GUARDIAN CAPITAL

Emerging Markets Quarterly Outlook

FOURTH QUARTER – 2020

NARROW MINDED MARKETS

Emerging Markets (EM) benefited from multiple factors over the Summer, including: the general "risk on" tone to financial markets worldwide, a rapid rebound in global economic activity amid easing of pandemic-induced restrictions, and low interest rates combined with a softer US dollar and firmer commodity prices.

The MSCI Emerging Markets Index (the EM equity benchmark) generated a 9.6% total return in the three months ended September (US dollar basis), outpacing the gains in Developed Markets (DM; the MSCI World Index's total return was 7.9%) and helping EM further recover from the peak-to-trough 34% decline recorded earlier in the year. As at the end of September, the EM equity benchmark has recouped 95% of its losses and stood just 1.2% below its opening level for the year. DM, in contrast, has already surpassed its opening level for the year, finishing the nine months ended September ahead by 1.7%

Notably, though, while the overall gains have been strong, they have not been particularly broad-based across EM countries.

For instance, just 15 of the 26 geographic markets that comprise the MSCI Emerging Markets Index were actually up in the third calendar quarter — and just three countries (China, Taiwan and South Korea) accounted for 90% of the overall increase during the period.

Moreover, on year-to-date basis, these three North Asian markets (which now account for two-thirds of the EM equity benchmark, up from just under 60% at the start of the year) are the only parts of EM that are in positive territory, up by a cumulative 13%. The rest of the regional stock markets are down by a combined 21%; 16 of these other 23 (70%) are down in excess of 20% with Colombia and Brazil the biggest laggards with declines still in excess of 40% (in US dollar terms).

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A clearly established motive

The divergence in regional performance is not without reason.

For starters, it is not a coincidence that North Asian countries have been amongst the best at managing the COVID-19 pandemic, which has allowed their economies to reopen more broadly and make greater progress at returning to “normal”. Latin America, in contrast, has fared much worse with the likes of Peru, Brazil, Chile, Colombia and Mexico ranking at the top of the list in terms of population-adjusted COVID-19 case and fatality rates.

Beyond that, the variance in market performance fundamentally reflects differences in the composition of these markets.

As the pandemic gripped the world and caused an acceleration of the shifts in established trends of business and consumer behaviour, some industries were better positioned to succeed (especially those in “internet enabled” sectors like Information Technology, Communication Services and e-commerce segments of Consumer Discretionary) while others were left playing catch up.

Indeed, Information Technology, Communication Services and Consumer Discretionary, as well as Health Care have unsurprisingly been among the market leaders so far through the recovery and are the best performing sectors year-to-date across global markets — this has especially been the case in EM where these four market areas are the only ones up on the year (and by a cumulative 21%); the rest of the sectors are down 19% in aggregate.

Looking specifically at Q3, eight of the EM Index’s 11 market sectors were in the green but it was still a story of a few sectors doing the heavy-lifting — Information Technology and Consumer Discretionary alone accounted for 85% of that increase.

With this in mind, the drivers of the outperformance of EM, and specifically the three North Asian markets, become clearer. These countries are the home to some of the most advanced technology industries and companies, and their respective markets are heavily skewed toward these “best in class” equity sectors — the MSCI Emerging Markets Asia Index is overweight Tech, Discretionary, Communication Services and Health Care, not just relative to the broader MSCI Emerging Markets Index, but also when compared to the DM equity gauge of the MSCI World Index.

The MSCI Emerging Markets Latin America Index, in contrast, is heavily underweight these sectors (substantially so for Tech and Discretionary) and instead is skewed to Materials, Energy, and Financials.

Gasping for breadth

Upswings in equity markets, like those of the broader economy, are generally stronger and more durable when they have a broader base with more companies underpinning the performance.

As such, the narrowness of the gains within EM understandably is a cause for concern for investors since it brings into question just how sustainable the gains will be going forward. To further emphasize the extreme narrowness, just two (Alibaba and Taiwan Semiconductor) of the almost 1,400 securities included the MSCI EM Index accounted for 45% of the total returns over the last three months.

But while the global economic outlook remains fairly cloudy and the confidence intervals wide, thanks to the persisting pandemic, there are reasons for cautious optimism with respect to near-term expectations for EM and its investment assets.

The road ahead

Starting with the broad macro outlook, the sharp snapback in activity across the globe was driven by reopening economies and underpinned by substantial fiscal and monetary support. This is expected to result in record-setting growth rates in Q3.

These gains represent a material recovery of lost activity, however, they do not recapture everything. Plenty of slack still remains which suggests the potential for global growth rates to remain above the trends that prevailed prior to this public health and economic crisis — however, expectations are for future growth to be much more moderate than the rapid pace recorded over the last few months.

The big reason behind these more muted growth projections in the coming months primarily relates to factors restricting consumers' ability to return to normal levels of activity.

Consumer spending accounts for more than half of global economic output and the rapid rebound of consumption from its April lows has been the key driver behind the broader snapback in economic growth since the Spring.

