Investing in Emerging Markets

Why have emerging markets underperformed for the last five years and outperformed for the last six months and will this trend continue?

Julian Mayo, Co-CIO, Charlemagne Capital (UK) Limited
in a transcript from our recent investor conference call, offers his insight into recent changes and what the future holds for emerging markets

September 2016

The past five years for us have been tough, being specialists in emerging markets (EM). We watched somewhat enviously as our developed market counterparts experienced returns of almost 50% whilst we have lagged behind with our markets down roughly 20%. However, there has been a turnaround and since the start of 2016 EM have done better than DM in absolute terms and are significantly outperforming them in relative terms.

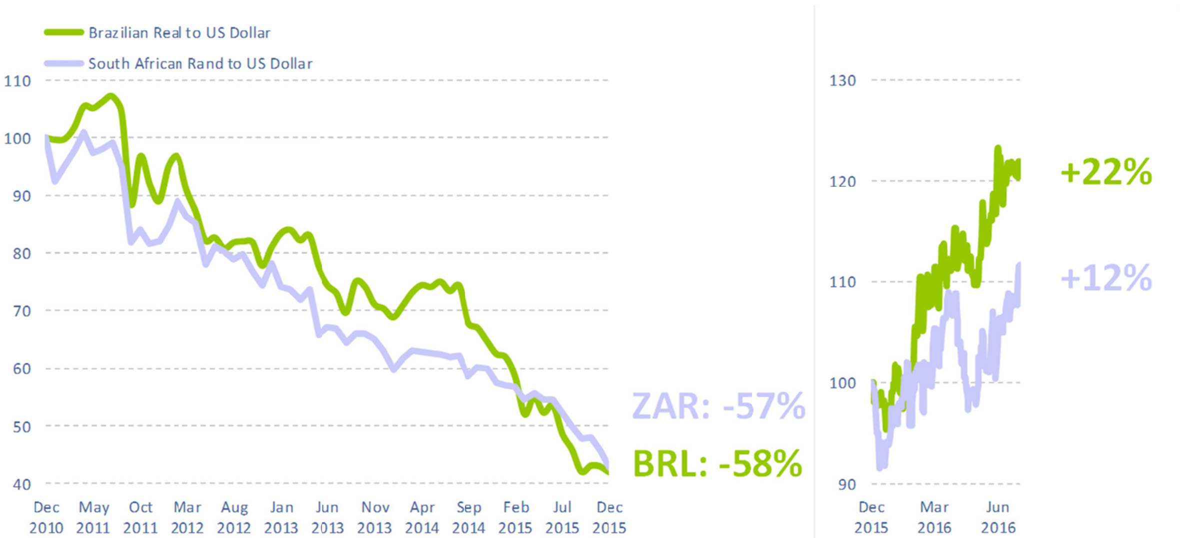
In order to understand what has gone on in recent years we need to look at three factors which have contributed to EM performance:

1. FX
2. Economic Growth
3. Earnings

FX

Many emerging market currencies have been weak over recent years due to weakening fundamentals and a strong US dollar (USD). To take an example, both the South African rand (ZAR) and the Brazilian real (BRL) have fallen over 50% against the USD in the last five years. However, in the first six months of 2016 the ZAR and BRL have both started to recover, up 12% and 22% respectively.

