Emerging markets: better times ahead?

By Lynn Strongin Dodds

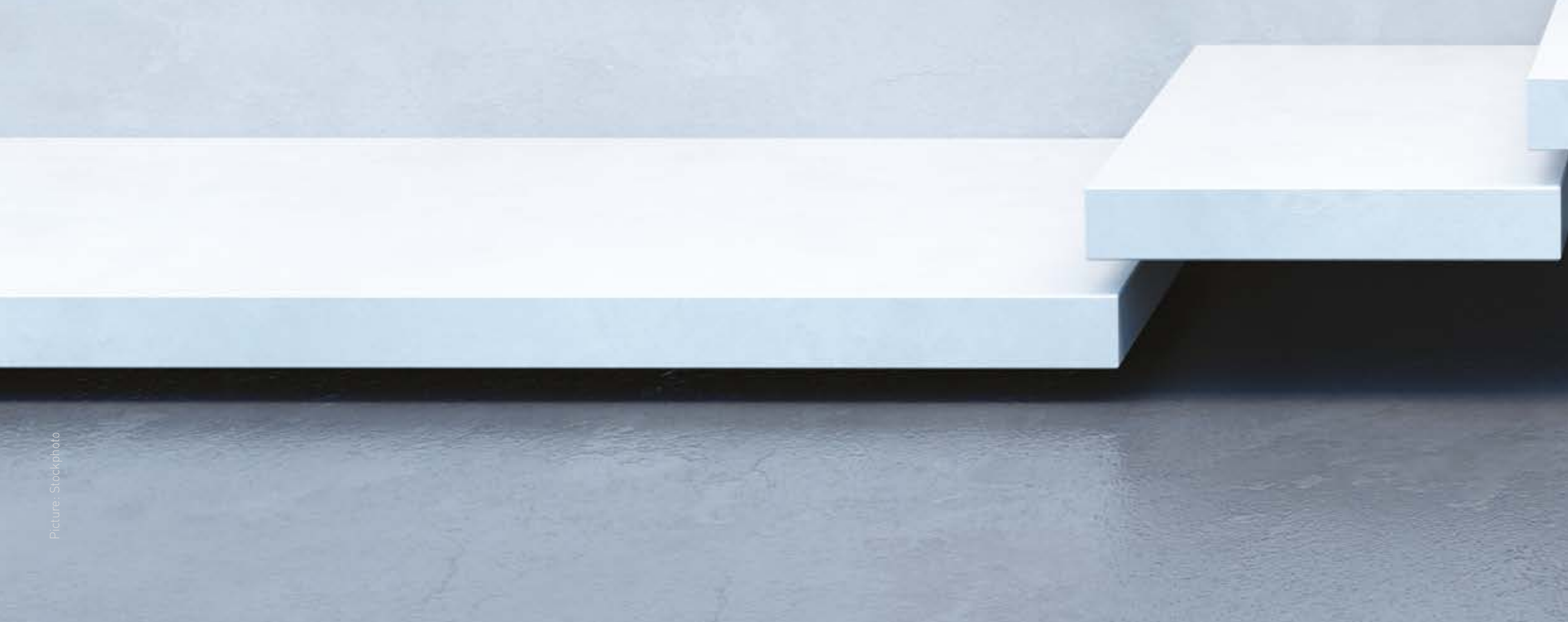
Once the darlings of the investment world, emerging markets fell from grace this year as the US Federal Reserve threatened to scale back its quantitative easing programme and the growth engines of China, India and Brazil spluttered. The days of double digit returns have faded but the more discerning investor will still find relatively attractive opportunities in 2014.

All emerging markets though went into a tailspin when Fed chairman Ben Bernanke hinted last May that it could start reducing its $85bn monthly bond programme. Shares plunged by 17% in dollar terms while currencies fell by up to a fifth and bond yields climbed two to four percentage points on the fears of rising rates. These markets recovered their equilibrium in September after the central bank postponed their plans, but institutions have remained skittish ever since because it is only a matter of time before the contraction begins.

At the moment there is no concrete date, but a spate of stronger than expected employment, housing and consumer spending news combined with the recent budget deal means tapering is likely to occur sooner rather than later. Before the year closed, the US House of Representatives approved a two-year federal budget bill in a strong showing of cross-party support. This means that the shutdown scenario in October will not be repeated.

Rush for the exit

The spectre of rising rates however has kept investors at bay or heading for the exit. The latest figures showed that they withdrew $4.7bn from emerging market stock funds in the week ended November 13, marking the biggest exit from the funds in 20 weeks, according to the latest Bank of America Merrill Lynch report, citing data from fund tracking firm EPFR Global. Their bond counterparts



