special report
Q3/Q4
2016

# Emerging Markets

BNY MELLON

special report



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# New directions

Selectivity is a key theme dictating emerging market investing today. While the underlying investment story of rising middle classes and supportive demographics remains intact, emerging markets are entering the next chapter of their development – albeit not all at the same time or speed.

Amid the continued climate of low interest rates and rising political risks evident in developed nations, emerging markets are stirring investor interest once more, but as managers from across BNY Mellon Investment Management state: not all pose the same opportunities.

Brazil has dominated world news not just because of the Olympics but also its ongoing political and economic turmoil; China fears have quietened as 2016 has progressed; South Africa's currency has been punished while the demographic advantage of the Philippines has sparked interest.

At the same time the developed world has been beset by negative government bond yields, political uncertainty and rising growth concerns.

As a result, hopes of a return to an upward growth trajectory in emerging market investments have risen with a resurgence of investor interest as the year has progressed. The year began with most emerging market (EM) equity and debt sectors seeing outflows, according to Morningstar figures. By April many EM fund sectors had moved to positive net flows. While the second quarter saw fund flows fluctuate substantially, the start of Q3 showed evidence outflows had largely been stemmed. European-domiciled EM equity funds went from net outflows of more than US$28m in January to net inflows of US$181m in June.

At BNY Mellon, several of our investment boutiques feature emerging market expertise, with managers specialising in equities as well as various aspects of bond investing (local, hard, corporate and long/short).

In our third annual EM special report fund managers from Standish, Insight Investment, Newton Investment Management, Mellon Capital, ARX and Siguler Guff look at the latest trends affecting emerging markets, outlining their views for the months ahead.

One theme is dominant: each emerging market region has a different story, offering varying opportunities and risks, requiring a discerning eye and a careful assessment of their individual investment pros and cons.

# The big picture

A rapid reversal in fortunes has prompted a resurgence of interest in emerging markets in 2016. But can the sector meet investors' lofty expectations and can the recent market rebound be sustained? Here, managers across BNY Mellon's investment boutiques explore the latest trends driving market growth.

After years of heavy outflows from emerging markets (EM), the asset class appears to be back in vogue. Investment returns have buoyed the sector and brought hope to investors locked in an apparently endless low interest rate, low yield, low growth global investment environment.

By August 2016 the leading MSCI Emerging Markets index, according to Bloomberg figures, was up by almost 12% in US dollar terms amid reports funds were investing in emerging markets in record numbers.[1]

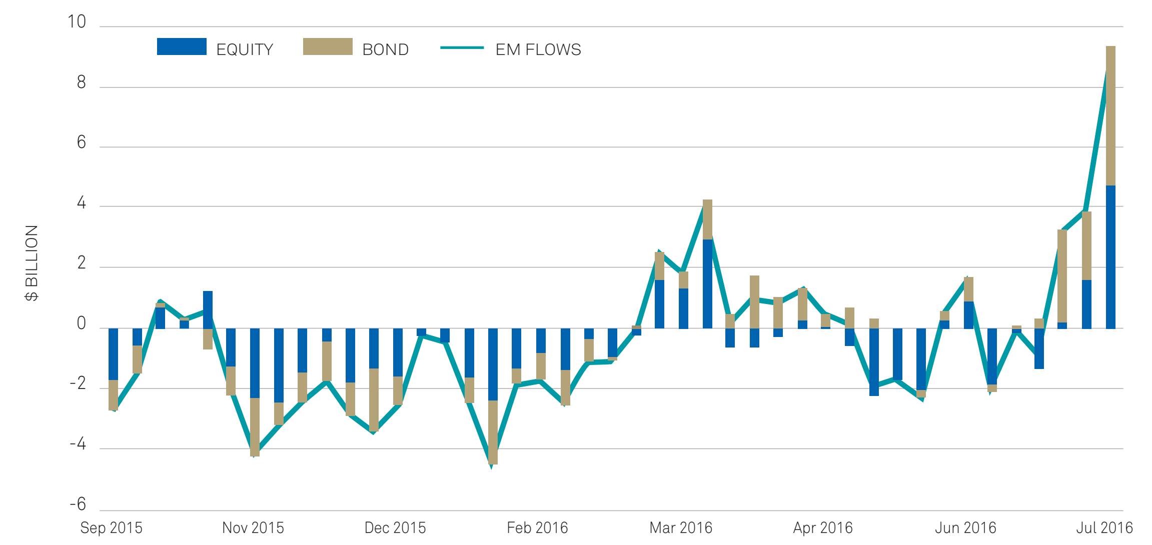
Factors driving the increased interest in emerging markets include a recent rebound in the price of commodities, renewed optimism on markets such as China and India, coupled with the perceived affordability of many emerging market stocks.

Fresh inflows to EM equities and other EM asset classes have also occurred at the same time as investors appear jittery over developed markets such as the UK, Japan and eurozone. This has followed a spike in developed market uncertainty and a rise in political risks, as evidenced by the unexpected UK referendum outcome to leave the European Union (EU), which initially left many policymakers and traders on currency and securities markets battling renewed volatility.





**EMERGING MARKETS INFLOWS**




Source: Barclays. As at end July 2016.

## Brexit effect

Opinions vary on the long-term impact of Brexit on the global economy but some believe its impact could be profound, with the potential for emerging markets to capitalise on its after effects.

Rob Marshall-Lee, investment leader emerging and Asian equity team at Newton Investment Management says: "We think the UK referendum vote is significant for many reasons and that the implications are wide-ranging.

"In Europe, the risk of knock-on fragmentation of the peripheral countries is likely to put pressure on the euro and further paralyse already weak economic activity, compounding existing structural impediments. For emerging markets, the change in interest-rate expectations is a boon in our view, potentially removing the fear of reduced rate differentials and hence the reversing of capital flows required by growing economies."

At Insight Investment, head of emerging market fixed income Colm McDonagh is more cautious on the Brexit impact. "While we do expect some ripple-effect in the aftermath of the EU referendum, from an emerging markets perspective we anticipate this will have most influence in Eastern Europe. In our view, the anticipated UK exit from the EU is unlikely to have a major influence on sectors such as EM corporate debt as a whole across other geographies such as Asia and Latin America," he says.

At US-based Standish, senior sovereign analyst Aninda Mitra is of the view the negative impact of Brexit will be limited, adding that developed market central banks, such as the US Federal Reserve (Fed), have sufficient tools at their disposal to protect against economic shocks.

"Thankfully Brexit seems to be turning out to be a prolonged political issue rather than an imminent credit or financial crisis of the kind many people though it might be. But that said, if it ends up slowing European growth and injecting wider uncertainty into European politics that could still prove to be corrosive for global growth and Asian exports," he says.

## Green shoots?

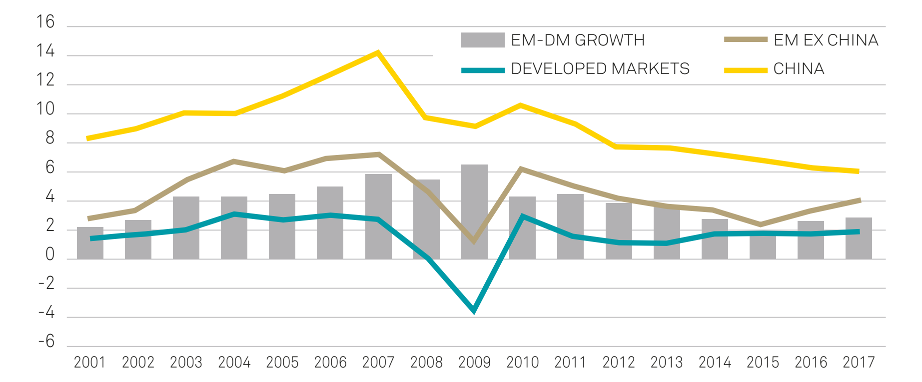
Developed market upsets aside, investment managers cite other reasons for optimism in emerging markets, with some previously challenged economies showing signs of recovery and others initiating reforms expected to help foster growth.

McDonagh says: "In the last few years, emerging market sentiment has been very poor and investors have shied away from the asset class. That was mostly to do with the relatively poor investment growth in emerging compared to developed markets and 2015 perhaps marked the worst point in this trend. But, going forward, EM growth is set to be higher than that in developed markets and we expect that differential will increase.

"At a macroeconomic level, after a sustained period of market volatility, certain emerging markets economies are now starting to bottom out, growth forecasts and differentials are improving, some currencies have weakened and interest rates have fallen, which should all be supportive of EM corporate debt," he says.

1 CNBC. Hedge funds invest in emerging markets in record numbers. 01 August 2016.

EMERGING MARKETS GROWTH DIFFERENTIALS IMPROVING




Source: IMF. As at end March 2016.

From a macroeconomic perspective, China presented one of the biggest market challenges of 2015. After three decades of almost uninterrupted growth the country experienced a sharp correction, which spooked investors, triggering net capital outflows of almost US$676bn for the year.[2] The Chinese government has since introduced a range of measures – focused on housing and infrastructure – to help steady the economy. Recovering commodity prices have also helped bring some stability back to the market.

Commenting on Chinese economic prospects and the impact of government intervention in the domestic market, Mitra says: "In terms of the outlook it is a good thing the Chinese government has so far avoided policy missteps in 2016. In 2015 the management of the Chinese stock market and currency regime detracted from confidence in the policy framework. Fortunately we have not seen that this year.

"The Chinese government seems to have become a bit savvier in terms of managing the exchange rate depreciation so far – without destabilising global markets. But while China has shifted from becoming a source of volatility in global markets, we cannot yet say the country has become an anchor of stability."

Elsewhere in Asia, the election of Indian Prime Minister Narendra Modi in 2014 brought high hopes of major economic reform. So far the process has been one of evolution not revolution. However, some market analysts remain optimistic changes being implemented will prove of major benefit to the Indian economy in the future.

## India's prospects

Mitra comments: "India has pushed forward with a lot of incremental reforms but some of the more notable changes will take time to implement and won't necessarily spark a huge amount of growth in the short-term. India's democratic process can sometimes be somewhat chaotic and time consuming but things are coming together slowly in what appears to be a sustainable fashion.

"Measures such as liberalising foreign direct investment across a range of sectors is driving stable capital flows into the country. A more modern monetary policy framework – designed to tame inflation in India – is also being created.

"In addition to this a new bankruptcy bill which will make it much easier to facilitate entry and exit of firms through a better established insolvency regime is also working its way through the Indian parliament. A new goods and services tax bill was recently passed in parliament. Its implementation by 2017 should lower the cost of doing business in India, while boosting overall efficiency levels."

