# Emerging Markets Quarterly Outlook

THIRD QUARTER – 2019

## SHOCK & AWE

The summer saw a resurgence in risk aversion against the seemingly non-stop barrage of political developments and negative headlines that reverberated throughout financial markets. The growing laundry list of concerns — heightened domestic political uncertainties across a growing swath of major economies, rising geopolitical tensions in the Middle East, the ebb and flow of the US/China trade conflict, and growing civil unrest are just a few of the goings-on that dominated headlines and investor sentiment in recent months — understandably brought a re-emergence of volatility and spurred a flight to safety that underpinned a broad-based strengthening in the US dollar. This all created a perfect storm for Emerging Markets (EM) that saw investors dash for the exits and withdraw funds from EM assets at a rate not seen in five years.

Equities bore the brunt of the selling pressure in Q3 — EM bond funds recorded only moderate outflows, as the yield premium on offer proved too good to fully abandon in a world where more than a quarter of debt securities trade at negative rates — as investors pared exposure. The MSCI Emerging Markets total return index dropped 4.2% (US dollar basis) in the three months ended September 2019, with 10 of 11 industry sectors down in the period (just Tech managed to keep its head above water in the quarter) and returns in local bourses in 22 of the 26 component countries in the red.

The weak quarter for the stocks in the less developed areas of the world came in contrast to the US-centric gains in the MSCI World Index for the quarter (albeit a meagre 0.5%), driving a further wedge between the performance of EM and Developed Market (DM) equities, as the former remain stuck in the range that has prevailed over the last decade, while the latter are once again in aggregate retesting their all-time highs.

## Overblown & Underappreciated

While there are some valid reasons underscoring the difference in fortunes for EM and DM investors — namely uncertainty over the outlook, particularly related to international trade where EM economies have a higher risk exposure — there are also arguments that suggest the divergence is overdone, which could well create opportunities for the underappreciated EM assets.

First and foremost, despite the uncertainty clouding the forecast horizon, the underlying trends in global growth remain intact (albeit more moderate than assumed at the outset of this year). The dataflow of late has in fact been showing increasing signs that the worst has largely passed, and growth has broadly steadied after decelerating from elevated rates over much of the last year and a half — and this is particularly the case for EM, where higher frequency indicators have been perking up in recent months, such as China's latest slate of purchasing managers' indexes touching multi-month highs.

There remains little reason to anticipate some sort of rapid acceleration, however, the signs of growth stability are more than welcome and affirm that the likelihood of a recession materializing over the next 12 months remains very low. Accordingly, a lot of the more downbeat views and general negativity with respect to the outlook are somewhat overblown.

China remains the driving force in EM and its fortunes will continue to dictate those of others. While growth trends are continuing to moderate, activity is not collapsing. The now septuagenarian People's Republic is forecast to achieve growth around the bottom of its 6% to 6½% official target, as trade-related headwinds are being countered by the roughly 100 fiscal and monetary stimulus measures rolled out by policymakers this year that are starting to show signs of gaining traction.

An improvement in growth in China would provide positive spillovers through Southeast Asia, a region which has benefitted from the move for global manufacturers to diversify their supply chains away from the Middle Kingdom — Malaysia, Taiwan and Vietnam in particular have seen increased trade flows to the US as well as an influx of foreign direct investment, as producers look to avoid Chinese rising costs and the risks of tariffs.

India is expected to return to the top of the growth leaderboard next year after performance this year was hindered by regulatory uncertainty and concerns over the health of the banking system. The strengthened mandate of Prime Minister Narendra Modi should mean that the needed push for economic and market reforms will continue, while recently announced corporate tax cuts and incentives should provide a near-term boost to the domestic economy.

A bevy of fiscal stimulus measures are also e xpected to be introduced by the recently re-elected President Joko Widodo in Indonesia, with the recent announcement of a five-year infrastructure program and lower corporate taxes as a part of a broader reform agenda that includes loosening labour laws and opening domestic industries to increased foreign ownership.

The reform-oriented government in Brazil is on the verge of pushing through its pension overhaul package, a key step in the plan to ensure the viability of its social security system and fiscal sustainability, and help revitalize Latin America's largest economy — though much work still needs to be done.

The fiscal sustainability of Argentina, however, is once again becoming a focal point ahead of the country's federal election in late October. The unexpected defeat of incumbent Mauricio Macri in August's primary election to Alberto Fernandez was not the tonic to calm the nerves of investors in the country — the last time Fernandez's Justicialist Party held power (under his running mate Cristina Fernandez de Kirchner, who served as president from 2007 to 2015 and as First Lady from 2003 to 2007), the tenure was marred by corruption scandals, the nationalization of companies, expanded deficits and a sovereign debt restructuring.

