# Emerging markets 2014

How central bank policy and increasing growth could drive returns.
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Emerging market investors endured challenging terrain in 2013, as decade-long tailwinds of falling interest rates and rising commodity prices faded. Fidelity's emerging market strategist Bob von Rekowsky believes 2014 may be a transition year—as emerging market assets adjust to faster overall global growth, more moderate growth from China, and a tapering of monetary stimulus in the United States.
Von Rekowsky anticipates another round of taper tumult, but believes a rising interest rate environment alone does not necessarily mean negative returns for emerging market stocks. His outlook for emerging market debt, however, is more cautious. Countries prioritizing long-overdue structural reforms that lift productivity rates, such as Mexico, should benefit from the next phase of growth in the emerging asset class. Countries dependent on foreign capital inflows that forestall reforms, such as India, risk further downward pressure on their currencies as tapering commences.
Here are 10 trends von Rekowsky believes could drive emerging market results in 2014:

### 1. U.S. Federal Reserve tapering and interest rate policy

U.S. monetary policy may significantly impact emerging market stocks and bonds in 2014. The Fed's accommodative policy has placed upward pressure on many emerging market currencies, which further fueled already-strong domestic demand in many countries, such as Indonesia and Brazil. As the Fed tapers its quantitative easing (QE), the resulting decrease in global dollar liquidity will weigh on stocks in the short term, especially in those emerging countries that are heavily reliant on external financing of their current account deficits.

The so-called "fragile five"—Brazil, South Africa, India, Turkey, and Indonesia—are among the most likely to suffer foreign capital outflows in the near term, which could drive their exchange rates lower. Weaker exchange rates may, in turn, worsen inflationary expectations in these countries, further dampening economic activity. This could prompt policymakers in these countries to raise interest rates to stem the capital outflows or bring domestic demand down to more sustainable levels. Both emerging stocks and bonds would suffer headwinds in this scenario.

### 2. Moderate growth in China

China released its much anticipated economic road map for the next decade during the November Party plenum, detailing reforms in that nation's financial, sociopolitical, and fiscal arenas. In my view, the reforms announced were largely necessary, but only time

and commitment will prove if they are sufficient. **For 2014, a not-too-hot/not-too-cold economy may prove just right for China, and for emerging markets broadly.**
Still, investors might want to prepare for slower growth rates from China. Eventually, the investment-led spending, which has been predominantly property-related, will likely moderate. A concurrent transition to consumer-led growth could bring overall GDP growth rates down to a more sustainable 5%–7% range, down from last decade's heady 8%–10% range.
What's more, careful analysis of China's current account balance reveals it may no longer be strongly positive, as Chinese exports appear to have been overreported in the last year. This matters for the 2014 outlook, because moving into a more structural current-account deficit would diminish liquidity in China, putting upward pressure on borrowing rates. Higher rates could slow the economy and place more indebted Chinese firms under pressure.

### 3. Results of a daunting 2014 election calendar

Emerging markets face an array of election challenges in 2014, with the potential for both optimism and disappointment with regard to necessary structural reform outcomes. The first half of the year is particularly significant, with general elections in South Africa (April); parliamentary and presidential elections in Indonesia (April and July, respectively); parliamentary elections in Hungary (April); presidential elections in Colombia (May); and general elections in India (May). In 2014, presidential elections will be held in Turkey (August) and Brazil (October), two countries whose economic management have been the subject of street protests by unhappy constituents.
Our previous studies of elections suggest that **markets tend to underperform in the three to six months prior to an election amid policy uncertainty, and recover in the subsequent time frame—no matter the political stripes of the winning party.**

### 4. The implementation of much-needed structural reforms

In the first decade of the 2000s, many emerging market countries rode a wave of liquidity, fueled by rising commodity prices, declining interest rates, and a subsequent bolstering of revenues and reserves, which steadily improved sovereign balance sheets. Rising prices for commodity exports filled the fiscal coffers of many emerging markets governments, and allowed some countries to plaster over structural cracks that went largely unaddressed.

Credit growth ensued across many emerging market countries, as low interest rates propelled consumer-led spending on cars, homes and durable goods. Rising voter aspirations may have deterred policymakers from long-overdue reforms aimed at infrastructure de-bottlenecking, government finance, and ending protection for politically sensitive domestic economic sectors.

After a decade of rising tides, easier finances and synchronized growth, emerging market countries are suffering myriad imbalances and need to deliver on structural reforms in 2014 to brighten their economic prospects. **Investors should closely assess investments in countries in need of structural reform, such as Brazil and India, while investments in countries where prospects have improved, including Philippines and Mexico, should offer a better risk/reward tradeoffs.**

### 5. Productivity gains necessary to secure the future

For many emerging market nations, productivity improvements are essential. The Conference Board, a global, independent business membership and research association, has asserted that "emerging markets need to generate more efficiency from investments in infrastructure, and raise productivity in growing industries, particularly the services and consumer industries." Many factors drive the overall rate of productivity—job creation, capital investment, and output per worker—so it is important to assess overall trends in productivity growth, rather than focusing on a fixed point in time. There are major productivity growth disparities between and within various emerging market regions, and recent slowdowns have been more pronounced in Latin America than in Asia. **Trends in productivity are an important gauge of economic well-being in developing economies, and governments that prioritize proper structural reforms in 2014 will better position themselves for future investment.**

