

Emerging Markets: Exploring Opportunities and Navigating the Path Ahead



Emerging markets equities have not been immune to the COVID-19 pandemic's global economic shock, suffering along with other risk assets. And the shock to the global economy sent emerging markets debt (EMD) spreads to levels not seen since the global financial crisis (GFC). Three of our portfolio managers share their thoughts on how emerging markets are faring in this global crisis, and what they see as the challenges and opportunities for equity and fixed-income investors.

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Broadly speaking, how are emerging markets faring during the COVID-19 pandemic and resulting economic crisis?

Todd: This year top-down country selection has affected overall investment returns because the market has very efficiently passed judgment on countries' perceived ability to deal with the COVID-19 shock. Exhibit 1 provides a three-dimensional view of a country's economic vulnerability going into the crisis, political capacity to deal with the crisis, and healthcare preparedness. The upper-right quadrant is the best because it indicates low economic vulnerability and high political capacity. Many northern European countries are here because they have the ability to backstop the economy with fiscal spending. China and Korea are also in this quadrant. Countries that have fared worse on these metrics appear in the lower-left quadrant and include most Latin American and African countries, where ability to spend is lower and political capacity to get the things done in a timely manner is low. Market returns have roughly mirrored this dispersion.

Is there anything else you use to guide your assessment of emerging markets' response to the pandemic?

Todd: A number of central banks in emerging markets have embarked on quantitative easing (QE) measures. This is the first time we have seen QE enacted in emerging markets. But it is being used differently than in the past. In the West, QE has been used to combat deflation. In emerging markets, it is being used to backstop market outflows and finance fiscal support measures. Market judgment on this is still out. Central banks with higher credibility, such as Brazil, may be able to convince investors it is a good idea. But countries with very politicized central banks, such as Turkey, may be harshly judged. I think it will also depend on the objective, how it is communicated to investors, and how it is unwound. If countries are seen to be monetizing fiscal deficit spending ad infinitum, the market will likely give that a thumbs down.

“Countries will be affected differently depending on their ability to respond to the crisis.”

Marcelo Assalin, CFA

What do you expect GDP in emerging markets to be?

Todd: From January through the end of March, northern Asia is doing well, with China, Taiwan, and Korea actually showing positive growth. The same cannot be said for Latin America and South Africa, as Exhibit 2 shows. In particular, northern Asian countries have been less affected than other countries by the collapse of travel because they are net exporter of tourists. In addition, northern Asian countries are benefiting from collapsing oil prices because they are net importers of oil; for them, lower energy prices are equivalent to a tax cut.

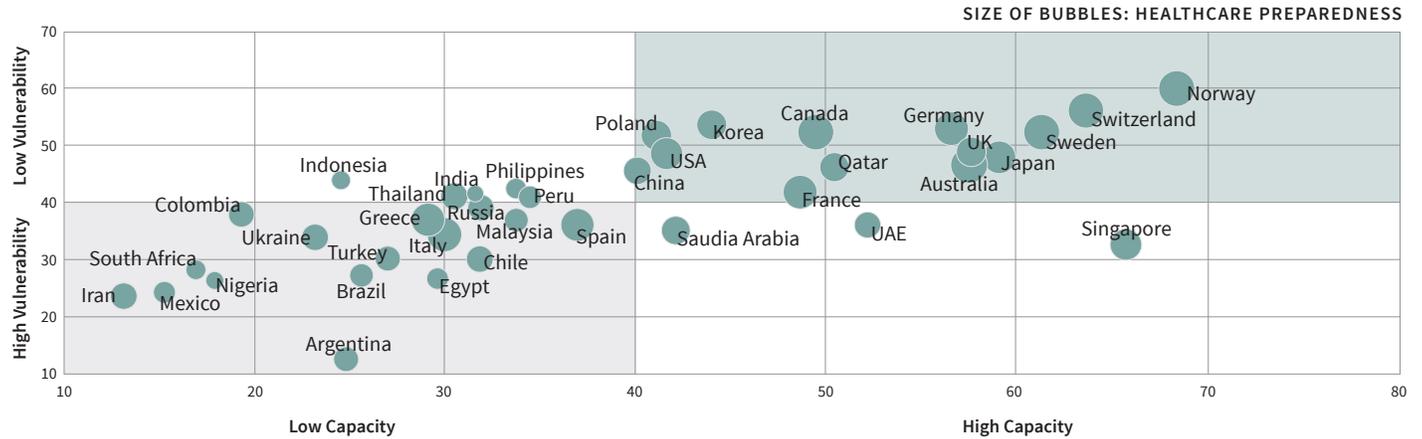
Marcelo: Previously, we were expecting GDP growth for our investible universe (the J.P. Morgan EMBI Global Diversified) to be around 3.5% per year, on average, for the next two years, as Exhibit 3 shows. We just revised this number down to slightly below 1%. That gives you an idea of the magnitude of the pandemic effect on 2020 growth. But like Todd, we expect the recovery to be gradual and uneven. Countries will be affected differently depending on their ability to respond to the crisis—and this depends on their healthcare systems, their economic buffers, their fiscal space, and their ability to utilize fiscal and monetary stimulus. We expect Asia to lead the other regions, and Africa most likely will be the laggard. There will be significant fundamental deterioration in some places, with worsening credit metrics and potentially some rising default risk.

