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WEALTH SOLUTIONS

A Buying Opportunity for Emerging Market Equities?

Emerging market equities appear inexpensive considering our expectation that these economies may soon outperform their advanced counterparts. Now may be the time for investors to act.

Overview

- China is dragging down emerging market valuations for reasons we believe markets are misjudging.
- A divergence in both economic growth prospects and potential monetary policy direction sets up emerging markets to potentially outperform advanced markets.
- We see many reasons why emerging market stocks represent an attractive opportunity.

The time may be right for investors to consider allocating to emerging market (EM) equities, based on our view of what we consider as historically attractive valuations and a favorable economic outlook.

Concerns about China's economic prospects and Beijing's ongoing trade tensions with Washington have cast a shadow, suppressing valuations well beyond the world's second-largest economy to the entire EM asset class. It seems that Chinese valuations reflect a worst-case outlook of continued economic deterioration. Instead, we expect Beijing will use the many policy levers at its disposal, as seen with surprise interest rate cuts in mid-August. With the Chinese consumer already starting to increase spending, we see a real chance that China's economy could stabilize and improve. In that scenario, any economic data surprise to the upside could drive Chinese equities significantly higher.

This situation creates a unique opportunity to buy EM equities at what could turn out to be historically favorable valuations.

The International Monetary Fund (IMF) forecasts global emerging market economies to grow by 3.9% in 2023 and by 4.2% in 2024. We believe those numbers could be even higher should the U.S. Federal Reserve reverse course and cut interest rates, an action that would typically weaken the U.S. dollar. (That would be good news for EM economies because U.S. dollar-denominated debt repayments would cost less to fund in domestic currency.)

This optimism is not reflected in EM equities pricing, even as advanced economy equities rebounded over the summer of 2023 despite much weaker relative economic fundamentals.

This dynamic has produced an unusually wide valuation gap between EM and developed market (DM) equities. However, history tells us that when EM as an asset class presents an investing opportunity, it is rarely spread evenly across countries and stocks. Capturing this opportunity demands fundamental, bottom-up research to find and exploit potentially mispriced opportunities.

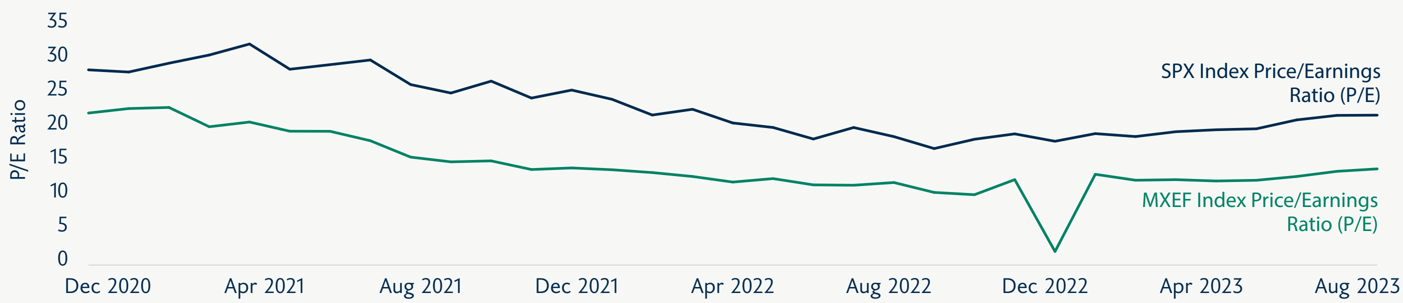
Five Reasons We Are Optimistic About EM Equities

① EM equities trade at a significant discount to advanced economy equities[1]

That is the case today even though the economic outlook is considerably brighter for emerging economies than developed economies. Among EM equity markets, Latin America and Europe, the Middle East and Africa (EMEA) are especially underpriced relative to Developed Market equities *and* to their own 12-month forward return on equity, as shown in **Figure 1**.

Figure 1: EM Equities Trade at a Steep Discount to DM Equities Trailing 12-Month Price-Earnings Ratios

Trailing 12-Month P/E Ratios



It is not possible to invest directly in an index. Index performance is shown for illustrative purposes only and does not predict or depict the performance of any investment. Past performance is not indicative of future results. MXEF refers to the MSCI Emerging Markets Index, SPX refers to the S&P 500 Index.

