EMERGING MARKET EQUITIES OUTLOOK:
SOME THINGS LOOK CHEAP FOR A REASON

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Historically, EM equities enjoyed a bull market every five or six years, often as a lagged 'high beta' play following positive performance in developed markets. At this time last year, it seemed like EM equities' time had arrived, but that turned out to be a mistake, with the exception of India. With the benefit of hindsight, the last EM equity bull market peaked on 17 February last year led by regulatory developments in China.

Also, while huge global monetary accommodation provided a supportive backdrop for EM economic stabilisation, there was an unequal global rollout of COVID-19 vaccines across EM and, therefore, the economic equality gap within it has worsened.

The US dollar was also a drag on the asset class. It could continue to see moderate strength versus most EM currencies until at least mid-year, after which it may weaken as November's American mid-term elections approach.

The Chinese yuan, which was trading around CNY 6.39/US$ towards the end of November, 2021, having strengthened from close to CNY 7.17/US$ at the end of May, 2020, has been one of the key stabilisers for EM currencies overall. The appreciation has allowed China to avoid the moniker of 'currency manipulator', but could have run its course with the CFETS yuan index hitting all-time highs last year. If the Chinese currency reverses course, that could bring forth another period of EM currency weakness.

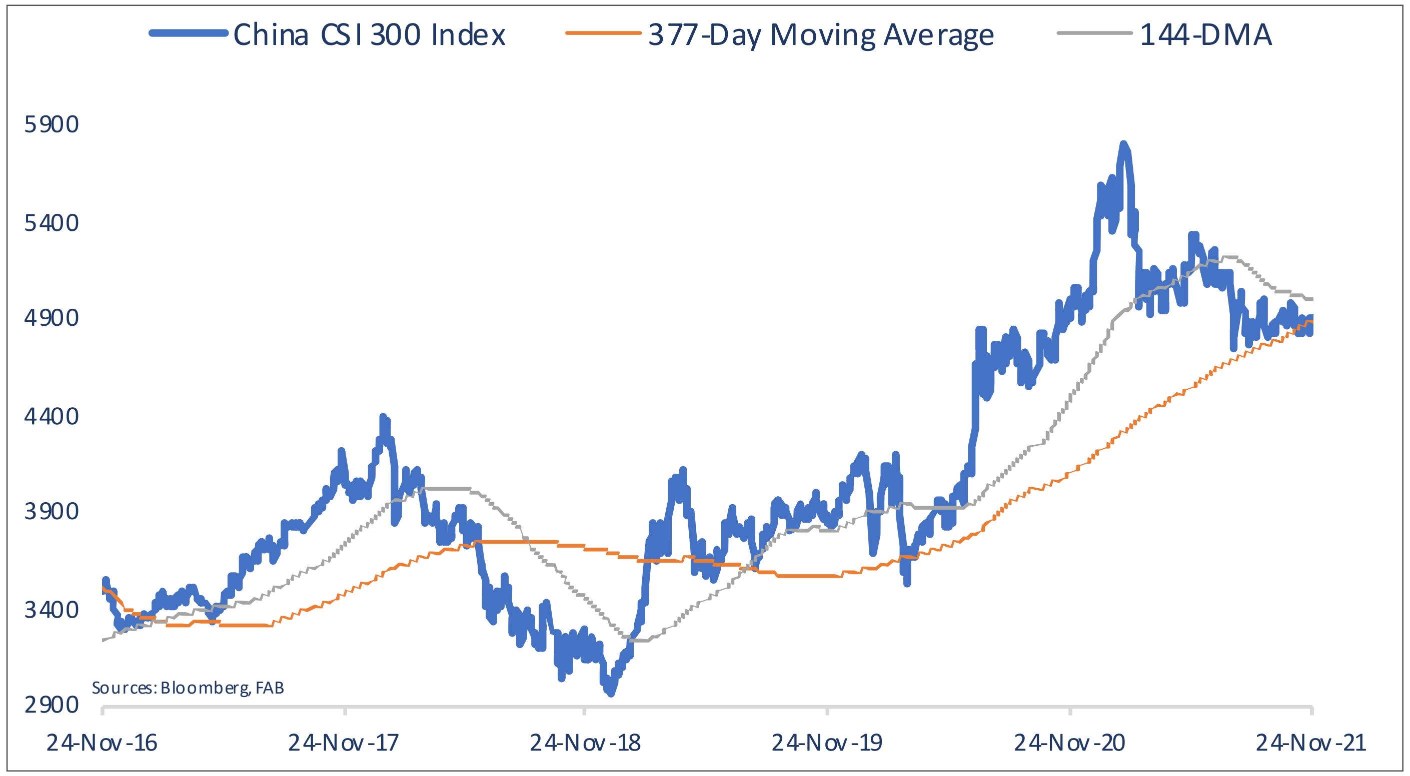
Global allocators should probably always expect EM equities to trade at a large discount to developed country equities, and last year was a salutary reminder of this – the only apparent exception being India. Indeed, around the end of November 2021, the CSI 300 index of Chinese stocks was 6.16% lower in local currency terms and down 4.11% in US dollar terms for the year. Driven by its exposure to semiconductors, Taiwan was 19.5% ahead in local terms. Indian equities were up 24.89% in local terms. At the other end of the scale, Brazil (as measured by the Bovespa Index) was down 13.43% in local terms and 19.94% lower in US dollar terms given the depreciation of the Brazilian real.

