Ashmore

ANNUAL OUTLOOK

Equity Outlook 2018: Emerging Markets

By Edward Evans

2017 was the best performing year for Emerging Markets equity since 2009, both in absolute and relative terms. The MSCI Emerging Markets index returned 37.5% and outperformed the MSCI World by 14.4%. Just as noteworthy was the nature of the market rally which was almost entirely driven by corporate earnings growth with little multiple expansion. Consequently, in 2018 investors are being asked to pay still reasonable valuations for improving economic fundamentals, well supported earnings growth and the potential for another strong, albeit likely more modest, year of returns.

Economic fundamentals

In 2018, Emerging Markets are expected to see support from an ongoing synchronised pick up in global growth. Investor sentiment should also be buoyed by an acceleration in the growth differential between emerging and developed economies. The IMF forecast 2018 emerging market and developing economies GDP growth to be 4.9%, a 2.9% growth premium compared to advanced economies. The gap is forecast to increase to 3.2% in 2019.

Growth prospects are almost uniformly favourable across emerging economies, in several cases supported by pro reformist leaders. In China, supply side reform and financial deleveraging, is likely to mean economic growth softens. However, a focus by the authorities on enhancing the quality rather than the quantity of growth should be regarded as a positive. This can also boost targeted and related industries, such as technology and financials, and provide attractive investment opportunities. Steps to greater centralise control and regulation, while not consistent with Western ideologies, help to reduce structural risk and balance maintaining growth with reform implementation.

In India, the positive impact of recent reforms, including expanding the formal tax base and simplifying tax, should become more evident in 2018. Fiscal stimulus is expected ahead of the 2019 elections which, coupled with improved credit extension following the bank recapitalisation, should support growth.

In 2018 economic growth in Brazil and Russia should continue to pick up. 2017 saw inflation fall to record lows and a corresponding easing of monetary financial conditions. The pace of monetary easing will likely slow but easier financing conditions should support a consumption recovery from a low base. Politics may be a source of market volatility, especially in Brazil's case given uncertainty surrounding 2019 elections, although this looks unlikely to derail ongoing economic recovery.

The benefits of pro reformist leaders should also be a positive in particular in Indonesia and hopefully in future in Chile given recent new leadership. There are exceptions, most notably Turkey and South Africa although recent political changes in South Africa may trigger more reformist policies.

After the longest Emerging Markets earnings recession on record, 2017 saw a strong rebound in earnings which looks well placed to continue in 2018

Economic rebalancing over recent years has seen trade balances improve reducing Emerging Markets vulnerability to monetary policy normalisation in the developed world. Emerging Markets currencies appreciated compared to the US dollar in 2017 yet remain competitive. Greater confidence in emerging economic growth should boost capital inflows, support currencies and release pent up domestic demand triggering domestic growth cycles. A refocus on strong Emerging Markets fundamentals will be welcome after several years of developed world central bank dominated headlines. It will also likely lead to increased divergence and investment opportunities among emerging countries as their economies develop and close capacity gaps at different speeds.

Corporate earnings and profitability

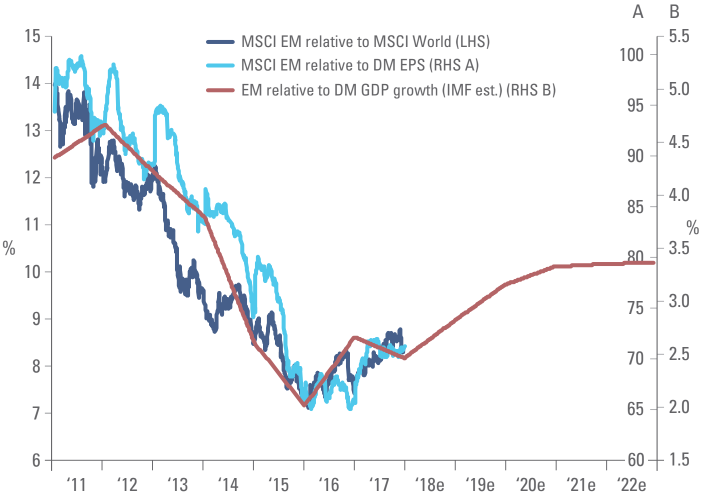
After the longest Emerging Markets earnings recession on record, 2017 saw an approximate 30% rebound in earnings and an improvement in earnings expectations. The recovery has been broad based with nearly all countries and industry groups participating, albeit led by technology stocks.

A positive global growth backdrop should continue to support top line corporate growth. Profitability also looks to be well supported given ongoing improvement in capital discipline and cost allocation. This is leading to higher free cash flow generation and the ability to deleverage balance sheets.

The pace of positive earnings revisions is expected to moderate and the opportunity for earnings to beat estimates will likely be more difficult, not least given the higher base. However, current earnings expectations for 2018 of around 14% look well supported. Earnings momentum is anticipated to remain broad based with currently only one country and no industry groups expected to see deterioration.

