

Investment Spotlight

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AXA Investment Managers - Research & Investment Strategy

WEEKLY COMMENT

Emerging Markets Equities: Overweight amid ample liquidity

by

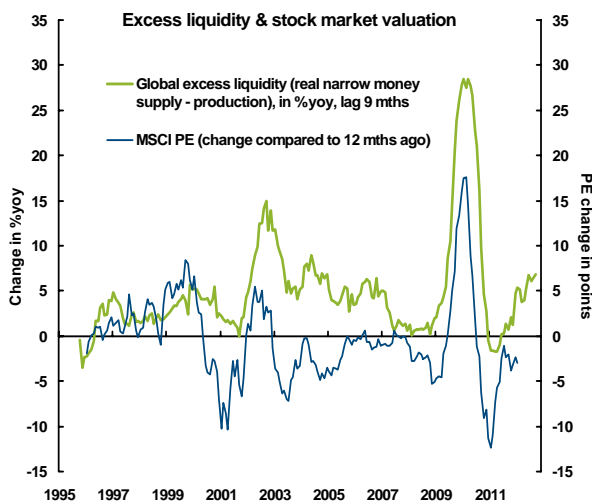
Franz WENZEL

Key points

- The global economic backdrop will remain lacklustre, which should help to alleviate some of the inflationary pressure in emerging markets.
- Most emerging markets will continue to lower interest rates, which will subsequently be the most important driver for their equity markets.
- We expect the negative earnings trend to swing to the upside toward mid-2012.
- Valuation is supportive, but a non-negligible part comes from Central and Eastern Europe (CEE), which we see at risk due to its significant exposure to the euro area.
- Three important risks stand out: stronger than expected inflation; a sudden liquidity squeeze, and the persistence of elevated beta in the markets.

Exhibit 1

Liquidity is an important driver of stock markets



Source: Datastream, AXA IM Research

At the beginning of 2012, investor sentiment towards emerging markets equities remains at best mixed. No wonder, given that this equity segment was strapped to a roller coaster in the course of 2011. With a performance of -12.5% (MSCI, in local currency), emerging markets only performed marginally better than the euro area (-14% MSCI EMU, in local currency).

Yet back in December, we suggested taking a contrarian view and putting money back into emerging equities in light of the outlook for further monetary easing.

In this note, we elaborate on a broader spectrum of the pros as well as the implied risks.

Lacklustre economic backdrop...

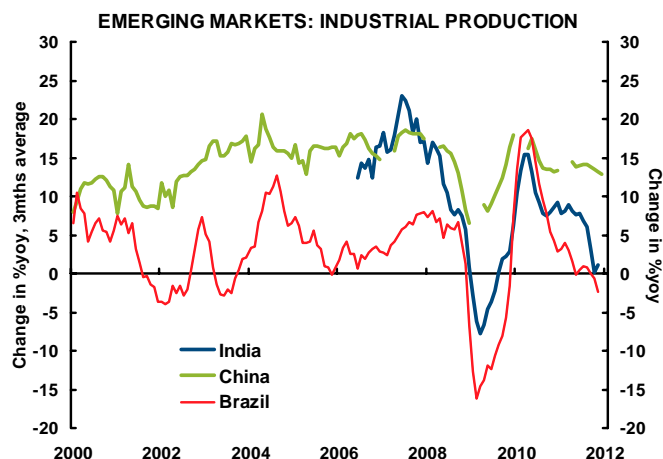
In 2012 global equities will, most likely, continue to dance, mainly to the beat of two tunes: First, the euro sovereign debt crisis, with a non-negligible risk of a break-up, which would have severe consequences for the global economy and presumably catastrophic repercussions for risky assets. Second, the cyclical swing factors, which clearly remain an element of concern, both for equities in general and for emerging markets in particular.

However, the most recent data flow has been more encouraging and leads us to think that the risks of a global recession are fading. The US looks to have taken a turn for the better, and we now expect GDP to grow around 2% on the back of brighter prospects for the manufacturing sector and, even more importantly, a ray of hope that the job market is finally awakening. Moreover, the Chinese 4th quarter GDP release, which came in at 8.9%yoy, corroborates our view of a soft landing for that economy. Clearly the euro area, for which we expect a recession in the first half of 2012 (implying an average growth rate of -0.5% for 2012), remains a substantial drag for the global economy.

Despite this better news overall, numerous concerns remain in place emerging market-wise. In particular, the manufacturing sector in the most important emerging markets is close to or already in contraction mode (*Exhibit 2*), thus weighing heavily on the overall economic picture.