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EXHIBIT 1

Pandemic Preparedness

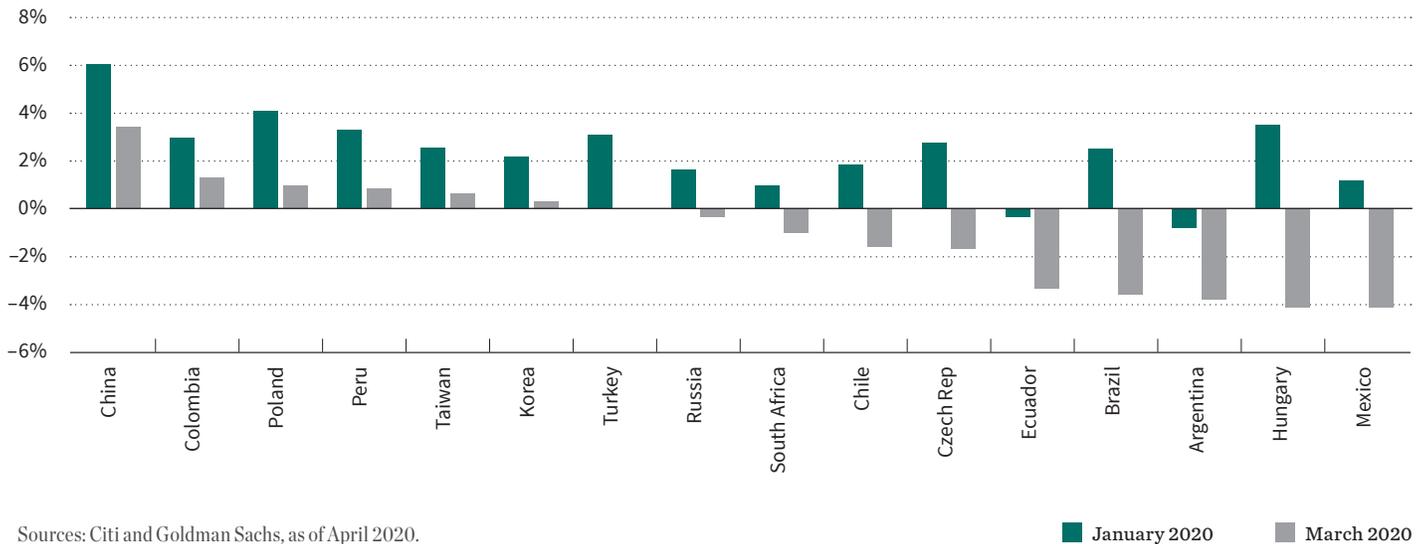
Economic Vulnerability, Political Capacity and Healthcare Preparedness



Source: Eurasia Group, as of April 2020. For illustrative purposes only. Economic vulnerability includes factors such as external debt, probability of default, current account balance, fiscal deficit, dependency on energy, and tourism. Political capacity to deal with the crisis includes factors such as bureaucratic effectiveness, government agility, social safety nets, and trust in government.

EXHIBIT 2

2020 Real GDP Forecasts (Year-Over-Year GDP Growth)



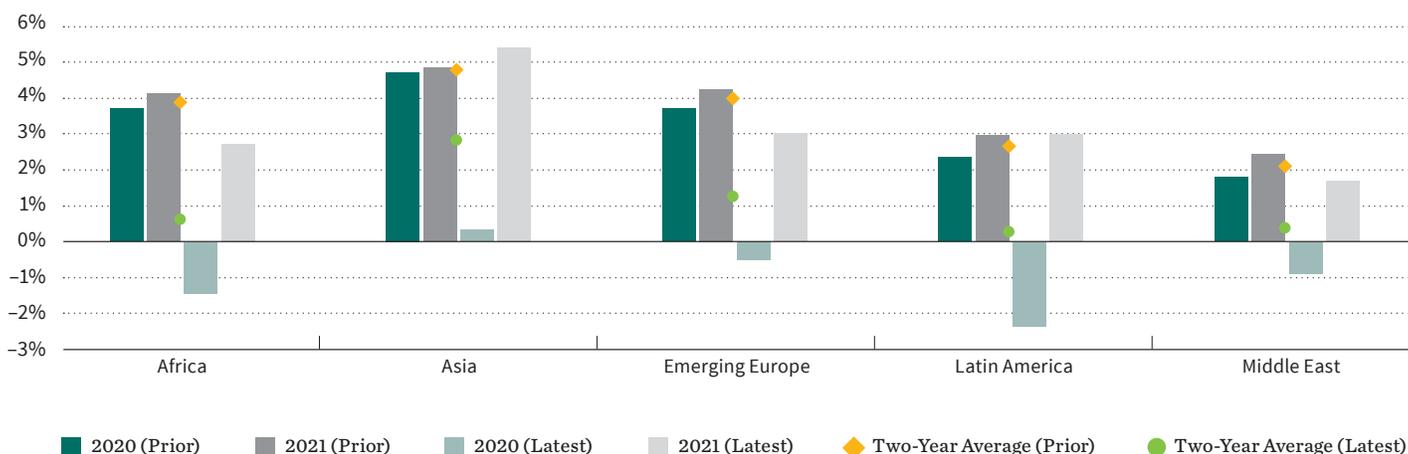
Sources: Citi and Goldman Sachs, as of April 2020.

■ January 2020 ■ March 2020

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EXHIBIT 3

Weighted Annual Estimates for Real Year-Over-Year GDP Growth, EMBI Global Diversified Universe



Sources: EIU and William Blair estimates. Prior as of January 2020; latest as of April 2020.

How are emerging markets equities performing today relative to other crises?

Todd: Exhibit 4 shows performance of emerging markets over the past decade, with peaks to troughs called out. During the GFC, the MSCI Emerging Markets Index was down 58.7%. The renminbi devaluation in August of 2015 led to a 29.1% decline. The fear of Federal Reserve (Fed) policy error in 2018 brought us down 23.0%. COVID-19 brought us down 23.8% peak to trough (though we are down about 16% year to date through May 29, 2020). But individual market performance is really quite different than what the index tells you. The difference between China and Brazil has been about 40% year-to-date through May 29, 2020.

