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INVESTMENT MANAGERS

Investment viewpoint

Emerging markets: behind noise and myths lie real opportunities

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Executive summary

Turkey is in crisis, raising the question of whether other emerging market economies are at risk. We believe the majority of these economies are fundamentally strong and problematic countries represent isolated, idiosyncratic cases.

Several problematic countries are currently dominating the news cycle which may create the impression they represent a reliable barometer of the health of emerging market economies as a whole. Investors should refrain from considering the full and diverse range of emerging market economies through the narrow prism of these troubled nations.

The fact is these developments should be viewed in isolation and do not amount to representations of emerging markets as a whole. The problematic countries are either extremely small components of the MSCI benchmark or are excluded from it entirely. Turkey especially represents an idiosyncratic case with deep fundamental flaws that are not shared by its peers.

The strength of the US dollar has been flagged as another potential problem for emerging market economies. There is also the growing threat of a trade war between the US and China. We believe the effect of this on emerging markets may be limited, but, in the event of a fully-fledged trade war, we would expect that to have some negative impact across markets.

While emerging markets are down year-to-date, this should be viewed as more of a typical correction in the current bull market, in our view. The fall is also limited to a small number of sectors which are experiencing isolated headwinds related to President Trump's penchant for tariffs. Taken in the proper context, these actually present a number of compelling valuation anomalies, in our view.

Investment implications

- The countries which are making headlines are either small or entirely absent from the MSCI emerging markets benchmark. The majority of emerging market countries are in good shape
- On the whole, emerging market equities are not as different to European equities as investors may perceive, as evidenced by the distinct lack of earnings revisions since the start of this year.
- Following what we believe is a normal market correction, the valuation of the asset class has become more attractive, in our view. And there are some particularly stark valuation anomalies to be exploited by the discerning investor.

Recent noise sparks concern among investors

The crisis in Turkey has thrown a spotlight on emerging market (EM) economies and, given other negative headlines, a casual observer could be left with the impression these structural weaknesses are endemic, or other EM economies are vulnerable to contagion.

Turkey has had a tumultuous few weeks, which have sparked a frenzy of news coverage. The Lira has collapsed as the diplomatic crisis between Turkey and the United States rolls on. US sanctions have come at an especially bad time for Turkey, as the central bank has repeatedly missed opportunities to address a credit-fuelled overheating of the economy.

There is also the growing threat of a fully-fledged trade war between the US and China. Emerging markets may not be as impacted as some estimates would suggest, since most have strengthened their domestic economies. That said, we are watching the situation between China and the US very carefully. If things were to deteriorate into an open trade war, we would expect that to have some negative impact across markets.

Perception versus reality

Sharp fall or normal correction?

Given the extent of negative newsflow over the summer months, investors would be forgiven for assuming a double-digit drop had occurred in emerging equity markets. But a look at the data reveals a picture of a justified market correction that appears to us as "normal" in both nature and magnitude.

In the year to 23 August 2018, the MSCI Emerging Markets index fell by 7.7% in USD terms and 4% in local currency. From the peak in late January to the trough in August, the index fell 18%, but this was on the back of a strong performance in January when the index rose 8.5%. This follows a stellar year in 2017 when the index rose 37% in USD terms. This seems to us to be a "normal" bull-market correction, similar in nature to those seen in 2004 and 2008 and bringing valuations back to their summer 2017 levels.[1]

Contagion or a few special cases?

Of equal importance to investors is a look under the hood to understand the real drivers behind the top line figures. This reveals that the majority of the year-to-date fall is explained by a limited number of countries and sectors, and that the "culprit" countries only represent a very small part of the overall index.

As Table 1 shows, 40% of the year-to-date fall was driven by four countries while two of the most prominent countries in terms of headlines are irrelevant since they do not feature in the benchmark.

Turkey has grabbed the headlines, creating a perception among some investors that it is a key emerging market country. In reality, Turkey is not only a small player, it is also something of an anomaly among its peers. President Trump's recent tariffs understandably put pressure on Turkey. But unlike many of the larger emerging market economies, Turkey's sizeable current account deficit, as shown in Figure 3 – i.e., strong reliance on external funding – has compounded this.

