Stresses on Emerging Markets

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Understanding the economic stresses across emerging markets is important. Still, it does not affect our core approach to investing, which is to unearth extraordinary companies, even in low-growth economies that we believe have the potential to generate strong returns.

In an uncertain world Justin provides an overview of emerging markets before taking a deeper dive into the risks that could lie ahead with a focus on the vulnerabilities, both internal and external, of the asset class. An examination of what countries are likely to rise/fall from the pandemic is then followed by valuable insight into where Justin is finding the most attractive investment opportunities.

Emerging Markets Outlook

Overview

The Covid-19 crisis turned what could have been the start of a long stretch of strong economic performance in the developing world into an era of uncertainty with profound consequences that will almost assuredly strain all economies globally, including many emerging markets (EM) for years to come. In exploring vulnerabilities both internal (fiscal and monetary policies) and external (balance of payments and debt), we seek to determine the relative potential winners and losers, while identifying what we believe are the most promising longer-term investment opportunities.

We think our long-held conviction that EM are all about China is continuing to hold true. In our view, China's long-term contribution to global growth is likely to become even more apparent as a result of the pandemic. We believe it could account for about 50% of global growth over the next few years. We are confident in our belief that China will offer investors the most appealing investment opportunity in the decade ahead.

Other Asian economies, we believe, also stack up well notably Taiwan, South Korea and Southeast Asia. In contrast, India's frailties, in our view, are likely to be exposed as a result of the pandemic, as structural growth could be stressed, with even the well-run private sector banks possibly facing the pressure of a tidal wave of non-performing loans (NPLs).[1]

Outside of Asia, we believe Russia's efforts in recent years to strengthen its economy will likely enable it to ride out the storm, even in the backdrop of collapsed energy prices. Other than Russia, we believe there is little to be sanguine about in the emerging market countries outside of Asia. The largest economies in Latin American and Europe, the Middle East and Africa (EMEA) – that is, Brazil, Mexico, Saudi Arabia, Turkey and South Africa – face a host of varying issues, from external debt and unsustainable deficits to asset quality stress, among others.

Bottom-up approach

While an understanding of the macroeconomic pressures facing EM helps to inform our investment decisions, our approach remains unchanged. We are bottom-up investors who seek out idiosyncratic companies that have durable long-term growth, sustainable advantages and embedded real options that may be realized over time.

Clearly, we believe the opportunities for investors are likely be plentiful in China. Europe faces numerous challenges, and the viability of the Euro cannot be ignored, while valuations in the US market currently seem, in our view, to ignore the challenges ahead. However, valuations across EM have become inordinately cheap, in our view, and we are excited to uncover well-run companies even in the most stressed economies.