How has currency performance been?

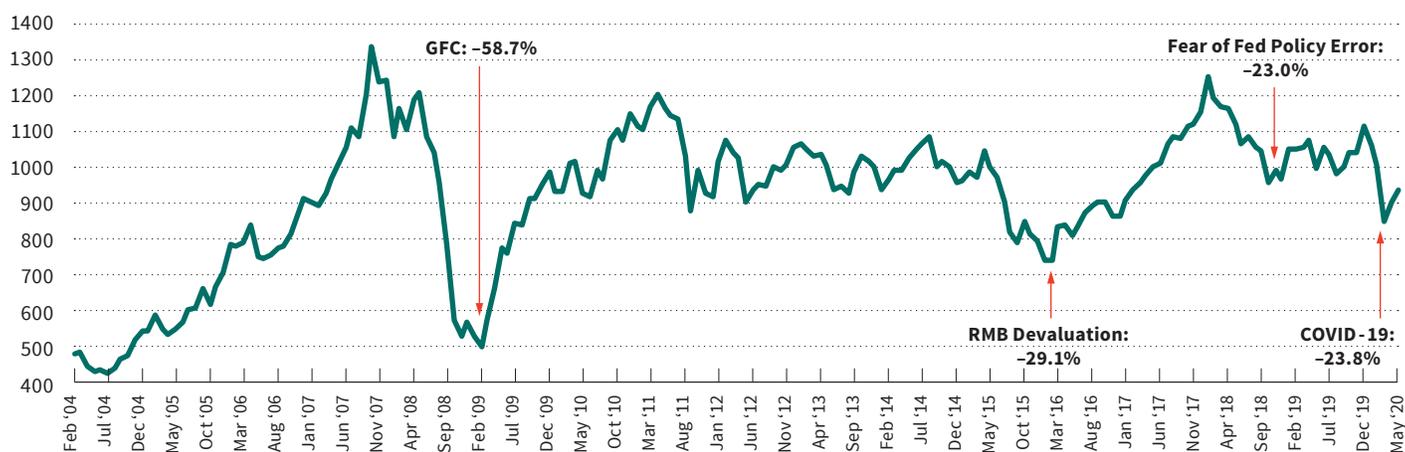
Todd: The story is similar to equities performance: Latin America and Africa have the worst currency performances. Northern Asia has the best currency performance. Southeast Asia is somewhere in the middle. Brazil and South Africa are seeing some of the worst currency performances year-to-date.

Marcelo: The U.S. dollar has been extraordinarily strong due to heightened risk aversion and a flight to quality. As market conditions start to normalize, we believe the dollar should lose some altitude. However, we do not believe it will enter a long-term depreciation trend here in spite of concerns about QE in the United States. The reason is that we are going to see QE all over the world, and some countries have very large external financing needs, which should in turn pressure their currencies. Thus, in the

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EXHIBIT 4

MSCI Emerging Markets Price Index Performance With Peaks to Troughs



Source: MSCI. Past performance is not indicative of future returns. Indices are unmanaged and do not incur fees or expenses. A direct investment in an unmanaged index is not possible.

medium term, the dollar should remain well supported, and I think it is premature to talk about it losing its stock as the international reserve currency.

Todd: Countries with weaker current account balances (which become an issue when you have economic and market stress, as we do now) should begin to see some currency depreciation.

“In the medium term, the dollar should remain well supported.”

Marcelo Assalin, CFA

How is the fundamental backdrop in emerging markets?

Marcelo: The fundamental backdrop in most emerging markets is positive, in our opinion. Public debt has been growing only gradually over the last few years, and remains significantly below that of developed economies. Most of the growth we have seen has taken place in the private sector and has been predominantly driven by China. But overall market economic fundamentals remain quite supportive. Current account balances have improved over the past few years, especially after the taper tantrum in 2013. Inflation has been very low, which has enabled central banks to use monetary stimulus. Many countries today have the ability to fund domestically and have had less large exposure to currency mismatches. And very importantly, the banking sector in most emerging markets is solid, with very high levels of capitalization. Therefore, concerns about systemic risks in emerging markets, in my opinion, seem overblown. Most of the sell-off we have been seeing has been driven by technical factors (flows).

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EXHIBIT 5

Risk Aversion Resulted in Unprecedented Outflows from Emerging Markets Debt Funds (in Millions)

