NOV
18
2019

Is This the Best that Emerging Markets Can Do?

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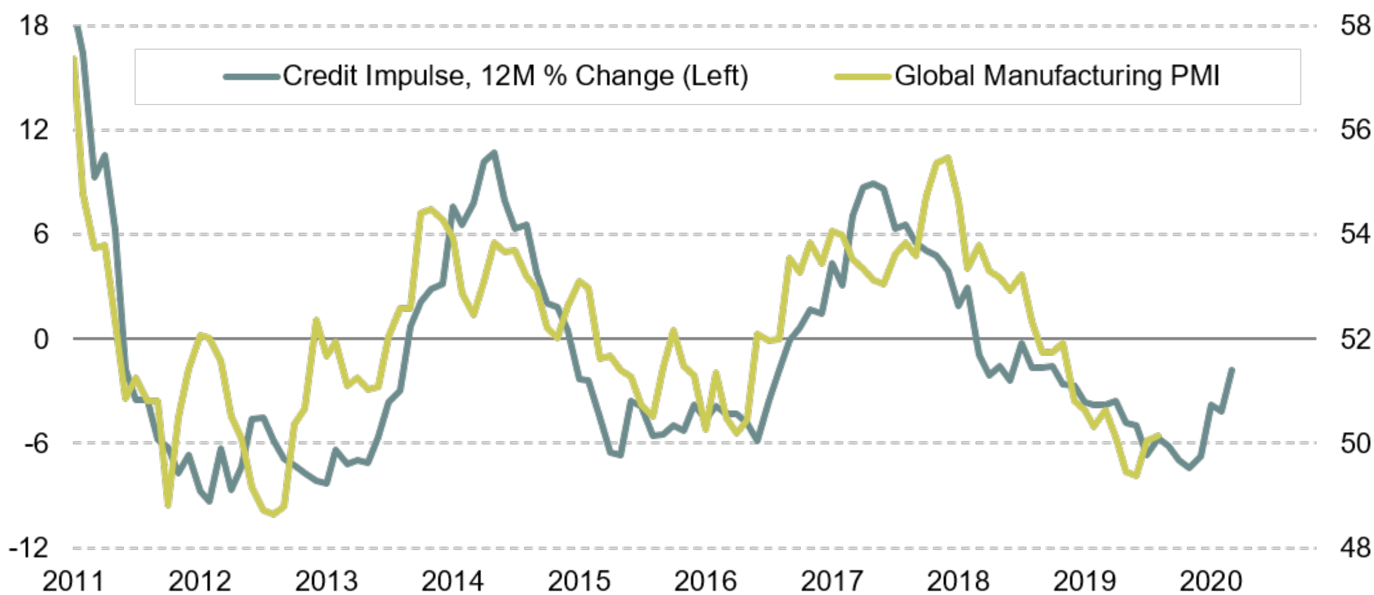
Cheap valuations in late 2018 had set the stage for an emerging market recovery, and finally receiving a lifeline this year. The Federal Reserve (Fed) cut rates three times totaling 75 basis points (bps), and equally important, oil prices stayed relatively flattish. As such, emerging market bonds and stocks have rallied despite local currencies staying somewhat flat. If there is an interim U.S.- China trade deal or a rebound in Chinese data, emerging market assets could breakout on the upside (see Chart 1 and Chart 2).