FIG. 1 MSCI EM & EUROPE IN USD AND LOCAL CURR. YTD

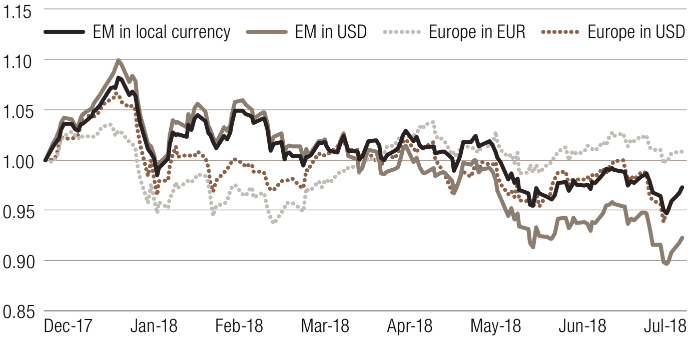
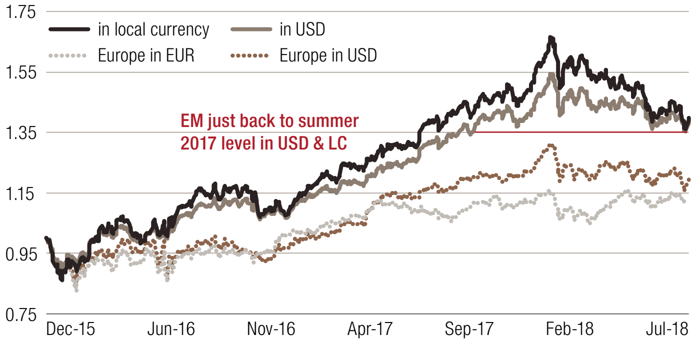


FIG. 2 MSCI EM & EUROPE IN USD AND LOCAL CURR. SINCE 2015



Source: Bloomberg. Notes: For illustrative purposes only. Total return indices are shown to 23 August 2018. Past performance is note a guarantee of future results.

TAB. 1 THE WORST PERFORMING COUNTRIES ARE ALSO THE LEAST SIGNIFICANT IN THE BENCHMARK

	WEIGHT IN MSCI EM	PERFORMANCE YTD IN LOCAL CURRENCY	PERFORMANCE YTD IN USD	CONTRIBUTION TO MSCI EM PERFORMANCE YTD IN USD	
Venezuela	0%	32433%	-99%	**Not in EM index**	Countries in the News
Turkey	0.60%	-21%	-51%	-50 bps or 6.5%	
Argentina	0%	-17%	-48%	**Not in EM index**	
South Africa	6.50%	-5%	-17%	-118 bps or 15%	
Brazil	5.90%	2%	-17%	-112 bps or 15%	
Indonesia	2.00%	-8.50%	-15%	-34 bps or 4%	
Total in MSCI EM	**15%**	**-3.40%**	**-19.70%**	**314 bps or 40%**	
MSCI EM		-2.70%	-7.70%		

Source: Bloomberg as of 23 August 2018. Past performance is not a guarantee of future results. Indices are in TR, USD. For illustrative purposes only.

[1] Past performance is not a guarantee of future results.

The limited number of other emerging markets that have witnessed sharp drops in performance are similar to Turkey in that they also play a negligible – if any – role in the overall emerging market index and have each been driven by their own country-specific dynamics, as shown in the grey box.

At the sector level, the Trump tariff effect has been fairly contained, focused on Consumer Discretionary where Trump's tariffs on the automobile sector have taken their toll, with the associated drop in Consumer Discretionary stocks accounting for almost a quarter of the overall EM index decline.

What else is keeping investors awake at night?

Aside from the immediate headlines, other concerns facing investors relate to the continued rise of the US Dollar. A strong dollar is widely perceived as bad for emerging markets with large quantities of dollar-denominated debt. However, the percentage of corporate debt issued in USD by emerging market companies is lower than many perceive – at 16% of total issued debt.[2] Furthermore, a significant amount of this is issued by corporates whose revenues and costs are also denominated in USD – meaning the impact of a strengthening dollar is arguably of less significance.

