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Opportunities in EM Stocks Emerge

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Emerging markets (EM) equities have not been immune to the pandemic's global economic shock, suffering along with other risk assets. Yet some EMs have fared better than others—and we see signs that there may be opportunities emerging.

Disparities in EM Returns as of 4/28/20

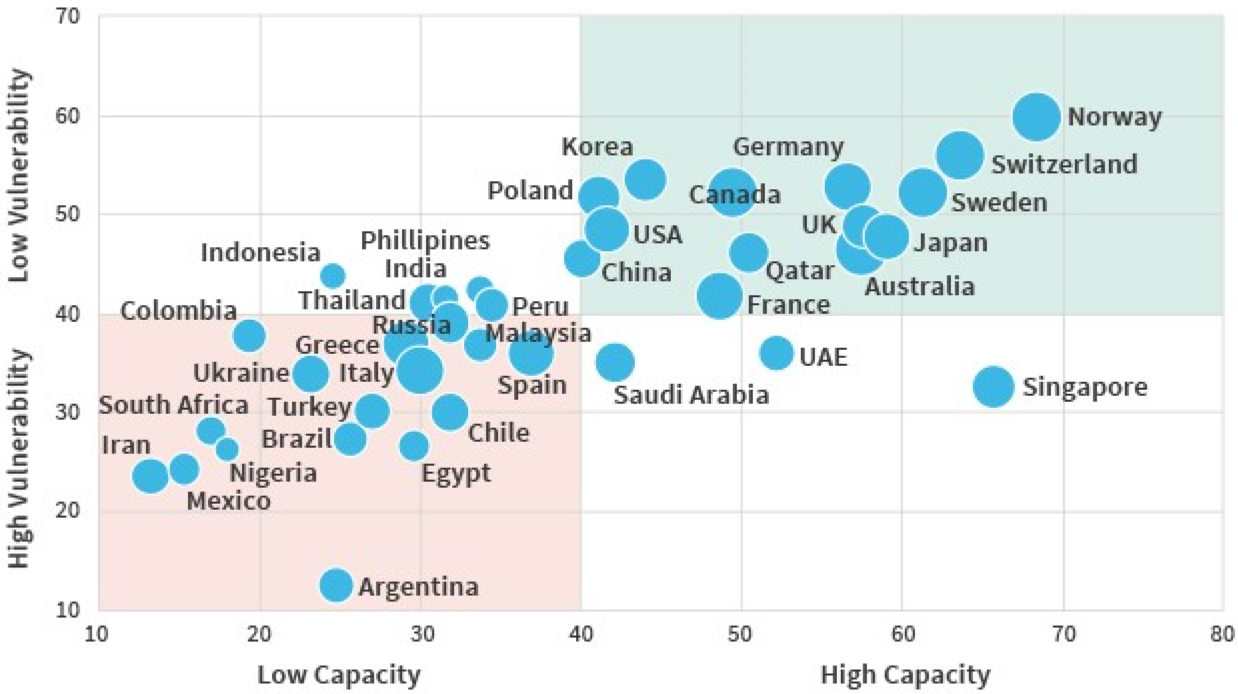
The MSCI EM Index is down roughly 20% year-to-date as of April 28, yet individual EM performance (based on MSCI IMIs for each country) has not been uniform. For instance, EMs in North Asia have performed much better than those in Latin America. China, one of the best-performing markets year-to-date, is down just about 5%; Taiwan is down roughly 11%, and Korea, 16%. In contrast, Brazil is down 49%; Colombia, 48%; and Mexico, 37%.

Currency movements are playing a role in the varied EM returns, but we also attribute the large disparities to relative differences in countries' economic vulnerability going into the COVID-19 crisis and perceived ability to deal with the shock. Markets have been efficiently judging countries on a relative basis, in our view.

Research shows the relatively better-performing EMs—such as those in North Asia—generally had low economic vulnerability heading into the crisis and have high political capacity and healthcare preparedness to deal with the shock. The underperformers—such as South Africa and the countries in Latin America mentioned above—generally have exact opposite profiles.

Pandemic Preparedness

Economic Vulnerability, Political Capacity and Healthcare Preparedness



Source: Eurasia Group, as of April 2020. For illustrative purposes only.

Factors used to gauge economic vulnerability include a country's relative external debt level, current account balance, fiscal room to deliver economic support, and dependency on energy and tourism revenues. Political capacity to handle the crisis is gauged by examining variables such as bureaucratic effectiveness, or the government's agility to deal quickly with a multifaceted shock; social safety nets; and local trust in government. Healthcare preparedness is assessed through metrics such as hospital beds and physicians per 1,000 people.

