Outlook on Emerging Markets

Firmer Sentiment

Emerging markets are outperforming in the backdrop of a broadening global recovery which is boosting demand without igniting inflation. A steady stream of positive economic and company indicators is helping to rebuild investor confidence in the asset class: Growth in the developing world is expected to widen its lead over developed markets over the next five years. Free cash flow yields continue to improve. Debt is decreasing and emerging markets dividend yields reached 2.5% in the third quarter in what is still a low yield environment. Investment spending continues to decelerate as companies cancel or shelve projects with poor projected returns. Capital expenditures have declined the most in Latin America, where sharp declines in capex to sales have coincided with rising free cash flow margins, which are now positive and on par with other emerging markets regions.

Global political discord and geopolitical tensions have generally not daunted emerging markets investors, yet they cannot be dismissed. The key risks we see include the potential for monetary policy missteps, resurgent populism, a war with North Korea, and a deepening of political and economic crises in countries such as Brazil and Venezuela. Technological disruption is also increasingly reshaping consumer and enterprise behavior, influencing anything from commodity price dynamics to how people shop and invest.

With all this being said, asset prices are rising globally and market volatility is at an all-time low. The emerging markets equity rally also appears to be broadening to the energy and materials sectors, from a recent strong focus on technology and financials (Exhibit 1). September’s pause is welcome from our point of view, and could help focus attention on undervalued market segments while easing some high valuations in the technology sector.

Viewed more strategically, emerging markets companies, with their higher risk premiums, have benefited from yield-seeking in a low-rate world. At 15.7 times trailing earnings and 12.6 times forward earnings, emerging markets equities offer increasing earnings growth, better (and rising) returns on equity, and slightly higher dividend yields compared to developed markets. Across emerging markets, companies have made inroads in reducing capex over the past two years and free cash flow margins have risen substantially. Despite these fundamental improvements, emerging markets equities continue to trade at a 25% discount to developed markets on a forward basis. We believe there is still good runway left for the asset class, with performance still off its historical peaks and more earnings.

Summary

- We maintain a favorable outlook for emerging markets equity and debt based on continued improvements in emerging markets fundamentals and supportive global economic conditions
- The emerging markets equity rally appears to be broadening and September’s pause is welcome as it could help focus attention on undervalued segments of the market and ease some high valuations in the technology sector
- Earnings growth is strong and rising for the majority of sectors, providing fundamental support for rising valuations
- For investors with medium-to-long-term investment horizons, we believe September’s pullback provides a compelling opportunity to allocate risk capital to emerging markets debt and equity

Exhibit 1
The EM Bull Market Broadened in Q3

<table>
<thead>
<tr>
<th>Total Return Contribution by Sector (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Q1 2017</td>
</tr>
<tr>
<td>MSCI EM Index</td>
</tr>
</tbody>
</table>

As of 30 September 2017

The MSCI Emerging Markets Index is a free-float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

Source: MSCI
growth to come. The issue of how and why emerging markets internal dynamics could change in the next leg of the rally, however, is at the forefront of our minds entering the fourth quarter of 2017.

A Broadening Rally

The MSCI Emerging Markets Index rose 27.8% for the year through September, outpacing its index counterparts for Europe (+22.8%, MSCI Europe Index), the United States (+14.2%, S&P 500 Index), and non-US developed markets (+20.0%, MSCI EAFE Index). Good earnings momentum, rebounding export growth, and strengthening balance sheets helped attract $19 billion in emerging markets equity inflows in the third quarter for total inflows of $65 billion year to date. While the record was $84 billion reached in 2010, approximately $155 billion flowed out of the asset class from early 2013 to mid-2016.

The second quarter was notable because the market’s gains were concentrated on a small cross-section of Chinese, Taiwanese, and Korean technology companies. Things appear to be changing. In the third quarter, market interest in energy and materials companies picked up amid stable oil prices, and better economic data from Russia and Brazil, which are home to large oil, gas, and mining companies.

Earnings growth is strong and rising for the majority of sectors and this supports rising emerging markets equity valuations (Exhibit 2). This has been a tailwind for stocks with growth attributes and has resulted in a much wider returns gap than we would expect between large cap growth and large cap value.

