Emerging Markets and the Return of Volatility

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The resurgence in volatility over the course of the last few months has created an opportunity to acquire Emerging Market companies with a sustainable growth outlook

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Introduction

After experiencing a closing low in early January, the VIX – which is the common measure of volatility in the US stock market – began a moderate climb towards the end of the month prior to exploding on the upside in early February. In the last two months, the VIX has traded at levels not encountered for two years, and not consistently exceeded since 2011. In such an environment, many would expect Emerging Markets (EM) equities to underperform (as they did from 2011) and the US dollar to gain notably (as it did from 2011).

So far this year, however, this has not been the case. Emerging Markets have remained encouragingly stable, with a flat return in USD terms. This is in line with major global equity markets, while the average EM currency has fallen only marginally against the US Dollar.

Source: MSCI, USD (Net), as at 3 April 2018. Past performance is not indicative of future results. Inherent in any investment is the possibility of loss.

The main cause of this bumpy environment is the fear that rising growth in the US will lead to higher inflation. This would likely force the new Federal Reserve Chair Jerome Powell to raise policy rates by more than the market originally thought.

Adding to this more cautious environment has been the imposition of steel and aluminium tariffs by the US on China and other economies, affecting $50 billion worth of Chinese exports. This has been followed by retaliatory measures of a similar volume for China's imports from the US.

What this means for Emerging Market equities

In our view, the investment case for the asset class remains resilient, essentially for the same three reasons we have remained bullish over the course of the last two years:

- Emerging economies are recovering
- Corporate profits are growing at a faster rate than experienced for most of the last decade
- EM currencies remain competitive despite their recovery over the past two years

In addition to this, the asset class is inexpensive relative to its own past and cheap relative to US equities in particular. It remains under owned by international investors.

A deeper dive into the fundamentals

From 2011 to 2015, the average economic growth rate across Emerging Market economies declined from 8% to 4%. With a recovery from 2016 in the economies of the US, the Eurozone and to a lesser extent Japan, the global trade cycle resumed. The fall in most EM currencies over the 2011 to 2015 period, especially against the US dollar, meant that these economies were competitively-placed to capitalise on renewed demand. In addition to this, domestic demand has since recovered with the credit cycle and the return of consumer confidence. Equity markets in general, and emerging markets in particular, rarely peak when economic growth is strengthening. The market expects growth to reach 5% this and next year. This recovery and a sense of greater stability have been factored in by EM fixed income markets, where spreads compared with the US have fallen sharply over the last two years.

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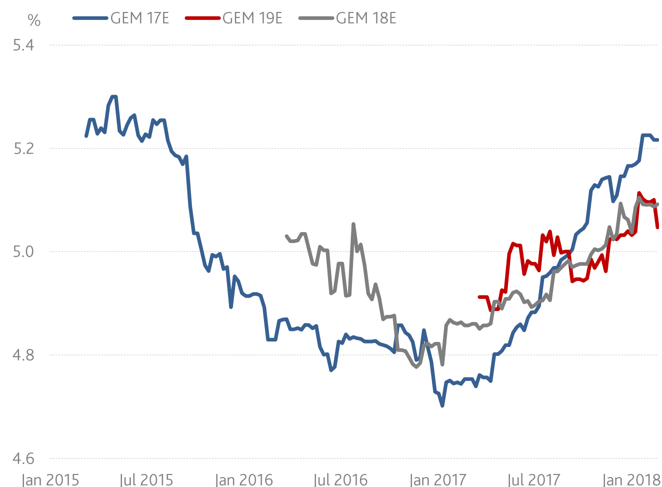
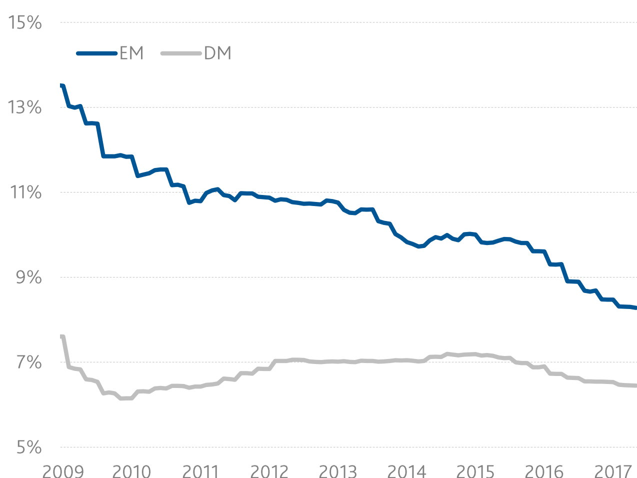
EM (GDP weighted) consensus real GDP growth forecast



Source: MSCI, Credit Suisse, as at 2 March 2018. Past performance is not indicative of future results. Inherent in any investment is the possibility of loss.