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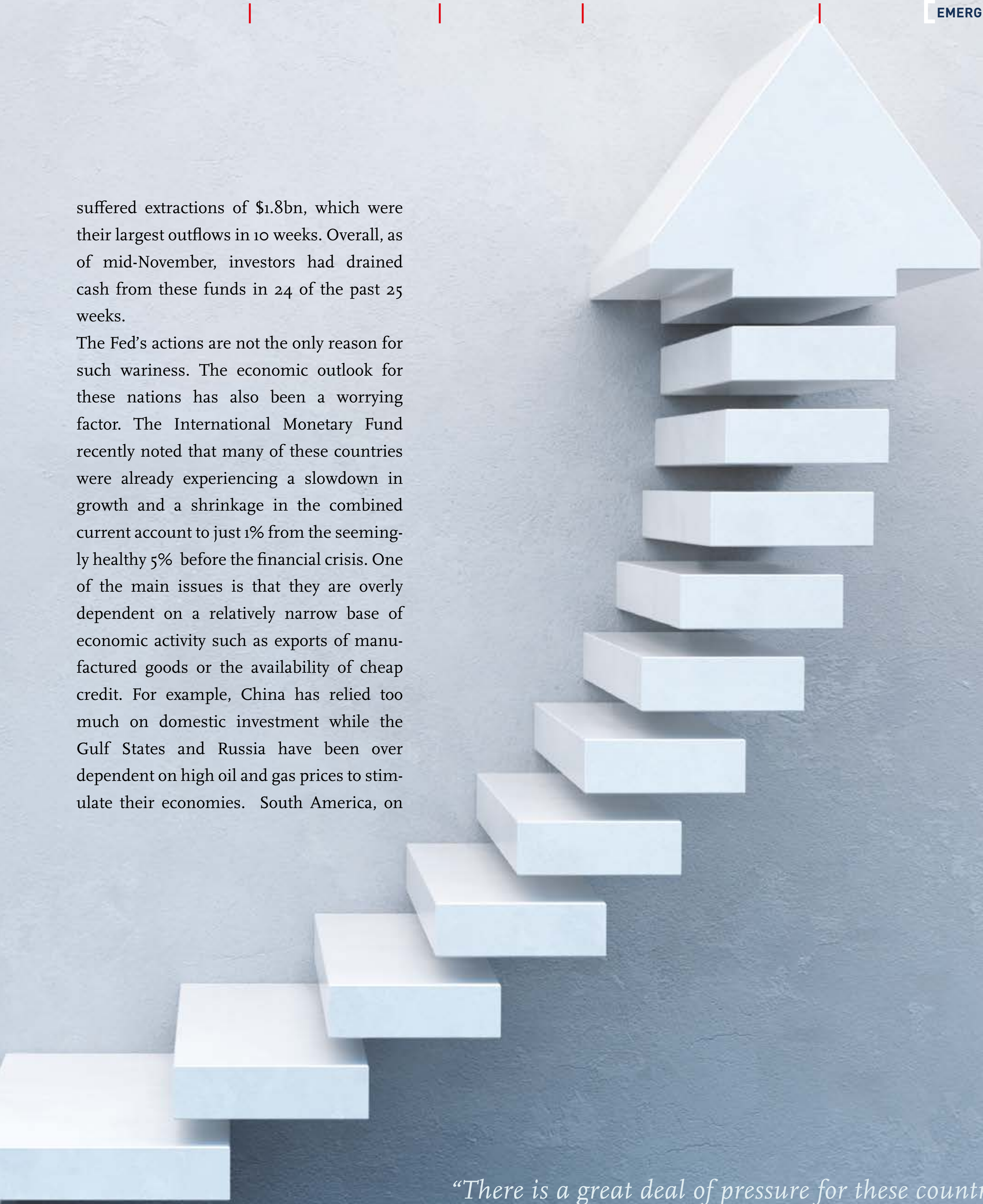
suffered extractions of $1.8bn, which were their largest outflows in 10 weeks. Overall, as of mid-November, investors had drained cash from these funds in 24 of the past 25 weeks.

The Fed's actions are not the only reason for such wariness. The economic outlook for these nations has also been a worrying factor. The International Monetary Fund recently noted that many of these countries were already experiencing a slowdown in growth and a shrinkage in the combined current account to just 1% from the seemingly healthy 5% before the financial crisis. One of the main issues is that they are overly dependent on a relatively narrow base of economic activity such as exports of manufactured goods or the availability of cheap credit. For example, China has relied too much on domestic investment while the Gulf States and Russia have been over dependent on high oil and gas prices to stimulate their economies. South America, on



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the other hand, has relieved too heavily on feeding the Chinese infrastructure engine with their natural resources.

According to Gary Greenberg, head of Hermes Emerging Markets, "the old model of debt fuelled overconsumption in the West is over, and central bank stimulus cannot be relied upon to support growth indefinitely. Domestic consumption and South-to-South trade have been widely mooted as part of the new paradigm, but more is needed. To remain viable investment destinations, emerging markets must streamline bureaucracy, modernise logistics and address environmental sustainability. Not least, companies in these countries need to modernise operations and take advantage of technology to become more efficient. Although this can fly in the face of a government's goal of full employment, it is the only solution in the global marketplace over the long term."

Political change

The call for structural change though comes at a time when the political sands could potentially shift in many jurisdictions. "There is a great deal of pressure for these countries to reform but there are elections being held everywhere next year, most notably in Indonesia, Turkey, India, Brazil and South Africa," says Sergio Trigo Paz, head of emerging markets fixed income at BlackRock. "This will delay any changes and is not constructive for emerging markets."

