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1-on-1 With Michael Hasenstab: Market Changes and Challenges

February 15, 2018

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Take an around-the-world market tour with Templeton Global Macro CIO Michael Hasenstab in our latest "Talking Markets" podcast. Hasenstab shares his thoughts on navigating today's market challenges. He covers recent market volatility, inflationary threats in the United States, upcoming elections in Latin America, potential "fault lines" in Europe and credit risk in China.

Here are some highlights of Hasenstab's views represented in the podcast:

- I think we have had some pretty meaningful changes in terms of US policy in the last several months that should push forward what was already decent growth, but accelerated. We have a number of things coming together that are likely going to pull inflation higher.
- In the United States, companies are trying to hire more people than they are able to find. So, ultimately, they are going to have to pay higher wages. This is all happening at the same time we have cut our labour supply. We have moved the supply curve in the wrong direction with pretty aggressive anti-immigration policies. And so, we are already starting to see some wage pressures.
- The amount of volatility and the magnitude of the [equity market] selloff really didn't reach a level that would trigger real economic impact. I think we are far away from that. It seemed pretty isolated and contained. I don't think we should panic about the moves that have happened. What I do think it does indicate, though, is there is a lot of leverage that is being built up.
- In emerging markets, we are looking for reform stories. We are quantifying and highlighting the governance in the policy framework and the social stability.
- As long as growth is good in Europe, you probably don't see any of its fault lines getting too critical. But the minute you have external shock or some sort of domestic shock, then I think the fault lines become very apparent and make coordinated policy work almost impossible.

The full transcript of the podcast follows.

Host/Richard Banks: Hello and welcome to Talking Markets with Franklin Templeton Investments: exclusive and unique insights from Franklin Templeton. I'm your host, Richard Banks. Dr. Michael Hasenstab, Executive Vice President and Chief Investment Officer of Templeton Global Macro at Franklin Templeton Investments breaks down what's behind current market gyrations and looks ahead to longer-term concerns. Speaking with Dr. Hasenstab is Franklin Templeton's Katie Klingensmith. Katie, take it away.

Katie Klingensmith: Let's dive right in. We have a lot going on in the United States and I know it from your team you have still highlighted that there's quite a bit of momentum in the US economy. What's your outlook?

Michael Hasenstab: I think we have had some pretty meaningful changes in terms of [US] policy in the last several months that should push forward what was already decent growth, but accelerated. Probably the most important is actually the deregulation that has been aggressively pursued by this [US] administration, as well as by Congress. That was probably one of the big bottlenecks for investment and one of the reasons we haven't had a lot of investment since the GFC [Global Financial Crisis]. This very burdensome regulation crossed a lot of sectors from financials to the health care sector and on. So I think that will be a significant boost to growth and it came at the same time with the [US] tax-cut changes and the repatriation. All of that I think is well-known and clearly positive. So you add those deregulation, tax changes on top of an economy that was doing pretty well and clearly, I think, the growth trajectory for the 2018 is pretty positive.

Katie Klingensmith: Could you give us a little more insight about tax reform? How much did that change your view of the US economy?

Michael Hasenstab: I think one of the things it did was increase the deficit, so we are going to have to borrow another US$200 billion a year to pay for the tax cuts. Theoretically in 10 years' time it's revenue-neutral, but we all know that's a little bit of an accounting gimmick and in the short term it's clearly going to create a larger deficit. That is happening at the same time as the Fed [Federal Reserve] is committed and announced that they will not be funding the deficit through their QE [Quantitative Easing] programme. As bonds mature, they are not going to reinvest those at the same rate. There will be a phasing-out period, but certainly it is going to be phasing out. So you have higher deficits; you have the Fed which financed 25% of our deficit now going to be gone from the market. I think that is going to have a meaningful impact on the Treasury market. Plus, you are seeing signs inflation is beginning to accelerate. We have a very tight labour market which is only made tighter by the anti-immigration policies of this administration. All these things I think are coming together where you are going to see an acceleration of growth, but it is going to pull inflation higher and Treasury yields need to back up.

