Quietly Chugging Away. Why Emerging Markets Deserve More Attention

Raf Choudhury
Head of Investment Strategy & Research, Australia

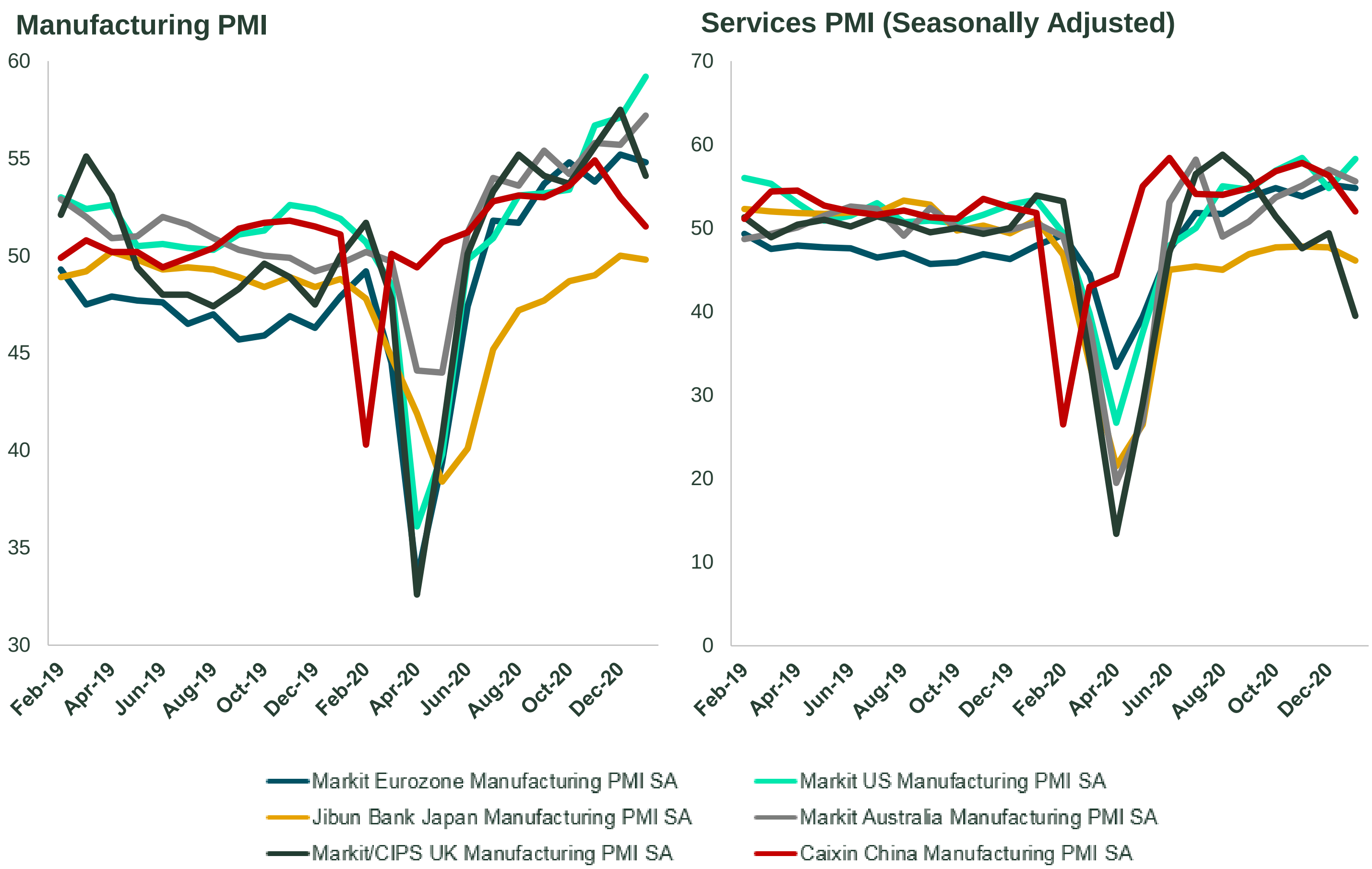
- Emerging market (EM) performance accelerated throughout the pandemic and is likely to continue to perform strongly.
- EM earnings look positive with valuations reflective of the current low rates and yields.
- Recent USD strength has mainly been against G10 currencies and more mixed against EM currencies.

Since the depths of the Coronavirus pandemic, equity returns have continued to rally, including in emerging markets. While US equities, in particular the technology sector, have been grabbing the headlines, EM equities continue to chug along keeping pace with the broader developed market equity indices. In 2020, EM equities delivered 8.0% in AUD terms (versus 8.09% for the S&P 500 Index in AUD, 1.4% for the S&P/ASX 200 Total Return Index and 5.8% for the MSCI World Index in AUD). Strong EM performance has continued into January this year with the MSCI EM Index up 3.8% (in AUD) outperforming Australian equities by 3.4% and International Developed Equities (MSCI World Index in AUD) by 3.1%[1].

