

# Luminary Series



 BNY MELLON

**October 2018**

There have been a few changes since you last met the Dreyfus Global Emerging Markets, Dreyfus/Standish Global Fixed Income, Dreyfus International Bond & Dreyfus Natural Resources teams.

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. *The US economy seems to continue to be on good footing and as such interest rate increases and a strong dollar may continue, can you discuss the implications for your strategy?***

**Standish<sup>1</sup>:** We had significant underweight to U.S. rates in our global bond portfolios relative to the index and continue to hold that underweight as we expect the Federal Reserve to continue their measured pace of interest rate increases in September and December of this year. The portfolios favor Treasury Inflation Protected Securities (TIPS) and other inflation linked notes as a way of maintaining some U.S. exposure while also protecting the portfolios from unexpected bouts of inflation. We continue to monitor any upward inflation surprises or changes in the long-term neutral policy rate from the Fed, which could push rates higher than anticipated. The continuation of interest rate increases in the U.S. underscores the need for a broader, global approach to core, fixed income investing, paying particular attention to opportunities outside of the U.S.

**Newton:** A strengthening US Dollar and/or rising US rates can be a challenge for Emerging Markets broadly as currency weakness directly impacts performance for foreign investors in US\$ terms. A rising dollar may also increase the cost of financing for firms and governments, either directly for those that have borrowed in hard currency or via higher domestic interest rates as central bank tighten policy to support their currencies or guard against inflation. This can slow economic growth momentum and earnings growth. The implications of all this can result in portfolio capital outflows from the region, which then exacerbates the trend above. A good example of this in recent months has been Turkey, where the central bank has been forced into a very belated rate hiking cycle in reaction to sharply rising inflation that stemmed from the lira’s 20% depreciation against the dollar. Government bond yields have widened considerably and the MSCI Turkey equity index was down 29% in US\$ terms in the first half of 2018.

However, the impact of a strengthening dollar will vary widely across emerging markets depending on the specific country circumstances. Argentina was also hard hit due to its high external financing requirements that left it vulnerable, despite the commendable policy actions taken by the government in recent years. Asian countries on the other hand, while by no means immune, have so far seen less stress so far with currencies falling by around 5 to 7% year to date in comparison, commensurate with their generally much lower external funding requirements relative to the size of their economies.

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<sup>1</sup> Standish is a brand of BNY Mellon Asset Management North America Corporation

This has already prompted pre-emptive action in the form of interest rate hikes by Indonesia and India (as well as the Philippines), which is encouraging. Current account balances broadly improved over the past five years and this should be supportive in due course for the respective EM currencies, particularly as they are trading significantly below where they were in 2013. Government budgets are also broadly in fairly good shape.

A large part of the dollar strength seen this year can be attributed the rise in US rates and yields thanks to the positive US growth outlook – which is typically good for global emerging markets too. However, more recently we have seen a stronger USD coinciding with falling yields, a scenario that is more indicative of a ‘risk off’ environment, and has been coincident with the likelihood for further US / China tariffs increasing and then materializing. Were this dynamic to continue, our very selective investment approach and long-term investment horizon focused on strong company fundamentals should benefit the portfolio from a relative perspective, although absolute performance could suffer in the short run.

## **2. What are your thoughts on rates globally?**

**Standish:** Rates across the globe look somewhat rich from a valuation perspective, particularly rates in the EU. Having said that, economic data from the region in the second quarter of this year was more disappointing than expected. This in turn has pushed out (slightly) the prospect of the first rate hike by the ECB, probably until September or October of 2019. The ECB did articulate the desire to conclude asset purchases by the end of this year, so taken together, this is simply a slightly longer time line of a gradual rise in European interest rates, similar to our base case at the beginning of this year. Our expectation at Standish is that while global growth slowed somewhat earlier this year, it will resume its positive trajectory and allow global central banks to begin the process of removing the extraordinary accommodative monetary policy that has been in place since the financial crisis. As a result, we believe that global interest rates in advanced economies will begin to rise soon.

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

**Standish:** Our global bond portfolios have the flexibility to invest across the globe and in countries that are in different stages of the interest rate cycles. Even though rates are drifting higher in some developed nations, there are still emerging market economies that are experiencing a decline in rates and slowing inflation environments. The ability to invest outside of the U.S. and EU and the ability to rotate from asset class to another asset class allows us to make relative value decisions and add or subtract duration based on our “best ideas”. Further, the portfolios have had an overall bias to be short duration relative to its benchmark which has been a positive in terms of returns.

