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Experience & Discipline

Singapore Trip Report

The Re-emergence of Emerging Markets in 2019

November, 2018

Executive Summary

In 2018, Asian markets were hit by an unfavorable macro policy mix that hurt performance and sentiment: Higher interest rates in the U.S. and a stronger USD led to tighter financial conditions and to capital outflows, trade tensions negatively impacted growth and dented risk aversion, and rising oil prices hit margins and currencies in countries with large oil imports

Pan-Asian equity managers went through a very challenging year in terms of performance, as two of Asia's key equity markets (China & India) suffered double-digit losses

After the massive corrections in the FX and equity space, emerging markets assets are attractively valued versus developed market counterparts and could present key opportunities in 2019

Equity managers deem India, China, and Thailand attractive investment places due to cheap valuations and a more favorable policy mix

India just had its "Lehman moment" with the collapse of IL&FS, but now growth is improving, a new credit cycle is about to start, interest rates will be reduced, and political uncertainty is largely discounted, while currency weakness has run its course

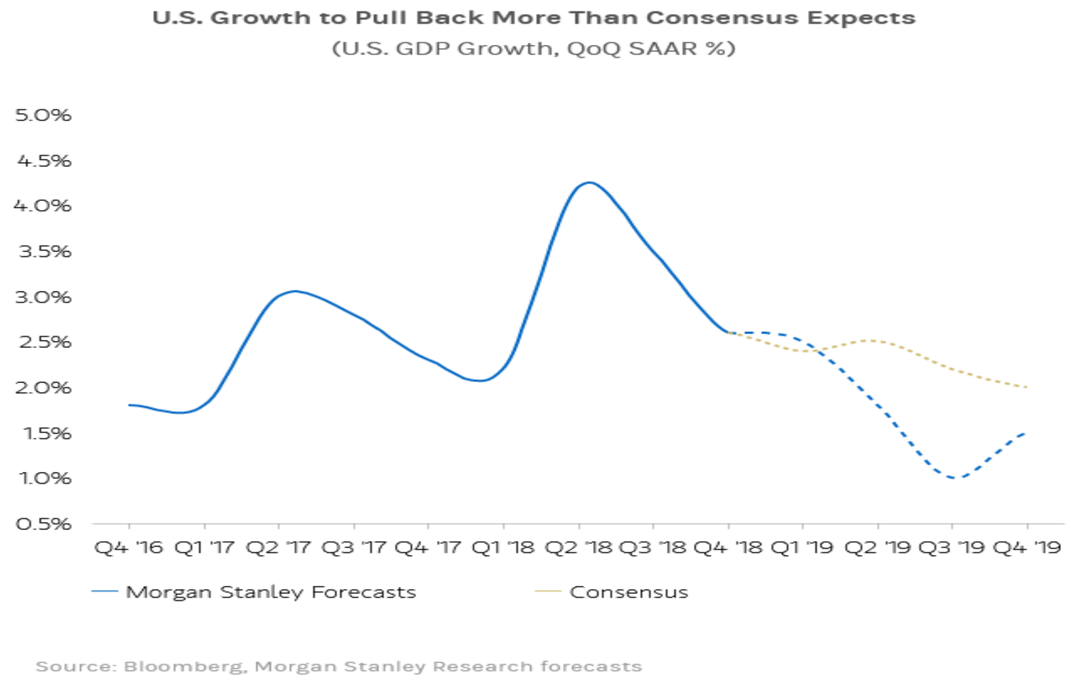
The Re-Emergence of Emerging Markets in 2019?

1. Unfavourable Policy Mix in Emerging Markets in 2018 Is About to End

In 2017, world equity markets benefitted from synchronised global growth, while in 2018 only the U.S. experienced a strong economic momentum and growth sagged in the rest of the world. As a result, it had been a challenging year for Pan-Asian emerging markets: Slowing growth, rising inflation, and tightening monetary policy provided a difficult backdrop for equity markets in Asia. EM markets economies, notably those in Asia serving as a workbench for the West, are vulnerable to the backlash against globalisation in the Western hemisphere if it results in shrinking global supply chains and trade. Rising interest rates in the US, a strengthening US dollar and the impact of QT on capital flows further exacerbated the situation and led to a tightening of financial conditions in EM, while the rise in oil prices coupled with trade tensions hurt growth and dented risk sentiment.

