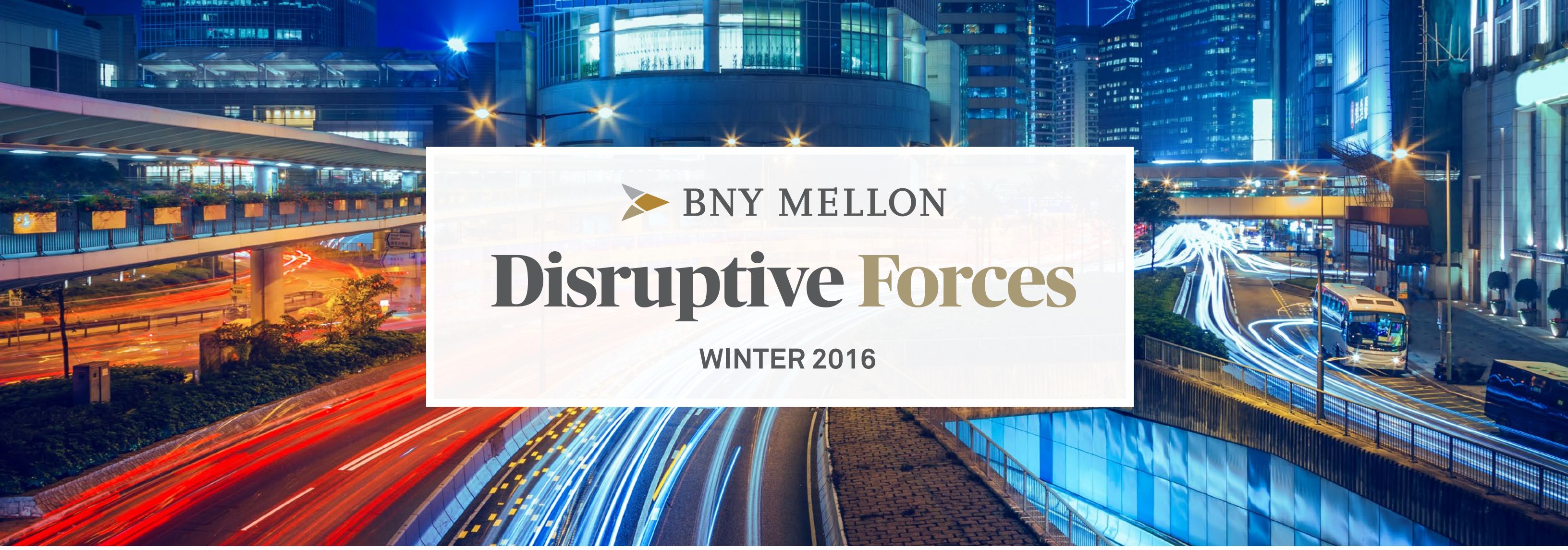

BNY MELLON

Disruptive Forces

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With rising global trade barriers, increased uncertainty around the sustained direction of U.S. interest rates and questions over Chinese growth, 2017 could be a watershed year for investors in emerging markets. Here, **Rob Marshall-Lee, leader of Newton's emerging and Asian equity teams,** looks at some potential winners and losers.

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Among the specific forces of potential disruption set to continue to shape emerging markets (EM) is the rebalancing towards internal sources of growth. One impetus for this is the sluggish growth in the developed markets, the traditional destination for exports. This trend is particularly marked in China, which is already shifting its economy away from manufacturing and fixed asset investment (now judged to be unsustainable due to the build-up of debt) to more of a focus on consumption and services.

So far, this transition has taken place in fits and starts, with periodic slowdowns spurring increased amounts of 'fine tuning' by the Chinese government via both monetary and, latterly, fiscal, policy. The most visible cost of this support has been the speed at which China's debt burden has continued to grow. (China's debt-to-GDP ratio has leapt from 147% of GDP in December 2008 to 255% more recently.)[1] The Bank for International Settlement is among the sirens warning that China is paving the way for a financial crisis.[2] That said, the growth in the domestic services economy has been remarkably robust despite the slowdown in the more capital-intensive industries.

While there may be the temptation to avoid China completely, there is also a danger of missing structural growth opportunities. The Chinese market may be heavily dominated by state-controlled companies but roughly one-third is in private ownership. Privately owned companies tend to offer the more attractive opportunities, especially in healthcare and Internet companies, in our opinion.

The economic reforms being undertaken in India under the leadership of Prime Minister Narendra Modi offer promise and are set to be good for growth over the next decade. (Under the previous government, growth had been stifled.) There is, for instance, pent-up demand for consumer durables after an earlier slowdown and

1. *Financial Times:* 'China Financial Stress Indicator Hits Record High,' September 19, 2016.
2. Bloomberg: 'Warning Indicator for China-Banking-Stress-Climbs-to-Record,' September 19, 2016.

Indian consumers are not burdened by high levels of personal debt. There is potential for a catch-up in productivity with an easing of regulatory constraints and onerous laws.

Weaker sentiment towards commodities and related economies has already exerted an influence on investment flows into emerging markets and, by extension, can also have an effect on the valuations of all equities in those markets. This can be the case for even those that are inherently attractive underlying investments. For example, most stocks in India benefit from a weaker oil price, which is also positive for its currency. This valuation squeeze now appears to be reversing from depressed levels.

