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**Q&A**

With portfolio managers  
Shaw Wagener and Rob Neithart

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## The potential for new opportunities in emerging markets



**Shaw Wagener** is a portfolio manager with experience in the emerging markets. He has 31 years of investment experience, all with the Capital Group, and is based in Los Angeles.



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Portfolio managers Shaw Wagener and Rob Neithart discuss investment opportunities in the emerging markets following market declines from May to August 2013. They address why the repricing of emerging markets assets during this time differs from 1997 and 2008. Among their observations:

- The emerging markets are not likely to experience a wide-scale balance-of-payments crisis.
- Countries with large current account deficits are nonetheless vulnerable.
- Many developing economies need deep structural reforms.
- Small-cap and mid-cap stocks continue to be of interest.
- Many local currency debt markets are attractively valued.
- Growth prospects for developing economies are still better than those of advanced economies.

**Why have emerging markets stocks lagged developed markets by such a wide margin over the past year and do you expect it to continue?**

**Shaw:** A lot of investor concerns about emerging markets equities are related to valuations. The decrease in price, and hence in valuations, is probably justified to some degree, because earnings growth has been lower than expected. But it is important to look at the factors contributing to this large-scale derating and determine if they are likely to continue.

Part of the reason for the slowdown in earnings has been slower global growth. A reduction in economic growth affects the top line of companies in emerging markets much faster than in developed countries. But the outlook for global growth is improving. There are

a number of reasons to be optimistic about Japan's economy: for one thing, the policies of Prime Minister Shinzō Abe, or "Abenomics," appear to be here to stay. Europe is stabilizing. The recovery in the U.S. also appears to be stable, even if it is less robust than what we might normally see after a crisis. So the external environment is better. Within emerging markets, many currencies have devalued, with the Chinese renminbi being the major exception. That should help export growth for the emerging markets over the next 12 to 18 months.

The most vulnerable countries are those with large current account deficits, including South Africa, Brazil, India, Indonesia and Turkey, sometimes called the "Fragile Five." Each of these countries has a different story. But a pickup in global growth should naturally benefit Brazil and South Africa, though South Africa is in a more

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October 2013

difficult position than Brazil given the extent of its short-term funding needs. Turkey appears to be in the most challenging situation; it is in an area of increasing geopolitical tensions and has a very large current account deficit, so it will take some time for conditions there to improve.

**Many emerging markets currencies have devalued sharply, in some cases on an order of magnitude comparable to the Asian debt crisis of 1997. How is the recent episode different and do we expect currencies to strengthen from these levels?**

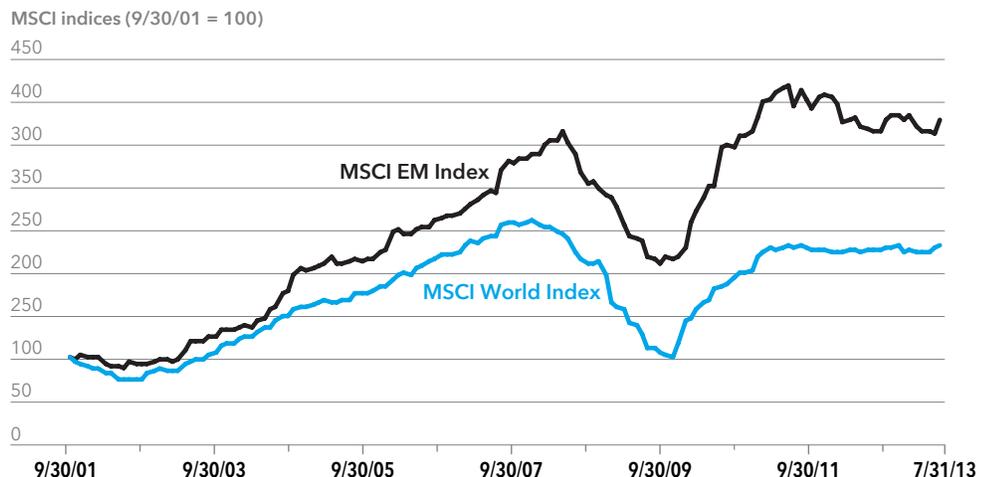
**Rob:** The financial vulnerability of emerging markets countries during the 1990s was largely centered around weak balance-of-payments positions, large current account deficits and significant short-term debt and rollover requirements. They found themselves in a real crunch in the face of tighter liquidity and just did not know what to do. They also had very weak foreign exchange reserve balances and lacked reserve cushions. Many countries had high debt levels relative to GDP because they were not being particularly careful about how they managed fiscal policy.

