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Still in a long-term upcycle

After a perfect top down storm in 2018, there are now large opportunities in emerging markets equities | UBS Asset Management

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Our positive stance on emerging markets (EM) since 2016 was predicated on the growing economic growth gap between EM and developed markets, plus a favorable cycle for EM accompanied by improving fundamentals at both the country and company level. This was driven in large part by a reduction in capex over the past few years, which contributed to a recovery in margins and profitability, China's continued rebalancing into services and consumption, and fair valuations, which are much cheaper than the US.

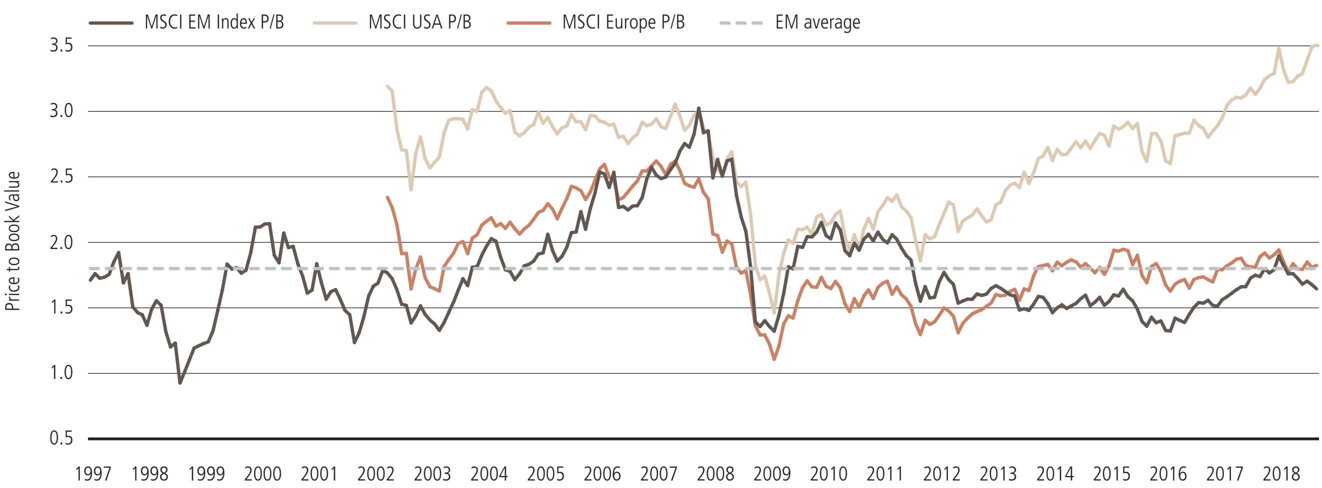
Tighter financial conditions

Given the strong domestic economic backdrop in EM countries, equity markets were well placed to withstand the rise in US bonds yields until early 2018. But the strength of the US economy, growing US/China trade tensions and the softening of growth prospects outside the US created a number of headwinds to EM equity performance.

Significantly higher US Treasury yields and a stronger US dollar have tightened financial conditions in EM and placed fresh pressure on EM currencies. Meanwhile, despite the increase in intra-EM trade in recent years, EM economies are still more exposed to global trade than their developed counterparts.

These combined factors triggered particular problems in small economies with large current account deficits and high net external debt such as Argentina and Turkey – and increased investor concerns about widespread contagion across the EM universe. This knee-jerk reaction and nervousness was more in-line with historical views of EM vulnerabilities. These developments caused outflows from fixed income markets and EM ETFs, which in turn created downward pressure on EM currencies and upward pressure on rates. With the drawdown even hitting companies with strong fundamentals, we believe the sell off to be overdone.

Exhibit 1: EM valuations are inexpensive



Source: FactSet, MSCI. Data up to 30 September 2018.

Chinese authorities to soften slowdown
All of this comes as China's efforts to reduce systemic risk by stabilizing leverage in its economy is inevitably creating near-term headwinds to the outlook for growth in Asia in particular.

But the Chinese authorities have responded to soften the growth slowdown by stepping up both monetary and fiscal policy support – all the while maintaining the long-term commitment to deleveraging and reforms. The result should be more sustainable and higher quality growth down the road. We believe there are still many levers the Chinese authorities can pull to successfully manage a gradual slowdown and avoid a hard landing.

The long-term investment case in China remains centered around the rebalancing of the economic structure toward services and the ensuing investment opportunities across sectors such as e-commerce, e-payments, social media, education and insurance. We are, however, closely watching the increased regulatory interventions in areas such as education services and gaming which have served to dampen recent investor sentiment.

Despite near-term risks, large opportunities exist in various sectors
Looking forward, it seems unlikely that the US-China trade tensions will dissipate in the short-term. In our view, the escalation of the US/China trade conflict has increased the risks around an EM economic recovery.

But while investor concerns are understandable in light of recent events, the real long-term impact of all of the above across EM remains fairly limited in terms of economic growth and company earnings. Against this backdrop the market reaction appears to have been driven by a sharp change in sentiment and subsequent outflows.

Yet history tells us that this is an asset class prone to short-term swings in both sentiment and market prices. In part we believe that this reflects that for many global investors, EM equities remain a tactical rather than a strategic allocation.

We believe that the current risks are already largely discounted in current valuations, which have fallen to 1.6x on a Price to Book (P/B) basis from 1.9x in January. Current valuations now sit well below the long term average of 1.8x P/B. EM currencies have also corrected meaningfully this year and we believe are undervalued.

Our positive mid- to long-term outlook for EM equities therefore remains unchanged. EM assets look attractively valued. Looking at current account balances and net external debt levels we maintain our view that most EM countries are fundamentally healthy. At the company level, we believe profitability and earnings growth prospects remain generally robust.

Our analysis shows that 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.

However, while near-term risks remain, a combination of the following catalysts could prompt a swift change in investor sentiment to EM: any improvement in rhetoric between the US and China over trade, reduced regulatory intervention in China, and perhaps most important of all – a stabilization in recent USD strength.

This article is part of *Panorama: Investing in 2019*, UBS Asset Management's outlook for the year ahead.
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