## Market diversity

In terms of structural development, McDonagh says the emerging markets sector is evolving at a steady pace and is far from the homogeneous asset class commonly reported in the wider media. Instead, each region and emerging economy has its own nuances, potential strengths and weaknesses. The key, adds McDonagh, when looking across such a diverse grouping, is to ensure risk exposure is adequately rewarded.

"There is no question there are some risks associated with emerging market countries. But it is our job to evaluate those and see if they are compensated appropriately. As emerging markets evolve and become more mature, this is a conundrum facing investors globally, not just in Europe but also in Asia and the US. We are at an interesting juncture to look at this asset class."

McDonagh sees significant value across emerging markets and believes specific pockets of opportunity are appearing across the EM corporate debt universe. He notes increasingly higher incomes have helped smooth volatility in the sector and that liquidity – an important consideration for risk-averse bondholders – is also improving.

"Liquidity conditions within EM corporate debt markets have continued to improve, helped by strengthening fundamentals and an increasingly global investor base. A deeper EM investor base has encouraged larger issuance from EM issuers across multiple tranches. As volumes have increased and tradable issuance has grown in size, liquidity across the EM corporate sector has improved," he says.

The constituents of the emerging markets universe have also seen significant change in the past 12 months, with wealthy Middle Eastern nations such as Qatar and Abu Dhabi releasing new tranches of debt in order to combat the impact of falling oil prices.

## An evolving picture

Demographics are an increasingly important factor in emerging market development, affecting everything from government tax receipts, to national savings, investment and productivity. Dynamic countries with young populations are increasingly finding favour with investors tempted by their potential for growth. According to Marshall-Lee, the Philippines is a classic example of this.

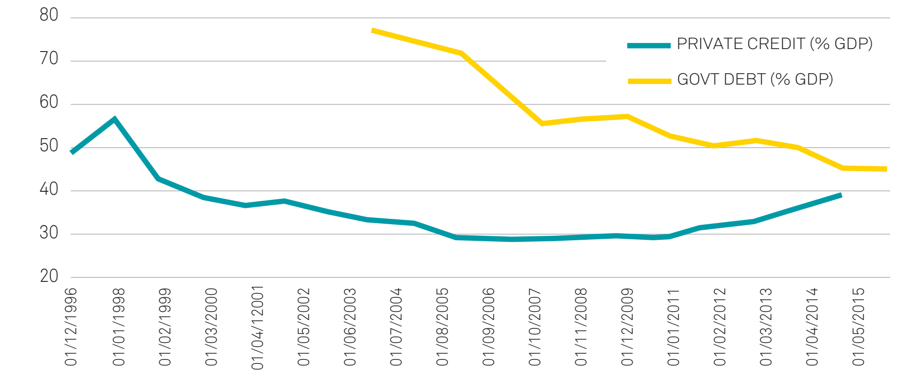
"In many markets, the underlying growth drivers of superior population dynamics, the potential for a catch-up in productivity, and low levels of credit penetration remain. Such a backdrop is typified by the Philippines, which saw a decade of balance sheet repair following the Asian crisis in which its debts were paid down, in sharp contrast to most developed markets," he says.

"This leaves room for credit expansion to drive growth, in addition to other drivers of economic activity, including fast growth in the labour force and strong productivity trends. The recent acceleration in private credit growth is indicative of this recovery."

In terms of broader market outlook, Marshall-Lee stresses the importance of assessing individual markets, regions and specific stocks on their individual merit. However, he contends the current overarching backdrop for emerging markets remains favourable.

"The outlook is highly differentiated but economies that do not ride solely on the commodity boom seem to be broadly attractive."

PHILIPPINES DOMESTIC PRIVATE SECTOR CREDIT TO GDP AND GOVERNMENT DEBT TO GDP RATIOS




Source: World Bank. As at 14 December 2014. CIA. As at 15 December 2015. For illustrative purposes only.

After several months of buoyant trading in emerging markets securities many wonder if this upward trajectory can be sustained. However, some analysts believe the low yield, low return global investment environment will continue to endure, encouraging many more investors to seek higher yielding returns amid growing equity and debt issuance in emerging markets in the months ahead.

## KEY POINTS

- Emerging markets have seen improved inflows in 2016.
- Rebounds in commodity prices have buoyed EM interest.
- Demographics are an increasingly important factor in EM development.

# Market divergence: A tale of two countries

The sheer diversity of emerging markets underlines the need for through research by investors. Even within the same broad geographic regions, national economies can enjoy hugely divergent fortunes.

Latin America provides a good example of this range, with Brazil and Mexico just two regional economies adopting different economic approaches and facing very different political challenges.

Brazil's political and economic situation has deteriorated dramatically following the 2014 election which brought left-leaning president Dilma Rousseff to power.

After some attempts at economic reform Rousseff was suspended in May 2016 amid allegations of corruption [3] and later forced from office.

Despite some signs of economic recovery following the appointment of acting president Michel Temer, the country remains in state of relative economic and political deadlock.

In positive terms, equity markets have recently seen signs of recovery, although many analysts believe the path to economic reform is unlikely to prove swift or smooth.

In contrast Mexico, economically buoyed by the economic drive of its young and growing population, is an emerging market offering tangible evidence of reform success.

Newton Investment Management points to the successful liberalisation of the country's tax system, electricity utilities and telecoms sector since the election of president Enrique Peña Nieto in 2012.

Signing the North American Free – Trade Agreement (NAFTA) in 1992 also cemented Mexico's place as a key trading partner of the US – and, in the years since, economic ties between the two countries have strengthened further, despite the looming threat of a US election victory for the apparently protectionism-friendly Donald Trump.

In its most recent country report, the OECD forecast steady if not spectacular GDP growth of 3% for Mexico in 2017, helped by a fresh wave of structural reforms.

2 FT. Capital flight from China worse than thought. 20 January 2016.

3 The Guardian. Dilma Rousseff suspended as senate votes to impeach Brazilian president. 12 May 2016.

# Gateways to emerging market investing

The emerging markets investment universe offers an increasingly wide array of entry points but a discerning eye is key as countries diverge in opportunity. Here, Siguler Guff's Ralph Jaeger and Newton's Rob Marshall-Lee explore wider market trends.

Even for those investors who have been allocating to emerging markets (EM) for decades, it can seem a daunting prospect to re-invest after a period of choppy returns.

Now investors are starting to re-assess their developed market exposure in an increasingly volatile environment, while considering the growth potential of emerging market economies.

For Ralph Jaeger, managing director and portfolio manager of emerging markets private equity at Siguler Guff, certain developing markets are now presenting attractive entry points.

He says private equity used to be thought of as more of a beta play and the opportunity set was concentrated to just a few large markets, namely China, India and Brazil, but adds: "It has evolved over the past 10 years and become far more sophisticated across numerous markets with various investment strategies and different sector focuses."

Jaeger notes EM publicly-listed equities can be skewed towards just a few sectors – energy, utilities, financial services and materials – because they make up a large portion of indices. Conversely, investors' exposure to healthcare, consumer or tech sectors can be limited, for the opposite reason. Yet the latter are the high-growth sectors he believes are among the most attractive in emerging market economies.

"In addition to the better breadth we believe private equity exposure can provide, valuations are generally lower than comparable publicly listed companies," he adds.

It is this lower average valuation for EM private equity, compared with publicly-listed counterparts, Jaeger believes is a big source of alpha versus listed equities right now.

Although there tends to be a valuation lag between public and private markets, Jaeger stresses that is not to say they are uncorrelated. He also admits private equity is unlikely to be the first asset class on investors' radar when they think about allocating to EM, particularly if they have no allocation to private equity in developed markets.

> **Even though high beta, lower quality stocks are bouncing first and fastest, we believe valuations look more attractive in opportunities where we see sustained strong profit growth.**
>
> Rob Marshall-Lee, Newton

But, in his view generally EM private equity investments can be complementary to public equity investments because of the relative ease and value in accessing index outliers such as healthcare, consumer and tech companies.

He adds investors need to "demand to get compensated for investing in private equity" where investments are typically held for much longer time periods. Jaeger suggests investors look for a premium of at least 500 basis points (bps) above the MSCI Emerging Markets index and at least 300bps over private equity returns in Europe and the US.

## Digging deep

Selectivity and a fine toothcomb are tools Rob Marshall-Lee, leader of Newton's Asian and emerging equity team also believes are a prerequisite for public equity investing in the asset class. Marshall-Lee says there has been a great divergence in emerging market economies over the past few years and there are no signs of reversal.

"This is great news for fundamental, active investors but not so much for those who analyse emerging markets from a relative index perspective," he says.

Marshall-Lee agrees with Jaeger on the diagnosis of emerging market equity indices in terms of their large weightings to commodity-exposed economies such as Russia, Brazil and South Africa but says investors willing to dig deeper and deviate from those benchmarks can benefit from far greater diversification.

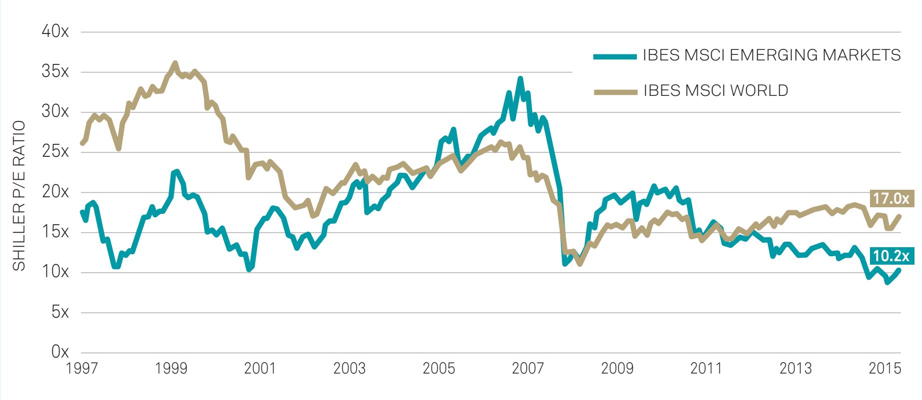
Like Jaeger, he prefers consumer-related sectors and those where growth is predicated on growing middle classes with higher disposable incomes – sectors such as healthcare and technology.

"When you have investment flows based on the shifting sentiment towards commodities, and related economies, it can impact the valuations of all equities in emerging markets – even those that are inherently attractive underlying investments."