Chart 1: China's Credit Impulse and Global Manufacturing PMI

As of 9/30/2019



Source: Bloomberg (© 2019, Bloomberg Finance LP), Haver Analytics

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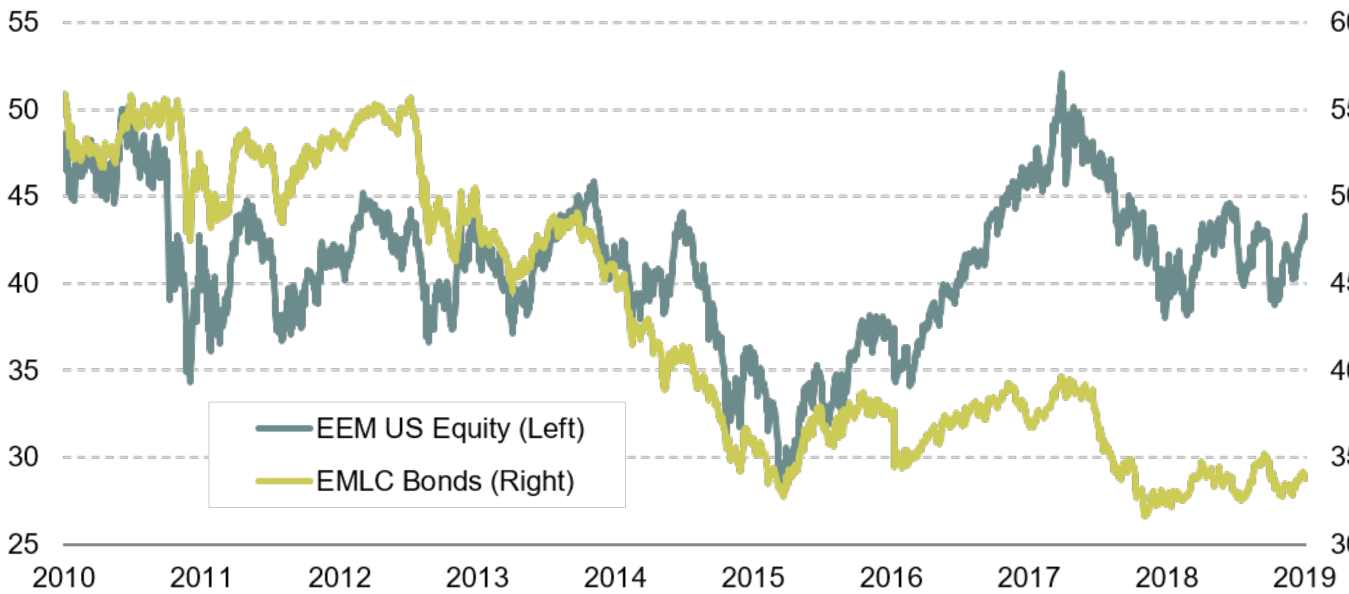
Chart 2: Emerging Market Equities and Bonds

