Market Commentary
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Emerging Markets – Where To From Here?

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Even if you do not follow market movements closely, it has been hard to miss the recent flood of articles, reports and comments about tumbling emerging market asset values. A devaluation of the Argentinian peso, concerns about growth in China and confusing policy directions in Turkey have all been used as excuses to abandon emerging market investments.

Does this mean emerging markets are turning into a long-term investment pariah?

The answer comes down to individual countries, since references to "emerging markets" as a homogenous group are becoming increasingly obsolete. To lump the Ukraine and South Korea together, or to view Mexico and Egypt as similar investment destinations are clearly stretching the imagination. **In short, we view the current sell-off as an investment opportunity, rather than the beginning of a much deeper correction in emerging markets.** However, plunging blindly into the wrong emerging country at this point could well be the beginning of more pain.

A closer look at emerging markets
Breaking up the emerging market group into subgroups is problematic, as many countries share characteristics. Apart from simply categorizing countries based on commodities or politics, the points below outline Signature's view on emerging markets in the current environment and where the risks and opportunities lie.

1. Quasi-emerging markets: Argentina, Ukraine, Venezuela and Egypt.

These countries are facing financial and economic ruin if no corrective measures are taken. In some respects, this group reflects the typical emerging markets of the 1980s: lacking policy visibility and stability, struggling with corporate governance issues and with political instability/radicalism as a continuous theme. This group represents a very high-risk investment destination. The potential of a full-blown crisis is never too far off.

2. The headaches (in order): Turkey, South Africa, Brazil, Indonesia and India. Also includes Hungary, Poland and Chile.

These countries are dependent on foreign capital inflows, struggle with excessive domestic spending largely financed by credit rather than productivity increases, run current account deficits and have deteriorating fiscal situations. High inflation and depreciating currencies limit policy flexibility in most of these economies.

But all is not lost for these countries, which are extremely vulnerable to higher U.S. bond yields (i.e. the end of easy and cheap global money). Although they exhibit many parallels with the debt-fuelled Asian economies in the lead-up to the 1997/98 Asia crisis, today's "vulnerable five" are much less dependent on short-term foreign debt, boast healthier bank balance sheets, have stronger foreign currency reserve positions and have the insight of hindsight following the Asia crisis. Thus, although Turkey, South Africa, Brazil, Indonesia and India remain vulnerable to further currency depreciations, a full-blown financial crisis within this group seems much less probable than 1998. Some analysts like to add Poland, Hungary and Chile to this group to form the "edgy eight." (Analysts love coming up with catchy group names; some stick, some are sensible and some make absolutely no sense from an investment perspective – think BRICs.) The recent sell-off is opening up very interesting investing opportunities based on idiosyncratic company analysis.

3. Export focused: South Korea, Taiwan, Malaysia and Thailand.

These economies are benefiting from a popular theme in emerging markets during the 1990s and early part of the 2000s: exports to mostly developed countries, although China has also become a key export destination. However, unlike the 1990s and 2000s, this group relies heavily on product competitiveness through innovation and efficiencies (South Korea and Taiwan) and tapping into global supply chains (Thailand, Mexico and Malaysia). The growth fortunes of these countries are closely tied to developments in other economies, and more specifically developed markets. These markets are not immune to adverse developments elsewhere in emerging markets, but tend to be more resilient given their export focus. Political risk in Thailand, however, remains a wild card.

4. The stars: Mexico, Philippines and Peru.

These emerging countries have relatively stable political environments that are conducive to structural reforms, healthy and/or improving fiscal balance sheets, positive current account balances and solid growth prospects. Mexico and the Philippines stand out in this regard, although equity valuations are more challenging given the strong macro backdrop. Peru could arguably belong to this group as well, although the country’s dependence on copper and gold weighed on investment sentiment in 2013. For the countries in this fourth group, we continue to focus on domestic sectors such as consumer, infrastructure, construction, health, education and financials. This group should be the least affected by concerns in the high-risk emerging markets, and a sell-off in sympathy with other emerging markets could open interesting entry points into these countries.

5. China.

China is indeed the proverbial elephant in the emerging market room. Not to say that there are few similarities between China and other emerging markets, but at the same time there are numerous developments that are specific to China, especially given its current political and economic structures.

After a decade of fast growth, not least thanks to a huge investment and credit boom after the 2008 Lehman crisis, China must now address a number of imbalances in the years ahead: a highly leveraged economy, an over-indebted local government sector, a loosely regulated shadow-banking system, huge excess capacity and extreme pollution.

On the positive side, the government and related authorities are very much aware of these issues and are moving (slowly) to address these problems. However, many of the factors mentioned above played a key role in driving economic growth in China in the last decade, especially during the last few years. Thus, although deleveraging and a rebalancing of the economy are needed to ensure long-term sustainable growth, addressing these issues will weigh on growth in the short to medium term. Global investors do not differ much on the topic of slower but sustainable growth; however, there is a major difference in opinion about the pace and depth of the slowdown and that is an important distinction between the China bears and bulls.

China bears predict a slowdown in growth that will happen faster than expected and eventually undermine the rebalancing/reform/deleveraging process. Given the amount of credit extended over the last few years and the difficulties countries have faced in the past in smoothly navigating a deleveraging process, this scenario should not be summarily dismissed and remains a significant risk.

However, a central government with huge cash reserves and a low debt ratio can, and likely will, ensure that the adjustment process does not become a disorderly correction. Selective defaults, targeting specific industries for capacity adjustments and a slow tightening of the rules (through regulations) and operations (through higher interest rates) regarding shadow banking are the most likely path forward. Even though growth is expected to slow, our view is that the slowdown can be managed without major hiccups. The risk is that well-planned and well-intended policies could easily bring unintended consequences, sending fear into an already largely skeptical global and local investment community.

Our one-sentence base case for China: A bumpy road ahead, with scary moments but no systemic risk.

Signature's view

Our cash positions peaked in the high-teens last year as we hunkered down in anticipation of U.S. tapering, Chinese reforms and continued slow growth in emerging economies. Since October, we have started putting cash to work and of late introduced a slightly more cyclical skew in our sector preferences. We are keeping a very close eye on U.S. bond yields, the U.S. dollar, developments in China, political risks and weak policy responses in emerging markets as potential risks that could change our cautiously optimistic view. That is not to say that there will not be worrying moments ahead, but overall we remain more optimistic about emerging market equity returns than last year.

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