Exhibit 2
Valuations Have Expanded in Line with Earnings Growth

<table>
<thead>
<tr>
<th></th>
<th>MSCI EM Index</th>
<th>Consumer Disc.</th>
<th>Consumer Staples</th>
<th>Energy</th>
<th>Financials</th>
<th>Health Care</th>
<th>Industrials</th>
<th>Technology</th>
<th>Materials</th>
<th>Telecom Services</th>
<th>Utilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>P/E NTM</td>
<td>Jan 2016</td>
<td>11.0</td>
<td>12.8</td>
<td>20.3</td>
<td>8.8</td>
<td>7.6</td>
<td>22.8</td>
<td>13.7</td>
<td>13.4</td>
<td>14.7</td>
<td>13.4</td>
</tr>
<tr>
<td></td>
<td>Sep 2017</td>
<td>12.6</td>
<td>16.7</td>
<td>22.1</td>
<td>9.5</td>
<td>9.2</td>
<td>22.6</td>
<td>13.7</td>
<td>14.5</td>
<td>12.5</td>
<td>15.7</td>
</tr>
<tr>
<td>EPS Growth</td>
<td>Jan 2016</td>
<td>11.6</td>
<td>13.4</td>
<td>14.5</td>
<td>-3.5</td>
<td>20.7</td>
<td>23.4</td>
<td>8.8</td>
<td>5.2</td>
<td>28.0</td>
<td>10.9</td>
</tr>
<tr>
<td>NTM (%)</td>
<td>Sep 2017</td>
<td>15.6</td>
<td>19.5</td>
<td>14.9</td>
<td>18.8</td>
<td>11.5</td>
<td>17.3</td>
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Technology

The tech sector’s trailing earnings multiple reached 19.7x in September 2017 from 12.4x in January 2016, near the market’s bottom. Returns have risen nearly 50% since January as investors respond to transformational themes including online retail and gaming, and cloud computing. Earnings growth has also been the strongest of any sector outside of energy (where earnings are coming back from lows). China-based Alibaba and JD.com (e-commerce companies in the tech and consumer discretionary sectors, respectively) and Baidu (an Internet search engine) are among the year’s best-performing stocks. Notably, these companies were only added to the MSCI Emerging Markets Index in November 2015.

The tech sector’s relatively asset-light models have translated into stronger earnings and free cash flow. This earnings momentum is one example of the current tailwind to emerging markets growth investors, who can tolerate a higher valuation in exchange for strong earnings growth. Value investing continues to be effective in the large cap space, but significantly less so than growth at this time. In the small cap universe, however, value attributes continue to be rewarded.

Energy and Materials

Valuations have been slower to rise among economically sensitive companies, including those in the energy and materials sectors, which declined 4.8% and 0.4% in the second quarter relative to the index’s 6.3% gain. But they began to pique the market’s interest in the third quarter, rising 13.4% and 10.2%, respectively, and outperforming the index’s 7.9% gain. Disruptive technologies such as fracking and deep-water exploration and drilling have had a deflationary effect on crude oil prices; however, oil demand has been better than expected this year and Brent crude oil rose by more than 20% in the third quarter.
Climbing the Wall of Worry

Many of the positive themes running through emerging markets equities are also driving emerging markets debt. For nearly three years following the taper tantrum, from 2013 to early 2016, emerging markets debt was in the throes of a painful bear market characterized by sharply widening spreads and significant emerging markets currency depreciation. Over that period, the emerging markets blended index lost 18%, even when including its high annual carry. Emerging markets debt finally set a bottom in the first quarter of 2016. Since then, the market has been on a bull run, returning nearly 27%. More impressive during this rebound has been the market’s relatively low volatility, with the occasional pullback only lasting weeks in each case (Exhibit 3).

With emerging markets debt having experienced one of those rare pullbacks in September, it is an opportune time to reassess whether this is a buying opportunity for investors or whether this represents a more pernicious retracement in markets. In order to answer this question, we addressed the three largest risks to the asset class that have been discussed within our investment council in order to determine whether the proverbial wall of worry can be climbed in the quarters ahead. Based on the following analysis, we remain decidedly bullish on emerging markets debt’s prospects and intend to use the recent market correction to increase exposure in our emerging markets debt portfolios in the fourth quarter.

