Emerging markets

OPPORTUNITIES IN A CHANGED EMERGING MARKET UNIVERSE

Douglas Ayton identifies the bright spots of the emerging markets universe as the region recovers from the COVID-19 pandemic.

EQUITY MARKETS HAVE extended their rally into 2021, discounting slowing economic growth rates emanating from renewed lockdowns, responding to central bank assurances concerning maintenance of easy monetary policies and an expectation of a successful vaccination program over 2021.

Addressing a global pandemic, vaccination progress appears to fall well short of its elimination, especially for emerging markets with several countries operating inadequate distribution infrastructure. A return to "normal" pre-COVID activity levels continues to be delayed, at this stage well beyond 2021.

Asia's emerging markets, dominated by China, Korea, and Taiwan, have displayed better pandemic controls, and recorded solid recoveries in their respective manufacturing activity. Somewhat ironically, given COVID-19's origin, China's economic recovery over 2020 is virtually V-shaped, representing the only major economy to expand relative to 2019 (gross domestic product (GDP) grew approximately 2% year-on-year (YoY) versus the estimated global GDP contraction of 3.5%).

Successful suppression of COVID-19 infections is critical to keeping businesses open and goods moving. In this respect Korea and Taiwan have performed well, and their 2021 annual corporate earnings are forecast to grow 20% YoY, aided by significant technology industry representation, boosting the region's aggregate earnings recovery.

An attractive sector offering long-term structural growth is technology, currently via the evolution of the Internet of Things (IoT), 5G and artificial intelligence. Digital technology is transforming the use, application and storage of information such as data, with the expanding application in our everyday lives.

Semiconductor chips are integral via the supply of memory and processing power to drive applications. Taiwan and Korea are advantageously placed with market-leading stocks, including TSMC for logic supply, and Samsung Electronics and SK Hynix for the supply of memory. Memory demand is experiencing robust demand from data centres and the early stages of the next smartphone upgrade cycle to 5G. Smartphones and high-performance computing processes are driving investment in further chip transistor compression for the provision of smaller and more powerful devices.

India is another market we view favourably. The country experienced a sharp 24% YoY contraction in 2Q20 GDP because of its two-month lockdown in response to the pandemic but was quick to recover as restrictions were eased. The government struck a balance between managing infections and keeping businesses and the population actively engaged. Activity and confidence levels have returned to near pre-COVID levels. Optimism concerning 2021 continues to rise, aided by the stark improvement in daily new infections, which peaked in mid-September but have since has fallen more than 85%.

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Improving sentiment is evidenced with the services PMI returning to normal levels. Confidence is an important driver for consumption growth in 2021 if health concerns subside as expected.

Indonesia is a classic emerging market with its large population base and significant development potential. The country's recorded infection rate did not spike to the degree of India, rather experiencing a gradual consistent rise, currently at a similar new daily infection rate as India. Both countries share similar high nominal interest rates (notable exceptions in today's global low yield environment), a carryover from the countries' inflationary past. Two years ago, both countries real cash rates approximated 2.5% but have since diverged with India down 2.5% and Indonesia up 2.0%. Both central banks' policy rates followed a similar path, with the difference a function of their respective inflation rates, with Indonesia's headline and core consumer price index (CPI) staying below the central bank's target since 2015.

Indonesian authorities are sensitive to foreign capital inflow and currency instability, resulting in sustained high real interest rates. Opportunity exists should real borrowing costs be reduced, particularly via productivity enhancements. In this regard we are encouraged by the introduction of the *Omnibus Law (Jobs Creation Bill)* in late 2020, aimed at stimulating investment and job creation. The government will in turn need to lower its twin deficit requirement following budget deficit deterioration in response to the pandemic to realise the reduction in funding cost.

SUSTAINED US DOLLAR WEAKNESS

Meanwhile the US appears set to persist with elevated twin deficits in budget and trade, as the Biden administration's substantial proposed stimulus programs are likely to gain approval from Congress, maintaining the recent record high both in nominal and real terms in broad money supply.

We quote Treasury Secretary Yellen: "In a very low interest-rate environment… even though the amount of debt relative to the economy has gone up… interest burden hasn't… the smartest thing we can do is act big… the value of the US dollar and other currencies should be determined by markets".