## Discerning value

Much of 2016 has been characterised by the countries and sectors that performed badly in 2015 witnessing a reversal of fortunes. But Marshall-Lee does not believe those pro-cyclical areas are necessarily sustainable long-term investments. "Even though high beta, lower quality stocks are bouncing first and fastest, we believe valuations look more attractive in opportunities where we see sustained strong profit growth."

**SHILLER P/E RATIO: INSTITUTIONAL BROKERS' ESTIMATE SYSTEM (IBES) MSCI EM vs IBES MSCI WORLD**




Source: Newton, Thomson Reuters Datastream. As at 30 April 2016.

Emerging markets as a whole appear to have de-rated substantially as evidenced by the Shiller P/E ratio but Marshall-Lee contends this measure of value is flawed as it is backward-looking and the future will not necessarily be a repeat of the past.

Over the next five years he still believes India will be the best performing market in hard currency terms. As a commodity importer with pent-up demand following a slowdown, he says the country is emerging from a painful credit cycle and has undertaken positive economic reforms. It is also a country with attractive demographics, hosts businesses with entrepreneurial spirit and features a relatively low level of government interference in listed equities.

When looking at China, he divorces headline rates of growth from company analysis. "China is rebalancing. While we are cautious on headline GDP growth, consumer wealth is growing consistently in high single digit to double digit levels. So you have to look for good companies with strong brands or business franchises in the highest growth areas.

"The Chinese credit overhang, which many commentators are concerned by, is very heavily slanted towards state-owned enterprises (SOEs) because banks have been lending mainly to them at the prompting of the state. You see a lot of capital misallocation in the Chinese government and SOEs but investing in independent companies that are self-funded through cash flows does hold some appeal."

From a private equity perspective, Jaeger believes China and certain countries in Latin America look attractive from a private equity point of view. In China, a transition towards a 'new normal' economy hinges on innovation, which he believes creates opportunities for venture capital investors.

Whether looking towards private equity or publicly-listed companies in emerging markets the message from both Jaeger and Marshall-Lee is consistent: developing economies can no longer be treated as a homogeneous group, if indeed they ever should have been.

A repeat of the mid 2000s boom is not expected but the managers see the potential for solid returns from specific parts of emerging markets over the next five to 10 years.

**WEIGHING THE COMPETITION**

| | Pros | Cons |
|---|---|---|
| EMERGING MARKETS | Growing middle classes and attractive demographics. | Corporate social responsibility can be lacking and state interference in some markets is high. |
| | Low penetration of credit in some countries means scope for growth in consumer spending. | If exposure is index based or 'closet tracker' then commodity-linked sectors and economies can dominate allocations. |
| | EM may leapfrog developed markets through adopting new technologies without ever having to build the infrastructure for older iterations. | Infrastructure spend can be piecemeal or ill-thought out by governments eager to provide a boost to their economy. |
| DEVELOPED MARKETS | An overall depth and breadth to the market through virtue of greater competition and a general commitment to capitalism. | Ageing populations and less attractive demographics from a working-age population standpoint. |
| | Home to multinational businesses well-positioned to resist volatility due to diversified revenues. | So-called 'zombie' companies considered to be propped up by central bank and government intervention since the global financial crisis. |
| | In many sectors and markets there is a strong culture of paying dividends to shareholders. | Mature companies, which could be considered ex-growth, can still make up a large part of the index due to their overall market capitalisation. |

## KEY POINTS

- Emerging markets cannot be treated as a homogeneous group.
- Consumer-related areas look appealing versus more commodity-skewed sectors.
- Thorough research and maintaining realistic risk/reward expectations remain important EM considerations.

# Spotlight on China

special report

**Robert Marshall-Lee,**
Investment leader emerging and Asian equity team, Newton Investment Management

**Ralph Jaeger,**
managing director and portfolio manager of emerging markets private equity, Siguler Guff

**Karsten Jeske,**
vice president multi-asset research, Mellon Capital

**Robert Simpson,**
portfolio manager, emerging market debt, Insight Investment

**Douglas Reed,**
emerging markets strategist, Newton Investment Management

**Aninda Mitra,**
senior sovereign analyst, Standish

The giant Chinese economy has shown encouraging signs of stabilisation in 2016 after a difficult 2015 dented economic growth and raised concerns about the fundamentals underpinning the market.

Indeed, despite intermittent bouts of market turbulence, China enjoys a healthy trade surplus and remains committed to shifting its economy from one reliant on manufacturing to create a more service-oriented economy. Against this backdrop, we asked investment specialists at Newton Investment Management, Mellon Capital, Insight Investment, Standish and Siguler Guff for their views on the Chinese market, its influence on various asset classes and the potential investment opportunities it holds.

## What are your biggest concerns regarding China and its wider market influence?

**Simpson:** The investment community has had a number of doubts regarding China and how its development might impact global markets. But many of the concerns expressed at the beginning of the year have not materialised.

Outflow pressure was expected to force the Chinese authorities to devalue the currency but these outflows slowed, resulting in less pressure to devalue. Consequently, the market is less focused on this risk.

The bigger structural risk coming from China is the amount of debt it has built up and what this means for non-performing loans and other financial risk areas. It is not clear if/when this will trigger a bigger crisis but, for now, these are not at the forefront of investors' minds. Nevertheless, investors need to keep an eye on these potential problems returning.

A further concern for other markets is that China has moved up the value chain – in effect now manufacturing what it used to import from other countries. This has materially affected the competitiveness of other big exporting nations.

**Reed:** We remain very wary of China's growing debt burden, which increased by some 15% of GDP last year and by 83% of GDP since 2008. This fairly unprecedented rise is partly related to China's growth slowdown, which we think is very likely to continue to gravitate lower given the maturation/reversal of a number of key following winds.

The government is attempting to delicately manage an orderly growth slowdown by stimulating the economy as and when necessary but with the trade-off of ever-increasing debt levels. It is likely the financial system has a significant level of underperforming loans yet to be recognised.

China is of course somewhat different from classic emerging markets in that it still has a degree of control over its financial system and has the ability to recapitalise its banks using public money if necessary. However, there are clear 'tail risks' to the downside if events do not go to plan.

**Jaeger:** The major risk is whether the government can implement the right structural reforms in a timely manner to successfully transition China into a more consumer and service-oriented economy while avoiding a hard landing incurred by loss of growth in fixed asset investment-related industries.

The slowdown in traditional industries could drag down the overall economy and pose challenges in economic transition. Among all the challenges in traditional sectors, overcapacity presents a major issue and exposes structural weaknesses in the process of China's industrialisation, such as excessive investment, low-tech expansion and high debt levels.

The government is fully aware of the importance of improving the efficiency and profitability of traditional heavy industries through "supply side reforms", i.e. the shutdown of sub-standard factories and facilitating consolidation. We have confidence in the Chinese authorities' committed efforts and resources in implementing the reform. Recently we have seen mergers of top players taking place in a number of traditional sectors such as cement and steel. Consolidation will take time but it is well on its way.

**Mitra:** The biggest concern is that private investment in China continues to slow very rapidly. Companies are not getting the loans they need because banks have become reluctant to lend to them. The banks would prefer to lend either to speculative activity or to state-owned enterprises, which still enjoy the implicit backing of the government and are less likely to default.

With that framework in place, credit supply to the private sector remains rather scarce and private investment – which is about 60% of total investment in China – continues to weaken. There is also a lot of overcapacity in the industrial sector and manufacturing.

But amidst all this, there is some good news in that the global environment has recently changed in China's favour. The strength of the US dollar has ebbed, relieving some pressure on China's currency. The Chinese authorities have used this opportunity to cheapen their own currency as a means of easing financial conditions quite gradually. This is timely because China cannot cut rates or dramatically loosen its monetary policy without risking more capital outflows.

**Jeske:** In terms of our concerns about China, we do wonder if the country is potentially building an unsustainable real estate bubble. At times, the underlying financial position of this sector can be somewhat opaque, raising questions about accountability and its overall stability.

Equally, many analysts wonder if there is a limit to how much stimulus the Chinese government can pump into the economy as there is already a lot of leverage in the system.

While China holds substantial financial reserves it is not inconceivable that there could be a day of reckoning at some point for the national economy. Just because we can't pinpoint when it might come doesn't mean it couldn't happen. The good news for economies such as the US is that a slowdown in China is unlikely to have any major damaging effect on them. In trade terms a more serious threat to China itself might actually come from a US economic slowdown.

## What are the key investment opportunities China currently presents, if any?

**Marshall-Lee:** The Chinese economy is slowing and we expect GDP growth to continue to slow down by more than consensus. This is led by a growth recession in fixed asset investment, following aggressive government infrastructure investment, debt-fuelled property development and over-investment by state-owned entities.

China is progressively rebalancing towards a more developed consumer and service-oriented economy. The latter is largely self-funded from cash flows as the banks focus on state-owned enterprises. The services economy can grow in the high single digits and we are finding companies growing at rates multiple times faster in underserved and structural growth segments, such as education, parts of the healthcare industry, e-commerce, social networks and certain other internet businesses. Here we find numerous stocks with what we see as the 'Holy Grail' of sustainably high profitability and strong growth, all discounted to low valuations due to China fears. Hence we are overweight China but purely exposed to these specific opportunities.

**Simpson:** We believe Chinese government bonds currently represent a strong investment opportunity. For a major economy, yields offer an attractive premium over other core rates markets with 10-year China government bonds offering a 2.8% return compared to 1.6% in the US, negative rates in Japan and Germany and a 0.65% return rate in the UK[1].

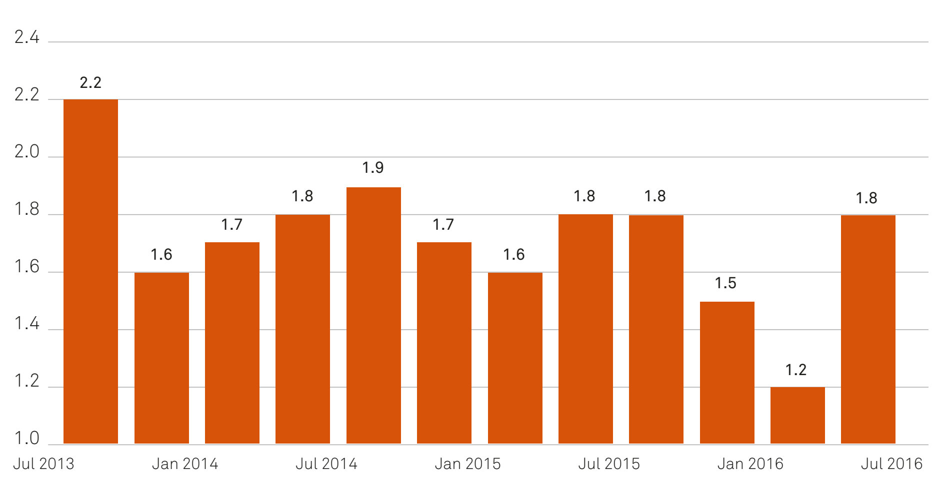
We expect Chinese growth to continue to slow down gradually and inflation to remain well contained. Therefore we see reasonable room for monetary policy to be eased further and rates have room to rally. As China enters the special drawing rights basket and continues to open up its financial markets to foreign investors we expect foreign inflows will pick up meaningfully over the coming years.