Three-Part Wall

1. We believe the single largest risk facing emerging markets today is whether the improved growth dynamics of 2017 can persist into 2018 and 2019. Perhaps surprisingly, this is also the risk we are most sanguine about. The bottom-up risks that directly affect emerging markets are low on our list of worries, while risks emanating from developed markets are what keep us up at night. Unlike a decade ago, when there were few strong leading economic growth indicators, today measures such as PMI diffusion indices can quite reliably describe near term growth prospects. These measures tend to be volatile, so as analysts, we focus on quarterly trends and how those change over time. The emerging markets manufacturing PMI bottomed in September 2015 (Exhibit 4), roughly five months before capital markets and six months before growth indicators found their

Country Highlight: China

The Chinese central bank’s deleveraging/liquidity-tightening campaign seems to be paying off. It is reported that interbank leverage declined in the first half for the first time since 2010, and the value of “wealth management products” dropped in May by the most in a decade. Continued progress in this direction could gradually ease concerns that a credit bubble is forming in China. Higher interbank rates from tighter regulation have favored big banks with large deposit bases and worked against smaller banks, which are more reliant on interbank financing. The four biggest banks hold 40% of China’s $36 trillion in deposits and reported higher net interest margins in the second quarter. We believe this analysis has not been fully priced into the market and we see opportunities in some of the bigger banks with access to low cost funding.

China will appoint its next generation of leaders in October, when the 19th National Congress convenes. This rotation is expected to further consolidate President Xi Jinping’s authority, which should help the president more effectively implement the market and domestic reforms that he has championed. Xi will likely continue to focus on reforms that improve the country’s financial stability and social welfare and promote economic rebalancing. Although there has been increased rhetoric about trimming excess capacity, particularly in the coal and steel industries, we expect progress to be slow. China’s economy expanded 6.9% in the second quarter, beating expectations and providing reassurance about its economic stability. Starting in May 2018, China A-shares will be included in the MSCI Emerging Markets Index as part of a two-step process. By August 2018, A-shares should represent about 0.7% of the index, and this begins to widen the playing field for non-Chinese investors who previously did not have access to these securities. Years of market interest in China has resulted in scarcer opportunity from a growth and value perspective, we believe, especially when rising valuations are taken into account.

Exhibit 4
EM Manufacturing Activity Is Sending Strong Positive Signals

EM Manufacturing PMI

As of 31 August 2017
Source: Markit

Exhibit 3
A Low Volatility Debt Rally

Growth of $100 from 31 December 2012

As of 30 September 2017
Measured by a blended 50% J.P. Morgan EMBI Global Diversified/50% J.P. Morgan GBI-EM Global Diversified Index
Source: Bloomberg, J.P. Morgan
through. The index’s most recent reading indicates a strong outlook for 2018 as it moved sharply higher and reached a five-year high. Emerging markets growth indicators are at five-year highs, and this is happening (not coincidentally) at the exact moment when leading growth indicators for economies in major developed markets and China head toward record highs (Exhibit 5). As such, we feel relatively confident that the next 6–12 months will be positive for growth and this should buoy risk assets in the emerging and developed worlds. Normally, when growth conditions strengthen in the emerging world, it coincides with rising inflation, due to shrinking output gaps and wage pressure. What makes the current environment unique is that while emerging markets growth is increasing, inflation is, in fact, moving lower. More than half of the local debt index’s constituent countries have central banks that are on a rate-cutting trajectory. Simultaneously, inflation differentials are rapidly moving in favor of emerging markets (Exhibit 6), which tends to translate to more attractive real effective exchange rate valuations. Given base effects from earlier this year, we expect inflation differentials between the emerging and developing worlds to continue to narrow well into 2018, thus providing more support for emerging markets currencies.

