Emerging markets equities ended a tumultuous year on a positive note, with the MSCI EM Index up 18.4% in US dollar terms. It was a near-perfect reversal of 2018’s dismal 14.6% decline. Over the course of the year, however, the asset class provided a faithful mirror of global uncertainty on trade, economic growth, and geopolitics. After strong performance (+10.6%) in the first half of the year, emerging markets equities had a difficult third quarter (-4.3%) and rallied in the fourth quarter (+11.8%).

Trade was the biggest driver of emerging markets equities’ performance. The third-quarter slump, for example, occurred as the United States levied an additional 10% tariff on US$300 billion worth of Chinese imports, labeled China a currency manipulator, and threatened to de-list Chinese companies from American exchanges. The strong rally in the fourth quarter came after two major trade developments. First, the US reduced existing tariffs on Chinese goods and cancelled additional planned tariffs as part of a prospective Phase 1 trade deal. Second, the US reached a rare bipartisan agreement on terms for a trade deal among the US, Mexico, and Canada.

Solid growth in the US, buoyed by strong labor markets, supported global growth and contributed to the positive performance in emerging markets. But any hint of a slowdown rattled the export-dependent developing world, as demonstrated by mid-year moves in the US Treasury yield curve. The difference between yields on 10-year and 2-year Treasury bonds began to fall in late July and inverted for a few days in late August. An inverted curve is a well-known historical predictor of recessions, and the MSCI Emerging Markets index followed the yield differential down as the curve flattened. When the curve turned negative on 26 August, the index touched its lowest point since the beginning of the year.

Finally, geopolitical risk surfaced in many places. Large-scale protests emerged in Hong Kong, Lebanon, and multiple Latin American countries, while Alberto Fernández upset market-friendly Mauricio Macri’s bid for re-election in Argentina. (The election news was more anticipated, and more palatable to market participants, in Indonesia, India, and South Africa, where leaders seen as pro-market reformers were re-elected.) Democrats in the US House of Representatives launched an impeachment inquiry against US President Donald Trump, and terrorists attacked Saudi Arabia’s oil infrastructure. Oil production in the rest of the world easily filled the gap when Saudi supplies briefly went offline, and prices remained weak due to fears concerning excess supply and global growth. And while oil prices increased following the US strike against Iran’s General Qassem Soleimani, many investors are wondering whether excess oil supply concerns will temper those gains.

Looking ahead to 2020, trade tensions are likely to continue to influence the path of emerging markets equities, despite the accord on a long-awaited Phase 1 deal between the US and China. Market participants will also be watching the US Presidential election closely for hints about what might be in store for the US economy.

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**Equity**

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markets in 2020. The two growth rates had been moving closer together in recent years, but emerging markets could easily start to pull away as the effects of US tax cuts in 2017 continue to fade. Meanwhile, stimulus measures in China, the largest emerging market economy, are likely to continue to bear fruit next year, particularly if a trade deal is in the books.

Monetary policy is also likely to remain accommodative in developed and emerging economies (Exhibit 1). Both the Federal Reserve and European Central Bank (ECB) eased in 2019, creating room for central banks to follow suit in a diverse array of emerging market economies, including Brazil, Mexico, the Philippines, Russia, and Turkey. The Fed’s easing, in particular, will likely help to keep the US dollar at bay, removing a major hurdle that plagued emerging markets equities in 2018.

Finally, there are the assets themselves. Though stocks rallied at the end of the year, valuations appear reasonably attractive, and consensus forecasts predict a return to positive earnings growth.

**All Eyes on Trade**

In 2019, the upheaval of long-standing trade connections posed the biggest threat to the global economy and emerging markets. That likely will still be true in 2020, but the Phase 1 trade deal between the US and China has diminished the threat trade tensions pose to global growth for now.

As part of the proposed agreement, the US cancelled a round of tariffs that had been due to take effect in December 2019 and cut tariffs already imposed on $120 billion worth of Chinese products in half, to 7.5%. Meanwhile, China agreed to step up US imports, particularly of agricultural products, and cut tariffs on goods such as pharmaceuticals and frozen pork. Specific provisions regarding intellectual property protections and forced technology transfers for American companies doing business in China were reportedly included in the agreement, but have not yet been clearly elucidated.

