Not all Emerging Markets are created equal

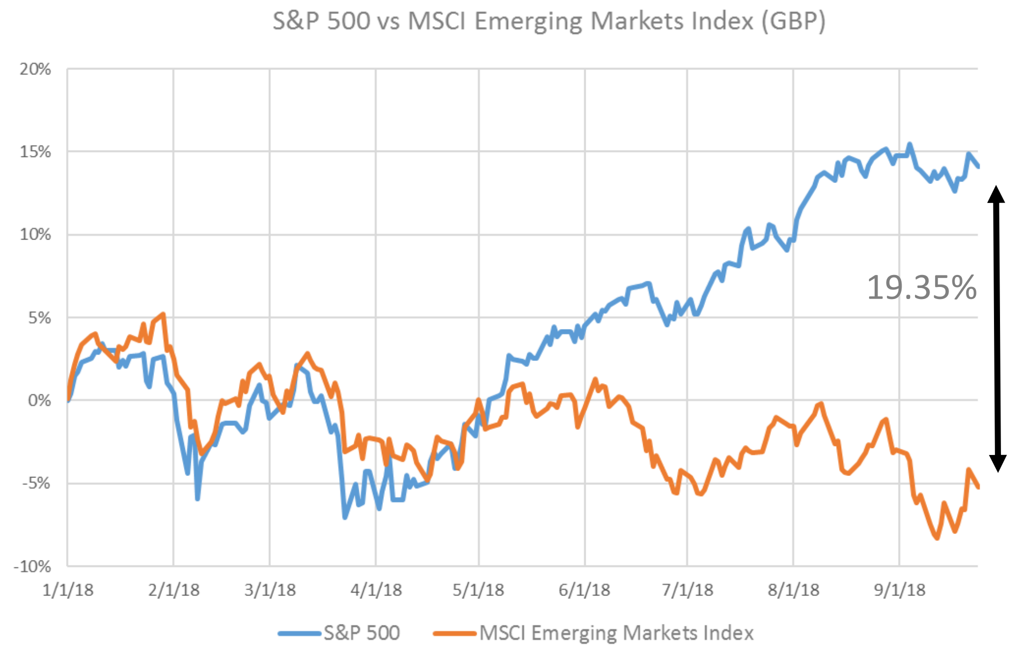
2018 has been turbulent for Emerging Markets. Sentiment is weak as a result of trade tensions between major trading nations, while certain Emerging Market countries' currencies have fallen markedly in recent months.

There is, however, a disconnect, since the fundamentals of underlying growth and profits for many Emerging Market companies remain healthy, while talk of 'contagion' has exaggerated the linkages between countries and ignored the country-specific nature of individual currency depreciations.

With this disconnect between weak sentiment and robust fundamentals, the time is apt for a closer look at Emerging Markets, both in comparison with Developed Markets and as a region with considerable variety. Although it is useful for investors to group them together, not all Emerging Markets are created equal.