But the headwinds are abating and the macro narrative in 2019 could turn into tailwinds for EM economies, as the macro story is about to change. A sharp decline in crude oil prices in Q4 2018 and a Fed that has now hinted at pausing from further rate hikes as it assesses the direction of the economy and the impact of its previous policy moves could provide some fuel to revive investors' risk appetites. Markets are already cautiously pricing in a positive outcome of the Sino-U.S. trade negotiations. And most Asian countries stand to benefit if oil prices stay range-bound or trade only modestly upwards.

In 2019, growth in the U.S. is expected to slow down, as the fiscal stimulus is petering out, the trade war and the government shutdown hit domestic growth, and higher rates take their toll on the economy in the form of a weaker housing market and higher input costs for companies. Morgan Stanley forecasts that the U.S. economy will slow down from a GDP increase of 2.9% in 2018 to a drop to 2.3% in 2019.



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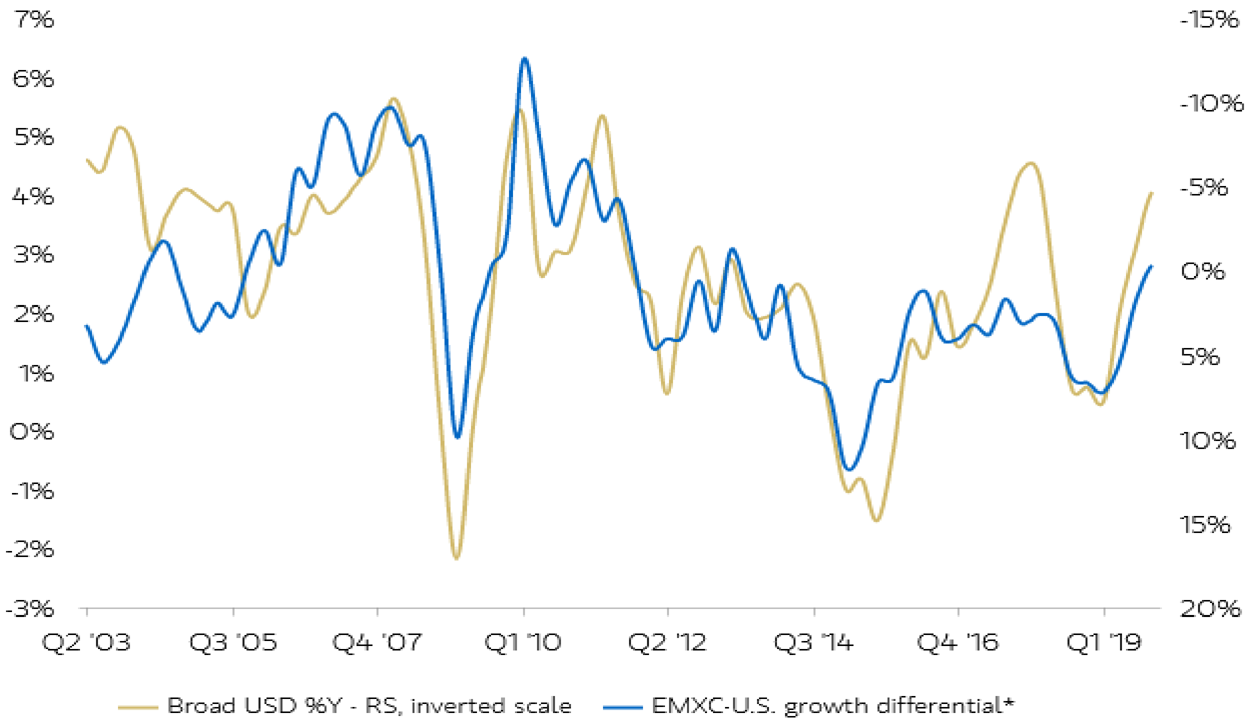
As growth subsides in the U.S. and in other developed markets, emerging markets should resume their role as the world's economic growth engines. A slowdown in U.S. growth with EM re-accelerating at the same time means that EM earnings growth should exceed that of the U.S. in 2019 and be more attractive on a relative value basis. This change in leadership, along with higher core inflation, tighter monetary policy and a possible easing of trade tensions, marks a potentially significant change in favor of EM in the outlook for the year ahead.

