Low valuations meet big opportunities in emerging markets

After a tumultuous period, the prospects for emerging markets are looking up...

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When looking at global markets, especially in a period of heightened volatility, it can be hard to know which signals to prioritise and which to dismiss.

As a result, investors can end up sticking to what they know – with UK investors, in particular, typically overweight to UK stocks. However, staying close to home can be detrimental to an investor's portfolio, with a failure to diversify geographically impacting risk management in aggregate. Secondly, other markets experience very different macroeconomic, cultural and policy influences to the UK, meaning that growth drivers can vary significantly.

Of all global markets, emerging markets offer some of the greatest differentiation from UK stocks. While many of these economies struggled as the COVID-19 pandemic slowed global supply chains, they are experiencing significant tailwinds over both the short and long term – as highlighted in a recent report from **Fidelity Emerging Markets Limited (FEML)**.

Ahead of the curve on rates

A global story that has impacted emerging markets has been the interest rate rises in response to elevated levels of inflation. However, some central banks – such as Brazil's – were especially proactive in raising rates and bringing inflation under control, meaning that rates in those countries are now set to come down. This should help fuel a revival in consumer demand. Indeed, the FEML management team are positive on a number of markets in Latin America, as the rate cycle across the region peaks.

A further support for valuations in emerging markets is the outlook for commodity prices. As several emerging markets economies, especially those in Latin America and the Middle East, are heavy exporters of commodities, they tend to benefit as these prices rise. Given that multinational efforts toward decarbonization and electrification are driving rising demand for commodities, the outlook for commodities is positive, which should in turn benefit emerging markets.

Analysts:
Alice Rigby
alice@keplerpartners.com

The China reopening opportunity

Another near-term positive for emerging markets is the reopening of the Chinese economy post-COVID-19. While the economic and consumer recovery in China has been slower than many anticipated it would be, significant household savings means the recovery is underway and the team continues to believe we will see the release of pent-up demand.

Chinese stock market valuations are also particularly cheap and the team is seeing increasingly shareholder friendly activity among companies, including those such as internet giant Alibaba, Tencent and Netease. The FEML managers explain that in an environment where growth in China could be lower than it was before, there is even more of a need to focus on whether companies are returning capital to shareholders.

Rethinking demographics

There are several other longer term tailwinds for emerging markets, too. These include a positive demographic backdrop, particularly in India, due to the low levels of GDP per capita in the country, leaving significant potential for future growth. While this story is by no means unnoticed by other investors, FEML's team have opted to avoid overvalued stocks in favour of cheaper financials. As a result, the trust holds several of the largest private sector banks, which stand to benefit from the under penetration of financial services in the country.

Keep your friends close

One other trend supporting emerging markets in the medium term is the near shoring and friend shoring prompted by deglobalisation and the shifting of supply chains, as economies such as the US look to bring their manufacturing closer to home, or to friendly partner countries. Mexico is a clear beneficiary of US nearshoring, with both railroad company Grupo Mexico Transportes and GCC, a Mexican cement company, in line to see increase demand in the wake of this trend. And when it comes to friend shoring, Vietnam has been identified by many developed markets companies as a market of choice for delivering consulting services, given its highly educated workforce.

As a result of the multiple drivers for emerging market economies, net income growth forecasts for emerging market equities in 2024 are higher than those for developed market equities. Despite this growth potential, emerging market equities are trading on depressed valuations in comparison to their developed market peers, a dynamic that makes them an interesting proposition for investors.

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