Figure 1

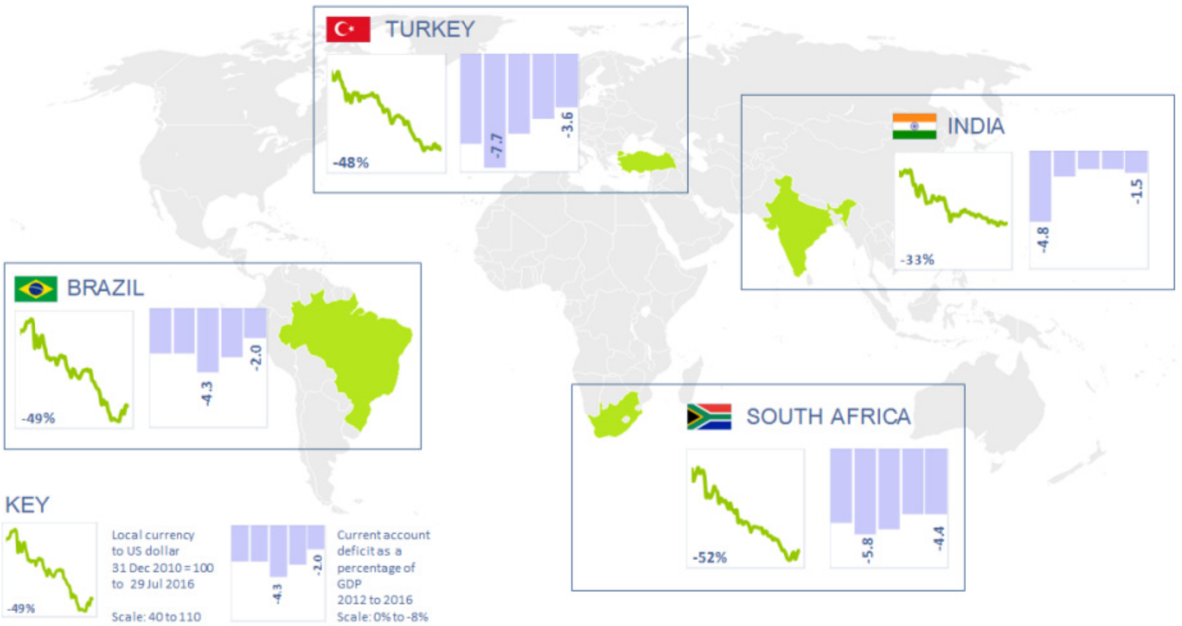


Local currency to US dollar rebased to 31 Dec 2010 = 100 (Left) and 31 Dec 2015 = 100 (Right)
Latest data 01 Aug 2016 Source: Bloomberg

On the flipside of the weak EM currencies is the strong USD. Over the past 50 years the dollar has risen in anticipation of US Federal Reserve interest rate hikes. The market has bought the dollar prior to the hike and then sold it in the aftermath of the hike. A bullish emerging market case does not simply rely upon a weak USD but as long as the USD is not too strong, which it does not appear to be, this should be positive for EM.

Returning to more familiar EM territory we can see in Figure 2 that weak EM currencies and a strong USD have resulted in narrowing of trade deficits of those countries that looked vulnerable a few years ago. The green lines highlight the currency movements over the past five years, while the blue columns show the improvement in the current account deficit in the same period. Each currency fell by at least a third and it has boosted their current accounts with significant reductions in deficits. This improvement is not an option for euro zone countries that are suffering from the rigidity of the single currency. In addition, the EM/DM current account differential is turning positive for the first time since 2008, which is supportive of EM FX.

Figure 2



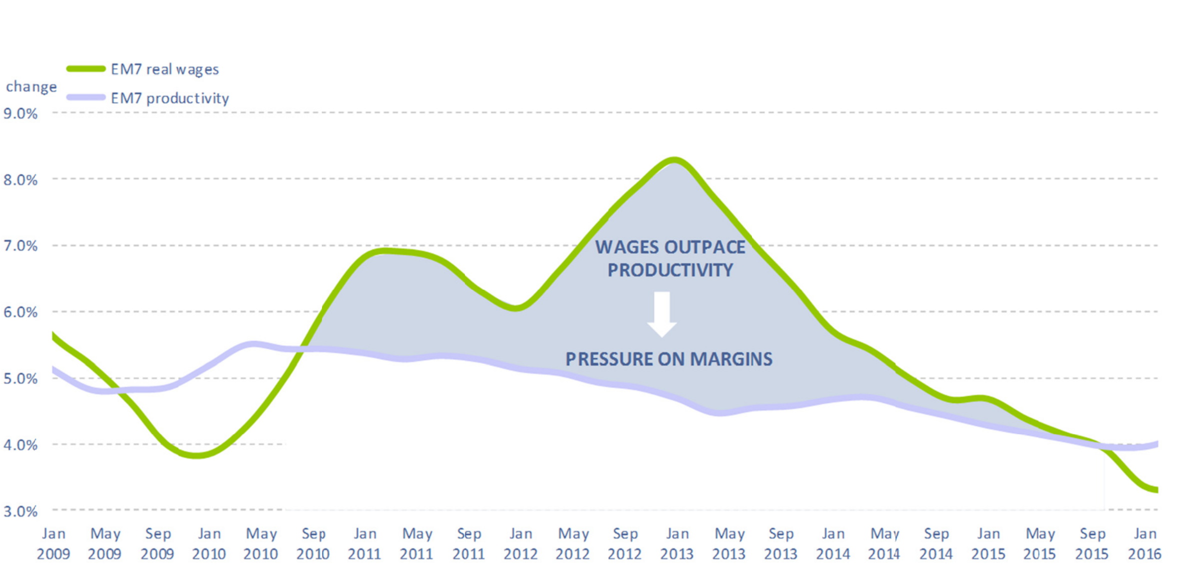
Source: Bloomberg, IMF World Economic Outlook April 2016 (estimates for 2016)

