EM EQUITIES
OUTLOOK
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The Investment Case for EM:

Huge global monetary accommodation has provided a supportive backdrop for EM economic stabilisation. The IMF expects emerging nations to grow by 6% in 2021, compared to 3.9% for advanced economies. From 2Q21, global GDP and earnings beats should drive EM equity prices higher, also, given the asset class is seen as a high-beta.

EM equities tend to enjoy a bull market every six or seven years, and we believe that time may have arrived. Historically, it has been correct to overweight EM when its prospective P/E discount to developed markets exceeds 25%. However, investors should become wary of the asset class when that discount narrows towards 18%-19%. The EM P/E discount to developed is 26.8% for 2021, and 27.5% for 2022, making EM equities attractive.

Spreads in EM debt markets are also expected to tighten during 2021, helping to increase equity risk premiums, making stocks more attractive. In addition, 'Value' as an equity style has resurfaced, and expected higher commodity prices should drive this in EM during 2021.

Even so, given the high probability of an unequal global rollout of Covid-19 vaccines, it is expected that the economic equality gap will worsen between emerging markets and developed nations. New coronavirus cases in EM grew by 11.3 million in the third quarter of 2020, three times the number of cases in 1Q20 and 2Q20, and far exceeding the pace of increase in the developed nations.

The North Asian nations, however, have dealt with the situation very well. EM countries that have most successfully handled Covid-19 include China, Vietnam, and South Korea, suggesting a potentially faster economic recovery in those countries. Meanwhile, the opposite appears to be the case in Russia and Brazil. South Africa has managed to contain the virus effectively, enabling the reopening of the economy, and the improving current account balance has made it less vulnerable to capital outflows.

However, monetary policy across EM still faces credibility issues, while fiscal policy is coming up against market and debt constraints, hampering governments' responses to the pandemic. Many of the currencies of EM countries saw serious depreciations in 2020, sometimes completely erasing what could have otherwise been winning years.

The Brazilian stock index the Ibovespa, for instance, was up 2% for the year on 18 December in local currency terms, but when expressed in US dollars, it was down 19.6%. The exchange translation worked the other way around for some markets. The Chinese yuan appreciated by nearly 6.5%, helping the CSI 300 gain 30.9% through 18 December in dollar terms.

The weight of the Chinese index in EM and the dynamic above explains why the MSCI EM index returned 15.84% in 2020, slightly better than developed market equities as measured by the MSCI World Index, which returned 14.06%. Similarly, since the 23 March low, developed markets have risen 67.91%, and EM has risen 70.31%.

That outperformance should improve this year as the currency losses continue to reverse, and, EM economies benefit from a rebound in manufacturing, which is likely to increase the demand for commodities. At the end of 2020, a technical reading of the MSCI EM Currencies Index suggested a long-term bullish configuration, and a break above its previous all-time high of April 2018 seemed imminent, helped by fundamental dollar weakness.

The EM Drivers

China drove 35% of the EM equities recovery since 23 March, and approximately 30% came from South Korea and Taiwan combined. The main reason for these countries' leadership is that they host top-notch advanced technology industries. Alibaba, Tencent, and Meituan were collectively responsible for some 90% of total Chinese performance attribution, and about one third of total MSCI EM Index return.

