Why we remain cautious on EM equities

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- **We remain cautious on emerging market (EM) equities and see the asset class underperforming developed market (DM) equities over the remainder of the year**
- **However, we retain our tactical exposure to Brazil and South Africa; we hold a structural overweight in India**
- **Over the longer-term, as global equity returns moderate over the next ten years, EMs could benefit from being high-return (also high-risk) proposition but some structural risks remain too**

Cautious on EM equity outlook in the near-term …

In our view, EM equities are still not attractive despite the recent underperformance. Of course, we cannot rule out a cyclical bounce for EM equities given accommodative monetary policy across the globe and depressed valuation of the asset class. However, in a strategic time frame, EM equities should still underperform DM equities.

EM growth premium over DM, which has in the past driven the relative performance of EM equities, is still subdued. Further, EM equities tend to deliver best returns when the global economy is in a synchronous upturn, not in a synchronous downturn. Moreover, domestic economic growth remains weak in EM. While the EM central banks have a bias towards easing, the banking lending conditions (assessed using the IIF Bank Lending Survey) continue to contract. This, in our view restricts the efficacy of easy monetary policy in reviving growth. Furthermore, building debt pile makes EMs more vulnerable in the long-run especially given the 'dollarization'. EM corporate profitability remains weak and the gap between EM and DM corporate profit margins, which was wide in the run-up to the Global financial crisis, is now almost negligible. Whilst EM equity valuations are cheap, we think, they are what they are for a reason. Further, EM FX has not been as supportive for international investors over the past few years as it was prior to the global financial crisis of 2008/09. Exhibits 1-10 makes these points.

… with focus on selective opportunities …

When looking at EM equities, we find it difficult to think of them as a homogenous group of countries/assets. Instead, we prefer a more nuanced approach. Also, at this juncture, in our view, divergence in earnings growth trends and differences in positioning in the cycle, warrants selectivity. Therefore, while we remain underweight EM equities very broadly with our underweight centered on China, we continue to have selective exposure to Brazil (tactical), South Africa (tactical) and India (structural) where the earnings growth potential is rather high.

… but more constructive on the long-term outlook for the asset class

We are rather more optimistic about the prospects of EM equities outperforming DM equities over the long-run. As we highlighted in our report The Equity Thematician: Bracing for lower long-term equity returns, February 2019, in the envisaged scenario of equity market returns moderating over the next ten years (for instance we forecast c5% annualized returns from equities over the next ten years compared with c12% annualized returns over the last ten years), EM equities could benefit from being high-return (and of course high-risk) investment propositions. A lower investment return environment in the US might prompt investors to seek opportunities in EM. As a starting point, EMs are massively underrepresented in many asset class benchmarks. For instance, EMs make c60% of the global population, c50% of the GDP (on PPP basis), c35% of global trade and more than 30% of the world GDP (in nominal terms). Yet the share of EM in MSCI ACWI is just below 12%. This underrepresentation of EMs in global benchmarks might provide active managers, a chance to look for opportunities outside developed markets.

When thinking about the long-term outlook for EM, a point to consider is the rising vulnerability of EMs in a deglobalising world. As we argued in our report The Equity Thematician: A deglobalising world and our 'Yellow brick road', June 30 2019, EMs benefitted from globalization with their economic weight rising rapidly over the past forty years or so. Therefore, a reversal in globalisation could mean rising vulnerabilities to the EM growth story especially given the USD's dominance as a reserve currency. In this context, "weaponisation of the dollar" is a double-edged sword. In the short-term, it could lead to dollar shortage, driving up spreads and the dollar nominal exchange, widening rather than reducing the gap between developed markets and emerging markets. In the long run, however, it could lead to (not only) emerging markets looking for alternatives to the US dollar.

China (underweight)

Chinese equities (especially the A shares) have had a strong start to the year rising almost 30% by April before correcting subsequently. On a year-to-date basis, Chinese equities have now underperformed the All Country World Index.