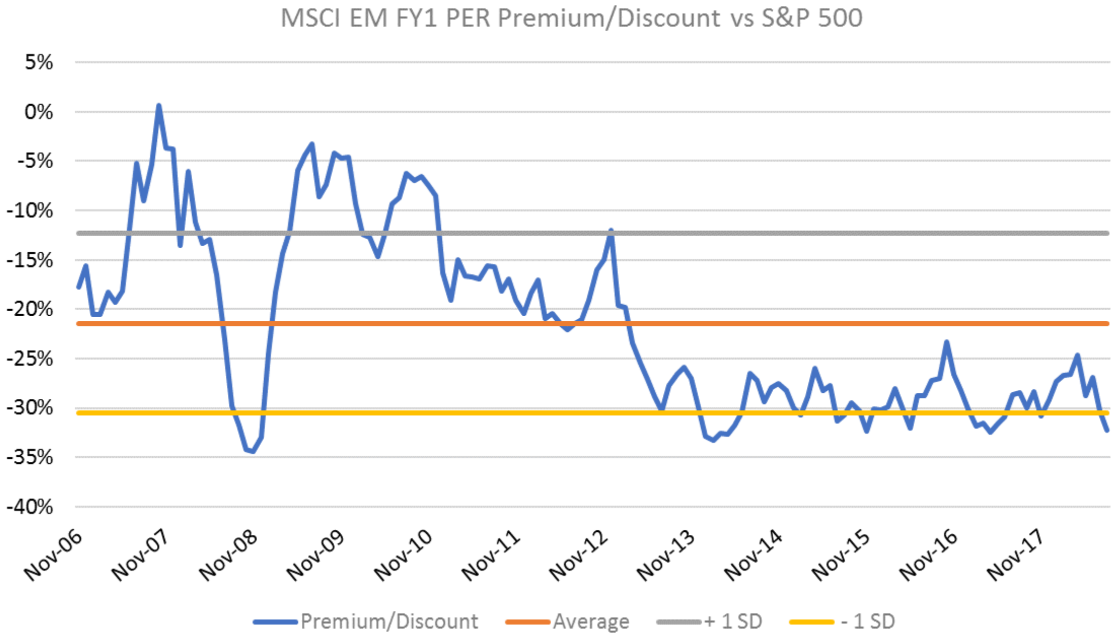
Divergence between Emerging Markets and Developed Markets

The performance of emerging and developed markets has diverged sharply this year, as the following chart shows:



Source: Bloomberg (S&P 500 and MSCI Emerging Markets Index, Total Return, 31.12.17 to 24.09.2018)

Despite the absence of a widespread problem for company earnings, EM equities are nearly at the largest discount they have been to Developed Markets for five years (on a forward P/E basis).



Source: Bloomberg; Guinness Asset Management (Data covering November 2006 to August 2018)

Current Account Deficits – Turkey and Argentina significantly worse

There have been notable falls in certain Emerging Markets currencies this year and it is true that two countries are in trouble in this regard. Argentina's government is in a fiscal crisis amid high inflation and the prospect of a bailout from the IMF, whilst Turkey's president has allowed a political spat with the US to escalate into sanctions, exacerbating existing concerns about an overly-politicised monetary policy. But there hasn't been significant contagion, partly because many other EM countries are in a much healthier state.

Current account deficits are at the heart of the recent problems. In Turkey, the large current account deficit is being funded by dollar denominated loans. When sentiment turns negative, as it has done, this can present big problems. With the local currency devaluing, it makes paying back these loans even harder. Aside from Argentina and Turkey, only South Africa has a current account deficit which could be viewed as being too high – and even then, not at dangerous levels.

Country	Overall Assessment	Current Account (% GDP) Actual
Argentina	Weaker	-4.8
Brazil	Broadly Consistent	-0.5
China	Moderately Stronger	1.4
India	Broadly Consistent	-1.9
Indonesia	Broadly Consistent	-1.7
Korea	Moderately Stronger	5.1
Malaysia	Stronger	3.0
Mexico	Broadly Consistent	-1.7
Poland	Broadly Consistent	0.3
Russia	Moderately Weaker	2.3
Saudi Arabia	Weaker	2.2
Singapore	Substantially Stronger	18.8
South Africa	Moderately Weaker	-2.5
Thailand	Substantially Stronger	10.6
Turkey	Weaker	-5.6

Source: IMF World Economic Outlook (WEO)

