Emerging Markets—Getting Beyond Traditional Thinking

Common misconceptions are creating opportunities within emerging markets.

August 2019

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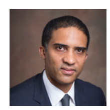

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KEY INSIGHTS

- Some investors continue to view emerging markets as a purely short-term, tactical allocation—offering potentially high returns but also the prospect of heightened risk and volatility.
- However, we would argue that this is a very traditional, stereotyped view and one that does not accurately reflect today's emerging market asset class.
- In this article, we consider some of the common misconceptions surrounding emerging markets—from both a debt and equity perspective—and the investment opportunities to be found as a result.

Following a difficult 2018, both emerging market (EM) equity and debt markets have rebounded strongly in 2019, providing positive year-to-date returns for investors. However, for some, EM will always be regarded as a purely short-term tactical investment—offering potentially high returns but also the prospect of heightened risk and volatility. We would argue, however, that this traditional view no longer accurately describes today's emerging markets.

In this article, we address some of the common investor misconceptions surrounding EM, from both a debt and equity perspective, and identify some of the investment opportunities that we are finding as a result.

1. In an Environment of Rising Market Volatility, Is It Best to Avoid Emerging Markets?

Contradicting the stereotype of a volatile, higher-beta asset class, many EM regions and sectors offer defensive opportunities that can outperform other asset classes during periods of risk aversion. The breadth of opportunities in EM is one of its key strengths. This is not to suggest volatility isn't a concern. Rather, it means that investors need to do their homework and identify sectors and regions with lower-beta track records when looking for defensive assets.

EM corporates stand out as a defensive sector due to their strong fundamentals. Asia credit, which has grown substantially in recent years, performs more in line with developed market (DM)

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investment grade, for example, than other higher-volatility EM sectors.[1]

From an equity perspective, one of the biggest investor misconceptions is that EM is all about dynamic, high-growth companies. And, by extension, that attractive EM value opportunities are few and far between.

This view seems to be confirmed by various surveys showing that the bulk of active money flows into the EM equity universe is allocated toward core and growth portfolios, with just a fraction of this total amount being value-focused. Given this large bias toward core/growth, there are many areas that are being overlooked or forgotten, and this is a particularly rich environment for value-oriented EM investors.

For example, in the quest for growth, many of the old economy[2] companies have been forgotten and so offer attractive upside from depressed valuations. Of course, simply being cheap is not reason enough for us to invest in a company. We look for those forgotten, or out-of-favor, companies that we believe are strong candidates for a positive rerating, based on our expectations of fundamental change. This might include a change in management, an improving economy, or any business-specific event that can drive the stock price back to fair value. We look to buy in at deeply discounted valuations, creating the potential for strong gains if, and when, sentiment subsequently turns positive.

2. Is the Risk of Error, Be It From Central Banks or Company Management, More Significant in Emerging Markets?

From a debt perspective, while negative surprises in political or monetary policy can impact both EM and DM investing, an active approach can help avoid sudden sell-offs. The positive reforms in many EM countries mean that most are no longer just one or two bad decisions away from a crisis. Bottom-up, on-the-ground research can identify countries committed to consistent, market-friendly policy directions, reducing investors' exposure to policy error and help avoid those that are slipping in the wrong direction.

Even when significant sell-offs do hit certain EM countries, we don't believe this constitutes a systemic risk to the wider asset class. For example, Turkey and Argentina dominated the headlines for much of 2018 as markets quickly lost confidence in the ability, or the will, of policymakers in each country to manage their currencies and fiscal accounts. However, the contagion-driven sell-offs from these events elsewhere in EM were relatively short-lived. These downturns can create opportunities to go against the grain and buy cheap assets. History shows that EM has consistently rebounded—and has rebounded quickly—following downturns (Figure 1).

On the equity side, evidence of stronger management discipline and better decision-making is one of the factors underpinning our positive, longer-term