Profitability and earnings growth prospects of Chinese corporates still remain weak in the global context, especially so in comparison to the US. As we argued previously, long-term EPS growth is expected to remain weak. In that note we also argued that the Chinese earnings should start to grow on a year-over-year basis some time in Q2 2019 due to the small base effect. The most recent data suggests that the Chinese industrial profits grew marginally in May (exhibit 11). However, in our view, the escalation of trade tension between US-China in May has delayed the prospects for revival in Chinese corporate profitability.

Of course, liquidity inflows remain supported by the MSCI related passive rebalancing for global investors. Just for the context, China A shares have a weighting of 0.8% in MSCI EM index which is expected to grow to 3.8% by November this year. What is worth noting is the potential for the Chinese A share representation to rise in MSCI EM index to eventually have a weight of 16%; however this is more a hypothetical scenario.

Whilst MSCI China index has historically traded on lower multiples compared with rest of Asia, the current 12M forward PE multiple is only close to the long-run historical average even after the recent correction.

We remain underweight Chinese equities. However, our overweight in Australia and Hong Kong (both derived plays on Chinese domestic conditions) should help capture any upside arising due to Chinese reflation.

Brazil and South Africa (tactical overweight)

We still hold our tactical overweight in Brazilian and South African equities (see page 15 of Quarterly Investment View, January 2019). Since that publication, MSCI Brazil delivered 20.6% – outperforming both MSCI ACWI and MSCI EM by 4ppt and 11ppt respectively. MSCI South Africa index delivered 8.2% on a year-to-date basis – underperformed MSCI ACWI by 8ppt but performing in line with MSCI EM. Performance of both Brazil and South Africa is influenced by an array of both domestic and global factors. On the domestic front, for both Brazil and South Africa, prospects for structural reforms – which have been central to our investment thesis for both these markets – have still not played out completely, in our view.

In Brazil, at the time of writing this report, pension reform bill was set for voting in the lower house of the congress after having successfully passed committee stages[1]. As we have been arguing, this bill, which proposes to amend the pension system is considered a crucial reform as it seeks to improve Brazil's fiscal standing by USD250bn over the next 10 years. Even a watered-down version of the proposed pension reform bill should make a positive impact on the state finances and result in optimism in Brazil's financial markets. Indeed the perceived risk of Brazil's economy already hit a five year low ahead of pension overhaul vote in the lower house[2]. We also saw evidence of the Bolsonaro administration's willingness to pursue further reforms beyond the pension system overhaul.

In South Africa, as expected the incumbent African National Congress (ANC) led by Cyril Ramaphosa retained its power in the recent elections held in May. Whilst the vote share for ANC has indeed reduced (compared to previous elections), we believe that Mr. Ramaphosa still has a strong mandate to implement some of the long-awaited structural reforms in South Africa. Looking ahead, investors (and business alike) are likely to focus on the pace of implementation of reforms under the new cabinet.

[1] Brazil's pension reform bill set for crucial first vote, Financial Times, 4 July 2019

[2] Perceived Risk of Brazil's Economy Hits Five Year Low Ahead of Pension Overhaul Vote, Bloomberg, 9 July 2019

Global macro factors – like rising trade tensions and weakening global/Chinese growth – are key risks to these tactical calls. Further, investors should bear in mind that in general both Brazilian and South African equity markets have higher levels of volatility (as measured by historical standard deviation of returns).

India (structural overweight)

India remains a strong structural proposition for global equity investors. Favourable demographics and constantly evolving technology eco-system all play into the strong potential of India.

