GUARDIAN CAPITAL

Emerging Markets Quarterly Outlook

SECOND QUARTER – 2019

LAST YEAR'S SHOWERS ARE YIELDING THIS YEAR'S FLOWERS

Risks abounded in 2018. Concerns over rising interest rates, a strengthening US dollar, slowing global growth, and the rise of protectionist trade policies clouding the outlook, all weighed heavily on market sentiment, and given that Emerging Markets (EM) were amplifying the developments on Wall Street (as is seemingly customary in periods of uneasiness), resulted in fund flows out of asset classes across the EM complex.

Equities bore the brunt of the selling pressure against the marked increase in risk aversion that accelerated through the end of the year (all 11 industry sectors and all but one of the 24 component countries in the MSCI Emerging Markets Index were down for the year). However, EM currencies and bonds also turned in negative performance — all three were down for just the third time in the last 20 years (the others being 2013 due to the fallout from the "taper tantrum" and the peak of the global financial crisis in 2008).

In stark contrast to the growing chorus of calls exclaiming that the sky was falling in on the global economic expansion, however, the heavens remain firmly above our heads. While growth did moderate and underperform relative to the elevated forecasts laid out at the ebullient onset of last year, it did not collapse completely as was increasingly priced in over the last six months of 2018. Moreover, the fears of a contagion of financial crises across the EM proved to be unfounded, while trade tensions between the US and China have come off the boil as the latest threatened tariff increases were shelved indefinitely.

Against indications that the worst case scenario is not actually the most likely one, markets have undergone a drastic reversal over this year as sentiment normalized from its excessive pessimism. The MSCI Emerging Markets Total Return Index bounced 9.9% in the three months ended March, with all 11 industry sectors up solidly in the piece (with Cyclicals leading the way). As well, 20 of the 24 countries that comprise the index recorded gains in US dollar terms in the best breadth since the start of 2017.

Of course, as is normal when such outsized gains are experienced — Q1 represented the best quarter for EM equities in two years and the sixth best of the past decade — the question is whether the market has gotten ahead of itself? This is possibly the case in the short-term, but while there are plenty of risks remaining that could cause a change in course, there appears to be reason to be cautiously optimistic about the prospects for EM over the coming months.

Bluer skies behind the clouds

Global interest rates had been largely grinding higher since touching lows in the aftermath of the Brexit vote in June 2016, with the upward move picking up through 2018 against the increasingly hawkish tone from global central bankers. EM economies rarely, if ever, make progress when the US Federal Reserve (Fed) is tightening aggressively, and the US dollar is strong. Indeed, it was the early jump in rates and concurrent firming of the US dollar last year that brought vulnerabilities to the fore in Argentina and Turkey (the EM economies most exposed to changes in the external conditions through their reliance on foreign funding), that spurred on concerns that the stress could spread through the region.

As inflationary pressures remained benign, and concerns rose over the health of the global economy amid increased financial market volatility at the end of the year, major monetary policymakers made a material shift in their approach that led to a dramatic repricing of global interest rates. In particular, the adoption of a dovish tilt by the Fed last November, followed by the removal of all projected rate hikes for this year in March, and the announcement that the US central bank would stop allowing maturing securities to roll off its balance sheet in the Fall, was key in spurring on the global bond rally that brought yields down to lows last seen two years ago.

While it appears as though market interest rates overshot to the downside, the room for significant upward adjustments remains fairly limited given central bankers appear committed to erring on the side of caution and keeping rates lower for longer. The renewed low-interest rate environment, combined with the fact that much of the needed rebalancing within EM economies was forced through last year, means that the likelihood of the liquidity issues that weighed on EM performance in 2018 returning to the front burner looks to be relatively low.

As well, the fact that the near-term ceiling on interest rates has moved lower also likely provides some scope for the higher-yielding EM currencies to find a bid from still-low levels, which would further help ease financial conditions across the EM while also providing an added support to equity total returns.

Growth green shoots

The other significant downside risk that has eased is related to growth as calls for an imminent global recession have ebbed in recent months. The sharp pullback in activity gauges globally registered through the second half of last year has given way to signs of stability in growth at what are still fairly decent levels, albeit with more modest momentum than was seen at this time last year.

The continued global expansion is a positive for EM economies which are highly geared toward the economic cycle but it is especially noteworthy that the bulk of the expected moderation in growth is likely to be concentrated among the Developed Markets (DM) where the US is decelerating from the tax cut-induced bounce in 2018, Europe continues to struggle to re-establish its footing amid ongoing political uncertainty, and Japan remains stuck in neutral.

In contrast, the comparatively higher levels of slack among the constituent economies in the EM are indicative of the region being at a relatively earlier stage of the business cycle and allow for stronger underlying momentum — something that has been affirmed by recent data for the aggregate region perking up to some of its best readings since last summer.