**Jaeger:** We have seen many investment opportunities in the upgraded consumer services and technology innovation sectors, which are key growth drivers for China's economy. As the Chinese population gets more affluent and older, it demands better quality daily products/service and better healthcare.

We see 10%+ annual growth in broad consumption. Sub-sectors like e-commerce are growing around 20%, media and entertainment spending at some 15% and healthcare spending is growing at c15%. Altogether these consumption-related sectors are expected to produce another market of US$6.3trn in the next five years, about 1.3 times larger than that of today's Germany or the United Kingdom.

More importantly, technology adoption and innovation have an accelerated growth in China, thanks to its strong entrepreneurial spirit and government's relentless promotion of tech development. Therefore, internet, mobile internet and other technology advancements will help create tremendous new and disruptive business models throughout all industries, thus proliferating venture investment opportunities.

**CHINA GDP QUARTERLY GROWTH RATE**




Source: Trading Economics. Com/National Bureau of Statistics of China. As at 31 July 2016.

**Mitra:** We see key opportunities in several areas. One important area is large state-owned enterprises, which are strategic in nature. Realistically, the Chinese government can simply not afford to allow these to weaken dramatically and some of these entities have reasonable operating metrics. These tend to be investment grade companies, closely linked to the government and with strong financial backing that should continue to be the case.

They also offer higher yields than many comparable investment grade enterprises in the rest of the Asia region. The other area consists of emerging e-commerce and internet companies with sound balance sheets, and further promise of consumption and services led growth. Although the level of competition remains fierce, the shift toward more value-added and tech-savvy activity will definitely keep this area interesting.

**Jeske:** We believe it is too early to tell if China is set for a sustained recovery and many investors are subsequently adopting a 'wait and hold' stance on the position, wondering what impact US Fed activity might have on both China and wider emerging markets.

In that context it is difficult to pinpoint specific opportunity areas at this time. However, in terms of valuation, China's earnings view looks very attractive compared to some of the other emerging markets. If the Fed were to keep delaying rate hikes that might be good for emerging markets and China.

## Chinese trading, stock exchanges and the MSCI

The three main stock exchanges servicing China are the Shanghai, Shenzen and Hong Kong exchanges. Shanghai, which lists so-called A-shares for domestic consumption, has traditionally catered for state-owned banks and energy companies, with Shenzen more oriented towards smaller companies in the private sector.[2] The Hong Kong exchange serves mainly non-Chinese investors such as Qualified Domestic Institutional Investors.

In 2014, China also opened the new Hong Kong-Shanghai Stock Connect trading scheme to broaden investor access to the Chinese market. The scheme, dubbed the 'through-train', has since attracted significant retail inflows, enhanced foreign access to China's A-share market and has also enabled some mainland Chinese investors to access Hong Kong's so-called H-share market.

As China seeks to open up its financial markets, one of the most intriguing stories has been its evolving relationship with emerging markets index provider MSCI.

At various stages MSCI has hinted it would include Chinese A-shares in its benchmark EM index, only to repeatedly defer the move. While including A-shares in the index could help boost confidence in Chinese equities and open up the market further, some commentators point out that Chinese companies listed in Hong Kong and New York already make up nearly a quarter of MSCI's Emerging Markets Index.[3]

The fear is that if all A-shares were included in the MSCI EM index at full weight this could jump to almost 40%[4], potentially distorting the market for investors who track the index. There are also wider concerns over Chinese corporate governance and the threat corporate or state intervention could potentially disrupt equity trading. While full inclusion is unlikely in the short-term, the MSCI has said it would keep the China A-shares inclusion proposal as part of its 2017 review[5] and the Chinese authorities remain optimistic the index-provider will at least partly embrace the change in the months ahead.

1 Source: Insight Investment, as at 5 August, 2016.

2 Wall Street Journal. Everything You Need to Know About China's Stock Markets. 10 July 2015.
3 Wall Street Journal. MSCI and China: Why There's No Fear of Missing Out. 15 June 2016.
4 FT. MSCI and China: A shares decision day. 14 June 2016.
5 CNBC. Key MSCI emerging markets index rejects Chinese mainland stocks, again. 14 June 2016.

# The income agenda

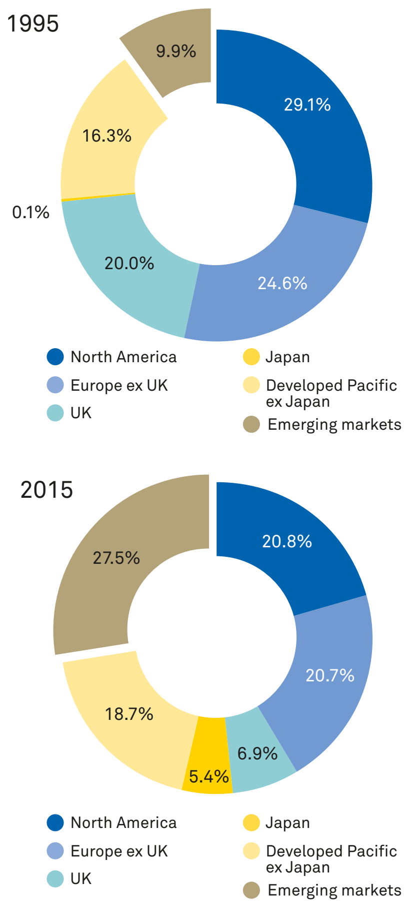
With investor appetite for dividend income continuing to rise, the lure of emerging markets (EM) is strengthening. But how can investors best identify companies, which can deliver sustainable yields while minimising risk? Here, Newton Asian and emerging equities team portfolio manager Sophia Whitbread explores the evolving EM landscape and the income opportunities it presents.



The increasing economic development and sophistication of emerging markets has seen a growing number of EM companies issue dividends over the last decade. To income-hungry investors EM dividends can offer some attractive prospects. Emerging markets have been growing their dividends at a rapid rate and today make up a large portion of the world's highest yielding equities globally.

## GLOBAL YIELD PROGRESSION

Geographical split of FTSE World index stocks yielding greater than 3%

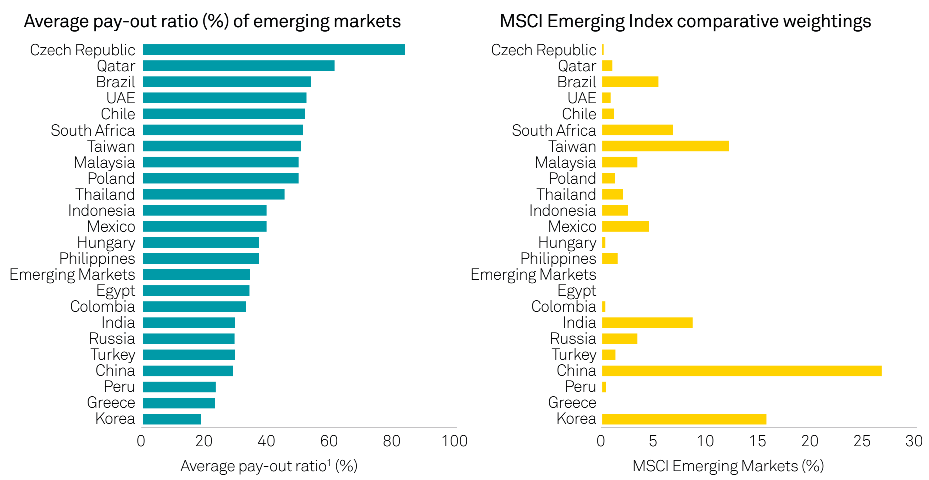



Source: FACTSET, Datastream. 31 December 2015.

Newton's Sophia Whitbread says: "There are several reasons why emerging markets can lead global dividend growth. These include the fact that they tend to have lower debt levels than developed markets, allowing more room for paying dividends as opposed to paying down debt. In addition, on average, emerging market dividend payout ratios are still lower than those of developed markets, giving scope for further expansion.

"In addition, selective emerging markets promise higher earnings growth, not only because of lower debt ratios, but because of more youthful demographics supporting productivity into the future; dividend growth should be tied to this earnings growth."

## WHERE ARE DIVIDENDS FOUND IN EMERGING MARKETS?




For illustrative purposes only.
Note: 1 Ratios are bottom-up aggregated with free-float adjustment based on current MSCI universe.
Source: Factset, CLSA, January 2016.

## Market divergence

With respect to the payout variances across EM, Whitbread notes: "More mature economies such as the Czech Republic, Chile and Taiwan can typically support higher levels of payout, as growth rates are lower and so companies can return more cash to shareholders as opposed to investing it in further growth."

"But there are other factors as well. Some countries, particularly in Latin America where there is an established culture of equity ownership through pension savings, have mandatory minimum dividend payout ratios, with Brazil being a case in point. In other countries, where only a relatively small percentage of the population owns equities, dividend payout ratios have been lower, in part because public interest in them is not considered particularly relevant."

In a world where payout ratios from the highest to the lowest across all emerging markets, don't necessarily correlate to a country's weight in specific EM indices (see table), understanding the difference in dividend cultures is key, she says.

Whitbread adds that even when a country places a high emphasis on generating dividend income – a trait which has been apparent in several emerging markets recently, including Russia and China – it is important to understand what sorts of companies are being encouraged to generate it.

"It is always important to look at the motivations of a company's management team for paying a big dividend as well. When a promoter of a business or a manager may have other operations, a profitable company might be used to fund a weaker one, stripping the profitable business of important cash reserves. So placing an emphasis on high dividend payouts alone is not enough to assure sustainability."

## Complex choices

With complex factors such as these to consider, how can investors in emerging market equities best identify assets which can deliver sustainable yields while minimising risk?

