



**PRICE
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analysis for our clients.



Ernest Yeung
Portfolio Manager,
Emerging Markets
Value Equity Strategy

Emerging Markets Equities **VALUE COULD EXTEND THE EMERGING MARKETS RALLY**

KEY POINTS

- Emerging markets (EM) equities have extended last year's rebound throughout 2017, and we believe that the rally could continue in 2018.
- While growth stocks outperformed so far this year, value may grab focus in 2018. Historically, value stocks tend to outperform in periods of economic recovery.
- EM remains a fertile hunting ground for value opportunities. In China, stocks closely linked to the strength of the domestic economy still trade at relatively cheap valuations.
- EM's improved macro conditions, better corporate fundamentals, and constructive valuations are likely to support the potential for outperformance in 2018.

In order to help our investors make more informed decisions, Ernest Yeung, portfolio manager of T. Rowe Price's Emerging Markets Value Equity Strategy, provides his insight on the outlook for Emerging Markets in 2018 and the case for value investing in the EM asset class.

EM HAVE ROOM TO RUN IN 2018

EM equities have extended last year's rebound throughout 2017, outpacing the gains of their developed world counterparts, and we believe that the rally could continue in 2018. The MSCI Emerging Markets Index has advanced significantly during 2017 and is on track to achieve its best annual performance since its 75% jump in 2009. However, we believe that we are still only in the early stages of the upturn: It has only been under two years since EM equities hit a February 2016 trough after a five-year downcycle.

Positive earnings trends and broad stability in EM economies outweighed geopolitical worries and other concerns, such as the impact of the UK's vote to leave the European Union and the U.S. presidential election, fueling the outperformance of the EM equity markets this year. We believe that earnings growth, while not as strong as 2017, will continue to be a tailwind to EM in 2018.

Emerging markets equities have extended last year's rebound throughout 2017, outpacing the gains of their developed world counterparts, and we believe that the rally could continue in 2018.

Historically, value stocks tend to outperform in periods of economic recovery. If we continue to see solid global growth into 2018, we think the outlook for value investing will improve significantly. Growth stocks have benefited from years of developed market central bank action that has pushed interest rates lower and crowded investment into higher-growth stocks. In a world where global growth continues to recover and central banks start to remove stimulus, investors should become less willing to tolerate multiple high-priced stocks and may start to seek value instead.

In China, for example, investor attention over the past year has been largely focused on high-profile growth stocks; in the technology sector, in particular. This has meant that many of the less dynamic, old-economy stocks have been largely ignored and are now trading at near historical lows. As such, we believe that there are ample opportunities to be found in these areas. Financials, industrials, domestic construction names, and consumer staples companies are now visibly underowned and fall within the ambit of old-economy stocks. Indeed, these stocks are closely linked to the strength of the Chinese domestic economy but still trade at relatively cheap valuations, only slightly above their levels during the global financial crisis.

We favor positions in Chinese stocks sensitive to the domestic economy, such as those in the financials, building materials, and industrials and business services sectors. The financials sector is our biggest overweight as of late-October 2017 followed by telecommunications and industrials. While we acknowledge their high growth, we deem Internet and technology companies as expensive and have the largest underweight allocation to the sector. Outside of China, Brazil is recovering well and emerging from its worst ever recession. Brazil is our largest country overweight in the portfolio in relative terms, and we hold positions in its financials sector.

Valuation-wise, Latin America and Europe, the Middle East, and Africa (EMEA), including Eastern Europe, are still historically cheap. In contrast, market valuations in certain countries, such as India and the Philippines, currently appear expensive. Meanwhile, the likes of Turkey and South Africa have yet to show signs of economic recovery, exacerbated by their murky political environment. South Africa and the rest of the African continent have fallen off investors' radar screens on the back of slow growth and sharp currency depreciation. This area has suffered, but it could still pull a positive surprise in 2018 and 2019, in our view.

BRAZIL, RUSSIA, AND INDIA ON RECOVERY TRACK

Aside from still attractive valuations, we believe that key EM economies have room for further expansion, which supports our constructive outlook for 2018. Industrial activity and growth rates of Brazil, Russia, and India are still below trend. In the first six months of 2017, these emerging market economies rose simultaneously for the first time in three years but are still below the growth recorded in the years 2003–2006. At the corporate level, EM companies are not overinvesting and are utilizing their existing capacities. Hence, the supply-versus-demand output gap of most major EM countries is narrowing—providing a boost for market sentiment.