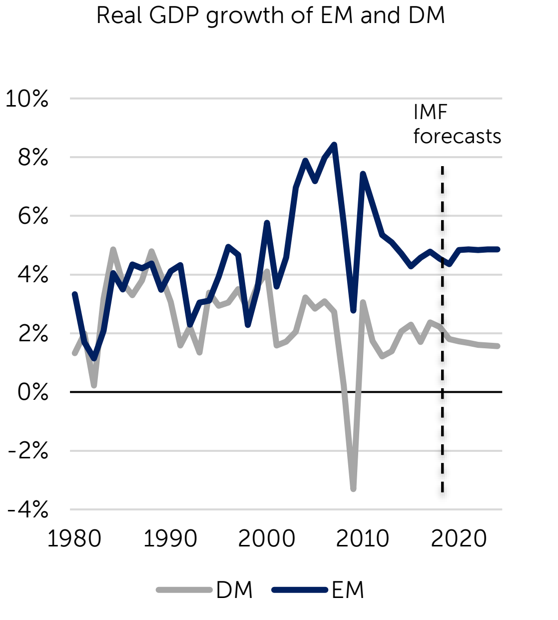
Now with the general elections out of the way and with the incumbent BJP-led NDA retaining power with an even stronger mandate, the capital inflows should resume in our view. After a prolonged period of rather inactivity (net flows), inflows are returning into Indian equities (exhibit 12). Also, capital expenditure decisions should pick up too. Of course, there could be increased focus on implementation of structural reforms but this is going to be a long process. In that context, whilst the recent post-election budget has to some extent underwhelmed investors, we do not see that as a reason for the long-term investors to abandon the ship.

Importantly, India is relatively defensive to rising global external risks. Indeed India could prove more resilient in a deglobalising world – in our opinion we are living in one. As we argued in our report The Equity Thematician: A deglobalising world and our 'Yellow brick road', June 30 2019, in the scenario of global trade continuing to falter, economies that are more reliant on domestic demand could do well compared to those that depend on exports. India fits this bill very well.

We keep India at an overweight with a structural focus. Within the market, we favour financials, consumer discretionary and healthcare segments where the earnings growth potential is the highest and valuations are not overly expensive. Near-term risks stem from an escalation of trade tensions with the US (which is not our base case) and persistently higher crude prices.

