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Global Perspective

Emerging markets: last refuge in a low-return desert?

November 2016

Executive summary

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Traditional risk premia are currently subdued, and interest rates in key developed markets look likely to remain historically low for some time, leading investors to look elsewhere to generate returns.

We believe that emerging market equities and bonds offer compelling opportunities through their improving fundamentals and attractive valuations. The outlook for developed economies remains weak: heavy debt burdens, declines in potential growth and the inability of policy makers to deploy impactful fiscal policy imply that monetary policy (manifested in low rates) remains the only source of stimulus. Even in the US, where economic conditions are much stronger than in other key advanced economies, the risk of negative external shocks have prompted the Fed to take a very cautious stance, which has been reflected in declining long-term growth and interest rate projections.

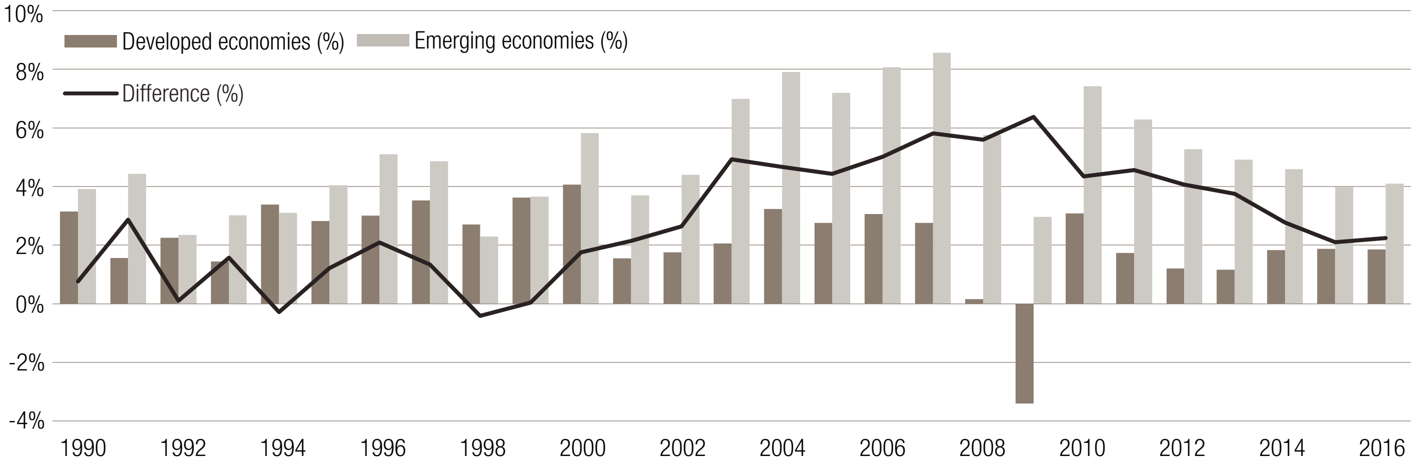
From an investment perspective, an environment of sustained low yields and weak expected returns (reflected in expensive valuations across most of the developed world) is leading to renewed focus on emerging market (EM) asset classes. Over the 2013/15 period, EM assets came under considerable pressure against a backdrop of weak economic fundamentals, a sharp increase in idiosyncratic risks (such as in Brazil and Russia) and the broad-based rise in the USD.

However, we now believe that the case for the asset class is becoming more positive. This is based on a risk/reward assessment of three key aspects, namely fundamentals, valuations and risk factors. On the fundamentals front, recent data shows a pickup in economic activity alongside a visible improvement in the external balances of a number of emerging economies. Focusing on valuations, despite the improvement in fundamentals, the current situation is reminiscent of 1997-98 crisis-type pricing, while potential systematic risk factors emanating from a China-centric financial meltdown and a hawkish Fed are starting to fade.

Fundamentals: signs of a positive shift

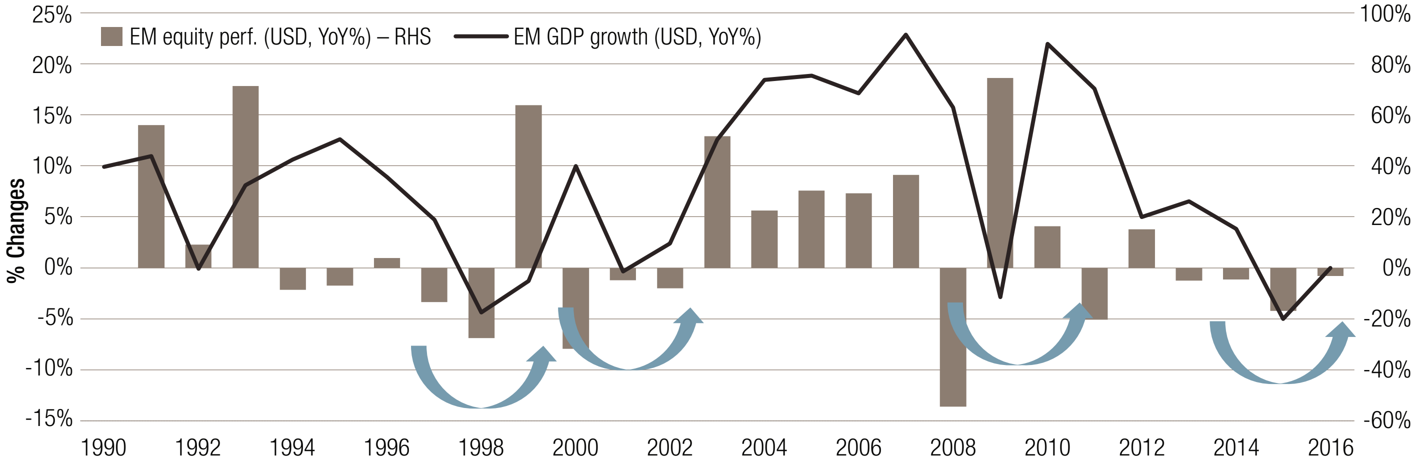
Starting with macro fundamentals, although many EM economies struggled in 2011-15, recent data shows clear signs of a pickup in EM economic activity. More importantly, the spread between EM and developed market (DM) growth, which had narrowed in every year during 2012-15, is starting to widen again. This spread has historically been a key indicator of EM asset outperformance (Figures 1 and 2).