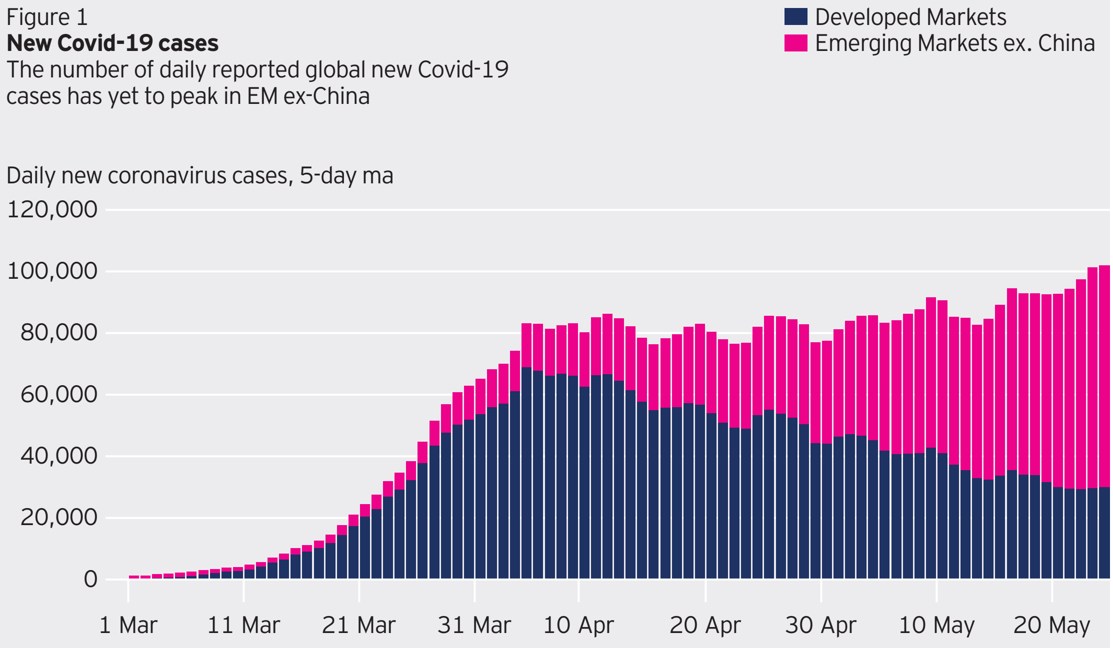
The unforeseen

> **"It is the unforeseen that causes the greatest disturbances, not the expected."**
> **Niall Ferguson**, The War of the World

In our opinion, 2020 held the promise of synchronised economic recovery in the developing world, after years of disappointment. Like others, we were confident in EM earnings and equity market returns at the beginning of the new decade. Alas, we were wrong. The unforeseen – the pandemic – came and caused, well, great disturbance. The accompanying high degree of uncertainty brought with it excess volatility, which has historically not been a friend to EM investors. Sadly, this uncertainty in the developing world is not likely to go away anytime soon.

We are forced to live in this period of heightened uncertainty. It is a period when investors may struggle to extrapolate recent conditions into reliable financial model projections. Simply put, the world is out of joint.

Figure 1
New Covid-19 cases
The number of daily reported global new Covid-19 cases has yet to peak in EM ex-China



Sources: Johns Hopkins, EM Advisors, May 2020.

The pandemic appears to be moving from the developed to the developing world with brutality. While the West has moved beyond the peak in new daily cases, these are still on an inexorably rising path in EM outside of China. To make matters worse, the health care systems across much of the developing world may be, we fear, ill-equipped to face the challenge. There will likely be much pain and human loss across Latin America, sub-Saharan Africa, and the Indian subcontinent.

For us, this is a period for existential contemplation – a time to consider with great care the many macroeconomic uncertainties across the developing world.

In our view, there are two types of risks:
1. Internal imbalances (fiscal debt dynamics and bank asset quality/capital risks)
2. External imbalances (balance of payments, external debt).

The dynamics between the two could have a pronounced influence on growth prospects in the developing market world. In our view, these factors will likely result in significant polarisation of performance across EM equity markets over the medium term.

Domestic/internal vulnerabilities include:
- Pandemic outcomes as the virus has moved its focus from the developed to the developing world
- Fiscal vulnerabilities across the EM universe, which appear to have been amplified by the pandemic response
- Growth vulnerabilities, both near term and, much more importantly, long term

External vulnerabilities include:
- Balance of payment vulnerabilities
- Debt risks
- Risks of financial market contagion
- Geopolitical risks, most notably the growing tension between Washington and Beijing

Internal imbalances

Fiscal
It appears that fiscal balances have been greatly disturbed by both the necessary efforts to deal with the pandemic crisis and the proximate collapse in growth and employment all across the world. However, it is structural imbalances that we are most concerned with, not the unforeseen pandemic cyclical shock. And here we can begin to separate the economies that we believe can successfully manage the crisis from those that may experience more prolonged damage from it.

