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Emerging Markets EMERGING MARKETS AT A CROSSROADS

KEY POINTS

- Despite recent headwinds, the fundamentals for emerging markets remain robust. The current cycle remains young, and we are encouraged by various policy and financial measures by governments and companies alike.
- While trade wars and monetary tightening are concerns, a range of other factors provide support.
- Near-term volatility due to macro and political concerns creates an opportunity to find companies with attractive valuations.

Emerging markets (EMs) represent more than half the world's population, accounting for over half of global economic growth since the 2008 financial crisis.¹ The potential for investors is enormous.

Yet the asset class is seemingly at a crossroads, with recent volatility posing questions for investors. Emerging market Portfolio Managers Ernest Yeung and Verena Wachnitz discuss their perspectives on the state of play within this dynamic area.

Q. Emerging markets have come under pressure from factors such as trade tensions and monetary tightening by the Federal Reserve. How do you assess the current outlook?

Yeung: Emerging markets are experiencing increased volatility, but the fundamentals remain robust. The trough in valuations was only reached in the first quarter of 2016—so EMs are only two years into the current cycle. A cycle within EMs usually lasts between

eight and 10 years, so the end of this cycle is some way off.

This represents one of the major differences between emerging and developed markets. In developed markets, monetary easing is being withdrawn and interest rates are rising as the cycle is more advanced and inflationary pressures are building. Conversely, inflation remains contained in EMs and the cycle remains young.

Meanwhile, at both the stock level and the macro front, financial and policy activity is encouraging. Governments have recognized previous mistakes and are making more prudent decisions, while corporates are more focused on shareholders.

While U.S. rate hikes and talk of potential trade wars have had an impact, EMs are moving in the right direction. Indeed, in my view, near-term volatility offers the opportunity to buy quality companies at potentially better valuations.

¹Source: OECD. As of December 31, 2017.

“Overall, many Latin American countries are very early in the cycle, so current volatility represents a source of opportunity.”

—Verena E. Wachnitz

Q. How is this impacting Latin America?

Wachnitz: Latin America is inherently regarded as one huge region, but in reality, it is a mosaic of countries often at very different stages of the growth cycle. Brazil, for example, is only just emerging from a deep recession and starting to grow again. Inflation is under greater control, interest rates are at multi-decade lows, and the current account has narrowed significantly. Elsewhere, countries like Chile, Peru, and Colombia have addressed past credit imbalances to some extent and are on a much better trajectory. Meanwhile, Mexico is much later in its growth cycle given its proximity and trade links to the United States. If the U.S. economy was to slow, we expect Mexico to follow suit.

Overall, many Latin American countries are very early in the cycle, so current volatility represents a source of opportunity.

Q. How concerning are trade frictions for emerging markets?

Yeung: It is important, but markets have already sold off considerably on these worries. For example, the Chinese A-share market is trading near five-year lows. More concerning is the overall level of Chinese gross domestic product (GDP) growth and whether it might moderate. Encouragingly, an aggregation of all the proposed trade tariffs still represents less than 1% of GDP, and China's economy is still growing at around 6% annually. It's

also important to bear in mind that the Chinese renminbi has depreciated by almost 10% year-to-date, which helps to offset the negative effects of trade tariffs.

For emerging markets generally, oil prices are a more crucial consideration given the dependency of industrial supply chains. Oil prices have risen steadily in recent years, helping to reflate many segments of emerging market economies. Importantly, this improves pricing power for many industries, and a little bit of inflation is always good for stock markets. However, if the oil price were to collapse (back to the U.S. \$30 range), the recovery could falter.

Q. Historically, Latin America has been correlated with commodity prices. Is it still a commodity play, or are you finding opportunities elsewhere?

Wachnitz: Commodities account for almost 20% of the MSCI Latin America Index. This is a large weighting, but there are more opportunities in other sectors. We have a strong focus on financials, where we see attractive long-term potential. It's a very consolidated sector with high barriers to entry, low credit penetration, and a strong focus on shareholder returns. Many companies have delivered returns on equity in the high teens or low 20s, but valuations remain cheap. For instance, a leading Brazilian private bank on a single-digit forward price/earnings ratio is yielding over 6%. With Brazil

emerging from a recession and having a long runway for growth, normalization of the economy should create good opportunities in this sector.