As of 10/31/2019

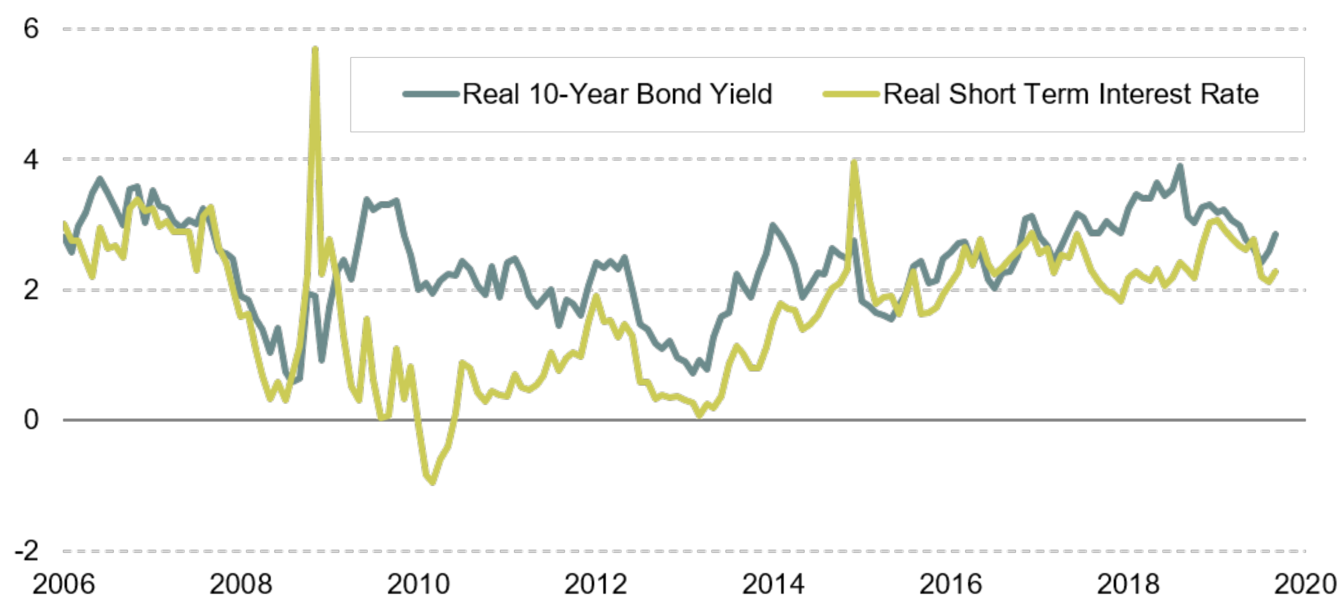


Source: Bloomberg (© 2019, Bloomberg Finance LP)

With inflation trending lower, emerging market real yields on both the 3-month and 10-year basis suggest bond valuations are hardly expensive yet (see Chart 3). Therefore, we are still in the early-to-mid stages of an emerging market recovery.

Chart 3: Emerging Market 3 Month and 10 Year Real Yields

Percent; As of 9/30/2019

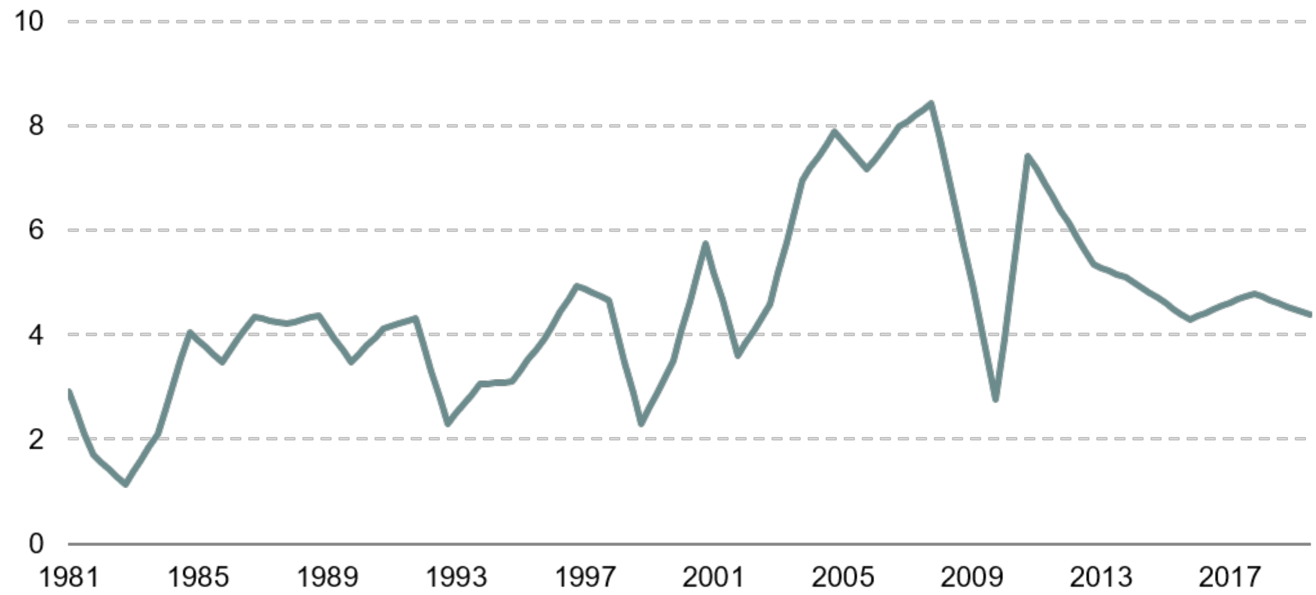


Source: Bloomberg (© 2019, Bloomberg Finance LP), Macrobond

But are emerging markets structurally a wilting story? The period of the early 2000s up until 2008 marked a structural change for emerging markets with the ascension of China into the World Trade Organization (WTO), marking the "official" onset of globalization (see Chart 4). The 2009-11 rebound in emerging markets was fueled by China's massive $4 trillion stimulus. Once again in 2016, emerging markets had a mini rebound stimulated by China's infrastructure push.

