



WILSONS

Emerging Market Equities: Checking in on our Positive View

Our weekly macroeconomic view.

23 November 2020

The Factors Behind our Position

In May this year, we outlined the bullish case for emerging market equities (EM). Our overweight position is based on several factors:

1. Superior virus control in the key North Asia region (China in particular) with resulting potential for a faster near-term economic recovery than in the developed world.
2. Significant leverage to a medium-term global economic recovery as growth rebounds in 2021 and 2022.
3. Strong secular (5 years +) growth potential beyond the near-term cyclical rebound driven by relatively better demographics, superior productivity gains, and growing addressable markets.
4. More attractive valuations relative to developed market equities.
5. A likely tail-wind for EM from progressive US\$ depreciation.

Read [The Investment Case for Emerging Market Equities](#).

In the 6 months since our deep dive, returns from EM have been very good with a US\$ total return of 33% compared to 29% for the MSCI developed world index (note the A\$ has appreciated 12% over this period).

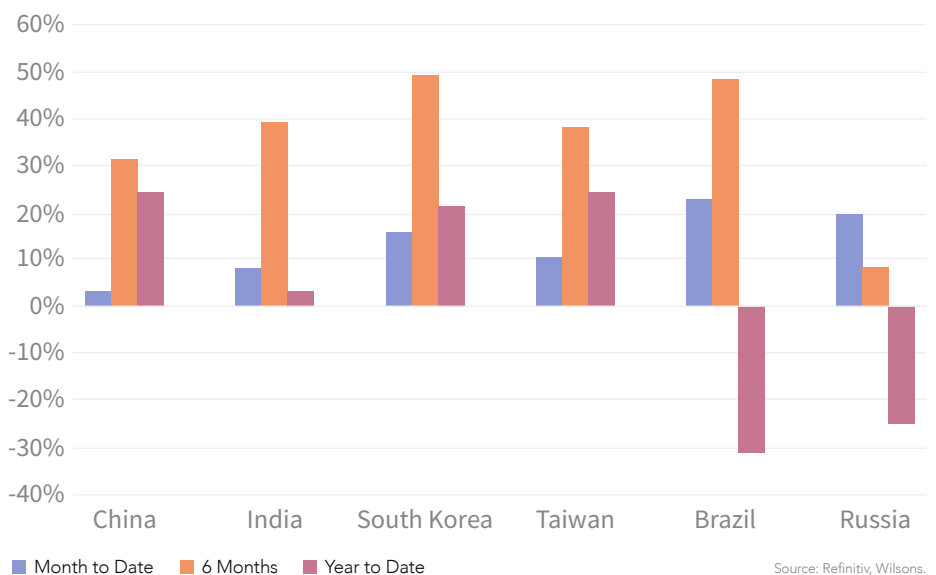
China leading but Rest of EM Catching a Bid

While there has been considerable focus on the strong performance of the Chinese share market, the rebound in EM over the past 6 months has actually become quite broad-based when measured on a country basis.

Exhibit 1: EM relative performance has begun to turn but early days



Exhibit 2: EM country performance in 2020 (US\$)



Markets such as India, Brazil, and more recently Russia are now recovering sharply, albeit still well down on pre-COVID-19 levels. The Chinese stock market shares some common ground with the US market in that it is now well above pre-COVID-19 levels, though China still trades on a much lower price-to-earnings ratio (PE) than the US market.

China does dominate the EM benchmark with a weighting of 43% (in comparison, the US is 67% of the developed world benchmark). The next largest emerging markets are Taiwan 13%, South Korea 12%, and India 8%. This group adds to 76% of the EM benchmark. The residual 24% is a long tail of smaller markets led by Brazil at 4%. Hence EM is very much a play on Asia with China at the core.

Tech-Related Stocks Have Led in EM

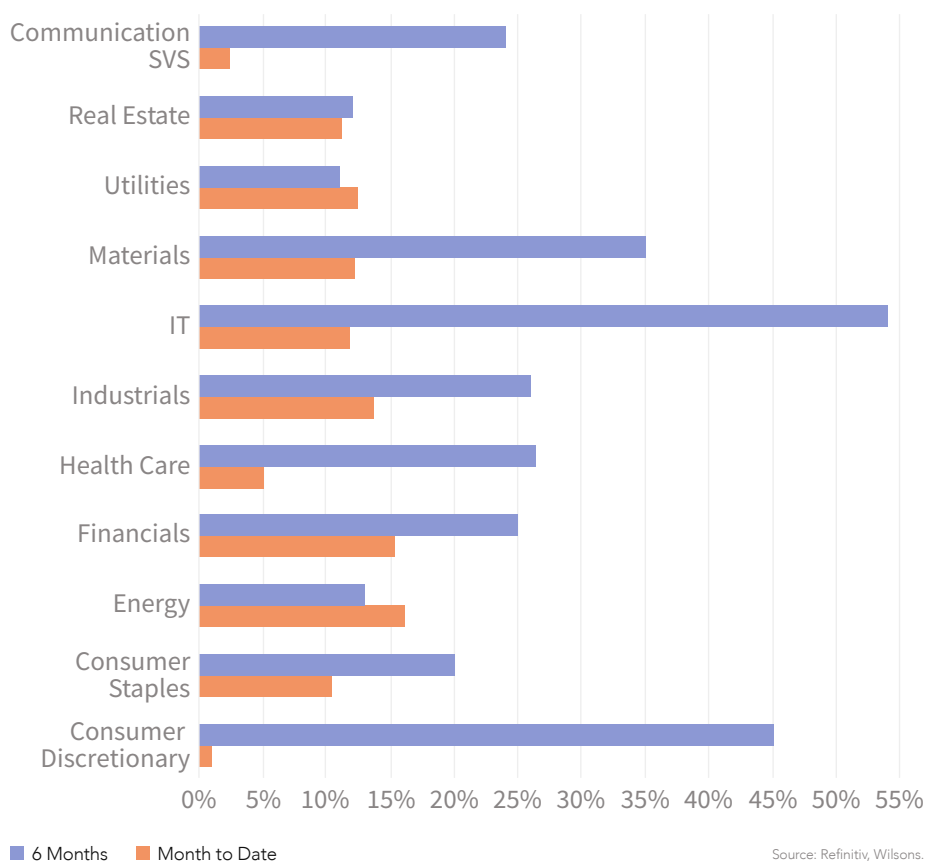
When examined on a sector basis, we can see the trends dominating developed markets have also been evident in EM. IT and consumer discretionary (dominated by e-commerce giants such as Alibaba) have led the way in the past 6 months. However, recovery cyclicals such as energy and financials have rallied hard in recent weeks in part due to positive vaccine news.

