Emerging Markets Quarterly Outlook

THIRD QUARTER – 2017

ONWARDS AND UPWARDS

Emerging Market (EM) equities continue to march on relentlessly upwards. On a total return basis, they have now clearly broken through the ceiling of the trading range that had held since the beginning of the present decade. Few would argue against the present advance now being designated a bull market for the asset class. If so, how long might it continue and how far is it likely to go? Typically, bull markets in EM last three to four years, so in terms of duration the present one is probably somewhere near its mid-point whilst the gains made are lagging a little behind the average for previous bull markets at this stage. This combination suggests that it is not too late to join the party. Of course, it might be different this time, but the two darts that normally apply the fatal blow, excessive valuation and recession, do not appear to be an imminent threat. Price to Book (PB), the most useful measure of valuation for EM equities when looking over the long term, currently stands at around 1.8X. This is well above the 1.4X it stood at in January 2016, but is a long way below the 3X mark reached at previous peaks. Moreover, return on equity is rising in EM following a prolonged period of capital expenditure restraint, which is an encouraging signal to investors and will merit a higher PB if sustained. Although there is good reason to be nervous about the unwinding of quantitative easing in Developed Markets (DM) and the sustainability of China's debt accumulation, neither seem likely to trigger a recession over the next twelve months. Elsewhere in EM, there are few warning signals flashing with respect to rising inflation or current account deficits, the usual harbingers of the build-up of recessionary pressure. If anything, the outlook for growth has marginally improved in recent months.

Although the macro-economic situation remains benign and valuation is reasonable, there is naturally a temptation to lock in the gains already made, given the high level of uncertainty prevailing in international politics and the prospect of central bank tightening in DM. History suggests that this would be a mistake. If political tensions do not derail economies, they are usually soon forgotten. Major corruption scandals in EM, the Syrian imbroglio, Brexit and various Trump protectionist announcements have barely interrupted the present charge, which is entirely in keeping with previous experience where shocking episodes, such as the collapse of the USSR, failed to dampen spirits for long. Similarly, previous EM bull markets were able to withstand rising international interest rates provided they do not go up too much in real terms, which seems unlikely to be the case this cycle. Sustained strength in the US dollar could undermine this rosy outlook given the high degree of correlation between it and weakness in EM financial markets. However, the present effective U.S. dollar exchange is still well above its average level of the past 30 years and EM currencies do not appear to be significantly overvalued or vulnerable to external shocks.

International inflows into EM equities, although healthy, remain relatively muted, especially in comparison to 2009-2011. Indeed, the cumulative total is still well below the all-time peak of 2013. This does not represent the type of investor stampede into the asset class that usually marks danger ahead. Analysts too remain reluctant to become aggressively optimistic. The consensus aggregate earnings forecast for this year has gradually nudged up and now indicates a gain a shade below 20%. The expectation is that the pace of growth in 2018 will then drop back to 12% or so. Given the struggle that EM Incorporated has had generating any earnings growth for most of the present decade, this caution is understandable. However, it flies in the face of experience as in previous earnings recoveries companies have delivered rather more. At present, the market may no longer be climbing a wall of worry, but neither does it face rampant bullishness. Again, this suggests that there is no need to leave the party yet.

A digital EM

The daily discussion about the coming wonders, disruption and dangers of the digital age rarely features poor and middle-income EM countries outside of China, yet they may prove to be the greatest beneficiaries of the consequent transformation of economies. This is because they have less invested in capacity that is likely to become obsolete, have a much higher percentage of their populations poorly connected to the national economy and have the most to gain from more efficient and increased delivery of public services. We have already seen a marker for the future in the way that cell phones have largely bypassed woefully inadequate landline technology in developing countries thereby massively increasing access to communications and improving economic efficiency. India, which is at the forefront of adopting digital technology to enhance the lives of its poorest citizens serves as a good example of what might happen. Facing mass illiteracy in rural areas and urban slums, it embarked on a programme to create a nationwide unique identification database using biometric information. Having done this, it is on track to deliver efficiently a whole range of government services to targeted end users without the need to deploy intermediaries, thus removing many opportunities for corruption and electoral fraud. Registration of land ownership and the payment of utility bills for instance are already possible. Ambitious schemes, e.g. the provision of universal access to elementary education and health insurance schemes to below poverty line families, are now in the offing (further this recognition technology is in use to advance other policy goals, notably financial inclusion). Real time, inter-operable, paperless banking is now available for illiterate clients. This offering is much more sophisticated than the mobile banking services provided in some African countries and it comes at a much lower cost to participating institutions than is the case in DM. Other financial products such as insurance and micro-loans are also available. Perhaps the most exciting element is that it is now possible to address a new e-commerce market that was previously inaccessible, the rural poor. This is achievable because of a combination of digital technology and the Indian knack of finding innovative solutions to reducing fixed costs and affordable delivery. The expansion of e-commerce should also serve to reduce prices, a useful macro-economic by-product in an inflation prone country. All of this should be repeatable elsewhere if it has not already started.