Historically, outperforming emerging economic growth compared to developed economies has a close relationship with outperforming earnings growth and also outperforming stock markets. We see little reason why this relationship should breakdown in 2018.

Fig 1: **GDP growth, earnings and equity performance**



Source: Bloomberg, MSCI, IMF, Ashmore. Data as at 31 December 2017.

Risks

The primary risk is the ability for developed world central banks to unwind quantitative easing without triggering economic and/or stock market dislocation. To date, the process has been facilitated by quiescent inflationary pressure and a supportive global backdrop. This could change. Importantly, measures to normalise policy are being driven by the desire to replenish policy tools to respond to future economic challenges. They are not in response to runaway growth and/or inflationary pressure. On this basis, we ascribe a low probability to a return to a strong US dollar environment.

While US tax reform may support sentiment, the positive impact on the economy is expected to be underwhelming. Corporates are not cash constrained, the prime consumer beneficiaries are high earners who have a lower propensity to spend and growth upside is limited given the mature stage of the US cycle. It can, however, be a short term source of market volatility and rotation which may provide an investment opportunity.

In Emerging Markets, concerns over China's ability to achieve growth targets while managing the complex transition of its economy will periodically resurface. However, for now investor concerns have rightfully dissipated. The volatility of sentiment towards China may reduce over time as investor understanding of the dynamics of a Chinese controlled economy broadens.

This leaves investor complacency. We mitigate this by being mindful of likely increased emerging economic and market differentiation and ensure we remain focused on fundamentals ready to take advantage of mispriced opportunities.

Valuations and investor positioning

An over 30% market move would normally point to stretched stock valuations. However, this is not the case. Market strength has been matched by improved corporate earnings growth. At the start of 2017, the MSCI Emerging Markets index was valued around 12x price-to-earnings ratio. It is approximately the same value today.

The long run valuation average for the index is also around 12x reflecting how undemanding current valuations are compared to history. Furthermore, the composition of the index has markedly changed over the past several years. Low margin assembly and exports have reduced in importance while structural growth consumption and technology have increased. Consequently, a rerating of the index could be expected, if only to reflect composition changes. Valuations compared to developed markets remain attractive with the MSCI World index trading around 17x.

Investor flows have returned to emerging markets with EPFR citing USD 86bn of net inflows to dedicated emerging market funds over 2017. This has served to recoup some of the USD 91bn of net ouflows witnessed since 2013.

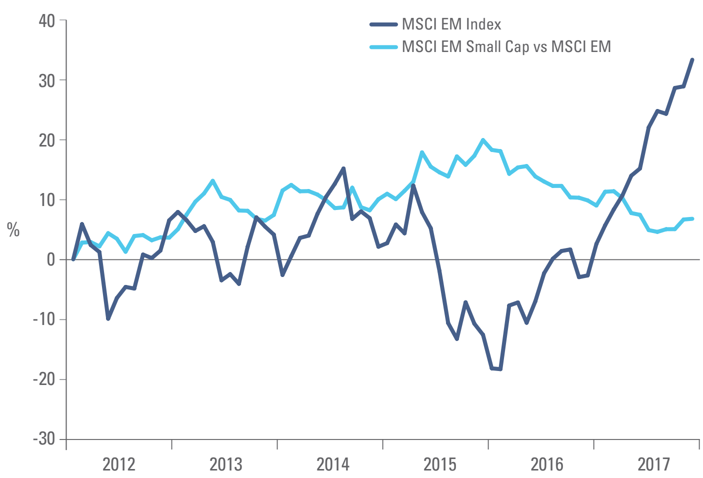
We believe this data is indicative of the start of a more significant rotation back to Emerging Markets by investors attracted to their strong fundamentals.

Emerging Markets Small Cap

In 2017 the MSCI Emerging Markets Small Cap index delivered strong returns, around 34%, although lagged the rally in the mainstream MSCI Emerging Markets index. Larger cap stocks outperformed small cap in part given their wider ownership and their greater exposure to technology stocks which led the rally.

As sentiment has improved towards Emerging Markets in general, we would expect investor attention to increasingly turn to less covered areas of the market including smaller companies. Investors are likely to be attracted by smaller companies' significant exposure to domestic consumption driven themes, not least given the anticipated development of strong domestic growth cycles. More export orientated companies will benefit from the anticipated ongoing positive global backdrop. The gradual pace of developed world monetary policy normalisation should not prevent still ample global liquidity supporting perceived risk assets.

Fig 2: **Emerging Markets Small Cap performance**



Source: MSCI as at 31 December 2017.

Improved sentiment towards Emerging Markets should see attention increasingly turn to smaller companies and Frontier Markets

Similar to large cap stocks, earnings have recovered in small cap. This has supported 2017 market returns. In 2018 improved earnings and profitability momentum looks well placed to continue given the positive global and domestic economic backdrop and improved corporate discipline.

