Ashmore

ANNUAL OUTLOOK

Equity Outlook 2019: Emerging Markets

By Edward Evans

Emerging Markets

The recovery in Emerging Markets performance that commenced in 2016 was interrupted in 2018. This was triggered by a series of transitory headwinds, most of which originated from Developed Markets. The result was a swift, and largely indiscriminate, pricing in of risk. This led to sharply divergent performance between perceived higher risk Emerging Markets and the US, in particular. The effect was only exacerbated in smaller companies and Frontier Markets. Meanwhile, Emerging Markets fundamentals themselves remained resilient and positive.

In 2019, several of the key concerns that have weighed on Emerging Markets should dissipate and in some cases may reverse. This should enable Emerging Markets to re-establish themselves as a prime destination for capital that was temporarily lost to the US. Stronger expected economic and earnings growth, lighter investor positioning and depressed valuation multiples, all bode well for Emerging Markets to deliver positive absolute returns and to outperform their developed peers.

Risks to this outlook primarily revolve around the pace of deceleration in developed economic growth and the rise of populism. The ability of the Chinese authorities to maintain policy discipline while boosting domestic sentiment also bears monitoring closely. These challenges are likely to sustain elevated levels of market volatility and provide significant opportunity for alpha generation in Emerging Markets.

Healthy macro economics

Emerging Markets economies have been thoroughly stress tested since the Global Financial Crisis. They have experienced prolonged US dollar strength, the pricing in of full monetary policy normalisation in the US and commodity price volatility. This has been possible, in many cases, due to disciplined orthodoxy and prudent policy, together with floating exchange rates and the growth of domestic institutional savings pools.

Emerging Markets inflationary pressure is generally well anchored and current accounts have already undergone an adjustment period. Exchange rates are competitive with around a 20% valuation gap with the US on a real effective rate basis. This backdrop should boost domestic economies and help them to navigate global stress. The IMF forecasts 2019 Emerging Markets GDP growth to be 4.7% in 2019 and 4.8% by 2023.

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Expanding growth premium

The period of quantitative easing artificially elevated developed world economic growth. Meanwhile, Emerging Markets struggled at first to adapt to a lower global growth backdrop. This led the growth premium between Emerging Markets compared to Developed Markets to narrow. This weighed on sentiment, capital flows, local currencies and ultimately relative market returns.

2016 saw the re-establishment of trend superior Emerging Markets growth, only to be interrupted in 2018 by US tax stimulus driving US growth unsustainably higher. With no resultant productivity improvement, US GDP growth has already softened and forward looking data points to a decelerating growth path. In 2019, tighter resources, a strong US dollar and the impact of US protectionist foreign policy are all likely to weigh on US growth. A repeat US stimulus package in 2019 of the same magnitude looks unlikely following the midterm election results. Meanwhile Eurozone and Japanese economic growth remain muted.

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The IMF forecasts that advanced economies will grow at 2.1% in 2019 decelerating to 1.5% by 2023. This should see the Emerging Markets growth premium reasserted over time with positive implications for relative stock market returns.

Less restrictive global financing

A deceleration of US growth towards its long running trend of 2% bodes for a more balanced path of US monetary policy normalisation. A recent communiqué from the Federal Reserve has already pointed to greater policy flexibility and dependence on data. While the ECB and Japan are expected to continue to unwind quantitative easing, their respective soft growth outlooks limit the risk of a steep tightening path. For those capital constrained Emerging Markets, this is a positive.

In 2019, Developed Market governments are likely to turn increasingly to fiscal stimulus to support their economies. While traditionally this is a positive for global trading activity and therefore Emerging Markets, the effect may be more muted given a likely pro-nationalistic bias towards investment.