FIG. 1 REAL GDP GROWTH (ANNUAL RATE): GROWTH IN EM ECONOMIES IS ACCELERATING AGAIN, OUTPACING DEVELOPED ECONOMIES



Source: IMF, July 2016. Data in local currencies.

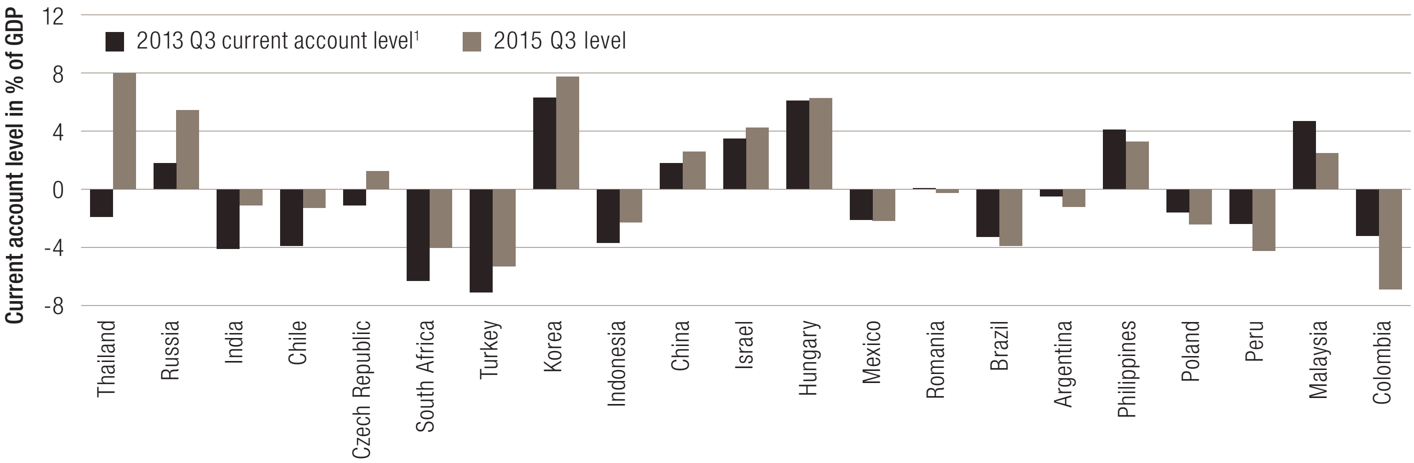
FIG. 2 CYCLICAL UPTURNS IN EM ECONOMIES HAVE HISTORICALLY INCREASED ASSET PRICES



Source: Bloomberg, 31 July 2016. Data in USD. Emerging markets (EM) as defined by Morningstar.
Past performance is not a guarantee of future performance.

As noted in a recent IMF report, economic activity in a number of emerging countries is now undergoing a cyclical upswing after several years of downward pressure. The policy stance taken by a number of countries (allowing their currencies to depreciate sharply) has helped to avoid a full-blown balance of payments crisis (in contrast to 1997, when fixed exchange rate regimes contributed to the instability). This economic stimulus has been visible in the improving external imbalances in a number of countries, including commodity exporters (such as Russia), which have seen their current account balances improve over the last three years (Figure 3).

FIG. 3 CURRENT ACCOUNT PROFILE DYNAMICS ACROSS EMERGING MARKETS



Source: Bloomberg, LOIM, Goldman Sachs.
[1] 2013 Q3 – time period when pressure on EM countries started to build.

Overall, regarding fundamentals, we believe that a number of EMs are entering a virtuous cycle in which improved macro fundamentals are able to support rising asset prices, which in turn reinforces the positive cycle. We also think that the Brexit vote shock is amplifying this process, as it is forcing key central banks to become more cautious. This, in turn, allows EM countries to reduce real rates via lower nominal rates as domestic inflation falls, thereby providing an additional source of policy stimulus for their respective economies.