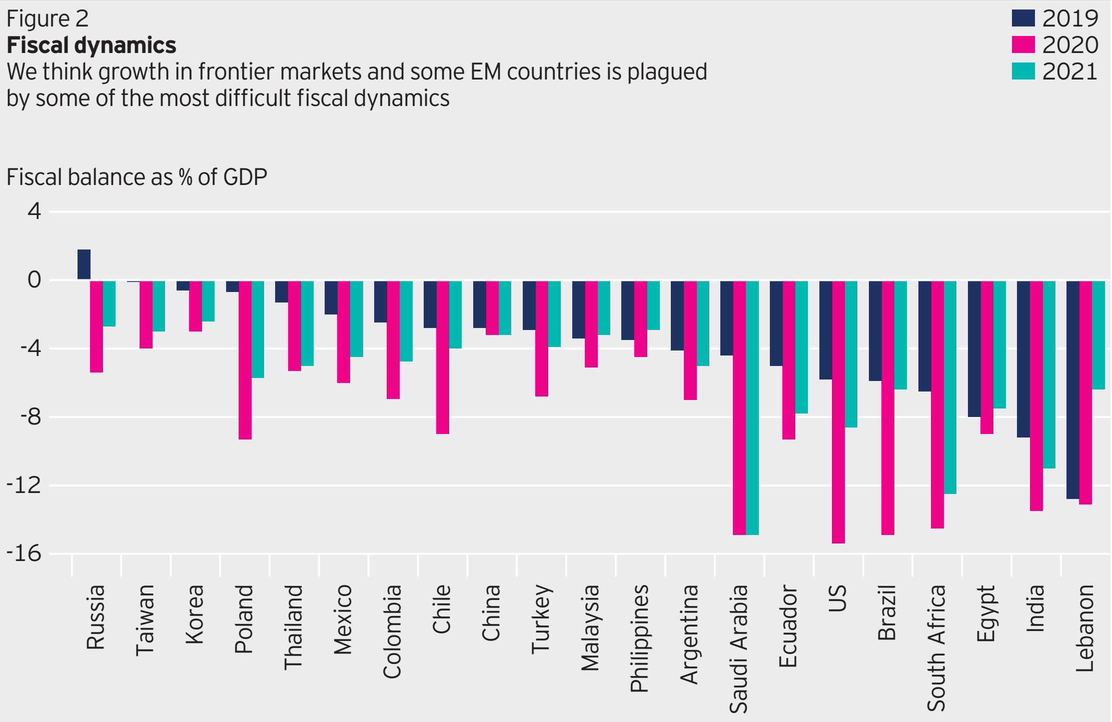
In our opinion, the strong here are extremely obvious and almost entirely in Asia: Taiwan, South Korea, Thailand, Indonesia, and the Philippines. We believe that China, of course, is in that group, as well. Its fiscal capacity appears to be durable, given enormous public ownership of large swaths of industrial, financial and physical assets. We do recognise, however, that its cyclical "augmented" fiscal deficits are large and growing. Finally, though perhaps less intuitively, we also believe that Russia is a bastion of fiscal strength. Over the past decade, the country has, in our view, built a fortress-like economy, that can prove to be resilient to even the most damaging downturn in energy prices.

So where are the fiscal problems in EM?
Frankly, we are very concerned with unsustainable debt dynamics in South Africa and Brazil, in particular, among the larger economies. We also have a concern about unsustainable deficits in India and Saudi Arabia. Saudi Arabia, in our view, is far frailer than most investors acknowledge. A structural fiscal deficit there is coupled with utter inflexibility of social spending (the social contract between the big royal family and the broader population). Finally, we believe the economic circumstances in Mexico could prove to be problematic. While the ratio of the country's fiscal debt to its gross domestic product (GDP) may not appear to be an issue superficially, its fiscal capacity is rather limited.