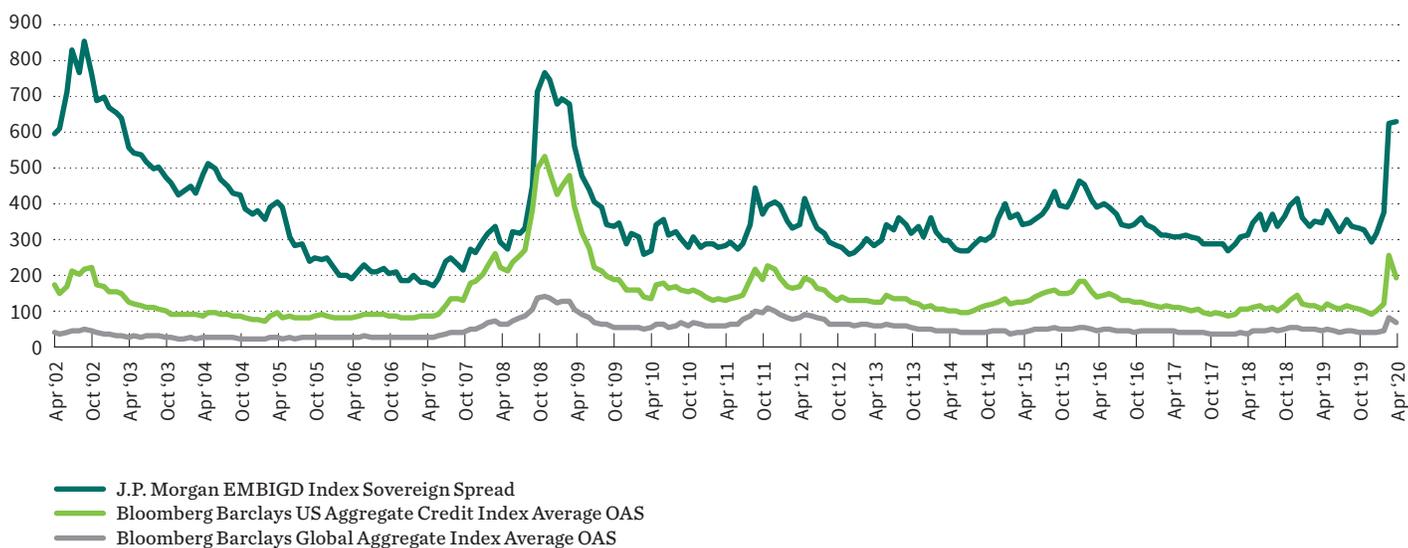


Source: JPMorgan and EPFR, as of April 2020.

■ Bond Flows, ETF ■ Bond Flows, Non-ETF

EXHIBIT 6

Emerging Markets Debt Spread Levels Not Seen Since GFC



Sources: JPMorgan and Bloomberg, as of April 2020. Past performance is not indicative of future returns. Indices are unmanaged and do not incur fees or expenses. A direct investment in an unmanaged index is not possible.

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Speaking of flows, in this environment, are investors turning to emerging markets or avoiding them?

Todd: Total equity and debt flows have collapsed, much more so than in 2008, 2009, and 2013. But again, there is dispersion between countries.

Marcelo: Concerns about COVID-19 led to unprecedented outflows from emerging markets debt funds during March and April this year. As Exhibit 5 shows, investors have pulled more than \$40 billion from dedicated emerging markets debt funds over the three months ending April 24. Outflows from EMD funds moderated in May, and more recently we started seeing small inflows into hard currency EMD funds. A large percentage of these outflows came from passive funds. These flows created massive selling pressure in the market in a moment when liquidity conditions were very, very poor. This has created significant price dislocation, especially in the less-liquid, higher-yielding part of the market. Consequentially, it drove spreads to extremely high levels that we have not seen since the GFC.

Marcelo, just how much have emerging markets debt spreads moved?

Marcelo: The spread of the EMD hard currency sovereign benchmark, the JPMorgan EMBI Global Diversified, moved from 300 basis points (bps) to about 600 bps in a matter of days. At one point, the high-yield component of this benchmark traded above 1,200 bps. Emerging markets debt underperformed other credit asset classes during this process, but we believe this rise in risk premium is not aligned with the fundamentals of the asset class. Spreads compressed around 100 basis points (bps) over May, reflecting better technical conditions driven by stable to marginally positive flows.

Do you see the technical backdrop changing?

Marcelo: Technical conditions have been a headwind because of very high market volatility and high transaction costs, which can prevent investors from coming back to the market. However, we see hope. Outflows have moderated significantly recently, and there was strong activity in the primary market in April, with more than \$55 billion in debt issued by emerging markets in April and close to \$30 billion issued so far in May (as of the 26th). The strong demand for EMD bonds in the primary market reflects what we believe is the attractive valuation of the asset class.

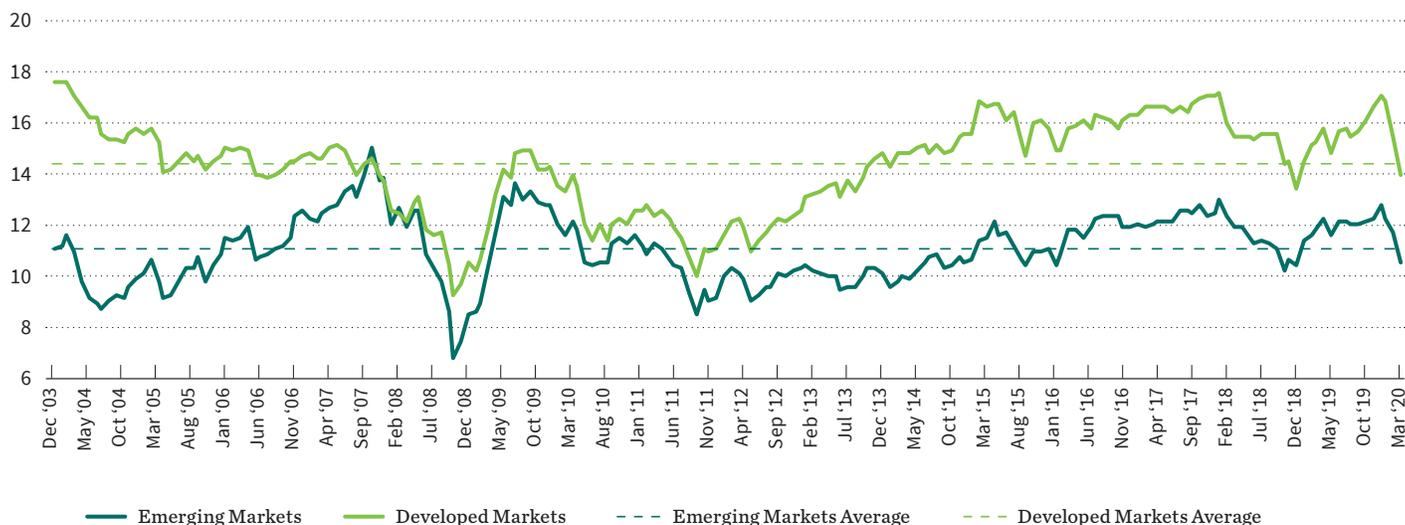
How do valuations look?