Exhibit 2

Weak industrial production in various emerging markets



Source: Datastream, AXA IM Research

This said, we think the relative performance of emerging markets is fairly reasonably correlated with two important leading indicators: the US ISM and the Chinese PMI. In particular, the US ISM offers brighter prospects as inventories are lean. The surprise gap (production relative to new orders three months ago) has swung back into expansion mode, whilst Chinese readings remain mixed.

Accordingly, we conclude that for the time being **the macroeconomic backdrop will be less supportive** as prospects of a reacceleration in emerging markets are unlikely. This is, however, water under the bridge. As long as we do not see a further significant deceleration growth-wise, markets should be able to withstand the current doldrums as central banks have changed course.

... puts the onus on central banks

Throughout most of 2011 inflation was the “enemy number one” for activity, but various central banks have since changed their target. To everyone’s surprise, Brazil’s central bank lowered its target rate last August (and continued to do so until most recently, when it cut the official rate by another 50bps to 10.5%), citing a weakening domestic and international economic outlook. Various other central banks followed suit (the news in early January was the Chilean central bank’s 25bp cut), embarking on an easier monetary policy path, which, given the weak economic backdrop and the prospects of easing

inflationary pressures, will leave the doors open for further rate cuts, since real rates either remain elevated (Brazil) or have even increased (India).

Liquidity has been and will remain, at least for the foreseeable future, a very important lever for equities in general. Basically all major central banks around the globe will most likely embark on further QE. Besides, we also expect the ECB to finally adhere to an outright QE in order to prevent deflation. History suggests a fairly reasonable relationship between excess liquidity and stock market valuation, as shown on the front page (*Exhibit 1*).

Emerging market equities have a similar reaction function. Aside from international portfolio flows, this phenomenon is presumably best illustrated by the strong correlation between Chinese money supply and the valuation of this stock market.

Feeble earnings, but rays of hope emerge

Earnings are generally a function of the economic backdrop and track cyclical swings. Emerging markets are no different! Against this backdrop, it can hardly be surprising that earnings, more precisely earnings revisions (*Exhibit 3*), have been weak from an absolute perspective. What is surprising, however, is that emerging market earnings revisions have been by and large in line with global earnings corrections.

So far so good! But what about earnings forecasts? After a stellar earnings recovery, 2009/2010 trailing earnings growth is currently around 7% and declining.

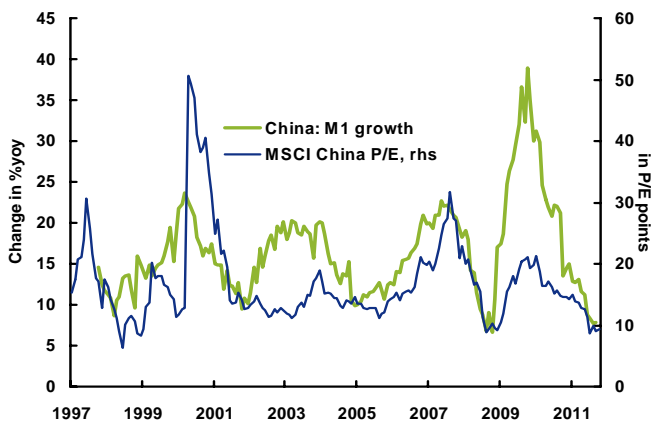
Whilst we think that the coming months will see further weakening in momentum, we are even more convinced that the tide will turn in the course of this year (provided our overall economic picture does not take a turn for the worse). Our preferred yardstick for assessing earnings momentum looks at margins, more precisely the relative change in output prices (proxied by the change in consumer prices) versus input prices (proxied by the change in producer prices). Admittedly, this yardstick can only provide a rough guesstimate, but the fit with earnings momentum is appealing. In addition, the correlation has a decent lead of around 12 months (*Exhibit 4*). Today's reading suggests that the earnings deceleration witnessed so far should bottom out in the first half of 2012, offering some hope for the second half.

