INVESTMENT

On the up?

After a somewhat rollercoaster ride in the global emerging markets equity space, Sandra Haurant **looks at what the sector has to offer following political change**

WRITTEN BY SANDRA HAURANT,

A FREELANCE JOURNALIST

Prior to 2016, emerging markets equities were spoken of in some very negative language. With 2015 described variously as a brutal year, disappointing and a perfect storm, emerging markets gave cause for concern to investors in this diverse sector. The MSCI Emerging Markets Index, which covers large and mid cap representation over 23 EM countries, saw negative returns in 2015, falling some 14.92 per cent, compared with a fall of 2.19 per cent in 2014. It was not a good year.

Over the longer term, things looked slightly brighter, PiRho Investment Consulting director Phil Irvine states. "Since 2005, there has been a small increase in value of emerging markets versus global equities." Nonetheless, he says: "It has been a bit of a roller coaster."

Back in favour?

Many forecasted a more positive performance in 2016, and indeed the market did pick up significantly, becoming far more attractive as the year went on. According to Candriam Investors Group head of asset allocation Nadège Duffosé, emerging markets have been back in favour since the end of the first quarter of 2016.

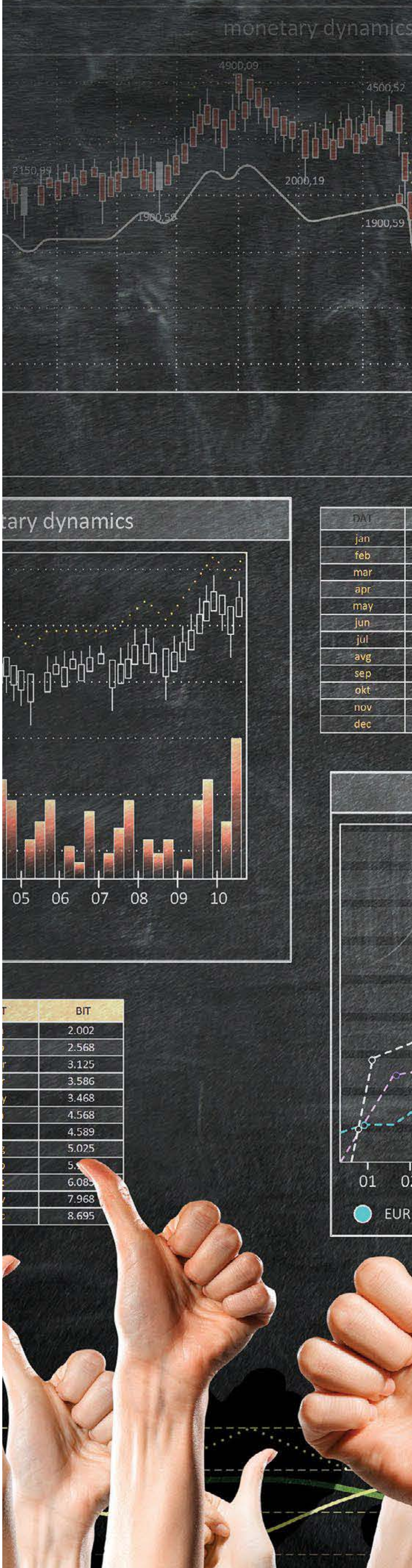
"Emerging markets has been our favorite region since March 2016," Duffosé says. "This recommendation was based on three main drivers: the valuation was very attractive following years of underperformance, the stabilisation of commodity prices was a strong support for expected growth and Chinese risk was receding."

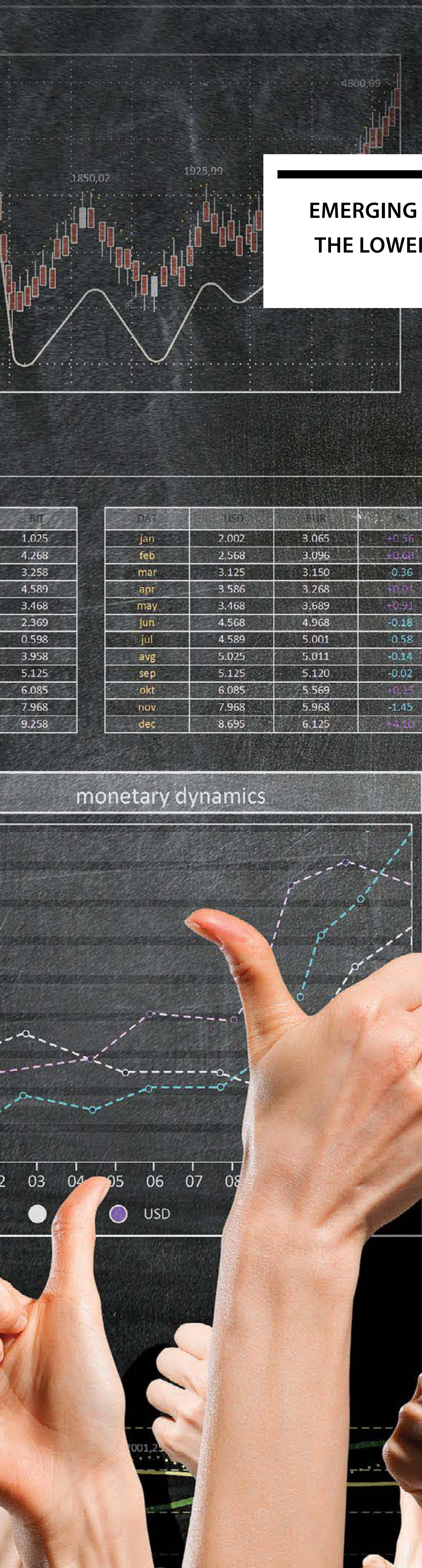
Indeed, the *Financial Times* reported that inflows into emerging market equity funds had reached a 58-week high in August 2016, as investors went in search of positive returns. The *FT* credited three-year lows in borrowing costs for developing economies, coupled with currencies hitting 12-month highs, for this renewed interest in a previously struggling sector.

