

Will Emerging Markets See the Light?

Quality Growth Boutique

October 2020



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Will Emerging Markets See the Light?



The lotus flower is regarded in many cultures, especially in Eastern religions, as a symbol of enlightenment and rebirth. Every morning, the lotus rises through mud and dirt to blossom through the surface of the water.

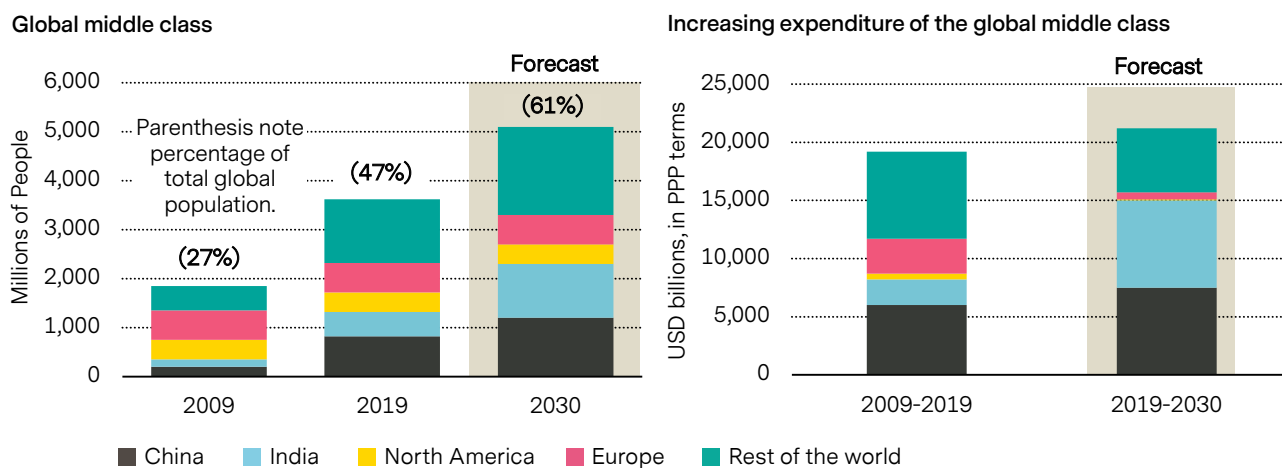
Like the lotus, developing countries naturally endure difficult conditions. They are vulnerable to political scandals, deficits and inflation, oil collapses and currency fluctuations. Over the past decade, the broad EM equity index has not kept pace with developed markets and now seemingly many economies are ill-equipped to deal with the pandemic. Will emerging markets blossom again?

The EM Consumption Story Remains Intact

During the past 10 years, emerging markets aggregate GDP Growth of 5% per annum on average has meaningfully exceeded the roughly 2% from the developed world¹. A rising middle class benefiting from increased wages has bolstered domestic consumption,

which has been one of the dominant and persistent structural themes behind the EM growth story. While the events of 2020 have disrupted current habits and patterns, viewed from a five to ten-year perspective, the long-term growth story is still intact.

Figure 1: Rise of Middle Income Population and Increased Spending Are Poised to Continue to Support EM Growth²



A household forms part of the middle class when its spending capacity per day and per person lies between 11 and 110 dollars a day (measured in terms of purchasing power parity, or PPP).

¹Source: IMF

²Source: CaixaBank Research, based on estimates by Homi Kharas. www.caixabankresearch.com "The Emergence of the Middle Class: An Emerging Market Phenomenon", Claudia Canals, 16 September 2019 | Monthly Report – Dossier.

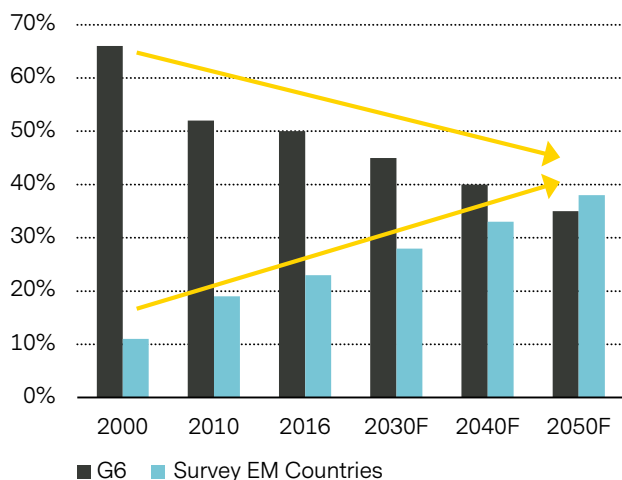


Increased spending fuels demand for better housing, consumer products, and discretionary items enjoyed by an upwardly mobile middle class. Spending in emerging markets is expected to grow faster than overall economic growth, while in developed economies, consumption is expected to grow in-line with GDP growth.

