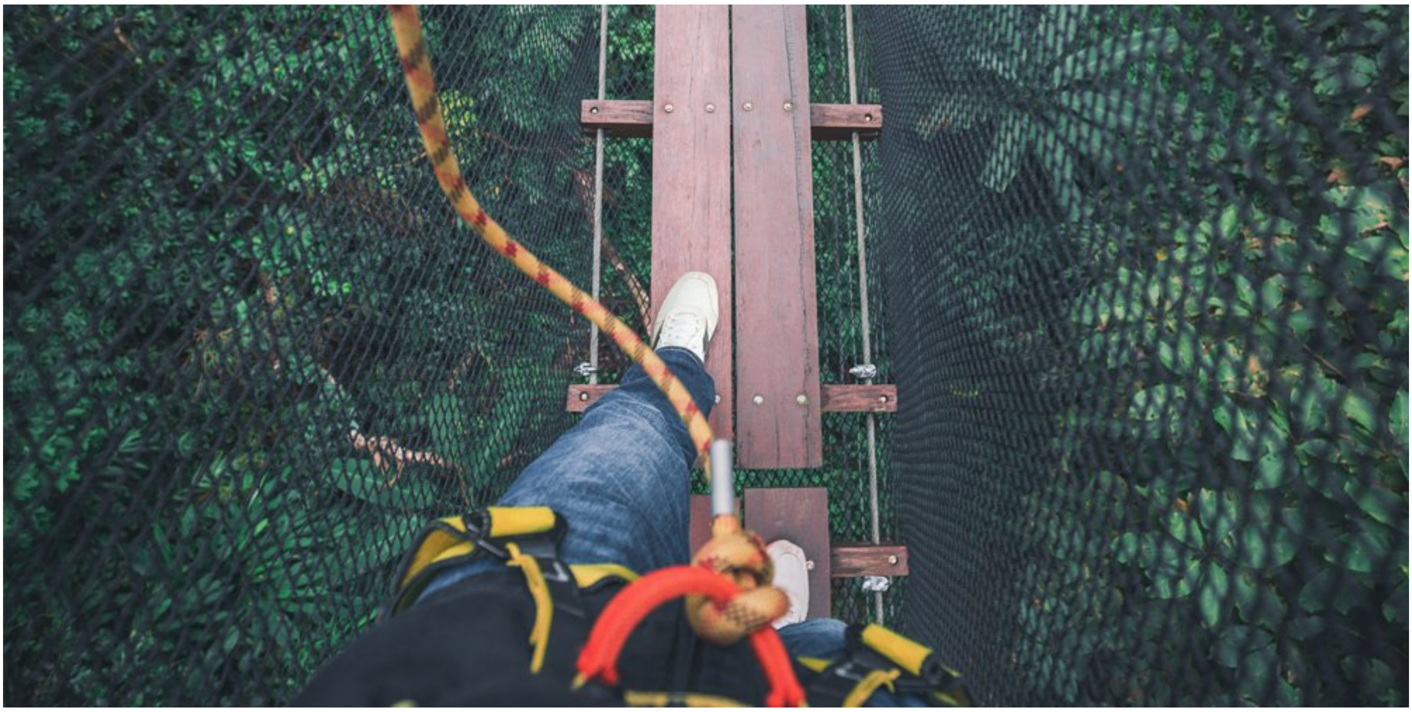


Three Risks in Emerging Markets

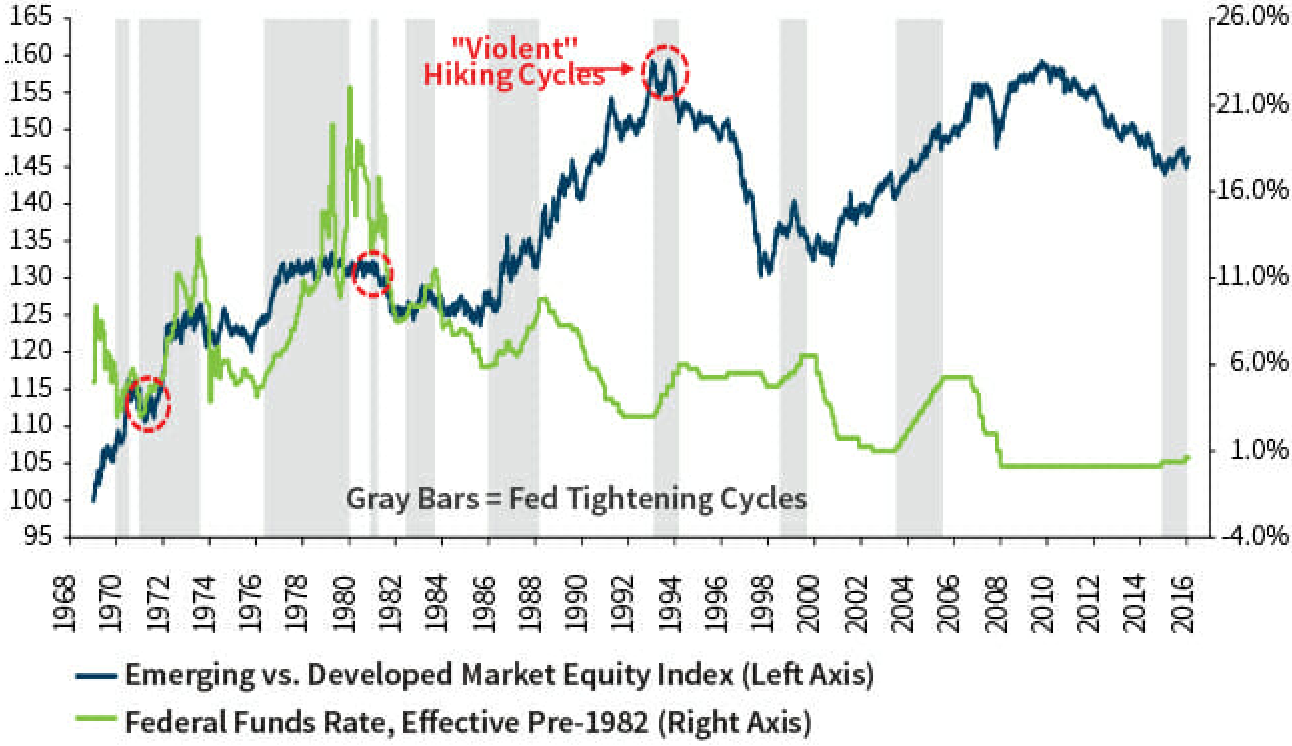
April 17, 2017

While a number of factors support positive emerging market performance, a few key risks could cause significant headwinds. The U.S. dollar could remain strong and U.S. interest rates are likely to rise. Global trade could decline amid increased protectionist measures. And, Chinese foreign exchange, debt overhang, and overcapacity risks will eventually need to be addressed.

U.S. Dollar Strength and Tightening Are Likely

As growth and inflation accelerates in the United States, we expect monetary policy normalization to continue. Even in the face of the Federal Reserve's rate hikes, emerging markets can continue to outperform developed markets as they have done in the past, provided that the pace of the tightening is measured and well-advertised. As the chart below shows, only "violent" hiking cycles have led to an underperformance of emerging markets relative to developed markets.

Emerging vs. Developed Equity Market Returns Around Fed Hikes



Source: William Blair, FactSet, Haver Analytics, Datastream, Goldman Sachs Global Investment Research, as of February 2017. It is not possible to invest directly in an index.

