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Investment Publications Highlights

CAMBRIDGE ASSOCIATES LLC

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“You Got to Know When to Hold EM, Know When to Fold EM: The Outlook for Emerging Markets”

Peter Berezin, BCA Research, November 2012

Slowing Chinese growth has raised concerns about overweighting emerging markets in the near term. However, loose monetary and fiscal policy and favorable valuations mean investors should consider increasing exposure on a two- to three-year time horizon. Further down the road, structural problems and the normalization of interest rates in developed markets pose a serious risk to emerging markets.

Many investors are hesitant to increase emerging markets exposures in the near term given concerns over a Chinese “hard landing,” yet believe that stronger growth will propel equities higher over the long run. Unfortunately, the exact opposite may be true. Concerns over China are overblown, emerging markets governments have ample fiscal and monetary capacity to boost growth, and relative valuations for emerging markets equities are compelling. In contrast, the long-term investment outlook for emerging markets is more difficult, as developed markets countries will be forced to narrow their current account deficits, emerging markets currencies will appreciate, and emerging markets productivity growth and governance are lacking.

Disappointing Chinese growth has been a source of angst for numerous emerging markets investors in 2012. Many worry the government has only contributed to imbalances through measures to boost growth like increased infrastructure spending and property market liberalization; a nonperforming loan problem is also feared. China bears worry about overcapacity in many industries, as suggested by high investment ratios.

There is some validity to these arguments, but also some important caveats. Chinese loan creation did soar over 2008–10, but this followed five years of credit restraint. Given that Chinese banks are essentially government-owned businesses, it also seems likely that any nonperforming loan problem would be met with state capital injections to support further lending. Leverage is low for other sectors like households and the government. Finally, China’s capital stock–to-GDP ratio is not out of line with those of other countries (including the United States). Just to maintain a constant stock of capital to GDP given current growth rates requires annual investment of around 30% of GDP. In a similar vein, the quality of Chinese infrastructure trails that of many peers, which suggests ample capacity for investment.

Beyond China, there is cause for optimism about the cyclical growth outlook for emerging markets as a whole. Growth is bottoming and global trade has picked up of late. Many countries appear likely to continue loosening fiscal and monetary policy; rate cuts in Eastern Europe and Asia are recent examples. These factors bode well for emerging markets equities, which currently trade at a discount to their developed counterparts. Consensus estimates of an 8% increase in emerging markets earnings per share (EPS) for 2012–13 might be too high, but they are less likely to disappoint than the 15.6% growth estimates for MSCI World EPS. Emerging markets equities should also benefit as net private capital flows increase from depressed levels.

Today’s situation may resemble that of the early 1990s, when the Federal Reserve lowered interest rates, a currency crisis struck Europe, and emerging markets capital inflows surged. This led to temporary outperformance by emerging markets equities, but eventually

ended poorly in the Asian Crisis that began in 1997. For Europe to regain a competitive edge and boost growth, the euro must weaken and the current account deficit must close. In the United States, QE programs will weaken the dollar, also narrowing its current account deficit. These improvements in current account balance will come at the expense of emerging markets economies. Emerging markets currency appreciation will reduce competitiveness. Structural problems are also a source of worry, such as poor education, which dampens productivity, and governance. Many emerging markets economies are too reliant on natural resources industries to drive growth, rather than their population's knowledge base. While commodity prices still have room to run up, the long-term outlook is bleak given over-investment in the sector and slowing Chinese demand.

Based on all of these factors, the conclusion is that the cyclical prospects for emerging markets equities are bright but longer-term challenges remain. Investors should thus remain overweight on a two- to three-year time horizon, but be prepared to trim exposure after that. Tighter developed world monetary policy, the swing from current account surpluses to deficits in emerging markets economies, and rapidly accelerating emerging markets inflation will signal that it is time for investors to reduce exposure. Within emerging markets, we favor equities over bonds, specifically those with attractive valuations, favorable corporate governance, and those within countries that have relatively cheap currencies.