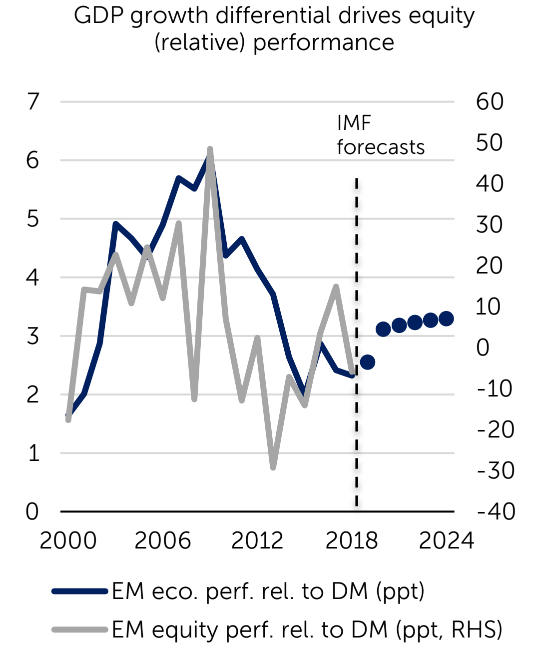
EM story in 12 charts

Exhibit 1: EM growth differential with DM remains rather subdued…



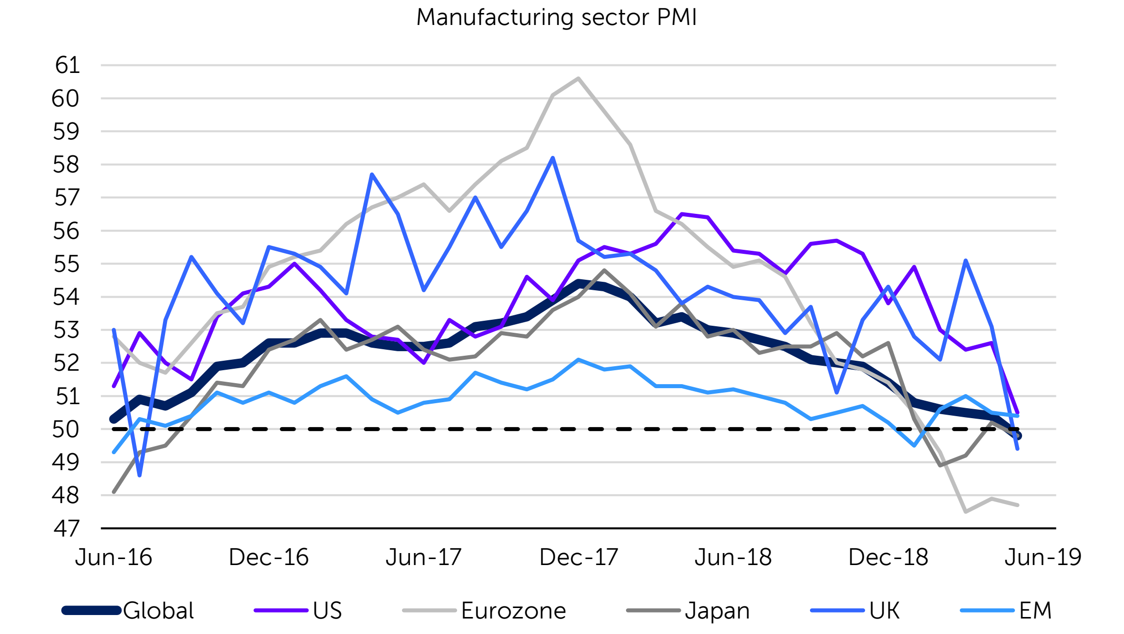
Source: IMF World Economic Outlook and ADCB Asset Management

Exhibit 2: … implying subdued performance of EM equities relative to DM



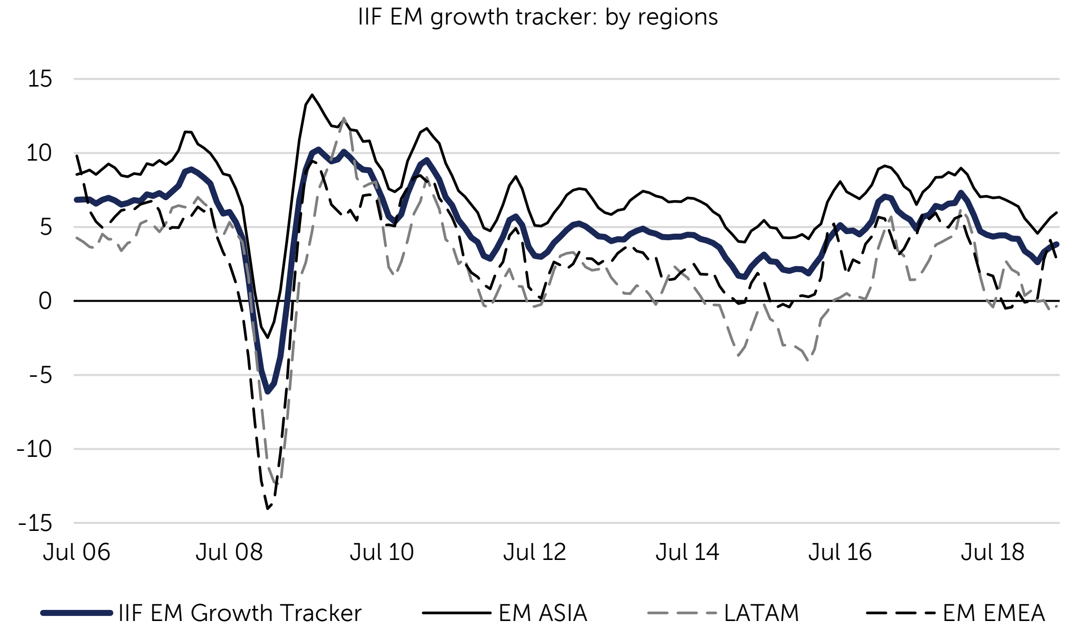
Source: MSCI, IMF World Economic Outlook and ADCB Asset Management

Exhibit 3: EM equities work when global growth is positive and broad-based, which is not the case now



