MONTHLY MARKET REVIEW

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Taper Tantrum Lite

EM Currency Woes; Political Intrigue in Rome

Jimmy C. Chang, CFA
Managing Director, Chief Investment Strategist
212.549.5218 ◆ jchang@rockco.com

It was quite an eventful May, and President Trump could probably call it a month of "America First". The U.S. equity market, as measured by the S&P 500 Index, gained an impressive 2.2% and brought the year-to-date performance back to positive territory. International markets lost 3% for the month, with European and emerging markets losing 3.6% and 4.4%, respectively. Part of the gap can be explained by the resurgent U.S. dollar, which gained 2.3% on a trade weighted basis during the month. The greenback's strength could be attributed to the rising U.S. long bond yields during the first half of the month, as the 10-year U.S. Treasury yield surged from 2.95% at the start of the month to 3.11% on May 17th. However, the 10-year yield subsequently retreated and ended the month at 2.86%. In spite of the pullback in U.S. long bond yields, the U.S. dollar remained firm as a safe haven with renewed political uncertainties in Europe – Italy's political paralysis and Spanish Parliament's no-confidence vote against Prime Minister Rajoy. Ironically, a stronger U.S. dollar was probably not favored by the Trump Administration as it pursued a mercantilist trade policy. The administration decided to impose tariffs on steel and aluminium imports from Mexico, as well as our allies Canada and the European Union, prompting threats of retaliation. Internal squabbles among the administration's trade doves and hawks also sent conflicting messages on whether the Sino-U.S. trade war was on hold. On the geopolitical front, there was much posturing on the upcoming Trump-Kim summit scheduled for June 12th in Singapore. Trump appeared to have pulled out as a negotiation tactic, but both sides have resumed the preparatory work. President Trump fulfilled his campaign pledges in withdrawing from the Iran nuclear deal and in officially opening the new U.S. embassy in Jerusalem. Rising tension in the Middle East sent Brent crude oil prices higher, but the WTI crude oil prices actually declined as the growing U.S. oil production has led to a shortage in pipeline capacity. Metal prices were mixed, with gold down 1.24% and silver up slightly; not bad considering the strength of the U.S. dollar.

EQUITY MARKETS INDICES[1]	4.30.18 PRICE	5.31.18 PRICE	MTD CHANGE	YTD CHANGE
MSCI All Country World	510	509	-0.2%	-0.8%
S&P 500	2648	2705	2.2%	1.2%
MSCI EAFE	2044	1986	-2.8%	-3.2%
Russell 2000®[2]	1542	1634	5.9%	6.4%
NASDAQ	7066	7442	5.3%	7.8%
TOPIX	1777	1747	-1.7%	-3.9%
KOSPI	2515	2423	-3.7%	-1.8%
Emerging Markets	1164	1121	-3.8%	-3.3%
FIXED INCOME				
2-Year US Treasury Note	2.49%	2.43%	-6	54
10-Year US Treasury Note	2.95%	2.86%	-9	45
BarCap US Agg Corp Sprd	1.08%	1.15%	7	22
BarCap US Corp HY Sprd	3.38%	3.62%	24	19
CURRENCIES				
Australian *(AUD/$)*	1.33	1.32	0.5%	-3.1%
Brazilian Real *(Real/$)*	3.51	3.72	-5.8%	-11.0%
British Pound *($/GBP)*	1.38	1.33	-3.4%	-1.6%
Euro *($/Euro)*	1.21	1.17	-3.2%	-2.6%
Japanese Yen *(Yen/$)*	109	109	0.5%	3.6%
Korean Won *(KRW/$)*	1068	1077	-0.9%	-0.9%
US Dollar Index *(DXY)*	91.84	93.98	-2.3%	-2.0%
COMMODITIES				
Gold	1315	1299	-1.3%	-0.3%
Oil	68.6	67.0	-2.2%	11.0%
Natural Gas, Henry Hub	2.76	2.95	6.8%	0.0%
Copper *(cents/lb)*	305	307	0.4%	-7.1%
CRB Index	202	203	0.4%	4.6%
Baltic Dry Index	1341	1090	-18.7%	-20.2%

Source: Bloomberg

Emerging markets still offer long-term growth potential, but selectivity remains paramount in the face of a tightening Fed.

The Oldest Comeback Kid

Here is a trivia question: who is currently the oldest head of state in the world? If you answered Britain's 92-year old Queen Elizabeth II, you would have been right as of a month ago. Since May 10th, however, that distinction has gone to Malaysian's new Prime Minister Mahathir bin Mohamad, who was born on July 10, 1925, 285 days earlier than the Queen. In fact, the word "new" may be somewhat inaccurate as this is the second time that Dr. Mahathir assumed power in Malaysia; he previously held a 14-year reign as Malaysia's Prime Minister from July 1981 to October 2003.