GROWTH STOCKS HAVE OUTPERFORMED THIS YEAR, BUT VALUE INVESTING MAY GRAB FOCUS NEXT YEAR

While investors in EM have strongly favored growth stocks in 2017, we believe that interest in value stocks may be heightened in 2018. The MSCI Emerging Markets Growth Index's total return rose 42.8% in the first 11 months this year, outperforming the MSCI Emerging Markets Value Index's total return, which only advanced 23.4% in the same period. So far this year, the performance differentiation between the two indexes has widened the most in two decades in favor of the growth benchmark.

Brazil and Russia are in similar positions, as both are moving out of a recession that saw high unemployment, lower wages, and significant deflation. We believe that while better oil and commodities prices this year have helped, both nations have weathered the slowdown and prices and wages have adjusted downwards, setting the stage for a recovery from here.

India's economy hit its trough in 2013, but the recovery has been below trend due to delays in cleaning up bad loans that were a legacy of the last investment cycle. We think that India's central bank is determined to resolve the bad debt problem. It has asked banks to reach resolutions with 50 of the biggest defaulters within a year. The government also announced a U.S.\$32 billion capital injection into state-controlled lenders over two years as it seeks to resuscitate Asia's third-largest economy. We believe that India's banking system, as well as its economy, can grow at a faster pace going forward. However, in general, we view Indian equities as expensive.

BELIEF IN CHINA'S TRANSFORMATION

Financial markets and the western media remain skeptical about China's economic transformation efforts. However, we would argue that, while the world's second-largest economy is facing a number of structural challenges, it is in a much better state now than at any time in the last five years. We believe in its economic transition story and, based on how it has fared this year, the risk of China's "hard landing" may have been overstated by the market. The inflection point was Chinese President Xi Jinping's understanding of the major problems facing China and the efforts he has made to tackle them during his first five years in office, including a far-reaching anticorruption drive, supply-side discipline measures in various industries, and the push to reform bloated state-owned enterprises (SOE). Xi tightened his already strong grip on power at the 19th China Party Congress in October, most likely ensuring that he will retain a key political role long after the remaining five years of his term end.

We believe that EM's improved macro conditions, better corporate fundamentals, and constructive valuations are likely to support the potential for outperformance in 2018.

FAVORING A "TOUGH LOVE" APPROACH TOWARD SOE

Looking into Xi's second five-year term as leader, SOE reforms will likely gain more traction. We favor efforts by the government to fix these ailing state-owned firms. The government has sought to improve the performance and efficiency of these SOEs through mixed-ownership and more market-oriented management. Already in 2017 we have seen improving profits from many of the SOEs, and some have even declared dividends after years of nonpayment as their cash flow management improves. These shareholder-friendly moves are giving the market confidence that Chinese companies are moving in the right direction.

CHINA SEEN TO BATTLE HUGE DEBT PILE

We also believe that Xi is committed to addressing China's debt dependency. The country's debt-to-GDP level has risen massively over the past decade, to the extent that many believe that it poses a structural risk to China's longer-term outlook. While there is recognition from the government of the need to control China's debt problem, finding a comprehensive solution is easier said than done. However, at the corporate level, there are clear signs of improvement, with a number of highly leveraged SOEs undergoing restructuring and made to clean up their debts. These positive changes in China are laudable, but they have received little appreciation from mainstream investors. Outside of information technology and health care stocks, which have led the rally this year, many old-economy Chinese equities remain underowned and trade at significant discounts that do not reflect the positive change dynamics we see coming though.

BEYOND GEOPOLITICAL RISKS

2018 will be a heavy election year for a number of EM nations, with presidential polls due to take place in Russia, Mexico, and Brazil. However, it is more than just political jitters that may drive EM sentiment. Investors may worry about the impact of rising interest rates on EM. Some investors fear that increasing interest rates and balance sheet reduction in the U.S. and other developed markets may lead to capital outflows and weaker currencies for EM. However, we believe that most EM economies are capable of weathering a higher rate environment as, broadly speaking, they have improved current account positions and increased foreign exchange reserves in recent years, while interest rates, in aggregate, remain much higher than in developed markets, providing a cushion. Importantly, as value investors, we believe a return to “normal” financial conditions may benefit our stocks. For example, our exposure to financials could benefit in an environment of rising interest rates and inflation.

We believe that EM’s improved macro conditions, better corporate fundamentals, and constructive valuations are likely to support the potential for outperformance in 2018. Notwithstanding the risks, EM remains a fertile hunting ground for value opportunities, particularly as many investors have been predominantly focusing on quality growth names, with little attention given to the many misunderstood and undervalued companies in the EM space. Moreover, information asymmetry in EM provides active investors with a heightened opportunity to take advantage of valuation anomalies. We remain steadfast in our focus on stocks cast aside by mainstream investors but where potential for a rerating looms.

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