

How emerging markets are responding to pandemic-driven policy shifts in China and the US

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Overview

- Policy responses to the pandemic in China and the United States are playing out in emerging markets.
- The effects of a higher US dollar are mixed, dampening some economies' growth prospects but benefiting commodity companies selling into markets denominated in US dollars.
- While current dynamics have not changed the team's long-term outlook for emerging markets, they are providing opportunities to invest at attractive valuations.

Almost a year and a half after the first reported cases of a new "SARS-like" virus in the city of Wuhan, we can look back at a period of some of the most dramatic volatility since the Asian financial crisis (AFC) and the global financial crisis (GFC). Even a year ago, it was unclear what set of policy responses was best to contain the growth of the virus and maintain economic stability — and hopes of a vaccine remained just that. Furthermore, the COVID-19 pandemic came on the heels of a still-unresolved United States–China trade war and the beginning stages of a restructuring of global manufacturing capacity to accommodate new trade patterns — whether reshoring to the US, moving to lower-cost countries in Southeast and South Asia, or retooling Chinese capacity to fulfill growing domestic demand in China.

China and the US take different policy paths

Whatever other countries have chosen to do in response to the pandemic, China and the United States stand out when it comes to fiscal/monetary and industrial policy.

In China, the policy focus was on maintaining domestic productivity and employment with as little disruption on the demand side as possible. Manufacturers were given liberal access to capital to maintain operations and specifically incentivized to retain staff without layoffs through social security tax and unemployment insurance refunds. China's central bank eased monetary policy by lowering its reserve requirements and removing blocks on certain loan extensions and renewals. Investment came through traditional infrastructure projects, such as housing and transportation, as well as accelerated spending in the nationwide 5G network. The net result was that despite experiencing a gross domestic product (GDP) contraction of almost 6% in the first quarter of 2020, China was the only major world economy to generate positive GDP growth for 2020.

From an emerging markets perspective, the most important parts of the US policy response to the pandemic were growth of the fiscal balance sheet and the US Federal Reserve's accommodation of this expansion by easing monetary policy. While this has not (yet, at least) brought unemployment back down to pre-pandemic levels, it has allowed unemployment to drop sharply from almost 15% in April 2020. This led to US dollar weakness through much of the year but also appeared to have finally stimulated real inflation in the US economy. That, in turn, has led to talk of tightening (through tapering of the asset purchase programs, if not increased rates) and, as there is less confidence in the policy responses of other major economies, particularly Europe, it is likely that we will see a strengthening US dollar going forward.

How a stronger US dollar may affect emerging markets

Historically, a stronger US dollar has been negative for emerging markets because of new burdens from debt denominated in US dollars. While this is much less a factor today than it was before the AFC and GFC, it is still true that a stronger US dollar can dampen growth prospects in some emerging market economies.

As long as global demand is there, the firms it can benefit are commodity companies that sell into markets denominated in US dollars. This is part of the reason for the dramatic out-performance by steelmakers, iron miners, commodity chemical companies, and even coal producers. The demand behind this outperformance is not, however, part of the same sort of super-cycle that followed China's admission to the World Trade Organization and the investments in capacity and infrastructure arising from its transition into the "world's factory." Even as some of this capacity is moving to other countries in the context of trade realignment, the overall demand for commodity materials is not in the same league as it was two decades ago. We see a short-term build-up of inventories (all the way through the product cycle, from raw materials to finished goods) that reflects "new normal" uncertainties about tariffs and pandemic lockdowns more than broad, sustainable demand growth.

Although these dynamics are almost certainly near term and will subside in the medium term, they do attract speculation that disrupts the markets. In the absence of significant inflows, there is a conservation of capital within the emerging markets asset class, so these sharp and transitory shifts are funded by parts of the market that have outperformed — in this case, growth companies and particularly growth companies in China. In this sense, China has been a victim of its success in dealing with the pandemic in 2020 as some investors look to lock in gains.

Long-term view of emerging markets remains the same

These sharp transitions do not signify, in our view, a change in the long-term view for emerging markets and the types of firms that create and capture value for shareholders. Even as it transitions to an aging demographic, China remains the large economy with the best outlook for sustained higher-speed growth. The continued growth of the middle class offers opportunities for investment in education, real estate services, and world-leading innovative technology platforms that enable consumption. The size and scale of the domestic market should also make it increasingly robust and less susceptible to external volatility than other markets in the asset class.

What these sharp transitions do offer is a chance to invest in the best long-term opportunities at more attractive valuations than normal market conditions afford. The key is to maintain a disciplined research and investment process based on building an intimate understanding of businesses and their fundamental drivers. Following management teams over different cycles, whether we are invested in the company or not, enables us to feel more comfortable deciding whether or not to allocate capital during periods of volatility. With an investment process structured around looking for opportunities that provide, in our view, a reasonably good margin of safety, as well as investment returns over the long run, we feel we can approach this investing environment with confidence.

Spotlight on Invesco Emerging Markets Select Equity

What differentiates the Invesco Emerging Markets Select Equity team and investment approach? It starts with our team of analysts and portfolio managers — either we were born in an emerging market or grew up there, or our families did, and we speak the local language. That deep-rooted familiarity contributes to our insights. There are eight professionals on our international team, with five of us specializing in emerging markets. Each of us on that team of five has more than 10 years of experience investing in emerging markets, as well as a direct personal connection to these markets.

In terms of our investment philosophy, we emphasize high-quality companies, meaning companies generating a high return on capital and have strong growth prospects and a capable and honest management team. Those traits are important everywhere but particularly critical in emerging markets, where there are often no strong corporate governance structures, and even the legal systems can be challenging to understand.

Perhaps our most distinguishing feature, though, is that we run a highly concentrated portfolio — typically owning just over 30 names — allowing us to do very thorough research. In a normal year, we visit dozens of countries and conduct at least 500 meetings with companies in which we hold a stake or are considering investing. While travel has been limited this year due to COVID-19, we're managing interactions through Zoom and Skype. Research doesn't stop because of the pandemic. Again, this is important for emerging markets because disclosure practices are not as strong there as they are in developed markets.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

As a large portion of the strategy is invested in less developed countries, you should be prepared to accept significantly large fluctuations in value.

The strategy invests in a limited number of holdings and is less diversified, and therefore this may result in large fluctuations in value.

Investment in certain securities listed in China can involve significant regulatory constraints that may affect liquidity and/or investment performance.

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