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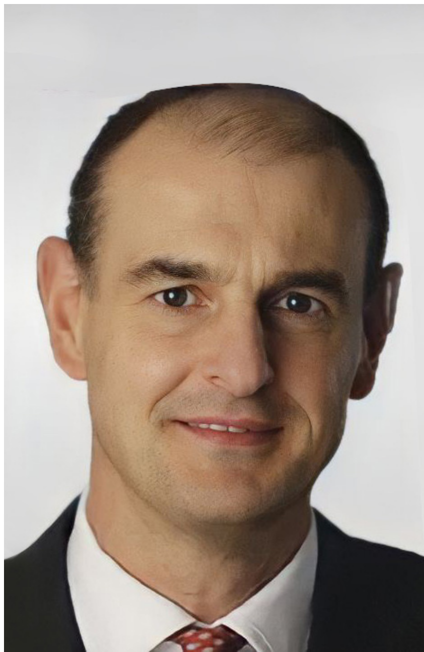
Is the emerging equities investment opportunity returning?



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The last EM bull market was 2003 to 2008. Is history set to repeat itself, and why and when?

The reason that I would suggest the answer is positive is that history tends to rhyme, rather than specifically repeat itself. There are a lot of nuances this time around, which are different from last, but the scene is set for a very, very material uplift on emerging market equities.

I say that because of various features, the most obvious one being valuations. Valuations are now back to where they were in the foothills of the two, sorry, of the 2003 period before its exceptional performance up to 2008. That was after it had already gone through Asian crisis and SARS, not dissimilar from what's going on at the moment with regard to a whole decade of financial repression followed by, in this case, COVID and then an oil shock.

So emerging markets being perceived, and perception is now in terms of reality being perceived as a higher risk asset class, which I would argue it's much more materially less so than last time, has come back to levels of valuations, which are akin to that if even lower than they were post the GFC, the Great Financial Crisis.

So, valuation starting point extremely attractive together with their earnings. Their earnings have changed in composition. They are much more modern. They're much more resilient. They're much more global-facing than domestic demand-facing, and they dominate in areas of centers of excellence on a global basis, many of the modern industries of tomorrow, including that of EVs, robotics, and many would say AI as well, in addition to semiconductors.

This is a fundamental change. It is no longer those marginal emerging markets in the past. These are core semi-developed world place, Korea, Taiwan, India, China. Already you're up to 75%. If you were to put on the EV chain on top of that, which are the green material chain, it would be platina in South Africa, lithium's in both China and in Chile, and then into rare earths in Malaysia. These, together with the domestic demand drivers of

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Southeast Asia/India and China, make up emerging markets of the future.

That is a different composition to what was there 10 years ago. So, valuations, composition of the index and the resiliency of those earnings make up a second point. The rest all relate towards its credit worthiness. There are eight investment grades this time around, there were only four last time round. On top of which the credit worthiness of the companies has enhanced itself tremendously and you've seen that through, as an example, net debt to EBITDA falls from three and a half down to one, and the Altman Z-scores going materially higher. In addition to which you've seen the currencies, which are not investment-grade, South Africa and Brazil, already having fallen 80%.

So how much more downside is there at this juncture, your valuations, your credit, your sovereign composition of your credit grades, and on top of which your ESG adoption materially higher governance in the G of the ESG together with, of course, the liquidity courtesy of the index change? These factors make it an under loved, underowned and undervalued asset class, again, very similar to the takeoff point in 2003, post an equally disastrous derating of the asset class during the Asian crisis and SARS. It's very much rhyming to my mind.

The headwinds in EM equities, China zero COVID, the war in Ukraine, the strong dollar accompanied by tightening, which of these headwinds will stop and be a catalyst for renewed growth? When and why?

There are many reasons why that a list of positives I've just gone through will be catalyzed into coming into reality, and the most obvious one being the perception or the reality of the peaking of the dollar in the next six months.

A lot of the negatives that you've seen on geopolitics, together with a lot of the positives on why the positive carry of US has been so unbelievably pro-dollar, are pretty much in the price. They are, by far, the preferential destination for many of those traders looking for a positive carry trade. The country with the ability to be independent on food and on oil, the country with the credibility needs to be replenished after a decade of negative financial repression and so, by definition, everybody, especially with a backdrop of poor risk-off with regard to geopolitics, has obviously gone for the country with the highest growth differential, with the highest interest differential, with the greatest need to restore the credibility.

That's the Fed. That is US. So, the US dollar has had a disproportionate tailwind. It's resulted in a real effective exchange rate on the dollar going to a 20-year high. That would've been the disaster of emerging markets in the last cycle. This cycle, because we've had much, much higher investment grades, much tighter credit, it's been one which has hurt, but not killed. It's compressed multiples in emerging markets so it is in a position where it will be tremendously uplifted like a coil spring at the right juncture. That juncture will be catalyzed by a dollar peak. I suggest the chances of that and the probability of that in the next six months is very high. That would be the prime catalyst.