In its October update, the IMF wrote that it expected emerging economies to grow 6.4% in 2021 followed by 5.1% in 2022. The IMF, however, is likely to revise its China forecasts downwards as the 8% expansion forecast for 2021 and 5.6% for 2022 were already out of date when they were published. The China Caixin Composite PMI for October came in at 51.5, registering moderate industrial expansion confirmed by the official equivalent data at 50.8, and these taken together might equate to current annualised GDP growth of 2%-3%. Accordingly, EM growth should come closer to the IMF forecasts for advanced economies, which stand at 5.2% and 4.5% for those years respectively.

The Bloomberg consensus earnings estimates for Chinese stocks and hence the MSCI EM Index are by their nature rather faster-moving than GDP data. In late 2021, market earnings expectations for EM equities as a class for 2022 and 2023 were for growth of 5.5% followed by 10.2% for those years for prospective P/E ratios of 12.63x and 11.46x respectively. This compares to 6.5% for developed equities for 2022 followed by 8.1% for 2023.

Expected corporate earnings growth is therefore expected to be one percentage point lower for EM than for developed countries in 2022, and just over two percentage points better in 2023. Based on the consensus, therefore, the discount of EM equities to developed markets from a forward price-to-earnings perspective is 33.6% for 2022 and 34.9% for 2023.

It may sound like a steep discount, but it does not automatically make EM equities cheap. Historically, it was correct to overweight EM equities when their prospective price-to-earnings discount to developed markets reached approximately 25%-26%, and to consider taking profits when the discount shrank to about 17%-18%. However, Chinese equities may have been the key to the gaping discount last year, and there is still plenty of uncertainty about Beijing's policies.



The recent country constituents of EM equities as defined by MSCI are as follows: China (32.47% of the total); Taiwan (14.66%); India (12.05%); South Korea (11.80%); Brazil (3.88%); Russia (3.68%); Saudi Arabia (3.38%); South Africa (3.02%); and Hong Kong (2.12%); followed by the UAE; Qatar; and Kuwait at sub-1% weights.

Although China is by far the largest constituent of EM equities, it represents just 3.76% of global equity capitalisation as measured by the MSCI All Country World Index (down from close to 4.8% a year ago). EM equities therefore represent just under 11.6% of global equity value, a relatively small amount. The sectoral allocation across EM equities is as follows: Internet (14.88%); Semiconductors (13.42%); Banks (12.18%); Oil & Gas (5.25%); Financial Services (4.76%); Telecoms (3.72%); Autos (3.24%); followed by Chemicals; Retail; and Computers.

