There have been a few changes since you last met our Speakers Robert Marshall-Lee, Investment Leader of The Emerging & Asian Equity Team and Lead Manager for Dreyfus Global Emerging Markets Fund, and Brendan Murphy, Senior Portfolio Manager & Investment Leader for Dreyfus/Standish Global Fixed Income Fund and Dreyfus International Bond Fund.

We wanted to bring you their latest insights around the strategies that were discussed – so we asked them a few of the same questions that were discussed at the Luminary Event you attended, within the context of today’s landscape. We hope you find this helpful and enlightening.

1. **Interest rates in the U.S. just went up. Can you discuss the implications for your respective strategies?**

   **Brendan Murphy:** We had significant underweight to U.S. rates in these portfolios but have recently taken profits on most of the positions as rates continue to move closer to our view of fair value. We continue to monitor any upward inflations surprises or changes in the long-term neutral rate out of the Fed, which could push rates higher. However, the market continues to be short U.S. rates which leads us to believe that U.S. rates should not move materially in the near term.

   **Rob Marshall-Lee:** Yes, the Fed increased rates in March, but this was very much as expected with little follow-through reaction in the Treasury market with yields now below the levels they were prior to the rate increase. There are two related threats that could impact emerging markets. Firstly, how much does the Fed’s tightening push up the global cost of capital, with knock on effects for EM, and secondly, does the Fed’s tightening lead to a strengthening of the dollar and a depreciation of emerging markets currencies. For a variety of reasons, EM currency depreciation usually coincides with EM equity markets underperforming developed markets in the near term. Last year, the US$ was weak despite three rate increases by the Fed; notably though, U.S. 10Y Treasury yields remained largely range-bound thanks to very loose monetary policy in other areas of the world, keeping downward pressure on world government bond markets, together with concerns over secular stagnation and the consensus that inflation would remain low as a result of this. So the global cost of capital didn’t increase very much, and as global growth outside the U.S. surprised on the upside, this contributed to a weaker US$.
What are your thoughts on rates globally?

Brendan Murphy: Rates across the globe look somewhat rich from a valuation perspective, particularly rates in the EU. We will be watching the ECB for any signal of tapering, which has a high likelihood of starting in September with net asset purchases going to zero. This could put upward pressure on European rates.

How have you and your team been able to successfully navigate this sensitive rising rate environment, and outperform the Barclays Agg?

Brendan Murphy: These portfolios have the flexibility to invest across the globe and in countries that are in different stages of the interest rate cycle. Even though rates are rising in most developed nations, there are still emerging market economies that are experiencing a decline in rates. The ability to invest outside of the U.S. and EU allows us to make relative value decisions and add duration based on our “best ideas”.

2. Specific to Emerging Markets, how do you see the U.S. tariffs on steel & aluminum affecting the asset class and the GEM strategy?

Rob Marshall-Lee: By themselves, the impact of the new steel and aluminium tariffs should be fairly small. For example, out of the top ten exporters of steel to the U.S. from EM, South Korea, Brazil and Mexico have already been able to secure exemptions, leaving just Russia, Turkey and China exposed to the 25% tariff, although South Korea has reportedly had to agree to a steel export quota equal to 70% of their usual export amount. China only accounts for 2% of U.S. steel exports however, and these are insignificant in size relative to China’s overall exports to the world. The 25% tariffs on $50-60bn on China exports to the U.S. announced since then are more material, accounting for about 12% of China’s exports to the U.S., but still only account for about 2.5% of China’s total exports and are by themselves only expected to slow China’s GDP growth by 0.1%.

A full-blown trade war would negatively affect the prospects of emerging economies as rising exports to developed markets have allowed emerging economies to grow and develop as globalisation increased in prior decades. Lost export earnings would limit the amount of imports an emerging country can afford, which would either reduce the growth rate countries can safely grow at or negatively affect their balance of payments. Having said that, we are not convinced that a full-blown trade war is in the offing and instead our base case is for only selective tariffs to be imposed by the Trump Administration, with a limited amount of retaliation by other actors, and which although generating a lot of news coverage, will not meaningfully hinder the broader prospects of emerging market countries as a whole.

