Equities

What's in Store for Emerging Markets?

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Following a lackluster 2011 for emerging market equities, the asset class got off to a very strong start in 2012. Will the outperformance last? Below, Justin Leverenz, Portfolio Manager of Oppenheimer Developing Markets Fund, shares his insights into the key issues developing economies face, and explains why he thinks that despite the potential for volatility, emerging market equities represent a strong, sustainable opportunity going forward.

Q: What has changed in your outlook since the beginning of 2011?

Justin Leverenz: At the start of 2011, I was a little concerned about the short-term outlook for emerging markets because of potential overheating and growth in monetary aggregates and credit. These simply looked unsustainable. Over the course of the year, however, central banks in almost every emerging market tightened monetary policy and reined in credit, cooling growth to more sustainable levels. As earnings estimates came down and concerns about the developed world—particularly the Eurozone—increased, emerging market stocks became more attractively priced.

Today, unlike most developed markets, many emerging economies enjoy significant policy flexibility, which will help them manage growth and protect against headwinds emanating from the developed world. And in an inversion of the historical pattern, unlike most developed markets, emerging markets now generally enjoy very healthy balance sheets.

Q: What risks and opportunities do you see ahead in 2012?

Justin Leverenz: Globally, crisis is on people's minds. Across the Atlantic, we have concerns about sovereign debt and the risk of a banking crisis. In America, we confront high deficits, debt levels and a dysfunctional government. In emerging markets, there are still a lot of concerns about China, and whether it can engineer a "soft landing."

But the whole heritage of Oppenheimer Developing Markets Fund has been about crisis. A year after inception, in 1997, we had the worst regional depression that we'd probably seen since the Great Depression. And then came a commodity and resource bust which took Chile, Argentina and Brazil down and then, of course, Russia defaulted. Despite all this crisis and volatility, however, we've been able to multiply our money many times over. Though past performance does not guarantee future results, we remain confident in our ability to navigate uncertainty.

You need something to hold onto in adversity. And this Fund has done really well because we do a couple of things. We invest not in countries, but in companies—specifically, beneficiaries of big, powerful, structural tailwinds, like the rise of consumer classes in emerging markets. And we're only interested in those companies when they also enjoy a massive advantage, a very significant competitive advantage that cannot be compromised through the introduction of a middleman. We're interested in market structures that are very unique. We're interested in the great assets, and we're *only* interested in that.

Q: What is your outlook on China, the largest developing economy?

Justin Leverenz: There's a lot of worry about China. The reality is that China's likely going to slow a lot in this decade after two or three decades of hyper-growth. But, the reality of the fact is that China's still likely going to be one of the biggest contributors to worldwide growth and is probably the biggest growth story of this decade still. It'll just have a different complexion.

The underlying growth narrative with China hasn't changed. It's about the "great convergence" and very substantial productivity gains that will persist for the next decade. China has its problems, but there are some really awesome companies with the same characteristics that we try to find in the rest of the world: Companies with long-tail, durable growth narratives, meaningful advantages and now, after 12 or 18 months of significant compression in valuations, very attractive prices.

Q: What about India?

Justin Leverenz: India is facing some cyclical problems. Capital formation has slowed significantly, inflation's moved up a lot, nominal interest rates have moved higher, and alongside all that is a completely dysfunctional government. But I think most of these are cyclical, not structural, issues. The main reason one invests in India is because there are great companies, and another reason is because progress will happen. There's a lot of long-term progress in terms of rising savings, a very positive demographic opportunity, and, with rising savings, more capital formation and, mathematically, more growth. So, India's going through a lot of problems at the moment, but problems sometimes lead to really good prices, which lead to long-term investment opportunities.

Q: How do you view Brazil and Latin America more broadly?

Justin Leverenz: Brazil has been overheating, reining in growth. Now, growth has completely stopped. You see that in all kinds of numbers in Brazil. Prices are down a lot in local currency. Prices are down even more in dollars because the real was ridiculously overvalued and has understandably weakened. And prices are, I think, fair in some areas.

Latin America has absolutely terrific companies, but it doesn't necessarily have the potential growth, I think, that other geographies have. And the reason for that is that across the world, when you get a sort of stabilization of systems and you get progressive growth (China and India being poster children, along with most of Asia ex-Japan), what tends to happen is you get slowly rising savings levels. Latin America has had probably the best decade since the 1970s in aggregate, and yet Latin America has not increased savings at all. As a result of that, the ability to grow is constrained. But while I'm less enthusiastic on the region from a top-down perspective, I'm very excited about a lot of fantastic companies headquartered there.

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