Be mindful of the make-up of the Index

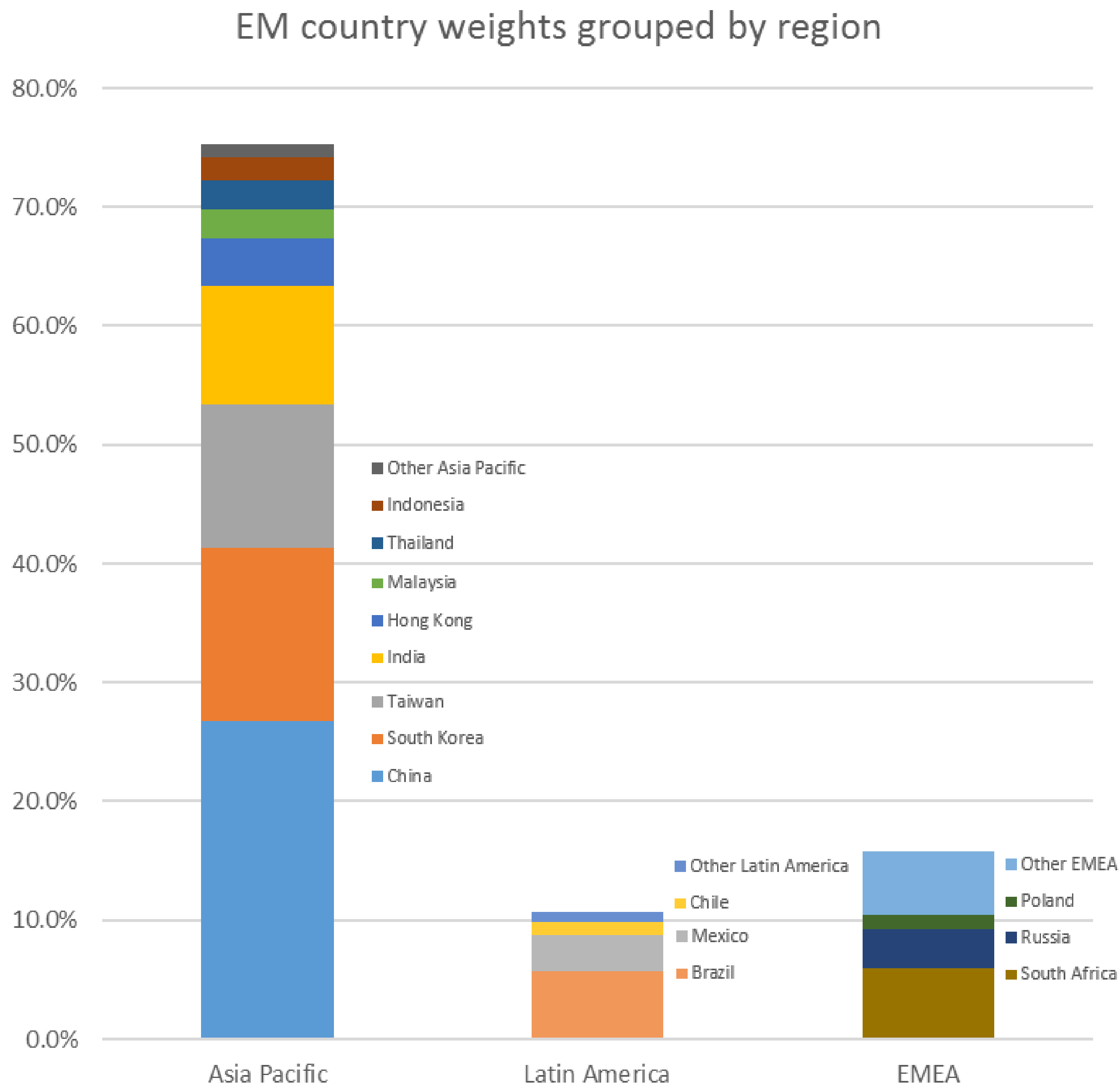
Although it can be useful for an investor to view Emerging Markets as a single bloc, they are considerably diverse. Economic drivers and market sector concentrations can vary widely between regions. For example, a rising oil price benefits oil producers such as Brazil, Qatar and Russia, but hurts oil consumers such as India, Korea and Thailand. In addition to affecting fundamentals, macroeconomic factors can have disproportionate impact on the sentiment towards EM countries and sectors. For these reasons it is worth taking a closer look at the country and sector weightings in the benchmark.

EM Benchmark country and sector weightings:

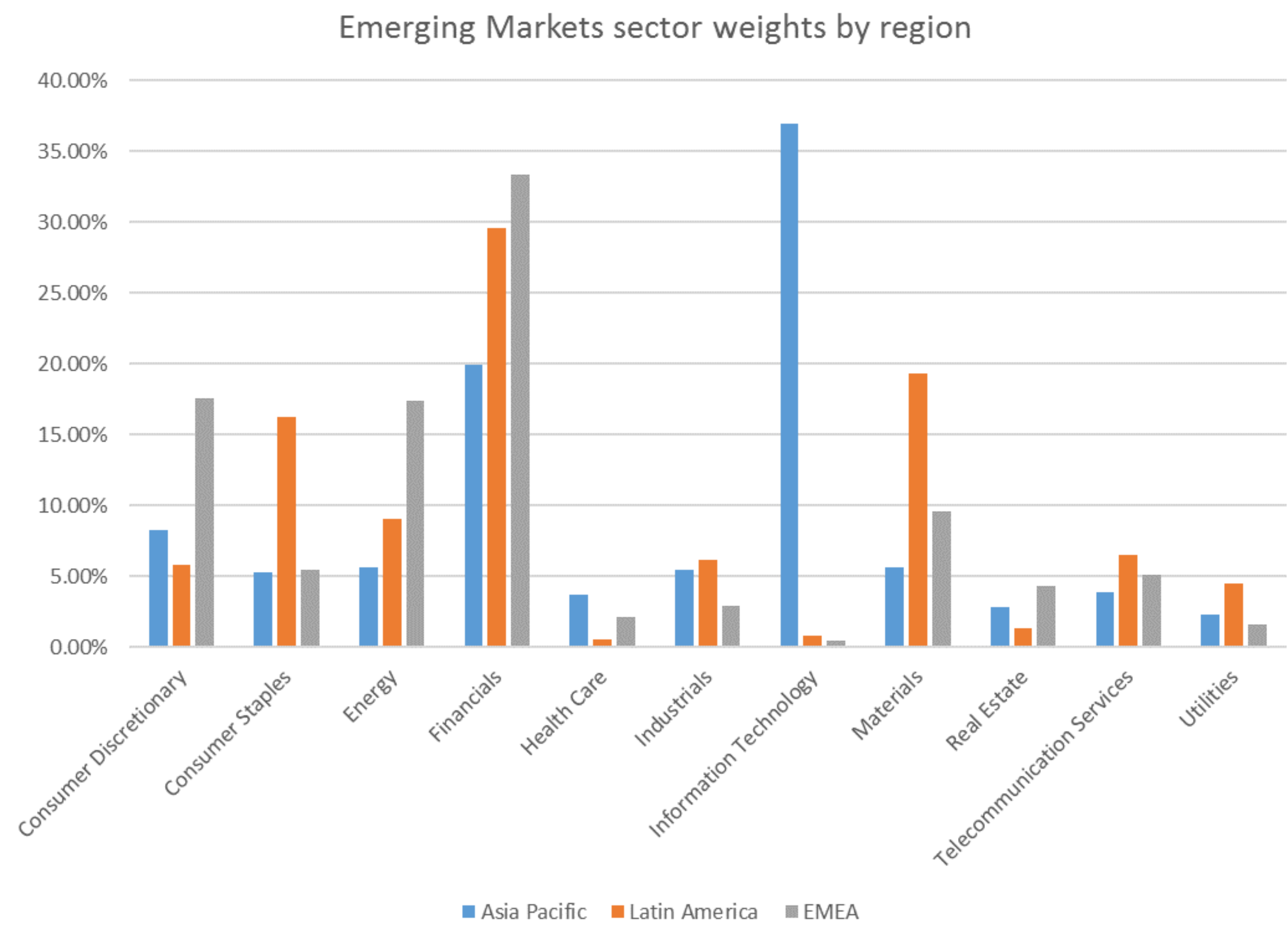
China alone accounts for a higher percentage of the benchmark than Latin America and Europe, Middle East & Africa (EMEA) combined.

