INVESTMENT research

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Research & Investment Strategy

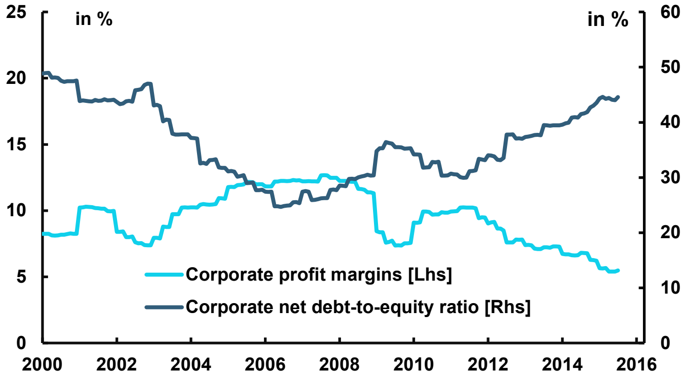
Emerging markets' equities: not yet the end of the tunnel

Key points

- Since late 2010 emerging markets have stayed flat while the MSCI World Index returned around +70%.
- Relative stock market weakness has its origins in economic fundamentals. With the emerging markets' high-speed growth model fading, structurally lower nominal global GDP growth implies single digit earnings growth going forward.
- Profit margins have gone from weak to weaker over the past couple of years while corporate leverage has increased, matching the heights of the early 2000s (*Exhibit 1*).
- Valuations are not encouraging either. The gap – 13.5x vs 20x on trailing earnings– is in line with historical norms, offering no real valuation advantage.
- The relative performance of emerging markets is moving in line with foreign exchange rates and suggests that **further EM currency weakness will lead to further stock market weakness, at least in relative terms**. We think that the real litmus test –the divergence in monetary policies of the US and emerging markets– still lies ahead.

Exhibit 1
Declining profit margins and rising leverage weigh on earnings

Emerging markets corporate data



Source: Datastream & AXA IM Research

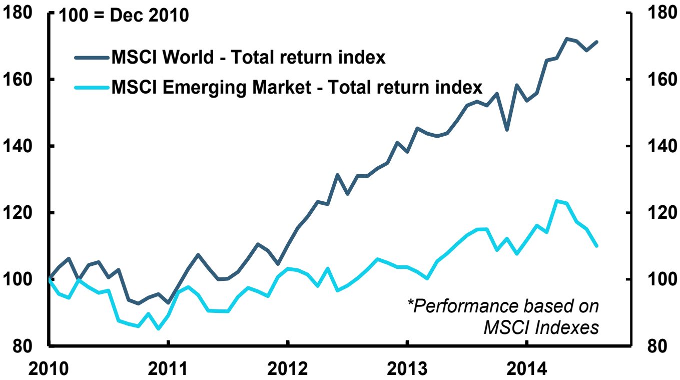
A prolonged period of underperformance

Emerging markets (EMs) have been lagging developed markets performance since late 2010 in both US dollar (USD) and in local currency terms. The MSCI Emerging Markets Index is flat over the past 5 years while the MSCI World Index returned roughly +70% *(Exhibit°2)*. This year's performance looks almost like a linear extrapolation of this negative trend as emerging markets' performance approaches -10% while the MSCI World is up +4% in USD terms. Several factors imply that emerging markets will continue to face headwinds.

Exhibit 2

Long-lasting underperformance of emerging markets

Global EMs vs World*



Source: Datastream and AXA IM Research

The most recent devaluation of the Chinese yuan (RMB) sent shockwaves throughout the region, putting the asset class back under the spotlight. Furthermore, the coming US interest rate hike can hardly be considered a good omen given the indebtedness of many emerging economies. Finally, overall economic momentum will most likely remain weak and thus weigh on forward earnings in the coming months.

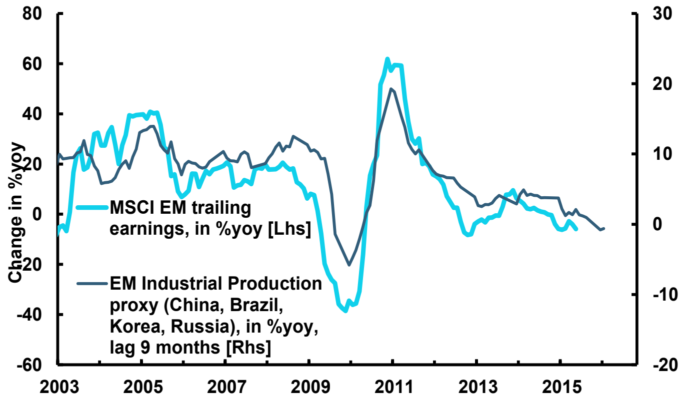
It's the economy, stupid

We think that **the relative stock market weakness has its origins in the economic fundamentals**. Most EMs have been built on a kind of a high-speed growth model which is fading. Structurally lower nominal global GDP growth is reflected in emerging markets' single-digit earnings growth, having shifted down a gear from high double digit growth rates before 2008. Industrial production, a proxy for volume growth, has been trending downwards over the past couple of years and converged toward zero recently. It is therefore no surprise that earnings dynamics turned negative and show hardly any sign of relief (*Exhibit°3)*. As a consequence we think that the current consensus earnings growth projections of around +10% for the coming 12 months look overly optimistic.

