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# CIO Viewpoint

# Emerging economies: where next?

Investment Solutions

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**Following a significant slowdown in global activity in late 2018 and the first half of 2019, the global economy appears to be stabilising. While uncertainty remains, the worst of the US/China trade tensions that so disrupted international trade flows may be behind us. Despite ongoing trade headwinds, cyclical growth in emerging market economies seems to have bottomed out and activity looks set to recover in 2020, albeit modestly. Positive news on the tail risks of trade and Brexit, prerequisites for an improvement in the outlook, now underpins investor and business sentiment.**

In addition, easier financial conditions from the Federal Reserve's interest rate cuts and a synchronised easing of monetary policy across emerging markets are likely to start having their positive spillovers on growth. Within our universe of 18 large emerging countries, 15 central banks have lowered rates this year, averaging around 100 basis points, against 75 bps in the US.

Importantly, emerging markets have, on the whole, the ability and potential to ease further – contrary to most major developed economies (except the US) - since inflation remains tamed. The People's Bank of China has room to continue to stimulate the economy via targeted interest rate cuts if needed, as well as lowering the reserves that it requires commercial banks to hold. India's Reserve Bank has cut rates by 135 bps over this year, and it seems likely that it will ease further. While these interest rate cuts are undoubtedly already helping, their impact may only start to be visible in the real economy in 2020 and so support emerging markets' cyclical growth.

## EM growth: structural vs cyclical

In the second half of 2018 and 2019, emerging market growth declined sharply. Between 2000 and 2010, emerging market real GDP growth averaged 6.5% year-on-year while between 2011 and 2015 it stood at 5.2% YoY. In 2019 it declined significantly to an estimated 4.5%. Inevitably the investment community started questioning the case for emerging assets. However, we should be careful in separating the structural from the cyclical trend, especially when trying to extrapolate this into asset performance.

### Key takeaways

- Emerging markets have the ability to ease interest rates further to stimulate growth
- We continue to prefer carry strategies in a low interest rate environment
- We remain overweight emerging market hard currency debt and believe EM currencies are undervalued
- The US/China trade dispute remains the single greatest risk to emerging economies' outlooks
- In the long term, the global economy will depend on emerging markets for more diverse growth sources.

Chart 1 shows growth in emerging market real gross domestic product since the mid-1990s together with an estimate of structural/trend growth (in this case, a five-year moving average). It is clear that structural growth in developing economies is slowing. But this should not be interpreted as a negative. It is a natural consequence of economies advancing in their development. This holds particularly true for China. Like Japan and South Korea in decades past, China is experiencing slowing growth as its economy becomes more services oriented and less reliant on manufacturing goods (see chart 2). While it seems probable that China's years of double-digit growth are behind us, it is nevertheless a managed slowdown and still offers strong potential growth as the global economy continues to shift its balance toward Asia and Latin America.

Importantly – and although growth is cooling – emerging markets' economic activity is more sustainable and less unstable, the volatility of real GDP growth has fallen significantly following the financial crisis for example. As domestic markets mature, deepen and become more accessible, they provide, in principle, a healthy mix of risk-adjusted investment opportunities.

The recent undershoot in growth, however, was mostly due to cyclical global disruptions of the US-China trade tensions. Growth in emerging markets should accelerate, modestly, in 2020 as trade frictions likely stabilise, global manufacturing bottoms out and monetary policies ease. This is important because it is this cyclical aspect which is positively correlated with asset price returns such as equities, emerging sovereign bonds and credit.

## Identifying value

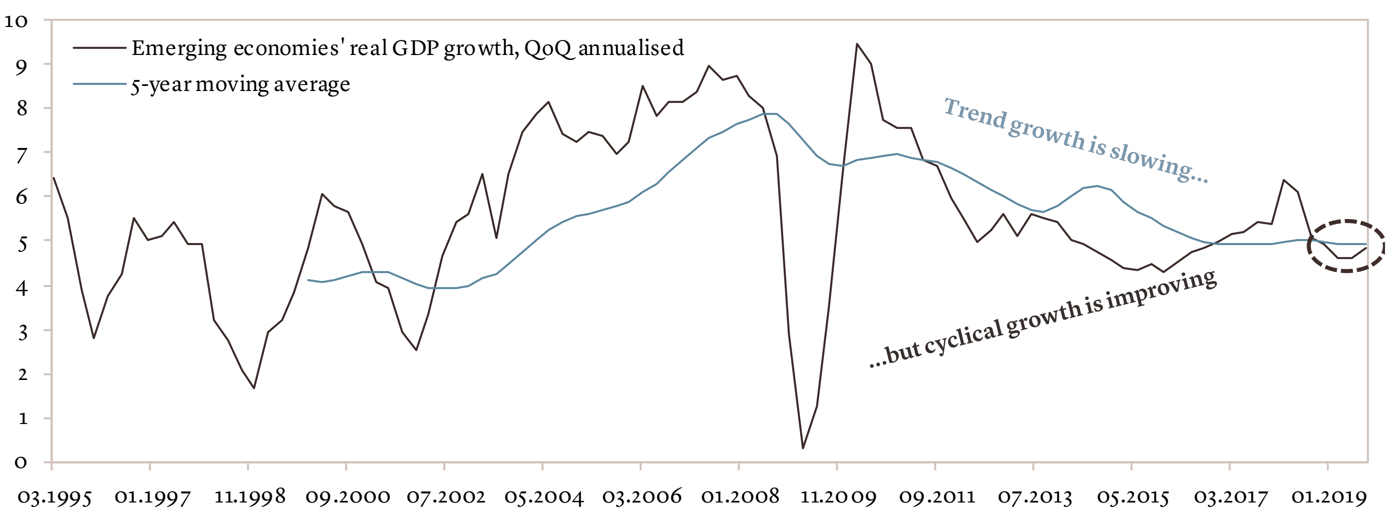
Much of the 2020 cyclical outlook for emerging market assets depends on the evolution of the US/China dispute. Our working assumption is that no further tariffs will be imposed and there is a reasonable chance that those already in place may be rolled back.

