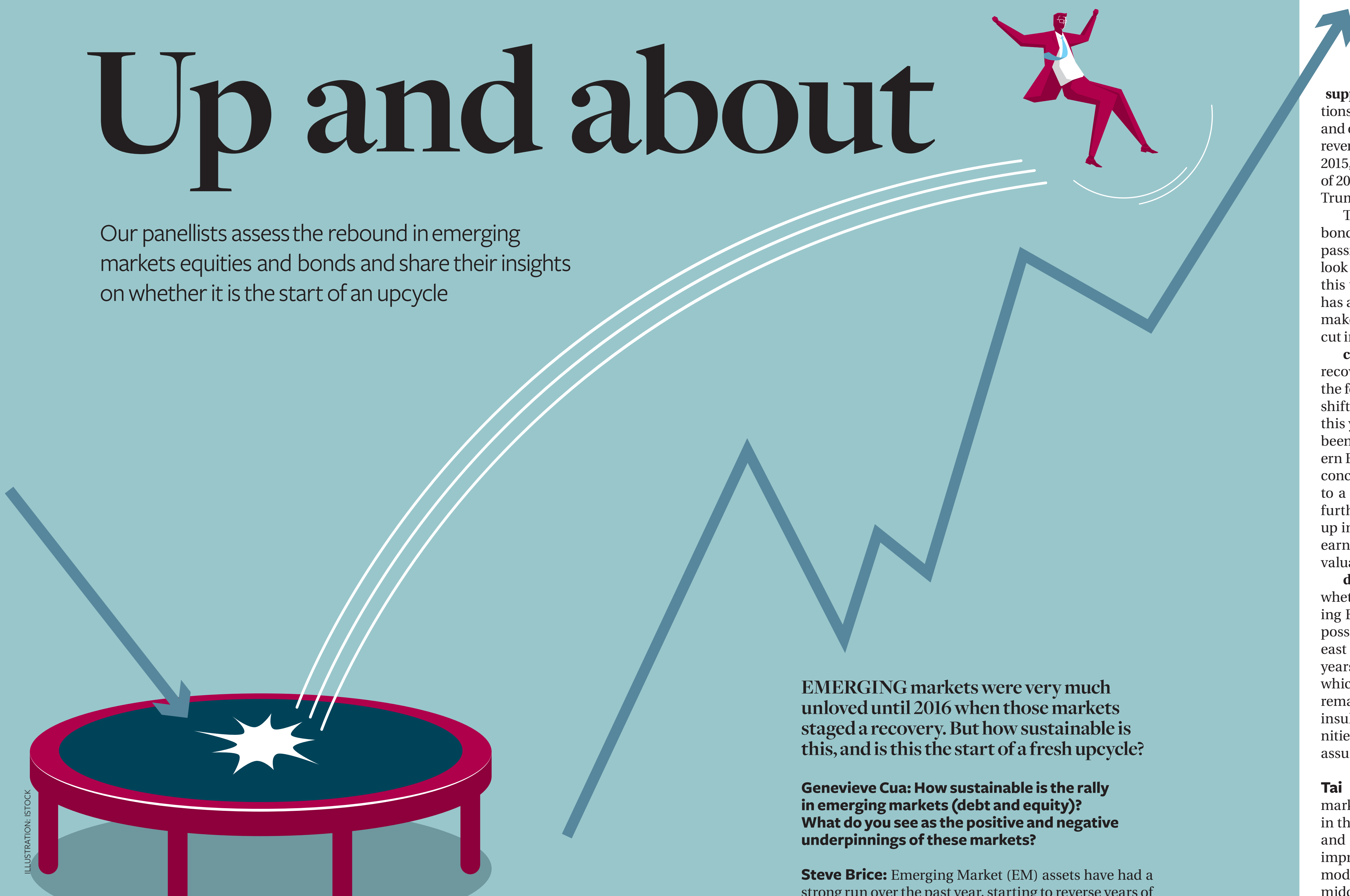
ROUNDTABLE

Up and about

Our panellists assess the rebound in emerging markets equities and bonds and share their insights on whether it is the start of an upcycle



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EMERGING markets were very much unloved until 2016 when those markets staged a recovery. But how sustainable is this, and is this the start of a fresh upcycle?