Consumption continues to play a bigger role in the GDP growth of the larger BRIC countries, as well as Indonesia, Mexico, Turkey and South Africa. And this is expected to increase over the next few decades.

Figure 2: Consumption to Continue to Help Drive Emerging Markets Growth

Distribution of Global Consumption Between G6 and Selected EM Countries



Selected EM Countries: Brazil, China, India, Indonesia, Russia, Mexico, Turkey, South Africa

Source: World Bank (World Development Indicators); Credit Suisse Research Institute "Emerging Market Consumer Survey 2018". The Credit Suisse Research Institute is Credit Suisse's in-house think tank. www.credit-suisse.com/researchinstitute.

A Rise in EM Discretionary Spending

An upsurge of young consumers, mainly in Asia, are entering the luxury market. They are an urban, tech-friendly group that wants premium products to symbolize their social status. This marks an important shift in EM to aspirational, consumer discretionary spending and a corresponding demand for strong brands.

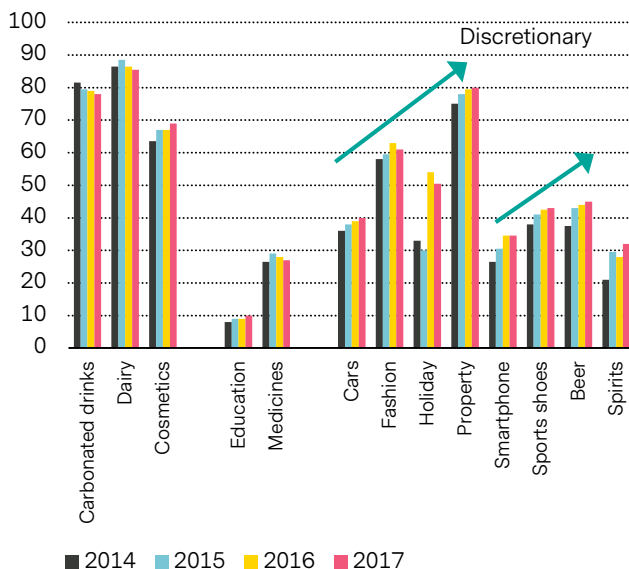
Global athletic brands Nike and Adidas have become household names across many EMs. American fast-food chains such as KFC, Pizza Hut and Taco Bell (Yum China) are integrated into popular culture and consumers' daily lives in China.

In Brazil, consumers continue to seek out recognizable brands, even in an economic downturn. The fast-fashion operator Lojas Renner offers youth fashion (Youcom), and home goods (Camicado), but at a 30% discount to global players. Shorter lead times allow it to provide more relevant fashion for its target customer base. As a result, same-store-sales have continued to outgrow the market. With this strategy, this Brazilian apparel retailer's market share has the potential to double.

In India, the paint sector is primed for structural growth opportunities for years to come. As the trend in home renovation continues to take hold, paint spend per capita will increase. Dominant player Asian Paints is poised to take market share as India transitions to a more organized paint sector vs. smaller independent players. With its lowest-cost domestic production, strong brand, pricing power and unmatched supply chain and dealer networks, Asian Paints may show strong earnings growth for decades.

Figure 3: Consumer Discretionary Spending in EM is on the Rise

Consumer Purchases in the Last 3-12 Months of Each Respective Year



Source: World Bank (World Development Indicators); Credit Suisse Research Institute "Emerging Market Consumer Survey 2018". The Credit Suisse Research Institute is Credit Suisse's in-house think tank. www.credit-suisse.com/researchinstitute.

How Will Covid-19 Impact Consumption in EM?

Covid-19 has not changed long-term growth expectations for consumption in emerging markets.

In many industries, Covid-19 has accelerated structural shifts. For instance, online retail has been taking share from offline shopping for decades in both developed and emerging markets. But even in markets that have seen a fairly high penetration of e-commerce, some of the population has still been slow to adapt. Out of necessity, Covid-19 has forced wary consumers to try online delivery channels and payment services, benefiting companies such as Alibaba. If the buying experience left a good impression, ecommerce shifts will likely become more pronounced.

