Emerging markets: Opportunities for growth amid evidence of fundamental change

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Growth dynamics are taking root across emerging economies. Stimulative government policies and an expanding consumer base are providing tailwinds for companies that have the expertise to generate good cash flows, design competitive business models, and allocate capital smartly. Indeed, such company-level developments are where opportunities for alpha generation reside. For investors seeking to diversify their equity allocations, the long-term case for emerging markets is worth considering.

In the years since the global financial crisis, support for emerging markets equities has been inconsistent — certainly less consistent than it has been for their developed market peers. This raises the question: Are emerging market equities destined to continue performing unevenly, or are there reasons to expect smoother sailing going forward? While such predictions are difficult to make and emerging market equities are regarded as risk assets, the asset class indeed appears poised to benefit from a number of fundamental factors.

In India, for instance, government-led initiatives are contributing to the long-term case for investment. One example is aimed at injecting capital into the infrastructure sector. The Indian government, as the lead investor in the project, has committed the equivalent of approximately $US3 billion to the National Investment and Infrastructure Fund (NIIF). The NIIF aims ultimately to double in size by bringing in institutional investors such as sovereign wealth funds and pension funds from other countries. As currently conceived, the fund will invest directly in infrastructure projects (and the companies that execute the actual work), aiming to produce a meaningful positive effect on the Indian economy.

India’s economy is already posting gross domestic product (GDP) growth that is among the strongest of the G20 nations; if additional infrastructure stimulus is effective, there is a likelihood that it will magnify the country’s potential for continued economic expansion.

Favorable growth dynamics

Across emerging economies, fundamentals are improving. A deliberate, organized shift is taking place, in which countries are pursuing responsible monetary and fiscal policies. This is exemplified by stimulative measures in countries that include China, Indonesia, South Africa, India, and Malaysia. Policy specifics vary by country, and we do not imply that stimulative policy can lift all emerging countries at once. But on the whole, we think positive developments are under way.

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An expanding consumer class

A growing middle class within a number of emerging economies is giving rise to a profoundly expanding consumer base, one whose spending power is fueled by rising wages and newly available access to credit. This consumer class is generating demand for services that go beyond the basic essentials of day-to-day living. Few countries exemplify this transformation as well as China. These are some of the conditions that are facilitating this sea change:

- Hundreds of millions of Chinese are entering the middle class, and for the first time in history, a substantial middle class sits between the elite and the masses.
- The labor market is tightening. In each of the last 10 years, more than 10 million jobs have been added to the Chinese economy.
- As a share of the Chinese population, urban dwellers have tripled since 1980, and they now represent more than 50% of the total population. This has positive connotations for the country’s consumerism, because urban households tend to earn higher incomes and spend more than their rural counterparts.

It’s worth keeping in mind that China’s evolving economy does not capture the entire story; it merely illustrates growth dynamics that are taking root in other emerging economies as well. Within Asia alone, evidence of an expanding consumer class can be seen in countries like Indonesia, where an estimated 90 million people will join the middle class by 2030, and in Malaysia, where the consumer class is starting to make a meaningful contribution to economic growth.

The table below highlights additional factors that are contributing to the transformation that is under way.

Four catalysts for growth in emerging markets

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| **Widespread increase in consumption** | • Annual consumption across emerging markets will rise from $US 12 trillion in 2010 to $US 30 trillion by 2025. During the same period, the share of world consumption will increase from 32% to 47%.
  • As millions move into the middle class, rising incomes are driving increased spending on discretionary items such as cars, clothing, and appliances. |
| **Commodity markets**            | The stabilization and rebound of commodity prices in 2016 was a precursor to a cyclical uptick in global economic activity that is expected to drive demand for raw materials as we continue into the coming quarters. |
| **Economic growth**              | Emerging economies are expected to have grown at a pace of 4.7% for calendar year 2017, rising from a rate of 4.1% in 2016.                                                                 |
| **Recent softening of the US dollar** | A weaker US currency makes it easier for developing countries to pay back dollar-denominated debt.                                           |

Data: Bank of America Merrill Lynch (economic growth expectations); McKinsey (consumption).

1Based on research conducted by: McKinsey (growth of middle class); Federal Reserve Bank of Kansas City (labor market); China National Bureau of Statistics (urban population).
Attractive valuations

Despite their strong advance during the past 18 months or so, emerging market shares have been relatively cheaper than their developed market peers. The cyclically adjusted price-to-earnings ratio for emerging markets is approximately 13.5, while US stocks are trading at multiples that are north of 20 (data: Dow Jones). By this measure, emerging market equities are reasonably priced while developed market equities are rich enough that some analysts are concerned about an impending stall. Valuations may defy gravity for a while yet, but there’s not much margin for error.

