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* Investment Managers are appointed by BNY Mellon Investment Management EMEA Limited (BNYMIM EMEA) or affiliated fund operating companies to undertake portfolio management activities in relation to contracts for products and services entered into by clients with BNYMIM EMEA or the BNY Mellon funds.

Shifting fortunes

S trengthening investment flows and improving returns have driven renewed optimism in emerging markets (EM) through much of 2017 but the spectre of political risk has never been far away. After numerous cyclical twists and turns in the emerging markets story, can the asset class ever deliver stable and sustainable gains?

Here, managers from across BNY Mellon Investment Management boutiques explore the rising appeal and development of emerging markets, the latest trends influencing flows and the potential risks and rewards.

The gap between emerging and developed market growth is expected to steadily narrow over the next few years on the back of accelerated EM growth, according to the International Monetary Fund (IMF). Although the differential is expected to remain below pre-financial crisis highs, expectations remain that EM growth will be a key driver of capital flows away from developed markets.

The first half of 2017 appears to back this trend with the year starting well for emerging markets as a whole. While managers say country selection remains key to returns, interest in EM has generally been on the rise. Although, on the back of a wave of words in late summer the rising geopolitical tensions between the US and North Korea led to a slight reversal of fortunes with some US$1.6bn withdrawn from EM equity funds in the week ending 16 August; a further US$79m was withdrawn from emerging market debt funds.1

Global Diversified, rose 7.97% and 6.55% respectively. The corporate bond index, JPM CEMBI Broad Diversified, gained 5.97% over one year and 1.64% over three months, Lipper figures show.

Standish managing director of emerging markets Federico Garcia Zamora says: “The rise of the US dollar has recently come to a halt, commodities have come to a halt, commodities have periodically frothy real estate market. “There will always tend to be some uncertainty over China but there are also many positive aspects. The major banks in China are quite healthy and attractive from a valuation perspective and, in our view, even some state-owned enterprises (SOEs) offer attractions to investors. We don’t believe the Chinese financial system is likely to be hit in the short to medium term by some major event that would call into question the sustainability of the wider economy,” he says.

Newton Investment Management investment leader of Emerging and Asian equity, Robert Marshall-Lee, is more wary on SOEs and believes that, despite some improvement, China has some way to go to reduce its debt to comfortable levels.

“While the debt and fiscal situations are better now in China we wonder about the transparency levels and real financial picture within many SOEs. The concern is that their debt position may be unclear and profits could prove to be illusory. We also believe these are generally potentially high risk investments,” he says.

**Protectionist threat**

Beyond China, some analysts worry about the impact of the US, fearing the negative effect of a more hawkish stance by the US Federal Reserve on interest rates. Although the wider protectionist threat some EM investors feared from the election of US President Donald Trump in late 2016 appears to have receded, his administration remains unpredictable and to some, unsettling. While July saw Republican lawmakers abandon plans for a controversial border-adjusted tax on imports, Trump’s pledge to “build the wall” between the US and Mexico remains intact. Trump’s perceived inconsistency on China and rising US tensions with North Korea also worry some analysts.

**POLITICAL RISKS**

Elsewhere, late summer political events in Brazil, Venezuela and Pakistan have underlined the potential for wider geopolitical risk across EMs while rising unemployment across some markets has been an added concern.

**Growth prospects**

Despite this, macroeconomic forecasts for key emerging markets remain broadly positive. The World Bank predicts growth in emerging market and developing economies as a whole will pick up from 3.5% in 2016 to 4.1% for 2017. In turn, EMs, even discounting uncertainty over China, look set to be a key driver of global growth. Growth among the world’s seven largest EM economies is forecast to increase and exceed its long-term average by 2018. Wider progress on the long road towards greater EM liberalisation, market infrastructure development and improved corporate governance remains patchy but Morgan Capital global investment strategist Shweta Narasimhadevara still sees grounds for optimism. “Emerging markets have made some rapid strides within development in the past two decades. Many now have much better monetary and fiscal policy management with North Korea also worry some analysts.”

**Market moves**

Geopolitical turbulence in Turkey has brought both positive and negative market impacts. By July 2017 – one year on from a failed coup – the Turkish lira had fallen nearly 20% against the US dollar. In contrast, GDP growth rebounded and Istanbul’s benchmark BIST 100 index was up 46% over the same period in Turkish lira terms.

**Mixed blessings**

Despite their rich energy reserves, several Middle Eastern emerging economies – including Saudi Arabia – have recently been impacted by a global reduction in oil prices, prompting falling GDP growth. Some analysts, however, believe an increasing focus on economic diversification, coupled with any eventual oil price recovery, should boost these economies.
various currency crises. They also weathered the slowdown in capital flows witnessed through 2015, better than in previous cycles. Policy management has improved significantly in a number of EMs and FX trading in some emerging markets has become easier,” she says. But for many investors, the question is not if but how to invest in emerging markets. An increasingly bewildering range of fund options is available with both active and passive investment approaches. Brazil – currently mired in damaging political upheaval – is typical of EM countries once perceived to be rising stars only to fall rapidly out of favour.10

While a weak dollar is a tremendous advantage for emerging market debt investors and prompted painful readjustments to EM economies with large current account deficits, which had come to expect this combination of supportive external drivers and improving domestic fundamentals to yield strong total returns for the asset class this year and likely into 2018.

Headwinds

History shows the US dollar mean reverts in real terms over long economic cycles. We believe the dollar-up cycle is in a mature stage; it is currently one of the world’s most expensive currencies. While a weak dollar is a tremendous benefit for local currency EMD, a stable dollar is all that is necessary for the asset class to deliver high single-digit returns. For example, from mid-2010 to April 2013 the dollar remained relatively stable yet local currency EMD posted a cumulative return of some 36% in US dollar terms.

Influences

Policy tightening by the US Federal Reserve has been another headwind for local currency EMD. Beginning in May 2013, the Fed announced that it would begin to curtail its policy of purchasing debt known as quantitative easing. This triggered abrupt sell-offs of emerging market debt by investors and prompted painful readjustments to EM economies with large current account deficits, which had come to depend on foreign investment to fund economic activity. Now, four years later, the Fed is very gradually raising interest rates and unwinding unconventional monetary policies. This process is already priced into asset valuations; hence, we do not expect the actual delivery to create much market disruption.

The technological revolution in the energy sector paved the way for the introduction of unconventional oil production methods, changing the very structure of the oil market and triggering a massive collapse in the price of oil between 2014 and 2016. This has had a huge impact on EMD local currency. As many emerging market countries are commodity producers, their external and fiscal accounts are heavily influenced by the prices of the commodities they produce. Conventional producers (both OPEC and non-OPEC members) have since intensified their efforts to improve the balance between demand and supply in the coming years. We expect these efforts to produce a much more stable price of oil during our investment horizon.

Fundamentals

In addition to the improving picture on the external front, a good portion of the emerging market nations are in better shape now than previously. Following the painful readjustments of the past several years, many now enjoy smaller current account deficits and significantly lower inflation. Today, the current account deficits in countries such as Indonesia, Turkey and South Africa have compressed materially due to slower growth and currency depreciation, reducing their external vulnerability. Lower vulnerability to external shocks, lower inflation and improved domestic growth prospects make emerging market debt local currency more attractive as well.
In recent years emerging market (EM) default rates have not been materially greater than those in developed market (DM) and the former’s bond covenant quality has also tended to be higher on average. Within the high yield (HY) area of EM debt, fundamentals are also improving and default rates are expected to decline this year.