There have been two key drivers behind our positive outlook for EM. Firstly, China which makes up a large part of the MSCI EM Index led the way in terms of the drop off and subsequent recovery in both manufacturing and services PMI's.

[1] Source: Bloomberg Finance L.P., as of 29 January 2021

Figure 1: Manufacturing and Services Purchasing Managers Index (PMI)



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 29 January 2021.

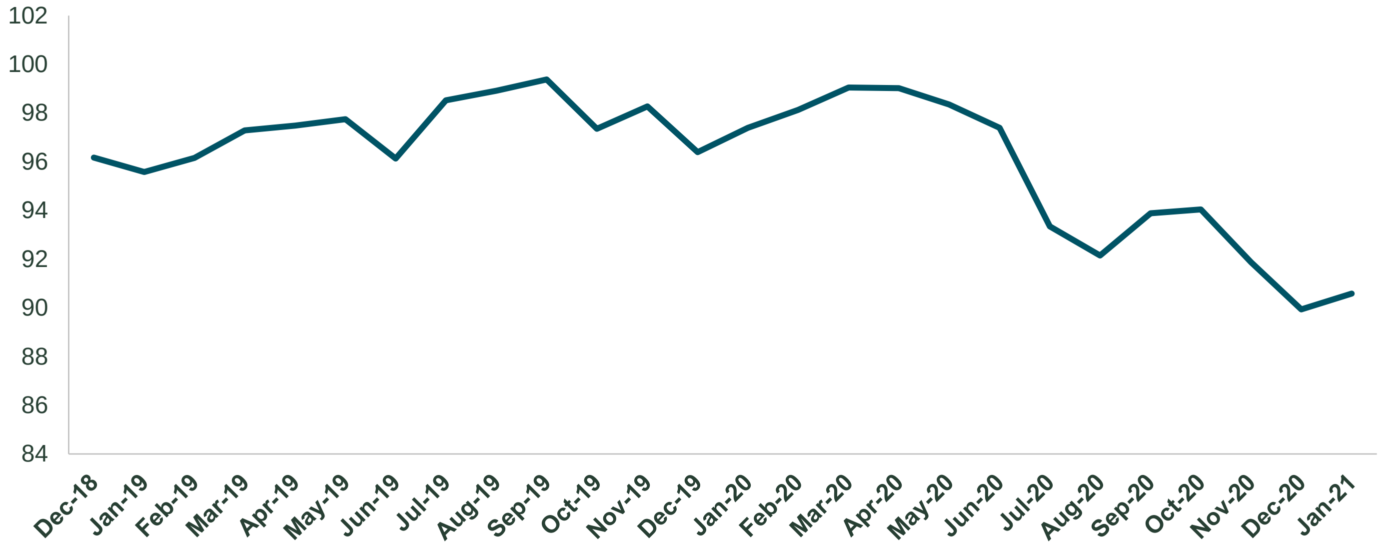
The improving global growth outlook as other countries got to grips with the virus, and the recovery in demand for exports as borders reopened, supported our more positive outlook on EM.

The second reason that was supportive of our EM exposures, was our view that the US Dollar was/is in a longer term cyclical decline. A weaker US is positive for EM markets because:

1. It tends to see capital leave the US to seek other opportunities
2. The fall in the USD increases the dollar value of local EM currency returns
3. A falling USD also supports corporate earnings in EM via higher commodity prices

However the rate of the sell-off in 2020 was accelerated and more recently through January this year we have seen the USD consolidate some of those losses.