According to Whitbread, conducting proper fundamental analysis is important, in order to understand the competitive advantage of any given business, market positioning and pricing power and the health of its underlying balance sheet. It is also wise to check that currency exposures of any given business are matched to their balance sheet level, she adds.

"Historically, larger levels of US dollar debt have destabilised businesses which sell their product in local currency. It is always crucial to speak to management directly to allow them to explain their dividend policy – where they have one – and to look at their history of paying dividends.

"For example, some companies can be more acquisitive and are honest about the fact that they will sacrifice their dividend should they see an appealing acquisition opportunity."

## Seeking sustainability

While country selection remains key, asset sector considerations are also important. According to Whitbread, some newer sectors are growing so rapidly it is hard to find an appreciable level of dividend because the companies are investing in future growth. A typical example of this would be the emerging markets e-commerce sector.

"Historically, the popular areas for seeking equity income in emerging markets have been predictably and sensibly-regulated, cash generative, utility-like sectors, such as transport infrastructure (toll roads), certain utilities and also telecommunications companies (telcos).

"Today, one particularly attractive sector has been the emerging markets real estate investment trust (REIT) sector. REITs can allow a fund to gain exposure to different sectors other than real estate, especially to consumption. Many emerging market REITs are made up of underlying shopping mall assets where the rents are calculated as a percentage of sales from within the retail properties in the mall. This allows a fund to gain exposure to rising consumption, along with an attractive yield, due to the minimum payout threshold associated with REIT status," she concludes.

## KEY POINTS

- Emerging markets account for the largest portion of the world's highest yielding equities.
- Understanding the difference in dividend cultures is key.
- Both EM country and sector selection are important to minimise risk.

# Coming up

A challenging global investment environment is driving significant interest in emerging market (EM) sovereign and corporate debt. Here, Standish director of emerging markets Federico Garcia Zamora, explores the latest developments in the EM debt universe.

This year has seen renewed investment interest in emerging market sovereign and corporate bond markets as doubts resurface about the global economic outlook and the search for returns extends beyond traditional, mainstream assets.

In July, emerging market debt (EMD) yields hit record lows[1], with the sector lifted by recovering commodity prices, improving prospects in some EM geographies and amid fresh concerns about likely growth in markets such as the eurozone.

EMD issuance has been intermittent throughout much of 2016 with a reported dip in bond sales in the second quarter of 2016.[2] However, Brazil and Turkey released new debt tranches[3] in February and in April the release of US$16.5bn issuance package marked Argentina's return to bond markets for the first time in 15 years.[4]

By July 2016 EM sovereign and local debt issuance had hit its highest level on record, according to industry data provider Dealogic.[5]

Standish's Federico Garcia Zamora feels market fortunes have improved significantly since last year and that there are now some encouraging signs of recovery in the market.

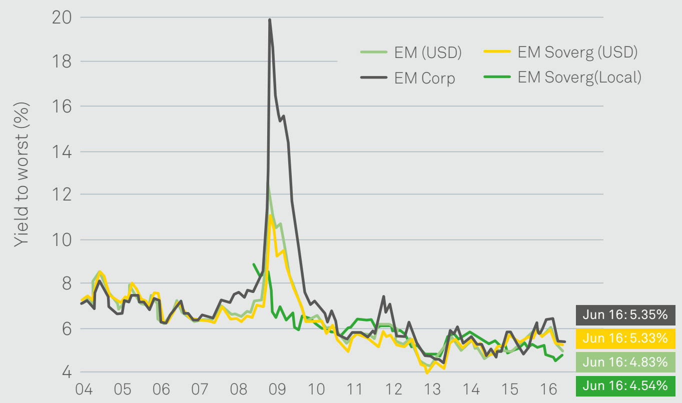
"There are many positives in the market and traditional drivers for the asset class appear more supportive than they were in the past three years. Low yields and low global interest rates seem to be here to stay in Europe, Japan and the US. That is a factor that will support the EM asset class," he says.

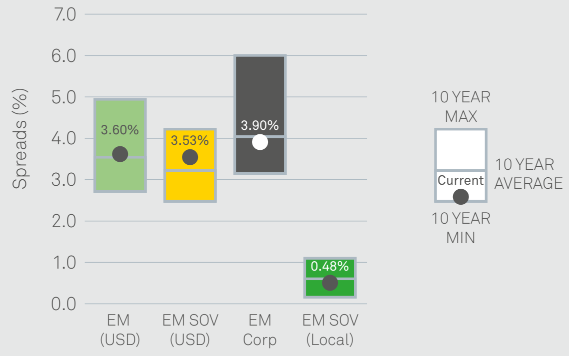
1 FT. Emerging market debt yields hit record lows. 28 July 2016.
2 Reuters. Sovereign emerging bond sales up 50 pct yr/yr in 2016. 29 June 2016.
3 FT. Bond markets reopen for EM borrowers. 13 March 2016.
4 Reuters. Sovereign emerging bond sales up 50 pct yr/yr in 2016. 29 June 2016.
5 FT. Emerging markets party as lower for longer morphs into forever.



## EMERGING MARKET DEBT: PERFORMANCE AND SPREADS

| | 1 month (%) | 3 months (%) | YTD (%) | 1 year (%) | 3 years (%) | 5 years (%) | 7 years (%) | 10 years (%) | Duration |
|---|---|---|---|---|---|---|---|---|---|
| EM $USD Aggregate | 2.86 | 4.67 | 9.40 | 7.83 | 5.99 | 5.99 | 8.81 | 7.74 | 5.65 |
| EM Sovereign (unhedged) | 3.63 | 5.14 | 10.39 | 10.52 | 7.03 | 6.60 | 9.08 | 8.13 | 7.26 |
| EM Corporate (unhedged) | 0.07 | 5.55 | 4.62 | 1.19 | 2.87 | 4.42 | 8.64 | 6.63 | 4.46 |
| EM Local Currency (unhedged) | -4.80 | 5.02 | 4.07 | -3.65 | -3.13 | -0.89 | 3.68 | – | 5.54 |




Source: ISSG, Barclays Capital and Bloomberg. As at 30 June 2016.

"Commodity prices, including oil, have at least partially rebounded from recent lows and seem on a more stable footing; the demand/supply dynamics projected into the future also look more positive."

## Market optimism

Despite ongoing political uncertainty in a number of developing countries, Garcia Zamora remains optimistic.

"While the return picture is rarely predictable and uniform there are a range of markets we feel could offer good prospects. Within central and eastern Europe we like Russia, Kazakhstan and Georgia, while in Latin America, Brazil, Colombia and Argentina look attractive," he says.

Garcia Zamora adds that in Asia, Indonesia currently stands out as one of the richest prospects in the region. He says: "In recent months, cyclical factors have been very supportive of Indonesia. The growth picture has improved and the government has been fairly stable and has been pushing for structural reform. Flows have been very supportive as well because it is, essentially, the main high yielding market in Asia."

Risk can be seen as a key feature of emerging markets and a tendency for unpredictable events to drive volatility means investment in EM sovereign and corporate debt sometimes requires both patience and strong nerves.

Citing this year's failed coup attempt in Turkey as a prime example of events that can damage short-term confidence in specific markets, Garcia Zamora says EMD investors should always think long-term while also keeping a close watch on international events.

> **Beyond emerging markets we have just seen the UK vote to leave the EU and now face upcoming French and Italian votes which could also influence the future direction of Europe.**
>
> Federico Garcia Zamora, Standish

"Within our universe there is always the risk something unexpected could happen which might spook markets. But despite the often short-term blips in the market, the fundamental need for returns remains and emerging markets currently offer some of the highest available. That technical backdrop has been with us for some time now and will most likely continue to be with us for the foreseeable future," he says.

## Risk profile

While Garcia Zamora acknowledges the situations in emerging markets such as Brazil and South Africa (which is facing an uncertain political future after recent local elections[6]), he points out such political risks are not confined to developing markets.

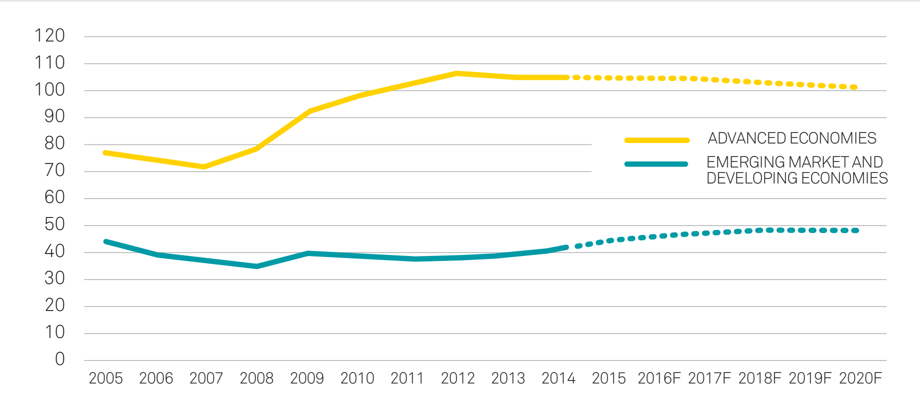
"We have just seen the UK vote to leave the EU and we now face upcoming French and Italian votes which could also influence the future direction of Europe. In developed markets there are clearly a range of events that could upset global investment markets – not least further activity by the US Federal Reserve (Fed) – and the outcome of the US election," he adds.

One important decision facing EM investors is whether to gain exposure to the sovereign market, look at corporate debt or a mixture of both.

While on average, emerging markets economies are less indebted than developed ones – according to the IMF –

6 Newsweek. South Africa left in limbo by landmark election results. 08 September 2016.

**EM INDEBTEDNESS (GROSS GOVERNMENT DEBT/GDP %)**




Source: International Monetary Fund, World Economic Outlook Database. As at 6 October 2015.

the sovereign debt sector is not immune to default or the threat of it. EMD has had a number of sovereign debt downgrades in recent years.[7]

Corporate debt can offer potentially higher risks than sovereign bonds but can also provide compensatory, attractive returns. Either way, good local knowledge of individual markets and geographies and specialist investment expertise are crucial in order to maximise opportunities while keeping risk to a minimum, Garcia Zamora adds.

Beyond sovereign versus corporate, another key consideration facing EMD investors is whether to gain exposure via US dollar-denominated (hard currency) securities or local currency. Traditional hard currency issuance has increasingly given way to local currency. This has helped to improve both the stability and scale of capital markets in developing markets. But Garcia Zamora says investors should always think carefully about the currency risks associated with their investments.

