Emerging Markets equities

Emerging markets should be able to withstand a challenging environment in 2019

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Key takeaways

- Headlines have dominated negative sentiment – it is important to take a more fundamental long-term approach to European equities.
- Domestic demand continues to drive the European economy.
- Valuations are attractive in many sectors.

2018 has been a challenging year for both Asian and global emerging equity markets. The year began with upbeat earnings expectations and valuations above long-term historical averages. However, since the start of the year, valuations have contracted due to a number of factors. Firstly, we have seen a marked increase in the risk premium for emerging markets given increased uncertainty surrounding trade tensions and geopolitics. Secondly, this has led to greater concern about China where growth has already been slowing due to the government's deleveraging campaign. Lastly, the tightening of US monetary policy has led to a deteriorating US dollar liquidity environment with negative implications for emerging market equities and currencies.

This backdrop is likely to continue into 2019, but emerging economies are better placed to withstand these pressures than before, in our view. Valuations are also beginning to reflect the risks being faced, and are currently nearer the bottom end of their historical range.

Trade

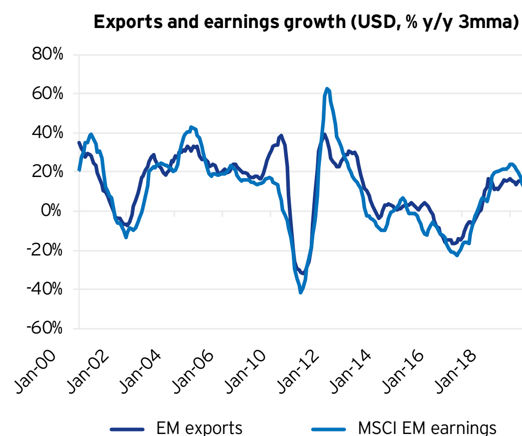
Escalating trade tensions between the US and its major trading partners have dominated the headlines in recent months and have accelerated the broader market's derating. Negotiations between the US and China have not yet yielded any results, with President Donald Trump happy to ratchet up the pressure by announcing further rounds of potential tariffs. The outcome is unpredictable, and there is a danger that tensions may escalate further. However, as the negative implications of tariff increases for the US economy become clearer, there is also a possibility that striking a deal becomes expedient. In the near term, we expect not only a direct impact on trade activity, but also an impact on corporate and consumer behaviour, with implications for investment and consumption. This would impact companies in different ways, and we are seeing more opportunities for investment where the market's reaction has been indiscriminate.

US monetary policy tightening

Although policy normalisation in the US has been well telegraphed, investors have been concerned about a potentially faster-than-anticipated rise in interest rates. As the risk free rate rises, so does the cost of capital, leading in theory to a valuation de-rating of long duration assets such as stocks. Also, a stronger US dollar has led to tighter global liquidity conditions and greater headwinds to global demand growth, which could impact emerging market earnings.

Earnings

Corporate earnings have so far been fairly resilient. However, leading economic indicators of global growth have declined, suggesting export growth is likely to slow from current double-digit levels. This is a key driver of earnings growth in emerging markets, as can be seen in the chart below.



Source: Emerging Advisers Group as at 21 November 2018

Secondly, China's economy has been slowing as a result of tighter policy settings. Initiatives to tackle excessive credit growth, reduce financial risk and improve environmental protection are all long-term positives in our view, as they address some of our biggest concerns, but in the near term we would expect a further weakening of economic growth in China.

Given the backdrop of slower global growth, it is likely that consensus earnings forecasts for 2019 are still too optimistic. Over the last six months earnings have been revised down 5% from the peak, and we would expect further downward revisions to the current 10% earnings growth expectations for 2019.[1]

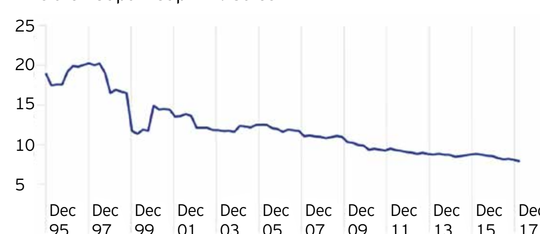
Asia
In China, deleveraging efforts have led to an economic slowdown while trade issues have increased uncertainty in the outlook. The authorities are likely to be more tolerant of slower growth than they have been in the past, in our view, but they are keen to protect the downside risk to the economy. As expected, we have started to see some moderate easing measures such as reserve requirement cuts, increased export tax rebates, tax deductions on household income and support measures for SMEs in the private sector. At the same time, authorities will not want to see another significant leveraging up of the economy given that this is a major macroeconomic concern. The balance between avoiding a sharp slowdown in growth and avoiding excessive stimulus is becoming more delicate.

