Themes, Trends and Opportunities in Emerging Markets

While the emerging markets only represent about 10% of the global equity markets, they have a majority of the world's population, landmass, foreign exchange reserves, GDP, and energy consumption. Also, 8 out of 10 of the world's largest cities are in emerging market economies.

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Michael Hedstrom, director of the Closed-End Fund Association (CEFA), spoke with Rennie McConnochie, head of global banks at Aberdeen Asset Management to discuss his insight on the many changes taking place in the emerging markets, and potential opportunities for closed-end fund investors.

The following Q&A recaps the conversation that originally took place as part of CEFA's podcast series on June 1, 2017, which can be heard at CEFA.com.

MH: Let's start with the market environment. Emerging market equities sold off significantly after the U.S. election, mainly due to concerns about increased U.S. trade protectionism and a stronger U.S. dollar. But since the turn of the year, the emerging markets have recovered strongly. Can you talk about what you are seeing in the market and your thoughts on the outlook going forward? Also, what effects could rising interest rates have on emerging market currency, and U.S. dollar valuations?

RM: Well, the markets have been pretty volatile and as you rightly say, post the election of President Trump, we saw significant selloff in emerging markets, both bonds and equities, and for that matter, currencies as well. It was, as you rightly point out, down to views on U.S. protectionism and the policies that Donald Trump was going to put in place. We've since then seen quite a significant rebound and I think that's down to a number of things. First of all, it seems that a lot of the rhetoric that President Trump was using pre the election has softened quite a bit in terms of actual policy actions post-election. The ability for President Trump to actually get stuff done in Congress seems to be proving a little more tricky than he and others might have thought.

I also think the response was post-election pretty knee jerk, and actually a good opportunity. The longer term themes in emerging markets are still very positive, and yes, there is a view that a rising interest rate environment, particularly in the U.S., isn't good for emerging markets. But I think I would make a couple of points there. First of all, any rate increases we see in the U.S. are going to be gradual and I think over a long period of time, so we're not going to see violent interest rate moves in the U.S. Secondly, the fiscal positions of a number of emerging market countries, and also the corporates within those countries, are significantly stronger than in other times of emerging markets crises.

I don't actually believe that the rising interest rate environment is going to have much impact on emerging markets this time around, and we've seen a significant rally both in bonds and equities, and also in emerging market currencies over the last few months.

MH: While GDP growth has slowed down in recent years, emerging economies are still growing faster than their developed counterparts. Countries like India, China, and Indonesia are stepping up their efforts on structural reform, which should bode well for long-term growth. We are also seeing a growing middle-class population. What are some interesting themes and trends in the emerging markets that investors should know about?

RM: I think you've touched on one of the more significant ones there, Michael, and that is referring to GDP growth. GDP growth in the emerging market area has remained pretty robust and the outlook for it remains pretty robust as well. If you look at average forecasts in the marketplace, you're probably seeing GDP growth of 200-300 basis points more than we're seeing in the developed markets of the likes of the U.S., Europe, and Japan. That's particularly important, and as you rightly say, there are a number of countries that have embarked on fairly significant reforms.

I think India in particular comes to mind there, where President Modi has pushed through a pretty radical reform agenda, tackling corruption, and making the ease of doing business much more significant in that country. In the Ease of Doing Business Index, you've seen India jump about I think 20-25 places over the last 12 months. Those reforms are certainly helping. Indonesia, as you point out, we've seen a reform-friendly government elected just over a year ago, and you've seen significant reforms pushed through there, and again, the great outlook in that country as well remains pretty exciting.

Another point I'd like to make in regard to that is looking at the whole area of demographics. The population in the Western world and Japan is aging, birthrates are falling, and that will undoubtedly be a significant long-term drag on our economic growth. The demographics in most of the emerging market countries are really quite exciting. We'll continue to see robust population growth which will certainly aid the longer term outlook for economic growth as well.

Just to put that in context, I think it was Citibank said in a piece of work they did a year or so ago, that by 2030, more than 50% of global GDP will be in the Asian region. You can see a significant shift taking place there in terms of the strengthening of economies and where economic growth is really going to take hold. From an investment point of view, one really needs to be cognizant of that when looking to allocate portfolios for the longer term.

MH: So there are some positive developments in the emerging markets. What is your view on some of the risks?

RM: Well, there are always risks, whether you're investing in the developed markets or emerging markets. Within emerging markets, I guess you have to understand that the rule of law in certain countries is not all it might be. You have to understand that varies of the political and judicial institutions are not as strong as they could be. You have to be on the lookout for corruption, so making sure you invest in the right companies with good management, that will treat all shareholders equally. We've just seen a good example of what corruption scares can do in Brazil over the last couple of months or so.

