LORD ABBETT

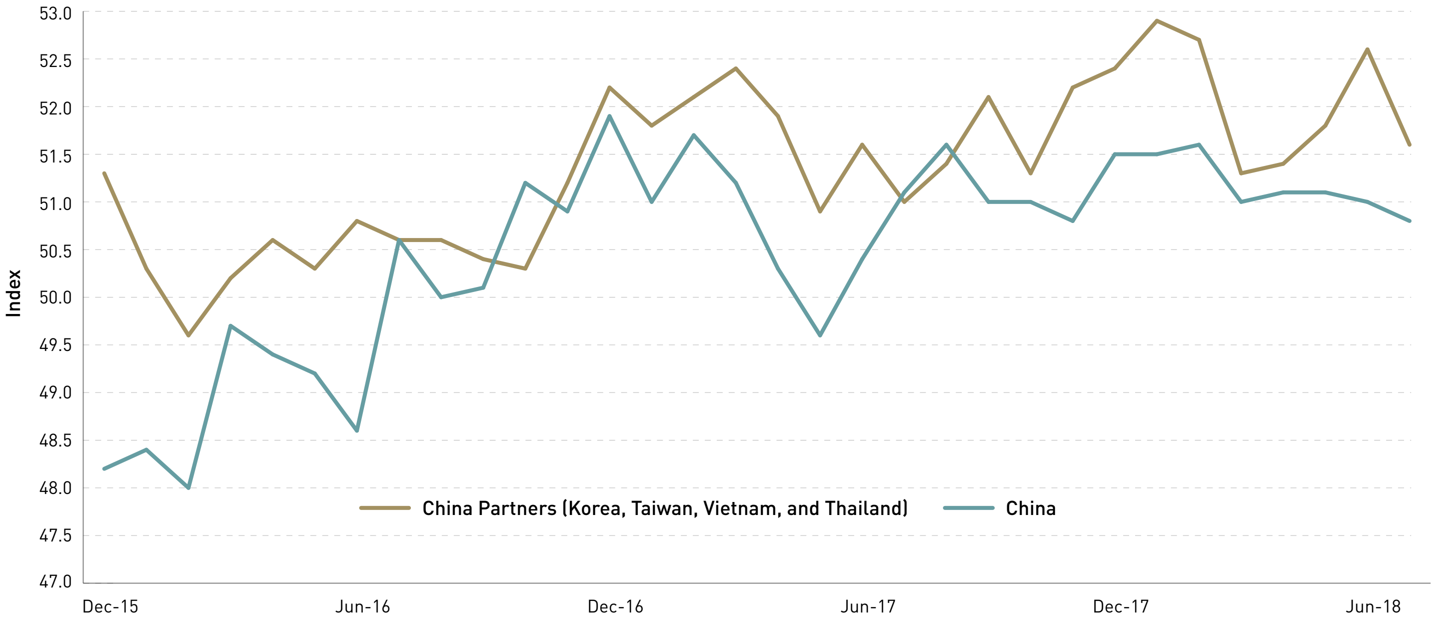
MARKET VIEW

EMERGING MARKETS: TURKEY AND CHINA IN THE SPOTLIGHT

Analysts agree that the economic outlook for Turkey is worsening, but there is less of a consensus on China.

CHART 1.
KEY ASIAN PURCHASING MANAGERS' INDEXES HAVE REMAINED SOLIDLY ABOVE THOSE OF THE LAST SLOWDOWN

MANUFACTURING PMI IN CHINA AND CLOSELY LINKED ECONOMIES IN NORTHEAST ASIA, DECEMBER 31, 2015 – JULY 31, 2018

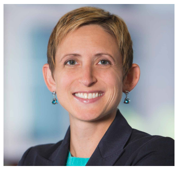


Source: Bloomberg. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

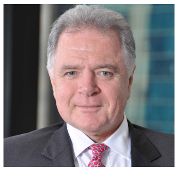
IN BRIEF

- By putting limits on currency swaps, Turkey has effectively made the lira untradeable, and some investors are selling other emerging-market currencies as proxies.
- Unless there is a sharp reversal in Turkey's economic policies, Turkey likely will head into a recession, with inflation estimated to hit 20% at least.
- Recently, a view has been developing that the Chinese economy is slowing down meaningfully, or will do so very soon. But that claim seems to be exaggerated.
- Chinese authorities are taking steps to ensure that growth does not fall below target, including ensuring that financing remains available for small to medium enterprises and exporters.

CONTRIBUTING STRATEGISTS



Leah Traub, Ph.D.
Partner & Portfolio Manager



Giulio Martini
Partner, Director of Strategic Asset Allocation

While investors have been focusing on Turkey and its plunging currency amid political turmoil, the economic outlook for China also is coming under increased scrutiny, given an intensifying trade war with the United States and the uncertainty arising from the conflict.

Turkey: Digging a Deeper Hole

It's clear that Turkey is in a bad place in terms of its economic outlook, with its currency, the lira, down nearly 40% against the U.S. dollar so far this year (as of August 17, 2018); its sovereign debt, already rated below investment grade, downgraded further by all three major U.S. credit rating agencies; and inflation at 15.4% and rising, according to Bloomberg.

