Why Macro Matters in Emerging Market Equities

Underpinning Stock-Picking Insights

George Bicher,
Asset Class CIO and *Portfolio Manager, Global Emerging Markets*

Laura Ostrander,
Emerging Markets Macro Strategist

STATE STREET GLOBAL ADVISORS

Fundamental Growth and Core Equities

While picking great stocks and managing risk is at the heart of all successful active fundamental equity investment, there is still a lot more to this endeavor. And that is particularly the case when it comes to emerging markets; great stock-picking ability on its own is not enough to ensure the long-term success of active emerging market strategies.

We believe that investors should manage risk in a comprehensive manner, rather than relying solely on bottom-up analysis to drive diversification. Macro and political factors across the emerging market universe are constantly in flux, impacting interest rates, economic growth, currency stability, asset values and capital flows. Understanding how macro factors may change the environment in which companies operate is complementary to a fundamental stock selection process. This all-encompassing approach provides for a more complete risk assessment and enhances the conviction of an active fundamental emerging market strategy.

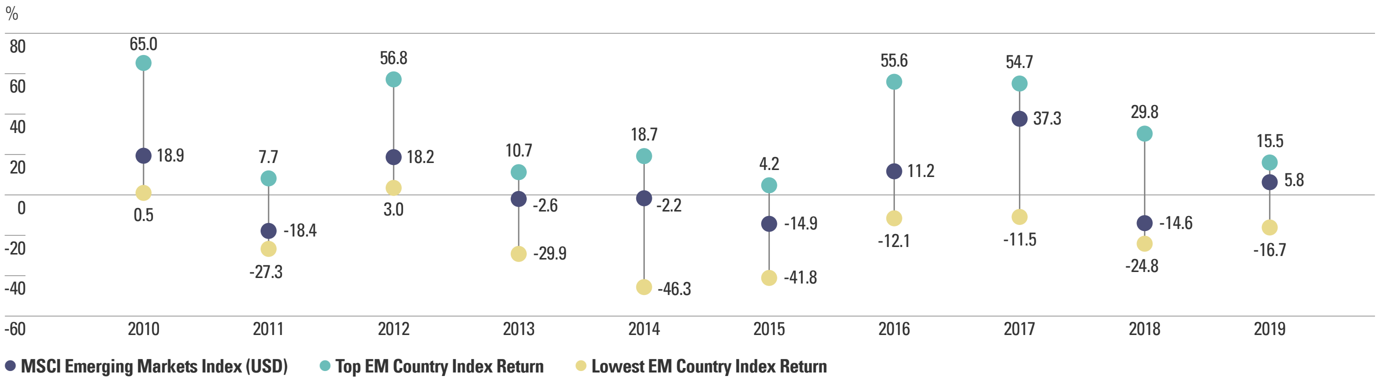
NOT ALL EMERGING MARKETS ARE THE SAME

The "Emerging Markets" covers a diverse collection of countries that typically share a range of similar characteristics; relative to advanced market economies, these generally have lower per capita income, higher economic growth and favourable demographics. Faster EM economic growth is often associated with higher investment returns for this group, although there are some caveats to be aware of in this relationship.

Large variations in economic and social development, as well as in policy and institutional credibility, can often lead to a wide dispersion of economic growth and market performance across the EM universe (see Figure 1).

Identifying countries where policymakers are committed to moving forward with the necessary policy and structural reform to ensure sustainable economic growth is an essential macro consideration for investors seeking to invest in this space. Countries with high sustainable economic growth are more likely to attract "sticky" long-term capital flows — such flows generally enhance growth, increase employment and income levels, and raise living standards. Strong economic growth momentum diminishes the risk of political and social instability, thus creating a positive environment for investment.

Figure 1: Range of EM Country Index Returns (Calendar Years 2010–2019) in US Dollars



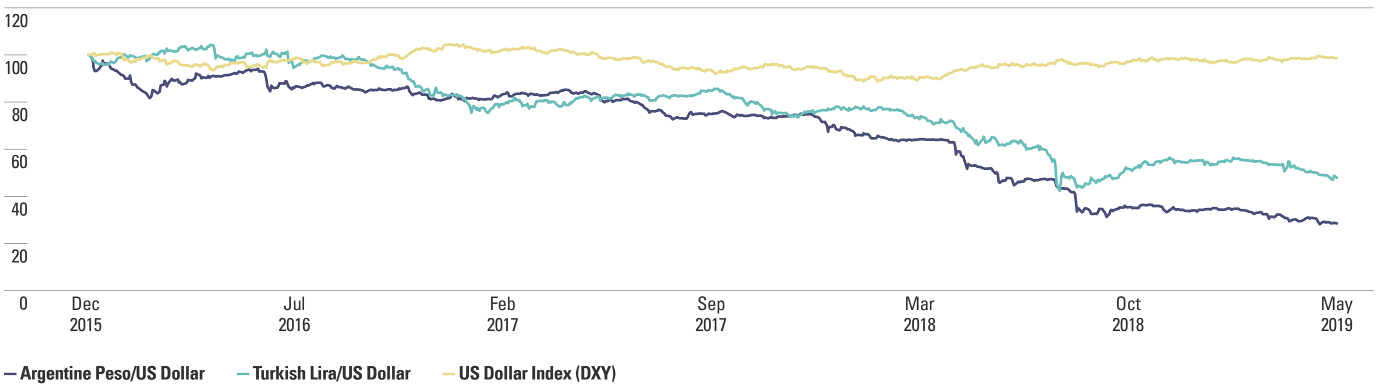
Source: MSCI, State Street Global Advisors. Past performance is not a guarantee of future results.