Todd: We are not even approaching GFC levels, as Exhibit 7 shows. Emerging markets equities, as measured by the MSCI Emerging Markets Index, are trading at valuations in line with their historical averages. Yet these valuations appear inexpensive when the index's changed sector exposure is considered. In 2008 low-valuation sectors (such as energy and materials) made up almost 40% of the index; now they make up 10%. On the other hand, in 2008 IT, consumer, retail, and media made up about 10% of the index, and now they make up 40%. So we are trading at much cheaper valuations than it would appear on a historical basis.

Marcelo: Valuations in emerging markets debt are very attractive, in my opinion. A considerable part of the investible universe is trading below what we perceive to be fair value because of the disruption created by forced selling in the marketplace. In our opinion, current risk premium overstates sovereign credit risk. The implied probability of default is not aligned with the fundamental backdrop. This presents an opportunity for long-term investors, particularly given different probabilities of default between countries. We believe in the near term we will see more long-term-focused investors come back to the market. This should help support prices.

EXHIBIT 7

MSCI Emerging Versus Developed Market Price-to-Earnings Ratio



Sources: MSCI, Factset, as of April 2020. P/E ratio is next 12 months (NTM).

Todd, you mentioned that some countries are doing better than others; are there any sectors you find more or less appealing?

Todd: From a sector perspective, technology is appealing, with the 5G and cloud buildout driving growth. We tend to avoid more challenged sectors, such as materials, energy, and real estate. Financials are also problematic, because a negative credit cycle and low interest rates have challenged business models, and these companies could be hit with national service and loan forbearance.

“We tend to avoid more challenged sectors, such as materials, energy, and real estate.”

Todd McClone, CFA, Partner

Marcelo, how are you positioning your emerging markets hard currency strategy in this environment?

Marcelo: We see three predominant investment themes. *The first is fundamental strength:* We seek countries with stronger buffers and faster-growing economies. *The second theme is multilateral support:* We seek countries that will have access to liquidity and financing conditions given their strong relationship with unilateral organizations. *The third theme is stress valuations:* We seek countries in which bond prices are trading far below what we expect to be a fair level given recovery values.

EXHIBIT 8

China Financial Conditions Index



Sources: Bloomberg, Citi, and CLSA, as of April 2020. Citi's Financial Conditions Index is modeled using PCA approach (rising index indicates loosening, decline is tightening) incorporating short-term money market rates, government bond yields, 2s and 10s yield curve, credit and CDS spreads, TED spreads, 2s and 10s rate differentials with the United States, country-specific MSCI index, equity volatility, country-specific MSCI Financial Index, FX, and FX volatility.

Marcelo, you also use a beta-bucket approach, correct? How does that fit in?

Marcelo: Yes, we segment the asset class into three beta buckets: high-risk countries, medium-risk countries, and low-risk countries. In the high-beta segment, we are overweight Argentina, Ecuador, and Lebanon, which are trading at distressed levels, and Ukraine, which has strong support from the International Monetary Fund (IMF); we do not like Oman, Iran, and Turkey, because of their fundamental macroeconomic weaknesses. In the medium-beta segment, we are overweight Guatemala, Qatar, and Brazil because we believe they offer strong fundamentals and decent valuations; we do not like fundamentals in Bahrain, South Africa, and Saudi Arabia, where fiscal dynamics are concerning as of this point. In the low-beta segment, we like Russia, Kuwait, and Hungary because they have strong economic buffers and solid balance sheets; we do not like the UAE, Indonesia, and Peru, because of their valuations.

Drilling down, what are your thoughts on China?

Todd: Our emerging markets equity portfolios entered the year overweight China, and are still overweight China. It was the first country to go into the crisis, and is now the first one coming out. It is about eight weeks ahead of the United States. It has done a good job containing the virus and stimulating the economy. Looking at China's financial conditions index in Exhibit 8, we can see China's financial conditions are loosening (as the line slopes up)—more so than we saw during the renminbi devaluation of 2015 or the taper tantrum of 2012-2013 (though not to the level of the GFC).

How does the recovery in China look at this point?

Vivian: As of now, China is nearing normal. Restaurants, hotels, parks, and public transportation have mostly all reopened in all provinces outside of Hubei. Domestic flights have also resumed, except to and from Hubei province.

Todd: Exhibit 9 shows the GTCOM China-Rework Index, which measures production and consumption activity. The decline in January and February 2018, 2019, and 2020 reflects Chinese New Year seasonality. But in 2020, the pullback is deeper and the recovery much more shallow. It is currently at about 80% of what is typical this time of year. What we don't see is that production is back to about 100% of normal levels, while demand is stalled at around 60% of normal levels. But it differs by category. Passenger vehicle sales have bounced back, but hotel occupancy rates have stalled out at around 30% of normal because there is still fear of the virus. And when we look at surveys of planned purchase, we see the Chinese are increasing spending on education, healthcare, and fitness, but dining out, travel, and entertainment are still suspect.

How big of a role has fiscal stimulus played in China?

Todd: China's total stimulus package is expected to be 13.2% of gross domestic product (GDP) to date. And the nature of stimulus is key. It has moved away from stimulating heavy industry, which drives demand for commodities, toward putting money in people's pockets and driving consumption. Tax cuts have been the bulk of stimulus measures in the past years and they continue to be the main focus. That has been a tailwind for quality growth investors like us, because that money is spent on consumer services, healthcare, etc. It is also worth noting that a big part of the infrastructure bucket is actually focused on 5G rollout, so China should be ahead of the United States and Europe on 5G rollouts going forward.

How have Chinese equities performed?