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

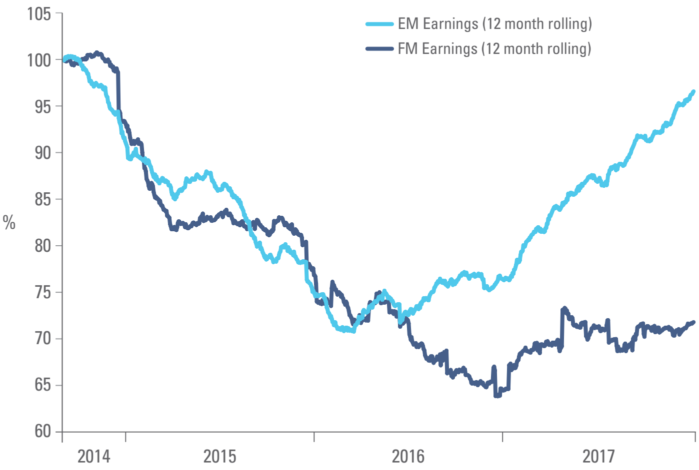
Absolute valuations are reasonable with the MSCI Emerging Markets Small Cap index trading around 1.5x price-to-book. This is broadly in line with history. Relative valuations are attractive, with small cap trading at a discount to larger emerging markets and developed markets. The MSCI Emerging Markets index and MSCI World index trade around 1.6x and 2.3x respectively.

Frontier Markets

The strategic case for Frontier and African Markets remains compelling and should continue to attract investors looking to diversify their global portfolios. In 2018, this longer term positive case is complimented by a particularly strong tactical case.

In 2017 Frontier Markets returned 31.8%, lagging the Emerging Markets rally. Similar to Emerging Markets, improvements in earnings growth and earnings expectations have driven returns. However, significantly, the earnings recovery is only just starting in Frontier Markets. Moreover, frontier valuations are reasonably attractive trading in line with emerging and at a discount to developed markets. The MSCI Frontier Markets index is trading around 12x price-to-earnings ratio.

Fig 3: **The recovery in Frontier Markets earnings**



Source: MSCI as at 31 December 2017.

Structural changes are also accelerating in several frontier economies simultaneously which can drive higher growth as well as boost stock market returns and provide attractive investment opportunities. Among those countries seeing the most change we would highlight the following:

Institutional framework	Economic reform	Enhanced security	Liberalising stock markets
Kenya	Argentina	Pakistan	Vietnam
Pakistan	Saudi Arabia	Egypt	Argentina
UAE	Egypt		Kuwait
Argentina	Pakistan		Saudi Arabia
	Sri Lanka		

In Argentina, the reformist government led by President Macri is well placed to continue to drive through change. Success at recent Municipal elections places Cambiemos well for the general elections in 2019, potentially paving the way for a further six years of reform. Attention in 2018 will be focused on the potential for inflation to be reduced triggering less restrictive monetary policy. This could drive an investment cycle and boost consumer confidence. Investment sentiment and stock market returns are likely to be boosted by the anticipated confirmation of Argentina's reclassification to the MSCI Emerging Markets in May. The primary risk to this outlook is the sensitivity to the global liquidity backdrop given a current account deficit of around 4%.

2017 was a transitional year for the Egyptian economy dealing with an FX devaluation and high inflation. The IMF program, in combination with ongoing reform momentum, especially around subsidies and tax, are positives and there is a notable increase in consumer and corporate confidence. It is hoped that greater currency stability in 2018 will ease inflationary pressure and trigger a fall in interest rates spurring increased private sector spending.

Despite the current political stalemate, Pakistan remains a self-help reform story underwritten by significant Chinese investment in the form of the CPEC. The economy continues to perform well and should increasingly benefit from Chinese led infrastructure investment prompting a multi-year credit cycle.

In 2018, Nigeria and Zimbabwe are also worth watching closely. Nigeria's economy is recovering from the sharp fall in energy prices in 2014/15. A situation made more painful given a self-inflicted liquidity crisis. However, the recovery in energy prices, coupled with improved security around pipelines which is lifting production volumes, are both serving to restore fiscal balances. This paves the way for greater government-led infrastructure investment and a consumer recovery. Policy stimulus is also made more likely given the start of the 2019 election cycle. Improved balance of payments and a current account back in surplus should help stabilise the currency and currency markets are now more functional. Meanwhile in Zimbabwe, the change of President after over 35 years has left international governments, investors and financial institutions keenly watching for any signs of credible policy change, including easing of capital controls.

Source: All market performance and valuation metrics are sourced from Bloomberg as at 31 December 2017. Market indices total return in USD cited.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 316 2070

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Other locations
Lima
Shanghai

Bloomberg page
Ashmore <GO>

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper