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## EMERGING MARKETS READYING FOR THE NEXT GREAT RACE



Interview with **Patrick Mange**  
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### **1. Emerging market equities have underperformed developed market equities for more than three years; do you think it will be different in 2015?**

Global emerging market equities' underperformance relative to that of developed markets started in late 2010 and was almost coincidental with a pronounced slowdown in world GDP growth, triggered mainly by the Eurozone debt crisis and a simultaneous slide in commodity prices.

We believe today that global growth, essentially led by the US, will gradually strengthen towards potential in 2015 and beyond. Moreover, while in our view there will be no outright deflation at global, regional or country level, prolonged low inflation is likely to be widespread. And while we do not see global liquidity rising any further, it should remain ample as both Japan and the Eurozone compensate for the end of US-led quantitative easing (QE). Against this background, equities as an asset class should do reasonably well. In fact as long as the world avoids recession, it is hard to imagine a prolonged bear market especially with cash yielding historically little and with earnings growth being positive.

Emerging market equities should outperform relative to their developed counterparts as their valuation discount to the latter is bigger than it should be, in our view. Most emerging markets are today structurally sounder than they were before the Global Financial Crisis, with most of them having, for example, improved

their credit rating. So it is not unreasonable to ask whether the valuation discount for many of them remains justified.

Equally, we do not foresee any meaningful rise in bond yields at a global level. That said, in the short term, bonds should do quite well as risk aversion is likely to remain high during the "cautious" transition phase from "super soft" to "normal" US monetary policy. However, given the current low yield on sovereign bonds and the tight spreads on corporate bonds and credit, the return potential of fixed income assets looks limited to us.

### **2. China, which accounts for the lion's share of emerging market equity market capitalisation, is facing slower growth, and there is no sign that this will change in the coming years. Does this not make you cautious on Chinese and thus emerging market equities?**

The growth slowdown in China is largely being engineered and seems to be well under control. In fact when the new Chinese government set up its ambitious reform programme in November 2013, they clearly understood that its implementation would entail softer growth. After all, you can't have all your turbines running at full tilt while you reallocate resources from low to higher value-added sectors at the same time as; a) engineering a transition to a more market-oriented growth model; b) reshaping the fiscal landscape and; c) progressively opening the capital account. We have no doubt that these reforms, which are generally on schedule, will have a very positive long-lasting impact on





Chinese government spending, financial stability and economic sustainability. One should also take into account that, at around 7% YoY, Chinese GDP growth is close to if not actually at its current potential. It is also contributing proportionately more to world growth than it was ten years ago when it was growing at more than 10% annually in real terms.

There is thus no reason to be pessimistic on Chinese equities, although as for all other equity markets they will never move up linearly. Moreover, should growth show signs of slowing too much below expectations, i.e. the targeted growth rate, the government would certainly continue to accompany “targeted stimulus measures” with broader action, in the form of a reduction in benchmark interest rates possibly combined with renewed fiscal stimulus.

Also worth mentioning are a savings rate of 40% and foreign-exchange reserves totalling USD 4 trillion, which give the Chinese government the financial firepower to counter most growth or financial stability problems such as the slowdown in real estate and the correlated increase in non-performing loans.

### **3. Besides the growth scares, investors worry that the tightening in Fed monetary policy likely in 2015 will lead to an underperformance of emerging versus developed markets equities. What is your take on this?**

We think that rate tightening by the US Federal Reserve (the Fed), which is indeed expected to be initiated around the middle of 2015, will ultimately prove positive for equities in general, since it should raise confidence in more sustainable economic growth and profits.

As regards emerging markets equities, we see the context in which the upcoming Fed tightening cycle next year will take place as being much more akin to that which prevailed in 2004 – during which emerging markets equities posted positive performances and outperformed their developed counterparts – than to that of 1994, when developed markets equities outdid their emerging markets peers.

We base this assessment on the view that, unlike in 1994 but similarly to what happened in 2004, market participants will this time not be caught by surprise by a Fed that seems more cautious than ever before in preparing the market for monetary policy changes. The route paving the way to an end of QE in October began many months earlier. It is also clear that the move towards higher US central bank rates, likely next year, will be very cautiously engineered by a Fed seeking to avoid any asymmetric risk to the markets or the economy.

Secondly, again unlike in 1994, when the Fed acted pre-emptively on “overheating risks”, there is nothing that hints at a strong inflation risk in the foreseeable future, as was the case in 2004. In fact the contrast could hardly be greater: softer commodity prices and more disciplined monetary policies across most of the world suggest greater pressures on prices. Aside any exogenous disruption, broad-based non-inflationary growth therefore looks to be the most likely scenario in the months and years ahead. The IMF is forecasting global real GDP annual growth at about 4% and US real annual GDP growth of around 3% from 2015 to 2017, when the Fed may start to think about tightening the monetary reins. By then, the Fed will have enough room to act at a “measured pace” since it will take a few years to close the still-wide “output gap”. Against such a backdrop, a sharp rise in fed fund rates and yields, which the Federal Open Market Committee (FOMC) in any case wants to maintain low, does not seem plausible.

