



## Many lights have turned green

# Emerging equities are on their way back

- Short- and long-term prospects for emerging equities look good
- Reforms, valuations, earnings and monetary policies are in favor
- Concerns on China, US rates and politics are put into perspective

### Executive summary

We have turned tactically bullish on emerging markets equities. This means that we expect emerging equities to outperform developed equities both in the short and in the long term. In this outlook we will explain why and we will address the concerns investors have about this asset class.

Over the last six years we have witnessed a lot of negativism towards emerging markets. Fears of a Chinese economic hard landing, Brazilian political and corporate corruption scandals, Russian geopolitical issues and an African collapse at the end of the commodity boom era are just a few of the events that made the headlines and have created negative sentiment towards the asset class. All the events mentioned have led to a disappointing performance in emerging equity markets and a lot of investors have withdrawn from the asset class over the last couple of years.

### *Resilience*

After the recent UK referendum, however, emerging equity markets have proven to be resilient, both in absolute terms and compared with developed equity markets. The Brexit vote is obviously predominantly a European issue and from a fundamental point of view the



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Emerging Markets  
Equities

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'Rock bottom  
valuations  
offer buying  
opportunities'

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longer term effect on emerging markets is limited. Among all the global trading blocs it is Europe that will face the most uncertainty in terms of future political and macroeconomic developments. Also important, since most emerging currencies are far more correlated to the US dollar than the euro, emerging currencies should remain relatively immune to potential turmoil in Europe.

#### *Expected pick-up in earnings expectations bodes well for EM performance*

The main cause of the underperformance of the emerging equities asset class from late 2010 to late 2015 was that earnings were weak compared with developed markets. We expect better earnings ahead on the back of more favorable monetary policies and less pressure on emerging currencies. The reforms in China, India, Korea and Indonesia are also positive, both from a macroeconomic perspective and for financial markets.

Investors tend to focus on short-term macroeconomic indicators. In the short term China has its debt issues and challenges with regards to opening the country's financial markets to the world, resulting in currency volatility. From a long-term perspective though, the Chinese are world champions when it comes to long-term strategic plans. China is in transition: from the world's production hub supported by low wages, to a knowledge-based service economy. In order to achieve this goal, they are more and more open towards foreign capital, entrepreneurship and private capital. And the Chinese really think in terms of decades. Indeed, looking at the longer term, the Chinese economy is in a strong position, with a large emerging consumer class, vast amounts of foreign exchange reserves, a huge current account surplus and still the largest production hub in the world. For the long term we worry about the debt levels in the Chinese economy, but so does the government. For the time being, we foresee an increase in debt-to-GDP ratios, but for now the levels are below the levels of many other countries, both developed and emerging.

After six consecutive years of underperformance of emerging versus developed equity markets (measured from June 30, 2010 onwards, see Figure 1) current rock bottom valuations offer interesting buying opportunities.

Figure 1 | Performance emerging versus developed markets



Source: Bloomberg

### Three pros and three cons

There are three main arguments against and three arguments in favor of emerging equities. We will analyze each of them and provide our point of view.

The three main concerns investors have about emerging markets are:

1. China's economic slowdown, the build-up of debt over the last few years, and the weakening renminbi
2. Increase in US interest rates
3. Political turmoil and corruption issues

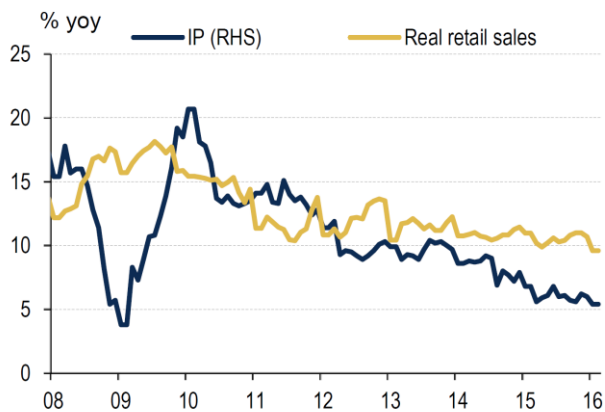
The main arguments pro emerging markets are:

4. Serious economic and corporate reforms in various countries
5. Attractive valuations and improving earnings revisions, allocation upside
6. A favorable monetary situation for time being

### 1. China's economic slowdown, the build-up of debt over the last few years, and the weakening renminbi

The Chinese economy has been slowing down since 2009, as illustrated in Figure 2. Both industrial production and retail sales have slowed down, although the consumer has held up much better.