But that was the 1990s. It is not the same situation today and the risks are different. Some of today's risks are at the corporate level. Corporations have accumulated a lot of U.S. dollar-denominated debt over the last several years. Even though the governments have fairly solid balance-of-payments and fiscal positions and their debt levels are modest or even low, when sovereign and corporate borrowing are combined, these countries have a lot more dollar debt than dollar revenues in aggregate. So they have potentially short positions in their debt exposures to the dollar and would need to cover those short positions if liquidity tightens.

The larger risk in emerging markets is not a looming balance-of-payments crisis in which governments run out of money and fail to pay their debts. They have the resources for that. The problem is that most governments have done very little in terms of structural change or reform for quite a while and it has caught up with them. Lack of reform has weighed on domestic demand in some markets. The model for economic growth in many countries has been dependent on exports and demand from developed economies.

**Exhibit 1:  
Emerging markets corporate earnings have disappointed in recent years but nonetheless have outpaced developed markets.**

Earnings growth for emerging and developed market companies in the MSCI EM and MSCI World indices



Source: Rimes as of July 31, 2013.

October 2013

“To their credit, many governments have not tried to prop up their currencies with reserves or attempted to defend them. I think it is a good thing to let interest rates and currencies go where they need to go and allow the rebalancing to happen naturally.”

That is not as strong as it used to be. In order to spur growth in domestic economies, governments need to reform their labor markets, modernize their financial systems and open their markets up to greater competition.

Investors are worried about decreased growth potential and profitability in the face of rising costs and limited efficiency. The market adjustment we have just experienced reflects the recalibration of lowered growth expectations for the emerging markets. I do not think any of this is news. To their credit, many governments have not tried to prop up their currencies with reserves or attempted to defend them. I think it is a good thing to let interest rates and currencies go where they need to go and allow the rebalancing to happen naturally. That being said, it is important to remember that emerging markets still have better growth prospects compared to the developed economies.

***Are there any countries that have been particularly slow to reform and are more vulnerable?***

**Rob:** India is a particular laggard in this area. I think that India’s government has been sensible to let the currency devalue. Authorities have not tried to stand in front of the tide and burn off a ton of reserves. The problem is less about debt sustainability than the fact that India has not initiated reforms to address some of the major imbalances in the system and make the country healthier and more profitable. The country has not been a reform leader in anything for years – from energy subsidies to food policy or anti-competition laws.

India is an exaggerated version of broader market weakness that has been triggered by global macroeconomic concerns. If general global pressures persist, India will feel it, but I do not think that its problems will spread to other emerging markets.

This might be palatable from an investor’s standpoint, given cheaper valuations in the emerging markets overall. But if governments do start to initiate reforms, the positive impact from those changes is also likely to be dramatic. We have seen this recently in Mexico, where assets have rallied on expectations that the new government will continue to push through reforms that are likely to result in long-term improvements.

***From an equity perspective, what investment areas interest you in this environment? Larger cap stocks have lagged small caps. Where do you see value?***

**Shaw:** The largest emerging markets companies are highly concentrated in energy stocks, banks in China and Brazil, technology heavyweights and a few telecom giants. For energy companies, their costs have risen significantly and the oil price is below its peak. The U.S. is also now becoming more energy independent and the nature of global energy demand is changing radically. This, combined with rising costs and flat revenues, suggests a muted outlook for energy stocks. If you look at consolidation in the telecommunications sector, it does not look like there is a lot of potential for growth there either. As we move forward, we plan to continue spending a lot of time investigating smaller to mid-cap companies in the market capitalization range of \$2 billion to \$40 billion that are likely to grow at a faster rate than large caps. It is a matter of valuation.

