Few & Selective Opportunities in Emerging Markets (EM)

While in the long term, many EM countries can reform their economic structures to make themselves more attractive to investors, in the short term many face challenges that will make this difficult to achieve. As such, we remain underweight and cautious in general on the EM asset class. However, we do identify a few good opportunities selectively on both the equities and debt fronts.

Since the 2008-09 Great Recession, we have been recommending clients to build portfolios centered in what we considered the "best neighborhood" around, i.e., the USA. During the market's taper tantrum in May 2013, we wrote a piece (EM: Time to be Selective) in which we warned clients that the time of a general bull market in EM was over, mostly because of our negative outlook on commodities. Since then, dollar strength has reigned, making the Fed worry about the impact on US exporters and more importantly, the impact on the rest of the world (ROW). In particular, many EM countries (specifically those with current account deficits) are weakened by capital flows. The Fed is ultimately looking at how the impact of a strong dollar on the ROW and EM might feed-back to the US through the financial markets channel (in particular equity and credit markets).

It can be misleading to generalize about Emerging Markets because the group includes very economically diverse countries. Some are commodity-dependent while others are geared more towards manufactured goods exports. There are also significant differences in corporate governance and economic/financial stability between countries. In this month's Thinking Man, we discuss a few attractive opportunities in different regions, countries, sectors and companies within Emerging Markets.

1. Be Selective by *Region*

In the existing global macro environment we live in, Central and Eastern Europe (CEE) has emerged as the new "safe-haven" region within global EM. While a correlation with the euro is an important basis of this behavior, we believe the low proportion of USD-denominated external debt and the significant deleveraging of recent years are important drivers too. Going forward, we believe there is potential for outperformance in the region due to conventional cyclical reasons as

The Thinking Man's Approach

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For more on how we are positioning our portfolios, please contact your investment advisor or email:

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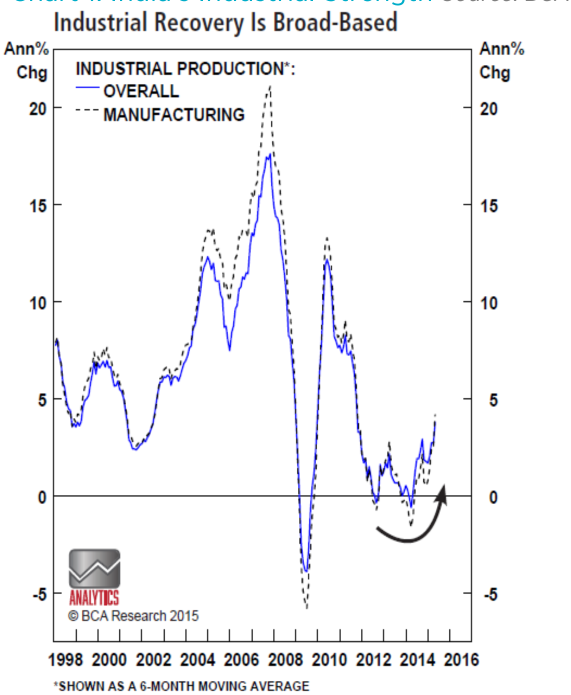
growth is accelerating and pressure for further easing diminishing. CEE will also be supported by tailwinds in the form of ongoing large-scale stimulus in the Euro Zone, its largest trading partner. Asia, on the other hand, faces headwinds, most importantly the fact that the Chinese Yuan remains expensive and over time, further weakness is inevitable. This puts other Asian currencies directly at risk because of these countries' strong trading relationships with China.

2. Be Selective by *Country*

EM countries such as Russia, Brazil, South Africa, Chile and Colombia are more dependent on commodities than others. These countries have fragile growth profiles, as commodity exporters are experiencing sharp deteriorations in their terms of trade and declining currencies, which are creating more significant debt service burdens. Other EM countries benefit from the downturn in commodities, as they are net importers of commodities and also have limited exposure to China (India, Poland and Hungary). Some countries face large current account deficits or domestic asset bubbles which have fueled high domestic inflation, notably Brazil, Turkey, and South Africa. Another vulnerability facing EM countries is high political risk which we are seeing in countries like Russia, Turkey and Brazil and Malaysia.