Elsewhere in the region, economies do not look particularly vulnerable. Current accounts are generally healthy and credit cycles are not extended. Where current account deficits do exist – Indonesia, Philippines and India – they seem manageable and growth forecasts have already been lowered. Those economies more sensitive to global demand, such as South Korea and Taiwan, are likely to be impacted by ongoing trade and Chinese growth concerns, but we believe their innovative companies have strong competitive advantages that should sustain them better than many fear.

Operational strength in Asia
Meanwhile, there have been some significant improvements at the corporate level in Asia over the last decade. As can be seen in the chart below, the region's capex/sales ratio has been steadily declining. In part, this reflects lower structural growth, but it also demonstrates that Asian companies are more cautious, focused and better managed than they were historically, and suggests that better returns on capital are sustainable. In a weaker growth environment, it is also positive that there are few industries with significant excess capacity risk.

Less capital-intensive companies have also been generating stronger free cash flow. The challenge has been how to better allocate that capital, with management facing growing pressure from minority shareholders to pay better dividends. While valuations and positive surprises in earnings are less likely to drive equity returns in the near term, there is an increasingly good dividend growth story in Asia.

Fig.1 Corporate capex discipline should support returns
- Asia ex Japan CapEx % Sales



Source: Worldscope, Factset, Citi Research as at 9 May 2018.

Latin America
Market volatility in Latin America has been exacerbated by politics and uncertainty over the North American Free Trade Agreement (NAFTA). Presidential elections in Mexico and Brazil have resulted in populist candidates from either side of the political spectrum gaining power. Markets have been buoyed by a reduction in political uncertainty and strengthened hopes that key areas of reform will now be addressed.

In Brazil, the pace of economic recovery has been sluggish. Plans to push ahead with pension and tax reforms would help reduce a large fiscal gap, and go some way to restoring investor confidence and promoting consumption growth and investment spending. Meanwhile, the prospects for Mexico are likely to be bolstered by the successful replacement of NAFTA with the US-Mexico-Canada Agreement (USMCA).

1 Sources: I/B/E/S, MSCI, JP Morgan as at 21 November 2018.

EMEA
Increased uncertainty over US-Russia relations may dampen economic growth, but the Russian economy is still expected to expand by 1.5% in 2019,[2] drawing benefit from recovering oil prices, strong consumer demand and prudent fiscal policy. However, aside from an easing in tensions with the US, the country needs to introduce further reforms for gross domestic product (GDP) to accelerate. Having said that, we still believe the status quo is a healthy environment in which domestically-focused companies can prosper. Unfortunately, our optimism is not being matched yet by market sentiment, which is currently being negatively affected by worries over the imposition of new sanctions.

Elsewhere in emerging Europe, countries such as Poland and Hungary are likely to enjoy healthy growth rates and low interest rates, in our view.

A bright medium-term outlook
Over the medium term, our outlook for emerging markets is cautiously optimistic. Economic and corporate fundamentals remain solid, and these economies remain the biggest driver of global growth. In particular, we are encouraged by the capital discipline being displayed by companies across emerging markets, with evidence of strong balance sheets and improving free cash flow generation. This is being reflected at the macro level too. Few countries are exhibiting signs of overheating – a far cry from the situation that prevailed in the run up to the global financial crisis in 2008. With valuations towards the low end of the historical range and at a significant discount to their developed market peers, the market appears too focused on short-term uncertainties and is ignoring the fundamental improvements that have taken place.

Investment risks
The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

In emerging and developing markets there is potential for a decrease in market liquidity, which may mean that it is not easy to buy or sell securities. There may also be difficulties in dealing and settlement, and custody problems could arise.

2 Source: Bloomberg, L.P., as at 21 November 2018.

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