Economic Growth

The growth in emerging economies has slowed both absolutely and relative to DM since the start of this decade. However, this year, the trend is starting to change. Russia and Brazil both suffered from negative growth of around -4% in 2015 but for 2017 should have growth figures at around +2/3%, showing a total swing of roughly +6% in GDP in favour of these economies. This is in contrast to the growth figures in the US which are staying at around 2% and are even lower in the EU and Japan with no signs of improvement. Emerging economies are not going to return to the glory days of a decade ago but the imbalances are being addressed and the GDP growth premium relative to DM is starting to accelerate again.

"Emerging economies are not going to return to the glory days of a decade ago but the imbalances are being addressed and the GDP growth premium relative to DM is starting to accelerate again."

Figure 3

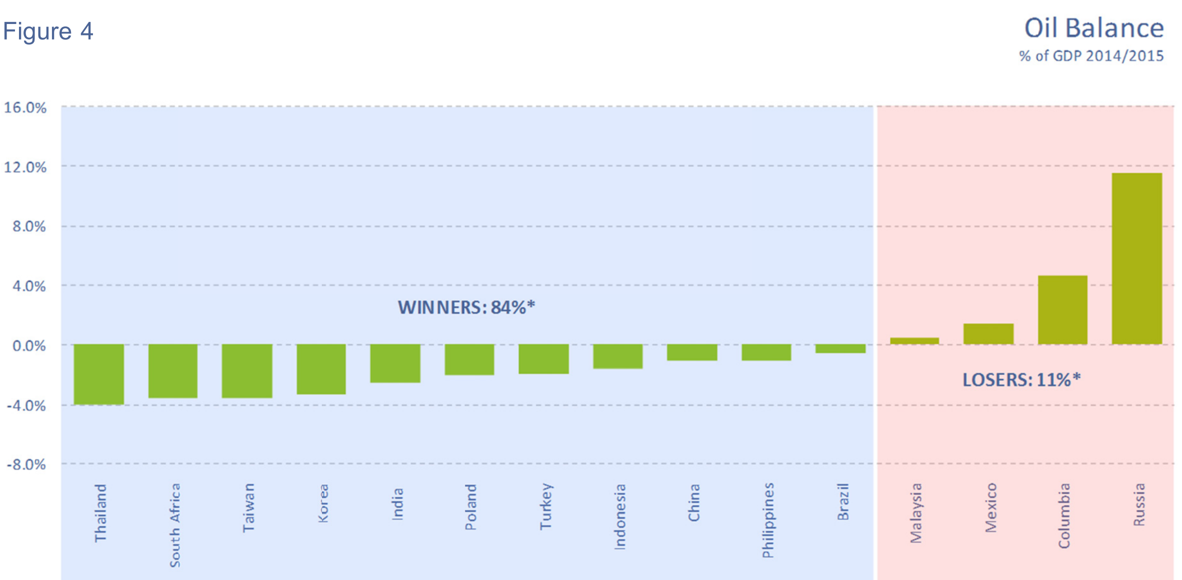


Source: Credit Suisse

Earnings

Performance in earnings both absolute and relative to expectations in EM economies is expected to change for three reasons. The first relates to wages, the second to oil and the third to capital discipline. Starting with wages, the period from 2010 to 2015 witnessed wage growth for EM well in excess of that warranted by growth in productivity. Figure 3 outlines this large differential between these two factors but also highlights the changes taking place with wage growth falling back to below the growth in productivity in early 2016. This coincides with relatively tight labour markets in the US/UK therefore further emphasising the positive effects for EM.