Even after the fall in the market values of the largest-cap Chinese technology stocks, technology remains dominant, and a far cry from the 'Old EM World' in which basic materials dominated.

China

China's tougher regulation of education and tech companies plus the woes of its property sector have taken a toll on the market. Earnings estimate revision trends for China's CSI 300 Index, for instance, are still weakening, and Bloomberg consensus earnings growth estimates of 15.8% and 13.9% for 2022 and 2023 respectively, which imply forward price-to-earnings ratios of 13.45x and 11.81x for those years, may be too bullish.

Taiwan

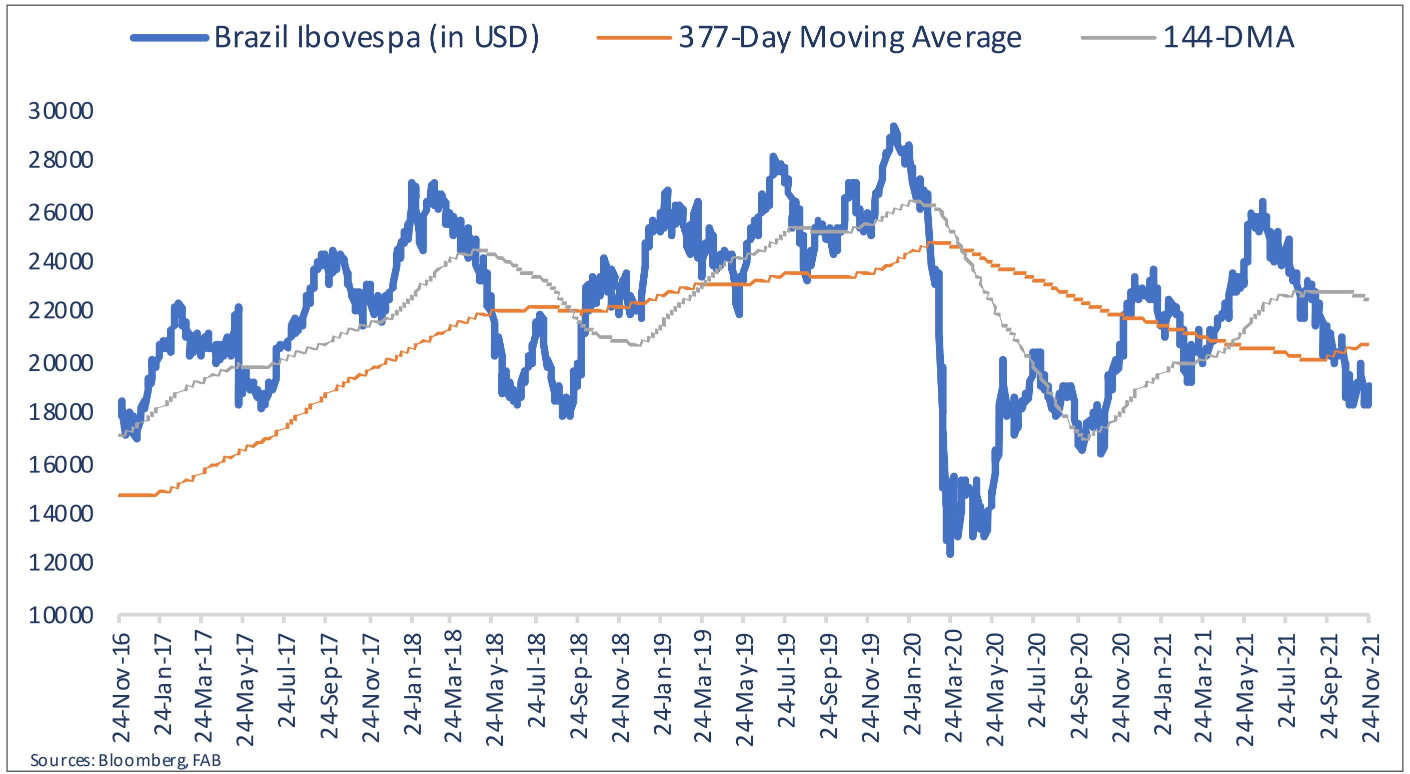
The second-largest member of the MSCI EM is Taiwan. The IMF expected its growth to be 5.9% in 2021, moderating to 3.3% in 2022. As with China, those estimates may be on the high side. According to the Bloomberg consensus, earnings for the MSCI Taiwan Index are expected to drop by 1.07% in 2022 followed by growth of 5.1% in 2023. The resulting P/E ratios are 14.96x for 2022 and 14.23x, respectively. These estimates, driven by semiconductors, make sense, but the appropriate political risk discount for Taiwan is unclear.

