Moving forward

Opportunities in emerging markets
Life in the new normal
Introduction

After the great financial crisis of 2008-2009, emerging markets looked more attractive than developed markets due to their higher expected growth rates. As a matter of fact, they grew much stronger than developed markets until 2011, when the euphoria surrounding the emerging markets growth story started to settle and investors turned to developed markets once more.

We think it is time to reconsider them now. Why? The cyclical challenges that hampered emerging markets returns in the past five years have started to reverse. Weaker currencies have started to improve trade balances, and those countries which suffered a recession are predicted to grow again. The pressure on governments falling short of providing a functioning governance structure has increased, as the example of Brazil shows.

For the last several years, global markets have experienced a “new normal” of low economic growth and persistently low inflation. The tepid economic recovery from the great financial crisis of 2008-2009 is one factor driving the New Normal. Low long-term bond yields and a flat yield curve bears evidence that the markets believe in the New Normal as the base case scenario.

Demographics lend further support to the case for tepid long-term growth. Global working-age population growth for the period 1980-2008 was 1.75% annually, but the rate is trending downward to an expected 0.71% annually over the next 50 years.1 All else being equal, this translates to a roughly 1% loss in potential gross domestic product (GDP) growth. If this outlook proves correct, investors will continue to seek out investment themes that are not overly dependent on global economic growth.

In our view, emerging markets have these characteristics with several having the potential to grow at a faster rate. These countries have favorable demographics, a thriving private sector, as well as a choice of quality companies to invest in.

Developing a robust country-ranking framework

The UBS Emerging Markets Equities investment team analyzed a spectrum of emerging markets (EM) and developed markets (DM) to conclude that EM countries offer encouraging reasons to invest. The team’s proprietary research has identified the most investable EM countries from a macro perspective, and the most promising investment themes and business sectors over the next few years.

Countries that possess inherent growth drivers will likely have an edge as profitable investments. To help us identify these countries, we draw on research on the drivers of economic growth and apply these to the current environment. In particular, we have built on research by Robert Barro of Harvard University, whose model identifies significant drivers of per capita GDP growth, including starting GDP, education levels, government consumption as a percentage of GDP, and political stability.

A second influence on our country-level evaluations is David Bloom of Harvard University, whose work has focused on the growth of the working-age population, rather than on growth in total population.2 Another influence is the work of Antonio Fatas and Ilian Mihov of INSEAD, who have identified the “4 I’s” of economic growth: Innovation, initial conditions, investment to GDP ratios and institutional quality (which we proxy with the World Bank’s Ease of Doing Business Index).3

Using these sources, to develop composite country rankings, we ranked 57 developed- and emerging-market countries across six of the key factors identified by the research: Working-age population growth during 2015-2020, average education (years), ease of doing business, per capita GDP in 2014 and purchasing power parity (PPP) in 2011 USD, investment as a percentage of GDP and finally, government consumption expressed as a percentage of GDP.

Our findings show that EM countries will likely produce 4.2% working-age population growth in the next five years, while developed market (DM) countries may shrink by 0.2%. EM countries also have an advantage in catch-up potential, with

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1 World Bank and US Census Bureau.
3 Antonio Fatas and Ilian Mihov, “The 4 I’s of Economic Growth, INSEAD"
lower per-capita GDP to begin with, greater investment as a percentage of GDP, and lower government consumption (which is considered a plus).

The differences between individual EM countries are as great as the differences between EM and DM, hence while investing in EM as a whole helps address the question of where to invest in the New Normal, choosing the most promising countries can yield better returns.

From a regional perspective, Emerging Asia comes out well, driven by good demographics in most countries a smaller government sector, and high levels of investment, especially in these Association of Southeast Asian Nation (ASEAN) members: Malaysia, Indonesia, the Philippines and Singapore. India is penalized in the rankings due to low education and ease of doing business scores. However, China scores low for demographics, and somewhat low for its education and ease of doing business scores.

Outside of Asia, countries in the Emerging Middle East, Africa and Latin America show relatively less growth potential because of higher government consumption and lower investment levels. However, Mexico, Peru and Chile are notable exceptions. Emerging Europe has quite a different set of scores. Education scores are excellent, and ease of doing business is good, but the region is hampered by poor demographics, with negative working-age population growth over the next five years.

Emerging market equities: looking beyond GDP growth

Whilst several EM countries are poised to outperform based on growth, GDP growth alone often does not translate into improved equity market returns. Corporate performance and secular investment themes that are attractive in a low global-growth environment must also be present.

In contrast to much of the developed world, which is facing lackluster growth for years, several emerging markets countries have growing, youthful and tech-savvy populations, whose incomes and propensity to consume are steadily rising.

This has led our emerging markets equity team to identify four key EM growth themes for the next five years: consumer spending, healthcare, real estate and information technology. We believe that these themes, combined with a good supply of investible companies from different sectors, create compelling investment opportunities.

