Research
Macquarie Wealth Management

Investment Strategy Update #25

Emerging market equities: Not buyers yet

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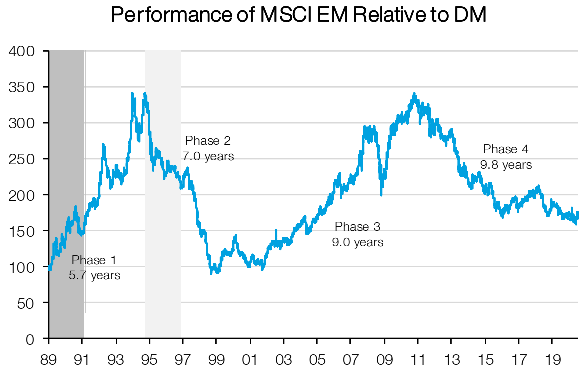
EM equities have consistently underperformed DM equities over the past decade. But, while they are trading at a substantial P/E discount, they still sit in the middle of their historic trading range – being neither cheap nor expensive.	EM equities move in long cycles lasting on average 8 years. While tactical shifts will drive powerful periods of outperformance, these come within extended up/down cycles and we think the signposts for a sustained upswing are not evident yet.	The Chinese government has sparked a rally in Chinese stocks but not the Chinese economy. Consequently, we have not seen this translate into broader EM equity market performance. The Chinese equity outlook is stronger than for EM's as an asset class. **We stay neutral EM's.**

EM back in focus as Chinese market rallies

Relative performance for Emerging Market (EM) vs Developed Market (DM) equities moves in long waves with only 4 distinct performance periods over the past 30 years. Since 2010, EM equities have consistently underperformed DM equities. However, they are now back in focus following a powerful rally led by the Chinese market, which comprises 41% of the MSCI EM index.

EM relative performance moves in lengthy cycles



Source: Factset, MWM Research, July 2020

We don't think the drivers that have underpinned these extended periods of out/underperformance for EM vs DM equities have altered. Therefore, while the tactical outlook for EM's is important in driving short term portfolio performance, it should also fit within the context of the longer-term outlook for EM's as an asset class in portfolios.

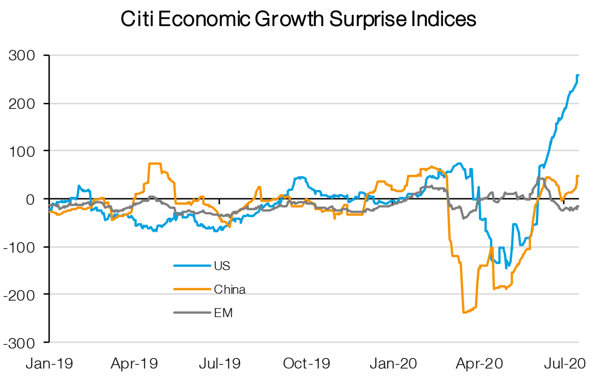
While the outlook for China has brightened, we remain cautious on the potential for the Chinese equity market to continue to outperform regional and global equity markets. In addition, the strength in Chinese equities is not being replicated in economic growth and so there is limited scope for China to be the engine for economic and equity market performance across other EM's. At this stage, while China has the capacity to support near term EM performance, we don't see this as being sustainable and neither do we see the drivers for the start of a period of structural outperformance being in place.

1. EM relative economic strength unsustainable?

Central to the case for EM equities is EM economic relative performance. Prima facie there is a case to be made here, given China's relatively robust economic performance. While China was the first nation hit by COVID-19, its lockdown was short and its recovery began earlier. Underlying this, China's GDP growth for Q2 recently rebounded to +3.2% y/y (consensus: 2.4%) versus -6.8% in 1Q20. However, while Macquarie expects Chinese GDP growth could rise to around +5% y/y in 2H, it believes the V-shaped recovery is already behind us.

Additionally, global economic data surprise indices are not flashing green for EM relative economic performance. China's data is now beginning to surprise on the upside but is clearly being outpaced by the US. Additionally, data surprise for EM's is still slightly negative. This is not surprising given Latin America (particularly Brazil) is continuing to struggle with COVID-19 and a 2nd wave has seen India reimpose lockdowns in some parts of the country.

