Are we close to a turning point?

It is always difficult to say when a party is over. After three years of falling returns in emerging markets, there weren't many people left at the party anyway. The guests have now started to return. Are they wrong to do so?

By: Kristoffer Stensrud (/en/contact-us/portfolio-managers/kristoffer-stensrud/)
Portfolio Manager
Date: 20/06/16

The political and economic situation in Brazil continues to be uncertain. Photo: Bloomberg

As a global emerging markets investor, I have watched as investors have fled emerging markets at the same time as the economic prospects have become gloomier and the concerns more manifold. The so-called BRIC countries (Brazil, Russia, India and China) have been at the root of much of this.

Brazil has been in political crisis, and an increasingly far-reaching corruption scandal has reinforced an economic downturn that was already in motion. A Russia that is increasingly hostile to business has felt the effects of falling commodity prices and is in recession. The major concerns for China have been the frequent signs of waning economic growth and companies' debt mountains. For its part, India is struggling to push through the economic reforms that are needed for it to reach its full potential.

All of this is topped by uncertainties regarding a potential rate hike in the US, which has resulted in strengthening the dollar and sucking large amounts of capital out of emerging markets. Rate hikes in the US are in themselves positive as they indicate a normalisation of the interest rate level and a growing economy.

Brighter than for a long time

This year started with a bang and a crash, but renewed optimism quickly returned. Is the desert journey at an end? In the short term, it could be that we are seeing a mirage, but for the time being it appears as though the major concerns have dissipated. After many years of strong expansion, companies in emerging markets are once again prioritising return on capital and a lasting fall thus appears to have been halted. In addition, despite the slight upturn since the new year, valuations are still at crisis levels.

In other words, the prospects at the time of writing appear brighter than they have for a long time. It is therefore also not entirely surprising that there is no lack of people willing to declare that we have reached the bottom. Media and analyst reports are full of these types of headlines. After more than 40 years in the equity markets, I can sympathise with investors' wish to start making money again. That is why it is important to put things in perspective. We have to consider whether the underlying challenges that emerging markets face have truly dispersed or whether it is just a case of wishful thinking.

Still uncertain

The political and economic situation in Brazil continues to be uncertain – if slightly less so now than in the prelude to the dismissal of the President Dilma Rousseff. When it comes to China, they have not yet been able to reduce their debt mountain or lift growth. Russia is no more business friendly even though the oil price has stabilised and India has not solved the challenges around implementing reforms.

Although emerging markets are still growing 3-5 percent per year and the valuation of companies is down to extremely attractive levels, it is likely that further development in these markets will continue to be volatile. This can of course provide long-term investors looking to build up their emerging markets exposure with good opportunities. However, it is important to remember that the path of least resistance to good equity returns is the companies' underlying developments. That is why company selection is so important. Companies which focus most on their return on capital are the ones I would prioritise.

In which case, it hardly matters whether the party is over, or whether it has even started yet for that matter.