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Emerging markets: cycles past and future

What can past market regimes tell
us about the next chapter?

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Introduction – a new cycle is on the horizon

With the US economy cooling down and interest rates approaching a likely peak, a new cycle in emerging markets (EM) is appearing on the horizon.

There have been two starkly different cycles in emerging markets over the past 15 years: a stellar ascent from 2003 to 2012, characterised by strong growth and high returns; and a largely disappointing era from 2013 to 2018, marked by lacklustre performance and stubborn headwinds.

For EM equities, the stellar ascent was interrupted by the global financial crisis. However, markets recovered well in 2009 to provide double-digit returns for equity investors who held their nerve across the 2003-2012 timeframe.

These earlier regimes have a lot to tell us about what to expect from the next cycle, though we think investors anticipating a repeat of either period will miss the mark.









Throughout the advances and reversals of the past decade and a half, emerging markets have been coming of age as an asset class. We believe emerging economies are well positioned having worked through fragilities in the recent cycle. Fundamentals are now in a much better position again and we believe valuations do not reflect this strength. As such, in our view, emerging market assets are poised to outperform developed markets over the next cycle.

We think it's time to re-anchor expectations and reassess the case for emerging markets – not only as an allocation with the potential to deliver attractive risk-adjusted returns over the medium term, but also as a long-term structural holding within a broader portfolio.

In this paper, we analyse past cycles and assess what they can tell us about the next chapter in emerging markets.

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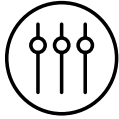
Emerging market cycles at a glance

	 STELLAR CYCLE 2003-2012	 LACKLUSTRE CYCLE 2013-2018	 THE NEXT CYCLE
STARTING VALUATIONS 	LOW Very low starting valuations provided a springboard for EM assets to deliver strong returns.	HIGH By the start of 2013, valuations were stretched across the EM asset class. Given the backdrop of US monetary tightening and softening economies, the asset class struggled over this period.	MID/LOW While not as cheap as the early 2000s, valuations look attractive relative to 2013.
GLOBAL ECONOMY 	STRONG The China-driven commodity supercycle, bolstered by globalisation, provided strong impetus to the global economy. Emerging markets, from manufacturers to commodity exporters, benefited.	WEAK A natural slowdown in China cooled commodity demand and global growth, and exposed structural weaknesses in EM economies. DM growth was also generally sluggish, except for the US in 2018.	MIXED The US economy is late cycle. Emerging markets are much earlier in their cycle, with room for an acceleration in investment, credit growth and consumption.
SPECIAL FACTORS 	POWERFUL TAILWINDS China's once-in-a-generation modernising boom fuelled emerging market economies worldwide, especially commodity-exporters. Post-financial-crisis DM central bank stimulus provided a strong tailwind for risk assets, including EM assets.	PERSISTENT HEADWINDS The gradual tightening of US monetary policy has been a persistent headwind for EM assets in this cycle. In addition, a number of political developments in EM have also weighed on the asset class.	HEADWINDS FADING As the US tightening cycle comes to an end, the headwinds for emerging markets should start to fade. Risks include a severe worsening of US-China trade relations and higher-than-expected US interest rates.
STRUCTURAL STRENGTHS/WEAKNESSES 	STALLED PROGRESS The strong growth during this period meant that some EMs left structural reforms incomplete and backtracked on fiscal prudence. Currency appreciation also left some markets uncompetitive, leading to worsening current account deficits. Credit bubbles also began to form in some countries.	GRADUAL REFORM Weakening growth prompted a sharp rise in fiscal deficits. At the same time credit bubbles burst in some countries. Then followed a period of fiscal consolidation, current account adjustments and structural reform, as EM economies adjusted.	POSITION OF STRENGTH Most emerging markets have continued to engage in reforms and conduct prudent fiscal and monetary policies. In the private sector, corporations have relatively low leverage and high cash balances.
INVESTMENT RETURNS (ANNUALISED, %) 	VERY STRONG EM local debt: 12.3% EM sovereign dollar debt: 11.0% EM corporate dollar debt: 8.6% EM equities: 16.9%	WEAK Local debt: -2.3% EM sovereign dollar debt: 3.1% EM corporate dollar debt: 3.5% EM equities: 1.3%	OUTLOOK: ATTRACTIVE In our view, emerging market assets are poised to outperform developed markets over the next cycle.

Past performance is not a reliable indicator of future results. Forecasts are inherently limited and are not a reliable indicator of future results.

Source: Investec Asset Management; Bloomberg date range for return figures: Stellar cycle: 31.12.02-31.12.12; Lacklustre cycle: 31.12.12-31.12.18. Any opinions stated are honestly held but are not guaranteed and should not be relied upon. Local debt index: JP Morgan GBI-EM Global Diversified. US dollar debt: JP Morgan Emerging Markets Bonds Index Global Diversified; Equities: MSCI Emerging Markets. EM corporate debt: JP Morgan Corporate EMBI Broad Diversified Index. For further information on indices, please see the Important information section.





Tailwinds generate a stellar cycle: 2003-2012

After decades of stop-start growth, EM economies began a sustained expansion.

China's once-in-a-generation transformation, coupled with the forward march of globalisation, underpinned the 2003-2012 cycle. Exceptionally low asset valuations at the start of the period and, later, the post-financial-crisis stimulus measures that drove investors towards risk assets created a recipe for a decade of spectacular returns from emerging markets. Yet the commodity-fuelled boom masked underlying fragilities.

