Outlook on **Emerging Markets**

JUL
2013

Market Overview

Emerging markets (EM) debt and equities declined sharply in May and June, with investors caught off guard by the prospect of a reduction in US quantitative easing. The May–June period brought the worst drawdown for emerging markets debt since September–October 2008. Despite encouraging signs of a more robust economic recovery in the United States, all fixed income indices sold off as a result of concerns about the tapering of quantitative easing in May and confirmation of its implementation at the June Federal Open Market Committee (FOMC) meeting. The J.P. Morgan GBI-EM Global Diversified Index recorded the steepest loss, ending down 7.04% for the quarter, with both currencies and rates contributing to negative returns. Dollar-denominated sovereign debt, as measured by the J.P. Morgan EMBI Global Diversified Index, fared slightly better, but still recorded a loss of 5.64% during the quarter. Finally, EM corporate debt performed best, recording losses of just 4.41%, as measured by the J.P. Morgan CEMBI Broad Diversified Index, as correlations to underlying US Treasury bonds are the lowest in that segment of the market. Negative returns across the EM debt space erased year-to-date gains, leaving the asset class in negative territory for the year.

EM equities extended their streak of weak performance, with year-to-date declines in the MSCI EM Index of about 9.6%. This stood in contrast to developed-market stocks, which gained approximately 8.4% over the same time period, as measured by the MSCI World Index. The divergence was even more pronounced relative to US equities, which have risen approximately 13.8% this year according to the S&P 500 Index. Companies in the materials and energy sectors led declines in the EM index, which took a toll on commodity-rich stock exchanges in South Africa, Russia, Brazil, and the rest of Latin America. The information technology, consumer staples, and consumer discretionary sectors held up relatively well. Stocks in many smaller Asian countries were also more resilient.

Emerging Markets Equities

In a highly reactionary environment, we believe it is important to maintain a carefully considered, long-term perspective on EM equities. Year to date, EM returns have been driven by homegrown and exogenous catalysts and can be analyzed at two levels; that is, relative to developed-market equities and on an absolute basis.

Underperformance relative to the developed markets has been a result of renewed investor interest in that sphere, particularly in Europe, Japan, and the United States. Although European issues are not yet fully resolved, sentiment appears to have stabilized as, tellingly, the shock from the Cypriot credit crisis was minimal. In addition, investors have warmed to Japan's "Abenomics" and yield-seekers have gravitated to US assets as a result of higher US interest rates, although we would remind them that EM stocks also offer competitive yields: 2.8% on average.[1] We do not view the improvement in developed-market conditions, especially in the United States, as a threat to the EM equities. To the contrary, we believe this is a healthy development provided that increases in the 10-year US Treasury rate occur gradually over an extended period of time. It is unlikely that growth will rocket in these postindustrial economies due to the lengthy deleveraging process that they must undergo. A measured pace of US expansion should contribute to steady global economic growth; an environment that we believe is most conducive to EM growth.

US dollar appreciation has also placed the spotlight on countries with current account deficits, particularly in the emerging markets. Thanks to structural improvements, EM country fundamentals are at their strongest in three decades and these countries appear better equipped than ever to absorb the stresses of a stronger dollar, having amassed over two-thirds of global foreign currency reserves and reduced the proportion of debt to GDP during this time.

The decline in absolute EM equity returns largely reflects homegrown factors, including slower Chinese economic growth and commensurate weakness in commodity prices, and weak EM corporate profitability. Investors have struggled to come to terms with China's deceleration, but we maintain that a hard landing by the Chinese economy is unlikely as new leadership will not permit such a threat to social and political stability. If necessary, the government can stimulate the economy, including fast-tracking infrastructure investments, stimulating consumption through subsidies, and relaxing some of the regulations put in place to dampen the real estate market. We believe that slower growth is no cause for alarm. Rather, it suggests a transition to a more sustainable consumer-driven economy, and is a necessary break from historical overreliance on fixed-asset investment (including infrastructure and real estate) and heavy industrial output. In our view, China will undoubtedly continue to be an important driver of global growth, but will take a more sedate role. We have taken advantage of recent weakness in Chinese stocks to build positions across a number of our EM strategies. Our relative value team currently holds its largest-ever position in China, albeit still at an underweight to the EM index, and our growth team is approaching a maximum position size.

Commodity prices have weakened in response to less Chinese demand, and commodity-centric markets, such as Brazil's, have traded down in sympathy. However, we do not expect any sudden downward adjustments in resource prices, especially as approvals have recently been granted for several large Chinese projects.

