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Spotlight on emerging markets

Improving fundamentals positive for equities

March 2018

Emerging market equities have had an active start to 2018. After a stellar 2017 underpinned by robust corporate earnings, we are optimistic that improving company fundamentals should continue to support the asset class. **Matthew Vaight,** fund manager, assesses the outlook.

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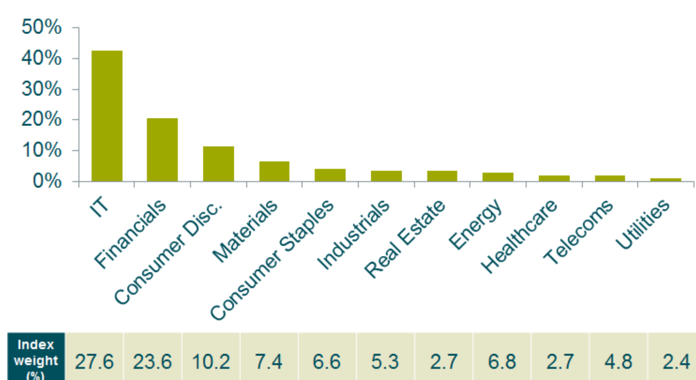
Emerging market equities rallied for the second consecutive year in 2017 and once again outperformed developed market stocks. In contrast to 2016 when the market re-rated in advance of an earnings recovery, last year's performance was underpinned by the earnings coming through.

A closer look at the drivers of returns last year reveals that the gains were concentrated in a narrow part of the market. Technology stocks really drove the rally. The sector returned over 60% in 2017 in US dollar terms and made the largest contribution to the market's overall return. It accounted for more than 40% of the performance of the MSCI Emerging Markets Index, despite representing less than 30% of the index.

Technology stocks drove the emerging market rally

Contribution to performance of MSCI EM Index in 2017



Index weight (%)	27.6	23.6	10.2	7.4	6.6	5.3	2.7	6.8	2.7	4.8	2.4

Source: Factset, in US dollars, 31 December 2017

A significant portion of those returns came from just two stocks, Alibaba and Tencent, two large Chinese internet firms which rallied amid considerable optimism about their growth prospects.

Style rotation

Given the strong performance of technology stocks last year, the 'growth' style substantially outperformed 'value'. As a result, the valuation premium of growth stocks relative to value is now very close to all-time highs.

By their very definition, growth stocks will typically trade at a premium to value, but today the valuation differential between the most expensive stocks and the cheapest is extreme. We believe that this valuation discount, combined with encouraging fundamentals at both an economic and corporate level, represents a favourable backdrop for a value approach to emerging market investing.

The search for value

As value-oriented investors, we are currently finding the most attractive opportunities among the more economically sensitive sectors, such as financials. In our view, the sector should benefit from the improving macroeconomic environment through increased lending and lower levels of bad debt. Furthermore, there are clear signs that emerging market banks are becoming better governed and more disciplined.

We also see investment opportunities in the IT sector, where we prefer hardware manufacturers to internet/social media companies on valuation grounds. In contrast, many of the internet companies are trading on very high valuations, which imply very high future growth rates of which we are cautious. We also see little value in expensive areas, such as consumer discretionary and healthcare.

From a country perspective, we are similarly attracted to the cheaper markets, particularly Brazil, where the economic outlook is improving after a severe recession.

The end of the 'Korean discount'?

South Korea was one of the best-performing stockmarkets last year, up nearly 50% in US dollar terms, yet valuations barely moved: the MSCI Korea ended 2017 with a P/E ratio of 11.0x

versus 10.9x at end-2016. This occurred primarily because the rally was fundamentals-based – the increase in share prices was matched by growth in earnings.

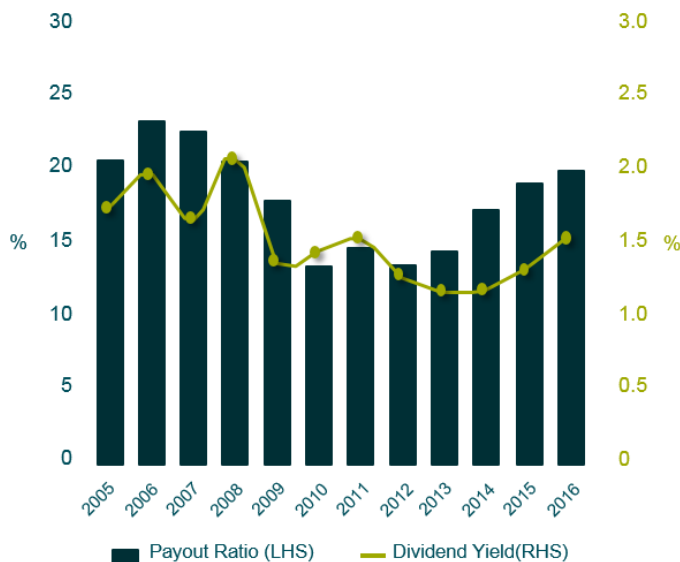
In our view, the fact the market did not re-rate suggests that the ‘Korean discount’ remains intact, with investors somewhat sceptical of the sustainability of recent reform initiatives.