South Korea

The MSCI South Korea Index was trading at 10.55x earnings for 2022 in November, based on a forecast earnings contraction of 4.4%, resulting from continued supply chain disruptions and especially affecting semiconductors (which account for 28.1% of the index). Earnings growth is slated to resume at 9.4% in 2023 for a prospective P/E of 9.64x, with the low P/E probably reflecting cyclicality.

Brazil

The MSCI Brazil Index is, according to the Bloomberg consensus, priced for an earnings contraction of 14.1% in 2022 followed by earnings growth of a lowly 2.7% in 2023 for P/Es of 7.36x and 7.16x respectively. In this instance, part of reason for the P/Es being in single-digits presumably reflects uncertainty regarding the currency outlook derived from the politics around presidential elections in 2022.



Sources: Bloomberg, FAB

India

According to the IMF, India's real GDP is expected to grow at 9.5% and 8.5% in fiscal 2021-22 and 2022-23 respectively, and it could be one of the fastest growing economies globally. India could generate compound growth of as in 5%-6% per year for the next few decades. The country should become a US$5 trillion economy by 2024-25 and, by 2030, it could become the world's third largest after the US and China, a leap from its current position as sixth. The middle class is growing strongly, fuelled by urbanisation, and the economy is benefitting from rapid digitisation and new technologies.

Among emerging and developing countries, India is the largest exporter of services within a grouping known mostly for exports of manufactured goods or commodities. Annual exports of close to US$310 billion are driven primarily by software services. India's foreign reserves are at an all-time high of US$642 billion equivalent, US$60 billion of which was added during the first seven months of fiscal year 2021-22.

Inflation can be a problem at times, and and was running at 4.5% in October, 2021. However, this is a phase that successful emerging countries tend to go through while they develop and assets get allocated. If oil prices move higher, inflation could be higher than is desirable and could lead to higher interest rates. On the other hand, India's economy has been quick to recover from the pandemic with more than 1 billion doses administered and around 500 million people fully vaccinated as of the end of November 2021.

