PWM 20 years
PROFESSIONAL WEALTH MANAGEMENT

India shines through emerging market gloom

BY ELLIOT SMITHER

Emerging market equities saw big losses in 2022, but while many countries face significant headwinds, there are also several bright spots to be found

LARGEST CROSS-BORDER EMERGING MARKET EQUITY FUNDS

PROVIDER	FUND	MANAGER	DOMICILE	CURRENT NET ASSETS	PERFORMANCE 1 YEAR RETURN	3 YEAR RETURN	5 YEAR RETURN	ONGOING CHARGE
			MSCI EM NR USD	*−9.74%*	*7.53%*	*13.41%*		
BlackRock	iShares Core MSCI EM IMI ETF USD Acc	n/a	Ireland	€15.0bn	−9.24%	10.25%	15.22%	0.18%
Vanguard	Vanguard Emerg Mkts Stk Idx Inv EUR Acc	n/a	Ireland	€10.2bn	−9.72%	6.52%	11.43%	0.23%
BlackRock	iShares EmergMkts Idx (IE) Flex Acc GBP	Kieran Doyle	Ireland	€9.1bn	−10.29%	6.89%	12.90%	0.07%
JPMorgan	JPM Emerging Markets Equity A (dist) USD	Leon Eidelman & Austin Forey	Luxembourg	€7.5bn	−19.75%	0.80%	16.67%	1.72%
Xtrackers	Xtrackers MSCI Emerging Markets ETF 1C	n/a	Ireland	€4.6bn	−9.85%	6.91%	12.24%	0.18%
Amundi	iAmundi IS MSCI Emerging Markets IU–C	Damien Pagnon	Luxembourg	€4.4bn	−10.73%	5.74%	11.09%	0.20%
Hermes Fund Managers	Federated Hermes Glb Em Mkts R EUR Acc	Kunjal Gala & Vivek Bhutoria	Ireland	€4.2bn	−13.83%	1.16%	9.68%	1.60%
Vontobel	Vontobel mtx Sust EmMkts Ldrs I USD	Roger Merz & Thomas Schaffner	Luxembourg	€4.1bn	−16.74%	−3.22%	4.29%	1.16%
Mercer Global Investments	Mercer Passive Em Mkts Eq M–6 EUR	n/a	Ireland	€4.0bn	−9.97%	6.19%	11.30%	0.24%
Schroders	Schroder ISF Em Mkts A Dis USD AV	Robert Davy & Tom Wilson	Luxembourg	€4.0bn	−15.20%	1.85%	7.58%	1.86%

Supplied by Morningstar Direct; Returns through to 30/11/2022

Emerging market equities have had a tough year. The Russian invasion of Ukraine saw the country excluded from most indices and Russian holdings removed from most funds.

In addition, China — for so long the engine of both global and emerging market growth — has suffered from geopolitical tensions with the US, ongoing issues in its real estate sector and the impact of its zero-Covid policy.

"China does a very good job of antagonising both those who are more bullish, as well as those who are more bearish, about its prospects," says Edward Evans, emerging markets equity portfolio manager at Ashmore, pointing to the numerous top-down events which have impacted the attractiveness of Chinese equities.

He gives the example of October's National Congress of the Communist Party, which saw president Xi Jinping consolidate his position and moves that suggest decision making will be even more centralised from now on.

Some investors see this as removing the necessary checks and balances which makes the country a less attractive investment destination, while others see the potential advantage of more enhanced policy execution -— which for an economy going through a transformation might not be a bad thing, says Mr Evans.

"Off the back of that Congress we saw some extraordinary market moves and extraordinarily bearish sentiment; but a degree of balance, or at least digestion, is required before judging the new political framework," he says. There have been some positive moves since the Congress, points out Mr Evans, such as Mr Xi's meeting with US president Joe Biden, and suggestions that the zero-Covid policy might be wound down.

Tech crackdown

Yet, the recent protests in China against zero-Covid have certainly not helped risk sentiment, and highlight the fact that any moves away from the restrictive lockdown procedures will be a journey, not a pivot.

Zero-Covid has stopped Chinese economic growth in its tracks, which has had a huge impact on the global economy, because "China's growth is the world's growth", says Kevin Carter, founder and CIO of EMQQ Global, which invests in internet and e-commerce companies in emerging markets. In addition, it is now causing civil unrest, which makes the rest of the world even more sceptical about the country's future.

"People have always been worried about China," he says. "Most investors have never been to the country and are worried that the Chinese government are communists who don't really believe in capitalism and are going to steal their money."