Contactless retailing is also relevant for businesses that manufacture products. Unilever, which derives more than half of its revenue from emerging markets, has been making investments and improvements in the online shopping experience, in its packaging and shipping, in target ads for online consumers, and with finer tuned price points and margins. This investment in online started years ago and the benefits are only highlighted by Covid-19. Conversely, those companies that were behind the ecommerce curve are likely more negatively positioned now.

Online delivery of education is also getting a boost as more classrooms become virtual during the pandemic. As parents and teachers are being introduced to new technology, they are seeing firsthand the beneficial role it can play in education as far as better managing finite resources and larger classrooms. Over the long term, the effectiveness of online learning in certain situations will surely be recognized from grammar schools to college.

China, in particular, is also seeing an uptick in disaster preparedness, telemedicine, and online entertainment. Many of these changes in consumer behavior and business operations will likely be enduring.

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Strong US Dollar Could Be Less of a Headwind for EM

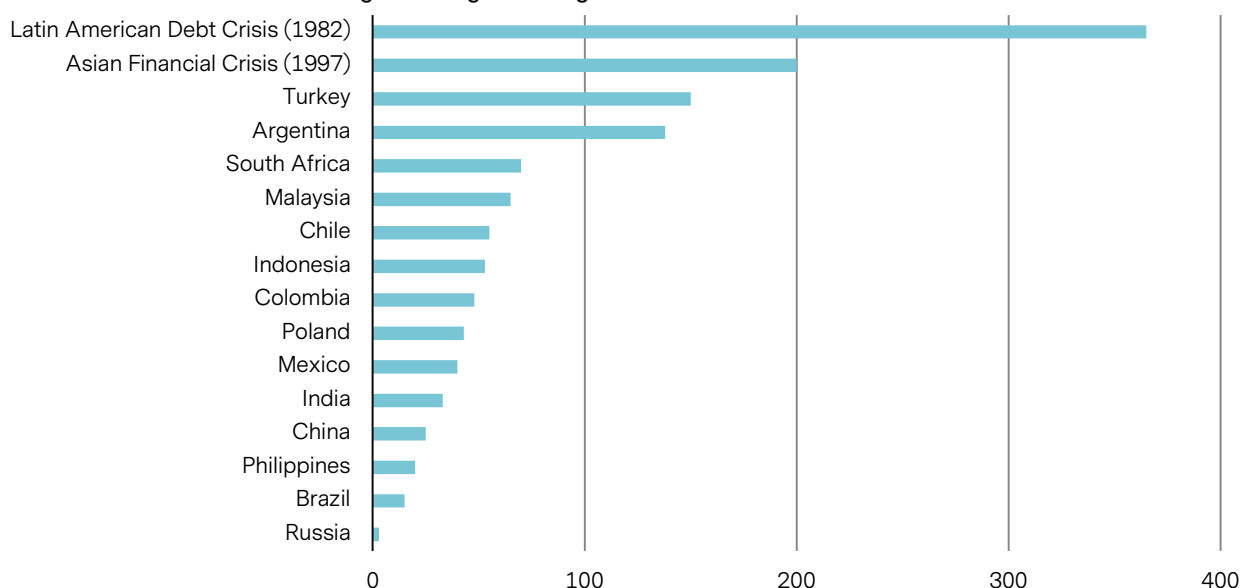
While steadily increasing consumption provides a tailwind for growth in emerging markets, a notable headwind in the past for the asset class in general has been the strength of the US dollar. Obviously, for US-based investors, a stronger currency weakens returns but it can also have a negative impact on economic growth.

In the past, EM countries increasingly relied on external debt (borrowings from foreign lenders mainly in USD) for

financing. As shown in Figure 4, external debt far exceeded EM countries' foreign exchange reserves at times in the 1980s and 1990s. Thus, bouts of dollar strength caused increased debt expenses and led to pressure on economic growth. For instance, during dollar strength cycles in the early 1980s and mid-1990s, there were several years where emerging market GDP growth trailed that of advanced economies¹.

Figure 4: Emerging Markets Have Been More Resilient to External Shocks Than in Previous Crises²

Gross External Debt as a Percentage of Foreign Exchange Reserves



¹Source: IMF DataMapper

²Source: The Financial Times Limited 2020, November 4, 2018. James Kynge "Emerging markets become more able to withstand a crisis; Developing economies appear more robust, but China slowdown is biggest threat"; "Emerging market debt: a case for concern?"