Businesses around the world have been holding off on capital expenditures and other spending as they waited to see whether and how tariffs and other trade barriers would affect their products, input costs, and overall demand and sentiment (Exhibit 2). In theory, they should breathe a sigh of relief. Not only does it seem that the US has come to terms with the world’s second-largest economy, it’s also reached a meeting of the minds with its North American neighbors—one that has rare bipartisan support. And it’s all happening against a backdrop in which central banks in many economies are lubricating the world’s credit valves with ease measures.
As the details of the recent trade agreement become more clear, we expect manufacturing activity and business sentiment to take a turn for the better, providing a boost to stocks in both emerging markets and export-dependent developed economies such as Germany. But there are still reasons to be cautious on trade. Many details about the purported Phase 1 deal are unclear. For example, the $40 billion in agricultural goods that China is reportedly set to buy from the US is an ambitious figure that has given many investors pause, considering that imports averaged US$25 billion a year from 2016 to 2017. And it’s always possible that another sentiment-killing trade battle begins in 2020 if the two countries begin to negotiate Phase 2.

It’s also possible that trade tensions will continue to break out or intensify in unexpected places. Argentina and Brazil were recently surprised to find themselves in the Trump Administration’s crosshairs, for example. The US President announced in early December 2019 his intention to impose steel and aluminum tariffs on the countries due to what he believes are intentional measures to keep their currencies weak. It was an especially surprising move because both Brazil and Argentina are going through the kind of economic struggles that can cause currencies to weaken without any intentional manipulation.

What’s become clear is that there is no longer a global consensus that freer trade is better trade, and pre-2017 conditions are not coming back anytime soon. Whether businesses all over the world can relax enough to step up investment in 2020 remains to be seen and will continue to have an outsized effect on emerging markets, which are not only export-dependent but risk-sensitive.

US Elections

The fate of emerging markets equities is often tied up with the state of the US economy, and emerging markets investors will no doubt be watching the US elections in 2020 with great interest. The candidates’ positions on trade are likely to be a topic of particular concern.

The rebalancing of the United States’ global trade relationships is not likely to be reversed entirely or quickly, regardless of the election results. However, if a candidate who is more pro-trade than the sitting President is elected—former Vice President Joseph Biden or former New York City Mayor Michael Bloomberg, for example—it could well mean an improvement in global business sentiment, the unleashing of dormant corporate capital, and a pickup in manufacturing activity.

However, many left-leaning Democrats, including Senator Elizabeth Warren, are just as skeptical as President Trump about the benefits of trade. If Trump were unseated by one of these individuals, we believe the corporate spending limbo would likely continue into 2021 and perhaps beyond.

In more general terms, emerging markets equities tend to do best when the US achieves “Goldilocks” growth: not high enough to strengthen the dollar significantly, but also not low enough to dent the optimism of US consumers and businesses. The extent to which candidates of either party, and the eventual President-elect, propose pro-growth policies will likely have ramifications for emerging markets equities.

However, it’s also possible that the election is getting more attention than it deserves. The MSCI Emerging Markets Index gained an average of 12.6% in the previous four instances when a sitting president was up for re-election, which isn’t so different from typical annual gains for the asset class.

The Surprises of 2019

Every year has its unexpected developments, and 2019 was no exception. The emergence of large-scale public protests in several emerging markets economies and Argentina’s election results were two emerging markets surprises that could continue to impact the asset class in 2020.

Social Unrest Spills into Public Demonstrations

From Hong Kong to Chile, Lebanon to Colombia, protesters took to the streets in 2019. Mass demonstrations usually point to some degree of heightened political risk in a given market, but it isn’t at all clear that the 2019 protests were motivated by a single, larger issue as, say, the Arab Spring uprisings were. Instead, most were motivated primarily by local management decisions.

In Hong Kong, by far the most dramatic protest, demonstrators took issue with a proposed law that would allow fugitives to be extradited to mainland China. In many ways, the law itself was a symbol of the concern that the mainland is encroaching too much on the autonomy to which Hong Kong has grown accustomed. The short-term investment impact was minor: The Hang Seng Index actually gained for the year despite the protests, as most of the companies in the index are now based in mainland China. While the tension between China and Hong Kong may have long-term ramifications for both places, as well as Hong Kong’s role as a global financial center, it has little chance of spilling over to the asset class as a whole.

Income inequality played some role in protests that broke out in Chile, Lebanon, and Colombia, but dissatisfaction with public officials played an arguably greater role. Income inequality played the most explicit role in Chile’s protests, which began over a modest increase in public transportation fares. The country is one of the 20 most unequal in the world, and protesters expressed frustration about everything from privatization of the country’s health and pension system to low wages.

In Lebanon and Colombia, however, protesters were at least equally concerned with governance as economic disparities. Colombia’s demonstrations began after a rumored proposal to cut pensions, but unhappiness with the progress of the peace process with FARC guerrillas, alleged human rights abuses, and perceived corruption also stoked anger. Lebanese protesters took to the streets after new taxes were announced, but their frustrations also dealt with perceived corruption and electricity and water shortages.

