The 21st century is supposedly unfolding as the Asian century and, more generally, as the time when emerging economies across the globe hit their stride, and “emerge”.

OUT WITH THE OLD, IN WITH THE NEW

The final decade of last century had been a troubled one, beset by financial crises, and with emerging markets ending the 1990s much where they had begun, at a market value around 4% of the total world equity market. But the eponymous new century began well, with emerging markets’ share of global markets lifting a compelling twelve percentage points to 16% between 2000 and 2011; with the ‘Global’ Financial Crisis, despite its name, being predominantly a North Atlantic phenomenon; and with developing economies well out in front in terms of GDP growth.

As we work through the second decade, however, the emerging markets story has hit a speed bump from an investment point of view. Underperformance of nearly 50% versus developed markets (in U.S. Dollars), since 2010 has seen their weight in the world index slump back to little over 12%. As political, economic and currency woes resurface in emerging markets, it’s timely to reassess their role in portfolios. Is this an opportunity to lift exposure? Or an ongoing threat to performance?

Short-term headwinds

In the short-term (next 3 months) we remain cautious, and are neutral to slightly underweight emerging market equities in global equity portfolios.

The key underlying drivers of short-term emerging market underperformance relate to the lagged effects of the slow-down in world trade through mid-2013; together with the looming end to a period of ‘crisis-level’ low interest rates in the United States, and an associated firming of the U.S. Dollar as shown in Figure 1 on the next page.

Weakness in some commodity prices has also been a negative for some emerging economies. These underlying negative factors have triggered a range of poor outcomes for emerging markets, as we enter 2014, including:

» Political and social unrest. These political issues are partly country-specific, and partly an outcome of heightened expectations interacting with disappointing economic results. Affected countries include Turkey, Egypt, Thailand and Brazil.
...the exports of nearly all the major emerging markets are now moving back into a growth phase.

Financial and currency crises. These problems have been concentrated in what have been termed the ‘Fragile Five’, namely, Indonesia, India, Turkey, Thailand and Brazil.

Poor momentum and sentiment
Emerging Market (EM) equities persistently underperformed Developed Market (DM) equities, both over the past 3 years as a whole, and in the first 6 weeks of 2014 in particular. One particular narrative surrounding that poor sentiment is the advent of U.S. Federal Reserve “tapering”, and associated fears that any slackening of monetary stimulus will be a particular negative for emerging markets.

Revenue downgrades. In the current (February 2014) company profit reporting season, positive earnings and revenue surprises are being recorded in the US, Japan, and Europe (particularly the UK). For emerging markets, the earnings cycle is (tentatively) stabilising, but revenue downgrades continue to predominate for emerging markets overall.

Lack of investor interest. As both a cause and effect of the foregoing difficulties, global investor interest in Emerging Markets at present is low.

Longer-term Opportunities
On a longer term view (12 months), we are positive about emerging markets. We do not believe that the current negative sentiment about particular countries is representative of all emerging nations, and we note that the countries facing the worst short-term crises – for example South Africa and Turkey – are also the countries with current account and foreign reserve levels that are significantly worse than their peers.

Major emerging markets such as China, South Korea and Taiwan are convincingly in positions of current account surplus. It is also the case that floating exchange rates are far more prevalent across the emerging world, here in 2014, than they were in the previous major crisis in Asia in 1997/8. It is also the case that world trade is reaccelerating, and that the exports of nearly all the major emerging markets are now moving back into a growth phase.
Particular reasons to be positive about Emerging Markets on a 12-month view, additional to the above, include:

« Very good value. Emerging Market equities are trading at a 30% Price Earnings (PE) discount to Developed Markets at present, versus a long-term average discount of 19% as shown in Figures 2 & 3.

« Greater profit upside. Emerging market companies are trading with significantly lower profit margins than developed markets, partly due to cyclical downturns in the resources sectors. This implies greater eventual margin upside.

« Under-owned. The fact that global investors are very underweight emerging markets at present provides potential for them to reweight in due course.
Signals to watch
Key indicators to watch for, as potential signs that short-term momentum is turning from negative to positive, include:

» **World trade.** Ongoing acceleration in Emerging Market exports is key to the Emerging Market thesis.

» **Political and exchange rate instability.** Our expectation is that the ‘Fragile Five’ nations are the most vulnerable of the emerging markets, and that contagion to other emerging nations will not occur. Rather, we would look for conditions in the ‘fragile’ nations to settle down as 2014 progresses. Alternatively, it would be of concern, if negative feed-back loops started to form – i.e., if political unrest led to recession, which led to further unrest, in affected regions.

» **Equity market and funds flow momentum.** In addition to share market momentum, we would also look for earnings revisions to firm convincingly in Emerging Markets to set up the preconditions for outperformance.

Conclusion
Emerging market equities are well worthy of consideration by investors over 2014. Short term momentum is uncertain, and even poor; but the current value, and the future growth prospects, are likely to be rewarding in the longer term.