Chart 4: Emerging Market Real GDP

Annual Percent Change; As of 10/30/2019

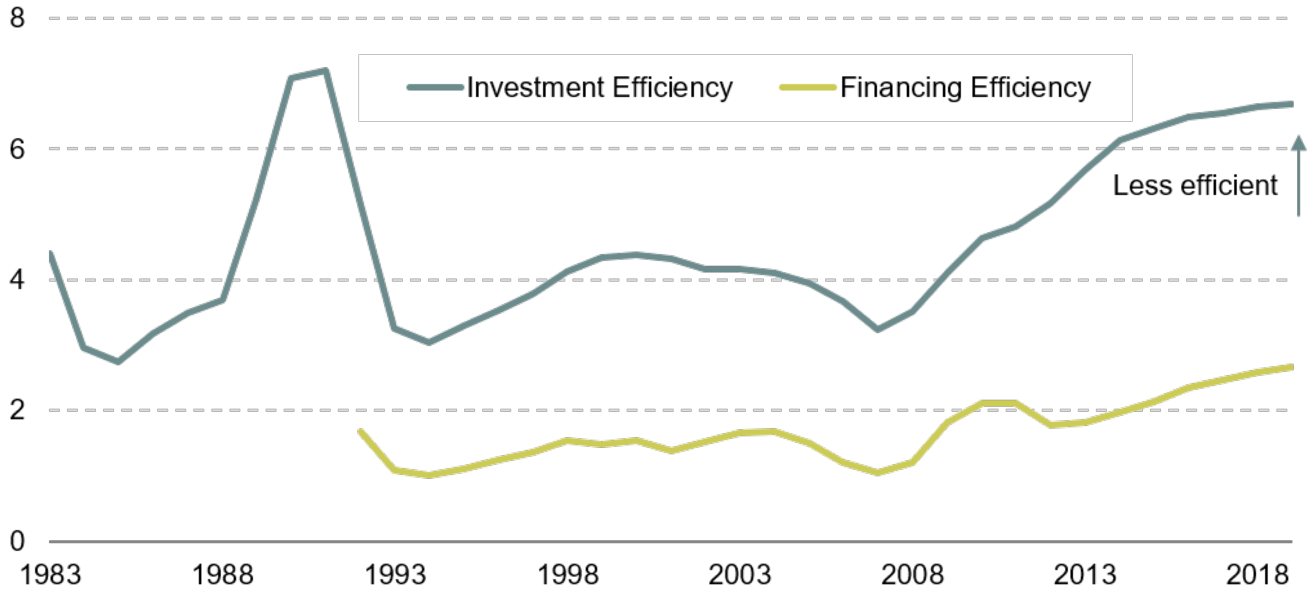


Source: IM, Macrobond

Unfortunately for emerging markets, China is now content with a slower growth path of below 6%, as it moves along a path of structural reforms, toward a consumer- and service-focused economy. Years of debt build up have lowered the investment efficiency of China (see Chart 5). And it doesn't help that the term "globalization" is on the back burner as U.S.-China frictions increase. Political upheavals in Latin America are also a sign that despite having done some reforms in the past, it is still lacking. These anecdotes all sound so dismal that maybe one would think "why should I bother with emerging markets!"