Other country-specific moves

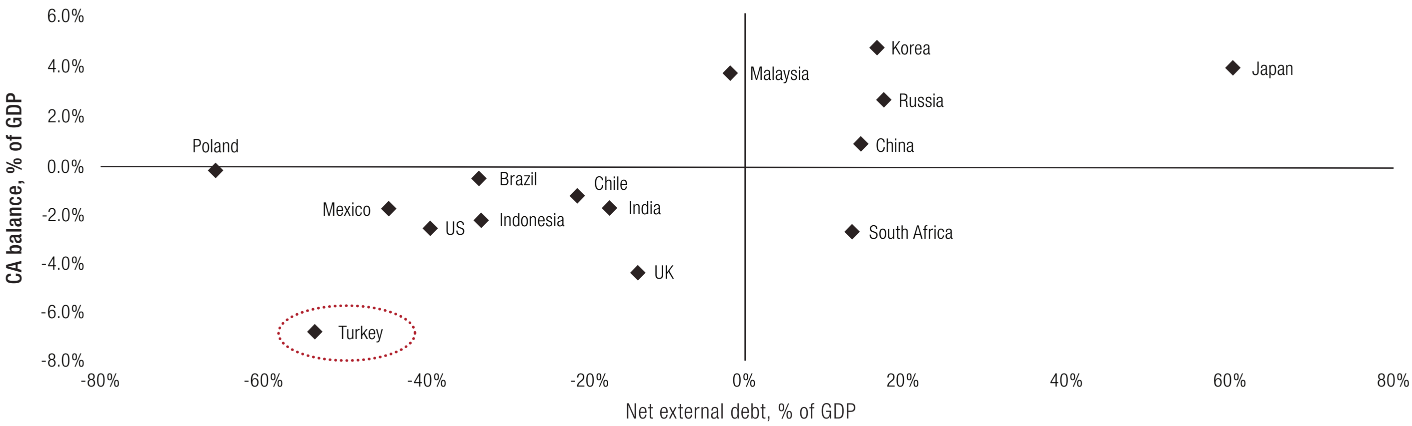
South Africa

South Africa rose in the run up to the election in February and then what has followed has been a normal correction as reality set in. Even though a lot of the gains established last year have been given back in 2018, we still believe South Africa's economy remains extremely promising. Challenges abound for President Cyril Ramaphosa and investors will be watching closely to see what changes the new government implements, while consumer confidence is at an all-time high.

Brazil

Brazil has suffered from a slowdown in economic growth but a lot of what happens next will depend on the outcome of the presidential election in October. The country has been gripped by political uncertainty and investors have understandably become cautious on the outlook. Brazilian voters will soon elect a president who will undoubtedly have their work cut out for them. Simply establishing clear and stable leadership will go some way towards reassuring investors that this work is underway, in our view.

FIG. 3 NET EXTERNAL DEBT VERSUS CURRENT ACCOUNT BALANCE



Source: Thomson Reuters, Credit Suisse Research. Past performance is not a guarantee of future results. Indices are in TR, USD. For illustrative purposes only.

TAB. 2 RETURNS OF MAJOR EMERGING MARKETS

	WEIGHT IN MSCI EM	PERFORMANCE YTD IN LOCAL CURRENCY	PERFORMANCE YTD IN USD	CONTRIBUTION TO MSCI EM PERFORMANCE YTD
China ex-IT, ex-disc	16.6%	-3%	-3.6%	-59bps or 8%
Korea ex-IT, ex-disc	6.7%	-7%	-10%	-65bps or 8%
Taiwan ex-IT	4.8%	11%	6%	+30bps
India	9.4%	10%	0.3%	+3bps
Thailand & Malaysia	4.9%	2%	1.2%	+6bps
Mexico & Colombia	3.7%	5%	5.5%	+20bps
Russia	3.3%	15%	-2.5%	-8bps or 1%
Qatar & UAE	1.6%	7%	7%	+10bps
Total in MSCI EM	**51%**	**+1.3%**	**-0.3%**	**-34bps or 4%**
MSCI EM		-2.7%	-7.7%	

Source: Bloomberg as of 23 August 2018. Past performance is not a guarantee of future results. Indices are in TR, USD. For illustrative purposes only.