Katie Klingensmith: A lot of different topics there that I want to make sure to explore. But before we dive into those specifics, market gyrations have a lot quite nervous; has there been any new information that causes you to change your view on the economy?

Michael Hasenstab: No, I think first, all the amount of volatility and the magnitude of the [equity market] selloff really didn't reach a level that would trigger real economic impact. I think we are far away from that and you didn't see it translate beyond kind of the core equity markets into all risk assets. It seemed pretty isolated and contained. So I don't think we should panic about the moves that have happened. What I do think it does indicate, though, is there is a lot of leverage that is being built up in these exchange-traded funds and I think we just don't know the magnitude of that leverage. We can do some estimates, but that I think is a concern that when you start to see either volatility or rising yields, those are conditions that we haven't had and so there is a lot of complacency, a lot of financial engineering has been built upon some of those assumptions of low yields and low volatility. When that comes unwound, we just don't know what the ripple effects can be. And I think this is one of the dangers of Fed policy being dovish, was that you build up these unknowns and that is a concern. So to us, we don't know exactly how those dominoes will fall, but we know one of the triggers will probably be higher [interest] rates.

Katie Klingensmith: So let's take a little time to think about what the Fed is doing. You mentioned that you expect there will be higher rates coming from that very dovish place, in part because of rising inflation. Can you expand a bit on your forecast for the Fed?

Michael Hasenstab: So I don't think the Fed changes a whole lot under the new chairmanship. I think probably the biggest change will come up on regulation. Remember, the Fed is in charge of bank regulation and that I think will get looser. In terms of the glide path for rates, it's probably not a big change. You have seen some voting members have rotated through and probably a slightly more hawkish Fed than we had before. But again, we've clearly got a dovish, I think, board for the time being.

Katie Klingensmith: And you mentioned that there are a few factors that will be driving up inflation?

Michael Hasenstab: I think most notably it's going to be in the labour market. We are at full employment; the job reports keep coming out stronger and stronger and we are starting to see that pass through into higher wages. Companies are trying to hire more people than they are able to find and so, ultimately, they are going to have to bid away people, pay higher wages. This is all happening at the same time we have cut our labour supply. We have moved the supply curve in the wrong direction with pretty aggressive anti-immigration policies. And so, it's already a full labour market, we are already starting to see some wage pressures and then you pull a huge section of the labour supply out. It's just simple math. It will have to go higher.

Katie Klingensmith: Your team has done quite a bit of research on the balance-sheet management, any updates about how that will play out in the current situation?

Michael Hasenstab: I would just emphasise that it is a really big factor that the Fed is no longer going to be financing our deficits. If this happens in a period where growth is okay and we don't have inflation surprises, you could have a gradual adjustment higher on rates, but we don't know exactly how that will play out. But it is a large change factor that I don't think is being talked about enough in the market. In addition to the fact that the Fed is out as a buyer, a lot of this repatriation likely means a lot of that cash was held in fixed income assets and is going to be sold to come back and either go to hire more people, to pay dividends, to do stock buybacks, but it's unlikely to be at the margin positive for the bond market as well, so that's one other technical factor that's changed.

Katie Klingensmith: What might the Treasury market look like in the next year or several and specifically around the US yield curve?

Michael Hasenstab: So I think it needs to continue to go higher. You know if you look at where, say, the 10-year [Treasury] yield is, if we have 3% growth, 2% inflation and a more normal buyer base—that is you don't have these price-insensitive buyers like China's central bank or the oil-exporting companies recycling petrodollars, or our own Fed doing QE. You take out those price-insensitive buyers and you put in price-sensitive buyers—banks and insurance companies and people like ourselves—3% growth, 2% inflation and you typically have a 5% 10-year yield. Well, we are a long way away from that. I think three months ago, when we talked about getting close to 3% yields, there was a lot of scepticism in the marketplace and look how quickly it happened. So the move from the 30-year [Treasury] going to four [percent], it wouldn't take a whole lot for that to happen.

Katie Klingensmith: But it seems like the dollar hasn't behaved in a predictable way and it's actually lost value, why is that?

