



Weekly Insight

Turning lions into vegetarians - the taming of EM growth

In the wake of last week's forced resignation of the Turkish Prime Minister, President Erdogan of Turkey defended his views of strengthening the role of his presidency and moving away from parliamentary democracy, declaring: "No one has the right to turn Turkey into a country of lions condemned to a vegetarian diet."

Turkey serves as a reminder to investors that political risk is always an important consideration when investing in emerging markets (EM). President Erdogan's comments were made in respect to constitutional changes, which lie at the heart of Turkey's domestic struggles. But as ever, underlying much of the current turmoil in Turkey is a deteriorating economy. Turkey experienced rapid rates of economic growth before 2011, when the country embraced a market reform agenda. Since then, however, GDP has fallen sharply - albeit to levels that would satisfy most developed economies, Inflation has been stubbornly high (8% as of April, 2016) and unemployment remains above 10%. For an economy that relies on external financing, Turkey's sizeable current account deficit (4.4% of GDP as of the fourth quarter of 2015) creates vulnerabilities for the economy.

EM has faced structural and cyclical headwinds

When times are hard, political discourse often becomes a battle between more orthodox, market-friendly economics versus populist rhetoric. Turkey's ousted Prime Minister, Ahmet Davutoglu, has favoured balancing budgets, reducing inflation and improving fiscal accounts. Erdogan, on the other hand, supports an approach of lowering borrowing rates and raising overall levels of growth to beat inflation.

Structural economic reforms were huge drivers of economic growth and capital markets in the earlier part of this century, but momentum has waned in the past couple of years. It is, therefore, unsurprising that EM growth has been on a decelerating trend since 2014. At the same time, EM countries have had to contend with cyclical headwinds: a China-led global slowdown, commodity price falls, uncertainty around Federal Reserve policy and US dollar strength. The consequence is that investors have voted with their feet. Flows into EM assets have dried up since the summer of 2015 and, despite the equity market bounce since mid-February, investors appear to be reluctant to pile back in.

Political crisis often harbingers change

Many EM countries are experiencing painful adjustments, which part explains weaker risk appetite. Brazil's current political and economic woes are payback for the lack of reform during the good times. Brazil's economy is smaller today than it was in 2012; a result of fiscal overspend, declining commodity prices and political corruption. The Brazilian real has fallen by nearly 60% against the US dollar since June 2014, though it has rallied 13% this year. However, with Dilma Rouseff facing an impeachment trial, investors are optimistic that change is afoot. Local equity markets are more than 40% higher since their January low, in part driven by the commodity price rebound but also expectations of Rouseff's impeachment. Given the strength of the rally, we believe that much of the good news has been priced in. Nonetheless, we are encouraged by current developments and believe they are a longer-term positive for Brazil's economy and capital markets.

We are less bearish than outright bullish on EM

Political events this week have encapsulated what EM investing is all about: being selective and avoiding country, idiosyncratic risk. Of course, it is not always that straightforward. Despite averaging a 6% annual growth rate since 2012, the Philippines electorate has just voted in an anti-establishment candidate, Rodrigo Duterte. So far, Duterte has gone some way to assuage market concerns by pledging to continue with the macroeconomic policies of the outgoing administration of Benigno Aquino. We are expecting continuity of policies for the time being and believe that the underlying economic fundamentals will remain intact.

Broadly, and despite this week's political headlines, the emerging markets asset class is in much better shape than two decades ago. EM equities continue to offer investors significant opportunities in an environment of low global growth. We have been increasing our EM equities weighting within our higher risk strategy since late 2015, when we were underweight. We would not yet describe ourselves as 'bullish', but we believe there are reasons to be less bearish; we are, though, cognisant of country-specific risk. Overall, if the US dollar weakens, the Fed remains dovish and we see more evidence of positive fundamental changes, then given how investors are positioned we can see EM doing quite well.

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Risk Warnings:

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