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FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Outlook for emerging markets

James Syme, JOHCM Global Emerging Markets Opportunities Fund

Enticing valuations suggest 2019 will be a better year for emerging equity markets

2018 has been a difficult year for the emerging equity asset class, as a challenging global environment has coincided with some country-specific challenges to see weakness in both equities and currencies. Chief amongst the global challenges has been the tightness in US dollar liquidity, higher US interest rates and a rising US dollar, these all stemming from two drivers: the US Federal Reserve's reduction in the size of its balance sheet by rolling over fewer of its holdings of US Treasuries, and a substantial upturn in US Treasury issuance to pay for the Trump administration's tax cuts. The effect of this on those emerging markets (EM) with current account deficits (i.e. those that depend on capital inflows to fund their growth) has been dramatic, with the equity markets in those countries generally underperforming, and those with the largest current account deficits (Turkey, Argentina and Pakistan) all seeing sell-offs that in another era might have been termed crises.

China slowdown

Other stresses on the asset class have included the ongoing slowdown in China as the economy there reacts to the substantial tightening of monetary policy that has accompanied the crackdown on shadow banking since 2017. Throughout the year steady evidence has emerged in both economic data and corporate results of reduced consumption and investment in China as a much slower rate of credit growth comes through. As well as seeing weakness in Chinese equities, other emerging markets with significant exposure to China have struggled. This weakness has been exacerbated by ongoing concerns about the outlook for global trade, with the tariffs and restrictions on US-China trade the focus. Finally, 2018 saw a very busy political calendar in emerging markets, with elections in Brazil, Colombia, Mexico, Russia, Malaysia, Pakistan, Egypt, the Czech Republic and Poland, as well as unexpected changes in leadership in Peru and South Africa. Many of these saw volatility in financial markets during or after the electoral process.

EM equities: cheap vs. history

So, with 2018 now drawing to a close, what can we expect for next year? The external environment remains difficult at the time of writing, but one legacy of 2018 has been the extremely attractive valuations appearing in parts of the asset class, particularly in some parts of the asset class exposed to EM domestic demand. The MSCI Emerging Markets Index is about one standard deviation cheap relative to its history, despite the rise of the (comparatively expensive) internet sector in the index. Many parts of the asset class now trade at single-digit forward price/earnings ratios. We believe that there is substantial opportunity in the asset class, but that this will need an improvement in the external environment before that opportunity can be realised.

Slowing EM to slow monetary tightening in DM?

The catalyst, we feel, will be the feedback of weak EM economic conditions back into the developed world (particularly the US), causing central banks there (again, particularly the Federal Reserve) to pause the monetary tightening process, allowing EM equity markets to rally, potentially quite powerfully. According to the IMF, emerging market and developing economies (including South Korea, Taiwan, Greece and the Czech Republic) represent 42.8% of global GDP, and weakness here will affect demand for US goods and services, ultimately influencing US monetary policy. A recovery in China would be an additional support, but we are less convinced that China will revert to credit-led growth in 2019. Finally, the political calendar looks far more benign in 2019, with Argentina, India, Indonesia, South Africa and Greece the key elections to look out for, although the effects of 2018's elections must also be watched, notably in Brazil and Mexico.

Overall, we are very positive on the outlook for emerging market equities in 2019, as we feel the current negativity towards the asset class (as expressed through valuations) is unwarranted, but we feel the gains may be loaded into the back-end of the year.

James Syme
Senior Fund Manager

Paul Wimborne
Senior Fund Manager

Ada Chan
Senior Analyst

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