Genevieve Cua: How sustainable is the rally in emerging markets (debt and equity)? What do you see as the positive and negative underpinnings of these markets?

Steve Brice: Emerging Market (EM) assets have had a strong run over the past year, starting to reverse years of underperformance, with EM equities and government bonds outperforming Developed Market (DM) counterparts last year and so far this year. However, there has been a rotation within this broad universe. While East European and Latin American markets were the leaders among EMs in 2016, Asia ex-Japan has emerged as a clear leader this year.

The rebound in EMs since early 2016 can be attributed to a few sustainable macro drivers:

a) Commodities rebound drove the initial recovery: The rebound in commodities since early 2016 (which was associated with a reduced risk of an economic hard-landing in China on the back of monetary and fiscal stimulus) helped revive leading commodity producers such as Russia and Brazil. Both Russia and Brazil's economies are set to grow for the first time in three years this year.

b) US dollar (USD) stability provides further support: We believe the USD has peaked as expectations for monetary policy divergence between the US and other major economies stabilise, and could possibly reverse over the coming year. Stability in the USD since 2015, barring a brief surge in the last couple of months of 2016 after the surprise victory of US President Donald Trump, has resulted in funds flowing back to EMs.

This is particularly noticeable this year, with EM bond and equity inflows exceeding US$50 billion, surpassing the net inflows for all of last year. The Fed's outlook remains benign (we expect two more rate hikes this year), helping USD stability. A stable USD in turn has allowed EM currencies to recover, allowing policymakers in major markets such as Brazil and Russia to cut interest rates.

c) EM leadership shifts to Asia: After the strong recovery in EMs in 2016 from a sharp downturn earlier, the focus is turning to fundamentals. This explains the shift in leadership within EMs to Asia ex-Japan markets this year. Asia ex-Japan's economic fundamentals have been healthier than those in Latin America and Eastern Europe. The stabilisation in China's growth, easing concerns about trade wars and capital outflows (thanks to a stable USD), and a recovery in global trade have further lifted Asia's outlook. This is reflected in the pick-up in corporate earnings in the region. The improving earnings outlook has created relative value as some DM valuations appear relatively elevated.

d) Reduced geopolitical risks: Geopolitical risks, whether in the form of eurosceptic parties destabilising Europe, or likely US trade disputes with China, or possible military conflicts in the Middle East or North-east Asia, have clouded the outlook for EMs in recent years. We believe many of these risks have abated lately, which has supported EM assets. However, North Korea remains a risk. Historically, tensions in the Korean peninsula have tended to create excellent buying opportunities, particularly in South Korean equities, but this assumes tensions remain relatively contained.

Tai Hui: We believe that the upturn of emerging markets, in both bonds and equities, could well continue in the next two to three years for several reasons. First, and most importantly, the economic outlook of EM is improving. With the rebound of commodity prices, modest uptick in exports and structural growth of the middle class, we expect economic growth in EM to once again outpace developed economies. Historically, EM's strong economic growth has been consistent with outperformance in its assets.

Second, we believe the USD bull market that started in 2011 is approaching its end. As we saw in 2016, even a stable USD is good enough for investors to embrace EM once again. With greater stability in EM currencies, their central banks can focus their monetary policy on growth, instead of keeping high interest rates to prevent their currencies from falling too much.

Third, the valuation of emerging market assets, especially equities, is not particularly demanding. We believe some of the uncertainties, such as China's high corporate leverage, threat of protectionism and geopolitical worries are partly priced in. Attractive valuation and improving fundamentals have been a strong combination to deliver potentially attractive returns to investors.