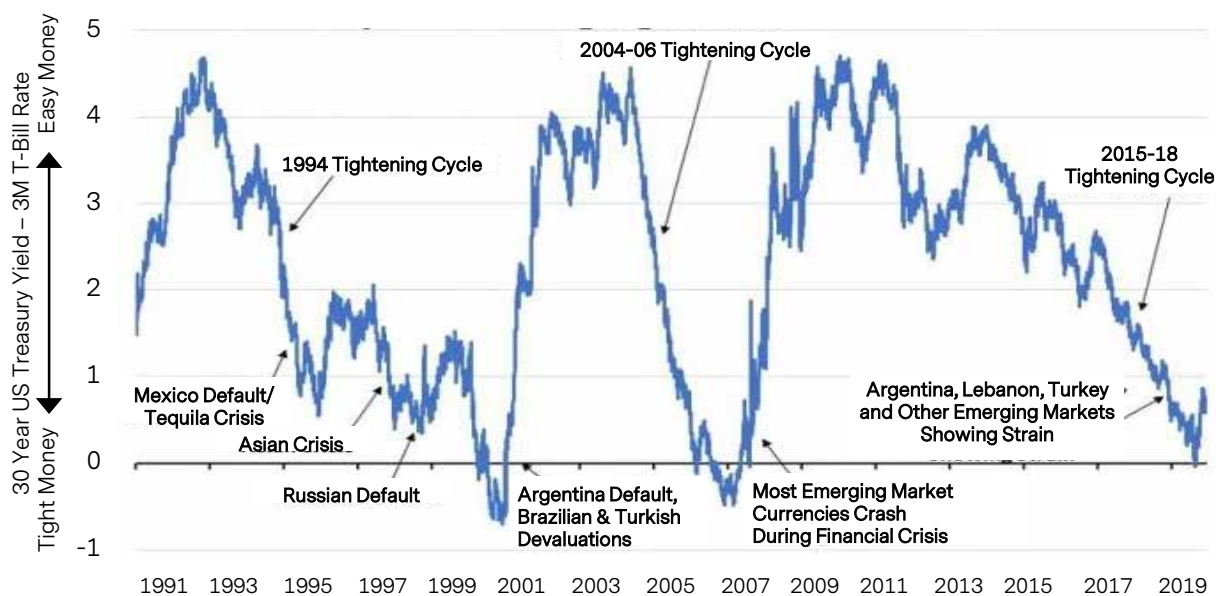


As the level of the dollar is typically correlated with changes in US Federal Reserve policy, investors have learned from history that crises in the EM tend to follow prolonged periods of Fed tightening and dollar strength, and rarely strike after periods of easy monetary policy.

Figure 5 shows how the Tequila Crisis, Asian Financial Crisis and Russian Default Crisis followed Fed tightening cycles and persistent dollar strength. During and immediately following these episodes, emerging markets GDP growth fell below that of advanced economies (IMF).

Figure 5: Fed Tightening and Stronger Dollar Impact on EM has Lessened Since the 1990s

Fed Policy and Emerging Market Debt Crises



Source: The Financial Times Limited 2020, January 10, 2020. Erik Norland "Opinion: Beyond BRICs; emerging market debt: a case for concern?"

Since the late 1990s, emerging market countries have become more intertwined in the global economy through the advance of globalization. They have been more prudent in terms of improved regulations and disciplined fiscal policies and several, that hadn't before, have adopted floating rate currencies. More stable policies and greater stability have lessened their dependence on external debt over the years. Thus, also shown in Figure 4, many countries have more manageable external debt exposure than in the past. (Except for Turkey and Argentina: Both have been outliers in terms of greater external debt exposure from past failed liberalization policies, an inability to restructure past debts, binging on cheaper dollar loans after the Global Financial Crisis, increased tariffs and economic sanctions on leaders).

During the Fed's most recent 2015-2018 tightening cycle and dollar strength, tensions within emerging markets were largely limited to Argentina and Turkey. The larger economies that underpin the asset class have shown more resilience and the group as a whole has continued to experience greater GDP growth than advanced economies in each of the last 20 years. This was not the case for periods in the prior 20 years.