RELIANCE ON COMMODITIES

For 2017, a useful way to differentiate the emerging markets is likely to continue to be a separation of the countries that are reliant on commodities from those that are driven by manufacturing. There is an excess supply of commodities and prices are highly unlikely to rise as they did in the 2000s, despite a near-term rebound linked to short-term Chinese stimulus. The commodity bull market followed a commodity bear market which had lasted since the1980s. We do not see a repetition of this scenario given the extensive investment in commodity supply, such as iron ore, for which Australian exports have increased approximately sevenfold since 2000.

China's rapid growth and voracious appetite for raw materials were the driving forces behind the industrial commodity 'super cycle' that lasted until 2011. Tightening measures following excessive stimulus post the global financial crisis and the managed growth slowdown that resulted, saw commodity prices fall almost as fast as they had initially risen. These rebounded somewhat as the near-term outlook for China's growth overall has improved, yet we strongly expect the slowdown to resume in due course, which will likely translate into renewed commodity price weakness.

The length of this recent boom and the capital misallocation that resulted are likely to take some time to work through the affected economies, adding to the pain of adjusting to a new reality. For example, commodity producer Brazil's fiscal deficit is running at 9.6% of GDP, suggesting that macroeconomic risks in the medium term may be higher than investors currently perceive.

POWER TO THE YOUNG

Demographic trends are not uniform across emerging markets and the differences can offer an economic advantage. There is substantial potential for future growth in countries where there is a rising population of young people, a cohort more likely to be future consumers. This is in marked contrast to many countries in the developed world, which are experiencing shrinking working-age populations.

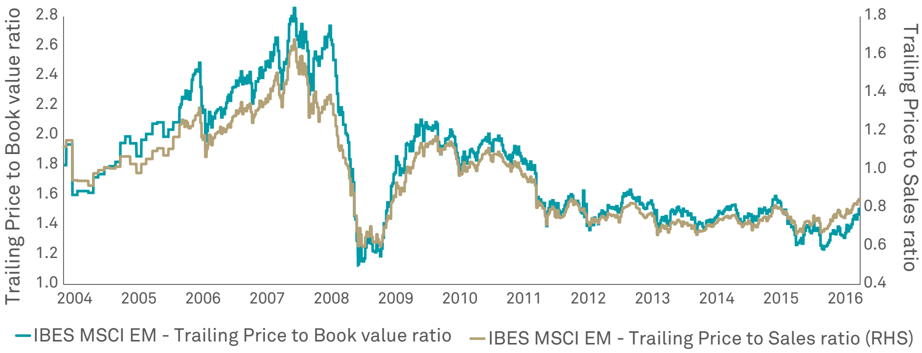
The Philippines is expecting more than 30% growth in its working-age population by 2035.[3] Such an economy as the Philippines' should also be able to harness productivity gains and rising consumer wealth. In addition, considerably lower debt levels than in the developed world, and versus its own history, should further insulate the domestic internal growth drivers from external shocks.

While Nigeria and Kenya are also likely to experience very high growth in their working-age populations, Asian economies are generally more attractive on a risk-reward basis. This is because of, at this juncture, their better economic policies and governance overall, which

3. Newton, UN Population Information Network: 'World Population Prospects: The 2015 Revision,' as of April 2016.

EMERGING MARKETS – ATTRACTIVE ENTRY POINT?

Valuations are still near 2009 lows



Source: Thomson Reuters Datastream, in USD, as of August 25, 2016.

can make a sizable difference over the long term.

Of note, while China is often characterized as having an aging population, there is less of a demographic time bomb there than the perceptions around the previous one-child policy would suggest.

Atypically, the younger segment of the working population normally earns the higher wages, whereas the older part of the population usually works on farms, for instance. Urbanization has further to go and will offset much of the decline in the urban workforce. Increased mechanization in factories will also free up labor from this sector going forward.

CHALLENGE OF TECHNOLOGY

To complicate the picture further, there is a range of factors—not just confined to the emerging markets—that have the potential to be disruptors.

Technology is accelerating change around the world. For instance, the move towards 'cloud' computing has the potential to disrupt not just mid-level employees but lawyers and accountants, the type of employees that previously would have been unscathed by such developments. In the emerging world, increased robotization could make it more difficult for less developed countries to follow the typical economic development path that relies on transitioning from using cheap and abundant labor in agriculture to light manufacturing in order to generate per-capita income growth.

Change always brings relative winners and losers, and the outlook for e-commerce, travel, education and healthcare spending in emerging markets is bright.

Over the course of 2017, investors will continue to face the question of whether it is a good time to consider investing in emerging markets. An examination of long-term measures through the economic cycle, such as trailing price-to-book value ratios, points to attractive valuations.

Since the 'taper tantrum' of 2013, emerging market currencies have broadly depreciated against the U.S. dollar with many of the economies we favor also seeing improvements in their external balances. This suggests that at least a partial rebalancing to a less accommodative global monetary environment has already taken place.

With a renewed slowdown in China in 2017, we think sectors exhibiting structural growth characteristics will outperform the more cyclical sectors.

What to Watch in 2017

- China's ability to avoid a hard landing.
- U.S. interest-rate cycle.
- Consumer retrenchment in commodity-driven economies.

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