From the perspective of the bottom line, company profits have benefited from the sales growth as economies have recovered. In addition, pricing power has returned. This has been helped by the recovery in China's export prices: the country is now exporting inflation rather than deflation. Greater discipline across emerging economies has meant slower growth in capital expenditures. This therefore, brings an end to a period in which capacity was being added to at a time of slowing demand thereby eroding pricing power.

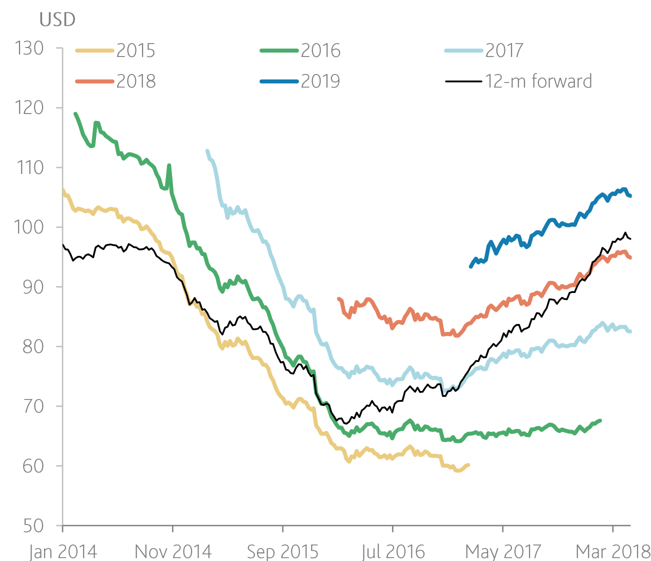
Capex to sales, excluding financials



Source: Credit Suisse, as at 1 April 2018. Past performance is not indicative of future results. Inherent in any investment is the possibility of loss.

As bottom up investors, our discussions with companies have indicated a commendable caution in the face of stiffer economic headwinds. With the recovery now underway, we are seeing greater optimism, even though it is still tinged with caution. Wage moderation is also supporting profits: the labour market is typically late cycle, and wages are unlikely to be a concern for a few years, unlike in the US, where the labour market has been tightening. The profits recession of 2013 to 2016 was followed by a sharp recovery last year – earnings per share gained over 25% and it is expected to grow by a further 15% this year and next. These are healthy numbers and are also higher than those in developed markets. Earnings are also outperforming expectations: the six quarters to the third quarter of 2017 all saw more earnings beats than misses, although the fourth quarter showed a more mixed picture, signs for the most recent quarter are encouraging.

Earnings estimates are recovering



Source: Morgan Stanley, as at 19 April 2018; MSCI EM INDEX EPS. Past performance is not indicative of future results. Inherent in any investment is the possibility of loss.

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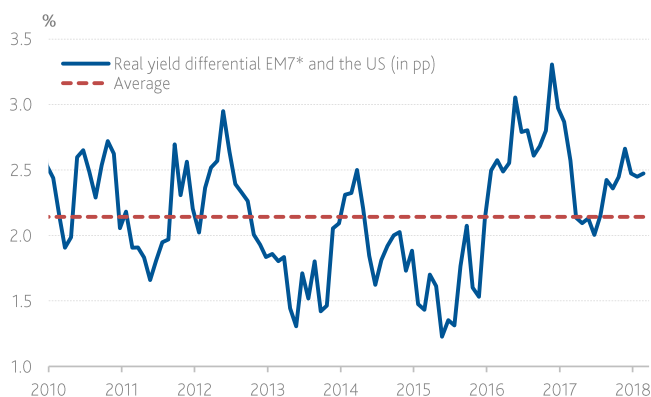
Over the last year or two, EM currencies have staged a gradual recovery as mentioned previously. However, as the chart below illustrates, they are still on average some 30% below the levels earlier this decade.

Source: Bloomberg, USD as at 3 April 2018. Past performance is not indicative of future results. Inherent in any investment is the possibility of loss.

We are not currency specialists, but we note that the current accounts of nearly all Emerging Market countries are in a healthy state – only 4 of the 24 countries in the index have a current account deficit of more than 3% of GDP as of the end of 2017, accounting for a weighting of only 1.7% in the MSCI EM index. The chart below shows that the real interest rate spread over the US is higher than average, which suggests there is still support for EM FX even as US rates rise further. The contrast with the 2011 to 2014 period, when the differential was much smaller, is clear. Even if we are slightly wrong, it's worth noting that historically emerging markets have outperformed even when the US$ rises marginally.