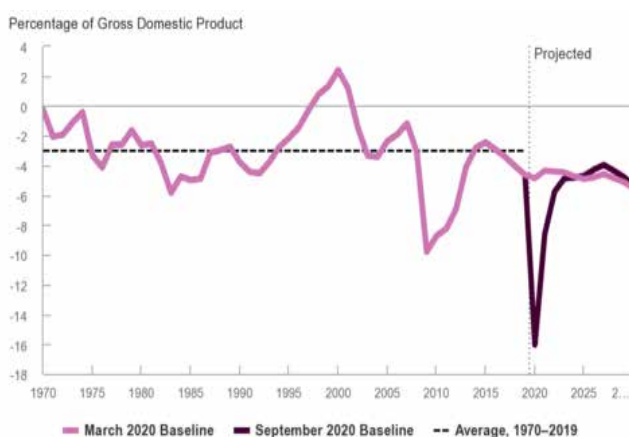
Will the US Dollar Headwind Continue?

As discussed above, the dollar has had less of an impact from an economic perspective on developing economies. However, for investors in dollar denominated investment vehicles, it still has an impact on financial performance and has been a headwind over the past several years. Persistent dollar strength continued with a surge in March of 2020 as investors piled into safe-haven assets as a result of the coronavirus pandemic. But the dollar has weakened in the face of:

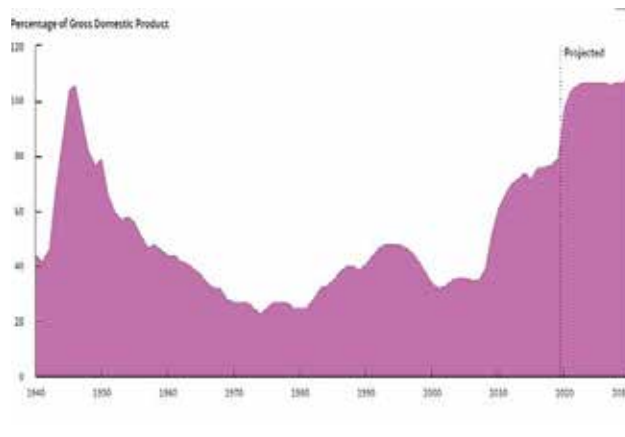
- US assets have become less attractive as a near-zero-rate policy and asset purchases have reduced inflation-adjusted 10-year yields
- The Fed pledged unlimited liquidity to support an ailing economy and agreed to a policy of “average inflation targeting” allowing it to run “moderately” above the Fed’s 2% goal “for some time” before making rate adjustments.
- Investor perception that the US is dealing with the pandemic less adequately than other economies.
- The deficit in 2020 will be the largest – as a percentage of GDP – since 1945. Federal debt has increased sharply this year and is projected to increase in most years over the coming decade. Beginning in 2023, debt would be higher than at any other time in the nation’s history.

Figure 6: US Dollar: Headwind or Tailwind?

