MACRO TIDES

Macro Factors and their impact on Monetary Policy, the Economy, and Financial Markets

Emerging Markets

The factors that most contribute to an emerging markets currency's direction are GDP growth, current account surplus or deficit, fiscal budget surplus or deficit, and the rate of inflation. In general, a country with good GDP growth, a current account and budget surplus, and low inflation is more likely to have a stable or rising currency. Conversely, countries with weak or negative GDP growth, current account and budget deficits, and higher inflation are more likely to have a weaker currency. Countries with current account deficits are more dependent on the kindness of strangers since those deficits must be funded by international inflows. A stronger Dollar often weighs on commodity prices, which can be painful for countries like Brazil, Australia, and Indonesia that rely on the export of commodities. Since most commodities are priced in Dollars, countries whose currency declines relative to the Dollar will experience more inflation, especially if the country imports food and energy and the local currency falls by more than 10%. Higher inflation and a weakening domestic currency often force the central bank of the affected country to raise domestic interest rates to prevent a further decline in its currency. (Argentina and Turkey in 2018) A weak currency frequently results in a surge of money leaving the country so higher interest rates can be a tool to entice money to stay. Even if the boost in interest rates stems the outflow of capital and stabilizes the domestic currency, higher rates punishes domestic companies and consumers and often leads to slower economic growth. Currency crises are born when higher interest rates produce a weaker economy without stemming the outflow of money. This often forces the country's central bank to increase rates even more to stabilize its currency. Currency crises build slowly and then explode overnight, as money flees the country irrespective of the level of interest rates. Currency crises are not pretty, easy to contain, occasionally lead to riots and revolutions, and historically have been a characteristic of emerging market economies.

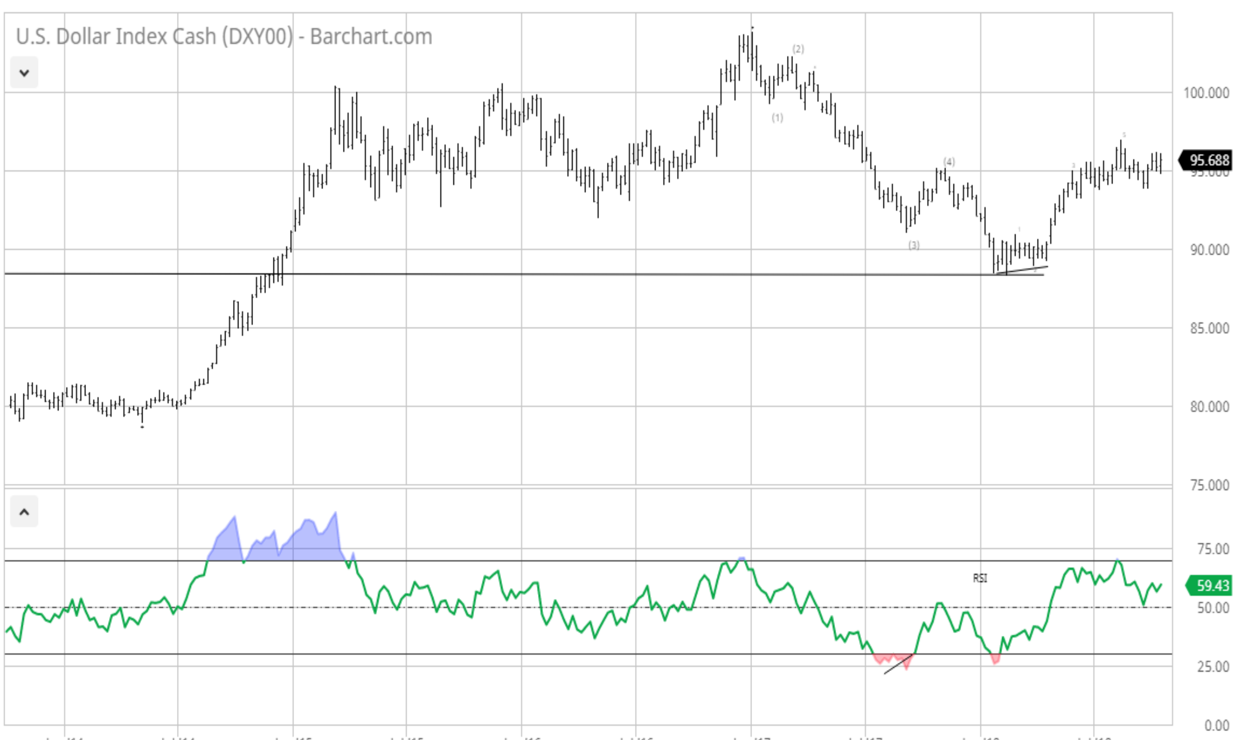
Since the 2008 financial crisis emerging market economies have accumulated upwards of $10 trillion in Dollar denominated debt, since it was cheaper to borrow in dollars than in their local currency. The increase in Dollar denominated debt means rallies in the Dollar exert more downward pressure on emerging economies as the cost of servicing and repaying the debt increases. If a company derives most of its revenue in the local currency, the cost of the debt increases by 10%, if the local currency declines by 10% against the Dollar.

