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EMERGING ASIA – I WANT TO BREAK FREE!

Attitudes towards the Emerging Markets (EMs) have been rather jaundiced in recent years, to say the least. For the better part of the past decade, investors have flocked towards developed market equities, especially those in the US. Moreover, when equities sold off, the EMs were often hit hardest.

Jason M Hepner
Senior Portfolio Manager,
Multi Asset Solutions
Eastspring Investments

On the surface, this performance seems counter intuitive. EM economic growth, for example, has consistently outpaced that of the Developed Markets (DMs), notably over the 2008/9 financial crisis - when the EMs recorded growth, albeit lower, while the DM economies shrank.

This period should have convinced critics that EMs have developed their own internal growth dynamics. Clearly, it did not - although it is naïve to argue that EMs will be completely independent of world activity.

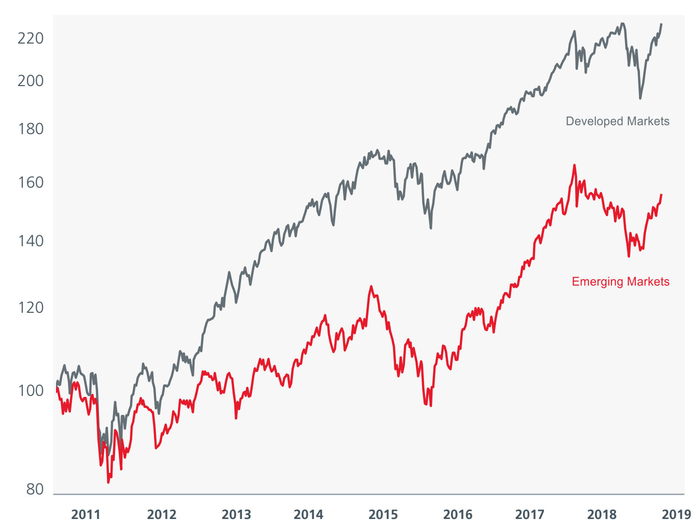
EM equities did swing back into favour in 2017 (briefly) only to give back around half the year's gains in the subsequent twelve months (Fig 1).

What are the reasons for this patchy track record - and do these reasons justify the resulting performance?

Moreover, as 2018's "global synchronized growth" perceptions slowly transition into fears of a 2019 "global synchronized slowdown", are we embarking on another round of EM underperformance?

Perhaps most significantly, have the EMs discounted those factors that lie behind their recent performances?

Fig. 1: Investors run to Developed Markets[1]



If the answer is "Yes", then an investor's focus should switch towards how best to take advantage of this situation against a background of rising volatility and slower growth concerns.

The challenge is sorting the wheat from the chaff. What fears are holding the EMs back? Have these fears been exaggerated? What are the "real" underlying drivers?

It is important to recognise that while EMs have similarities, it is a mistake to treat them as an identical whole; each region has its own growth dynamics. Nevertheless, in many instances, investors have tarred the "innocents" with the sins of the "guilty" as will soon become apparent.

This reality is clear when comparing the differing performances of the various EM regions – Asia, Europe and Latam. While all follow a similar path, that followed by Emerging Asia is quite different (Fig 2).

Emerging Asia is clearly trying to break the chains that bind it, so far with little success.

It has tried twice and failed. Will it fail a third time? Or will it succeed?

Many reasons have been cited for this swinging interest in the EMs. Heading 2018's "hit" list were the combined impacts of (supposedly high) US dollar debt exposure and the ability (or otherwise) to service that debt. President Trump's trade wars have had a specific impact on China. There were others.

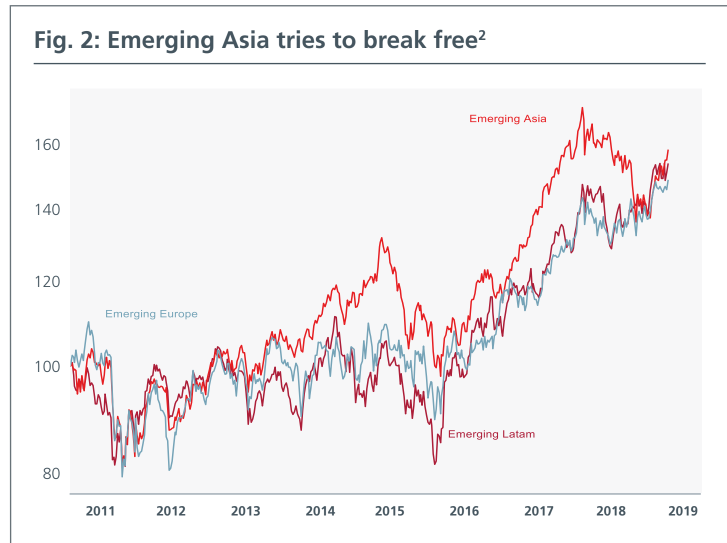


Fig. 2: Emerging Asia tries to break free[2]

