Summary
- Emerging markets have been particularly volatile due to trade tensions between US and China.
- Investors are advised to look beyond the headlines at the fundamentals of each country.
- Long-term performance outweighs short term shocks.
- There are opportunities in equities, local and hard currency bonds but selectivity is the key.

In it for the long run

Despite tensions between China and the US, experts advise investors to look beyond short-term shocks and focus on the longer term when it comes to emerging markets. Lynn Strongin Dodds reports

External head and tailwinds are par for the course when investing in emerging markets, but the ride has been particularly bumpy lately. Trade talks between the US and China broke down yet again, while Turkey and Argentina's economic woes have not dissipated. Investors fled in droves in May but specialist fund managers counsel patience as the long-term rewards will compensate for the short-term shocks.

Many though lost their nerve last month when the US raised tariffs on $200 billion worth of imports from China from 10-25 per cent and threatened to tax roughly $300 billion worth of goods imported from the country. The situation was further exacerbated by the fallout from the US ban on Huawei's equipment in the name of national security. The Chinese tech giant is planning to file a lawsuit, claiming the Trump administration is trying to put it out of business.

Fund managers, most notably Goldman Sachs Asset Management, reacted by scaling back its overweight position in emerging market currencies and debt, while equity and fixed income investors ran for cover. They withdrew around $1.1 billion from emerging market bond funds in the third week of May, after outflows of $2.8 billion in the middle of the month, according to the EPFR Global, which tracks mutual and exchange traded funds data. Emerging market equities fared worse with the MSCI Emerging Market index handing back half of its 15 per cent gains since December. Around $3.8 billion money was pulled in the seven days ending 22 May, while overall global equity fund withdrawals have totalled $116 billion in 2019, on course to be the worst year since 2016.

A little perspective

Ashmore Group head of global research, Jan Dehn, believes investors need to put these events in perspective against a long-term global growth backdrop. "What we are seeing is that monetary policy has become less effective in terms of stimulating growth as most Western economies now operate near to their full potential," he adds. "This means that, barring significant slowing, central banks face big macroeconomic trade-offs if they continue to ease. This is reflected in the recent International Monetary Fund (IMF) forecasts, which shows that emerging markets will grow around 5 per cent over the next five years while developed markets will see a drop from 2.2-1.6 per cent by 2024."

Moreover, the IMF is predicting that over the five years, emerging market and developing economies' will see their share of global growth jump from the current 76 per cent to about 85 per cent in 2024. This is based on a host of factors including sound fundamentals, favourable demographic trends and a growing middle class. On average, these countries are becoming more consumer-oriented, technology-focused, and less commodity-dependent.

Figures from Ashmore that show in total six billion people or approximately 85 per cent of the world's population live in an emerging market country and except for China they are not grappling with the same ageing populations issues that many of their Western counterparts are facing.

"The gap between old and young is narrowing but the demographics are still in favour of emerging markets," says Pictet Asset management chief economist, Patrick Zweifel. "The other

positive factors are an increase in educational levels as well as productivity. What we are seeing is a move from low level production sectors to higher-value add manufacturing. This trend will continue even in China where most of the moves have been done. This leads to greater efficiency, which will further drive performance."

Despite the bright economic future, the ebb and flow of geopolitical tensions means that "investing in emerging markets has to be a selective story," says Schroders emerging markets economist, Craig Botham. "The trade wars have dominated the headlines and this has scared people. However, if you look more broadly at the global economic backdrop, some of these markets did well over the past 18 months. Going forward, investors should avoid the markets that are most exposed to the US and China trade such as Korea, Taiwan, Mexico, South Africa and Malaysia and look more at those who are least exposed, including Brazil, Turkey, India and Indonesia."

From an asset class perspective, equities remain attractive from a valuation perspective, trading on 12 times earnings, compared with 15 times for developed markets. "The trade issues are the wild card and markets may be bearish short term but the touchstones of earnings and valuations are strong for a strategic asset allocation to emerging market equities over the long term," says J.P. Morgan Asset Management head of the emerging markets and Asia Pacific (EMAP) equities investment specialist team, Luke Richdale.

He adds that the headwinds of a strong dollar are gone as the Federal Reserve has turned dovish as the US growth slowed. "We have seen the worst of the downgrades," he adds. "Also, the Chinese government started coordinating its monetary policy in the last quarter of 2018 and whatever happens to the trade negotiations, the country will be able to underwrite any deterioration in trade."

One of the major concerns is that emerging market equities will be hit when the US stock market rally finally dissipates but Richdale believes that there is plenty of steam left. "They are relatively resilient and many markets look attractive," he adds. "A good example is Korea which, on some valuation measures, has moved down to global financial levels because it is easier to sell Korean won than the renminbi, but we are beginning to look at the country now. As for Latin America, Argentina and Venezuela, they are not relevant areas for equity investors but we think there could be opportunities in Mexico as well as Brazil depending on the success of the reforms."

South Africa, Indonesia and India are also on many fund managers' buy lists given the election outcomes. South Africa's newly re-elected President Cyril Ramaphosanow has vowed to address the country's inequalities and the corruption of the Zuma era, while Indonesia's President, Joko Widodo, has a window of economic opportunity for further GDP growth if a young population can be supported by infrastructure spending and improved labour laws. Meanwhile India's Hindu nationalist Prime Minister Narendra Modi has to deliver on his campaign assurances of adopting a harder line on national security and a pro-business agenda.

Longer-term outlook

Caution is also the watchword in emerging-market debt, although investors have a much wider universe to choose from. Over a 10-year period, the number of instruments has significantly expanded by 257 per cent while the number of countries has jumped from 37 to 736 over the same period. Breaking it down, Dehn believes there is strong investment case for sovereign dollar denominated debt that comprises the smallest part of the $24 trillion EM fixed income universe.

He says that the near-term outlook has risks, but the outlook over the medium-term is favourable over developed market bonds thanks to the unwinding of distortions caused by quantitative easing. "Over the next five years, assuming no rally, i.e. no reduction in yields, we believe that EM external debt could easily deliver nearly 35 per cent return in dollars, with significant potential for additional return via alpha generation as the asset class continues to deepen and broaden," he adds.

As for local bonds, PGIM fixed income's managing director and co-head of emerging markets debt Cathy Hepworth says that depending on the market environment and country macro fundamentals, there are potential opportunities to overweight or underweight specific issuers. However, it is important to be selective given the vastly different economies and political undercurrents across individual countries. "We believe the best approach to hard currency bonds is an active bottom-up process that looks at mispriced and oversold bonds, price distortions and spreads between, for example, single and double B-rated bonds, or relative value compared to developed market higher-yielding bonds," she says.

On a country level, Hepworth adds: "Investors may want some exposure to the Czech Republic local bond market as a defensive move. Latin America can be fairly dynamic with trading opportunities across a number of countries and yield curves. Sub-Sahara presents several opportunities for hard currency investors, but local currency investors should have high conviction as those markets are relatively less liquid."

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