Beyond macro conditions: Emphasizing stock selection

Within the context of the reasonably positive macro conditions described above, several company-specific examples of investment ideas show strong potential for growth. Indeed, these company-level stories are where opportunities for alpha generation reside — a phenomenon that can get lost in the fray when investors are led purely by country-level conditions.

One example comes out of South America, a continent that is grinding its way through a host of fragile situations. Corruption, unstable public finances, pensions in need of reform — these headwinds are all part of the narrative, without question. Nevertheless, stories of genuine entrepreneurship can be found at the company level. We are seeing evidence of companies that are being managed effectively and competing vigorously. These firms are using management techniques that are no longer the sole provenance of companies in developed economies. What’s more, they are generating decent cash flows, building sustainable business models, and allocating capital smartly. Perhaps most importantly for investors, these companies have room to grow.

For some of these companies, the rise of Internet technology has paved a route to success, as shown by firms such as Mercado Libre, an Argentine operator of an online marketplace. We believe the company is run by a capable management team, and its results have shown as much: Sales volume is growing at a rate that is somewhere between two and three times that of Amazon.

The company’s competitiveness can be illustrated with other metrics as well, including a so-called take rate of 7.5%. In Brazil, to cite another example, the same dichotomy holds true: The country’s macro conditions are not without sore spots, but company-level research can reveal compelling opportunities. Here, a traditional retailer with a large operation (approximately 800 stores) is operating an online marketplace that is getting meaningful traction. The company’s performance is strong enough that it has essentially put a virtuous cycle in motion, by which it is able to arrange attractive financing terms, fund new initiatives, and do so while keeping its balance sheet in good order.

Mexico also is nursing its share of structural and political problems yet provides a home for companies that are determined to compete. There appears to be room for growth across several industries, and wireless communications is one that is worth studying. Operators of cell towers, for instance, appear poised to expand, particularly in light of the penetration rate for mobile phone usage in Mexico — it is relatively low, and we think it will grow.

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2 This measures the company’s revenue and is calculated as a percentage of the total value of goods sold on its platform.
Questioning old stereotypes

Two additional circumstances can, we believe, help make the case for emerging markets. Both tend to go against conventional thinking and challenge old stereotypes:

• **Government involvement is not automatically a bad thing.**

  Investors can be forgiven for assuming that industries automatically suffer when government plays too big of a role. Particularly in emerging markets, state involvement is often viewed with suspicion, and investors tread cautiously when assessing these relationships. But our research suggests that this trepidation can sometimes be overdone, and government involvement should not automatically be deemed detrimental to company-level performance. We have revealed cases in which well-managed companies actually benefit from aligning themselves with their governments.

  The airline operator Turkish Airlines is one example. Forty-nine percent of the airline’s ownership is government related, via the country’s sovereign wealth fund. With a fleet of more than 300 aircraft, Turkish Airlines flies to approximately 120 countries and is the fourth-largest carrier in the world based on total destinations. It uses the city of Istanbul as a hub that connects Europe and the Americas to the Middle East, Africa, and Asia. Our knowledge of the airline’s operations suggests that it will continue improving its position as a globe-spanning carrier. At this writing, the Turkish government has begun construction on an airport that will accommodate 100 million passengers per year. With all of this in mind, we think Turkish Airlines supports the idea that aligning with government can be a good thing.

• **State-of-the-art businesses exist outside of developed markets.**

  There’s an increasing amount of evidence that certain companies in emerging economies are capable of doing things as well as, if not better than, their developed market counterparts. China’s Tencent Holdings has been masterful at this, growing from a relatively simple text-messaging service to an online giant whose user base is bigger than that of Google, Amazon, and Facebook combined. The company’s ascent is instructive, and we believe it drives home the fact that developed-market merchants such as Amazon do not dominate ecommerce globally. This is partly because order fulfillment is not easy or cheap in some corners of the world; local companies are better equipped to step in and compete strongly, delivering value and convenience that established kingpins like Amazon cannot replicate.

Stock selection is where performance originates

While macro concerns are always part of the emerging market landscape, company-level research can reveal compelling opportunities. We think it makes sense to focus on companies that are early to market and have the potential to grow. In other words, we think portfolio returns can benefit from identifying early-stage growth companies that have the potential to add scale. With the right people, processes, and entrepreneurial drive, good companies in emerging markets can earn their way toward becoming great companies, rewarding investors along the way.

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