China propels a world in transformation

After decades of stop-start growth, EM economies began a sustained expansion around the turn of the millennium. The engine of this stellar growth cycle was China's stunning economic transformation, which saw the Middle Kingdom's gross domestic product triple in real terms over the 2000s.

The blistering pace of Chinese growth helped to drive growth in other emerging markets, particularly the commodity-exporting nations called upon to feed China's gargantuan appetite for the raw materials required to build a modern economic superpower.

Seeds of transformation

The seeds of this expansionary cycle had been sown much earlier. The collapse of communism in the late 1980s ushered in a broad international consensus around the policy prerequisites for economic development, and a host of newly independent states reoriented towards market-based models.

At the same time, the world's trading system was being radically, if slowly, overhauled. Along with various regional free-trade agreements, the World Trade Organization's Uruguay Round of negotiations gradually liberalised international commerce and gave impetus to globalisation.

The stars align

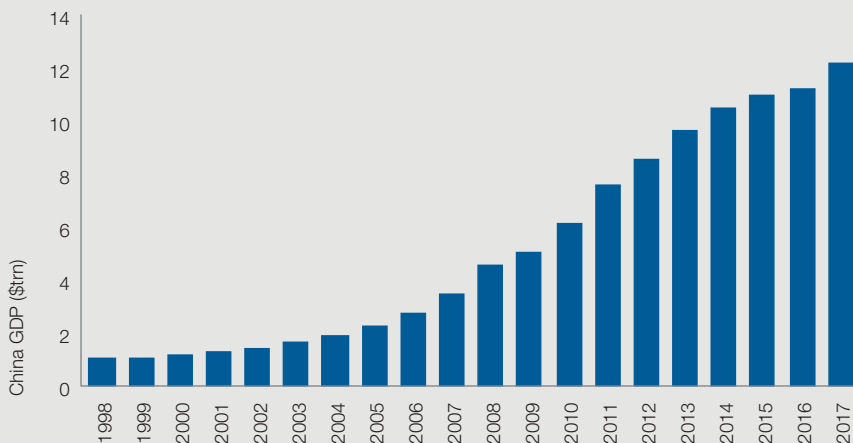
All this took time and there were, unsurprisingly, setbacks. The transition to market economies was particularly painful in central and eastern Europe, while fixed exchange rates in Asia helped precipitate the 1997 Asian financial crisis. It was not until the new millennium that the stars aligned for emerging markets. But by the time China unleashed its modernisation programme, the stage was set for explosive growth across emerging markets:

- In Eastern Europe, cheap currencies fostered a strong manufacturing base on the (then) eastern border of the European Union
- In Asia, structural reform and floating exchange rates helped the region's manufacturing economies recover strongly from the crises of the late 1990s
- In Latin America, the China-fuelled commodity supercycle drove expansion, which was bolstered by improved governance in some markets
- In Africa, growth was also driven by strong commodity demand, as well as supported by institutional improvements and less conflict, particularly in the Sub-Saharan region, which averaged annual growth of 5.5% between 2000 and 2015.

China: ascent, consolidation and transformation

China's accession to the World Trade Organization in 2001, coupled with a clean-up of the country's financial system and state-owned enterprises, laid the foundations for a period of remarkable growth that would see nominal GDP rise nearly six-fold between 2000 and 2011.

Figure 1: China – the world's growth engine



Source: Haver Analytics, as at 31.12.17.

With overseas companies shifting production to China in droves, China's share of world exports increased from less than 4% in 2000 to over 10% by 2011. Investment in fixed assets averaged an astonishing 23.3% annually over the same period, rising 11-fold in renminbi terms. China's output also grew rapidly, with steel production expanding at an average annual rate of 16.6%.

Protecting growth, but at a cost

The 2008 global financial crisis hit China hard, its effects magnified by a devastating earthquake that same year. From a peak of 23.8% in the fourth quarter of 2007, nominal growth slumped to 6.6% in the second quarter of 2009.

China enacted a broad-based package to boost domestic demand. Growth quickly rebounded, but the stimulus was poorly targeted and ill-disciplined. With the focus on quantity of growth rather than quality, China increasingly came to rely on debt to support economic expansion, with the debt-to-GDP ratio rising sharply in 2009-2010.

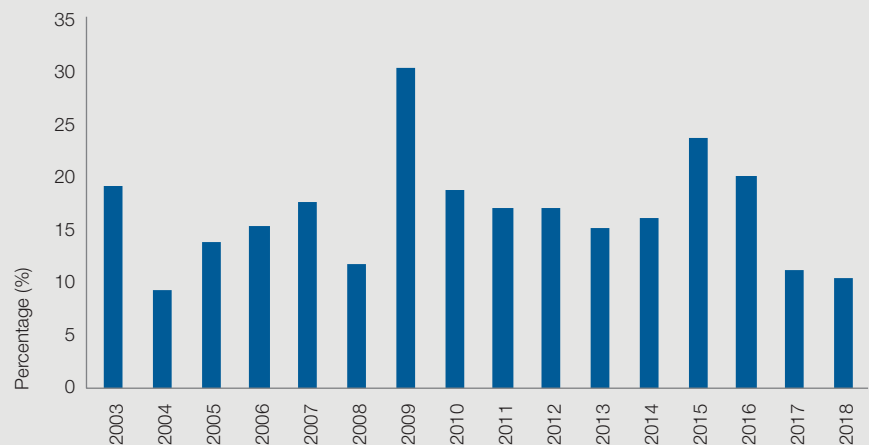
China's share of world exports increased from less than 4% in 2000 to over 10% by 2011.