Figure 2 | Chinese industrial production and retail sales



Source: BofA Merrill Lynch Global Research, CEIC

#### *Green shoots in the economy*

Still, we are starting to see some green shoots surfacing in China:

- After 18 months of declines, Chinese heavy duty truck wholesale volumes have recently risen by 27% yoy (+6.3% ytd)
- Chinese Property Fixed Asset Investment (FAI) rebounded to +3% yoy following a 2% yoy decline late last year

- Chinese cement producers have recently raised prices in East China by RMB 20/t (circa 9%-10%) – the second largest increase since 2011.

In April 2016 the official NBS manufacturing Purchasing Managers' Index rose to 50.2, which was the first reading above 50 since August 2015, and so far this year has remained above the 50 level, which marks the transition from contraction to expansion. Property prices (100-city average price change) have been up by low double digits in the first half of 2016 and have maintained their strength. Besides higher prices, data showed that inventories decreased in the 11 major cities for which data are available (the 11 cities cover all tier-1 cities, 5 tier-2 cities and 2 tier-3 cities).

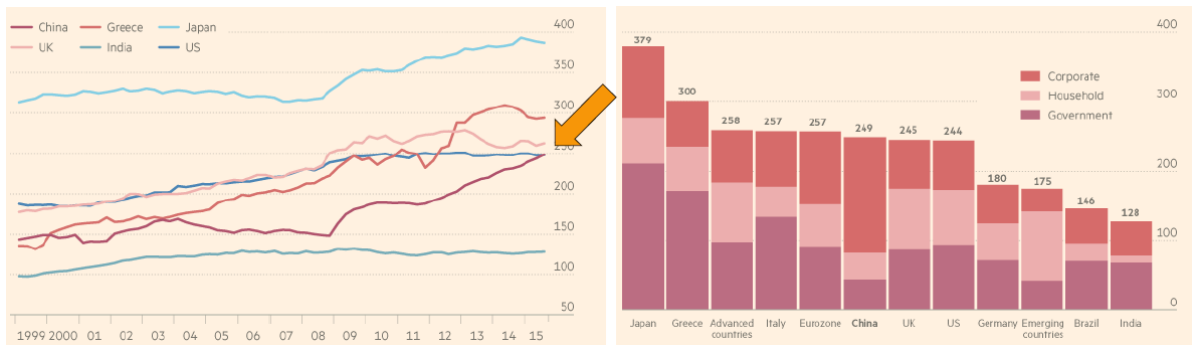
From an economic and GDP point of view, things have stabilized year-to-date and we are on track to achieve roughly 6% to 6.5% growth of GDP in 2016 and 2017. This achievement comes at a price: increasing debt levels from already elevated levels.

*Debt levels: high, but comparable to other advanced and developing countries*

The Chinese debt-to-GDP ratio has gone up substantially over the last couple of years to levels similar to those of the US. Also, Chinese banks have become riskier after the large stimulus packages, which the banks made possible with huge credit lending to the State-Owned Enterprises and other corporates. Corporate debt in China has risen to about 150% of GDP, while total debt stands at almost 250% of GDP.

China has plans to cope with the issues: more and more debt will be swapped into equity; this arrangement was launched by the central bank and will allow the banks to avoid non-performing loans by converting them into equity. Clearly, while this buys the country some time to deal with the debt issue and limit future debt growth, it does not solve the problem permanently. Therefore, this is an area that we are monitoring very closely. We should keep in mind, however, that the real risk to China's economy depends on whether debt levels to GDP will continue to grow at the high pace of recent years. In terms of the country's outstanding stock of debt, China's debt-to-GDP ratio is still sustainable and comparable to (and in some cases significantly lower than) other 'advanced' and 'developing' countries as can be concluded from Figure 3. The chart on the left hand side shows that China's debt has gone up rapidly since 2009. The chart on the right illustrates the leverage relative to other countries, which proves that China does not stack up badly at all.

