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More to go

The upcycle is not broken in emerging markets

UBS Asset Management

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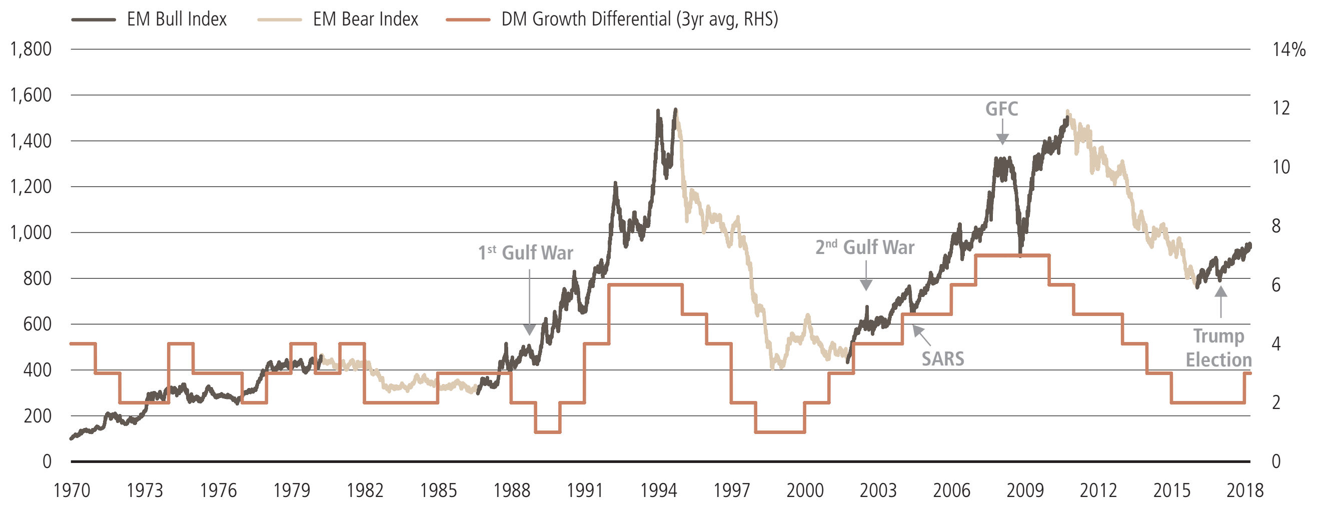
Although investors may have been worried, we believe the recent bout of volatility in emerging market equities was driven more by sentiment than fundamentals. While risks overall increased (including stronger USD/US rates, trade concerns and geopolitics), fundamentals have remained strong with continued positive earnings and economic growth across EM.

Absent a strong growth shock, we assume these risks will not derail the multi-year upcycle currently underway for emerging markets equities (see Exhibit 1). After being cut for several years, capital expenditure is on the rise again. This development should drive demand across emerging markets and support further improvement in corporate margins and earnings, although at a more moderate pace going forward.

Trade issues: An escalation of the trade conflict between US and China into a full blown trade war is not our base case. However, there are uncertainties as to how the situation might evolve. We believe US President Donald Trump wants a fairer trade playground and we believe China will be ready to offer some concessions (e.g. China recently ended the requirement for foreign car brands to set up a joint venture with a local company when building manufacturing facilities in China).

Exhibit 1: EM: In the middle of a multi-year upcycle



Source: FactSet, Datastream, Bloomberg, Goldman Sachs Global Investment Research, data up to April 4, 2018. GFC: Global Financial Crisis of 2007/08, SARS: Severe Acute Respiratory Syndrome in the Guangdong province of China in 2002-2004.
Note: We used the MSCI World as a proxy for DM. For EM, MSCI EM was used from Dec. 1987 onward. Prior to this, the EM index was reconstructed using individual EM exchange-level data available at the time

Stronger USD: A stronger USD may continue to overhang the performance of EM assets in the near term. However, we see reduced crisis risks for EM given the asset class is healthier than in the previous episodes of weakness (e.g., during the 'taper tantrum' in 2013). This is thanks to stronger fundamentals both at the macro level via more balanced current accounts, more competitive exchange rates, less FX debt with localized exceptions and replenished FX reserves—and at the micro level via lower corporate indebtedness.

China: Rebalancing continues to offer investment opportunities
Looking across emerging markets, the Chinese economy continues to face many structural challenges, but we believe they will result in lower medium-term economic growth, accompanied by some volatility, rather than pose crisis risks. China has remained resilient at the macro level.

The rebalancing of the economic structure toward services should continue to provide investment opportunities, especially within sectors such as e-commerce, e-payments, social media, education and insurance. For the next few years, we expect China to focus on the quality of growth and to continue its reforms agenda including corporate deleveraging and environmental improvements.

India remains an attractive long-term story
In India, corporate earnings are beginning to improve but only gradually. While we currently see attractive bottom-up opportunities, we are also monitoring the macro risks, such as the widening trade and current account deficit.

In the nearer term, the government's focus on infrastructure spending continues to boost domestic sentiment. There should also be further fiscal support in the run-up to 2019 national elections, especially for the rural economy. The consumer remains somewhat robust and household sentiment has improved from last year.

We see India as an attractive long-term story and believe that the Modi government will continue to focus on removing bottlenecks and pushing through calibrated reforms to revive investments for sustained growth in the medium term.

Outside Asia—contagion risks and political uncertainties overshadowing economic improvement
We see limited contagion risks from Argentina and Turkey woes, which we believed are already reflected in currencies that have weakened against the USD, and inexpensive valuations. The situation is also quite different for many countries, primarily commodity producers, as commodity prices are currently strong despite the stronger USD, which should offer some buffer and offset the potential economic impact of tighter financial conditions.

Overall, while we don't view the upcycle as broken, risk perception has risen and we expect heightened stock price volatility going forward. We thus encourage investors to look through the noise and focus on long-term fundamentals and the continued economic recovery. Our analysis shows large opportunities exist in various sectors, including consumer, internet/e-commerce, and financials. While there are some small vulnerable spots in EM, we are mindful of these risks and have very limited exposures to these areas.

Equities: More to go from Panorama: Mid-Year 2018.
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