One of the key benefits to government of digitalisation, is that it should be easier and cheaper to collect taxes. The large scale of the informal economy and poor record keeping in many developing countries means that effective tax yields are well below planned levels. This means that many EM counties fail to raise enough money to pay for necessary infrastructure, which holds back economic development in both public and private sectors. In this respect, it will be interesting to see what success India has with its initiative to use electronic registration for its recently introduced General Sales Tax. Pursued properly, digitalisation will also lead to major improvements in public sector efficiency and accountability.

The speed at which the benefits of digitalisation come through will be as much a function of government policy as private sector investment. Low-income EM countries have been loath to open up high employment activities such as retailing and agriculture to international competition despite their inefficiency. They will also be reluctant to give international giants free rein. However, consumers armed with low-cost smart phones are likely to force the pace of change. As China, where online shopping now accounts for 13.8% of all retail spending, has already shown, once the ball starts rolling it is likely to pick up momentum rapidly.

Reassuringly dull

Other than the irritation caused by North Korea, the Chinese government has enjoyed a smooth run towards the opening of the 19th Communist Party Congress in the middle of October, much to its satisfaction. Critically, the economy has moved forward nicely without any real alarms. Although the pace of growth has begun to decelerate a little in recent months, this was expected and it does not threaten a new downturn. With spending on retail goods and services continuing to grow steadily, the fall off is mainly attributable to slowing investment, in keeping with official policy. Government infrastructure spending this year was front-end loaded whilst efforts to reduce overcapacity is constraining capital expenditure in the manufacturing sector. Importantly, investment spending in the 'new' economy – technology, education, health care etc – remains healthy. Despite this relatively stable background, the authorities remain nervous about the possibility of a full-blown financial crisis developing. Accordingly, they have been trying to take the steam out of credit growth, particularly where it has been feeding the expansion of shadow banking. They have had some success in this as data points to off-balance sheet lending in the financial sector ceasing to gallop forward at breakneck pace. This is welcome, but Standard & Poor's recent downgrade of China's sovereign debt serves as a reminder that there is no room for complacency when debt in the system remains so high and continues to rise as a percentage of GDP, albeit at a slightly slower rate than previously.

Although the upcoming Congress will mainly be a political event, there may well be important ramifications for investors, particularly as to where economic priorities lie. Any retreat from the strategy of modernising the economy along the lines already indicated is unlikely, but is reform still top of the agenda? Various moves made by the authorities this year suggest that it may no longer be the case. Although there has a slight opening up of the bond market to foreign investors recently, liberalisation of the financial markets has generally gone backwards. A Financial Stability and Development Committee has been established and the press has been used to prime public awareness for the need to deal with various grey rhinos in the financial arena (long-term, visible problems that are gradually increasing but have been overlooked). Efficient capital allocation and the development of a strong financial services sector now seem less important than keeping a lid on short-term instability. Similarly, it increasingly looks as if consolidation of SOEs to produce national champions is the goal of industrial policy rather than opening markets to competition. Further, the private sector no longer appears free to invest overseas as it sees fit. Several companies have been rapped over the knuckles about acquiring inappropriate international assets, whilst there is increasing pressure to support the One Belt, One Road initiative, which will help promote China's influence abroad. It will be interesting to see if Mr Xi choses to formalise this policy drift when he addresses the CPC in his keynote speech.