This means that any time the government does something which worries investors, it feeds into this negative viewpoint and scares them off. Mr Carter gives the example of the crackdown against online education and tech companies, which did see some investors lose money, but he believes that many of the reforms were needed.

Investors can try to avoid China, says Nick Payne, lead investment manager for the Jupiter Global Emerging Markets Funds team — and who has a relatively low weighting at the moment — but those who do are ignoring a dynamic economy which is an interesting and potentially very lucrative place to invest. "It's just a bit more challenging because of the completely different nature of its political system."

A lot of people forget two very important points in China, he says. Firstly, Bejing's policy-making has generally been very pragmatic over the years. "The authorities see a problem, maybe they take some time to respond, but they do respond."

Secondly, China is one of the few emerging markets to actually emerge over the last 30 years. “And the route out of the extreme poverty of the 1970s and 1980s has been capitalism,” adds Mr Payne. “It’s been capitalism with Chinese characteristics, but it has been capitalism, it has been innovation.”

Beijing knows the ongoing growth of its economy will require capitalism, so it will continue, he says, although he also cautions investors to be carefully tuned to the direction of travel the party wants to go in, which it does generally communicate.

Bright spot

If recent events have scared investors off China, then one country which seems to have benefitted has been India. While Beijing has struggled with its zero-Covid policy and the impact of its reforms in the tech sector, the longevity and stability of Narendra Modi’s government has been a major boon.

“What you’re seeing in the Indian economy is a cumulative, delayed effect from the reforms that were carried out a few years ago, like the goods and services tax, demonetisation and general progress towards some of the technological initiatives that the Indian government has put in,” says Mr Payne.

Inflation in the country is pretty stable, he says, pointing out that in any case, most emerging market economies are used to dealing with numbers in the mid-single digits. And that needs to be balanced against the real growth being seen in the Indian economy.

“With what is going on in the developed markets, it is easy for people to lose sight of the fact that many economies, be it India, Indonesia or elsewhere, are all still growing. None of the countries that we are looking at in emerging markets are anywhere near a sustained recession of any kind,” asserts Mr Payne.

It is certainly true that Indian equities are expensive, though he says that they have never really been cheap. “But it’s the wrong way to look at it in any case,” says Mr Payne. “They are not cheap because the runway of growth in India is spectacular and people are prepared to pay a higher multiple to buy that future growth.

“Trying to go bargain hunting in India seldom works. What you want to do is buy proven winning franchises that actually have the ability to convert that economic growth into their own growth, corporate profitability, and ultimately returns to shareholders.”

India is underrepresented in global markets, irrespective of what’s happening to China, believes David Cornell, manager of the India Capital Growth Fund from Ocean Dial Asset Management.

> „India is attracting more attention on its own merits, rather than because of anything negative that’s happening in China„
>
> David Cornell, Ocean Dial

“India is attracting more attention on its own merits, rather than because of anything negative that’s happening in China,” he says. “But nonetheless, India is becoming a very credible alternative for both investors who have been quite heavily exposed to China, or multinational corporations who’ve been using China as a cheap source of labour or manufacturing.”

The reforms carried out between 2014 and 2018 have made India much less vulnerable to global economic volatility, says Mr Cornell, which makes it much more attractive to investors. And while it is expensive, long-term investors will be reaping the benefits of sustained economic growth.

Mr Cornell’s fund targets companies in the small and mid-cap space, which is where he believes investors will gain real exposure to the country’s domestic growth story.

“We’ve got a big exposure to financials, because the financial sector is right in the middle of any kind of economic recovery. And we want to be properly exposed to all the different components of that sector, be it retail banks, wholesale banks, asset management, insurance or consumer lending.”

He also likes consumer-facing companies, as well as those which are winning market share from China, be it in the digital economy
or chemicals in car component manufacturing.

Achilles heel

One potential headwind for India could be rising energy prices. The country is a big importer of oil, and in the past rising prices have proved a major headache for the country.

But as oil prices have risen in recent months, the Indian economy and stockmarket has continued to perform well, points out Mr Cornell, indicating how the country is less sensitive to movements than it has been previously.

Energy imports remain India’s Achilles heel, says Ashmore’s Mr Evans, though the country has benefitted from its “neutral geopolitical role”. For example the country has continued to access cheaper Russian oil, a commodity that has been closed off to much of the world. Investors should nevertheless be wary of how global drivers could impact India.

Looking at emerging market equities as a whole, Mr Evans believes they look attractive. In a world of greater polarisation and elevated geopolitical risk, they undoubtedly offer diversification and a wide range of growth drivers in countries in different stages of the economic cycle.