Beware the frontier
It is additionally worth underscoring that we think the most difficult fiscal dynamics in the developing world are disproportionately concentrated in the frontier market geographies, where fiscal capacities are extremely under-developed. These include countries like Argentina, Ecuador, and Lebanon that have been highly dependent on assistance from the International Monetary Fund (IMF); countries that some view as IMF success stories, like Egypt (still an EM country by definition); and those that may be dependent on IMF support in the future, like Pakistan. Given these uncertainties, we believe the frontier markets present considerable risk for investors.

We are particularly concerned about the unsustainable fiscal debt circumstances among four larger emerging markets – Egypt, Brazil, Mexico and South Africa.

Figure 2
Fiscal dynamics
We think growth in frontier markets and some EM countries is plagued by some of the most difficult fiscal dynamics



Sources: International Monetary Fund, JP Morgan, May 2020.

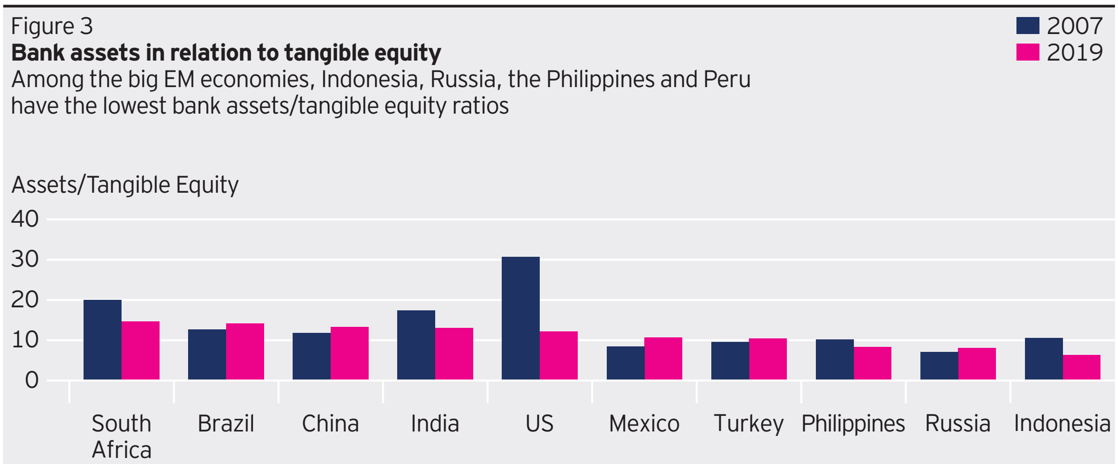
Bank stability
Broadly speaking, regulatory capital levels are strong across the EM universe. After many years of disappointing economic growth and credit expansion, there are, in our view, few outsized structural problems among EM banks. However, we believe cyclical stress will likely have a severely negative impact on EM bank earnings in 2020 and will likely test their resilience. We believe the countries with strong banking systems are easy to identify – Russia, Peru, Indonesia, the Philippines, and perhaps, unexpectedly, Egypt. These countries have banking systems with low leverage, extremely demanding capital regimes, and what we consider to be strong funding and excellent liquidity.

The risky three in our view are Turkey, India and South Africa. We think, among the big EM economies, Turkey and India are the standout structural risks. The Turkish banking sector is a volatile mix of external funding risks, growing asset quality stress and what we consider to be self-sabotaging macroeconomic policy decisions. India suffers from a long-burning hangover of asset quality problems, including a corporate credit cycle among the public sector banks that has persisted since 2015, as well as a liquidity crisis in the non-bank financial sectors that has prevailed since 2018.

This cyclical impairment stress could prove to be the straw that breaks the camel's back, as the private banks – the last bastion of India's financial sector – could suffer severe consequences if the volume of NPLs greatly increases as a result of this extended lockdown. All of this has the potential to lead to much weaker structural economic growth, especially if the challenges of this period are not managed properly.