It is of value to be able to discern when the Dollar is likely to rally or fall, as it will influence how emerging market bonds and equities perform. This was especially true from September 2014 2014 to the end of 2016 as the Dollar rallied by more than 25%. As the Dollar corrected in 2017, Emerging Market bonds and stocks performed well, but terribly as the Dollar rose in 2018 after recording a low in February. My analysis of the trend in the Dollar has been helpful in identifying when an opportunity in Emerging Markets was developing or when Emerging Markets were not attractive. (Dollar analysis **Here)**

Economic growth in Emerging economies will exceed growth in Developed economies in coming years, which is why financial Advisors and investors should allocate a portion of their portfolio to EM. However, Emerging Markets are volatile which makes them a good candidate to employ a tactical approach for a portion of the allocation to Emerging Markets, rather than a static buy and hold strategy as the majority of financial Advisors and investors normally do. I believe I can help lower the level of EM volatility in a portfolio and potentially avoid the large draw downs that frequently occur in Emerging Market equities and bonds.

Macro Strategy Review
October 2014
<u>Emerging Markets</u>

The Emerging Market ETF (EEM) has just failed to break above the trend line that connects the high in 2007 and 2011, and broken below intermediate support at $43.25. This failure suggests equity markets in emerging countries could be vulnerable to a decline of more than 10%, since EEM could decline below $39.00 before reaching trend support. The emerging economies will be buffeted if the Dollar index climbs to 89.00-90.00 and especially impacted if it reaches 100.00-101.97.



Macro Strategy Review
April 2015
Emerging Markets

In my October 2014 MSR I wrote that emerging economies would be buffeted if the Dollar index climbed to 89.00-90.00 and especially impacted if it reached 100.00-101.97, which was my long term upside target for the Dollar. On Friday March 13, 2015 the Dollar reached 100.38, so the Dollar is vulnerable to the largest correction since the rally began in May 2014.

Macro Strategy Review
August 19, 2015
Emerging Markets

In the October 2014 MSR I presented a chart of the emerging Market ETF (EEM), and noted that it had just failed to break above the trend line connecting the highs in 2007 and 2011, and had fallen below intermediate support at $43.25. I thought EEM was likely to decline below $39.00. It bottomed at $37.22 on December 19, 2014.

As this is being written on August 19, 2015 EEM closed at $34.33. Given the EM fundamentals, I suspect this area of potential support will prove temporary. In 2011, EEM fell from $49.35 on May 2, to $34.29 on October 3, a loss of $15.06. If EEM matches that decline from the high of $45.35 on September 14, 2015 it would drop to $30.29. The low in 2008 was $18.22 on November 20, which was followed by a rally to $49.35 in May 2011. If EEM retraces 61.8% of $30.11 rally from November 2008 to May 2011, EEM would fall to $30.11. These two technical measuring techniques suggest EEM is likely to fall another 10%. (EEM recorded an intra-day low of $30.00 on August 24, 2015)

Macro Strategy Review
October 2015
Emerging Markets

Emerging markets are becoming attractive from a valuation perspective. Based on Robert Shiller's Cyclically Adjusted Price Earnings (CAPE) ratio, EM valuations are cheaper today than they were in 2009. In February of 2009, the EM CAPE ratio bottomed at 9.91. On July 31, the CAPE ratio was down to 10.02, and is surely lower than in 2009 since EEM is more than 10% below its July 31 price level. Three year returns have been especially good after the CAPE ratio dropped below 15, as the nearby table illustrates.