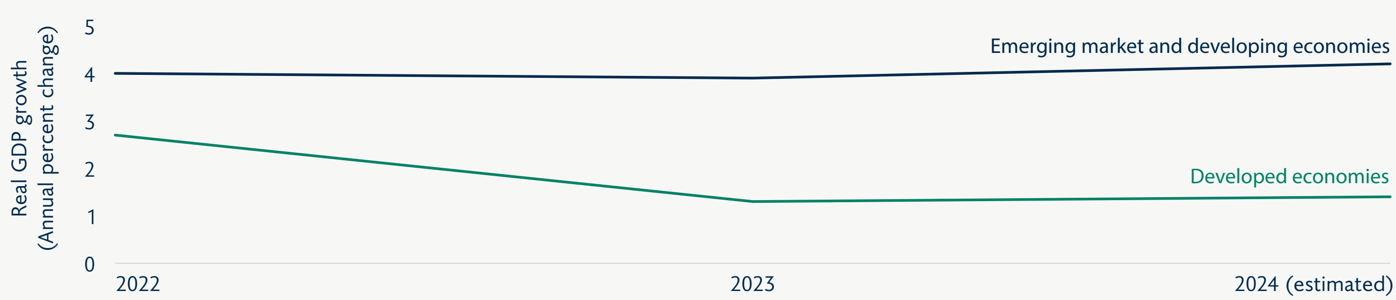
Source: Bloomberg, as of August 1, 2023.

② EM economic prospects are bright

While the IMF projects accelerating EM economic growth, it forecasts advanced economies slowing (**Figure 2**). We see several trends potentially boosting EM growth. First, the diversification of global supply chains beyond China should remain a powerful driver of growth for other EM countries. Second, many EM countries will benefit from a generational surge in demand for copper, lithium, nickel, cobalt, rare earth elements and other commodities crucial in the energy transition.

Figure 2: IMF Projects Stronger Economic Growth for EM Economies GDP Growth

GDP Growth 2022-2024



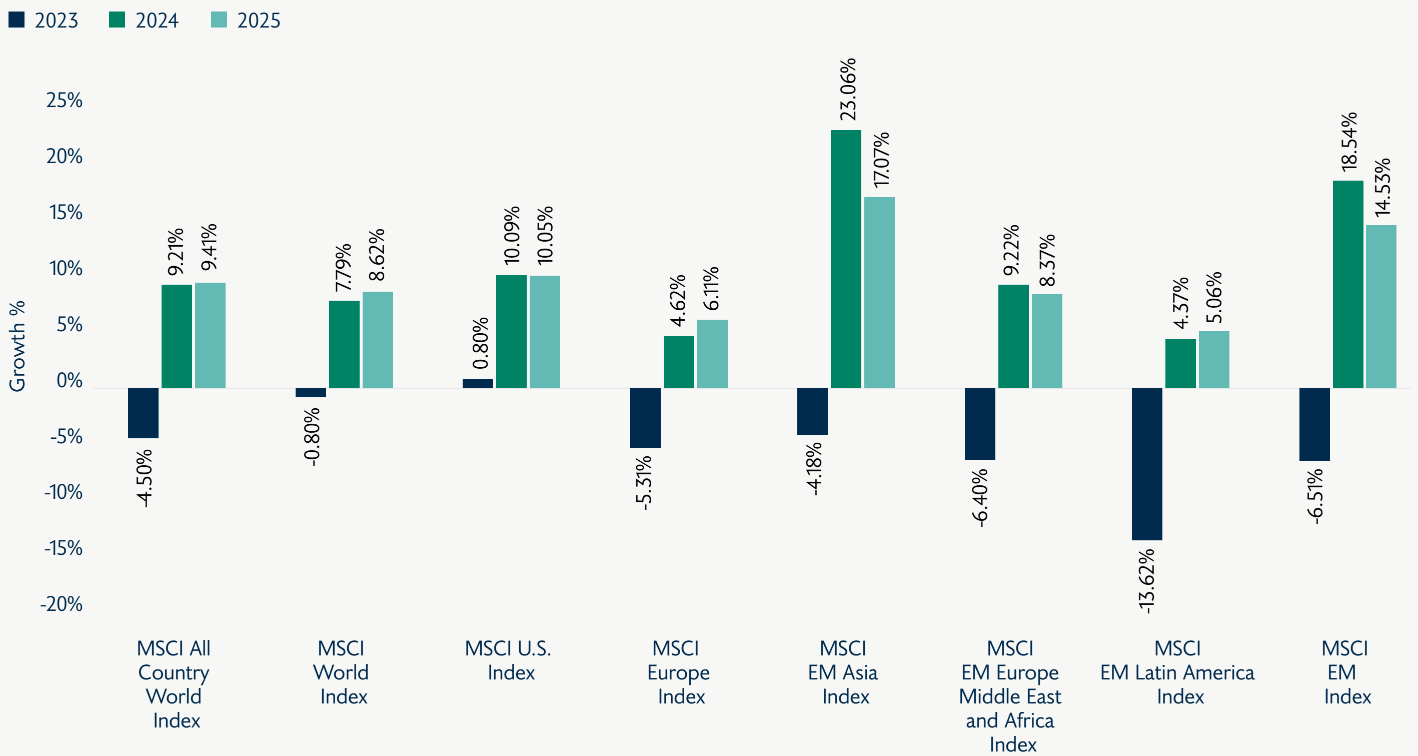
Source: International Monetary Fund, World Economic Outlook, as of April 2023.

