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Emerging Markets: how to unlock the next wave of returns

Yerlan SYZDYKOV
Head of Emerging Markets

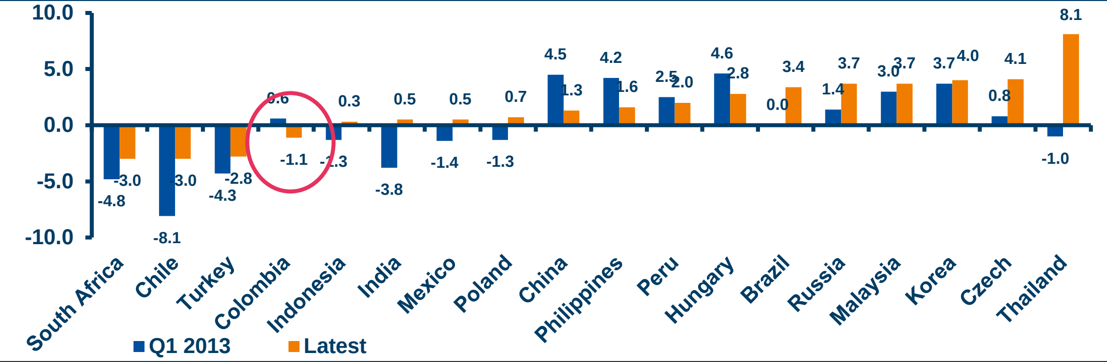
- ***Cyclical conditions:*** *EM economies continue to benefit from a phase of globally synchronised growth. Different countries are in different stages of the cycle: China is now in a more advanced phase, while other countries, such as Russia and Brazil, emerged from recession in 2017.*
- ***Vulnerability to higher rates****: We observe that as far as external balances are concerned, conditions have improved markedly since the 2013 Taper Tantrum for almost all countries.*
- ***Structural conditions****: Reforms implementation is a key distinguishing factor for assessing the ability of a country to make its growth story not just superior, but also sustainable. China is one of the most active countries in adopting structural reforms, as the structure of the economy is shifting towards less debt-dependent, more efficient sectors.*
- ***EM equities:*** *In 2018, sound earnings per share growth, attractive valuations and improving corporate governance are among the positive conditions for this asset class which is structurally underrepresented in investors' portfolios.*
- ***Fixed income:*** *Short duration bonds can offer an interesting carry with low interest rate risk compared to other fixed income sectors. With no major disruption, we expect average returns of 4-5% for 2018 in EM debt in hard currencies and 7-8% for those denominated in local currencies.*
- ***EM evolving world:*** *We think investors should reassess the role of EM assets in a portfolio. They should also consider moving away from an "asset class" perspective regarding EM and embracing a more selective approach in order to capture country, sector or even company-specific stories and avoiding areas of major risk.*

No longer only a 'superior growth story'

"Sustained global trade, positive commodity price dynamics, and the phase of a soft dollar continue to be tailwinds for many EM. The EM vs DM output growth differential is expected to widen to 3.3% in 2020".

The recent increase in stock market volatility raised awareness among investors regarding the vulnerabilities in financial markets created by market complacency and associated with the extended phase of exceptional central bank (CB) monetary stimulus. The challenge today is to gauge the risk/return potential of the different asset classes in an evolving scenario, as inflation is gently picking up and CB are trying to lower the excess liquidity. EM seem to be showing that a good amount of strength was built up during the phase of exceptional liquidity, supported by favourable cyclical and structural dynamics. From a cyclical perspective, EM economies continue to benefit from the phase of globally synchronised growth. Sustained global trade, positive commodity price dynamics, and the phase of a soft dollar continue to be tailwinds for many EM. The EM vs DM output growth differential is expected to widen to 3.3% in 2020. The positive aggregate figure, however, masks material regional and country differences: for example, China is now in a more advanced phase of its mini cycle, while Russia and Brazil emerged from recession in 2017. The analysis of economic conditions, which underpins investment opportunities, has to go beyond the aggregate level and look at growth by single country to uncover upside potential. In this respect, we believe that Central and Eastern Europe are exposed to the European renaissance story. In Asia, Malaysia, the Philippines, Thailand and China could benefit from a domestic demand story. In Latin America (Latam), Brazil is recording stronger macroeconomic momentum. The political factor is also crucial to assessing investor sentiment (and flows) towards EM countries. In particular, US trade policy (specifically, protectionist risks) needs to be closely monitored. In 2018, elections in a number of countries, particularly Latam, could also increase divergence in terms of geopolitical risk among EM. In assessing EM opportunities, in addition to economic backdrops and geopolitical risk, we believe it will be crucial to look at vulnerability to external shocks. The highest risks are related, in our opinion, to faster-than-expected Fed tightening (higher rates, and, eventually, a stronger dollar). We observe that, as far as external balance is concerned, conditions have improved markedly since the 2013 Taper Tantrum for almost all countries, Colombia being the main exception. However, a sharp rise in the 10Y US Treasury rate, accompanied by a material appreciation of the USD could put pressure on the overall EM investment universe and, in particular, on countries that rely heavily on external borrowing, especially in the short term. Again, a focus on country-specific vulnerabilities is very important.

