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Investment Insights
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Emerging markets: where do we go from here?

FOR PROFESSIONAL INVESTORS ONLY

Emerging markets: where do we go from here?

It has been a difficult few years for emerging markets. Having been beset by challenges – from a potential rise in US interest rates to low commodity prices and slower economic growth – many investors are asking where we go from here. While the asset class faces headwinds, the long-term case is strong and intact: it remains a broad and diverse universe, currently at a potentially attractive entry point for long-term investors in both equities and bonds.

The first decade of this century proved a strong period for emerging market equity investors, as the annualised 10-year return from the MSCI Emerging Markets Index reached 15.9%, versus 2.3% achieved by developed market equities.[1] Then, as the global economy emerged from the Global Financial Crisis, emerging markets (EM) such as China, India and Brazil remained important engines of global growth. Meanwhile, emerging debt markets expanded, and local currency and US-dollar denominated bonds became a source of strong investment returns.

In recent years, a mix of cyclical, structural and political challenges has led sentiment to change. The International Monetary Fund (IMF) has now forecast that 2015 will be the fifth successive year in which economic growth will slow in EM, with Brazil and Russia expected to contract. EM equities have lagged developed markets over the past five years and, in 2015, the relative strength of the US dollar against most other currencies has contributed to negative returns for US dollar-based investors.

While some investors have withdrawn from EM, on balance, we believe that the long-term growth story for the asset class has not changed. Some of the world's faster-growing economies are emerging markets. International trade, structural reform and productivity improvements offer scope for corporate earnings growth, while the high real yields available from certain EM debt issuers are attractive in the search for income.

In a diverse universe made up of more than 60 countries at different stages of maturity, opportunities abound for long-term investors. Understanding what differentiates markets and drives valuations of different assets is likely to be the key that underpins investment returns for selective investors in the future, particularly in a lower-growth environment.

1. 2000 – 2010 Annualised 10-year return of the MSCI Emerging Markets Index versus MSCI World in US dollar terms with net dividends reinvested: 15.9% vs. 2.3%. As at 31 December 2010. Source: MSCI

Emerging markets: recognising challenges

A mix of cyclical, structural and political challenges help explain the downward trends in EM in recent years. In particular:

- **The global economy is fragile** in the aftermath of the Global Financial Crisis; deleveraging is taking place in some markets.

- There are concerns over the eventual **tightening of global financial conditions**, and, in particular, rapidly rising interest rates in the US. Higher US interest rates could be detrimental for countries with large current account deficits and reliance on foreign capital flows, such as Turkey. The prospect of rising US interest rates has contributed to US dollar strength and precipitated EM capital outflows; we recognise that there is potential for further disappointment if the pathway for US interest rates is more aggressive than forward market expectations imply.

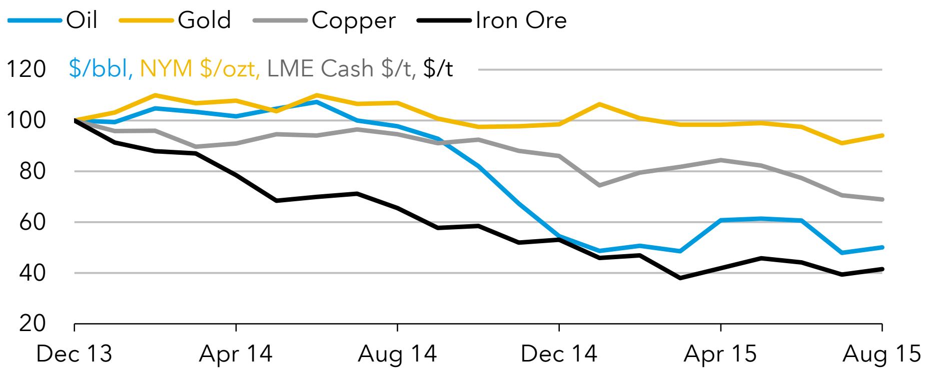
- **China is experiencing a structural slowdown**. China has entered a slower growth phase as it attempts the difficult transition to a less export-intensive, more consumption-oriented model. The IMF forecasts that annual GDP growth will average 6% over the next five years, versus approximately 2% forecast for developed markets over the same period.[2] Leverage is high in certain sectors, including local authorities and corporates.

- **Excess capacity in commodity markets** is placing downward pressure on pricing (see Exhibit 1, below). Falling prices can mean lower current account surpluses or higher current account deficits for producers, placing pressure on exchange rates. Oil exporters such as Russia and Venezuela have had to reduce fiscal expenditure to meet budget targets. As the global outlook is uncertain, it is possible that commodities could suffer further price falls.

Higher US interest rates could be detrimental for countries with large current account deficits and reliance on foreign capital flows.

Exhibit 1: Commodity prices have weakened

Core commodity price trends from 2014



Data as at 30 June 2015. 'Oil' = WTI price ($/bbl); 'Gold' = NY price (NYM $/ozt); 'Copper' = copper price (LME Cash $/t); 'Iron ore' = CRB Iron Ore 62% FE CFR China price ($/t). Prices are rebased to 100 starting at 31 December 2013. Source: FactSet

2. IMF average annual growth forecast for China and developed markets to 2020. Source: World Economic Outlook, IMF 2015

Emerging markets: recognising challenges

- **Attempts to implement structural reform have stalled**. Some EMs failed to make productivity-enhancing structural reforms after the Global Financial Crisis as the world became awash with liquidity.

  As economic conditions have become more testing, it has become more difficult to reach political consensus on reform. In Brazil, for example, the governing multi-party coalition has faced union opposition for its plans to reduce the size of the public sector.

- **There is political turmoil /regional instability** affecting some emerging and frontier markets, particularly with the intensification of conflict in the Middle East.

- A sustained period of **US dollar strength versus local currencies** has undermined returns from EM assets. The Turkish lira, South African rand, Mexican peso, Brazilian real, Colombian peso and Russian rouble all fell to multi-year lows against the US dollar in 2015.

- Cumulative EM equity returns have been positive over the past five years in local currency terms, but US dollar returns have been negative.[3]

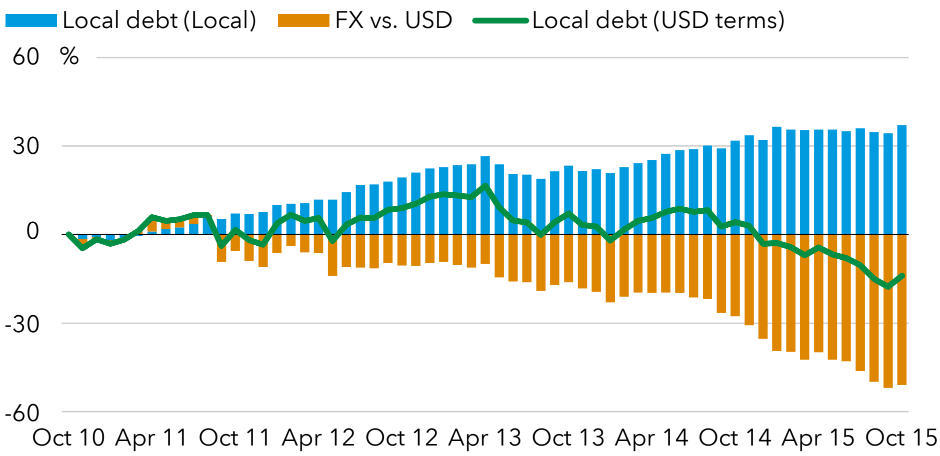
- Similarly, cumulative returns from the EM sovereign debt issuers in the JPMorgan GBI-EM Global Diversified Total Return index have been positive in local currency terms since 2010, yet negative in US dollar terms (see Exhibit 2, below).