The second catalyst would be the counter-cyclical ability of the biggest country in emerging markets, namely China, to stimulate their own economy. As it would happen, you have not only the National Party Congress, but the 20th also coming up in the context of October 16th in one month's time. When, and as that happens, the chances of Xi being reelected and then blessing the national council for stabilization to initiate movements, whether it be through multiplier effects of the property market, or indeed the infrastructure, or indeed select manufacturing. Any of those would do in terms of generating multiplier effects on the positive side for China, Inc. That would be countercyclical and tremendously positive.

Put the two factors together, coming out of COVID with those stimulus measures, at the same time as a dollar peaking, and you can see that you are on the other side of the mountain skiing down, rather than climbing up. When that happens, that's your catalyst, in short.

How is ESG is a factor to manage assets? How's that evolved in recent years, especially over COVID, and how has it enabled you to improve portfolio outcomes?

ESG. Well, it's a nomenclature, which incorporates the G, the G is the governance. Governance has been a core of our whole philosophy for over 25 years.

If you have the philosophy of trying to regress high-quality stocks and buy them when they're cheap in accordance with their own history, the key is to find out whether or not there's longevity, there's procedure, there's audit. There are components on the governance and non-exec board checking the exec at all junctures to actually qualify as a high-quality stock in the first place.

So, for 25 years, we've been identifying high-quality stocks, high-governance stocks, especially on the audit side, to

reduce the probability of corruption and fraud. That is a real problem in emerging markets. So, by definition, embedded in our philosophy and our process is the need to have high governance, high quality.

In addition to which, to answer your question directly, has it been enhanced of late and has it helped? Yes. Whether you have sustainability or whether you have environmental overlays, which have become much more forensically useful for us because they have finally been able to have been screened on scope one, scope two and, in some cases, scope three, to give you a science-based analysis to actually do exactly the same analysis that you do on the governance, but on the environmental side, as an example. So, by definition, doing that allows you to avoid those poor equality environmental stocks and those poor equality placements, which can in many cases lead towards corruption of their own.

So, in the environmental side, or whether it's on the governance side, there are ways to enhance, but also to avoid having errors, in addition to which the sustainability side is only for the good. To have diversity in a workplace, as an example, to reflect your customer base is tremendous for idea generation as one. So, by definition, E, S and G either enhance, or they stop you making a mistake you would otherwise make. So yes, we've embraced totally. We have a single A on the main fund and a double A on our sustainable fund and we think it's a tremendous force for good.

Overall, how do you see the growth opportunity in the Middle East as part of your portfolio allocation over the next few years?

We see an awful lot of FDI flow coming into this region. We see an ever-increasing GDP per capita within the region. And we see, most importantly, the opportunity for the consistency of earnings to be enhanced throughout the cycle.

As you've got lesser sovereign concerns, courtesy of much better-run reserve degrees, it has enhanced the risk-return quadrant within the Middle East on a relative basis to other areas tremendously. That's been reflected and found in stock valuations, which has resulted in the whole Middle East as itself in the MSCI emerging markets now been bigger than the whole of Latin America. That was not the case 10 years ago. It was a poor cousin. So, by definition, Latin America is down two sub-six as a whole, and here we have banging on the door of nine, eight and a half, which is a heck of an increase. That's courtesy of all those factors.

In addition to which the composition of the index here is become much more diversified. It's what the Russians try to do for many a decade, to diversify away from hydrocarbons into a multifaceted economy. They have succeeded here, and they will continue to in the case of Saudi with the NEOM project, as an example.

So where would we be investing money? We have a huge amount of allocation towards four or five at the core banks, which we think are repetitive, alpha-generative, well-run opportunity sets. They're a little bit ahead of themselves at the moment, but whether it's Al Rajhi Bank, whether it's Al Qatar National Bank or whether it's Emirates, they're all fantastically high quality so there's no reason at all why these banks shouldn't be bought.

Within the context of the cycle, EMEA and ALDA is still perhaps a bit elevated to their historic levels, but they are, as always, very good examples of good execution with an acceptable balance sheet and very attractive yields.

In addition to which the broader to the diversification point is coming through on a whole host of industrial plays, not only in Riyadh, but also in UAE, Tabreed being one. So, by definition, there's a diversification of opportunities, there's a higher quality of the sovereign and the credit, there's a deeper liquidity, which is always a problem historically, which is reducing, and a current account surplus with an FDI gives you currency support. So, what's not to like? ■

About the Interviewer

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