

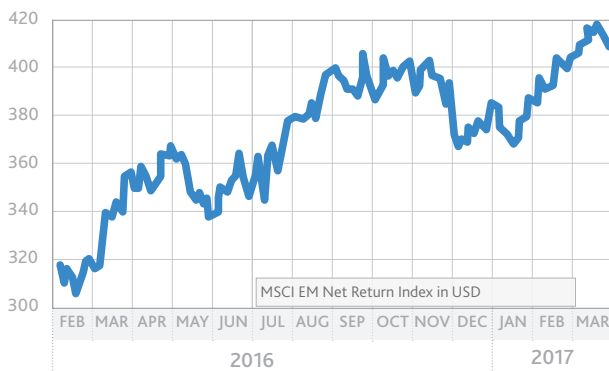
Investing in Emerging Markets An Improving Trend?



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Since early 2016, emerging market equities have started to recover, following five poor years. This note looks at why we believe this has happened and whether it seems likely to continue.

Figure 1: Positive Performance in Emerging Markets



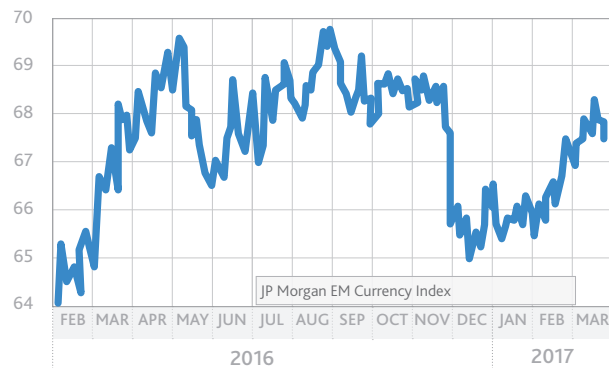
Source: MSCI

In our view, the underperformance¹ of Emerging Markets was driven by three factors: currencies, growth, and corporate earnings. Each of these factors has started to reverse and it is our opinion that there are good reasons why this positive trend should continue.

The turning point for emerging markets equities was early 2016 (see Figures 1 and 2). While the US election interrupted this outperformance, this proved a temporary setback: from December 2016, the market resumed its uptrend and, as we write, is sitting above its pre-election level.

The 25% gain over the last year equates to a 10% outperformance in US dollar terms against developed markets. This has come as a surprise to many investors, most of whom have been and remain very underweight emerging markets.

Figure 2: Positive Performance in Emerging Markets



Source: Bloomberg

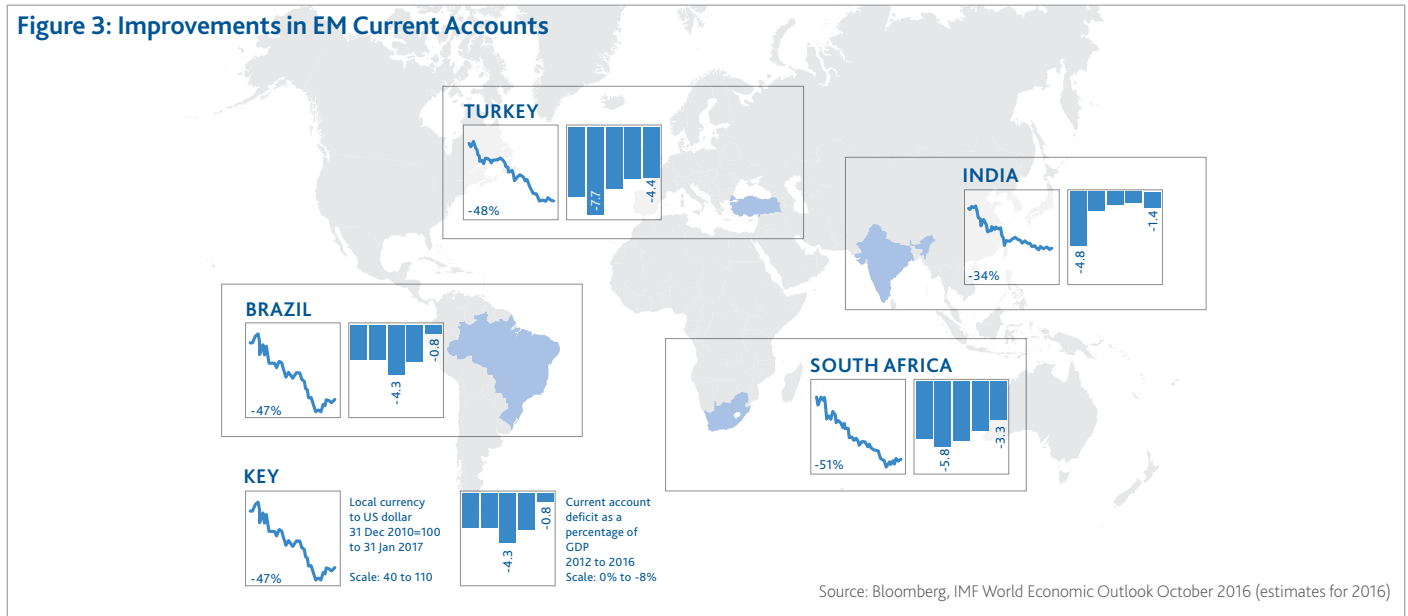
Apart from the US election, the end of last year also saw a much less surprising rise in the US federal funds rate. We have noted in the past that, over the last 30 years, the start of the rate hike cycle, in our view, has not typically been associated with a strong US dollar, contrary to common belief. This may be because the market buys the expectation and not the fact. Although we are not dollar experts, it seems to us that if the dollar were to strengthen, it would be more against currencies such as the euro, the pound and the yen - all of which have their own problems - rather than against emerging currencies.