Michael Hasenstab: This is very unusual and if you go back and look at any economic model when you have US growth accelerating, inflation picking up and rates going higher, that would point to a stronger dollar, particularly versus the other G10 countries. But it's not. This is just what we have been experiencing for the last 10 years is sort of that rubber-band effect of… you have macroeconomic developments that should lead to a certain price, but the market is distorted and doesn't behave rationally in the short term and you get that deviation. The sentiment was very bullish on euro and it was not inconsistent with what had happened in euro growth. They had some better growth numbers. But if we think about 2018, the real growth surprise I think will come in the United States with a lot of these tax-regulatory changes. I think you are going to see that growth differential in the United States significantly higher than Japan, significantly higher than Europe. Interest-rate differentials are already widening out and that should pull the currency stronger.

Katie Klingensmith: So the growth and the yield differentials will drive the dollar back up relative to developed countries. Are there other factors that are influencing the major currencies right now?

Michael Hasenstab: I think the optimism I said, the speculative optimism on euro, was clearly probably the biggest driver there. I think with regards to Japan, it has not even behaved as you would expect with a good global growth environment. There is no need for that sort of safe-haven asset, like the yen could be, so it's definitely behaved very atypically. And I think emerging markets have been a bit better-behaved and we have seen they should respond well to a stronger US economy and to a stronger global economy, improved trade. I think it's not surprising to us to see some of the emerging-market currencies at least have some decent support.

Katie Klingensmith: So I want to go a little deeper into Europe, your team has recently been underscoring concerns about political risk in Europe and obviously the euro has done a little better, what's your outlook and what worries you there?

Michael Hasenstab: I think the political dynamics continue to deteriorate. They are getting no, really, sort of, acknowledgement from the marketplace, but you just have—particularly in central Europe, places like Poland, Hungary, Czech—pretty strong moves towards unorthodox populist direction. Probably in a good-growth environment without an external shock, you don't see the fault lines affect policy dramatically, but our concern is that you are moving the shift towards nationalism, populism and when there is a shock and Europe needs to come together to address imbalances or debt issues in Italy, there's not going to be the ability to come together. So as long as growth is good, as long as risk assets are doing okay, you probably don't see one of these fault lines get too critical. But the minute you have external shock or some sort of domestic shock, then I think these fault lines become very apparent and make coordinated policy work almost impossible.

Katie Klingensmith: But the ECB [European Central Bank] seems to be sending signals, maybe more on the economic front, that there is some normalisation in the momentum.

Michael Hasenstab: I mean, the economy broadly throughout the eurozone has been doing decent. Again, what matters for euro-dollar is relative growth between the two and relative rates between the two. So on the interest-rate side, the ECB [European Central Bank] will eventually back away, but they are still involved in the market whereas the Fed is going to be out of that. I think that will put some sort of cap upon European yields and again that interest-rate differential will widen and the currency should feel the effects.

Katie Klingensmith: And on the yen, you mentioned they really need a weak yen in order to continue to see some sort of growth and inflation, so it behaved a bit abnormally recently…

Michael Hasenstab: Yes, but I think we also need to remember that the interest-rate differentials between Japan and the United States are probably the number one driver of that exchange rate. And you are likely to have a continuation either [Haruhiko] Kuroda himself will continue on to run BOJ [Bank of Japan] or it will be someone similar. It's a very dovish central bank and [Prime Minister Shinzo] Abe needs that central bank to be dovish. So if they change their QE programme a little bit, or they change their 10-year yield target a little bit, it's going to be pretty trivial. In the big picture it's going to be close to zero yields and US yields rising, I think ultimately that will flow through. What would cause us to change our view on the yen is if we saw really, kind of, the end of this growth cycle, if we saw global crisis looming, or a big recession, then that's a different equation. The yen tends to perform quite well in periods of risk aversion, but we just don't, for 2018, it's just hard to see the end of this cycle quite yet.

Katie Klingensmith: So there have been more political comments about currency rates and even some concern that currency wars could be back threatening market conditions. What's your perspective on some of those recent comments?