Well supported corporate earnings

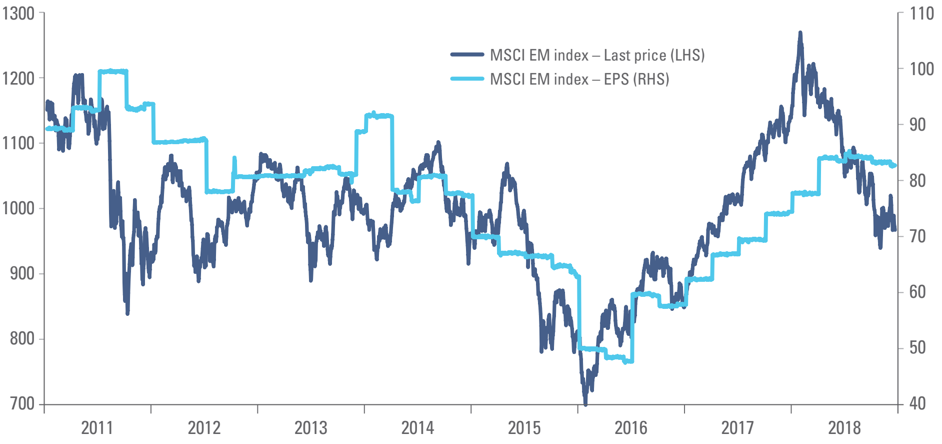
The primary long-term driver of Emerging Markets stock market returns is earnings growth. 2018 saw early year investor euphoria for projected earnings revised lower and settle from mid-year around low double digits. While not as impressive as 2017, it is nonetheless a resilient performance and reflects a combination of capex expenditure and wage discipline, together with healthy free cash flow generation.

Emerging Markets earnings should be supported by resilient domestic growth and expectations of a weaker US dollar… although one should watch for any signs of a sharper contraction in global trading activity

2019 Emerging Markets unweighted earnings expectations in US dollars is around 10%. This looks reasonably prudent and deliverable. It is also twice as strong as the S&P 500. Corporate profitability and earnings should be supported by resilient domestic growth and expectations of a weaker US dollar.

However, one should watch carefully for any signs that the poor global consumer demand seen over year end 2018 is not a precursor of a sharper contraction in global trading activity in 2019 than current macroeconomic indicators suggest. The front loading of activity in China ahead of tariffs earlier in 2018 may also weigh on earnings at the beginning of 2019, although this is expected to give way to the positive of more stimulative Chinese policy.

Fig 1: **Strong relationship between earnings growth and stock market returns**



Source: Bloomberg as at 19 December 2018. EPS reflects TTM data.

Light investor positioning

Contrary to common perception, Emerging Markets did not benefit from quantitative easing related flows. Aside from the period directly in the aftermath of the Global Financial Crisis, from 2011 to 2017 dedicated Emerging Markets funds saw net outflows according to EPFR. Consequently, unwinding, or quantitative tightening, of Developed Markets stimulus in 2019 should have limited impact.

Investors have been slow to embrace the lagged recovery in Emerging Markets owing to global risk concerns. This has led to light positioning as reflected by only modest outflows from dedicated Emerging Markets funds over the second half of 2018 despite elevated risk aversion. Consequently, should perceived risks either dissipate or become better understood and priced, a re-focus on robust Emerging Markets fundamentals could see inflows return and boost stock markets.

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Attractive valuations

The ‘beauty of Emerging Markets’ is that perceived risk is typically priced quickly and often indiscriminately offering active managers such as Ashmore ample opportunity to generate alpha. This was true for 2018 where despite resilient earnings, the MSCI Emerging Markets index was de-rated from 12x to around 10.5x. In comparison with the US, the pricing anomaly was stark. This is despite around half of S&P 500 revenues stemming from overseas operations and subsequently also vulnerable to global activity concerns and a strong US dollar.

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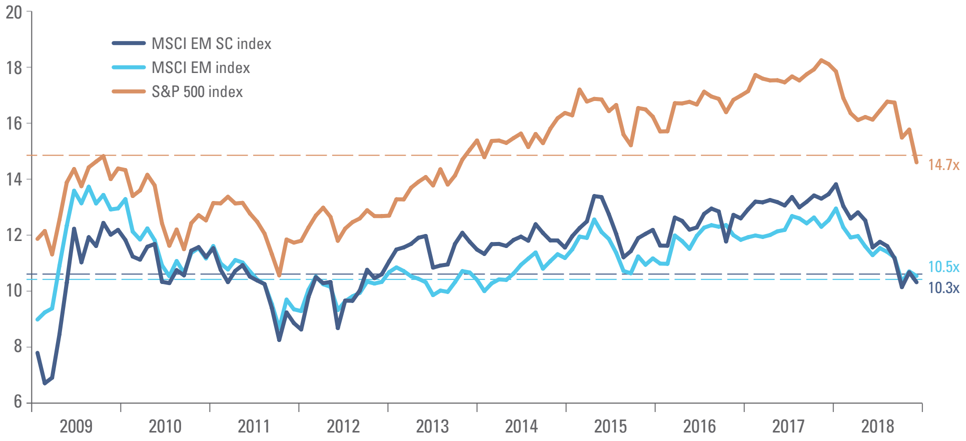
This effect started to reverse towards the end of 2018 with US corporates guiding towards a more challenging 2019 and Emerging Markets stock market returns outperforming the US. A convergence, hopefully to the positive, between the US and Emerging Markets could become a hallmark of 2019.