[2] Sources: Bloomberg as at July 2018.

Core strength shines through

In recent years, many key emerging market economies have evolved and strengthened. Lower inflation, stronger currencies and rising domestic demand are just some of the positive trends that have been shaping emerging markets for a number of years now. In Table 2, above, we show the performance of the major index constituent countries – painting a picture of a robust core.[2]

Over the past two decades, EM equities have structurally changed. Brazil, Mexico and South Africa were dominating. They have been displaced by China, South Korea, Taiwan, and a growing India. This has been accompanied by a structural shift in sectors. Commodities and regulated monopolies such as utilities now command less of a presence compared with a surging tech industry. This has led to a profound financial shift with less capital intensity and more capital efficiency, as seen in Figures 4 and 5.

As we say above, in contrast to Turkey, many other countries' current accounts have been improving. Some key developments include:

- **China's** economy is showing strength, despite a lower PMI. China's banking system is in much better shape than in 2013-14, in our view. Domestic demand remains strong (accounting for 70% of GDP growth but still around half of GDP overall). At the company level, second quarter earnings releases appear in line or above expectations for the majority of firms.
- **India** is booming, despite its currency weakness since the start of this year. Consumption demand is recovering sharply, growing at above 10% for most companies. After two weaker years, capital expenditure is now beginning to rise and we expect GDP growth to exceed 7% for 2018.
- **Indonesia** is similar to India (consumption/capex) but with lower magnitude.
- **Korea** and **Taiwan** are still very strong and solid countries, but their equity markets are tightly linked to industrials which may be exposed to import duties. (45-60% of their respective benchmarks).
- **Mexico/Columbia** numbers are improving quickly post presidential elections.[3]

FIG. 4 CAPEX AND LABOR INTENSITY ARE DOWN

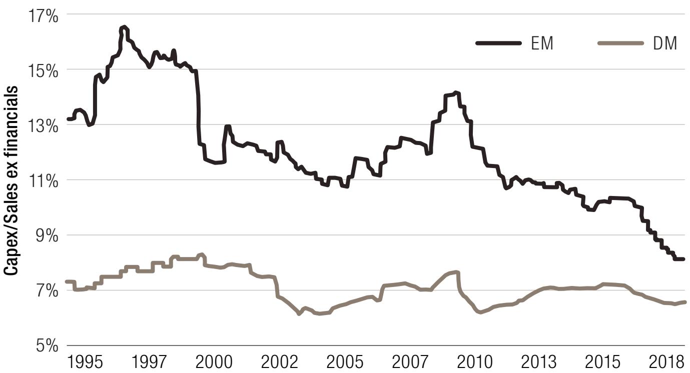
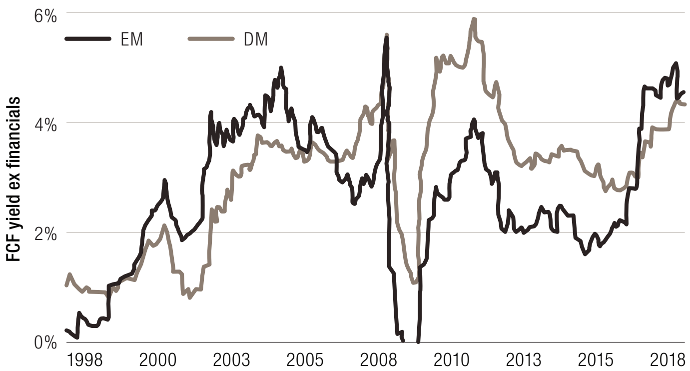


FIG. 5 FREE CASH FLOW ARE BACK ON PAR WITH DM



Source: Thomson Reuters, Credit Suisse Research. Past performance is not a guarantee of future results. Indices are in TR, USD. For illustrative purposes only.

