Emerging Markets Equities

Staying the course and being selective reaps long-term rewards

- March 2020 sell-off worse than Aug. 2015 but better than Oct. 2008
- We have seen this before: this is where we find the best opportunities
- In last 20 years, our strategies outperformed after extreme sell-offs

With the relentless march of Covid-19 around the world, the policy response of many governments has been truly staggering. The 2008 Global Financial Crisis took 12 months to spread globally. Covid-19 has taken just three months – impacting first China before spreading to the rest of the world. Strict government measures to try and slow the contagion – the so-called 'lockdowns' – now affect more than half of the world's population. The economic disruption from these measures will be enormous, with the flow of goods and people severely curtailed, and a global recession is all but inevitable. Economic contagion is now spreading as fast as Covid-19 itself. The crisis will pose great challenges to emerging markets. The sharp sell-off seen last month was a clear sign of investors' concerns.

At current levels, emerging markets are broadly pricing in a global recession, in our opinion. Yet, we have seen steeper market retracements in the past, and this time too we could face further declines. These could be triggered by yet more bad news. The further spread of the disease in different countries and the related policy responses, or additional strains in credit markets could rattle equity markets further. Most importantly, earnings estimates will also suffer from another round of negative revisions.

History tells us that, at some point, equity markets will recover their losses. And we believe, that for a number of emerging equity markets, we are closer to the end than to

Update
For professional investors
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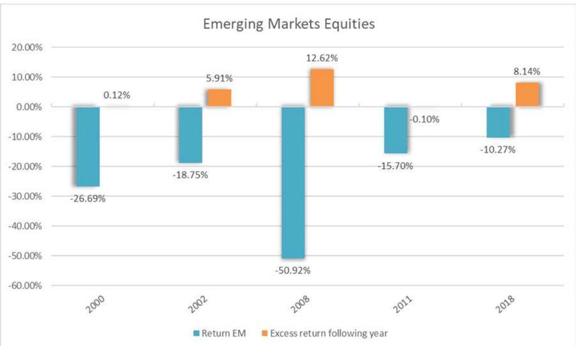
the beginning. Although the economic backdrop will remain extremely challenging in the near future, the long-term structural factors that drive economic growth in emerging markets are still firmly in place.

In risk-off environments, the value tilt intrinsic to the emerging markets strategies should result in underperformance. Yet their historic track records tell a different story. Over the last 20 years, both the Robeco Emerging Markets Equities and Robeco Emerging Stars strategies have regularly produced positive relative returns both during or following market downturns. Crucially, after extreme sell-offs (defined as markets declining by more than 10% in a calendar year), our strategies have usually subsequently outperformed with only 2011 an exception for the Emerging Markets Equities strategy. Our experience tells us that it is in markets affected by extreme risk-off sentiment, that we can find the best alpha opportunities. Figures 1 and 2 illustrate this.

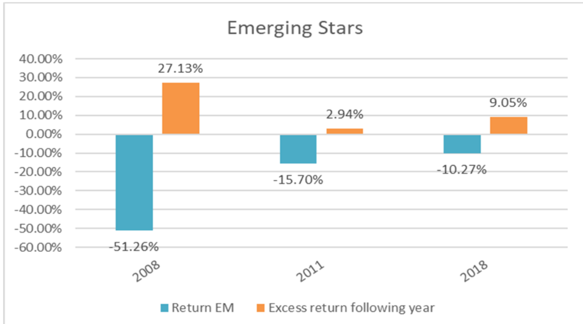
Figure 1 | Excess Return following significant sell-offs – Emerging Markets Equities



Source: Robeco, FactSet

Being active investors and well-resourced with in-depth in-house research capabilities provides critical advantages: this is not a market to buy indiscriminately, as it can be easy to end up in structural losers. These are companies that will be affected by the current economic slowdown either permanently or for a longer period than their competitors. Conversely, there are other companies that have seen their stock prices hit in the sell-off, but whose fundamentals are likely to stay resilient despite the current economic backdrop. As long-term equity investors, we have learnt that the best strategy is to start seeding during the market panic, by slowly and gradually picking our entry points in those companies that we believe have been unduly hit by the sell-off. Our investment process is inherently designed to unearth those stocks where we believe the market is mispricing the future earnings potential. Historically, such a strategy has brought us some of the best harvests.

