GUARDIAN CAPITAL

Emerging Markets Quarterly Outlook

SECOND QUARTER – 2017

CAN IT GET ANY BETTER?

Despite falling commodity prices and the occasional political hiccup, EM equities continued to march forward in Q2 albeit at a slower pace than in the previous three months. Technology stocks in Asia were the driving force, reflecting not only their heavy index weighting but also favourable conditions in the market niches that they dominate. With exports picking up and consumer demand gently recovering, the economic background was generally positive and virtually all sectors in the region comfortably outperformed their global peers. EMEA and Latin America did not fare so well. This was in part due to their greater economic exposure to weak natural resource-based industries. Russia, in particular, is suffering from the consequences of the implicit negative budgetary impact of the tumbling oil price. Another factor was reduced confidence in the direction of economic policy, notably in Brazil and South Africa. In the former, the ongoing saga of corruption in the highest offices of state is draining support from President Temer's attempts to push through reforms necessary to stabilise the country's fiscal position, particularly with respect to pension payments. In the latter, the sacking of a respected finance minister, the populist policy inclinations of President Zuma, and the ongoing power struggle within the ANC over his future, have led to downgrades of the country's debt status. The misfiring of the major non-Asian markets meant that double-digit percentage gains in some smaller markets, such as Turkey, were merely chinks of light in an uninspiring investment landscape. Fortunately, whilst the anticipated recovery of some countries from recession is taking longer than hoped, the long-awaited rebound in corporate profits has arrived. Consensus earnings estimates continue to rise, meaning that the P/E for EM equities is still around 13x for 2017, notwithstanding the rally seen so far this year.

Can EM equities finally break out of the trading range that has prevailed since the beginning of the decade? Based on their own dynamics, the answer is probably yes. The pace of earnings growth will slacken next year, but it should still be respectable. The asset class is trading at a decent discount to global average valuation, and there is scope for international money to flow in before investors' exposure gets back to historical highs. Domestic trading has always been volatile, but the amount of EM wealth held in equities should rise over the long-term and there are few signs of speculative excess other than in China. For the most part, economic conditions should remain benign. China may slow a little next year, but the overall rate of GDP growth in EM should remain roughly the same as this year, a smidgeon above 4.5%.

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Importantly, this should not threaten a significant uptick in inflation, all too often the Achilles Heel of the developing world. Subject to global monetary conditions, this means that monetary policy should largely remain on hold, which will help underpin the market.

Currency appreciation, which has been an important element of the present bull-run, is unlikely to be particularly helpful from this juncture as there is no longer any conspicuous undervaluation of EM currencies against the U.S. dollar. If anything, there could be some downward pressure if the U.S. Federal Reserve and, possibly, the European Central Bank, become more aggressive about neutralising money supply than currently anticipated. That said, most EM economies look more robust than in 2015 with respect to external and fiscal imbalances, so a repeat of the sell-off on the scale seen in that year does not look on the cards.

Juggling with the Index

MSCI has recently completed a periodic review of its EM index. As usual, this exercise caused a ripple of excitement before the announcement of its conclusions, because of the implications for rebalancing on the part of index trackers. As it turned out, the immediate changes to weightings proved to be pretty small beer. However, the long-term message was that EM will eventually become a significantly bigger slice of the global market and there will be a material change in country weightings. For those of you that are not index construction buffs, inclusion of markets in the EM index has little to do with countries' level of economic development and everything to do with access for foreign investors, liquidity and the free functioning of the local market. Thus, wealthy Korea at present sits side-by-side with poor Indonesia in the index, due to similarities in the way that their respective equity markets operate, rather than because their economies have much in common. In this context, China has long been a problem for MSCI. Its economy is massive, the local stock market is huge by comparison with the rest of EM, but the lack of access for foreigners, and government market intervention, have been difficult hurdles to get over. In the past, index setters have deployed various fudges, such as including Hong Kong listings and ADRs, to get around this problem. However, facing significant reservations from global asset managers, they have bridled at inclusion of domestic stocks in the benchmark. Albeit in a very limited fashion, this is about to change. By August 2018, a small group of so-called 'A' shares will be included in the main EM index, with a combined 0.7% weighting. These are all large-cap shares that are investible through cross-border exchange links. This is the first step on a long road to full inclusion of China, but if the government does eventually liberalise financial markets sufficiently, given that the capitalisation of the domestic equity market is roughly US$6.9 trillion, the country will come to dominate the broad EM index, which itself will greatly increase in size. More fundamentally, inflows from international investors should help stabilise China's capital account and make local markets less speculative. However, even if things go smoothly, it is likely to take a long time before the process is completed. It took Taiwan nine years to win a full weighting and it faced less obstructions.