"Global Emerging Markets Strategy Outlook 2013: Liquidity Inflows Do Not Reflect Any Fundamental Shift"

John-Paul Smith and Priyal Mulji, Deutsche Bank, December 10, 2012

Emerging markets equities, despite their recent liquidity-driven outperformance, face significant structural headwinds going forward relative to their developed markets counterparts.

Much of the rally in emerging markets equities in the final quarter of 2012 can be attributed to inflows motivated either by recent performance or by ongoing strategic interest in the asset class. This recent outperformance is unlikely to persist over the course of 2013. Valuations are not as attractive as they seem, partially because margins across non-financials are declining and bank nonperforming loans are rising. A bigger issue is that the intellectual arguments behind a strategic overweight (such as "decoupling") are crumbling, as the implications for shareholders of state-directed economies and commodity cycle–geared businesses come to light.

The fate of the Chinese economy is central to the outlook for emerging markets equities, and the defining event of 2013 may be that its structural weaknesses are revealed. These shortcomings have been evident at the micro level for some time, but are reaching the point where they are becoming too big for investors to ignore. Many companies have low and deteriorating returns on capital driven by overcapacity and inefficient production techniques; government subsidies and interference to preserve jobs misallocate capital and prevent the creative destruction that is necessary to improve efficiency. Dodgy lending is part of the problem, as the poorly regulated shadow banking system has been used to prop up ailing business and fund pet projects of local governments.

Increased lending explains the recovery in GDP growth; corporate lending has increased overall private sector debt to a whopping 116% of GDP. In addition, due to increased competition from other emerging markets countries for the developed world's outsourced manufacturing, China no longer is competitive on wages. Given China's significance to global growth, these trends could be ominous.

An increasing level of state intervention in the corporate sector and weak corporate governance is not specific to China. Countries like Brazil and Russia also exhibit significant official sector intervention in many listed companies, often to the detriment of minority equity holders. Many large companies in both countries are seen by the state as vehicles to facilitate broader social and political agendas; returns for shareholders are a lesser priority. In contrast to Western peers, few emerging markets companies have used the recent financial crisis to streamline operations and improve their competitive position. This is partially because managers were too optimistic, but also because state intervention makes layoffs and reducing production more difficult. Emerging markets corporates have continued to sacrifice margins for volume in the aftermath of the crisis. They have had little choice because the intellectual capital and brand power that protect margins still reside mainly with developed markets peers.

Part of the issue is that a significant number of emerging markets companies operate in commodity or other cyclical sectors. A long stretch of high commodity prices resulted in an incredible amount of money spent on capital expenditures over the last few years, and managers have been caught out by a turn in the commodity cycle. Part of this has been driven by slower growth, but prospects for U.S. energy independence also play a role. The excess capacity that was created, especially in the industrial metals and energy sectors, may damage future returns. Slower Chinese and global economic growth dim the outlook for commodity prices.

Investors also should be skeptical about emerging markets financials, though comparisons with developed markets peers are more difficult because they face separate problems. Developed markets financials have cleaned up balance sheets, but an increasing amount of regulatory pressure and higher capital requirements will dampen margins. In contrast, margins for emerging markets financials have held up since the crisis, but price-to-book ratios have dropped as many believe nonperforming loans are understated. This is especially a problem for China, but given that the state plays a major role in lending decisions across all of the BRICs, there are reasons to be worried about other countries.

While many institutional investors are too optimistic about the prospects for emerging markets equities, many emerging markets portfolio managers are well aware of these secular challenges. As a result, they have migrated to safe-haven sectors and countries or secular growth stories. The problem is that valuations have been bid up—witness the discrepancy between equity valuations for the emerging markets consumer staple or health care sectors compared to those of financials and utilities. The same is true of geographic allocations. Countries where state intervention is high, like China and Russia, trade at large discounts to more open economies, like Chile and Mexico. Despite this discount, investors should continue to tread cautiously and favor positive structural stories, while demanding cheaper valuations elsewhere. Those that are able should hold some cash, as our bearish forecast suggests better buying opportunities await. ■