Comparing default rates for EM corporate HY issuers with those of their US equivalents since 2000, two observations are worth highlighting. First, the close similarity in trend between the two series suggests global cyclical factors, rather than regional idiosyncrasies, explain a large part of the default experience for both DM and US corporate issuers. Second, the magnitude of defaults has been broadly similar across cycles, with 2002 the only meaningful exception in the period surveyed.

With regard to sovereign debt, over recent years we have become more accustomed to associating crisis events with DM entities – the subprime crisis and European sovereign debt crisis being notable events from the past decade. While individual EM countries such as Ukraine and Brazil have seen crises of a geopolitical or recessionary hue, these events have been localised rather than global phenomena.

On aggregate, EM economies have matured considerably since the 1980s and 90s, and sovereign credit events have become more of a rarity. Using JPMorgan’s Emerging Market Bond Index (EMBI) Global benchmark, we represent the investable hard currency EM sovereign issuers accessible to international investors, only seven EM sovereigns in the index have defaulted since 2000. The adoption of flexible exchange rates, strengthened external balances, reserve accumulation and a move from external to local currency debt issuance go some way toward explaining this shift.

Regional disparities

Given the geographic breadth of the asset class, regional default disparities within EM can be significant. Over the past five years Latin America has experienced elevated default rates relative to the rest of EM, while the default picture in emerging Asia has been relatively benign. Latin America’s default experience can largely be attributed to political and economic headwinds in Brazil.

Brazil’s economy continues to emerge from a severe recession, while a corruption scandal centred on state-owned oil company Petrobras has generated a considerable amount of political instability. Against this economic and political backdrop, corporate debt exposures increased significantly, profitability levels declined, leverage metrics deteriorated and defaults ensued.

While Latin American corporates have also experienced a commensurate increase in leverage, the region’s recent experience with defaults has been mild in comparison. Most of Asia’s leverage build-up can be attributed to Chinese state-owned enterprises. The Chinese authorities have been at pains to avoid realising defaults that would adversely impact the asset quality of financial institutions’ portfolios. However, with increasing focus on financial and structural reforms, and signs authorities are now starting to allow more defaults occur, this rate could push higher.

Covenant quality

Fundamental credit analysis extends far beyond the examination of a company’s financial statements. Also important is an understanding of the degree of investor protection, measured by overall covenant quality. Moody’s Investors Service computes bond covenant quality scores across regions to gauge the level of protection in six key risk areas: restricted payments, investments in risky assets, leverage, liens subordination, structural subordination and event risk (change of control). According to their analysis, EM Asian high yield bonds provide stronger investor protection than those from Latin America and Europe, Middle East and Africa. However, these three EM regions all scored better than the North American and global averages. Such protections could provide comfort for investors in the event a credit episode occurs and in our opinion further dispels the myth that EM lacks creditworthiness.

Balancing risks

Looking ahead, with EM corporate default rates currently tracking close to 0.5%, we expect to see a significant decline in 2017’s full-year default rate versus the 1.1% level recorded in 2016. Two factors are driving this improvement. From a top-down macroeconomic level, we expect the global economy to continue to experience broad-based and sustained growth. For EM this should translate into higher levels of domestic and export demand, and a more supportive backdrop for commodities. From a bottom-up perspective, EM corporate fundamentals are improving on the margin and most notably for Latin American and commodity sector names.

For Latin America specifically, gross leverage levels appear to be turning a corner, while for EM corporates more broadly, EBITDA margins and interest coverage ratios are all pushing higher. Relative to European and US HY corporates, EM credit metrics remain stronger in aggregate. With many EM companies now focusing on reducing their financing requirements and capital expenditure, this should ultimately translate into stronger cash flow generation and a more rapid deleveraging process.

While EM corporate HY spreads, at 6.80% in August, are at the tighter end of recent ranges, such valuations may be justified when viewed against this improving fundamental backdrop. These valuations should also be evaluated in the context of the global low yield environment and EM corporate HY’s relatively lower duration (c5.7 years) profile – a particularly appealing trait given the shift toward monetary policy normalisation.

Furthermore, index compositional changes over time need to be recognised. Over the past few years, several large EM countries have been downgraded from investment grade to HY. This automatically brought a majority of corporates from these downgraded countries to HY as well, even if many still retain investment grade-quality metrics.

Despite the commonly held view, EM debt issuers are not inherently less creditworthy than their DM counterparts. Realised historical defaults and measures of covenant quality confirm this. In a world of limited yield, EM corporate HY offers a compelling investment opportunity that should not be ignored.

### Key Points

- Seven EM sovereigns in JPMEMBI have defaulted since 2000
- Some EM corporate fundamentals are improving
- Bond covenants stronger than in some developed markets

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**EM Bond Covenants in Asia, Latin America and EMEA Are Stronger Than in North America**

<table>
<thead>
<tr>
<th>Region</th>
<th>Covenant Quality Score</th>
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Peering past controversy

Filipino President Duterte has been hitting the headlines for all the wrong reasons. Here Newton's Douglas Reed outlines the macro backdrop, while portfolio manager Caroline Keen assesses the selective investment case for the Philippines.

Controversial Filipino President Duterte has created quite a stir since taking office in June 2016, putting the Philippines on the news map for notorious reasons, says Douglas Reed, strategist on the Emerging and Asian Equities team at Newton.

Notable events in his thus far short tenure include threatening to withdraw from the UN in response to criticism of his hardline anti-drug policy (and associated deaths); threatening to eat terrorists alive if given some 'salt and vinegar'; and likening himself to Hitler in his pursuit of ridding the country of drug addicts.

Reports suggest there were more than 1,000 people a month killed in his first six months in office through vigilante attacks on criminals. The reignition of conflict between government forces and Islamic separatists in Marawi City on Mindanao Island has been another adverse development.

Yet, economically, the country continues on a trend of robust growth. While the GDP forecast for 2017 has been revised downwards, it is still one of the fastest growing economies in South-East Asia and the 10th fastest in the world.

GDP growth was lower in the first half of 2017 than in 2016 as a whole but not too drastically; 6.4% year-on-year down from 6.9%. This was due to “a gentle slowdown in consumption and government spending and a more visible slowdown in fixed investment,” according to Reed, “but revenues through higher car and fuel taxes and expanding the tax base, which will be spent on infrastructure. This is "exactly what the country needs," says Reed. Investment spending as a percentage of GDP is still relatively low, and he believes expanding the tax base to finance a higher level of public investment is in the country’s longer term development interests. Government spending on infrastructure is targeted to be 7.4% of GDP by 2022 up from 4.3% in 2015 and 5.4% in 2017. The bill will also reduce the number of personal income tax brackets and rates at each bracket, except for the highest earners, which should encourage consumer spending, Reed says, adding that inheritance taxes and those on small businesses will become more favourable.

