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Emerging Markets

DESPITE HIGHER VALUATIONS, OPPORTUNITIES CAN STILL BE FOUND

KEY POINTS

- Emerging markets (EM) equity valuations appear competitive versus developed markets and their own historical levels, although not as cheap as a year ago.
- Although yields on EM bonds have compressed, the asset class still offers broadly healthy fundamentals as well as attractive yields relative to historical volatility.
- Alongside a sharp China slowdown or Korean Peninsula conflict, external 2018 EM risks include the withdrawal of quantitative easing or a downward commodity price shock.
- Active management lets equity investors focus on attractive pockets of EM growth and allows debt investors to own countries that are not in their benchmark.

We believe global emerging markets (EMs) continue to offer attractive investment opportunities even after the strong performance seen in 2017. Many of these markets are in much better shape today, boosted by the ongoing progress of meaningful economic and political reforms in key developing countries. Many of their traditional vulnerabilities, such as large current account deficits and low inflation-adjusted interest rates, have markedly improved.

After 2017's strong performance, valuations for both equities and bonds are not as compelling as they were a year ago. However, they remain attractive relative to their history and to most developed markets. Importantly, they do not reflect emerging markets' contribution to the global economy and to overall growth. In fact, we would view a pricing dislocation triggered by an event in developed markets as an opportunity to broadly add to EM debt at lower valuations.

EM GROWTH SHOULD CONTINUE TO OUTPACE DEVELOPED MARKETS

Broadly speaking, economic growth in EMs outpaced developed markets growth in 2017. This stronger growth should continue in 2018 as countries like Brazil, Russia, and India improve, widening the growth advantage for EMs over developed markets. This supportive economic backdrop should allow for further gains in corporate earnings, which recovered strongly in 2017. Furthermore, we continue to see many companies undertake steps to control costs and improve profit margins. Importantly, margins have more room to improve, as they remain below historic averages in most emerging countries. Also, more disciplined capital spending is contributing to a strong recovery in cash flows, which should help support increases in dividends.

EM equity valuations, as measured by price-to-earnings ratios, still look competitive versus developed markets and their own historical levels, even if they are not as cheap across the board as they were a year ago (Figure 1).

ASIAN EMs LEAD ON REFORMS

Emerging countries in Southeast Asia are leading the way in enacting reforms and correcting the fundamental imbalances that made them vulnerable in past financial crises. India and Indonesia, in particular, have made notable progress implementing needed reforms. Capital flows into these countries were unexpectedly strong in 2017 while inflation was contained, helping them improve their current account balances, which contributed to better average balance sheets across EMs. This should help their economies achieve more sustainable growth (Figure 2, page 3).

While geopolitical tensions involving North Korea continue to present a risk, stable growth in China has been a key factor in supporting the rest of the EMs, particularly the Asian economies that are closely linked to the Chinese supply chain. As China addresses overcapacity in some of its industries, tackles true reform of its state-owned enterprises, focuses on improving quality of life, and works through its buildup of debt, its growth could slow, but only modestly. Furthermore, concerns about potential instability in the Chinese financial sector due to the country's growing debt levels have eased.

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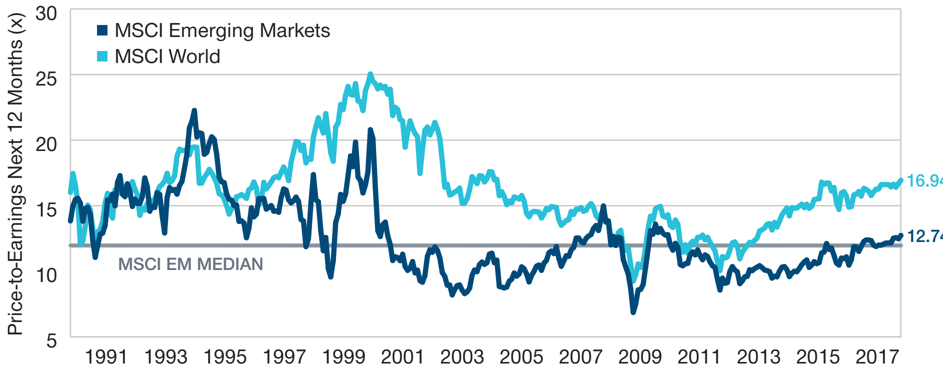
FIGURE 1: Emerging Markets Equity Valuations Remain Attractive

Emerging markets price-to-earnings valuations relative to developed markets. As of October 31, 2017



Sources: MSCI and FactSet.
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A BROAD SHIFT IN LATIN AMERICAN POLITICS

While volatility is likely to remain in the short to medium term for some Latin American countries, we see attractive long-term equity investment opportunities in the region, even after the market gains of the past year. Latin American countries are benefiting from a broad shift toward political leaders who tend to implement investor-friendly policies and away from populist politicians who have dominated the region more recently. For example, Argentine President Mauricio Macri, elected in 2015, has already made significant progress on meaningful reforms and looks likely to win reelection in 2019.

