Outlook on Emerging Markets

Equity

Emerging markets equities rose 0.6% in the second quarter but remained well in positive territory—up 10.6%—for 2019. The asset class’s performance was volatile over the period, reflecting extraordinary uncertainty among investors about the geopolitical environment, particularly US actions on trade in May and early June. The volatility reversed six months of emerging markets equity outperformance versus US equities (Exhibit 1), which had been partly driven by easing monetary policy, a pause in US dollar strength, and optimism that a trade deal would be reached.

The favorable fundamentals underlying emerging markets outperformance, however, have mostly remained. The US economy has slowed, but this deceleration helped convince Federal Reserve policymakers to turn dovish and pause the Fed’s cycle of interest rate hikes, with growing speculation of a rate cut this year. The policy change reduced upward pressure on the US dollar, which in turn benefited emerging markets equities (Exhibit 2) (much of emerging markets equity underperformance in 2018 was related to the rising US dollar).

Looser Fed policy in the United States has also allowed some emerging markets central banks, such as India and Indonesia, to ease monetary policy in their economies.

Trade Anxiety and Slowing Growth

Investor uncertainty and anxiety about trade overwhelmed the positive fundamentals in emerging markets. In May and early June, the Trump administration took several actions that, together, reinforced a dramatic shift in how the US government sees its trade relations with the rest of the world. The US actions included:

- Higher tariffs on $200 billion worth of Chinese products and the threat of new tariffs on the remaining Chinese imports—worth about $325 billion. The Chinese government responded by raising tariffs on $60 billion worth of US goods. Global and US stocks sold off, with Chinese equities on 6 May registering its largest one-day drop in three years.
- A $16 billion trade aid program for US farmers impacted by Chinese tariffs
- Sanctions against Huawei and an executive order that could apply similar sanctions on technology companies from any foreign government deemed an aggressor

Summary

- Despite a sharp decline in May as geopolitical uncertainty undermined investor confidence, emerging markets equities ended the second quarter flat-to-slightly higher.
- Fundamentals for emerging markets appear mostly favorable, as global growth slows but also stabilizes.
- Emerging markets debt has delivered outsized year-to-date returns, but the current environment is challenging global investors with divergent crosscurrents.
- As the global growth outlook has grown more uncertain, liquidity from central banks has supported emerging markets debt; however, current valuations provide less compensation for the increased risks.

The favorable fundamentals underlying emerging markets outperformance, however, have mostly remained. The US economy has slowed, but this deceleration helped convince Federal Reserve policymakers to turn dovish and pause the Fed’s cycle of interest rate hikes, with growing speculation of a rate cut this year. The policy change reduced upward pressure on the US dollar, which in turn benefited emerging markets equities (Exhibit 2) (much of emerging markets equity underperformance in 2018 was related to the rising US dollar). Looser Fed policy in the United States has also allowed some emerging markets central banks, such as India and Indonesia, to ease monetary policy in their economies.
The majority of global growth will likely come from emerging markets, where GDP growth is expected to be 4.4% in 2019, down from 4.5% in 2018.

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Production figures for April, and both exports and imports were down sharply. European Central Bank (ECB) President Mario Draghi announced in mid-June that the bank had “considerable headroom” to implement further stimulus, including a new round of quantitative easing.

The global economy is slowing as well, though growth remains positive and appears to be stabilizing. The International Monetary Fund (IMF) revised its global economic growth forecast lower for 2019 from 3.9% to 3.5%. Germany, Europe’s largest economy, released weaker-than-expected industrial production figures for April, and both exports and imports were down sharply. European Central Bank (ECB) President Mario Draghi announced in mid-June that the bank had “considerable headroom” to implement further stimulus, including a new round of quantitative easing.

The majority of global growth will likely come from emerging markets, where GDP growth is expected to be 4.4% in 2019, down from 4.5% in 2018. India, China, and Indonesia are projected to have the fastest-growing economies this year, with real GDP growth expectations of 7.3%, 6.3%, and 5.2%, respectively.

One of the reasons emerging markets growth expectations are holding up is due to stimulus in China. China’s economic growth rate has been in long-term secular decline as the government seeks to rebalance the economy to be more sustainable. However, as relations with the United States over trade have deteriorated and dampened investor sentiment, Chinese officials have taken additional measures to support the economy. In June, the Chinese finance ministry lowered the restrictions for local governments that raised money through special bond sales. The move allowed governments to boost spending on infrastructure projects. In addition, by the end of the first quarter 2019, credit growth appeared to be stabilizing, and economic activity may have reached a bottom as the impact of the stimulus has spread into the wider economy. Real GDP growth in the first quarter of 2019 was a higher-than-expected 6.4%.

