

## CIO Flash Bulletin

## How can investors exploit opportunities in emerging markets in 2019?

Investment Solutions

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**Emerging markets saw their share of troubled headlines this year. Yet beyond the news of political turmoil, trade tensions and currency chaos that tested investor resilience, we see value in select regions and sectors. Broadly sound current account balances, adequate foreign exchange reserves and early-cycle economies will reward a search for value in emerging markets (see charts).**

Let's first look at where we are. Emerging equities, in particular, suffered this year with the broad MSCI EM index tumbling 13.3% in dollar terms, year to date. Across the board emerging market performance has dropped. In fixed income for instance, EM dollar-denominated debt has fallen 7% YTD, while the EM currency index has slipped 4% against the USD.

The correlation between equity markets and slowing Chinese growth, especially exports, suggests that developments around US/China trade tensions and fears of an eventual global growth slowdown may continue to preoccupy investors. We think it moderately likely that trade tensions will escalate in 2019. Support for markets, on the other hand, will come from global growth, fiscal stimulus in China and a less hawkish Federal Reserve.

There are also plenty of other volatility triggers ahead. From elections in Argentina with its shrinking economy and balance of payment crisis, to India's election testing the country's reform path, high expectations for the new presidents of Mexico and Brazil, to the impact of oil prices on exporters such as Russia.

<sup>1</sup> Source: Factset, data as of 6 December 2018

## Market nerves, tech tensions

For a couple of days last week, markets reacted positively to the news that the US and China had agreed a 90-day tariff truce at the beginning of this month. **If nothing else, the market’s reaction showed just how low expectations for multilateral cooperation have fallen.**

The positive news flow did not last. On 5 December, Canada announced that it had arrested Meng Wanzhou, global chief financial officer of Huawei, the world’s third-biggest builder of mobile phones, while she changed flights in Vancouver. Meng, daughter of Huawei’s founder, may be extradited to the US accused of exporting products from the US to Iran in violation of US sanctions, creating a diplomatic crisis that negated Chinese government promises that the tariff truce holds. Nervous markets worldwide fell on the news with the MSCI World Index losing 4.9% before stabilising on 7 December.

Potentially even more diplomatically significant in the longer term is the security assessment of a number of governments that have banned Huawei components from their communications networks. The list of governments now blocking their own agencies from using Huawei parts, on fears that the private company is closely linked to the Chinese government, includes the US, Australia and New Zealand, possibly Japan and the UK. China passed a law this year requiring companies and citizens to work with the nation’s intelligence agencies on request.

Trade tensions won’t disappear soon since the US-long term interest is to contain Chinese economic growth. And that will most likely eclipse any US consumer complaints about higher prices or potentially higher inflation.

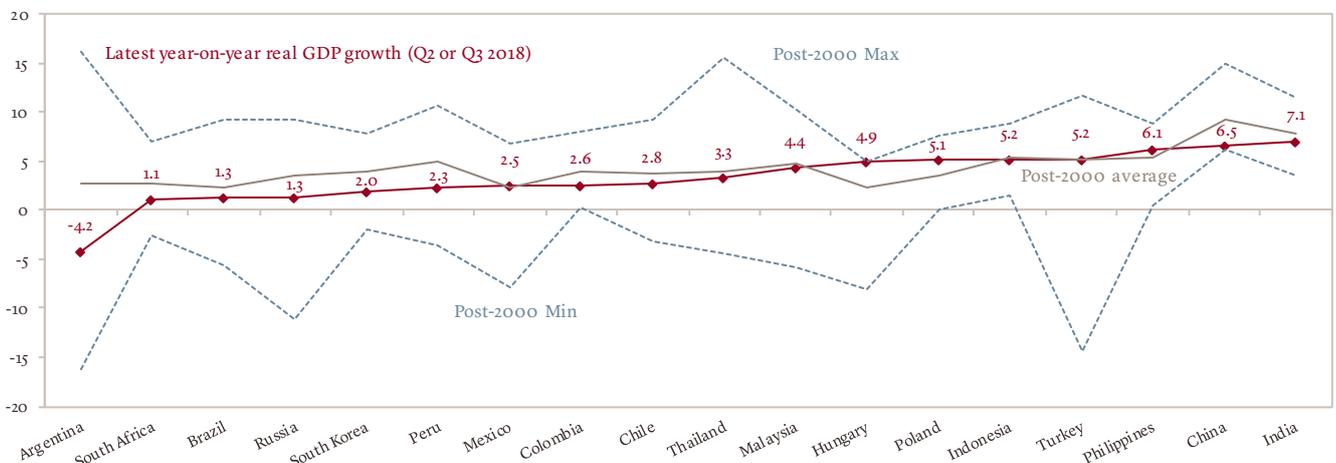
## ‘Late cycle’ dynamics and the Fed

US monetary policy in response to its late-cycle economy remains the key risk factor for EM assets. As the effect of the US’s pro-cyclical fiscal measures fades, the Fed seems to be approaching the end of the current hiking cycle, suggesting that this EM market driver will disappear as interest rates and growth differentials normalise, and the dollar weakens.

