Can the Emerging Markets Remain Hot for the Rest of 2017?

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"This world is clearly emerging before our eyes. The shifts ahead, the opportunities ahead are massive" Carly Fiorina

If you embraced the underperformance of emerging market equities during 2016 then you are likely to be reaping the benefits now, as geographically the emerging markets outpointed all other major asset classes during the first quarter of 2017.

This return to form will be viewed by many as a logical development. The theory is compellingly simple, based on the increasing net wealth of most emerging markets, pushed along by their inherent relative cost competitiveness, expanding urban middle classes, more professional governments and the sensible application of developed world technology. Like most compellingly simple theories it makes a lot of sense strategically but over shorter time periods a lot can go awry.

The relative emerging market malaise of the last few years before recent months was an almost direct corollary of rising US confidence – and a rising US dollar – and lower commodity prices. A strong US economy should be good for the emerging markets, but the higher US dollar pulled up costs at a time when general commodity prices pulled down many emerging markets with significantly sized metals, minerals and/or energy sectors. It was not a perfect storm, but versus the attraction of the US market in particular, investors voted with their feet and sold out, deepening the fear of capital outflow concerns in key emerging markets like China.

There are always reasons – as investors - to be concerned about even the largest emerging markets. Brazil's recession, Russia's sanction issues and India's monetary reform actions were all legitimate reasons during the last year or two to avoid the emerging markets. However, in the investment game of risk and reward, the opportunity set got skewed in a very positive manner.

GDP PER CAPITA 2015

Country	GDP per capita 2015 (to nearest '000 US dollars)
US	55
UK	42
Germany	41
France	35
Spain	26
Poland	12
Hungary	11
Russia	9
Mexico	8
Brazil	8
China	7
India	2

Source: Franklin Templeton, Bloomberg, World Bank

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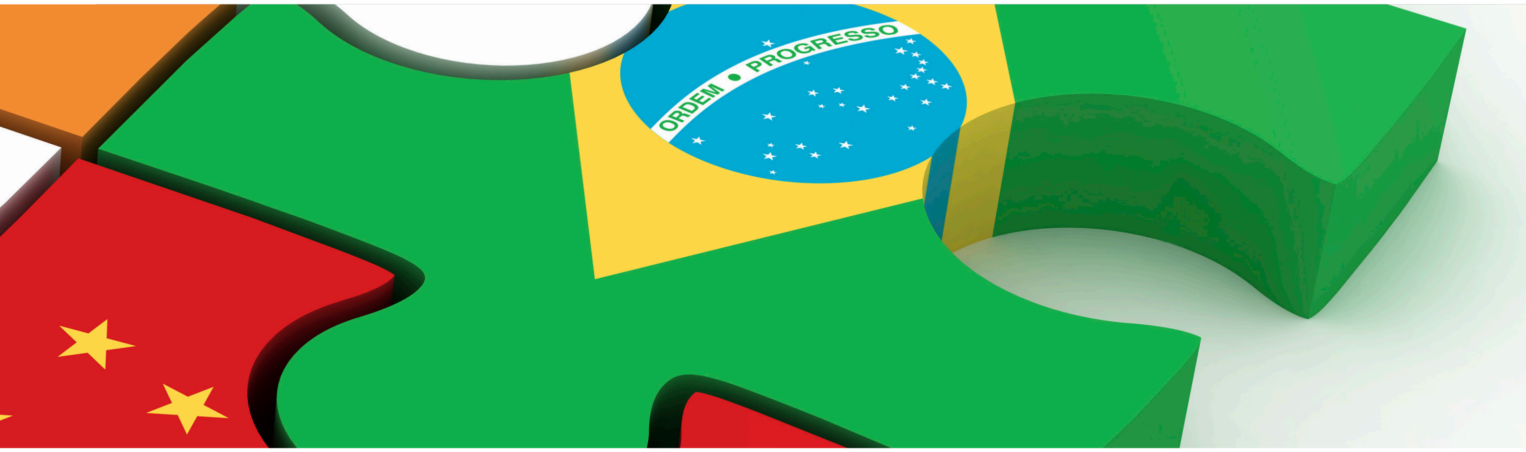

Moving away from the rise of the middle class and over time enhanced consumption levels, the two key issues that will drive – or not – the emerging markets for the rest of 2017, are first the level of the US dollar and second the actions of US investors. As noted above, a lower US dollar would have the reverse effect of a couple of years ago by typically reducing the burden of dollar denominated debt as well as boosting the demand (via lower prices in emerging market currency terms) for commodities, creating a virtuous positive circle for many emerging market investors. This will not go unnoticed by the big American investors, who currently are usually underweight in their benchmarks in emerging market assets. This just potentially further deepens the aforementioned virtuous circle. Good news then, that the most recent Big Mac purchasing power parity currency index in *The Economist* again showed a large swathe of emerging market names as being the cheapest foreign exchange rates in the world.

> The two key issues that will drive emerging markets in 2017 are the level of the US dollar and the actions of US investors

What it will not be driven by, however, I feel is relative valuation across the whole of the markets. Yes, emerging markets are a little bit cheaper than many other developed markets but dig a little more deeply and sector mix is influential here. Simply put, the higher weighting in typically more lowly valued industrial or commodity sector assets impacts the cross-comparison.

A far better valuation angle would be to find strong performing emerging market listed names that look cheap, all matters considered against their developed market peers. This stock picking scope is undoubtedly the still hidden value within the emerging equity markets.

A muted dollar, continued inflows and mix opportunities equates to a positive backdrop for emerging markets in 2017. I would wager they continue to outperform from their strong first quarter start.

KEY TAKEAWAYS:

- Emerging markets outpointed all other major asset classes during the first quarter of 2017
- A muted dollar, continued inflows and mix opportunities equates to a positive backdrop for emerging markets in 2017
- Stock picking scope is undoubtedly the still hidden value within the emerging equity markets.

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