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MSCI status also marks the relative economic fortunes of countries. It is possible to slide down the rankings as well as achieving promotion. The travails of Greece, for instance, meant that it lost developed market status and it re-joined the EM index, where it now ranks below Qatar in importance. However, it is also possible to return from the cold. Argentina and Pakistan, both previously demoted to frontier market status, hoped for an upgrade in the latest review. Only the latter achieved it, but it is probably only a matter of time before Argentina gets there too. Saudi Arabia, which has been opening up its equity market as part of its reform programme, looks as if it too will also become part of the MSCI EMF index next year. Gaining access to increased international investment flows is a prize worth having.

Steady as she goes

The Chinese economy continues to tick along at a pace acceptable to the government in the run-up to the Communist Party National Congress later this year. Although there may be some deceleration in the second half of the year as construction activity falls back, it is likely to be modest. When the economy is on a relatively even keel, attention usually switches back to implementation of the reform agenda. The political timetable always meant that major new initiatives were unlikely until late in the year and, so far, this has proved to be the case. Accordingly, with capital flight slowing down, attention has turned once again to financial deleveraging. Beginning in April, the authorities have been trying to rein in credit growth, particularly in undesirable off-balance sheet lending, which has mushroomed since the last time they pressed the growth panic button in the second half of 2015. Initially, the degree of regulatory tightening surprised investors. Both bond and equity markets tumbled in response. Fortunately, the central bank now has a much wider range of monetary tools to prevent a rout in financial markets leading to another general credit crunch, so nothing too bad resulted. So far so good, but effectively deflating the shadow banking bubble in the long-term will require the restoration of moral hazard. Currently, there is a general belief that, if push comes to shove, the government will bail out high-risk investments rather than inflict pain on a significant number of retail investors. This is realistic in light of past behaviour on the part of officialdom. However, we may have finally come to the point where a few carefully selected bankruptcies will be tolerable in order to encourage less risky behaviour in future. If successful, a change in policy of this nature would lead to capital allocation becoming more efficient, due to more appropriate pricing of risk, and banks becoming more careful about underwriting wealth management products. Such a move is not without danger, as pushing too hard could trigger widespread financial panic in a country where, for many, guessing the direction of government intervention is a major part of their investment process. Yet needs must prevail, as without a decisive improvement in capital allocation efficiency, China will eventually run out of wiggle room to keep its economy growing at a socially acceptable rate whilst avoiding a full-blown debt crisis. There are plenty of candidates for withdrawing implicit state guarantees, but local government financial vehicles, which have blossomed in the world of

shadow banking, look a good place to start, given that central government has already re-financed a large chunk of local government debt. Dealing with the elephant in the room, zombie SOE debt, may have to wait until the leadership summons up the courage to introduce a viable bankruptcy scheme. Optimists that point to China's high savings rate should bear in mind that total debt as a percentage of GDP for the country, is now roughly equal to the average in DM, having consistently grown much faster since 2009 despite China's much higher rate of GDP expansion. Something needs to change.

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Important political events in China are always carefully stage-managed and the upcoming Congress will be no exception. According to convention, the CCP General Secretary, Xi Jinping, will deliver the political report, which includes the presentation of the themes for government over the next five years. Critically, the priorities outlined represent the consensus of the party elite and in effect will be the CCP manifesto. The best guess is that there will be subtle shifts in emphasis rather than a radical departure from current policies, but these can be significant so investors need to pay attention. The other key development will be any changes made to the makeup of the Politburo and the all-powerful Politburo Standing Committee. The presumption is that these will confirm the further consolidation of power by President Xi. However, the ages of newcomers will receive close attention. If nobody born after 1960 features, it will encourage speculation that Xi intends to stay at the top beyond 2022. Alternatively, there may be some insight into who will be the successors to him and Premier Li Keqiang. It should be interesting.