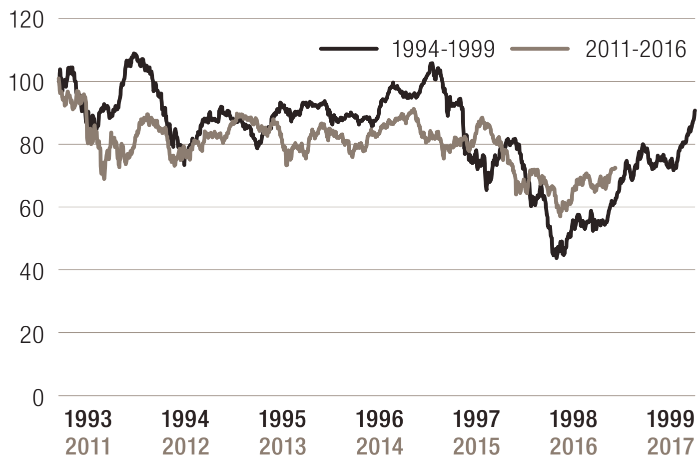
EM valuations: pricing reminiscent of the crisis era

Turning to valuations, after more than five years of underperformance (Figures 4a and 4b overleaf), EM assets are starting to show signs of deep under-valuation. EMs have faced several shocks over this period, including the Fed's taper-tantrum in 2013, lower commodity prices and specific idiosyncratic risks (such as corruption scandals in Brazil, Russia's annexation of Crimea and the anti-graft campaign in China) which have acted as strong headwinds to both relative and absolute asset performance, generating similarities with the 1994-99 cycle (Figure 4b overleaf).

FIG. 4 ALREADY 5 YEARS OF UNDERPERFORMANCE, AND EMERGING MARKET EQUITIES ARE NOW CLOSE TO 1998/99 LEVELS

4A. MSCI EMERGING MARKETS VERSUS MSCI WORLD

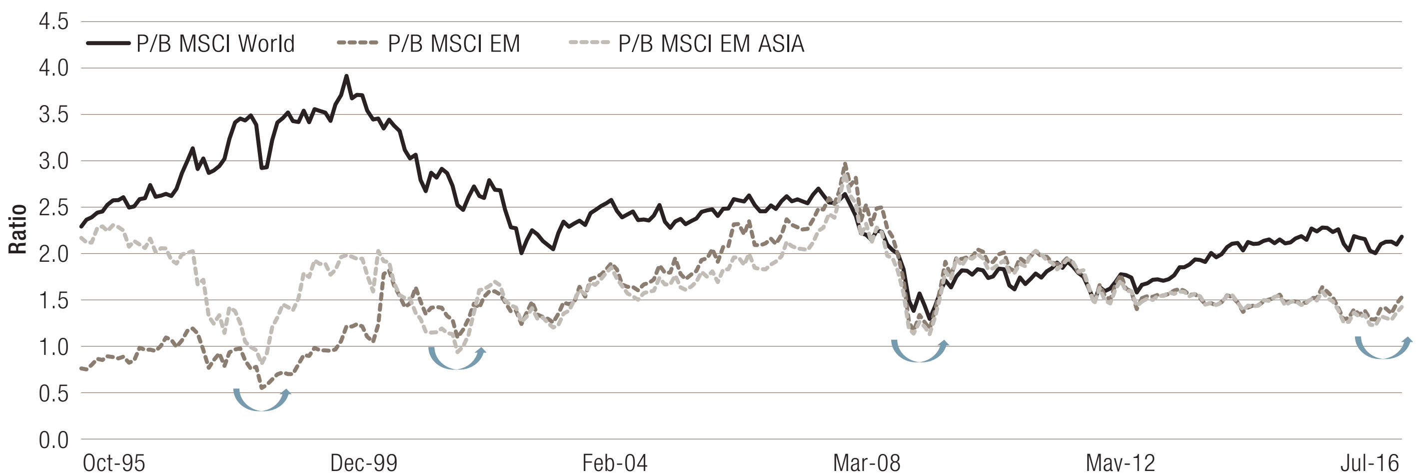
4B. MSCI EMERGING MARKETS COMPARED TO 1994-1999 CYCLE



Source: Bloomberg as at 31 July 2016. Past performance is not a guarantee of future results.

For instance, looking at EM equities' price-to-book ratios shown in Figure 5, current valuations are similar to the dark days of 2008-09, while the gap with world equities is close to the crisis levels seen in the late-1990s. Such depressed valuations are rare amongst global assets at the moment and, more importantly, we think are inconsistent with the improvement in fundamentals that a number of emerging economies are experiencing.

