



---

# EMERGING MARKETS QUARTERLY: BETTER FUNDAMENTALS BUT STILL RISKS IN DM POLICY

## Q3 2016 Insights

---

Emerging markets (EM) have endured strong adjustments in commodities and currencies that coupled with reforms makes a good case for better growth ahead. Still, it will take time for EM to navigate to more stable sources of growth, requiring relative stability through the delicate transition. Since the US Federal Reserve (Fed) pivoted to a slower pace of rate normalisation early this year, stability has returned but could be disrupted with policy tightening that is likely to resume in December.

EM is clearly in much better shape than late 2015 when the Fed first hiked rates, so it is possible that a rate hike may have no impact at all or could even be read as positive, signalling better growth prospects ahead. We do not know how markets will respond, but we can imagine potential risk scenarios and estimate the relative impact across the EM complex.

Risk exposure is always uneven across EM, but even more so now given the broad risk rally leaving valuations less compelling and more reliant on fundamentals that can deliver. In the months ahead, it will be increasingly important to own quality EM assets that can deliver on fundamentals while weathering the potential storms of a changing risk ahead.

Typically, we describe our preferred assets in terms of hierarchies, first by asset class and then by region. However, opportunities are different enough within and across regions that we describe our hierarchy this time more granularly.

Local currency bonds remain at the top of our hierarchy, preferring Latin America (LatAm) for high real yields and

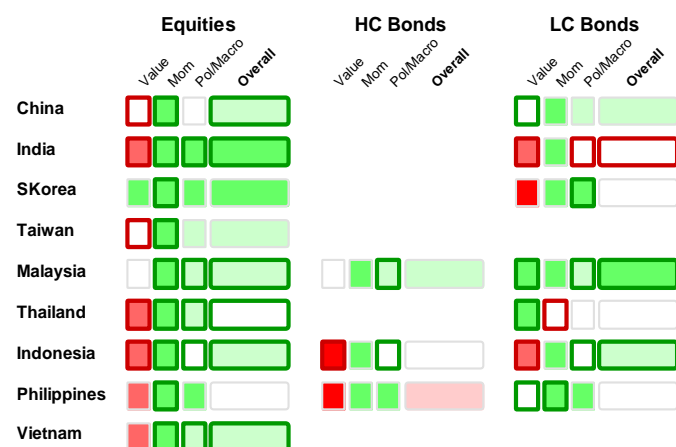
peaking inflation coupled with political improvements while Asia maintains potential for further rate compression. Asian equities are second in the hierarchy for attractive valuations, a more visible path to growth and now positive momentum across the region.

Hard currency bonds are third in the hierarchy – a more defensive asset – helping to balance portfolio risk. Outside of Asia, equities remain at the bottom of the hierarchy though we remain neutral in LatAm and underweight Europe, the Middle East and Africa (EMEA), mainly in Turkey and South Africa where macro imbalances are met with little political capacity to address them. This quarterly report summarises our current views and quarterly adjustments by region, with an asset class score summary followed by the key elements of our analysis and current thinking.

### Asia inexpensive with improving internal growth fundamentals

Asia remains our favoured region, particularly in equities for attractive valuations with a visible path to earnings improvement – partly for normalising demand following last year's growth scare and improving growth fundamentals driven by reforms with the continued tailwinds from still low commodity prices. Local bonds are attractive, although the degree of rate compression is more advanced than in other regions.

## Asset Class Scores



Score Summary: For each country and asset class, scores are represented by colours where white is neutral, green is positive and red is negative. The overall score is shown to the right with the underlying scores – value, momentum and political/macro – shown to the left. The border shows gray for no score change, while green shows positive and red negative.