Ratcheting up these concerns is the now inverted US yield curve (at the short end, at least), which is fanning fears of an impending US recession. Investors, have apparently forgotten the growth lessons implicit in the financial crisis and are again fretting that potentially slowing global growth will impact disproportionately the EMs.

Many of these fears, especially those related to US dollar exposure, can be dispelled easily. While, for example, some EMs are indeed constrained by dollar debt and servicing fears, this situation applies to only a few. It is by no means the case across-the-board (Fig 3).

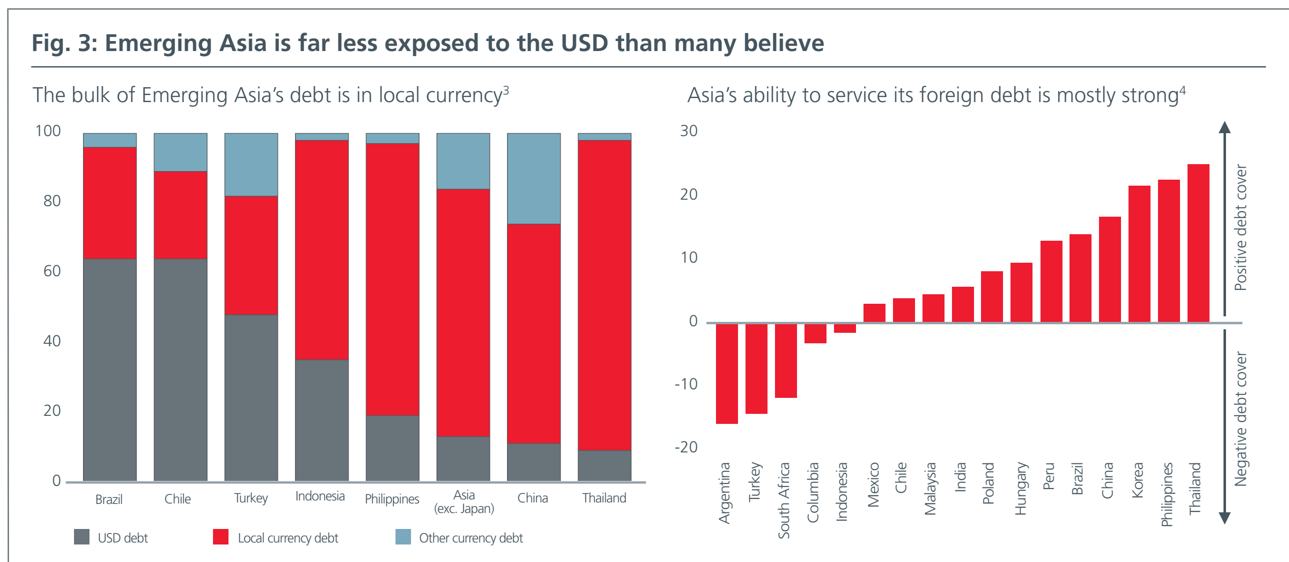


Fig. 3: Emerging Asia is far less exposed to the USD than many believe

A quick perusal of the two charts in fig 3 highlights those emerging economies exposed to the US dollar, but to tar China and Emerging Asia with the same brush as Turkey, or Argentina or Brazil? A step too far, one would suggest.

Indonesia is Asia's most exposed on this score, and its exposure is well below that of Latam, for example.

If Emerging Asia, therefore, has been valued on the same basis as Turkey et al, this strongly suggests a gross mispricing of the Emerging Asian equity markets.

And, this indeed, seems to be the case.

But while strong US dollar fears circulate (whether justified or not), Emerging Asia will unlikely break free.

It is tempting to lay the cause of the EM underperformance solely at the door of the aforementioned fears, but a more fundamental issue has been quietly at play – and that is the delivered earnings when measured against expectations.

This "Investment 101" approach not only exposes market performance to the scrutiny of a laser like spotlight but also puts each performance into stark relief.

The contrast, for example, between the two main protagonists, US and China, is particularly illuminating.

