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Where We See Opportunity in Emerging-Market IT Stocks

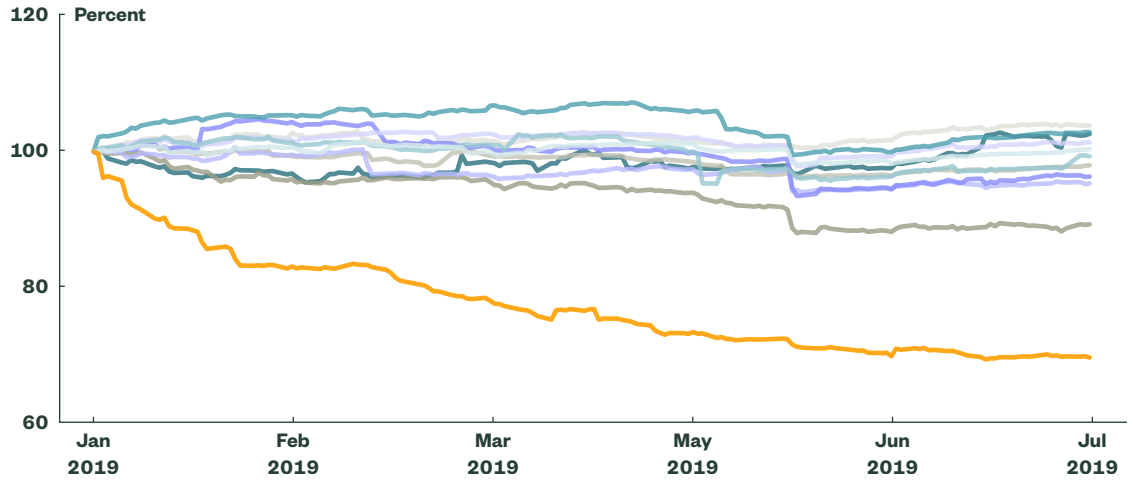
- We continue to see opportunity in emerging markets, despite a lack of sustained earnings growth.
- Even in the Information Technology sector, where expectations for falling earnings are concentrated, we see opportunity in EM Software & Services firms, which are performing relatively well on a range of valuation and quality metrics.

The lack of sustained earnings growth in emerging markets has frustrated equity investors in recent years. The trend does not show much sign of reversing: Consensus forecasts for earnings-per-share (EPS) growth in the MSCI EM Index have been revised down from 8.9% at the end of 2018 to approximately 5.6% for 2019.¹ A closer look at earnings expectations reveals that a large portion of this decline is concentrated in the Information Technology (IT) sector, where EPS growth is expected to fall 31% (see Figure 1). Given this deceleration in earnings, it may surprise some that we see opportunity in emerging-market IT firms — even though our stock-selection model prefers stocks showings signs of consistent earnings growth.

Understanding this opportunity requires a closer examination of EM IT firms. The IT sector within emerging markets has become extremely bifurcated at the industry level. In general, our bottom-up assessment shows that Software and Services (“S&S”) firms exhibit many positive drivers of return. Technology Hardware and Semiconductor companies, by contrast, are confronting a range of challenges.

Figure 1
Consensus EPS Growth Forecasts By Sector Across the MSCI EM Index
 December 31, 2018
 Through July 31, 2019

- EM Information Technology
- EM Materials
- EM Industrials
- EM Consumer Staples
- EM Consumer Discretionary
- EM Health Care
- EM Financials
- EM Utilities
- EM Communication Services
- EM Real Estate
- EM Energy