With growth slowing sharply, the authorities began easing financial conditions in the second quarter of 2015.

Attempts to rein in credit expansion led to a significant tightening as banks became reluctant to lend to the private sector. By the start of 2016, Chinese nominal GDP growth reached 6.5%, the lowest level since 2000.

With growth slowing sharply, the authorities began easing financial conditions in the second quarter of 2015. Domestic credit growth, which was running between 15%-17% from 2011 to 2014, picked up sharply to 24% in 2015, as shown in Figure 2.

Figure 2: Domestic credit growth



Source: Haver Analytics, Deposit Corporation Survey, as at 31.12.18.

At the same time, the authorities began to tackle overcapacity in the steel and coal industries. This improved profitability, easing the strain on the financial sector as debt could now be better serviced out of earnings. Refocusing on quality rather than quantity of growth reduced the credit intensity of the economy.

2016 saw a significant improvement in growth, which continued into 2017 buoyed by a pick-up in the global economy, giving the authorities room to continue supply side structural reform.

Learning from the past

Deleveraging remains one of the key underlying themes to domestic policy, as evidenced in Figure 3, although this focus has eased as growth concerns have intensified.

Figure 3: China GDP vs. credit growth



Source: Haver Analytics, as at 30.09.18.

We expect a gradually declining pace of growth, though with no let-up in the emphasis on quality. That means a continued rotation away from exports and investment, and towards consumption and services as the drivers of growth.

Beijing will adopt counter-cyclical policy when required, such as tax cuts and reductions in the reserve requirement ratio. However, we do not expect policymakers to repeat the mistakes of the past. Unless a collapse in growth threatens social cohesion, we are unlikely to see the sort of all-encompassing stimulus packages we saw in 2009 and 2015/2016. A key focus for policymakers going forward will be to ensure policy easing is better transmitted to the more profitable and productive areas of the economy, in particular privately-owned enterprises.

We also expect more financial liberalisation. China is on course to become a major constituent of global equity and bond markets, which will help professionalise China's capital markets as the country aspires to global standards. It should also make China's capital structure more efficient, aiding Beijing's pursuit of deleveraging as equity becomes a larger proponent of China Inc's capital funding.

China is on course to become a major constituent of global equity and bond markets.

Maintaining the lead

Throughout the 2003-2012 cycle, emerging nations maintained their growth advantage over developed markets – partly due to the length of the commodity supercycle. This boosted exports everywhere from Chile and Zambia (copper); to Russia and Colombia (oil); and Brazil, Kenya and Indonesia (soft commodities). Moreover, globalisation created international value chains (such as the smartphone production cycle linking South Korea, Taiwan, China and the US) that helped sustain global growth.

Not even a series of US interest-rate hikes early in the period – the Federal Funds Rate climbed by more than 4 percentage points to over 5% from mid 2003 to mid 2006 – nor the 2008 global financial crisis derailed emerging markets' progress. The buzzword of the era was 'decoupling'; however, the notion that emerging markets had become independent of the vagaries of developed economies would soon prove false.

As the 2000s wore on, commodity-driven growth masked underlying fragilities. Some governments slowed the pace of structural reform and, assuming that stellar growth was the new norm, implemented generous but ultimately unsustainable welfare systems. For similar reasons, some countries allowed public and private debt to swell to dangerous levels.

Markets: investors reap the rewards

The chickens came home to roost as China's expansion began to moderate, but not before investors had enjoyed spectacular returns.

The chickens came home to roost as China's expansion began to moderate, but not before investors had enjoyed spectacular returns – helped by the fact that, at the beginning of the stellar cycle, most emerging market assets were cheap. The springboard of low starting valuations propelled EM equities to return an annual 16.9% in the decade to the end of 2012, while EM local and sovereign dollar debt returned 12.3% and 11.0%, respectively, and EM corporate dollar debt returned an annualised 8.6%.

- **EM local debt:** Currency appreciation from low levels, combined with yields in excess of 7% for much of the cycle, buttressed returns
- **EM dollar debt:** Spreads on EM sovereign and corporate debt were wide after the Asian and Russian financial crises of the late 1990s (EMBI spreads were about 600 basis points over US Treasuries on average), and tightened significantly as sovereign credit quality improved and EM corporates matured
- **EM equities:** As well as low starting valuations, EM stocks were supported by strong earnings growth as companies took advantage of globalisation.

Following the 2008 crash, which was particularly painful for EM equities, these asset classes received a further fillip as quantitative easing and rock-bottom interest rates drove yield-hungry investors towards emerging markets. Having averaged 7% from 2002-2011, the yield on EM local debt dropped to a record low of 5.5% in the early months of 2013 as investors flooded in, while EM sovereign and corporate dollar debt spreads fell to record lows. Indeed, having begun the stellar cycle at very low valuations, EM assets across fixed income, equities and currencies ended the period looking decidedly expensive.

Brazil: a bumpy path to a brighter future

The case of Brazil, more than any other emerging market, neatly illustrates the contrasting nature of the two cycles.