## Broad upgrade in equities

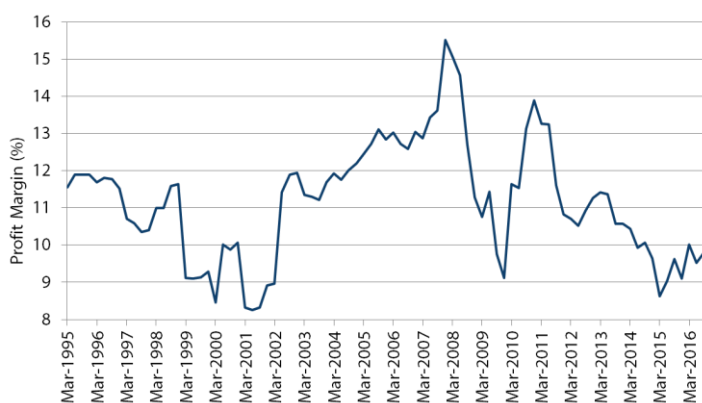
There were numerous upgrades driven by shifts to positive momentum and upgrades in macro politics. We focus on India to illustrate the drivers at play, which are similar to those of South East Asia. We also focus on China for its different dynamics and high relative importance for maintaining economic stability in the region and across EM.

## India earnings supported margin expansion and improving growth

The earnings outlook is improving as margins start to expand. Companies are also benefiting from a steady improvement in top line growth, as reforms help to lift demand. Top line growth is also gaining from a healthy monsoon season which is boosting consumption.

Not uncommon across EM coming out of a downturn, margin expansion is a key dynamic for improving earnings growth. By early 2015, profit margins compressed to levels not seen since 2002 shown in Chart 1. Through rate cuts, restructuring, and now improving growth, margins are expanding but with plenty of room for the expansion to continue.

Chart 1: MSCI India profit margins



Source: Bloomberg 2016

Top line growth stands to improve through further normalisation in demand, while reforms continue to create new sources of growth. Last quarter, we noted a strong pick-up in much needed infrastructure investment, which continues to gather pace.

So far, investment is mainly government financed with funding made available through fiscal reforms. Private sector investment disappoints, mainly due to a weak banking sector which is an important signpost to watch for improvement. FDI is also helping to fill the gap, climbing to \$63 billion in 2015, as states within the country are pushing forward to help bring in investment and business to India. Fiscal reforms have also allowed the government to directly support consumption in the form of disbursements, higher wages and pension benefits. The recent healthy monsoon provides an important boost to rural consumption, after several years of disappointment.

The countries upgraded in South East Asia enjoy similar dynamics with margin expansion and varying degrees of reform helping to add to growth through government support as bank balance sheet repair.

These developments are promising, but the key is that reforms do not progress fast enough bring in more private sector participation. Banks need to be recapitalised and reforms need to continue to attract capital investment. The danger is that growth remains dependent on government support rather than the private sector.

Malaysia and Indonesia local currency bonds were upgraded mainly for improving macro fundamentals as inflationary pressures recede. In contrast, India bonds were downgraded to neutral as the new central bank governor appears to be running policy easier than his predecessor which risks lifting inflation expectations in the future.

## China fundamentals continue to improve though growth remains a challenge

Like India, China is also pushing a significant reform agenda, but with a much bigger demand gap to fill given the country's greater dependence on exports. Policymakers tried to reign in credit growth while pushing reforms, but were forced to pivot earlier this year to better balance between reforms and growth support – i.e., letting credit expand.

The most impressive feat this quarter was the devaluation of Renminbi while managing to limit capital outflows. In effect, China has reversed most of the tightening that occurred during the dollar rally. Easier conditions coupled with stimulus to maintain growth are now working together to help normalise demand.

Like others in EM, most of the earnings support is coming through margin expansion, improved by normalising demand but also falling yields with a particularly steep compression in corporate spreads as shown in Chart 2, helping to reduce servicing costs, particularly for those with high levels of debt.

Chart 2: China Corporate Bond Spreads



Source: Bloomberg 2016

On the reform side, China continues to push restructuring to reduce unsustainable debt and excess capacity. The potential for China is enormous but, for now, policymakers walk a fine line pushing reforms while trying to allow for enough growth. The recent credit-driven speculative rally in property is a good example for how difficult this balancing act actually is.