Thirdly and more importantly, market valuations, while somewhat richer than in 2004 are far less stretched than in 1994. The average emerging markets P/E ratio currently stands at around 11x compared to around 15x for developed markets (and 16x in the US). Incidentally, as in 2004 (but not in 1994), the average emerging markets P/E ratio is below that of developed markets, which hints at the potential for outperformance of EM equities versus their developed peers. Since however many emerging economies are going through structural reforms, which will pay off in the long run but act as a drag on growth somewhat in the short to medium term, their equity outperformance against developed markets should be more muted than in 2004.

### **4. The emerging market universe is wide. Do you believe all emerging markets move in parallel so that they can be seen as a unified asset class or would you recommend following a more granular approach based on different markets, local influences and sector-specific pressures, whereby one market might succeed while another struggles?**

Once financial markets see the Fed start its policy tightening cycle and thus discount the higher cost of money, there will be initial selling pressures on all equity markets, emerging and developed, without any distinction. We saw such behaviour not long ago, before the official end of QE3 in the US. For the reasons highlighted earlier, any such consolidation should be taken as an opportunity to reinforce equity positions.

Once this initial risk trade passes by, we would discriminate between markets. In the context of Fed rate tightening and thus generally a stronger US dollar and weaker commodity prices, we would privilege those markets among the emerging economies that





have no or only small external funding needs, that are users rather than producers of commodities, whose inflation is below target and whose equity values are comparatively cheap.

The logic here is simple. A fundamentally justified stronger US dollar generally goes hand in hand with softer commodity prices. The latter is currently exacerbated by lower demand from China, which is gradually reallocating resources to less commodity-dependent industries. This redistributes profits from net exporters of commodities, which face a negative terms-of-trade shock, to net commodity importers, which see their input costs soften. Countries that subsidise oil, like India and Indonesia notably, also benefit from the drop in oil price, since this improves their fiscal situation and thus provides more fiscal policy leeway. A stronger US dollar moreover leads to an increase in the funding needs of countries with a current account deficit, very often reflected in higher rates. Those countries that have a narrowing and small current account deficit and inflation under control or being “seriously” tackled have more flexibility on monetary policy and will thus see their equities markets behave comparatively better than those with sticky inflation and wide current account deficits.

#### **5. So which regions and markets would you then privilege?**

Not surprisingly, most economies fulfilling all or most of these criteria are in Asia – which is generally a continent of manufacturers – as opposed to Latin America, which is largely a continent of commodity producers.

Among Asian markets we like China, which fulfils all of the above criteria and is currently very underweight in portfolios. Taiwan, although not outright cheap, still has supportive valuations and a high beta to growth in the US. The latter is true for South Korea too, but the substantial depreciation of the Japanese yen remains a drag on its exports, so we prefer to wait a little longer before jumping in. Though starting to look a little expensive, we also like India, which appears to be picking up speed in terms of reforms and seeing improvements in its external balances and inflation levels. Indonesia has stickier inflation and a stubborn current account deficit as well as not being as well set up for exports. Indonesia’s reform programme is promising, but we prefer, for now, to adopt a wait-and-see position on that market, too.

In Latin America, Mexico is our preference, since its economy is heavily geared to US growth and the country has one of the most positive structural reform stories among emerging markets. Nonetheless, Mexico as a net exporter of oil and other commodities is likely to experience a negative terms-of-trade shock. Mexico

is also currently one of the most expensive markets in the EM universe. Brazil has a lot of potential but probably one of the least compelling growth outlooks, a large current account deficit and above-target inflation. This doesn’t make it a good investment candidate in the short to medium term, although valuations are starting to reflect all of these issues.

In EMEA Turkey stands out, as does to a certain extent, Poland. Turkey will benefit from a huge positive terms of trade effect, and – like Poland – should benefit from likely QE in the Eurozone and its strong trade links with Germany, the most dynamic Eurozone economy. Turkey’s inflation is well above target, however, and a large part of its current account deficit remains funded by short-term money. Poland, on the other hand, has negative inflation and valuations there are not cheap either on its own historical basis or in comparison with its peers.

#### **6. Are emerging markets now yesterday's story or are they in the starting blocks for a new race?**

Emerging markets today are stronger than they were in the past, and they should further strengthen in the years ahead. In fact many of them, notably China, India, Indonesia and Mexico to name but a few, are implementing structural reforms that will have lasting positive effects on the strength and stability of their economies. Others, such as Brazil and Turkey, are still lagging behind. But they too will have to shape up, as EM peer and population pressures increase. Using the analogy suggested in the question one could say that at the start of the decade emerging markets sprinted ahead, but soon lost their breath and fell behind. However, for quite a while now, they are preparing themselves for the next great race, not a sprint this time, but a marathon. Their chances for success look excellent!



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