The case of Brazil, more than any other emerging market, neatly illustrates the contrasting nature of the two cycles discussed in this paper, from both an economic and investor outcome perspective.

After years of working hard to end the hyper-inflation of the 1980s and 1990s, Brazil suffered a major financial shock in 2002 when the election of left-of-centre President Lula spooked the market and sent bond yields above 20%. However, fears of unsustainable economic policy-making and debt restructuring proved unfounded: Lula appointed an orthodox economy team including Henrique Meirelles at the central bank, who restored market confidence and embarked on a multi-year programme aimed at improving economic governance. In response, bond yields fell to single digits by mid-2012.

Powerful tailwinds and over-exuberance

Brazil was also a key beneficiary of the China-led commodity supercycle. Monthly exports rose from US\$4 billion in 2002 to more than US\$23 billion at their peak in 2011 and the real effective exchange rate appreciated by 148%. Credit growth ran at more than 20% year-on-year for much of that period, including a further government-sponsored boost in 2009, which allowed Brazilian growth to apparently bounce back post the global financial crisis. Confidence prevailed.

Figure 4: Brazil year-on-year credit growth, 3-month moving average



Source: Haver Analytics. January 2000 to November 2018. Chart shows 3-month moving average of year-on-year % change in total financial credit operations.

Brazil's rise was reflected in the ascent of major corporate names such as Eike Batista's EBX group of commodity companies, national oil company Petrobras, and regional infrastructure heavyweight Odebrecht.¹

¹This is not a buy, sell or hold recommendation for any particular security.

In early 2012, Batista was estimated to be worth US\$35 billion, making him the 7th richest person in the world.

Headwinds force a stark reality-check

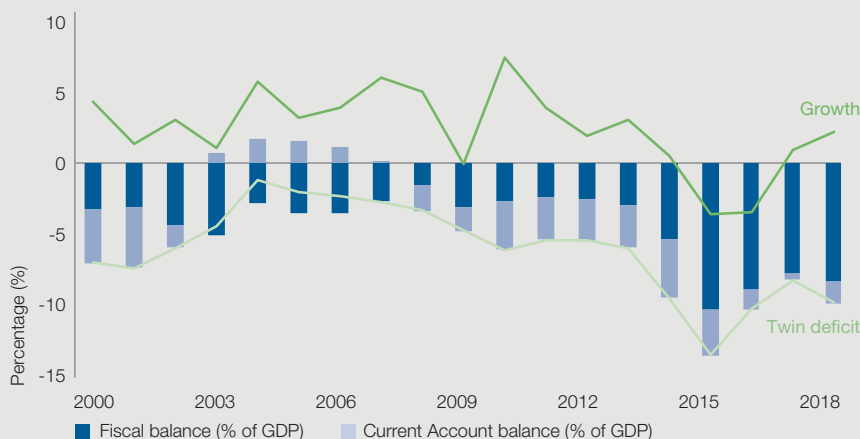
Sadly, this bull cycle was doomed to end poorly, as became increasingly clear during the painful correction of 2012-2016. The election of Dilma Rousseff, Lula's anointed heir in 2010, combined with the end of the commodity cycle and beginning of monetary tapering by the US Federal Reserve, drove a sharp reversal in fortunes for Brazil's economy.

Initial evidence of economic over-heating appeared in the form of a sharp deterioration of the current account deficit, which left Brazil highly vulnerable as US dollar liquidity began to tighten. Growth slowed from above 5% year-on-year and the Brazilian real began to weaken on a secular basis, causing financial conditions to tighten further. The economic policy response was a text-book example of what not to do in such a situation, focusing on state bank lending and loose monetary policy to try to shore up growth, rather than prudently overseeing a managed fiscal and credit correction.

When the fall finally came, it was dramatic: the slowdown in GDP growth worsened to what would become an eight percentage point fall between 2014 and 2016. The entire financial system faced a shock which eventually resulted in negative credit growth year-on-year, exacerbating the recession. And years of misguided fiscal policy meant that the headline fiscal deficit exploded to more than 10% of GDP, and bond yields rose back to 16%. In a sharp reversal of fortunes, Eike Batista's business empire collapsed (he currently faces a 30-year jail sentence); Odebrecht sparked a region-wide wave of corruption scandals; and Petrobras's credit rating was downgraded to junk status, followed swiftly by Brazil's sovereign rating.

The economic policy response was a text-book example of what not to do.

Figure 5: Brazil growth vs. twin deficits



IMF World Economic Outlook October 2018.

Now, as in many other emerging markets, Brazil is seeing the green shoots of a multi-year renaissance.

A new era of strength

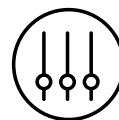
Now, as in many other emerging markets, Brazil is seeing the green shoots of a multi-year renaissance and seems to have learned from its past mistakes.

Dilma Rousseff was impeached in early 2016, and Vice President Michel Temer initiated a rapid economic recovery programme focused on a fiscal contraction, a new and credible central bank, and much needed structural reforms.

Brazil returned to growth in 2017, and the outlook for 2019 is for growth to exceed 3%. The current account deficit has improved to less than 1% of GDP and for the first time in its history Brazil's overall balance of payments has moved into surplus. Furthermore, the Brazilian central bank has pursued credible monetary policy to reduce inflation to below 4%. All in all, the Brazilian economy is on a more solid footing, in our view.

