Emerging Markets: Renewing The Promise

After nearly five years of underperformance, emerging market equities regained some favor from global investors in 2016 and have outperformed so far this year as well. Yet, many investors still worry about the risks, perceived as well as real. Is it yet another false dawn that could quickly fade when the U.S. Federal Reserve and other major central banks start scaling back their balance sheets? Or could the pessimism reappear if commodity prices falter again?

KEY TAKEAWAYS

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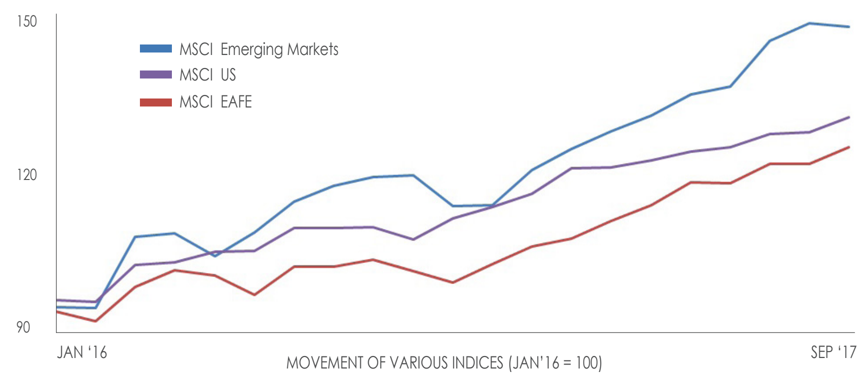
EMERGING MARKET EQUITIES HAVE OUTPERFORMED RECENTLY



Data source: MSCI

GROWTH DIFFERENTIAL WITH THE DEVELOPED WORLD IS WIDENING

For nearly a decade before the 2008 global financial crisis, the appreciably faster economic growth in Emerging Markets attracted global investors. At the peak in 2007, emerging and developing economies were expanding at an annual pace of over 8.5%, compared to around 3% for the developed world. After the dip in 2008 and 2009, short-term fiscal spending by governments helped emerging economies accelerate again. However, as commodity prices started to moderate and global trade slowed, growth in emerging economies cooled off. In 2015, when the developed economies expanded at an average rate of 2%, emerging economies registered a not so impressive 4%.

Nevertheless, it now appears likely that emerging markets could regain some of the growth momentum and widen the growth differential with the developed world. The International Monetary Fund (IMF) estimates that average the growth rate for emerging markets could rise to 5% annualized by 2019, and that rate could be sustained through 2022, while the developed countries are unlikely to expand faster than 2%. Though the pace is nowhere close to the pre-crisis high, even a moderate acceleration would be much appreciated in a world starved for growth.

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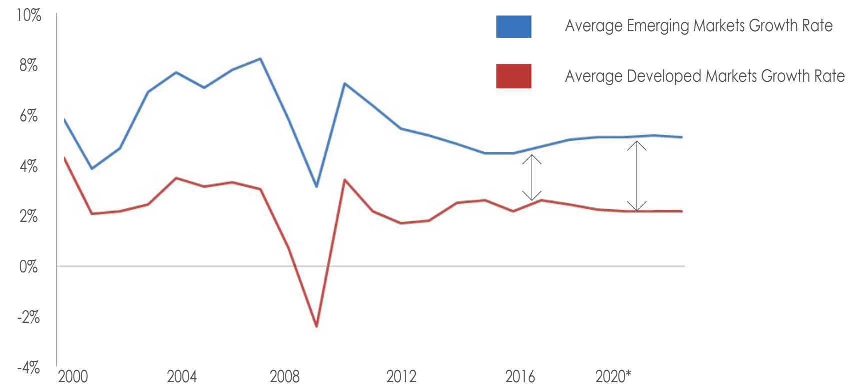

*Forecast
Data source: International Monetary Fund

ENERGY AND COMMODITY PRICES: NOT TOO COLD, NOT TOO HOT

The sharp decline in energy and commodity prices after 2014 did benefit large importing countries such as China, South Korea and India. But the abrupt fall in export realizations hurt Brazil, Russia and other emerging countries, and pushed some of them into recession. The weak outlook forced energy producers and mining groups to cancel or delay capital investments, hurting equipment manufacturers and their supplies even in countries that have benefited from low commodity prices. On balance, the boost from cheaper commodities for the emerging world as a whole fell short of expectations.

