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BARON CAPITAL

Guilty Until Proven Innocent:
Trump and the Potential Impact on International and Emerging Markets

Michael Kass, Portfolio Manager of Baron Emerging Markets and Baron International Growth Funds and Strategies, provides his views on the possible impacts of a Trump presidency on the international and emerging markets.

The international markets' initial reaction to Donald Trump's victory in the U.S. presidential election was *"guilty until proven innocent."* Immediately following the election, fears that policies/positions communicated by Trump on the campaign trail would be put into action propelled a substantial decline in the international and especially the emerging markets.

We believe much of what Trump espoused during his campaign is not likely to be enacted, at least not without consequences reverberating back to the U.S. We would characterize the market response as largely correct directionally, but probably far larger in magnitude than warranted, and expect some reversion to the mean.

Trump's election is a sea-change event for markets that had become complacent in positioning for an extension of the policies and economic environment of the Obama era (regardless of whether the policies ultimately prove successful).

A Trump administration will likely pull new levers, relax headwinds on certain industries, and establish new leadership within the equity markets. As a result, we expect multiple expansion in financials and industrials, as well as inflation plays on the margin at the expense of yield-sensitives, bond proxies, and secular growth companies. While we can identify candidates for a mean reversion in fundamentals and stock market performance, we think it is too early to contemplate the magnitude, or make any large bets on specific winners or losers, *at today's existing market prices*, as a substantial re-pricing has already occurred. We note, however, that at some point, the re-pricing will have run its course and company fundamentals will again prevail. While we have made a few modest moves, we have mostly done little thus far amid the substantial volatility across all financial markets.

It is still far too soon to be predicting the ultimate course of economic and foreign policies under Trump. However, we are thinking hard about possible outcomes and how they may shape longer-term fundamentals. We suspect that over time, as details become clearer, we will have some new investment themes in our international and EM portfolios.

More specific thoughts appear below:

1. Trump's proposed economic policies appear to be pro-growth, on the margin inflationary, and if enacted would accentuate the transition already underway from QE/monetary policy-driven stimulus to a balance of monetary and fiscal policy. The implications are: higher inflation expectations, higher bond yields, greater Fed tightening as growth accelerates, and a stronger dollar.

2. Should Trump implement his proposed changes, this would likely represent a departure from the "re-synchronization" of global policy we have been discussing since late last year. It threatens a return to an asynchronous environment, in which U.S. monetary policy is out of step with the rest of the world. On the margin, this may slow the momentum and leadership of emerging markets, and may extinguish the leadership of these markets. Within the developed world, this environment would likely benefit Japan the most, and we are actively looking for opportunities to add to Japanese equities in our international portfolios. All of the above implies that the cyclical earnings recovery in EM that we have been anticipating would likely moderate.

3. Regardless of any changes under Trump, we believe most EM economies are in a better position today than a year or two ago to absorb a modest increase in interest rates, given positive fundamental reforms and political reversals in Brazil, India, Indonesia, Argentina, and to a lesser extent China and Mexico. South Africa may also tilt positively over the next year or so. While clear tailwinds for EM have become more complex and mixed, the fundamental, long-term driver of EM opportunity remains pointed in the right direction, and we await further signs of progress.

4. Protectionism and/or the unwinding of trade treaties is another uncertainty that contributed to the post-election knee-jerk sell-off in export-oriented markets/currencies and companies. We believe it will be difficult to enact the types of protectionist policies Trump threatened on the campaign trail, with 30-45% tariffs on Mexican and Chinese imports an obvious example. He may attempt to unilaterally ram some type of protectionist measure through, but any such attempt will likely lead to some combination of 1) alienation of his Republican base in Congress, thereby shutting down chances of further meaningful legislation; 2) China's ascendancy as the world's favored trade partner – particularly throughout Asia and Australia; 3) much higher U.S. inflation causing more Fed hikes and likely triggering a U.S. recession; 4) a short term-collapse in global trade and trade finance, likely leading to a global recession and financial stress; and 5) likely damage to U.S. foreign relations and a rebalancing of global influence in the direction of China, who will gladly fill the void, elevating long-term aspirations for the RMB to rival the dollar as the world's reserve currency.

   For these reasons, we think major protectionist/trade policy is likely to be on the back-burner. Trump has called out tariffs on U.S. companies moving to foreign jurisdictions for tax purposes and then exporting goods back to the U.S. If this is the extent of the direction Trump's trade policy is going, then the steep post-election sell-off is likely overdone short-term.

5. Thus far, markets have discounted a fairly large magnitude of change as well as the likelihood that Trump's proposed policies will be implemented and lead to desired outcomes. This is a major assumption to make while we continue to await key cabinet selections and other announcements. Nevertheless, in the U.S. equity and bond markets, the message has been largely "*innocent until proven guilty.*" While this is a reasonably likely position to take, it does not reconcile with the international and EM market response to date. If the U.S. is about to enter a sustained period of higher growth, it will not be all bad for EM markets, and the magnitude of the divergence likely represents a buying opportunity.