2. The second largest risk for markets is the potential for the Trump reflation trade to return. Recall the aftermath of the US election in November 2016, when investors rushed to sell US Treasury bonds and buy US dollars on the view that significant US fiscal stimulus would result in higher growth and, hence, less monetary stimulus. The market’s reaction was swift as 10-year US Treasury yields rose more than 80 basis points to 2.60% and the US dollar appreciated more than 7% in roughly two months. The dollar move sent the greenback soaring past its first quarter 2016 level, when investors were panicking over falling growth in emerging markets, to its most expensive level in 14 years (Exhibit 7). Over the next several quarters, however, hopes of significant US stimulus dwindled, US inflation fell, the Federal Reserve took a dovish posture, and the US dollar returned to its pre-election levels.

In September 2017, details of the Trump stimulus plan were released, outlining $1.5 trillion of net tax relief over the next 10 years. That level of stimulus was slightly overstated, as it was partially inflated due to a change in the way that cash flows are calculated over time. Adjusting for that accounting treatment, the actual tax relief is expected to be closer to $1.1 trillion, or about 0.57% of GDP on an annualized basis. The key question going forward for markets is what kind of multiplier effect that stimulus will have on annual US GDP growth. Academic studies differ on this topic, largely because multipliers themselves are not stable. Simply stated, the more slack there is in an economy, the more effective stimulus will be and vice versa. Therefore, to the extent that the US economy is near the end of its growth cycle, the stimulus effect on GDP growth will likely be minimal. However, if the US economic recovery still has years left to run and stimulus trickles down to consumers, who subsequently increase their spending, then the economy could see a more meaningful increase in annual growth. Unfortunately for investors, it will take
years to determine which of these scenarios will come to fruition. What is more certain is that regardless of the pass-through, stimulus should result in higher US growth and this is positive for emerging markets in the medium term. The question then becomes whether the shorter-term speed bump (i.e., the 2.5% drawdown in the blended index since early September) marks a short term bottom, or whether the correction will approach the 5% mark, similar to the Brexit and Trump sell-offs. Although the answer is not yet clear, we believe any further corrections from current valuations will mark a significant opportunity for investors to add to their emerging markets debt positions.

3. The largest binary risk, and one that could certainly change the narrative in 2018, emanates from the US Federal Reserve. Fixed income investors, in many ways, have been privileged to invest under the leadership of Fed Chairs Ben Bernanke and Janet Yellen. We believe both have shown extraordinary doveshine in their decision-making and have made large strides to create better transparency around the Fed’s decision making process. Dot plots, early releases of Fed minutes, and speeches by voting members have all helped to develop a clearer narrative around how the Fed intends to withdraw stimulus as the US economy emerges from the global financial crisis. In many ways, that transparency has resulted in lower overall volatility across fixed income asset classes. Glaringly, the one time that the Fed lost control of its forward guidance resulted in the taper tantrum of 2013. Subsequently, the Fed has been extremely cautious in its policy guidance to investors.

Over the next quarter, President Trump will make the decision whether to retain Yellen or replace her. The list of her potential replacements consists of individuals perceived to be more hawkish. Interestingly, it is not the potential for more hawkish policy that could upset markets, but rather the uncertainty of not knowing what policy will look like under a new leader. Whether positive or negative, that potential transition at the world’s most influential central bank remains the largest tail risk to fixed income portfolios as year-end nears, and we will consider instituting portfolio hedges to help mitigate this risk.

For investors with medium term to long term investment horizons, we believe the current dip in markets provides a compelling opportunity to allocate risk capital to emerging markets debt. Bottom-up fundamentals across emerging markets countries have improved significantly over the past 18 months. Further, the majority of these countries are still growing well below their estimated potential, which creates further room for their economies to rebound over the next few years. While valuations are always less compelling as bull markets reach their second year, our analysis suggests there remains both significant beta and alpha return opportunities in emerging markets debt. From a country perspective, the most meaningful change has been in fiscal and monetary policies, with newly installed, market-friendly technocrats in countries ranging from Argentina to Brazil to Ghana. The combination of strong economic management in emerging markets countries, coupled with positive global growth trends and supportive technicals, makes the recent asset class correction a compelling time to add risk.