Ashmore

ANNUAL OUTLOOK

Equity Outlook 2020: Emerging Markets

By Edward Evans

Emerging Markets

The 2020 outlook for Emerging Markets equity is brightening. After a prolonged earnings recession from 2011-2015, Emerging Markets staged a recovery in 2016 and 2017, only for it to be interrupted in 2018.

In our 2019 outlook, we expected the recovery to be reinstated and for Emerging Markets to deliver strong absolute performance and to outperform developed markets. While Emerging Markets bore the brunt of elevated geopolitical protectionism that exacerbated a global economic slowdown, the rally towards year-end led the MSCI Emerging Markets to return 18.4%. This was comparable to Europe and Japan, although lagged the US, which saw its best return since 2013.

Over 2020, we expect the modest cyclical rebound that commenced for Emerging Markets in Q3 2019 to continue and to support equity returns. Whether the recovery 'green shoots' broaden and flourish relies primarily on improvement in Sino-US relations. In turn, this would trigger greater capital investment, improve the transmission of ample USD liquidity to real economies and boost corporate earnings. The principal risks emanate from developed markets due to a combination of overvalued markets, fading growth prospects, inadequate policy options and rising populism. Over 2020, an active investment approach that can respond to diverging scenarios looks best placed to generate sustained performance for investors.

Macroeconomic data – Turning more constructive

Since early 2018, global economies have undergone a significant slowdown driven by weakness in manufacturing and export orientated industries. What commenced as a cyclical downturn, triggered by tighter USD global liquidity and a more restrictive Chinese policy stance, morphed into a more severe global slowdown driven by geopolitical trade disputes.

The tail of 2019 saw incremental signs of stabilisation in global leading indicators, with Emerging and developed markets PMIs returning to expansionary territory by November. The key catalyst for a more meaningful and broad based pickup in economic activity, and consequently also corporate capital expenditure and investment, is improved relations between superpowers US and China. Should the 'Phase 1' trade deal announced at year-end be realised, this could serve as a powerful driver to unlock the transmission mechanism of expansionary policy on real economies.

Investors will likely spend much of 2020 disentangling the effects of the trade dispute from 'normal' cycle drivers

Investors will likely spend much of 2020 disentangling the effects of the trade dispute from 'normal' cycle drivers. Emerging Markets were among the first to be impacted by the global economic cycle slowdown and are well placed to be the first to recover. As can be expected for such a heterogeneous universe, the pace and intensity of rebound will vary by country, industry and company, and investors should be wary of generalisation.

Domestic economic growth has been resilient supported by measured policy easing and this should continue to be the case in 2020. For example, in Brazil, anchored inflation expectations and reform progress are contributing to a pickup in consumer confidence and credit growth, which should help to underpin economic recovery. India experienced its own domestic cyclical downturn, in part triggered by an election cycle 'hangover' and a domestic liquidity shock. The expected transitory nature of these headwinds should place India better in 2020.

The IMF forecast Emerging Markets economies to grow 4.6% in 2020, a 0.7% increase on their 2019 expectation. They believe advanced economies will reflect their later cycle stage and see growth largely stable at 1.7%, the same as 2019.

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Policy stance – Set to remain accommodative

The trajectory of Emerging Markets macroeconomic data is often informed by global and domestic policy stances. The year is expected to see central bank policy remain accommodative. The Federal Reserve's rhetoric points to policy stabilisation, where possible, and it will move to the sidelines as the US Presidential election campaign progresses. The view that the outlook for Sino-US trade 'hangs' on the Presidential winner is an oversimplification. The US stance towards China has received broad based internal support and hence is unlikely to be fully reversed. Investors should also be mindful of the Democratic Party's 'anti big tech' campaign as a potential source of market volatility, and opportunity.

The trajectory of macroeconomic data is often informed by global and domestic policy stance

The policy direction of new ECB president, Lagarde, also bears monitoring, although it is anticipated to be market friendly. Pro-cyclical fiscal policy is expected to play a more important role in 2020, especially in Japan, Germany and the UK, not least given the pressure of increased populism. All else equal, fiscal expansion would be reflationary and positive for Emerging Markets.

In China, there are signs of selective policy stimulus. For example, incremental monetary easing, more market orientated loan pricing and Hukou reform. However, investors hopeful for more pronounced measures may be disappointed unless the overarching strategic goal of maintaining social stability through full employment is threatened. Consequently, identifying industry and stock policy winners will likely remain key to generating alpha.

Counter cyclical stimulus measures are expected in Indonesia and India. While policy is expected to be more muted in Taiwan given elections. In Brazil, the government's commitment to reducing the size of the state and stabilising its debt profile, together with ongoing reforms, is a positive for investor confidence, capital expenditure and earnings momentum. Colourful politics and policy execution pose the biggest challenges to implementation. Social unrest that flared up towards the end of 2019 in Peru, Chile and Colombia, risks reversing reform implementation and triggering further FX volatility, although the fiscal stimulus response is positive for consumption.