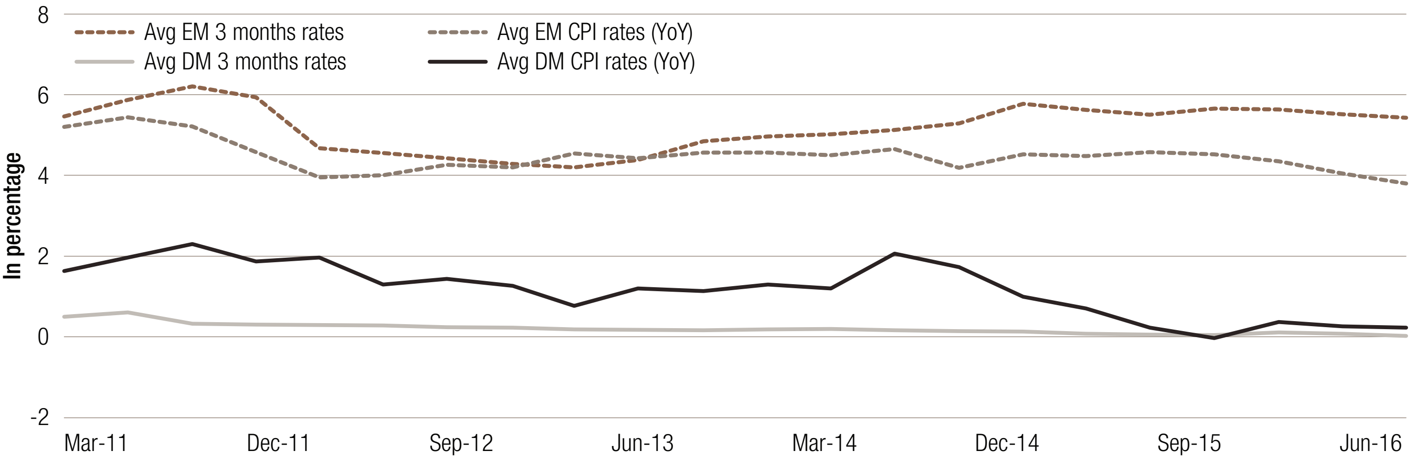
FIG. 5 PRICE-TO-BOOK (P/B) RATIOS OF DEVELOPED AND EMERGING MARKETS



Source: Bloomberg as at 31 July 2016. Past performance is not a guarantee of future results.

In fixed income, the relatively high real rates in the EM space (in both absolute terms and relative to DMs) also highlight the presence of attractive valuations, particularly given the strengthening trend of falling inflation that is currently taking hold across a number of emerging economies (Figure 6).

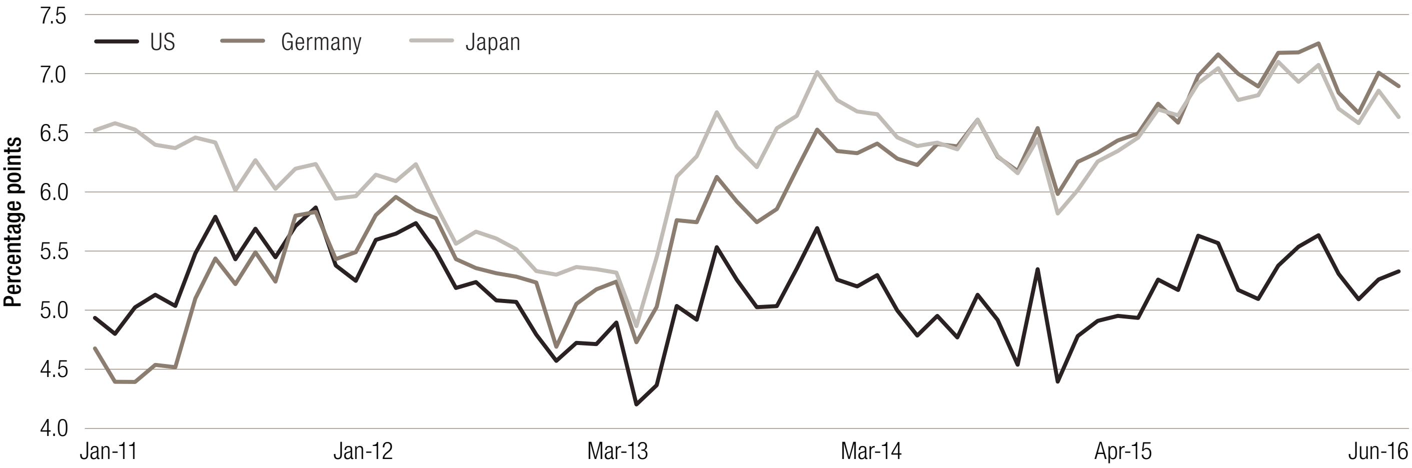
FIG. 6 EM ECONOMIES EXPERIENCING FALL IN INFLATION



Source: Bloomberg as at 31 July 2016, LOIM calculation/illustration.

With respect to nominal yields as shown in Figure 7, severe interest-rate compression in advanced economies over the last six months has pushed EM yield differentials (in local currency terms) to around 5.2% p.a. versus the US and nearly 7% p.a. versus Germany.[2] The current climate of low-to-negative interest rates in developed countries, coupled with sustained easing by central banks, has created a strong yield differential in favour of the EM space.

