IQ INSIGHTS

Take Two: Why Reformers are the Performers


by **Stéphane Barthélemy**, Head of Active Emerging Markets strategies in Paris and **Olivier Ekambi**, Co-Head of the Active Europe Equity Unit of SSgA France in Paris

It is a fundamental truth that countries and companies that do the things that markets like attract greater investment flows. And at a country level, markets have made clear that governments with reform agendas that promote growth, transparency and deregulation are typically higher up their preferred list of investment destinations.

If we focus on the relative merits of the investment landscapes in the emerging markets and euro area, any assessment will invariably begin from different starting positions. For example, many emerging markets are deregulating at a quicker pace than in Europe, but that reflects the fact that plenty of reforms have already been implemented in the Old Continent. Furthermore, while many in the EM world are moving towards economic liberalism, the EU has been re-regulating aspects of the financial sector following lessons learned over the past six years. Some EM countries will need to switch from a central spending culture to one that encourages greater budget discipline and private initiatives, while in Europe there is a need for some governments to loosen the purse strings and move away from the policies of austerity.

At a recent client conference in Paris, two portfolio managers on the SSgA Active Quantitative Equity Team, Stéphane Barthélemy and Olivier Ekambi, debated which countries in the Emerging Markets and Eurozone have benefited from a constructive approach to reform, which countries have a lot of work to do and which countries are moving in the right direction. What follows is an edited version of how the discussion unfolded.

What Reforms are Actually Taking Place in the Emerging Markets and Eurozone?

Stephane: It is important to state at the outset that it would be inaccurate to say that 'Emerging Markets' are either reforming or not reforming, as EM is not a homogenous asset class . From one country to another, the macro-economic and political situations can be very different, although sometimes this can also serve to highlight common features within a region.

For example, in general terms the economies of Latin America and Asia have fared better than those of Emerging Europe, both during and since the subprime crisis erupted in 2008. This may be partly attributable to the fact that both regions had experienced their own crises at various points during the previous decade and as a result many had already sought to address some of the imbalances that had contributed to those difficulties. By way of contrast, many countries in Emerging Europe improperly based their growth plans on credit, unfortunately just as the global financial crisis was about to arrive.

Ultimately, there is little political or economic coordination between the 23 emerging market countries that make up the MSCI EM Index. So while these countries may account for 85% of the world's population, each state's individual situation needs to be assessed independently.

We know that markets do not just like reforms, they also love stability while fearing uncertainty. What markets really like and want is comfort that countries' governments are always looking to improve their regulations, structures, and economic prospects.

Olivier: Like the Emerging Markets, the Eurozone is not a homogenous area. But unlike EM, the countries within the Eurozone are linked by a single currency. Before the introduction of the euro, the Maastricht criteria provided a blueprint of how the different economies could be brought closer together. But, it is not an optimal currency union. And the financial crisis served to highlight the significant differences that remained. The main lesson that one can take from the crisis is that an economic zone without political sovereignty and without economic solidarity will not work.

A North-South divide has developed between strong and fragile states. Countries in Northern Europe have typically been more competitive, benefiting from the protection of strong public finances and public debt levels that are largely under control. Across Southern Europe (Portugal, Italy, Greece, Spain), there has been a significant rise in budget deficits and the debt burden has increased considerably under the weight of the economic crisis.

So while the European Union thought it had created a strong union, the crisis has served to identify the weak points and forced it to improve its governance of the region. With the exception of Italy, the other countries of the South (and Ireland) have required financial assistance. This help largely came from the troika (EU, ECB, IMF) and came with conditions attached — the primary ones being the implementation of austerity programs and the prioritising of structural reforms. So while Eurozone economies are reforming, the reality is that they had few alternative options.

At a Europe-wide level, the reforms include:

- A European fund to finance ailing states
- Financial Supervision (Golden Rules)
- Guarantee of bank deposits
- Banking Supervision

At the government level:

- Stimulus to the economy
- Restoration of public finances

The worst of the crisis is probably behind us, but the challenge now is to continue fiscal consolidation while putting in place structural reforms to enhance growth potential and tackle the drag of high unemployment.

So Where have Reforms Worked?

Olivier: Germany is the ideal model to illustrate the benefit of reform. Germany has weathered the crisis in the Eurozone more comfortably than other member states. Part of this stems from the fact that transformative reforms were actually implemented in the wake of reunification a decade earlier. At the time, Germany was considered the 'sick man of Europe' and, under the leadership of Chancellor Schroeder, undertook a series of reforms to restructure the labour market. The country's economic model is one that is outward-looking in nature and that has proved beneficial. Germany's policy of wage moderation over the past decade has allowed the greatest benefit of those reforms to fall to companies rather than consumption. This partly explains the strength of Germany's export-oriented industry and the dynamism of its trade balance.