Indeed, emerging currencies have actually risen since the Fed hike in mid-December. This is - in our view - justified by the sharp improvement in EM currency fundamentals over the past three to four years.

¹From 2011 – 2015, MSCI EM Index showed underperformance as compared to MSCI World Index.

In the five-year-long emerging markets winter, from 2011 to 2015, their currencies - which had been bid up prior to 2011 in the carry trade euphoria of easy money - sold off. In many cases this decline was more or less continuous over the period, some currencies falling by over 50% against the US dollar.² External balances started to worsen, currencies fell further thereby suppressing domestic demand from increasingly leveraged consumers, while the global trade multiplier stagnated.

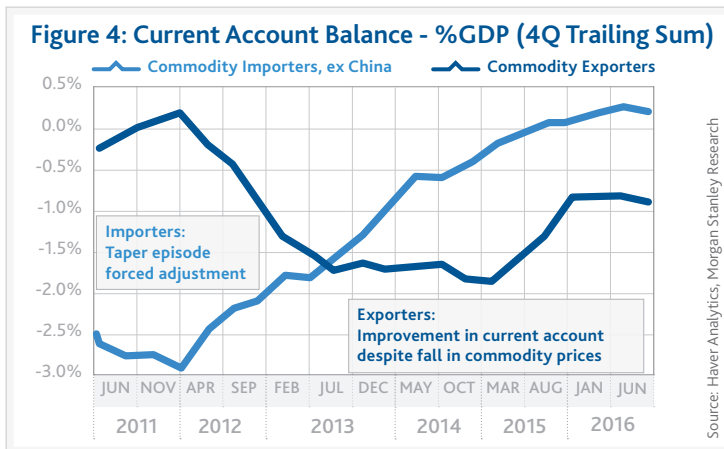
Figure 3: Improvements in EM Current Accounts



At some stage - early 2017 to be precise - investors realised that the sell-off had gone too far. They started to recognise that current accounts³ were improving, partly because of increasingly competitive exports and partly because of the cumulative effects of the slowdown in domestic demand. The graphic above illustrates how previously-stressed current accounts in Turkey and India, in South Africa and Brazil, have improved markedly over the last few years.

For the four countries mentioned above, currencies - which are, among other things, a measure of relative competitiveness - stabilised and then started to strengthen.

Figure 4: Current Account Balance - %GDP (4Q Trailing Sum)



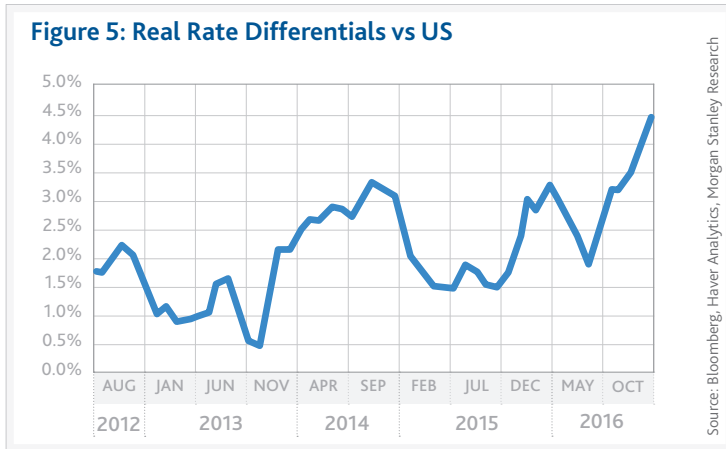
Encouragingly, this is not just as a result of the recovery in commodity prices since the start of last year. Certainly, commodity exporters have seen a recovery in current accounts since the start of 2015. However, per Figure 4, commodity importers, which include the largest emerging market countries such as North Asia and India, as well as the likes of Turkey and central Europe, have also seen an improvement, albeit a gradual one over a longer period of time. Given the recent start of a recovery in global trade, we would expect this improvement to continue.