The new Bolsonaro government has laid out a highly ambitious fiscal and structural reform programme which, if achieved, will cement and expand the turnaround of the last two years. With the legacy of a debt-to-GDP ratio of 80% following the years of mismanagement, delivery on fiscal reform will be key to truly starting a new cycle for Brazil.

Persistent headwinds: 2013-2018



The 2013-2018 cycle has been characterised by disappointing returns as EM economies faltered. The process of unwinding the extraordinary monetary stimulus following the financial crisis has been a persistent headwind, while performance has been further undermined by stretched valuations at the start of the period. But behind the lacklustre returns lie some important developments in EM economies that should support EM assets in the years ahead.

Macro backdrop: crunch time and consolidation

The cycle that began in 2013 stands in stark contrast to its predecessor. By that year, China's growth had entered a natural slowdown, cooling global demand for commodities. Concurrently, quantitative easing began to be withdrawn, notably sparking the Taper Tantrum in 2013, and the US Federal Reserve eventually started raising interest rates. Emerging markets again looked conspicuously coupled to the global economy:

- After steady appreciation, overvalued exchange rates undermined the international competitiveness of EM economies, pushing up current account deficits and hence increasing EM economies' reliance on foreign investment inflows. With growth flagging, credit bubbles burst in several emerging markets
- Partly as a consequence of the deteriorating economic backdrop, politics in many EM nations destabilised, while some country-specific developments – such as Brazil's corruption scandal and Russia's annexation of the Crimea – further undermined investor confidence.

As emerging markets struggled, economic growth in developed markets, especially the US, started to surprise positively versus admittedly very gloomy expectations. The 'growth premium' usually associated with EM economies relative to developed markets started to shrink. EM economies recovered from the lows from 2016 onwards, but the gap to developed countries is still relatively modest and growth rates have become much more uneven across emerging markets. The bounce in 2016-2017 could not be sustained in 2018, and – fuelled in part by the temporary sugar rush of tax cuts – US growth momentum was stronger than that of many emerging economies last year.

Positive change

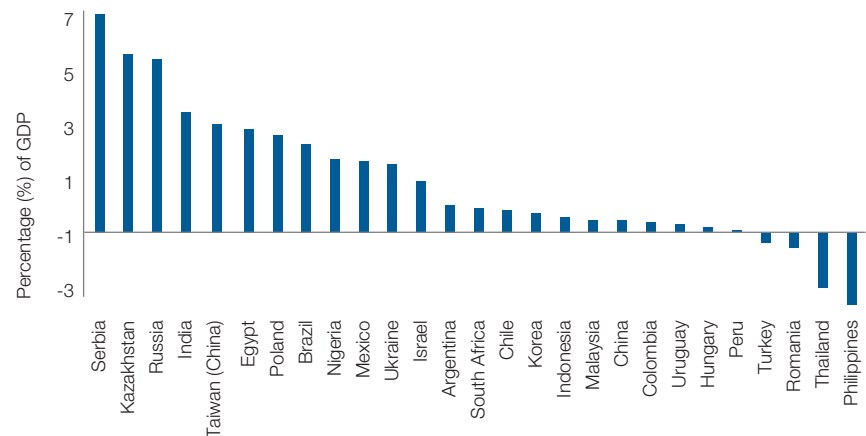
Nevertheless, this cycle has been marked by some important positive developments. Sluggish growth and crises in several countries have reinvigorated governments' commitment to structural reform, and fiscal and current account balances have improved significantly (see Figures 6 and 7 overleaf). Among EM corporates, the 2014-2015 credit crunch was a catalyst for constructive change, as our analysis shows (see page 17); businesses in emerging markets now have healthier margins and more resilient business models.

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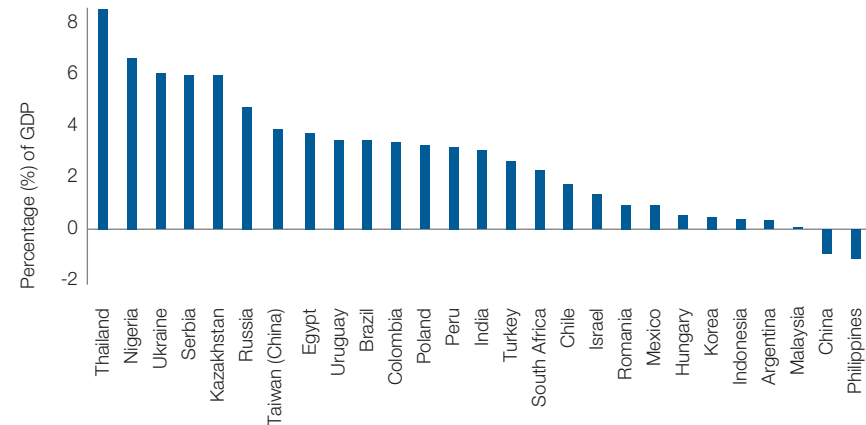
Fiscal and current accounts have improved in most emerging markets

Figure 6: Fiscal adjustment: 2018 balance vs. lowest point during 2012-2017



Source: IMF, World Economic Outlook, October 2018.

Figure 7: Current account adjustment: 2018 balance vs. lowest point during 2012-2017



Source: IMF, World Economic Outlook, October 2018.