In June the Philippines’ House of Representatives passed the first of four planned tax reform bills. If approved by the Senate, the new rules will increase revenues through higher car and fuel taxes and expanding the tax base, which will be spent on infrastructure. This is "exactly what the country needs," says Reed. Investment spending as a percentage of GDP is still relatively low, and he believes expanding the tax base to finance a higher level of public investment is in the country’s longer term development interests. Government spending on infrastructure is targeted to be 7.4% of GDP by 2022 up from 4.3% in 2015 and 5.4% in 2017. The bill will also reduce the number of personal income tax brackets and rates at each bracket, except for the highest earners, which should encourage consumer spending, Reed says, adding that inheritance taxes and those on small businesses will become more favourable.

As well, consumer confidence meanwhile remains robust at its highest levels since 2008, providing some comfort that the slowdown in personal consumption may prove temporary.

Also in the government’s plans is an increase to the deficit limit (previously 2% of GDP) to 3% of GDP, in order to fund help these changes, says Reed. “This more conservative goal was inherited from the previous administration but 3% will still be viewed as well-managed overall given the Philippines’ low government debt to GDP ratio (34%) compared with most of its trading partners.”

On the topic of trade, Reed notes there is an ongoing structural change in the current account balance, where the Philippines’ faster domestic growth rate versus its trading partners has led to its imports generally growing at a faster rate than its exports, with remittances from overseas Filipino workers only partially offsetting this. The growth in imports has however been largely in capital goods to drive investment in productive capacity which should benefit the economy in due course.

Related to this, says Reed, is the relative strength of the currency against its trade-weighted basket. “The evaporation of the current account surplus over the past two years has gone hand in hand with the modest depreciation of the Philippine peso versus its peers. “Looking ahead, despite some misgivings over the relative strength of the currency, the Philippines still offers genuine prospects for domestic demand growth and should be fertile ground for investment, with returns outpacing any depreciation over the medium term.”

Investment considerations

Allocating capital to the Philippines takes careful consideration, according to Caroline Keen, portfolio manager on the Emerging and Asian Equity team at Newton. “There are many well run companies that can benefit from the low starting point of the country but there are also those where the corporate governance is not up to the standards we see in other Asian countries,” she adds.

Yet there have been some steps in the right direction. The Philippines Securities and Exchange Commission has tried to promote corporate governance among its members, says Keen. “Since 2013 every single company has had to produce an annual corporate governance report and a new corporate governance code was produced in January this year, limiting the term for independent directors to nine years. Previously there was no limit.”

Another issue to consider is the dominance of family-owned conglomerates. “Generally we can bucket these companies into two broad types: First, the well-established Filipino/ Spanish family businesses in existence since the Spanish-era of the 16th century; second, the newer Filipino/ Chinese conglomerates which are generally positioned in faster-growing, scale businesses, e.g. consumer sectors.”

Keen says in general she dislikes conglomerates where capital allocation decisions are unclear and perhaps driven by motivations other than value creation for minority shareholders. “That being said, one of the Filipino companies we like owns a major car franchise in the country, as well as owning stakes across the banking sector, infrastructure, property and insurance industries.”

In terms of income, the Philippines is a fairly low-yielding market, for two main reasons: First, as an economy in the early stage of growth, companies can be better off re-investing in the business rather than paying out cash to shareholders. Second, the high multiples in attractive areas of the market mean yields are low, even if dividends are paid.

Keen says that unfortunately, in the telecom sector, where dividend yields have been higher, the two largest players have been in a “value destructive price war” of late.

Ultimately the demographic story is still favourable for consumption and Keen believes the “demographic dividend” is yet to fully emerge. “The dependent part of the population is high on the young side rather than the old side (as in many western economies) so while there could be a challenge ahead for the government to stimulate job creation and ensure there is not brain drain, this is a factor it is well aware of.”

Aside from its notorious president and the need for continued progress in corporate governance, to align with its Asian peers, the opportunities in the Philippines still exist, says Keen. As ever, the key is to look beneath the headlines and make the most of company specific research to try to navigate any problematic sectors or themes, she concludes.

KEY POINTS

- President Duterte has attracted negative publicity despite robust national growth.
- Tax reform is hopefully on the way.
- Corporate governance standards are in progress.

1 Al Jazeera: ‘Philippines: Death toll in Duterte’s war on drugs’ , 15 December 2016.
2 Thomson Reuters Datastream
5 Thomson Reuters Datastream
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A watching brief

From an investment perspective, what is your favourite emergent emerging market (sometimes called ‘frontier’ markets) and why? Is the universe of these markets growing?

McDonagh: There are a number of markets which, in our view, offer compelling value. Firstly the banking sector in Nigeria. Non-performing loans should peak as the economy strengthens and capital levels are robust. Secondly, Kazakhstan’s sovereign debt. Moody’s recently upgraded the country to a ‘stable’ outlook and we believe production from the Kashagan oil field will underpin government revenues in the medium term, even if technical difficulties have caused some short-term delays.

We also like sovereign debt issued by the Ivory Coast where economic growth is expected to recover sharply in 2017 and we believe market pricing already reflects the effect of lower cocoa prices on government revenues.

The universe is growing which is likely to deliver further opportunities to active managers. This year alone has seen a number of large deals from countries such as Lebanon, Nigeria and Romania - all of which have seen strong demand.

Marshall-Lee: We have kept an eye on Nigeria for several years but are still waiting for its currency and economy to correct. Unfortunately corruption is widespread within the country and recent uncertainty over the leadership of the Central Bank of Nigeria has not helped underpin confidence in the equity market. Beyond that though, there are some good companies in Nigeria. The country also has strong demographics, low credit penetration and entrepreneurial people so we believe there will be serious investment opportunities there in the future.

Garcia Zamora: Uruguay has fostered a very strong structure for growth, especially given the various regional crises it has faced such as Argentina’s default in 2001 and regional hyperinflation. The economy has surged since last year’s recession. Uruguay has shown a commitment to fiscal discipline. Despite relying upon fiscal stimulus last year, which some countries become dependent upon after emerging from recession, Uruguay’s government has shown a commitment to cutting back spending and moving toward a more balanced budget. Uruguay also has incredibly high levels of foreign exchange reserves and they expect to earn quite a bit from interest payments on the foreign debt they hold. Additionally, inflation has slowed at an unexpectedly positive rate. This has helped Uruguay’s local currency and its efforts to build a local yield curve.

Shepherd: My favourite emerging or frontier market is local currency Peruvian bonds. To my mind they aren’t really frontier as the government has a credit rating of single-A and with falling inflation, very strong fundamentals, a peaceful transition of power and a track record of prudent fiscal management, I think the bonds yield too much.

The universe for local bonds continues to grow and Peru recently issued a euroclearable local currency bond with the aim of making existing issuances euroclearable within the next two years, which should boost market liquidity.

Narasimhadevara: Within the EM universe, we find the differences in classification between developed and emerging markets more interesting than between emerging and frontier markets. Definitions are not always universally recognised, MSCI classifies South Korea as an emerging market while other indices recognise it as a developed market. Either way, it is widely felt countries like South Korea and Taiwan have the potential to move beyond emerging market status to become developed markets in the next few years.

Saudi Arabia is an interesting frontier market that MSCI has considered including in its EM benchmark and there are signs the Saudis have taken steps to allow greater foreign access to their local stock market.