Figure 2 | Excess Return following significant sell-offs – Emerging Stars



Source: Robeco, FactSet

Yet, the road is not always straightforward. As active investors, we know that trying to follow short-term market gyrations will eventually deplete alpha through high transaction costs. We have learnt to stick to our investment process to generate our high conviction ideas, probing them along the way to make sure that we are not missing any new information that would make them less compelling. At times, this implicitly implies underperforming the index in the short-term, before recouping this underperformance later on.

We are patient. While it is never fun to be in the midst of a market meltdown, we have learned that this is also a good time to be long-term active investors.

Fundamentals

As explained in previous market updates, we believe that the depth of the impact of Covid-19 on global economic activity will depend to a large extent on the policy response from governments. In particular, it will depend on the duration and extent of economic activity shutdowns. Though significant policy steps have already been taken, at this point we do not know what further steps in policy response will be required, or how deeply and for how long they will affect the global economy. There are two threats: one financial, related to credit and liquidity constraints, and one based on the real economy. There is a real possibility of an unprecedented extended real economy "freeze." Months and months of lockdown will not only disrupt demand but also supply. Unlike previous financial crises, an extended freeze of this magnitude, damaging productivity and supply chains around the world, would be new territory for governments and policymakers.

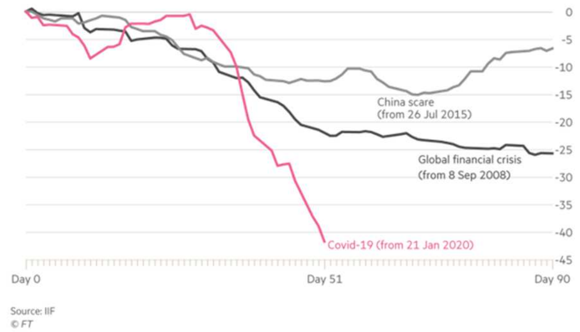
Predicting the market bottom is therefore next to impossible, as multiple dimensions of the crisis are unprecedented. There are simply too many unknowable aspects such as the timing and content of policy decisions, the reactions of firms and households and the progression of the outbreak.

Accordingly, we have become increasingly concerned about the extent and depth of the economic impact, and a global recession has now become our base case scenario. It is clear that H1 earnings will be severely affected around the world.

Since the onset of the crisis, foreign selling of emerging markets assets (both equities and bonds) has been very significant. Nearly USD 45 billion worth of emerging markets assets have been sold. As shown in Figure 3, the reduction in emerging markets asset holdings has been much quicker and steeper than the one seen during the global financial crisis, over a decade ago.

Figure 3 | Retreat of EM investors

Accumulated non-residential flows to/from EM equities & debt from start date, $bn



Source: IIF, FT

Reflecting this significant outflow, emerging equity markets lost close to 25% in the year to date (in euros) in the first quarter and then recovered somewhat towards the end of the quarter to finish down 22%.

These figures hide a wide disparity amongst countries. Countries that have been able to resume economic activity earlier than others fared relatively better. China is a clear example, with a year-to-date decline of only 9% (in euros) at the end of March. The country managed to contain the outbreak and is now tentatively loosening the draconian lockdown measures that were in place. Other countries such as Brazil have been badly hit by a combination of the Covid-19 fall-out, a strong US dollar and collapsing commodity markets.

Emerging countries are dealing with the crisis in disparate ways. Emerging markets are not a homogeneous asset class and countries have very diverse fiscal situations. The current environment has separated the chaff from the wheat. There are a number of emerging countries with limited fiscal deficits – such as Taiwan and South Korea in North Asia, and Poland, the Czech Republic and Hungary in Eastern Europe – or with strong balance sheets, such as China. These countries have more room to maneuver. Brazil is in a more difficult position, and recent market dynamics indicate that investors are concerned by the country's situation. It is also clear that an accommodating monetary stance from major central banks from around the world will be necessary – though this in itself will not be enough. It would require emerging markets to also deal effectively with the outbreak and implement fiscal policies that are designed to support domestic demand and shore up the economic fallout.