From a policy perspective, prudence and orthodoxy are in the ascendancy, and central bank independence in most markets is helping to drive inflation structurally lower:

- Far-reaching Chinese reforms have been echoed in reform agendas of varying depths by countries as diverse as Brazil, South Africa and Malaysia; the oil-dependent states of the Gulf Cooperation Council are also implementing wide-ranging structural reforms to diversify their economies
- IMF programmes in weaker markets have supported positive structural change in countries such as Argentina and Ukraine, and in frontier markets such as Egypt, Ghana and Jordan
- On the political front, populist movements have generally failed, bringing about a return to pragmatic macro policies; and while some large developed economies retreat from globalisation, most emerging markets continue to look outward, seeking to deepen integration through regional trade agreements.

Of course, emerging markets are diverse, and broad trends are not reflective of the situation in every country. We are watching Mexico closely for a deterioration in macro policy, and we have concerns about the policy direction in Turkey and Romania. But for emerging markets as a whole, the structural changes that have occurred leave them much more resilient than they were at the start of this otherwise lacklustre cycle.

From a policy perspective, prudence and orthodoxy are in the ascendancy.

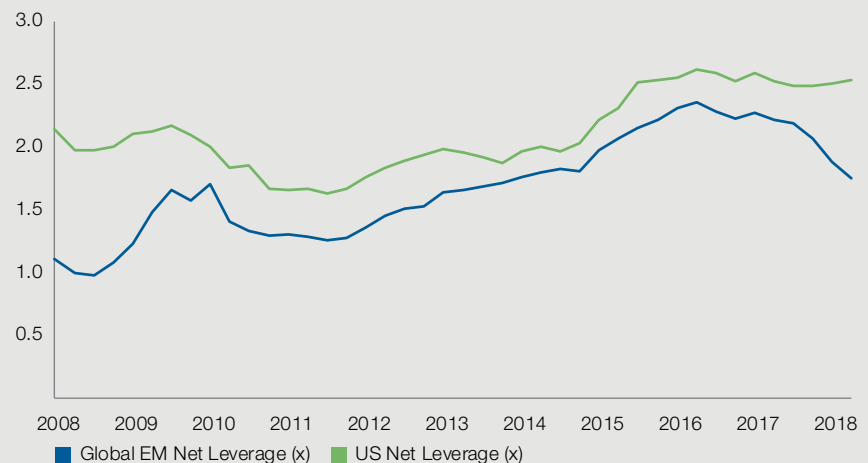
Analysis by our Corporate Credit team reveals a notable strengthening of the debt metrics of emerging market companies.

Emerging market corporations: strength from adversity

When looking at the cheapest companies identified by our 4Factor Equity team's value factor, the underlying quality of these companies reached their highest ever level in 2018 for the EM universe. Behind this lies a significant improvement in return on equity for the group over the past two years; a positive trend in companies' ability to turn asset growth into sales growth; and a reduction in capital intensity. Capital expenditure (capex) has fallen in absolute terms and the ratio of cash flows from operations to average capex has reached historically high levels, particularly in Asia ex Japan.

Analysis by our Corporate Credit team reveals a notable strengthening of the debt metrics of emerging market companies, which on average maintain better credit fundamentals than their developed market peers with similar ratings. Having lived through repeated periods of volatility, emerging market companies tend to adhere to a culture of retaining cash for a rainy day, while containing leverage. They are also reducing the percentage of short-term debt they carry, hence lowering refinancing risk, and we expect this trend to continue. Finally, the birth of the emerging market corporate dollar debt universe has improved companies' access to capital by providing an alternative funding source to local-currency debt financing and bank loans.

Figure 8: EM corporates have strengthened their positions



Source: Bank of America Merrill Lynch, as at 30.06.18.

Markets: lacklustre performance

The structural changes discussed earlier took time and their positive effects have so far not translated into asset strength. The latest emerging market cycle has been tough for investors – partly because, in contrast to the start of the previous regime, valuations were excessive going into 2013. Average annual returns on EM equities and EM sovereign and corporate dollar debt have been in the low single digits since then, while EM local debt has delivered -2.3%.

Beneath the disappointing headline results, it is worth noting that local-debt returns have been dragged down by some of the larger benchmark weights, while a few structurally stronger names – such as Peru – have managed to deliver positive absolute returns in US-dollar terms despite the headwinds. Nevertheless, the large number of investors who flocked into EM asset classes toward the end of the stellar cycle have been left largely disappointed.

The structural changes discussed earlier took time.



The next cycle – what might the next chapter hold?

Quietly and gradually, emerging markets have been maturing and we believe they are now positioned for sustainable growth.

One of the most striking lessons from examining the last two decades in emerging markets is that investors – and governments, for that matter – have a habitual tendency to anchor their expectations in the too-recent past. Just as talk of decoupling and assumptions of continual rapid growth were far too optimistic at the end of the stellar cycle, in our view many investors are excessively pessimistic about emerging markets now.

Perhaps more importantly, a narrow spotlight fails to illuminate the slower-burn transformations that take place beneath the ups and downs of markets. A wider lens highlights that an allocation to emerging markets today is a very different investment proposition than it was either in 2003 or 2013. Quietly and gradually, emerging markets have been maturing and – nearer-term gyrations notwithstanding – we believe they are now positioned for sustainable growth. In this final section, we consider the next cycle in emerging markets and the context against which it will play out.