It is notable, however, that Chinese banking authorities took over a bank—Baoshang Bank Co.—in late May. The move sparked fears about China’s financial system and drove up short-term borrowing costs for smaller banks. This threatened to choke off credit to small- and medium-sized businesses, which rely on smaller banks for their lending. To ensure liquidity, the People’s Bank of China (PBoC) injected 270 billion renminbi (about $39 billion), allowing smaller banks more freedom to make loans and raising the limits on how much commercial-paper brokerages can sell to banks and other financial institutions.

As of 3 June 2019
Source: FactSet

Exhibit 2
The US Dollar Is Expected to Be Less of a Headwind

As the US administration employed trade in an unprecedented way to support its interests, the US economy showed signs of a slowdown. The United States outperformed the global economy in 2018, powered higher by tax cuts and fiscal stimulus while the rest of the world slowed. This divergence, however, appeared to be coming to an end as the effects of the stimulus faded. While US consumer confidence remains relatively healthy and the S&P 500 Index is setting record highs, recent economic indicators were weak. The US manufacturing PMI dropped from 55.0 in January to 50.5 in May, the slowest pace since mid-2016 and barely avoiding contraction. The New York Fed’s Nowcast of GDP growth is at 1.0% for the second quarter of 2019 and 1.3% for the third quarter. The US Treasury yield curve remains inverted between the 3-month bill and the 15-year bond, a trend that has been strengthening over the past several weeks.

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Emerging Markets Are Fundamentally Attractive and Offer Idiosyncratic Opportunities

After posting significant gains in the first half of 2019, emerging markets continue to trade at discounts of about 23% compared to developed markets (as represented by the MSCI World Index), near their historic averages (Exhibit 3). However, in our view, valuations still reflect a high level of investor uncertainty, and we believe positive data, a favorable trend, or a resolution to trade negotiations could buoy sentiment and further lift indices.

While the market reacted mostly to changes in the macroeconomic environment, idiosyncratic issues continued to play out in individual countries.

- Russia’s equity markets are inexpensive, both in historical terms and when compared to other emerging markets. Equity valuations have been weighed down by sanctions implemented by US authorities for cybercrimes and the use of force in Ukraine. The prospect of additional US sanctions continues to suppress valuations despite Russia’s strong fundamentals. Russian economic growth has recovered from the country’s recession in 2015 after oil prices collapsed, and inflation has come down significantly from the highs of late 2015, aided by an independent central bank implementing credible monetary policy. Russia has sufficient foreign-exchange reserves of $495 billion to cover its total external debt of $468 billion. Russian equities offer investors a 7% dividend yield, 1.5 to 3.0 times higher than other major regions globally (Exhibit 4).

- In Brazil, equities markets rose in May and June, even as the government reported that the country’s first quarter GDP had shrunk (the first quarterly contraction since 2016). President Jair Bolsonaro, a far-right political figure seen as pro-business, has promised a number of reforms, including an all-important overhaul to the nation’s pension system, with the goal of saving approximately one trillion reais over ten years. The International Monetary Fund (IMF) has forecast Brazil’s government debt-to-GDP to hit 90% in 2019—partly due to unsustainable obligations to retirees. Investors have been encouraged that pension reform remains on track, despite scandals and controversy in Bolsonaro’s administration.

- In South Africa, investors were reassured by the election of Cyril Ramaphosa as president. Although a member of the incumbent African National Congress (ANC) Party, Ramaphosa has promised to root out government corruption and implement needed reforms. However, investor sentiment has declined as GDP growth contracted more than expected by 3.2% in the first quarter. The decline was partly driven by continued problems at the state-run power company Eskom, which has been affected by corruption and indebtedness and requires significant investment. The country is no longer facing the rolling blackouts that paralyzed the economy earlier in the year, but the company’s debt (which is guaranteed by the state) is a significant strain on South Africa’s budget.

- Other emerging markets countries, such as India and Indonesia, faced important elections in 2019. In both cases, the outcomes generally favored investors. In India, the world’s largest democracy, Narendra Modi retained his position as prime minister when his Bharatiya Janata Party (BJP) received landslide support from voters. The BJP’s victory cements Modi’s status and provides him with a mandate to continue his economic and market reforms, which have had mixed results in his first term.