DIFFERENTIATING BETWEEN GOOD AND BAD

An investment environment widely viewed as ideal involves a scenario of synchronized global growth with low inflation, often referred to as "goldilocks". However, this tends to give way to large indiscriminate flows that lift the performance of all emerging market countries, stocks, bonds and currencies. And quite often, it is the more risky countries, currencies and companies that benefit the most. Indiscriminate flows can often reward "bad-behaving" countries and companies, while penalizing those that are "good" and/or of a high quality. The trajectory of the fortunes of Argentina and Turkey during 2017 and into the beginning of 2018 is instructive (Figure 2).

At the time, inflation was stubbornly high in both countries with double-digit annual rates. Political noise was also growing louder and questions were mounting over the direction of monetary and fiscal policy. Despite the alarm bells that this might ordinarily be expected to set off, flows into emerging markets fixed income and equities continued, pushing interest rates to levels that no longer compensated investors for the risk; a consequent decrease in liquidity helped drive a sharp fall in EM currencies. As a result of the shift in the global macro environment, the vulnerabilities of both countries were exposed through 2018 and 2019.

Figure 2: The Deteriorating Currency Fortunes of Argentina and Turkey 12/31/2015 to 05/13/2019



	FX Spot Return			
Currency	**2016 (%)**	**2017 (%)**	**2018 (%)**	**2019 YTD (%)***
US Dollar	3.6	-9.8	4.4	1.2
Turkish Lira	-17.2	-7.2	-28.2	-13.1
Argentine Peso	-1.6	-14.7	-50.6	-16.9

Source: Bloomberg Finance LP (Indexed to 100 at 12/31/15). Past performance is not a guarantee of future results.
* As at 05/13/2019.

A MACRO PERSPECTIVE

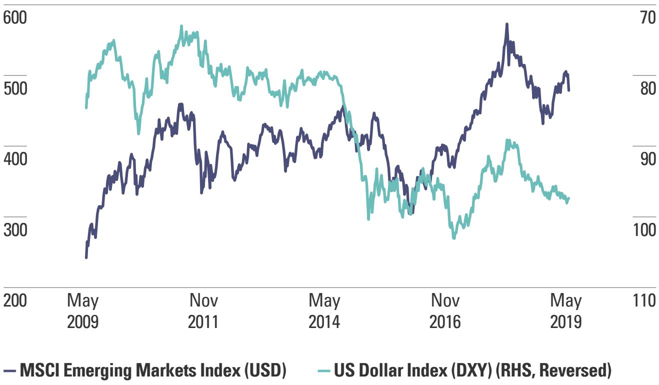
It is during periods like this when the importance of having a macro perspective becomes clear, as the temptation to add risk or test the boundaries of the stated investment process can otherwise often rise.

A perspective that is focused on understanding the underlying macro and political opportunities, risks and vulnerabilities of individual emerging market countries allows investors to differentiate. Investors can thus be better positioned to weather any sudden end to risk-seeking fund flows, such as those attracted by the goldilocks scenario.

Emerging market currencies tend to be more volatile than those of major developed countries; factors such as size, liquidity, economic openness, as well as the type and availability of underlying instruments in individual currency markets, are important considerations here. But domestic macro factors such as inflation, interest rates, trade and the direction and credibility of monetary and fiscal policy are also key drivers in the level and direction of a currency. Furthermore, the level and trajectory of US interest rates and the US dollar is also key — especially as a barometer for the overall level of global liquidity.

Interest rate levels, both current and projected, impact the cost of capital for companies. Furthermore, the level and direction of currencies can affect a company in several different ways: these include the cost of imported inputs; the value of revenue streams; and the overall value of the stock when translated back into US dollar or other hard currency terms.

Figure 3: The Experience of MSCI EM Index (USD) vs. US Dollar Index (DXY) — May 2009 to May 2019

