Active engagement with emerging markets

James Lindsay reveals why active matters for emerging market opportunities

2019 proved to be another bumper year for asset returns, despite a bumpy geopolitical environment. What does 2020 hold in store, and how will markets fare in a post-Brexit world?

As events in recent years show, from continuing trade tensions to Brexit-related currency volatility, few things in markets and investing are certain. This is why we believe taking a longer-term perspective and viewing opportunities through a secular or structural lens can help in allocating capital responsibly for clients.

When viewed through such a lens, emerging markets (EM) have the potential to provide UK institutional investors with a variety of portfolio benefits compared to developed markets (DM) – from the prospect of higher returns to geographical diversification and, importantly, exposure to secular trends that may mean emerging markets grow faster than developed ones in the coming years.

Higher growth and returns in EM?

Given both the labour and productivity growth advantages of EM versus DM, we expect a gradual increase in the developing world's contribution to world economic growth. With the potential for EM growth to pick up modestly and developed market growth to further decelerate, the EM/DM growth differential, which has historically been a key driver of capital flows into EM, could widen modestly, supporting EM asset prices.

Over a 10-year time horizon, as of January 2020, MFS Long Term Capital Market Expectations EM equities (8.5 per cent) to outperform US equities (2.1 per cent) as well as global equities (3.9 per cent), and EM debt (4.0 per cent) to outperform global investment-grade credit (2.7 per cent) as well as global aggregate bonds (2.4 per cent).

Why does active matter in EM?

While we feel EM equities and debt offer potential return premiums to DM equivalents over the long term, we believe security selection in both asset classes offers significant alpha opportunities for asset owners.

Corporate margins, which had been at historically high levels, deteriorated throughout 2019 as companies faced challenging business conditions and an increasingly unpredictable policy environment. However, we expect margins to fall further as they revert toward their longer-term average over the coming five years.

While corporate debt service appears manageable under current conditions, we remain watchful of both the level and diminishing quality of corporate debt, particularly in cyclically-oriented industries such as energy. In the sovereign space, as central banks diverge in their policy stances and toolkits, this could allow the market mechanism to better align fundamentals and valuation, potentially allowing issue selection to become a large source of portfolio return.

The search for alpha in EM

Investing in EM is not black and white – with the potential for additional return

comes the possibility of added risk. To uncover the most attractive risk-adjusted opportunities, we believe investors need to gain clearer perspectives by seeing the full colour spectrum.

To us, the clearest perspectives require assessing EM opportunities in the light of DM equivalents. These perspectives require gathering insights into the entire capital structure, across equity and debt. They also require big picture macro analysis in addition to deep fundamental analysis.

That's why we bring together our equity, fixed income and macro analysts across both EM and DM. We believe this fully integrated global research platform brings EM investors the clearest perspectives possible, helping to uncover opportunities that EM-only managers may miss.

As conditions become more difficult for companies and countries in a world of continuing trade tensions and economic uncertainty, investors need to incrementally build portfolios, while looking through the lens of fundamentals and long-term owners of capital.

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