Outlook: The Global Emerging Markets Asset Class

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2018 has been challenging for investors in Global Emerging Markets (GEM), with rising volatility in Forex, debt and equity prices causing negative returns. As the year has progressed, several themes have increasingly influenced sentiment and momentum.

The US continues to tighten its monetary policy: the risk of fiscal laxity could further this trend. Tighter US monetary policy affects GEM policies, especially in economies where domestic currency weakness leads to rising inflation. Although the importance of the US dollar (USD) to GEM countries has been reduced since the Chinese renminbi now represents around 30% of the world's broader monetary base and China has an increasing role in GEM investments and trade, movements in the USD still influence GEM with regards liquidity conditions. The ongoing USD appreciation presents headwinds for these markets.

The deterioration of global trade rhetoric and the tit-for-tat ratcheting up of tariffs is generally not good for markets, especially those markets and companies reliant upon trade. The more aggressive geopolitical stance associated with US trade policy is adding to uncertainty. Linked to this, the developed markets (DM) economy and corporate profit cycle is increasingly mature.

Domestic politics – especially presidential elections – are impacting markets, for instance in Turkey, Brazil and Mexico. Progress on economic reform is questionable unless forced by financial markets, e.g. Argentina. At the other end of the spectrum, China's newly deemed "president for life" invokes different questions.

Our ability at Comgest to answer big-picture questions with conviction is, as ever, limited. Nevertheless, some observations are worth noting.

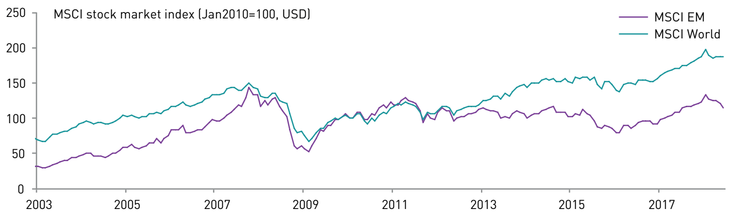
When emerging markets assets peaked in January 2018, they were still only around the level of the last peak in 2011, but below the all-time high of 2007.

As figure 1 shows, GEM went sideways for over a decade, one reason being weak fundamentals – a situation that has now evolved. Consumption and investment are accelerating, supported by decent income growth and healthy balance sheets.

GEM currencies have depreciated markedly over the past half-decade and now seem cheap. They are supported by an aggregate balanced current account position while the positive carry on local currency debt is approximately twice the expected inflation differential to DMs according to the International Monetary Fund. Equally, GEM external debt-to-GDP sits at 28%, below the previous peak of 38% seen in the late nineties and close to the 30-year low of 25%.

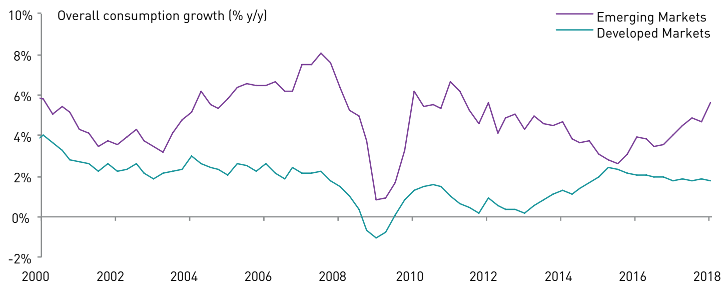
The GDP outlook for GEM growth remains modest in absolute terms, around an expected 5% p.a. over the next few years. This represents a meaningful acceleration in relative growth with DMs growth expected to peak this year at 2.5% and then decelerate.

Figure 1. Emerging markets have gone nowhere in 10 years



Source: EM Advisors, as of 30 June 2018.

Figure 2. Fundamentals are improving



Source: EM Advisors, as of 30 June 2018.

As company-focused investors, we are encouraged by several thematic developments originating from GEM middle class growth over the past two decades:

Increasing demand for sophisticated financial services

While life insurance is a saturated and largely ex-growth market in DMs, it has dynamic demand growth in GEM: over the past decade "emerging Asia" has consistently been the strongest growth region boasting a premium CAGR of 11.1%, followed by Latin America at 8.2%. At the same time, Europe, North America and "advanced Asia"[1] – around 80% of the global life insurance market – have been ex-growth. We believe companies such as Ping An, Sanlam and BB Seguridade are strong corporate franchises that exemplify this long-term growth story. Their valuations appear depressed absolutely and relatively, despite faster growth and better returns than DM peers.

Accelerating innovation

More companies in GEM, specifically north Asia, have prioritised investment into R&D in the last decade. The results have expanded the list of companies able introduce innovative products and services, thereby competing globally. Hangzhou Hikvision, Samsung Electronics and NCSoft are examples of this trend in our view. Their shares seem attractively valued despite rapid growth and increasing competitive positions.

Soaring healthcare needs

Emerging markets are home to two-thirds of the world's population, many of which have higher living standards but are not yet receiving a commensurate standard of healthcare. In some countries the dynamics of an ageing population adds to demand. The opportunity in this sector is highlighted by very low levels of spending per capita across Asia, Latin America as well as the Middle East, Africa and Eastern Europe – suggesting sustained future growth for the appropriate companies. Comgest believes that Mediclinic, Lupin and Discovery have promising prospects both domestically and internationally.

Compared to global equity markets, GEM equities have seen valuations contract with 2018's correction and return to a 20% discount on P/E (NTM)[2]. In contrast to other parts of the world, quality growth stocks in GEM are now trading at their lowest premium in six years. The Comgest Growth Emerging Markets fund is also trading at its lowest P/E (NTM) – 13.8x – in five years, with an estimated five-year EPS CAGR of 13%. Based on our predictions of future growth, we believe we have good average upside across our holdings.

The sell-off in GEM assets, perhaps understandable from a sentiment perspective, does not appear to be based on fundamentals. While it is hard to predict if volatility will stay elevated in the intermediate term (we suspect it might), from our view the backdrop seems increasingly attractive, if only from a margin of safety perspective, for long-term investors in the GEM asset class.

FOOTNOTES

[1] Japan, Taiwan, Singapore, Hong Kong, South Korea
[2] P/E NTM refers to "price-to-earnings ratio" and "next twelve months"

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