The Turkish lira, South African rand, Mexican peso, Brazilian real, Colombian peso and Russian rouble all fell to multi-year lows against the US dollar in 2015.

Exhibit 2: US dollar strength has undermined local currency returns

Cumulative results from EM local currency sovereign debt (%)

JPMorgan GBI-EM Global Diversified Total Return index



Data as at 31 October 2015. Source: JPMorgan

3. As at January 2015. Emerging Markets Foreign Exchange (EMFX) valuation & US Federal Reserve hiking cycles. Calculations based on Purchasing Power Parity (PPP). Source: Deutsche Bank

Emerging markets: finding opportunities

Cumulative returns from emerging market equities outstripped the MSCI World index in three out of four Fed tightening cycles since 1988, reflecting the positive impact of a strengthening US economy.

Despite current challenges, we see opportunities for selective investors. We note the following:

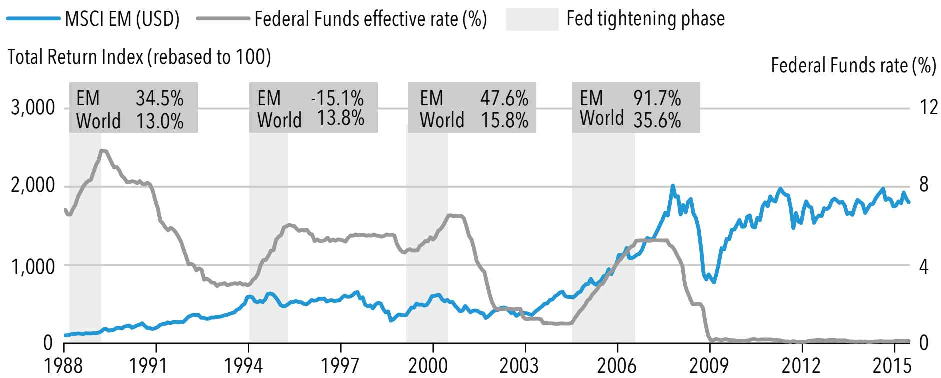
- **Economic momentum is building in the US**. The end of US quantitative easing and gradual increase in interest rates is a sign of normalisation. Although a faster-than-expected increase in US interest rates could be detrimental to some EMs, we believe that the US Federal Reserve is likely to take a gradual path, given the fragility of the global recovery.

Assuming that rising US interest rates will be negative for EMs is perhaps misleading: cumulative returns from EM equities outstripped the MSCI World index in three out of four Fed tightening cycles since 1988, reflecting the positive impact of a strengthening US economy (see Exhibit 3 below).

Exhibit 3: Past tightening episodes from the US Federal Reserve and their impact on EM equities

Cumulative returns from EM equities have risen faster than developed market equities in the majority of Fed tightening cycles since 1988

Cumulative returns from EM equities in relation to changes to the US Federal Funds effective rate



Federal Reserve tightening phases highlighted in grey relate to the increases in the Federal Funds effective rate occurring in March 1988-March 1989; December 1993-April 1995; January 1999-July 2000; and May 2004-August 2006. EM equities lagged in the second phase shown on the chart when the rate rise was largely unexpected. Cumulative returns are expressed as % in US dollar terms. As at 30 June 2015. Sources: Thomson Reuters Datastream, Capital Group

- **Fears about slower growth in China may be overstated**. It was inevitable that the 10% average growth rates of the past three decades would wane as China's economy matures, but that does not mean that the country will no longer help drive global growth. We believe that President Xi is committed to maintaining economic momentum and there is scope to reduce interest rates further with limited downside risk to the currency.

- **Lower commodity prices are not uniformly bad for EMs**. There are potential benefits for net commodity importers, such as India, China, South Korea and Taiwan, including reductions in current account deficits, reduced fiscal pressures and/or the potential for easier monetary policy. Lower prices have allowed some net energy importers to reduce energy subsidies, allowing new-found revenue to be used in more productive ways.