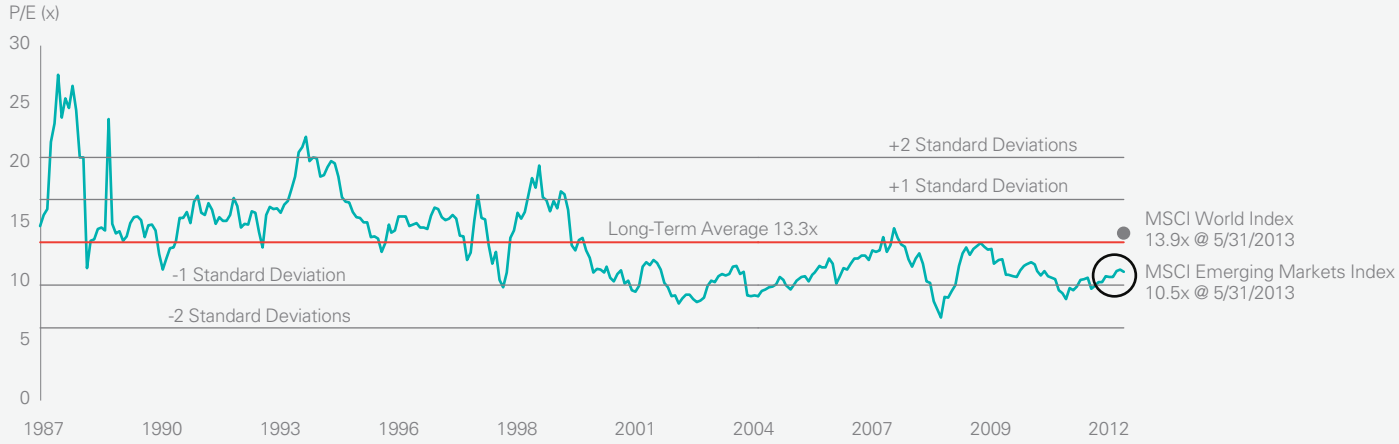
While weaker EM profitability has been an Achilles heel for stock performance, it is a result of high capital expenditure and depreciation—both prerequisites for growth. Although some EM companies have been less adept at capital stewardship (for example, overpaying for acquisitions), investors can avoid these poorly-run companies through bottom-up stock selection. On average, EM companies are still generating higher returns on equity than their developed-market counterparts (see Exhibit 1) and have done so consistently every quarter over the last decade.

Exhibit 1
Return on Equity Remains Higher in the Emerging Markets

As of May 31, 2013
Data shown on a trailing 12-month basis.
Source: UBS, MSCI, Datastream

In addition to higher return on equity than developed-market stocks, EM equities appear attractively valued and as of May were trading below their long-term average at less than 11x forward earnings, as well as at a discount to developed-market equities (see Exhibit 2).

Exhibit 2
EM Equities Are Cheap Relative to History and Developed-Market Equities



As of May 31, 2013
Data shown on a forward 12-month basis.
Source: IBES, MSCI, FactSet, Morgan Stanley Research

Recent developments have not altered our view of the EM opportunity, as we believe that EM countries and stocks in the aggregate have strong fundamentals and should remain competitive in a global setting. Positioning has remained essentially unchanged across our equity strategies and, while we are always mindful of the broader investment context, we remain committed to building portfolios based on fundamental, company-specific analysis.

We frequently encounter examples whereby attitudes toward investments in a specific country are influenced by macroeconomic or event-driven factors. Turkey has been a recent example. Investors have been discouraged by unrest in Turkey reflecting tensions between secular-minded Turks and a government that appears to be challenging those ideals. Among the ruling AKP's (Justice and Development Party) inflammatory moves have been enactment of laws with religious overtones and Prime Minister Erdoğan's heavy-handed response to peaceful demonstrations. The latter, in particular, has tarnished his popularity. Its political agenda aside, the AKP under Erdoğan's leadership is widely credited with Turkey's dramatic economic reform. Although challenges still exist in a weak lira, a widening current account deficit, and slowing GDP growth, the government counts among its many successes inroads into debt, reduction of high interest rates, taming of high inflation, and improved corporate governance—all of which have helped attract foreign direct investment and established dialogue for membership in the European Union. We have concluded that there is little risk of a serious challenge to AKP's position and little risk of an escalation in conflict and, commensurately, business risk. We maintain high conviction in our Turkish holdings as expressed by overweight positions in our EM relative value, growth, and small-cap portfolios. Our core strategy also maintains an overweight position.

