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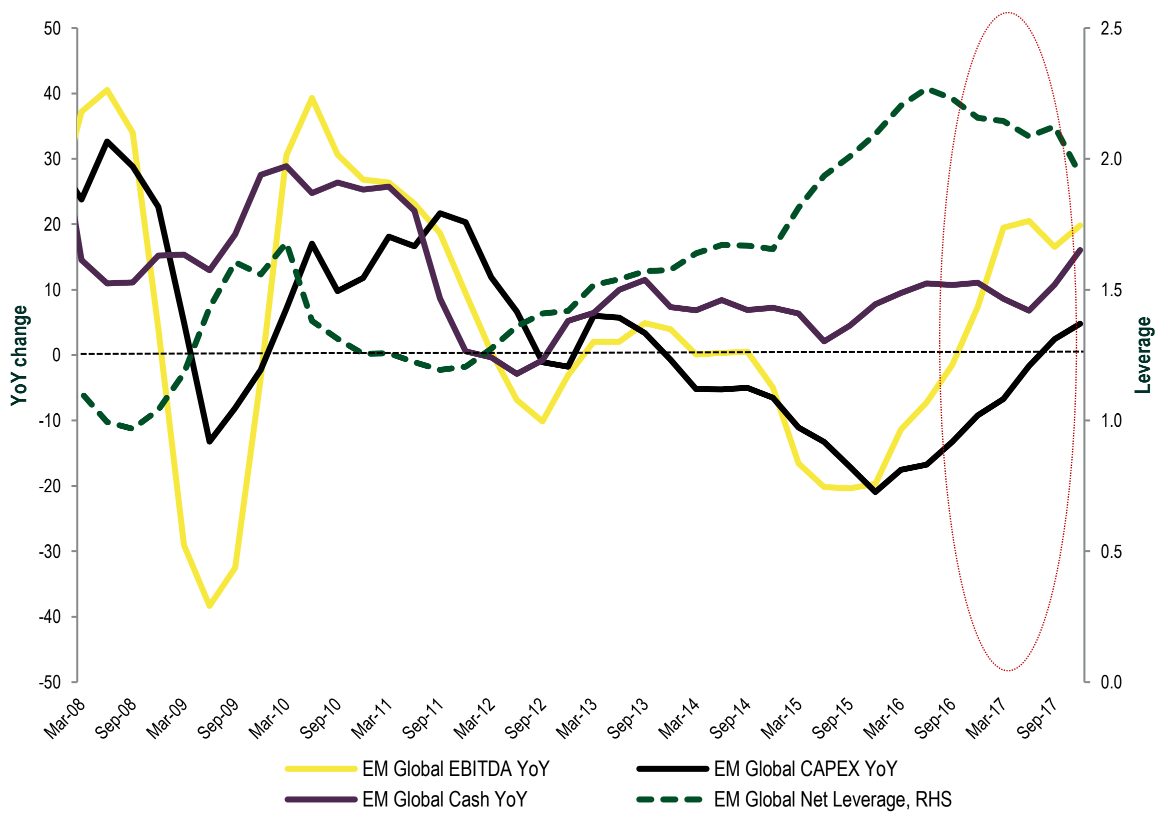
Favourable Fundamentals for Attractive Returns in Emerging Markets

EM fundamentals are intact and dedicated experts can profit from attractive buying opportunities says Thomas Rutz, EM fund manager at MainFirst.

Emerging Market fundamentals are much more resilient than they used to be. Although uncertainty over trade tariffs, a strengthening dollar and Trump's Twitter tirades recently led to market corrections, compared to the time of the taper tantrum Emerging Markets are much less vulnerable to such factors as the macro economic backdrop and credit fundamentals remain constructive. Moreover, account, debt and fiscal deficits are lower while real yields are higher. This could be seen in 2017, which brought record profit growth throughout the Emerging Markets: In total, EBITDA growth YoY was 19.8%, corporate balance sheets improved. In addition, cash positions are increasing and leverage is decreasing. These positive signals indicate that the slowdown in EM is of a temporary nature.

EM corporates continue to have interesting buying opportunities and since July inflows are coming back. At the same time, valuations are likely to start going up again and credit spreads are likely to tighten soon. The commodity market remains in a balanced supply demand environment and credit fundamentals are continuing to improve (see chart below).



The potential of exacerbating trade tensions are certainly real and pose a substantial potential risk for EM, as they do for the world economy in general. One silver lining is that while imposing the initial tariffs was easy, implementing any additional protectionist measures will be harder as the US administration faces increasing risk of derailing its own economy and needs to keep the upcoming midterm elections in mind. Still, these threats have dampened investor sentiment as they react to a lot of the sabre rattling that is taking place.

An example of investor sentiment reacting to noise is the recent broad based sell-off in Indonesia. As the largest economy in Southeast Asia, it has charted impressive economic growth since the late 1990s and become an emerging middle-income country. Its diverse industrial portfolio includes coal, petroleum, natural gas as well as textiles and its fundamentals are in good shape.

Yet despite the strong fundamentals, bonds were sold indiscriminately in the recent correction, probably in reaction to general fears of Emerging Markets being weakened by rising US-Treasury Yields and fears of the Indonesian Rupiah (IDR) depreciating. The latter is an overdrawn fear as many of the companies e.g. in the commodity sector are naturally hedged, i.e. paid in US-Dollar. So, their profit margins are actually rising since most of the operating costs are paid in IDR. Experienced investors are starting to use the elevated levels in volatility as buying opportunities for under-valued quality names.

Attractive investment opportunities can, for example, be found in oil and gas. The sector as a whole is expected to continue to expand further. An interesting player is the integrated energy company Medco. It explores for and produces oil and gas, operates gas-fired power plants and is also in the process of developing renewable fuels, namely bio-fuel. The EBITDA of its oil and gas business grew by 51 percent in 2017 and is expected to grow by 25 percent this year. This organic growth is compounded by the company's working towards deleveraging. All these factors are likely to warrant a rating upgrade to high single-B level.

EM stories such as these show, that experienced investors can find attractive opportunities and generate bond yields exceeding those in Developed Markets. Thomas Rutz together with Cornel Bruhin and Dorothea Fröhlich have extensive experience in finding such investment opportunities. The track record of their funds is proof of this: the MainFirst Emerging Markets Corporate Bond Fund Balanced has generated an annual performance of 5.5 percent over the last five years and the MainFirst Emerging Markets Credit Opportunities Fund has generated an annual performance of 8 percent over three years (as at 31 July 2018).