South Africa is also problematic, in our view, because of its uniquely challenging macroeconomic conditions (including external imbalances, unsustainable fiscal dynamics and structurally impaired growth), which could cause deep cyclical stress to bank profitability and capital.

Figure 3
Bank assets in relation to tangible equity
Among the big EM economies, Indonesia, Russia, the Philippines and Peru have the lowest bank assets/tangible equity ratios



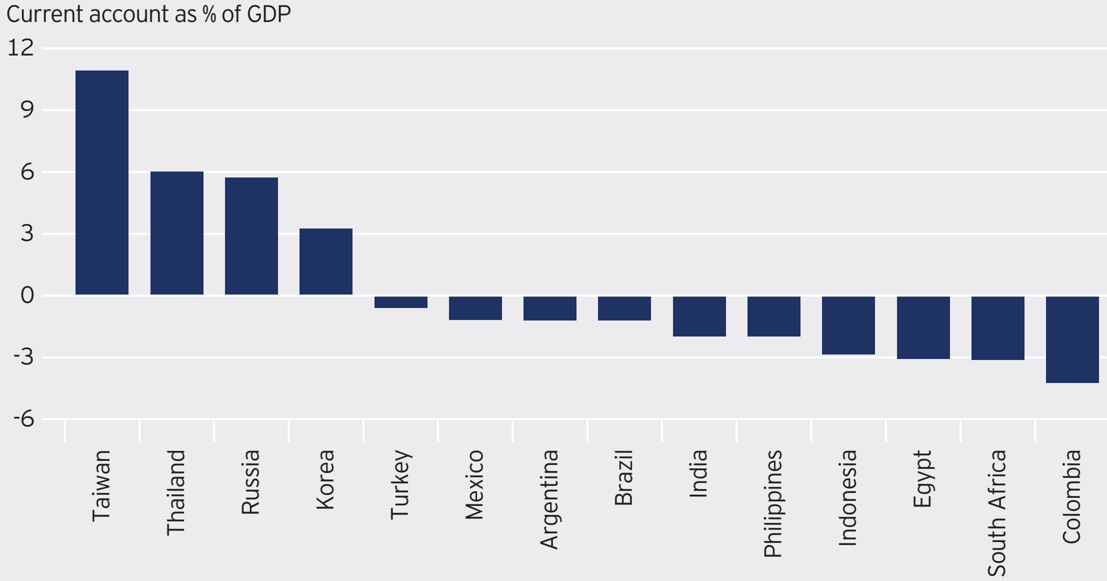
Sources: HSBC Database, Bloomberg, as at 31 December 2019. Tangible equity is calculated by subtracting preferred equity and intangible assets from total book value. It is used to evaluate a financial institution's ability to deal with potential asset losses.

External imbalances

External imbalances are generally the bane of developing countries as they do not have the same luxuries as the developed world. In general, developing countries' fiscal and monetary policies can be severely hindered by external constraints. Unlike the US, which can practice the demand management described by economist John Maynard Keynes – whereby a government can support demand by fostering full employment equilibrium in the economy – nearly all emerging countries have a more limited ability to employ this strategy when a recession might require it.

Balance of payments
Given the external constraints, developing countries should be extremely cautious about running serial current account deficits. If they do so, we believe their currencies could decline, inflation in their country could rise, and real economic growth could be greatly diminished. At first blush, one can generalise that the manufacturing powerhouses of Asia have demonstrated greater resilience in this worldwide economic crisis, as they have maintained their current account surpluses. Taiwan and South Korea, in particular, have demonstrated solid performance on this measure. But perhaps the real rock has been Russia, where despite the carnage of a sudden collapse in crude and natural gas prices, we believe the country will run a modest current account surplus of 1.5% in 2020.[2]

Figure 4
Current accounts – mixed bag
Among the larger EM countries, Taiwan, Thailand, Russia and South Korea had solid current account surplus in 2019



