GUARDIAN CAPITAL

Emerging Markets Quarterly Outlook

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YEAR OF THE DOG NOT LOOKING LIKE A DOG OF A YEAR

Despite the uncertainty and risks that loomed over the outlook entering 2017, last year proved to be a banner year for Emerging Markets (EM), with the broad equity index making a notable break from the range-trading that had prevailed since 2011. The MSCI Emerging Market total return index rallied 37% for the year as a whole (its best performance since 2009) and finally set a new high for the first time in a decade.

And as impressive as that aggregate increase was, perhaps more so was that the breadth of the gains within the EM grouping — stock markets in 22 of the 24 countries that comprise the MSCI Emerging Markets index posted positive returns for the year (just Pakistan and Qatar saw their domestic markets soften), a degree of synchrony not seen in five years.

So, after years of shuffling sideways, EM has finally broken into a broadly-based bull run. And as the New Year begins, the two factors that typically signal the Tercio de Muerte (the final act of a bull fight) — namely recession and excessive valuation — are nowhere to be seen in EM as a whole, suggesting there is still some room to run.

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The Wagging Tail

The year 2018 is the Year of the Dog in the Chinese zodiac calendar, which may be very fitting with respect to the outlook for EM over the coming year.

Dogs are known for their loyalty and companionship — not necessarily leading the journey but happy to be along for the ride among friends. While EM have gained significant sway in terms of the global economy (the International Monetary Fund estimates that Emerging and Developing economies now account for 40% of global output, which is double what it was just 15 years ago), they are still more of a tail that gets wagged by the developments in the more Developed Markets (DM).

This nature would seem to serve the EM economies well as the calendar rolls over and starts anew. Eight years into this global economic expansion, growth appears to be on a sustained upward trajectory against a synchronized expansion. All 45 major economies monitored by the Organisation for Economic Co-operation and Development (OECD) are estimated to have seen real GDP increase in 2017 and that is expected to be repeated in 2018 — something that has not occurred since 2007.

Looking beyond just those major economies, the IMF projects that 179 of the 192 countries for which they generate forecasts saw their economies expand in 2017 (best since 2007), with that number expected to creep up to an all-time high of 186 countries in 2018.

This unprecedented breadth of global growth is an important development and a key factor why the economic expansion appears to still have legs upon which to stand even at its ripe old age.

Much like bull markets, economic expansions are stronger when they are broadly-based because such an environment can help create a "virtuous cycle" of growth — rising demand in one economy creates rising demand for another country's exports, which in turn supports domestic demand there and further supports more exports as the wealth is spread from richer nations to those less so.

The data clearly bear this theory out. Global trade growth accelerated throughout 2017 and we are seeing what is arguably the first material and persistent acceleration in the gauge of merchandise trade volumes since the turn of the millennium — and note that the comparatively higher rates of growth in the 2000s coincide with China joining the World Trade Organization (China signed December 11, 2001), which resulted in a significant uptick in trade flows.

"more countries are joining the party"

The pickup in trade is particularly beneficial to the export-oriented EM economies and echoes what is playing out for top-line economic growth. With more countries joining the party, that means fewer are detracting from global growth — and against this, the pace of expansion accelerated for the first time this cycle in 2017 and that upward momentum is expected to be sustained through 2018. Indeed, with respect to EM as a whole, the macro outlook for 2018 appears to be an improved version of last year.

While China faces domestic issues (the debt and demographic problems are not going away anytime soon), the government (which has seen Xi Jinping's power consolidated following October's Communist Party Congress) has the capacity to weather the storm near-term and growth is expected to maintain an above-trend pace once again (though it is seeing a gradual and expected downshift). Policymakers are intent on trying to avert a crisis and deflate the growing credit bubble, but not in such a manner that growth gets choked off entirely.

India continues to see Prime Minister Narendra Modi's economic reforms gain some traction (and the recent wins by the ruling Bharatiya Janata Party in two state elections provide an indication that Modi's mandate will be re-upped in the 2019 elections) and growth there is slated to tick up, which helps spin the dial for the global add-up thanks to the world's sixth largest economy's increasing heft.

While Mexico has been a target of the Trump Administration, America's neighbour to the south has seen its economy perform solidly in recent years. It, however, runs into heightened uncertainty in 2018 against the tumultuous North American Free Trade Agreement (NAFTA) negotiations and impending Presidential and Congressional elections.