Growth Differential to Swing Back in Favor of Emerging Markets

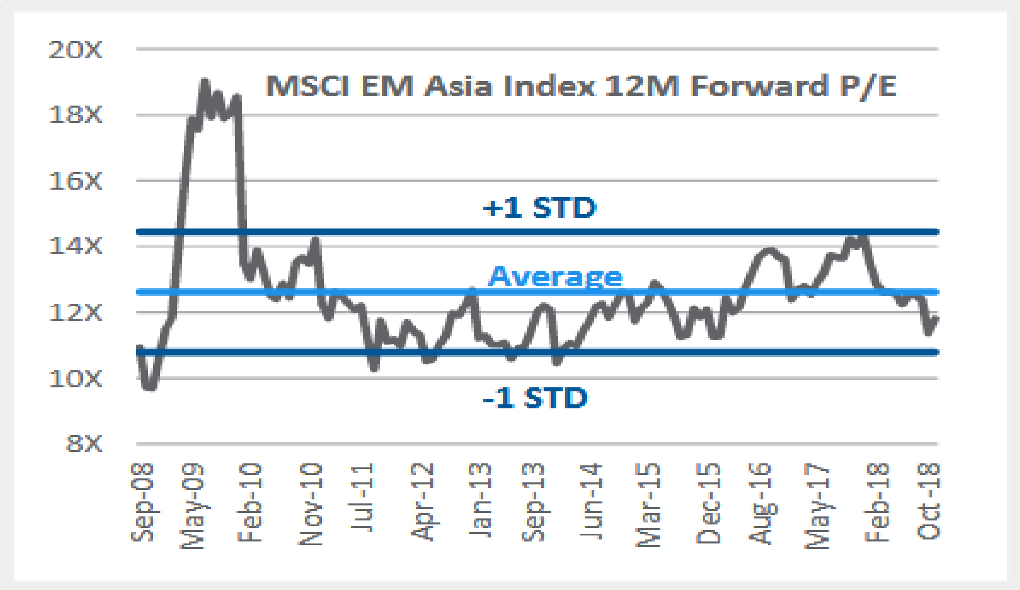


Source: Haver Analytics, IMF, Morgan Stanley Research forecasts; *EMXC includes emerging markets countries (excluding China) under Morgan Stanley coverage excluding Argentina, Venezuela, Nigeria, Saudi Arabia and Kazakhstan.

With the Fed being less aggressive in 2019, the U.S. dollar strength may reverse, further bolstering emerging markets. Most EM Asian currencies look fundamentally undervalued, and more modest rate hikes would more than support these valuations. Stronger Asian currencies would also be another positive catalyst for Asian EM equities.

Another possible positive ingredient is valuations. EM equities have already corrected substantially in 2018. Valuations based on P/E and P/B are now well below the long-term mean levels, as EM equities have underperformed U.S equities over the past ten years.

EM Asia Valuations Have Reached Compelling Levels



Source: Bloomberg as of 13 Dec 2018

As long as economic and corporate fundamentals remain solid, these economies remain the biggest driver of global growth. In particular, the capital discipline displayed by companies across emerging markets, with evidence of strong balance sheets and improving free cash flow generation provide a strong basis for higher valuations. This is also being reflected at the macro level. Few countries are exhibiting signs of overheating. With valuations towards the low end of the historical range and at a significant discount to their developed market peers, the market appears too focused on short-term uncertainties and is ignoring the fundamental improvements that have taken place. Even though historical data does not provide any comfort for hopes that EM equities can perform on the back of a correction in U.S. equities, EM equities might re-take the lead for 2019 and outperform DM equities.

Morgan Stanley Top-Down Bull, Base and Bear Target Prices for 2019

Index	Current Price	Morgan Stanley 2019 Target Price (% Change from current levels)			June 2019 Target Price (% Change from current levels)		
		Bull	Base	Bear	Bull	Base	Bear
S&P 500	2,650	3,000	2,750	2,400	3,000	2,750	2,400
		13%	*4%*	*-9%*	*13%*	*4%*	*-9%*
MSCI Europe	1,478	1,890	1,540	1,170	1,860	1,540	1,150
		28%	*4%*	*-21%*	*26%*	*4%*	*-22%*
Topix	1,616	2,100	1,800	1,300	2,140	1,720	1,340
		30%	*11%*	*-20%*	*32%*	*6%*	*-17%*
MSCI EM	975	1,230	1,050	750	1,350	945	830
		26%	*8%*	*-23%*	*38%*	*-3%*	*-15%*

Source: RIMES, IBES, Morgan Stanley Research Forecasts; Data as of November 21, 2018