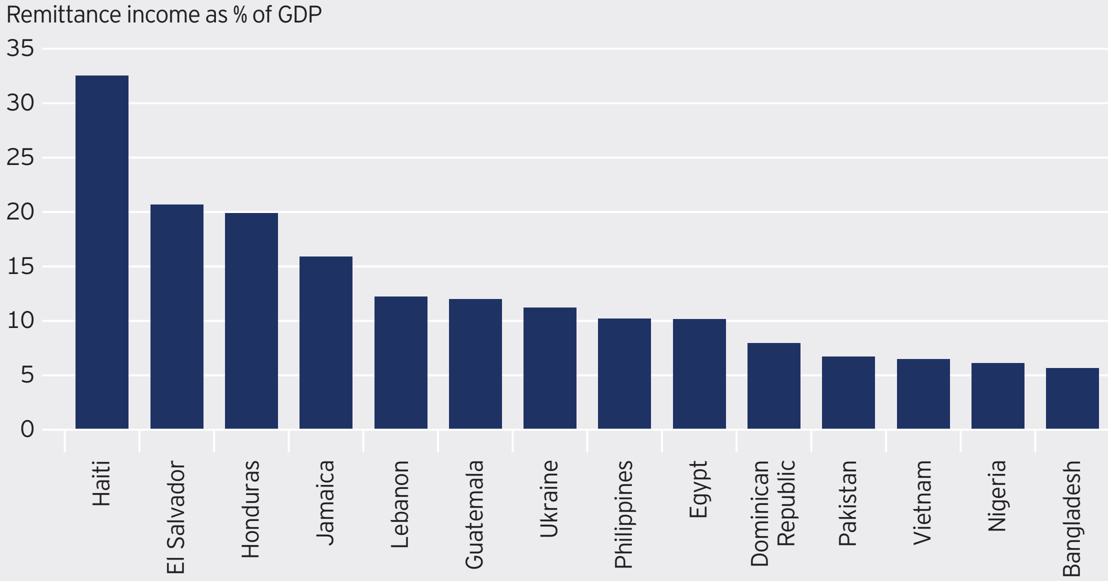
Source: EM Advisors, May 2020.

We do not live in "normal" times, and nuance really matters across EM today.

While the dramatic decline in oil prices and domestic recession may help alleviate balance-of-payment pressures across many developing countries, we believe these developments will be offset by a dramatic retreat in remittance income (money sent by foreign workers to their home country) and tourism in many economies, including:

- The Philippines (where remittance income is structurally 10% of GDP, according to the IMF, as of December 2018)
- Big frontier markets with substantial risks from the decline in remittance income – including countries in Central America and the Caribbean, as well as Egypt, Pakistan and Vietnam
- Sunnier climate countries – Thailand, Turkey and Egypt – which are highly dependent on tourism revenue

Figure 5
Remittances highest in frontier countries
The big frontier economies have the highest risk, given how much remittances contribute to their GDP

