Emerging markets have learned from their past

Emerging markets equities struggled in 2022, with the lowest returns since the 2008-2009 Global Financial Crisis, but climbed in the first months of 2023. However, these assets still lag behind their developed peers. What are the drivers for growth and performance in emerging markets? Financial Investigator spoke to Amit Goel, Portfolio Manager at Fidelity International, about the opportunities emerging markets have to offer.

By *Esther Waal*

How do you expect emerging markets to perform over the next 5 years?
'We firmly believe global emerging markets (GEMs) are well-placed to provide superior returns over the medium-to-long term. The medium-to-long term fundamentals in GEMs are very reasonable today compared to the past. At a time when high inflation and interest rates are leading to a standard-of-living crisis in the developed markets (DMs), GEM economies have been ahead of the curve in raising rates. They are now carrying positive real rates while inflation is plateauing. Whenever the US Fed pivots, GEMs will have a lot of room to cut rates. Also, GEM economies have learned from their past and have strengthened their external balances and foreign reserves. They are now in a better position to absorb external shocks.

Similarly, the growth profile of GEMs is superior. China is opening up this year. In India, ongoing investment into infrastructure and manufacturing is supporting the country's rate of growth. Technology companies in Korea and Taiwan have already gone through a deep inventory destocking cycle which is expected to normalise going forward. Meanwhile, valuations in GEMs are much more reasonable and the GEMs index is trading at a discount to the DMs index, that's close to the highest in 20 years. So overall, whether you consider fundamentals, quality of underlying assets, or valuations, GEMs are in better shape, more resilient, and more attractively valued than in the past.'

What are the biggest risks in emerging markets?
'The biggest risks include US recession, higher rates and inflation, and geopolitics. These risks are well understood today and

'Our high discount rate and corporate governance concerns in Russia meant we were underweight in Russia before the conflict with Ukraine started.'

PHOTO: SHUTTERSTOCK

> ‘We firmly believe global emerging markets are well-placed to provide superior returns in the medium to long term.’

are largely priced into the valuations. So, while the environment remains volatile, we think we are building most of these into the price.’

How has China’s reopening impacted emerging markets?

‘Chinese consumers saved a lot during lockdowns. After the initial rebound, we see that the reopening is leading to a gradual return of consumption. This should be positive for other parts of the emerging markets as well.’

To what extent are emerging market countries well equipped to manage inflationary pressures?

‘Historically, emerging markets have lived through an environment of relatively higher inflation and interest rates and they seem to have learned from their past. While being a very heterogenous market, one trend that we see is that, across GEMs, economies are carrying positive real rates at a time when inflation is plateauing. This means whenever the Fed pivots these countries have a lot of space to cut rates.

Also, because these economies are used to higher inflation and interest rates, most countries have the transmission mechanisms, such as higher wage growth et cetera, such that they do not face a standard-of-living crisis like in DMs.’

What impact does geopolitics have on investment opportunities in emerging markets?

‘Growing geopolitical issues are as much a concern for emerging markets as they are for developed markets, and these are increasingly impacting investor confidence.

While we are bottom-up investors, we do assign a higher discount rate for countries where we believe risks are higher. For instance, our high discount rate and corporate governance concerns in Russia meant we were underweight in Russia before the conflict with Ukraine started and this helped our fund’s relative performance in 2022. Similarly, in China we are very mindful of the increased risks from China-US issues as well as regulatory surprises.’

To what extent is the trend of deglobalisation affecting investment opportunities in emerging markets?

‘Restriction of free trade may lead to higher production costs, which is inflationary in nature, but it is tough to base our investment decisions on such macro trends. We will stick to our strength, which is company research, and build our portfolio bottom-up.’

Which emerging markets offer the biggest growth opportunities?

‘We remain focused on high quality sustainable businesses operating in areas benefiting from structural growth or improving industry structures that are available at a reasonable price. From this perspective we are finding opportunities in domestic businesses in China, that are benefiting from the growth of the upper-middle class buying high-end consumption goods. In India, we are focusing on growth from financial inclusion with our positions in best quality private sector banks and discretionary companies benefiting from the growth in middle class buying products, such as automobiles and consumer electronics, and services, such as mortgages, loans, and credit cards. Outside Asia, we own very specific businesses, such as the monopoly stock exchange company in Brazil, where equity investments should recover over medium term as interest rates reduce from current levels. In Mexico, we own a leading airports operator and a bank, which benefit from near-sourcing and a shift in global supply chains.’ ■

Amit Goel

Portfolio Manager,
Fidelity International

SUMMARY

Global emerging markets are expected to provide superior returns over the medium-to-long term.

The biggest risks for emerging markets include US recession, higher rates and inflation, and geopolitics.

Global emerging markets are carrying positive real rates at a time when inflation is plateauing.

China, India, Mexico and Brazil offer interesting growth opportunities.

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