Figure 3 | Total debt (% GDP) and distribution of debt



Source: Bank of International Settlements, Financial Times, April 2016

While the government might set up counter-cyclical policies to bolster growth, the chance of a huge policy intervention program with rapid debt expansion remains low. The central government has taken a number of steps to restructure the existing local government debt. Meanwhile, the household sector's balance sheet remains sound, helped by resilient income growth and lower interest rates.

*Renminbi: weakness expected, but devaluation far from sure*

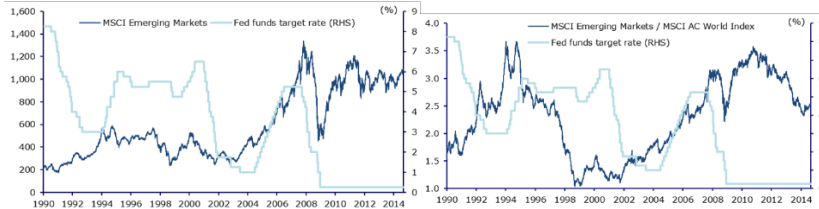
With regards to the renminbi, weakness is expected, but a devaluation against the US dollar is far from sure and if any, a relatively mild and gradual depreciation is the most likely scenario. The authorities use a basket of thirteen currencies to measure the renminbi against and not purely the US dollar anymore. So a depreciation of the renminbi depends on the relative strength of the US dollar as well. The Chinese authorities still sit on an immense foreign exchange reserve of USD 3,200 billion. Ultimately, the renminbi remains a currency under the control of the People's Bank of China (PBoC): China's central bank has enough FX reserves to set the daily renminbi rate and the currency is far from fully fungible. It is not a free market and the PBoC is the biggest player. The scenario of low to mid single digit percentage depreciation is most likely in our opinion.

We conclude that China can still count on its high domestic savings, government ownership of banks and corporates, and a relatively close capital account. A brutal end to China's credit cycle is very unlikely.

**2. Increase in US interest rates**

Another often heard concern about emerging equities is the rise in US short-term interest rates.

Figure 4 | Performance EM (absolute and versus DM) and Fed funds target rate



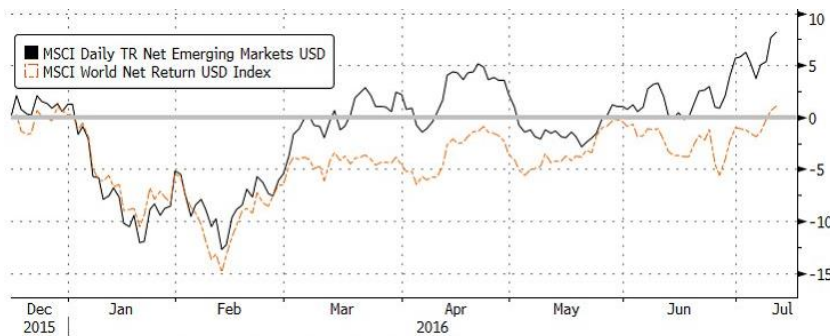
Source: CLSA, DataStream

However, as illustrated in Figure 4, it was actually the last monetary tightening cycle (2004-2007) in which emerging markets did very well, both from an absolute point of view (left chart) and in comparison with developed equities (right chart). This can be explained by the fact that it was economic growth that pushed inflation expectations higher, causing the Fed to hike rates from mid-2004 to mid-2007. This time around it is again US economic strength that pushes rates up from an historically low level, and the Fed will continue to hike for the foreseeable future, albeit very gradually. The growth trajectory in the world will be lower than in the early 2000s though, so the uptick might be smaller as well.

The first signs are pointing to an outperformance of emerging over developed equities since the first rate hike in the US at the end of 2015. As this most recent hiking cycle is also 'growth-inspired', the prospects of emerging equities outperforming developed equities are looking good.