Venezuela remains a hot mess and is all but assured to experience the first major debt default since Argentina in 2007. Importantly, though, this will be an idiosyncratic event, with limited spillover outside the country's own borders.

Russia will likely continue to struggle but should see a sentiment swing that comes with hosting the FIFA World Cup (forecasts point to it eking out modest growth for the second straight year in 2018). There is a Russian presidential election in March, but with Vladimir Putin overwhelmingly expected to win his second consecutive term (and fourth overall), there is no expectation for anything but the status quo from a policy perspective.

The Middle East remains a hotbed of tensions and the "purge" by Saudi Arabia's Crown Prince Mohammed bin Salman against power-players in the region did not exactly help matters.

That said, the continued agreement on production curbs by the Organization of the Petroleum Exporting Countries (OPEC) and OPEC-adjacent oil producers (namely Russia), does provide for a somewhat rosier fiscal picture for those economies that have seen their financial position deteriorate significantly over the last three years, as oil prices collapse against substantial supply/demand imbalances.

One notable story in EM this year will be the two largest economies in South America. Brazil, despite the best efforts of its government, is on track to expand, shifting the on-again-off-again oscillation from expansion and recession back into growth mode (albeit modestly).

More significantly, after years of malaise, Argentina's economy is finally showing some nascent verve as the will for change has been met with the willingness of Mauricio Marci's government.

Watch Out for the Bark and the Bite

Another characteristic of dogs is that they can be temperamental — exuberance can quickly turn into growling through bared teeth, and vice versa.

Such volatility has always been a characteristic of EM equity markets, where their standard deviation of annual total returns has been 75% higher than that of their DM counterparts over the last decade.

But as was the case with virtually every asset class around the world, 2017 was a year of remarkable calm in EM stocks, with measures of volatility touching down to record lows as returns set new records.

While the base case remains that the good times will continue to roll in 2018 (albeit, with more modest gains than seen in 2017), there is still ample risk on the horizon with a series of concerns that could drive a return to more normal levels of volatility and bring the exuberant tail wagging to a stop.

First and foremost, as was alluded to earlier, political risks sit very much at the forefront. There are no fewer than five major elections in the coming year, including ones in Latin America's biggest economies of Brazil and Mexico which feature the threat of populist candidates gaining or attaining power (we dive deeper into this topic in the section below).

The outcomes of the flurry of EM elections to end last year — most notably Sebastian Pinera's victory in Chile and Cyril Ramaphosa assuming the leadership of the African National Congress in South Africa — proved well received by markets and the expectation is for economic reform-minded candidates to trump populist politics, but there is the possibility that outliers in the slate of elections over the next 12 months could sour sentiment.

Next, there is the foreign exchange risk. The basket of EM currencies rallied 11% against the U.S. dollar in 2017 and provided a nice tailwind for EM equity markets. While this sharp up-move was likely more a function of mean-reversion from significantly undervalued levels — and the expectation is that there is still some catch up to be made, especially given that current account balances among the group are not flashing signs of stress — any retracement would dampen an otherwise upbeat outlook.

And note, that to the extent that there is a depreciation in EM currencies, it could feed into another risk lingering over the outlook: inflation. A softening currency is inherently inflationary for the domestic economy since it makes the cost of imported goods more expensive. Add to that the fact that output gaps are increasingly diminishing and tight job markets could drive a push toward labour taking a larger share of the income pie, which could stoke "cost-push" price pressures, and there is a risk that policymakers could be misjudging the trajectory of inflation and find themselves forced to react more aggressively than currently thought.

But with all of this in mind, there is the scope for continued positive performance by EM assets. Unlike DM, valuations do not represent a constraint — price-to-earnings and price-to-book ratios remain in middle-of-the road territory with respect to their own histories — and actually provide relative value opportunities versus those more developed equity markets.

"we are not seeing ... speculative pile-on"

Moreover, even faced with multiples holding steady in the context of gradually rising global interest rates, the positive macro outlook is feeding into increasingly upbeat earnings backdrop in the EM and provides fundamental support for continued market strength. Analysts have become more optimistic on their forecasts for EM, with earnings upgrades now outpacing downgrades, and aggregate estimates for the group now pegging low double-digit earnings growth for 2018 following the 20% gains in 2017.

Furthermore, despite the rosier outlook from the analyst community and the rally in EM equities in 2017, international inflows into these markets, while healthy, continue to trend below their 2010 to 2014 averages. In other words, we are not as of yet seeing the type of speculative pile-on from non-resident investors that is typically associated with the warning lights starting to flash red.