③ The outlook for EM earnings is favorable

EM equities are also expected to outperform advanced economy earnings growth in 2023 *and* 2024. Indeed, EM equities are already outpacing developed economies this year, and EM earnings per share (EPS) growth is projected to accelerate in 2024, while developed markets could flatline (**Figure 3**).

Figure 3: EM Outpacing Developed Economies on EPS Growth Earnings Growth: Consensus Forecasts by Region

Forcasted EPS Growth by Region



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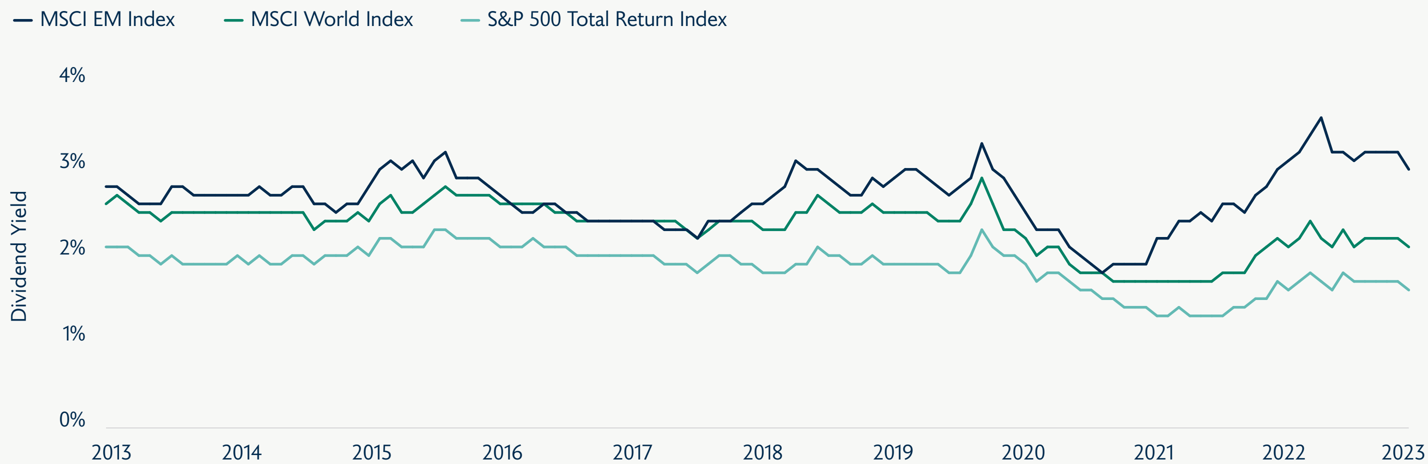
Source: Bloomberg, as of August 15, 2023.

④ EM companies are increasing dividends

EM companies increased headline dividend payouts by 22.7% in Q1 2023. **Figure 4** shows how the differential in benchmark dividend yields has historically helped boost returns on EM equities relative to developed markets.

Figure 4: EM Equity Returns Boosted by Higher Dividends Trailing 12-Month Dividend Yield

Trailing 12-Month Dividend Yield: MSCI EM Index vs. S&P 500 Total Return and MSCI World Index



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Source: Morgan Stanley, as of June 30, 2023.

⑤ A weakened U.S. dollar may generate a tailwind for EM equities

Historically, EM equities have had a powerful inverse correlation to the U.S. dollar. Any eventual rate cuts by the Fed could weaken the U.S. dollar, providing another tailwind for EM equities. We believe that the recent downgrade of the U.S. credit rating by Fitch suggests that U.S. dollar strength may have peaked. Future dollar weakening would provide fresh room for EM central banks to shift to more stimulative policies. EM countries started raising rates long before the Fed, so real EM interest rates have been higher for longer. We expect central banks in Brazil, Chile and other EM countries to start cutting rates soon.

Conclusion

In many ways, investors face a potential dream scenario in EM equities. Worries about China are affecting valuations across the entire asset class. However, we believe the current risk/return profile for both China and EM should be highly favorable. In our view, compared with developed economy stocks, EM equities are cheap and enjoy superior fundamentals. While developed economies appear primed for a slowdown, most projections call for a better business environment and stronger profitability for emerging markets. Those fundamentals should only improve once the Fed stops hiking (and ultimately cuts) interest rates.

Despite this encouraging scenario, EM stocks continue to trade at a significant discount to advanced market equities. Given these reasons, we believe current prices represent an attractive opportunity for investors to improve portfolio returns by allocating to EM equities.

ENDNOTE

[1] Generally, developed markets are countries with industrialized economies, strong political and legal systems, and robust technological infrastructures. Emerging markets are countries transitioning to modern, industrial economies.

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