In our view, this represents an important positive tailwind for emerging market equity markets by attracting foreign investment, encouraging higher commodity prices, and easing funding pressure on externally-sourced debt. Although, one potential headwind concern of a weaker USD is a stronger renminbi, reducing relative competitiveness of China's exported goods, and those emerging markets with "managed currencies" such as Hong Kong and Taiwan.

ACTIVE MANAGEMENT IN EMERGING MARKETS

China's equities lagged the MSCI Emerging Market index over 2020 despite the economy's impressive economic growth recovery. Authorities have displayed relative restraint of fiscal and monetary stimulus compared with other major economies, yet there are other pressures emerging notably an acceleration in accumulated debt, evident since the Global Financial Crisis, raising debt to GDP to more than 280%, likely leading to policy enactment targeting restrained credit growth in 2021, from the +14% Total Social Financing growth rate of 2020.

China accounts for an expanded 40% share of the emerging market benchmark, triple the next largest constituent. Mainland China as an investment destination faces a material hurdle due to its high cost of capital. Over time we are observing a deterioration of desired pillars relating to investor protection, including encroachment of the Chinese Communist Party across all facets of society including the corporate sector, on top of its control of the judiciary, military, and media.

There are also concerns over property rights and the enforcement of "Variable Interest Entity (VIE)" structures where the investor does not have direct ownership of the underlying assets as they are in sectors where foreign ownership is prohibited.

An additional mainland China corporate governance concern arose in late 2020 concerning Alibaba – the Chinese internet, e-commerce, and content behemoth. Founder Jack Ma made disparaging public remarks in October 2020 regarding the regulator resulting in the last-minute cancellation of the company's Ant Group US$35 billion ($44.9 billion) initial public offering (IPO), the world's largest. This coincided with an antitrust investigation into Alibaba and a two-month disappearance of Ma himself. Alibaba stock fell nearly 30% over the two months, a material occurrence given its benchmark prominence and 6% index weight.

Note that majority ownership of Ant Financial's predecessor Alipay was transferred from Alibaba to an entity controlled by Jack Ma and 17 other executives in 2011. The transfer happened without the knowledge or approval of Alibaba's minority shareholders, including Yahoo!, who owned 43% of the company at the time. This was possible due to the VIE ownership structure which gave Alibaba's onshore shareholders near complete autonomy over business decisions.

Moreover, Ant Financial was set to be valued at c. $300-400 billion before its IPO was pulled, so the ownership loss of half of this significant business by Alibaba minorities in 2011 could be considered to be one of the largest cases of corporate theft in history! Despite this historic case of egregious governance, investors still queued up for Ant Financial's IPO last year with $3 trillion of orders.

Geopolitical tensions between China and the US are another source of potential investment risk, recent development include the November 2020 signing of an Executive Order prohibiting US investor's purchase of securities identified as "Communist Chinese military companies". The original list numbered 31 companies, including the three major telecommunication players listed in the US and Hong Kong, resulting in their removal from the benchmark and a combined loss of US$30 billion in market capitalisation over six weeks.

Tensions between the US and China are also increasingly on display in the Taiwan Strait with the Chinese air force recently conducting sorties over the southwestern corner of Taiwan's Air Defence Identification Zone. The timing is possibly an early test of the new US administration's resolve to enforce freedom of navigation through the disputed territory in the South China Sea.

Ultimately, if China gets too provocative on Taiwan, then there is a significant risk its financial markets would suffer from foreign capital outflows and trade and investment embargoes.

CONCLUSION

As we commence 2021 the world continues to grapple with significant challenges, yet as always there are appealing opportunities with which to focus attention and capital. Emerging market equities remains an attractive asset class but requiring very careful and consistent application of active equity investment.

For 2021, there is a risk the emerging market economic recovery could disappoint (due in part to the slower than expected rollout of vaccinations and some tapering in fiscal and monetary stimulus). This reinforces the requirement to own structural growth companies with strong balance sheets, that can prosper, almost on their own volition despite COVID-19 complications.

While there are several opportunities we are seeing across parts of Asia and more broadly in emerging markets, despite its V-shaped 2020 recovery, given the risks highlighted above, we remain comfortable holding a deep underweight versus China's equity market benchmark weighting. MM

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