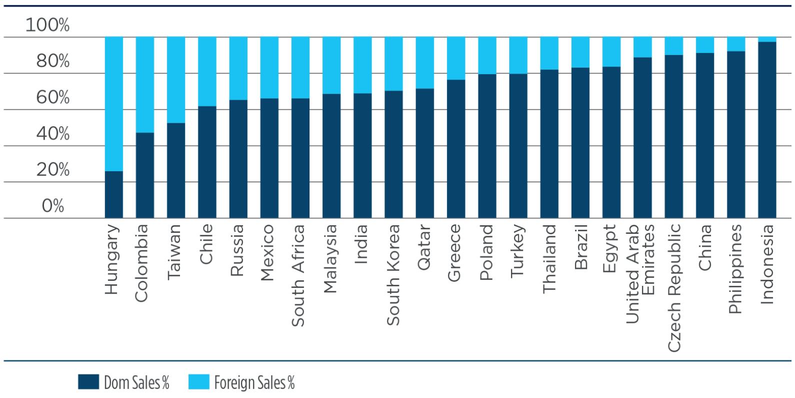
Domestic focus to exploit Emerging Markets equity opportunities

The emerging markets (EM) universe has experienced significant changes in the last decade with the further addition of investible countries (i.e. China A shares in 2018).

Figure 1: MSCI EM - Domestic vs foreign revenue breakdown by country



Source: Amundi, Factset. Data as of May 2019

This world in transformation remains highly heterogeneous as differences between EMs exceed similarities. In EM equities field this is also, why investors can benefit from lower correlation across countries compared to the developed countries group. Nevertheless, when a risk-off mood prevails, Emerging Markets tend to move in the same direction as investors pull out money from these assets, with the most vulnerable countries facing severe challenges. This was for instance the case during the EM turmoil in 2018 when the six most solid equity markets experienced a significantly better than the six vulnerable countries: +16% extra performance on equities in 2018.[1]

In a world of diminished return potential, the ability to mitigate downside moves by avoiding most vulnerable areas and tackle market opportunities will be even more relevant. To detect areas of opportunities we rely on the assessment of cyclical as well as structural dynamics. In particular, we have identified five key drivers of EM opportunities (Debt, Dynamism, Diplomacy, Dependency, Domestic demand).

- **Debt dynamics:** Understanding the debt sustainability path is key to uncovering market opportunities. Rising expenses on public debt can harm the growth potential of the country and make it more vulnerable to external shocks. Therefore, this is a key element in the vulnerability assessment of each country.
- **Dependency on foreign capital:** this is also very much related to vulnerability assessment. High dependence on external debt in hard currency represents a weakness in case of crisis. The overall level of dependency on foreign capital has improved in recent years, as there has been a slowdown in the level of EM external debt. A backdrop of a US economic slowdown (with no recession) and a dovish Fed could continue to be supportive for emerging markets investing.
- **Dynamism:** the ability of countries and companies to dynamically adapt to a changing market environment will be crucial to their success. Infrastructure, business reforms, market openness are key. India is a virtuous example on the reform side, while most recently Brazil has captured the investor attention with the pension reforms moving faster than expected. Mirroring the dynamism of EM economies, EM benchmarks have also experienced major changes in terms of sector allocation, with information technology and communication services the fastest-growing sectors over the last decade, energy, and materials shrinking the most, giving active investors a wider opportunity set with different cyclical features.
- **Diplomatic attitude:** In a still-globalised financial world, but with a more polarised geopolitical order featuring trade disputes, sanctions and counter-sanctions, diplomacy will be even more relevant than in the past. In this respect, we see major developments occurring that could drive major transformations for certain countries. The example of China's Belt and Road (BRI) initiative is one of these. At the corporate level, this dimension reflects in greater demand for high governance standards and overall greater focus on ESG factors.
- **Domestic Demand Focus:** by 2030, 2/3 of the global middle-class based on the current population is expected to be in Asia (according to the Brookings Institution). This expansion will drive consumption and growth in the future. The EM universe of companies/sectors and countries with different exposures to foreign revenues provides fertile ground for selection of investment ideas that can be more resilient to further escalations of trade disputes and the imposition of tariffs.

In Amundi's view, **to capture the next wave of returns in EM, investors will have to embrace what we call an EM-MOVES (Multi-Opportunity Vulnerability-Enhanced Selective)** approach based on an assessment of the vulnerability of each economy and an analysis of the five key drivers of EM opportunities mentioned above.

- **Multi-Opportunity** means enlarging the opportunity set by widening the investment universe to off-benchmark countries/companies/instruments to enhance our choices. For example, companies with strategic importance to the sovereign and quasi-sovereign entities may withstand economic pressures better than peers with no direct or indirect support from governments. In addition, as EM assets tend to be exposed to certain specific factors (USD dynamics, Fed policy, commodity pricing, among others), we can benefit from allocating risk to assets linked to factors that are supportive in certain phases of a cycle.
- **Vulnerability-Enhanced:** With vulnerability being the most important discriminatory factor, Amundi believes it is vital to assess if markets are correctly pricing different country vulnerabilities. Vulnerability is mostly undervalued during 'good times' and typically overvalued during periods of crisis, creating investment opportunities for active managers.
- **Selective:** Amundi focuses on bottom-up selection for each investment case with integration of ESG (environment, social and governance) criteria and combines this with top-down assessment. We screen the opportunity set in EM based on fundamentals, valuation, macro cyclical opportunities and the assessment of the five key drivers (the 5Ds: Debt, Dynamism, Diplomacy, Dependency and Domestic demand) to uncover the most compelling investment ideas.

Within a mid-term horizon we believe that EM equity will offer among the most compelling returns for investors. Also with a shorter-term view, the current environment bode well for this asset class. The growth differential between emerging and developed markets is widening, valuations remain attractive on a relative basis and earnings growth is stabilizing. Furthermore, dividends are an attractive investment theme to play in the EM world and improving corporate governance is also attracting further investor inflows. For investors, the best way to exploit these themes is through domestic demand focus, exploiting ESG factors and opportunities coming from a new geopolitical order through the One Belt One Road initiative.

FOOTNOTE

1 Source : Amundi Research paper > Investing in the Changing Shape of EM, available on research-center.amundi.com.

Read the full Amundi's Research paper on Emerging Markets

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