



Are emerging market equities re-emerging?

After falling out of fashion and lagging their developed market peers in recent years, emerging market equities are back in the headlines and back in investors' sights. We spoke to some of Schroders' investment desks to see if the optimism is justified.

Philip Haddon

Head of Investment Communications



“Time for investors to revisit emerging markets”, the Financial Times wrote on 2 September. On the same day, Bloomberg heralded “the re-emergence of emerging markets”.

Looking at the performance of stockmarket indices, it's plain to see why emerging markets have been catching the eyes of journalists and investors alike.

Year-to-date as at the end of August, the MSCI Emerging Markets index is up 14.7%, compared to a rise in the MSCI World index of 5.5%, according to Bloomberg.

This reverses a five-year trend of submerged emerging market returns. In the five years to the end of 2015, the MSCI World index returned 44.2% in dollar terms while the MSCI Emerging Markets index posted a negative return of -21.8%; a remarkable difference of 6600 basis points.

During this time, developed market indices such as the S&P 500 have hit record highs and company valuations have become stretched.

Meanwhile, the major central banks, whose policies have been important drivers of the developed market bull market, are running out of ammunition. There is also the destabilising effect of political uncertainty caused by events such as the US presidential election and the UK's Brexit negotiations to be considered.

These factors have led some commentators to suggest the tide could be turning in emerging markets' favour.

We collated the differing views of various desks around Schroders, one of Europe's largest emerging markets fund managers, to get a sense of whether the change in sentiment is justified.

The emerging market equities view

Schroders' **Emerging Market Equities** team sees reasons for optimism but retains a balanced view overall.

"Valuation discounts versus developed markets have grown over recent years but only as much as ROE[1] discounts have fallen," the team said. "Signs of stabilisation in emerging markets profitability then may be enough to start closing this valuation gap."

"The global outlook remains uncertain and after a strong recent run some profit-taking can be expected. Should we see the global economy pick up and / or emerging corporate earnings surprise more positively, we believe emerging markets are well-placed to perform and outperform developed peers."

