ARTICLE
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Emerging stocks could make a comeback in 2019

Jeroen Blokland, Senior Portfolio Manager, Robeco Investment Solutions

- US rate policy and widening growth gap support EM stocks
- Low valuations from 2018 sell-off are a potential springboard
- Risks though include threat of US recession or China downturn

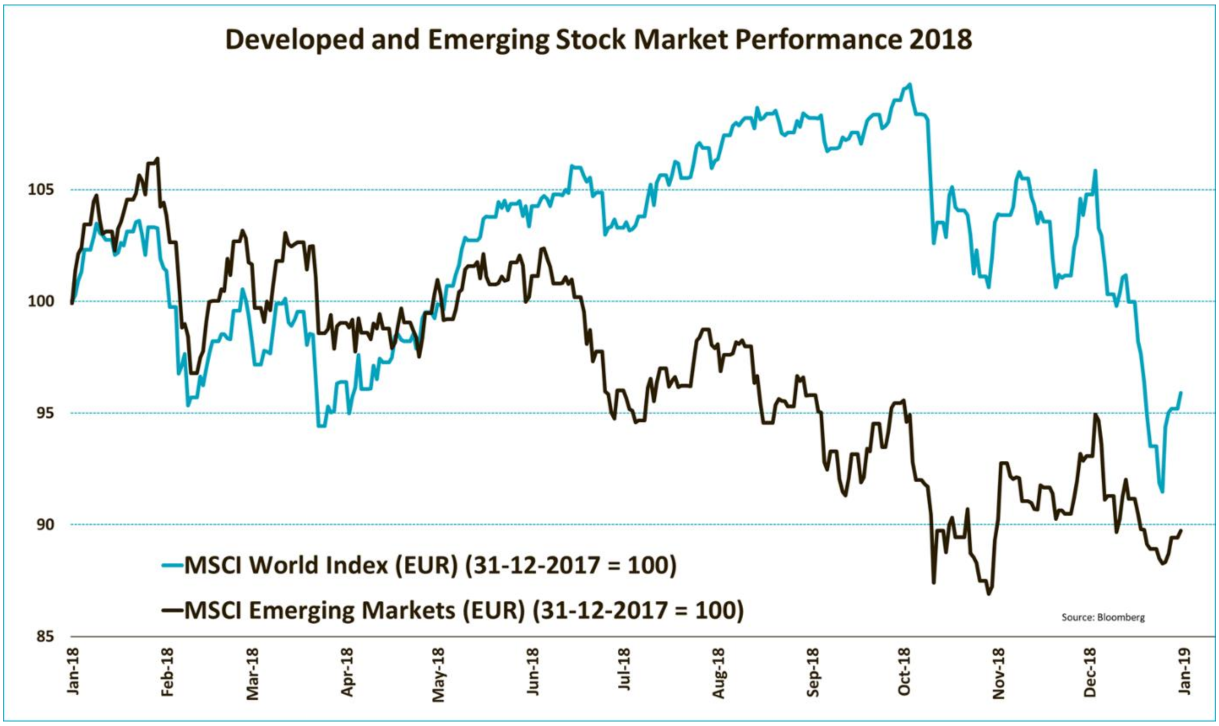
A number of factors bode well for emerging market equities this year, says investor Jeroen Blokland.

A pause in US monetary tightening, a widening gap in GDP growth rates between emerging and developed markets, and stocks trading at cheap valuations could all be positive for the much-maligned asset class.

However, the threat of declining US growth – or even a long-overdue recession – or risks to Chinese growth due to the ongoing trade war continue to pose a threat to an emerging recovery, according to Blokland, Senior Portfolio Manager with Robeco Investment Solutions.

"2018 wasn't a pretty year for equity markets in general, and for emerging markets in particular," he says. "Global stocks fell 4.1% in euros, whereas emerging market equities realized a negative return of more than 10% in euros."

'Gradually, the pieces of the puzzle are falling into place'



Emerging stocks suffered last year. Source: Bloomberg

"But given the recent developments in markets, the odds for a solid emerging market performance from here on are pretty decent. Gradually, the pieces of the puzzle are falling into place."

The Fed at the forefront

The first thing working in their favor is the path of the Fed's monetary tightening. "Contrary to the messages of just a few months ago, the end of, or at least a pause in, US monetary tightening is now on the table," says Blokland. "After a period of three years, during which the Fed has made nine rate hikes, Chairman Jerome Powell has changed direction in his recent speeches to embracing a more neutral policy."

