INVESTMENT INSIGHTS

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Harness the Power of Emerging Markets

With the U.S. very late in its economic cycle, emerging markets offer an attractive alternative. In this Q&A, *Pensions & Investments* speaks with Ernest Yeung, portfolio manager for the emerging markets value equity strategy at T. Rowe Price, about the prospects for emerging markets, including the unique opportunities in companies that many investors are missing.

|Pensions & Investments| ***How concerned are you that the Federal Reserve's increases in interest rates will lead to further pressure on emerging market economies and markets?***

|Ernest Yeung| That's the topic of the month. There are two impacts on emerging markets from the rate hike: short term and longer term. Short term, it will prompt capital outflows from emerging markets back to developed markets. That process is ongoing and to some extent has happened for much of the year to date.

Secondly, and what is more important, is the medium- to long-term impact. Previously, when the Fed was hiking, emerging markets were at a late-cycle stage, similar to the U.S. today. What characterizes a late cycle is the economy is growing really fast. Everything is accelerating. Corporate balance sheets and fiscal balances are stretched. When the Fed hikes interest rates, it puts pressure on all these fundamentals. Currently, although the U.S. is at the tail end of a nine- to 10-year cycle, EM are only two years into the up cycle. We are not seeing those late-cycle characteristics. We are not seeing balance sheets getting stretched.

My conclusion is that, for the medium to long term, the rate hikes should not have much fundamental impact on emerging market economies and corporates. They are at the early cycle of recovery, and that path will not be easily derailed by rate hikes.

|P&I| ***What changes have occurred within EM economies that you think better position them for more sustained and higher-quality growth?***

|Yeung| First of all, most EM governments as well as central banks have gotten smarter. EM central banks are behaving like developed market central banks — most are independent, and they are making good decisions thus far. They're not easily influenced by politics or elections, and they have a mandate to tackle inflation and keep currencies stable. This situation is very different compared with five or 10 years ago.

Secondly, EM countries have been very prudent with their macro spending. How they manage the currency is very different from five to 10 years ago as well.

Because we're stock pickers, we focus more on corporates. A lot of EM corporates have been through a very tough few years, with slowing economies. So their capital spending has also been very prudent.

Also, the composition of the MSCI EM index has changed a lot. Ten years ago, it was full of oil companies and commodity companies, which are both cyclical sectors. Today, if I look at the index components, we see the emergence of new tech companies and more consumer companies. The proportion of cyclical companies has fallen. Emerging markets have higher-quality companies to invest in compared with 10 years ago.

|P&I| ***What are your views on rising trade tensions and their impact on EM ?***

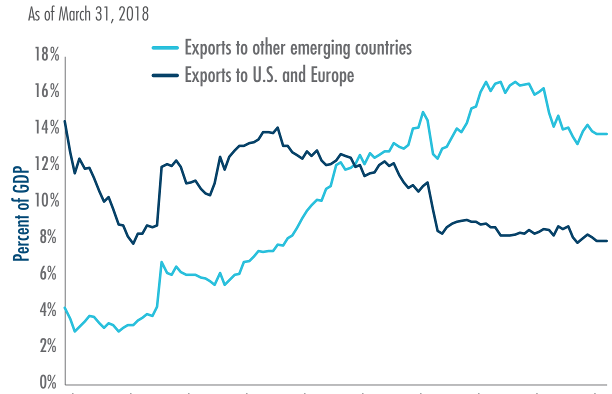
|Yeung| Most of the trade tension is between the U.S. and China, although from time to time Canada and Mexico get sucked in.

The majority of emerging markets will not be impacted by trade tensions unless there is an all-out trade war, which we do not expect. The trade to the U.S. from other emerging markets is smaller than you might think. In the last few years, the trade within emerging markets has grown. They're not as dependent on the U.S. as they were 10 years ago.

Economists have quantified the exact impact on China if all the trade war policies were to be implemented: It's less than 1% of Chinese GDP.* The headlines are affecting perception and sentiment, but the real impact on the economy and corporates is going to be less than investors fear.

EMs EXPORT MORE TO NEIGHBORS THAN U.S. AND EUROPE

As of March 31, 2018

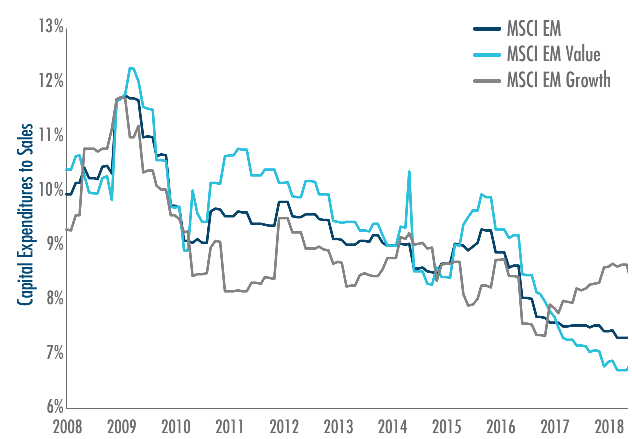


Sources: U.S. Department of Commerce, J.P. Morgan Chase.

The market is worried that trade wars will escalate into something bigger, but both sides realize that trade wars benefit no one. My base case is that the U.S. and China will eventually sit down and strike a reasonable trade deal.