According to Leah Traub, Lord Abbett partner and portfolio manager, a currency expert whose outlook for the Turkish lira is sobering, there were several events that precipitated the currency's decline in August:

- The Turkish central bank neglected to raise interest rates at its meeting on July 24, 2018, despite inflation's rise of more than 15% earlier in that month. The central bank's inaction was preceded by President Recep Tayyip Erdogan's announcement that the central bank and other public banks would now come under the control of his son-in-law, who would head the newly combined Ministry of Finance and Treasury—a move that did not sit well with currency traders.
- In August, the United States imposed sanctions on two Turkish officials as a direct result of the government's failure to release American pastor Andrew Brunson, who has been incarcerated (currently in house arrest) for more than two years on charges of terrorism regarding a failed coup.
- As part of the pressure on Turkey to release Brunson, the Trump administration increased tariffs on Turkey's steel and aluminum exports. While these metals are not key exports for the country, the move may have been intended to show the U.S. administration's willingness to impose further, and perhaps more damaging, economic sanctions down the road.

"In response, Erdogan has unfortunately dug a deeper hole," says Traub. Turkish authorities did what so many emerging-market countries have done in the past: put controls on capital. Specifically, Turkey's banking regulator put limits on currency swaps, capping local lenders' swap and swap-like transactions to just 25% of shareholder equity. "These limits have made it very expensive to short [the Turkish lira] in the forward markets, and have effectively raised rates for foreign-exchange traders," Traub says.

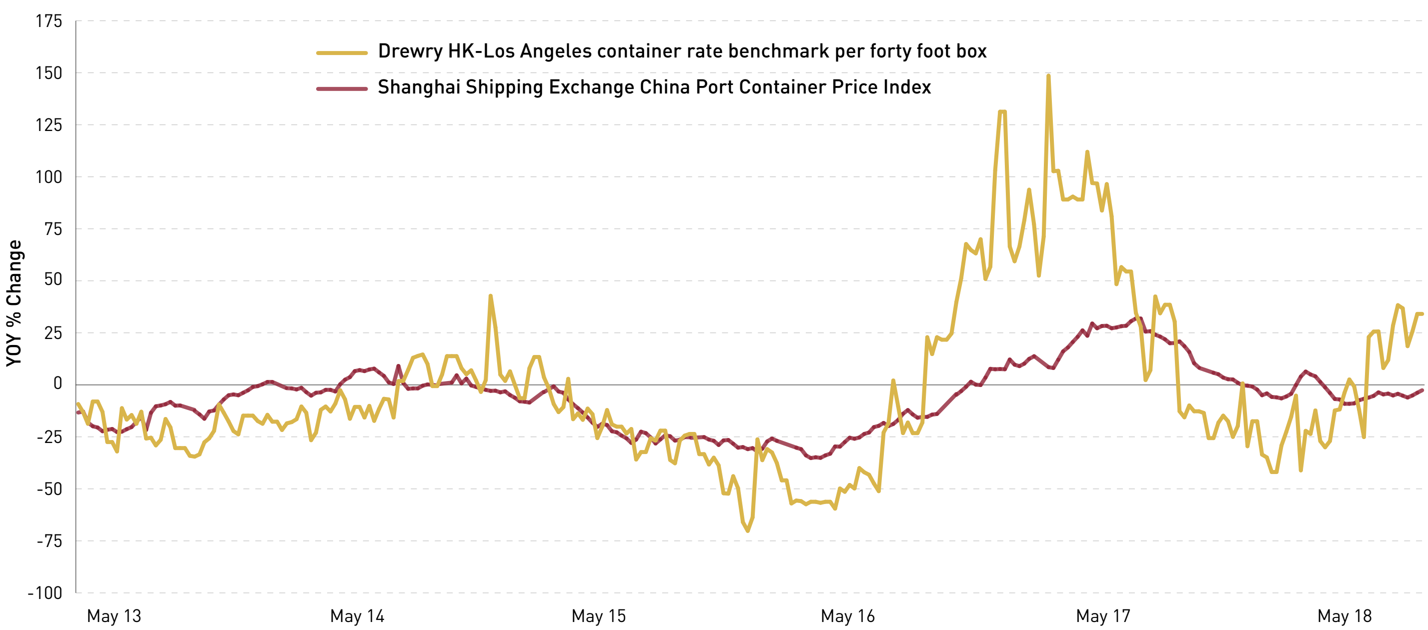
That consequently made the lira untradeable, forcing speculators betting against (shorting) the lira to close their positions. That, in turn, is making it much harder for foreign investors in local bonds and stocks to hedge their currency risk, giving them every incentive to bail out as well.

All this has had a ripple effect on emerging-market currencies in general. "Because it is now so expensive to sell the lira," Traub says, "investors are selling other emerging-market currencies as proxies for the lira."

Investors also are concerned about Turkey's large U.S.-denominated debt that is due to mature in 12 months. International Monetary Fund data show that Turkey's foreign-exchange reserves (of about US$100 billion) are insufficient to service that debt. European banks in particular have considerable exposure.

