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TAKING STOCK

NEAL SMITH: Signs emerge of a bull run in emerging markets in 2021

Recent developments could mark the start of a big rotation out of US assets into the rest of the world

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Picture: BLOOMBERG/ALEX KRAUS

US president John F Kennedy noted: “When written in Chinese, the word ‘crisis’ is composed of two characters — one represents danger and one represents opportunity.”

Though it has subsequently been shown that this is not the correct translation of the Chinese characters, the wisdom about a crisis yielding opportunities may be a more important lesson than ever.

The spread of Covid-19 in 2020 has negatively affected the world’s populations as it morphed from a health crisis into an economic one. SA investors have not been spared the impact it has had on their retirement funds. One of the knock-on effects of the pandemic is that it has shone a spotlight on the fragilities in the economy from before Covid-19.

Those fragilities include:

- More than 80% of tax revenue spent on government wages, social grants and debt-servicing costs;
- Public sector debt to GDP increasing to more than 80% by year end with no signs of stabilising;
- Anaemic economic growth;
- A growing skills shortage as education outcomes disappoint and many citizens choose to emigrate;
- Corporate governance failures in the private sector;
- Government corruption and the capture of state entities; and
- SA's diminishing relevance in a global investment landscape, driven by the inability to attract foreign direct investment.

Though global markets have bounced back from their March lows, SA investors find themselves in a position of earning no returns on their SA equities (in dollar terms), as represented by the MSCI SA index, over the past decade.

We believe that a powerful alternative for SA investors is to look at the opportunity presented by equities in emerging markets (EMs). Most other EM countries have strong growth drivers in place, are in a strong financial position and offer compelling, unique investment opportunities.

Over the past 50 years EM equities have materially outperformed developed market (DM) equities by an annualised 4.4% in dollar terms. While over the past decade DM equities have turned the table on their EM counterparts — due to various macro and geopolitical events and the flight to safety in US assets — recent events have signalled that the catalysts for an extended EM bull market are emerging.

A weakening dollar has historically equated to EM outperformance. The dollar has been on a weakening trend since March, losing close to 11% versus a basket of trading partner currencies. A Joe Biden US presidential victory and the potential for the Democrats to gain control of the Senate in January could lead to larger fiscal stimulus than the market expects. The combination of continued significant fiscal stimulus, very loose monetary policy in DMs, reduced trade war risk, the search for yield, high US asset valuations and extreme US positioning should continue to put pressure on the dollar.

Global positioning is heavily overweight on the US. The country makes up 58% of the MSCI All World index, close to historical highs, which is significantly more than its contribution of 24% to world GDP. In contrast, DMs ex-US and EMs make up 30% and 12% of the MSCI All World index and account for 30% and 45% of global GDP, respectively. Recently EM and DM ex-US equities have begun to outperform US equities. This could mark the start of a big rotation out of US assets into the rest of the world, including EMs.

Biden's victory and positive vaccine news have been a trigger for what could be the beginning of a switch from growth to value. The value-growth trade is about money rotating out of the few, scarce growth stocks (US tech) into many smaller value stocks (EM falls into the value category). Economic growth then needs to broaden out for value to continue to outperform growth. The low base of second quarter 2020 should be low enough to see a cyclical recovery over the next year. This will be helped by a global vaccine rollout. This switch would be a powerful tailwind for EMs.

Within the EM context, SA has performed poorly. The country has underperformed EMs by 43% over the past five years. Over the past 16 years SA's weighting in the MSCI EM index has decreased from 10.2% to 3.6%. This should be of concern to local investors as the size of the JSE now makes it irrelevant to global active investors, who can afford to take the risk of having no exposure. Global investors need compelling investment ideas and SA offers few persuasive unique investment opportunities.

Historically SA investors have taken the view that because the country forms part of EM, they have preferred to diversify into DM