GUARDCAP

Emerging Markets Quarterly Outlook

SECOND QUARTER – 2016

OVERVIEW

EM equities have reverted to following Wall Street's lead, albeit somewhat noisily. Within EM itself politics have been an important factor in determining relative performance. Positive economic news remains in short supply, but there is the odd glimmer of light on the horizon for struggling countries such as Russia.

High volatility and low returns have diminished Emerging Market's appeal in recent years and traditional reasons to be interested in the asset class, such a rapid economic growth, have faded in importance. However, the next phase of the Emerging Market story should mean sustainable earnings growth for good companies becomes possible as market disciplines replace state direction. This will take time. Meanwhile, a modest pickup in economic activity in the second half of the year should deliver mid-single digit earnings gains in 2016 with the potential for better to come next year.

In China the economy appears to have stabilized, for the time being at least. Unfortunately, little progress has been made towards State-Owned Enterprise (SOE) reform and dealing with the growing mountain of bad debt in the financial system. The government still has enough ammunition in the locker to keep growth near the official target for the next year or so, but the risk of an internal financial crisis developing further out remains high.

A Quieter Q2

After the excitement of the opening months of the year, Q2 provided relatively dull fare for EM investors. Rather than continuing to advance independently of what was happening elsewhere, EM equities resumed their familiar role of a high beta play on DM risk, which increased somewhat after the first few weeks of April. Accordingly, the MSCI EMF index once again appears to be tracking the S&P 500, albeit somewhat noisily. The relationship appears to have survived the increased volatility arising from the Brexit debacle, mainly because most EM economies are sufficiently detached from events to not suffer too much damage and Fed tightening has been postponed. This is a lot better than what happened in 2015, but it is hardly the stuff of a new bull market.

Within EM itself politics was the main driver of relative performance over the quarter. Voters are angry about corruption and incompetence in government and investors dislike political uncertainty and populist economic policies. Whilst the impeachment of Dilma Rousseff in Brazil captured most of the headlines, elections in Mexico and the Philippines underlined voters' unwillingness to put up with venality and failure. In the former the ruling Principles for Responsible Investment (PRI) suffered severe setbacks in a series of gubernatorial contests, whilst in the latter Rodrigo Duterte, running on a strong anti – crime and corruption platform, achieved a decisive victory over more establishment figures. Investors were unimpressed with the prospect of policy drift in Mexico but were encouraged by the decisive outcome in the Philippines and the respective markets reacted correspondingly.

Elsewhere, in Poland the increasingly statist pronouncements of the Law and Justice led administration have received a firm thumbs down as has the loss of the restraining influence of Prime Minister Davutoglu in Turkey following his ousting from office by President Erdogan. Positive economic news remains in short supply, particularly with respect to any acceleration in the pace of growth. However, anxiety about a hard landing in China has diminished and there is the odd glimmer of light in the worst performing countries. Brazilian corporates are no longer locked out of international bond markets and the bottom of the current recession is in sight. In Russia the central bank appears more confident about growth and inflation prospects and has started cutting interest rates. The dramatic decline in oil revenue has forced the Saudi government to start putting in place the sort of reform program that has always been welcomed by international fund managers. This includes the slashing of subsidies, trimming the public sector workforce, selling state assets and opening up the economy. Everything depends upon delivery, but the pronouncements made so far are a step in the right direction.

Is the EM Story Changing?

The only feature that has been consistent about EM equities over time has been their high volatility by global standards. Given that this does not look like changing in the foreseeable future, it is only reasonable that they should compensate for this by offering higher returns. Unfortunately, in recent years such reward, at least at the broad index level, has been conspicuous by its absence. The old props of the case for EM: persistent fast GDP growth, low asset valuation by DM standards and economic reform, have withered compared to the past and only extreme optimists anticipate a repeat of the 2003 -2007 cyclic boom.

