FOUNDATION INVESTING

SHORT EEM – 11/13/15

ISHARES MSCI EMERGING MARKETS INDEX ETF

SUMMARY

Monetary policy has begun to diverge between the U.S. and the rest of the world. While the U.S. is healing and ready to lift their rates from the zero bound, everyone else is still struggling. This is especially true for emerging markets. An increase in U.S. rates would cripple them.

Over the last 7 years, many emerging market companies aggressively took on USD debt. Now as the dollar grows stronger, these debts will become far more costly to service. EM companies will struggle to pay these increasing costs while still remaining profitable. This is especially difficult in the current global slowdown and deflationary environment. EEM provides an enticing way to profit from a downside move in the stock prices of these EM companies.

Total Risk: 60 BPS	**Target 1: $30.32**
Entry Point: Near $34.00	**Risk Point: $34.91**

MACRO VIEW

Our global economic outlook on the world is largely the same as in previous reports. It's the United States versus the "rest of world". In one corner stands the mighty United States, still the most powerful economy in the world. In the other stands ROW (rest of world), which includes everyone from the European Union to South Africa.

Led by an easy money policy and the fracking boom, America has officially "recovered" from the Great Recession. Jobs data last week put unemployment right around 5%. It's now time for the FED to begin the "lift off" and raise our interest rates to something higher than zero.

But ROW is not ready for this liftoff. They are still struggling to recover and get on their feet. They would much rather have easier monetary policy around the world. Take Brazil for example. Their unemployment rate has skyrocketed in the last year from about 4 to almost 8 percent.

A scenario has now developed where the U.S. does not need easy monetary policy but ROW does. The FED and the other central banks of the world now have to figure out how to manage this divergence of needs. But even so, not much uncertainty remains on whether the FED will hike in December. The FED seems to only be focused on the U.S. and not ROW. Traders speculating through the Fed Funds Rate futures market show there is around a 70% chance of the hike happening in December.

The currency markets have been actively pricing in this hike as well. In 2015, the Brazilian real, South African rand, and Turkish lira, all reached record lows against the US dollar. We believe these emerging market currencies will continue to fall in 2016.

Normally, a weaker currency is beneficial because it makes a country's goods cheaper in the global marketplace. This in turn increases demand for exports. Of course this helps, but it's not enough to outweigh the real problem currency weakness causes. The real problem comes from the vast amount of dollar denominated debt that EM companies took on during the easy money era of the last 7 years. EM companies are loaded with this debt and pay large interest payments on it. Weaker currencies make it harder for them to meet these interest payments. This could lead to wide ranging defaults.

To make the situation worse, commodities have not stopped their relentless march downward. Crude oil futures are threatening to make new yearly lows, while natural gas futures have been in a bear market for the last 2 years. Metals have been violently selling off in recent weeks and soft commodities like sugar have struggled to catch a bid. Most emerging markets rely on commodities like these to drive their industrial economies. But with prices this low, companies will have a hard time generating profits.

CONVICTION LEVEL: **HIGH = 30 BPS**

FUNDAMENTAL VIEW

Money has been cheap for years now and emerging markets have been taking full advantage. EM companies account for about 18% of all U.S. dollar-denominated corporate debt. And since 2008, EM corporate debt has grown faster than every other fixed-income class!

With higher U.S. rates just around the corner, EM companies will be forced to de-lever to stay solvent and service their debt. We can already see the beginning of this deleveraging by looking at EM capex growth. It has recently turned flat to negative.

Companies have been leveling off their capex since 2013, a trend we predict will continue. Larger debt servicing charges means a higher percentage of revenues will go to pay them off. This leaves less money for reinvestment into the companies.

CONVICTION LEVEL: **LOW = 15 BPS**

TECHNICAL VIEW

Earlier this year, EEM broke an important monthly trend line that dates back to 2011. Breaking through this 4 year consolidation is a significant event. EEM is now back to 2005 prices.

This downtrend saw a sharp retrace after the August 24th flash crash that has since stalled out. But the recent break down from the 4 week sideways consolidation may signal a re-ignition of the trend. This area provides a tactical entry point to get short EEM with a good risk to reward ratio.

CONVICTION LEVEL: **LOW = 15 BPS**

RED TEAM

India and China still have decent growth numbers. This growth may allow them to weather the storm caused by rising U.S. rates. China and India thus pose the greatest threat to continued downside in EEM.

China's total growth has slowed, but still remains wrapped around the 7% handle. While the manufacturing sector has cooled off, China's consumer sector is clearly growing. This is easily overlooked because EM economies are generally viewed through a manufacturing lens.

India has also been able to keep their growth wrapped around 7%. Plus India is a net importer of oil, so the oil sell off is less of a concern to them. It could even be construed as a net positive for the country.

Both India and China also still have much higher benchmark interest rates than the U.S. China's official rate stands at 4.35% and India is even higher at 6.75%. This gives their central banks some firepower to stimulate their economies further. They can still lower rates to curb any downside moves in their equity markets. We already saw an example of this in the August sell off. China took a firm stance in respect to supporting their equity markets.