The economies that have experienced protests are, with the exception of Brazil, relatively small. While continuing unrest may have an impact on local companies in the short term, their issues are disparate, and we expect their impact to be relatively contained in 2020.

Brazil and Argentina at Inflection Points

Each of Latin America’s two biggest economies enters 2020 at an important crossroads. In Argentina, the unexpected ouster of then-President Mauricio Macri put a new administration in charge of reversing the economy’s precipitous decline. Meanwhile, Brazil has
taken the decisive first steps toward putting its economy on a path to sustainable growth, but the outlook for future reform is cloudy.

Argentina’s voters rejected in October the pro-market reforms of President Mauricio Macri in favor of the more left-wing Alberto Fernández. Fernández must find a way to address the country’s eye-watering inflation, weakening currency, and capital flight, while also battling Argentina’s high unemployment and poverty rate. On top of that, the new administration must seek to renegotiate the terms of its bailout from the International Monetary Fund (IMF).

In his first days in office, Fernández proposed a bill (Social Solidarity and Production Reactivation Plan) that would increase export taxes for soya, wheat, and corn, apply a 30% tax on purchases made abroad, and raise taxes on the wealthy. The grains taxes alone are expected to yield $1.8 billion, but it is estimated that closer to $4 billion is needed to avoid increasing the primary fiscal deficit. The administration has also proposed higher spending to address hunger, infrastructure, and housing, while the central bank lowered its policy interest rate from 63% to 58% to support an economic recovery. The government also delayed payment on roughly $9 billion of US dollar-denominated debt for the second time in five months, asking bondholders to show “good faith” while it seeks to restructure its debt. The success of Argentine assets in 2020 depends on how well Fernández can juggle pro-growth policies and social spending with demands from the country’s creditors to right the fiscal ship.

Meanwhile, the Brazilian Congress in 2018 approved a long-awaited pension reform that is expected to save the government as much as US$200 billion over the next decade. However, the government recently delayed further reforms to the tax and civil service systems, as well as spending cuts.

Reforms are necessary to jumpstart economic growth that has long been stalled (Exhibit 3). Pension transfers consume 45% of the federal budget, an amount equal to 8.6% of the nation’s total GDP. The 20-year budget caps enshrined in a 2016 constitutional amendment already need adjusting, and at the current pace, growth in non-discretionary items could force a government shutdown by 2021.

The right policy mix could help both Brazil and Argentina reverse a freefall in their respective currencies, which have declined 22% and 69%, respectively, over the past two years. If Brazil makes further

significant reforms and Argentina arrests its inflationary spiral and comes to terms with the IMF, their respective stock markets could experience a significant re-rating.

**EM Fundamentals Are Flashing Green**

Given the eventful year, it’s understandable that investors have been especially sensitive to news, as opposed to fundamentals, in emerging markets equities. But the big-picture positives supporting the asset class deserve a closer look.

Emerging markets economies appear poised to grow more and grow faster than those in developed markets, offering investors access to growth at a time when the economic cycle in the US in particular is...
getting long in the tooth (Exhibit 4). Multiple central banks in emerging markets eased in 2019, and many have room to do so in 2020 as well. Emerging markets equities should benefit from the stimulative effects of lower rates in their home countries as well as from a weaker US dollar (Exhibit 5).

Speaking of the dollar, the currency headwinds that put a strain on emerging market assets in 2019 seem poised for retreat in 2020. Particularly since the end of August (Exhibit 5), the US dollar has weakened, while emerging market equities have recovered more than 15%. Notable currency standouts include the Russian ruble, Thai baht, and Mexican peso, which had the best spot returns this year. The fourth quarter has been led by the South African rand, up more than 7% despite weaker economic data and concerns over its debt burden and credit ratings. Many Latin American currencies bounced back in December, led by the Chilean and Colombian pesos, up more than 7%, as well as the Brazilian real, up more than 5%. In addition to dovish monetary policy from the Federal Reserve and a flatter US yield curve, America’s twin deficits are ballooning. The current account deficit accounts for 2.4% of GDP and the budget deficit is 3.8% of GDP. A caveat: If global growth deteriorates significantly, investors looking for safe havens could drive the greenback higher relative to other currencies.

As for corporate fundamentals, we expect a tech-led earnings growth recovery in 2020 that would push earnings-per-share growth in emerging markets equities to 14.1%, compared to 9.6% in the United States (Exhibit 6). A stretch of earnings declines dating back to mid-2017 seems to have bottomed in 2019, and analysts’ forward expectations are improving. Demand for 5G smartphones and higher-end components should drive the technology rally, and we would expect that change to disproportionately benefit South Korean earnings, which we believe will rise 24% over the next 12 months. Many important semiconductor and other technology companies are based in the country.

