EMERGING MARKET EQUITIES - OPPORTUNITIES AND CHALLENGES

Mohammed Zaidi of Principal Global Investors talks about the opportunities and challenges in emerging market equities

"If you are looking to invest in style, what's worked is value and momentum and large caps have outperformed small caps"

Mohammed Zaidi
Portfolio Manager, Principal Global Equities
Principal Global Investors

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The performance of equities in the emerging markets are interesting because of the dynamics of the different regions. The last quarter has witnessed a sea change in the political and economic environment of countries like India, Indonesia, Thailand and the Philippines and it is expected that those changes will help facilitate international trade, commerce & investment.

The equity markets are sentiment driven and are quick to factor in expectations and confidence in the economy & the machinery of government. An analysis of the historical performance of equities across the emerging markets should explain the story so far, in numbers.

Year-to-date, the emerging markets are almost flat with 0.2% growth however, when we dissect the performance of the markets and look at the performance from quarter to quarter, we realise that there was about 4% growth in the last quarter.

The Asian markets have grown about 6% while the Latin American markets have grown 4%. The Indian, Indonesian, Thai and Filipino markets are up at least

20% this year. Zaidi observes that the key theme across the Asian markets is political change and reform that is expected to lead to a new investment cycle.

The good news first

India, for example, has a political system that elects governments for a tenure of 5 years at a time. The Congress was in office for two consecutive tenors. The first was very positive and promised growth and saw a lot of investments, the second saw it all fall apart with corruption scandals and regulatory red tape that stagnated business and caused the return on investments to plummet.

"Now, it's about reform and focusing on the way change is taking place because it can't go on the way it is"

This year, the BJP was elected to run the government for the next 5 years which has promised structural reforms and removal of regulatory bottle-necks in business. With Modi leading the country, these reforms might see the light of day very soon given his prior experience leading the state of Gujarat in India to success.

The story is similar in Indonesia, says Zaidi, with Joko Widodo being elected as president who has promised structural reforms, lowering of subsidies and investment in infrastructure & industry. An example would be the government's intention to install 5 Giga-Watts of power every year for the next five years which requires roughly US$10 billion of investment each year.

Markets in Thailand and the Philippines are also picking up. The former's army staged a controversial coup d'état, and now the military government is helping revive the economy under the leadership of Prayuth Chan-ocha. The latter doesn't have a fascinating story but the economy is attractive and investments are picking up. The property markets in both countries look promising.

There is sufficient evidence that the growth in these markets will sustain for a while because they're in the early stages of accepting investments. A lot more investment is yet to come whose quantum will be based on how efficiently they can employ the funds they have and generate returns for investors.

Brewing trouble in China, Korea

On second thought, however, it doesn't add up. If countries like India & Indonesia grew over 20%, we must wonder what caused the growth in Asia to fall to a cumulative average of 6%. Zaidi says that this is because of the growth figures contributed by two of the largest markets in Asia. The Chinese equity market is up only 1.4% and the Korean markets are down 3%.

It is reasonable for people to wonder what the story with China & Korea is and if there is hope to turn them around in the next few years. Simply put, Zaidi believes that the concerns with those economies are already being tackled by their governments and the efforts seem to be paying off.

China, for example has plenty of savings & capital and most importantly, has a government that is committed to not letting the country & the financial system fail. A fresh round of "Mini-stimulus measures" were announced in August and measures are being taken to support the property market. The results aren't captured in the equity markets as yet because confidence is still not very high, but Zaidi believes there is no macroeconomic risk in the region.

Korea is already in the red and the government is taking vigorous action to help the country. Zaidi sees their commitment to fiscal & monetary stimulus as a favourable move as also their attempts to kick-start the property market with more funding. State Owned Enterprises are also being reformed and some early signs of success on that front come from KEPCO which has finally started making money because of tariff increases and rebalancing their fuel-mix.

Zaidi's advice to people looking to invest in Asia is to stick to large-cap stocks which have historically outperformed small-cap stocks. There is growth in the markets, and there are reforms that are striving to replace the old-way of doing things. The structural themes underlying those will continue for the next few years, which will benefit investors and an Asian exposure is expected to positively impact their portfolios.