## Going local

While issuance in local currency denominated debt has grown significantly in recent years[8], many investors show a preference for US dollar issues as a way to guard against local currency fluctuations that may impinge on returns.

Garcia Zamora says: "Many asset allocators are still cautious on local currency EMD given the volatility local markets have seen over the past three or four years. They generally feel more comfortable with hard currency EMD, where they understand the currency volatility much better than on the local side. That said, local currency denominated debt can be used as a positive tactical vehicle. If a major fall in the dollar, say, was anticipated then it could perform well."

## Positive factors

Looking ahead, a number of factors look set to boost growth in the EMD sector. The low yield environment currently holding back many developed markets shows no sign of reversal and while prospects remain weak, the comparatively high returns offered by emerging markets investment will continue to attract investor interest.

From an investment standpoint, EM sovereign and corporate debt can provide both portfolio diversification and income generation. Governments in a number of emerging markets, such as India, are also taking steps to improve governance and boost their economies in order to attract new investment.

At a macroeconomic level emerging markets are becoming increasingly sophisticated and the development of pensions systems across many developing nations[9] is expected to foster continued growth of assets, including both sovereign and corporate debt that can help them match their longer-term liabilities.

Commenting on other potential longer term advantages of investing in emerging markets, Garcia Zamora adds: "We believe economic growth in emerging markets is set to continue to outpace growth in developed countries."

## Shifting sands?

In May 2016 the diminutive Gulf State of Qatar launched the Middle East's biggest ever bond issue – releasing US$9bn worth of debt via Eurobond markets.[10]

In recent months, the oil rich Gulf States have been hard hit by falling commodity prices, prompting nations such as Qatar to take new steps to head off budget deficits. In April, Abu Dhabi separately raised US$5bn from a sale of five and 10-year dated government debt and further issuance is expected from the United Arab Emirates.

Earlier in 2016 Saudi Arabia also announced plans to arrange its debut international bond which could be worth up to US$15bn, according to financial news provider Bloomberg. Dubai was also reported to be considering a fund raising drive on international debt markets.

This issuance from Middle Eastern markets represents a significant new tranche of debt from what are still generally viewed as some of the wealthiest and most advanced emerging markets in the world.

## KEY POINTS

- Recovering commodity markets, and fresh concern about developed markets have triggered a resurgence of interest in EMD.
- Events such as Brexit highlight developed markets' risks.
- On average, EM economies are less indebted than more developed ones.

7 FT. EM debt rally soars to new heights. 27 July 2016.
8 Teachers Insurance and Annuity Association (TIAA) Global Asset Management. Investing in EM local currency debt markets. 01 March 2016.
9 Ibid.
10 Bloomberg. Qatar Raises $9 Billion in Middle East's Biggest Bond Sale. 25 May 2016.





# An emerging consideration

Taking a strict view on environmental, social and governance (ESG) considerations when investing in emerging markets will sharply reduce the universe of countries that are investable and liquid, says Stephan Bonte, director of sustainable investing at Standish.

The required nuanced approach means needing to make compromises, Bonte says. Data points can be identified in terms of environmental management, social concerns and governance as well as assessing individual country and sovereign risk, he adds. The question would then be how these would be factored into overall positioning in a fund, while maintaining a fiduciary duty to increase risk-adjusted returns.

An impact investor – i.e. one who targets investments that generate a measurable social or environmental benefit alongside a financial return – would likely question investing in China given its heavy reliance on coal production and the resultant environmental impact. Acting on environmental and social concerns would weigh more heavily than the broad risk management aspects of ESG.

With regards to investing in EM, a focus on ESG is becoming more defined as a discrete approach but its elements can be said to have always been present in credit analysis, he notes. An unstable political system could have a considerable impact on the ability of a sovereign to pay back its debts and for the investor to get repaid within the time horizon of the investment.

Determining the risk premium expected from investing in a particular country could involve examining the level of political polarisation, says Bonte.

A country could be examined to determine whether it is prone to splinter between secular and religious factions or demonstrating very left-wing or extreme right-wing tendencies.

When investing in an emerging market, it is important to gauge the ability of the government to grow the economy as well as to maintain a stable system including robust tax collection, comments Bonte. Other aspects are creating conditions for exporters to flourish, including fostering a stable currency, as well as upholding the rule of law, the integrity of the judicial system and ownership structures.

## Shadow economy

The shadow economy – economic activity that falls outside a country's rules and regulations regarding commerce – is not always consistently measured, notes Bonte. When things go well and the formal economy grows, the shadow economy grows with it. However, there is no accompanying positive outcome in terms of tax collection. In contrast, when an economy gets into trouble, paying healthcare aid for the unemployed, for instance, has the effect of skewing the primary budget balance of a sovereign.

Regardless of whether being an oil producer is judged as being less desirable because of climate change, it means being extremely reliant on the export of a commodity, says Bonte.

Having a more diversified economy and a highly educated workforce is more likely to result in steady GDP. Relying heavily on the exports of commodities, energy or minerals and facing the challenge of their cyclicality make it difficult for countries to save when the times are good (in the form of a sovereign wealth fund) in order to weather the not so good times.

There is anecdotal evidence to suggest that the pollution that comes from the use of fossil fuels can have an impact on healthcare costs and ultimately GDP, says Bonte. If people cannot go to work, because they cannot breathe as a consequence of air pollution or are locked in traffic jams, GDP suffers, he adds.

China is clearly trying to push for renewable energy given the level of issuance of 'Green bonds', says Bonte. So far, emerging markets represented US$10bn of issuance of such bond in 2016 more than double than in the previous year[1].

## KEY POINTS

- In emerging markets, ESG owes its influence to sovereign analysis.
- The ability to integrate ESG (and the ease in doing so) varies.
- ESG and credit concerns now overlap significantly.

1 FT: Chinese banks lead 'green' bond boom, May 2016.

# The heart of the matter

For many developing economies the commodities 'super cycle' has been both a blessing and a curse. Insight Investment's Rodica Glavan and ARX's Alex Gorra consider how pricing volatility has affected governments around the world.

The flipside of stratospheric growth is abrupt decline – and for the commodity producers of the world that's been the story of the past couple of years. Oil led the way, falling from over US$100 a barrel in mid-2014 to just above US$26 a barrel at the start of 2016[1]. But amid a global surplus of supply and low demand, the full spectrum of commodities took a drubbing – with everything from metals to soft commodities falling to levels not seen since the dark days of the global financial crisis.

Emerging market (EM) countries in many ways bore the brunt of the collapse: the Institute of International Finance estimates global investors pulled US$735bn out of emerging market bonds and equities in 2015, the worst capital flight in 15 years.[2]

But according to Insight EM debt manager Rodica Glavan, the popular view of emerging markets as predominantly commodity-dependent net exporters – is a mistaken one. For some countries, energy is a key export; while for others (Latin America, for example) exports are predominantly soft commodities and metals. In Asia, with one or two exceptions, countries are mainly net importers, particularly of energy. Across emerging markets, just 44% of countries are net exporters, while 56% are net importers.[3]

For Glavan, these nuances matter. They demonstrate the importance of viewing EM not as one monolithic whole but rather as a broadly differentiated set of investment opportunities and challenges.

"In our view, it is not a country's degree of dependence on commodities but how it uses those revenues that determine long-term success or failure. In this sense, it's hard to overemphasise the need for fiscally-prudent policies. If they can put those revenues to good use then the country will be far stronger and the investment case more compelling."

1 CNBC: 'US oil falls on unexpectedly large inventory build', 20 January 2016.
2 Bloomberg: 'Emerging Markets Lost $735 Billion in 2015, More to Go, IIF Says', 20 January 2016.
3 JP Morgan: 'EM exposure and vulnerability to commodities revisited', 9 March 2016.





**EMERGING MARKETS: NET COMMODITY EXPORTS**

Exports minus imports as % of total gross exports and % of GDP

| | % of total exports | | | | % of GDP |
|---|---|---|---|---|---|
| | Energy | Metals | Soft | Sum | Total |
| **Emerging Markets** | **1.9** | **-1.4** | **5.3** | **6** | **3** |
| EM Asia | -9.7 | -7.2 | 0.6 | -16.2 | -3.5 |
| EMEA EM | 30.4 | 2.8 | 2.9 | 36.2 | 16.2 |
| Latin America | -0.5 | 10.5 | 22.6 | 32.5 | 5.2 |

Source: JP Morgan, ITC Trademap March 2016.

One important concept, says Glavan, is progressive taxation – that is, only taxing commodities producers what they can afford. Far too often, she says, large quasi-sovereign commodity-producing companies have been seen as cash cows which can be milked to the point of exhaustion to help pay for often politically-motivated social programmes. This is the case in Venezuela, where the contributions to social programmes from State-owned oil company PDVSA went up by more than 72% in 2015 – even as net earnings dropped over 19% due to weaker global oil prices.[4]

A similar scenario played out in Mexico, where for the past two decades state-owned oil company Pemex has underwritten between 20% and 40% of the country's federal budget.[5] The long-term impact of this protracted policy of capital extraction has been devastating. Pemex's oil production fell by 20% over the 10 years to 2013; reserves declined by a third over the same period and Mexico went from being a net exporter of energy to being a net importer.[6]

As a salutary lesson in how to avoid this kind of unsustainable approach, Glavan points to countries like Colombia. There, since 2000, the government has charged state-owned oil firm Ecopetrol higher taxes only when its profits reach above a predetermined level. Even in the face of precipitately declining oil prices, this has allowed the company to maintain and even increase investment and output.[7]

## In search of positives

While the commodity collapse may have sparked investment outflows from emerging markets, on a country level there is evidence to suggest price volatility may have had some upsides.

Glavan notes how cheaper oil prices were a boon not just for the economies of energy importers, but also for legislators keen on reform. "Asia, which on a net basis imports more oil than it produces, is one of the regions to have experienced a windfall from cheaper energy," she says. "But even in export countries, the collapse in oil pricing had its benefits."

She highlights Indonesia as a case in point: it used the breathing space of a plummeting oil price to scrap an expensive fuel subsidy programme that in 2013 cost US$23bn or around 20% of the state budget.[8] President Joko Widodo pledged to invest the billions of dollars of savings into infrastructure projects and push for "total reform" of the aviation sector.[9] Nigeria, where oil revenues account for some 90% of the federal budget and where subsidies hit a peak of US$14bn in 2011, followed suit.

