Diamonds in the rough

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After a very strong performance during 2017, investors are curious as to what 2018 will bring for global emerging market (GEM) equities. In general we remain quite optimistic on the outlook for GEM equities over the next few years, based on what we can see in our "fundamental-driven crystal-ball".

GEMs in general have rebalanced their economies significantly since they came out of the global financial crisis and suffered the "taper risk" in the summer of 2013. We see stronger economic growth in GEMs, with significantly less debt than Developed Markets (DM) over the medium to long term. Additionally, external balances are generally in good shape across the different countries and EM FX looks fundamentally very cheap. In investment terms, we see attractive long term valuation opportunities, particularly for quality growth companies.

We also believe there are certain trends that will benefit GEMs as we go forward. For instance, the urbanisation trend that is becoming more and more solid across several Asian countries, especially in India, may bring very attractive investment opportunities. We can also see that technology adoption, financial inclusion and rising education levels in GEMs will lead to structural productivity gains much greater than those that will be found in DM. And finally, there is the potential for government reforms in the region, such as those already happening in India.

Historically, GEMs have delivered a high return at the operational level and we believe this will continue; this may be one of the drivers of a re-rating. Furthermore, we see a strong case for a free cash flow and dividend story coming from Asia in particular. Moreover, local equity market participation is rising fast in GEMs, and in our view, this will contribute to a vibrant and dynamic equity market in the years to come. In fact we estimate that by 2030, GEMs will account for 40% of the global equity benchmark (today they represent 11%). However, it is important to note that despite our positive outlook, we are still talking about GEMs. In other words, do not expect a "straight line" performance: be long-term focused and take advantages of short-term volatility.

Within BRICS, we favour India and China from a long-term perspective. We think that both countries have a very strong bottom-up story as well as a good top-down one. Besides offering a lot of really great stock picking opportunities, we have Mr. Modi and Mr. Xi, respectively, controlling and driving forward the economic growth agenda. Taking a more short-term perspective, our view is that the international, as well as local, investor base will not "walk away" and we do see a very favourable risk/reward here.

In Russia we see a very cheap and a very bottom-up market, where we can find some good companies. However, we feel that political risk will always be around and the economic growth outlook is less compelling than in many of the Asian markets. On a short-term view, we do remain relatively positive on the stock picks we have there: they have an attractive valuation and the earnings outlook is positive.

Brazil is a difficult market. On the one hand it does offer some interesting growth opportunities and there are some great companies, but on the other hand, there are high political risks and it is a country with a delicate long-term debt balance situation that needs to be well managed. As a result, we are cautiously optimistic on the country.

South Africa and Turkey are the only two GEMs countries where we are directly negative from a structural perspective.

Fundamentally the BRICs – and in particular GEMs in general – should not be negatively impacted by US Federal Reserve rate hikes/balance sheet contraction. We must assume that the Fed will act only if it sees acceleration in the economic growth outlook, and that will be good for GEMs. From a capital flow perspective, we see current account balances, equity valuation, EPS growth differentials between GEMs and DM and the interest yield differential being at such levels that fundamentally there should be absolutely no pressure on GEMs when the Fed moves. Furthermore, the USD debt funding situation in GEMs is very different today from what it was back in 2013. However, we do acknowledge there is a reasonably high likelihood that a number of investors will take a traditional approach towards investing in GEMs, and with that we cannot rule out some volatility in 2018 as we approach rising US rates. If this occurs we see it as something that will be very short term driven, as sellers will be "betting against fundamentals". We see a reasonably high likelihood that each potential rate hike by the Fed will be met relatively quickly by a flattening yield curve, as we have seen in the past, and this will again – in our opinion – give support to a case for GEMs from a more global market perspective.

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GEMs still remain relatively cheap and since they also offer a good economic growth outlook with many sectors showing favourable dynamics, we see the potential for a favourable earnings environment and even for some rerating, which brings a very positive risk/reward situation and could produce a good full-year return in 2018. We continue to favour Asia, and within Asia we remain weighted towards India (mostly Financials, Real Estate and Consumer) and northern Asia, where China (IT, Healthcare, and Consumer), South Korea and Taiwan (IT) continue to offer very attractive stock picking opportunities. It is, of course, important to be more cautious and selective now given the strong returns in 2017, but we feel confident about the stock-picking opportunities we continue to identify.