Macro backdrop: winds of change

We are nearing the end of a robust US economic growth phase and an exceptionally long period of US equity outperformance. Global investors are overweight US assets at high valuations and likely towards the end of a US growth cycle.

In contrast, having worked through macro vulnerabilities in recent years, emerging markets are on solid footing for growth. There is significant room for investment, credit growth and consumption to pick up from relatively low levels. If we combine that with better demographics, better fiscal starting points and potential for higher productivity gains (based on the ability of their economies to catch up with developed markets), we see on the horizon a cycle where emerging markets once again can outperform developed markets.

For emerging markets to truly deliver on their potential, further structural reform will be needed to unlock those productivity gains. There are also pockets of vulnerability, notably in a few frontier names, and we may see further sovereign defaults. Investors will have to remain selective and discerning.

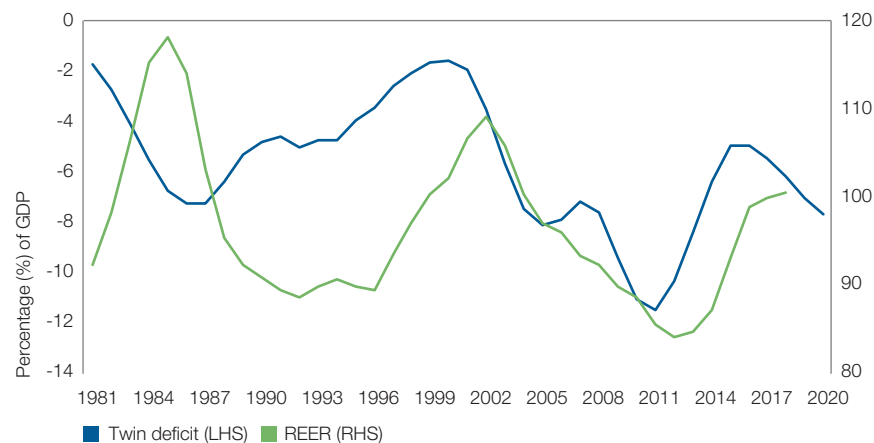
Nevertheless, the structural reforms of the past few years should underpin emerging markets from here. Most emerging nations are more robust than they were at the start of the last cycle; both at the macro level, with stronger current accounts and controlled inflation, and at the micro level, with firms generally having healthier balance sheets.

While it is difficult to predict exactly when the US Federal Funds Rate will reach its peak, we are almost certainly closer to the end of this hiking cycle than the beginning, at which point the headwinds from US monetary policy will start to recede. It also seems likely that the next phase of emerging markets' development will take place in the context of a weaker US dollar, as the world's largest economy grapples to contain its current-account deficit. That would provide a significant tailwind for emerging market returns.

The price of Trump's procyclical policy: a lower US dollar?

Figure 9 shows the US twin balances and the real effective exchange rate (REER: inflation-adjusted currency valuations). Given the unsustainable growth of the twin deficits, the likely path of the US REER is downward.

Figure 9: US Current account and fiscal balances combined and REER

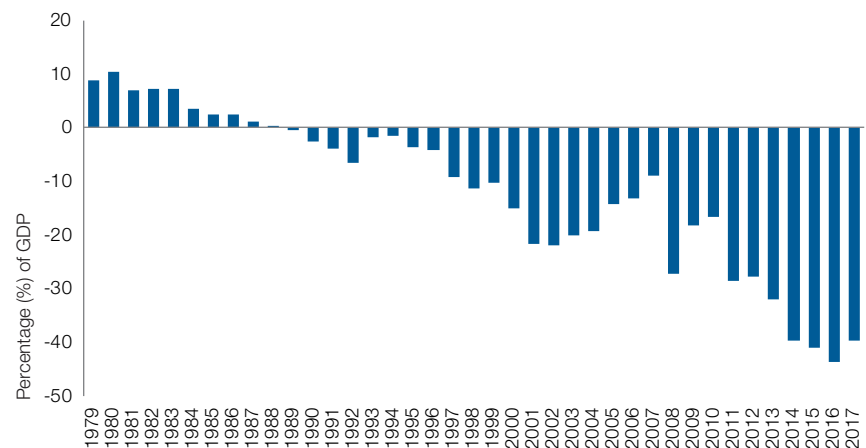


Source: St Louis Federal Reserve (until end of 2017); IMF forecasts from start of 2018.

It also seems likely that the next phase of emerging markets' development will take place in the context of a weaker US dollar.

Furthermore, given the worsening current account deficit, this will exacerbate America's negative net international investment position (the NIIP is the difference between a country's external financial assets and its liabilities).² As Figure 10 shows, the US has become a very large net debtor. At the current percentage of GDP, the NIIP is starting to look extended, in our view, and points to foreign investors' over-exposure to US assets.

Figure 10: US net international investment position as % of GDP



Source: Bloomberg, St Louis Federal Reserve, as at 31.12.17.

Understanding the drivers and dynamics of the two most recent cycles is crucial to anchor expectations for the future.

Markets: a solid starting point

In our view, understanding the drivers and dynamics of the two most recent emerging market cycles is crucial to anchor expectations for the future. A repeat of the double-digit gains in the stellar cycle is not a realistic hope. But nor should investors allow the lacklustre performance of the most recent period to underplay the opportunity.