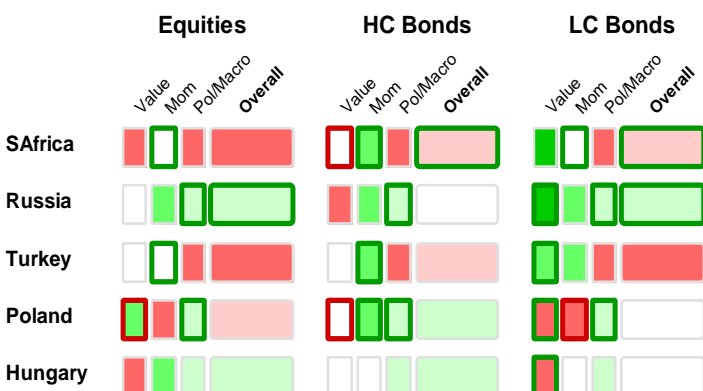
For now, credit expansion can still work because of high savings rates and trust, but it is an important source of risk that needs to be watched as reforms progress.

Opportunities in equities still lean toward those companies and industries already benefiting from increased consumption and other reforms.

### EMEA challenged by Brexit and rising political risks

EMEA continues to remain challenged by structural imbalances and rising political risks, mainly in Turkey and South Africa. However, financial conditions in Europe have eased following the initial stress caused by BREXIT, which takes some of the stress out of the region. There are still select opportunities, such as in Russia where fundamentals are relatively stable and improving.

### Asset Class Scores



Score Summary: For each country and asset class, scores are represented by colours where white is neutral, green is positive and red is negative. The overall score is shown to the right with the underlying scores – value, momentum and political/macro – shown to the left. The border shows gray for no score change, while green shows positive and red negative.

### South Africa hard currency and local currency bonds upgraded to neutral negative

Hard and local currency bonds both upgraded, driven by now positive momentum. Macro politics remain negative, though improving macro and liquidity conditions are helping to offset near-term risks of external imbalances coupled with rising political risk.

S&P will review the country’s credit rating in December where analysts will need to weigh these relative dynamics. As shown in Chart 3, the debt to GDP ratio has risen back to levels of the mid-1990s when it was rated “junk”, so the key assessment is whether debt dynamics can improve from here or are likely to deteriorate.

Chart 3: South Africa Debt to GDP ratio



Source: Bloomberg 2016

The downgrade seems likely, which would push its rating back down to junk – a clear negative.

### Russia equities and local bonds both upgraded to neutral positive

Despite rising geopolitical friction with the West, status quo is more likely than not as rhetoric serves political objectives better than the actual follow through.

The Russia recovery continues to gather pace and, more impressively, the government has shown policy restraint, keeping policy tight despite a significant drop in inflation. These developments are positive for long term growth, and very different from the Kremlin’s prior tendency to run policy hot, hindering investment.

We upgraded the macro political score, supporting an upgrade for local bonds and equities. The earnings recovery is impressive, mainly driven by margin expansion as shown in Chart 4, lifting to early 2014 levels set just before the imposition of crippling Ukraine-related sanctions and oil crashing more than 50%.

Chart 4: MSCI Russia Reported Profit Margin

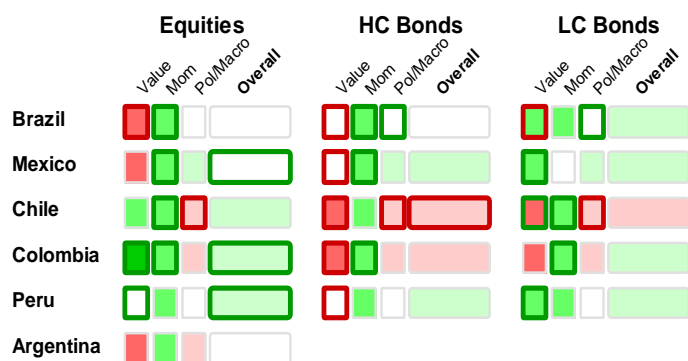


Source: Bloomberg 2016

### Latin America maintains commodity stability and improved political capacity

LatAm remains second in the regional hierarchy, above EMEA, mainly in local currency bonds where inflation is peaking and where there is improved political capacity to push reforms. We are more neutral with respect to equities though several countries were upgraded this quarter.

