Schroders Outlook

2014: Emerging Markets

Allan Conway, Head of Emerging Market Equities

- The structural case for emerging markets is intact, valuations are attractive and profit margins have room to surprise on the upside
- However, a number of clouds remain on the horizon which could weigh on emerging markets, including a tapering of US policy stimulus
- 2014 is likely to be a challenging year for emerging markets, but one full of opportunities for longer term investors.

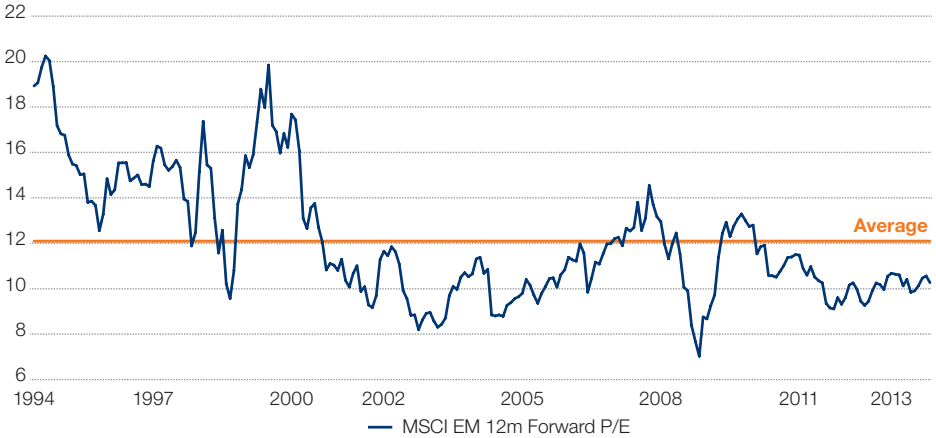
Global emerging markets (GEMs) have underperformed developed markets for the past three years due to a combination of weaker-than-expected economic growth and earnings, a strong dollar and more recently, concerns over the potential ramifications of policy stimulus tapering in the US. These factors have led some commentators to suggest that the positive structural story for emerging markets is over. We would strongly disagree with this view.

Given this background, what are the prospects for GEMs in 2014?

First, it is worth reiterating that GEM economic fundamentals are very solid. In aggregate, current accounts are in surplus, debt levels are modest and external debt is low. This is in stark contrast to the developed world which is still going through a prolonged period of debt deleveraging. An expanding emerging market middle class continues to drive strong consumption and fixed capital investment is growing due to the still low levels of capital stock per capita. So in our opinion the structural story remains intact.

Second, valuations are very attractive and appear to be pricing in a lot of bad news; for example, the 12-month forward price-earnings (P/E) of the MSCI Emerging Markets index is 10.3 times, based on 11.4% earnings-per-share growth. This compares to a long run average of over 12 times. It is also at a significant discount, around 30%, to the P/E of the MSCI World index. Furthermore, the GEM price-book ratio is 1.5 times. This is also at a large discount to the long-run average despite a return-on-equity of 12.3%. Although these valuations are not at rock-bottom levels, they are not far from trough levels in some cases. Furthermore, GEMs have historically delivered strong absolute returns over the medium and long term from such levels. As noted above, GEM margins have been under pressure, unlike in the US where profits as a share of GDP are at a record high, so there is also clear upside to GEM profit growth.

Forward Price Earnings



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	Emerging Markets	USA	World
Forward P/E	10.3	15.1	14.4
EPS Growth	11.4%	10.1%	11.5%
PE/EPS Growth	0.9	1.5	1.3

Source: Schroders,FactSet,IBES, MSCI, data shown to 14 November 2013

In addition, anecdotal evidence indicates that investors have become extremely bearish. Indeed recent data suggests that global fund managers have been reducing their GEMs exposure to such an extent that the net percentage of overweight to underweight managers is now at its lowest level for many years.

However, several clouds remain on the horizon which could continue to weigh on GEMs.

Tapering challenge

The timetable of stimulus withdrawal in the US remains unclear but steps towards policy normalisation look ultimately to be only a matter of time, unless a substantial deterioration in the US outlook occurs. Although investors were quick to price in the potential negative impact of liquidity withdrawal in the summer, concerns around tapering may not fully be in the price yet and the threat of tapering could continue to be a headwind for GEMs in the near term. Significantly however, the impact on individual markets will likely vary and we have already seen correlations between GEMs falling back towards pre-crisis lows.

When US Federal Reserve Chairman Ben Bernanke first mooted the idea of tapering, countries such as India, Brazil, South Africa, Indonesia and Turkey experienced a sharp sell-off due to their large current account deficits and reliance on external funding. However, these 'fragile five' 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. Furthermore, significant currency weakness is already helping some of the 'fragile five' reduce their current account deficits as their economies adjust. Currency weakness has also led to an improvement in the competitive position of several emerging economies which should be well placed to benefit from a recovery in growth in the developed world.

Threat of deflation

There is a possibility that global growth does not recover as expected and the developed world enters a period of deflation. Although this would probably result in ongoing abundant liquidity, low nominal growth is not good for earnings and could therefore impact markets. Developed Europe is still a long way from resolving its structural problems and another European crisis cannot be ruled out; Spain stands out as being one possible catalyst given high unemployment and a large debt overhang. Should the situation in the eurozone deteriorate, the impact on GEMs would likely be limited from a macro-economic perspective given only a relatively small proportion of exports go to the region. The most vulnerable emerging markets would likely include the neighbouring Central European markets (Poland, the Czech Republic and Hungary) owing to the open nature of their economies. The most likely negative repercussion would be through increased risk aversion.

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Election year

Politics will be another area of focus for investors in 2014. Next year, five emerging countries have important elections which could create increased uncertainty as government policy in the run-up is likely to be unpredictable. Finally, China will need to avoid a major problem if GEMs overall are to do well. We believe recent reform announcements, together with China's large reserves, should be supportive in this regard.

Allan Conway
Head of Emerging Market Equities

Allan joined Schroders in October 2004 as Head of Emerging Market Equities. He is a fellow of the Securities Institute (FSI), Member of the Institute of Chartered Accountants (ACA) and has a BA (Hons) Degree in Economics from York University. His investment career began in 1980 and he previously worked at WestLB Asset Management (where he was Head of Global Emerging Markets and later Chief Executive of WestAM (UK) Ltd) and LGT Asset Management (where he was Head of Global Emerging Markets).

Long-term opportunities

The short-term outlook remains uncertain so we believe it is too early to get super-bullish and push up the beta (a measure of market risk exposure) in our portfolios. Tapering in particular could create volatility, although the impact on GEMs will likely be selective. Some countries could continue to come under pressure and will likely have to tighten policy to address their deficits, but we have little or no exposure to these markets. Others will benefit from the stronger growth tapering implies and we are generally overweight these countries.

Beyond the near term, however, the outlook for GEMs is extremely positive in our opinion. As discussed above, the structural case for GEMs is intact, valuations are attractive and profit margins/earnings have room to surprise on the upside.

Even though we would not rule out further weakness in the near term, a strong GEM rally at some point in 2014 is quite possible. Moreover, we are confident that returns over the next three years or so will be substantial, both in absolute terms and relative to developed markets. One thing is clear though and that is that the country decision, which has always been important when investing in GEMs and is one of our explicit alpha drivers, is likely to become even more important in the period ahead. So 2014 is likely to be a challenging year for GEMs, but one full of opportunities for longer term investors.