Michael Hasenstab: Certainly Davos was not a good couple of days for policymakers. Discussions about currencies and sort of unspoken rule that a secretary of Treasury would not talk about, you know, the way he did. There has kind of been some backtracking on that. I do think trade frictions and the implicit implication for currencies is going to be front and centre for some time. You have already seen first round imposing penalties on some Chinese exports that arguably certainly some of those were probably being dumped, you know solar panels was pretty egregious, so I think it's not just a broad anti-trade policy, there were some legitimate violations, but I do think underpinning this is the Trump administration's view that these free-trade agreements were not good for the United States and they are going to unwind some of those. I don't think it ends trade, but certainly the price of goods which all the consumers benefitted from cheap goods, that's going to be shifted from benefitting the consumer to maybe benefitting a narrower sector of manufacturers that make those within the United States. And so, prices go higher. So it's another inflationary dynamic that we would highlight as well.

Katie Klingensmith: I want to spend a little bit more time on trade. Renewed concern around NAFTA [North American Free Trade Agreement] being entirely eliminated and a much less advantageous trade arrangement in North America, I know that your team has had some pretty strong views on that, what's your perspective?

Michael Hasenstab: If NAFTA goes away, then it reverts to WTO [World Trade Organization]. Trade doesn't stop. There will be a couple of sectors I think that will feel a little bit of pain, but it's not going to be the end of trade between the United States, Mexico and Canada. That's the worst-case scenario, they dump it, go to WTO, people still trade. A lot of the trade actually goes outside of the NAFTA sort-of system. So I think it's a little bit overblown, it obviously at the margin is a negative for a place like Mexico, but I think that's already been priced into the market. I mean, with the exchange rate moving significantly we are kind of in the mid-18s, far away from fair value. So I think it's already been discounted and now probably the more likely is that there might be a surprise that it's not as big of a change and you could actually have appreciation.

Katie Klingensmith: So overall currencies, you don't see a big risk of trade wars or major escalation in a, sort of, anti-trade rhetoric, causing big problems for the global economy?

Michael Hasenstab: I think the worry would be with China. I mean, it's one thing for the United States to try to push around its neighbours Canada and Mexico, a big country, small country, there's little one of those other players can do. But if the United States tries to take that aggressive stance with China, it's a whole different story. I think that is one of the risks we need to monitor, that if you had a very aggressive retaliatory trade war with China, that could be a risk to the global economy. I don't think we are there, but it's something we have to watch.

Katie Klingensmith: Right, something you are monitoring as a risk scenario. Interesting. The EM [emerging market] currencies have been much better behaved in light of this potential increase in US rates. What are the overall dynamics in emerging markets?

Michael Hasenstab: I think you have had some very strong inflows, in particular in the equity side, which has helped support these currencies. We have seen very good interest in emerging-market equities and that makes sense given the good growth dynamics, cheaper valuation, so that's been an important underpinning. But also, just a lot of these places have a relative yield advantage that's hard to get, you know, places like India, Indonesia close to 7% rate, Argentina over 20%, even Mexico above 7%, so there's a pretty big yield advantage as well. So it's not just the equity inflows, but also the fixed income inflows. And at the same time, many of these countries have reduced their current account deficits, are either running surplus or limited deficits. The fiscal accounts look a lot better, so a lot of the dynamics that will drive currency valuations look pretty positive for many emerging markets, not all emerging markets, but many.

Katie Klingensmith: I think with this rhetoric around the Fed potentially lifting rates much more quickly and Treasury selling off further, many people are worried that that could really pose headwinds for emerging markets. Are there particular sectors that are more vulnerable or how does that play out?

Michael Hasenstab: So I think it's going to be broken out into two groups: you will have emerging-market currencies that are low-yielding, which could be very vulnerable. And emerging-market currencies that have big structural imbalances or weaknesses, like Turkey, could be very vulnerable. But then you go over to a country with either a current account surplus or very high yields, it's hard to imagine that 100 basis points higher in US 10-year [Treasury] yields is really going to change much in terms of the underlying fundamentals because the yield advantage is already so massive. So even if the Fed hikes 100, 200 basis points, you are still going to have a pretty positive carry in this handful of emerging markets that we have identified, but you will lose that carry with some countries, like [South] Korea, which will make it more vulnerable.