CHART 2. IS CHINA SUFFERING FROM THE TRADE WAR? NOT ACCORDING TO THIS KEY DATA

CHINA FREIGHT SHIPPING RATES, MAY 1, 2013 – AUGUST 22, 2018



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So, unless there is a sharp reversal in Erdogan's economic policies, Traub believes that Turkey will head into a recession, with inflation, she estimates, likely to hit 20% at least.

Of course, Turkey is not the only story in emerging-market news. Commodities also are taking a bit of a hit following weaker-than-expected data out of China in July 2018; industrial output, fixed asset investment, and retail sales all came in below consensus expectations. What does that portend for China?

China: Slowing or Growing?

Recently, a view has been developing that the Chinese economy is slowing down meaningfully, or will do so very soon, according to Giulio Martini, Lord Abbett partner and director of strategic asset allocation. This pessimism is based, in part, on the uncertainty generated by changing relations between the United States and China, in particular, the trade war between them.

So far, the United States has imposed levies on $34 billion in Chinese goods, according to *The Wall Street Journal*, with tariffs on an additional $16 billion in goods scheduled to take effect soon, and plans for tariffs on an additional $200 billion in Chinese imports under review for October. As tariffs have been imposed, China has matched them dollar for dollar.

"As to whether the Chinese economy is slowing, it's pretty hard to find evidence, aside from plunging copper prices, that there is an actual slowdown underway," Martini says. "Or at least one that exceeds the modest easing in growth that was widely expected" after the 19th National Congress of the Communist Party of China held in October 2017. He notes that gross domestic product growth slowed, from 6.9% year over year in the second quarter of 2017 to 6.7% in the same quarter 2018; the government's official target through 2021 is 6.5%.

For one thing, "policymakers appear to be keen to ensure that growth does not fall below target," Martini says. For example, there have been widespread reports that the authorities are taking steps to ensure that local governments accelerate their approved spending. "Only 27% of the funding available for new projects was taken up in the first half of 2018, so there is plenty of room to step up activity," according to Martini. In addition, banks have been tasked with ensuring that financing remains available for small to medium-sized enterprises and exporters, even as deleveraging continues to be pursued through targeted actions aimed at state-owned enterprises.

In addition, China appears to have the tools available to enable it to pursue a fully independent monetary policy. The nation's central bank, the People's Bank of China, has allowed the differential between U.S. rates and domestic funding rates in China to narrow significantly, as it has eased, while the U.S. Federal Reserve has tightened. Foreign-exchange reserves also have stabilized at around $3.1 trillion, notwithstanding estimated valuation losses due to a strong U.S. dollar of around $60 billion in the second quarter of 2018.

As a result, vulnerability to capital flight (which has arisen in prior periods of economic slowdown and uncertainty over policy) appears to be contained this time around, according to Martini.

Meanwhile, the potential negative effects of tariffs on goods produced in China have not yet shown up. For example, shipping rates on bilateral trade between the United States and China have remained resilient through mid-August.

And while purchasing managers' indexes in China and its closest trading partners have moderated somewhat, recent levels have remained solidly above those in 2015–16, when growth last slowed sharply.

To summarize Martini's views:

- Martini believes that it is unlikely that tariffs, even if extended to a broader set of products at the end of October, will do much to slow down demand for exports from China in the short run. Why? He cites the extremely strong U.S. domestic demand due, in part, to stimulus from tax cuts—and the time and expense needed to shift the location of production in globally integrated supply chains.
- However, it appears that the authorities in China aren't taking any chances by easing monetary policy and ensuring that approved plans for spending by local government entities are executed on schedule.
- Thus, fears that the economy in China could be slowing much more severely than it seems from the evidence in hand appear exaggerated, according to Martini.

Summing Up

While Turkey and China have dominated investment headlines over the past few weeks, the governments of each nation are in far different positions in terms of addressing their near-term challenges. Turkey's monetary policy and currency moves have made an already difficult situation worse. China, in contrast, likely has the financial resources and policy flexibility to help it counteract any near-term economic headwinds. ■

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GLOSSARY

A **currency swap**, also known as a **cross-currency swap**, is an off-balance sheet transaction in which two parties exchange principal and interest in different currencies. The purpose of a **currency swap** is to hedge exposure to exchange rate risk or to reduce the cost of borrowing a foreign currency.

The **Purchasing Managers' Index (PMI)** is an indicator of economic health for manufacturing and service sectors.

The **Drewry HK-Los Angeles Container Rate Benchmark** consists of container freight rates on 40-foot containers on the major route from Hong Kong to Los Angeles.

The **Shanghai Shipping Exchange China Port Containerized Price Index** consists of container freight rates on the major route from Shanghai to various ports in the index. It reflects spot rates and only tracks exports (not imports) from a single market (Shanghai).

Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

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Lord, Abbett & Co. LLC | 90 Hudson Street | Jersey City, NJ 07302-3973 | T 1.888.522.2388 | lordabbett.com

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