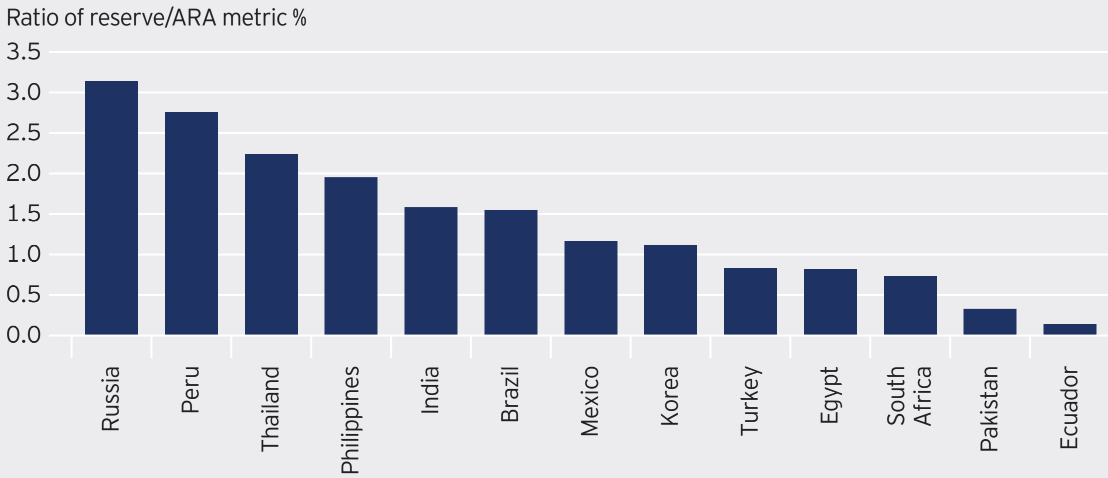


Source: World Bank, as of December 2018, most recent year for which data is available. Remittances are money sent from foreign workers to their home country.

External debt
The developing world exhibits great heterogeneity in terms of sovereign risk (the possibility that a country will default on its sovereign debt), between net external creditors and debtors in terms of external balances. Among the countries with the circumstances to manage sovereign risk are Taiwan, South Korea, Peru and Russia. There are also notable strengths in Southeast Asia – namely Thailand, the Philippines and Vietnam. India, Brazil and Mexico also are braced by reasonably healthy external debt circumstances.

We believe the weaker countries with regard to sovereign risk are just as easy to identify. They are, in our view, Turkey and South Africa among the larger economies, and Egypt and Pakistan among the less developed economies. The countries that we believe present the greatest sovereign risks are concentrated, again, most prominently in the frontier markets – Argentina, Ecuador and much of sub-Saharan Africa.

Figure 6
Ratio of countries' reserves to the IMFs ARA (assessment of reserve adequacy) metric
Russia, Peru, Taiwan and South Korea have the strongest sovereign circumstance globally in terms of reserve adequacy



Source: IMF, Dec 2018, the most recent year for which data is available. The reserve adequacy metric is a measure of a country's potential FX liquidity needs in adverse circumstances, against which reserves can be used as a precautionary buffer. A ratio between 1 and 1.5 is considered adequate.

Which economies are likely to hit the wall in response to the pandemic?

We believe that South Africa and Turkey present the greatest risks. We fear that South Africa could be on a dangerous train ride that may derail because of unsustainable fiscal dynamics (compounded by contingent state-owned enterprise risks that the government seems to lack the courage to deal with), external vulnerabilities (structural current account deficits that cannot be repaired by currency devaluation as the country lacks competitiveness in anything outside of commodities), and thin reserve coverage. And, of course, Turkey, which has enormous external leverage, significant corporate and bank currency mismatches, and an unrealistic political addiction to growth, which cannot be funded with domestic savings. We believe "creative" policymaking has the potential to get Turkey into big trouble down the road.

Growth winners
Barring the possibility of financial contagion, we believe most of the larger EM economies will get through 2020 as a "gap year" of sorts. We do worry, however, that structural growth will be seriously impaired for many of the bigger economies beyond 2020. This view is premised on the trends we see – lower global growth, structurally weaker commodity prices, and the contingent damage of higher fiscal debts. We see years of weaker real growth potential in many of the larger EM economies, including Brazil, Mexico, India, and Russia, unless, of course, much-needed structural reforms are implemented. These changes include privatisation and state-owned enterprises reform (in Mexico and India), foreign liberalisation (in Brazil) and labour market reforms in India). In our view, the real growth winners in a global economy with growth moving at a more glacial pace may be almost exclusively in Asia. Among the structural growth engines, we favour the Philippines, Indonesia and Vietnam, alongside, of course, what we consider to be the well-positioned, historically dependable developed economies of South Korea and Taiwan.