Katie Klingensmith: But I know also that you have been very specific about which high-yielding emerging markets are attractive to you. So it's not just a carry story. How else are you differentiating?

Michael Hasenstab: So we are looking for reform stories. When you map, it's not surprising, but when you map the countries that we have been increasing our exposure to many of them correlate to expected positive changes in governance, positive changes in social dynamics or the environment and countries that we have been reducing or cutting show the biggest expected decrease in their ESG [environmental, social and governance] score. So I think one of the factors that we have looked at and now are quantifying and highlighting is the governance in the policy framework and the social stability. And when you see a place like Argentina that's moving towards more orthodox governance, less manipulation of markets and has social cohesion and a buy-in for this process, that's a country that can likely weather a 200-basis-point hike from the Fed. A country which has used the central bank to finance the government deficits and has moved very populist, which has taken over control of the judiciary, places like Poland, I think they are going to be more vulnerable should there be any sort of destabilising triggers. It could be higher rates leading to the financial-market adjustments. We don't know what it is, but if you have, if you're on weak footing, you are more vulnerable. So, I think that governance part of the ESG is really critical to look at right now.

Katie Klingensmith: Before I dive into some of the specific governance issues in individual countries. I want to spend one more minute on a comment that you made before about how emerging markets have been well behaved and have not sold off, we haven't seen a big selloff in risk assets with this selloff in US equity markets. Why is that and are you worried that there could be some more systemic issues around the world with the Fed hiking rates?

Michael Hasenstab: I mean, it's sold off a little bit, but it's pretty, as I said, pretty well-behaved**.** I think we don't know what all this loose money has done in terms of asset price, or sort of where the skeletons are that it's created. I would say one obvious implication and adjustment that would have to happen is a lot of the risk asset markets and spread sectors, particularly in some of the fixed income space, are very expensive and an adjustment higher in yield wouldn't surprise that that causes some sort of adjustment there. Now, if that happens now while the economy is doing well, I think it doesn't become a really catastrophic effect. If that adjustment of the Fed waits too long and makes that adjustment when growth is actually really rolling over or inflation is actually elevated, then you have a bigger problem. So I think we have a really… and the Fed has, you know, the next 6 to 9 months to take advantage of this positive growth outlook to make the adjustments now which are inevitable to come about. But it had better do it in that backdrop versus waiting when growth is maybe more tenuous and inflation is rising and people begin to think it is behind the curve and those risk assets are even at a higher value, then that could be systemic. But, I think at this point there is a window to make that adjustment.

Katie Klingensmith: And that's as much for US credit markets as it is emerging markets.

Michael Hasenstab: Well, it depends, I would say in emerging markets we need to break out the hard-currency debt which I think is very expensive, the dollar-denominated debt, versus the local currency debt which still trades at a decent valuation. So, two separate asset classes.

Katie Klingensmith: I do want to jump into some specific governance questions in individual countries. I understand that you and your team just completed a research journey through Latin America. I will start with Mexico**.** We talked about the trade dynamics and maybe they are overpriced in the market, but the political dynamics within Mexico, is that something that's of concern to your team?

Michael Hasenstab: We spent a lot of time trying to understand, AMLO [Andres Manuel Lopez Obrador], his party, his platform.

Katie Klingensmith: Can you tell me who AMLO is?

Michael Hasenstab: He will likely, we don't know it's still too early, but he is leading in the polls to be the next president, still we have a while to go and campaigns really haven't gotten started, but it is a fairly likely scenario and he is definitely left-centre, more populist type of politician. But on the other hand, when he ran Mexico City, the finances were managed very prudently, he actually did a very effective job of governing there. His party has moved more towards the centre in terms of policy versus where they were in the past, so I think we need to continue to watch and actually get more details on the exact policies that he would propose if he is president before we can make a definitive call one way or another. But, I think the other thing in Mexico's benefit is the strength of the institutions. The central bank's independence is really on very strong footing and so I think they have checks and balances and institutions that a president can't just decimate and run. Like in some other countries, those institutions were a little bit weaker and in the past, for example, prior to [Mauricio] Macri's administration in Argentina, the president used the central bank basically as a piggy bank. That can't be done in Mexico; it's more codified in the constitution, that protection.