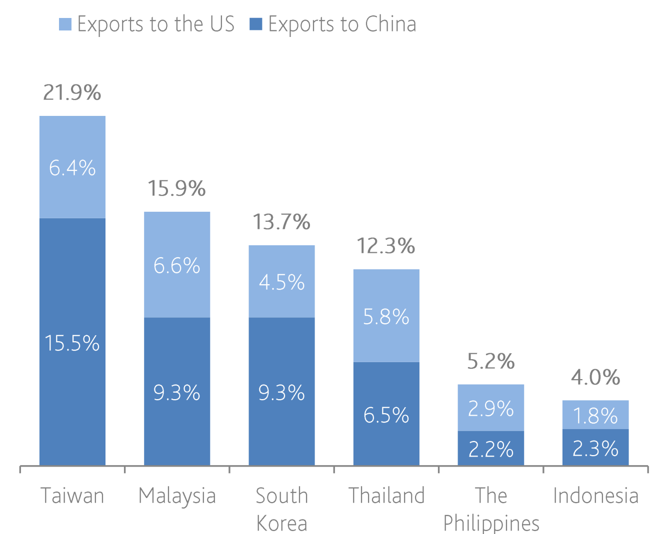


Source: Credit Suisse, as at 23 March 2018. Past performance is not indicative of future results. Inherent in any investment is the possibility of loss.

* Simple average of respective data for Brazil, Indonesia, Mexico, Poland, Russia, South Africa, Turkey

Turning to trade, whether this squabble turns out into an all-out trade war remains to be seen. We do not share President Trump's view that "trade wars are good, and easy to win". After all, the 1930s did not pan out especially well. Over the last two decades, emerging markets have been trading a lot more with each other and less with the US.

Ranking economies by their trade exposure to China and the US (% of GDP, 2017)



Source: CEIC, Morgan Stanley Research, as at 31 December 2017.

The chart above shows that the wealthier, more open economies generally trade more with the US than the less developed Asean economies. The categories subject to the tariffs account for below 0.3% of these countries' economies (apart from Malaysia, where the impact is somewhat higher), so a 25% tariff would have a limited impact.

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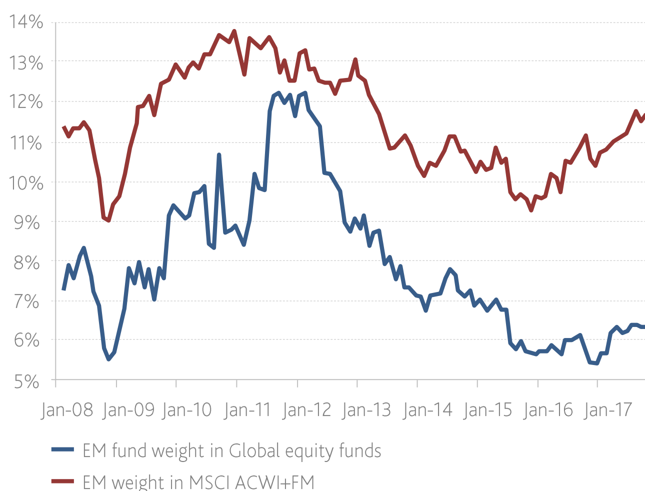
International investors are generally underweight EM equities at this time. Crucially, the extent of their underweight is greater than average. In the past, investors have generally missed turning points. They continued to buy when the market turned down in relative terms in 2011, before reversing and aggressively cutting positions from 2012. Likewise, as the bear market ended in 2016, their initial response was to continue to sell. Only from 2017 did they start to buy, but as the chart below shows, only to keep pace with the outperformance of Emerging Markets.