If one were asked, "On the basis of the declared versus expected profits illustrated in fig 4, which market do you think outperformed?", it would not take too much analysis to answer, "Market A"; its profits forecasts were rising as were declared profits.

Market "A" is the US. Market "B" is China.

Suddenly, a fundamental driver of each market's performance has been exposed. Similar earnings-related explanations can be found for the other EMs. Notice that the 2017 rally in EM equities coincided with a surge in the declared profits.

The emerging picture is that while less-than-robust declared earnings have been a major factor behind EM performance, investor focus has seemingly been on exaggerated and often misplaced fears - apart from those individual EMs that really do have a major US dollar problem.

It is only a matter of time before the pendulum swings back towards EM earnings delivery, especially if the nascent upturns in China's declared and forecast earnings continue and broaden out into other EMs.

How individual EMs then perform will likely reflect their valuations. Here the picture is varied. But if we look at the fundamental cyclically adjusted price earnings multiple (adjusted

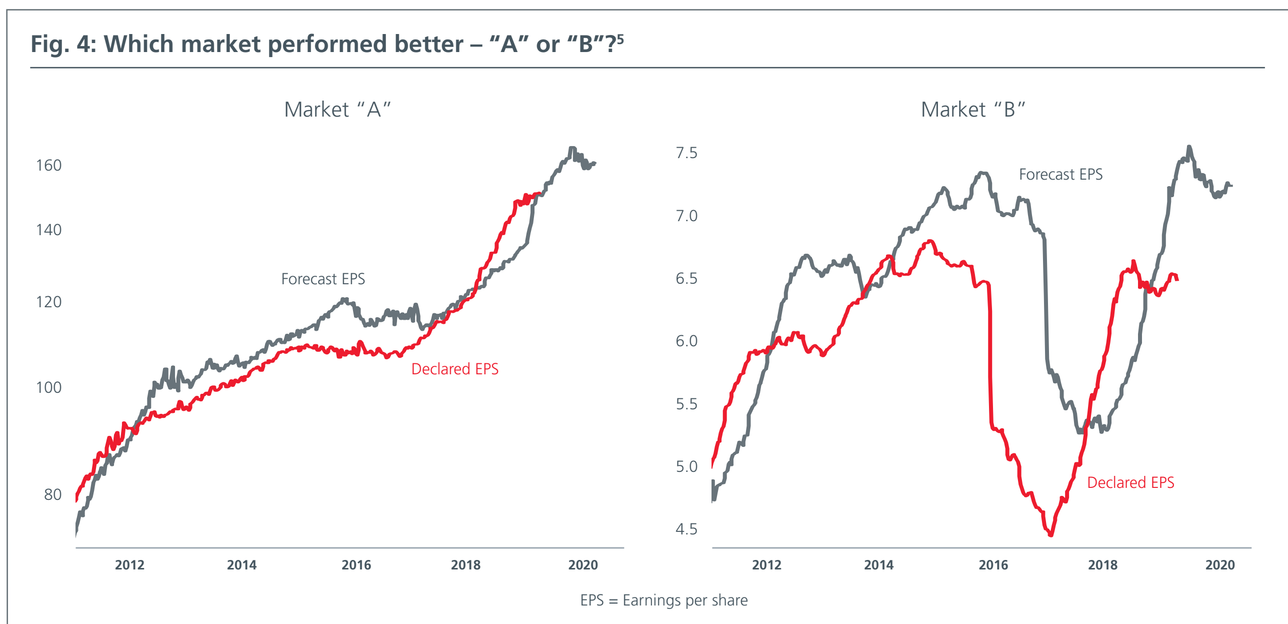
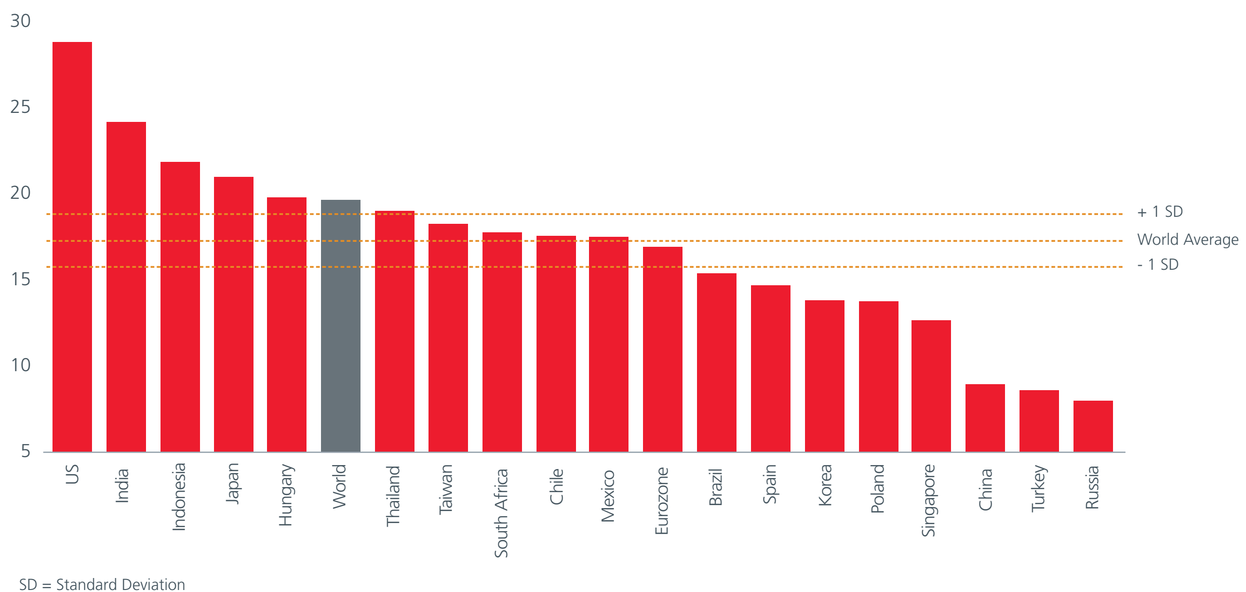