South Africa is one example whereby our teams have found varying levels of opportunity, reflecting different points of view. The country has contended with a highly leveraged consumer, and a budget deficit driven by welfare subsidies in a society with deep income divides. Oligopolistic industry structures and low education levels have also deterred organic growth, while a strong union presence, particularly in the mining industry, has distorted profitability. These factors combined have obstructed earnings growth opportunities, leading to our growth team's large underweight position in South African stocks. Our core team is also underweight in this area. Conversely, South Africa has the advantage of a developed institutional framework, including sophisticated financial regulation similar to that of developed markets. Many companies have proven to be efficient capital allocators and have expanded operations throughout sub-Saharan Africa. This has created opportunities for our relative value team, which is overweight South African stocks relative to the EM index. Our small-cap team maintains a market weight position relative to the MSCI EM Small Cap Index, comprising well-run consumer companies that are benefiting from cheap rents.

We believe that the long-term case for the emerging markets remains intact. Although new and existing pressures may color current sentiment, many EM companies should continue to benefit from powerful catalysts, including middle-class income growth, more efficient management, and strong inter-EM and global trade. Stock selection remains the bedrock of our investment philosophy as we seek stock winners that will differentiate from the broad market based on their stronger fundamentals.

Emerging Markets Debt

As has been the case for the better part of ten years, large monthly drawdowns in emerging markets debt have not occurred because of asset-class-specific events but, rather, due to crises in the developed world. In late May, US Federal Reserve (the Fed) Chairman Ben Bernanke's presentation to Congress triggered market unrest when he suggested that if real economic data and jobs continued to improve in the United States, and deflationary conditions did not persist, then the Fed could start to taper ongoing bond purchases in the third quarter of 2013. This resulted in a large sell-off in US Treasuries and a commensurate strengthening of the US dollar against all global currency pairs.

In short, we believe that the magnitude of the recent negative move in emerging markets debt is not in line with the given risk. The potential tapering of bond purchases in the United States is just that—a possibility, not a certainty. Economic and jobs data need to consistently strengthen over the next three months, above and beyond what has been largely mixed data over the previous three months. Further, past episodes of rising rates have typically been matched by a contraction in emerging markets debt spreads, thus offsetting another large move in rates to the upside. We believe the much-written-about "death of fixed income" is both exaggerated and premature. Global economic data remain mixed at best and, in our view, it will not be until expectations of rising inflation persist across the developed world that investors could realize negative returns from their fixed income portfolios. Thus far, inflation expectations in the developed world continue to fall, not rise, suggesting that the pass-through effect of unprecedented monetary stimulus remains largely ineffective with respect to the real economy. In fact, we continue to expect further monetary easing in Europe and Japan, while US authorities ponder the shift from open-ended quantitative easing to just large stimulus.

Emerging-market sovereign fundamentals have changed little over the last six months, a departure from past behavior. Instead of the consistent improvement in EM sovereign balance sheets that markets have grown accustomed to since 2009, we are now witnessing a more static state of affairs for the asset class as commodity prices contract at a measured pace. The result has been a 100+ bp rise in EM debt spreads since early January, most of which was justified by the deterioration of the rate of improvement from positive to flat. The recent sell-off, however, has moved spreads past our fair value estimates and, thus, we now expect returns for US dollar–denominated sovereign debt in the mid-to-high single digits over the next 52 weeks (up from low single digits in February). Although not the equity-like returns that investors enjoyed over the last decade, we believe these levels of returns are in line with expected volatility of 5% to 6% for external debt as an asset class.

Local markets also witnessed a historically large sell-off, which was not limited to currency. Both bonds and currencies weakened over the May–June time frame, as the potential for Fed tapering implies higher US rates and therefore a stronger US dollar. While we agree that the dollar ought to strengthen in the initial stages of a US-led rally, we believe that strength has presented itself too soon and too rapidly. Since early January, we have held the view that emerging markets debt, while continuing to receive strong inflows from institutional investors who are generally underweight the asset class, was priced to perfection. Spreads were tight and currency valuations not overtly cheap. Further, we anticipated that 2013 would be much more of an "alpha" year for the asset class versus 2012 where nearly every country and currency provided strong beta returns. However, given May's multi-standard deviation move in valuations without an underlying deterioration in fundamentals, we now believe that this is the best buying opportunity in emerging markets debt in nine months. Both sovereign and local currency debt offer compelling valuations, potentially allowing investors to realize attractive running carry on top of capital returns. While it is nearly impossible for any investment team to call a bottom in capital markets, we can certainly state that for the first time in almost a year, investors are being handsomely rewarded for taking risk in emerging markets debt.

Notes

1 Source: MSCI. As of June 24, 2013.

Important Information

Published on July 2, 2013.