Todd: Better than many other emerging markets equities. It is notable that in March, China moved up in the MSCI Emerging Markets Index by about 650 bps. That is quite dramatic. We expected China to go from 30% to 40% of the index over the next 5 to 10 years, but this happened in weeks, thanks to China's outperformance and the massive dispersion of country performance.

Vivian: As of the end of May, the MSCI China A Index has also held up very well since the epidemic broke out, with approximately a 5% dollar decline year-to-date versus the MSCI Emerging Markets Index, which is down nearly 16%, and the S&P 500 Index, which is down around 5%. It is one of the best-performing equity asset classes year-to-date.

What do you think led to this relative outperformance?

Vivian: The resilient performance of China A-shares has been largely due to resilient earnings growth, as shown in Exhibit 10. The steady currency was also helpful. It also speaks to the effectiveness of the Chinese government, which quickly and successfully managed the epidemic, and came out with supportive economic policies at the same time.

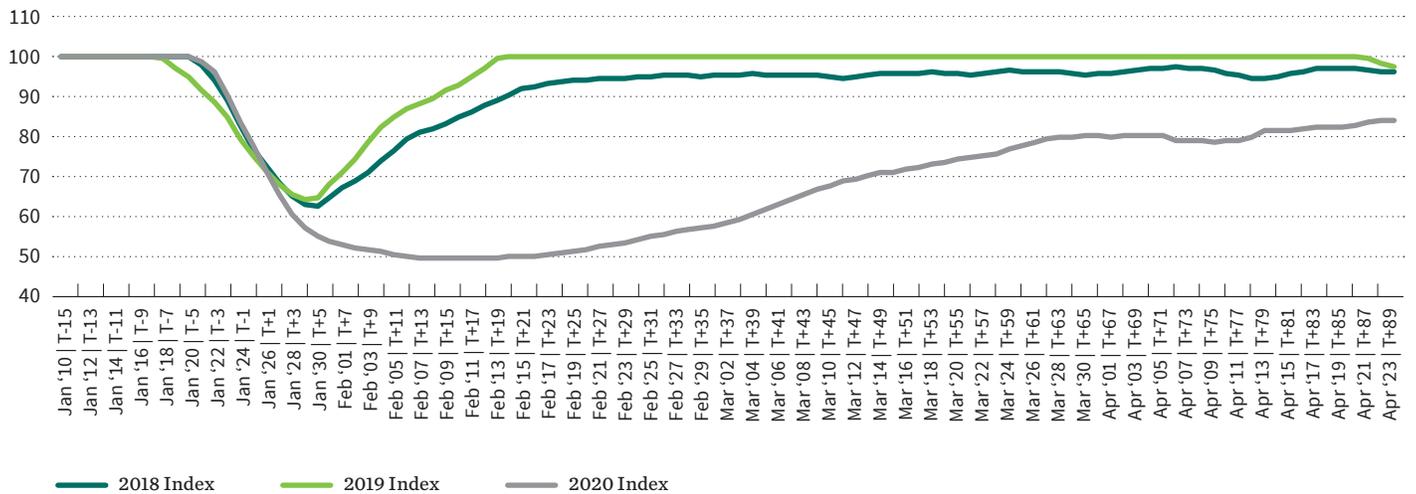
“It is notable that in March, China moved up in the MSCI Emerging Markets Index by about 650 bps.”

Todd McClone, CFA, Partner

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EXHIBIT 9

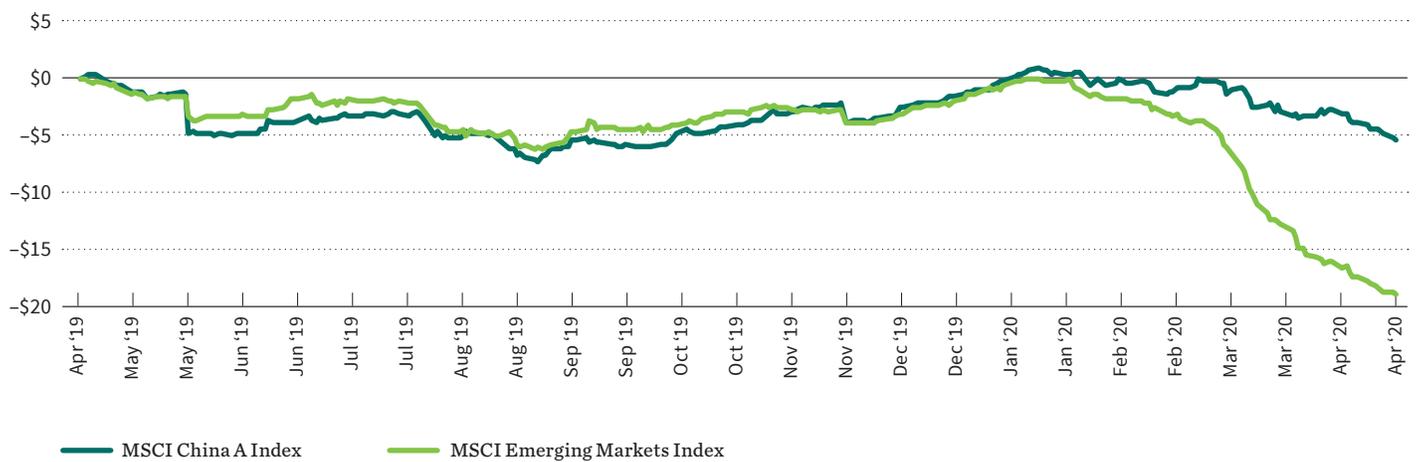
GTCOM China-Rework Index



Sources: Jeffries, Credit Suisse and Bank of America Merrill Lynch, as of April 2020. The GTCOM China-Rework Index is an aggregation of GTCOM Coal Consumption, Urban Consumption, and Metro Passenger Transport Indices weighted. 100 represents a “normal” level based on observations prior to CNY each calendar year and t=0 represents the start of CNY.