EM weights in Global portfolios – still underweight

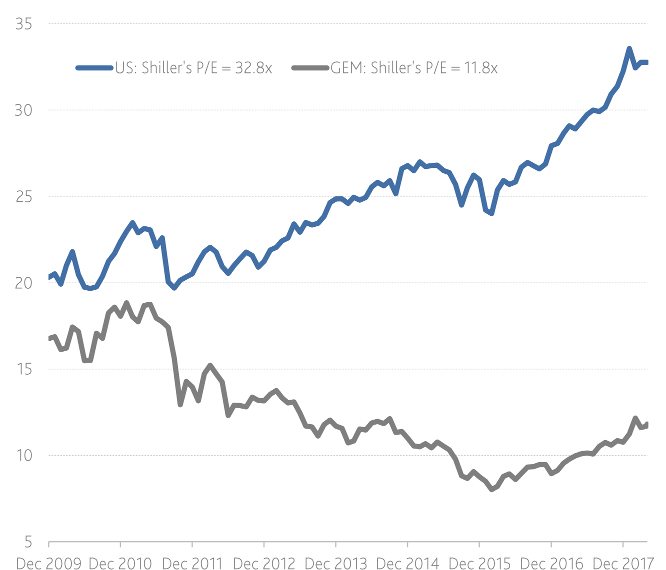


Source: Morgan Stanley, as at 16 November 2017; MSCI EM INDEX EPS. Past performance is not indicative of future results. Inherent in any investment is the possibility of loss.

To paraphrase from textbook economics, the relationship between Developed Markets (especially US) equities and those Emerging Markets equities can be viewed with reference to "income" and "substitution" effects. With respect to the first, we look at the total pool of liquidity available to global investors. The end of super easy money in the West suggests that the rate of increase of liquidity in capital markets as a whole is slower, even as the absolute amount of liquidity continues to grow. In this sense, the "income" effect is less positive than in the last 6 to 7 years. However, the reason for the end of this extraordinary monetary experiment is that the Western economies are recovering, which augurs for higher equity exposure at the expense of bonds. This is a "substitution" effect, and helps explain equity performance relative to bonds globally. Furthermore, a change in the relative attraction of EM verses US and Europe - based on changing fundamentals and valuations - is another substitution effect, as investors reallocate from more fully valued Western equities into Emerging markets.

Finally, valuations still remain relatively attractive in the asset class. The market may have risen, but so have earnings. The forward PER of the market is a modest 12-13x, a modest number. From a Shiller PE/CAPE perspective, the gap between EM and US valuations has widened considerably: the US is now on over 30x its CAPE, while EM is only 12x. Of course, this is partly a function of good earnings growth in the US and, until recently, the poor profits performance of Emerging Markets from 2012 to 2015. However, the gap is extreme, especially when one notices how narrow the gap was at the start of the decade. Looking at Price to Book, historic peaks in EM Equities (2000, 2007, 2010) are associated with PBRs of 2.1 to 3.1x, compared to the current value of around 1.7x. Furthermore, compared to the fall in interest rate spreads referred to earlier in this piece, the relative outperformance of Emerging Markets equities has been relatively muted.

Cyclically-adjusted PER differential – US looks stretched relative to EM, as QE is ending



Source: Credit Suisse, as at 2 April 2018. Past performance is not indicative of future results. Inherent in any investment is the possibility of loss.

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Conclusion

Emerging economies are an increasing engine of global growth. Accounting for 60% of the world's population and almost 50% of its economy, they only account for 12% of the global MSCI benchmark and less than 7% of the average portfolio measured against that index. Their stock markets have enjoyed a solid last two years, with the MSCI Emerging Markets index having gained around 50% since the start of 2016. However, most of the reasons for this – improved growth, the recovery in corporate profits and competitive currencies – still apply. From a valuation perspective, the markets have become more expensive – but not significantly so, because earnings growth has been strong over the last year and is expected to continue to be so. Despite the strong performance over the last two years, international investors continue to be underweight Emerging Market equities. Their recent outperformance barely registers on the longer term chart.

30 year EM vs S&P 500 – a turning point?

Source: Bloomberg, data as at December 2017. Past performance is not indicative of future results. Inherent in any investment is the possibility of loss.

The long term cycle of out- and underperformance of Emerging Markets is, in our view set to play out in the next few years, as investors allocate additional funds to the asset class.

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Index Definitions:

MSCI EM Index – The MSCI Emerging Markets Index is a float-adjusted market capitalization index that consists of indices in 23 emerging economies: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates.

MSCI World Index – The MSCI World Index is a stock market index made up of approximately 1,600 global stocks. It is often used as a common benchmark for 'world' or 'global' stock funds. The index comprises a collection of stocks of all the developed markets in the world, as defined by MSCI. The index includes stocks from 23 countries but excludes stocks from emerging and frontier economies. Index results assume the re-investment of all dividends and capital gains.

The S&P 500 is a stock market index made up of approximately 500 US large cap stocks. It is often used as a common benchmark for US stock funds. The index comprises a collection of stocks of 500 leading companies and captures 80% coverage of available market capitalization. Index results assume the re-investment of all dividends and capital gains.

JP Morgan EM Currency Index – This is a market-cap weighted index of 10 emerging market currencies versus the US dollar.

*It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns and will bear the cost of fees and expenses that will reduce returns.

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