#### Asset Class Scores

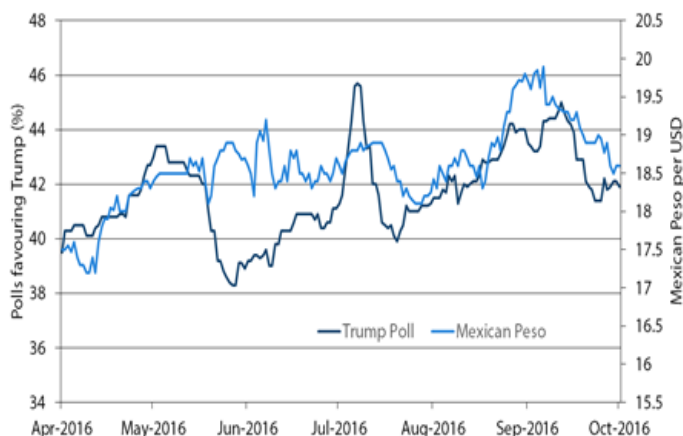


Score Summary: For each country and asset class, scores are represented by colours where white is neutral, green is positive and red is negative. The overall score is shown to the right with the underlying scores – value, momentum and political/macro – shown to the left. The border shows gray for no score change, while green shows positive and red negative.

### Mexico equities upgraded to neutral

Equities were upgraded for momentum shifting positive, while fundamentals have been challenged through a weak currency. Up until mid-September, the Mexican Peso significantly underperformed most EM currencies, partly attributable to Trump rising in the polls increasing the threat of an actual wall being built and the renegotiation of NAFTA. There are many dynamics at play, but as shown in Chart 5, Trump’s recent decline in polls seems to support the Peso.

Chart 5: Polls favouring Trump versus Mexican Peso



Source: Bloomberg 2016

Excessive weakness in the Peso has been a clear headwind due to inflation pass through and the increasing burden of US dollar debt that weighs heavily on corporate balance sheets. Currency support lends a much-needed tailwind, with the US presidential election remaining an important signpost to watch.

### Chile hard currency bonds downgraded to neutral negative

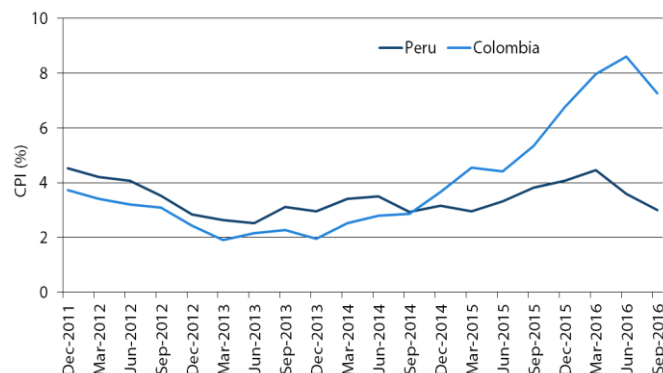
Last quarter, hard currency bonds were upgraded for the perverse tailwind of President Bachelet running out of steam in pushing a more populist agenda. While the political dynamic remains in place, confidence has slipped as growth remains weak with commodity support unable to overcome weakness across an otherwise diverse economy.

Based on deteriorating local macro fundamentals and stretched valuations, the hard currency was downgraded to neutral negative.

### Colombia and Peru equities both upgraded to neutral positive

Different than Chile, Colombia and Peru remain relative “pure plays” in their exposure to commodities. In these economies, commodity is the driving growth agent helping to lift currency support and importantly, drive down inflation as shown in Chart 6. Valuations are attractive, momentum is positive with earnings outlook continuing to improve to justify the upgrade.

Chart 6: Peru and Columbia Inflation



Source: Bloomberg 2016



## Important Information

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

**Japan:** The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association/Japan Securities Dealers Association.

**United Kingdom and rest of Europe:** This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules).

This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such

persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

**United States:** This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity.

**Singapore:** This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you

**Hong Kong:** This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong.

**Australia:** Nikko AM Limited ABN 99 003 376 252 (**Nikko AM Australia**) is responsible for the distribution of this information in Australia. **Nikko AM Australia** holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice

**New Zealand:** Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme and the Nikko AM NZ Wholesale Investment Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website [www.nikkoam.co.nz](http://www.nikkoam.co.nz)).