This, incidentally, is what we consider a good indication of the relationship between commodities and the overall health of emerging markets. We believe many commentators mistakenly view rising commodity prices as good for emerging markets. In fact, the four largest EMs (three in north Asia, plus India) are commodity importers. Thus, strong commodity markets are often a symptom of economic strength in EM, not a cause, even if for some countries the latter is the case.

² Source: Bloomberg

³ Current account is defined as the sum of the balance of trade net income from abroad and net current transfers.

Figure 5: Real Rate Differentials vs US



Another factor supporting strength in EM currencies is high interest rates in real terms relative to real developed market rates. This single line in Figure 5 incorporates four variables: (US interest rates in nominal terms – US inflation) – (emerging markets rates in nominal terms – emerging markets inflation). Real US rates are not rising, because inflation in the US is rising at least as fast as nominal rates. The key variable here is that emerging market rates remain high while emerging market inflation rates are starting to fall. We believe the likes of Brazil and India are likely to see lower nominal rate whilst Mexico and Turkey will probably see higher interest rate.

However, overall inflation rates should fall over time as the impact of stable and rising currencies in 2016 starts to come through. Real interest rates should therefore remain supportive of currencies in emerging markets as 2017 progresses.

Despite an improvement in emerging economies' growth, relative to developed markets, currencies still seem depressed, in our view. We believe this illustrates the relationship between relative emerging market and developed market growth rates, and emerging currencies, and shows that by this comparison EM currencies look unusually cheap at around these levels.

With reference to trade, November's election in the US has given rise to concerns about increased protectionism. Our view is that 'Trump the pragmatic businessman' is likely to outweigh 'Trump the rhetorician', given the complex linkages in world trade, the millions of US jobs that depend on this, and the checks and balances in the US system which mean that a president can't always get what he or she wants. The tone of the more recent comments from the White House has been more accommodative and less confrontational.

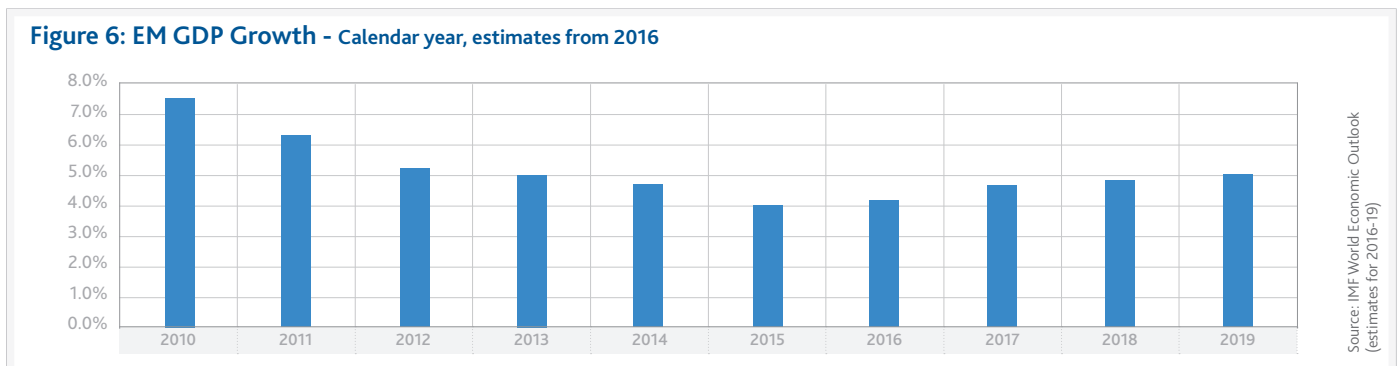
There have been significant long term developments in trade patterns. Intra-EM trade – between EM countries – is expanding rapidly. 15 years ago, this trade was merely as important as EM exports to the US. Now, it is more than twice as significant. 15% of Asia's exports go to the US – but 21% of US exports are to Asia. So the US matters, but not as much as it did 15-20 years ago.