FIG. 6 EM EPS 24M FORWARD REVISIONS

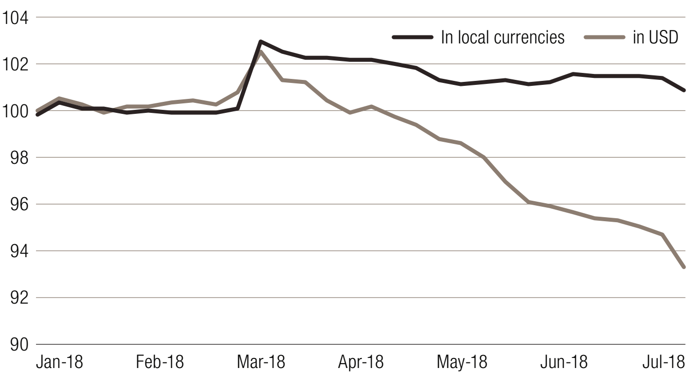
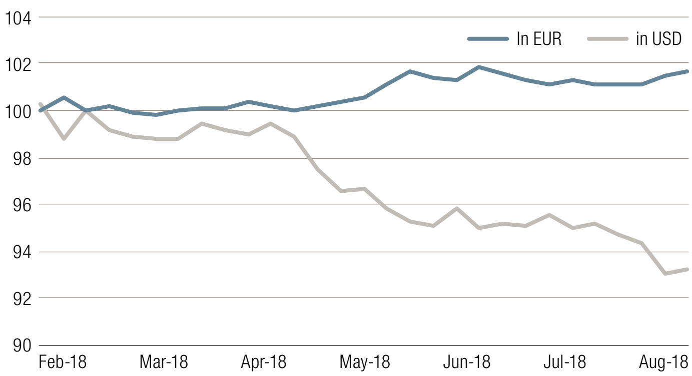


FIG. 7 EUROPE EPS 24M FORWARD REVISIONS



Source: Bloomberg. Past performance is not a guarantee of future results. For illustrative purposes only.

[2] Source: Bloomberg. Past performance is not a guarantee of future results. Indices are in TR, USD. For illustrative purposes only.
[3] Sources: Bloomberg & LOIM.

Opportunities for investors

The fundamentals of emerging market companies remain strong, as evidenced by the lack of earnings revisions since the start of the year, as shown in Figure 6. The fact there has been no downwards revision in terms of earnings per share since the start of 2018 creates a parallel with the situation in Europe. The earnings dynamics in these countries is, in our view, on par with Europe.

While emerging markets are down year-to-date, we believe this represents a relatively minor drop overall. It is not unusual to see this type of correction in what we believe is a bull market cycle in EM. For instance, from 2003 to 2008, EM equities doubled relative to the MSCI World index, during a US tightening cycle. There were, however, two short-lived corrections in early 2004 and mid 2006 amounting to a drop of 13% relative to the MSCI World. The fall is also limited to a small number of sectors which are experiencing isolated headwinds related to President Trump's penchant for tariffs. Taken in the proper context, these actually present a number of compelling valuation anomalies, in our view.

While market moves have been quite contained and modest in the context of the recent bull market, they should not be ignored from a valuation opportunity perspective; we believe that the recent correction makes for an attractive entry point to emerging market equities.

And performance anomalies relative to developed markets appear particularly pronounced in the IT sector, as shown in Figure 10.