EXHIBIT 10

Bloomberg Estimated Earnings Per Share



Sources: MSCI and Bloomberg, as of April 2020. Earnings per share is NTM.

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Does that mean your investment case for China has not changed?

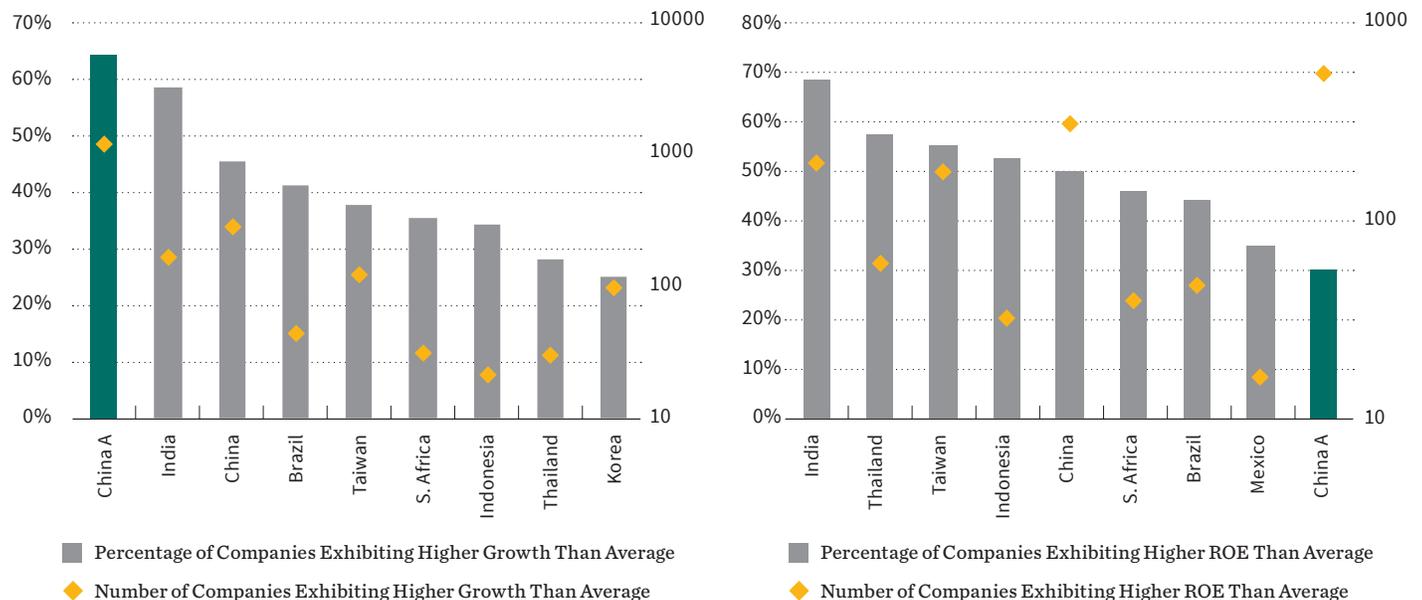
Vivian: The underlying premise of our investment case for China is that its economy continues to shift to domestic consumption. Domestic consumption as a percentage of GDP has risen from 48% in 2010 to 53% today. At the same time, China's dependence on investments and exports has declined substantially, from 36% in 2006 to 20% today. That speaks to both the quality and sustainability of China's growth going forward. This structural shift should also lead to us seeing more companies in China with higher quality, better sustainability, and lower environmental impact. This should support quality growth managers like us. Interestingly, I believe the ongoing pandemic further solidifies China's commitment to a structural shift and helps accelerate its pace.

Why China A-shares versus Hong Kong or U.S.-listed Chinese companies?

Vivian: China A-shares offer exposure to a few key structural growth sectors, which cannot be obtained by investing in Hong Kong or U.S.-listed Chinese companies. Within information technology, consumer staples, and healthcare, China A-shares accounted for approximately 90% of the market value of all publicly listed Chinese companies. This shows that investing in China A-shares is essential for investors who want to capture the growth of the "new" China.

EXHIBIT 11

Compelling Opportunities for Quality Growth Investors



Sources: William Blair and Factset, as of March 2019. Universe consists of all listed emerging market companies (excluding financials) with market caps above \$100 million. Growth is defined as the William Blair long-term growth rate, which is based on a combination of realized and forecast growth rates. Actual growth rate for the emerging markets universe is 12.5%, and actual ROE for the universe is 7.9%.

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“The China A-shares market has more than 2,000 companies (65%) exhibiting higher-than-average growth, the highest level globally.”

Vivian Lin Thurston, CFA, Partner

Where do you find the most attractive opportunities in China A-shares?

Vivian: We continue to see attractive opportunities in the consumer, healthcare, and technology sectors. Exhibit 11 illustrates. The China A-shares market has more than 2,000 companies (65%) exhibiting higher-than-average growth, the highest level globally. The China A-shares market also has the highest number of companies generating higher-than-average return on equity (ROE)—nearly 1,000. While this only represents approximately 30% of names with ROE above-average emerging markets levels, the number of names is nonetheless significant.

What is supporting growth in healthcare in China?

Vivian: China’s chronic disease prevalence (including diabetes, hypertension, cancer, and cardiovascular disease) has risen significantly in the past couple of decades. Yet healthcare is largely underdeveloped in China compared to other developed emerging markets, both in terms of total spending and per capita spending. China vaccine penetration and spending remains very low, for example. But there are signs of change. The contract research organization (CRO) industry—which provides support to the pharmaceutical, biotechnology, and medical device industries—has outgrown the global CRO market by more than two and a half times in the past 10 years, at a stunning compound annual growth rate (CAGR) of 26%. As the Chinese pharmaceutical industry focuses on innovative drugs and global pharmaceutical companies continue to expand in China, the demand for Chinese CRO companies should continue to rise.