The chart below shows the performance of emerging versus developed equities since the rate hike in the US on December 16, 2015.

Figure 5 | Performance EM versus DM since Fed rate hike of Dec 2015



Source: Bloomberg

### 3. Political turmoil and corruption issues

Over recent years, political turmoil has been concentrated in Brazil, Russia and South Africa. In all three countries political troubles coincide with a serious economic recession – Brazil and

Russia – or a near recession situation – South Africa-. In the shorter term this political uncertainty is here to stay, so caution certainly remains key in these three nations. In the long term, both in Brazil and in South Africa the democratic system works at its best and that is a change from the past. In Brazil the president has been impeached and in South Africa Zuma narrowly escaped the same procedure. Independent prosecutors are able to do their work, no matter who is the suspect. This is a very positive trend for the long-term development of these democracies and ultimately also for their financial markets and currency trajectory.

In Russia, the geopolitical situation has calmed down and the tailwind of higher energy prices helps the financial markets in Moscow. We expect a pause in the oil price rally and a gradual improvement in the relationship between Russia and the rest of the world. Both sides acknowledge that there are too many shared interests, such as trade and security, to maintain the current tough relationship.

In Turkey, recent events are not necessarily positive for the political and economic development of the country. We were already cautious before the ‘coup attempt’ of July 15, 2016, and have become even more cautious.

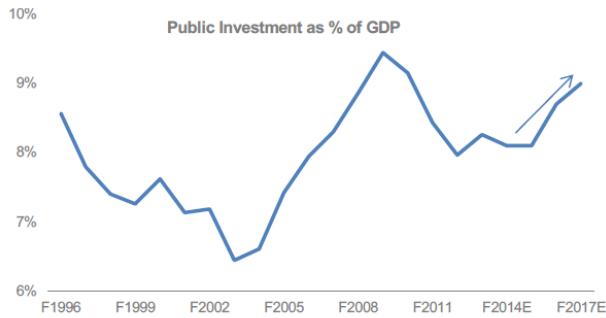
#### **4. Serious economic and corporate reforms in various countries**

Having discussed investors’ three main concerns about emerging markets, we will address three arguments in favor of emerging markets. The first one is the reform path in various countries, most prominently in Asia.

In *South Korea*, respect for minority shareholders is gaining in importance and we expect corporate Korea to continue to raise dividend payouts. With a payout ratio way below the 38% regional average, the Korean market has ample scope to hike dividends and trigger a meaningful increase in stock valuations. The most exposed companies are the traditional defensive dividend stocks, such as telecom stocks. Most upside is offered by some select cyclicals, such as Samsung Electronics, SK Hynix, Hyundai Motors, Kia Motors and Hyundai Mobis. The expected rerating would thus lower the ‘Korea discount’, which refers to the structurally low valuation of this country in comparison with emerging markets’ average valuation.

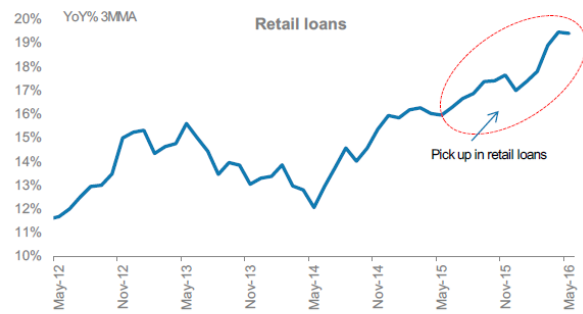
In *India*, Prime Minister Modi has initiated a reform path in 2014. Not so long ago India was one of the fragile five countries, together with Brazil, Indonesia, South Africa and Turkey. After a rather painful adjustment in 2013 and 2014, it is no longer a member of that ‘exclusive’ club of nations. The adjustment has been broad in nature and pro-active in timing: interest rates were hiked to slow domestic demand and shrink the wide current account deficit, rural wage growth and fiscal spending slowed while the business climate showed a big improvement. More recently India’s central bank was able to start lowering interest rates again, which resulted in a pick-up in consumption and public expenditure (Figures 6 and 7).