Business cycle – Country, industry and stock specific

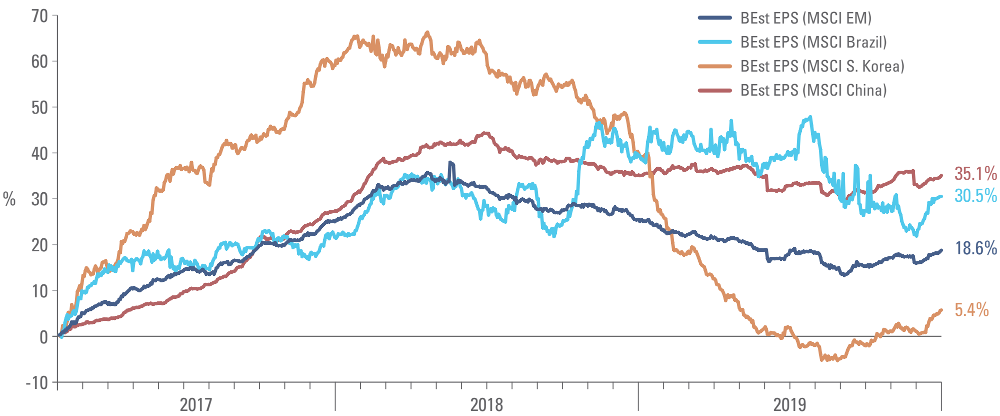
The last 18 months have seen Emerging Markets earnings move largely sideways. On an unweighted US Dollar basis, market expectations for 2020 earnings are 13%. They are 9% for the S&P 500. Overall, Emerging Markets earnings should benefit from a continued cycle rebound, as well as lean inventories and cost discipline at the corporate level.

One should caution against generalised comparisons. Emerging Markets comprise a myriad of evolving economies and stock market compositions. Consequently, their economic and earnings trajectory are typically highly divergent and hence offer the potential for significant investment opportunities.

For example, the Korean semi-conductor industry saw net income contract 85% in 2019, yet the market expects them to rebound 98% in 2020. The chart below offers some context for the inherently heterogeneous nature of Emerging Markets earnings cycles from a country perspective. A similarly diverse picture applies among different industry groups and stocks.

Fig 1: **Earnings per share for the MSCI EM and significant markets over past 3 years**

Emerging Markets have rerated and earnings will increasingly be required to drive performance in 2020



Source: Bloomberg, Ashmore.

Identifying positive industry inflections and corporate self-help cases, where costs and capital expenditure have been controlled, will remain key to alpha generation.

Emerging Markets rerated at the tail of 2019 and absolute valuations are around long-term average, the MSCI EM index trades at 12.9X PER. Consequently, earnings will increasingly be required to drive equity performance in 2020.

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Market implications – extreme bearishness set to reverse?

One of the key characteristics of 2019 was persistently poor investor sentiment towards perceived risk assets, including Emerging Markets. This was reflected in reported consistent outflow trends, high cash levels and light investor positioning.

The increased relative attractiveness of Emerging Markets compared to developed markets could see this skewed investor stance reverse. Indeed, the prospect at year-end that global geopolitics may turn calmer alone prompted a meaningful improvement in risk appetite and led Emerging Markets to outperform developed markets. Passive funds also bucked the year long trend and begun reporting sustained net inflows, which is often a leading indicator for a change in investor sentiment in general.

Emerging Markets Small Cap

Emerging Markets Small Cap comprises high returning companies that offer investors enhanced exposure to Emerging Markets secular growth drivers. These positives have not been reflected in recent price performance and since 2016 smaller companies have lagged larger cap peers. Significantly, 2020 should see several of the headwinds that faced smaller companies reverse. The catch up potential is meaningful and idiosyncratic stock specific performance drivers, and the potential for alpha generation, remain compelling.