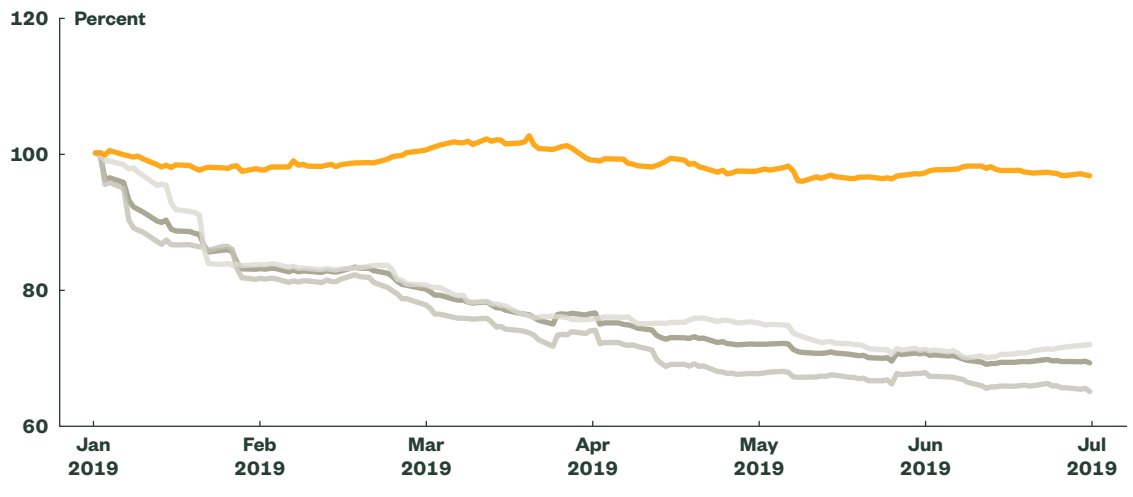
Source: Bloomberg Finance L.P., as of July 31, 2019.

Software and Services firms are typically engaged in business consulting, and in application development and maintenance. A significant part of their business is focused on helping clients run more efficiently. This cost-focused spending is less impacted by economic cycles. As a result, unlike other IT segments, S&S firms have been able to generate consistently high returns on equity and to increase dividend payout ratios, despite a slowing global economy.

More strikingly, a look at earnings-per-share forecasts for the three industry segments within the IT sector shows that Software companies, unlike their peers in the Tech Hardware and Semiconductor industries, have remained immune to many of the headwinds generated by the ongoing China/US trade dispute. Due to their more strategic business models, S&S companies are less sensitive to trade volatility, and they've been able to increase profit margins in an environment that has challenged other exporters.

Figure 2
Consensus EPS Forecasts By Industry
 December 31, 2018
 Through July 31, 2019

- EM Software & Services Industry
- EM Information Technology Sector
- EM Tech and Hardware Industry
- EM Semiconductors



Source: Bloomberg Finance L.P., as of July 31, 2019.

In addition to exhibiting relatively favorable profitability characteristics, EM Software firms also offer diversification benefits. We are not suggesting, of course, that Software and Services companies are somehow immune from a global slowdown — a reduction in their customers' IT spending certainly would have negative consequences. But the drivers of return for software and services firms are quite different compared to other IT sectors. These differences have become even more evident in light of recent fears over global trade.

Two examples are the influence of movement in the Indian Rupee (INR) and passive equity flows into India, each of which have proven to be more directly related to S&S equity returns than the slowdown in trade. Eighty percent of EM Software and Services stocks are located in India, which means their costs are incurred in INR, while most revenues are recognized in US dollars (USD). As a result, they profit from a weakened domestic currency when revenues are repatriated to INR. In addition, S&S firms are a relatively large component of the Indian market and have been direct beneficiaries of improving investor sentiment and passive flows into the country. The correlation matrix across the EM IT sector reveals the diversification that S&S exposure can offer vis-à-vis EM Technology and Hardware and EM Semiconductors, respectively, and with respect to the EM IT sector as a whole (see Figure 3).

