

Emerging Markets Equities: Is the correction over?



October 3, 2018

Summary

- Emerging Market currencies unlikely to weaken further, in the absence of a breakdown of the world trading system
- Emerging Market debt/GDP has risen: but has stopped rising and remains below Developed Markets
- Emerging Market current accounts are less vulnerable than in 2013 and should start to improve
- Growth remains reasonable...
- ...as do corporate profits
- And some comments on sovereign risk

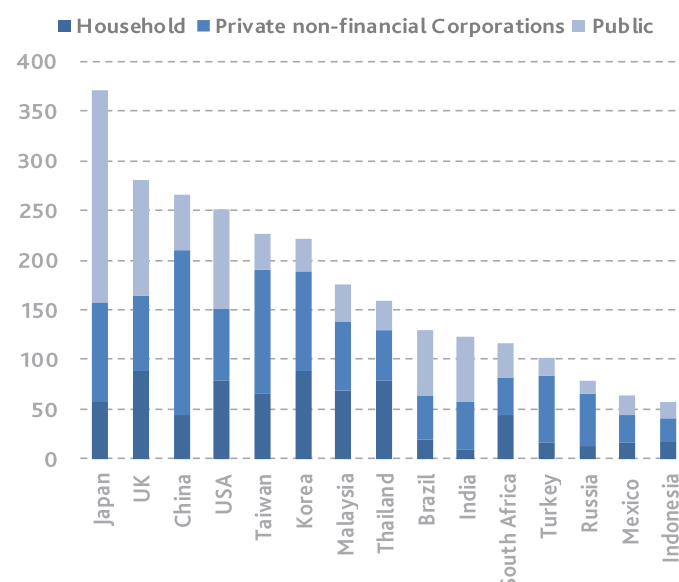
The 10% gain in the value of the US Dollar from mid-February to mid-August led to a sell-off in emerging market assets. To mid-September, the MSCI Emerging Markets index fell had fallen by 19% from late February and by 22% from its January highs – technically, although somewhat irrelevantly, a bear market.

This rise in the Dollar has been a result of the ongoing removal of the monetary stimulus; the easing in fiscal policy; and heightened trade tension. The first has long been in the market and the second is also not a surprise. These go a long way to explain the 30% rise in the Dollar from 2014 to late 2016, just after the US election. However, the extent of trade war has been a surprise to most.

As always when the Dollar rises, those countries with US\$ funding requirements come under most pressure. In our space, this meant Argentina, where fiscal adjustment and tight money was not deemed sufficient, and Turkey, where irresponsible monetary laxity was combined with loosening fiscal policy. However, Turkey is a mere 0.6% of the MSCI Emerging Markets index while Argentina remains, for now, not in the benchmark. The huge divergence of performance of EM currencies belies the 'contagion' theory: the Lira is down almost 40% this year while only a handful of other currencies have fallen by even 10%. Overall, debt/GDP levels have risen in emerging economies since the start of this decade, as they have in developed markets (DM), but remain generally far below DM levels. Furthermore, in the last two years, corporate debt in Emerging Markets (EM) has

started to fall as a percentage of GDP, even in China. By the end of 2016, total (private plus public) debt/GDP in Japan, the UK and the US reached 372%, 281% and 252%, compared to 268%, 129% and 123% for China, Brazil and India respectively.

Debt/GDP (%) for end 2016



Source: JP Morgan, September 2018

One consequence of the recovery of domestic demand in emerging economies in the last two years has been increased imports. This has led to narrower current account surpluses - and, in some cases, wider deficits. It is worth noting that in composite, EM runs a current account surplus. Furthermore, where there are deficits, this widening has generally been limited: even in the Fragile Five, so named in 2013, the position looks much less painful than at that time, even in the case of Turkey:

Current accounts (as % of GDP)

	2013	2018
South Africa	-5.8%	-3.6%
Turkey	-6.7%	-5.2%
Brazil	-3.1%	-1.2%
Indonesia	-3.2%	-3.1%
India	-4.8%	-1.9%

Source: Citibank, September 2018

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As with the 2013-2015 period, the weakness in currencies resulted in increased inflation in the short term but helped pave the way for a narrowing of these deficits and an improvement in their trade competitiveness, setting the scene for the rally in share prices from early 2016.

Market interest rates have risen across the EM landscape and in many cases policy rates have been raised. For example, both Indonesia and the Philippines increased rates in the last week of September. The result is that, although the US Fed has been gradually tightening, the interest rate differential remains sufficiently high in inflation-adjusted terms to compensate investors for the perceived risk associated with the asset class. Indeed, it is close to a decade-long high, a level which should be supportive of EM currencies. This is in contrast to the 2012-15 period, when the differential was consistently below 2% (see chart below) and provided less of an encouragement for investors. Monetary policymaking is orthodox across EM, with even Turkey belatedly joining in with its above-consensus 625bp rate hike.

