Emerging Markets: Not Out of the Woods Yet

Despite some recent improvements in the markets, we remain reluctant to fully re-engage emerging market equities at this point due to several factors:

Uncertainties for emerging markets remain high as COVID-19 continues to spread. While it appears to be peaking in some countries, the full impact of the pandemic is still unknown. The economic impact of social distancing measures on economies, demographic differences between countries, the efficacy of stimulus, the timing and pace of the expected economic recovery and the probability of a second wave of the pandemic outbreak, coupled with potential social unrest, are issues that are still emerging.

There are currently good reasons to re-engage emerging markets. We saw valuation and record outflows last month, an increase in developed market stimulus and improved U.S. dollar (USD) liquidity. The credit market shows signs of improving and there are expectations of a global recovery in the second half of 2020, provided we do not offset the uncertainties that emerging markets are facing.

The duration of the economic disruption and the ability to recover afterwards will depend on many factors, but it ultimately boils down to what extent permanent economic damage can be avoided. The key in determining the difference between temporary and permanent damage will be the number of unemployed returning to work and the number of businesses resuming after social distancing restrictions are relaxed.

As it stands, the case for a recovery in developed market equities and economies in the second half of 2020 is much stronger than that of emerging market equities and economies.

Historically, emerging market equities have tended to outperform in an upswing given their cyclical nature, but we would caution in reading too much into this historical correlation. Overall, we find ourselves increasingly on the more cautious side of the emerging market spectrum.

The impact of COVID-19
There are likely more shocks to come with the ongoing issue of the COVID-19 outbreak. The low number of daily confirmed cases in many countries (India, Indonesia, South Africa and Mexico as of April 3, 2020) are a cause for concern as it reflects a low occurrence of active testing,
rather than a contained situation. Turkey is a case in point. Up until March 20, 2020, they had a low number of confirmed cases (total of 670), only to see that number jump to 20,921 within just two weeks, forcing the government to start releasing more detailed statistics about the outbreak.

The risk is that the healthcare systems in emerging markets will be overrun from the hospitalization of COVID-19 patients, if and when the outbreak spreads exponentially. Physician density, availability of hospital beds and shortage of essential medical equipment add to the vulnerability of emerging markets in effectively addressing the outbreak.

Almost all emerging markets have implemented social distancing measures of various degrees to delay and dampen the spread of the outbreak, but as we’ve seen in Italy, a lackluster public response to these policies severely undermines the efforts to contain the outbreak. In emerging markets, prolonged lockdowns are problematic since not only livelihoods are affected but lives as well. Subsistence living in high density dwellings, malnutrition and starvation are common in most emerging markets.

Emerging markets were growing between 7% and 8.5% per year during the four years before the 2008 crisis. Heading into 2020, that momentum slowed to between 4% and 5% per year during 2016 and 2019. Therefore, the pandemic shock did not arrive when emerging market growth momentum was at its crest, but came when most emerging markets were already facing an economic slowdown.

Although emerging markets have, in theory, more room to cut rates than developed markets, the importance of real rates (nominal rates minus inflation) to investors do prevent many emerging markets from even contemplating zero interest policies or aggressive quantitative easing.

Whereas many developed countries have announced fiscal support measures equaling 5% to 20% of gross domestic product (GDP), the fiscal room for many emerging market governments are much more limited – and weaker – than 2008. So far, with a few exceptions (Malaysia, Poland and Czech Republic), fiscal stimulus announcements have not exceeded 5% of GDP and tend to cluster around the 0.5% to 2.0% range. Not enough to offset the expected economic shock and social impact. If South Africa is any indication, don’t expect credit rating agencies to give emerging market countries a pass on credit downgrades if they dare to open the fiscal tap more aggressively.
Compared to 2008, emerging market corporates and governments are significantly more indebted than they were 12 years ago. Many emerging market corporates have turned more to USD debt financing over the last decade given the ample supply of cheap USD financing. Although emerging market societies tend to have a higher tolerance for economic and social hardships, the breadth and depth of this outbreak and the limited ability of governments to implement policies, could easily spill over into broader social discord. Many emerging market governments were already facing protests and riots in 2019 as economic growth started slowing.

**Positioning**
Our cautious stance towards emerging markets is also reflected in the positioning of the emerging market fund, reflected in sector and country allocations, asset allocation and currency hedging. Although the fund has returned to be fully invested following the bottoming of equities in March, holding cash and gold continue to be viable defensive strategies.

Geographically, the fund is overweight China and underweight high and vulnerable emerging markets such as India, South Africa, Mexico and Turkey. From a sector perspective, the fund is overweight technology and, surprisingly, consumer discretionary. However, within discretionary spending, the overweight is mainly driven by online retailers and food delivery services. The fund ended the quarter heavily underweight energy and materials. Energy could surprise with a decent rebound in the second quarter independent of the underlying global economic situation if the Russia-Saudi relationship could be resolved. A number of high yielding, high risk currencies were added to the hedging program to reduce the impact of depreciating emerging market currencies.

We will continue with our defensive bias but acknowledge that the current situation is highly fluid. If the resilience and ability of emerging economies, governments and societies start outweighing the reasons and expectations to remain more cautious, we are ready to shift positioning in line with a more sustainable recovery.

**Sources:**
- https://www.worldometers.info/coronavirus/
- World Bank
- World Health Organization (WHO)
- International Monetary Fund (IMF)
- TD Bank
- JP Morgan
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