Deficits in CBO's September 2020 Baseline Verses its March 2020 Baseline



Federal Debt Held by the Public

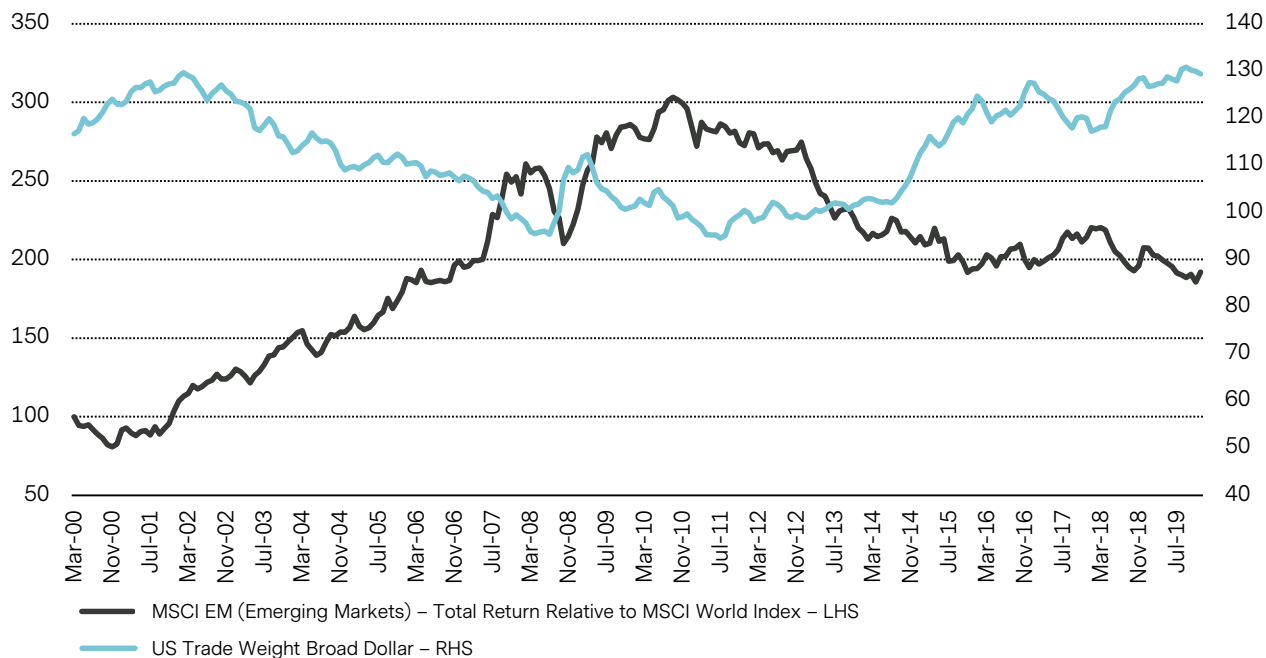


Source: “Congressional Budget Office, Non Partisan Analysis for US Congress”. “An Update to Budget Outlook 2020-2030” https://www.cbo.gov/publication/56542#_idTextAnchor020 Figures 1 and 3.

Exchange rates clearly can be an important contributor or a significant detractor from returns. In a complex macro

environment, exposure to emerging markets can be a good hedge against the risk of dollar depreciation.

Figure 7: Strong Dollar Has Had a Meaningful Impact on the Last Decade's Returns



Source: FactSet.

Past performance is not indicative of future results.

US Trade Weighted Broad Dollar Index is the weighted average of the foreign exchange value of the US Dollar against the currencies of a broad group of major US trading partners. The base year for this index is Jan 1997.

As depicted in Figure 7, a considerably weaker greenback from 2001 to 2008 augmented strong EM returns during this period. However, the U.S. dollar has appreciated in the last decade, particularly hurting U.S.-based returns

for the emerging market investor. For the reasons listed above, this could potentially be less of a headwind in the coming years.

Will the Covid-19 Pandemic Put More Pressure on Emerging Markets?

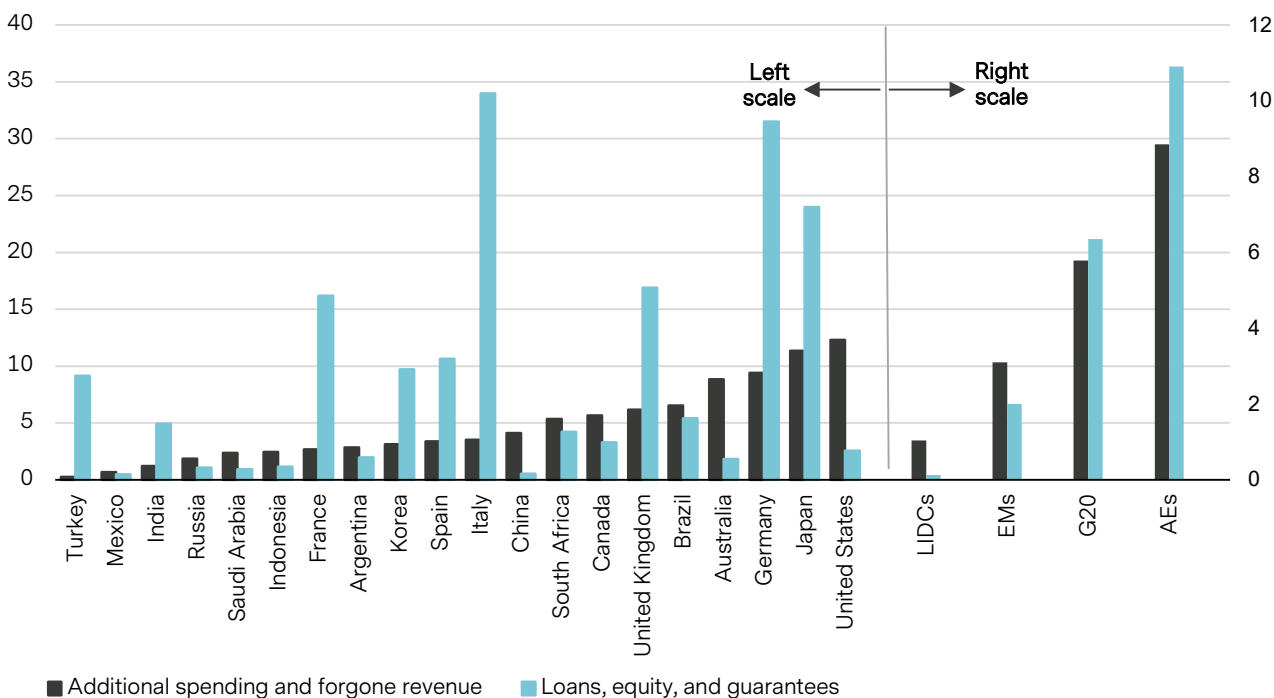
Covid-19 started in China, but it has had a profound impact on all global economies. The total number of cases per million people in many large Asian countries, such as China, South Korea, and Taiwan, has been significantly less than in developed Western countries such as France, Germany, the UK, and the US (according to the European CDC).