FIG. 7 EM YIELD DIFFERENTIAL VERSUS ADVANCED ECONOMIES AT MULTI-YEAR HIGHS

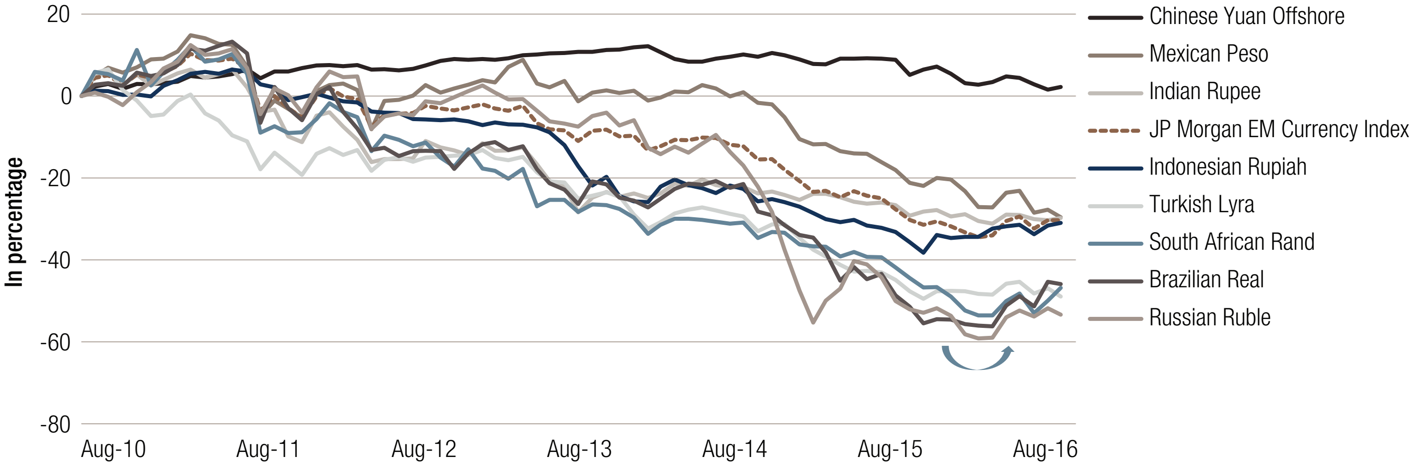


Source: JP Morgan GBI-EM Index yields used for EM, 5-Yr Government Bond yields used for advanced economies.
Source: Bloomberg, JP Morgan, June 2016.

[2] Source: Bloomberg.

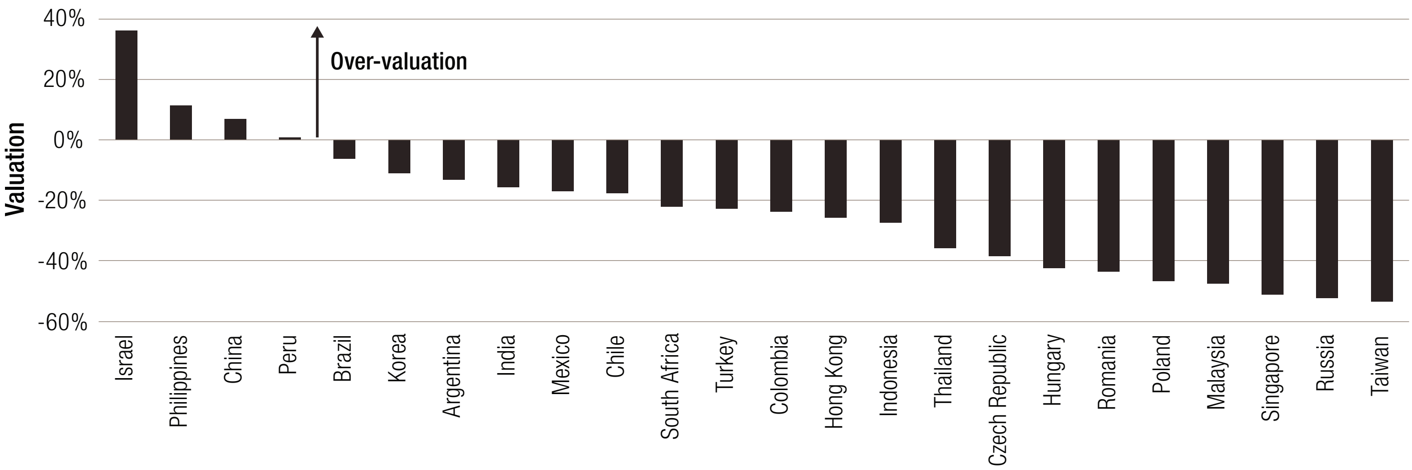
Focusing on currencies, the sharp depreciation trend in nominal exchange rates (Figure 8), which accelerated in 2013, has resulted in under-valuation across a range of fair value metrics. For example, the depth of under-valuation becomes clear using a purchasing power parity-based fair value model (PPP), which takes into account per-capita income differentials (specifically, the model stipulates that richer countries can tolerate a stronger exchange rate). Sharp deviations from fair values exist across a number of EM countries (the extent of which is shown in Figure 9).

FIG. 8 FX MARKETS ARE STARTING TO RECOVER



Source: Bloomberg as at 31 July 2016. Past performance is not a guarantee of future results.

FIG. 9 PPP SCREENS SHOW STRONG SIGNS OF UNDER-VALUATION IN THE EMERGING MARKET FX UNIVERSE



Source: Goldman Sachs Global Investment Research.
Note: (i) Poland, Hungary, Czech Republic and Romania valuations are shown against the EUR and rest are against the USD; (ii) based on 2016 Q4 forward valuations.

There is strong evidence across a range of metrics that EM equities, fixed income and currencies are under-valued. This under-valuation is starting to reverse. However, given the scope for a continued catch-up against a backdrop of improving fundamentals, we believe this trend has the potential to last.