Exhibit 3

Little hope for an earnings recovery

Emerging markets: production & earnings growth



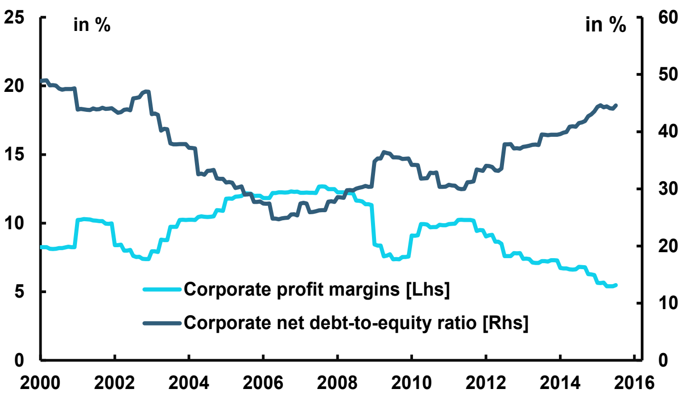
Source: Datastream and AXA IM Research

Worse, **profit margins have gone from weak to weaker** over the past couple of years while corporate leverage has increased, matching the heights of the early 2000s (*Exhibit 4*). The risks associated with the macro and micro fundamentals have increased. We would not be surprised to see analysts' earnings growth forecasts of almost 10% to be trimmed in the coming weeks.

Exhibit 4

Emerging markets: declining profit margins and rising leverage weigh on earnings

Emerging markets corporate data



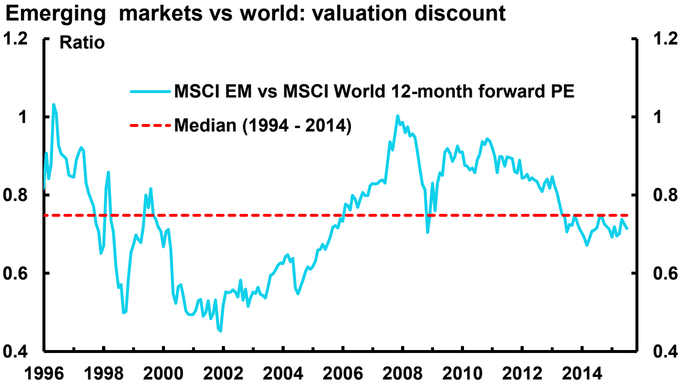
Source: Datastream and AXA IM Research

Not as cheap as it appears

In light of this situation, a stereotypical observer would point out that **valuations are cheap and a lot is discounted already—though we beg to disagree.** Admittedly, emerging markets seem to trade at a decent valuation discount (13.5x vs 20x on trailing earnings, MSCI indices). Yet this discount is bang in line with historical norms, as shown in *Exhibit 5*. Other valuation measures corroborate the fact that emerging markets simply trade around the average discount and thus do not offer a real valuation opportunity.

Exhibit 5

Emerging markets offer no real valuation discount



Source: Datastream and AXA IM Research

Admittedly, today's situation in emerging markets is not comparable with the period of the late 1990s/early 2000s when the 'Little Tiger' and the Russian/Long Term Capital Management crises left deep traces in investors' minds, pushing the valuation discount to the extremes with emerging markets' multiples of around 10x in early 2000. Today's numerous problems stem from both structural and cyclical origins. In such an environment we would argue that emerging markets should trade at a serious discount rather than around their historical average.

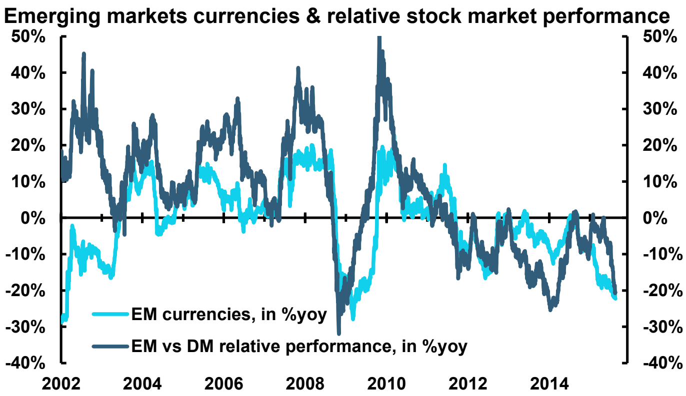
Further currency weakness will weigh on EM equities shoes to drop

Most worrisome is the fact that the **relative performance of emerging markets is positively correlated with the foreign exchange rate**[1]. Emerging currencies and the relative performance of equities move hand in hand — in stark contrast with developed markets for which a weaker currency is a clear positive, provided the devaluation is relatively smooth. The strong performance of the Tokyo Stock Exchange over the past couple of quarters and the Euro area stock markets are presumably the best examples for the positive impact of a weaker currency.

Based on data starting at the end of 2001 we find that movements of the broad emerging markets currency basket explain roughly 40% of emerging markets' performance relative to developed markets.

Exhibit 6

Emerging markets offer no real valuation discount



Source: Datastream and AXA IM Research

Admittedly, emerging currencies have already lost between 25% and 30% since then-Fed Chairman Bernanke's 'Taper tantrum' remarks back in May 2013. In many cases they currently trade at lower ranges looking over the past 15 years. Yet, we think that the real litmus test still lies ahead: diverging monetary policies between the US and the emerging world. **Further EM currency weakness will lead to further stock market weakness, at least in relative terms. It is not the time to be brave.**

[1] Valls, N., Chulia, H. Volatility Transmission between the stock and Currency Markets in Emerging Asia: the Impact of the Global Financial Crisis, Research Institute of Applied Economics, working paper 2014/31

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