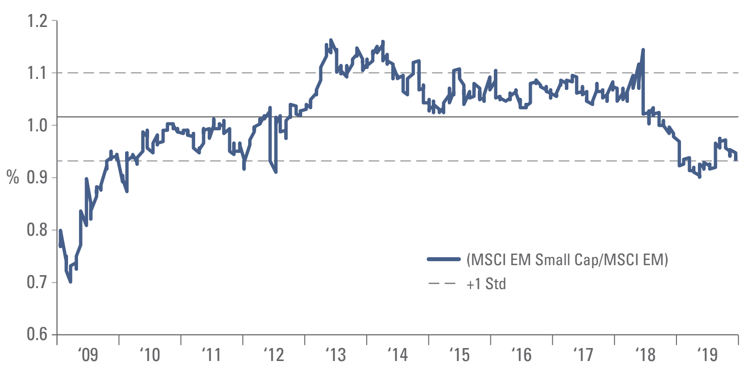
Recent subdued domestic economic growth and financing conditions in certain key countries has been a disproportionate headwind to smaller companies operating environments. This has pressurised earnings and led earnings expectations to disappoint. For example, India, which is a large component of the small cap universe, experienced its own domestic cyclical downturn. This was triggered by an election cycle 'hangover', a domestic liquidity shock following a loss of confidence in Non-Bank Financing Companies and a late monsoon that elevated food inflation. This weighed on investor and consumer confidence, as well as credit growth. To make matters worse, smaller companies were negatively impacted by a local regulation change that reduced ownership levels. Since 2017, Indian smaller companies fell 30% and underperformed India larger cap stocks by 29%. However, Indian authorities are well placed to respond given a strong parliamentary majority. So far, they have loosened monetary policy and embarked on meaningful fiscal stimulus. This is a positive for activity levels, domestic liquidity and the backdrop for smaller companies in particular.

Smaller companies catch up potential is meaningful

A similar situation has been unfolding in Brazil. The past two years have seen smaller companies outperform larger cap peers as the economy has started to recover, interest rates have fallen and consumer demand has increased. Parallels can also be drawn at a global level. Since early 2018, global economies have undergone a significant slowdown exacerbated by geopolitical trade disputes. This has led to distorted stockmarket performance and narrow investor positioning reflected in persistently poor sentiment towards perceived risk assets, including smaller companies. The tail of 2019 saw incremental signs of stabilisation in global leading indicators. Should this trajectory be sustained in combination with abundant US dollar liquidity, it should trigger a review of asset allocations to the benefit of smaller companies.

The catch up potential is meaningful. Smaller companies lagged performance has led valuations to look notably attractive. Smaller companies trade at a historically wide discount compared to Emerging Markets, as shown below.

Fig 2: **Risks disproportionately priced into EM smaller companies –**
Forward price-earnings MSCI EM Small Cap / MSCI EM



Forward P/E (12 months)	
MSCI EM Small Cap	12.2%
MSCI EM	12.9%
MSCI World	17.0%

Source: MSCI, Bloomberg.
Data as at 31 December 2019.

Most importantly, the large universe of smaller companies globally continues to offer active investors considerable scope for alpha generation. The universe comprises high returning and growing companies given their earlier stage of development. They are underowned and under researched and offer a means of portfolio diversification given no overlap with larger capitalised portfolios or indeed likely other small cap exposure of investors. They also display a comparable level of volatility to larger caps. These attributes have led smaller companies to outperform large caps over time. Investors are best placed to take advantage of periods of lagged performance and attractive valuations to build exposure.

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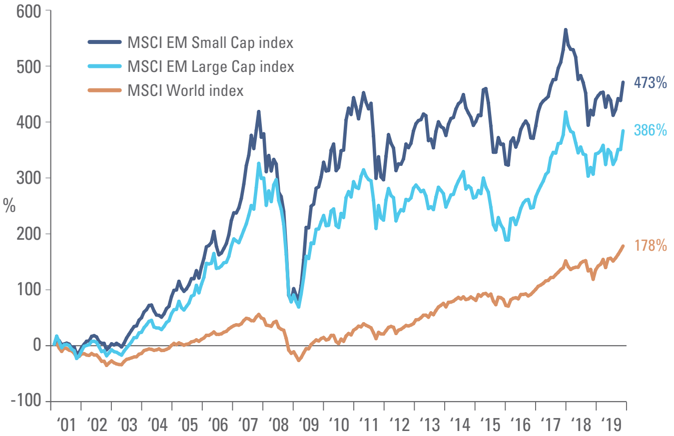
Fig 3: **Strong stock market returns and lower volatility**



Volatility		
Index (Net)	**3 years (Ann.)**	**5 years (Ann.)**
MSCI EM Small Cap	**13.2%**	**14.6%**
MSCI EM Large Cap	14.6%	16.0%
MSCI World	11.3%	11.7%

Source: MSCI, Bloomberg.
Data as at 31 December 2019.

Risks to smaller companies primarily revolve around idiosyncratic stock specific events. This is best mitigated by maintaining strict adherence to owning high quality businesses with established track records that are able to self-sustain their growth trajectory.