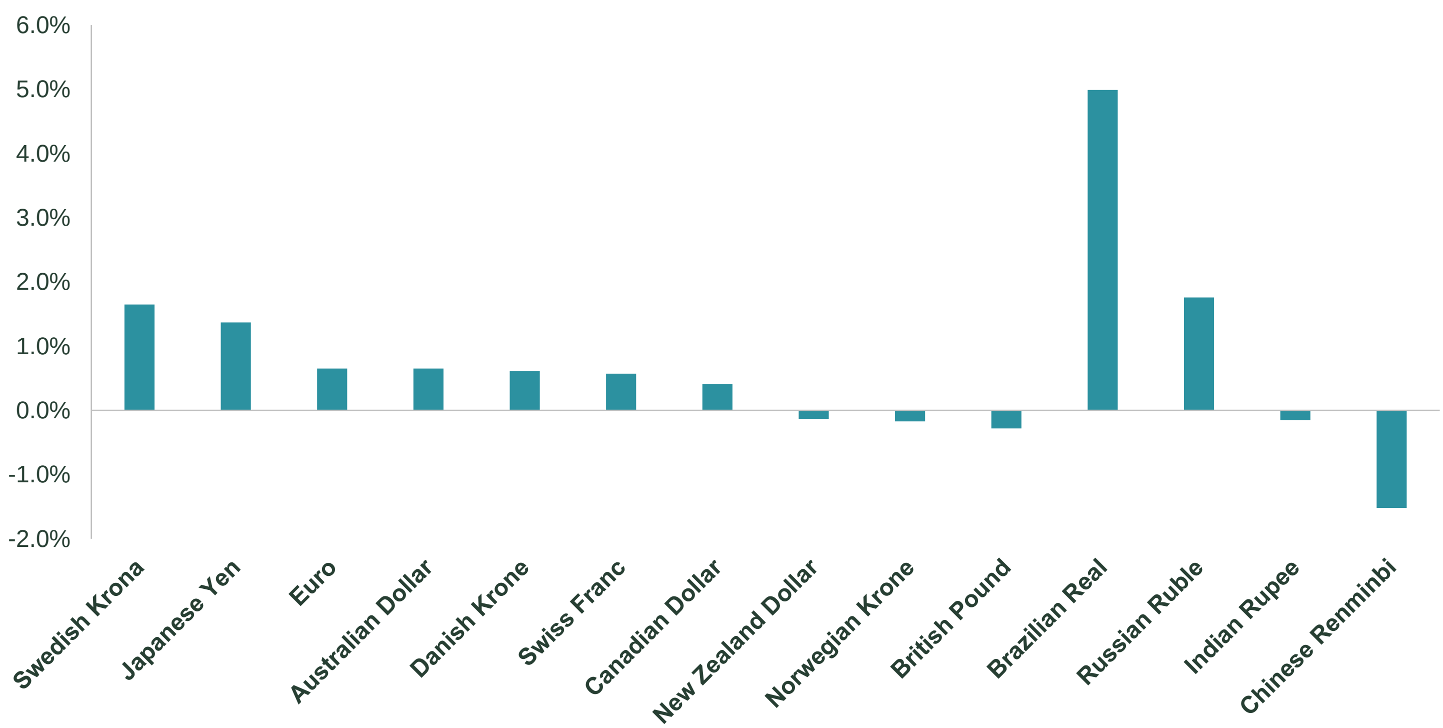
Figure 2: U.S. Dollar Index



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 29 January 2021.
Past performance is not a reliable indicator of future performance.

So far and particularly throughout January 2021, the US Dollar has shown some strength but this has mainly been against G10 pairs where the US Dollar retains strong potential growth and yield advantages. In EM, growth will also likely recover and is still expected to provide a growth advantage, although this might be narrower than in the past. Reflective of this, performance of the US Dollar against EM currencies has been more mixed but overall still positive for EM.

Figure 3: USD Performance vs G10 and BRICs (Brazil, Russia, India and China)



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 29 January 2021.
Past performance is not a reliable indicator of future performance.

Looking at the BRICs in Figure 3 above, the USD has shown strength against the Brazilian Real and Russian Ruble. These two markets have a combined weight in the MSCI Emerging Markets Index of approximately 7.3% while India (9%) and China (38%) stood up well to the US Dollar in January[2].

Going forward we are also positive around the earnings story for EM. China makes up the biggest part of the EM complex but EM isn't just a China story. Revisions to earnings estimates are taking place across the EM complex, especially across Asian EM markets. Analysis from State Street Global Markets identifies India as having the best earnings upgrade potential[3] - even better than tech-heavy markets like Taiwan and South Korea.

That isn't to say there aren't some potential headwinds on the horizon for EM which include yields moving aggressively higher in the US as well as the risk of weaker than expected growth and reduced policy support. Our view is that these latter two are unlikely at least through the first half of this year and overall we remain positive on EM. The vaccine rollout – the pace of which has been increasing, underpins our expectations for growth to recover strongly this year. We also expect to see positive earnings momentum across a broad range of emerging market countries which should be supportive of current valuations, the MSCI EM 12-month forward Price to Earnings (P/E) currently stands at 15.9x[4] which despite being above the historical average, is reflective of the low levels of interest rates and bond yields. Improved global demand and the recovery in commodity prices which are also seeing positive revisions to forecasts – should also benefit EM.

[2] Source: State Street Global Advisors, Bloomberg Finance L.P., as of 29 January 2021.
[3] State Street Global Markets: "Don't Abandon EM – just be a bit more Pacific" published on 5 February 2020.
[4] MSCI EM Index Forward PE, source Bloomberg Finance L.P., as of 29 January 2021

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