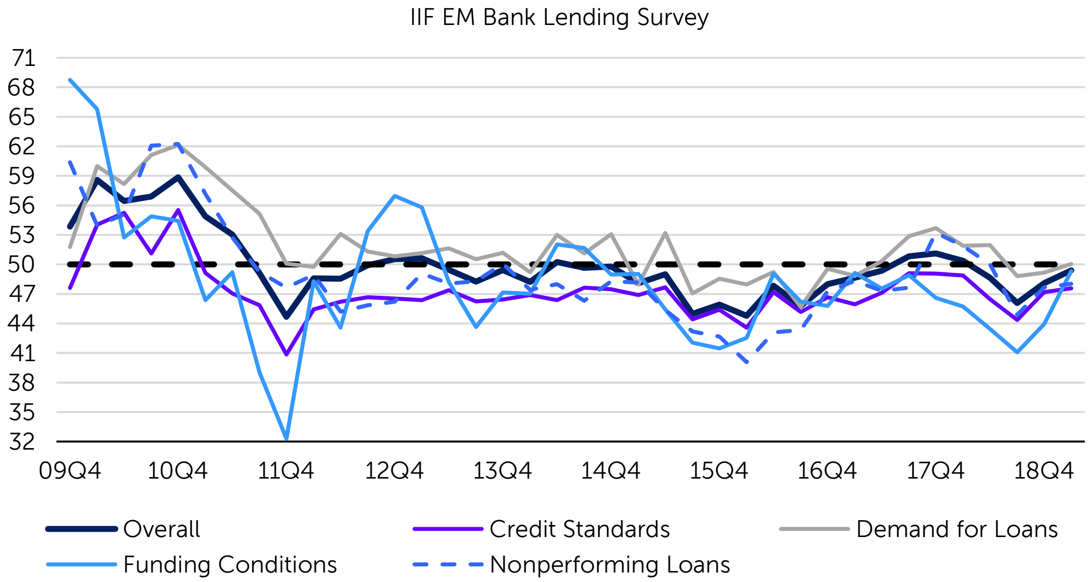
Source: Markit, Bloomberg and ADCB Asset Management