Korea’s stockmarket has historically traded at a discount to regional peers, but we believe that improving corporate governance could help this discount narrow in future. Investors have been cautious about putting their capital into Korea on account of the country’s poor corporate governance practices. The market is dominated by large family-owned groups, known as *chaebols*, which have tended to be run in the interests of the family rather than minority investors.

However, this appears to be gradually changing. The Korean government has been passing reforms aimed at stopping poor treatment of minority shareholders. Among other things, these have incentivised companies to increase their dividend payments and empowered minority investors to vote in response to management actions.

These efforts seem to be working: for example, there has been a marked upwards trend in dividend distributions by Korean firms, indicative of a greater commitment by corporates to sharing success with their shareholders.

Rising payouts: KOSPI dividend payout trend



Source: Bloomberg, Citi Research & Factset, MSCI, December 2017

Samsung Electronics, the Korean technology giant, has been at the forefront of these new shareholder-friendly reforms. Over the past few years, Samsung has significantly increased its dividend payout and bought back shares. The company currently returns 50% of its free cashflow to shareholders, up from just 5% in 2012. Encouragingly, Samsung recently cancelled some of the shares it bought back, a move which would arguably not have occurred a few years ago.

Despite this progress, Korea’s payout ratio remains well below that of other markets. In our view, there is plenty of room for dividends to grow as more companies follow Samsung’s lead. We believe better treatment of minority investors and increased shareholder returns could lead to the market re-rating.

Positive reforms in China

Despite ongoing concerns about China’s economy and debt levels, we are becoming more optimistic about China amid signs that the government’s recent reforms are taking effect. We are seeing the results of efforts to reduce overcapacity in a range of industries, as well as the benefits from measures to stabilise the financial system. While we remain a cautious investor in the market as a whole, we have been becoming more active over recent months.

For the past few years, many investors in China have focused on the exciting prospects of the so-called ‘new economy’. While we recognise that the shift towards a services-driven economy will create opportunities, we believe valuations of many stocks related to popular themes such as the internet, social media and consumer spending are simply too high to offer value.

In contrast, we see attractive opportunities in the mainly state-owned manufacturing and industrial companies associated with ‘Old China’. These stocks have arguably been overlooked in the past few years as investors have concentrated on the consumer theme. However, profitability in sectors such as energy and industrials has risen recently, but valuations have not. As contrarian, value-focused investors, we believe this represents an interesting situation.

China old and new: valuations and profitability

Source: MSCI, Factset, Morgan Stanley Research, ROE monthly data as of October 2017 while P/B data as of November 21, 2017

As a result of the government’s supply side-reforms, production capacity in heavy industries such as cement and steel is being permanently cut. In addition, as part of its environmental protection campaign, many of the most polluting projects have been closed. Alongside this reduction in capacity, we are seeing consolidation into fewer, larger, more efficient operators. Importantly, there appears to be a new focus on profitability and cashflows rather than just revenues.

In our view, these developments are an encouraging shift and the potential improvement in performance of these companies does not yet seem to be fully appreciated.

Cleaning up the banking industry

At the same time, we believe we are nearing an inflection in the Chinese banking industry. The level of bad debts in the system appears to be falling, partly as a result of the improving economic environment, but also as a result of the banks writing off or selling bad loans.

Most significantly, however, in our opinion, is that the government has taken steps to improve the functioning of the financial system. The government has sought to reduce the amount of leverage in the system, tightening regulations around lending and clamping down on certain savings products.

There is now greater discipline around bank lending with the ability to lend dependent on a bank's financial strength. In this environment, the better-run, more disciplined banks with the strongest balance sheets should benefit from greater pricing power. For arguably the first time ever, in our opinion, there will be real differentiation amongst the banks. Furthermore, there is a general shift in the sector towards more profitable, less risky retail lending.

Given these changes, we believe that the leading Chinese banks could potentially sustain decent levels of returns over the longer run. However, the stocks continue to trade at attractive valuations. For this reason, we have recently invested for the first time ever in a state-owned bank.

Optimistic outlook

After two years of impressive gains, we remain optimistic about the outlook for emerging market equities. The improvement in company fundamentals looks sustainable and should continue to support the asset class. Better capital discipline and cost controls by company management teams are underpinning the increase in profitability. In our view, this upturn in fundamentals is yet to be fully reflected in valuations.

Notwithstanding the significant returns over the past two years, emerging market equities remain attractively valued, in our opinion, relative to developed markets. In particular, we believe the wide differential between value and growth means there are currently promising opportunities for selective value-focused investors.

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