Basic balance in EM (current account + net direct foreign investments) has improved compared to the 2013 Taper Tantrum



Source: Amundi Research and IMF data. Data as at 8 January 2018.

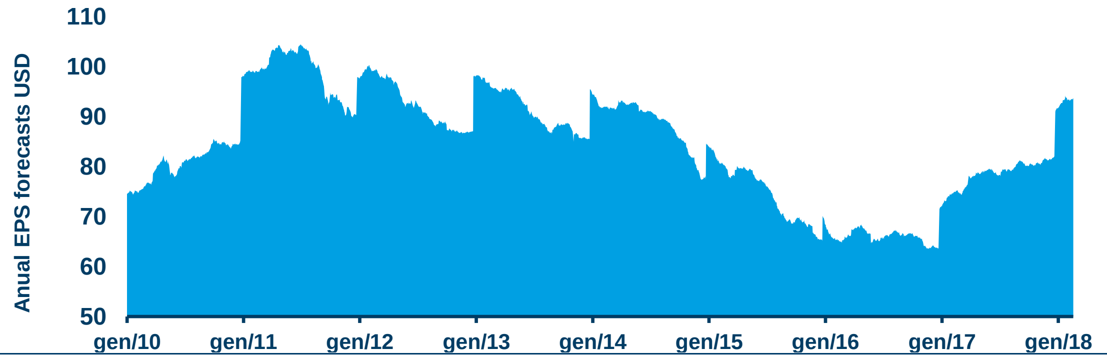
From a longer-term investment perspective, we stress how structural changes in EM have contributed to an improvement in their core strength, and this is making the **growth story not just superior, but also sustainable**. In China, the structure of the economy is shifting towards less debt-dependent, more efficient sectors. The output share of services and most skilled industrial sectors has been rising since 2012, and the progress of structural reforms in the direction of "quality growth" are starting to impact the real economy. In this new phase, strong differences among countries will continue to persist and determine different development paths and, as a consequence, areas of risk and opportunity for investors.

"Forecasts for earnings for companies included in the MSCI Emerging Markets index have been raised for the first time since 2010".

Equities: Look at fundamentals, valuations and governance for a maturing asset class

EM equities could provide fertile ground for investors in search of growth opportunities with a medium-term horizon. After a period of declining earnings per share, EM are finally showing some earnings growth, a situation that we expect to remain in place over 2018 considering the supportive macro framework and the still mildly favourable financing conditions. From a valuation perspective, EM still look attractive, especially vs DM (the EM P/E index is about 25% lower than for the US), with value/traditional economy sectors offering the best upside (eg, financials, industrials) in countries such as China and Brazil.

Forecasts of corporate earnings for the MSCI EM index



Source: Amundi Research and IMF data. Data as at 26 February 2018.

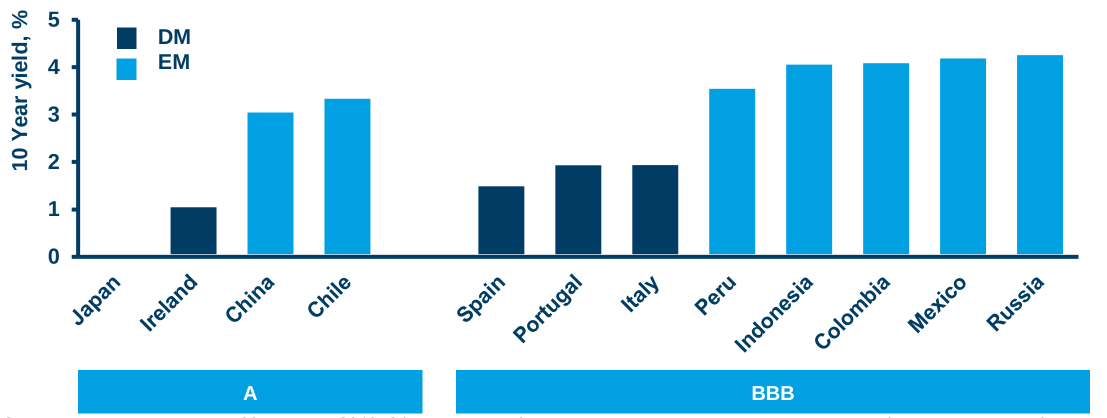
In EM, where corporate governance has generally improved, a focus on selection based on ESG criteria has been a key determinant for outperformance (the ESG leaders indexes outperformed the market by roughly 4% over the past year) and this should continue, in our view, to be a crucial selection criterion in the search for opportunities in the future. EM continue to be underrepresented in investment portfolios (5% is the EM average equity allocation compared to a share of EM in world market capitalisation of about 11%). EM equity is a maturing asset class: both sector and country composition of the MSCI EM index has evolved to reflect the new EM world. Moreover, active investors can benefit from an enormous opportunity set to add quality and good growth potential beyond the benchmark by enlarging the investment universe to include market "niches" (eg, some small and medium cap equities). Exploiting these opportunities requires deep and direct knowledge of industries and dedicated fundamental research coverage. Here, familiarity with the ESG (Environmental Social Governance) principles – governance in particular – is key to avoiding areas of risk.

Fixed income: yield premium, with short duration

"In fixed income, EM bonds with short duration can offer an interesting carry with low interest rate risk compared to other fixed income sectors".

EM bonds with short duration could offer an interesting carry with low interest rate risk compared to other fixed income sectors. Even accounting for heterogeneity and for higher risks due to multiple factors (i.e. geopolitical risks or external vulnerabilities), valuations of EM sovereign debt appear interesting, especially if compared to developed market bonds, where yields, even on 10Y securities, remain compressed.

Yields on 10Y sovereign bonds



Source: Bloomberg data as at 28 February 2018. S&P Ratings LT foreign currency issuer credit rating. A includes from A+ to A-; BBB from BBB+ to BBB-.

We are constructive on local currency debt: Mexico, South Africa and Turkey may offer interesting opportunities. Fundamentals are also favourable for corporate markets which are showing moderate declines in leverage and lower default rates, thanks to the global recovery and the positive commodity cycle. We believe that EM corporates are still interesting compared to DM. In a base case scenario, with no major disruption, we expect average returns of 4-5% for 2018 in EM debt in hard currencies and 7-8% for those denominated in local currencies.

"Investors should also consider moving away from an 'asset class' perspective regarding EM and embrace a more selective approach in order to capture country, sector or even company-specific stories and avoid areas of major risk".

In conclusion, we think investors should reassess the role of EM assets in a portfolio. They should become more relevant in strategic asset allocation. Investors should also consider moving away from an 'asset class' perspective regarding EM and embrace a more selective approach in order to capture country, sector or even company-specific stories and avoid areas of major risk. To do this, investors should develop a solid understanding of the macro backdrop for each country to identify the best investment themes and further exploit how to play them in EM equity and/or bond investing based on a more detailed bottom-up analysis. An integrated approach, analysing EM through multiple lenses (country, credit and geopolitical risk; macro and micro reform momentum) will, in our view, be key to understanding a complex and rapidly evolving world. Moreover, being able to analyse an investment case by looking at the full capital structure and bringing together varied expertise (loans, debt, equity, distressed situations) can be a distinctive competitive factor with regard to unlocking returns from all the available sources and to enhancing opportunities from market dislocations.

Important Information

Date of First Use: 15 March 2018.

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