GW&K INVESTMENT MANAGEMENT

GLOBAL PERSPECTIVES

AFTER THE FALL: ASSESSING VALUE IN EMERGING MARKETS

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Diverging Trends within Emerging Markets

As markets swooned this year in response to the coronavirus pandemic, it was not surprising that Emerging Market (EM) equities underperformed Developed Market (DM) equities. As of mid-May, the MSCI EM Index had lost about 18% for the year-to-date period. That compares to 14% for MSCI World Index and 12% for the S&P 500 Index.

But trends within EM diverged greatly across regions. EM Asia has weathered the storm relatively well. Three of the largest Asian equity markets – China, South Korea, and Taiwan – were well prepared to act quickly to contain the pandemic within their borders. As of mid-May, the EM Asia Index was down only 12% for the year to date, about the same as the S&P 500 Index.

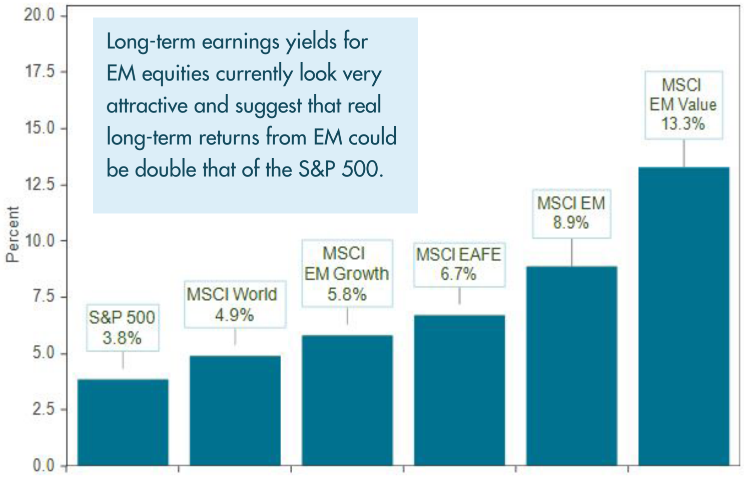
In contrast, the regional indexes for EMEA and Latin America were down respectively by 27% and 46% for the year to date. Those regions struggled with weak commodity prices and rapid growth of COVID-19 cases. Key nations like Brazil, Mexico, Russia, and South Africa were hard hit. Their currencies have also been among the weakest in the world this year.

Amid Great Uncertainty, Long-term Expected Returns for EM Look Quite Robust

Many economists have penciled in significant economic recoveries around the world as economies reopen in coming weeks. However, such forecasts are offered with low conviction. For example, the International Monetary Fund's (IMF) most recent forecast was hedged by noting that "much worse growth outcomes are possible and maybe even likely." Reflecting the high degree of uncertainty, many companies in both EM and DM have suspended normal earnings guidance.

In view of such uncertainty, looking at market valuations through the lens of normalized earnings makes sense. One such method is to use Shiller PE ratios, which are based on the market price of an index divided by a ten-year average of inflation-adjusted earnings. Even if the near-term outlook is highly uncertain, the ten-year earnings average may be a reasonable proxy for the earnings capacity of the companies in an index.

CHART 1: Long-term Earnings Yield Comparison: S&P 500 vs. MSCI World, EAFE, EM (Value & Growth)



Long-term earnings yields for EM equities currently look very attractive and suggest that real long-term returns from EM could be double that of the S&P 500.

Note: Based on inverse of Shiller PE ratios of 4/30/2020; Source: GW&K Investment Management, Robert Shiller, MSCI, Bloomberg, and Macrobond

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Inverting the Shiller PE generates a long-term earnings yield (LTEY), which financial economists sometimes use as a rough proxy for future long-term real returns for an index. Using LTEYs to compare various asset classes suggests that future long-term returns to EM equities could be quite robust.

Based on data from the end of April, Chart 1 suggests that long-term real returns for EM could potentially be more than double those of the S&P 500. That is based on comparing the long-term earnings yield of 8.9% for the MSCI EM Index against the corresponding yield of 3.9% for the S&P 500 Index.