From a valuation perspective, the next cycle's starting point is not quite as favourable as in 2003, but for the most part far better than in 2013. After a long period of rebalancing, valuations of emerging markets assets look attractive:

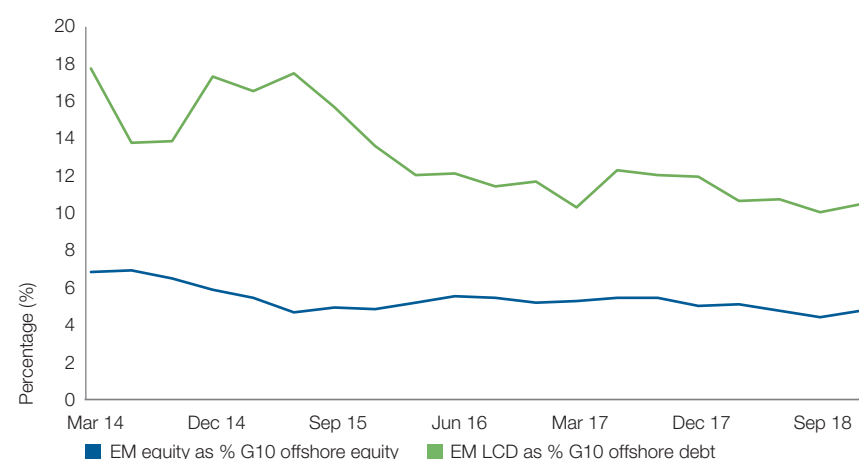
- EM currency real effective exchange rates are towards the bottom of recent ranges
- While nominal yields on local EM debt are not especially cheap relative to history, real yields are elevated given the structural fall in inflation in emerging markets over recent years. We thus think nominal local yields have room to compress over time, especially relative to developed markets. Attractive currency and yield valuations should underpin EM local bond returns from here, in our view

²Since the current account deficit is funded by a financial account surplus (that is, inflows of portfolio investment and foreign direct investment).

- The spreads on EM sovereign and corporate dollar debt are not notably wide from a historical perspective. But they look attractive relative to US credit markets, in our view. Given the relatively high yield on US Treasuries, cash yields are elevated on a historical basis
- Our emerging market composite valuation indicators suggest that current equity valuations are attractive relative to history. The indicators use a range of metrics such as book value, free cash flow yield, sales to enterprise value and a bottom up indicator that includes forward earnings multiples. These aggregate scores suggest that emerging market equities offer compelling value currently, not only relative to the global opportunity set but is also towards the extreme end of the historic range.

A further potential near-term positive is that allocations to emerging market assets are at low levels relative to history – positioning is arguably quite ‘clean’ in the sense that foreign ownership is below pre-2013 levels and crossover investors are disengaged from the asset class – and relative to ownership in developed bond and equity markets. Figure 11 shows estimates of emerging markets as a percentage of global offshore investment holdings in equity and debt for the G7 plus Switzerland, China, and The Cayman Islands. This highlights the extent to which emerging market allocations have been diluted as quantitative easing inflated overall portfolio holdings, falling to 10% at the end of 2018 from almost 18% in March 2014. We anticipate inflows into emerging market asset classes over the coming years as investors re-engage with emerging markets.

Figure 11: Estimates of emerging market as a share of global offshore investment holdings in equity and debt for the G7 plus Switzerland, China, and The Cayman Islands



Source: Bloomberg, Haver Analytics, National Sources, Investec Asset Management, as at 31.12.18.

Allocations to emerging market assets are at low levels relative to history.

Risks to the outlook for emerging markets

We believe the fates of the world's largest economies will continue to influence the outlook for emerging markets.

We would flag several risks:

- Near term, the biggest danger is trade tension between the US and China, given the implications for growth and trade. From a longer-term perspective, US-China rivalry is likely to be a persistent theme for years, if not decades
- A significant recession in the US could provide a temporary challenge to emerging markets in the next cycle, notwithstanding the possibility that a prolonged period of lower rates may drive flows into the asset class
- Though not our base case, if the Federal Funds Rate rises significantly above 3% this could also create a headwind for emerging markets.

Overall though, our outlook for emerging market asset classes is positive across equities and debt. For investors with an understanding of the risks, an appropriate time horizon and realistic expectations, we regard this as an attractive entry point and a good time to reassess existing allocations.

Conclusion

A look back at the last two cycles in emerging markets is instructive – not least because one of the lessons of the past is that investors have a habit of not learning the lessons of the past.

We believe China's dizzying ascent early in the millennium will not be repeated, and so those waiting for a return to the spectacular performance of the stellar cycle will be disappointed. At the same time, investors whose return expectations are anchored in the most recent cycle will fail to appreciate the significance of the wide-ranging structural changes that have taken place in emerging markets over the past six or so years.

In our view, emerging markets have come of age. With the start of a new cycle on the horizon and current valuations suggestive of an attractive entry point, we think this is the right time to reassess emerging market exposure and the role that an allocation can play within a broader portfolio.

General risks: All investments carry the risk of capital loss and past performance is not a reliable indicator of future results. Any opinions stated are honestly held but are not guaranteed and should not be relied upon.

Specific risks: Developing market: Some countries may have less developed legal, political, economic and/or other systems. These markets carry a higher risk of financial loss than those in countries generally regarded as being more developed.

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