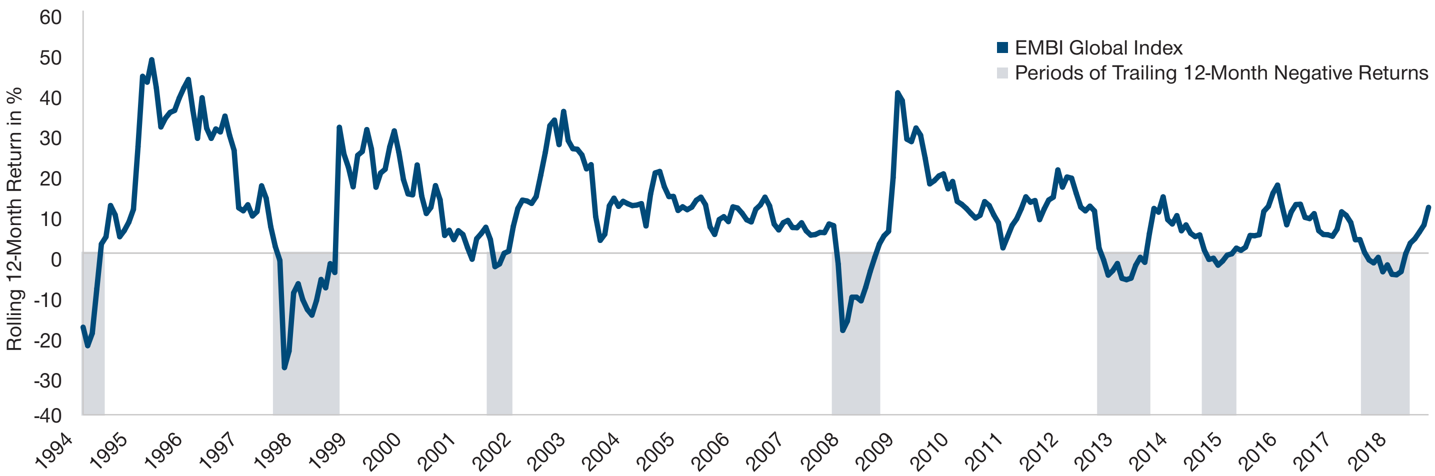
[1] Asia IG: JPM JACI Diversified, z spread; US IG: Bloomberg Barclays U.S. Aggregate Corporate Investment Grade Index, OAS; Euro IG: Bloomberg Barclays Euro-Aggregate Index, OAS.

[2] **Old economy sectors**: real estate, construction materials, coal, metals and mining, insurance, household and personal products, transportation, utilities, conglomerates, banks, machinery, food beverage and tobacco, chemicals, electrical equipment, diversified finance, construction and engineering, telecoms, oil and gas.
New economy sectors: consumer services, automotive, internet, technology hardware, pharmaceuticals, consumer durable, health care, semiconductors.

(Fig. 1) History Argues for a Rebound in Emerging Market Debt

Historically, EM debt has rebounded quickly from a downturn.

As of June 30, 2019



Past performance is not a reliable indicator of future performance.

Refers to the J.P. Morgan EMBI Global Index.

Source: J. P. Morgan (see Additional Disclosures).

outlook for EM equities. As a result, companies have generated more free cash flow compared with previous years, as management teams pay more attention to spending and other capital allocation decisions. Profit margins have improved as a result, giving us confidence that EM companies are positioned to start delivering improved earnings growth and shareholder returns.

Given this more disciplined approach, capital spending as a percentage of sales for EM companies has fallen to the lowest levels in more than a decade (Figure 2). However, after many lean years, we believe that a resumption of capital spending could have a significant impact, in terms of spurring job creation, loan growth, and wage increases. This spending upturn is already evident among more growth-oriented companies, and as the anticipated recovery becomes more widespread, it could provide a powerful impetus, driving valuations higher for many companies in the EM universe.

Given this expectation of increased corporate spending, one area that we like currently is financials. Banks, for example, stand to benefit considerably from an expected upturn in borrowing/loan growth. Meanwhile, having been out of favor with investors for some time, financial sector valuations remain well below long-term average levels.

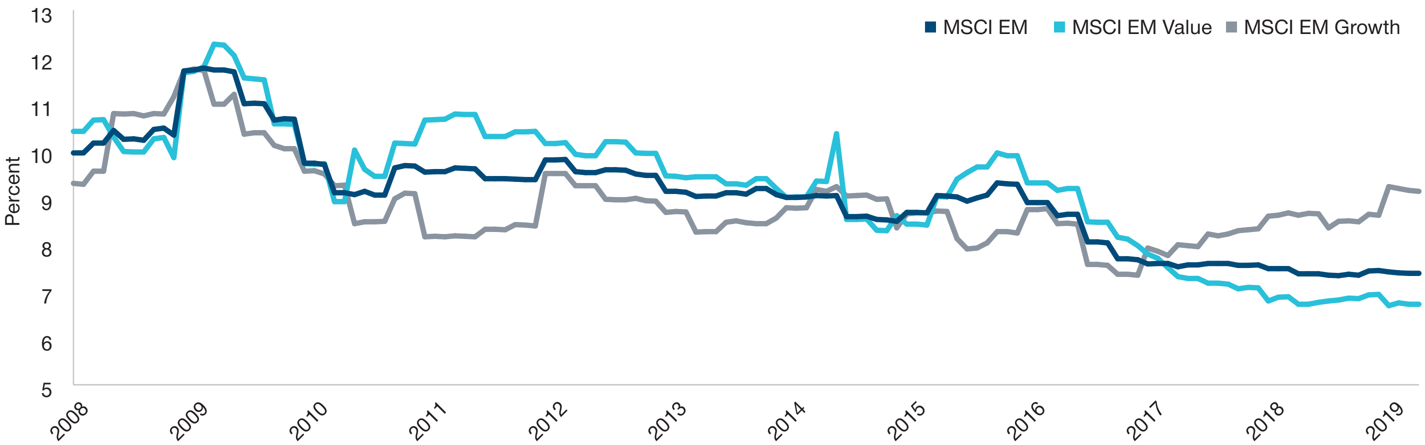
We like certain South African financials, for example. Many of these companies have been forgotten about—but their balance sheets are sound, they have made good progress on cleaning up bad debts, and they pay an attractive dividend. The companies are also leveraged to the economic recovery cycle in South Africa, as well as having prominent exposure within continental Africa.

