Equity Insight.

Resisting temptation

It's no secret that emerging market equities have had a tough time in recent years. They have underperformed developed market equities since 2010, falling by a third in a period when the S&P 500 has almost doubled, and have recently posted large absolute declines. When an asset has underperformed by so much and for so long, it can be tempting to see it as a value opportunity. However, although we're no perma bears on emerging markets, we expect several headwinds to persist in the short term and valuations are not cheap enough to compensate and allow for a quick recovery.

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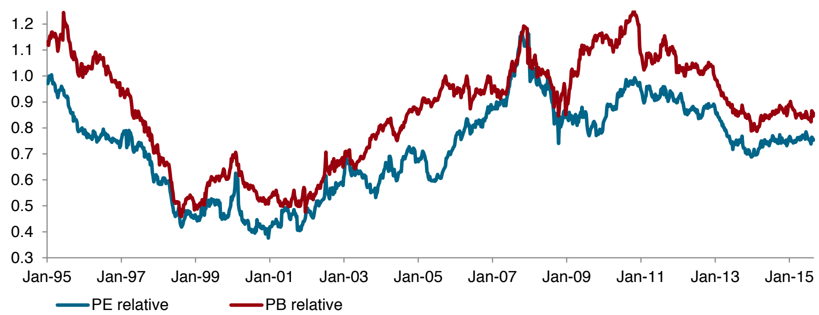
Are emerging market equities bombed out?

Prices have fallen significantly and emerging markets have become oversold by some measures. The recent sharp falls took emerging market equity prices a full four standard deviations below the mean of the last twelve months, a sharpness of correction that has not been exceeded for three decades. In addition, fund flows have been unusually negative in recent weeks and investor surveys show that pessimism surrounding emerging markets is universal.

These indicators may suggest that a lot of negativity has been priced in and that emerging markets equities should be disproportionally sensitive to any positive news flow. However, these are very short-term considerations and prices have rebounded somewhat from the lows of a couple of weeks ago. From a more fundamental and structural perspective, it is difficult to argue that emerging market equities are truly bombed out.

Valuations have an excellent track record of predicting long-term returns, but unfortunately most metrics suggest that emerging market equities are only a bit on the cheap side and remain far away from extreme levels. The trailing price-to-earnings (PE) ratio, at 13.2 times, and the price-to-book (PB) ratio at 1.7 times, are a touch below their historical averages, but both remain a long way (more than 50%) above their 20-year lows.

Figure 1. Relative valuations of emerging and developed market equities



Source: LGIM and Datastream

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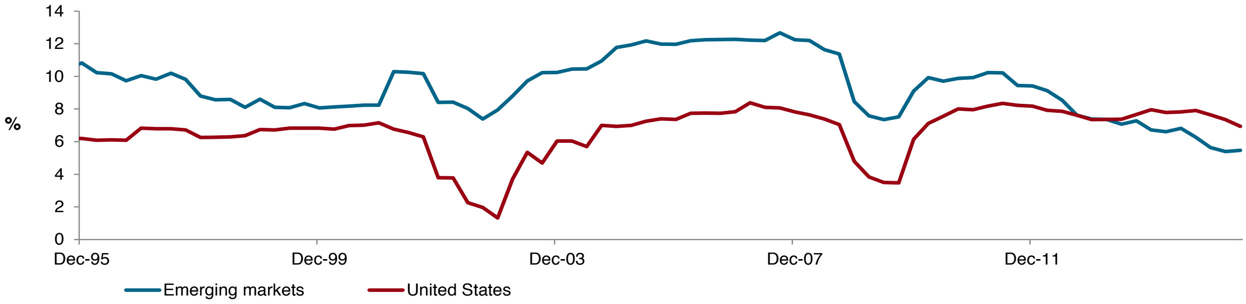
Figure 2. Net margins by region



Source: LGIM and Datastream

In a world where most assets are unusually expensive, a relative valuation approach is arguably fairer, but the conclusion remains the same. Emerging markets equities have admittedly de-rated a lot against developed markets, with the relative PE having shrunk from a 2% discount in 2010 to a 25% discount today as per **Figure 1**. However, it's worth remembering that they traded at a 60% discount for several years in the aftermath of the 1998 Asian Crisis. While we may not return to such extreme discounts, it is difficult to argue that emerging markets are excessively cheap when both absolute and relative valuations are close to historical averages.

Earnings headwinds unlikely to reverse

From an emerging market equity investor's perspective, the most frustrating development has been persistently disappointing earnings growth. This has largely been driven by a dramatic collapse in net margins from 12.7% in 2007 to 5.4% today, as shown in **Figure 2**.

A closer look at what has driven down margins over the last few years holds both good and bad news. The good news is that margins don't appear to be stuck in a structural decline they could not break out of. We can explain the majority of the margin contraction with the same factors that have explained emerging market margin changes in previous years: commodity prices, industrial production growth, the dollar and unit labour costs. Much of the rest can be attributed to margin convergence. Emerging market margins had been significantly higher than developed market margins, but as companies become more global and in many ways more similar, margins should become more aligned with those in developed markets. With margins in emerging markets having fallen below those of developed markets, much of this gradual pressure should now be behind us.

The bad news, however, is that margins (and therefore earnings) appear unlikely to rebound quickly from current levels, as we don't expect any of the margin drivers mentioned above to improve materially for some time. Recent developments in global commodity markets and concerns around worsening credit conditions make us believe that emerging market GDP growth is likely to decelerate further and our forecasts are below consensus. The slowdown in growth should ultimately result in abating wage growth, but there are no signs of this yet. We are agnostic on the direction of commodity prices, but given the new supply dynamics in oil, a weak emerging market growth backdrop and past capacity increases in many commodities, a sharp rebound seems unlikely. Overall, emerging market margins are more likely than not to be flat or to decline and to lag behind those in developed markets.

Being picky

With valuations not excessively cheap and without the catalyst of margin expansion and an earnings growth rebound, we are currently resisting the temptation to see emerging market equities as an attractive value opportunity. Instead, we prefer to differentiate. We favour Indian equities as a relative safe haven within emerging markets, and as a market more dependent on a domestic investment and reform story than on the China or commodity cycles.

There is also some theoretical merit to looking at the other end of the emerging market growth spectrum. Equity markets in economies with the lowest past growth have gone on to deliver some of the best returns, suggesting that it might be profitable to buy equities in countries that are in recession, such as Brazil currently. However, the political and economic downside risks in Brazil remain high. For the time being therefore, it's one for the watch list rather than the buy list.

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