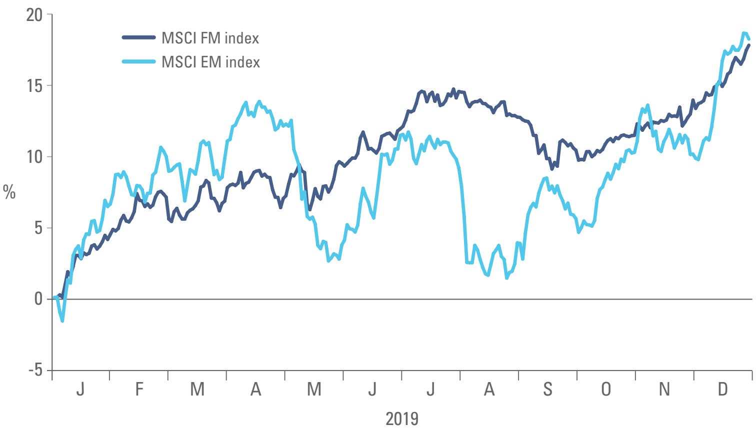
Frontier and African Markets

2019 saw Frontier Markets deliver strong absolute returns in US dollars with a less volatile performance profile compared to developed and Emerging Markets, which moved largely in lock-step. It was a welcome sight after the surprisingly poor and, at least superficially, correlated performance of Frontier Markets with global peers in 2018. 2020 should see several catalysts spur increased investor attention to the compelling tactical and strategic case for investing in Frontier and African markets.

The only disappointment in 2019 was that not more investors benefitted from these structurally higher returning and higher yielding markets that also display lower volatility compared to Emerging Markets. 2019 was characterised by persistently poor investor sentiment towards perceived risk assets, including Frontier Markets. This was reflected in reported consistent outflow trends, high cash levels and light investor positioning.

Frontier Markets delivered strong absolute returns with pronounced lower volatility than EM

Fig 4: **Strong absolute performance of Frontier Markets in US dollars –** Index performance



Volatility	
Index (Net)	**3 years (Ann.)**
MSCI FM	**11.2%**
MSCI EM	14.4%

Source: MSCI, Bloomberg.
Data as at 31 December 2019.

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2020 could see this picture reverse as investors increasingly recognise the benefits of adding Frontier Markets to their global allocations. There are a number of key catalsyts:

Frontier Markets comprise some of the world's fastest growing economies which stands in stark contrast to expected ongoing decerlation in developed countries. For example, 2020 GDP growth is expected to be in the range: Vietnam 6.5-7%; Phillippines 6-6.5%; Egypt 5.5-6%; Kenya 5.5-6%; Kazakhstan 3-4%; and Peru 3-3.5%. This is a particularly supportive backdrop for Frontier Market companies, not least given they typically operate in underpenetrated sectors, to generate strong revenues and earnings.

Strong and improving economic growth trajectories are typically domestic in orientation and are being boosted by structural reform. There are several notable examples where this is currently the case. These can be grouped by primary reform driver. For example: there is evidence of **enhanced institutional framework** in Kazhkstan, Kenya, Ethiopia and Pakistan; **strong economic reform** in Egypt, Ghana and Sri Lanka; **improved security** in Pakistan and Egypt; and **stock market liberalisation** in Vietnam and Kuwait. All of which create ample investment opportunities for active stock pickers.

Alpha generation opportunities remain abundant providing global asset allocation diversification as well as return enhancement benefits

Currency risk has been reduced given several of the more at risk currencies have already devalued to more sustainable levels. For example, Nigerian Naira in 2016 and 2017, Egyptian Pound in 2016 and the Pakistani Ruppee in 2019. Furthermore, some countries have pegged, or managed ties, with the US dollar, for example the Gulf states, which also reduces FX risk.

There will be a significant liquidity event in 2020 given Kuwait, currently 38% of the MSCI Frontier Markets (FM) index, is set to join the MSCI Emerging Markets in May. Index reclassifications are a nuisance given they can trigger market noise and distortion. However, they also serve to remind international investors of the significant development made by Frontier Markets. For managers unconstrained by index definitions, such as Ashmore, the investable universe remains unchanged given Kuwait continues to display early reform charactersitics. In fact, this latest index reclassification will render the MSCI FM largely irrelevant as a representation of the opportunity set.

Frontier Markets display notably attractive valuation metrics. These include structurally higher returns and higher dividend yields compared to more developed peers, yet they trade at a meaningful valuation discount. Indeed, the discount is even greater if the largest country market Kuwait, that has seen disproportionate porftolio flows ahead of index reclassification, is excluded.

Fig 5: **Frontier Markets valuation metrics**

	Return on equity	Dividend yield	Price to earnings
MSCI FM index	**14.6%**	**3.9%**	**12.0%**
MSCI EM index	11.4%	2.6%	12.9%
MSCI World index	12.2%	2.4%	17.0%

Source: Ashmore, Bloomberg. 23 December 2019. Forward Price to Earnings. Indices shown as an indication only.

Finally, yet most significantly, alpha generation opportunities remain abundant. This reflects the little owned, under researched and primarily domestic orientated investment opportunities. Our investable universe spans over 30 global markets and over 750 investable stocks and is unconstrained by index definitions. This enables us to build 'a portfolio of everything you do not already own' and provide global asset allocation diversification, as well as return enhancement.

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