Chart 1: India's Industrial Strength *Source: BCA*



While many countries face difficult challenges, there are a few bright spots. Take India for example. Fiscal restraint and low commodity prices will foster low inflation, which will allow the central bank to cut rates further. That will help reignite the credit cycle and corporate investment. There are many signs that India's economy is strengthening: overall industrial production and manufacturing output growth are both breaking out, and this shows that economic expansion is broad-based (see above Chart 1). Capital goods imports have recovered briskly of late, a sign which normally precedes higher capital investment. Also, domestic production of capital goods has also revived. Finally, there are budding signs that the number of announced capex projects and industrial investment proposals is stabilizing and turning the corner, albeit from very low levels. Poland is another example of an "EM safe haven," country in Central and Eastern Europe, with improving fundamentals. Poland has shown notable growth and output (GDP growth in 2015 is forecasted at 3.6%, see Chart 2 on next page), a strengthening fiscal position, and low USD denominated debt.

The table on the next page shows a glimpse of the current macroeconomic and fiscal state of the different EM countries, very important factors to study prior to making an investment.

Chart 2: Economic and Fiscal Positions of Emerging Markets Vary Greatly *Source: JPMorgan*

	Real GDP (%oya)				Inflation (%Dec/Dec)			Current account balance (% GDP)			External Debt* (% GDP)		Fiscal balance (% GDP)		
	2014	2015	2016	Potential	2014	2015	2016	2014	2015	2016	2014	2015	2014	2015	2016
Emerging Markets	**4.3**	**3.3**	**4.1**	**4.6**	**4.1**	**4.6**	**4.0**	**1.5**	**1.7**	**1.8**	**23.9**	**26.3**	**-2.1**	**-3.0**	**-2.7**
Emerging Asia	**6.4**	**5.9**	**6.0**	**5.9**	**2.3**	**2.5**	**3.0**	**2.5**	**3.2**	**3.0**	**15.6**	**15.6**	**-1.9**	**-2.1**	**-2.2**
China	7.4	6.9	6.8	6.9	1.5	2.3	2.7	2.1	2.6	2.7	10.1	10.4	-2.1	-2.3	-2.5
Hong Kong	2.5	2.5	3.0	2.8	4.8	2.3	3.4	0.5	0.6	0.2	—	—	1.5	1.0	0.8
India	7.3	7.8	8.0	7.0	5.0	5.3	5.5	-1.3	-0.9	-1.2	22.4	22.9	-4.1	-3.9	-3.6
Indonesia	5.0	4.4	4.0	4.5	8.4	3.1	3.7	-2.8	-1.5	-1.6	29.0	27.9	-2.2	-1.9	-1.9
Korea	3.3	2.6	3.5	3.0	0.8	1.9	2.2	6.3	8.3	6.6	32.0	29.0	0.6	-0.4	-0.2
Malaysia	6.0	4.0	3.3	4.2	2.7	1.1	2.2	4.5	3.3	2.0	17.8	17.4	-3.5	-3.2	-2.8
Philippines	6.1	4.1	5.4	5.1	2.7	1.7	2.4	4.5	5.3	4.9	21.4	20.8	-2.0	-2.0	-2.0