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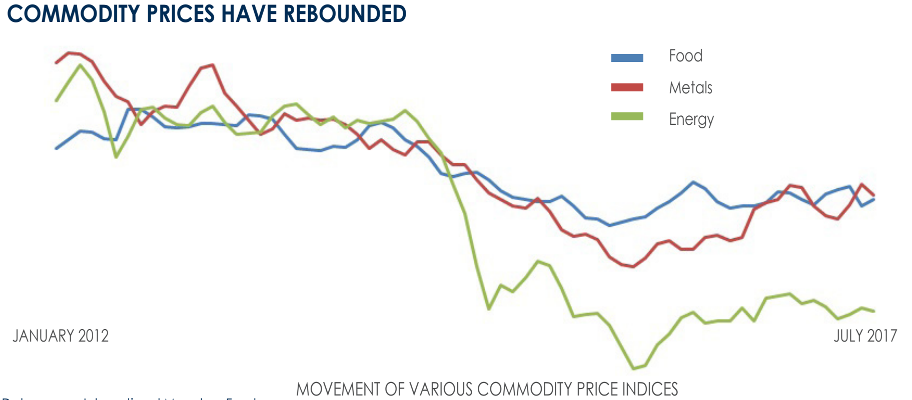
Last year's rebound in crude oil and other industrial materials such as iron ore helped the resource exporting countries recover from deep recessions. Brazil and Russia are expanding again, while most Latin American countries should grow faster by next year. At the same time, commodity prices have not moved high enough to appreciably detract from growth rates in China and other resource importers.

COMMODITY PRICES HAVE REBOUNDED



Data source: International Monetary Fund

GOVERNMENTS IN SELECT COUNTRIES ARE PUSHING REFORMS

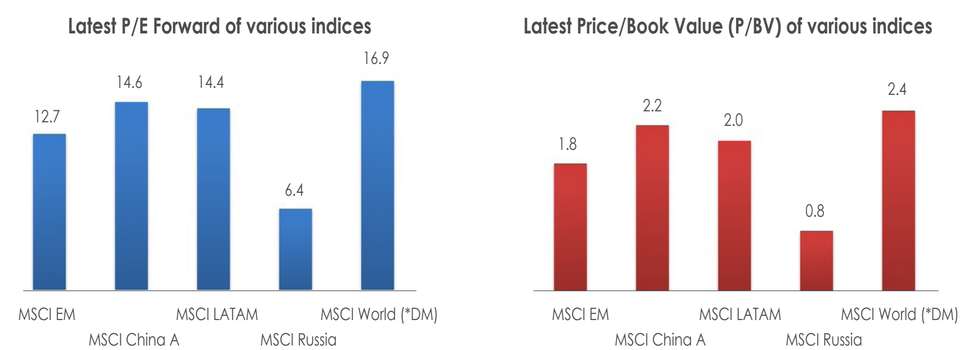
After dramatically opening up their economies to join the globalizing world, and enjoying the growth boost afterwards, governments in several emerging countries lost the urgency to initiate additional reforms to support businesses and make them more competitive. In some countries, governments became embroiled in corruption scandals and lost the political goodwill to make policy changes. The current governments in India and Indonesia did not have those constraints and have implemented significant policy initiatives, even at the risk of short-term disruptions to economic activity. Both governments have also proactively taken steps to reduce corruption and make it easier to do business in their countries. Similarly, several of the smaller Latin American countries are implementing business-friendly policies and reducing public spending.

Political risks in other emerging countries have also eased, though some of the governments have become more authoritarian and their policies have become somewhat unpredictable. Governments in Brazil, South Africa and Malaysia are facing corruption allegations, but the risk of these governments losing power appears low. If reform-oriented governments come to power in elections scheduled in 2018 and 2019, it is possible that some of these countries could see policy measures that enable faster economic growth.

EMERGING MARKET VALUATIONS REMAIN ATTRACTIVE

Despite outperforming the developed markets for the last eighteen months, we believe equity valuations in emerging markets remain relatively more attractive and continue to offer long-term opportunities. Unlike earlier when most large emerging market corporations were energy or material producers in a handful of countries, investors now have the opportunity to participate in the growth of a broad array of industries and geographies.

EMERGING MARKET VALUATIONS CONTINUE TO OFFER LONG-TERM OPPORTUNITIES



Data source: MSCI, as of October 31, 2017
*Developed Markets

To conclude, the economic and political environments in several large emerging markets have become more favorable for businesses to grow their revenues and earnings. Years of slow demand growth have forced emerging market corporations to trim their costs and become more efficient. Some of them have used this period to invest in capacity expansion, which should help them grow their market share. We are now seeing clear signs of a revival in earnings, across most sectors, in emerging markets. If the environment remains supportive and the earnings cycle continues to revive, emerging market equities may deserve more favorable consideration from international investors.

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To succeed in this approach, we have built an exceptional global research team that uses our proprietary techniques to identify the most attractive stocks in each of the major regions of the world. This in effect is our trump card."

— Thomas S. White, Jr., Portfolio Manager

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