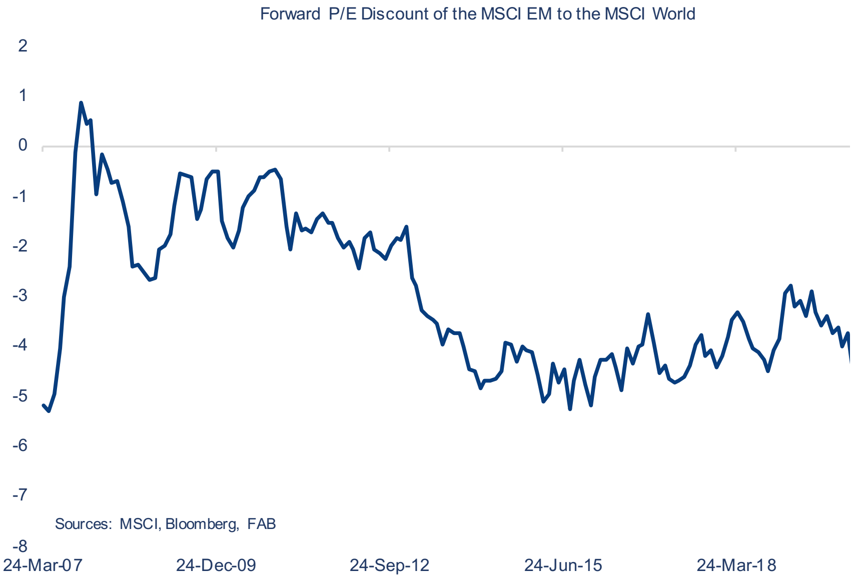
China has a dominant weight of 40.95% in the MSCI EM Index (43.24% including Hong Kong), comparable with its weight of 37.26% of GDP within MSCI EM countries. The second largest is Taiwan, with a 12.67% weight in the index, yet only 1.73% of GDP in EM. The third largest is South Korea, at 11.9% of the index, and 3.09% of GDP. India is the fourth largest constituent of the index, at 8.15%, and 15.17% of GDP. Brazil is 4.39% of the index, and approximately the same GDP share, followed by South Africa, Russia, and Saudi Arabia. Saudi Arabia has a weight of 2.66% in the index, and the UAE has a 0.52% weight.

During the last decade or so, raw materials have become far less important (now at 6.84% of the total value) than they once were within the overall EM index. Information technology has grown substantially, and is now 18.42% of quoted MSCI EM value, via the rise of Chinese, Taiwanese, and South Korean tech stocks.

China

Chinese stocks account for just under 4.8% of the MSCI All Country Index, and with the authorities there meeting more index trackers' requirements, over time, many global investors have little choice but to attempt to understand the sub-asset class better and to make larger allocations. The Shanghai Shenzhen CSI 300 Index is trading at a P/E ratio of 14.2x for 2021, and 12.5x for 2022, assuming earnings growth of 17.6% and 14% respectively. Importantly, earnings estimates appear to have bottomed, and prospective PE-to-Growth (PEG) ratios offer very good value at below one.

The Chinese economy has rebounded quickly. Consumer confidence continues to recover, helped by the Chinese authorities managing to keep daily new coronavirus cases extremely low over recent months. Retail sales turned positive on a year-on-year basis in August, and services PMIs continue to be very healthy. Road traffic congestion, auto sales, housing transactions, and other high-frequency indicators have also confirmed the economic recovery. The IMF expects China to have grown by 1.9% in 2020, excellent under the circumstances, and to rebound to 8.2% in 2021, stabilising at 5.5% by 2025. Continued disagreements between the US and China could remain a significant risk in 2021, although these may moderate with Joe Biden in the White House.



Taiwan

The MSCI Taiwan Index is dominated by semiconductors (36.8% of the total) and electronics and computers (19.2%). The index is trading at a prospective P/E ratio of 17.6x for 2021, and 15.9x for 2022, assuming earnings growth of 13.6% and 10.5% respectively.

Taiwan is the only country that has successfully limited the spread of the pandemic without resorting to lockdowns. It has begun to take advantage of renewed technology demand and global manufacturing recovery.

Exports have recently been positive year-on-year, supporting the economy, which the IMF estimates to have been flat in 2020, although the government says the IMF assessment undervalues its economy. The IMF expects growth of 3.2% in 2021, moderating to slightly above 2% in 2025, which appears too low to us. Taiwan's manufacturers are currently shifting their factories back to the country from China. It is also possible they will open new facilities in the US (in the case of Taiwan Semiconductors), which is beneficial to their local suppliers.