## **4. Specific to Natural Resources, although your strategy’s top sector is not Energy, we can’t talk about Natural Resources without talking about oil. Generally, the direction of crude has been on the rise this year. Can you talk about the fundamentals behind that move, or lack thereof? Where do you see headwinds or tailwinds for oil supply and demand going forward?**

**The Boston Company<sup>2</sup>:** Actually, energy is now our top weight in the strategy as our thesis for tighter oil markets has been playing out. OPEC has agreed to end their cuts, but with Venezuela and Mexico suffering from massive under-investment, not to mention tightening Iran sanctions, the US is being

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<sup>2</sup> The Boston Company is a brand of BNY Mellon Asset Management North America Corporation.

called on to add more oil. Unfortunately we are seeing challenge to US supply as equipment, labor, and pipes are proving to be a constraint. This will likely alleviate in a few quarters, but it does tighten oil markets and should drive the equities higher. The only requirement is that demand continues to hold these levels of moderate to no growth- a recession of course would be problematic.

5. The U.S. has become a larger player in oil production, how far along are we as a producer and what are our greatest challenges?

**The Boston Company:** The US is now the number one oil producer in the world, even though we import nearly half of our consumption. Production will continue to grow in this country and we are in need of additional infrastructure to manage the record setting scale of the current and future markets.

6. ***Specific to emerging markets, how do you see the current global trade and tariff disputes impacting your portfolio?***

**Newton:** Despite recent escalations, our base case is the 'tit for tat' reactions being seen do not develop into a full-scale trade war. The latter would result in a notable drag on growth for all economies concerned, the IMF estimated this week that global growth would be 0.5% lower by 2020 in an intermediate trade war scenario.

However, we believe the portfolio is relatively well positioned should a trade war and/or global economic slowdown occur for a few reasons. We have less exposure to countries that are predominantly driven by trade growth and little exposure to exporters. Instead, the portfolio is invested mostly in countries with stronger domestic demand characteristics that should be less affected by a trade war. From a bottom up perspective, roughly 80% of the portfolio is exposed to domestic demand growth with limited dependence on exports. The other 20% is exposed to areas of structural growth, including electric vehicle demand and semiconductors, which we believe are supported by long-term demand trends that should help these areas withstand some of the negative effects a trade war could bring.

7. ***Can you discuss any specific opportunities within EM?***

**Newton:** With an average GDP growth rate of roughly 4% (well ahead of developed markets at roughly 2%), much more attractive valuations (a P/E ratio of 13 times earning vs. 18 time earning for the S&P 500 Index on a 12-month forward PE basis), and superior demographics, debt levels and productivity growth for many EM economies we believe there are many opportunities within Emerging markets. However, we do not believe that the MSCI EM Index is fully efficient and therefore believe in taking a benchmark agnostic approach focused on thematically attractive areas and business, which can out-grow the index in an attractively risk-adjusted context. Two of our favorite areas include select opportunities in India and Electric Vehicles. However, we cannot emphasize enough that within these areas we are highly selective when identifying stock-specific opportunities, with the individual companies remaining the most important driver of performance and secondly that the overall portfolio remains well diversified across a range of areas, as well as exposed to these two. \

## **India**

- India continues to be our favorite economy overall, on a 5-year basis. The position size as at the end of Q2 was 24.62%, which is a reduction from end-2017 owing to stock specifics, but still the biggest overweight (vs. 8.61% in the MSCI Emerging Markets Index). We view India as a strong investment location over the next five years, owing to a combination of factors including:
  - GDP growth – in Q1 2018 the Indian economy grew by 7.4%yy, the fastest rate in six quarters. The IMF projects GDP growth of 7.4% for 2018, and 7.8% for 2019.
  - Superb demographics and productivity pickup – one of the world’s best demographic pictures with a large working-age population, which is growing rapidly. Productivity growth is also picking up from a very low base.
  - Indian Prime Minister Modi’s difficult but necessary decisions to support the drive for long-term growth. The introduction of Goods & Services Tax (“GST”) will likely remove many inefficiencies for business.
  - Big upside potential for the car industry. India currently has only 18 cars per 1,000 people vs. 500 cars+ for more developed economies. (Source: OICA, 2015 PC registrations, data accessed on 24 August 2017.)
  - Mortgage penetration and investment growing from a very low base – the government’s financial inclusion initiative along with a growing middle class represents huge upside potential for companies operating in this space.
  - Diversification benefits – India is an economy largely driven by domestic factors, unlike many other developed-market and emerging-market investments, which are highly dependent on global demand and global growth. We believe it is also attractively positioned at an early cycle point, with room for investment and margins to pick-up, at a time where leading economies are closer to the end of their cycles.