Does China’s recent experience fighting the COVID-19 pandemic further support the case for healthcare growth in China?

Vivian: There is already an awareness of healthcare in China. For example, the average Chinese citizen quickly and voluntarily adopted mask-wearing practice in public after the outbreak, which we did not see abroad. We expect the COVID-19 pandemic to help promote China’s general public awareness of vaccines and accelerate demand growth.

What is supporting growth in technology in China?

Vivian: In my view, some of the most exciting technology investment opportunities in China are in semiconductors. Semiconductors are key to most technologies, and China has the largest semiconductor market in the world, accounting for nearly 60% of global demand. Yet, China only generates about one-third of the world’s semiconductor revenue. Insufficient semiconductor supply (both in terms of quantity and quality) has been a problem in China due to the 5G launch and the U.S.-China trade war. To address this challenge, China has accelerated its semiconductor development, and we have seen the emergence of a number of attractive semiconductor companies in the last few quarters. Of course, we are also cognizant of the high volatility of the industry given the relatively early stage of its development. Therefore, we believe stock selection is key.

Are there any other areas of technology growth?

Vivian: Two other attractive opportunities in China A-shares are cloud and cybersecurity companies. China's public cloud market is estimated to see a CAGR of 41% from 2017 to 2021, and its cybersecurity market is projected to see a CAGR of 25% from 2017 to 2020.

What is the likely impact of rising tensions between the United States and China?

Vivian: This is not a new phenomenon; we have been talking about U.S.-China trade tension for the past two years. I believe it will continue because U.S.-China relations are entering a new era as China's economy continues to grow. The geopolitical side is uncertain, but I believe investment opportunities are enhanced, because the sectors we like benefit from increased domestic consumption.

How is India doing in this crisis?

Todd: India has fallen in the middle of the pack in terms of economic, political, and healthcare preparedness. The number of cases is still rising but the growth rate of cases has decelerated, and no hospital in India has reported being overwhelmed by COVID-19 cases. The government just announced a lifting of restrictions across a number of states. Although low testing might be skewing the data, it is also possible that the virus has not spread as much as feared. Currently, 2020 GDP is forecast to be -0.4%. That's in the middle of the continuum, but this is the first time in 40 years that India will have negative GDP. That speaks to how healthy a growth market India is. Quality is also abundant; recall Vivian's Exhibit 11, which shows growth and ROE for companies in a number of emerging markets. More than 60% of Indian companies exhibit higher ROE than the emerging markets average. That is why we have been consistently overweight.

What are your views of Brazil's political, fiscal, and healthcare crisis?

Marcelo: Brazil is facing the perfect storm—the political scandal regarding the president and his family, the public health emergency, and the economic crisis at the same time. This increases the risk of impeachment for the president, although we think that is unlikely, because Jair Bolsonaro has a strong base and much higher popularity today than the previous presidents who were impeached. That said, this situation will affect the progress of the reform agenda, which is concerning for investors. There is also pressure to start easing lockdown restrictions, and that is also a big risk for Brazil because a premature release could affect the country's ability to recover economically. It is a complicated scenario.

What are your views of both sovereign and corporate Mexican debt?

Marcelo: We have seen a long-term fundamental deterioration in Mexico, and it is reflected in the country's credit rating. Mexico will likely be affected significantly in this crisis. It is very dependent on revenues from oil, tourism, and remittances, and has strong links to the U.S. economy. That said, we do not think Mexico will be running into any solvency problems in the next few years. It still has very strong macroeconomic buffers.

“We have seen unprecedented fiscal and monetary policy response on the macro and micro level across the globe.”

Marcelo Assalin, CFA

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Does investor sentiment tell us anything about the future?

Todd: We are deep in panic levels on the Emerging Markets Risk-Love Sentiment Indicator, which tracks positioning, put-call ratios, investor surveys, price technicals and volatility, spreads, and correlations measures. Levels like this have historically been a good indicator of positive six-month forward returns.

Marcelo, what do you see as necessary for emerging markets debt to recover?

Marcelo: I believe global liquidity conditions will be the predominant investment theme for fixed income in general and emerging markets debt in particular (as opposed to economic growth). We have seen unprecedented fiscal and monetary policy response on the macro and micro level across the globe. We believe the consequence of this stimulus will be ample global liquidity conditions and extremely low rates for a considerable period of time. This will be very supportive of emerging markets debt. But another important factor will be unilateral and bilateral support. The IMF and World Bank have more than \$1 trillion in lending capacity, and the IMF has been moving quickly and aggressively, providing liquidity support for a number of emerging markets in need. Moreover, we have seen a G20 initiative to approve a debt relief program that will benefit more than 70 low-income emerging markets. This support, combined with a very favorable liquidity environment, should keep default risk in emerging markets well contained.

What's the key takeaway?



Vivian Lin Thurston, CFA, Partner
Portfolio Manager, China A

Vivian: The pandemic helped accelerate the shift to China's domestic consumption, which further strengthened our quality growth investment opportunities.



Todd McClone, CFA, Partner
Portfolio Manager, Emerging Markets Equities

Todd: Given the extremes in investor positioning, sentiment, and flows, and I would say that it might not be a bad idea to add some emerging markets risk at this time. However, differentiation is again key to navigating the current crisis; I believe active management is more than ever warranted.



Marcelo Assalin, CFA
Head of Emerging Markets Debt

Marcelo: Emerging markets debt has been an appealing asset class because it has offered low default risk and high recovery values. We may see some pickup in default risk in the very near term, but longer term we believe the default rate will remain significantly below those of other credit markets.

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