EM economic data lagging US

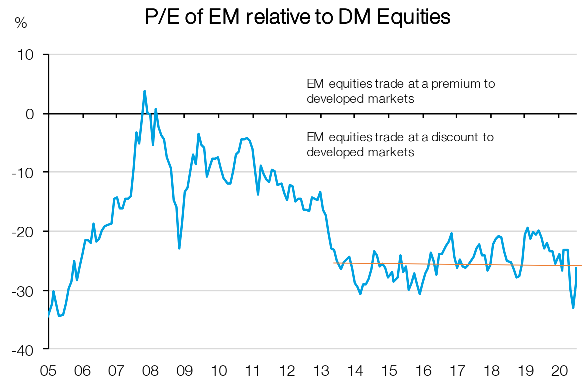


Source: Citigroup, Factset, MWM Research, July 2020

2. EM Relative Valuation Re-Rating

EM valuations appear undemanding, trading at a deep 26% discount to DM equities on a P/E basis. Unfortunately, this is in line with the average over the last 7 years (25% discount), with the P/E discount having traded in a range of 20-30%. In other words, EM equities are not particularly cheap, but equally valuations will not prevent them from trading higher.

EM equities not cheap relative to history



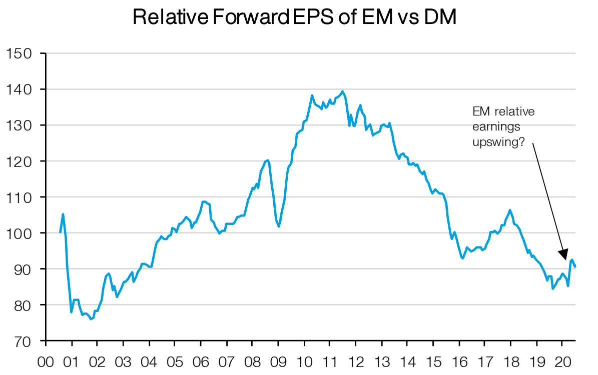
Source: Factset, MWM Research, July 2020

Historically EM outperformance has been accompanied by a period of sustained P/E re-rating and hence this would likely be necessary should EM's begin another period of relative outperformance. To judge the likelihood of this, we need to understand why EM equities have traded at a large and consistent discount for the past 7 years.

We think the answer lies in the fact that Asia ex Japan (a substantial component of MSCI EM) has been delivering weak earnings growth and progressively lower ROE's (which depress the P/E). This has been driven by slower nominal GDP, diminishing pricing power of corporates and operating / asset inefficiencies. This has manifested itself in poor relative earnings growth for EM's versus DM's (see *"What caught my eye v.134: AxJ – land of scarce growth and inefficiencies"* Viktor Shvets).

The implication is that while EM's are trading at a discount to DM equities, there are structural reasons for the relatively low P/E multiple that are unlikely to reverse soon given a strong and sustained cyclical recovery in economic growth is unlikely and downside earnings pressure on corporations remains in place.

Fundamentals don't point to a relative EPS recovery

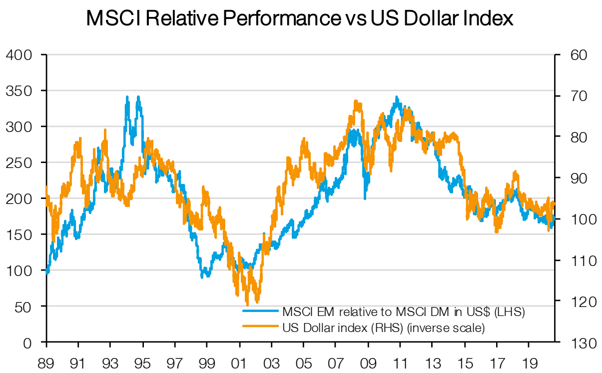


Source: Factset, MWM Research, July 2020

3. US Dollar Weakness

A weakening US dollar has historically been a major positive for EM equities given a close inverse relationship. The major reasons for this are: 1) the US$ is historically a counter-cyclical currency while EM equities are typically cyclical; 2) commodity prices are priced in US$ and many EM countries are commodity exporters which therefore benefit as the US$ weakens; and 3) EM debt is typically priced in US$ so a weaker US$ improves debt serviceability.

EM equities outperform as the US$ weakens



Source: Factset, MWM Research, July 2020

The US Dollar has weakened since spiking in March, but the decline has been modest and is yet to manifest itself into a full-blown dollar correction. Macquarie's FX team believes the US Dollar could sell off as the November election approaches and if a new US President rolls back Trumps corporate tax cuts, eroding what has been a pillar of support for the dollar ever since (see *"Global FX Outlook - USD: The Great Unravelling"*, Gareth Berry).

