The case for emerging smaller markets

James Johnstone explores the investment opportunities of those emerging markets currently under represented by indices

There is considerable diversity within emerging markets. Some countries are at nascent stages of industrialisation and infrastructure development whereas others are at the cutting edge of technology. Some have promising macroeconomic backdrops while others are suffering from economic and political instability.

Within smaller emerging markets there are growth opportunities in countries currently under-represented by indices. For example, Indonesia, Colombia and Egypt all have minimal weightings in indices but possess significant investment opportunities akin to some of the larger emerging markets 10-15 years ago.

A well-trodden path

The economic development of emerging markets follows an established path. Generally speaking, economies in an early stage of development tend to rely on agriculture. As an economy maximises its output from agriculture, the overall result is a productive surplus that primes demand for goods and services. This incites a drive towards manufacturing and urbanisation that takes place as workers migrate out of agriculture.

Cheap labour and attractive prices for manufactured goods generates interest from other economies and as an economy's export base grows, disposable incomes rise. Technological upgrading then streamlines the manufacturing process, leading to increased imports, thus laying the foundation for industrialisation.

Financing and credit at this point becomes a necessity, and so financial inclusion is a constant theme of the process. Furthermore, as disposable incomes rise, demand for property and white goods increases exponentially *[see figure 1]*.

Current opportunity set

Currently 84 per cent of the MSCI Emerging Market Index is composed of eight countries. Fourteen per cent is allocated to the remaining 17 countries. These 17 smaller countries, along with some of the large frontier markets, provide an interesting and diversified investment universe.

Most of these countries are at an earlier stage of development than large emerging markets but are more advanced than many of the smaller frontier markets. There are over 2,500 publicly-listed companies within this category. Many, while under-owned and under-researched, are fast growing, well managed and can deliver compounding growth. While c.27 per cent of the current MSCI Emerging Markets Index represents the technology sector, the traditional emerging market themes of financial inclusion, industrialisation and urbanisation are far more prevalent in emerging smaller markets.

The more domestically focused companies also tend to be less sensitive to global economic factors and have lower correlations to the larger emerging and developed markets.

Attractive valuations

Supporting the case are valuations that look attractive relative to larger emerging markets *[see figure 2]*.

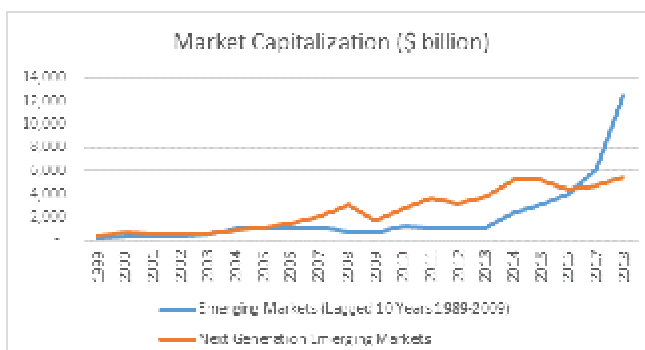
Opportunities by country

Saudi Arabia

The Saudi Arabian stock market is big and liquid. It boasts a total market capitalisation of $570 billion and trades roughly $1 billion per day and despite its up-coming inclusion into the MSCI Emerging Markets Index this month, foreign ownership of the market remains low at 2.1 per cent. Saudi Arabia presents a potentially attractive investment opportunity in light of the significant transformation programme initiated by Crown Prince Mohammed Bin Salman in 2016.

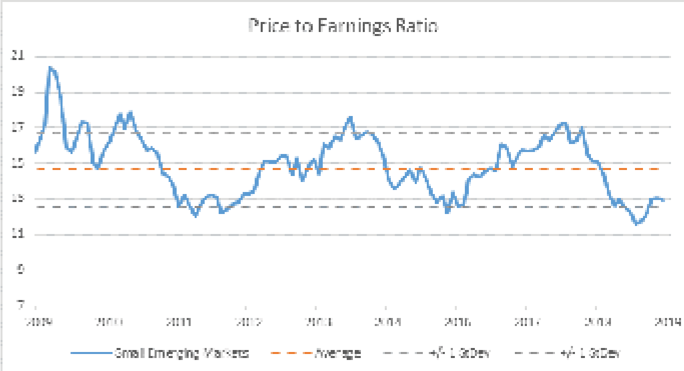
Whilst containing numerous pillars and goals, the overriding ambition is simple: the country aims to progress from a government-driven economy to one that is powered by private enterprises. The government plans to double GDP and increase the participation of Saudi men and women in the country's workforce.