Chetan Sehgal: The macroeconomic backdrop in emerging markets improved considerably through 2016. After a period of currency and commodity price adjustments and widespread political change, many of the emerging economies are now improving. Many of the factors that originally attracted investors to the emerging market equity asset class have come back into play, including stronger earnings growth, higher economic growth and robust consumer trends.

Even in regions that are still going through adjustment and rebalancing, we are seeing improved visibility and increasing signs of robust underlying economic conditions such as low debt, stabilising commodity markets, reduced currency volatility and improving consumer confidence. The implementation of reforms in many countries further drives market confidence.

We believe the recent improvement in EM fundamentals should be helpful for continued strength in EM equities and we also believe valuations in these markets appear attractive relative to developed markets. Nonetheless we are mindful of potential volatility and remain watchful for risks, some of which include the potential of further increases in US interest rates, uncertainty about the new US adminstration's policies and the ability of China to continue its growth while making structural adjustments.

Cesar Perez Ruiz: EM equities tended to lag in the bull market for equities that stretches back to 2013. But things are changing. The MSCI Emerging Market Index made a total return of 13.9 per cent (in US dollars) in the first four months of this year, far higher than the MSCI AC World's 8.8 per cent.

EM is benefiting from the upturn in global growth, and there have also been other tailwinds. Even though the Fed has embarked on rate tightening, the USD has stumbled against a range of EM currencies, reflecting mixed hard data out of the US and scepticism about the Trump administration's fiscal plan. Since his inauguration, Mr Trump has also gone some way to tone down his protectionist rhetoric, enabling currencies such as the Mexican peso to recover. Throughout much of the past year, the rebound in commodity prices has also helped the performance of many EM markets.

The rally in EM assets may have further to run in the short term, but faces challenges from further Fed rate hikes and the stalling of commodity prices. Improved current accounts mean EM is less vulnerable to US rate rises than in 2013, so we should not see a repeat of the "taper tantrum". In addition, the slowdown in Chinese growth we foresee later this year will weigh on EM exporters.

Based on forward price-earnings ratios, valuations for EM equities look cheaper than their developed-market equivalents. And while the rebound in commodities has petered out of late, earnings growth remains strong. But cheaper valuations are partly because of the dominance of financial and IT stocks in the MSCI EM index, and EM financials are generally of lower quality than in DM, which is reflected in much lower returns on equity. Another factor that will eventually cap EM equities' outperformance is the reduced gap in 2018 earnings growth expectations between EM and DM, compared with 2017.

For EM to regain fully its attractiveness, we would need to see some new drivers for growth, and especially firmer signs of domestic growth. In countries such as China, we need to see a clearer picture regarding capex spending and free cash flow so that we have a firmer idea of how much operating leveraging companies have. Work still needs to be done in corporate governance.

Genevieve: What do you see as the most promising investment themes in emerging markets, that could withstand near and medium-term volatility?

Steve: We are bullish on Asia ex-Japan equities. Asia ex-Japan is one of our two most preferred equity markets globally, ranking only slightly behind the euro area. Expectations of future earnings are being revised higher across both regions, painting an increasingly optimistic picture.

A distinguishing factor for Asia ex-Japan equities is valuations. Trading on a P/E (price-earnings) of 12.8x consensus 12-month forward earnings forecasts, Asia ex-Japan has the second-lowest P/E of the six regions/geographies we track globally as at mid-May. While non-Asia EM has a lower P/E at 11.7x, we note Asia ex-Japan's P/E is in line with its long-term historical average.

Asia ex-Japan is also the top-performing equity market globally so far this year, rising 17 per cent (as at May 4). Our most preferred market in the region, China, has rallied 15 per cent over the same period. India, also a preferred market, is the second-best performer over the same period, rising 20 per cent, just behind South Korea which has gained 21 per cent. While valuations for both China and India are high relative to their historical averages, consensus earnings growth expectations for both are 16 per cent, supporting improved investor confidence. We have also turned more bullish on South Korea as the new government is likely to boost fiscal stimulus to revive growth.