Positioning

We need to make sure that the companies we hold in our portfolios can weather the current crisis. Their earnings outlook and liquidity/balance sheet risk are key aspects to monitor. For example, companies in industries that will be affected for longer by the economic shutdown will take longer to recover. Some may never recover.

Companies that face bigger difficulties include those in seasonal businesses, where there are short periods for goods to be sold before these become inventory. Another example are companies depending on complex and global supply chains that are facing disruptions. Demand may recover at some point, but supply could take longer to fall back into place. Other industries could see a significant and sudden recovery in demand, but the extent of the prior decline may have made them unable to operate. Companies with weak balance sheets that are unable to finance their working capital needs might not survive. We are likely to see restructuring and consolidation ahead. Also, companies that need to roll-over bonds or have significant working capital financing needs during this period can come into significant difficulties.

Over recent weeks, we have seen that those emerging markets that have managed to control the pandemic (such as China, Taiwan and South Korea) have performed relatively well, with China and Taiwan even outperforming the S&P 500. Taiwan and South Korea, in particular, learnt some important lessons from the SARS outbreak in 2002-2004 and were better prepared for another outbreak. Regarding the spread of the pandemic across emerging countries, we are especially concerned by those where the policy response is proving to be rather slow (such as Brazil and Mexico), and/or where the country dynamics are such that a spread of the virus will very difficult to contain, which is the case of India. A small ray of hope is that for some of these countries there is a potentially important offsetting factor: their demographic profile. Many emerging markets have a much younger population than developed countries, and young people appear to be much less affected when they get infected by the virus. At this point in time, however, it is difficult to say whether this will help them in this crisis. Consequently, country allocation will be a crucial differentiator for performance in the coming quarters.

In the end, as always, equity market performance will follow earnings results. While earnings will be affected globally, and therefore also across emerging markets, within emerging markets we expect countries that have been able to weather better economic disruption to be rewarded by investors.

Taking all these elements into account, key changes to the portfolios have been:

- In the Emerging Markets Equities strategy, we have reduced our exposure to banks in a number of countries such as India, Brazil, and South Korea. Banks are vulnerable to a recession and are likely to see an increase in non-performing loans and other associated credit costs. They could also be asked to do "national service" – being forced to help fund the recovery effort. In the Emerging Stars strategy our position in Indian banks was reduced.

- In both strategies, we have also decreased our exposure to India, as we are concerned about the country's ability to contain the pandemic and its impact on the domestic economy.

- We have selectively added exposure to companies that continue to have good long-term prospects, and that we are now able to buy at an attractive valuation.

- We are funding these purchases with both new inflows and the sale of stocks of companies that we believe will face more structural problems as a consequence of the of the crisis.

Summary

Emerging markets strategies with their value tilt should typically underperform in risk-off markets. However, over the many years that our team has been in place, we have learnt to use market over-reaction to find opportunities. Over the last 20 years, our emerging market strategies have often generated positive relative returns following periods of extreme risk-off, outperforming the index over the investment cycle. We continue to adhere to our investment process, gradually changing our positioning wherever superior risk-reward prospects emerge. The most common mistake that value investors make in economic downturns is to get into value traps, i.e. companies that will either take longer to recover or will never recover. Balance sheet strength and earnings outlooks remain key.

Robeco's emerging markets equity funds are well positioned to benefit when the market recovers. In a rebound, the tide will lift all boats, but once the impact of the crisis on earnings becomes clear, we will be able to distinguish winners from losers. Our investment process is inherently designed to unearth those stocks for which we believe the market is mispricing the future earnings potential. Our track record shows that this type of portfolio tends to outperform when the market recovers after a crisis. The economic cycle will differ a lot from region to region, since North Asia went into the economic slump earlier than the rest of the world. China, Taiwan and South Korea have for now tackled the virus and are gradually recovering. It is really a first in-first out phenomenon that could result in large discrepancies between countries' economic and financial performances.

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