FIG. 8 RETURN ON EQUITY EM VERSUS EUROPE

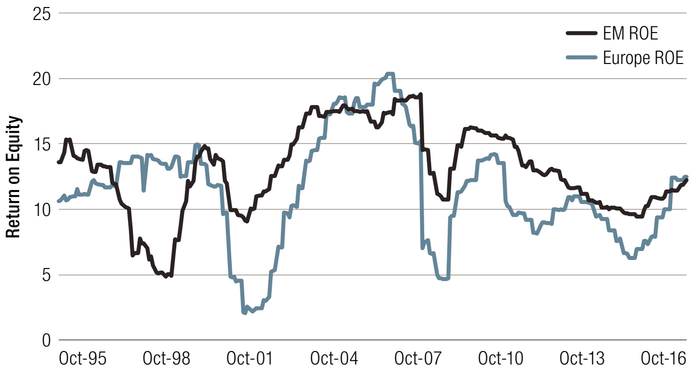
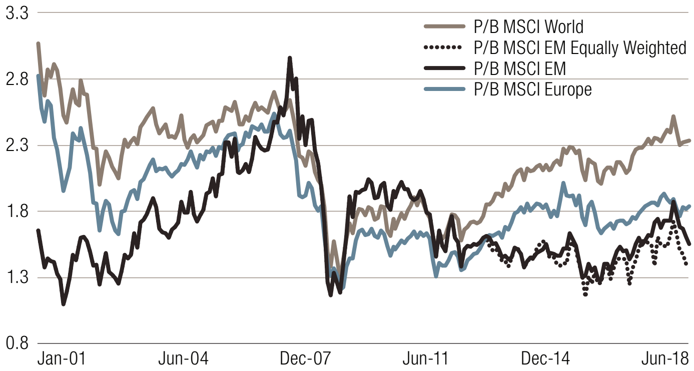
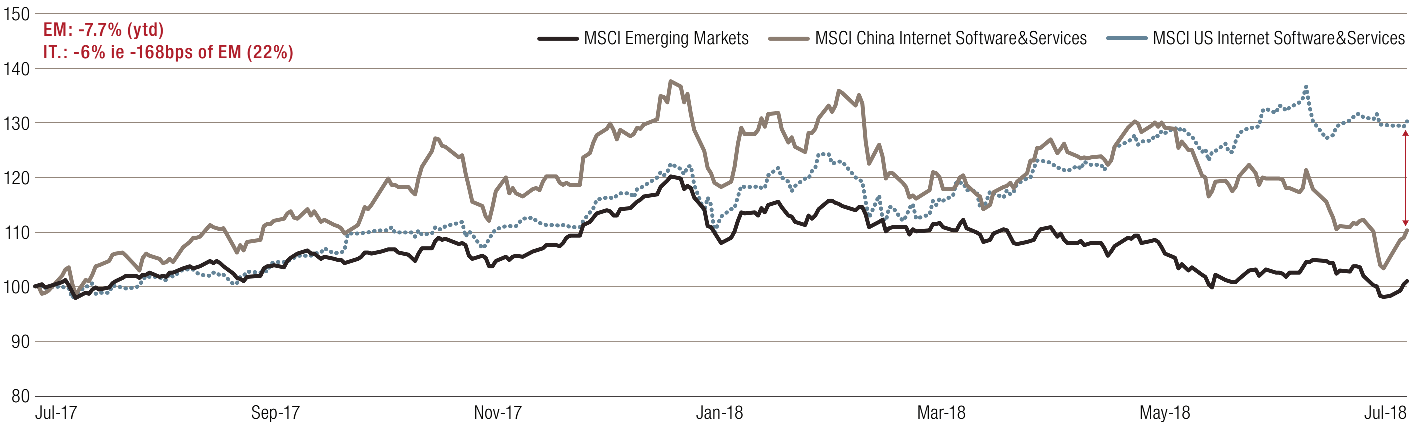


FIG. 9 PRICE TO BOOK OF DEVELOPED AND EMERGING MARKETS



Sources: Bloomberg as at July 2018. Past performance is not a guarantee of future results. For illustrative purposes only.

FIG. 10 IT IN EM RESILIENT BUT LAGGING SIGNIFICANTLY BEHIND THE US



Source: Bloomberg. Past performance is not a guarantee of future results. Indices are in TR, USD. For illustrative purposes only.

What lessons for investors?

We believe a key takeaway for investors is that emerging markets are much less homogenous than news stories may appear to suggest. For that reason, we believe that the incorporation of top down views (country and sector preferences) are vital in equity portfolio management, both from a risk management and an opportunistic perspective.

Not forgetting that within even the strongest emerging economies, the prospects of individual companies vary dramatically, a robust bottom-up process is equally important.

Noise is not always a bad thing if you can see the wood for the trees: panic among others can, if contained, provide opportunities for investors who keep a cool head and are discerning.

IMPORTANT INFORMATION

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