A more mainstream emerging market economies continue their path towards a developed classification, global investors are exploring the potential of less established markets. Here, investment specialists from Newton Investment Management, Insight Investment, Standish and Mellon Capital consider the potential risk and reward these emergent emerging markets present, their development needs and accessibility.
Emerging Markets Q4 2017

From a geopolitical, economic and financial perspective what do these countries need to do to move into a mainstream emerging classification?

Marshall-Lee: There is a large divergence across the emerging and frontier markets. Many are still basically commodity-led economies and market classification is not simply based on how much GDP per capita any country generates. Other factors such as governance and capital market development are also very important and market liquidity levels must also be taken into consideration. Many of the emerging economies are making progress in these areas but more can and will need to be done to improve their infrastructure and political frameworks before they can become attractive investment propositions.

McDonagh: Develop, reform and diversify: Frontier markets are countries which are at an early stage of development, often with a high proportion of state involvement in their economies and economic concentration towards a single sector or trading partner.

Liberalisation and improving property laws will attract private capital and can lead to rapid economic growth. Where there is an over reliance on a single economic driver, such as commodities, then investing in infrastructure and broadening the depth of the economy can reduce economic risks.

Over time, rising wealth levels and deepening capital markets will see the country shift towards a mainstream classification. Strong, stable government is also critical and is needed to help ensure that rising wealth does not lead to corruption, or cause social unrest if income inequalities grow.

Shepherd: These economies should continue to develop the sophistication, depth and regulation of their domestic financial markets and boost key economic data such as per capita. There are no real hard and fast accurate categorisations of frontier markets, which obscures and can sometimes offend. I believe they would warrant a frontier categorisation based on decision and policy making being carried out by a very small number of unaccountable people, leading to high volatility when sudden changes occur as they are wont to do.

Nasirahmedevara: Governance is very important but change takes time. By way of example, it has taken many years for China to get to a point where its A-shares can be listed in the MSCI emerging market index. In some less developed emerging markets, constant intervention by the government can be a problem, as can restrictions on foreign ownership.

 Liquidity issues, currency convertibility, market access and a willingness by governments to remain open to the needs of trading in those securities are all important. While some of the less developed emerging markets still have some way to go, they are generally making efforts to improve their attractiveness to foreign investors.

Garcia Zamora: By way of example, take Uruguay. We believe it needs to lower its high rate of dollarisation (the process of aligning a country’s currency with the US dollar), which reduces the efficiency of its monetary policy, though this should be remedied in part by the slower rate of inflation.

Despite our general optimism about Uruguay, we have some concerns about its high debt to GDP ratio, which is currently at 59%, with some 40% of that debt held in FX. The debt stock remains too high, preventing an upgrade in the foreseeable future unless the government makes meaningful progress in reducing it. That may also remain highly dependent on commodities, namely agricultural goods.

What are the investment risk/reward levels in being exposed to these types of economies and how do these compare with more established emerging markets?

Marshall-Lee: These markets do not always offer both higher risk and, ultimately, higher rewards. From a risk perspective, many of these markets have been historically driven by commodities and the long bull-run in that sector, driven by Chinese demand, looks unlikely to repeat itself. The direction of travel of politics and governance are also important in any EM country.

Interestingly, even some of the more established emerging markets have shown signs of regression in recent months. In our view, from a governance perspective, Turkey, Poland and Hungary have all been rolling backwards, Greece, which lost its developed market status in 2013, has been one of the worst performing emerging markets, which underscores the point that reward doesn’t always correlate with risk.

McDonagh: Frontier markets tend to be countries developing very rapidly from a low income base. Political reforms and economic liberalisation can lead to high levels of economic growth and, as underlying fundamentals improve, potentially high returns.

A smaller investor base can also lead to valuation anomalies, presenting opportunities, which would be more rapidly exploited in mainstream markets. The risks come from lower liquidity, greater political risk and more concentrated economies which can be more vulnerable to changes in the external environment.

Frontier markets will generally have low credit ratings relative to mainstream emerging markets and only a limited number of bonds in issue. Careful analysis is needed to pinpoint how to best extract higher returns while minimising the associated risks to an investment portfolio.

Shepherd: We should be rewarded with a higher reward for investing in frontier markets as they will lack the track record of meeting obligations and reputational credit that established emerging markets have earned. In times of financial distress where portfolio capital is in a flight to quality, we should expect frontier market investments to exhibit a higher beta than emerging market counterparts and display higher volatility.

However, in some EM government bond markets this has not been the case. This is a symptom of a few concentrated emerging market debt funds struggling to achieve desired diversification of issuers and so intending to hold the smaller market frontier names until maturity with little regard for wider market risk. This is in the expectation that it would be difficult to re-establish positions quickly when sentiment changed.

Nasirahmedevara: Some of the less developed emerging markets do tend to offer higher risk and potentially higher rewards. The difficulty in measuring risk in frontier markets is that they are often an unknown quantity and it may be a fallacy to say you can accurately measure their counterparty risk. Relative to well-traded, liquid, regulated markets with good governance, indicative risk measures – such as the Sharpe ratio – are unlikely to offer a reliable gauge in markets where transparency, liquidity and access are limited.

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Garcia Zamora: Frontier markets have different return drivers relative to mainstream emerging markets and only a limited number of bonds in issue. Careful analysis is needed to pinpoint how to best extract higher returns while minimising the associated risks to an investment portfolio.

Shepherd: We should be rewarded with a higher reward for investing in frontier markets as they will lack the track record of meeting obligations and reputational credit that established emerging markets have earned. In times of financial distress where portfolio capital is in a flight to quality, we should expect frontier market investments to exhibit a higher beta than emerging market counterparts and display higher volatility.

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Emerging Markets Q4 2017

Growth priority

China’s economy is unique for being both enormous and rapidly and relentlessly growing. Like a jumbo jet with fighter plane performance, the Chinese economy can have a massive impact for good or ill far beyond the country’s borders. Here, Standish’s senior sovereign analyst Aninda Mitra discusses the latest developments in China.

Several times in the past two years, policy shifts and missteps in China have brought volatility to what had been mostly placid markets. So is China a looming source of potential volatility or a bulwark of stability and a counterweight to destabilising forces elsewhere?

The good news for investors is that in the short term at least, we believe China is a source of both macroeconomic stability and positive global risk sentiment. A variety of factors are contributing to China’s positive contribution to the benign conditions that have characterised global markets for most of the past 12 months. State-owned enterprises and other firms alike have reduced excess production capacity, which has pushed up producer prices and shored up domestic revenues and profits. The weaker US dollar has also reduced pressure on the renminbi and boosted external liquidity. Above all, though, the greatest contributor to stability from China is the determination of its policymakers to maintain the momentum of economic growth even as they weed out pockets of excessive risk.

Achieving growth

For China’s leaders, growth remains a top priority. They view it as indispensable to domestic stability, which also contributes to stability in the global economy. The question is whether and how China can continue to sustain this growth in the longer term.

China’s policymakers have been challenging changes in both its domestic and global economies in the past couple of years. China’s export growth has slowed, asset price bubbles have arisen and capital has flowed out. Despite these challenges, policymakers are showing they remain able to steer their country’s massive economy.