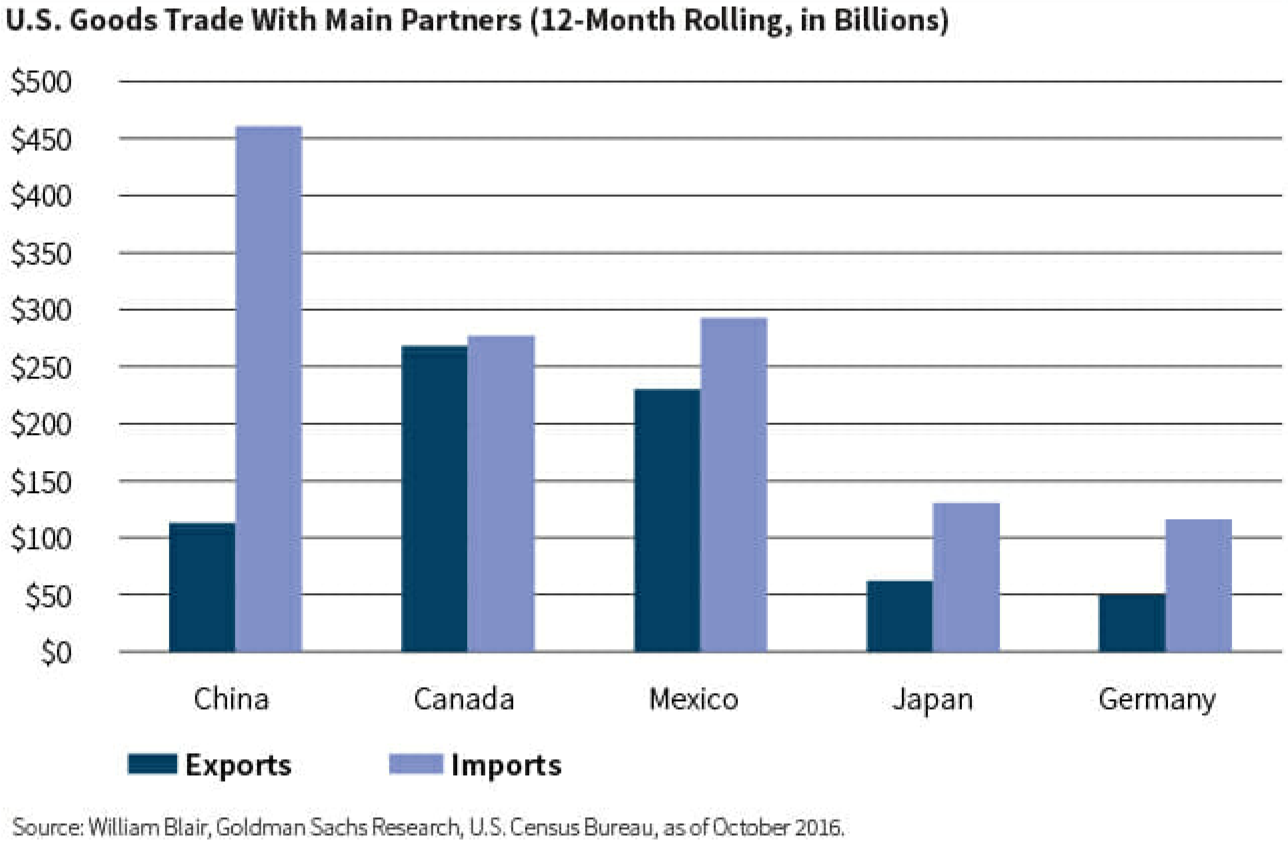
U.S. dollar strength in the wake of the U.S. election clouded the outlook for emerging markets, because the performance of emerging markets relative to developed markets is highly correlated to the Trade-Weighted U.S. Dollar Index. But the dollar does not need to appreciate further if U.S. interest rates increase.

Interestingly, the correlation of the U.S. dollar and the 10-year bond yield has historically been around 0.25, but increased to 0.75 in the aftermath of the election amid Trump's campaign promises of infrastructure spending and tax cuts. However, the correlation has declined over the past weeks. In addition, the real rate differential between emerging and developed markets continues to be positive, and more attractive than it was in 2013, supporting emerging market currencies.

Global Trade Could Decline Amid Increased Protectionist Measures

U.S. protectionist measures were rising before the U.S. election, and have increased. If the Trump administration wants to have a meaningful impact on the U.S. current account deficit, it must address the trade deficit with China, which is illustrated in the chart below.

As rhetoric with China heats up, as we believe it inevitably will, markets will likely get unnerved. And the reaction will likely be more significant than it was in the wake of discussions about the North American Free Trade Agreement (NAFTA), given the size of China and the inherent risks of potential escalation.



China Is Stabilizing, But Still Risky

Last spring, global markets sold off violently over fears that the Chinese slowdown would result in another surprise devaluation of the renminbi. To overcome these risks China enacted significant credit and infrastructure stimulus, and the economy responded. Purchasing manager indices have risen. Almost 50 months of producer price index (PPI) deflation has ended. And, the industrial sector has stabilized.

China's actions were based on a page from an old playbook: using outsized credit growth to stimulate the economy, arrest a slowdown, and create a cyclical bounce (which we are now experiencing). But we were told this playbook was being retired in favor of reducing chronic overcapacity and excess leverage in the system. Since those long-term challenges still exist, China will eventually need to address them.

In addition, we believe reserve declines will continue to weigh on sentiment. After surprise renminbi devaluation in August 2015, the People's Bank of China (PBOC) monthly reserves declined as local investors and corporations converted renminbi to other currencies given expectations of renminbi weakness. The PBOC had engineered a controlled devaluation of the renminbi using various capital-control mechanisms to stem capital flight, but these measures were not completely successful. Reserves have continued to decline. If outflows accelerate again, markets will fear another steep devaluation, and could sell off. It is a risk to watch.

Reasons for Optimism

That’s the bad news. Despite these risks, on balance, our outlook for emerging markets in 2017 is optimistic, and we are off to a good start, with emerging markets outperforming developed markets in 2017. In future posts, I will delve into some of the details behind our positive outlook.

Disclosure:

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