elections and directions in emerging markets

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AN ENTRY POINT AMID ELECTION CONCERNS?

Public policy often defines the economic and investment potential of an emerging market (EM) country. Let's look at the Korean peninsula. Sixty-odd years ago, a single country was divided in two. The North adopted a closed Communist-style mix of policies, while the South chose an educate-export-integrate model. Two generations later, the South is roughly 17 times richer per capita than the North, and on average, South Koreans live a remarkable ten years longer. In addition, South Korea boasts one of the highest percentages of college graduates in the world.[1]

Policies are the direct result of political trends, and 2014 marks one of the busiest election years in emerging markets: voters head to the polls in more than 40 countries that together account for 20% of the world's global output. Key markets worth watching include South Africa (April-July), India (May), Indonesia (July), Turkey (August), and Brazil (October). In total, these countries represent approximately 40% of EM bond indices and more than 25% of the equity indices.

KEY TAKEAWAYS

- Elections take place this year in 40+ countries that together account for 20% of the world's global output.
- Amid the global economic sluggishness, we may see political shifts that could provide clues to future trends.
- Emerging market assets currently look attractive relative to valuations. This may be an interesting year to add these assets.
- With relatively low inflation, more productive workforces, $8 trillion in hard currency reserves, and growth rates still ahead of the US and Europe, we believe most emerging markets are in a better position to cope with the sluggish environment than in the past.

Country	Date	Election Type	Expected Outcome
South Africa	May 7	Parliamentary	• The ruling African National Congress party will win with a smaller majority than they currently have • Zuma will likely remain president
India	By May 31 (date TBD)	Parliamentary	• Opponent Bharatiya Janata Party will win and lead a coalition government with Narendra Modi as prime minister
Indonesia	July 9	Presidential	• A likely three-way race between Bakrie (Golkar), Megawati/Joko (Indonesian Democratic Party), and Prabowo (Gerindra coalition)
Turkey	August 10	Presidential	• Erdogan will win the presidency
Brazil	October 5 (October 26 runoff)	Legislative Presidential	• Ruling party will maintain majority coalition in congress • Rousseff will be reelected as president

Source: PwC R&C Trendwatch, December 2013.
Opinions and/or forecasts reflect the subjective judgments and assumptions of the author(s) only and do not necessarily reflect the views of Loomis, Sayles & Company, L.P. This information is subject to change.

[1] *CIA, "The World Factbook, East & Southeast Asia" as of March 24, 2014.*

These elections are going to be important to watch because amid global economic sluggishness, we may see political shifts that could provide clues to future trends. Most EM countries are now facing economic headwinds, especially compared to a decade ago. GDP is generally down some 40% from peak pre-2008 levels. The external environment is becoming less favorable amid higher US interest rates, and foreign investors have been shying away from emerging markets. Indeed, current sovereign and corporate credit spreads are approximately 100 basis points (bps) wider than the post-crisis highs. On the equity front, many institutional investors have changed their sentiment on EM equities. Flows into emerging stock markets reversed over the last year: Bank of America Merrill Lynch investor surveys note that the ten-year trend toward overweight EM equities from 2003-2012 ended abruptly in 2013.[2]

Impatience is mounting as external factors, primarily China's slowing growth and tapering by the US Federal Reserve (the Fed), have led many investors to see some structural vulnerabilities of selected countries that failed to tackle meaningful reforms during the go-go years leading up to 2008. Politicians in these countries are between a rock and a hard place. On one end are foreign investors, who often shape the tone for EM returns, demanding reforms to curb inflation and stimulate growth. On the other, their local middle class constituents are demanding improved public services.

> "incumbents should win approximately **75%** of this year's elections in key emerging market contests"

Many analysts believe that incumbents should win approximately 75% of this year's elections in key EM contests. While pro-growth promises may be made before elections, winners may find they might have limited fiscal resources to address local and foreign investor demands, making major reforms very difficult. Many of those reelected will, for the most part, have weaker second terms and continue to face economic headwinds. Moreover, despite the recent selloffs and political unrest we've seen so far in 2014, none of the leading emerging markets are close to the solvency crises we witnessed in the mid-1990s. As such, many politicians may not feel the urgency for quick reforms and we may not see a noticeable change in policy direction.

LOOKING BEYOND THE HEADLINES

Headlines have been discouraging for emerging markets in 2014, and the election cycles only stoke continued press coverage, making it tough for investors to separate the signal from the noise. Keep in mind that fundamentally, these markets are very different from a decade or two ago. With relatively low inflation, more productive workforces, about $8 trillion in hard currency reserves, and growth rates still ahead of the US and Europe, most emerging markets are better positioned to cope with the sluggish environment than in the past.

Currently, EM assets actually look attractive relative to valuations. On the credit and currency side, emerging markets seem to offer more yield with better credit than US credit, which looks relatively expensive as of April 15, 2014. EM stocks, too, have fallen to very cheap levels not seen in a decade.

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[2] *Bank of America, "BofA Merrill Lynch Fund Manager Survey Finds Investors Moving Toward a 'Risk-off' Position Amid Geopolitical Unrest," March 18, 2014.*

J.P. Morgan notes that as of mid-March 2013, EM BB bonds are actually paying more than US industrial single-B-rated instruments, and EM investment grade bonds now pay roughly double what you would earn for similarly rated US industrial bonds, about 260 bps over US Treasurys versus 130 bps. On the equity side, EM stocks are now trading at a price-to-earnings (P/E) discount not seen since 2004-2005: while the US and European markets are trading at roughly 16 P/E, emerging markets are down to around 10, or less than two thirds.

Investors who accumulate risk assets, including emerging markets, when they are out of favor have often been handsomely rewarded over time as sentiment gives way to fundamentals and valuations. This may be an interesting year to add such assets.