Fig 2: **Attractive valuation levels**

Price-to-earnings ratios



Source: Bloomberg, as at 19 December 2018.
Dotted lines reflect long run average valuation over the period. PE ratio reflects Bloomberg 12-months forward estimate.

Risks

2019 is unlikely to see a reversion of the relative panacea of 2017. In the developed world, the combination of decelerating economic growth, increased populism and potential policy stalemate in several countries, for example the US and the UK, is likely to mean global market volatility remains elevated.

The ‘elephant in the room’ remains trade relations between China and the US where both sides are likely to look for a perceived mutually successful outcome

The ‘elephant in the room’ remains trade relations between China and the US which investors have so far struggled to quantify and hence price the risk. A pragmatic outcome remains most likely, in our view. President Trump’s attention, and policy, are likely to focus increasingly on winning the next Presidential election in two years time and hence avoid exacerbating the slowdown in domestic growth. Meanwhile, the destabilising effect of tariffs on sentiment in and towards China is unhelpful at a time when President Xi Jinping is orchestrating a domestic economic transition to a more sustainable footing. Consequently, both sides are likely to look for a perceived mutually successful outcome. Investors can take heart from the experiences in 2018 around North Korea and NAFTA that concluded in pragmatism.

Nevertheless, one must remain vigilant to the risk of tariffs becoming synonymous with the start of a protracted power struggle between the two superpowers with associated market volatility. Technology risks becoming a focal point, which given particularly complex cross boarder supply chains would be difficult to disentangle and for markets to price. Should this materialise, investors should remain vigilant for opportunities to exploit mispriced assets through active investing.

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Emerging Markets Small Cap

The global risk off backdrop in 2018 weighed disproportionately on smaller capitalised stocks. This was despite their fundamentals proving more resilient than their larger cap Emerging Markets peers. The largely indiscriminate global sell off has led the already significant pricing inefficiencies in these less researched stocks to be amplified. It has also led valuations to trade at notably attractive levels.

Over 2018, the MSCI Emerging Markets smaller cap index saw only around 4% downward earnings revisions, which was more resilient than larger cap peers. This is perhaps a reflection of smaller caps greater orientation towards more secular themes such as domestic consumption and hence less vulnerable to the ramifications of tariff wars. Despite this the MSCI Emerging Markets Small Cap index saw a disproportionate derating of valuation multiples from 14x forward price-to-earnings to around 10.5x. This is at a discount to their history. It is also a discount to their long run average relative valuation compared to the MSCI Emerging Markets index.

Fig 3: **Risks disproportionately priced into Emerging Markets**

Price-to-earnings percentage change

Source: Ashmore, Bloomberg as at 19 December 2018. PE ratio reflects Bloomberg 12-month forward estimate.

For an area of the market that is inherently difficult to market time, it may pay to take advantage of extreme mispricing and build exposure

One needs to be wary of analysing smaller companies as one collective, especially on a historical basis. The MSCI Emerging Markets Small Cap index has grown from around 200 constituents in 2000 to over 1,700 today. Moreover, the largest constituent represents only 0.4% and the index suffers meaningful turnover. The November MSCI review led to around 12% index turnover as concept stocks came and went and as successful companies grew in size and were reclassified to the mid cap index. Consequently, the primary driver of returns in small cap investing is stock specific and there is ample opportunity for alpha generation compared to such an inefficient index. Incidentally, this is also why taking a passive approach to investing in smaller companies is fraught with challenges. It is an inherently difficult part of the market to track, among other factors.

The disproportionate sell off in Emerging Markets smaller companies in 2018, and hence opportunity for investors in 2019 and beyond, is highlighted even more explicitly at the single country level. For example, Indian small cap valuations have derated from 24x to around 16x PER. They now trade at cheaper valuations than large caps (17.5x) despite higher earnings expectations. Another example is South Korean small cap where earnings have been more stable than developed peers yet they have suffered from a more severe multiple derating.