This kind of reform is important for developing countries, says Glavan, since it frees up investment into more productive areas of the economy. The International Growth Centre, a UK-based think tank, estimates artificially low fuel prices cost governments around the world US$500bn each year. It says subsidies encourage wasteful energy consumption, create fiscal burdens on developing country budgets, and disproportionately benefit wealthy households.[10]

## Upsides in adversity

Alex Gorra, senior investment strategist with Brazil-focused investment boutique ARX, highlights another possible upside from the commodity price collapse. For Latin America's second largest economy, sluggish Chinese demand and the end of the commodities super cycle exposed not only economic losers but also revealed some unexpected winners, he notes. "When the tide went out on pricing it left a lot of companies stranded – and unquestionably that was painful. But the upside is how it also helped investors identify hitherto unrecognised areas of resilience within the economy."

Even companies that suffered the most have benefited in unexpected ways. This is the case with Petrobras, the state-owned energy company beset by the twin challenge of falling oil prices and a national political scandal. Here, says Gorra, the previous management team's investment plans have been pared back with a far firmer focus on core profitability.

Elsewhere, the receding tide of commodity prices helped reduce the weighting of basic materials companies in the Bovespa stock exchange, allowing the financial services, consumer and infrastructure sectors to gain prominence after being in the shadow of commodity producers for so long.

For now, says Gorra, what Brazil needs most is stability, particularly in its currency. Coupled with an ongoing reform programme, this should provide a platform for a return to growth and help restore investors' confidence in the economy.

Glavan agrees, noting the longer term question of whether commodity prices could rebound is almost irrelevant. Far more important, she says, is a period of pricing equilibrium. "Countries and companies around the world need that breathing space," she says. "A respite from price volatility could make all the difference – even if it's only for a few months."

## KEY POINTS

- Commodity price volatility may have had some upsides.
- While worrying for many, cheaper oil prices proved beneficial to some economies.
- The commodity slump encouraged some companies and governments to focus on core profitability.

4 Bloomberg: 'Venezuela's PDVSA Revenue Plunges Amid Commodity Price Collapse', 3 July 2016.
5 The Economist: 'Make or break for Peña Nieto', 23 November 2013.
6 The Economist: 'Make or break for Peña Nieto', 23 November 2013.
7 Library of Congress Federal Research Division: 'Colombia: A country study', 2010. "In 2000 the government modified the royalties system, with variable coefficients based on output and ranging from 5 per cent to 25 per cent."
8 The New York Times: 'Indonesia Struggles to End Fuel Subsidies', 2 May 2013.
9 Financial Times: 'Indonesia's Joko Widodo pledges to accelerate reforms', 13 January 2015.
10 International Growth Centre: 'Low oil prices: An opportunity for fuel subsidy reform', 18 January 2016.

# State of play

Great progress on increased transparency and corporate governance has been made across emerging markets despite scandals such as Brazil's Petrobras, which has led to the re-surfacing of investor worries over the impact of political corruption. Here, Insight Investment emerging market debt portfolio manager Rodica Glavan explores some of the latest developments.

Brazil's Petrobras crisis is the latest in a long line of high-profile corruption scandals to have shaken confidence in emerging markets. What began in 2014 as a bribery investigation at Brazil's largest oil producer exploded into a far-reaching political, economic and financial crisis.

As the investigation spread, claiming the scalps of dozens of executives and politicians – including the country's former president Dilma Rousseff – it has reinforced widespread prejudices about poor governance and state interference in emerging markets.

However, such ingrained views ignore a great leap forward that has been made in corporate transparency over the past decade, says Insight's Rodica Glavan.

As emerging market corporates have sought access to funding from external markets many have been forced to adopt developed market standards. The message has been clear: if you want to join our club you play by our rules.

"You still have these big scandals like Petrobas but on average corporate governance has improved," says Glavan. "Companies know that they need to improve transparency and reporting to satisfy investors. Without these improvements fixed income investors could demand a higher price, pushing up bond yields, or would simply not buy their debt. Either way this would push up corporate financing costs."

What is good for debt investors is also positive for equity investors. Glavan continues: "Companies have moved to the internationally accepted standard of reporting every quarter. Most also have a management call at quarterly results where investors can ask questions about the company."

## Governance challenges

Despite these improvements, the corruption probe at Petrobas, which is 60% owned by the Brazilian government, is a reminder that endemic graft, poor governance and a lack of transparency can be a hazard in emerging markets. The crisis has been hugely negative, not just for the oil giant but for the government and entire country.

Brazil's 60% government-owned oil giant is a textbook case of how too much political interference in a business can be potentially harmful. State-ownership of companies remains common in many emerging markets: the countries where state-owned enterprises make up the highest share of national economies are China, United Arab Emirates, Russia, Indonesia, Malaysia, Saudi Arabia, India and Brazil.[1]

This can be a negative when the government interferes and abuses state ownership for its own ends. However, state ownership can also be a plus, especially during hard times, says Glavan.

"Earlier this year when oil was tanking, the high yield debt of both US and emerging market energy companies sold off. However, the US companies are mostly independent while some 80% of the oil and gas companies in emerging markets are owned by the state. If things had become really dire, the government would have been there to help."

## Silver lining

Petrobras is also a reminder that the crises that do periodically appear in emerging markets can have positive outcomes.

1 PWC: State-Owned Enterprises Catalysts for public value creation? April 2015.





"While it has been painful and damaging for the country and the company, longer term this is a massive positive for Brazil because it has prompted a structural change for the country in terms of corruption and corporate governance," says Glavan. "It has led to the appointment of a more market friendly government that is trying to fix the country and put it on a longer term growth path."

A number of market-friendly initiatives have been implemented by the new government to try and win back the confidence of international investors. For example, Petrobras' management has been granted more independence.

Brazil's government is also trying to repeal the legal requirement for Petrobras to lead on all offshore drilling in the country's "pre-salt" oilfields, so-called because they are located under a thick layer of salt.[2] Currently, Brazilian law gives Petrobras exclusive rights to the oilfields.

While the arrangement was viewed favourably by previous governments, eager to capture revenues from the pre-salt fields for the state, extracting oil in these areas is technically challenging and expensive. Now, with Petrobras heavily in debt, it seems financial necessity has trumped political expediency.

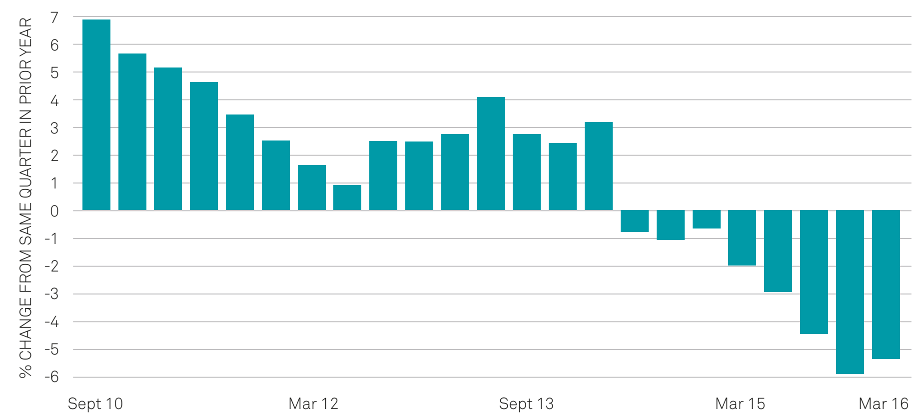
## A rocky road

Of course, implementing change and altering practices, which may have been accepted as the norm for decades, is not easy. The road to improved governance and greater transparency across emerging economies can be bumpy.

There are emerging markets that are still lagging in the corporate governance stakes. "In particular, Venezuela, and I do not know when that is going to change," says Glavan. "There is also a wide difference in terms of transparency when it comes to Chinese companies," she adds.

Elsewhere, improvements have been striking. In Russia state interference in business is still high but recently the country has been free of any high level

**THE SLIDE OF BRAZIL'S GDP**




Source: Brazilian Institute of Geography and Statistics March 2016.

corruption scandals. Meanwhile its neighbours and former allies in Eastern Europe have had to align to the European model of governance as they seek to become members of the European Union.

In April, Argentina successfully returned to the sovereign debt market for the first time since its 2002 default.[3] This has opened up the global debt markets not just to the government but Argentinian corporates too.

"Argentina's sovereign bond issue was hugely positive and follows the appointment of a more market-friendly government," says Glavan. "The new government is trying to steer the economy in the right direction and demand for this issue was a sign of support from investors for its structural reforms."

## Yield appeal

Despite these improvements, spreads between emerging market and developed market debt remain wide, opening up potential opportunities for investors.

Glavan says: "On an absolute yield level emerging market debt (EMD) may not look attractive with investment grade EMD yielding 4% to 4.5% while high yield EMD yields c7% to 7.5% (as of August 2016). However, with Japanese yields in negative territory and Treasuries at their lowest level ever at a spread level they look very attractive. On a spread level they were only cheaper than this during the 2008 crisis."

Analysing transparency remains a challenge: for years no one spotted the scale of the political interference in Petrobras, for example.

However, in many emerging markets corporates and governments are heading in the right direction. Many have woken up to the benefits of greater transparency as a positive way to promote their business to external investors.

"Some of the companies that have filled out an ESG (Environmental, Social and Governance) questionnaire we send have asked us to suggest where they can make improvements. They want advice on how they can be more open, which is very encouraging. They understand that, as investors demand greater accountability, there is a cost for them if they are not transparent."

## KEY POINTS

- Emerging market corporates have been encouraged to adopt developed market standards.
- The road to improved governance and greater transparency can be uneven.
- EM companies are increasingly aware of the need to demonstrate strong accountability.

2 Oilprice.com: Brazilian Oil Giant Petrobras Could Lose Its Most Valuable Assets. 29 February 2016.
3 Reuters: Argentina returns to global debt markets after 15-years. 19 April 2016.

# Riders on the storm

Africa's most developed market retains huge potential despite having been beset by political and economic problems. Here, Newton's Asian and emerging markets equity team reflects on South Africa's economic and investment highs and lows.





More than two decades after the end of apartheid, Africa's second largest economy is still struggling to fulfil its potential.

South Africa's growth slowed to 1.3% in 2015, the lowest since the global financial crisis and below most emerging market economies.[1] In July 2016 the International Monetary Fund downgraded its growth forecast for the year to 0.1%, which would see the economy move perilously close to recession.

Politics have also been a destabilising factor, with the ruling African National Congress (ANC) under frequent fire amid allegations of corruption. However, for investors who can look beyond the country's apparent problems, South Africa offers many compelling opportunities.