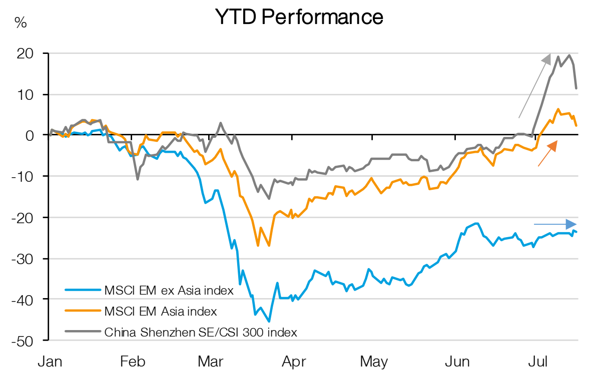
However, their bearishness is tempered given the US$ can also strengthen due to US growth outperformance, even in the midst of a benign global expansion, as the past two years have demonstrated. Relatively strong US economic data may be enough to counterbalance any negative political outcomes, even if global risk appetite improves further.

This would imply that while there is the potential for further US$ weakness, it is still too early to call a major bear market.

So far, the rally is mostly a 'China thing'…

Chinese equities rallied strongly after Beijing signalled its appetite for higher stock prices. State media outlets published several bullish articles encouraging retail investors into the market and unlike most developed markets, retail investors play a major rather than a minor role in China's equity markets.

EM ex Asia yet to participate in recent rally



Source: Factset, MWM Research, July 2020

However, the recent rally in Chinese equities has not yet been mirrored by some other EM countries, namely India and Korea, though Brazil has performed well recently due to iron ore price strength. China's market has effectively dragged the EM index upwards. Also note that the MSCI China index has lagged the domestic CSI 300 index, presumably because of the greater retail investor influence on the CSI 300.

EM performance dragged up by China

	MTD	Since 23-March	YTD
MSCI Developed World	4.0%	44.4%	-1.4%
MSCI Emerging Markets	5.6%	41.1%	-3.8%
MSCI EM ex Asia	4.8%	40.5%	-23.5%
MSCI Brazil	8.3%	54.3%	-32.2%
MSCI Russia	2.5%	37.5%	-23.0%
MSCI EM Asia	5.8%	41.2%	3.3%
MSCI China	7.0%	36.6%	12.0%
MSCI Korea	2.6%	51.1%	-3.9%
MSCI Taiwan	7.5%	43.6%	6.8%
MSCI India	5.6%	48.9%	-10.8%
China Shenzhen SE / CSI 300 Index	10.2%	33.1%	12.3%

Source: Factset, MWM Research, July 2020

…& does the Chinese rally have legs?

The Chinese government-backed media signalling is reminiscent of late 2014 when a co-ordinated state media campaign led to a margin-fuelled 150% rally in less than 12 months.

Another boom-bust in Chinese equities coming?

Source: Factset, MWM Research, July 2020

However, we don't believe Chinese authorities want a repeat of the 2014/15 boom bust that saw the equity market tumbling 50% through 2015/16. In the near term, how Chinese regulators react to the recent rally will be important in determining their willingness to see it continue. At this stage, sentiment and valuations are not nearly as extreme as in 2015. But if market turnover and margin lending continue to rise rapidly, then regulators might take more action to cool down the market.

Conclusion

EM equities have underperformed for almost 10 years and are trading at a substantial P/E discount to DM equities. However, none of our key signposts for a sustained period of outperformance are 'flashing green' and we are not convinced that the appeal of buying because China is rising is sustainable.

While the Chinese government has sparked a rally in Chinese stocks, it is a financial market rally rather than an economic rally, which would be a more significant tailwind for other emerging markets (both economies and equities). There is the potential for the rally in Chinese stocks to continue, but we think this is likely to be more a reflection of the authorities' willingness to continue to be the fuel for the rally rather than because the economic backdrop is likely to be surprising on the upside. Stay neutral.

…a final word on EM's as an asset class

Our tactical view on EM's is separate from a strategic asset allocation view on EM's. Traditionally EM's have been added into equity allocations to boost returns and diversify risk. We continue to think they have an important part to play within a broad equity allocation and balanced portfolio.