From a sector perspective, consumer discretionary at 22% is the largest sector in EM, followed by IT at 18% and financials at 17%. This compares to the developed world mix of IT at 22%, healthcare at 14%, with financials and consumer discretionary at 12%. So EM does have a similarly high weighting to tech in the broad IT plus e-commerce sense. However, we see the EM e-commerce growth runway as longer and stronger than in developed markets. Alongside favourable trends in tech and e-commerce, EM still offers a good level of exposure to value recovery in energy, financials, industrials, and materials.

Exhibit 3: EM continues to trade on a large PE discount to developed markets



Exhibit 4: EM sector performance - IT leading but month to date value rally



Emerging Markets Provide Leverage to China and Global Growth Recovery

The post-GFC environment has been challenging for emerging markets as a series of headwinds have crimped earnings and index performance. While it is possible to point to structural headwinds that have weighed on EM growth, we think cyclical challenges and a series of exogenous shocks (e.g. China and commodity price slowdowns, trade tensions and COVID-19) have played a large role in keeping EM economic and profit growth well below potential.

We now see a clear inflection point for the global and EM growth cycle extending at a minimum through 2021 and 2022. The COVID-19 situation is now improving in a broad range of emerging markets, and their recoveries are gaining momentum. The pace of the China growth recovery has been impressive with China already surpassing pre-COVID-19 levels of economic activity. In 2021 the combined effect of global vaccine rollouts, ultra-low interest rates, a weaker US\$ dollar, China's ongoing reflationary impulse, and a period of above-trend growth for the global economy should lead to a sharp rebound in EM growth.

As this cyclical recovery takes hold, it can help create a virtuous cycle where stronger nominal GDP growth drives earnings upgrades. EM appears on the cusp of transitioning from downgrades to upgrades. The last genuine upgrade cycle occurred in 2016/17 but was relatively brief as the US-China trade war

Exhibit 5: EM share prices have historically tracked the earnings cycle



short-circuited the expansion phase. The last truly multi-year upswing occurred from 2003 to 2007, which was a period of strong earnings growth and a multi-year outperformance period for EM. We see the potential for the coming upswing to dwarf 2016/17. It may not have the same commodity-intensive character as the 2003-07 expansion, but it should be a strong one reflecting the rise of the Chinese and broader EM consumer in particular.

A More Stable Geopolitical backdrop for EM?

Under a Biden administration, we are not expecting US/China relations to change dramatically, particularly as the President-elect is likely to focus on more pressing internal issues over the next 6-9 months. Medium-term we believe a Biden administration will manage the China relationship differently. He will look to increase pressure on China via multilateral

support using the combined weight of Japan, Canada, Australia, the UK, Europe, and India to have China evaluate unpopular practices and legislation. US/China relations are unlikely to become overtly cordial, but geopolitics could well progress toward a more stable phase, with benefits for the global trade cycle.

EM Poised for Extended Outperformance

We see emerging markets as being well placed to offer significant leverage to a progressive global recovery over the next couple of years. In addition, EM also offers secular growth appeal extending beyond this cyclical rebound. Emerging markets offer a good mix of exciting structural growth in areas such as e-commerce alongside deep value recovery potential, which should see them well placed for multi-year outperformance in our view.

Exhibit 6: Performance metrics of 10 largest companies in EM

	YTD Price Returns	PE 12 Mth Fwd EPS	Index weight %	Country	Sector
Alibaba Group Holding	21%	22.1	8.8	China	Consumer Discretionary
Tencent Holdings	57%	32.1	6.7	China	Consumer Staples
Taiwan Semiconductor	-6%	22.1	5.7	Taiwan	IT
Samsung Electronics	16%	12.5	3.7	South Korea	IT
Meituan	194%	105.2	2	China	Consumer Discretionary
Naspers	35%	21.2	1.3	South Africa	Consumer Discretionary
Reliance Industries	33%	23.8	1.2	India	Energy
JD COM ADR	145%	39.6	1.1	China	Consumer Discretionary
China Construction Bank 'H'	-10%	4.9	1	China	Financials
Ping An Insurance China 'A'	0%	10.3	0.9	China	Financials

Source: Refinitiv, MSCI.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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