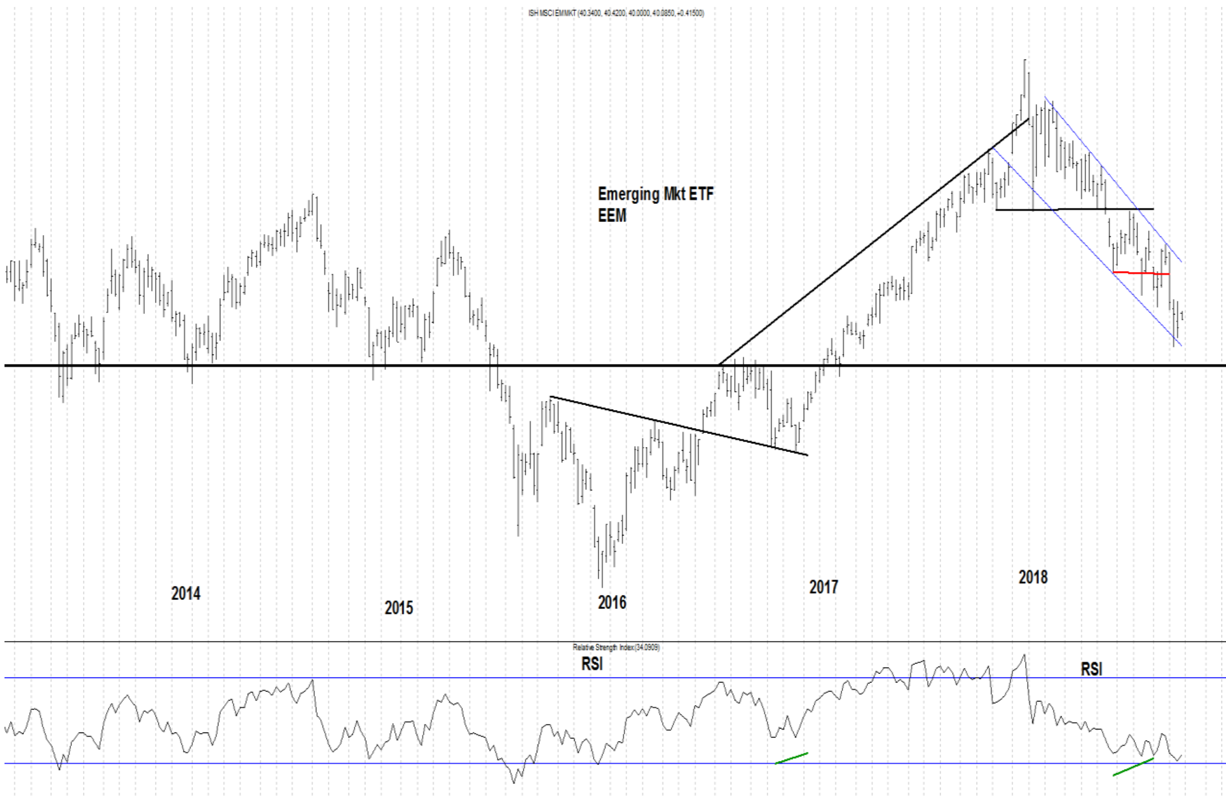
Future Returns Based on EM CAPE Valuation

CAPE	1 Yr.CAGR	2 Yr.CAGR	3 Yr.CAGR	5 Yr.CAGR
<15	10.0%	8.3%	6.1%	6.1%
15-20	7.2%	-2.6%	-5.6%	-0.9%
>20	-27.5%	-16.7%	-6.0%	-6.8%

Source: Wavefront Capital, period ending 07/31/15

Macro Strategy Review
November 2015
Emerging Markets

I think the rally since the August 24 low is merely a bounce within the context of a longer term decline. Last month I presented chart analysis of EEM that concluded that the low at $30.00 was not THE low, and that a decline into a range of $24.73 - $28.84 was possible in coming months. (In January 2016 EEM bottomed at $27.61.)



Macro Tides
January 9, 2017
Emerging Markets

The Dollar has rallied strongly in the wake of the election, the Federal Reserve's decision to increase the Fed funds rate, and the Fed's forecast of an additional three rate increases during 2017. The consensus of strategists is that the Dollar will continue to rally in coming months. Surveys of currency traders have recently indicated that more than 90% of traders are bullish the Dollar, which means they have already bought the Dollar. The last two times bullish sentiment toward the Dollar exceeded 90% was in March 2015 and January 2016. The Dollar subsequently declined by more than 7% in the months following these two periods of ebullience.