President Temer was alleged to have been involved in a discussion regarding bribery, and you saw a significant selloff in both the currency and the Brazilian equity market in response to that, because investors became nervous that President Temer was no longer going to be able to push through the fairly radical reforms that he was intending. One has to be aware of that, and really know the companies and the management of the companies, and perhaps the families that are the majority owners of these companies, that you're investing alongside good solid people who, as I said before, will treat all shareholders equally.

Having said all that, as I point out to clients of ours, corruption in the developed world is very much a factor there, too. Last time I looked, I think the Western banks have been fined a total of something like $350 billion for various nefarious activities that they've been embarking upon. Corruption is alive and well in developed markets, just as it is in the emerging market space as well.

MH: You mentioned the importance of knowing the companies that you invest in, that's a good transition into the next question. Emerging markets offer active managers one of the best opportunities to outperform the benchmark. What are your thoughts on active versus passive investing in the emerging markets?

RM: Well, passive investing is definitively here to stay. There's no doubt about that, and the ETS/index world will continue I think to take more market share. But I think you've got to be pretty careful when you look at the emerging market world because significant opportunities both in terms of equities and in terms of bonds do not appear in any emerging market index. If you decide to invest in emerging markets via an ETF, you can really miss out on very significant investment opportunities because there are a number of very good companies that are not listed in any of these indices. If you invest with an active manager, that active manager can take advantage of all the opportunities, both in the index and outside of the index, and I think that's a much better way to look at things.

Equally, the various areas of the emerging markets world are fairly illiquid, and I think if we see a significant selloff, it'll be interesting to see exactly how the ETF world performs in that area. Closed-end funds, for example, are actually a very good way of investing in emerging markets because they are permanent capital vehicles, and they can take advantage of some of the more attractive but less liquid areas that maybe mutual funds and certainly ETFs cannot do. I'm not against ETFs per se — I think in a lot of areas they provide benefits that investors are looking for at a very cheap price. I'm just not convinced that they serve that purpose as well in the emerging market world.

MH: You mentioned a bit about why you think the closed-end fund structure makes sense when investing in the emerging markets. You also have several single country funds at Aberdeen. Why should investors consider using one of them and, for example, an India fund versus a broader emerging markets fund?

RM: Well, I'd love to say that emerging markets were all the same but they are not. There are very different investment opportunities that are offered in different countries. Some countries are very much driven by commodities, other countries are significant commodity importers. India is a good example of that. India imports a lot of its crude oil and the reform story in India is one that is very exciting, both as an equity investor and as a bond investor.

As I say, President Modi has pushed through some very significant reforms in the country and we've seen a lot of money flow into bond and equity markets as a consequence of that. The Indian market could arguably look a little expensive at the moment, but with significant GDP growth potential, with inflation under control, with bond yields around the 7% mark, it's actually a very attractive story.

Investing in emerging markets funds per se can give you significant exposure to both the bonds and equity asset classes, much more so as I said before, than an ETF. There are some very specific stories within emerging markets where investing via a country fund can be a very good way of gaining that exposure. We've certainly seen a lot of interest in our Indian closed-end fund from financial advisors over the last 12 or 18 months.

MH: Many investors are attracted to the track record of emerging market growth and performance, but are reluctant to invest due to the volatility. In summary, what are you potentially missing out on if you have an investment portfolio without exposure to the emerging markets?

RM: Well, I think you're missing out on getting significant exposure to long-term economic growth. As I said earlier on, there's hardly a forecaster out there that isn't forecasting fairly anemic growth of the Western world over the next five or 10 years, and with aging populations, that is not going to make matters any easier. The real growth is going to come from emerging markets, so if you want to tap into that economic growth as an investor, you really do have to have a significant exposure to the emerging market world. As I said before, by 2030, 50% of global GDP will be based in the Asian region. You really can't afford to miss out on that as an investor, and yes, there is volatility from time to time. There's no question of that.

We would see that volatility as an opportunity. If you do get significant corrections in the markets, then we would see that as an opportunity to add to the good quality companies that Aberdeen has in its mutual funds and closed-end funds that are invested in emerging markets. We are very much long-term investors, and we fully expect our clients to understand that. From time to time, you will have to ride out periods of volatility because they'll be there in emerging markets. The really significant story is the long-term growth potential there and that is what investors will increasingly, I believe, need more and more exposure to.

You can find more insight from Aberdeen and information about their closed-end funds on their website at www.Aberdeen-Asset.us. Information is also available on CEFA.com – your comprehensive resource for education, data, and timely insight on closed-end funds.

Disclosure

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