They have imposed strict capital controls to limit the liquidity drain, which has become a policy headache. They have also tightened property market regulations in some cities and price increases are slowing. Finally, stricter regulations on shadow banking and interbank borrowing are cooling risky, and leveraged, lending practices.

To be sure, the cooling of property market activity is already becoming a drag on the Chinese economy. Lower property prices may also increase investors’ interest in other asset classes such as domestic equities, commodities or foreign currency. However, we expect ongoing investment in infrastructure, technology and energy efficiency – alongside tougher regulations – to create growth multipliers, limit speculation, slow the further buildup of leverage and move China’s overall productive capacity to higher value-added areas.

The long-term efficacy of several of these reforms, regulations and investments remains to be seen but in the near-term, they should lower macro and policy headwinds from elevated leverage and an eroding current account surplus.

Demographics

The government clearly possesses a variety of policy levers. However, there remain forces at work in the world that do not yield to the dictates of policymakers, no matter how much temporal power they may wield. While King Canute who recognised that the waves and tides of the ocean rose and fell despite his ordering them not to, China’s leaders confront the fact that the country’s demographic realities do not necessarily support Beijing’s push for continued growth.

China’s growth potential is being reduced by the rapid ageing of its working age population, slowing migration to urban areas and rising debt – all of which depress domestic demand. The shrinking labour pool will undoubtedly lower China’s potential growth rate and the country faces a clear risk of getting considerably older before it becomes much richer.

However, China’s rural population is still large compared to other East Asian or other OECD economies. Continuing migration and urbanisation, albeit at a much more moderate pace, would buffer but not offset the drag from worsening demographics. Additionally, the imbalance in the sex ratio in favour of males lowers the number of child-bearing women over the medium-term. The reversal of the fertility ratio resulting from the ending of the one-child policy will therefore take much longer – if it succeeds at all – to reduce the demographic drag on growth.

These secular trends do not pose an imminent threat to social stability because wages are likely to rise due to labour shortages in the near-term. They do, however, highlight worsening inter-generational economic prospects, an undereveloped social safety net, loosening long-term credit risks and a halting commitment to reforms that would deepen China’s credit and equity markets.

In this less-favourable-than-it-used-to-be environment, China’s continued long-term growth will need to come from different sources than it has during previous decades. Instead of seeking to boost manufacturing of goods for export, policymakers are trying to increase domestic consumption, which is low compared to developed markets, though not significantly slower than in other fast growing emerging markets.

Government allocations

Investment-driven growth in sectors other than real estate is another important driver of potential growth. Heightened infrastructure spending and investment in high-tech sectors of the economy will remain important components of the overall thrust of investment. China’s overall share of investment in GDP has remained distinctly and persistently higher than other emerging markets and in comparison to past investment booms in Japan and other older East Asian Tigers. Even then, China’s capital stock per capita is still considerably lower than many other economies, highlighting the country’s continuing “catch-up” potential.

The incremental capital to output ratio has worsened markedly in recent years. This underscores the need for better allocation of capital. The big question facing Chinese authorities is whether a continuing investment drive in non-real estate areas should be spurred by state directives, backed by tightening macro-prudential measures or driven by market-based mechanisms.

An additional policy initiative with implications for growth involves reducing the use of leverage in investment. Earlier this year, China’s National Financial Work Conference, which meets every five years to set financial policy, committed itself to reforms intended to lower leverage. Reducing the high capital intensity of state-owned enterprises (SOEs), private companies and consumers is intended to reduce the likelihood of future financial crises. It will hopefully be accompanied by not only increased capital investment in infrastructure and high-

technology but also changes to the underlying management and incentive structure of the SOEs – to limit arbitrary growth targets and prevent the risk of implicit guarantees by the government, which, previously, have distorted perceptions of financial soundness and mis-allocated credit.

Meeting targets

We continue to believe the authorities will be largely successful in smoothing the GDP slowdown to slightly below 6.5% in coming years. Without meaningful reform and with the increasing centralisation of authority, it will remain difficult to find new wellspring of productivity, which could otherwise keep the growth target easily within reach.

Still, the government has shown it remains committed to the growth target with a limited stimulus and accompanying supply side adjustments. These initiatives have ended producer price deflation and sparked a stronger-than-anticipated cyclical rebound. This firmer cyclical context has then become the basis for doubling down on tackling pockets of financial risk and broadening the scope of de-leveraging efforts.

Risks to growth and stability

So far, neither geopolitical risks on the Korean peninsula, nor a tightening of domestic financial regulations appear to have diminished the global stability imparted by China’s growth momentum. However, if a sharper than expected slowdown were to occur, it would quickly test the authorities’ resolve to push ahead with further reforms and regulatory tightening. The most serious source of potential risk lies in a strong recovery in the US dollar or in much wider cracks in the bilateral trade and political relationship with the US.

Further domestic failures by the US administration could raise the likelihood of President Trump lashing out on an external front for example in a trade war with China. Some of Trump’s advisers have publicly said they believe the US is already in such a battle. For its part, China may grow less willing to overlook provocations from the US. However, a trade conflict would hurt both US and Chinese exporters, as well as damage other Asian exporters who are part of the China-centric manufacturing and export production chain. It would also complicate the PBOC’s exchange rate management and financial reform plan as most of China’s (dwindling) current account surplus is derived from a chronically elevated bilateral trade surplus with the US.

KEY POINTS

- Rapid ageing of Chinese working age population
- Policymakers trying to increase domestic consumption
- Growth viewed as indispensable to domestic stability
Grand visions of China’s One Belt One Road (OBOR) infrastructure project continue to make headlines but for now portfolio manager Naomi Waistell, of Newton’s emerging and Asian equity team, is curbing her enthusiasm. In May 2017 China’s President Xi Jinping officiated at the largest event to take place in Beijing since the 2008 summer Olympics. Delegates from some 130 countries attended, as did 29 heads of state – including Russia’s Vladimir Putin and Turkey’s Recep Tayyip Erdogan. The heads of the United Nations, the International Monetary Fund and the World Bank were also in attendance. The agenda: the official launch of a latter-day Silk Road – a vast infrastructure project spanning three continents linking China with Europe, central Asia, the Middle East and Africa by road, rail, sea and air.

In his speech the marking the launch, President Xi Jinping drew comparisons between the historic Silk Road (think camels laden with silks and spices winding their way through vast steppes and deserts) and the modern One Belt One Road (OBOR) project. The development, he said, “will unleash new economic forces for global growth, build new infrastructure for global development, and rebalance economic globalisation so mankind can move closer to a community of common destiny.”

So much for the history and current ambitions but for investors a key question is will the hype match the reality? Will the grand visions encompassing everything from power stations to gas pipelines, technology hubs to motorways reach fruition or – like so many centrally mandated infrastructure grand projects of the past – fizzle out in the face of hard facts? For Newton portfolio manager Naomi Waistell, it’s an important question. On the one hand, she describes the initiative as stunning in its scope. With an estimated price tag of some US$900bn1, it’s an important question. On the one hand, she describes the initiative as stunning in its scope. With an estimated price tag of some US$900bn1, “OBOR is nothing if not ambitious, ” says Waistell. “But if it is anything goes wrong, it’s an opportunity to look to the future.”