The key risk factors: China and the Fed

When assessing the medium-term outlook for EMs, fears of a China-led financial crisis are often at the forefront of investors' minds. These concerns first surfaced in April 2015, when the CNY fix depreciated by roughly 3% over three days, causing widespread stress among EMs, especially for China's EM competitors in the external sector. In addition, for emerging economies with strong import links to China (mainly commodity exporters), the sharp depreciation was interpreted as confirmation of a steep slowdown in Chinese growth. Several months later, as the currency fix weakened further, first in mid-December and then violently in early January, market concerns about a full-blown financial meltdown peaked, with widespread damage to EM asset returns. Since then, stability in the CNY and visible easing in both monetary and fiscal policies by the Chinese authorities have helped put a floor under economic growth (as highlighted by a number of high-frequency surveys and hard data). This stabilisation has been a significant factor in the rally in EM assets in recent months.

Here, it is also important to note that part of the fall in foreign reserves which took place in 2015 (see Figure 10a) was driven by a decline in the external liabilities of Chinese firms as USD denominated debt was switched back into domestic CNY obligations (Figure 10b). Indeed, as the losses of foreign reserves are used to pay down outstanding foreign debt, it helps to rebalance China's balance of payment.

FIG. 10A CHINA'S FOREIGN RESERVES DECREASED SHARPLY IN 2015

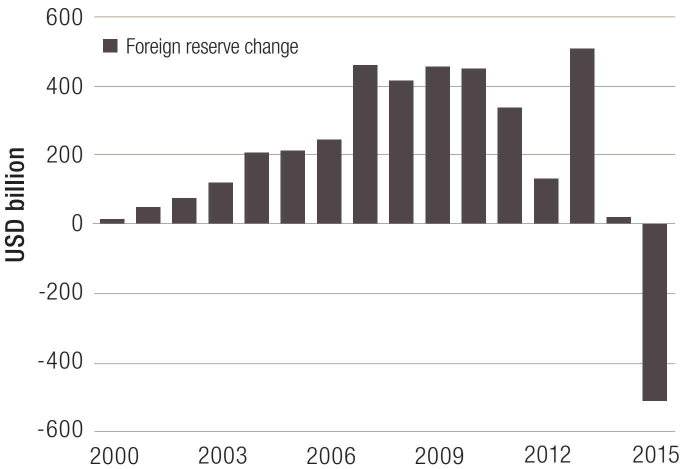
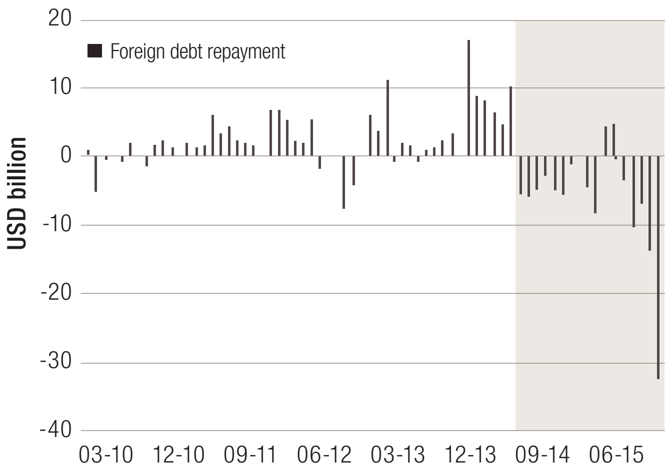


FIG. 10B THE CORPORATE SECTOR INCREASED FOREIGN DEBT REPAYMENT



Source: CEIC and BBVA Research.

Looking ahead, China is presently running a current account surplus of around USD 50 billion per month, which, alongside a rise in the country's share of world exports, implies that policymakers have less incentive to use the CNY as a stimulus tool (via a large devaluation).

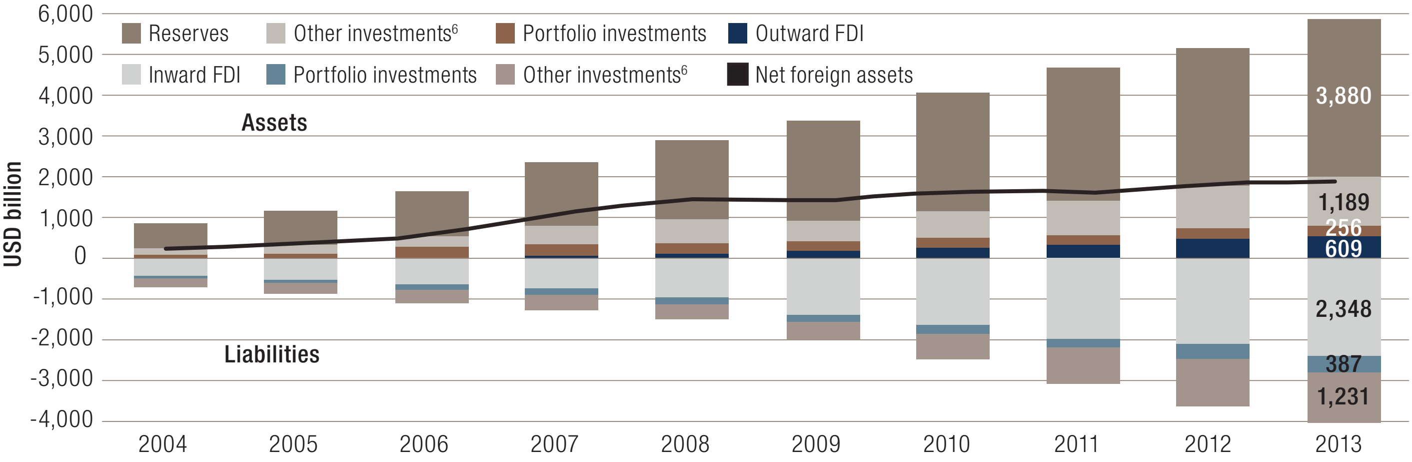
The sharp re-leveraging witnessed in China in the aftermath of the 2008-09 crisis is clearly worrying. The Economist reported recently that the country's total debt/GDP ratio has surged from 150% then to a current level nearing 260%. The risk of a full-blown financial meltdown remains, should a sustained default cycle take hold and overcapacity be shed.