Exhibit 4: Domestic growth is not strong in EM



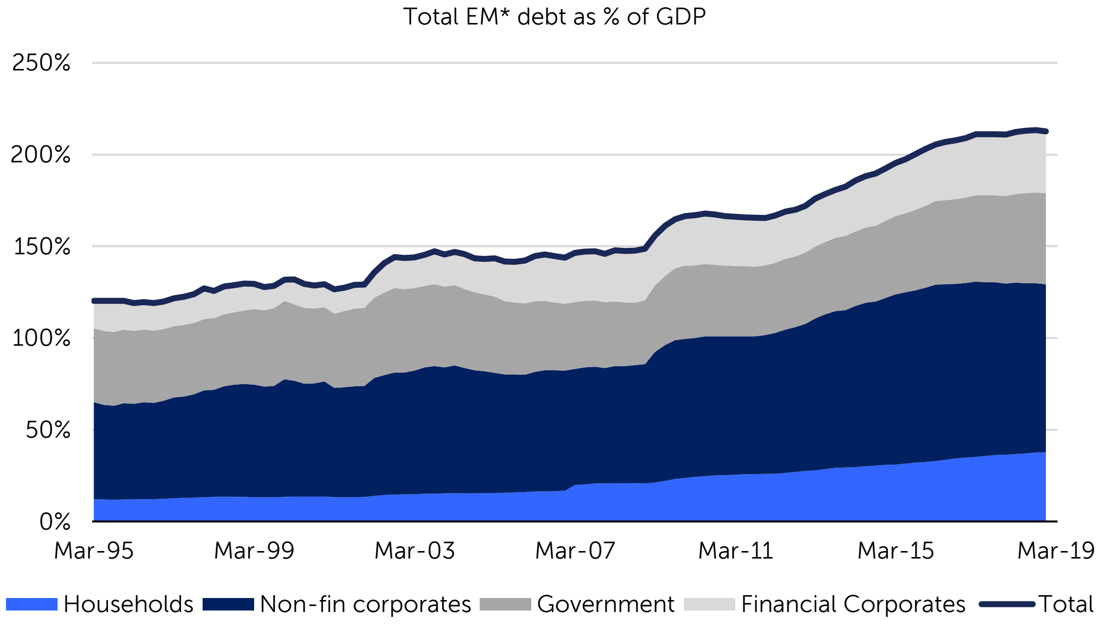
Source: IIF and ADCB Asset Management

Exhibit 5: Bank lending conditions are not expanding in EM



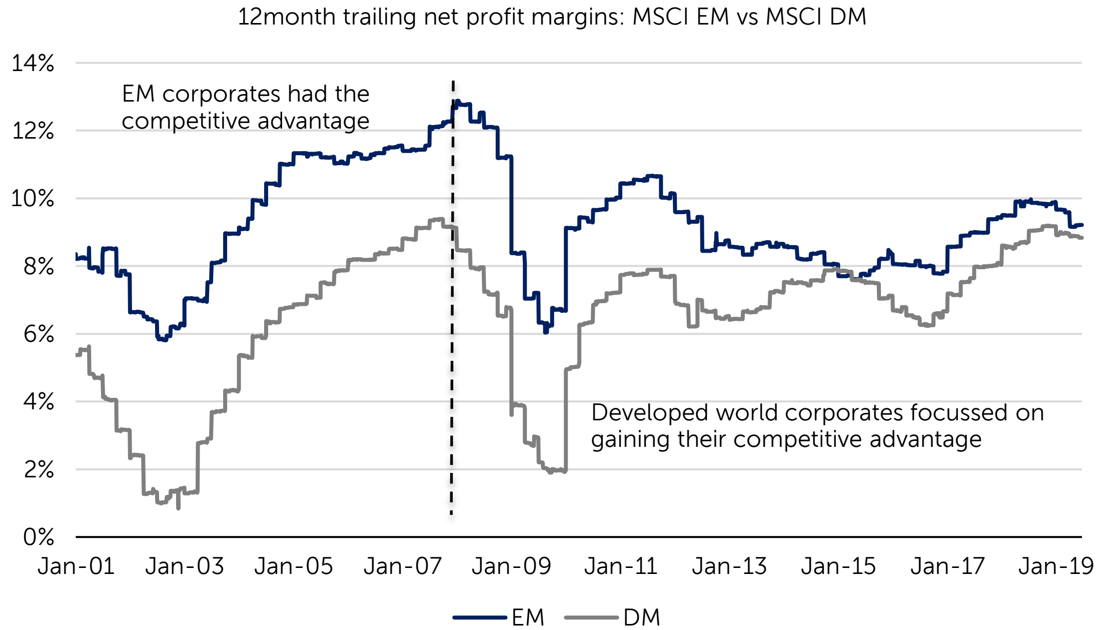
Source: IIF and ADCB Asset Management

Exhibit 6: Debt pile makes EMs vulnerable in the long-run especially given the "dollarization"



Source: IIF and ADCB Asset Management | Note: *aggregate of 30 EMs: Argentina, Brazil, Chile, China, Colombia, Czech Rep., Egypt, Ghana, Hong Kong, Hungary, India, Indonesia, Israel, Kenya, Korea, Lebanon, Malaysia, Mexico, Nigeria, Pakistan, Philippines, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand, Turkey, Ukraine and UAE

Exhibit 7: Developed world corporates closed their profitability gap with their EM counterparts