Fig. 4: Which market performed better – "A" or "B"?[5]

Fig. 5: Some deep value exists in the Emerging Markets[6]



SD = Standard Deviation

additionally for local inflation), there is plenty of value, indeed some extreme value, to be found in the EMs (Fig 5).

While tempting, it is probably too early to argue that cheap valuations alone will be sufficient to unleash selected EMs despite some apparent deep value.

Strong US dollar fears, for example, could continue given that the US needs to suck in dollars to fund economic growth[7]. But should this inflow ease and the Fed inject capital into the system, a weaker dollar could be the signal that the EMs resume their upward ascent.

A successful conclusion to the US-China trade war could also unleash China's equities. The omens are increasingly suggesting that Presidents Xi and Trump would like to have a trade deal signed and sealed at the G20 meeting scheduled for late June.

In short, the fears restraining EMs have yet to fully run their respective courses. The slashing of the earnings forecasts is well underway, but with few signs of a slowdown yet.

Nevertheless, the conditions for an EM rebound are falling into place. When the bounce-back does occur, especially in those cheaper markets dragged down by exaggerated or misplaced fears, it could be very strong indeed.

Positioning is the key.

The Multi Asset Strategy team has an overweight in US equities (https://www.eastspring.com/insights/hanging-tough), but is keeping a close eye on the various Emerging Markets. China's low valuations have attracted a significant overweight. The team is closely monitoring critical signals, such as US dollar strength.

Sources: [1]MSCI World and Emerging Market total return indices in local currency terms. Both indices are indexed to 100 as at 1 January, 2011. [2]MSCI Emerging Market total return indices all in local currencies and indexed to 100 as at 1 January, 2011. [3]Worldscope, Factset, Citi Research published in GEMS Research as at 24 May 2018. Debt refers to "Non-Financials". [4]Eastspring Investments based on official data from Thomson Reuters Datastream as at 8 April 2019. Reserves refers to foreign exchange reserves plus the current account balance less both identified short-term capital flows and the three-year accumulated net portfolio flows. [5]IBES based on the MSCI US and China indices from Thomson Reuters Datastream. EPS = Earnings per share. [6]Eastspring Investments based on official data on Thomson Reuters Datastream as at 5 April, 2019. Value as measured by the inflation adjusted, cyclical price earnings multiple calculated over the preceding ten years (aka the Shiller ratio). Note that the dotted lines represent the world average and one standard deviation either side also calculated over the ten-year period. [7]US M1 growth has been below nominal US GDP growth for the past three quarters suggesting that the US banking system is creating insufficient liquidity to fund growth. This implies the Fed will keep rates and hence the dollar relatively high to attract an inward flow of USDs. Should this flow ease, the Fed would have little option but to inject capital into the system thus undermining the USD.

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