### ***Electric-vehicles: growth is a key theme, representing roughly 11% of the portfolio***

- The automobile industry globally is currently being impacted by policies on fuel economy, climate change, and air pollution. Electric vehicles (EVs) look well placed for dramatic growth, but costs will have to fall as subsidies are removed.
- We expect EVs to reach cost parity with combustion vehicles by 2021, as battery pack costs decrease to \$100/kwh, from \$1000/kwh in 2010. This should create an inflection in demand, such as has been witnessed historically in the adoption trends of many compelling consumer technologies, which scale their penetration faster than is anticipated.
- The market remains far more cautious about this demand outlook and provides us a point of differentiation. We believe demand is supported not only by policy and pricing, but by the fact that EVs are ultimately better products.
- Tesla has done a lot to make for the credibility of consumer perception, but EVs also have higher instant torque, are more reliable, safer, have lower maintenance costs and no engine noise! We believe that both electric battery manufacturers and lithium producers are very well positioned to create value from what is set to be a long-term trend.
- In 2017, the number of electrical vehicles globally increased from 740,000 to 1.1 million. Pure electric vehicles grew at 61%, while hybrids grew at 36%. We expect EV penetration to rise from 2% to 10% of new car sales by 2025.

- We know that this is still very much a nascent industry, with a number of ongoing challenging, such as insufficient charging infrastructure, mass-market models still subject to 'range anxiety' and affordability.
  - We do not expect straight-line progress, as the early-stage industry scales to multiples of its current size, but we are excited about identifying the right investments to capture the value of this high multi-year growth opportunity.
8. With the constant chatter about inflation, both here and abroad, how should investors view a Natural Resources strategy? Does it offer different opportunities than traditional equities and commodities? Why?

**The Boston Company:** Natural Resource equities present a compelling opportunity for managing inflation. The underlying asset, commodities, tends to be a good store of value in a rising price environment. However, if inflation is not present, the commodities may lag broader equity markets which prefer low inflation. What is compelling about NR equities is that they are commodity sensitive, but still provide equity returns. This suggests that in low inflation the NR equities may benefit from being in equity markets and when inflation starts to rise, the commodity aspect should drive returns to be an equity market outperformer.

9. ***Specific to the Fixed Income Portfolios: Any Concerns around HY/Credit & equities, and the return of volatility?***

**Standish:** 2017 was an unusually calm year in the context of historical VIX levels. The return of volatility in 2018 has been exacerbated by unusual trade rhetoric and tactics as well as some idiosyncratic events in certain emerging market countries and the unexpected outcome of the Italian elections. But overall, the higher volatility that we've experienced in the recent past is closer to normal and something that we will be monitoring closely. In the near term, we believe fundamentals are positive for investment grade credit as earnings have been strong in the first half of the year, defaults rates remain low and recovery rates are still very solid. High yield is more challenging because valuations are stretched more than in investment grade and the light supply has more people chasing fewer bonds. Further, we believe the quality of earnings are not as good as those available in investment grade bonds and are therefore leery of too much exposure. We continue to have a modest overweight to investment grade bonds and a very small allocation to high yield with a bias to higher quality bonds in that sector.

10. ***And finally, what are your feelings on Mortgage Backed Securities?***

**Standish:** We have a negative view on agency MBS as we believe this sector is vulnerable to increase rate volatility and reduction in reinvestment by the Fed. Additionally, without the support of FNMA and FHLMC, the buying universe is limited to banks, REITS and real money clients; a relatively limited pool of buyers. We continue to have a zero allocation agency MBS in our global bond portfolios and look for a better entry point as option adjusted spreads increase.

***Interested in continuing the conversation?***

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