Emerging Markets Have Potential

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The investment case for Emerging Markets (EM) is strong and exciting. The population in EM accounts for approximately 70 pct. of the world's population, of which about 50 pct. is under 30 years old. In addition, EM companies account for almost 50 pct. of world patent applications, even though only some 7 pct. of the world's 500 largest companies are based in EM. Therefore, over the coming years and decades, we also expect a growing number of EM companies to become more relevant at the global level – especially in the technology sector. At the same time, we are currently in a bull market for EM stocks which started in early 2016 and perhaps can continue for a couple of years driven by an upcycle in loan growth, capex and profitability.

Previously, the EM's were to some extent considered a homogenous group of countries. For instance, in the 2000s, favourable conditions meant that most stocks in virtually all sectors in the EM rose in sync. The main drivers were China's explosive growth, global growth, rising commodity prices and rising global trade and debt-fueled consumption. However, between 2011 and 2015, EM faced headwinds from the two major cyclical factors – the US dollar and the growth in China. With these headwinds it became quite visible which countries had failed to ensure stability through structural reforms and which countries were still highly dependent on commodities and/or had high levels of debt.

Since the trough in mid-January 2016, EM stocks have been in a bull market, rising 60 pct. (in USD). The current bull market in EM has similar characteristics as the previous six bull markets since 1976. On average, these bull markets last about three to four years and rise approximately 230 pct. driven by an upcycle in loan growth, capex and profitability. If history can be a guide, we foresee an opportunity for continued outperformance of EM stocks for perhaps the next two years.

The supportive backdrop is framed by an expanding and synchronous global economy combined with low interest rates, low inflation and a weak US dollar, which are normally key factors supporting EM competitiveness and relieves the debt burden for EM countries with dollar denominated debt. Finally, valuation is quite reasonable at 1.8 times book value. Usually, the outperformance ends when valuations reach upwards of 3 times.

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Not all countries are equal

Although there is a positive cyclical backdrop currently, it is crucial to focus on countries with strong political leadership that have an agenda of structural growth reforms, including expanding coverage of education and build-out of infrastructure to make superior long term investment decisions in EM countries.

We are looking for countries that, in addition to having a strong political environment, move up the value chain from agriculture and commodities to value-added services and technological innovation – a process that can take multiple decades. Today, we are particularly excited about countries such as India and

China, while several South American countries are showing improved tendencies on the political front. For example, in Brazil up to a third of the congressmen are currently being investigated for corruption. It is clear to us that the judicial system is functioning, as opposed to countries like South Africa, Russia and Turkey. At the same time, there is a reasonable reform focus in the Brazilian government, which so far has implemented a labour market reform and measures to prevent an increase in public spending in real terms as part of managing the fiscal budget deficit. Not least, a solid monetary policy is set by a strong, independent and orthodox political team that has managed to drive down inflation and inflation expectations. If the reform agenda continues, this will create a foundation for sustained growth in the coming decades. In the 2000s, we saw that after Lula became president and delivered market-friendly initiatives, the Brazilian market rose 19x in dollar terms. Since the lowest level in the spring of 2016 the market is now up approx. 155 pct. (in USD).

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Innovation is becoming an important factor

While the outlook is challenging for the commodity sector it is brighter for the technology sector, with an explosion in Asian companies involved in the IT innovation wave. For instance, we see that Chinese companies are at least as prominent in the development of artificial intelligence as those in the US. Furthermore, much of the innovation around critical components for smartphones and autonomous cars come from Asian companies.

Many EM countries leap-frogged the development in telecom by upgrading their mobile infrastructure rather than investing in the legacy fixed line infrastructure. However, technology does not generally provide a silver bullet for EM countries to progress towards the wealth of developed market countries. For EM countries to really meet their potential, they need to have a solid political environment and focus primarily on education, infrastructure development and inclusive growth. Nevertheless, EM countries that are focused on these areas can leverage technology to further accelerate growth and move up the value-chain. In certain countries we are seeing exactly that. For instance, in India, they have launched the Aadhaar-system, which gives each individual a personal unique identification number and thus paves the way for a substantially more efficient social security system. Furthermore, again using technology, Prime Minister Modi has introduced a nationwide state-of-the-art VAT-system, where goods including VAT-payments can be identified and paired along the value-chain thus diminishing the level of fraud. The productivities from this can potentially increase GDP by 0.5 pct. annually. Read more about this here.

Education is an opportunity

While Modi and other government leaders are exhibiting strong political leadership, poor political environments and corrupt leadership can still be found in other countries. As a general rule, we believe that it is wise for investors to steer clear of these countries. However, certain pockets of growth can be found regardless of the political environment. One such area is education. The World Bank states that there is an educational crisis in the EM. For example, in Brazil, with the current advancement in education levels, it will take a 15-year old about 75 years to achieve the same mathematical skills as that of an average OECD citizen, and 260 years to achieve the same literacy skills. The opportunity for private players in the education space is sizable, given that many governments in EM countries do not have the resources and abilities to build and run strong educational institutions. We see this as a growth opportunity in the private education sector, especially in Brazil and South Africa, where a high-quality education provider will have strong growth potential in the coming 10-20 years.

Stock selection remains key

Currently, we have a cyclically favourable environment for EM equities that may continue for some time. However, we are convinced that long-term positive returns in EM's are enhanced by finding thematic growth themes and innovative companies that operate in the right political and economic environment. However, as EM is a multi-speed group of countries, it is important to understand the art of selecting going forward.

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