Even with a favorable earnings outlook compared to developed equities, emerging markets stocks are trading at a 20% to 30% discount to the MSCI World and S&P 500 indexes (Exhibit 7). After peaking at 17x price to earnings, emerging markets are back in the 14x to 15x range. Valuations last traded at those levels in 2016, just before the start of a two-year rally. Emerging markets equities have been caught up in risk-off sentiment due to trade and other factors, but if investors can look past those headlines and examine the fundamentals in 2020, another long-term rally could be in the offing.

**Conclusion**

Emerging markets fundamentals point to an asset class that appears poised for solid growth in the coming year, but fundamentals have taken a backseat to global issues of late. If someone were to list the ideal conditions for emerging markets equities in 2020, they would include Goldilocks growth in the United States, steady global growth, continued central bank easing, and perhaps most importantly, a more concrete settlement to the trade issues hanging over the US and China. How those global issues evolve and how investors weigh macro forces versus stock fundamentals in 2020 remains to be seen.
Debt

Emerging markets debt delivered a return of 14.3% in 2019, marking the best return for the blended asset class since 2012. Notably, the strong gains last year more than offset the roughly 5% decline the asset class suffered in 2018. Returns over the past year were largely driven by duration, benefiting from the benign inflationary environment and accommodative policies from central banks around the world, though modest spread tightening and currency appreciation also boosted returns.

As we head into 2020, the key question for investors is whether the asset class can continue to deliver strong risk-adjusted returns (Exhibit 8). The answer is: We do expect positive returns next year, albeit at more subdued levels. Investors are likely in our opinion to earn returns commensurate with the carry on the asset class, which we believe is attractive both on a standalone basis as well as in comparison to other fixed income markets.

We believe a number of factors support our constructive outlook. First, the global growth outlook has stabilized over the past several months. The risk of an imminent recession in the US has receded, and monetary easing both in the US and across the globe should limit the downside risks to global growth in 2020. Indeed, the high bar for monetary tightening in core markets should keep global liquidity conditions favorable for emerging markets assets (Exhibit 9) in 2020.

In emerging markets specifically, leading economic indicators have begun to stabilize. Both the composite and manufacturing Purchasing Managers’ Index surveys appear to have plateaued of late (Exhibit 10), giving investors hope that a long, worldwide manufacturing slump that had been holding down growth may swing in the other direction in 2020. The countries that have seen the greatest improvements are those that had in recent years suffered some of the biggest setbacks, such as Brazil and Turkey.

From a fundamental standpoint, growth differentials between emerging and developed markets should widen in favor of emerging markets in the coming year, as the equities portion of the outlook also noted. While developed markets countries are clearly in the late stages of the economic cycle, many emerging markets countries exhibit early-cycle characteristics.

From a valuation standpoint, spreads in external sovereign and corporate debt, while less attractive than a year ago, are not stretched and provide adequate compensation for risk. Default rates should remain low, with exceptions such as Argentina, Venezuela, and Lebanon, which are already either in default or priced as such. In fact, we believe that any progress on restructuring the debts in these countries could provide significant alpha opportunities.
Meanwhile, valuations in emerging markets currencies provide a healthy buffer. Currencies have depreciated nearly 40% on a spot basis since 2013 and, at a minimum, are a source of attractive carry. In an environment in which the US dollar is stable or weakening, however, they could provide a meaningful boost to returns (Exhibit 11).

Technical should also remain supportive of emerging markets debt, in our view. Net issuance is expected to remain subdued, while the ongoing search for yield and the large universe of negative-yielding debt in global bond indices should lead to continued investor inflows for emerging markets.

As always, there is no shortage of things to worry about, and emerging markets debt is subject to many of the same potential issues as emerging markets equities. The key risks we are focused on are those that pose a threat to global growth and could lead to heightened uncertainty. The US and China have been locked in a trade dispute for nearly two years, and the uncertainty surrounding that important trade relationship has weighed on business sentiment and investment. While the recent preliminary agreement to a Phase 1 trade deal is a constructive development, trade tensions are likely to linger and could remain a source of anxiety for businesses and investors. An escalation in tensions would certainly be negative for emerging markets debt, but a détente would be positive for the asset class. Should tariffs be rolled back as promised, emerging markets currencies could provide a significant boost to returns. The lead-up to the November election in the US could also add to uncertainty. Nevertheless, we believe emerging markets are well positioned to deliver attractive risk-adjusted returns in the year ahead.