- **Success with structural reform has varied.** Reform is key to unlocking faster growth, and there has been progress in India, Indonesia, China and Mexico, among others.

In India, weaker energy prices have allowed Prime Minister Narendra Modi's BJP-led government to remove a costly diesel subsidy, without significantly impacting consumers, while helping to fund an extensive road-building scheme. Indonesia has also made progress with deregulation and plans to accelerate infrastructure development projects.

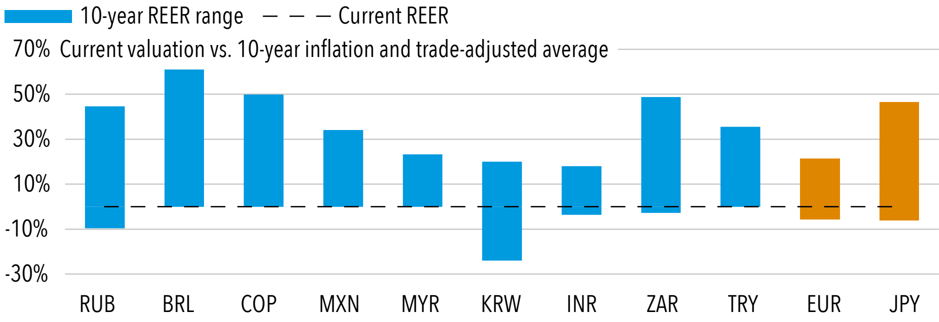
Emerging markets: finding opportunities

Valuations of EM currencies, EM debt and EM equities all look attractive relative to longer-term history.

Exhibit 4: A number of EM currencies are trading towards the bottom of their historical ranges relative to the US dollar

In our view, EM currencies might be expected to be at the forefront of any rally in EM assets

Current Real Effective Exchange Rates (REER) within 10-year range

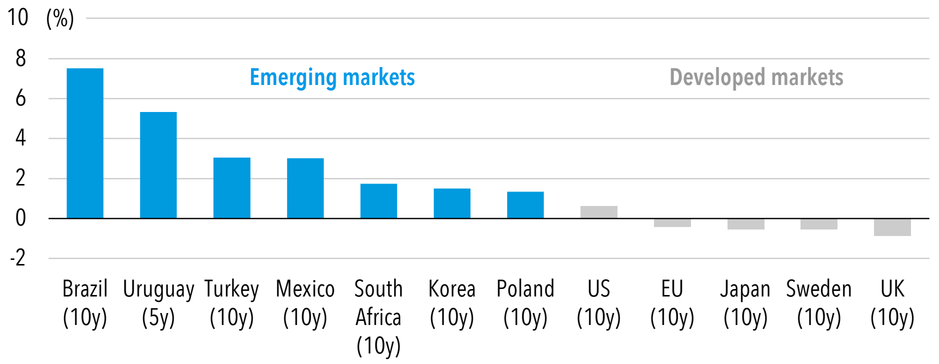


Real Effective Exchange Rate (REER): Weighted average of a country's currency relative to an index or basket of other major currencies adjusted for inflation. Weights are determined by the respective trade shares of each currency in the index with each other. Currencies are the Russian rouble (RUB), Brazilian real (BRL), Colombian peso (COP), Mexican peso (MXN), Malaysian ringgit (MYR), Korean won (KRW), Indian rupee (INR), South African rand (ZAR), Turkish lira (TRY), euro (EUR), Japanese yen (JPY). As at 30 June 2015. Source: Deutsche Bank

Exhibit 5: EM debt valuations have adjusted and now look cheap relative to historical ranges and relative to other asset classes

Real yields from EM sovereign issuers are significantly higher than those available from developed markets