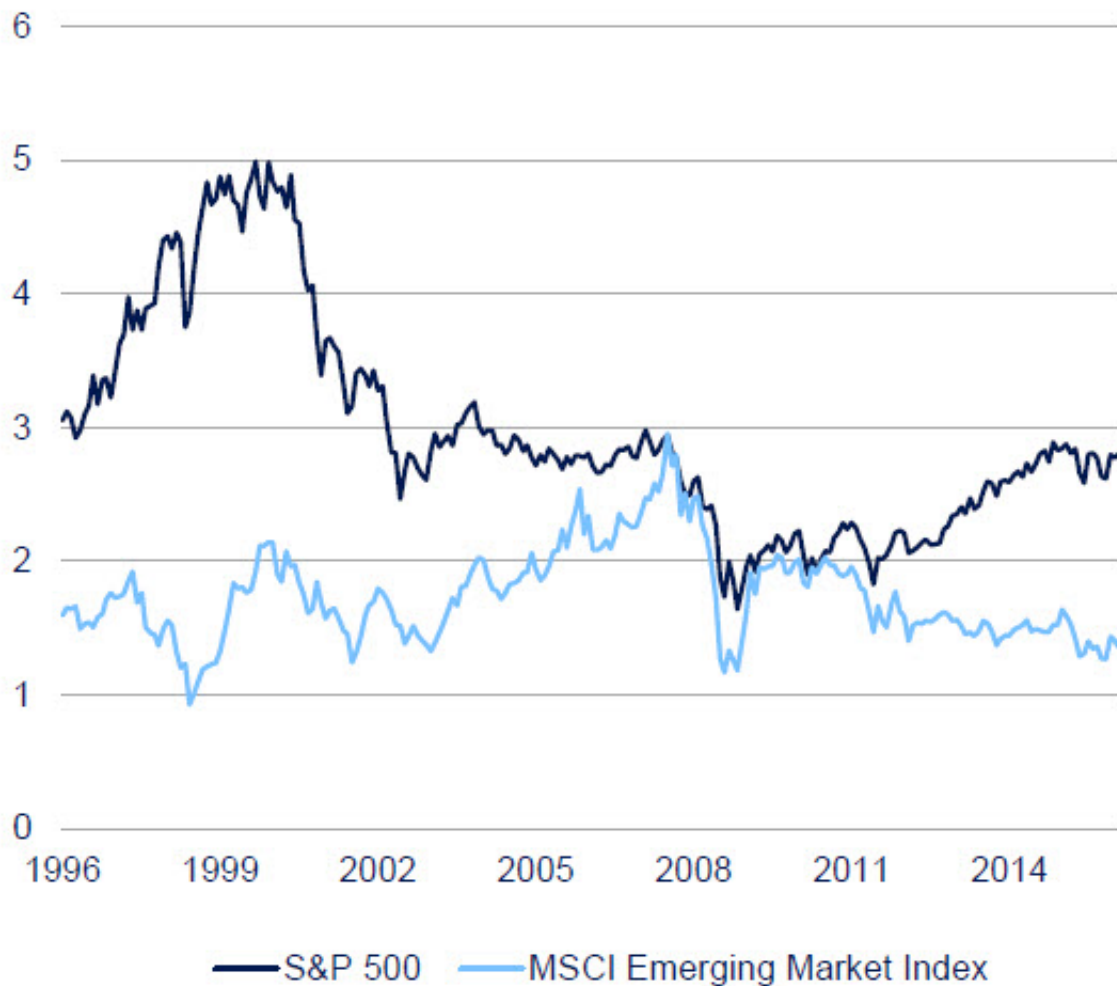
The multi-asset view

Schroders' **Multi-asset team** has also grown more constructive on emerging markets and earlier this year updated its asset allocation view on the region from

underweight to neutral.

“Having underperformed for more than five years, we believe that emerging market valuations are undemanding and have adjusted to reflect a subdued growth outlook. Still, as emerging market equities are a levered play on the global economy, it would be unwise to turn positive before seeing a solid improvement in the economic backdrop.”

Figure 1: Valuation discount - emerging markets versus S&P500 price-to-book ratio



Source: Schroders, Bloomberg, Datastream 30 June 2016

The multi-manager view

Head of Multi-Manager Marcus Brookes had long been avoiding emerging markets, with a large underweight exposure in his portfolios since 2011. However, earlier this year he started “dipping his toe” back into the region.

“The commodity price declines which had hampered emerging markets have now eased and stabilised. This has allowed emerging market economies to get back on a better

footing,” he said.

He also highlights that the troublesome political backdrop which had hindered valuations has improved, such as with the impeachment of President Dilma Rousseff in Brazil.

The chart above shows the price-to-book ratios^[2] of the emerging markets index compared to the US S&P 500 index and the extent to which they have diverged.

“Emerging market equities are trading at a significant discount to developed markets, having underperformed in recent years for the right reason: fundamentals. Now they are cheap, the fundamentals are improving, and they are under-owned. This makes it an interesting asset class for us.”

The optimistic tone is not shared by all of Schroders’ investors, however.

The Asian equities view

Robin Parbrook, Head of Asian Equities, strikes a more wary tone on emerging markets, particularly China, where he remains extremely cautious on sectors that are heavily influenced by the state. He is, however, more sanguine on so-called “new economy” sectors (such as IT and services) as China seeks to rebalance its economy.

“The reality is nothing has changed in China, least of all our consistently-held view over the last five years that Chinese banks - post the biggest credit bubble the world has ever seen - are sitting on a mountain of bad debts that are likely to cost 30-50% of GDP to clear up. With no serious reform effort underway, China will ultimately head towards a financial crisis.”

He warns investors to curb their enthusiasm on Asian and emerging equities.

“Asian and emerging stockmarkets are having one of their periodic rallies,” he said. “We have seen similar stockmarket rallies regularly over the last eight years and they now almost feel like the “new normal”. The claimed reasons for the rallies are nearly always the same: basically that Asian stockmarkets are cheap, an economic recovery is coming, China has sorted out its financial mess and the economy is rebalancing.

“As has been the case consistently over the last eight years, these arguments prove broadly spurious and the rallies peter out quickly.

“We see no difference this time around and therefore would caution clients to tread carefully before chasing Asian or emerging markets at current levels.”

[1] A measure of company valuation, with the higher price-to-book ratio suggesting a more expensive valuation.

[2] Return on equity (ROE) is a measure of the profitability of a company. Effectively, how much profit a company generates with the money shareholders have invested



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