From our standpoint, there are some strong structural drivers across emerging markets. A growing working-age population and rising income levels are lifting millions of households from middle class to higher middle class. We see a marked growth in urban and tech-savvy consumers and decreasing age dependency ratios. Not only in China but also in many other Asian, Latin American and European emerging economies, including India, Indonesia, Malaysia, the Philippines, Argentina, Brazil, Mexico, Poland, Russia, and Turkey. Crucially, as per capita income approaches USD 5000, consumption patterns change rapidly. Bangladesh, Egypt, India, Indonesia and the Philippines are around this threshold and are undergoing this change.

We have identified four key themes that should benefit from these changes. Firstly, discretionary spending grows as income rises with more spent on education, leisure and entertainment. For example, whilst spending on consumer staples tends to plateau, consumers upgrade their dining choices. Secondly, consumers are becoming more brand conscious, trading up from unbranded to branded merchandise and products in categories that improve their quality of life.

Thirdly, online channels in emerging markets are growing rapidly. As with the west, rising online penetration has been accompanied by declining same-store sales for traditional retailers. China has led the way in e-commerce, and India too offers huge potential going forward. Last but not least, there is an increasing focus on personal wellness and health. Rising affluence drives the demand for good-quality healthcare services, but also leads to higher incidences of lifestyle-related diseases such as obesity and heart diseases.
Emerging market debt: yielding attractive returns

In the world of the new normal, developed market bond yields have been driven to historical lows by central bank policy action. Yet the needs of investors with income obligations – such as pension funds and endowments – have not decreased since the start of the great financial crisis. Indeed for many they will have increased.

In an environment of ‘lower for longer’ many investors have moved further out the risk spectrum in the search of that all important yield pick-up.

And yet emerging markets have not benefitted from this trend to the degree that, perhaps, they should have. Much has changed since the Tequila Crisis (Nov ’94), the Asia crisis (Summer ’97), the Russian default (Nov ’98) and the Argentine default of 2001/2 events that have tested investor sentiment.

Since the 1990s, emerging market policymakers have moved a long way towards increasing their country’s creditworthiness as policy discipline was imposed by capital markets and the International Monetary Fund.

Orthodox macro-economic policies have been implemented by many emerging country governments, regardless of political orientation. Important achievements include, for example, the reduction in external debt levels, the liberalization of fixed exchange rate regimes and the adoption of inflation targeting as a pillar of monetary policy decision making.

Improving political governance, stabilizing commodity prices and sound fundamentals – driving the growth differential over developed markets - all make emerging markets in aggregate an attractive proposition once more.
Moving forward | Opportunities in emerging markets

As the chart above illustrates, emerging market bond issuance has grown significantly since the start of the new millennium increasing tenfold in size until it is now one fifth the size of the US bond market. This represents a significant pool of assets from which to select investments.

However, we caution investors to take an active approach with selective exposures to countries and issues to make the most of the potential opportunities on offer.

We also caution that in an ever more globalized economy, the emerging markets are just as exposed to external shocks as they are to internal ones. For example, continued monetary easing by the major central banks will continue to support risk assets, but any resumption of monetary tightening by the US Federal Reserve or any other global macro event that would increase the relative strength of the dollar could create a negative environment for emerging market bonds.

And whilst commodity prices appear to have started their recovery, a further leg down will have an asymmetrically negative impact on some emerging market economies.

Overall, the recovery in commodity prices, an improving supply demand balance, ongoing fiscal structural reform, more reform minded new governments and the global search for yield make emerging market debt an attractive asset class for investors.

Multi-asset opportunities: It's all in the mix

For investors seeking the long-term growth opportunity presented by the emerging markets story but who seek a lower level of volatility, a multi-asset approach brings all the benefits of diversification of a traditional multi-asset policy. Moving between equities and debt, the portfolio manager can take advantage of long-term secular trends and short-term tactical opportunities to optimize the long-term risk/reward trade-off. With both emerging market equities and bonds under-appreciated at this point in the investment cycle, investing now in a multi-asset approach targeting a total return from current income and capital appreciation could reap long-term benefits.
Conclusion

• In the ‘New Normal’ of low long-term bond yields and a flat yield curve in developed markets, investors are seeking investment themes that are not overly dependent on global economic growth.

• Emerging Market countries may offer several strong investment opportunities.

• In equities, working-age population growth and rising incomes in many Emerging Markets could drive health care, leisure and online spending. Consumer spending, real estate, information technology and pharmaceutical business sectors will see growth in selected markets.

• In bonds, the lower for longer mantra in the developed markets and accommodative central banks should continue to provide a backdrop for strong demand growth. Further, stabilizing commodity prices, lower political uncertainty and a willingness by some EM countries to address their macroeconomic imbalances should be positive for investors.

• However, an active investment style with a selective approach to countries and issues is recommended.