Katie Klingensmith: And elsewhere in Latin America, we have continued political challenges in Brazil, what's your outlook?

Michael Hasenstab: It looks increasingly difficult for Lula to probably run for president. The charges on appeal, they did not accept the appeal, now there are a lot of other things that can happen before we get to the presidential election. And so he is not completely out, but it's looking more and more difficult. And so, if his candidacy is removed then we need to look at a whole other array of candidates that have been kind of under the radar and it's still little too early to figure out where they stack up. But by and large, there is more of an orthodox policy bent amongst this sort of second-tier of candidates. Certainly, no one out there with the type of policies that say President Dilma [Rousseff] had pursued. Lula is probably is close to that, but we have to remember under his first presidency actually his policies were reasonably orthodox; it's just later on they deteriorated. So I think we have seen some steps which look a little bit positive, but it's a long way to go before the election.

Katie Klingensmith: You mentioned Argentina and you have been positive on the long-term outlook for reform in Argentina, any new findings?

Michael Hasenstab: I would say positive on the short term, too. I mean, they passed tremendously difficult and unpopular pension reforms that used a lot of political capital, but I think President Macri was very wise in using that political capital two years before the next election, so he has time to kind of rebuild it. I think the next couple of years are not about these big pension reforms, they are about the micro reforms, just undoing all of the regulations and administrative problems that have been created through decades of mismanagement and just trying to wash those out and let the economy function. And I think a lot can be done and the president has a very strong team and I think there's a good agenda on sort of a political realism, but also doing a lot of the things that are necessary and his party and he, in this last sort of midterm election, his party did very well, shows a lot of support for him and his administration.

Katie Klingensmith: It seems like a good example of the thesis that your team has maintained around Latin America turning away, learning from populism. Any other countries or themes that you observed during this trip?

Michael Hasenstab: So we were also in Colombia and I think the election there outside of one candidate who has a very low popularity, all the other candidates are centre-left or centre-right and unlikely to be very different policies so think it'll be a continuation of what's been a pretty orthodox regime. And I think we will see ebbs and flows in terms of the resolution with FARC [Revolutionary Armed Forces of Colombia], but clearly I think by and large we have moved towards a period where the country will begin to earn a peace dividend over time. Now we are not completely done with it, but I think it has moved in a positive direction, a lot of the investment in the infrastructure is on track, is being funded and is on schedule to really open up the country which I think will have tremendous implications, but I think that's another positive or neutral political dynamic.

Katie Klingensmith: Well in our around-the-world tour, I know you have expressed some caution around the dynamics in South Africa. A question around [Jacob] Zuma's potential exit. Now does that make way for more positive governance scores?

Michael Hasenstab: We will have to see. I mean I think one of the concerns we have had is that you know this current administration has really whittled down the strength of other institutions. You know, the Ministry of Finance or central bank and there's a lot of, I think, of movement, whether it be Zuma or other parts of his party to kind of take over those institutions and politicise them. And in any other country that has done that, is usually led to bigger deficits, more inflation, you know, just problems. So I think that we would need to see more than just a change in one person. We would need to see a real shift in terms of the overall governance score to rank it more positively. Hopeful, but more needs to happen.

Katie Klingensmith: No automatic, abrupt change just because of the change in leadership potentially. Aright, well then, taking us to Asia, you mentioned before that one of the potential trade fallouts could be between the United States and China and your team has a long track record of deep expertise in China and East Asia. What's your perspective on the credit dynamics in China? And, I would be interested in your overall outlook.