Hence, a new port alongside road and rail links in Pakistan provides direct access to the Chinese Ocean and the Gulf, while pipeline agreements such as the Central Asia-China natural gas pipeline, which runs from Turkmenistan through Uzbekistan and Kazakhstan to Western China, will allow unrestricted overland transhipment of oil and gas. Russian exports of coal, oil and energy to China are also expected to rise as rail links and pipelines between the two countries improve.

OBOR fulfils another strategic goal too, according to Waistell: namely the soaking up of China’s vast excess industrial capacity. She notes that Chinese companies are expected to dominate the construction phase of many of the larger infrastructure projects and so will likely import Chinese materials to support that process. “This should take the pressure off domestic overcapacity in sectors such as steel, cement and aluminium – and China’s heavy industry sector should see direct benefits as a result.”

While the strategic rationale of OBOR might make sense for China, there are still questions marks over how much of what has already been announced will actually come to pass, according to Waistell. In railways, for example, high speed projects associated with OBOR in Libya, Mexico, Myanmar, Venezuela and Indonesia have either been cancelled or are facing major delays. According to an investigation by the Financial Times, cancellations and delays account for at least 25% of the combined US$143bn value of overseas high speed rail schemes initially announced as part of OBOR.2

Challenging projects

The One Road maritime strategy has been far from plain sailing too. Even though China has secured contracts to build a port in Myanmar, a deal with Bangladesh fell through in 2016 when Dhaka opted for an offer from Japan instead. A US$1bn deal to construct Hambantota Port in Sri Lanka was scaled back after it sparked protests – and other projects from Europe to Africa have been met with differing degrees of suspicion as to China’s true intentions.

Here, says Waistell, is an important sticking point. Neither Japan nor the US are directly involved in OBOR, India – a key regional player – was also notable by its absence from the May launch event in Beijing. Partly this was a response to China’s involvement in the US$86bn China-Pakistan economic corridor, which exacerbated regional tensions, says Waistell, not least because part of the development is in the disputed border region of Gilgit-Baltistan. “China has done an incredible job of moving from a predominantly agricultural economy to its current status as the manufacturing hub of the world,” says Waistell. “But if it wants its grand vision to be a success, part of its strategy will need to be about addressing the concerns of countries like India, the US and Japan who can be said to be ambivalent about OBOR at best.”

Notwithstanding these considerations, recent data highlights how at least some parts of OBOR seem to be gaining a head of steam. During the May launch event, for example, China signed 270 cooperation agreements with 60 countries to further OBOR development. These agreements covered many sectors including industrial cooperation, infrastructure development, trade promotion and finance. Year to date, China has acquired 68 countries in the 68 countries officially linked to OBOR, surpassing the US$3tn tally for the whole of 2016. This rise is all the more remarkable given that it came against a 42% fall in overall outbound mergers and acquisitions from China.

At first sight, the numbers are impressive but here too other factors could be at play, says Waistell. She concludes: “We know China has cracked down on foreign investment, tightening capital controls and raising restrictions on foreign M&A – but this doesn’t seem to have stunted the enthusiasm for investment in OBOR projects. For us, this raises the question: Is investment by Chinese firms in the New Silk Road simply capital flight by another name? If so could we simply be looking at a gross misallocation of capital?”

KEY POINTS

- 65 countries participating in OBOR1
- 60% of the world’s population is affected by OBOR;2
- Nominal price tag of the initiative is US$900bn1

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2 Fung Business Intelligence Centre: The Belt and Road Initiative: 65 Countries and Beyond, May 2017.
5 Reuters: “Exclusive: China’s Belt and Road acquisition surge despite outward capital controls”, 16 August 2017.
7 Fung Business Intelligence Centre: “The Belt and Road Initiative: 65 Countries and Beyond”, May 2016.
Virtuous cycle

With improved growth leading to a decrease in the need for foreign capital to finance current account deficits across emerging markets, capital inflows are now driving currency appreciation. Here, Insight Investment head of emerging market debt Colm McDonagh outlines the currency outlook across key EM markets and the challenges they face over the next year.

It has, to date (August 2017), been a positive year for investors in emerging market local currency assets, especially those with a US dollar base. Currency returns only partially explain this move, with income and bond price appreciation also important factors for some markets. During 2015 and 2016, emerging markets experienced a period of significant capital outflows as markets adjusted with income and bond price appreciation to historical average levels. This has caused a virtuous cycle in some markets, with currency appreciation dampening inflation and allowing central banks to reduce interest rates, in turn causing bond prices to rise and driving further currency appreciation.

There are many reasons to believe this shift in valuations is more than just a short-term fluctuation and has deeper foundations. As we have progressed through 2017, so it is becoming clearer that the world is experiencing a broad-based economic recovery. In the US, the recovery continues to perform well, despite uncertainty surrounding the prospect of fiscal stimulus. In Europe, growth has improved markedly, with unemployment now rapidly declining in previously crisis-hit countries such as Spain and Ireland. Within emerging markets, China has proved more resilient than previously expected, despite authorities taking measures to limit the shadow banking sector and reduce overcapacity in some sectors. Two other significant economies, Brazil and Russia are now in the process of returning to growth after a period of deep recession.

Fundamental outlook

This improvement in the global growth outlook has led capital to return to emerging markets. According to research from the Institute for International Finance, net capital inflows to emerging markets could total US$76bn in 2017, accelerating to US$167bn in 2018. Before the recent period of capital inflows, some emerging markets had built up significant external imbalances and were thus left vulnerable to outflows. The International Monetary Fund (IMF) estimates that the aggregate current account deficit of Brazil, India, Indonesia, South Africa and Turkey (nicknamed the fragile five during the taper tantrum) peaked at US$255bn in 2012 but remained well in excess of US$200bn even by 2014. Currency devaluations, combined with various policy measures in individual countries, led this closed just to over US$100bn by 2016. With less need for foreign capital to finance current account deficits, capital inflows are instead driving currency appreciation.

To establish whether this move can be sustained over a longer period, we need to consider the outlook for global growth. If the global economy continues to experience relatively broad-based growth, this should continue to be supportive for emerging market assets. On this issue we take an optimistic view. Inflation remains at only moderate levels, which should grant developed market central banks considerable time to slowly normalise interest rates, lowering the risk of policy error. Global corporate profits have grown strongly over the first half of 2017 and this is generally a good forward indicator for future capital and job creation.

The IMF forecasts that the gap between emerging and developed market growth reached its lowest level in 2015 and that emerging market growth should steadily accelerate in coming years. Although the differential is expected to remain well below the pre-financial crisis highs, it should nonetheless be a driver of future capital flows away from developed markets and towards emerging markets.

Finding alpha

Despite this potentially positive outlook, challenges certainly remain for emerging markets. Political uncertainty has been a problem for the world in recent years and shows little sign of abating. This will almost certainly continue to be a source of future volatility, both for individual markets impacted by specific events and more broadly if policy missteps from the US or Europe affect global sentiment.

The dispersion of value across emerging market regions and countries is one which can provide significant potential for alpha generation. If currency valuations continue to revert towards longer term averages, high returns from some markets will likely be counterbalanced by losses in others. This would currently favour currency investments in Latin America and Eastern Europe over investments in Asian. Careful consideration is thus necessary to establish which markets within those regions have the potential for further adjustment and which will be constrained by politics or country-specific issues.