Should global sentiment stabilise, smaller capitalised stocks could be a prime beneficiary and see a sharp rerating. For an area of the market that is inherently difficult to market time, it may pay to take advantage of extreme mispricing and build exposure. Over time, Emerging Markets smaller companies have a proven track record of providing handsome risk return reward dynamics.

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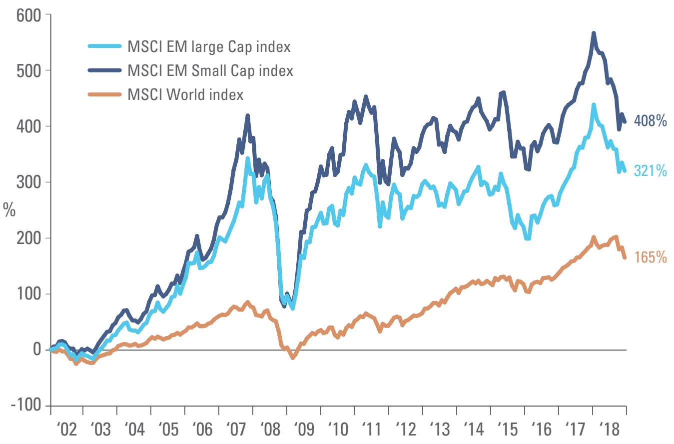
Risks to smaller companies primarily revolve around idiosyncratic stock specific events

Fig 4: **Strong stock market returns and lower volatility**



Volatility		
Index (Net)	**3 years (Ann.)**	**5 years (Ann.)**
MSCI EM Small Cap	**14.2%**	**14.1%**
MSCI EM Large Cap	16.8%	18.8%
MSCI World	9.5%	10.2%

Sources: Ashmore, MSCI as at 30 November 2018, Bloomberg as at 19 December 2018.

Smaller companies tend to be less impacted by investor flow volatility due to a lower level of passive trackers compared to larger caps. Their ownership structures are also typically more concentrated and domestic orientated. Moreover, small cap has greater exposure to defensive sectors. For example, the MSCI Emerging Markets Small Cap index has more exposure to consumer and health care sectors and less to financials and energy sectors, which are more sensitive to changes in discount rates.

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

The magnitude of Frontier Markets weak performance in 2018 was surprising. The largely indiscriminate and disproportionate selling pressure on these idiosyncratic, lower correlated markets has created an opportunity for investors to access a compelling investment case at particularly attractive levels of valuation.

Frontier Markets look well placed to stage a recovery in 2019. Catalysts include structural reform, a dissipation of idiosyncratic single country challenges and increased investor attention

Frontier Market drivers are primarily domestic in orientation. These economies are often at an early stage of structural development and hence less integrated in global financial markets. Indeed, institutional reform, enhanced infrastructure and increased access to capital often result in largely self-propelling economic cycles. This in turn garners increased investor confidence and ultimately can drive strong market returns over time. Consequently, a global risk off 2018 revolving around tighter US dollar global liquidity and the relative stronger economic and earnings growth of the US overshadowing Emerging Markets, should not have been much of a headwind for many Frontier Markets.

Frontier Markets look well placed to stage a recovery in 2019. Catalysts for performance will likely include structural reform implementation across a number of markets driving an ongoing lagged earnings recovery, a dissipation of idiosyncratic single country challenges and increased investor attention owing to a busy index reclassification timetable. Furthermore, already modest earnings expectations for Frontier Markets limit the risk of earnings disappointment, which cannot be said for the US in particular.

There are several examples of reform implementation underway in Frontier Markets. Egypt and Nigeria stand out. In the former case, under powerful leadership the country has completed an IMF programme and devalued the currency. In turn, this has triggered improved economic growth, FDI flows, FX reserves and account balances. As a net energy importer, the volatility of energy prices in 2018 acted to slow the progress in subsidy removal. It also meant inflationary pressure remained high. This prevented the Central Bank from being able to cut interest rates to help kick-start the economy. However, this is a transitory impact and new energy sources coming on stream should reduce this reliance over time. Inflationary pressure has also recently started to print lower which paves the way for more expansionary monetary policy in 2019.