Because of past reforms, Germany does not need to reform in the same way that France does. And perhaps this is part of the reason why the German model can both fascinate and annoy. Its strength impresses, with faster output growth than other major economies in the region, allowing it to avoid the worst of the impact from the region's debt crisis.

But its model also irritates: focusing on its exports does little to help exporters from other European economies looking to sell to German consumers. The country is currently subject to a review by the EU under its 'excessive imbalance procedure', and disciplinary action could follow.

At this point though, the real challenge that Germany faces is the aging of its population. That's a long-term challenge that faces all major European countries but Germany has placed itself in a good position by virtue of its reformist approach up to now.

Stephane: There is ample evidence to support the view that reforms at a government, sector or company level help drive share price rallies. Within the Emerging Market universe, India and Mexico fall into the 'good' reformers camp.

India is very much a reform-in-progress model. There is an appetite for change and voters handed reform-driven Prime Minister Narendra Modi a parliamentary majority in this year's election — to the delight of markets. Expectation of his success helped drive the market higher in the nine-months prior to his election.

Reforms are required in India to address two related problems.

1. India is one of the most bureaucratic countries in the world.
2. India suffers from a chronic infrastructure deficit which limits its growth potential.

Modi has pledged:

1. To reduce government deficits and introduce a less cumbersome and more effective administration to help boost investment. He aims to reproduce on a national level the economic miracle he governed over in Gujarat state for 13 years.

2. To overhaul the right of access to property to allow for the easier building of the roads, railways and ports that are needed by a fast-growing economy. At present, negotiations are required with a multitude of stakeholders, with local tribes being able to veto such developments, causing major delays to projects.

Are There Other Examples of Good Reformers?

Stephane: Mexico has been a reformer for longer than India. President Enrique Pena Nieto caused a regime change with his Charter for Mexico in late 2012. The pact was supported by the main political parties and targeted the development of telecoms and the introduction of oil sector reform.

The state has a monopoly in the energy sector via its ownership of PEMEX and while the government has not moved to privatise the company, it is opening up the market to the private sector. Furthermore, the private sector can partner with PEMEX in exploration, extraction, refining and petrochemicals activities with the aim of increasing production to 3.4 million barrels per day by 2025, compared to the current level of 2.5 million.

One particular challenge that Mexico faces is that revenue from PEMEX funds about 40% of the state budget. Nonetheless, Nieto's commitment to reform sparked a strong equity rally in the period before US Federal Reserve tapering speculation resulted in a widespread EM sell-off.

Oliver: As noted, Germany has reaped the rewards of reforms it implemented a decade ago. Reforms now being undertaken in the Eurozone have largely been driven by the recent sovereign debt and banking crisis.

Post-crisis reforms in **Spain** are beginning to bear fruit. A decade of strong growth between 1997 and 2007 fuelled a massive credit expansion and corresponding real estate bubble. When that bubble burst in 2007 with the global financial crisis, and was exacerbated by the subsequent sovereign debt crisis, the country's public finances deteriorated amid a fall in property-related taxes, the explosion of unemployment and the high cost of bailing out the banks.

From a surplus of 2.4% of GDP in 2006, the budget deficit stood at 10.6% in 2012. Public debt grew from 36.3% of GDP in 2007 to 94.0% in 2013. And the unemployment rate rose from 8% in 2007 to 27% in 2013. Forced to seek EU financial assistance in June 2012, Spain was given €100 billion support that was conditional on austerity measures and the rehabilitation of the financial system.

Governments under Zapatero and Rajoy have implemented arguably the most painful reforms in the region. It has raised taxes across the board, including VAT and income tax. The public wage bill has been cut resulting in lower salaries, retirement pushed from 65 to 67 years, and unemployment benefits have been reduced. These measures have a significant impact on fiscal consolidation, and wage moderation has helped Spain regain competitiveness and boost exports.

The trade balance deficit of 10% of GDP in 2008 has transformed to a surplus of 1% of GDP in 2014. Spanish GDP growth is expected to be 1.2% in 2014. However, the unemployment rate remains troublingly high at around 26%.

Spain's stock market clearly welcomed the reversal and the market return since June 2012 is +68%, well ahead of France (47%), Germany (49%) and Italy (+46%).[1]

Who are Failing to take Necessary Reform Measures?