Political change

Now the political landscape has changed in ways that had been widely unexpected, and which could once more alter the direction of emerging markets' course. First came Brexit. Could the UK's withdrawal from the European Union have an impact on emerging markets' performance? Duffosé believes that the effects are likely to be limited.

"For us, Brexit has no direct immediate impact on emerging markets," she says. What's more, with the government yet to start the ball rolling with the triggering of Article 50, and the subsequent long negotiations that are expected, this





EMERGING MARKETS PROBABLY DESERVE A HIGHER RISK PREMIUM GIVEN THE LOWER VISIBILITY WE HAVE ON THE EVOLUTION OF 'GLOBALISATION' AND THE THREAT OF PROTECTIONISM

one is going to run and run, meaning that any impact might be far into the future. "It will take time to have an effective Brexit."

PAAMCO managing director Alper Ince adds: "The impact of Brexit is unclear as trade negotiations between the UK and individual countries will take a while, and different EM countries will have various politics and leverage points in negotiations."

But, he warns: "The bigger risk is a scenario where the European Union disintegrates as a result of next year's elections in France and Germany, which are bigger export/import markets for emerging market countries, particularly for Asian emerging markets."

And now, as the new US president elect prepares to take up the reins at the start of 2017, emerging markets are potentially facing greater challenges. Following the US election, star fund manager Neil Woodford, in a much-quoted blog post, wrote: "The election result could … puncture the love affair that the market has had this year *[2016]* with emerging market equities and debt. Globalisation will come under the spotlight under a Trump administration and I believe we should expect a greater focus on domestic political priorities at the expense of free trade and globalisation."

The potential for a significant move towards protectionism and a shift away from globalisation, then, could see some very real changes, and the markets have been responding. "Since the US elections, emerging markets performance has dropped, which has given a new momentum to the valuation argument," Duffosé comments. "Commodity prices have rebounded and the positive effect is at least partly discounted in next year's expected growth."

But, she adds: "What has changed since the US elections is the strengthening of the US dollar, and the risk around trade policies. Emerging markets probably deserve a higher risk premium given the lower visibility we have on the evolution of 'globalisation' and the threat of protectionism. We are therefore less constructive on emerging markets, have reduced our exposure toward a more neutral positioning."

Goldman Sachs Asset Management head of the global portfolio solutions group for EMEA and Asia-Pacific ex-Japan Shoqat Bunglawala says the election outcome has "generated some near-term headwinds for emerging markets, due to a significant sell-off in US Treasuries and the narrative around growing trade protectionism".

"Prior to the presidential election, we held a constructive medium-term view on emerging markets," Bunglawala adds.

"Asset valuations were attractive, after five years of relative underperformance, growth was at a cyclical low-point according to our estimates, external macro-imbalances had eased to more sustainable levels following the large emerging market FX adjustment and, finally, the bar for a positive surprise in terms of political uncertainty was low." But, he says, the election result "does not alter our medium-term view on EM in a meaningful way."

"First, the re-pricing of government

bonds was long overdue, in our view, and was also a key risk for emerging-market assets prior to the election (which has now materialised). Second, we do not expect a big disruption in global trade from a shift in policies after the US election, as such a disruption would also have a significant negative impact on the US economy," he says. "Finally, it is sometimes overlooked that the prospects of fiscal easing and dollar strength will generate a disproportionate boost to US imports which will benefit its trading partners (eg Mexico). Therefore – once the dust settles – we see this correction in emerging markets assets as a buying opportunity."

Awareness

The extremely diverse nature of the emerging markets sector makes it a tough one on which to generalise but, says Irvine: "Investors in emerging markets need to be aware of the volatility and to ensure that their time horizon is long enough to be 'forced' sellers at low point." Although, he adds: "The entry point for a switch between developed equities to emerging market is relatively attractive on a 10-year time horizon."

With such a broad sector, taking a decisive and agile attitude is important. Ince says of PAAMCO's approach: "We are big believers in accessing emerging market opportunities by hiring local managers with on-the-ground research presence, particularly in less efficient regions. This is the sort of market environment that should be conducive for active managers taking advantage of opportunities created by macro volatility."

He adds: "Despite the market taking a very negative view of the Latin American region post-US elections, there are many high-quality companies that would benefit from domestic drivers, such as local infrastructure programmes in places like Colombia. In the EMEA region, Russia would be a net beneficiary if the new US administration relaxes economic sanctions. On the other hand, South Africa can remain under pressure due to high external current account deficit and domestic political turbulence."

The broad spectrum of emerging markets, with its huge variety of economies and corporations, can create both challenges and opportunities. The difficult part is identifying which is which.

As Irvine underlines: "The term 'emerging markets' makes the asset class sound homogenous, whereas in practice the different countries, sectors and levels of corporate governance means that there is room for a knowledgeable skilful manager to add value."

For this reason, Irvine believes that passive investment vehicles could be a mistake. "Unlike most developed equity markets where passive investments can often be a tough hurdle to beat, we prefer active management in emerging markets." ■

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