Figure 3
Correlation of Equity Returns
 September 30, 2018
 Through July 31, 2019

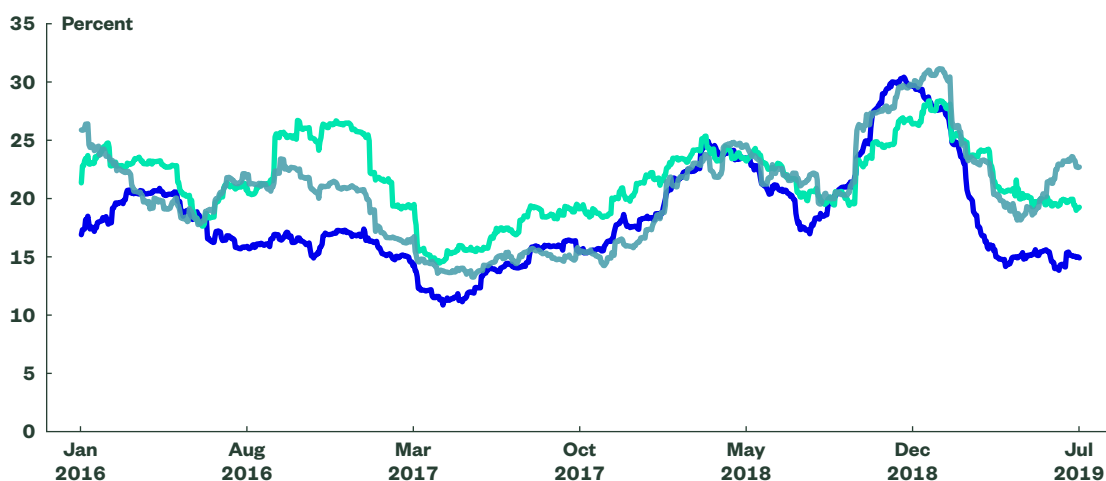
	EM IT Sector	EM Software and Services	EM Tech and Hardware	EM Semiconductors
EM IT Sector	1.00	0.68	0.90	0.90
EM Software and Services	0.68	1.00	0.43	0.49
EM Tech and Hardware	0.90	0.43	1.00	0.77
EM Semiconductors	0.90	0.49	0.77	1.00

Source: Bloomberg Finance L.P.

Taking this a step further, one can see that the lower correlation to the broader sector has resulted in more defensive risk and return characteristics for S&S stocks. This relationship holds over longer periods but has been particularly noteworthy throughout 2019, as S&S stocks' resilient growth profile and lower exposure to economic cycles have resulted in significantly less volatility (see Figure 4).

Figure 4
Historical Volatility Levels By IT Industry Within Emerging Markets
 January, 2016 Through July 31, 2019

- EM Software & Services Industry
- EM Tech & Hardware Industry
- EM Semiconductor Industry



Source: Bloomberg Finance L.P., as of July 31, 2019.

A reasonable question to ask is whether this analysis of EM software companies translates to their counterparts in the developed world. Emerging markets are characterized by a lower degree of market maturity. This is very evident in the IT sector, where emerging markets can be heavily concentrated in specialized lines of business. The Software and Services industry within EM has a high concentration in Indian business consulting firms, whereas the developed software index has a higher exposure to technology payment and processing companies as well as internet stocks. These are securities that continue to be more expensive when compared to the rest of the investable equity universe and as a result score poorly on our valuation metrics.

The Bottom Line

Emerging-market equities are an inherently risky asset class, characterized by lower levels of transparency and elevated levels of political and currency risk. Nonetheless, we continue to see opportunity in the asset class, despite a general trend of deceleration in earnings. Identifying those opportunities amid a global slowdown and persistent trade-related fears requires a close examination of both return and risk drivers, through a disciplined investment process. At present, we continue to see opportunities in the EM Software & Services firms, which are fairly valued and performing quite well on a range of quality and sentiment metrics — and which also offer substantial diversification benefits compared with other IT segments.

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Endnotes

1 Source: JP Morgan Emerging Markets & Developed Asia Strategy Dashboards, as of July 18, 2019.

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Glossary

Quality Quality indicators include a range of measures that go to a company's capital productivity and balance-sheet health, among other attributes.

Sentiment An investment theme that can help investors take advantage of the return opportunities generated by the emotions, perceptions and actions of market participants.

Value Investing Investing in stocks that exhibit solid fundamentals (e.g., dividends, earnings and sales) that tend to trade at lower prices than their peers.

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