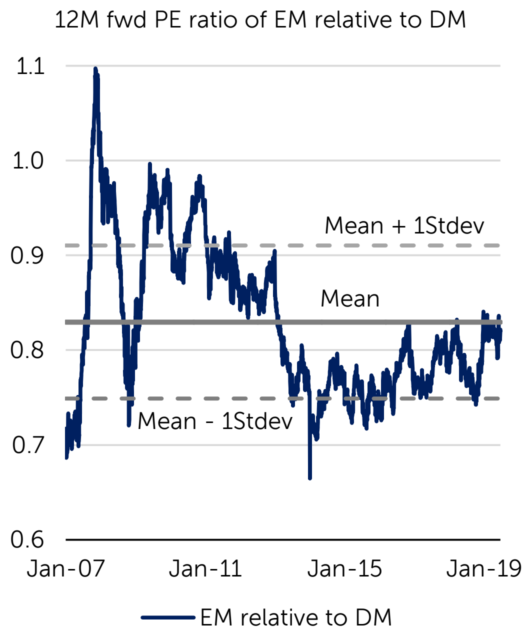


Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 8: EM-DM valuation divergence is reflective of the dynamics in profitability trends

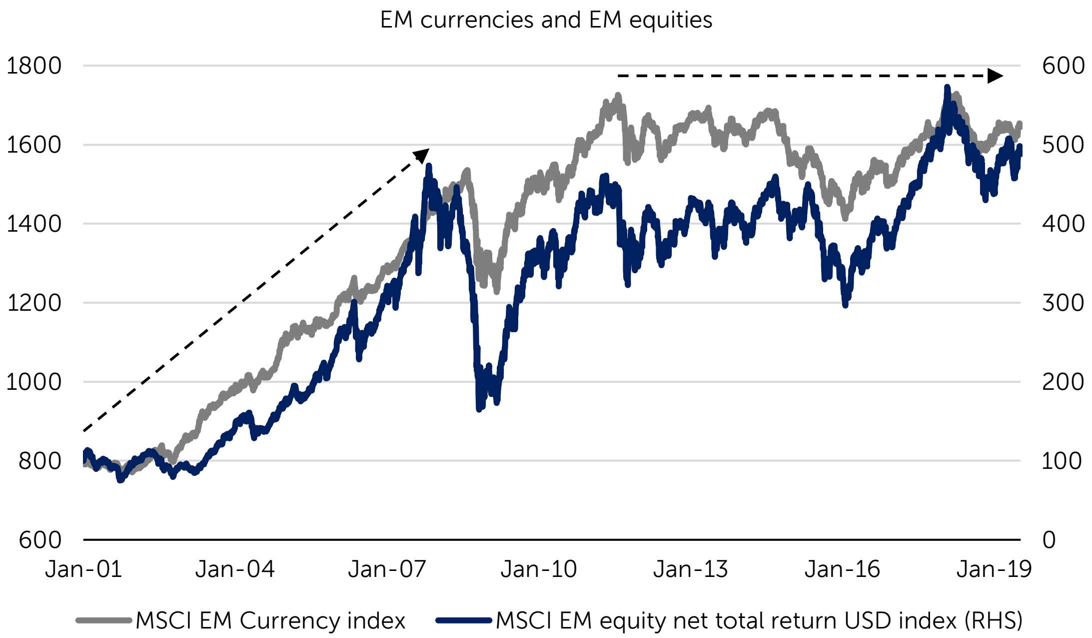
Source: MSCI, Bloomberg Consensus Estimates and ADCB Asset Management

Exhibit 9: EM valuations have remained cheap compared to DM for almost five years now