Figure 6 | Public investment in India (% of GDP)



Source: CEIC, Morgan Stanley

Figure 7 | Indian retail loans



Source: CEIC, Morgan Stanley Research

Source: CEIC, Morgan Stanley

More reforms are on the Indian agenda, and those are meant to increase the efficiency in the execution of government projects in general and the infrastructure sector in particular. The Indians used to build 2 kilometers of extra roads every day, but are targeting a daily average of 30 kilometers in 2020. Currently we are halfway as India builds an extra 17 kilometers of roads each day. A change of administration run by Modi and a change in central bank policy have been crucial in passing the point of inflection.

Another Asian nation with a change in administration is *Indonesia*, where president Widodo took over at the end of 2014. Here the adjustment was due to the pro-active measures of higher real interest rates and currency depreciation that sacrificed growth in order to restore macro stability. Thanks to the terms of trade correction, the current account deficit shrank and now hovers around a low single digit percentage of GDP. Together with India, Indonesia left the club of 'fragile nations' last year.

Countries that lag substantially on the reform side are Brazil, Russia and South Africa. The hope is that the new Brazilian president Temer might be able - in this Olympic year - to steer the country away from recession and public discontent. He should execute on the fiscal

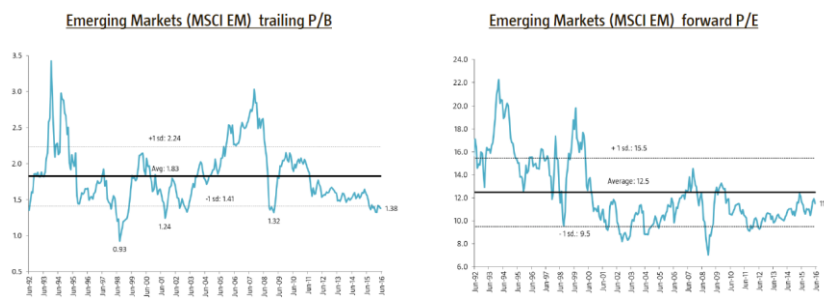


reform agenda, which could mean the start of a monetary easing cycle, since interest rates are still very high at over 14%. That said, given the steps that still need to be taken to rehaul the country, it is still too early to call the Brazilian trough in the economic cycle.

### 5. Attractive valuations and improving earnings revisions, allocation upside

Emerging equity valuations have fallen to attractive levels, trading at 1.4 times book value and a discount of 30% to their 10-year average, while developed market equities are at 2.8 times book value and a premium of 15% to their 10-year average. In terms of price-to-earnings, emerging equities are at 11.5 times forward earnings, which is below 25-year average levels and also 30% lower than in developed markets (see Figure 8).