Moving on from currencies, economic growth is accelerating at last. We believe the likelihood is that this will be the first year since 2010 in which GDP for EM will grow faster than in the previous year.

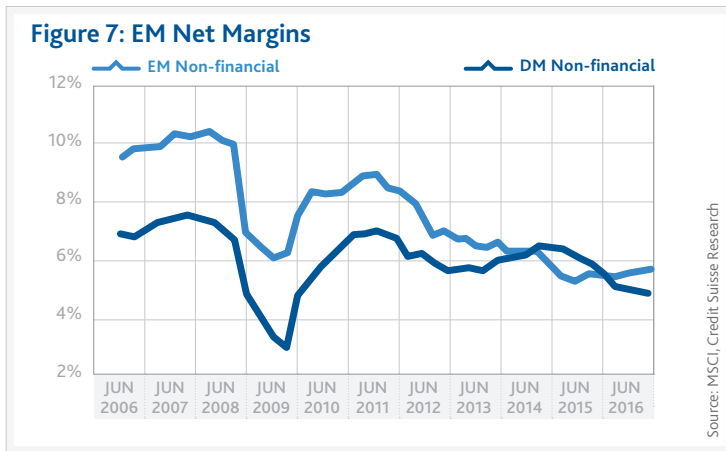
This recovery could be quietly impressive - from 4.1% in 2016 to 4.6% this year and to nearly 5% in 2018 (Figure 6). Not exactly the gangbusters 7-8% of 2010 but not bad nonetheless - especially when considering that China, the biggest EM, grew by over 10% in 2010 and is gliding towards a 5 to 6% longer term growth rate.⁴ Excluding China, emerging economies' growth rises from 2½% last year to 3½% this and 4% next year. As a sign of this improvement, PMI's for both emerging and developed economies are recovering - but this improvement is more marked in emerging economies, for two reasons. Firstly, the resumption of growth as Brazil and Russia following their recent recessions; secondly, the natural catch-up which one would expect from moderately well-managed middle to lower income countries. To give one example: Germany, Europe's powerhouse, is recovering somewhat and is growing at a 1½ to 2% rate; but Poland, which is a lower cost supplier to German businesses and consumers, is growing at 3 to 3½% per annum.

Overall, of the 23 countries in the MSCI EM index, we believe at least 15 should see faster growth this year than last.

Figure 6: EM GDP Growth - Calendar year, estimates from 2016



⁴Source: IMF World Economic Outlook, 2016 estimates



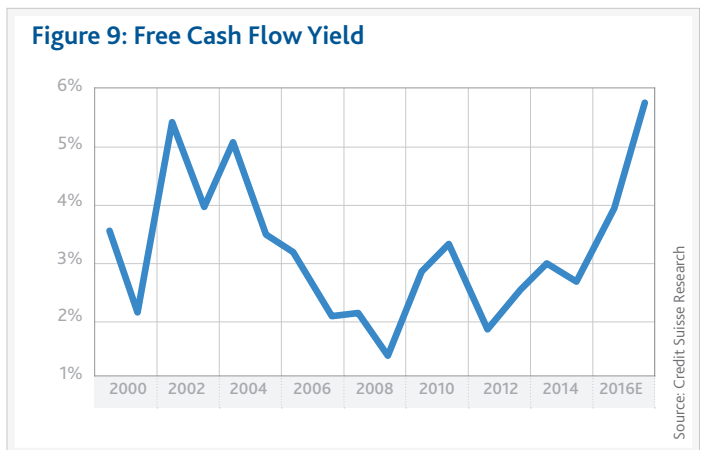
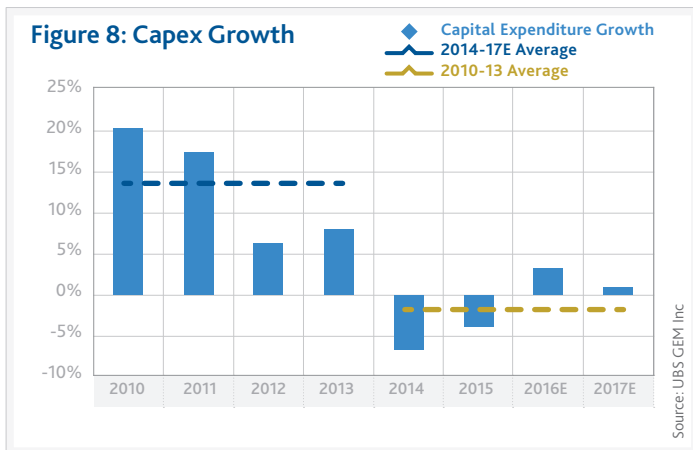
An additional factor driving emerging market equities higher is company profits. This has been on a multi-year downtrend, with margins initially converging with developed markets before, in 2014, falling below them. From last year, however this has turned around. Emerging markets margins are now both higher and rising. As we've said before, two factors are helping turn this around. For much of the last 6 to 7 years, wage growth in emerging economies has exceeded productivity growth. While this boosts consumption in the short term - and indeed is one reason why current account deficits widened for 3 to 5 years - in the long term, wages can only grow faster than productivity at the expense of lower corporate profits margins.