However, the rationale for adding EM's into a strategic asset allocation has also changed over time for the following reasons:

EM's underperformed DM's over past 10ys

	Returns p.a.		St Dev p.a.	
	EM	DM	EM	DM
Since Dec-87	10.2%	7.8%	22.5%	14.8%
Last 10 years	3.6%	10.6%	17.9%	13.8%

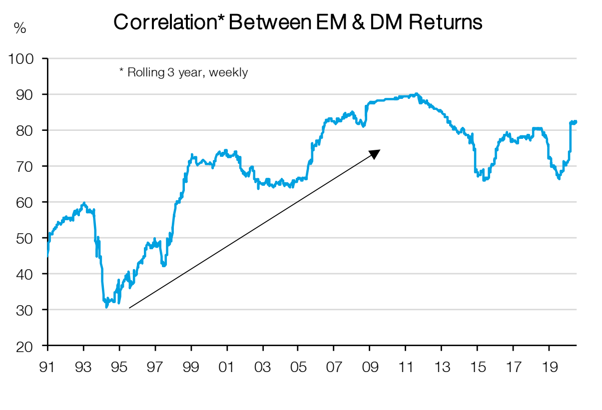
Source: Factset, MWM Research, July 2020

- Returns have been inconsistent and risk higher: A key rationale for adding EM equities as an asset class has been access to higher returns. Over the past 30 years, EM equities (+7.8%) have slightly outperformed DM equities (+7.5%), but this has come at substantially higher risk and this performance has been very time specific e.g. EM's have substantially lagged DM's over the past 10 years.

Our CME's continue to place the return profile for EM's above DM's over the next 10 year at 9.3% versus 7.2% respectively but the changing composition of the EM index is beginning to make country selection more important than treating EM's as a homogenous asset. We think over time the larger EM markets, such as China, will increasingly be treated as a separate allocation.

- **Correlations with DM's are increasing:** A traditional benefit of EM's has been a low correlation with DM's. This provides diversification benefits for a portfolio. However, over time, this correlation has been increasing.

EM correlation with DM has increased

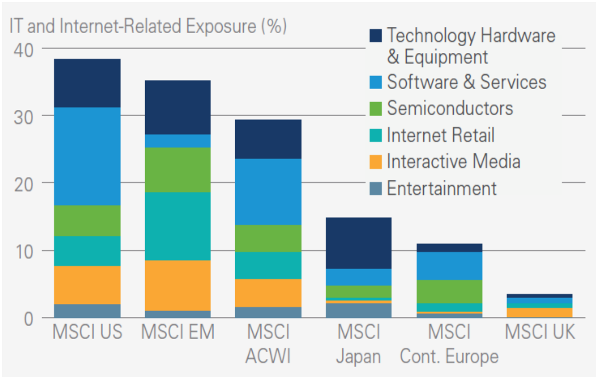


Source: Factset, MWM Research, July 2020

We think there are several reasons for this.

- First, EM growth is a beta on DM growth, but the world has been mired in a weak growth backdrop which has kept EM's shackled to their DM neighbours.
- Second, the dispersion in growth across EM's has been increasing with the largest weighted EM countries (like China, Korea and Taiwan), slowing down.
- Third, the index composition of EM's is becoming more consistent with DM's. The 5 largest technology stocks within the EM index are around 24% of its market capitalisation - not too dissimilar to the 5 largest tech stocks within the US equity market.

EM equities provide a high-tech exposure



Source: Lazard, July 2020

Overall, we think EM's should still be part of a balanced portfolio. But the benefits via higher return and greater diversification have fallen over the past decade and we think this is a more normal reflection of the outlook.

In addition, as EM's continue to develop and increase in size, we think investors will look to differentiate across components of the EM index in order to concentrate exposure to certain areas (i.e. China/India for middle class consumer transition, Brazil for commodities and Korea/Taiwan for technology).

Preferred exposures to EM equities

- For a broad EM equity exposure our preference is to the **RWC Emerging Markets Fund** (CHN8850AU). The fund provides a highly active pro-growth allocation across emerging and frontier markets with its largest portfolio weightings to technology disruption, 5G and infrastructure.
- The **Vanguard Emerging Markets Shares Index Fund** (VGE) is our preference for a cheap index exposure to EM equities.
- For China-specific exposure we would look to **iShares China Large-Cap ETF** (IZZ) or **VanEck Vectors China New Economy ETF** (CNEW) for a tilt towards higher growth sectors related to healthcare, technology and the consumer.

Jason & the Investment Strategy Team

The report was finalised on 19 July 2020

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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