The consumer sector also has significant potential due to the rising middle class. From a bottom-up perspective, there are many high-quality companies in this sector. They include companies that have emerged stronger from the crisis, gaining significant market share in growing markets. Earnings are predicted to grow strongly over the next few years—a formula of compounding earnings growth over time that can be a powerful driver of performance. Valuations are depressed as markets have tended to indiscriminately punish companies on wider macro concerns; the investment case for this sector is strong.

Q. What are your thoughts on Argentina?

Wachnitz: Investing in Argentina is not for the fainthearted. Clearly, the government reacted too late to the crisis. However, it has since responded with corrective measures, including raising interest rates significantly, committing to much stronger fiscal consolidation, signing an agreement with the International Monetary Fund, and allowing the currency to depreciate. If the economy begins to grow again and the currency stabilizes, the outlook will improve.

A potential dampener is next year's general election. Argentinian elections, like Brazilian ones, can be a great source of volatility. With President Mauricio Macri's popularity having fallen sharply and real incomes falling (with inflation at over 40%), it is not clear whether he will be reelected. Will the economy recover fast enough for Macri to regain popularity, or will a new contender come to the fore? The outcome is uncertain. However, even if a moderate candidate wins, the key economic problems should largely have been addressed. On a longer-term view, it could be a good place to invest, although volatility is expected in the interim.

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–Ernest C. Yeung

Q. How would you assess valuations in these developing countries?

Yeung: Within EMs, company valuations need to be viewed in two distinct pockets. Many new economy stocks, such as Baidu, Alibaba, and Tencent (the so-called BAT stocks), have performed well over the last two years and now look expensive. Outside of the new economy, there are many companies that, on our analysis, look cheap and represent a stronger opportunity.

Wachnitz: In Latin America, political and economic uncertainties have caused significant headwinds for many markets, creating attractive valuations. Currencies are cheap, and that is an important contributor to performance. Conversely, the countries that have been relatively stable from a macroeconomic perspective, such as Chile and Mexico, are more expensive. In these countries, we are focusing on high-quality companies that can grow into their valuations.

Overall, with Latin America having been flat over the last five years, while the S&P 500 has delivered a total return of over 100%, valuations are reasonably attractive.

Q. Value investing in EMs has historically been a hard place to invest, but where are you finding opportunities?

Yeung: There may be around 3,000 stocks within the opportunity set, but a selective approach is essential as many are not very attractive. This means that an active investment approach is, in our view, the best way to access the potential of the asset class and identify the best opportunities.

State-owned enterprises (SOEs) represent a current focus for opportunities. Many investors have viewed these stocks as rather toxic—and rightly so—over the last 10 years. Performance has been very poor, but market forces are driving change. Many SOEs are cleaning up their balance sheets, deleveraging, and starting to generate decent free cash flow.

Between 2000 and 2009, Chinese SOEs were the best-performing asset class in EMs. A huge inflection point was reached in 2009 when the Chinese government stopped all stock option programs. This caused significant disruption and made the sector particularly unattractive, due to the lack of focus on shareholders and removal

of incentives for management. The stock option restriction was recently reversed, which could be positive for the sector.

Q. How should investors think about this asset class? Are there changes occurring that may warrant a more strategic allocation?

Yeung: Currently, the allocation to EMs by global investors is at its lowest level in 10 years.² In some ways, this is down to the outperformance of U.S. markets attracting investment flows. However, we sense a shift in sentiment. Increasingly, investors are concerned about the expensive nature of some of these more crowded areas. Combined with tangible evidence that emerging market companies are beginning to exceed earnings expectations and have improving free cash flows and that managements are becoming more disciplined with that capital, we see a more positive future. Once mainstream investors recognize these factors, we believe strategic asset allocations back to the asset class are likely.

Q. What are your major takeaways for investors?

Yeung: Outside of the technology stocks that have attracted so much attention, there are many well-run, high-quality companies that have been ignored by the wider investment community. This is where investors can potentially make money.

Wachnitz: Do not be dissuaded by some of the negative headlines over macro and political concerns. Instead, use the opportunity to buy some great companies currently trading at attractive levels and hold them for the medium to long term.

²Source: EPFR Global. As of June 30, 2018.

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