MAERKI BAUMANN & CO. AG

PRIVATE BANK

INVESTMENT COMMENT

April 2017

The latest on the emerging markets

For a long time, the emerging markets were a favourite play of global investors, but attitudes towards this investment region have experienced a significant shift in recent years. This is attributable to a wide range of factors. In addition, we would point out that the term "emerging markets" encompasses a very heterogeneous group of economies. Depending on a given person's propensity to assume risk, 20% of the overall equity exposure may be invested in this segment.

Brazil, Russia, India and China are frequently referred to as an individual subgroup by their own acronym "BRIC", but even here there are very large differences between the economies in question. For example, Brazil and Russia are major commodity exporters, while India and China are major commodity importers. There are also significant differences in the second tier of emerging markets, which includes countries like South Korea or Poland (for which the designation "emerging market" is open to question), Indonesia, Mexico, Turkey, Argentina, Thailand and Nigeria. Based on the 2017 GDP estimates published by the International Monetary Fund, 6 of the 15 largest economies in the world – and 12 of the 30 largest – are emerging markets.

There are many criteria that could be applied when making distinctions between countries, be it economic (market-based economy or planned economy, commodity reserves), political (one-party or pluralist political system, degree of democratisation and personal freedoms), or demographic (size of the working population as a proportion of total population today, in 10 years, in 20 years, ...).

With their fondness for pithy forms of reference, the financial markets have taken to heart the notion of the "fragile five" – a term first coined by Morgan Stanley in 2013. In May and June of that year, the yields on 10-year US government bonds rose by more than 1.1 percentage points in a development forming part of the "taper tantrum" – the response by markets to the announcement by Federal Reserve Chairman Bernanke that the Fed would be scaling down its purchases of securities in a phased manner.

The "fragile five", (namely Turkey, Brazil, India, South Africa and Indonesia), were the emerging markets with high current account deficits and therefore a permanent need for foreign capital to cover these deficits. As long as interest rates in the industrialised nations remained very low, the necessary capital could be drawn from portfolio investments from abroad for many years. In the spring of 2013, however, the appeal of investments in secure US government bonds rose in parallel with the higher interest rate environment, and so the central banks of these five countries were confronted with falls in the external value of their currencies, which they sought to counter with interest rate rises. This also had the effect of choking their economies, however. While on the one hand this did improve the current account situation, it also lent further impetus to the depreciation of their currencies. This in turn set off a spiral that was intensified by the decline in commodity prices (the emerging markets are for the most part beneficiaries of high prices), which only came to an end at the start of 2016. By this point the relative performance of emerging market equities (compared to the equities of industrialised nations) had reached an 11-year low, while their currencies (as measured by the JP Morgan Emerging Market Currency Index) plunged to new lows vis-à-vis the US dollar.

Today, some 15 months after this nadir, emerging market equities and bonds may have recovered handsomely, but they are still low in historical terms. Without doubt, a major factor here is the (painful) discovery by global investors that the term "political risk" plays an incomparably bigger role in connection with emerging market investments – notably in Venezuela, South Africa, Russia, Ukraine, Turkey, Malaysia, Egypt, and other such countries. In addition, there is also a chance that US interest rates will undergo a further sharp rise (which is indeed our medium-term expectation), which could result in a further significant rise in the value of the US dollar in the medium term. Although we retain a degree of scepticism with respect to the upside potential of the greenback, the argument that emerging market investments do not look very appealing is uttered rather frequently in the financial press.

We feel that the – in some cases very sharp – depreciation of certain emerging market currencies has been exaggerated, making a further (upward) correction likely over the next months. When measured against the aforementioned currency index of JP Morgan, emerging market currencies lost more than 40% of their value over the five-year period up to the nadir of January 2016. The Russian rouble is almost 70% down from its high of 2011, while the Brazilian real and the Turkish lira are both down more than 60% (all vs. the US dollar). The JP Morgan Emerging Markets Index has clawed back just under 9% since its low on 19 January 2016, with the real having gained more than 30%, the rouble more than 40%, and the rupee 25%, whereas the Chinese yuan has lost another 4%. For that reason, even a further strengthening of the US dollar over the next few months need not be seen as a disastrous development, as to a certain extent there is still a "valuation buffer" factored into the cheaply valued emerging market currencies.

Just like their currencies, we also view the equity markets of the emerging economies to be clearly undervalued on average. When measured according to the Shiller price-earnings ratio, their valuation is more than 25% below the average of the last 12 years, wheras the Shiller P/E for the broad-based MSCI All Countries World is currently just under 4% below its 12-year average. The level of volatility in emerging market equities is historically some 50% higher for the industrialized nations. For this reason, we recommend these equities as an addition to an existing portfolio, while at the same time advising against any excessive cluster risks. Depending on a client's propensity to assume risk, emerging markets equities may make up to 20% of the equity exposure in a portfolio, in our view. Depending on a given person's propensity to assume risk, 20% of the overall equity exposure may be invested in this segment.

Where the bonds of the emerging markets are concerned, in contrast to the industrialised nations we anticipate positive returns over the next few years, despite the risk of rising inflation: the interest rate level here is much higher, which means potential capital losses can be offset by the steady stream of interest income ("carry"). The yields on emerging market bonds even look attractive when compared to those of high-yield bonds: historically, yields on global high-yield bonds have been between 1 and 3 percentage points higher (with a significantly lower average term), whereas now they are practically at the same level – despite the fact that emerging market bonds have a superior credit rating to the tune of some three notches. We also consider the local currency bonds of the emerging markets to be attractive, as we are anticipating a continuation of the upward trend that has become apparent on the currency front. Although yields are very low in historical terms (just under 5% p.a., compared to just under 5.5% p.a. for hard currency bonds), these could enjoy substantial rises thanks to the upside currency potential we discern here.

When investing in the emerging markets, we recommend adopting a diversified approach based on collective investment schemes. Whether to adopt a passive or active fund approach is for investors to decide themselves. Our own view is that the markets for these investments are not yet fully efficient, i.e. a combination of solid analysis and agile positioning should enable active funds to achieve a higher return, which will more than compensate for the additional management fees.

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MAERKI BAUMANN & CO. AG

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EDITORIAL
Daniel Egger, Chief Investment Officer

(Editorial deadline: 19 April 2017)

ZURICH
Dreikönigstrasse 6
CH-8002 Zurich
Phone +41 44 286 25 25

info@maerki-baumann.ch
www.maerki-baumann.ch