Emerging market equities: identifying the key long-term trend

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As we enter 2022 we can expect robust fundamentals to serve as a key tailwind for emerging markets (EMs). From a top-down perspective, regulation noise in China, ongoing COVID concerns, geopolitical risk and inflationary pressures have all weighed on sentiment. However, we remain excited by the opportunities we see across the asset class.

In China, we are witnessing a regulatory cycle that started in the back end of 2020. We can expect this to continue into elections next year with the government focusing on the notion of common prosperity. We believe dismantling the private sector is not the objective and many of the policies are, in fact, on the "wish lists" of Western economies — for example, data privacy and curbing monopolistic practices. We are focusing on areas of the economy with policy tailwinds that will benefit from the government's prosperity and productivity agenda — such as "Made in China 2025" — in everything from the semiconductor industry to biotech and electric vehicles to name a few. We believe we are out of the first phase of regulation where equity risk premium from domestic regulation feels priced in and are moving to the next phase where regulatory rules get applied. There are also signs of policy easing as we move into an election year; however, we can expect normalized policy as opposed to large stimulus.

In terms of U.S.-China relations, we can expect the Biden administration's stance to remain unchanged given bipartisan support for its policy toward Beijing, with the administration also likely to have the support of allied countries. We are also monitoring the optionality around U.S.-China trade tariffs, as Treasury Secretary Janet Yellen explores relaxing Trump-era tariffs to help ease some inflationary pressure.

Although vaccine optimism has fuelled positive investor sentiment globally, we still envisage distribution challenges in the near term. We are continuing to monitor the scale of new infection waves globally while considering the risk of new variants. Meanwhile, the outlook for inflation remains a key issue for both emerging and developed markets, as central banks may begin to moderate monetary policy accommodation.

It's fair to say that concerns over Fed tapering still have an impact on sentiment related to emerging economies. In 2013, the "fragile five" (Brazil, India, Indonesia, South Africa and Turkey) were identified as most at risk due in part to their large current account deficits. This still weighs on investors to some degree. However, the notion of the fragile five is no more; it seems to be just Turkey that is vulnerable. Even if we exclude China, which has a large current account surplus, in aggregate emerging economies are in a current account surplus. This doesn't mean the market won't react to concerns over Fed tapering and ask questions later, but when they do ask questions they will get much better answers than in the past. From an investment perspective, we will use the sentimental market reaction as an opportunity to add to specific companies that we like long term.

EMs are breaking away from their dependence on the developed world, with heightened domestic demand increasing resilience to external forces, the development of local debt markets and the stabilization of the interest rate differential between the U.S. and emerging economies. Therefore, we don't have the same weakness in different pain points.

We also place a lot of importance on environmental, social and governance (ESG) characteristics, which will no doubt become yet more important throughout 2022. Understanding how well a company manages its material ESG risks is key to assessing the quality of an investment. The focus of our ESG research approach is to understand exposure to, and management of, factors that have an impact on performance through regulation, physical threats to assets, brand and reputation, and operational costs. We follow a best-in-class approach and assess companies against peers.

More broadly, we believe the key long-term trend for EMs is the transition from predominantly export-led growth to reliance on buoyant domestic demand. This is reflected in the change of composition of the universe, which is now dominated by higher quality structural growth companies with a domestic focus. In 2008, more than 60% of the universe was exposed to cyclical growth; today around 60% of the universe is exposed to structural growth.* Furthermore, there has been nearly a 90% increase in the number of companies coming to the market in the past decade.* We believe the innovation of the universe, in both depth and quality, is ideal for stock pickers and is where we can add value in active management. Investors should now be looking at EMs through a different lens.

Structural wealth creation, a rising middle class and the associated changes to consumption and services are the dominant themes for us. This leads us to various trends, including: the technological revolution, with the emergence of platform companies with various verticals (the adoption of technology in general usually happens faster in EMs because infrastructure isn't as well developed so it's easier to start using e-commerce); financial penetration, where we're seeing both an increase in traditional participation and inclusion, as well as fintech developments; and localization, with many countries focussed on creating strong domestic brands and developing domestic industries.

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* MSCI, Dec 2021

CTNP L92 **(02/22)** 4241813
exp. 02/23