GUARDIAN CAPITAL

Emerging Markets Quarterly Outlook

SECOND QUARTER – 2020

THE BEST LAID PLANS…

Things were looking good for 2020 out of the gates. The main risks that hampered activity for much of the last few years were moving to the backburner, the most important for Emerging Markets (EM) being that tensions between the US and China were showing signs of softening as progress was made toward a nascent trade agreement. At the same time, there were growing signs that the pendulum of economic growth was broadly swinging back toward the positive. With central bankers globally indicating a strong preference toward erring on the side of caution, tighter monetary conditions – which have their fingerprints on almost every economic downturn in the post-WWII era – looked unlikely to derail this momentum anytime soon, suggesting that the global expansion (and the bull market with it) could continue into the new decade.

Of course, to borrow from Scottish poet Rabbie Burns, *"The best laid schemes of mice and men/go often askew/and leave us nothing but grief and pain/for promised joy!"*

Those sanguine forecasts have been dashed by the spread of the severe acute respiratory syndrome coronavirus 2 (SARS-CoV-2) and the resultant coronavirus disease 2019 ("COVID-19"). While there were initial hopes to contain the contagion – the first reported cases were in Wuhan, a metropolis of 11 million in the Hubei province in central China on December 30, 2019 – this clearly has not happened, and the approach worldwide has since shifted toward mitigating the pace of the outbreak, so as not to overwhelm healthcare systems.

Governments around the world have implemented unprecedented measures to help "flatten the curve" of the spread – with earlier-hit regions in north Asia leading the way. Schools, public spaces, festivals & events, non-essential businesses and borders have closed and there is wide adoption of social distancing protocols. There are indications that these efforts are having the desired effect of slowing the spread of COVID-19. However, the stringent measures have also resulted in effectively idling a significant amount of production capacity across

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the globe and all but assuring an unprecedented contraction in economic activity – China reported its first contraction in output in decades with real GDP falling nearly 7% year-over-year in Q1 (and almost 10% versus the last three months of 2019), and with the expectation of the rest of the world echoing this in the current quarter.

The crisis understandably spurred on a completely new level of uncertainty, resulting in a tidal wave of panic selling that stopped the decade-long global bull market dead in its tracks. Investors pulled funds out of EM at among the fastest rates on record in Q1, seemingly selling assets indiscriminately in a rush for the exits from anything that carried any perceived risk. Overall, the MSCI Emerging Markets Total Return Index plunged 23.6% over the first three months of 2020, marking the worst quarter for EM equities since 2008. All 26 component countries in the index saw their regional stock markets plunge (more than two-thirds of them recorded declines in excess of 30%) and all 11 industry sectors were deep in the red as well.

For their part, EM bond prices (as per the Bloomberg Barclays EM Aggregate Total Return Index) plunged 9.5% in the worst quarter for the asset class since the Asian/Russian financial crisis in 1998, while the the MSCI Emerging Markets Currency Index plunged 6% (the worst quarter since China devalued its currency in the summer of 2015). Investor appetite for anything EM evaporated, with the plunge in commodity prices further exacerbating the issue for the grouping's natural resource-dependent economies.

The Road to the Other Side

Amid the heightened uncertainty, policymakers stepped up with governments worldwide (especially in Developed Markets (DM)), introducing significant stimulus packages to try to mitigate the economic hit. At the same time, central banks slashed interest rates and pumped liquidity into the financial system to stave off a potential financial crisis.

These actions have helped to provide some stability to financial markets and diminish economic tail risks, while indications that infection rates are ebbing and many countries are starting to foment plans to begin reopening their economies has provided a lift to sentiment.

Indeed, there are more and more signs that activity is getting back to normal in parts of Asia, as societal lockdowns put in place at the end of January are being gradually lifted. In China, the epicentre of this pandemic, estimates indicate that the economy is back to running at about 85% of normal capacity, with that percentage expected to further perk up in short order as limitations on activity are also rolled back throughout the country.

While hopeful, these developments are being viewed with cautious optimism as there is no certainty that the worst of this global crisis has fully passed, especially in EM.

As seen recently in Malaysia, the risk of outbreaks of COVID-19 remain a real threat in Southeast Asia and other areas that are just starting to see the disease start to spread. Further, a second wave of contagion is very likely in areas that have already started to ease – as seen recently in Singapore, for example.

The severity and the degree to which any renewed outbreaks are contained is therefore of significant importance – especially in EM where healthcare systems are generally weaker than their DM counterparts and already under pressure. As well, social distancing is inherently more difficult given how densely packed some cities in the region can be.

Moreover, the ability of EM economies to regain momentum should the spread of COVID-19 be largely kept in check within the group is dependent on how quickly DM economies get back to business. While the current crisis began as a supply-side problem in China, the shuttering of large swaths of the global economy represents a massive demand shock – the fact that Chinese factories are able to run at full capacity does not matter if their order books

are empty against the collapse in demand from export markets. And what happens in China will create knock-on effects in those other economies that are heavily dependent on the Middle Kingdom created an increased dependence through significant investments over the last decade as part of its Belt and Road Initiative.

Finally, EM policymakers, in general, face larger constraints than those in DM in supporting their domestic populations and economies, due to their already stretched fiscal positions, and their ability to tap into international financial markets. While many EM countries (predominantly those in Asia and Central Europe) are better positioned to provide support than in previous crisis periods, others will face difficulties that could well propel a new wave of fragile currencies into financial market headlines.

This is all to say that while measures of market stress have ebbed from their peaks, they have not fully subsided and EM financial markets in particular are likely to remain volatile for some time – though, as seen in previous periods of heightened uncertainty, any small ray of light cracking through may well trigger powerful rallies even if they are not sustainable.

The unprecedented economic challenges facing governments mean that recovery may prove slow and leave a trail of corporate corpses. In this environment investors need to pay close attention to the financial strength of the companies in which they are invested. This has always been a key element of the quality-focused investment process, but added emphasis is currently warranted on forensically examining EM holdings for any sign of potential weakness.

When the dust settles, strong companies will be able to gain significant market share, suggesting that the current period perhaps represents a once-in-a-decade opportunity for those investors with a long enough time horizon and willingness to look through near-term headline risks. An opportunity that is emphasized by the price-to-book ratio for the MSCI Emerging Markets Index, currently sitting two standard deviations below its 10-year average and at a discount to DM that is nearly double the norm of the past decade.

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