It is also critical for emerging markets that the policy errors of recent history are not repeated. As some economies return to stronger, more sustained growth, so the potential for a rebuilding of external imbalances rises. It is notable that policy makers in many emerging markets have become comfortable with using currency markets as a buffer to insulate their economies from negative shocks. One of the first lines of defence on any political, economic or external shock is to allow currency weakness, with authorities only stopping in counter falls once they become significant enough for inflation pass-through to become a concern. As long as local bond markets are not disrupted, such policy can have positive economic benefits.

One possibly important factor will be global commodity prices. The growth of US shale oil production is likely to constrain gains in global oil prices, and many other commodities are still working through overcapacity issues. If commodity prices remain well below historical highs, pressure is reduced on countries which are net commodity importers; at the same time commodity exporters are encouraged to diversify their economies.

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Strength in efficiency

Generic power
The struggle to meet these separate needs has dictated much of India's healthcare developments, says fellow analyst Emily Heaven.

"The primary care system is a developed market concept and most emerging markets do not have access to such practitioners. They are more focused on the development of mobile units that can travel to patients and vaccination programmes which target specific diseases," she says.

However, there are healthcare areas where India excels, such as the ability to deliver the same product or service more efficiently and at a lower cost than other countries. This is partly responsible for increased medical tourism and pharmaceutical exports as well as the adoption of its logistical models by the west.

Rowntree says the country is renowned for its chemical engineering expertise and efficiency, making it a leader in the production of generic medicines. A drug may have a manufacturing process with say, 15 steps, Rowntree explains, yet in India they might work out how to produce the same drug in 10 steps. "India may not be at the forefront of healthcare product innovation but when it comes to improving chemical technology, they are second to none."

This expertise has enabled cheaper drug production and a healthy export market in this area, he says. While there are hundreds of domestic pharmaceutical companies in this area, most global multinationals also have a presence in India, Rowntree adds. Recently, however, key markets such as the US are seeing a decline in the prices paid for many types of generic drugs and this is starting to impact Indian generic drug manufacturers.

Hospitals and services
As a consequence, Rowntree says, some of the more interesting and innovative healthcare areas in India are in services, such as hospitals. Heaven says another area of excellence in India is in optimising procedures, which enable doctors to perform operations more efficiently and with fewer resources. This helps to improve access to healthcare within India and attracts medical tourists from surrounding countries and Africa, who are looking for affordable but decent healthcare, Heaven notes.

Healthcare companies have been very clever at adapting to the hurdles they face and creating innovations in delivery she adds. For example, Heaven points out India has made use of remote doctor access, excelling at telemedicine, which was introduced there in the late 1990s, despite being thought of as a recent developed market initiative.

India's innovations in efficiency are aided by the lack of incumbent infrastructure. In the west hospitals, and the care system as a whole, have evolved slowly, which can make new solutions more difficult to conceive and implement, bolting onto existing structures, procedures and processes. Heaven says: "As they say, necessity is the mother of invention, India, as in most places, does not have enough hospital beds. This has prompted companies to come up with different solutions. The government has also been happy for private companies to take the lead in this area; regulations have been kind as a result. The skill and knowledge of medical staff is robust in India and clinical quality is impressive."

There are five large hospital chain companies operating in India and individual hospitals within these chains can each have several thousand beds, which is still not enough. The ratio of hospital beds to people in the country remains low with the facilities concentrated in urban areas. For example, in 2014 the city of Delhi had over 10 times more hospital beds per 1,000 people than the northern state of Uttar Pradesh.

Heaven says given the state of primary care in India, many just turn up at hospitals seeking treatment, creating demand pressures. As a result hospital chains are attempting to implement a "hub and spoke" model, a version of the west's GP system, she explains. "This system could encompass all stages of care: primary, secondary, tertiary and quaternary care (quaternary care is seen as an extension of tertiary in reference to advanced and highly specialised levels of medicine). This would then enable patients to be funneled to the most appropriate site of care for their level of illness." It is quaternary care where real innovation and pioneering procedures are taking place, she believes. As in many places there is also a shortage of doctors and nurses in India, particularly the latter. "We spend a lot of time discussing recruitment and retention of staff with some of the hospital companies we see," Heaven says. In addition, she believes the staffing challenges in healthcare may change. With the implementation of practices such as telemedicine and a greater focus on using medical data to inform treatment options, in the future, the role of doctors may change, the Newton analysts conclude.

Elsewhere in India... the road ahead
The introduction of India's first toll road investment trust, called IRB, in May 2017 underscores the expectation infrastructure will be a key driver of the country's growth over the next few years.

Naomi Waistell, portfolio manager on Newton's Emerging and Asian Equities team, says the IRB trust is likely to be the first of many. The proportion of India's road network that is national highways is just 2% and yet it carries some 40% of the traffic volume. Clearly there is a need for more motorways, Waistell says, noting the government plans to spend some US$20bn on improving India's roads. "For context, the capital spend on roads and rail combined by the government over the past two years has been about US$9.5bn."

Also underscoring the potential growth in Indian infrastructure trusts is another government initiative – tax reform. "At the moment India's state has varying tax regimes so drivers paying at tolls is a manual process and leads to long queues," Waistell says. The newly launched unified Goods and Services Tax, a harmonised system across India, could enable automation of toll collections, speeding up travel times. This in turn could see an increase in traffic growth and more toll income, thereby supporting asset income distributions from trusts like IRB, she notes. The IRB trust holds six toll roads and features a 10-12% yield in a country where just 10% of the Indian market's large cap stocks yield more than 3%, Waistell says.

KEY POINTS
- Urban and rural healthcare needs appear at odds
- India is renowned for its chemical engineering expertise
- Hospital efficiency creating medical tourism

Corporate governance standards are gradually improving in the emerging markets and increased focus on environment, social and governance (ESG) factors is expected to drive corporate transparency further, says Insight Investment ESG analyst Joshua Kendall.

Increasing ESG information by more market participants beyond CRAs should have two significant effects, comments Kendall. First, companies will be expected to disclose more – especially where transparency is inadequate, as is often the case in emerging markets. Second, it may encourage improved corporate performance in ESG-related themes as companies become more cognizant that ESG performance links to investors’ evaluation of an issuer.

Insight acknowledges that corporate governance standards are already improving in the emerging markets, comments Kendall. As that improvement takes place, integrating ESG in investment processes may help identify companies lagging their peers or where there is an increasing possibility things can go wrong. In the past, credit investors have been particularly affected by the poor disclosure of financial statements and weak covenants. ESG can be seen as a risk variable alongside other salient factors, such as liquidity, leverage, buyouts or specific events and changes in regulation.

Filling the gaps

More accurate and relevant information can translate into better investment decisions, says Kendall. However, in respect of many smaller issuers, especially in the emerging markets, the availability of relevant non-financial data often lags behind that for larger issuers. While ESG research from independent third-party providers of investment-grade issuers is around 95% (by market weight of popular corporate indices), emerging market issuers have lower coverage in popular corporate indices, he notes.

In those instances, where independent ESG analysis cannot be sourced from market data providers, an alternative approach is to ask company management directly to conduct a self-assessment survey on ESG factors. Refusal to comply can be taken into account in the credit assessment of the issue, comments Kendall. This self-assessment can also be used to generate an ESG scorecard. As bonds are often held to maturity, investors need to be confident in the management and the financial position of the companies in which they invest.