So, while 2018 may be the Year of the Dog, there is no reason to expect that both EM economies and markets will turn in a dog of a year.

Latin American Politics

Latin American politics have traditionally been a powerful factor in determining what happens to equity markets in the region. The meltdown in Venezuela aside, political influence in recent years has mostly been benign despite massive corruption scandals and the occasional burst of populist rhetoric from Washington. A key reason for this is, the prevailing drift has been towards business-friendly government. This has been true whether regime change has come about through the ballot box or an enforced change through impeachment — the promise that new governments intend to deal with fundamental economic imbalances and improve the operating environment for business has bought them a good deal of slack from investors.

Thus, whilst the new Argentine administration has delivered immediate economic pain, investors have been happy to focus on consequent long-term gains and stock prices have moved up accordingly.

Similarly, Brazil rallied strongly following the ousting of the left-leaning Dilma Roussef. The centrist coalition led by Michel Temer, which replaced her administration, has hardly been a sparkling success, embroiled as it is by its own issues with past corruption, but its failure to deliver its keystone policy, pension reform, has not triggered a significant market setback. The implicit assumption is that there is unlikely to be a shift back to the previous populist agenda. Whether such complacency will continue to prevail throughout the run up to national elections, scheduled for October, is questionable.

With voters also going to the polls in Mexico in July, history suggests that, at a minimum, volatility in the region's biggest stock markets is likely to increase. It could be a lot worse if candidates with populist agendas look likely to win.

Latin American elections usually start to impact market performance six-to-seven months before the event if they appear likely to result in negative outcomes, so Colombia (which has Congressional elections in March and Presidential elections in May) should provide the first test of investor nerve according to the traditional timeline. However, although it is still unclear who will win there, as all candidates for the Presidency are broadly centre-right, the outcome of the race is not likely to be a game changer — hence, there should not be much turmoil in equity prices.

No such certainty applies to the Mexican elections, due in July. In part, this is due to the country' electoral mechanics whereby the winner of the contest for the Presidency is decided by a simple plurality — and that opens the door for a populist candidate who does not command a majority of the overall vote.

Currently the leader in opinion polls is Andres-Manuel Lopez Obrador (AMLO), the nominee of the leftist Morena party that he founded. AMLO was the runner-up in the two previous contests in 2006 and 2012 and was usually ahead at this stage of the contest, but previously he eventually lost out when a clear front-runner from the centre-right parties emerged.

At present, the support for Jose Antonio Meade (the PRI candidate) and Ricardo Anya (the PAN candidate) appears roughly equal, raising the spectre of a leftist victory by default — this possibility may have already been partly taken into account judging by the relatively poor performance of the Mexican market in U.S. dollar terms over the past six months, December's rally notwithstanding. Although the lack of a working majority in Congress will almost certainly restrain AMLO in office, his rhetoric still has plenty of scope to cause a few wobbles if he looks likely to win nearer the ballot.

Brazil goes to the polls in October. With compulsory voting and a second round run-off, should there not be a clear winner in the first round, there is less scope for a populist victory in the Presidential race than in Mexico. Thus, whilst ex-President Lula is heading the opinion polls at present, the market does not appear to be unduly alarmed despite the unpopularity of the present government.

Lula is espousing more radical policies than when he was in office, but he faces two significant obstacles to regaining power: firstly, it is still uncertain whether the Federal Court will allow Lula to stand and secondly, he regularly polls a very high rejection rate.

It is still not clear who is likely to be the main contender from the centre, but the controversial Jair Bolsonaro, the conservative populist leader of the Social Christian Party, has been making good headway on the right. The market may well wait for a few more months until the mist of battle begins to clear before reacting to the political runes — it could become interesting when it does.

Campaigns in Latin America usually focus on three main themes: social equality, corruption and economic competence. The relative influence of the three varies according to the electorate's recent experience. Change tends to occur when voters are profoundly dissatisfied with incumbent governments with respect to at least one and usually two of these issues — for example, Mauricio Macri attained power in Argentina only when corruption and the appalling state of the economy became unbearable.

The main threat to the political establishment in both Brazil and Mexico this year is the former. This, along with changing social dynamics (such as the rise in the number of declared evangelical Christians in Brazil) increases the possibility of surprise results and attendant political uncertainty. The lesson of the past couple of years elsewhere in the world has been that pundits have been poor guides to the outcome of elections. Fortunately, if this proves to be the case in Latin America, there is unlikely to be much fallout elsewhere in EM