We are finding value in technology stocks that are relatively inexpensive. Among other investment themes, the rising standard of living in the emerging markets is a major area of interest for me. People want better housing and the Internet among a whole range of other goods and services, and they are concerned about their well-being.

October 2013

Health care is a small but growing area of the emerging markets, and we spend a lot of time trying to identify the best companies in that industry. Some of these firms are globally competitive in terms of manufacturing as well as research and development, such as the Indian pharmaceutical companies. Medical device manufacturers that make high-quality products at cheaper prices are another example. Many of these firms are based in China. The quality of their products is not quite as high as in the U.S. or Japan, but they make good products available at reasonable prices.

Another area of interest can be referred to as medical tourism, though I think of it more as high-quality hospital care. Hospitals are generally more difficult to invest in because they have higher capital and operating costs. Another factor is that some countries do not allow for foreign direct investment in hospitals. China and Brazil have regulatory constraints on investments in hospitals by both private enterprises and foreign investors,

for example. So we do not see as many opportunities in this area, but there are a few. Finally, there are a number of consumer discretionary companies that benefit from higher standards of living, such as automakers and gaming companies.

Infrastructure is another major focus. The move toward urbanization in the developing world, particularly China, is not likely to slow down. The government is not emphasizing growth in tier one cities such as Beijing and Shanghai. But by the end of this year, they are expected to provide additional incentives for people to move into third- and fourth-tier Chinese cities with smaller populations. So we are expecting greater infrastructure spending in these smaller cities.

There is also a shortage of infrastructure spending in other major countries like India and Brazil. We would expect to see more development there, as we have for a long time. There may be some fits and starts given the different economic circumstances from market to market.

**Exhibit 2:  
 U.S. dollar-denominated emerging markets bonds have fallen sharply in line with local currency bonds and U.S. Treasuries in recent months.**

Emerging markets bond returns for the U.S. dollar-denominated JPMorgan EMBI Global index and the local currency GBI-EM Global Diversified index compared with the 10-year U.S. Treasury yield



Sources: JPMorgan and Bloomberg as of July 31, 2013.

October 2013

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**What value are you finding in debt markets?**

**Rob:** I am leaning toward local currency emerging markets bonds and removing currency hedges. I like Mexico, Colombia and the Philippines for their ongoing reform efforts and likelihood of structural change. Russia is not there yet, but has potential. I still like Polish bonds, which are not cheap, but Poland has some of the best growth prospects within the emerging markets. I have exposure to inflation-linked bonds in Turkey where valuations have become more attractive in recent months, but I am maintaining a significant hedge on the currency. In terms of other markets, it is more or less a question of whether they are cheap enough. I find it difficult to get excited about reform in Brazil, but the valuations there are very attractive. The same is true for several markets in Asia, such as India and Indonesia. I also continue to invest in inflation-linked bonds for the inflation protection they offer.

I like corporate bonds that have identifiable dollar cash flows and attractive valuations. I have invested in a number of corporate credits but remain very selective. As I mentioned earlier, I worry about dollar borrowing being excessive relative to companies' ability to generate dollars – so unless our analysts are really confident that a company can generate dollars or obtain government support, I prefer to stay away.

We continue to invest in some of the quasi-sovereign businesses, especially energy companies. In Asia, there are some companies with strong balance sheets. There is one company in particular that generates large amounts of dollar-based revenue. It is an example of a corporate bond that remains sound, in my view, despite the challenging macroeconomic environment. Overall, the investment risks and rewards are unique to specific countries and issuers. This is a positive sign that these markets are becoming a little more developed and mature.

**Rob, do you expect to increase your investments in emerging markets bonds in your global bond portfolios, including Capital World Bond Fund?**

**Rob:** I think so. Valuations today are much better and provide a cushion of support. We can expect some improvement in bond prices and currencies on top of the running yield. This is especially likely if global industrial activity improves. Emerging markets tend to be cyclically leveraged, so better global economic conditions should support assets in the developing world. But even without that tailwind, there is still the potential for a compression in spreads and yields and a rise in currencies, which would help generate decent bond returns. I believe this is the case even if the tide does not lift all emerging markets.

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