To some foreign observers, Dr. Mahathir was perhaps best known as a fierce critic of Western values, even though he has overseen much economic liberalization in shepherding Malaysian's growth. During the Asian Financial Crisis, he accused foreign speculators who had shorted against the Malaysian ringgit and equities of being part of a Western and Zionist conspiracy. The crisis, which started with a currency attack on the Thai baht in July 1997, soon engulfed the region and beyond. The Malaysian ringgit lost 50% of its value, devaluing from less than 2.5 MYR per U.S. dollar in early 1997 to over 4.7 MYR per U.S. dollar by early 1998. Malaysia's main stock exchange index collapsed by more than 75% from its prior peak. The International Monetary Fund (IMF) then stepped in with its usual prescription of austerity programs and interest rate hikes. However, Prime Minister Mahathir defiantly told the IMF to take a hike and instead increased government spending and fixed the currency at 3.8 ringgits per U.S. dollar. To the surprise of foreign observers, the Malaysian economy wound up recovering faster than its neighbors.

In 1998, Prime Minister Mahathir ousted his one-time protégé Anwar Ibrahim as the deputy Prime Minister and the Finance Minister. Anwar, a younger reformer credited with Malaysia's rapid growth since 1991, was becoming a political rival. In 1999, Anwar was found guilty and imprisoned for various infractions from corruption to sodomy. Following his release from prison in 2004, Anwar became the opposition leader, but was once again jailed in 2015 on a second sodomy conviction.

Dr. Mahathir returned to politics in late 2016 to lead an effort to oust then Prime Minister Najib Razak, his one-time protégé, over alleged acts of corruption in which $4 billion was misappropriated from Malaysia's sovereign wealth fund 1MDB. Dr. Mahathir united the opposition parties and ran on pledges that included pardoning and handing the power to Anwar Ibrahim – politics indeed makes strange bedfellows. On May 9th, to the surprise of many political observers, Dr. Mahathir's coalition won the election, paving the way for the controversial politician to return to power.

Taper Tantrum Redux?

During the Asian Financial Crisis, Dr. Mahathir made George Soros a scapegoat, calling him a moron and blaming him as the main culprit for the ringgit's decline. He characterized currency speculation as "unnecessary, unproductive, and immoral" and likened IMF policies to economic colonialism. Interestingly, George Soros actually echoed some of Mahathir's concerns on the instability of financial markets as a cause of serious economic and social dislocations. Soros' remedy, however, was that countries needed to "mobilize domestic savings for domestic capital formation efficiently". In other words, as long as a country is dependent on foreign capital markets for funding, it will be at the mercy of market discipline, or as some may say, market fickleness.

With the U.S. dollar remaining the predominant currency in most of emerging markets' foreign-currency debt issuance, the Federal Reserve monetary policy and the U.S. dollar movement have had an outsized impact on emerging market performance. Generally speaking, during the Fed's easing cycle, emerging markets tended to do well as declining U.S. Treasury yields meant lower financing costs for them. On the other hand, rapidly rising U.S. interest rates tended be a headwind for emerging markets that depend on foreign capital inflow, as the cost of debt service would be on the rise. To wit, in May 2013, soon after then Fed Chairman Bernanke indicated that the Fed would consider tapering the pace of asset purchases, emerging markets were hit with the so-called *taper tantrum*. With the 10-year U.S. Treasury bond yield having surged from 1.67% at the end of April 2013 to

3.0% by the end of that year, emerging markets were hit hard with capital outflow. The Fragile Five – Brazil, South Africa, Turkey, India and Indonesia – in particular, experienced material currency devaluation on concerns over their then deteriorating current account deficits.

From the beginning of 2014 to the middle of 2016, the 10-year U.S. Treasury bond yield experienced a prolonged period of decline and provided some relief to emerging markets. 2017 was a banner year for emerging markets as the greenback weakened through the year. However, since early 2018, with the Fed having commenced quantitative tightening, which in effect reduced U.S. dollar liquidity to financial markets, and U.S. Treasury yields rising in unison, some emerging market vulnerabilities – Turkey and Argentina in particular – have resurfaced.

Turkey has long been beset by a combination of high inflation and chronic current account deficits. Similar to Dr. Mahathir's old antics, Turkish President Erdogan has railed against international investors. However, the Turkish central bank finally relented on May 23rd to hike its benchmark rate by 300 bps to 16.5% in an effort to put a floor under the currency, which had already lost 17% year-to-date at the time.