Singapore	2.9	1.9	2.3	2.2	-0.1	0.4	1.2	19.5	14.4	17.2	—	—	5.0	4.8	4.5
Taiwan	3.7	1.3	2.4	2.6	0.6	0.6	1.5	11.1	14.1	14.4	33.7	39.0	-1.6	-1.5	-1.5
Thailand	0.9	2.6	3.8	2.7	0.6	-0.2	2.4	3.5	5.7	4.3	21.2	20.7	-2.8	-2.7	-2.7
EMEA EM	**2.4**	**0.8**	**2.2**	**3.2**	**6.9**	**7.8**	**5.6**	**2.8**	**2.8**	**2.7**	**39.9**	**45.3**	**-0.7**	**-3.4**	**-2.8**
Bulgaria	1.5	1.5	1.2	3.0	-0.9	1.9	1.5	0.1	-0.8	-0.8	94.7	95.0	-3.8	-3.3	-2.8
Croatia	-0.4	0.3	0.9	2.0	-0.5	1.5	1.6	0.6	0.0	-0.2	99.1	104.5	-5.7	-5.2	-4.5
Czech Republic	2.0	4.5	3.4	2.5	0.1	0.8	1.7	0.6	0.6	0.4	60.9	58.8	-2.0	-2.5	-2.4
Egypt	2.1	4.2	3.2	5.0	10.1	11.9	9.8	-1.6	-2.6	-2.6	15.9	16.7	-12.2	-11.4	-9.8
GCC	3.9	3.6	2.9	3.9	2.9	3.2	3.3	13.9	9.4	10.2	31.1	35.1	5.3	-3.0	-2.0
Hungary	3.6	3.0	2.7	2.5	-0.9	2.2	2.4	4.0	5.4	6.3	114.7	105.5	-2.6	-2.4	-2.5
Israel	2.9	2.6	3.0	4.0	-0.2	0.3	1.2	3.9	5.1	4.2	33.1	34.5	-2.7	-3.2	-3.0
Kazakhstan	4.3	0.9	1.5	5.0	7.4	6.4	7.1	2.1	-2.4	-3.0	72.1	81.0	1.7	-3.4	-1.6
Nigeria	6.2	2.7	3.9	6.5	12.0	10.7	10.7	1.6	-1.4	-0.6	1.7	1.8	-1.2	-2.5	-2.9
Poland	3.6	3.6	3.5	3.3	-1.0	0.4	1.5	-1.3	-0.3	-0.8	64.3	64.0	-3.2	-3.0	-2.8
Romania	2.8	3.9	3.5	3.5	0.8	-0.8	1.3	-0.5	-0.2	-0.9	57.3	53.2	-1.5	-1.2	-2.4
Russia	0.6	-3.7	0.5	1.5	11.4	12.2	6.2	3.2	6.2	5.4	32.4	42.1	-0.5	-3.2	-3.0
Serbia	-1.8	-0.2	1.0	3.0	1.7	4.0	4.2	-6.0	-4.2	-4.5	80.0	81.2	-6.6	-4.9	-4.6
South Africa	1.5	1.4	1.3	2.5	5.3	6.0	6.1	-5.4	-4.7	-4.1	41.4	42.3	-3.5	-4.0	-3.3
Turkey	2.9	2.9	2.8	4.0	8.2	8.0	6.7	-5.7	-5.2	-4.7	46.2	51.7	-1.3	-1.3	-1.2
Ukraine	-6.8	-9.7	3.8	4.5	24.9	47.5	24.5	-4.0	0.4	0.2	96.5	149.4	-11.8	-14.4	-5.1
Latin America	**0.9**	**-0.6**	**1.0**	**2.8**	**5.3**	**6.5**	**4.7**	**-2.8**	**-3.6**	**-2.9**	**26.0**	**30.7**	**-4.5**	**-5.0**	**-3.9**
Argentina	0.5	1.4	2.6	3.0	24.0	15.0	25.0	-1.1	-1.4	-1.4	27.6	25.1	-3.0	-4.5	-4.4
Brazil	0.1	-2.8	-1.0	2.2	6.4	9.1	5.5	-4.4	-4.3	-3.5	21.0	27.4	-6.7	-6.1	-4.7
Chile	1.9	2.3	2.6	3.5	4.6	4.7	3.8	-1.1	-0.4	-1.0	52.9	58.3	-2.0	-2.5	-1.9
Colombia	4.6	2.8	2.2	4.4	3.7	5.3	3.4	-5.2	-6.0	-5.1	21.7	28.0	-2.4	-3.2	-2.5
Ecuador	3.8	0.5	0.0	3.0	3.6	4.6	4.0	-0.6	-3.0	-2.0	20.3	21.7	-5.0	-4.0	-4.0
Mexico	2.1	2.2	2.8	2.8	4.1	2.9	3.8	-2.1	-2.5	-2.5	19.5	22.4	-3.2	-3.5	-3.0
Peru	2.4	2.7	3.2	4.2	3.2	4.0	3.5	-4.1	-4.0	-3.7	28.2	31.4	-0.1	-2.0	-1.0
Uruguay	3.3	2.5	3.0	3.5	8.3	8.0	7.5	-4.3	-3.4	-4.1	44.3	51.9	-3.5	-3.3	-3.0
Venezuela	-4.0	-8.0	0.0	3.0	64.7	200.0	90.0	3.0	-6.8	-2.1	54.1	66.1	-5.0	-9.0	-6.0