Strong China
We expect a massive separation over the next few years between China and the other countries in the developing world. In fact, we believe China is likely to emerge as a dominant growth engine of the world over the next decade. Having accounted for 30%-40% of total worldwide growth over the past 10 years[3], we believe that China will represent more than half of all global growth in this decade. We believe the combination of high investment levels (massive savings), powerful structural reform, sustained urbanisation, and improved capital allocation could underpin a level of compound real growth over the next few years that, on a US$14 trillion economy[4] could create, by our estimates, economic output the size of India over three to four years. We also believe China, from our estimates, could be in for a major equity bull market, despite the geopolitical tensions.

Investment decisions
We believe it is incorrect to follow the common assumption that all EM are growing at a faster rate than developed markets. We cite as evidence the fact that high levels of growth among emerging countries outside of China have not been a story for nearly a decade, and we do not expect it will become one in the foreseeable future.

We also believe it is wrong to use macroeconomic growth as the basis for investing in EM equities in the pursuit of sustainable returns.

To generate long-term performance, or alpha, in EM equities, we think investors should apply the same approach that should be applied to investing anywhere. That is, invest for the long term in attractive companies with durable growth, sustainable advantages, and embedded real options that have been underappreciated over time, while being mindful of significant currency risks in times of high volatility like we are experiencing now.

Idiosyncratic company investment cases
Despite the absence of a case of strong macroeconomic growth in other EM countries, besides China, there is an abundance of idiosyncratic company investment cases – and many of which we believe are inordinately cheap now.

In the EM universe, we believe there are two types of high-quality companies that tend to have the intriguing potential of gaining a ubiquitous market presence and, in turn, outperforming over the long term.

1. Companies that despite being in lower-growth EM economies have innovative products or unique assets that capture demand in a large overseas market. We believe an example of this type is Novatek[5], a Russian-listed natural gas company. Similarly, undeterred by the limitations of its small domestic home market, Taiwan Semiconductor (TSMC)[5] supplies about half of the global chip market and stands at the confluence of multiple future technologies, including 5G and cloud computing.

2. Idiosyncratic companies that have competitive advantages in terms of scale and efficiency in informality, which they leverage to gain domestic market share. Femsa[5], the largest Coke bottler in Mexico, falls into this category. By introducing an innovative convenience store operation called Oxxo, Femsa has taken market share from independent stores. Today, Oxxo is by far the largest convenience store chain in Mexico.[6]

Trailblazer China
The case for China is an entirely different matter. We believe it will be the global trailblazer for economic recovery and provide what we think may be the most compelling investment opportunity in the next decade. Our confidence stems from the fact that we believe China will emerge stronger from this crisis, with durable macroeconomic growth and a very strong currency. We believe high-quality companies like AIA[5] and Ping An[5] – which have been strengthening their insurance and financial product offerings to cater to the specific needs of mainland customers – have capitalised on greater market share and their technological and business innovations.

Footnotes

1. A non-performing loan (NPL) is a loan that is in default or close to being in default. Many loans become non-performing after being in default for 90 days, but this can depend on the contract terms.
2. Source: Sberbank, as of April 2020.
3. Sources: World Bank, International Monetary Fund, Bank of America Merrill Lynch, as of May 2020.
4. Source: The World Bank, of 12/31/2018.
5. As of 31 March 2020, the Invesco Emerging Markets strategy's portfolio held positions in the following companies: Novatek, Taiwan Semiconductor Manufacturing Company, Femsa (Fomento Economico Mexicano), AIA and Ping An Insurance.
6. Sources: Post-Gazette, Femsa website.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. As a large portion of the strategy is invested in less developed countries, you should be prepared to accept significantly large fluctuations in the value of the strategy. The strategy may invest in certain securities listed in China which can involve significant regulatory constraints that may affect the liquidity and/or the investment performance of the strategy. The strategy invests in a limited number of holdings and is less diversified. This may result in large fluctuations in the value of the strategy.

Important information

EMEA6443/2020