The reversal of this trend, which we have highlighted over the last six months, has become more established. Wages are ticking up again as economies recover - but only slowly and by less than productivity growth. Given that the labour market generally lags other key economic variables, we would expect this positive differential to benefit profits over the next few years.

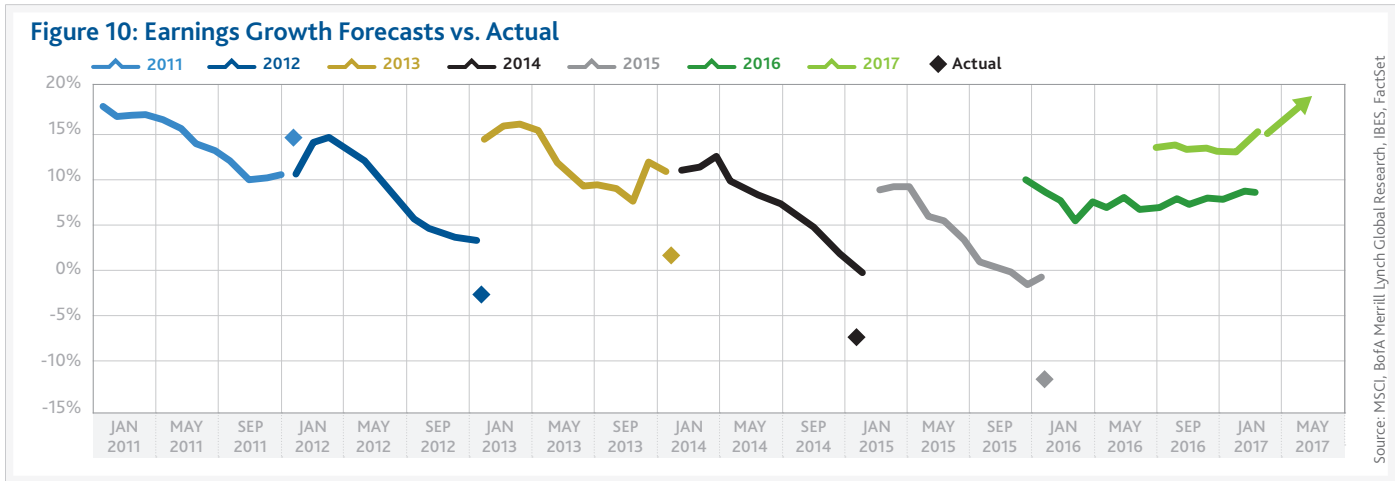
Also worth mentioning is capital spending. Over the last two years, the capex⁵ to sales ratio in EM has fallen from 9 1/2% to 8% as corporates belatedly acknowledged the persistence of the slowdown in their economies. They recognise that the breakneck growth era is over and that sustainable GDP growth rates are likely to be closer to 5% than to 7% in the longer term. Businesses can no longer simply 'grow' their way out of a problem - if this were ever a solution, it isn't now.

Growth of Capex has moved from an annualised level of +13%, to a decline, a growth rate of -2%, within the last five years. This in turn has led to an explosion in free cash flow.

Together with this greater realism on the part of corporates, they are also treating their shareholders better. Dividend payout ratios have risen from around 30% to closer to 40% over the last five years. Shareholders are increasingly focused on ESG - environmental, social and governance - factors, and reforms both top-down and the individual company level are resulting in improved payouts in key markets such as Korea.