In Indonesia, President Joko Widodo (or Jokowi) won reelection. Like Modi, Jokowi spent his first five-year term focusing on economic reform and development, particularly through an ambitious infrastructure program (e.g., Trans Java toll road system, underground rail network in Jakarta). With his reelection secured, Jokowi will focus on additional infrastructure development, as well as labor and health care reform.
High Uncertainty, Positive Fundamentals

Emerging markets investors continue to face a variety of risks, especially related to trade. We believe that these risks have become heightened over the past several months and could undermine investor sentiment in emerging markets equities. However, we also believe it can be easy in this environment to overlook the positives for the asset class. Fundamentals across the emerging markets remain relatively sound—country balance sheets have been steadier than expected, and fiscal deficits generally remain in good shape. Real interest rates are relatively high compared to developed markets. Interest rates were last near these levels in 2016, just before a two-year rally in emerging markets assets. In addition, despite the decline in the IMF’s global economic forecast, it is critical to note that the developing world increasingly drives the majority of global growth and that the economic growth premium over developed markets is projected to re-widen in emerging markets’ favor this year. Emerging markets EPS growth is expected to be in line with US EPS growth in 2019 and exceed it in 2020 (Exhibit 5).

Monetary tightening by some global central banks appears to be on hold as inflationary pressures remain benign and central bankers have signaled cuts. In the past, this has been a catalyst for emerging markets equity outperformance. It could also help reduce the strength of the US dollar. Looking forward, we expect US earnings growth will continue to moderate as the effects of the tax stimulus wane in 2019, potentially to a level below emerging markets.

We believe this relatively wide discount offers long-term investors a particularly attractive entry point to gain exposure to industry-leading companies with potentially greater economic growth premium over the slowing developed world. Emerging markets equities also offer attractive free-cash-flow yields (5.5% versus 4.7% in developed markets and 4.6% in the United States) and opportunities to pick up dividends—the MSCI Emerging Markets Index dividend yield is about 2.7% compared to 1.8% for the S&P 500 Index. If we experience an increase in developed markets capital expenditure, after very little in the last decade, emerging markets companies should be significant beneficiaries.

Although macroeconomic and political issues will continue to influence the asset class, we believe that emerging markets economic growth will continue despite the recent decline in global growth expectations, and we will witness renewed confidence in some of the more economy-sensitive stocks.
Debt

Like emerging markets equities, emerging markets debt has delivered outsized year-to-date returns (almost 10%), but the current environment is challenging global investors with divergent crosscurrents. On the one hand, many financial markets are trading near record highs, but on the other, leading economic indicators of growth are at or near contractionary levels. Capital spending and business confidence is falling rapidly, but global consumers (especially in the United States) have shown remarkable strength and endurance. We have a slightly different outlook than our equity team, and we see three possible pathways for the global economy going forward. We detail each one below, along with best estimates on probabilities and theories on how various parts of emerging markets debt perform in each outcome.

Path 1: Global growth slowdown that is met with extraordinary measures from central banks (Base Case: 60% probability)

Since the end of the financial crisis, the US economy has experienced three multi-quarter growth slowdowns (2011, 2012, 2015–2016). In each of these periods, quarterly growth fell from an unsustainable -3% level to approximately 1% over the span of 3–4 quarters (Exhibit 6). At the same time, US Treasury yields were the proverbial canary in the coal mine, falling 100 to 200 bps in anticipation of significant monetary easing. In addition, risk market valuations compressed, with equity market corrections and emerging markets currency depreciation alongside US dollar strength. In each case, the selling abated when the Fed delivered an extraordinary response in the form of Operation Twist (2011), Extension of Operation Twist (2012), and a 12-month rate hike pause (2015–2016).

Similar to those times, our base case is that the United States will experience a significant quarterly growth decline from 3.1% in the first quarter of 2019 to less than 2.0% in the second quarter, and likely a growth rate of 1.0%–1.9% in the second half of the year due to prolonged worries regarding global trade. While capital spending has already declined, it will be important to track the resilience of US consumer spending into the second half of the year to determine how extended and deep an impending slowdown will be. In this type of scenario, we expect marginal US dollar strength, high yield spread widening, emerging markets currency weakness, and equity markets to correct. Based on prior corrections, a typical mark-to-market move would be roughly mid-single digit losses for the blended emerging markets debt index.