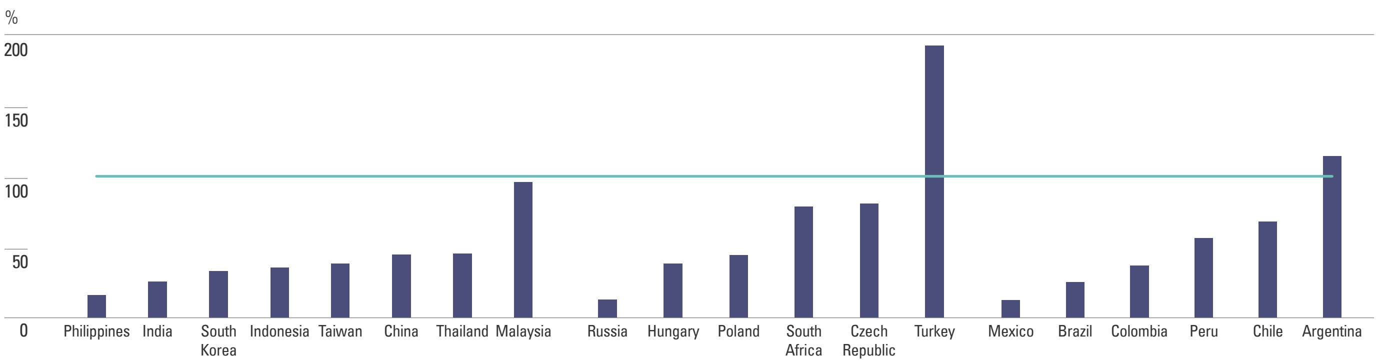


Source: Bloomberg Finance LP. Past performance is not a guarantee of future results. All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment.

Credible monetary policy will work to keep inflation in check; this, in turn, should lend support to the currency. The higher the level of external debt and/or the lower the foreign exchange reserves level, the more important it is for an emerging market country to have such a credible and transparent policy. As Figure 4 illustrates so clearly, Argentina and Turkey feature most prominently among those countries with an unfavourable debt-to-reserves ratio.

In addition, some emerging markets are commodity producers and exporters, while others are commodity importers. The rise and fall of commodity prices unsurprisingly affects exporters and importers differently. So here again, we can see the potential danger awaiting investors who view emerging markets as a homogeneous group, especially in times of broad US dollar strength or global market crisis.

Figure 4: Short Term External Debt as % FX Reserves



Source: Deutsche Bank and Citibank as of May 2019.

THE BENEFIT OF A DISCIPLINED PROCESS

We believe the absence of a macro perspective to be a shortcoming for many emerging market investors. A better approach, in our view, is a disciplined process of picking the best stocks from a bottom-up perspective and complementing this with an understanding of the macro environment, both globally and in each country where the companies operate. Assessing macro and political risks in individual emerging markets drives country allocation decisions that best capture the opportunity and raise awareness of the risks.

ssga.com

State Street Global Advisors Worldwide Entities

Abu Dhabi: State Street Global Advisors Limited, Middle East Branch, 42801, 28, Al Khatem Tower, Abu Dhabi Global Market Square, Al Mayah Island, Abu Dhabi, United Arab Emirates. Regulated by ADGM Financial Services Regulatory Authority. T: +971 2 245 9000. **Australia:** State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services Licence (AFSL Number 238276). Registered office: Level 17, 420 George Street, Sydney, NSW 2000, Australia T: +612 9240 7600. F: +612 9240 7611. **Belgium:** State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: 32 2 663 2036, F: 32 2 672 2077. SSGA Belgium is a branch office of State Street Global Advisors Limited. State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Canada:** State Street Global Advisors, Ltd., 1981 McGill College Avenue, Suite 500, Montreal, Qc, H3A 3A8, T: +514 282 2400 and 30 Adelaide Street East Suite 500, Toronto, Ontario M5C 3G6. T: +647 775 5900. **Dubai:** State Street Global Advisors Limited, DIFC Branch, Central Park Towers, Suite 15-38 (15th floor), P.O Box 26838, Dubai International Financial Centre (DIFC), Dubai, United Arab Emirates. Regulated by the Dubai Financial Services Authority (DFSA). T: +971 (0)4 4372800, F: +971 (0)4 4372818. **France:** State Street Global Advisors Ireland Limited, Paris branch is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Paris Branch, is registered in France with company number RCS Nanterre 832 734 602 and whose office is at Immeuble Défense Plaza, 23-25 rue Delarivière-Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00. F: (+33) 1 44 45 41 92. **Germany:** State Street Global Advisors GmbH, Brienner Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381. T: +49 (0)89 55878 400. F: +49 (0)89 55878 440. **Hong Kong:** State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103 0200. **Ireland:** State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered number 145221. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. **Italy:** State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano) is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano), is registered in Italy with company number 10495250960 - R.E.A. 2535585 and VAT number 10495250960and whose office is at Via dei Bossi, 4 - 20121 Milano, Italy. T: +39 02 32066 100. F: +39 02 32066 155. **Netherlands:** State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands. T: 31 20 7181701. SSGA Netherlands is a branch office of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Singapore:** State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826 7555. F: +65 6826 7501. **Switzerland:** State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16. **United Kingdom:** State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350. **United States:** State Street Global Advisors, One Iron Street, Boston MA 02210. T: +1 617 786 3000.

Important Information:

The views expressed in this material are the views of George Bicher and Laura Ostrander through the period May 20, 2019 and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without SSGA's express written consent.

All information is from SSGA unless otherwise noted and has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor.

Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Foreign investments involve greater risks than US investments, including political and economic risks and the risk of currency fluctuations, all of which may be magnified in emerging markets.

Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

Investing involves risk including the risk of loss of principal.

STATE STREET GLOBAL ADVISORS

ID16628-2547722.1.1.GBL.RTL 0519 Exp. Date: 31/05/2020