On the other hand, we remain cautious toward Mexico because of the twin risks of the U.S. renegotiating the North American Free Trade Agreement and a potential victory for leftist candidate Andrés Manuel López Obrador in Mexico's July 2018 presidential election. Although continued political corruption scandals have knocked reform momentum in Brazil off course, optimism that Michel Temer's administration will eventually accomplish meaningful structural reforms has contributed to an impressive rally as the country's economy shows signs of recovering from its deepest recession in 100 years.

WILLINGNESS TO IMPLEMENT REFORMS LAGGING IN EMERGING EUROPE

Countries in emerging Europe are broadly behind other EM regions in terms of their willingness and ability to make meaningful reforms. The governments of Russia and Turkey are key laggards. However, Russia enjoyed impressive domestic demand-led growth in 2017. Russia's central bank continues to have room to cut interest rates amid moderate inflation, which could bode well for growth going forward and could support both bonds and equities.

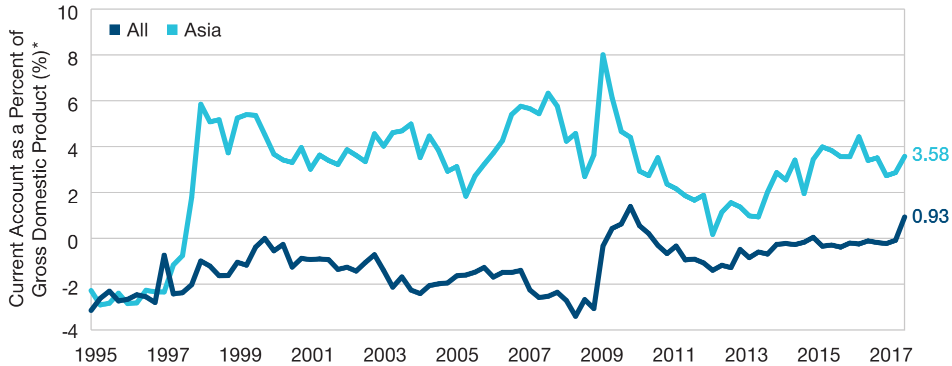
THE PRIMARY RISKS FOR EMs ARE NOW EXTERNAL

Unlike in the past, when internal political or economic problems were most typically the triggers for sell-offs in EMs, today we think that the primary risks for these markets are mostly external. However, while unexpectedly hawkish monetary policy in developed markets would likely lead to some volatility, we view EMs as being relatively well positioned to maintain stability in an environment of gradually higher interest rates, primarily due to healthier current account balances and more prudent fiscal positions. Furthermore, inflation-adjusted interest rates in some EMs remain high, giving their central banks the flexibility to lower rates if necessary.

Another downturn in commodities prices could cause some selling pressure, although the EMs as a whole are more broadly balanced between commodity-importing countries and commodity-exporting nations than in the past. Although concerns about a sharp downturn in China have eased, we continue to monitor the country's transition to an economy based on domestic consumption—with a particular focus on the health of its financial system.

FIGURE 2: Emerging Markets Current Account Balances Have Improved

Surpluses in emerging Asian countries have helped broad EM current accounts. As of June 30, 2017



Sources: National central banks and Haver Analytics.
*Moving average of the most recent four quarters.

RIGOROUS FUNDAMENTAL EQUITY ANALYSIS IS ESSENTIAL

We believe the future path for EM equities is likely to be less homogenous and more divergent than it was in an era when commodity prices were rising, global trade was strong, and China's economy was growing at over 10% annually. This suggests that rigorous analysis of company fundamentals will be more important than ever in 2018. Being proactive will be essential to identify and invest in the most attractive opportunities within these highly diversified markets.

CORRECTION CAUSED BY EXTERNAL FACTORS COULD BE A POTENTIAL BUYING OPPORTUNITY

We would view any correction in EM bonds caused by an external event—such as a further escalation of geopolitical tension involving North Korea, political instability in developed markets politics, or protectionist trade policies in the U.S.—as a potential opportunity to add to our favored positions. As of late 2017, we preferred local currency EM debt over U.S. dollar-denominated bonds, as some major local currencies appeared poised to gain against the U.S. dollar.

ACTIVE MANAGEMENT SEEKS OPPORTUNITIES IN FRONTIER MARKETS

We see select opportunities to capture value in frontier markets bonds, which tend to involve more country-specific idiosyncrasies than mainstream EMs. For example, Sri Lanka's local currency debt currently offers some of the highest inflation-adjusted yields in the world. This, combined with the country's improving fiscal condition and funding agreement with the International Monetary Fund, makes it attractive for us.

Argentina continues to look attractive, and we increased our overweight positions in the country's stock and debt following the recent midterm elections that solidified support for President Macri's reform agenda. We believe the ability to invest in countries—such as the frontier markets—that are not included in the standard EM benchmarks is an important benefit of active portfolio management.

Active management of EM bonds also provides the ability to overweight countries, such as Brazil, that are easing monetary policy and to make country allocations based on fundamentals as opposed to a given issuer's amount of debt outstanding. In equities, we actively target well-managed companies that we believe can open up potential opportunities to outperform passive benchmarks.

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