Exhibit 4

Expect earnings trend to turn towards mid-2012

Exhibit 3

Liquidity is an important driver of stock markets

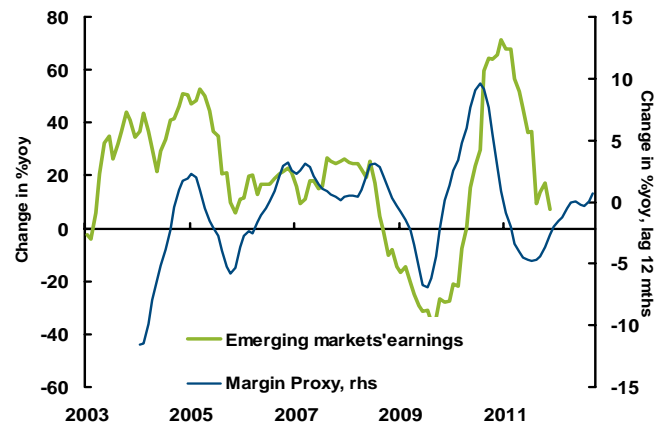


Source: Datastream, AXA IM Research

Even though we do not expect fast and furious rate cuts or aggressively lower reserve requirements from the People's Bank of China (PBoC), we remain convinced that authorities will do their utmost to steer the economy smoothly with the help of a well-dosed monetary policy, which should in turn help to stabilise or even reverse the negative trend in liquidity and subsequently help the stock market, albeit indirectly.

At this stage of the cycle, we think that **monetary policy is of utmost importance for emerging equity markets**, therefore putting our conviction call on this lever.

EMERGING MARKETS & MARGIN PROXY



Source: Datastream, AXA IM Research

Valuation: supportive!

Even though we think that valuation is presumably less important now, current readings should offer some welcome support: emerging markets do indeed trade well below their peers. Trailing PE¹ trades at 10x versus 13x for the MSCI world. A price to cash flow (PC) analysis shows a similar valuation advantage for emerging markets. Put differently, 2012 earnings could undergo a significant downward revision before emerging market valuations match global readings, offering welcome support for this market segment.

Exhibit 5 - Equity Valuation

	Trailing PE	Trailing PC	Forward PE
MSCI World	13.2	7.9	11.3
MSCI EM Markets	10.7	6.9	9.3
MSCI EM Asia	11.4	7.1	10.4
MSCI EM Europe	5.8	3.9	5.6
MSCI EM LatAm	11.8	7.8	10.1

Source: DataStream, AXA IM Research

Admittedly, the fact that emerging markets are cheap overall is in part attributable to Eastern Europe, which trades significantly below all other markets. A big proportion of this discount is due to the Russian energy sector, which currently trades below book value, reflecting a non-negligible political risk for this sector.

Moreover, we think that Central Eastern Europe (CEE) is heavily exposed to the euro area sovereign debt crisis, not only through its geographic vicinity but also through the sizeable operations of EU banks in the CEE. According to the Bank for International Settlements, foreign claims of European banks from their operations abroad are the highest in the CEE. European banks have large shares of European sovereign debt on their balance sheets, implying that a sovereign debt restructuring will have a negative impact on the capital adequacy of EU banks. In fact, the European Banking Authority recently stressed that EU banks will need €115bn of fresh capital in order to meet a 9% core Tier-1 capital adequacy ratio. Given this setup, EU banks will consider all options,

and deleveraging from the CEE is one of them. In addition, fiscal fundamentals in the CEE are currently worse than they were in the wake of the Lehman crisis, implying that there is not currently sufficient fiscal leeway to stimulate activity, which was done post-Lehman. Furthermore, although the current account deficit in CEE economies has shrunk considerably compared to the pre-Lehman period, its financing depends on short-term capital flows more than on longer-term, stable foreign direct investment.

We thus suggest remaining fairly prudent with regard to CEE exposure.

Risks to this strategy

Three risks need to be taken into consideration.

Growth-inflation disappointments: Our central case scenario is based on US growth close to potential and a mild euro area recession, whilst emerging markets are expected to weather a slowdown accompanied by decelerating inflation. Both elements clearly remain a source of concern. However, given that various emerging central banks have embarked on a pro-growth policy, we guess that any disappointment inflation-wise, which would call into question the monetary policy outlook, could have harsh repercussions for risky assets.

Liquidity squeeze: Second, a fairly important part of the emerging market growth story has been supported by a substantial credit cycle via domestic credit creation as well as foreign capital flows. In particular, the latter element implies a non-negligible risk if foreign investors were to withdraw liquidity. Our colleague Manolis Davradakis thinks that economies in Central Eastern Europe, Egypt and Turkey are the most vulnerable to this possibility, whilst Asian economies score the highest in this respect. Countries in Latin America are in the middle of the range. (“Global liquidity squeeze: CEE, Egypt and Turkey most at risk”, [Investment Strategy Special 2012 Outlook p22](#)).

High Beta: Even though emerging markets have undergone substantial structural changes in the past decade or so, market-wise they remain high beta, with a current reading of around 1.2 (on a 60-month rolling basis).

¹ Price-earnings ratio based on published earnings

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