GUARDIAN CAPITAL

Emerging Markets Quarterly Outlook

FIRST QUARTER – 2020

HINDSIGHT & 2020

For a year that started amidst a large market correction and widespread expectations of an imminent global recession, 2019 ended up as close to a best-case scenario for Emerging Markets (EM) investors as could be hoped.

The MSCI Emerging Markets index generated an 18.4% annual return in 2019, more than reversing the 14.5% drop recorded in 2018, in its best calendar year since 2017 and third-best of the decade (behind 2017 and 2010). The gains were broad-based within the aggregated grouping, with 20 of 26 component country indexes up on the year (and half of these posting gains of at least 10%) as well as all 11 industry groups (with the cyclicals like Tech and Consumer Discretionary leading the way, while traditional defensive sectors like Health Care, Utilities, and Consumer Staples were at the other end of the spectrum).

Of course, performance was far from being slow and steady throughout the period, with strength out of the gate giving way to softness through the middle of the year before a seven-year best 11.8% surge in the final three months of the year that served as a near-mirror image to what played out 12 months earlier. Q4 saw gains across 22 local EM stock markets with all 11 sectors up in the period too.

That this strong performance occurred against a broad-based slowing in global economic and earnings growth, and a backdrop of persistent and significant geopolitical risks that stifled business investment and trade and clouded the outlook, makes the performance all the more notable — and may be concerning for what it suggests for the coming year.

Over the last three decades, EM equities have generally seen returns moderate following a calendar year with returns in excess of what was recorded in 2019 — in the previous ten instances since 1996, the average return in the subsequent year is just 3% (with half of these periods posting outright declines). Moreover, multiple-driven expansions such as 2019's do not typically prove to be sustainable, as the investor optimism-driven multiple expansion tailwinds one year turns to a headwind for the market the next.

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2020 visions

Importantly, though, as focus shifts from the year that was to the year to come, there is reason to expect that there is still room for risk assets, and those in EM, in particular, to continue to perform.

For one, the outlook for earnings growth has turned more constructive in recent months as an improving underlying macro backdrop is poised to regain the driver's seat — which is particularly beneficial given EM economies are highly geared toward the economic cycle.

Global growth did indeed moderate again in 2019, with the International Monetary Fund's estimates showing that expansion of the world's aggregate gross domestic product moderated to its slowest pace of expansion since 2009's contraction. This slowdown, however, did not morph into the economic downturn that many pundits were fretting. In fact, there are increasing indications that last year may mark a nadir for growth momentum.

The recent flow of data has been increasingly showing that stability established in the fall of 2019, has given way to a nascent pickup in growth around the world. For example, the composite leading indicator (a forward-looking gauge of economic trajectory based on a broad swath of activity data) for the 36 Developed Market (DM) economies that comprise the Organization for Economic Cooperation and Development (OECD), and six other major emerging economies, increased for the first time in two years, suggesting that the worst could be in the rear-view mirror.

This improvement is particularly evident among the data for the EM, which suggests that after a year of moderation among the group, the growth premium over the Developed Markets (which are facing growth headwinds due to rising capacity constraints and ageing demographics) could be poised to expand in a somewhat notable way.

Global central banks are likely to provide support to this divergence as well. Not only has the renewed easing of monetary policy in the DM (particularly by the US Federal Reserve) and the commitment to keep ample stimulus in place helped to alleviate foreign exchange pressures faced by EM (the broad basket of EM currencies firmed by 3% against the USD in 2019), it also opened the door for EM central banks to follow suit — policymakers cut rates in the likes of Brazil, Mexico, Argentina, Russia and India last year, with scope for further easing remaining on the table in the coming months.

Add to that the fact that the EM governments are increasingly stepping up to support their domestic economies — among others, China has introduced a wide range of initiatives, India is re-upping its focus on progressive policies, and Russia has announced stimulus equal to 0.5% of GDP in the pipeline.

Clouds are parting…

Perhaps even more important than these positive underlying trends is the fact that some of the major clouds of uncertainty that have obscured the outlook and restrained activity are finally subsiding.

Most notably, the spectre of an ever-escalating and expanding trade war has been exorcised (or at least warded off for now). After labelling China a currency manipulator, issuing threats of raising import duties, and discussion of de-listing Chinese companies on American exchanges brought tensions to a head in Q3, things cooled significantly in Q4 as the US and China came to terms on the first phase of a broader trade deal that was ultimately signed in January. The agreement may be fairly limited in its scope — it includes a pledge by China to purchase more US-produced goods (particularly in agricultural products) and discussions on reforms in the areas of intellectual property, technology transfer and financial services — but it does mark a welcome de-escalation of tensions between the world's two largest economies.

Further, the renegotiated trade agreement between the US, Canada and Mexico also successfully passed through the legislatures of each signatory.

Understandably, these developments have helped reduce the uncertainty that has been persistently dominating the market narrative. The increased clarity provided should be supportive of businesses pushing forward with previously delayed capital projects — which would also help kick-start trade flows and benefit the export-oriented economies that are highly prevalent among the EM.

…but horizon not completely clear

Welcome though recent trade developments maybe it would be dangerous to presume that "Phase Two" of the comprehensive agreement between the US and China will go smoothly. EM also remains vulnerable to any backwash from political developments in the US. Similarly, continued civil unrest in many EM countries and geopolitical tensions could provoke occasional sell-offs. However, in recent years, markets have largely shrugged off such episodes, and it is difficult to see why this should change.

The immediate threat to financial markets comes from the outbreak of a new coronavirus in Wuhan. Similar episodes in the past, such as avian flu in the late 1990s, SARS IN 2002/03 and H1N1 triggered sharp falls to Asian equity prices in the short-term followed by a quick rebound once it became clear that the tide was turning with respect to infection rates. Economic disruption was limited due to factories mostly remaining open with the immediate fall in local consumption largely compensated by fast sales growth in the following half-year. Could it be different this time? Possibly is the answer, due to the stringency of the Chinese authorities' measures to contain the outbreak and a higher risk of a global pandemic. The global supply chain depends heavily on China, and any disruption could have negative consequences elsewhere, particularly for counties in North Asia. For now, the odds remain in favour of historic precedent proving to be a reliable guide.

If the dust settles as anticipated, earnings growth will once again become the driver of market direction. In this respect, the outlook for EM appears favourable.

Forward thinking

This is all to say that while the macroeconomic fundamentals look to be constructive at the moment, the road to the end of the year will likely be a bumpy one given the preponderance of risk events that litter the political landscape over the next 12 months. These bumps, however, do not look likely to knock the market off its tracks, setting the stage for further positive performance for risk assets, and suggesting scope for EM assets to generate potential outperformance relative to their DM peers.

Evidence of a widening in the trajectories for growth in EM versus DM would come at a time when elevated risk premiums have made it such that EM equities are continuing to trade at a material discount to their DM counterparts. The forward price-to-earnings ratio on the MSCI Emerging Markets Index remains nearly 25% below that of the MSCI World Index, a wider disparity than has been historically normal — and that discrepancy is amplified when scaled to expected earnings growth. The valuation gap is also significant when looking on a price-to-book basis, where EM stocks are trading in line with their historical norms but offer a discount relative to DM that is one standard deviation from the longer-term average — and a rising return on equity offered by EM would appear to justify closing that gap.

Of course, the positive fundamentals can be obscured by persistent headline shocks that can continue to drive sentiment and place a premium on safety and earnings visibility, and undercut risk appetite for EM securities. But the backdrop of improving underlying growth momentum, benign inflation, low-interest rates, and easing currency pressures would appear to be quite constructive for the EM complex over the coming months.

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