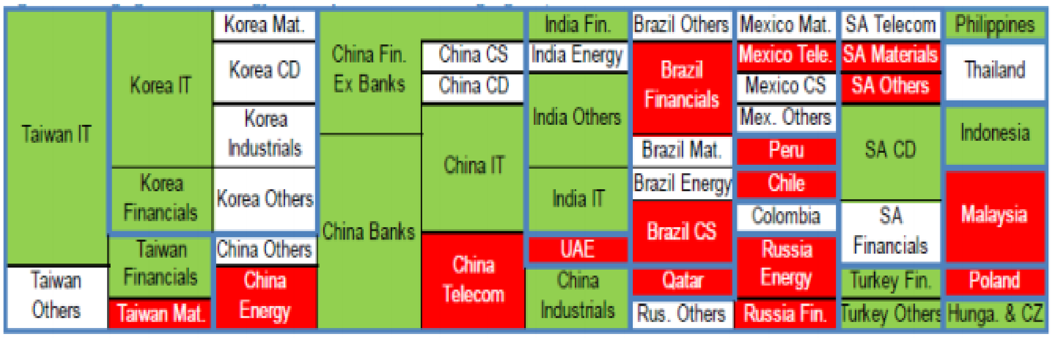
3. Be Selective by Sector

One theme benefitting the Emerging Markets is the rise of the consumer. Economic and corporate growth of the last decade, along with positive demographic dynamics have made Emerging Market consumers the one of the most powerful forces in global demand. Many countries boast a large and powerful middle class, and some, like China, are changing into a consumption economy.

Sectors that benefit from increased consumption in EM are ones we are looking to play. There are a few Exchanged Traded Funds (ETFs) and mutual funds that look to capitalize on this theme, and our Investment Committee is currently evaluating them.

There are also a few sectors that are still doing well even in the "problematic" EM countries. Examples of this include exporters in Brazil, which will not face as many challenges as other industries. Chart 2 below from JPM shows their views on different plays in EM.

Chart 3: Emerging Markets Strategy Heat Map *Source: JPMorgan*



Green: Overweight

White: Neutral

Red: Underweight

4. Be Selective by Company

We're looking for earnings growth in a low growth EM world. For example, we have been analyzing a large Indian consulting and outsourcing company, which is benefitting from a weaker rupee, as it is an exporter of services. Thus, analysts expect a 16% earnings growth for the company over the next year, and with a 2.6% yield and valuation of 19x earnings, we think it's an attractive play.

There are other companies which play the consumer theme, like the Mexican arm of a US based consumer product company. This company sells personal products such as diapers, tissues and toilet paper and a few health care products to Mexican consumers.

Our Investment Committee is screening through companies such as these to find attractive opportunities for our clients. We also have a special focus on EM corporates bonds and equities with strong balance sheets, low USD debt and high growth.

Conclusion

This theme of selection is not new to our investing approach in EM, this has been our philosophy ever since the market's taper tantrum in May 2013. We wrote a piece (EM: Time to be Selective) in which we warned clients that the times of a general bull market in EM was over. We mentioned it was time for investors to be more selective when taking investment decisions, examining both fundamental and technical factors when selecting regions, countries, sectors and companies to invest in. We have stayed with this philosophy over the past 2 years and believe this story continues to play out. Currently, our investment committee is researching and analyzing specific value driven opportunities in EM for our clients.

Four members of the BigSur team and a few of our clients will be going to China on September 25th. We are being hosted by a private equity funds of funds team many of our clients invested in a few months ago. We are meeting with corporate leaders, government officials and private equity managers. We jumped at this unique opportunity to be guided by well-respected and connected locals and be given access to leaders in the real economy. We'll follow-up with this thesis after our trip in China, which will enrich our perspective on the largest Emerging Market economy. Stay tuned!

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