Even more striking, the long-term earnings yield for the MSCI EM Value Index was a remarkable 13.3% at the end of April. That reflected extremely high yields for the EMEA and Latin American regions of 15.9% and 12.9% respectively. Likewise, the highly depressed Value sectors of EM Energy and Financials offered yields of 17.4% and 13.4% respectively at the end of April.

Will a Deep Value Style in EM be Required to Generate Superior Performance

In contrast, the LTEY of the EM Growth Index was merely 5.8% at the end of April. That raises an important question: will a contrarian "deep value" style be required to generate superior returns in EM over the next few years?

We doubt it.

An EM deep value strategy would involve high-conviction investments concentrated in the most depressed regions and sectors, such as EMEA, Latin America, and Energy and Financials. The catalyst for unlocking such value would probably need to be a V-shaped global recovery and commodity price boom.

Absent a miraculously short time table for a COVID-19 cure or vaccine, that scenario seems unlikely.

Suppose, as seems more likely, that the global economy experiences more of a partial recovery. If the virus is contained, but not eradicated, we could be dealing with continued social distancing and consumer and business caution for many quarters. Recent damage to both public- and private-sector balance sheets may dampen global growth into next year. The impact of temporary fiscal policy support may also fade next year, leaving GDP levels in 2021 and 2022 significantly below where they otherwise would have been.

Under those assumptions, the high long-term earnings yields we see in the most depressed EM regions and sectors could be illusory. The problem is that normalized earnings based on the last ten years will then be a poor guide to normalized earnings over the next few years.

Factoring in High Margins and Revenue Trends, EM Growth Stocks Look Very Attractive

Under a partial recovery scenario, we would expect the markets to continue to reward companies with robust business models, as reflected in high margins and strong revenue growth. Interestingly, a recent study by Empirical Research Partners suggests that stock valuations have become increasingly driven by those two factors.

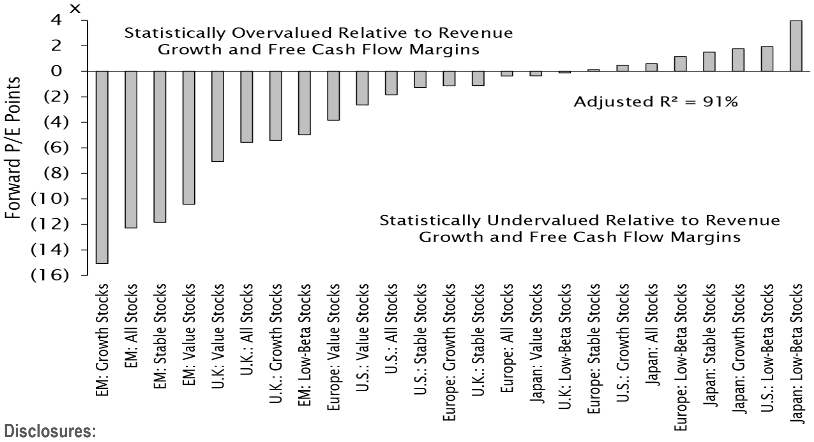
As shown in Chart 2 below, their work suggests that EM Growth stocks are the cheapest equity category in the world relative to the "fair value" implied by their free cash flow margins and trend growth rates. EM Stable stocks and Value stocks also score well.

But EM Growth stocks stand out. Heavily weighted in fast-growing sectors like Information Technology, Communication Services, and Consumer Discretionary, EM Growth stocks have been delivering similar growth to their U.S. counterparts. Yet they trade at half the forward multiples of their U.S. counterparts.

Are trailing revenue growth rates meaningful in a world turned upside down by the pandemic? Empirical Research Partners finds that forward estimates for revenue growth that view the pandemic through 2021 mostly preserve the relative pecking order, with U.S. and EM growth stocks continuing to lead.

As the old saying goes, "the race is not always to the swift, nor the battle to the strong, but that is the way to bet."

CHART 2: Under- and Over-valuation of Key Global Equity Categories Relative to Fair Value*



EM Growth stocks are statistically the most undervalued equity category in the world relative to revenue growth and free cash flow margins.

*Fair value is based on regression model over U.S., European, and Japanese stocks using five-year trailing revenue growth and free cash flow margins as of April 2020.

Source: Empirical Research Partners Analysis

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