Why Recent Weakness in Emerging Markets Equities Presents an Opportunity

MICHAEL LEVY
Co-Head of Emerging and Frontiers Equities

WILLIAM PALMER
Co-Head of Emerging and Frontiers Equities

Emerging markets (EM) equities have undoubtedly suffered a difficult first half of the year. Several factors have contributed to the weak share price performance, and in our view, these represent temporary headwinds to an asset class in which valuations and growth prospects remain attractive.

In this article, we'll discuss these headwinds and the factors that have contributed to the recent weakness. While each of these presents legitimate concerns for investors, we believe they are outweighed by an earnings outlook that remains healthy, and valuations that appear to already factor in these risks. In short, investors should retain confidence in the EM equity asset class.

US and China Trade War

A major contributor to current market sentiment is the trade dispute between the US and China. The risk of an escalation in the dispute has created unwelcome uncertainty for global investors. The bilateral trade deficit (US$365 billion) between the two nations, which accounts for about two-thirds of the total US trade deficit, is a major source of contention. China has acknowledged this imbalance, but there is still disagreement over the size and timing of achieving an acceptable bilateral trade deficit reduction. Frustration has built on both sides and the US and China have recently engaged in a tit-for-tat exchange of proposed trade tariffs.

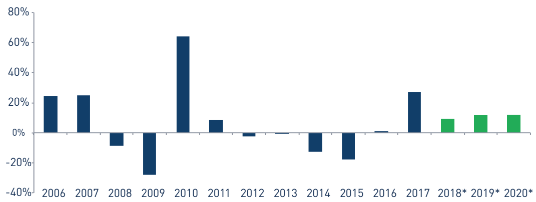
This uncertainty is causing concern among business leaders, and we would expect the business community to apply pressure on politicians through direct and indirect means to find a sustainable resolution. The announcement by Harley Davidson of its intention to increase production outside of the US to avoid tariffs in Europe is an example of this. China's reaction to the recent tariffs remains measured, leaving the door open to future constructive negotiations. Furthermore, should trade war fears weaken the economic outlook, it could soften future interest rate expectations in the US and lead to an acceleration of monetary easing in China.

Contagion Risk

A second factor concerning EM investors is the fear that the separate financial crises witnessed in Argentina and Turkey may extend to other EM economies. Argentina's failure to implement structural reforms at a time when its fiscal and current account deficits grew to represent about 5% of GDP led to the Argentine peso collapsing against the US dollar and a subsequent IMF backed US$30 billion credit line.

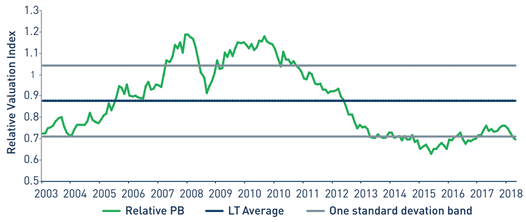
Similarly, Turkey has seen a sharp selloff in both its equity market and its currency. The prioritisation of high economic growth rates by President Erdogan's government saw the country's current account deficit expand to about 6% of GDP. Investor confidence has waned following the combination of creeping fiscal indiscipline and excessively loose monetary policy. Further, the politicisation of the central bank has raised serious questions of the Turkish Central Bank's ability to conduct independent monetary policy under the shadow of Erdogan, despite a rapid increase in inflation. Turkey needs to enact strong measures to anchor inflationary pressures, which should help to build a more solid foundation for sustainable growth going forward. This would also allow equity markets to return to more normalised risk premiums.

Figure 1. EPS Growth - MSCI EM (Emerging Markets)



*Forward Looking Estimates. Source: Factset, 31 July 2018

Figure 2. Price-to-Book Ratio Remains Attractive



Source: Barings, Factset, MSCI. As of 30 July 2018.

US Dollar Strength

The recent rebound in the US dollar has also contributed to volatility in the asset class, in particular putting a spotlight on those countries with a current account deficit. Emerging markets are in a much stronger position to withstand any tightening of global liquidity than they were in 2013's "taper tantrum," as evidenced by an aggregate current account surplus – either including or excluding China. Moreover, given the US's own twin deficit position, we do not believe we stand at the beginning of a sustained rally in the US dollar, which we expect to remain in a wide trading range going forward and so should not represent a sustained headwind for EM equities.

Inflation Concerns

Finally, the oil price has been supported by the OPEC production cut together with the recent withdrawal of the US from the Iran nuclear deal. This has led to increased inflationary concerns in developed as well as emerging markets. In the case of EM, some policy makers have raised interest rates in order to ensure their currencies remain supported and imported inflation minimised. This will inevitably lead to some slower than expected economic growth in those respective countries in the near term but doesn't change the overall earnings outlook for EM. It's also notable that OPEC has recently agreed to raise production, which once implemented, may see the oil price return to its previous trading range.

Positive Earnings Growth

Looking beyond these near-term challenges, we believe the outlook for EM remains positive, and with a fundamental bottom-up active investment approach, the near term volatility has provided a unique entry point to a vast range of compelling opportunities. Since 2016, EM companies as a whole have delivered positive earnings growth, reversing a five-year decline, and this is expected to continue, with all 11 major sectors of the MSCI EM index forecast to grow through 2020, according to Factset. In our view, this increase in profitability has been driven by margin expansion, which we believe is largely non-cyclical in nature and will remain supportive of profit growth.

Investors Remain Underweight

The upturn in the earnings cycle has not gone completely unnoticed by investors, as evidenced by net inflows into the asset class over 2017 and 2018. However, analysis of global equity fund weightings in emerging markets suggests that investors remain markedly underinvested in the asset class.

Valuations should not prove to be a deterrent for investors either, as the relative valuation of the MSCI EM index vs. MSCI World remains attractive, despite the strong performance in the two years through 2017. This is particularly relevant on a price-to-book basis, where it is now only modestly higher than the level occupied in 2002, after which we saw a pronounced bull market lasting five years.

In conclusion, the recent performance of emerging markets equities has clearly been more challenging than expected. However, the fundamental strengths of the asset class remain intact, and so we believe the recent short-term correction could provide an attractive entry point for investors.

BARINGS

IPE Reproduced from Investment & Pensions Europe, September 2018