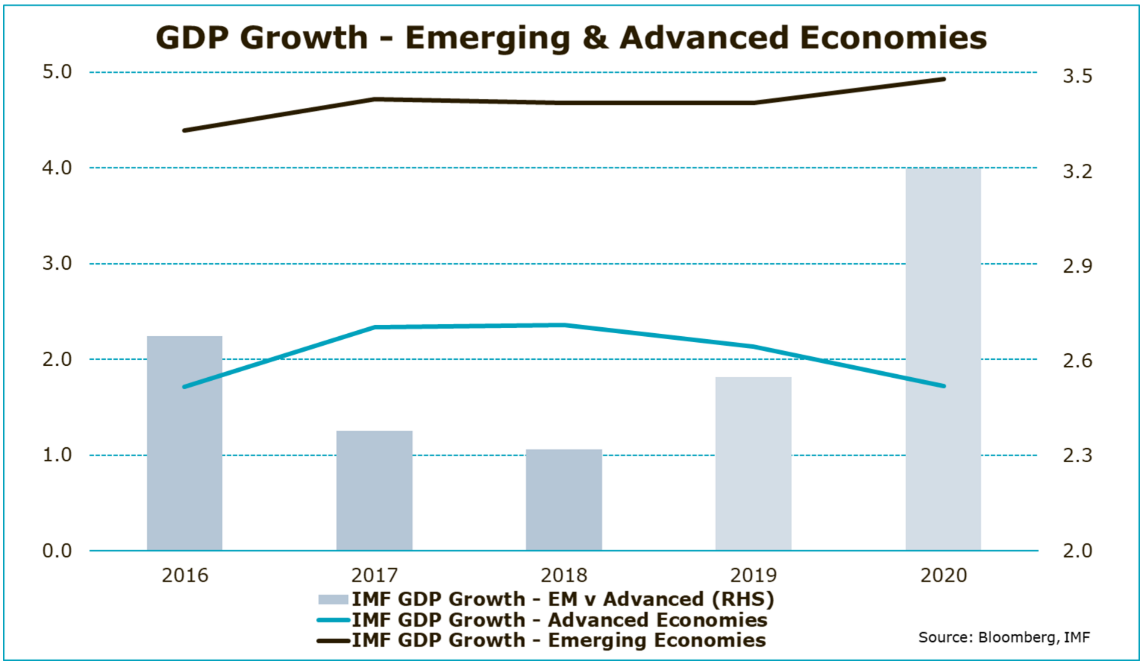
"As current market circumstances aren't particularly favorable, it seems likely that the Fed will take a break from further raising rates. This means that the difference between interest rates in the US and, for example, the Eurozone will not widen further."

"And that means the US dollar – which is already overvalued – won't necessarily strengthen, as the attractiveness of a currency largely depends on interest rate differences between two regions. This is an important development for emerging markets, as a stronger US dollar often coincides with lackluster emerging market performance."

Mind the gap

Then there is the gap between GDP growth in emerging and developed countries, which is seen widening this year for the first time 2016. "Historically, the gap between growth rates in emerging and developed markets has been one of the strongest drivers of emerging market equity performance relative to developed market equities," says Blokland.

"In the latest IMF growth forecasts (see chart below), growth in emerging countries is expected to accelerate somewhat, while growth in developed markets is seen easing in the coming years. While the divergence will be slow at first, the gap will likely widen to above 3% in 2020, the biggest differential since 2013."



Diverging growth rates: the bigger the better for emerging equities. Source: Bloomberg, IMF

Trade tantrums

But what about the effect of the ongoing trade war between China and the US? "Emerging markets are particularly vulnerable to a slowing of global trade," admits Blokland. "This is probably why they started to decouple from global equities from June onwards as the dispute escalated, although the effect of the currency crises in Argentina and Turkey should not be ruled out."

"In recent months, however, both parties seem to have refocused on de-escalation. A temporarily truce was declared: China lowered tariffs on some US imports, and President Trump offered some willingness to come to an agreement."

"While that doesn't necessarily mean the dispute is fully solved, it does mean that the marginal effect on trade and GDP growth will decrease. When this happens, we expect emerging market stocks to be among the main beneficiaries."

Valuation catalyst

Finally, valuation could provide a catalyst. "The average price/earnings ratio of emerging market equities has dropped by as much as 30% as a result of the sell-off last year," says Blokland. "As a result, the valuation for emerging stocks has fallen significantly below its long-term average."

"And even though the pattern in the valuation of developed market stocks is similar to those in emerging countries, especially outside the US, emerging equities also remain mildly cheap on a relative basis. Although it is rarely the trigger for market reversals, we believe that the current level of valuation can become an important tailwind when things start to turn around."

Recession risks remain

So, what are the risks? "If we do get a US recession this year – which we don't expect at this point in time – emerging market equities are likely to fall further before they bottom out," Blokland warns. "In that case, earnings will probably decrease, removing the potential valuation catalyst as well."

"The same scenario is true if Chinese GDP growth slows further, meaning current stimulus is insufficient to accelerate growth. For many emerging countries, and not just in Asia, trade with China is far more important than with the US."

"The Fed also poses a risk if the US jobs market and wage growth forces the central bank to continue raising rates, putting renewed upward pressure on the US dollar. Still, recent developments make us believe that the odds of these risks materializing have decreased and not increased recently."

"A pause in the Fed hiking cycle, and/or any progress in the trade dispute between China and the US, would further substantiate this observation, and pave the way for a solid return on emerging market equities going forward."

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