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So, why bother? Ultimately, the answer is that while the quantity of growth will diminish, the quality of it should improve. In particular, as time goes by good companies should be able to generate decent earnings growth on a more sustainable basis. Governments increasingly have neither the ability nor, in most cases, the desire to prop up ailing state owned enterprises (SOEs) indefinitely. Gradually, Return on Equity will supplant Return on Political Investment. Bit by bit markets continue to open up, as exemplified by India's recent announcement of a major overhaul of rules controlling foreign ownership of companies. Eventually, EM economies will become more balanced and the present extremes of excess capacity will diminish as good money is no longer poured into industrial lost causes, notably in China. The process will take a long time and will be painful for those left behind, but the direction of travel is inevitable. This should colour longer term investment thinking, but immediately the current earnings cycle and valuation are more pressing issues.

Fortunately, the expectation that EM aggregate GDP growth should pick up modestly in the second half of the year still appears valid. This, along with commodity prices holding up, should deliver single digit earnings growth for EM this year with better to follow in 2017, subject to what happens in DM. Valuation is still low enough, at least in relative terms, for the asset class to deliver decent returns this year.

China - Some Stability but Little Progress

The relative calmness prevailing in China's financial markets during Q2 provided welcome relief to the hard pressed authorities. However, the price paid in terms of pushing back financial sector reforms is a high one. Aggressive intervention to stabilize equity markets and reduce capital outflows means that the refinancing of bank and SOE balance sheets has become an even more distant goal. The attempt to galvanize the market in securitized non-performing bank loans (NPLs) has fallen flat. Equity raising has been minimal. The widely anticipated inclusion of 'A' shares in the MSCI EMF index did not take place in June, because local markets are not functioning freely. Capital controls have suppressed the rate of loss of f/x reserves but not the desire of both individuals and corporates to move money offshore. A sure sign of this is the recent apparent rise in import demand, which looks suspiciously like a reversion to the old trick of over-invoicing in order to gain access to dollars rather than a significant uptick in activity. Even financial reforms that have taken place do not appear to have dealt a mortal blow to the issues that they were supposed to deal with. A prime example of this is local government finance where hard pressed administrations have found new ways to create off balance sheet liabilities, contrary to the intentions of the finance ministry's massive debt swap program. The major rating agencies have all indicated their concern about the rising level of such contingent liabilities that ultimately will fall back on the central government. Bad debt remains at the heart of China's problems and there is no sign that either of the principal agents, banks and central government, is willing to confront the challenge of recognizing its true extent and writing off the unrecoverable. Meanwhile the time-bomb continues to tick and the potential explosion becomes ever larger.

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In the economy at large, monetary and fiscal stimulus seems to have stopped the slide in the growth rate. The official purchasing managers' index (PMI) is now hovering around 50 while services continue to be the driving force in the economy. Construction activity has rebounded strongly from its cyclic nadir and has been the driver of growth in 2016, but recent data suggest it is now running out of steam. The area of most concern is private sector manufacturing investment. The combination of overcapacity, surging production costs and a lack of medium term bank finance availability has led to new investment in this area shrinking at an alarming rate. The dearth of profits in the sector means that it is unlikely that the situation will improve in the second half of the year. Nonetheless, given that previous stimulus injections have not yet kicked in fully and the trade-weighted value of the yuan has depreciated 3% since the beginning of the year, the authorities appear content to sit back at present. However, any renewed weakness in demand would probably trigger another round of stimulus measures, but probably not until the fall.

Meanwhile government attention has turned back to new supply side initiatives, not before time. Despite the fanfare when they were announced, SOE reforms have made little or no progress so far. Regional authorities pay lip service to the necessity of closing loss-making facilities, but they would prefer it to take place in other parts of the country than their own. In light of the reluctance of banks to face up to taking the necessary haircuts in offloading problem loans, zombie enterprises largely remain afloat and monetary policy is rendered ineffective. In this respect talk of converting SOE debt into equity is worrying, as it neither eliminates surplus capacity nor fundamentally improves lending institutions' balance sheets.

The IMF has indicated its concern about the issue, rightly so. If the government unexpectedly decides to deal with this thorny problem in a radical fashion, it would be very encouraging from a long term perspective. However, tinkering and muddling through seems the more likely outcome. As there are still enough national financial resources to kick the can down the road for a while longer, a China meltdown is not imminent and growth over the next twelve months will probably be near or not too far below the official target of 6.5%.