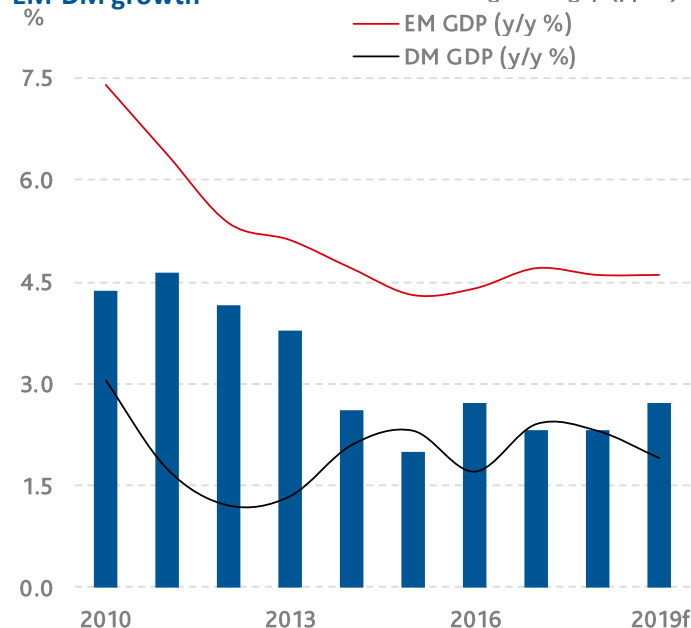
Real bond yield differential for emerging markets over the US



Source: Credit Suisse, September 2018

The economic growth outlook has stopped improving, following the sequential recovery over the last two years – but neither in aggregate has it weakened noticeably. Consensus forecasts are for GDP growth in EM of 4.5-5% for both this year and next, even accounting for slowdowns in Turkey, Brazil and South Africa. The distribution of this growth changes over time: for example, oil producers are benefiting from US\$ 80-plus/barrel Brent crude, while for importers – which are more numerous – this is a headwind. The growth differential between emerging and developed economies should expand again in the next two years.

EM-DM growth



Source: HSBC, September 2018

What about trade?

This remains the major unknown, because the world has not seen a trade war of this nature for almost a century. The US now already has the highest import tariffs in the G7 but the possibility is that tariffs are implemented on all US\$500bn-plus of imports from China. This would result in lower growth in both developed and emerging economies; and it may take some time before the full effects of the tariffs are felt, given the complexities and interconnected nature of global supply chains, and the multiplier effects on domestic demand. Encouragingly, many emerging

markets have the fiscal firepower to counteract these negative developments. Together with the improved competitiveness as a result of currency weakness, this will reduce the impact of the tariffs.

As bottom-up investors, developments of corporate profits are critical to us. Some hitherto overly optimistic analysts have been revising down their earnings growth forecasts for 2018 – partly driven by currency movements - but expectations seem to be settling on low/mid-teens growth for both this year and 2019, which are still healthy numbers. The second quarter of 2018 saw a healthy ratio of earnings beats to misses relative to consensus, at 42% to 31%, the gap widening in compared to the first quarter despite the generally negative news-flow. The fall in share prices so far this year vastly exceeds these earnings revisions. As a result, the forward PE of emerging market equities is now below 11x, below the long-term average and at an unusually high discount (over 25%, twice the 15 year average) to developed markets.

International investors have been reducing exposure to emerging markets and positioning reflects this renewed caution. The average international equity portfolio has 7.4% of its assets in emerging markets compared to an historic average of 9.2%.

Finally, a word on relative sovereign risk

In June 2016, a few days after the UK voted to leave the EU, we penned a note on the implications of the referendum for global investors who include emerging markets in their universe. We wrote that “The EU’s reaction has been in keeping with that of any organization whose principal interest is survival; they are torn between a pragmatic response of doing a deal

which is economically beneficial to the EU and a more ideologically-driven one of punishing Britain to discourage others from following her lead.” Over the last two years, and especially in recent months, it has become increasingly clear to us that it is in the EU’s political interest to ensure that Brexit is a failure from the UK’s perspective; and that this must therefore damage the EU’s own economic interests, even if that damage is small relative to the effects on the UK.

We wrote at the time that the risks associated with investing in developed markets, not least the EU and the UK, had increased. Developments of the two years have supported this view. Analysts often comment on sovereign governance as if it were purely an emerging markets problem. There’s no doubt that countries such as Turkey come under the microscope with good reason. But insufficient attention is paid, in our view, to more positive developments, such as the peaceful transition of power in Malaysia and of the leadership of South Africa’s ruling ANC, two countries which from an MSCI index perspective are together well over ten times as important as Turkey. And it is more than likely that the coming months will bring developed market risk into a sharper focus.

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