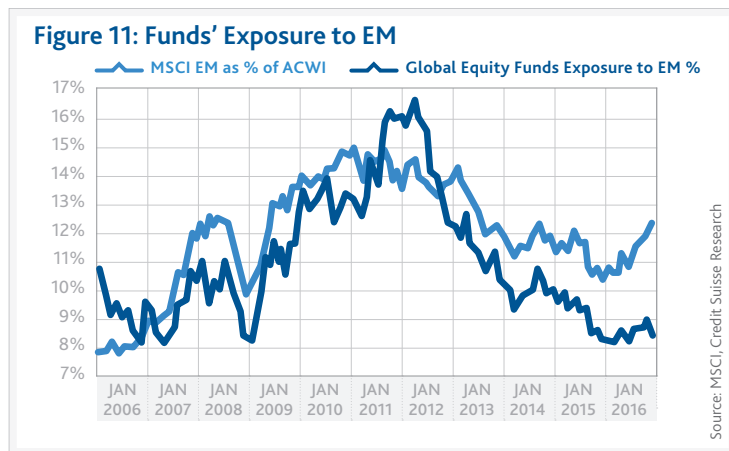


⁵Growth capex is the capital expenditure undertaken by an organization to further its growth prospects and/or expand its existing operations.



So how have analysts responded? Figure 10 above illustrates clearly how ‘the market’ got it wrong persistently over the last six years. Earnings were revised downwards every year, as each year progressed - irrespective of movements in, for example commodity, prices. By contrast, you can see that 2016 – the dull grey line towards the right of this chart - was the first year this decade in which earnings estimates were not revised downward; whilst the early signs for 2017, shown here in green, are even more encouraging. This points to earnings growth of double digits and an upward momentum in earnings estimates. Given that market sentiment is linked not only to the level of earnings growth but also to the direction of earnings estimates, this bodes well for equities in our asset class.

Finally some comments on investor positioning. A look at cyclically adjusted EM PE ratio suggests that, if earnings were to normalise, valuations would be at rock bottom levels - levels only seen at the depths of the GFC in 2009. Having had EM outflows of close to USD100 billion over three years to the end of 2015, recent inflows have only totalled USD5½ billion last year and another USD7 billion so far this year - a fraction of those earlier outflows, this in an environment of ever expanding global liquidity.



The result is that investor positioning is very light. The average global fund has only 8½% in emerging markets - a 400 basis points underweight compared to an index weight of around 12½%. This difference is higher than it was even in 2009. We believe this demonstrates the scope for significant investor inflows into emerging markets equities, as the improvement in sentiment gathers pace, especially at a time of what looks like heightened risk in developed markets.

In conclusion:

- In our view, the recovery in emerging economies is fairly robust and broad based
- Emerging currencies could be surprisingly supportive for foreign investors
- And corporate earnings, which have been such a headwind facing EM equities over the last six or seven years, are starting to turn

These factors are already causing investors – who have had good reason to be cautious in recent years – to reassess their portfolio allocations. Even if this is unlikely to be as extreme as, for example, 2009 or 1999, past experience causes us to believe that, once a trend is established, it can be a lot stronger than it appears from the start, especially in companies with high returns on equity that compound their earnings and cashflows over time.

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Index Definitions:

MSCI EM Index – The MSCI Emerging Markets Index is a float-adjusted market capitalization index that consists of indices in 23 emerging economies: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates.

MCI World Index – The MSCI World Index is a stock market index made up of approximately 1,600 global stocks. It is often used as a common benchmark for 'world' or 'global' stock funds. The index comprises a collection of stocks of all the developed markets in the world, as defined by MSCI. The index includes stocks from 23 countries but excludes stocks from emerging and frontier economies. Index results assume the re-investment of all dividends and capital gains.

MSCI EMxCHN – MSCI EMxCHN is the MSCI Emerging Markets Index excluding China.

MSCI ACWI Index – The MSCI ACWI Indices offer a modern, seamless, and fully integrated approach to measuring the full equity opportunity set with no gaps or overlaps. MSCI ACWI represents the Modern Index Strategy and captures all sources of equity returns in 23 developed and 23 emerging markets.

ISM Manufacturing Index – The ISM Manufacturing Index monitors employment, production, inventories, new orders and supplier deliveries. A composite diffusion index monitors conditions in national manufacturing and is based on the data from these surveys.

EMXC – EMCX is the Morgan Stanley real rate index, which includes Argentina, Brazil, India, Indonesia, Korea, Mexico, Poland, Russia, South Africa and Turkey.

*It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns and will bear the cost of fees and expenses that will reduce returns.

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