Countries that have had a higher infection rate within emerging markets, such as India, are those that unfortunately have a large population at the poverty line. Thus, it is very difficult to enact longer quarantines and closings of economies when most people are living hand to mouth. As a result, several emerging market economies have been less impacted or simply cannot bear longer periods of economic shutdowns.

Another relevant factor in comparing the impact of Covid-19 on various economies is the ability to implement fiscal stimulus. In response to Covid-19, Advanced Economies (AEs) implemented much larger stimulus packages than Emerging Market Economies (EMs) as a share of GDP as shown below in Figure 8.

There are exceptions: Brazil put forth a relatively larger stimulus package. In the near term, such stimulus has acted as a support valve for economic growth. However, over the longer term, it could be argued that many emerging market countries will have less of a financial burden from Covid-19.

Figure 8: Summary of Fiscal Measures in Response to the Covid-19 Pandemic (percent of GDP)



Source: National authorities and IMF staff estimates. Note: Data are as of June 12, 2020. Country groups are weighted by GDP in purchasing power parity-adjusted current US dollars. Revenue and spending measures exclude deferred taxes and advance payments. For details, see the Fiscal Monitor Database of Country Fiscal Measures in Response to the Covid-19 Pandemic. AEs = advanced economies; EMs = emerging markets; G20 = group of twenty; LIDCs = low-income developing countries.



Even with less stimulus support, consensus still predicts that emerging economies will contract by less than advanced economies in 2020, and recover even faster in 2021 as depicted in the latest IMF Real GDP Global

growth projections (Figure 9). While each country still faces its own unique challenges, as a whole, emerging markets have been fairly conservative in their use of stimulus and cautious in terms of their finances.