3. Can Emerging Market Assets Still Perform Amid a More Mixed Global Economic Outlook?

The growth of EM debt as an asset class in recent years means that investors can find a wealth of investment opportunities in different global economic

(Fig. 2) A Recovery in Capital Spending Could Drive EM Valuations Higher

Percentage of emerging market company capex, relative to sales.
As of March 31, 2019



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Source: MSCI via FactSet (see Additional Disclosures).

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environments. While we do recognize that strong growth is important for the prospects of EM, this must be kept in perspective as we see several reasons for continued optimism.

Many EM countries have enjoyed favorable economic growth rates supportive of fundamentals. We believe investors need to cast aside any preconceptions of EM being a single investment opportunity and take the time to look at individual EM regions and sectors to find attractive investments.

A number of EM economies boast a growing middle class that is underpinning domestic demand. Consequently, EM is no longer just an export-driven investment reliant on DM, or even Chinese, economic growth. EM economies are trading with other EMs now more than they are with DMs.

EM credit is on a strong footing. Corporate fundamentals remain favorable despite the difficult 2018. The EM corporate default rate is at its cyclical low. Issuers have relatively low debt levels, and companies have been able to extend bond maturities and buffer balance sheets.

Growth concerns in key global markets could also become tailwinds as central banks appear to be shifting to more accommodative policies. These central bank shifts could suppress core DM yields, which would lend further support to EM assets.

Similarly, we remain positive about the outlook for EM equities. We believe the recovery in the EM cycle is less advanced than in DM and so has further to run. Capital spending discipline should lead the next leg of EM growth as we expect companies to continue to focus on better capital allocation and cash flow generation. Meanwhile, in China, despite trade-related concerns and worries about a slowdown, we do not expect a hard economic landing.

This backdrop is conducive to finding good opportunities that are overlooked by other investors. For example, many of the state-owned enterprises (SOEs) in EM countries offer good potential, in our view. Global investors generally have a very negative view of these businesses. However, the sector has been tainted by a small group of very bad, highly publicized companies.

The reality is that SOEs exist in all EM countries, and therefore, it is possible to uncover good-quality, but unloved, SOEs trading at low valuations.

Sberbank, for example, is owned by the Russian central bank and is widely regarded as one of the highest-quality, most progressive banks in the EM universe. Elsewhere, Chinese SOEs are also undergoing major change. Not only has Beijing cut excess industrial output—thereby boosting the profits of many SOEs—significant efforts are also being made to become more shareholder-friendly, with some large SOEs even paying out special dividends, something rarely seen in the past. Many Chinese SOEs are also reintroducing stock option incentive programs for management, and this is a positive step moving forward.

In conclusion, we are confident that EMs can continue to dispel many of the traditional perceptions and concerns surrounding the asset class. EM growth and diversity mean that it offers many compelling opportunities across many different market environments. Moreover, information asymmetry in EMs provides active investors with a heightened opportunity to identify valuation anomalies. We are steadfast in our ability to find these stocks, names that are often overlooked or neglected by other investors. Meanwhile, we do not see the early-year rally as a surprise but rather a reflection of the generally sound fundamental support for the EM asset class.

WHAT WE'RE WATCHING NEXT

After a strong rebound in both emerging market debt and equity during the first half of 2019, the risk of a potential pullback remains present, particularly as market volatility has ticked up recently. That said, emerging market fundamentals on both the debt and equity sides remain broadly supportive, and we continue to watch for any deterioration here.

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ID0002474 (08/2019)
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