September 2017

For Emerging Markets, Fundamentals Matter

by Josephine Shea
Director of Emerging Markets and Senior Portfolio Manager

The recent recovery in emerging-market assets is being driven by more than market technicals.

Since 2016, a weaker US dollar and higher global commodity prices have benefited investors in emerging markets (EM), with the MSCI Emerging Market equity index rising by 27% from the start of 2017 through the end of August and the JP Morgan Emerging Markets Bond Index Global up by 8.2% during the same period.

Monetary policy normalization in the US, ongoing pro-growth policies in China and a global economic recovery have produced a rising tide that has helped lift emerging markets; the IMF forecasts that 94% of all counties will show positive GDP growth this year. However, those external circumstances can and will change over time. For long-term investors, understanding the case for EM requires taking a look at the seaworthiness of the emerging economies themselves.

Headlines certainly raise some concerns about EM countries, such as Venezuela whose leadership seems more interested in consolidating power than in preventing economic collapse. Elsewhere, South Korea's economic success story faces the ongoing menace posed by Kim Jong Un in North Korea. ISIS and other threats loom in the Middle East, corruption plagues Brazil and Russia plagues Ukraine. Despite these geopolitical risks, though, we believe that the fundamental case for emerging-market investment remains solid.

Emerging markets have been defined as places where geopolitical circumstances influence investment returns as much as business and economic cycles do. While non-market risks remain a fact of life in EM, such risks increasingly exist in many developed markets as well. Unlike those slow-growing markets where idiosyncratic risks are now rising, however, emerging markets have an impressive track record of long-term growth despite the existence of these types of risks. Even with various financial crises since 1990, the value of US dollar-denominated and local currency emerging markets debt has increased from $26bn then to $4 trillion today. Unlike stagnant and aging developed markets, most emerging economies have demographics that are favorable for long-term economic growth and most are free of the massive debt overhangs that weigh on developed markets. Many EM countries are also making substantial structural reforms that improve the quality and efficiency of governance, such as the package of tax reforms pushed by Indian Prime Minister Narendra Modi. All of these developments help encourage long-term growth, while also reducing risk.

Another fundamental factor favoring emerging markets is the extent to which they are now integrated into the global economy. Private capital flows into these countries have been strong for decades as multinational firms have replicated operations in many countries to serve their fast growing domestic consumer markets. Advances in information technology have also helped bind emerging economies more tightly to global supply chains and financial markets.

A Track Record of Resilience

Another factor in emerging markets' favor is their track record of delivering long-term growth despite volatile periods. It has been 36 years since Antoine van Agtmael, then-World Bank economist, coined the term 'emerging markets' to describe less developed but fast growing economies. During this time, EM countries, such as India, Argentina and China, have experienced a number of highs and lows without derailing long-term growth. Some