Figure 4



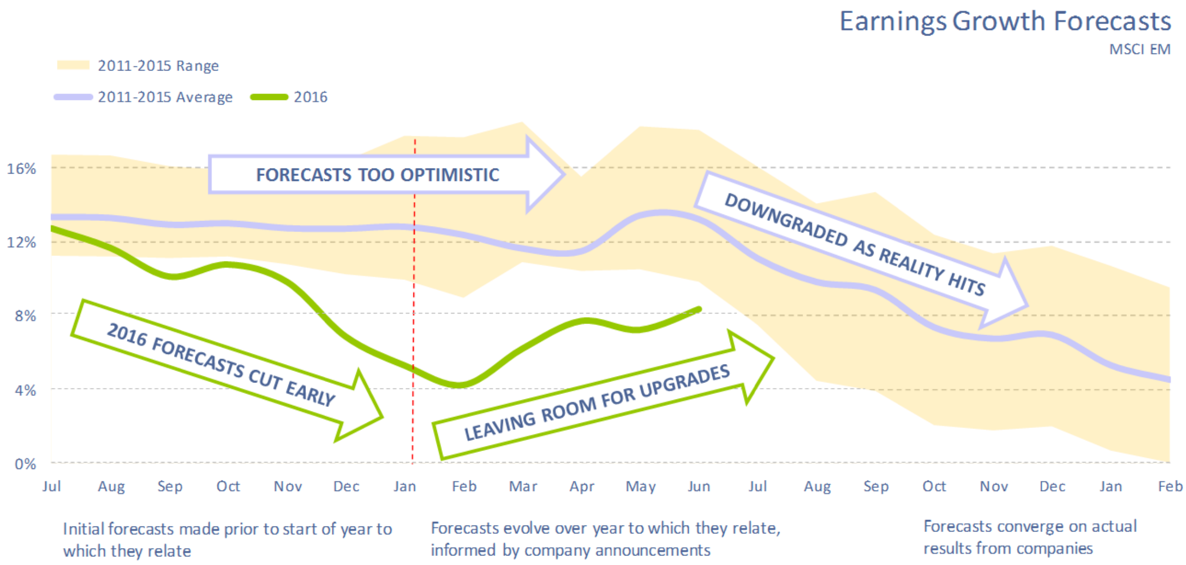
* MSCI EM Index. 2015 average oil price and USD FX applied to 2014 oil production/consumption to capture the oil price action in 2015

Source: Morgan Stanley Research Jan 2016

Moving onto oil, emerging markets are often considered plays on commodities. However resource stocks actually only amount to 14% of the MSCI EM index. Figure 4 shows that Russia and Columbia are losers from the fall in oil prices, but they only amount to 4% of the total MSCI EM index. The Big Four by contrast, China, Korea, Taiwan and India, which account for 62% of the index, are all significant beneficiaries from the drop in oil prices in the last two years. In total around 80% of EM are benefiting from the reduction in the price of oil.

Finally, one legitimate criticism of EM for many years has been overinvestment. They have built for the past assuming historic growth figures will persist and not for the future. Since 2012, capital expenditure to sales figures have dropped to more realistic levels and have now shown signs of bottoming. Our bottom-up investment approach at Charlemagne Capital, visiting companies around the emerging world, certainly supports the view that firms are now much more disciplined and focusing more on cash flow and returns and not so much on top-line growth. All these factors have consequences for the earnings outlook in emerging market economies. Figure 5 shows the ongoing pattern in recent years of over-optimistic forecasts early in the year and resulting downgrading as reality hits. The difference in 2016 is that forecasts have been cut early in the year and have presented the EM economies with scope for upgraded earnings forecasts. Moreover, cyclically adjusted price earnings ratio (CAPE) for the MSCI EM index is at rock bottom levels, so if earnings begin to recover and margins start to expand again like we think they will, markets could turn out to be cheaper than they appear to be.

Figure 5



Source: FactSet, Earning Growth Estimates - Calendar Year

So in summary, the key negatives which have faced EM equities - weakening currencies, plunging GDP growth and poor corporate earnings both in absolute terms and relative to expectations - are being reversed. This at a time when the fundamentals of many developed markets such as policy risk appear to be an increasing issue can only point towards taking a renewed look at our very much unloved asset class.

Address: Charlemagne Capital (UK) Limited
39 St James's Street
London
SW1A 1JD

Tel: + 44 (0)20 7518 2100
Fax: + 44 (0)20 7518 2199
Email: marketing@charlemagnecapital.com
Website: www.charlemagnecapital.com