"New China" equities (those focused on consumer-driven, new economy sectors in China) remain a preferred theme within Asia ex-Japan. The theme continues to perform well, rising 21 per cent since we initiated it in December 2016.

We are also positive on other EMs outside Asia; however, with the exception of Turkey, the group has been a weak performer this year, dragged down by a decline in commodity prices, led by oil and iron ore, over April/May. Brazil stands out as our preferred market in EM ex-Asia, but is being held back by the recent weakness in iron ore prices. Headline earnings growth in Brazil is impressive at 40 per cent, but this reflects a low base following the prior downturn in the economy and corporate performance.

Earnings growth in EM ex-Asia is forecast to increase 22 per cent on a 12-month forward basis, but similar to the comments on Brazil, this reflects a rebound from a low base due to losses in prior years. Underlying earnings growth is recovering, but not as fast as the headline number suggests.

Similar to other regions, valuations in EM ex-Asia are elevated compared with the historical average. As we believe oil prices will recover to a range of US$55-65/bbl in 2017, we have a positive bias for this country group-

THE BUSINESS TIMES' WEALTH ROUNDTABLE

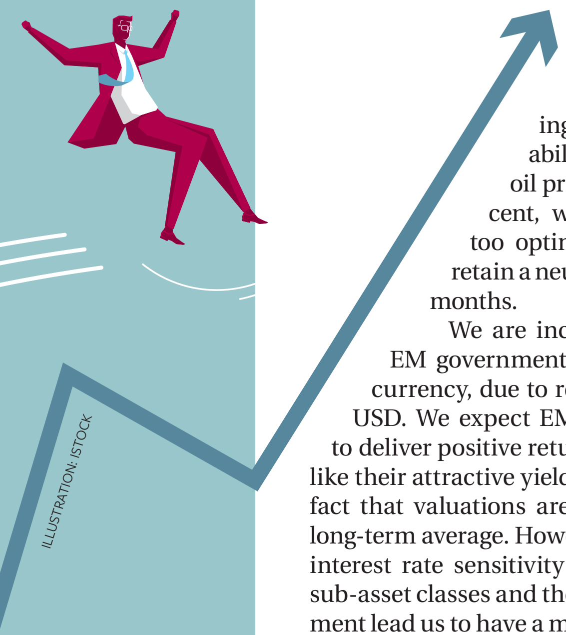
Genevieve Cua, BT Wealth Editor poses questions to wealth experts for their views on whether the rebound in emerging markets equities and bonds is sustainable.

Steve Brice is *Chief Investment Strategist, Group Wealth Management, Standard Chartered Bank.* Steve is an expert on the world economy and global markets, and has more than 15 years' financial markets experience in senior positions. He is an ardent sports fan focusing on cricket, rugby and Liverpool FC.

Tai Hui is *Managing Director and Chief Market Strategist, Asia, JP Morgan Asset Management. Based in Hong Kong,* Tai formulates and disseminates JP Morgan Asset Management's view on the market, economy and investing, to financial advisers and investors in Asia. He enjoys sports especially running and basketball.

Chetan Sehgal is *Executive Vice-President and Director of Global Emerging Markets/Small Cap Strategies, Templeton Asset Management.* He is responsible for strengthening the overall global emerging markets and small cap strategies, providing guidance and thought leadership, and leveraging the group's expertise to add value across products within the strategies. He likes spending time with family and friends and playing table tennis.

Cesar Perez Ruiz is *Chief Investment Officer, Pictet Wealth Management.* Cesar has more than 20 years' experience running investment strategies for both wealth and asset management, with a strong bottom-up equity portfolio management track record. When he is not looking at markets or reading business publications, he likes watching Real Madrid and looking after his kids.