As one of the most shareholder-friendly emerging markets, South Africa retains many features attractive to international investors. Corporate governance standards are high and the stock market is not dominated by state-owned entities. As a result of highly cash-generative business models and generous dividend payout ratios, shareholder returns over the long-term have been among the highest in emerging markets and stack up well against global peers.

In addition, the current level of the South African rand looks very attractive following a significant depreciation against the dollar and pound over the past five years.

## Sluggish growth

The rand's weakness is a consequence of the nation's lacklustre economic growth and current and fiscal account deficits that stood at -5% and just under -4% respectively in Q1 2016.[2]

Like other emerging markets, South Africa has suffered due to concerns about a slowdown in China, rising US interest rates and the weak recovery in many developed countries. As the country is rich in gold, platinum, manganese and iron reserves, the nation has been hard hit by the slump in global commodity prices.

However, global factors alone cannot explain the country's poor economic run: South Africa's growth last year was below the average for commodity-producing economies. While international factors have exacerbated the nation's economic problems, many of its sources are homegrown.

A severe skills shortage, strained industrial relations and one of the highest unemployment rates in the world are persistent concerns. In a country where only about 13% of the population pay tax and many receive social grants, balancing necessary social and fiscal spending is a constant struggle. South Africa's budget deficit, as reported in the February Budget statement, is expected to be -3.2% in 2017, a reduction from -3.9% in Q1 2016.

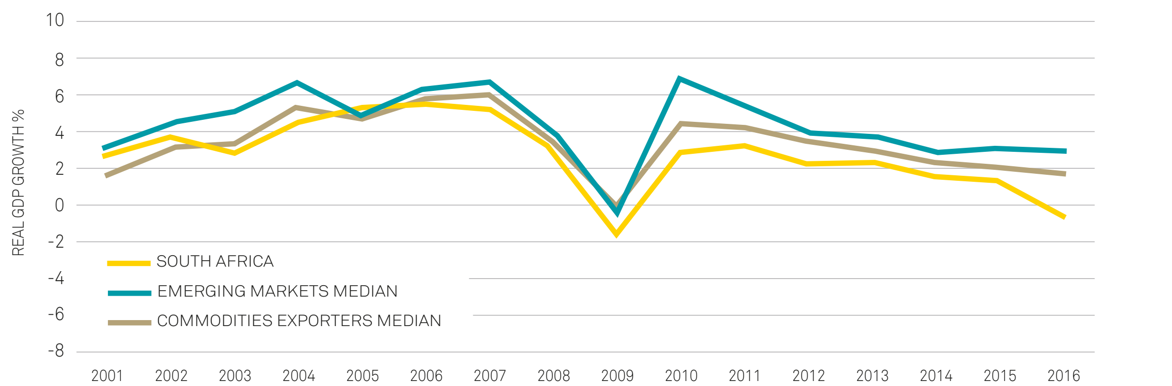
The political environment has also been less than inspiring, with President Jacob Zuma presiding over a slow-moving ANC bureaucracy, which has been plagued by corruption scandals and accusations of mismanagement.

At the end of 2015, the markets were shocked by Zuma's replacement of well-respected finance minister Nhlanhla Nene with David Van Rooyen, a little known backbencher. The rand dropped more than 5% in a single day and billions of dollars were wiped off South Africa's equity and bond markets before Zuma recognised his mistake. Van Rooyen lasted only four days in the job before he was ousted in favour of Pravin Gordhan, Nene's predecessor.

## Healthy opportunities

"Nene-gate" highlighted the difficulties associated with Zuma's administration and its potentially negative impact upon the country's investment climate. However, despite this difficult backdrop we continue to believe there are promising investment opportunities in South Africa.

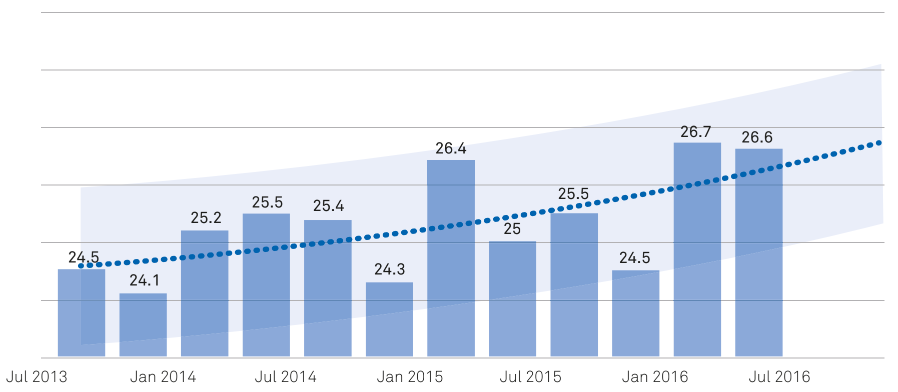
**LACKLUSTRE GROWTH**




Sources: IMF, World Economic Outlook; and IMF staff estimates.

1 International Monetary Fund: South Africa Latest Outlook Shows Urgent Need for Policy Reforms, 7 July 2016.
2 Reuters Africa. South Africa's Q1 current account deficit widens to 5 per cent of GDP. 14 June 2016.

## SOUTH AFRICA UNEMPLOYMENT RATE




Source: Thomson Reuters DataStream 31 July 2016.

Indeed South Africa demonstrates the poor correlation that can exist between returns from financial markets and the economy. Around the time the IMF cut its forecast for economic growth, investors sent the Johannesburg Stock Exchange soaring to a record high.[3]

We believe the most attractive investment opportunities are in areas where South Africans face tough challenges, specifically healthcare and areas of the retail and financial sectors linked to that sector.

South Africa is a classic example of the attractive structural growth story associated with provision of healthcare in emerging markets. Provision of state healthcare in such markets tends to be of a poor standard, meaning consumers are highly motivated to save money to spend on their health.

The prevalence of disease and its impact on productivity and the economy tends to be higher in emerging markets than in developed countries. In South Africa's case the World Health Organization has shown that the country suffers a higher number of "Disease Adjusted Life Years" (DALY) relative to other countries. (DALY is a measure of the years of productive life lost to disease or premature mortality). Higher levels of infectious diseases such as HIV and tuberculosis and a rise in diseases associated with developed market lifestyles, such as diabetes and heart conditions, contribute to South Africa's poor reading on the DALY scale.

Though this is clearly troubling from a public health perspective, it is a very supportive environment for private healthcare providers, including private hospitals. Interesting opportunities can also be found in areas of the retail sector connected to healthcare.

Another area of promise, in our opinion, connected with health is insurance. Against a backdrop of higher illness levels and less secure incomes, both health insurers and funeral insurers look well-positioned.

One of the attractions of South Africa as an investment destination is that it has a relatively well-developed equity market that offers liquidity across a number of sectors. However, whereas the financial and consumer services sectors can offer better growth and higher profitability than in many other emerging markets, South Africa has been left behind in other areas, most notably technology.

Less attractive areas of the investment universe include those with more unionised labour forces, such as the commodities sectors. We view these as more vulnerable to rising labour costs as expenses associated with extraction rise in a low commodity price environment.

There are also a number of retailers reliant on consumer credit to generate sales. Here we see little room for growth, on account of a weaker macro backdrop.

### Ongoing challenges

There are a number of reasons why South Africa has retained the goodwill of international investors even as the economy has stumbled. The fact many South African companies do most of their business outside of the country is one. The nation's record of strong corporate governance and transparency has also kept foreign investment flowing. However, the government recognises that benevolence could quickly disappear. In June 2016 S&P Global Ratings warned that it would cut South Africa's credit rating to junk if policy measures do not turn the economy around.[4]

The National Treasury is working to improve confidence in fiscal sustainability and it is crucial that South Africa demonstrates strong fiscal leadership and consistent execution of policy to boost investment and productivity.

### Political change

A key requirement for this to be achieved is an improvement in the political situation. Currently, this is difficult to foresee. The local government elections in August 2016 showed the ANC losing significant ground in a number of municipalities to the moderate Democratic Alliance (DA) and more populist Economic Freedom Fighters (EFF), led by Julius Malema.

This watershed moment argues for a marked change in tack by the ruling party if they wish to shore up support ahead of the general elections in 2019: either adopt a moderate approach similar to that of the DA, with an increased focus on anti-corruption; or else adopt more populist measures in sympathy with EEF supporters, who have campaigned to nationalise the mines, for example.

The current situation of increased polarisation and fragmentation in the political environment is not promising with regard to any improvement in government execution within South Africa in the near term.

Despite the continued uncertainty, we continue to like select South African companies, which have proved their ability to generate superior returns against a very tough macro backdrop.

### KEY POINTS

- South Africa's economic growth last year was below the average for emerging markets.
- An improvement in the political situation is required to boost investment and productivity.
- Attractive investment opportunities exist in sectors such as healthcare.

3 The Wall Street Journal: Stocks Soar as South African Economy Stumbles. 13 July 2015.
4 Bloomberg: S. Africa Gets Reprieve From Junk as S&P Keeps Rating Unchanged, 3 June 2016.





# About BNY Mellon

BNY Mellon's multi-boutique model encompasses the skills of 13 specialised investment managers. Each is solely focused on investment management and each has its own unique investment philosophy and process.

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| ARX | With expertise in macro analysis and bottom-up stock selection, ARX Investimentos is dedicated to investments in Brazil and Latin America. Headquartered in Rio de Janeiro, the group's philosophy is to optimise risk adjusted returns, with a focus on capital preservation. |
| Insight INVESTMENT | Insight is a London-based asset manager specialising in investment solutions across liability driven investment, absolute return, fixed income, cash management, multi-asset and specialist equity strategies. |
| Mellon Capital | Mellon Capital Management Corporation offers investment capabilities ranging from indexing to alternatives with the infrastructure and skill to transact in all liquid asset classes and securities. |
| NEWTON Investment Management | Newton is renowned for its distinctive approach to global thematic investing. Based in London and with over 30 years' experience, Newton's thematic approach is applied consistently across all strategies. |
| SIGULER GUFF | Siguler Guff & Company is a multi-strategy, private equity investment firm which, together with its affiliates, has over US$10bn of assets under management. Its clients include corporate and public employee benefit plans, endowments, foundations, government agencies, financial institutions, family offices and high net worth individuals. |
| STANDISH | Headquartered in Boston, Massachusetts, Standish is a specialist investment manager dedicated exclusively to active fixed income and credit solutions, with a strong emphasis on fundamental credit research. |

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