Each region has large exposure to Financials, but digging deeper, the differences become more apparent. The Asian region has significant exposure to Technology while Latin America and EMEA have major concentrations in Materials, Energy and Consumer Staples.

Concentration is not just at the country and sector level, stocks like the BATs (Baidu, Alibaba and Tencent) make up 9.7% the total benchmark. Samsung and Taiwan Semiconductor Manufacturing Company add another 7.9% of the total benchmark. These mega-cap companies are heavyweights in the benchmark; it is worthwhile being aware of this.



Source: Bloomberg, Guinness Asset Management (Data as at 31.08.2018)

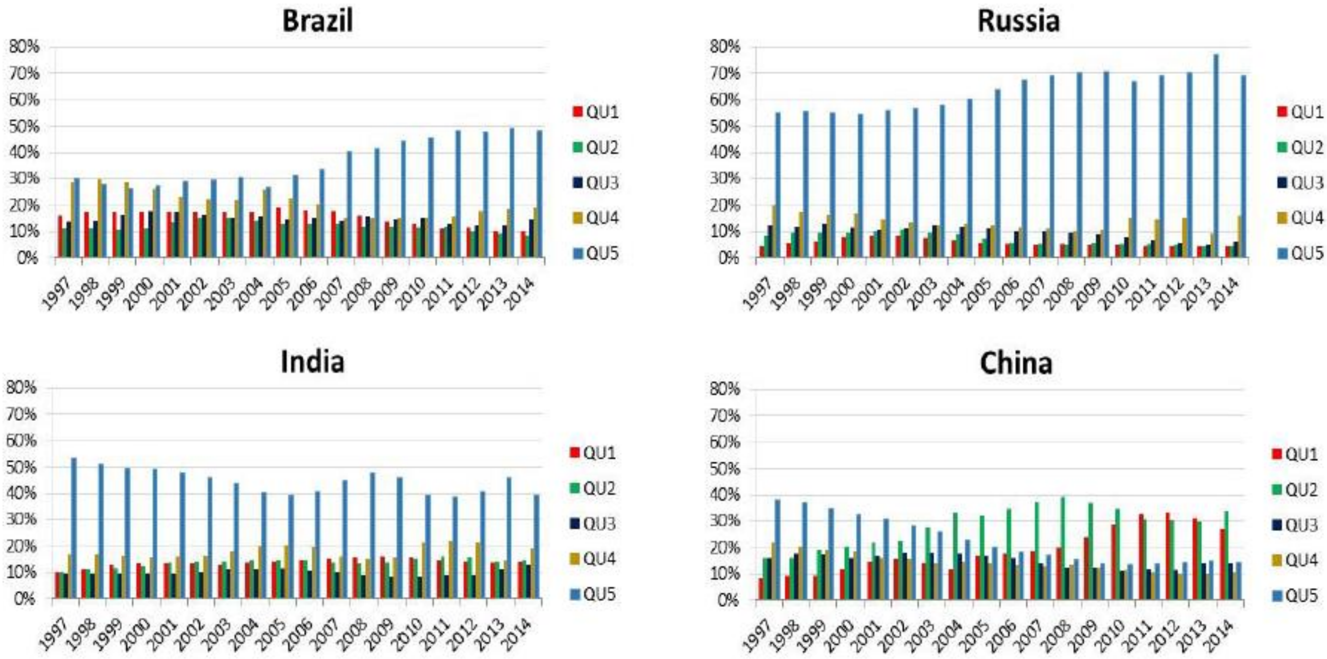


Source: Bloomberg, Guinness Asset Management (Data as at 31.08.2018)

Trade complexity and the flaw in the BRIC concept

Data compiled by the Observatory for Economic Complexity again highlights that you must be careful bunching together EM countries as one homogenous group. The data measures the complexity or sophistication of goods produced in each country, and we can sort these into quintiles. The most complex goods (such as computer chips and cars) are in the highest quintile, with the least complex (commodities and textiles) in the lowest quintile.