Michael Hasenstab: So China is a little bit similar to concerns about Europe, as long as global growth is fine, as long as there is no external shock, China can continue to grow; they don't have a credit problem. Our concern comes more if there is a big external shock. They have expanded so much credit that it's like pushing on a string at this point that they probably will not be able to expand enough credit to get growth to prevent a recession. It's only natural. I mean, they are moving towards a market-based economy, recessions are part of that. So it shouldn't surprise anyone, but it hasn't happened for a long time. So I think that will be the risk shock a couple of years out. In the short term, because it is a closed system, they have closed down the capital accounts. The government owns all the major banks, so it's very hard to have a credit crisis like you had in Scandinavia, or we had in the United States, that typical banking-sector crisis. If you just look at their credit numbers, the GDP, you would say, "wow, we are there," but the difference is it's a contained and closed system. If it were a small open economy and had those numbers, it would be very vulnerable, but it's different, but it is a vulnerability that will limit their ability to have countercyclical policies if there were a shock.

Katie Klingensmith: Elsewhere in East Asia, a question about the outlook for the won and sovereign bonds for South Korea?

Michael Hasenstab: We have been out of South Korea for a while on the currency side. I think Korea will be a little bit vulnerable when rates go higher because they are going to be at a negative yield gap, probably, to the United States. They do have a fairly large current account surplus, so that does support the currency, but the yield dynamic could turn negative. I think some other longer-term concerns about the competitiveness of Korea vis-à-vis China and a lot of the sectors that Korea has been very successful at, China is now building out, cellphones in particular, semiconductors. So I think there are some longer-term competitiveness issues that will challenge Korea and could be felt through an exchange-rate depreciation if they are not able to maintain that competitiveness. So medium term, we don't see any imminent crisis in Korea, but just not a lot of value.

Katie Klingensmith: I know you found more value in India and Indonesia. What are the latest updates on those two countries?

Michael Hasenstab: So I think we have had little bit of backup in yields in India, but I think the reforms that Modi has put in place and the political buy-in that he has from the population at least large enough chunks of the population in enough states, has set the stage for an improvement in growth couple of years out. In the very short term, the bankruptcy law, the bank deleveraging, the VAT [value-added tax], tax changes, all those actually are a headwind to growth in the short term, but they're a headwind for the right reason. So we are kind of looking through this next 12 months of possibly weaker growth and see the longer-term benefits of the unification of tax codes, allowing for better commerce and trade and bankruptcy law that needed to happen to serve sort of flush out insolvent entities and the deleveraging of the state banks. All of those needed to happen, but it will put pressure on growth in the short term.

Katie Klingensmith: And Indonesia?

Michael Hasenstab: Indonesia is just very, I would say, steady. Not a lot has changed in the very short time horizon, policies have been consistent, prudent central bank, prudent ministry of finance. I mean, they hold to that 3% deficit target, quite adamantly and they keep beating it. They have decent reasonably robust growth despite global volatility. I mean, they never went through a recession even in GFC because there is a big domestic base.

Like any country, we have to watch if populism leads to, you know, when it's taking place everywhere, does it affect policy? Does it lead to radicalisation of certain parts of the population? It doesn't appear it has reached that point, but we always have to watch that.

Katie Klingensmith: Well, Michael, I am hearing quite a bit of optimism about growth dynamics for 2018 and how even if there's some volatility as we adjust to higher rates in the United States and maybe even potentially slightly higher rates in other developed countries that we are still being cautiously optimistic about a number of emerging-market opportunities. I also hear that you are finding some fault lines and that you are monitoring them for perhaps your longer-term investment thesis, with that how would you conclude your overall outlook for 2018?

Michael Hasenstab: So I think we have some nice tailwinds in, certainly, the beginning part of 2018. I think, you know, that growth environment is going to be very supportive to some risk assets. My concern though is for a couple of years out. If policymakers get this wrong and they don't make the adjustment soon enough, and the adjustment comes later in the cycle when growth isn't so strong, and you have China less able to do counter-cyclical policy, of fault lines growing in Europe, I do think there are some real risks out there.

Katie Klingensmith: Thank you for your insights.

Michael Hasenstab: Thank you!

What are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds adjust to a rise in interest rates, the share price may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging market countries involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Such investments could experience significant price volatility in any given year. High yields reflect the higher credit risk associated with these lower-rated securities and, in some cases, the lower market prices for these instruments. Interest rate movements may affect the share price and yield. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Treasuries, if held to maturity, offer a fixed rate of return and fixed principal value; their interest payments and principal are guaranteed. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges.