“If we’re in with the new, are we out with the old?”

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3 Fragile five turns to fragile few

SUMMARY: Emerging market growth has rebounded over the last couple of years and the growth differential over developed markets has started widen once more. There is clearly a cyclical element to this, however, we believe that more fundamental, and underappreciated, improvements are taking place in many emerging markets. These consist of a recommitment to orthodox policy decision making, including inflation targeting by some central banks; successful economic rebalancing across a number of economies; supporting more sustainable economic growth; and rapid progress in addressing Environmental Social & Governance (ESG) issues, as the world looks away from the US for leadership.

Structural economic themes across emerging markets

We believe the end of the commodity super-cycle, which meant countries could no longer rely on inflated natural-resource prices, accelerated the different economic trajectories of different countries. Most emerging market economies fall into five broad categories:

1. Structural improvement in policy decision-making, helping to revive macroeconomic balances. (Argentina, Peru, Indonesia, Ghana, Egypt, Kazakhstan, Serbia, China, Mongolia, Dominican Republic, Sri Lanka);

2. Solid emerging economies backed by credible institutions and participating in the cyclical pick-up in global growth. (Korea, Mexico, Hungary, Czech Republic, Poland, India, Malaysia, Thailand);

3. Painful adjustments during a challenging couple of years, with ongoing recoveries. (Russia, Brazil, Nigeria, Zambia, Ukraine, El Salvador);

4. Countries taking proactive stances on ESG issues to drive a cleaner future, notably in Latin America. (Chile, Costa Rica, Uruguay);

5. Still more needs to be done in terms of addressing imbalances and controlling fiscal expenditure. (Turkey, Venezuela, Lebanon).

Case studies

Argentina — The socialist and increasingly isolationist Peronist movement contributed to economic stagnation and arguably diluted Argentina's global influence. However, the historic election victory by Mauricio Macri's centre-right party signalled a wave of change for a country which had previously defaulted on its debt and recorded triple-digit inflation:

- The Argentinian peso's unsustainably high peg was removed;
- The central bank began explicitly targeting inflation;
- Government spending has been cut to more manageable levels;

- Bad debt has been cleared;
- Market-friendly reforms passed and more promised.

Of course, significant challenges remain when it comes to confronting the legacy of the Kirchner era. Indeed, the country's external & fiscal vulnerabilities, combined with a worsening in investor sentiment, forced the government to approach the IMF for financial assistance in April. However, by gaining access to an IMF stand-by arrangement the Argentine government has earned itself time and space to continue with the structural reform agenda – a development we have seen elsewhere in our universe over the last couple of years, where the IMF (less dogmatic and rigid than in the 1990s) has helped support important macroeconomic reforms and anchor investor expectations.

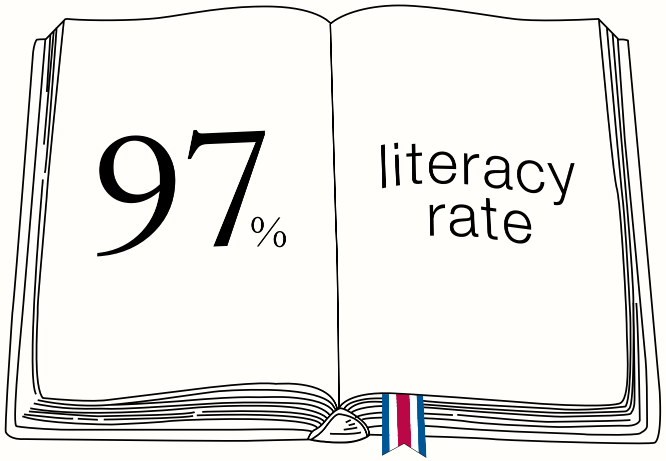
Czech Republic — Few countries have enjoyed the benefits of EU membership more than this formerly Soviet-bloc nation. Economic growth has averaged between 3-4% p.a. since the end of the communist era, unemployment is among the lowest in the EU and living standards remain comparable to those in Western countries. It's also one of only two EU countries that have recently increased interest rates.

Brazil — Few EMs experienced the economic meltdown as severely as Brazil. Economic output collapsed by nearly 10%, unemployment rose into double digits and government finances took a sizeable hit. But growth began to bottom and the trade balance reversed. Although challenges remain for this country, its future looks much more promising.

China — China is emerging as the new world leader on environmental issues, backing up its words by drastically increasing renewable energy infrastructure, stamping out corruption and reforming State Owned Enterprises (SOEs). The deleveraging cycle by authorities also continues to help prevent any unwanted economic shock. We believe many commentators underestimate the drastic improvement in the quality of economic policy-making under the Xi Presidency. On the face of it, this effort has done little to dampen economic momentum, with growth still trending above 6% p.a., activity data strong and capital outflow pressure easing.

ABCs equal lots of 123s

Impact of free and compulsory education in Costa Rica



Source: UNICEF, December 2013

Costa Rica — The country is rapidly expanding its renewable energy capacity, with the electricity grid running completely on clean energy for part of the year. The government now compensates landowners for promoting forest and water conservation, while fuel and water taxes also advance the goal of a cleaner environment. The literacy rate is approximately 97% as a result of free and compulsory education.

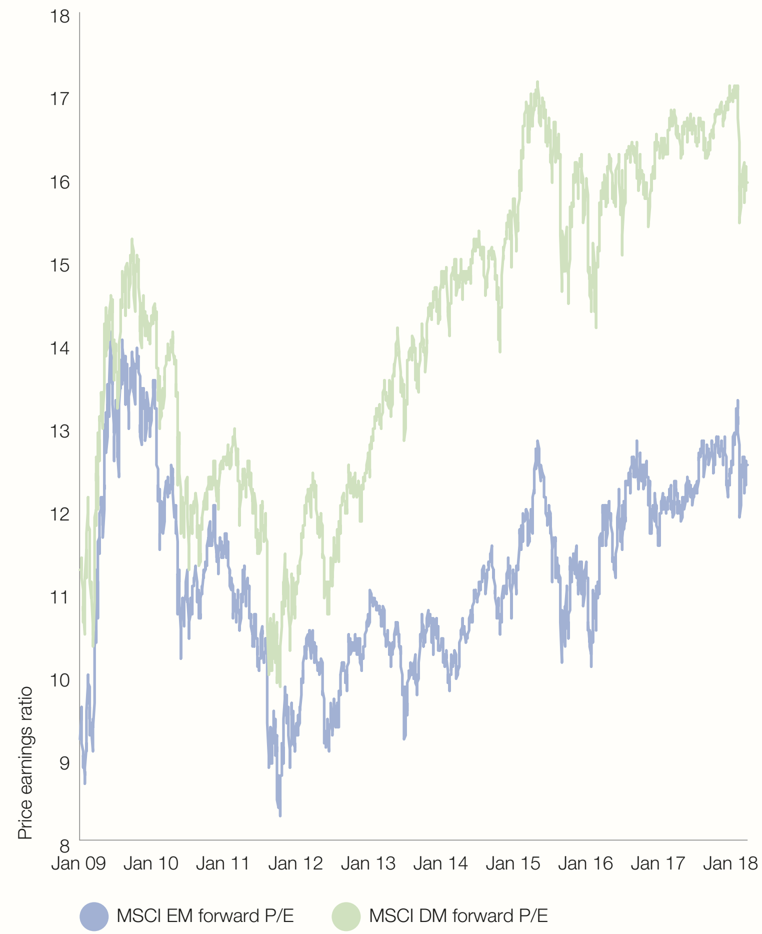
How are markets digesting economic improvements in emerging markets?

The changing economic climate and the value they offer relative to developed markets (DM) is driving strong inflows into EM asset markets.

Equities

With EM equities still cheap relative to DM, corporate governance becoming more sophisticated and the investor base becoming more institutional, we see flows into EM equities continuing. Despite equity prices rising, earnings have improved, which keeps price-to-earnings ratios stable. Official data suggests global investors have yet to add materially to 33 EM equity holdings despite the compelling case to do so.

Figure 1: EM equities still offer value compared to developed markets



Source: Haver, Bloomberg and Investec Asset Management, as at 15.03.18.

Hard currency bonds

A favourable growth outlook, rise in foreign exchange reserves and solid reform pipeline have helped drive strong portfolio inflows. Likewise, painfully low developed-country bond yields are driving demand from liability-matching institutional investors. Spreads now look relatively tight compared to history, although pockets of value persist.

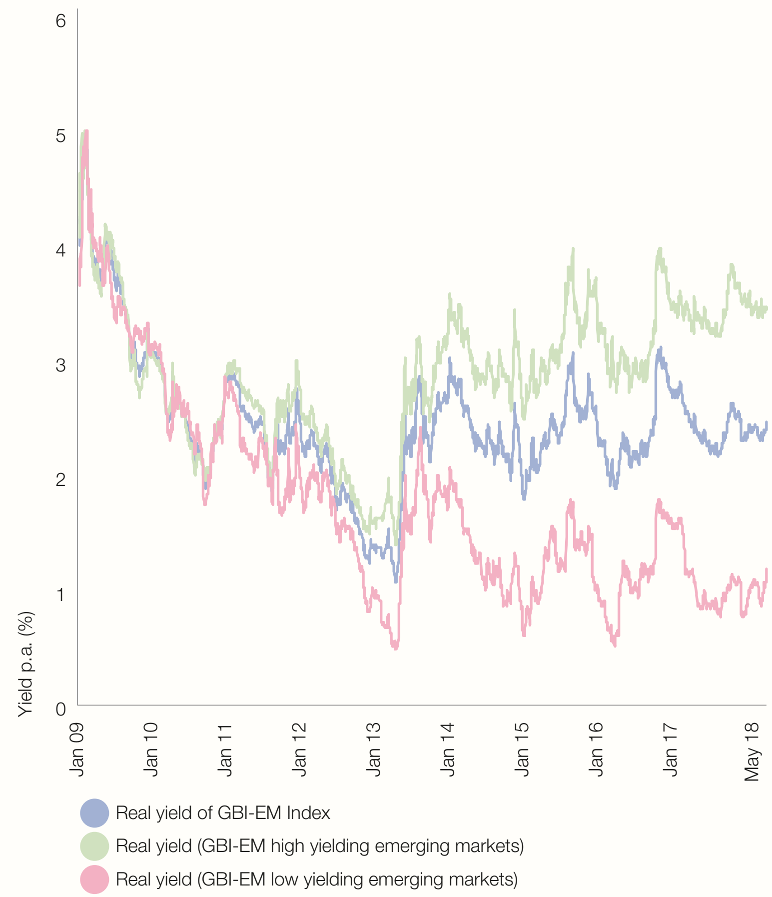
Figure 2: Spreads looking closer to fair value in hard currency bond markets

Source: Haver, Bloomberg and Investec Asset Management, as at 21.03.18.

Local currency bonds

Investors remain conservatively positioned in this asset class, with two-thirds of 2017 inflows to EM fixed income going to hard-currency debt. Real effective exchange rates (REERs)[1] are still historically cheap, real yields are attractive and inflation is at low levels, supporting investor interest.

Figure 3: GBI-EM real yields still not expensive compared to history



Source: Haver, Bloomberg and Investec Asset Management, as at 09.05.18.

[1]The weighted average of a country's currency relative to an index or basket of other major currencies, adjusted for inflation.

Navigate US monetary policy tightening

Rising interest rates in the US and unwinding of the Federal Reserve's balance sheet clearly pose risks for EM assets. The European Central Bank will gradually reduce its quantitative easing programme, while Japan may adjust its stimulus. Yet we are heartened by the current health of EM economies, rather than comparing this time with previous periods of market stress.

However, those countries that have not rebalanced their economies are much more exposed to tightening. Thankfully these countries are the exception rather than the norm, resulting in a breakdown in correlations, which in turn favours active managers. We expect this divergence to continue through 2018.

Figure 4: Emerging market currency correlations at lowest point in a decade

Source: Haver, Bloomberg and Investec Asset Management, as at 30.05.18.

Emerging markets emerge as global leaders

EMs are helping to lead the world by promoting a cleaner economic future while supporting further trade integration in the wake of the US withdrawal from the Paris Agreement on Climate Change and Trans Pacific Partnership trade deal. China is stepping into the void by reforming state-owned enterprises and migrating to a cleaner electricity supply, spurred on by its unhealthy levels of pollution. Costa Rica, Chile and Uruguay are all prioritising environmental issues when setting economic policy. Key Asian economies, along with Mexico, are developing trade and investment arrangements which no longer rely on developed economies.

We think it's an exciting and potentially rewarding time to be involved in EM investing and believe that this long-term picture is critical when deciding on strategic asset allocation.