J O Hambro Capital Management Group

Outlook for emerging markets

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Fed rate freeze bodes well for domestic EM equities

From an emerging market standpoint, one of the fundamental truths in the world is that the US dollar is the global currency and that US interest rates underpin the global risk free rate. We feel that the story of emerging markets in 2018 was that the US Federal Reserve erred by misunderstanding this and then had to re-learn the responsibility it carries.

We have highlighted before the importance of the May 2018 statement by Chairman Powell of the Fed ('there is good reason to think that the normalization of monetary policies in advanced economies should continue to prove manageable for Emerging Market economies'). We see this as symptomatic of Fed indifference to the stress that the US tightening created in selected EMs, exactly as then-Governor Patel of the Reserve Bank of India predicted in June 2018 ('the Fed must respond by slowing plans to shrink its balance sheet. If it does not, Treasuries will absorb such a large share of dollar liquidity that a crisis in the rest of the dollar bond markets is inevitable.')

By the fall of 2018, the Fed began to recognise this ('We do understand, though, that when our economy is strong and we're raising rates, that puts upward pressure around the world and can affect countries, particularly countries that have external dollar borrowing… The performance of the emerging market economies really matters to us in carrying out our domestic mandate' – Chairman Powell), achieving full acceptance by the year end with the change to a more patient and cautious stance.

Demand feedback loop

In particular, the mechanism by which the Fed has been made to care about emerging markets is the demand feedback loop. Emerging markets collectively are half of the world economy, and there cannot be rising distress there without feedback into the developed world. This can be seen in the Q4 2018 results of various global-facing US corporates, including Apple ('while we anticipated some challenges in key emerging markets, we did not foresee the magnitude of the economic deceleration, particularly in Greater China. In fact, most of our revenue shortfall to our guidance, and over 100 per cent of our year-over-year worldwide revenue decline, occurred in Greater China'), Caterpillar ('Construction activities remained at low levels in Latin America... weakness in the Middle East… sales in Asia/Pacific declined due to lower demand in China'), Nvidia ('deteriorating macroeconomic conditions, particularly in China') and Disney, where a trend of very strong results from parks and resorts was broken by 'lower operating income at Shanghai Disney Resort… primarily due to lower attendance'.

What caught the eye around the year-end was the Fed's reaction function not waiting for the EM slowdown to show up fully in US economic data but rather being a market-driven response. That does suggest that any building slowdown is likely to be short-lived given how highly pro-active the Fed is being. From an emerging market perspective, though, what matters is the change and how that in turn feeds back into emerging market economies and equity markets.

US exposure influences the EM macro

The global macro sensitivities of different emerging markets can be assessed in different ways, but one of the key drivers is exposure to US interest rates and the strength of the US dollar. This is generally most marked in those countries that run current account deficits, and that relationship played out clearly in 2018, in particular in those countries with the weakest current account balances seeing the steepest falls in currencies and equity markets. With the easing and even reversal of Fed policy, the pattern of relative performances of 2018 has largely been reversed year-to-date in 2019.

India and the UAE – domestic demand stories

Turning to forward investment opportunities, the EM domestic demand space, particularly in current account deficit markets, has generally been a tough space in US dollar terms since the taper tantrum in the second quarter of 2013. Recent moves in markets point to this now being the primary area of opportunity, particularly where valuations have been driven down during the 2018 sell-off. We would emphasise the exciting combination of supportive top-down conditions, good quality companies and attractive valuations, and have been rotating the portfolio accordingly.

Just to highlight some examples of areas we have become significantly more positive on in recent months, Indian mortgage lenders substantially de-rated in 2018, with regulatory pressure and volatility in the Indian fixed income market causing some high-profile failures. With global liquidity tight, the central bank (the RBI) was unable to cut rates even as consumer price inflation declined to 2%. Now that the global liquidity outlook has eased, there is the prospect of the RBI continuing to cut rates even as Indian credit growth recovers. India, unusually in EM, has not had a credit cycle in the last ten years, so the current pick-up in credit could be enduring. Alongside that, India has ongoing demand for 5-10m residential units per year needing financing, and we see selected Indian mortgage lenders as amongst the best opportunities in the EM world.

In addition, property stocks in the United Arab Emirates (UAE), particularly in Dubai, have performed very poorly as the real estate cycle there seeks a bottom. Through its currency peg, the UAE effectively imports US monetary policy, which has coincided with oversupply of development properties to push both real estate prices and related stocks down significantly. Even with a more benign US monetary outlook, the residential property market may take some time to recover. However, property companies exposed to the tourist trade through retail, entertainment and hospitality assets have similarly de-rated, despite tourist arrivals to Dubai rising 5% in 2018. As the Fed's shifting stance improves financial conditions in Dubai, we expect the highly attractive valuations in Dubai property stocks to lead to strong performance.

Mexico, sí, Brazil não

Other opportunities will present themselves. Brazilian equities look very expensive against their history despite growth remaining anaemic, implying some very positive market expectations for Brazilian politics and social security reform, while Mexican equities look markedly cheap relative to history, despite growth being fairly strong, implying some extremely negative market expectations for the political environment there. Given that we do not expect revolutionary change in politics in either country, we substantially prefer Mexico to Brazil, again with a focus on domestic demand.

China is a slightly separate story, China has also seen significantly tight monetary policy in the last 18 months. That is not directly the consequence of US rate hikes, but the strength of the US dollar does put pressure on the Chinese renminbi and has been a constraint on the People's Bank of China's ability to act. Activity indicators remain very soft in China, and we think that more stimulus through faster credit creation remains key to a recovery in China. It may be that we are now at that point, certainly the January all-system financing number was very large, both against history and against expectations. So, China may be an investment opportunity later in 2019, but it isn't a direct beneficiary of the Fed's new-found caution like some other emerging markets. It is important to note that all-system financing tends to see some large prints around the Lunar New Year festival, and the February print will be key, with the potential to either confirm or dash hopes that the credit stimulus is underway. It is also important to note that, given the size of the Chinese financial system, a high level of monthly stimulus must be maintained for some time to turn the economy round.

Our optimism on EM

In summary, after five tough years, we think the combination of a more benign US monetary outlook and some extremely compelling valuations makes for some powerful opportunities in the emerging market domestic demand space. Our process remains structured to first seek opportunities at the country level, and then seek those stocks that offer optimal economic exposure within that country. We find the current investing environment to be target-rich. Many clients we speak to are conceptually positive on the emerging market equity space, but have been put off from increasing allocations by, first, weak markets in 2018, and then by strong markets in 2019 year to date. We think that this approach carries the risk of missing out on the potential gains that are now available in emerging markets.

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