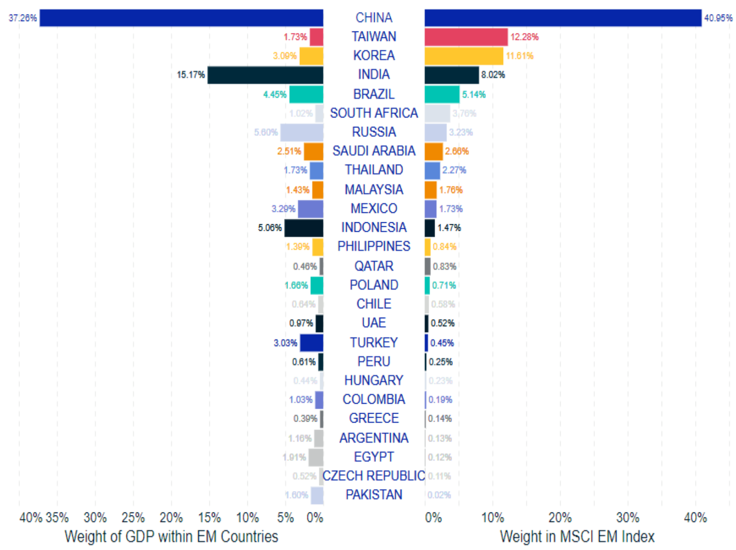
South Korea

The major constituents of the MSCI Korea Index are semiconductors (29.4%), and internet stocks (7.1%). The index is trading at a P/E ratio of 13.3x for 2021, and only 11.1x for 2022, based on consensus earnings growth of 41.8% and 20.1% respectively. While global investors usually value semiconductor companies conservatively, and despite the recent excellent performance of the index, South Korean equities as a class appear to offer good value, underpinned by very low PEG ratios, and are likely to be supported by strengthening global manufacturing demand in 2021.

The country's successful containment of the pandemic has enabled its economy to be extraordinarily resilient. The IMF expects GDP contraction of only 1.9% for 2020, followed by growth of 2.9% in 2021, moderating to 2% in 2025. Life in South Korea is almost back to pre-Covid levels, a major contrast to much of the rest of the world. Its manufacturers are broadly competitive, and their supply chains have been substantially restored, with exports back to pre-pandemic levels.

India

India has been the third hardest-hit country globally by the pandemic, and the IMF is forecasting a contraction of 10.3% in GDP for the 2020-21 fiscal year. Nonetheless, inflation has increased to above 7%, driven by higher food, gold, and transportation prices. The RBI believes the rise in inflation is temporary, and doubled its QE purchases. The states are expected to fund deficits via debt issuance. The national fiscal deficit may exceed 12% of GDP in the current year. Keeping the economy mostly open, however, has helped recovery, with the IMF forecasting GDP growth of 8.8% in 2021-22, moderating to 7.2% by 2025.



The Sensex Index is up 77.4% since 23 March in local currency terms, with investors focused on leveraged earnings recovery. It is trading at a P/E ratio of 20.7x for 2021-22, and 17.0x for the following year, based on consensus earnings growth of 36.7% and 21.6%. Earnings estimate revisions appear to have bottomed, and the PEG ratios suggest good value. Investors should benefit from the increasing realisation of India's economic potential.

Brazil:

An increase in IPOs appears to be around the corner in the Brazilian equity market, with 60 or so Brazilian private companies worth approximately US$20 billion contemplating going public. The MSCI Brazil Index is trading at a prospective P/E of 12.7x for 2021, and 11.7x for 2022, based on earnings growth off a very low base for the former, and of 9.0% in 2022. The index has 17.6% in iron and steel, 16.7% in banks, and 13.0% in oil and gas. Earnings and valuations have been complicated by large moves in the Brazilian real.

Covid-19 has, to date, arguably tormented Brazil more than any country in the world, and the IMF forecasts a contraction of 5.8% to the economy for 2020, followed by a moderate recovery to 2.8% growth in 2021. The country's fiscal situation improved in 2020 on the back of pension reform. Furthermore, general tax reform is possible in 2021, capable of enhancing Brazil's international competitiveness and reducing concern about its public debt.