Figure 9: Latest World Economic Outlook Growth Projections

Real GDP Annual Percentage Change

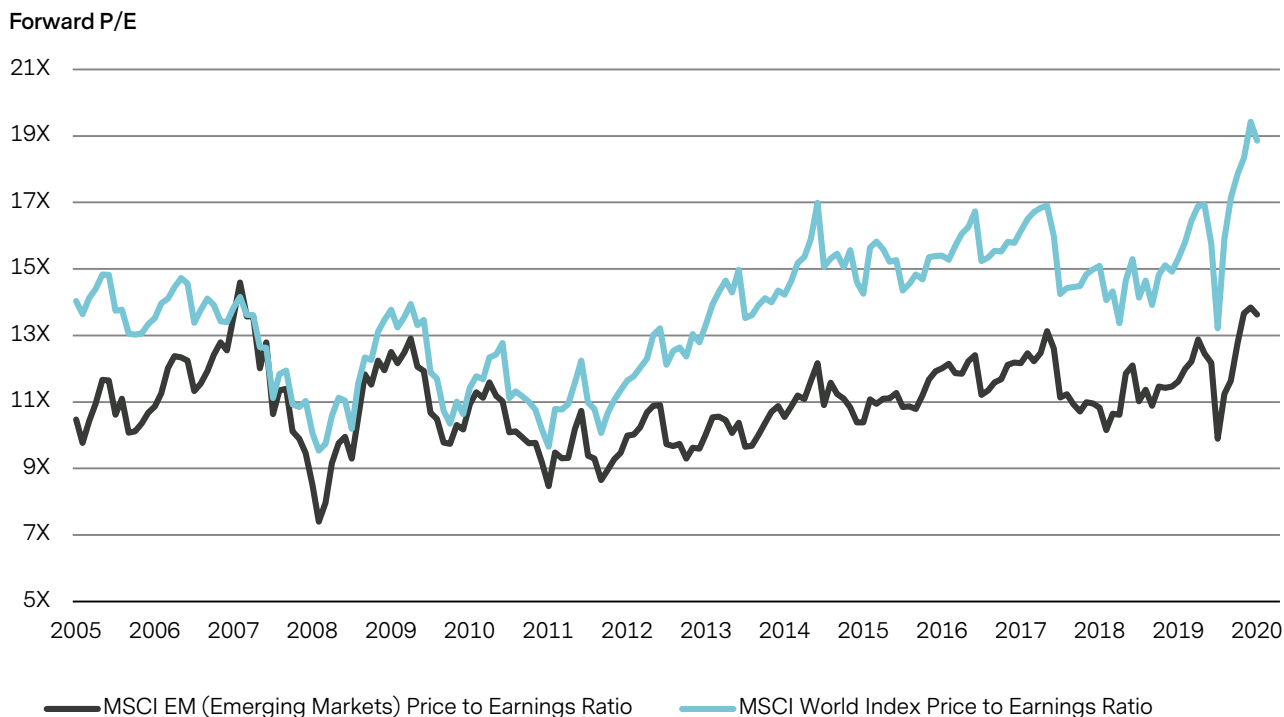
		PROJECTIONS	
	2019	2020	2021
World Output	2.9	-4.9	5.4
Advanced Economies	1.7	-8.0	4.8
United States	2.3	-8.0	4.5
Euro Area	1.3	-10.2	6.0
Germany	0.6	-7.8	5.4
France	1.5	-12.5	7.3
Italy	0.3	-12.8	6.3
Spain	2.0	-12.8	6.3
Japan	0.7	-5.8	2.4
United Kingdom	1.4	-10.2	6.3
Canada	1.7	-8.4	4.9
Other Advanced Economies	1.7	-4.8	4.2

		PROJECTIONS	
	2019	2020	2021
Emerging Markets and Developing Economies	3.7	-3.0	5.9
Emerging and Developing Asia	5.5	-0.8	7.4
China	6.1	1.0	8.2
India	4.2	-4.5	6.0
ASEAN-5	4.9	-2.0	6.2
Emerging and Developing Europe	2.1	-5.8	4.3
Russia	1.3	-6.6	4.1
Latin America and the Caribbean	0.1	-9.4	3.7
Brazil	1.1	-4.7	3.3
Mexico	-0.3	-10.5	3.3
Middle East and Central Asia	1.0	-4.7	3.3
Saudi Arabia	0.3	-6.8	3.1
Nigeria	2.2	-5.4	2.6
South Africa	0.2	-8.0	3.5
Low-Income Developing Countries	5.2	-1.0	5.2

Source: IMF, World Economic Outlook, June 2020. Economies are listed on the basis of economic size. Note: For India, data and forecast are presented on a fiscal year basis with FY2020/2021 starting in April 2020. India's growth is -4.9% in 2020 based on the calendar year.

Attractive Valuations

Figure 10: MSCI World P/E Ratio Premium vs. MSCI EM is Highest in the Last 15 years



Source: FactSet. **Past performance is not indicative of future results.**

Conclusion

Emerging markets today are more resilient to external shocks. Their economies have generally proven to withstand the pressures of a stronger dollar, which so often in the past tipped them into a recession and crisis mode. So far, EM countries appear to be dealing with the economic hit from Covid-19 in a fairly conservative manner regarding fiscal stimulus. This makes the potential for more prosperous times ahead more likely after a vaccine has been developed and distributed, and pandemic pressures begin to finally alleviate.

Figure 10 indicates that the MSCI EM Index is currently trading at a 15-year low when compared with the MSCI World (Developed) Index. Thus, there is a relative “margin of safety” built into the emerging market asset class, even if positive catalysts take longer to materialize.

Certainly, no one can predict the timing and depth of the current headwinds and the outcome of the Covid-19 global pandemic. But as in previous crises and from a valuation point of view, the market is offering an opportunity to participate in an enduring emerging markets growth story.

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