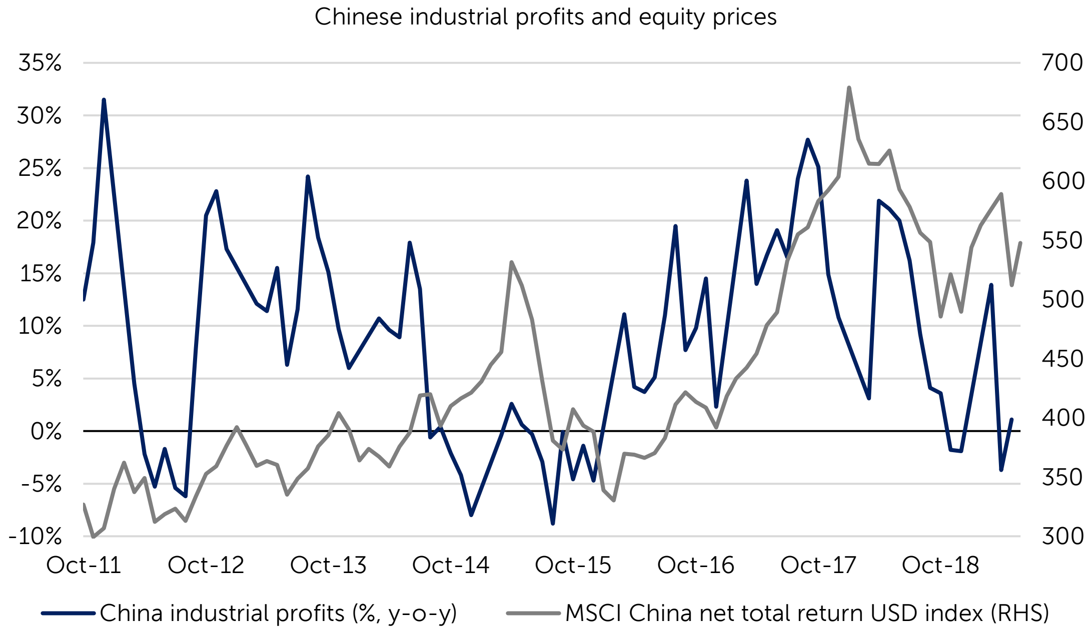
Source: MSCI, Bloomberg Consensus Estimates and ADCB Asset Management

Exhibit 10: EM FX has not been supportive for international investors' returns in recent years



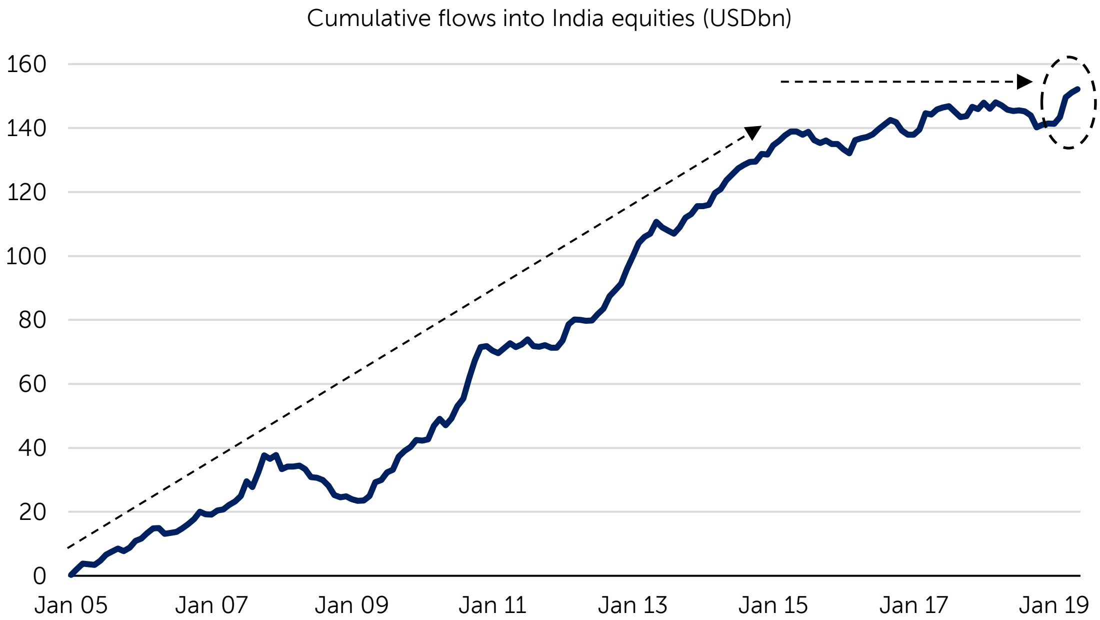
Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 11: Revival in Chinese industrial profits not yet in sight



Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 12: Equity portfolio inflows to India are picking up



Source: IIF and ADCB Asset Management

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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