Figure 8 | Emerging markets P/B and P/E

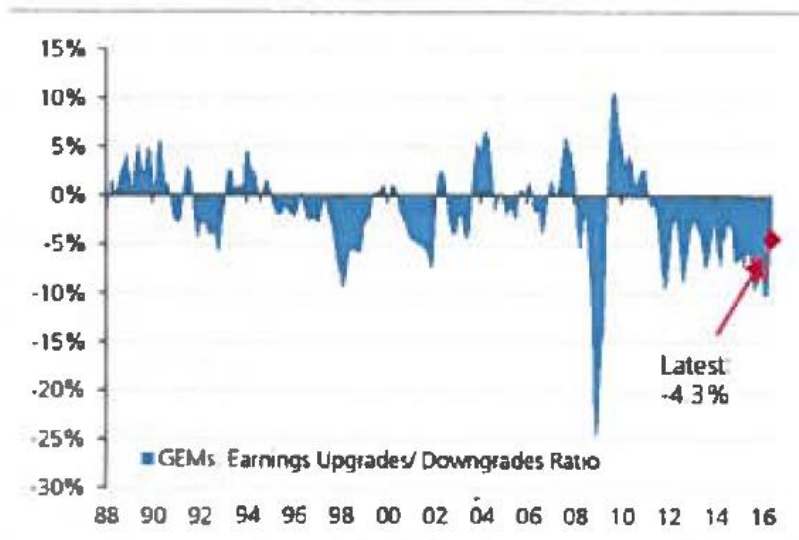


Source: IBES, Factset, MSCI, Morgan Stanley, as of May 2016

As for earnings, the expectation in 2016 has been for consensus earnings growth to fall during the first half of the year as in four of the five prior years. However, this year's consensus estimate, which plummeted from double-digit growth to a low of 3.9% in February 2016, has now rebounded to 6.2%. The contrast between the relentless collapse of earnings forecasts in 2015 – as the US dollar surged and commodity prices crashed – and 2016, when they have both reversed, is clear.

Furthermore, although the upgrades-to-downgrades ratio of emerging markets earnings is still negative, recently it has recovered sharply and is now at a 20-month high, as illustrated in Figure 9.

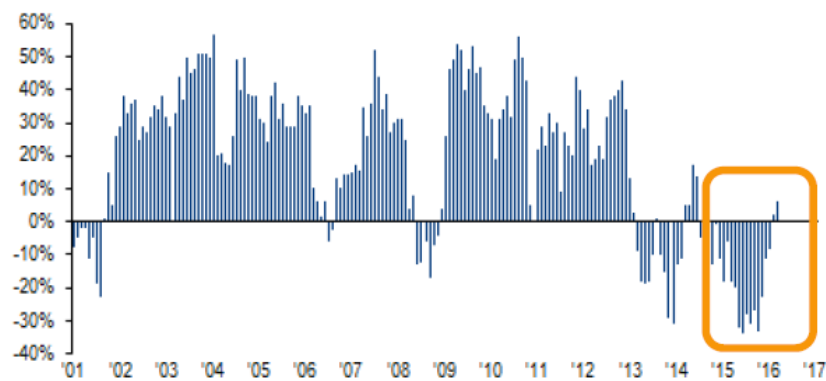
Figure 9 | EM earnings upgrades/ downgrades ratio



Source: IBES, UBS

During the last couple of years, investors' allocation to emerging markets has fallen to historically low levels, as shown in Figure 10. The allocation to global emerging equities is just recovering from a 15-year low.

Figure 10 | Global allocations to emerging markets equities



Source: Bank of America Merrill Lynch, monthly fund managers' survey, net % of fund managers surveyed overweight/(underweight) stocks in EME

## 6. A favorable monetary situation for time being

As discussed above, emerging markets policymakers are setting up quite comprehensive reform agendas, even if implementation has been slower than hoped for. China is key here and that country is easing monetary policy decisively, via negative real deposit rates and

stronger monetary growth. The latter is up 12% yoy and therefore exceeds the approximately 6% nominal GDP growth. Excess money supply is working its way through property prices in the four tier 1 cities: Shenzhen up 45%, Shanghai up 15%, Beijing up 8% and Guangzhou up 2% yoy. In tier 2 and tier 3 cities property prices have stopped falling. This is the way monetary policy is supposed to fight debt deflation – China’s four tier 1 cities have a GDP of about USD 1.3 trillion, which makes them the world’s 12th largest economy, accounting for some 12% of China’s economy.

In almost all other emerging countries the odds are pointing to monetary easing for the foreseeable future. We expect more interest rate cuts in Indonesia, Taiwan, India, Malaysia and Thailand.

#### **Conclusion: a positive short- and long-term stance**

Given the favorable developments we discussed above and the fact that most concerns can either be refuted or put into perspective, we are optimistic about the outlook for emerging markets equities.

In our global emerging markets equity strategy we overweight India (because of its reforms, and for having the strongest macro-economic picture in emerging markets), South Korea (reforms, a strong earnings recovery and low valuations) and, to a lesser extent, China (positive macro-economic outlook, reforms, and attractive valuations) and Indonesia (reforms, macro-economic recovery).

Outside emerging Asia, the strategy is overweight Russia (for its increased geopolitical stability, the improved oil price, strong earnings and low valuations) and Peru (which has a bright earnings profile).

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