Chart 5: China's investment and financing efficiency

Ratio; As of 10/30/2019



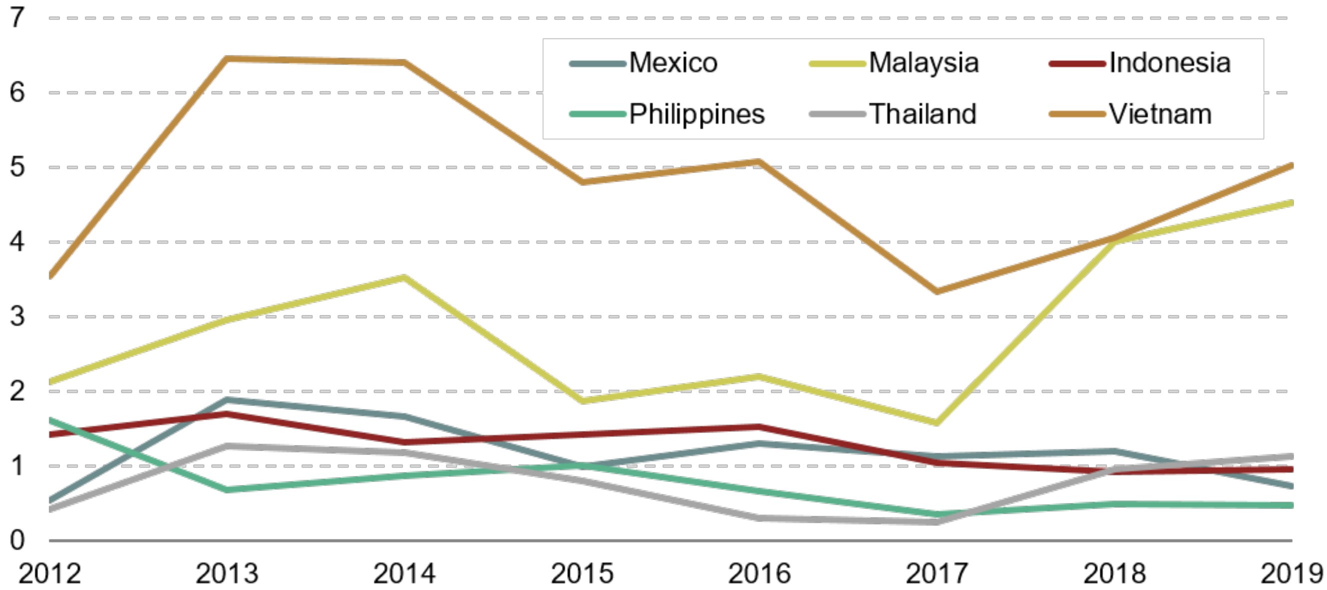
Shown as 3Y moving average; Assuming Q3 2019 YTD investment % GDP to be equal to the share in 2018

Source: Haver Analytics

Is it worth investing in emerging markets at all? We think so. While emerging markets are reliant on China's growth, we prefer to look at emerging markets with a half glass full perspective. Globalization is taking on a different form. As the Chinese economy undergoes a structural transformation, rising consumption could spur import demand. Supply chains are diversifying out of China into other emerging markets. Countries with a large demographic base like Brazil, Indonesia, and Mexico may see more goods manufactured within their economies. Some countries that have a labor cost advantage, such as Vietnam and Malaysia, have started to see the benefits of shifting supply chains. Manufacturing investment approvals are rising (see Chart 6). As we track this news, we expect a further pick-up in foreign direct investment inflows which would benefit their economies and currencies.

Chart 6: Approved/realized/registered manufacturing FDI

% GDP; As of 6/30/2019



Source: CEIC

In summary, emerging markets across the board have started to engage in multiple rate cuts, putting in place a reflationary tilt in this macro cycle. Additionally, some countries have increased fiscal spending and started on regulatory reforms. Alongside with supply chain diversification, some emerging markets will benefit more than others. For example, manufacturing-centric emerging markets may benefit more than commodity-driven economies given the movements in supply chains. Therefore, emerging markets are not quite withered yet—and to the contrary—exposure to select emerging markets that are poised to benefit from reflation, onshoring, fiscal stimulus, and government reform can add alpha to an actively managed investment portfolio.

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