### 6. Slow growth in Europe

Things looked bleak in 2011 and 2012 with concerns that Greece might exit from the euro and lead to the EU's potential unraveling. Amid this market upheaval, European Central Bank (ECB) president Mario Draghi pushed more than €1 trillion in three-year loans into European banks, which he proclaimed "avoided a major, major credit crunch." These long-term refinancing operations (LTROs) forestalled a liquidity crisis in European banks, but kicked the can down the road regarding banking sector viability. Now, as these three-year LTROs come due, the ECB's balance sheet (in euro terms) has been shrinking, while the U.S. Federal Reserve and Bank of Japan's balance sheets are expanding. The ECB surprised the market in early November by cutting its benchmark interest rate by 25 basis points to a record low 0.25% and extending its LTRO program to mid-2015. Draghi continues to see downside economic risks, so the idea of another round of LTRO financing has been floated. **If growth remains tepid, another round of LTROs may boost euro-area liquidity, providing a tailwind for emerging markets, rather than the potential European growth headwind.**

### 7. Financing sources for emerging markets

Record emerging market sovereign and corporate debt issuance in 2012 and early 2013 led some to proclaim a potentially unsustainable credit bubble was building. This bond issuance helped finance emerging markets issuers after European bank lending to EMs shrank considerably along with euro-area bank balance sheets. The Bank for International Settlements (BIS) reported a “surge” in cross-border lending to emerging markets of $267 billion to a total $3.4 trillion in first quarter 2013 This surge was driven predominantly by three borrowers: China, Russia, and Brazil. Indeed, the BIS reported that by Q2 of this year, estimated cross-border lending to emerging market countries had all but collapsed. One exception was borrowing by China, which may be related to the possible overreporting of Chinese exports.

**I remain cautious about the outlook for U.S. dollar–denominated emerging market debt in 2014, based on the views of our emerging markets debt team.** The pace and rate of change in global interest rates will be a key driver of any spread widening between emerging market debt and Treasuries, and of the impact on long-duration debt instruments, which are more sensitive to rate hikes.

### 8. Impact of lower energy prices and disruptive technologies

In the United States, low-cost natural gas and oil accessed via hydraulic fracking has pressured tax revenues and growth in Russia, Venezuela, and other energy-reliant regimes. Middle Eastern producers have also felt the sting on their market share. Longer term, U.S. fracking may spark an investment boom abroad. An estimated 400 shale wells may be drilled beyond U.S. borders in 2014, with most of the activity being in China and Russia, according to energy consultants Wood Mackenzie.[1]

**Other disruptive technologies, such as the advent of 3D printing, may benefit the United States and higher value-added emerging economies with regard to the location of future manufacturing sites.** Meanwhile, wage gains in some emerging market countries (e.g., Brazil, China) have outpaced inflation and, in some cases, productivity. This may force other countries to reconsider strategies aimed at attracting low-wage manufacturing jobs, as disruptive technologies tilt the balance toward U.S. and more-developed emerging market locales. Mexico, for example, with its sizable auto and auto parts manufacturing industry, may benefit at the expense of China in this regard.

### 9. Potential spillover effects from an emerging market sovereign crisis

In 1993, less than 2% of the emerging market debt universe carried an investment-grade rating; today, nearly 65% of emerging market sovereign debt issuers are rated investment grade.[2] However, the secular tailwinds of the past two decades—such as rising commodity prices and falling interest rates—are turning into headwinds moving into 2014.

Until recently, some nations were particular beneficiaries of high commodity prices and investors’ search for yield, including Venezuela and Ukraine. While we are not forecasting a specific sovereign event in either of these two countries, **an emerging market sovereign crisis could certainly roil the debt markets of other developing economies.** This, in turn, could widen interest rate spreads and present other investment opportunities. Overall, we remain cognizant of the increased possibility of sovereign distress in 2014.

### 10. Strong competition from developed countries

A buoyant outlook for earnings growth in the United States sent several broad U.S. stock indexes to record highs in 2013. The 2014 U.S. outlook remains positive, which may be a continued headwind for emerging market stocks, especially if accompanied by a strong U.S. dollar. Japan is another contender for investment dollars flowing abroad next year, based on Japanese structural reform expectations and earnings forecasts. While the outlook for European equities remains mixed, the continent's periphery still holds fertile hunting ground for stocks as growth stabilizes.

As central banks move closer to a credit-tightening cycle, emerging market equities may experience one more round of taper tumult before stabilizing. But **if global rates rise in response to better economic growth, emerging market stocks could post positive results.** Specifically, financials are a smaller share of the broader emerging market than they are in the United States or Europe, so rising will not necessarily hinder cyclically-driven emerging market shares with decent, and potentially rising, dividend yields.



1. Bloomberg Businessweek, "Fracking Spreads Worldwide," November 14, 2013.
2. JPMorgan Emerging Market Bond Index Global, as of September 30, 2013.