We expect emerging market equities to be supported and see most value opportunities in China, Brazil and Russia. Chinese stocks have underperformed over the past three quarters owing to the ongoing trade disruption, but once trade stabilises we should see some recovery next year. China alone now accounts for more than 15% of global GDP. Its domestic bond market is one quarter of the global debt market while its equities market lags in scale at the equivalent of around 4% of the MSCI All Country World Index. The continued integration of Chinese assets into global financial markets is strategic for investors, as they might need to rethink their emerging market allocations and consider standalone exposures to China.

In Brazil, various macro measures should boost earnings growth. The country is still recovering from a long recession and currency weakness since 2018 should support exporters and corporate profitability. In Russia, we see room for further gains as trade numbers are improving and there is a relatively stable political outlook.

In currencies, our estimates suggest that – as a whole – emerging FX is undervalued by between 5% and 10%. As the cycle shifts in favour of a modest pickup in global trade and the dollar comes under pressure, we expect EM FX gains to average around 3-4% next year. We favour the Mexican peso, the Malaysian ringgit and the Russian rouble on valuation grounds.

**1. Emerging markets' structural growth is slowing**




Sources: Bloomberg, Lombard Odier calculations

## Keep calm and "carry on"

As for most of 2019, we remain constructive on carry strategies, which involve preferring higher-to-lower yielding assets. This is because we anticipate interest rates will remain low or trend lower. We continue to be overweight in emerging market hard currency debt, where we expect spreads to stay stable while corporate net leverage is falling.

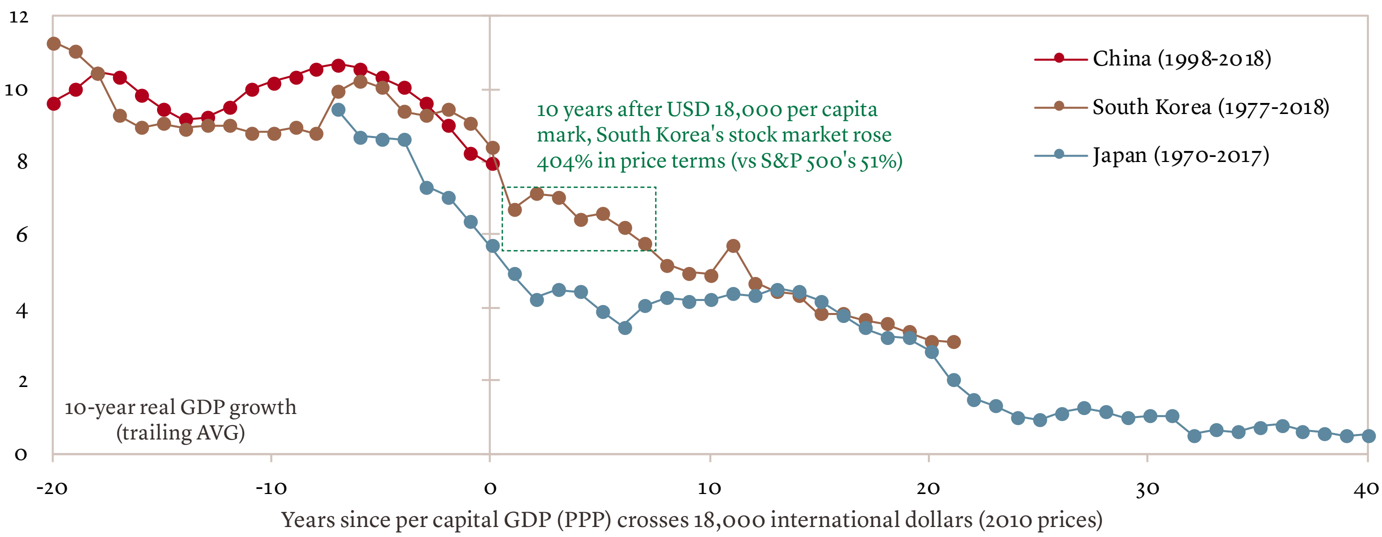
While we prefer to express this pro-carry view via readily investable global emerging indices, certain economies need close monitoring. Countries such as India, South Africa or Nigeria will need to meet their potential and demographic pressures through meaningful structural reforms. In South Africa for example, the International Monetary Fund called last week for measures to overhaul state-owned enterprises, boost growth and lower financing costs. Nigeria, Africa's biggest economy and most populous nation, is experiencing high inflation, low growth and the need to diversify away from the volatility of oil and gas prices.

For 2020, the clear risk remains US-China trade frictions. Though not our central scenario, a re-escalation of tensions would weigh more on business and investor sentiment, amplifying concerns over a structural shift away from globalisation. The outcome would be even further trade-chains disruption and result in underperforming emerging assets.

Over the long term, we have little doubt that the global economy will increasingly depend on emerging markets for their more diverse sources of growth. We are still confident that the longer-term potential for them to do so remains in place.

**2. China's structural slowdown is a reality markets can live with**

Growth tends to follow credit growth with a 6-month lag




Sources: Datastream, Lombard Odier calculations

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