Stephane: South Africa's business model has disappointed under the political doctrine of the ANC-led government (an alliance of ANC-PC-union federation COSATU). This doctrine is not market-friendly with trade unions and the far left opposed to the rest of the political system, which is torn between self-interest and economic imperatives since the formal end of apartheid in 1994.

The initial fiscal and monetary policies put in place at the time were arguably not imaginative enough to revitalise the economy and fell short of expectations. Since then there has been an absence of any more real reforms. Youth unemployment is alarmingly high at about 75% and labour strikes are increasingly common. A worsening budget deficit, weak domestic demand, and deteriorating trade and current account balances are weighing on the currency.

Former trade union leader and recently appointed South Africa Vice President Cyril Ramaphosa is now a respected businessman, but he may be struggling to counteract the political apparatus, corruption allegations and internal ANC conflicts that have weighed against reform. The Democratic Alliance, historically a party of liberal whites, is gaining ground but remains a distant alternative to the ANC.

In the aftermath of Mandela's election in 1994, South Africa's stock market outperformed the broader EM index by about 60% in the subsequent 12 months. The market has struggled to get back to that level in the period since amid investor scepticism that the required reforms will be forthcoming any time soon.

In Emerging Europe, the **Russian** economic model has hardly changed since the fall of the Berlin Wall in 1989: Drill and Spend. The incentive to pursue any other approach has been lacking. So far, Putin's regime appears to work only towards the restoration of Great Russia, and the oil and gas bonanza is such that the pursuit of reforms has been unnecessary amid cash flows that benefit the wider population via rising incomes, which in turn has driven consumption and credit growth.

But there is a clear, if unspoken, problem: the Russian business community have little confidence in the Kremlin and, alongside a sense of fear about Putin's possible future actions, this has driven capital out of the economy.

After launching in 1995, the Russian market peaked in 2008, after which it has lost over half of its gains. Even before the current concerns stemming from Ukraine-related economic sanctions against Russia, investors had spoken.

Olivier: The Eurozone is in a different situation to that facing various emerging markets. There is a price that comes with being a member of the euro area. Laws and regulations are handed down from central bodies and all countries have to implement them. So, although some countries may be slower to implement reforms, there are no governments failing to take any action.

Ok, So What about Countries that could Benefit from Better Reform Implementation?

Olivier: Italy is probably the country that most needs to accelerate the pace of reform. GDP growth amounts to about zero over the past decade and public debt stands at about 130% of GDP, among the highest in the region. Seemingly trapped by a deteriorating economic situation the debt dynamics are proving difficult to reverse. After contracting by 2.4% in 2012 and 1.9% in 2013, the Italian economy could shrink further in 2014 (consensus is currently at 0%). While core Italian fabric and auto industries, where there are world renowned names such as Gucci, Prada, Ferrari, Alfa Romeo, remain vital to the strength of the economy, Italian enterprises are struggling to cope with globalization. Relatively low productivity levels have had a knock-on impact on their ability to pour resources into innovation and R&D. The labour market continues to have structural problems: the participation rate of women is low, youth unemployment is high and labour costs are high; all of this undermines Italian competitiveness.

But after a number of false starts, reform is now at the heart of the political agenda. Prime Minister Matteo Renzi is trying to strengthen his reformist government's resolve to pursue reforms, and while the coalition has looked fragile at times Renzi has stressed that he intends to control and improve the trajectory of the country's fiscal situation.

Renzi's primary objective is a new electoral law capable of promoting clear majorities, rather than the fragile coalitions seen in recent years. This reform would help to assure investors that Italy would have stable government for at least five years.

Once this and labour reforms are prioritised, other pending reforms concern the reimbursement of arrears to the state and the establishment of a fund to help SMEs. Reform of the public administration and judicial system is also on the cards.

Italy has not had to request international assistance and markets have broadly welcomed Mr. Renzi's plans. While Italian stocks have thus far lagged behind other major countries in the euro area, there is real potential for recovery, if the pace of reform can be accelerated.

Similar to Italy, the pace of necessary reform in **France** since the crisis has been relatively slow, but the failure of France to sufficiently reform has potentially wider implications given its position with Germany at the heart of the Eurozone. In contrast to Germany, its economic strength is more dependent on domestic consumption, which itself is supported by social transfers. The ills of the French economy are also well known:

- High public spending (57% of GDP versus a Eurozone average of 46%).
- An inflexible labour market that contributes to high youth unemployment.
- The comparatively low competitiveness of French companies also explains the de-industrialization of France and sliding market share in international trade.

After a period of increasing taxes, recent government reforms are on track to help company competitiveness while limiting public spending.