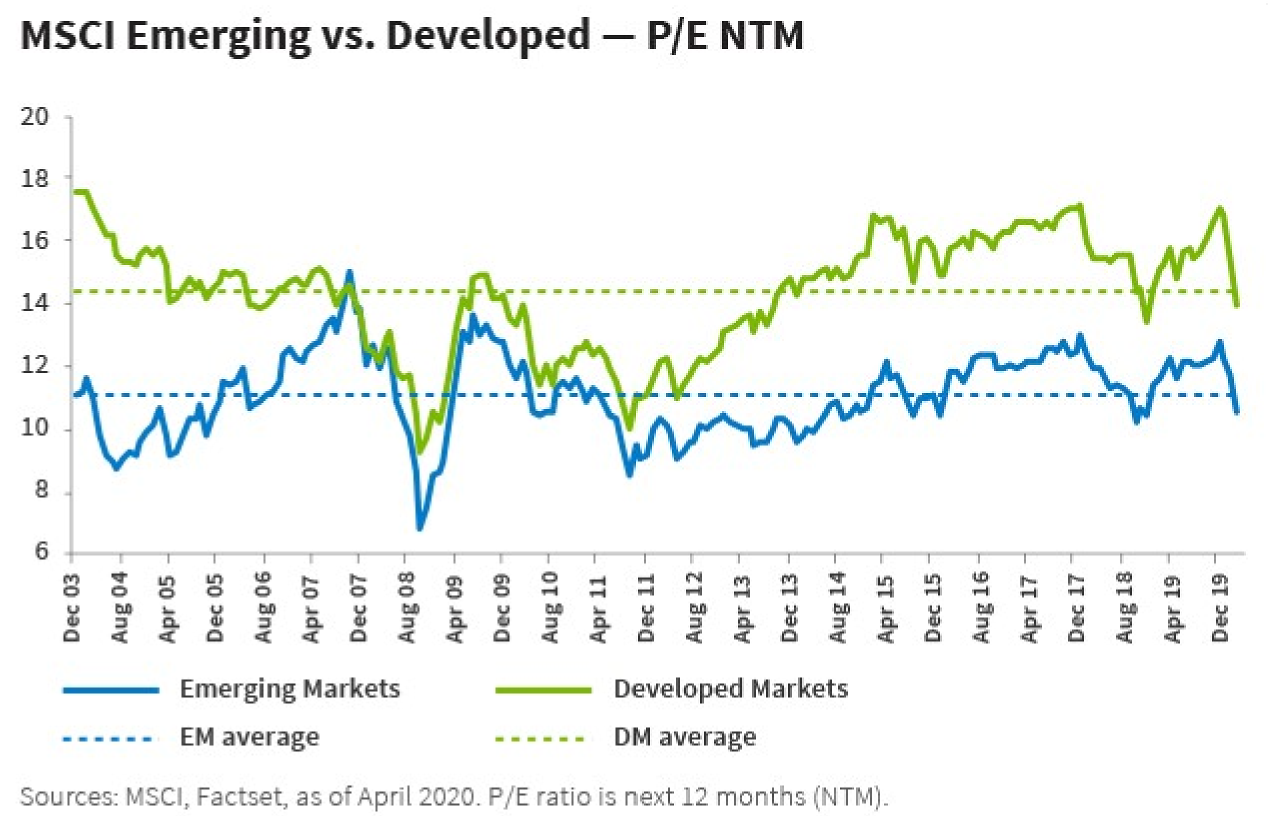
Emerging Opportunities

We see EM flows, sentiment, and positioning at extreme levels following the recent sell-off. Total debt and equity outflows from select EMs are much larger than we saw during the Great Global Financial Crisis and during the 2013 taper tantrum. At the same time, investor sentiment has become extremely pessimistic.

Meanwhile, overall market economic fundamentals remain quite supportive. Current account balances have improved over the past few years, especially after the taper tantrum in 2013. Inflation has been very low, which has enabled central banks to use monetary stimulus, and both fiscal and monetary stimulus is flowing. It is notable that a number of central banks in emerging markets have embarked on quantitative easing (QE) measures. This is the first time we have seen QE enacted in emerging markets.

In addition, EM equities, as measured by the MSCI EM Index, are trading at valuations in line with their historical averages, yet these valuations appear inexpensive when the index's changed sector exposure is taken into account. The higher-valued information technology, consumer retail, and media sectors were about 10% of the index in 2008, and the lower-valued energy and materials sectors about 40%. Today, the former is about 40%, and the latter roughly 10%.

MSCI Emerging Versus Developed Market Price-to-Earnings Ratio



A Selective Approach

Against this backdrop, we believe now is a good time to consider adding to EM exposure using an active approach. We have remained steadfastly focused on seeking opportunities to add to our best ideas in this tumultuous environment, looking beyond transitory virus-related business effects. We are interested in companies with superior quality and growth characteristics relative to competitors that have been out of our reach purely from a valuation perspective.

Our focus is on companies that are tied to more structurally advantaged themes amid the downturn—technology-enabled growth areas such as 5G telecom, e-commerce, and online education. We believe these companies' competitive positions are likely to strengthen in this environment.

We find many of these structural growth themes are flourishing in China, a market we particularly like. China is emerging from the COVID-19 crisis after doing a good job of containing the virus and stimulating its economy via loosened financial conditions and stimulus measures aimed mainly at driving consumption. We expect China to announce another round of easing efforts later in May, further supporting the economy and market.

Our research process continues to uncover opportunities in Chinese companies that have attractive growth rates and high-quality attributes that we think are underappreciated by many investors. More broadly across Asia, we are attracted to the relative stability of markets like South Korea and Taiwan.

Overall, we tend to have more exposure to the markets we find are less vulnerable to the COVID-19 crisis, and to have lower exposure to the more vulnerable markets. This year so far has been one in which country-specific performance has made an outsized impact on overall EM investment returns.

Todd McClone, CFA, partner, is a portfolio manager on William Blair's Global Equity team.

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The MSCI Emerging Markets Index measures equity market performance of global emerging markets.

The MSCI World Index measures equity market performance of developed markets.

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