Saudi Arabia (which was added to the MSCI Emerging Markets index in addition to Argentina this year) also faced a shock in recent months as two major oil installations in the country were bombed in September, knocking a significant amount of crude production offline. Activity is expected to be brought back online in fairly short order, which should drive a rebound in the domestic economy, while the highly anticipated initial public offering for Saudi Aramco would be a big draw for foreign investment dollars.

## A favourable tilt

While plenty of uncertainty remains, this generally positive economic foundation is supplemented by the balance of risks to the outlook appearing to be somewhat tilting to the upside — a stark change of pace compared to what has prevailed over much of the last year.

First and foremost, the main risk clouding the outlook for EM has recently shown indications of abating.

Tensions between the US and China — which became more heated in early August with the surprise announcement by the US of plans to impose tariffs on the remaining untaxed $300 billion worth of Chinese exports, followed by tit-for-tat retaliatory actions at the end of that month — appear to have once again come off the boil.

Not only have the tariff increases that were initially intended to come into force on October 1 now been shelved (though, those slated for December 15 currently remain on the table), but a first phase of a trade agreement has reportedly been established with hopes of being formalized in the near future.

It has undoubtedly been the case that progress made has not been progress kept, and there is still a long way to go before calling an end to the trade war, but at the minimum this appears to be a much needed step in the right direction.

Next, while it is arguable that monetary policy has reached the limits of what it can be expected to achieve in terms of stimulating additional growth, financial conditions are unlikely to tighten soon. This is not insignificant given that almost every recession in the post-WWII era has central bank fingerprints all over it — policymakers drove interest rates too high too quickly in an effort to cool an overheating economy only to choke off credit and end the party. Instead, global central banks appear willing to keep the punchbowl filled to the brim.

Most notably, the European Central Bank took its policy rate even deeper into negative territory while also announcing the restart of asset purchases and further adding to liquidity through another targeted long-term refinancing operation. For its part, the US Federal Reserve cuts its policy rates twice in Q3 and also resumed reinvesting the proceeds from maturing securities on its balance sheet to prevent its asset holdings from continuing to shrink.

The easing by the US monetary policymakers has relieved some of the upward pressure on the US dollar, which combined with benign price pressures globally and well-anchored inflation expectations provide little impetus for EM central bankers to step up to defend their currencies' domestic purchasing power — indeed, central banks in Brazil, Chile, India, Indonesia, Mexico, Peru, Philippines, Russia, South Africa, Thailand and Turkey have all made cuts to their policy rates in recent months.

Market expectations remain one-directional with respect to policy rates, with some degree of easing being priced in for virtually every central bank in the world. Whether or not the full range of cuts materializes (and the general underlying health of the global economy would argue that markets may be getting ahead of themselves), the monetary environment will likely continue to remain highly accommodative and provide some support to global growth.

## Relative values

The gearing of EM economies to the cycle in an environment of broad-based and persistent, if unspectacular, global growth provides for a positive underlying foundation that should support the EM again materially outpacing its DM peers, and by a growing margin.

Despite this, however, the elevated risk premium embedded in the markets right now results in EM equities continuing to trade at a material discount to their DM counterparts. The forward price-to-earnings ratio on the MSCI Emerging Markets Index is nearly 25% below that of the MSCI World Index, a wider disparity than has been historically normal. This valuation gap is even more considerable when looking on a price-to-book basis where EM stocks are still on the cheap side of their history and offer a discount relative to DM that is one standard deviation from the average for the last decade.

The same is true for debt markets as well. EM bonds offer a material yield premium over those available in DM and default rates remain near historical lows against strong corporate balance sheets that are less levered and more liquid in aggregate than those of firms in DM. That said, relative valuations point to EM debt securities being on the undervalued side of history — and that is particularly the case for speculative-grade EM debt, for which credit spreads have drifted above their longer-term averages, even as they press against their lows for issuers from more advanced economies.

Of course, the elevated uncertainty that continues to linger over the global outlook and expectation that volatility will persist (especially given that political developments in the US all but assure that headline risks will remain ever present for the foreseeable future) means that investors are placing a premium on safety and earnings visibility, which is undercutting risk appetite for EM securities. As long as uncertainty persists, market risk aversion will likely continue to outweigh attractive valuations.

Importantly, though, should key risks continue to subside and drive a shift in market sentiment, the backdrop of positive underlying growth and benign inflation amid low interest rates would appear to be quite constructive for the EM complex, with valuations providing opportunities for outperformance.