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Reports of the Death of Emerging Markets Have Been Greatly Exaggerated

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Emerging markets (EM) are very much on investors' minds these days. After Donald Trump's surprising victory in the U.S. presidential election in November, consensus opinion was that emerging markets would be in for a tough time. The new president had been swept into the White House on a populist wave, promising "America First," with all its attendant protectionist and reflationary implications. However, since the inauguration, EM have outpaced developed markets handily, buoyed by cyclical recovery and global growth, as well as by improving fundamentals within EM themselves. We are optimistic that the tide has turned for EM. Some uncertainty remains, of course; the new U.S. administration's issues with implementing policies are well documented and the sustainability of burgeoning pockets of global growth is tenuous.

The immediate outlook for EM after the election was one of caution, if not downright pessimism. Prospects for trade renegotiation, higher U.S. interest rates, and an even stronger U.S. dollar weighed on the asset class. Indeed, EM traded down sharply through year-end. Companies, countries, and sectors were painted with one macroeconomic brush, regardless of individual company fundamentals; if it was in EM, it was to be avoided.

Reasons for Optimism: The Importance of Differentiation in the Age of Trumponomics

In our view, when an entire group of stocks underperform regardless of their individual company fundamentals, this signals an opportunity for bottom-up, fundamental research-minded investors like us. And that view has been rewarded so far in 2017. Good EM companies have rebounded, outpacing developed markets stocks despite the downturn following election day. Supported by global growth and the cyclical recovery—both in EM and developed markets—EM are taking advantage of increased demand from developed markets and the resulting pickup in EM export activity as well as from improving local demand driven by the emerging markets consumer. Of course, there are always risks involved with international investing in general, and emerging markets in particular. It is possible the new administration's agenda may eventually create pressures for EM economies through currency fluctuations, higher inflation and interest rates, trade conflicts, or other conditions.

Specific Opportunities

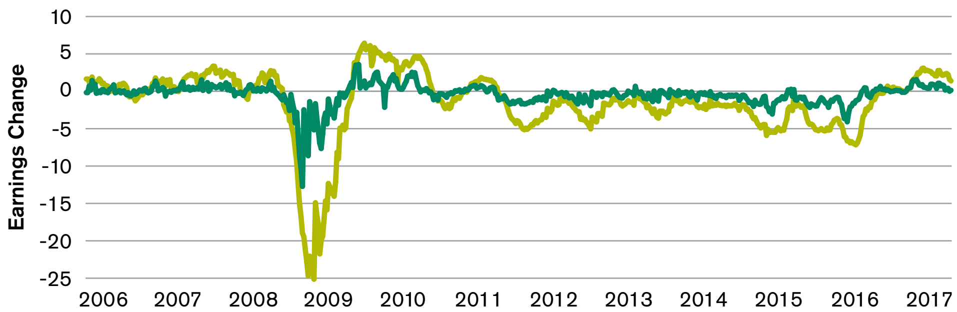
Stabilization in China, where government economic measures appear to be reflected in economic data, is also positive. China's manufacturing PMI (Purchasing Managers' Index) data has been strong, and the growth target for 2017 remains well above developed market estimates. China also remains committed to public infrastructure support, which should bode well for railways, telecommunication services, utilities, and environmental projects. We have exposure to a number of opportunities in this area.

Additionally, discretionary spending patterns across EM highlight opportunities within individual names positioned to deliver the goods and services consumers are demanding in their quest for a higher quality of life, including education, e-commerce, environmental services, personal finance and investing, and health care.

In this environment, EM stocks in general appear attractively valued relative to developed markets, despite the recent rally, and more favorably positioned in the earnings cycle. EM forward earnings estimates have turned positive and are currently above those of developed markets. And, as we have seen, earnings improvement drives stock prices.

Figure 1: Forward Earnings Estimates Are Improving

12-Month Forward Earnings for Global Emerging Markets



Source: IBES Datastream, UBS. Data for the period 1/5/2006-6/29/2017.

Conclusion

Uncertainty remains. Questions around the timing of the President Trump's agenda and its ultimate effects on global trade in general and EM in particular will not be clearly answered for some time. While the delay in U.S. trade policy changes should give EM some breathing room, this underscores the importance of earnings improvement on a company-by-company basis. We expect earnings per share (EPS) improvement will transition from commodity price stabilization and U.S. dollar levelling to improving operating leverage as we move forward. This also favors our bottom-up, fundamental analysis investment process. In the short term, the focus on the likelihood of higher interest rates in the U.S. could color some investors' views on EM and keep volatility in play. However, we believe the long-term secular growth story in emerging markets remains intact, and EM equities should continue to provide attractive opportunities, despite the occasional macroeconomic headwinds.

The opinions expressed are those of Nathan Chaudoin and are no guarantee of the future performance of any American Century Investments portfolio.

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