This response to the US’s ‘late cycle’ environment and rates normalising globally, in addition to this year’s sell-off and the improvement in emerging economies’ foreign-debt levels and current account balances, means that we expect to see a weakening USD against other currencies as the spread between US interest rates and the rest of the world narrows. While it’s likely that emerging currencies will rise in response to a falling USD, there have also been occasions since the turn of the century (in 2002 and 2011) when that hasn’t held and emerging currencies have fallen with the USD, or risen only feebly, as in 2006. For this reason, it’s important that investors maintain a very selective stance in emerging currencies, favouring those with high real yields, momentum in reform implementation and low dependence on external debt.

### I. GDP growth remains below post-2000 average

18 select emerging countries - Q2 or Q3 2018



Sources: Datastream, Bloomberg, Lombard Odier calculations

Our expectation is that **the current low valuations and under-exposure of many funds in EM equities will provide investors with a ‘valuation cushion’**, as long as they focus on resilient macro conditions, prudent policy and organic earnings growth.

It should be clear to any investor that it’s impossible to treat emerging markets as a single group. 2018’s turmoil remained both local and contained. As the year draws to a close, we’re not talking about a regional crisis triggered by Turkey or a crisis in Latin American sparked by Argentina. With these two exceptions, and the vulnerabilities visible in the South African economy, most emerging economies now boast stronger fundamentals and a relatively early economic cycle (see charts).

It is also worth underlining that EM forward price/earnings ratios are currently close to, or below, their five-year forward averages in most markets. Finally, if as we expect, the oil price rebounds in 2019, this will provide additional support to EM currencies.

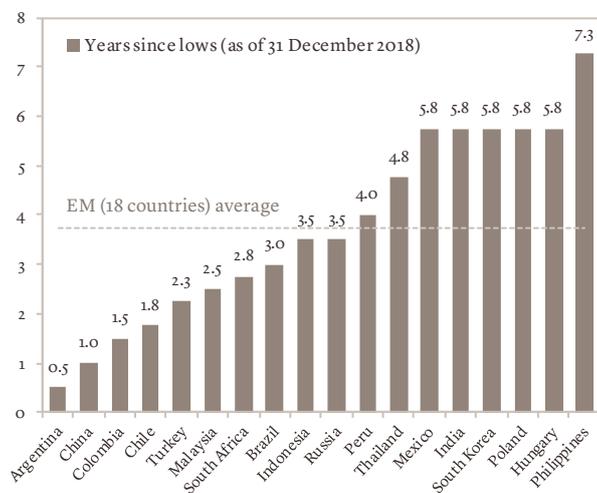
### Increasing EM exposure

In June, we began implementing a reducing risk reduction strategy in our portfolios to take account of the Fed’s monetary policy and rising uncertainties over China/US trade tariffs. Last week we saw the Fed announce a more flexible and data-dependant approach to rate hikes and a US/China trade truce from the G20, supporting investor sentiment, especially after the declines in markets in October and November. In our view, undervalued emerging market equities are positioned to benefit most from this decline in trade-related risk.

POLITICAL CALENDAR 2019	
• 1 January	Jair Bolsonaro takes office as <b>Brazil’s president</b>
• 24 February	<b>Thailand</b> holds general election
• 31 March	<b>Ukraine’s</b> presidential elections <b>Turkish</b> local elections
• 17 April	<b>Indonesia</b> holds general election
• April/May	<b>India’s</b> general elections
• South Africa	general election expected between May and August
• 27 October	<b>Argentina’s</b> general election

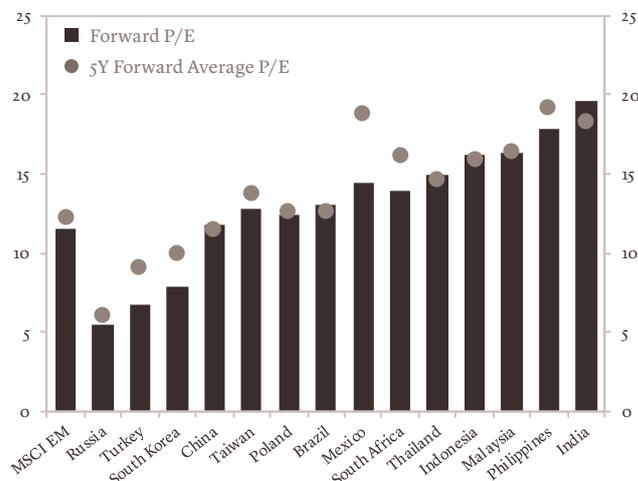
## II. The emerging recovery is still young

Under 4 years on average (versus 10 in the US)



Sources: Datastream, Bloomberg, Lombard Odier calculations

## III. Current forward P/E vs. 5Y average forward P/E



Sources: Datastream, Bloomberg, Lombard Odier calculations

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