Naturally there is also a wide dispersion amongst emerging economies with regards to their dependence on exports for growth, with some much less exposed than others. The GEM strategy is arguably less exposed to trade protectionist risks than the MSCI EM benchmark, with underweight positions in most countries that are more dependent on trade, such as South Korea, Taiwan, Thailand and Malaysia.
3. **Specific to the Fixed Income Portfolios: Any Concerns around HY/Credit & equities, and the return of volatility?**

*Brendan Murphy:* 2017 was an unusually calm year when looking at the historical VIX levels. The return of volatility is normal and something that we will be monitoring. Near term, we believe fundamentals are positive for HY & Credit as earnings are expected to be strong in Q1. We continue to have a modest overweight to IG & HY but just fair pricing and being late in the cycle has kept us from a significant overweight in these sectors.

4. **With regards to Emerging Markets – can you touch on the return of volatility?**

*Rob Marshall-Lee:* Volatility was bound to return at some stage, and in some ways is a good thing as it should allow for more rational price setting in the markets. This being said, we should probably expect further bouts of volatility this year, as the market is forced to adjust its expectations around growth, inflation or trade policy as new information is received. These occasions should however provide opportunities for active managers like ourselves to pick up fundamentally sound stocks on more attractive valuations. EM countries that have less secure external balances may see their currencies come under pressure during these bouts of uncertainty, and we would highlight Turkey as one likely vulnerable candidate here.

5. **Let’s move on to sector allocations. Can you discuss any specific opportunities within EM?**

*Rob Marshall-Lee:* For some years now we have found the best opportunities to be within ‘new economy’ services sectors, exposed to consumers, who have seen significant increases in their real wages over the last two decades and now have more disposable income to spend on healthcare, ecommerce, insurance, travel or other goods and experiences. Within the financials sector, we have found a number of very well positioned, differentiated insurance, asset management and housing finance companies, able to benefit from low penetration and rising savings and investments trends. This contrasts with the benchmark’s exposure to what we believe to be higher risk, and typically lower growth banks in this sector.

In addition, due to the way capital markets have developed (and are still developing) in emerging markets, it is often the case that certain sectors dominate the market, while others, which may offer very attractive growth opportunities, are barely represented. As active investors, we are able to take sector positions that reflect investing for future areas of economic growth, rather than just staying close to the weightings of the comparative index. The healthcare sector, and our rising exposure to the electric vehicle supply chain, are two examples of this. Our healthcare sector weighting has come down slightly, as we have re-allocated capital away from some hospitals businesses after a re-appraisal of their return-on-capital potential, whilst maintaining exposure to a range of other core healthcare holdings. Conversely, we have increased exposure to electric vehicles via both battery makers and lithium miners, up to 12.25% of the portfolio, including the introduction of a second miner, which explains our higher weighting in the materials sector. We continue not to hold any metal miners or energy companies.

We are seeing huge disruption to the global auto backdrop due to concerns on climate change, air pollution and fuel economy, which are now being supported by world-wide policy action and media pressure to significantly reduce the number of diesel and traditional fuel vehicles on the roads over the next few years. As a result, we are already seeing a steady rise in demand for electric vehicles, which we estimate to account for 8% of new car sales by 2025, up from 2% today. This is supported
by the fact that EVs are ultimately better products: they have higher torque, are more reliable, safe, lower maintenance costs and emit no engine noise! Concerns over range will be abolished and technology will reduce costs. The proportion of vehicles may sound small for the OEMs, but it is huge for the car battery makers. Never before has one auto-component accounted for so much of the value of the car – the battery is 1/3rd of the value for an EV. We believe this gives battery manufacturers unprecedented bargaining power.

We believe that a scenario of rapid adoption of EVs could trigger a huge demand shock, and that the market is erroneously over-focused on near-term supply, when the key issue is the long-term demand outlook. The inflection point for this, likely comes in 2020/21 at which point the costs for EVs and ICE vehicles reach parity. In order to meet the levels of demand we estimate to be likely by 2025, supply must increase by 4x, and by 12x by 2030. Prices for lithium may have rallied significantly, but they need to do so to incentivize the extra production that is necessary. It is still early days for what is a very long-term trend, and we have high conviction in continued demand growth. As mentioned above, 12.25% of the portfolio is exposed to these trends.

6. And finally, what are your feelings on MBS?

Brendan Murphy: We are negative on MBS as we view this sector being vulnerable to increase rate volatility and reduction in reinvestment by the Fed. We don’t own any MBS in either portfolio.

Interested in continuing the conversation?
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