1. November 2012 – A pact for growth, competitiveness and employment (CICE) was agreed among the social partners with a Public Investment Bank also created to provide tailored funding to companies.
2. April 2014 – This next stage of reforms targets the reduction of labour costs, a reduction in taxes and a simplification of the demands on corporate entities. This included an agreement promoting a more flexible approach to job security to help company management more easily manage fluctuating income and labour costs.

The latest cabinet reshuffle has highlighted the reform focus of the new government and the market is watching to see how far Prime Minister Valls progresses with his pro-business reforms.

Like Italy, the benefit to France from labour market reforms could underpin the markets for goods and services and, according to the OECD, may increase GDP per capita by 15% over 10 years.

And What Emerging Market Countries have Potential?

Stephane: Protests at the 2014 World Cup highlighted that all is not well in **Brazil**. Current President Dilma Rousseff has failed to build on the reforms introduced by her predecessor Luiz Inacio Lula da Silva (Lula) and the economy has stuttered. Furthermore, a brewing political scandal that oil company Petrobras funded politicians has bolstered views that the current regime has been in power for too long. Recent opinion polls showing that Rousseff may lose the October Presidential election stirred gains in the stock market as investors look towards the reform potential if Socialist Party candidate Marina Silva was to win.

Silva's candidacy is attracting support and is now seen as a credible alternative among the middle classes, discouraged by 20 years of rule by the Workers' Party and Social Democratic Party. Meanwhile, Rousseff is increasingly viewed as someone who offers little but a continuation of interventionist policies.

Silva is expected to improve fiscal discipline and deliver a more efficient public sector (including the creation of a body to assess and control public expenditure). Among other expectations is transparent tax reform, a fight against increased inflation (4.5% in spite of price deregulation), the gradual reduction of government loans (to improve productivity, investment and competition) and the return of the floating exchange rate regime. A Silva election success is seen by markets as one that would impact positively on the economy.

The appetite for reform among investors is evident in the stock market gains or declines that meet rises and falls in support for Marina Silva.

China is the long-standing great hope of investors in the emerging markets and there are signs that it is now making the reforms required to propel its economy to the next level. The administration of Xi Jinping has announced 130 reforms since the Third Plenum in late 2013. The aim of these reforms is not more vigorous growth, unlike the goal of most emerging economies, but rather to develop a more durable economy that is better balanced. The reforms look to transform its business model and state-owned export-oriented industry towards a more services and domestic consumption driven model. The purpose of this is to make the economy less sensitive to external shocks. It also aims to reduce poverty levels, particularly in rural China.

Notable among these reforms are:

- A transformation of state-owned enterprises by encouraging the sale of assets and inviting private investment.
- Liberalization of financial markets, including the floating of the renminbi and the gradual connection of the Shanghai and Hong Kong stock exchanges that will allow for outside investment into China and vice-versa.

However, this financial reform comes with the risk of stoking a real estate crisis as it indirectly remains the main destination of Chinese household savings.

China has little room for error and must resolutely support the pace of change through the coming years as its population is aging rapidly. Its social security system will be overhauled, but the pension system is still in an embryonic state.

How can Investors Benefit from Reforms?

Stephane: Reforms impact the markets in two distinct ways. Individual EM markets can be more sensitive to country-specific events and reforms than developed countries.

A decline in the risk premium that typically accompanies reform benefits the whole market. Reforms can also bolster future earnings growth, which can benefit some companies or sectors more than others. It can be difficult to price these reforms, which are generally spread out over time and their impact depends on the ability of states to successfully implement them.

Moreover, these countries understand the importance of strategic reforms, but tactical, internal and external factors also determine the response of stock markets.

As investors, this is why we believe a combination of fundamental and quantitative techniques can help optimise returns from equity investments, with multi-dimensional or multi-factor approaches being rewarded. Moreover, it is the most crucial reforms and ones that take longest to implement that can prove the most difficult for the markets to price. These include reforms that focus on education and research, and are designed to make emerging markets as economically 'sophisticated' as their developed market counterparts. In the EM universe, giving greater weight within an investment model to countries undertaking reforms makes sense.

Olivier: In the Eurozone, the situation is that bit different. All countries are reforming at some level, but some reforms may have a greater impact at a stock or sector level. Reforms affecting healthcare may boost pharmaceutical stocks while country specific reforms may benefit companies that are more leveraged to domestic demand. Reforms generally have the effect of boosting company cash flows. There is a slightly different dynamic at play in the Eurozone periphery at present, where a post-crisis recovery is ongoing. Given the largely domestic orientation of small-cap stocks, these may present one way for investors to benefit from specific changes to boost economic activity within particular countries.

[1] For period 30 June 2012 to 31 August 2014. Source: Factset.