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Taking centre stage

A post-COVID world might just be emerging market equities' time to shine.

As COVID-19 battered the world's economies last year, emerging markets were among some of the hardest hit; they also saw one of the better recoveries when equity markets rebounded towards the close of 2020.

This strong recovery has hit a few headwinds though, with fresh or continuing waves of COVID-19 putting differing levels of pressure on several nations. For instance, China, Korea and Taiwan's economies have remained relatively open, while India and Latin America suffered greatly.

The resurgence in both the US economy and the US dollar also have the potential to hinder the emerging markets' progress.

Still, in April the International Monetary Fund raised growth projections for emerging markets to 6.7% for the year; up 0.4% in just three months.

Much of this, Fidelity International cross asset specialist Anthony Doyle says, is down to vaccination rates beginning to trend up after having started out slower than expected in the first half of the year.

For context, the median emerging market economy has fully vaccinated 12% of its population to date, a number that is expected to accelerate materially to about 65% by year end.

"Emerging markets feature some of the highest-ranking countries in terms of total doses per capita, such as the United Arab Emirates, Chile, Turkey and Poland," he says.

"With a higher share of younger people in places like South Africa and India, a number of large emerging market economies will be able to vaccinate their more susceptible people in a relatively short period."

So, how are emerging markets tracking at the moment?

To date in 2021, the MSCI Markets Index is up 8% in Australian dollar terms. For all its suffering in 2020, Latin America has performed well this year, largely buoyed by Brazil. This is followed by markets in Europe, the Middle East and Africa (EMEA) and Asia.

From a sector perspective, healthcare, energy, and industrials have posted strong gains, followed by materials and financials securities. Real estate, consumer discretionary, communication services, and information technology have lagged.

However, a key consideration for all economies – no matter how developed – is whether we will see the return of inflation any time soon.

Holding a similar view to Federal Reserve chair Jerome Powell, Doyle believes much of the high inflation readings seen in recent times can

be attributed to temporary factors, such as supply shortages and rising consumer demand.

Therefore, any inflation related to stimulus or reopening of economies is likely to also be transitory, he says.

"From a macro perspective, the roll-out of vaccines that we are seeing across the world and the reopening of economies have resulted in a sharp pick-up in global activity momentum," he says.

"This has led to shortages in several inputs such as semiconductors, leading to mismatches between supply and demand, pushing up prices of consumer durables such as cars."

Combined with base effects related to the COVID-related activity collapse last year, some measures of inflation are now at their highest levels since the 1990s.

"But we believe this stimulus/re-opening fuelled demand bounce has likely peaked and should drop-off towards year-end as stimulus is phased out and savings are partly depleted," Doyle says.

"Additionally, Fidelity's bottom-up analysts are telling us that the vast majority of the supply chain, disruptions that we have seen are already beginning to resolve themselves, but much will depend upon how inflationary expectations develop from here and whether central banks will respond."

Recent surges in commodity prices have also fuelled speculation that inflation will return, and this is a good thing for many countries, particularly those that rely on exports.

Unfortunately, not all emerging market countries are created equal, and the impact of rising prices will differ broadly as not every emerging market benefits from an inflationary environment.

But overall, the potential for growth in emerging markets is significant, with certain sectors already competing on a global scale – individual companies too. For example, as the world's largest contract chipmaker, Taiwan Semiconductor Manufacturing Company (TSMC) is responsible for almost all of the world's chips. It's also the top holding in the Fidelity Global Emerging Markets Fund.

As a global COVID-induced chip shortage wears on, TSMC stands to benefit. The US is in particular need, and TSMC has very recently announced plans to expand stateside and build new factories to meet demand.

Similarly, India's Tata Consultancy Services is the world's largest IT services company by market capitalisation. Reported in early July, the company's Q1 net profits were up nearly 30% year on year and plans to expand its US operations are underway; hiring more than 220 employees in the next two years. Tata also accounts for 3% of the fund's holdings.

It's investments like these that saw the Fidelity Global Emerging Markets Fund return 37.06% in the year to June end. Over the same period the benchmark, the MSCI Emerging Markets Index, returned 29.22%. The pandemic aside, since its December 2013 inception the fund has returned 13.02%, beating the index's 3.58%.¹

And while some of the fund's holdings have already made a name for themselves, Doyle says the team sees increased opportunities for emerging market equities to disrupt global companies.

"For example, domestic companies and brands are challenging established developed market companies in the consumer discretionary and staples sectors. In sectors like industrials, construction, chemicals, and heavy equipment local emerging market companies are gaining market share and consolidating the market," he says.

"We've also seen new business models developing in e-commerce, fintech and financial products which are disrupting old and legacy businesses."

All said, the outlook for emerging markets is positive, Doyle says, with emerging market economies with large domestic consumption to benefit from disruption of supply chains over the short to medium term.

The rise of regional economic centres, where growing demand from a large economy like China or India, will also fuel growth in other developing countries nearby. Couple this with strong domestic consumption as a result of a rising middle class and the evolution of growth industries, and there is quite a compelling case for investing in emerging markets.

"Because of the risks associated with emerging market economies, they often generate higher-than-average returns for investors," Doyle adds.

"Not all are good investments, but for those investors willing to research and focus on identifying high quality names, emerging markets will remain an attractive proposition for some time yet." **FS**

¹The fund inception date: 16/12/2013. Total net returns represent past performance only. Past performance is not a reliable indicator of future performance.

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The quote

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