GUARDCAP

Emerging Markets Quarterly Outlook

THIRD QUARTER – 2016

THE WINDS OF CHANGE

Although there were a few hiccups along the way, Emerging Market (EM) equities enjoyed a good Q3 with returns comfortably outstripping those in Developing Markets (DM). The keys to this were the increasing belief that the macro-economic wind is becoming more favourable for EM. In particular, the composite Purchasing Managers Index (PMI) has begun to turn up and now stands at over 50, i.e. in expansion territory. With current account deficits diminishing and inflation, EM's Achilles heel, being reined in, international investors have begun to put their worry beads away. Instead, the prospect of superior economic momentum passing from DM to EM is resulting in significant inflows for the latter. In particular, it benefited from its high exposure to technology, which did notably well on the back of the iPhone 7 production ramp up. It also helped that MSCI China bounced strongly, even though local markets were dull. This was primarily due to a good run in the US-listed internet giants Alibaba, Baidu and Tencent along with a decent recovery in big bank stocks. Foreign investors are becoming a bit more sanguine about China's growth outlook, which is expressing itself through interest in the drivers of the new economy and diminishing concern about the old economy hitting a brick wall in the near future.

In EMEA and Latin America performance was a bit more mixed. Notwithstanding yet more investigations into corruption amongst its political elite, the Brazilian market continues to thrive on the back of anticipation of economic policy reform. Valuation is no longer attractive unless the Temer administration begins to deliver, but this may prove difficult given the fragility of the government coalition. Peru looks a more solid bet in this respect, where the new President, Pablo Kuscynski, is a firm believer in market friendly policies and can work with opposition leaders. Mexico, which is enduring an uncomfortable period of domestic politics, remains out of favour. Cyclic recovery rather than steady plodding is the flavour of the day. This remains true in EMEA too, underscored by the continued progress of Russia despite the dip in energy prices. Provided economies show evidence of turning round, investors are in no mood to punish political transgressions. The questionable nature of the recent Russian parliamentary election barely caused comment and the fallout from the coup attempt in Turkey, and Mr Erdogan's purge of dissenting voices has merely taken the gloss off the local market rather than triggering a full scale withdrawal.

It should be noted however, that the rally experienced since the beginning of the year has merely taken EM equities back into the middle of the trading range that they have occupied since the end of 2010. Further progress and a possible breakout depends on the economic background remaining benign and earnings growth being delivered. With Brazil and Russia gradually emerging from recession, provided China can sustain its target growth rate, EM may see GDP expanding a bit faster in 2017, possibly nearer 5%. However, the decisive test of confidence in the asset class will be provided by the Federal Reserve. Although the long awaited second hike will cause a ripple of fear, it is the pace of tightening and where interest rates settle in real terms that will prove decisive. History suggests that EM can live with moderate tightening but will struggle if a more hawkish approach is taken. At the moment the former approach seems likely to prevail. Q2 earnings reports were moderately encouraging and mid-single digit growth looks on the cards for this year. 2017 should be better with the consensus estimate pencilling in a 13% gain. This would represent a considerable improvement versus the flatlining of the past five years, but it is only similar to the pace expected from DM. However, earnings surprises in EM have begun to run ahead of those in DM, which is a positive sign.

What Discount Does EM Deserve?

Traditionally EM equities have traded at a discount to the global average. Based on consensus figures for 2016, the discount currently stands at around 20% in P/E terms and 25% with respect to P/B in aggregate. This is towards the high end by historical standards, although not extremely so. Accordingly, potential investors may take some encouragement that they have not missed the party following the run up seen so far this year, but this begs two questions: should there be a discount and if so what should it be?

The easiest way of tackling this thorny problem is to think about it through the prism of the relevant MSCI indexes as proxies for the average EM and average global stock. In broad brush terms the main sector differences between the two are that EM has a much higher weighting in IT and financials and a much lower weighting in healthcare. A possible surprise is that EM has only slightly more in energy and materials combined and if industrials are thrown into the mix, it has less than the world average in more cyclical stocks. This certainly contrasts to the position in 2007 when this trio represented 45% of the EM investable universe, a much higher ratio than in DM at that time. Given that healthcare attracts a relatively high multiple and financials a relatively low one in the post Financial Crisis world, this would suggest that EM should trade at a small discount due to its business mix, with its high exposure to IT to an extent compensating for it having less in consumer-related industries. Even if the spectrum of activity is no longer too different, it is no guarantee that EM will deliver a similar pattern of results. Investors will have to take into account expected volatility of return, growth rates and capital efficiency before coming to a view as to what multiples EM and global market trade on.