Because this is our base case, we have moved over the last two months to significantly reduce beta risk across our portfolios and reallocate to safer investment grade US Treasury–sensitive securities. We plan to maintain this position until two developments occur:

1. Markets correct enough that investors are, once again, adequately compensated to take risk in emerging market debt. Thus, should the market move back to early 2019 valuation levels, we would look to re-risk our portfolios.
2. Global central banks implement appropriate policy responses. The market is already pushing the Fed and ECB in that direction, as we discussed above, with rate cuts having been priced into forward curves (Exhibit 7). However, we believe it is more important to markets that monetary easing is not simply “precautionary” or “one-off events” but that both the Fed and ECB are willing to telegraph more permanent easing of liquidity conditions. Thus, to the extent that the Fed moves to a forceful dovish outlook and reveals a cycle of rate cuts at one of its fourth quarter meetings, that could be a credible enough response to move markets back to positive territory. Note that there are four Fed meetings remaining in 2019 and six in 2020 before the US presidential election, which should be more than enough opportunity for the Fed to get ahead of a potential growth slowdown.

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<thead>
<tr>
<th>Exhibit 7</th>
<th>Market-Implied Probabilities for Fed Rate Cuts (%)</th>
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<tbody>
<tr>
<td>Fed Meeting</td>
<td>Hike Probability</td>
</tr>
<tr>
<td>31 July 2019</td>
<td>0%</td>
</tr>
<tr>
<td>18 September 2019</td>
<td>0%</td>
</tr>
<tr>
<td>30 October 2019</td>
<td>0%</td>
</tr>
<tr>
<td>11 December 2019</td>
<td>0%</td>
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</tbody>
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As of 30 June 2019
Source: Bloomberg
Path 2: Out-of-consensus reversal of global trade tensions through legitimate US–China deal (15% probability)

Over the last three years, we have learned the unpredictability of polls, the failure of economies to hit growth escape velocity, and policy changes that are announced via tweet. As such, while it does not make logical sense for the United States and China to reach a meaningful and sustainable trade deal ahead of the US elections, goalposts can certainly be moved by either side and markets can react to headlines instead of substance. Further, the market may be underestimating the resilience of the US consumer and its ability to power through reversions to the mean in growth. In this scenario, global central banks will have overreacted by cutting rates, thus providing a jolt of stimulus into late-cycle economies. Equity and emerging markets currency markets would likely significantly rally, while safe-haven securities such as US Treasuries would re-steepen to more normalized levels. This would also be an environment where non-investment grade spreads could tighten considerably through fair value levels to post-financial-crisis tights. It should be noted that our portfolios are not positioned for this scenario, as we have very limited exposure to FX and high yield and much more exposure to US dollar investment grade bonds.

Path 3: Global slowdown that unearths other tail risk vulnerabilities and morphs into a recession (25% probability)

The final scenario is one in which the longest-running economic expansion in US history comes to an end. If that were to happen, history books would likely deem the two causes to have been unnecessary rate hikes by the Fed in 2018 and a trade war, started by President Trump, in an integrated global economy. Essentially, this would be the scenario where Trump’s tariffs backfire and harm the US economy. As has been well researched and documented by economists, investors should focus on the bond market to best predict if this scenario is about to occur. Currently, the bond market is flashing severe caution (Exhibit 8) with parts of the US yield curve already inverted. It should be noted, however, that the traditional measure of curve inversion (2y to 10y) is still positively sloped, albeit barely. Other warning signs for investors are flagging energy demand (March and April oil demand were the lowest in years) and high yield spread movement (still trading close to yearly tights).

Recessions are normal events in even the best-run global economies, as cycles wax and wane. They tend to revert valuations to generation-marking lows, opening up significant opportunities to realize outsized gains. While no investor looks forward to these events, we are highly confident that an event like this would begin a multi-year cycle of emerging markets outperformance. For, unlike previous global economic downturns, emerging markets would enter the next one already in a valuation recession. Emerging markets currencies have been in a bear market since 2011 and emerging markets equities trade at significant discounts to their developed markets peers. In short, emerging markets are cheap and will likely get cheaper in a US recession scenario, and investors should look at that opportunity to significantly increase weights across the emerging markets capital structure.

Given that our base case investment thesis assumes negative global growth surprises in the second half of the year, we have chosen to reduce risk. It remains difficult to predict when markets turn negative, but we are confident that there will be more attractive emerging markets debt entry points by year end. As such, we have positioned portfolios to lock in the first half of 2019’s high absolute and relative performance so that we can increase firepower to be able to deploy again.
Outlook on Emerging Markets

Notes
1 As of 9 April 2019. Source: International Monetary Fund.
2 Foreign exchange reserves (including gold) as of 31 May 2019; gross external debt as of 31 March 2019. Source: Central Bank of the Russian Federation, Haver Analytics

Important Information
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