However, when assessing the risk of such a hard landing, it is important to note that China is a net creditor to the world (to the tune of USD 2 trillion as at December 2013, after which capital outflows started in earnest), and has an external balance sheet with a very liquid asset profile. In addition, China runs a relatively closed capital account, which acts as a dam with regard to domestic capital flight.

We view this very strong international investment position as a key backstop against the risk of full financial meltdown, although we continue to envisage a sustained period of slow growth in China.

FIG. 11 **CHINA'S INTERNATIONAL INVESTMENT POSITION IS AN IMPORTANT BACKSTOP TO THE SYSTEM**

TOTAL STOCK, ASSETS (+) AND LIABILITIES (-)



Source: PBOC, SAFE, Bloomberg.

[3] Other investment categories include credit loans, currency and deposits and other investments.

Secondly, to re-engage in EMs, investors must feel confident that the strength of the USD has peaked at a time when the Fed is undertaking a hiking cycle. There are a number of channels through which an appreciating USD can pose a problem for the emerging economies. Firstly, for commodity exporters, the negative link between USD and commodity prices (which trade in USDs) can generate a negative income shock. More generally, there is a further detrimental impact on the existing external debt of EM countries linked to the tightening of global financial conditions and a rising USD.

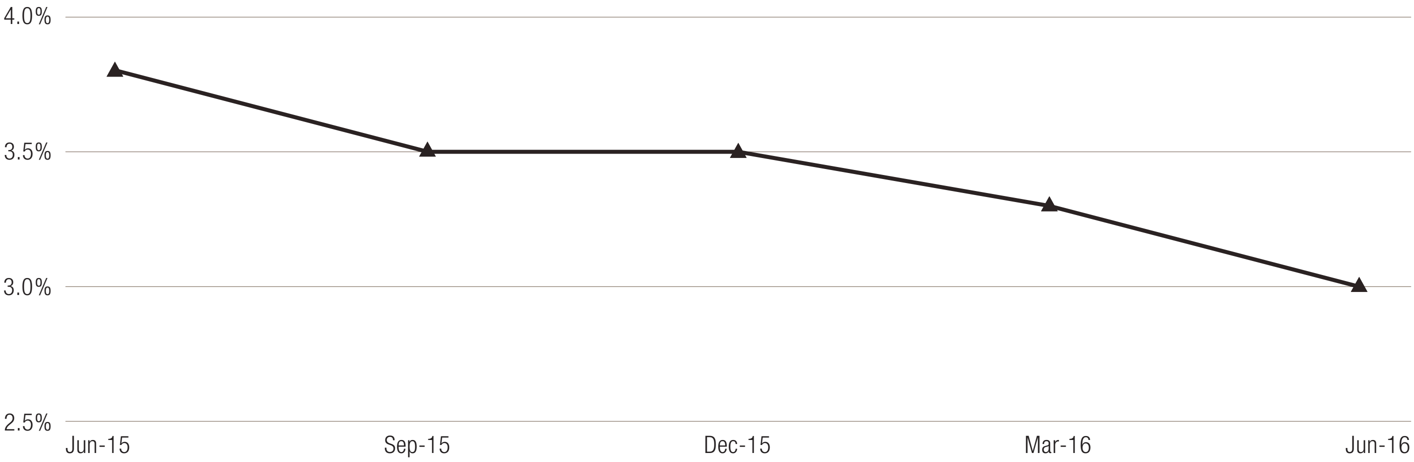
In our view, the fundamentals no longer point to an ever-rising USD. Here, it is important to differentiate between the risk of higher interest rates and the risk of a stronger USD, as the empirical relationship between US interest rates and EM asset pricing has historically been tenuous at best, and has only held true through influence on the reserve currency (i.e., the USD).

We believe that there has been a strong shift in the Fed's working framework in recent months, with USD movements (as a driver of financial conditions) becoming an increasingly significant consideration when the Fed is determining its overall policy objectives. This shift has been apparent in a number of speeches by key Fed officials, including New York Fed President William Dudley, Fed Governor Jerome Powell and Fed Chair Janet Yellen herself, in which the focus on international developments has received significantly more attention than in the past. Other key advanced economies (Japan, Eurozone, UK) are at least a business cycle behind the US in terms of the monetary policy cycle. This means that the impact on the USD of hiking by the Fed is significantly magnified. Given the US's key role in defining global financial conditions, it is perhaps unsurprising to see signs of a shift in the Fed's thinking. This is likely to manifest itself further as the upswing that began recently in domestic labour market data is downplayed.