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With respect to volatility EM has two hurdles to conquer before being regarded as an equal, namely its previous history of macro-economic blow-ups and its relative lack of liquidity, which tends to amplify market swings. 2015 and the early part of this year tested investors' nerves in both respects, but some comfort may be drawn from that experience. Although equity markets in individual countries swung wildly, notably Brazil and China, contagion was very limited and for EM as a whole, the reaction of financial markets was distinctly muted compared to past periods of stress. This was because most EM countries are in decent financial condition and where they aren't, with the odd exception, they are biting the bullet with respect to sorting their problems out. Sovereign risk has not gone away but it appears lower than in the past. Further, it is not altogether obvious that it is much higher in EM than DM at present given Brexit, the problems in Euroland and the seemingly intractable economic malaise afflicting Japan. EM remains less liquid than DM, but, outside of small cap stocks, trading has become much easier.

So yes to a volatility discount for EM, but probably a smaller one than the past. In former times enthusiasts believed that higher GDP growth and the modernisation of EM economies would compensate for more uncertainty in corporate profit streams. However, for a variety of reasons company earnings in aggregate have not matched this expectation, particularly during the present decade. As alluded to previously, EM earnings seem likely to start expanding again, but there is little prospect of them racing away.

No growth premium appears to be merited and there is a good case for arguing for an EM discount to be applied until the earnings record improves. Another criticism of EM companies in the past was that they were not run to maximise shareholder return. This was certainly true before the Asian financial crisis when revenue growth appeared to be main objective of CEOs and corporate governance was poor. Since that near-death experience, balance sheets have been repaired to the extent that many are underleveraged according to financial orthodoxy. Lack of reliable access to funding means this attitude is unlikely to change greatly.

Nevertheless, return on capital has risen up the ranking of corporate objectives and returning excess cash to shareholders, by way of higher dividends or buybacks has become more fashionable. Corporate governance has improved significantly and capital is less likely to be sunk into non-core projects. However, EM is unlikely to match the RoE delivered in the USA over the long term but it should be in the ballpark versus the rest of DM. At this juncture a modest discount on the basis of capital efficiency is probably fair. In summary, whilst it is hard to argue against EM trading at lower multiples than DM, there are reasons to hope that the gap between the two may narrow over time.

China

Although the condition of China's economy is no longer the subject of daily headlines about pending disaster, this does not reflect meaningful progress towards reforming the economy. Rather it is due to fiscal and monetary stimulus at last stemming the deceleration in the country's rate of growth, restrictions on financial markets dampening volatility and capital controls reducing currency outflows. None of this is sustainable if the government is serious about rebalancing the economy so that it is no longer dependent on debt-financed, investment-led growth

Unfortunately, the authorities continue to vacillate about which should receive priority: politically acceptable job creation or its plans for reform. Having emphasised the former so far this year, it has signalled that it will now push the latter. This may prove tricky to do without risking a further slowdown.

Growth in 2016 has been excessively skewed towards real estate and infrastructure development. Despite various attempts to curb it, there is a house price bubble in tier 1 cities which is beginning to spread to tier 2 and 3 cities. This is largely the result of monetary stimulus making mortgages cheap and plentiful. Past experience suggests that it will be difficult to deflate this without causing a sharp fall in building activity. Further, less government money is slated to go into infrastructure projects in Q2. This might matter less if there were signs of the private sector picking up the baton, but there isn't.

The capex to sales ratio for quoted companies' remains at an all-time low and as other countries have already seen, managements lacking confidence are allowing cash to pile up on the balance sheet. Exports remain weak and the high rate of real wage rises that has supported rising consumption in recent years is now easing. Meanwhile, the debt mountain continues to expand, albeit at a slower pace. Reading the political runes in Beijing is always hazardous, but the best guess must be that further stimulus measures will be introduced if the economy slackens too much. Reform can always be postponed a bit longer before the precipice is reached.