The key to EM performance is China: while the world's second-largest economy is continuing to experience a secular downshift in its growth from the unsustainably high rates that prevailed over the previous decade, concerns over a "hard landing" have generally abated. A big reason for this shift in sentiment is that policymakers in Beijing have turned on the stimulus spigot. Monetary authorities have reversed course on their efforts toward tightening financial conditions to rein in escalating debt burdens via multiple cuts of required reserve ratio and large-scale injections of liquidity into the domestic financial system. On top of that, the Chinese government has announced fiscal policy stimulus measures totalling RMB¥4 trillion ($600 billion) of which half is tax cuts, and the other half is funding for local infrastructure projects.

These measures are designed to support the domestic economy reach its stated growth target and help mitigate the impact on the Chinese economy of the ongoing trade dispute with the US. The latter is starting to be felt in a more meaningful manner as the hangover from American importers front-loading orders ahead of the then-expected increase in tariffs in the New Year sets in for exporters. But while developments on this file remain fluid, there are signs of continued progress on a trade deal that could result in an agreement sooner rather than later which would reduce a key headwind for the outlook.

Elsewhere, there are some other bright spots, particularly Latin America (which will be discussed in more detail later) and India. For the latter, expectations are for the world's second most populated country to again sit atop the global growth leaderboard supported by government stimulus and more accommodative monetary policy abetted by moderating inflationary pressures — though there are rising concerns that Prime Minister Narendra Modi's reform-oriented policy agenda could see a weaker mandate in the upcoming elections, while the escalating tensions between India and Pakistan are another source of geopolitical risk.

The bloom is not yet off the rose in markets

The moderation among DM, combined with the generally stable pace of expansion among EM in aggregate, suggests that the EM's growth premium should begin to expand again and draw an uptick in investment inflows into the groupings' assets. These developments would underpin a further expansion of valuation multiples in the EM, which though they may not be as compelling as they were three months ago given the sharp recovery of equity markets over the period, still represent a decent discount to their DM counterparts and are reasonable in their own right with price-to-earnings and price-to-book ratios hovering just under their longer-term averages.

Additionally, earnings growth in the EM proved to be resilient through the second half of 2018, and forward earnings momentum has taken a notable swing to the upside, with analyst earnings revisions ratios improving in recent months in part boosted by more benign expectations for the US dollar. That said, there is reason to anticipate that the Q1 earnings season could prove to be rockier than currently expected against indications that domestic demand in the region, particularly in China, was much softer than projected to start out the year.

While risks to the outlook obviously still remain and subdue investor risk appetite, the EM's underpinnings would still suggest that while assets have performed well in recent months, the bloom is not yet off the rose and there is potential for further positive performance as sentiment continues to improve further.

Speaking Latin

Latin America has been a source of general disappointment for much of the cycle as fiscal largesse, political scandal and corruption, and related persistent policy uncertainty have provided significant headwinds for the region. Last year was no exception as the region again underperformed as the crisis in Argentina, protests in Brazil, continued collapse of Venezuela and the angst over US trade policy, for a region that is highly dependent on trade with and investment flows from the Americas, weighed on growth and sentiment.

There is, however, reason for cautious optimism for the EM sub-grouping given that most forecasters are flagging Latin America to be one of the few regions in the world to post an acceleration in growth over the coming year, granted the pace will still be below par for this stage of the economic cycle.

Monetary policy is expected to remain accommodative (or even ease) in most of the region as inflationary pressures are benign outside of Argentina and Mexico and policymakers err on the side of caution. On the fiscal side, while budget constraints limit the degree of stimulus likely available, the recent tilt toward business-friendly and reform-oriented governments in Chile, Colombia and, most recently, Brazil, have buoyed market sentiment in the region and supported investment inflows.

In terms of Brazil, the shine of the new government in the region's biggest market has yet to wear off. Hopes for progress on much-needed pension reforms and increasing openness for foreign investment in the country are supporting business and consumer confidence. The key test will be the government's ability to deliver on its promises of putting the country on a more sustainable fiscal path — and something tangible is needed sooner rather than later as the honeymoon period for incoming presidents has traditionally been shown to be short-lived.

The direction of policy in Mexico, Latin America's other heavyweight, faces more concern from the investor community given the left-wing populist government's less orthodox approach. Little has been accomplished on the policy front so far, but what has been done has generally gone in the wrong direction (most notably, the cancellation of a partly-constructed international airport and stopping auctions for private oil contracts). That said, the new president is highly popular and consumer sentiment is at all-time highs which should be positive for domestic demand, while the local market should also benefit from the reduced specter of increased barriers to trade with the US thanks to the updated agreement (though, it still needs to be signed into law).

Finally, while Argentina remains beleaguered, the worst is now arguably behind it, and the drag it is creating on the overall region's growth rate is expected to lessen over the coming year and leading up to this October's election. As well, the country's upcoming inclusion in the MSCI Emerging Markets Index in June should serve to support an inflow of investment dollars into its borders. The other Andean states (aside from Venezuela, which remains in a near-constant state of turmoil) are on track to see sustained expansion as global growth concerns and trade tensions ebb, and commodity prices recover lost ground.