More structurally, there has been a clear reduction in the estimates of potential long-term US economic growth, as well as in estimates of the terminal federal funds rate (as shown in Figure 12), both key determinants of overall economic performance. Within this revised framework, we believe that the Fed will remain very sensitive to financial conditions and that the current emphasis on USD trends will persist.

A cautious Fed, coupled with additional easing by other major central banks implies tailwinds for EMs overall, in contrast to last year's headwinds.

FIG. 12 FED'S PROJECTIONS OF LONG-TERM FUNDS RATE: CLEAR DOWNWARD TREND HIGHLIGHTING INCREASINGLY CAUTIOUS FED

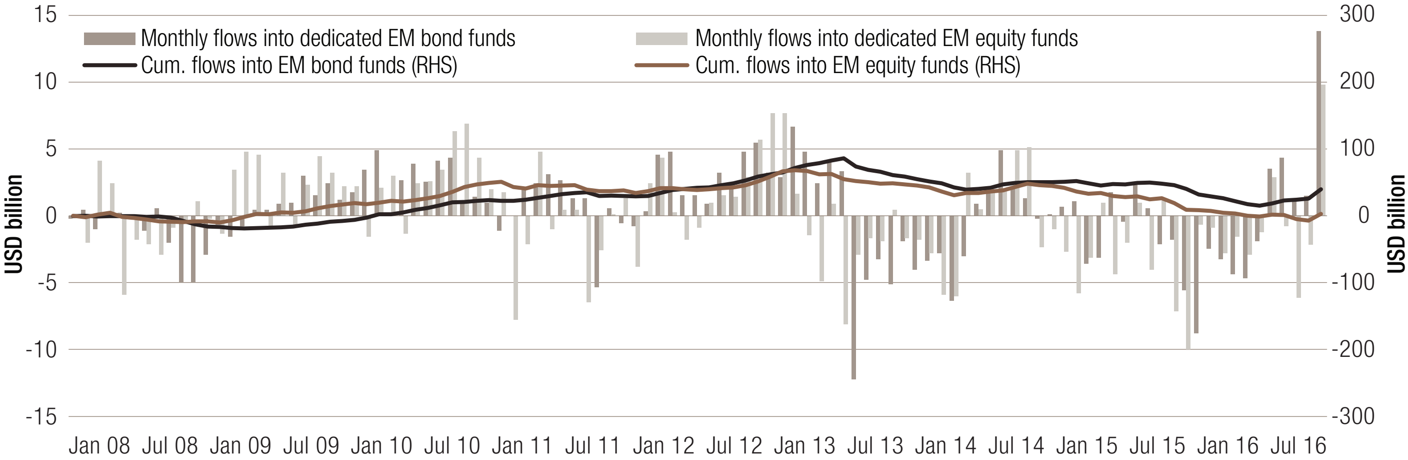


Source: Summary of Economic Projections by the Fed, June 2016.

Conclusion: Implementation matters

Overall, we believe that the fundamentals and valuations-driven case for investing in EMs looks strong against a backdrop of global disinflation and low/negative interest rates in a number of developed economies. Portfolio flows into EMs over recent months (Figure 13 overleaf) have already begun to show signs of a turnaround in both bonds and, more recently, equities, as the top-down case for EM investing starts to reassert itself. Here, it is important to note that the inflows seen recently are still a fraction of the outflows that the EM universe saw from 2013 to early 2016 when a number of investors (both institutional and retail) went underweight.

FIG. 13 EM PORTFOLIO FLOWS FOR EQUITY AND BOND FUNDS



Source: EPFR Global and JP Morgan, released in August 2016.

However, when it comes to investment implementation in the fixed income world, central-bank dominance and tightening regulations mean that today's world is characterised by fractured liquidity (an issue we discuss in detail in our recent research piece entitled "A new paradigm in fixed income markets and implications for portfolio management"). Risks when investing in EM debt include concentrations in the same few positions being increased ("herding"). Together, fractured liquidity and herding leave investors heavily exposed to growing liquidity and market risks. With underlying economic differentials within the EM space becoming wider (for example, the impact of lower commodity prices on exporters versus importers) and the ability to exit positions in a frictionless manner decreasing, focusing on quality becomes critical. We believe that, rather than following the traditional market-cap approach that dominates EM debt investing and is designed to reward leverage, investors should focus on issuers' underlying fundamentals. This would entail assessing each country on its own merits and bringing quality to the heart of portfolio construction, especially within a low turnover framework.

That said, the reality is different in equity markets, where studies (such as the H1 2016 market highlights by the World Federation of Exchanges) continue to show quite benign liquidity conditions. This means that when it comes to EM equity investing, the degrees of freedom still available lend themselves to high-conviction-driven approaches, which utilise manager skill based value-added versus the traditional market-cap approach (which effectively favours only size and momentum).

We believe that, in the current environment, assessing the risk/return profile of an asset class needs to be augmented with careful consideration of implementation design, given the current seismic shifts in the nature and shape of the global financial system and their consequent implications on traditional investing frameworks.

Important information

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