Real yields of select 10-year sovereign bonds

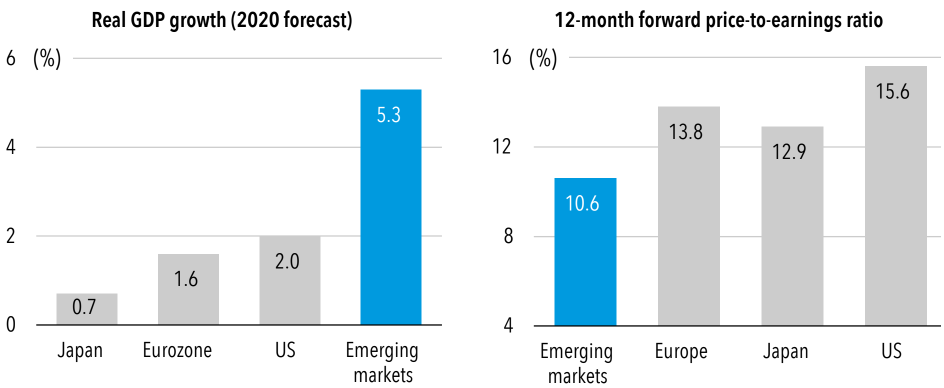


Real yields represent the yield on 10-year local currency government bonds, with the exception of Uruguay (5-year). 'EU' represents 10-year German government bond.
As at 30 September 2015. Source: Bloomberg

Exhibit 6: EM equity valuations are at a discount to developed markets and look attractive given growth prospects

EM growth is expected to outpace developed markets yet EM equities are trading at a discount to developed markets

Forecast GDP growth rates and equity market valuations



Price-to-forward earnings calculated using the FY1 estimate. As at 30 September 2015.
Source: MSCI

Summary

- Economic growth in EM is expected to remain higher than that in developed markets, albeit the differential has narrowed.
- EM currencies have fallen to multi-year lows versus the US dollar; EM currencies might be expected to be at the forefront of any rally in EM assets.
- EMs give access to higher real bond yields than developed markets.
- EM equity market valuations are potentially attractive; valuations are currently at a significant discount to developed markets.
- Understanding what differentiates markets and drives valuations of different assets is likely to be the key that underpins investment returns for selective investors in the future.

Emerging markets: finding opportunities

Most importantly, there are multiple ways to access EM opportunities and manage risk.

- In equities, that may include taking EM risk via developed market assets, or China risk via other EM-listed companies, based on risk-reward trade-offs. For example, it may be more effective to access the growth of digital media and mobile internet services in China via other EM-listed stocks, rather than directly.
- In credit markets, a flexible and selective approach to investing in higher yielding securities is particularly important as the prospect of normalising interest rates in developed western economies has altered credit market dynamics. The diverse EM opportunity set includes some higher risk but potentially higher returning segments, including debt issued in economies that have historically shown a low degree of correlation with the US and the Eurozone.

Capital Group: in emerging markets for the long term

Capital Group is committed to a research-driven approach to investment management and to achieving superior long-term investment results for our clients.

We have substantial investment experience in EM equity, debt and private equity, and were among the pioneers in the asset class when, in 1986, we launched Capital Group Emerging Markets Growth Fund, one of the first of its kind.

We have deep, on-the-ground research resources at our disposal, with 45 EM analysts with an average of 14 years' investment experience.[4] Our research teams work closely together and benefit from the cross-pollination of investment ideas.

Emerging markets offer important diversification benefits for investors, including exposure to economies, sectors and types of business at different stages of growth.

Our strategies can complement existing EM equity and debt strategies, addressing different trade-offs between return and volatility. In particular, we recognise that a diverse universe requires a flexible approach to accessing opportunities and managing risk; on occasion, that may include taking EM risk via developed market assets as well.

While EMs face their own political, economic and fiscal challenges in the near term, our belief in the longer-term positives is unchanged.

4. As at 30 September 2015. Source: Capital Group

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