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Meanwhile, Nigeria is undergoing its own cyclical recovery, albeit from a lower base compared to Egypt. Economic growth should continue to pick up driven in part by increased oil production and infrastructure projects fuelling a recovery in consumption growth. The pace of recovery slowed in 2018 in part given energy price volatility and a deferral of investment decisions until after the February 2019 Presidential elections but these are temporary headwinds. Vietnam is particularly strong from a top down perspective. It could also benefit from disruption among US Sino supply chains. Pakistan is also one to watch in 2019. The macroeconomic cycle looks to be troughing and there is a new pro reformist government in place focused on strengthening institutions. Support has already been confirmed from China and Saudi Arabia with the IMF likely to follow in 2019, albeit one should watch for associated restrictive lending criteria.

Argentina suffered a balance of payment crisis in 2018 after its slow policy adjustment was exposed given the global risk off and tighter US dollar liquidity environment. The peso and local market returns suffered the consequences. However, one needs to be wary of how quickly a more constructive outlook could materialise for Argentina in 2019. Balance of payments are already adjusting given strict IMF lending criteria. Should global sentiment improve and domestic policy remain disciplined, this liquid market and the peso could react quickly. Investor attention is also likely to be drawn towards Argentina's inclusion in the MSCI Emerging Markets index in June.

There are several examples of Frontier Markets liberalising their stock markets. Vietnam is undergoing greater equalisation as state companies list stakes and Kuwait recently announced increased foreign ownership limits. Notable IPOs have also recently been seen in the African markets of Ghana and Morocco. The significant sized market of Saudi Arabia is due to be classified an Emerging Market in June 2019.[1] This should serve to increase investor attention towards the wider Middle East region. However, investors need to watch for the distorting market effect of index reclassifications.[2] This was witnessed in 2018 in the build up to Kuwait's move to FTSE's Emerging Market index where stocks with poor fundamentals performed relentlessly well.

We expect Frontier Markets to continue to attract investors due to their structurally high returning and yielding attributes. 2019 offers an opportunity to access these at notably more attractive valuation levels.

Fig 5: **Attractive profitability and valuation metrics**

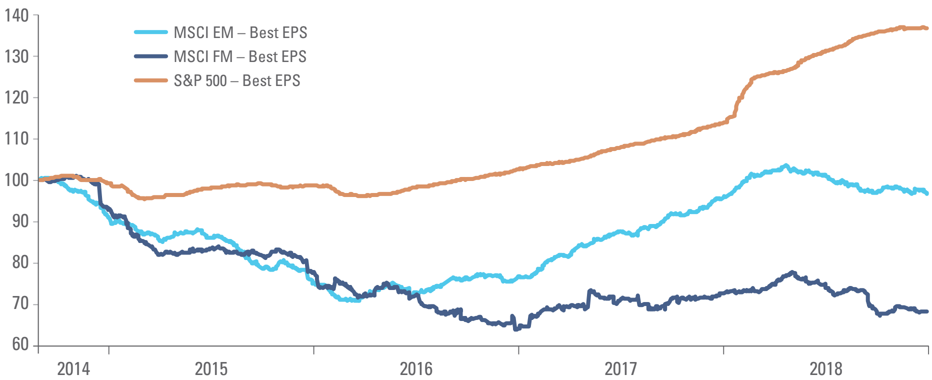
	Return on equity	Dividend yield	Price to earnings
MSCI FM index	**15.8%**	**4.0%**	**9.4%**
MSCI EM index	13.2%	3.0%	10.5%
MSCI World index	13.4%	2.7%	13.6%

Source: Ashmore, Bloomberg as at 19 December 2018. PE ratio reflects Bloomberg 12-month forward estimate.

Given Frontier Markets lagged earnings recovery cycle compared to both Developed and Emerging Markets, the risk of downward earnings revisions is much lower

Should market uncertainty continue in Developed Markets, Frontier Markets offer defensive, or at least lower correlated, qualities as their growth drivers are structural in nature and their investor base is typically dominated by local investors. Over the previous ten largest drawdowns in the MSCI World index, for those six years that the Frontier Markets index has existed, it has outperformed the MSCI World in four cases. Moreover, given Frontier Markets lagged earnings recovery cycle compared to both Developed and Emerging Markets, the risk of downward earnings revisions is much lower. This reinforces the long term attractive risk reward attributes of investing in Frontier Markets.

Fig 6: **Frontier Markets lagged earnings cycle**



Source: Ashmore, Bloomberg as at 20 December 2018. EPS reflects Bloomberg 12-month forward estimate.

[1] See *'Saudi Arabia's Big Year'*, Market Commentary, April 2018.
[2] See *The EM equity Universe: 7 implications of evolution'*, The Emerging View, September 2018.

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