EM CAPITAL EXPENDITURES RECOVERING FROM MULTIYEAR LOWS

As of June 30, 2018



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|P&I| ***What factors do you think will support strong performance from emerging countries, markets and companies over the next three to five years ?***

|Yeung| One pocket of opportunity we're exploring relates to emerging market countries coming out from recession. We want to find companies that will benefit from that recovery path. As I have mentioned, many emerging markets, such as Brazil and Russia, are only two years into the recovery cycle. South Africa has actually been experiencing a prolonged slowdown since 2011. When these countries recover, it tends to last for many years, as long as policymakers and corporates are doing the right thing.

We have investments in all these countries — Brazil, Russia and South Africa. We think stocks are very cheap in these markets. As the countries continue to recover, I think stock prices can do very well.

The recovery of capital expenditure is another pocket we're looking at. In EM, capital expenditure levels as a percentage of revenue are at a multiyear low. Corporate spending has been very disciplined. The next move is for capital expenditures to slowly recover. That should bring emerging markets into a virtuous circle. The first stage of capital expenditure recovery means investing in higher-return projects that are going to create jobs. That means wages are going to improve. That means bank-loan growth is going to recover and accelerate. This leads to many positive spillovers, taking the economy onto a faster recovery path.

|P&I| ***What role does currency play in your analysis and investment process?***

|Yeung| The simple answer is we do not hedge currency.

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We try not to have a very precise view of the currency. That is, we do not forecast what the Brazilian real will be next year. We tend to have what we call a currency "weather forecast" to see whether it's going to be getting better or worse. When we think a currency has elements to become weaker, we tend to avoid that country; or we try to invest tactically, for example, in the exporting sector that would benefit from a weak currency.

Despite the Fed hikes, which are putting pressure on EM currencies, what really matters for the currency in the long term are the fundamentals of these countries we invest in, which we think are quite healthy.

|P&I| ***EM investors have focused their attention on technology and other "new economy" stocks. Are there investment opportunities in some of the "old economy" companies?***

|Yeung| Yes. New-economy EM stocks are quite expensive but many old-economy stocks — which we define as companies outside the information technology, health care and consumer durable and services sectors — have been trading at historically low valuations. There's a huge valuation gap between these two segments of the market.

The big-picture view is that over the past two years, emerging market performance has been driven by a handful of new-economy stocks, but the EM economy as a whole is improving. This should prompt investors to start focusing on these old-economy sectors and realize that there are a lot of very attractive opportunities there.

|P&I| ***Could you give us an example of where you see specific opportunities?***

|Yeung| China is interesting. China has done very well over the last two years. If you dissect the performance of China, it has been driven by a handful of new-economy stocks, whereas the old-economy sectors have lagged.

China has put into place tangible reforms and the economy is getting better. These old-economy sectors have been trading at very cheap valuations, and they're under-owned by mainstream investors. China's old economy is a very fertile hunting ground for us. However, if you were to just buy a basket of state-owned enterprises, there are a lot of bad apples in there. If you deploy fundamental active stock picking, some of these state-owned enterprises are experiencing positive changes, and we are bullish on them.

|P&I| ***Can you tell us more about why your fundamental EM approach should be important to plan sponsors?***

|Yeung| I invest in the segments within EM that most investors are ignoring. If a plan sponsor just uses a passive approach, buying a basket of stocks for exposure, some of these companies may have very cheap valuations, but they are not managed for shareholders. They may not have the best corporate governance. Those cheap valuations may not mean revert, and we've seen this lack of mean reversion through the last 20 years within EM.

We believe fundamental active research can help us to avoid those value traps, enabling us to pick companies that can experience fundamental improvement.

At T. Rowe Price, we have a very large and experienced EM research team. That enables us to look at a lot of ideas that other investors don't.

For my strategy in particular, I like to look at stocks that I call "forgotten stocks." These stocks are neglected by mainstream investors and are not well followed by the sell side. If we pick them well, these forgotten stocks could have asymmetric risk/return characteristics. When bad news comes, they're not going to fall a lot, because expectations are already diminished for them. But with good news, the upside potential could be tremendous.

|P&I| ***The gap between EM growth and EM value is as wide as it's ever been. Should investors be looking at value strategies or are there considerations within EM that may temper that?***

|Yeung| A lot of plan sponsors want to invest in emerging markets for diversification from developed markets. However, if you only invest in EM growth, which basically means the new-economy sectors — technology, the internet, biotech — these can be correlated with U.S. markets. So if you only invest in EM growth, you do not get the diversification benefits, because developed markets are driven by the same sectors.

Hence, investors should look at the whole of emerging markets, including the old economy. These companies are experiencing trends that are not closely tied to developed markets and can potentially offer diversification benefits.

|P&I| ***Are there additional reasons why EM demand a place in investors' portfolios?***

|Yeung| We believe that emerging markets should have a place in portfolios for the long term because these countries' demographics are more favorable than developed markets' demographics. Many have young populations and a rising middle class; it's a bit like the U.S. baby boomers of 40 years ago. The countries will continue to see job creation, higher wages and greater consumption. These demographics are the long-term structural drivers for emerging markets to trade at a premium over developed markets.

Emerging markets are early cycle to midcycle and are recovering from the trough of 2016. The Fed's hikes and the strengthening U.S. dollar have temporarily weakened sentiment toward emerging markets, but this is a healthy correction to a very strong two-year rally.

The fundamentals of emerging markets are sound. Within emerging markets, new-economy stocks have done very well, whereas the EM value space has lagged. We can find a lot of good stocks within the EM value space that are forgotten, are very cheap and are experiencing positive fundamental improvement. ■

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[1]The combined emerging market equity and fixed income assets managed by T. Rowe Price Associates, Inc. and its investment advisory affiliates. Includes separate accounts and other commingled products.

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*Source: Credit Suisse.

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