Argentina, which was the darling of global bond investors less than a year ago when it issued $2.75 billion of 100-year sovereign bonds, had to once again request a credit line from the IMF to contain the precipitous fall in the Argentine peso. The country's current account deficit has ballooned, as the worst drought in decades has seriously damaged its crop production and exports, and inflation has remained a persistent issue. During an eight-day stretch in late April and early May, Argentina's central bank hiked its policy rate three times from 27.25% to 40% in its attempt to stem the capital outflow – tough medicine indeed.

As the 10-year U.S. Treasury yield surged above the psychologically important 3% level in late April, panicky investors started ditching other currencies of nations with current account deficits – the Brazilian real, the Indian rupee, and the Indonesian rupiah – as well as their bonds. To defend their falling currencies, the Brazilian central bank had to forgo an expected rate cut, while the Indonesian central bank raised rates twice in May. International investors also greeted Prime Minister Mahathir's new term by selling down the ringgit and Malaysian bonds to the lowest levels in more than 10 months.

The Italian Job

Just when the surging 10-year U.S. Treasury yield, which closed at 3.11% on May 17th, appeared to be agitating for another round of emerging market currency devaluation, political paralysis out of Rome came to the "rescue" by pushing investors into the U.S. Treasuries as a potential safe haven and collapsing the 10-year U.S. Treasury yield to as low as 2.76% intra-day on May 29th.

Since the early March election, Italy's two populist parties – the League and the Five Star Movement – had a difficult time forming a coalition government. When a compromise was finally reached, the proposed cabinet was blocked by Italian President Mattarella on May 27th as he refused to accept academic Paolo Savona, a euroskeptic, to be the new finance minister. The failure of the populist parties to form a coalition government would set in motion another election in the second half of 2018.

The market reaction was swift and severe as investors appeared to have suddenly realized that Italy's chronic political paralysis and its rising anti-euro antics could potentially lead to another financial crisis. The 10-year Italian bond yield surged to as high as 3.4% intra-day on May 29th, nearly doubling the level at the start of the month. Italy's 2-year bond yield surged from *negative* 31 bps at the start of May to as high as 2.7%. The euro also lost more ground to the U.S. dollar, confounding the earlier market consensus that it would strengthen against the greenback due to a combination of monetary policy normalization by the European Central Bank (ECB) and the widening U.S. budget deficits.

With Italy's government debt-to-GDP ratio sitting at a bloated 132%, the sharp rise in interest rates sent a stern message to even the anti-euro populists. Mr. Matteo Salvini, the leader of the League Party, had to relent on his nominee for finance minister. However, the new finance minister, economist Giovanni Tria, has also exhibited euroskeptic tendencies, and Paolo Savona will still be in the cabinet of the new Prime Minister Giuseppe Conte, a law professor with no prior political experience. It's clear that Mr. Salvini and Five Star's leader Luigi Di Maio will likely be pulling the strings from behind the curtain.

Not Out of the Woods Yet

It's ironic that the longer the political uncertainty persists in Italy, the later the ECB would commence the monetary policy normalization process. With the ECB potentially staying easier for longer, it could provide more liquidity to financial markets, thereby potentially offsetting some of the negative impact from the Fed's monetary tightening. Ultimately, however, Italy needs to resolve its policy paralysis and tone down the threat of "Italeave".

As for emerging markets, some countries remain vulnerable to further tightening by the Fed, and one cannot rule out the risk of contagion due to less liquidity and the rise of trigger-happy, algorithmic-driven quant funds. In time, the artificial intelligence driven quant funds may replace George Soros as Dr. Mahathir's new pet peeve – countries that need external financing will always be at the mercy of the market's fickleness.

In the final analysis, we believe emerging markets still offer long-term growth potential, but selectivity remains paramount in the face of a tightening Fed.

[1] Index pricing information does not reflect dividend income, withholding taxes, commissions, or fees that would be incurred by an investor pursuing the index return.

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For more information on Rockefeller Capital Management:

rockco.com

NEW YORK, NY

10 Rockefeller Plaza, Floor 3
New York, NY 10020
212.549.5100

WASHINGTON, DC

900 17th Street NW, Suite 603
Washington, DC 20006
202.719.3000

BOSTON, MA

99 High Street, Floor 17
Boston, MA 02110
617.375.3300

ROCKEFELLER TRUST COMPANY, N.A.

10 Rockefeller Plaza, Floor 3
New York, NY 10020
212.549.5100

THE ROCKEFELLER TRUST COMPANY (DELAWARE)

1201 N. Market Street, Suite 1401
Wilmington, DE 19801
212.498.6000

ROCKEFELLER
CAPITAL MANAGEMENT