Valentina Chen, fund manager, Aviva Investors emerging markets local currency bond fund, agrees. "The countries who are holding elections this year will not want to do anything difficult. I think though that overall investors will have to readjust their expectations and realise that going forward they will not be able to get the returns they have been used to over the past few years. The focus now should be on those countries that have the strongest long-term macro stories."

Allan Conway, co-head of emerging markets debt relative return at Schroders, also believes that investors should drill down further. "The country decision, which has always been important when investing in

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global emerging markets and is one of our explicit alpha drivers, is likely to become even more important in the period ahead."

For example, he adds, if you look at the impact of tapering, countries such as India, Brazil, South Africa, Indonesia and Turkey experienced a sharp sell-off but they represent only 30% of the MSCI Emerging Markets index. "On the other hand, those countries running large current account surpluses such as China, Korea, Taiwan and Russia were unaffected and represent 50% of the index."

Mixed fortunes

Greenberg also advocates breaking down emerging markets into segments. "There are countries such as India, South Africa, Brazil and Turkey who will be challenged by elections and tapering due to their large current account deficits and reliance on external funding but there will also be those such as China who will not be as impacted. The Third Plenum marked acceleration in the pace of market reform and new premier, Xi Xinping, is seen to have the political power to push these reforms through although it is not a done deal."

Jian Shi Cortesi, manager of the JB Asia Focus Fund at Swiss & Global is also optimistic about the country's prospects despite the slowdown in growth.

"China's credit-driven economic growth model is unsustainable, but the world's second largest economy is evolving as it moves away from an overreliance on investment towards increased consumption," says Cortesi. "The new reform packages included 60 initiatives which are to be implemented over the next 10 years. This ambitious plan will enable China to embark on a new growth path through promoting a market driven economy, supporting private businesses, increasing consumption and importantly building trust in the new government."

New opportunities

In terms of sectors, Shi Cortesi notes, that the "MSCI China Index has an overrepresentation of China's 'old economy' with 70% of its constituents comprising telecommunications, energy and financial companies. Many of these companies are mature, state owned and slow-growing industries with significant policy headwinds. The best opportunities exist in emerging fast-growing industries benefiting from favourable government policy such as consumer, technology, healthcare and clean energy."

Bartosz Pawlowski, global head of EM strategy at BNP Paribas also believes there will be more relative-value opportunities as countries emerge from the crisis at different speeds in the FX and fixed income space. "The idea of buying 'good' and selling 'bad' emerging markets is the wrong way to think about cross-EM FX trades due to the negative carry often associated with these trades, as well as their exposure to risk sentiment. Looking at the delta on the macro fundamentals of emerging markets is key. We have identified Poland, Israel, the Czech Repubportfolio institutional awards 2014

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Michael O'Higgins

Michael became chair of The Pensions Regulator in January 2011. He was chairman of the Audit Commission for the six years to September 2012. Michael is also a non-executive director of HM Treasury and chair of the Treasury Group Audit Committee.

Joanne Segars

Joanne became chief executive of the NAPF in October 2006 having joined the organisation in 2005. Before joining the NAPF she was head of pensions and savings at the Association of British Insurers from 2001 to 2005. Joanne held the pensions brief at the Trades Union Congress for 13 years.

Mike Taylor

Former chief executive of the London Pensions Fund Authority, Mike joined the LPFA in 2006 having previously been County Treasurer of Surrey County Council for eight years. Mike was a CIPFA accountant with the City of Westminster and worked for the London Boroughs of Southwark and Hammersmith and Fulham before joining Surrey.

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lic, Korea and Singapore as the countries that are likely to benefit most if growth is sustained."

The general consensus is that local currency bonds are a better bet than the dollar denominated international bonds typically favoured by global investors. "Yields in developed markets are still much lower than historical averages with US five-year government bonds trading near 1.55%," says Jan Dehn, head of research at the Ashmore Group, an asset manager which specialises in emerging markets. "This is in contrast to local currency bonds which are trading near 6.8% with the same duration."

Kaan Nazli senior economist, emerging markets debt team at Neuberger Berman, favours local currency debt due to recent real yield rises making them less vulnerable to a sell-off in Treasuries and improving their relative value to hard currency debt. "I also think that when the Fed does start to taper it will be less of a shock than when it was first announced in May," he says. "The appointment of Janet Yellen as the new chairman has given people more confidence because she is very employment focused." Market participants also believe the launch of Bank of America Merrill Lynch's emerging market local currency corporate bond indices – the first of their kind – will give the asset class a boost. Many developing countries already have large local bond markets denominated in domestic currencies, which companies tap to raise financing. However, global investors have been concerned over their liquidity and tradability. Dehn believes this is a significant development because "the vast majority of the world's institutional investors only recognise asset classes if they have indices. The BAML index is imperfect – it only represents 5% of the universe of local currency corporate debt – but its existence enables investors to tap into what could eventually become a $30trn asset class."

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