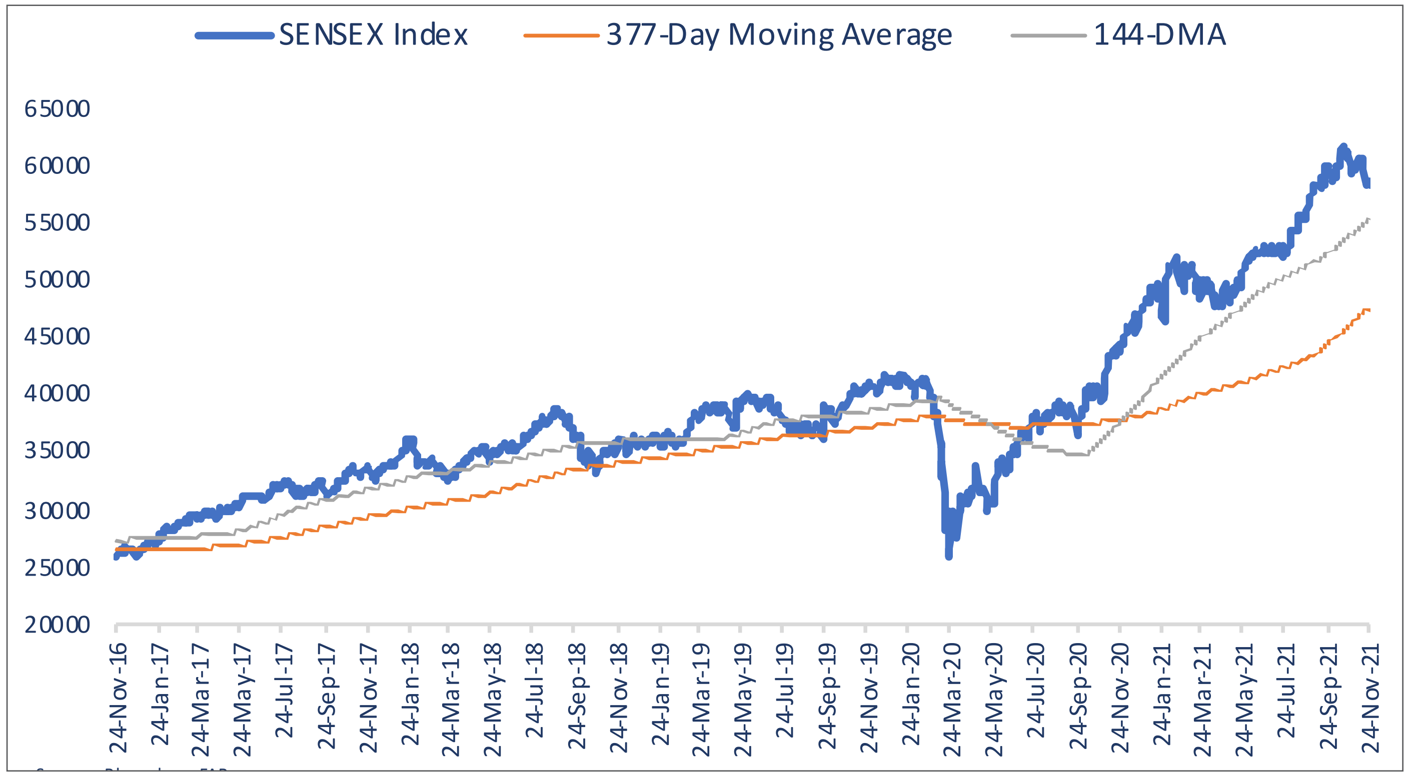
India is generating many exciting business start-ups, and recently had more than 70 'unicorns' (defined as young companies that achieve a valuation in excess of US$1 billion), with the potential for this number to grow continually in the years to come. Unsurprisingly, many of these are new generation technology companies. Indian companies tend to be well-managed and borne out of a uniquely entrepreneurial mindset. India is a global leader in software, pharmaceuticals and automotive-ancillary industries.

An increasing number of first-time investors are entering the market as reflected in the 14.2 million new domestic accounts opened in fiscal 2020-21, taking the total number to 70 million. Furthermore, systematic investment plans alone result in about US$1.3 billion of monthly inflows into mutual funds, and this reduces market volatility. Previously, the market was overly-dependent on net foreign inflows.

Given the high returns on equity (often higher than 20%) achieved by many quoted companies, Indian equities have traded at a premium to other emerging markets and forward P/E ratios of 20x or above for India have become the norm. Seasoned investors know this underlines investor confidence, sound regulation, transparency and good corporate governance.

India was one of the best-performing markets last year, with the S&P BSE SENSEX Index up by 23% in early December. Over the past 10 years, the Indian market has generated close to a 10% compound annual return in US dollar terms, compared to 5% for the MSCI EM Index.

In Indian equities, the Bloomberg consensus for earnings growth on the SENSEX Index stands at 17.4% for 2022-23 followed by 15.6% for 2023-24, resulting in P/E ratios of 21.63x and 18.70x respectively. That does not look expensive, and it merely underlines the growth that is likely.



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