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ing. However, as the probability of such an outcome for oil prices is pegged below 50 per cent, we refrain from becoming too optimistic on the outlook and retain a neutral view for the coming 12 months.

We are increasingly constructive on EM government bonds, in USD and local currency, due to receding risks of a stronger USD. We expect EM USD government bonds to deliver positive returns over the next year. We like their attractive yield of over 5 per cent and the fact that valuations are broadly in line with the long-term average. However, their relatively higher interest rate sensitivity compared to other bond sub-asset classes and the risk of a turn in EM sentiment lead us to have a more balanced view.

Asian bonds remain core holdings. We continue to view Asian USD bonds (diversified across Investment Grade and High Yield) as a core and defensive holding in an investment allocation, as they continue to be supported by strong regional demand and supportive conditions in China.

While valuations for Asian High Yield (HY) bonds remain expensive by historical standards, we believe the scarcity factor can support their valuations in the near future. The share of HY bonds has dropped from 40 per cent to nearly 20 per cent of the Asian bond universe over the last five years. Additionally, nearly 60 per cent of HY bonds mature or are callable in 2017-18. Therefore, unless we see a significant pick-up in supply, Asian HY valuations could remain technically supported and thus, we prefer a diversified exposure across Asian Investment Grade and HY bonds.

We are constructive on local currency bonds. The outlook for EM local currency-denominated bonds has brightened to some degree as well. The relatively high yield on offer (6.4 per cent) remains a key positive, especially relative to much lower yields in their DM counterparts (1.1 per cent). However, this higher yield comes at a price of relatively high volatility, especially against EM bonds denominated in USD. The rate-cutting cycle in many EMs – thus far a source of capital appreciation in bonds – may also be drawing to a close.

Tai Hui: We see two possible themes when investing in EM that can help investors to strike a balance between risk and reward. First, it is the income generation from EM assets, combining equities and fixed income. EM bonds tend to offer higher interest rates than their developed market counterparts.

For EM equities, there are several companies that are paying reasonably decent dividend yields (3-4 per cent per annum), but are still in the cyclical sector that can benefit from global reflation. This equity-bond combination can also help to reduce overall portfolio volatility compared with a pure equity portfolio.

Beyond asset allocation, we still believe in the structural development story of emerging markets, especially the rise of the middle class and the business opportunities that come with it. As we have experienced in recent years in China, consumers are switching away from consumer staples to more discretionary spending, including healthcare, entertainment, education and other services. This upgrade is also facilitated by technology and this could deliver a number of new winners in coming years. We believe these structural trends can deliver long-term returns to investors and mitigate some of the cyclical uncertainties.

Chetan: We believe that companies in the information technology (IT) sectors and consumer-related stocks are particularly attractive in the current environment. The greatest change we have seen in the emerging markets over the past decade is the emergence of large IT players which have created world leading platforms, products and services. We feel emerging market companies have become leading players in adoption and development of technology, which augurs well for continued growth of many of these economies.

Select stocks in the consumer sectors can provide an effective means to gain exposure to EM economic expansion and, in particular, access to growth in spending as rising regional wealth fuels a burgeoning consumer class. With low commodity and energy prices, as compared to the peaks achieved in the previous decade, we feel that select commodity shares remain attractively valued.

Cesar: We like Latin America. Brazil is emerging from its deep crisis, and Argentina is showing progress on reforms. More generally, with more US interest rate rises on the horizon, we favour emerging markets with robust external buffers (for example: Russia, Indonesia). We also like India, given its favourable demographics and assuming progress on reforms. By contrast, South Africa and Turkey, with sizeable current-account deficits, inadequate foreign-exchange reserves and worrying politics look especially vulnerable to a rise in US rates.

Local-currency EM sovereign debt looks attractive – although currency risk can be high. We see a slight rise in yields by the end of 2017, but the high coupon on local-currency EM bonds (about 7 per cent on average), should more than compensate. For hard-currency (USD) EM debt, though, the spread cushion against a rise in US Treasuries is now very thin, especially for corporate bonds. Developments in China will be key – moves to tighten monetary policy are already causing corporate spreads to widen.