As it stands, there is also an argument that CRAs do not always assess ESG risks in a consistent or fully transparent manner, failing to capture the relevant key indicators and leaving them hidden behind other information, says Kendall.

The impact environmental risks can have is particularly illustrative. For example, a Singaporean commodities trader has been affected by a number of reputational concerns. Among these, the company was implicated as possibly contributing towards deforestation in Indonesia, which the firm strongly denied. Governance concerns were well-documented, especially those related to the board of directors. These problems manifested in a series of related party transaction risk, boardroom power struggle, executive turnover and accounting problems. These have been a distraction for the business and its strategy, causing financial conditions to worsen, Kendall says. 

Cazalet says the ESG information available in emerging markets is also now on a more granular level: it is feasible to drill down not only to ‘Environmental’, Social and ‘Governance’ levels but to focus on specifics, such as water stress or supply chain labour standards.

This more granular approach can help to identify companies that may have an adverse environmental impact, such as petroleum companies or utilities. With manufacturers in countries such as Taiwan, there can be concerns around employment practices and employee welfare, he observes.

Good examples of information providers are MSCI ESG Research and Sustainalytics, which lend themselves to both negative and positive screens, he adds.

Cazalet sees raised standards as evidence of greater adherence by emerging market exchanges and, by extension, the companies listed on them, to reporting criteria such as Generally Accepted Accounting Principles and International Financial Reporting Standards. The GRI’s Sustainability Standards are also now more prominent in the emerging markets. GRI is an independent international organisation that has promoted sustainability reporting since the late 1990s.

For Cazalet, in trying to evaluate the long-term benefits of incorporating ESG into an investment process, it is also important to increase the historical set of data as possible in order to understand how stocks perform in terms of ESG criteria over an extended time frame.

According to Karen Q. Wong, managing director and head of equity portfolio management at MOM, this trend – mostly driven by investor demand – gathered momentum, particularly after the global financial crisis. In Wong’s view, the lack of focus on governance was a contributing factor to the crisis.

As mainstream investors have started to look for ESG risk-adjusted returns, the positive screening approach has tended to predominate, says Wong.

There is a need for a shared ESG agenda was a contributing factor to the crisis. As mainstream investors have started to look for ESG risk-adjusted returns, the positive screening approach has tended to predominate, says Wong. This has evolved into a ‘best in class’ approach with regards to sectors or countries and investing more into ‘good’ companies and less into ‘bad’ ones. There has been a more systematic integration of ESG data in portfolio construction, she notes.

Wong believes there are more opportunities in emerging markets as well as greater efficacy. For instance, in terms of carbon reduction, it can be possible to engage with an emerging market company to achieve a higher reduction in carbon emissions for the same level or at a lower level of risk than with a company in the developed markets.

A possible threat to the convergence of trends between emerging and developed markets is the potential introduction of more protectionist trade policies in the US, says Cazalet.

These could force emerging markets to take a more protectionist stance in return and may stall or slow the progress of that convergence. However, he notes there has already been considerable progress in this respect, citing how companies in South Korea or Taiwan compete with their counterparts in developed markets in many sectors.
R
defying gravity

Brazil’s political establishment, in the space of three years no less than three presidents (or former presidents) have either been indicted, convicted or faced charges for corruption. First Dilma Rousseff was removed from office for manipulating the budget to improve her chances of re-election.1

Next, Luiz Da Silva, Rousseff’s two-term predecessor, was sentenced to nearly 10 years in prison after being found guilty of money-laundering.2 In the most recent twist of the tale, Rousseff’s centre-left successor President Michel Temer only narrowly avoided being removed from office after being secretly taped allegedly discussing bribes with a businessman.3

The allegations of wrongdoing go further than just the presidency. As one point in 2016, 396 out of a total of 594 members of Brazil’s Congress were facing charges of corruption.4

Yet for ARX fund manager Rogério Poppe the extraordinary thing about Latin America’s largest economy is not the political turmoil that has more or less been par for the course in recent years – but rather the country’s resilience in the face of such upheavals. He points out that, far from hitting the buffers, the economy continues to make headway while capital inflows have remained steady.

Year-to-date, for example, Brazilian equities returned a far from shabby 21.1%, while over 12 months the return has been 24.6%. This compares well with both developed market equities (the UK, for instance, returned 11.9% year-to-date and over 12 months) and many other emerging market countries (Colombia, for example, with 14.4% year-to-date and 11.0% over 12 months).5

The result? Roughly US$1 bn of flows into Brazilian equities, the highest level in five years, according to data tracker EPFR.6 Partly, says Poppe, this sustained level of investor confidence is due to the actions taken by Brazil’s newly appointed central bank which moved quickly to regain credibility and lower interest rates after Rousseff’s impeachment in 2016 as the economy faltered. This helped steady the ship and put a lid on inflation, which hit a peak of 10.7% in 2015 before falling to a decade low of 3.6% in May this year.

Allied to this is a reform programme under the auspices of finance minister Henrique Meirelles. Although some of these measures have faltered on popular opposition, says Poppe, enough has been done to give investors confidence in Brazil’s forward trajectory.

Now, says Poppe, with allegations of graft largely behind him, President Temer can once again push ahead with his stalled economic reform programme. Key targets include an overhaul of the country’s generous pension system that allows people to retire as early as their mid-50s but tax reform is now also on the cards.

With all of these measures, the prize is to reduce government spending and narrow a budget deficit that was at around 10% of GDP. At the end of August Finance Minister Henrique Meirelles told Congress that should his reforms be approved he expects Brazil’s economy to be growing by around 2.5% early in 2018.

KEY POINTS:
1. Major Brazilian pensions and tax reforms planned
2. Inflation hit decade low in May 2017
3. Brazil politicians plagued by corruption scandals

About BNY Mellon

With expertise in macro analysis and bottom-up stock selection, ARX Investimentos is dedicated to investments in Brazil and Latin America. Headquartered in Rio de Janeiro, the group’s philosophy is to optimise risk-adjusted returns, with a focus on capital preservation.

The Boston Company is a global investment management firm providing a broad range of active, fundamental research driven equity strategies, including both traditional long-only portfolios and alternative investments.

Mellon Capital Management Corporation offers investment capabilities ranging from indexing to alternatives with the infrastructure and skill to transact in all liquid asset classes and securities.

Newton is renowned for its distinctive approach to global thematic investing. Based in London and with over 30 years’ experience, Newton’s thematic approach is applied consistently across all strategies.

Headquartered in Boston, Massachusetts, Standish is a specialist investment manager dedicated exclusively to active fixed income and credit solutions, with a strong emphasis on fundamental credit research.

1 BM&F: Brazil’s President Dilma Rousseff removed from office by Senate, 1 September 2016.
2 The Guardian: Brazil’s ex-president Lula sentenced to nearly 10 years in prison for corruption, 2 July 2017.
3 Financial Times: Brazil’s markets reflect investor resilience, 16 June 2017.
4 Los Angeles Times: Brazil politicians plagued by corruption scandals, 18 May 2016.
5 FTSE All World Index, in US dollar terms as of 31 August 2017.