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MARKET INSIGHT

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EMERGING MARKETS: THE AGE OF OUTPERFORMANCE

Emerging market (EM) equities have returned the strongest year-to-date performances among global equity markets in 2017, surging by 31%[1]. In comparison, developed market (DM) equities have returned +16%[2] over the same period. Analysts agree on the fact that this incredible rally is attributable to Chinese growth stabilising, coupled with a weak US dollar, low US rates and increased investor appetite for risky assets. The main question which now dominates investment discussions is whether this asset class harbours further potential upside.

Historically, performance cycles among EM equities relative to DM equities last 5 to 8 years. For example, from 2002-2010 EMs outperformed DMs by almost 300%, despite falling by more than 50% in 2008 during the global financial crisis. In 2011-2015, the relative trend inverted, with EMs underperforming DMs by almost 70%. We believe that since the beginning of 2016, a new outperformance cycle has begun, with EM equities already outperforming by 20%. Our hypothesis is that the relative appeal of EMs is founded primarily on strong economic growth and bullish corporate profit momentum. From 2011 to 2015, tighter financial conditions among EMs, falling commodity prices and weaker EM currencies led to a contraction in earnings with lower growth than that witnessed in developed countries. Q1 2016 marked a turning point and a return of positive earnings momentum, which should prove durable and support the equity outperformance cycle.

The global macroeconomic context continues to provide a bullish landscape for EMs. Without the implementation of the reflationary policies announced by President Trump, US rates can steepen only moderately and the US dollar will remain under pressure. Inflation among emerging economies has eroded, enabling the central banks to maintain their accommodative monetary policies. Meanwhile, emerging currencies remain undervalued on average, compared with their equilibrium price based on purchasing power parity. The growth rate among emerging economies is therefore currently double that of developed countries, and the spread is expected to widen to 3.3% in 2021 according to the IMF.

The Chinese economy grew by 6.9% in H1 2017, allaying fears of a rapid slowdown to 5%. The real-estate market remains buoyed by low mortgage rates, despite steeper interbank rates. The forthcoming transition towards a new political leadership supports our hypothesis that the economy should continue to expand at a decent rate over the medium term.

Consensus forecasts predict earnings per share (EPS) growth among EMs of 20.6% in 2017, and 12.3%[3] in 2018, which is significantly higher than that of DMs. In addition to the favourable macroeconomic environment, there has so far been only a slight uptick in corporate earnings, whereas companies harbour strong operational and financial leverage, which should enable them to increase their margins over the medium term. We believe that growth in excess of 10% in 2018 remains plausible, which bodes well for EMs. These forecasts nonetheless incur a high concentration risk, as they are 68% based on four Asian countries[4] (China, India, Korea and Taiwan) and on three sectors[5] (tech stocks, financials and consumer discretionary).

Valuation is a further argument often cited to highlight the relative appeal of emerging equities. We believe, however, that valuation is not a particularly pertinent approach, as there have been significant changes in this asset class in terms of regional and sector composition. For example, the earnings contribution from commodities companies has fallen from 44% in 2003 to 15% today. Changes in valuation multiples are therefore partially attributable to modifications in the index, which obscures historical comparisons. Over the shorter term, since the lows recorded during Q3 2011, the structural discount observed among EMs compared with DMs has widened by 8%[6]. Although emerging equity valuations have increased since 2016, driving the forward price/earnings ratio up from 11.2x to 12.7x, multiples nonetheless remain relatively attractive.

Asset allocation factors must also be taken into account. In 2015, emerging equities recorded outflows of 64 billion USD, followed by an almost stable year in 2016. The asset class then saw inflows of almost 62 billion USD in 2017[7]. Despite this considerable return of capital, inflows since 2016 represent only just over half of outflow recorded since 2013. Furthermore, portfolio managers remain globally 50% underweight in this asset class[8]. Economic and earnings momentum should continue to attract investors, who are currently underexposed to this market, and support the bullish trend.

What about adopting a positive investment opinion on EMs? Most investors gain exposure to emerging equities through vehicles, funds or ETFs which track or replicate the MSCI Emerging Markets index (MSCI EM), which is the benchmark in this asset class. It is therefore important to highlight the structural defaults within this index, particularly its regional and sector concentration, which contrast with the potential diversity in the emerging investments universe. The index is 65% concentrated on four Asian countries, namely China (30%), Korea (15%), Taiwan (11%) and India (9%). The index is even more concentrated in terms of sectors, with a 28% weighting in tech stocks, 23% in financials and 10% consumer discretionary. Lastly, 16% of the index is concentrated on the four tech stocks, Tencent, Samsung Electronics, Alibaba and Taiwan Semiconductor. Besides its lack of diversification, 27% of MSCI EM index components are state-owned enterprises, which are less profitable and less well-managed, which represents a major inefficiency. We believe that it is in investors' interests to opt for a different approach from the passive MSCI EM indexation, in order to gain diversified and efficient exposure to EMs.

Although emerging equities contribute almost 60% of global GDP, they represent only 11% of global equities. For decades now, investors have been attracted by the EM growth premium based on the structural rise in domestic consumption, coupled with favourable demographic dynamics and developing political and social institutions. Despite the structural popularity of passive investment techniques, studies have demonstrated that the vast majority of actively managed emerging equity funds outperform the MSCI EM index, which proves the potential for alpha generation within this asset class. Today, investors can benefit from a variety of approaches, including regional or country allocation, core-satellite strategies, actively managed funds which buck the index-based focus, or smart beta instruments which passively replicate an alternative "intelligent" index.

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"We believe that since the beginning of 2016, a new outperformance cycle has begun, with EM equities already outperforming by 20%."

1 MSCI Emerging Markets index in USD on 22 September 2017. Source: Bloomberg, MSCI
2 MSCI World index in USD on 22 September 2017. Source: Bloomberg, MSCI
3 Source: I/B/E/S, MSCI, J.P. Morgan forecasts on 21 September 2017
4 Contribution to 2018 EPS growth forecasts: China 34.7%, India 13.5%, Korea 10.9%, Taiwan 7.3%
5 Contribution to 2018 EPS growth forecasts: tech stocks 28.7%, financials 17.9%, discretionary consumer 17.7%
6 Forward price/earnings ratio (PE forward) Source: Bloomberg
7 Source: EPFR Global, J.P. Morgan research
8 Source: EPFR Global, Thomson Reuters Datastream, HSBC research

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