Genevieve: What are the biggest risks for EM on the horizon and how should clients hedge against these, if at all?

Steve: Geopolitical events remain one of the key risks to the constructive view on EMs. One of our geopolitical themes is the pivot from "Pax Americana" to a multi-polar world, whereby we have nations/regions competing with one another to assume regional/global leadership. Such a shift raises the probability of disruptive "black swan" events. It is against this backdrop that tensions between the US and China, North Korea and Iran should be understood.

Therefore, we believe it is dangerous to call the peaking of geopolitical risks. Meanwhile, we should remember that Italian elections due in 2018 could be more challenging for European unity than either Dutch or French elections, or indeed Brexit negotiations. However, recent events, including Mr Trump's seemingly more pragmatic approach to foreign policy, is positive for risk assets, at least for now.

One way to mitigate geopolitical risk is to invest in traditional safe-havens such as gold or high quality bonds. However, we believe a broader approach of focusing on fundamentals and allocating to a diversified mix of assets that should do well in a range of scenarios (good or bad) may be superior, particularly given how difficult it is to predict the final outcome of such geopolitical events.

Chetan: The US Federal Reserve monetary policy is still a source of apprehension for many participants in EMs. We expect the trajectory of any rate increases to be gradual, although larger or faster-than-expected US interest-rate moves could dampen sentiment and lead to volatility. However, at this juncture it appears that many emerging markets have strong reserve positions and lower external debt than historic levels making them less vulnerable.

Potential changes to the US trade policy remain a source of uncertainty in global markets, with EM countries with the most exports to the US being viewed as most vulnerable, including Mexico, Malaysia, Chile and Thailand. At the same time, key economies including India, Indonesia and Brazil are relatively more insulated, and more dependent on domestic dynamics. The growth of inter-emerging market trade acts as a buffer to changes in trade policy in any one economy even though there could be short-term ramifications of abrupt trade policy changes.

We remain mindful of the fact that China is still in the process of making adjustments in its policy framework. The growth of shadow banking, the presence of high leverage in the system and regulatory objectives on ensuring stability in the system, mean that we may see strong policy response from China which could impact growth and have implications on various sectors including commodities and real estate.

Cesar: EM assets still face challenges, most notably from further Fed rate hikes, slowing growth in China and the stalling of commodity prices. For the Fed, our expectations are for two more quarter-point rate hikes in June and September. But the rise in the US dollar should remain moderate, in our view.

Our analysis indicates that the trade-weighted dollar – having declined this year – could recover by about 5 per cent over the next 12 months. In addition, the level of real rates in emerging markets and generally improved current accounts mean they are less vulnerable to a rise in US real rates than in 2013 (which gave rise to the so-called "taper tantrum"). Nevertheless, hedging currency risk remains highly advisable.

Notwithstanding China's strong Q1 GDP (gross domestic product) growth, we maintain the view that the Chinese economy will likely gradually decelerate through the rest of 2017, especially in the second half of the year. First, while it has proved resilient so far, property investment will likely start to slacken as the government steps up measures to control the housing bubble. Second, the Chinese central bank is likely to maintain a tightening policy bias.

The slowdown in Chinese growth we foresee later this year will probably weigh on Asian countries and on countries linked to the export of industrial metals. Commodity exporters are already facing pressure from the petering out of the rally in natural resource prices.

Other notable risks include the possibility of protectionist measures by Mr Trump which could yet create volatility for EMs. Geopolitical risk is also on the rise, especially in Asia – the US looks determined to prevent North Korean nuclear tests. Call options on gold are one way to hedge against geopolitical risk. More generally, for risk-averse investors, one way to reduce the risks linked to investing directly in EM is to play EM growth through DM exporters. W