Looking at the graphs below, which include 20 years of data, it is clear to see a pattern emerging in the BRIC countries (Brazil, Russia, India and China). We can see China has moved up the value-added chain and is now producing more and more complex goods. The blue and gold bars have diminished, with the red and green bars taking up a greater share of the total. China's top exports in 1995 were models and stuffed animals. In 2016, China's top export category was computers. In contrast, looking at Brazil, we can see it relies on commodities and agricultural produce such as soybeans; Russia is heavily focused on gas and oil. India is a slightly different picture – while its exports are relatively unsophisticated, its economy is more diversified, with services (not included in the economic complexity data) playing a more prominent role.



Source: Observatory for Economic Complexity, Guinness Asset Management

Conclusion

At a time when several Emerging Market countries have difficult but specific problems, investors in Emerging Markets should be aware of the great diversity that the bloc encompasses – and the inevitable idiosyncrasies this throws up for any Emerging Markets benchmark.

At Guinness Asset Management, we focus on the companies we buy, the strength of the underlying businesses and the consistency of profit growth generated, reflected in cash flow growth that translates into dividend growth. Our assessment of macro risks to industries, country and global cyclical and financial conditions are all viewed in terms of their impact on the underlying business and the valuation of its shares.

If investors can satisfy themselves that the companies in which they are investing are sound and that the cash profits which have distinguished them in the past are likely to continue, then depressed valuations in Emerging Markets represent an opportunity. There are three parts to the total shareholder return: profits, earnings multiple and the dividend. Our approach is designed to seek out sustainable and growing profitability, which in turn should underpin a sustainable and growing dividend. In this framework, the earnings multiple is the volatile element and when it is low, we think there is opportunity.

Edmund Harriss, Mark Hammonds and Sharukh Malik - Guinness Asian and Emerging Markets Equities Team

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Funds

Guinness Asian Equity Income Fund

Invests in Asian companies with persistently high return on capital, that are well placed to pay a sustainable dividend into the future.

Guinness Best of China Fund

Invests in companies benefiting from exposure to economic expansion and demographic trends in China and Taiwan.

Guinness Emerging Markets Equity Income Fund

Invests in dividend paying companies in Emerging Markets world-wide.

Guinness Asset Management

Guinness Asset Management provides a range of long-only actively managed funds to individual and institutional investors. Founded in 2003, Guinness is independent and is wholly owned by its employees. We believe in in-house research, intelligent screening for prioritisation of research and well-designed investment processes. We manage concentrated, high conviction portfolios, with low turnover and no benchmark constraints. At heart Guinness is a value investor.

Since our establishment we have developed a variety of specialisms in global growth and dividend funds, global sector funds and Asian regional and country funds.

The Guinness funds sit within an Irish-listed OEIC. They are managed alongside a range of mirror SEC-registered funds offered to US investors by our US sister company, Guinness Atkinson Asset Management Inc.

We also offer Enterprise Investment Schemes investing in UK renewable energy projects and AIM-listed companies.

The Guinness Asian Equity Income Fund, Guinness Best of China Fund and Guinness Emerging Markets Equity Income Fund are equity funds. Investors should be willing and able to assume the risks of equity investing. The Funds invest in stocks of companies that are traded on Asian and Emerging market exchanges or that do at least half of their business in Asia / Emerging markets; it is therefore susceptible to the performance of those regions, and can be volatile. Details on the risk factors are included in the Fund's documentation, available on our website. Share- holders should note that all or part of the fees and expenses will be charged to the capital of the Fund. This will have the effect of lowering the capital value of your investment.

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- the Manager: Link Fund Manager Solutions (Ireland) Ltd, 2 Grand Canal Square, Grand Canal Harbour, Dublin 2, Ireland; or,
- the Promoter and Investment Manager: Guinness Asset Management Ltd, 14 Queen Anne's Gate, London SW1H 9AA.

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