Emerging markets vs. emerging smaller markets **Figure 1**



Source: RWC, Bloomberg. Emerging Markets = MSCI Emerging Markets Index Constituents 1989-2009, Next Generation Emerging Markets = Malaysia, Thailand, Indonesia, Poland, Chile, Turkey, Philippines, UAE, Qatar, Colombia, Peru, Hungary, Greece, Czech

Figure 2



Source: RWC Partners, Bloomberg, 31 March 2019

Thailand

Thailand is one of the more well-known Asian emerging markets. However, the economy has faced various headwinds, which has led to foreigners selling more than $19 billion of equities since 2013. High levels of household debt and an ageing population have discouraged foreign investors, but the country still possesses idiosyncratic investment opportunities. Furthermore, the country has strong external dynamics with a current account surplus, which equates to around 8 per cent of Thailand's GDP. Tourism has seen considerable growth over the past 10 years. While the initial bout of inbound tourism was driven by Europeans, in the past five years arrivals from China have increased rapidly. Regional inbound tourism is set to continue as Thailand's unique geography allows it to tap into the potential flows from neighbouring frontier markets.

Indonesia

Indonesia has encouraging economic fundamentals with a large population of c.270 million, a young workforce and low household leverage. However, the country was pushed into a structural current account deficit in 2013, which led to a less favourable macroeconomic outlook over the past few years. Nonetheless, the country is still growing robustly at c.5.2 per cent. Bank Indonesia has kept interest rates elevated to preserve macroeconomic stability, which suggests a good environment for equity investors. The palm oil price is currently attractive due to constrained supply and better-than-expected demand, which is a good proxy for the Indonesian economy.

The Philippines

The Philippines is one of the fastest growing economies in Asia. GDP growth is expected to continue from 6.5-7 per cent, while President Duterte's policies will likely lead to a significant improvement in the country's infrastructure development. The Philippines boasts an encouraging demographic dividend with more than half of the 100 million population below the age of 25. The country's growth continues to be supported by two key pillars: The first is Business Process Outsourcing, which is currently 8 per cent of GDP, having been at around 1 per cent of GDP in 2004. The second is remittances which account for c.10 per cent of GDP. Over 10 million Filipinos work overseas, and inflows may continue to bolster the economy.

Turkey

The country is currently undergoing a significant macroeconomic adjustment after the currency crisis of 2018. However, the country boasts a young, well-educated population and a strong business culture that has attracted significant foreign direct investment and has led to robust GDP growth in the past. While both households and corporates have a significant degree of leverage, valuations are attractive and the country is currently offering idiosyncratic investment opportunities.

Egypt

From an investment perspective, Egypt is one of the most attractive reform stories in the emerging market universe. Years of policy mismanagement under the Mubarak administration led to the emergence of large fiscal deficits, weakening growth, high levels of debt and declining foreign exchange reserves. Since then, Egypt has undertaken significant reforms under the supervision of the IMF. GDP growth has started to accelerate driven by investment and exports and the overall fiscal deficit is expected to come down from c.9 per cent to c.7.5 per cent in 2020. FX reserves have improved significantly, inflation is coming down and Egypt has one of the lowest minimum wages in the world which should continue to boost the country's manufacturing segment.

Pakistan

After a strong performance from 2011 to May 2017, Pakistan's equity market fell considerably during the next 18 months as a combination of current account and fiscal deficits and diminishing foreign exchange reserves led to the Pakistani Rupee falling from 105 to 141 vs. the US dollar. However, the macroeconomic environment seems to be bottoming out. An IMF deal in the range of $6-8 billion is close and Pakistan is receiving additional support from China, Saudi Arabia and the UAE.

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