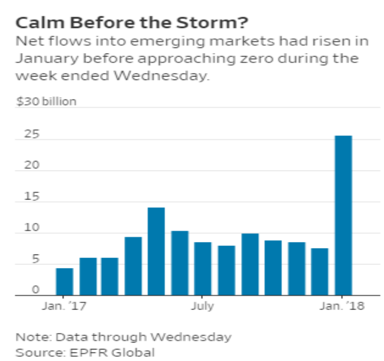
If the Dollar weakens as I expect the Emerging Market ETF (EEM) could rally to $42.00 - $44.00 during 2017. On January 9 EEM closed at $35.91.

Macro Tides
August 7, 2017
<u>Emerging Markets</u>

Emerging market equities and bonds have performed well in 2017, which I thought was possible if the Dollar corrected as I expected. As noted in the January 9, 2017 issue of Marco Tides, "*If the Dollar weakens as I expect, the Emerging Market ETF (EEM) could rally to $42.00 - $44.00 during 2017.*" After Janet Yellen adopted a more dovish stance in her Congressional testimony on July 12, the Emerging Market ETF (EEM) jumped and traded up to $44.16 on July 27.

The range of $42.00 - $44.00 has been an area of stiff resistance on five separate occasions since 2012. The emerging market sector is overbought and there are several reasons why this resistance is likely to hold for awhile. Emerging market equities and bonds have attracted a torrent of inflows in 2017 based on valuation comparisons with U.S. equities and much higher bond yields than can be garnered in advanced economy debt markets. With the run up in prices, the valuation argument is not as compelling as it was coming into 2017.

Macro Tides
September 6, 2017
<u>Emerging Markets</u>
In the August Macro Tides I cited a number of fundamental reasons why lowering exposure to EEM seemed appropriate. "*The economic outlook is starting to soften based on the EM Economic Surprise Index, and debt levels in EM ex China relative to GDP have increased. This has led the ratings agencies – S&P, Fitch, and Moody's – to increase the number of their downgrades. Finally, the Dollar's decline was supportive of the rallies in EM equities and debt, but that may reverse soon since the Dollar Index is approaching major support near 92.00 and 119.00 on the Trade Weighted Dollar Index.*"



I am a big fan of using contrary opinion in helping identify lows and highs in various markets. Money flows into EM equities and EM bonds has soared since January, which suggests that EM equities and EM bonds have become a crowded trade. On five separate occasions, the rally in EEM has run out of steam just above or below the trend line. The weekly RSI is more overbought now than at any time in at least the last 10 years, and did not confirm the recent new high in price. The rising blue trend line on EEM from the low in December is still intact and comes in near $43.50. Until EEM closes below this trend line, the intermediate trend is still up. The odds seem high that a break of this trend line is coming. Selling into strength makes sense, rather than waiting for EEM to drop 5% and break the trend line. (On September 7, 2017 EEM closed at $45.19.)

Macro Tides
March 4, 2018
<u>Emerging Markets</u>

If the Euro declines in coming months the Dollar Index will rally since the Euro comprises 57.6% of the Dollar. The recent low was 88.25 (cash) and could be retested amid trade discussions that include retaliatory actions by other countries in response to U.S. steel and aluminum tariffs. Once the top in the Euro is confirmed, the Dollar chart suggests a rally to near 95.00 is possible in coming months. This would represent an increase of almost 8.0% from its low at 88.25. A Dollar rally of this magnitude could prove a headwind for U.S. stocks, some commodities, and Emerging Markets, especially if Treasury rates breakout before Labor Day and are joined by higher rates in Europe. The Emerging Market Local Currency ETF (EMLC) declined from $19.42 on March 5 to $15.80 in early September a drop of -18.6%.

On a valuation basis Emerging Markets are far less expensive than U.S. equities and economic growth in the majority of EM countries will be stronger than in the U.S. or Europe. However, the combination of higher interest rates in the U.S. and a stronger Dollar could prove a heavy burden on the $10 trillion of EM debt denominated in Dollars between now and Labor Day. Money flows into EM soared in January before the markets got clipped. The inflow suggests a bit too much enthusiasm and leaves EM funds vulnerable. (EEM subsequently fell from $48.20 on March 5 to under $41.00 in October 2018, a decline of -14.9%.)

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