The bulk of the boom in consumer spending has been a product of pent-up demand. Retail spending predominantly reflects tangible goods and the bounce since April reflects consumers making purchases of items that had been deferred at the onset of the crisis either because of concerns about cash flows or an inability to actually make a transaction either due to lockdown-driven supply change constraints or forced store closures. As this pent-up demand is sated, growth in spending on goods will moderate to more "trend-like" rates.

In contrast, spending on services (which account for the majority of consumer spending) experienced a more significant hit as a result of business closures and event cancelations, and has seen more modest improvements in recent months.

Unlike goods, pent-up demand plays a diminished role with services. While consumers can go back and buy a car that was intended to be purchased earlier, they will not get all of the haircuts that would have otherwise been had if not for self-isolation.

As well, most services do not lend themselves to home delivery — online shopping during lockdown can replace buying something at a brick-and-mortar shop but tourism cannot exactly be ordered-in.

This last point is important in terms of the near-term outlook because it is increasingly looking as though business re-openings have largely reached their limits under the current stages of restriction-rollbacks, which stands to constrain any future gains.

Absent the continued unwinding of restrictions on all activity (especially those that face issues implementing social distancing), there is limited near-term scope for services spending to achieve pre-COVID-19 levels. Further, there are already signs that the sharp upswing in growth momentum that came with the initial easing of COVID-19 restrictions is ebbing as services purchasing managers' indexes (PMI) across the globe moderated in September.

Moreover, there are rising risks that supply-side constraints may worsen before they improve.

The resurgence of contagion following a Summer lull paused reopening plans and, in several cases, resulted in a reversal in the easing of some restrictions — particularly scaling back allowable crowd sizes and re-imposing restrictions on indoor commercial activities (such as dining).

On top of that, the demand side of the equation is facing pressure as well.

While labour markets have improved markedly, the pace of gains has slowed recently in tandem with the moderation in the expansion of activity, and unemployment remains elevated. This, combined with fading fiscal support for households, creates a headwind for the consumer sector that will serve to set a speed limit on how fast the broader recovery is able to proceed over the near-term.

Calling for backup

Of course, while consumers account for the bulk of global economic activity, they are not everything.

There are, thankfully, reasons to anticipate that these other areas will help provide something of a counterbalance to moderating household spending and prove supportive in widening the growth differential between the more services-oriented DM and goods-producing EM.

It is understandably the case that businesses worldwide remain hesitant to commit to longer-term capital projects given the current backdrop, but their hands look likely to be forced to engage at least in increased investment in working capital in the coming months.

As consumer spending on goods rebounded sharply, producers and suppliers of those products did not fully keep up with demand, resulting in a substantial drawdown of inventories — for example, the ratio of inventories to sales for US manufacturers, retailers and wholesalers (excluding those dealing in petroleum) has fallen to its lowest levels since 2012 and is near its lowest levels of the last two decades.

Even in the absence of further increases in sales to end-consumers, the depleted inventory levels suggest that companies need to increase efforts to rebuild stockpiles back to more normal levels. Even if sales stay flat in the US, for instance, inventories would need to rise by more than $100 billion to bring the inventory-to-sales ratio back in line with its pre-crisis five-year average.

Moreover, given the recent experience, there would be good reason for businesses to target even higher inventory levels as a precaution against any potential shocks to the global supply chain resulting from future pandemic-induced shutdowns or the re-escalation of trade tensions. Thankfully, however, for EM economies that are geared to the US, the risks of the latter are coming down as the US election looks to be headed in a direction that would likely be less hostile to trade partners.

The scope for a material upswing in the global inventory cycle is quite constructive for industrial production and international trade flows, and in combination with the record low costs of capital, could spur increases in capital investment. Such developments would be unambiguously positive for those EM economies that are heavily entwined in global supply chains, particularly those raw materials producers in Latin America and manufacturers of consumer goods in Southeast Asia.

The factory sector is already experiencing a bit of a renaissance. The global manufacturing PMI has increased for five straight months and is at its highest level in more than two years, led by EM where the PMI sits at its best level in nearly a decade.

Looking for growth in all the right places

At the same time, those areas that have thrived to this point continue to have scope to outperform.

The pandemic has accelerated the shift toward digitization everywhere, particularly with respect to how goods and services are consumed — and the tech hubs in Asia remain at the forefront. These developments are only going to continue.

Moreover, investors have made it abundantly clear that there is an ongoing preference for growth in the marketplace above anything else. Companies that are able to generate consistent high earnings growth and return on equity are increasingly scarce in this general low growth macro environment. Negligible costs of capital will further widen this potential growth upside that can be gleaned from investment versus other areas in the market.

EM economies overall continue to offer a growth advantage over their DM counterparts but EM equities still trade at wider-than-normal discounts to DM on both a price-to-earnings and price-to-book basis thanks to the persistent risk aversion in the marketplace. These disparities are even greater when incorporating the improvement in earnings momentum and earnings expectations beyond just the coming year — i.e. looking to a time when crisis-era social distancing protocols are removed and life returns to something more "normal" — which suggests that there is room for further gains.

Of course, there is a lot of uncertainty over the outlook because of the pandemic but underlying trends of continued above-average growth, benign inflation and low interest rates should continue to provide a supportive backdrop for risk assets to continue to generate positive returns, though the gains are likely to be more moderate than the outsized increases registered over the last six months.

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