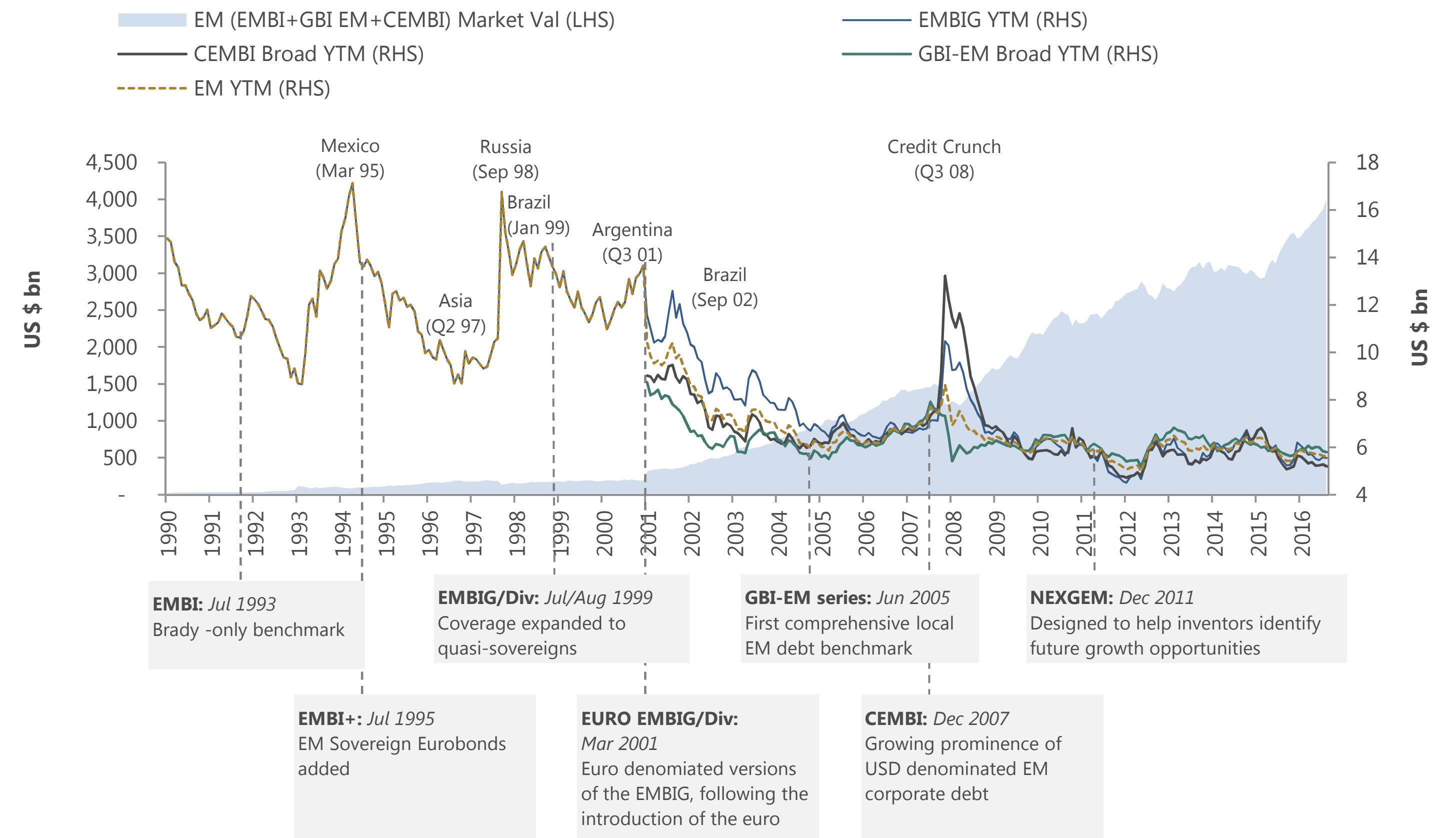
STANDISH
➤ A BNY MELLON COMPANY℠

events, like the 1997 Asian crisis, the global financial crisis and the rise of the US dollar that began in 2014, hurt many emerging markets simultaneously; however, EM economies come in many varieties and idiosyncratic risks and opportunities have always been present.

An Unwieldy Index

The increased resilience and improved fundamentals of emerging markets have earned the confidence of international investors including banks, non-financial institutions and pension funds, as well as individual investors. This increased interest has helped fuel the growth of the EM investible universe. Since 1995, the number of countries represented in the JP Morgan Emerging Markets Bond Index Global has risen from 27 to 66, while the index's market capitalization has increased from $169 billion to $880 billion. Since its inception in 2007, the JP Morgan Corporate Emerging Markets Bond Index Broad has grown to include 52 countries, up from 16, and its market capitalization has grown from $192 billion to $916 billion, which is comparable to the US corporate high yield market cap. While that growth reflects what we believe to be a compelling case for EM, the index now includes one third of the world's 195 countries and embraces a wide variety of creditworthiness and idiosyncratic risks. We believe that the variegated nature of this increasingly vast and heterogeneous asset class makes asset allocation and security selection based on rigorous research indispensable. Emerging markets have much to offer for global investors. We believe that skilled active managers that understand the differences between South Africa and South Korea are key to delivering the best balance between risk and reward.

EMBI Global Market Value Growth 2003-2016



Source: JP Morgan as of July 31, 2017

WP/Sept2017/8-31-17/BR

STANDISH
A BNY MELLON COMPANY℠