Mexico is one country which stands out for Mr Evans. Ashmore has a “modest” overweight to the country and valuations are attractive. Mexico has run a tight fiscal policy for some time, meaning its domestic economy has had a tough time, but while growth has been muted, it does not need to deal with the unwinding of a fiscal stimulus, which puts it in a strong position going forward.

Its central bank also hiked rates early to head off inflation, so it could benefit from a “first in, first out” situation, he says.

There is also the nearshoring theme playing to its advantage. Labour costs in Mexico are increasingly competitive compared to both the US and indeed China, and there is some evidence of US companies shifting manufacturing to the country.

Latin American countries are less dependent on oil imports than those in Asia, says Solange Srour, chief Brazil economist at Credit Suisse. With oil prices expected to remain at relatively high levels, this could be a driver for Latin America to outperform Asia in relative terms, she says.

"Moreover, Latin American countries are mostly commodity exporters and have raised interest rates at a faster pace than most developed countries. Since they are more advanced in their monetary cycle, there is less pressure to further increase interest rates in these countries, which could benefit risky assets," says Ms Srour.

Turning to Brazil, where the impeding return of former president Luiz Inácio 'Lula' da Silva to power in January has made headlines across the world, she notes greater fiscal uncertainty in the period between administrations.

"Up until now, Brazil was seen as one of the countries that would lead the monetary easing process. However, we need to wait. In order for Brazil to return to a scenario of economic pragmatism, we need to know who will be in the economic team of the new administration and its proposals," says Ms Srour.

A rosy economic outlook is the main event for Brazil, taking centre stage over the recent election result, says Saira Malik, CIO at US asset manager Nuveen. "Lula's victory did not come as a surprise with pre-election odds in his favour, but mixed governments across key Brazilian states and Congress is likely to lead to political gridlock, which is generally favourable for markets," she says.

Economic tailwinds will remain in the spotlight, she predicts, with monetary tightening likely to become a policy of the past, GDP surprising to the upside and market valuations remaining cheap.

VIEW FROM MORNINGSTAR: Geopolitics takes its toll

Fears of a global recession, hardening monetary policies from central banks around the world and heightened geopolitical risks have weighed down on emerging market equities in 2022.

The average fund in the Morningstar Global Emerging Markets equity category is down 30.7 per cent in dollar terms in the year-to-date through end-October 2022 compared to a 27.0 per cent decline for the Morningstar Emerging Markets index.

This is materially worse than the decline observed in developed markets, with the Morningstar Developed Markets Index down by 20.5 per cent during the same period. This performance comes after an already disappointing 2021 for investors in emerging markets with the average fund down 2.4 per cent last year.

Despite stronger macroeconomic fundamentals and somewhat lower inflation compared to the developed world, emerging countries globally have still suffered as geopolitical risks have taken their toll. The most significant event was doubtless the war in Ukraine. Shortly after the invasion, Russia was excluded from indexes and most asset managers took the decision to completely write down Russian holdings in their portfolios. Russian stocks accounted for 2.8 per cent of the Morningstar Emerging Markets index at end-January 2022.

Tensions between the US and China and new US restrictions on semiconductor chips exports have also scared investors and hurt the tech-heavy Taiwanese market, as evidenced by the Morningstar Taiwan index's 37.7 per cent decline this year. TSMC, a key supplier to global IT hardware manufacturers and by far Taiwan's largest listed company, has seen its share price almost halve this year. It remains the index's largest position and is widely held across portfolios with a 7.3 per cent weight on average in the category at end-September 2022.

China — the largest market in the index — has also been among the worst performers this year with the Morningstar China Index losing 41.2 per cent as of end-October. The enduring zero-Covid policy has slowed down the economic rebound with a series of local lockdowns, worrying investors that a full reopening may be further delayed.

President Xi Jinping's third term as general secretary was received with caution by market participants, whereas concerns on the real estate sector have weighed down further on sentiment about China. The e-commerce, real estate and technology sectors have been the most impacted.

Other emerging market countries have fared relatively better. India has posted strong economic growth numbers and its stock market — albeit gauged relatively expensive by many fund managers — proved resilient. The Morningstar India index has limited its losses to 7.8 per cent this year. Among the bigger markets, Brazil has been one of the few to post positive returns in US dollars (up 18.7 per cent) with banks and energy leading the way. Petrobras, for example, is up 53 per cent in dollar terms this year.

Finally, Saudi Arabia performed well thanks to its stockmarket's high correlation to oil prices.

Despite these few brighter areas, investors have taken risk off the table. Emerging market equity funds domiciled in Europe have recorded $2bn of net outflows in 2022 through to the end of October. These funds had garnered net inflows of $9.2bn in 2021.

Mathieu Caquineau, CFA, associate director, manager research, Morningstar