Fidelity INTERNATIONAL

Global emerging market equities: The year ahead

January 2020

A glance in the rear-view mirror

Investors are weighing up what 2020 may bring for emerging market (EM) equities. Like the years that went before, 2019 was not short of headlines: Argentina's lurch to the left spooked markets in the summer, the Turkish incursion of Syria raised the risks of sanctions and the US-China trade war whipsawed markets, as the mood oscillated between risk-on and risk-off. Hopes that the US Federal Reserve's (Fed) decision to cut rates would alleviate dollar strength were met with some disappointment as yield and safe-haven status appealed to nervous investors. And, whilst EM delivered positive absolute returns in US dollar terms, marked underperformance versus developed market (DM) equities did not go unnoticed.

So where do we go from here?

It would be wrong to argue that the fortunes of the EM are guaranteed; this is a volatile asset class suited to investors willing to take a long-term view. Certain issues run particularly deep
and can flare up without warning. However, when we look at the developing world through a different lens there are reasons to feel encouraged as we head into a new decade.

Five reasons to be positive about EM equities in 2020:

1. Accommodative monetary policy
2. Pivotal government reforms
3. Light investor positioning, with scope for increase
4. A high valuation discount to DM and a promising earnings outlook
5. Slower growth does not destroy structural growth

Don't underestimate the importance of monetary policy

The year 2019 was characterised by easing monetary policy, with central banks simultaneously slashing rates. With limited firepower, developed market peers made small reductions whilst policy makers across EM cut rates aggressively in a relatively short time frame supported by high real rates. From here, further cuts may follow in 2020. Whilst this should not be perceived as the panacea, lower rates can potentially stimulate activity and boost demand: cheaper borrowing can reduce the burden of servicing debt and, in turn, help companies finance capital investment, hopefully leading to higher future profits. Lower interest rates can also draw investment into the stock market from other areas of the financial system.

> In 2019, 18 out of 26 EM countries loosened monetary policy[1]

As for the effects of Fed cuts, this should reduce upwards pressure on the dollar in time, particularly when one considers the detrimental effects of protectionist policy, a mounting twin deficit and the political uncertainty that comes with a late 2020 US election (whilst elsewhere in the world there are signs of greater clarity).

Change is afoot, but Rome wasn't built in a day

A busy election cycle across emerging markets in 2018 and 2019 has started to provide investors with insights into the future path of government policy.

This is not to say that all governments will pursue a pro-business agenda, but there are signs that some leaders are willing to take bold and decisive actions to shore up their finances and set their country on the path to more sustainable growth.

Here, there is a need for patience, as we know markets tend to penalise the stock market or celebrate success in haste, whereas real progress takes time. As 2020 evolves more green shoots may emerge.

Geopolitical ructions have dealt a blow to sentiment, with EM having borne the brunt of bad news as relations between countries deteriorated. The trade war –or tech war, as it's been labelled by many – runs deep, and should not be dismissed as an irrelevance. However, elsewhere in the emerging world, we have seen evidence that long-running disputes can be addressed – the spat between the US and Mexico comes to mind.

> During 2018 and 2019, countries including India, Mexico, Brazil, South Africa and Indonesia hosted elections

As the US and China take baby steps towards some form of resolution (such as the 'Phase One' trade deal), there remains an opportunity for EM equities to play catch-up following a period of pronounced relative underperformance.

Moving from one extreme to another?

The year 2019 commenced with a big bang: In the first quarter, cumulative industry inflows reached +US$22.8 billion. However, tensions between the US and China re-escalated and investors headed for the doors. A wave of de-risking saw cumulative outflows reach -US$28.4 billion by the end of the third quarter.

> EM share of global mutual funds' assets under management is 7.1% vs. 9.1% historical average[2]

If we examine the resultant industry-wide positioning, investor exposure to EM looks incredibly light relative to history. However, the inflows we witnessed in the latter part of 2019 could provide a glimmer of hope. In November, investors embraced more risk, committing US$7.6 billion to the asset class.[3]

Mind the gap

The valuation gap between EM and DM is trading at its widest in 15 years: -35% on a price-to-book basis.

> The EM P/B multiple is trading at a 35% discount to DM vs a 15-year historical average of 13%[4]

When one considers this alongside the outlook for earnings, there's good reason to think EM could lure investors in. Consensus estimates place EM earnings growth above DM, with estimates ranging from +11% to +13% for 2020, +12 to +13% for 2021 (US dollars), providing real reason to feel positive about the year ahead.[5]

2020 – time to be structurally positive

EM has not and will not escape the slowdown in growth, with some of the largest economies, such as India and China, offering us proof that growth rates have long since peaked and rolled over.

However, as we look ahead, many countries continue to exhibit the highest levels of economic growth in the world. Many nations have or are striving toward shoring up their finances. Moreover, some of the uncertainties and headwinds that prevailed upon the asset class through recent years could be dissipating. In this context, the relative attractiveness of the asset class has certainly risen.

We have long argued that despite the headlines, EM offers an abundance of structural growth opportunities, which lends support to a positive view on the asset class. There are pockets of long-duration growth which underpin the argument for being structurally positive, with companies operating in significantly underpenetrated categories. These are attractive characteristics for the discerning investor, as these areas of the market can offer sustainable growth.

fidelity.com.au

Fidelity INTERNATIONAL

1. EM rate cuts: Based on MSCI EM Index constituent countries. Trading Economics, 18 December 2019. **2**. Industry AUM: JP Morgan, EPFR Global, MSCI, Datastream, 18 December 2019. **3.** November flows: JP Morgan, 2 December 2019. **4**. Valuation data: Bloomberg. MSCI World versus MSCI EM Index. 15 years to December 2019, monthly data. **5.** Consensus Earnings Estimates: JP Morgan, 20 November 2019 and 18 December 2019.