Emerging market equities

Back to Brazil

Chief Investment Office Americas, Wealth Management | 16 November 2017
Soledad Lopez, Strategist, soledad.lopez@ubs.com; Jorge O. Mariscal, Regional CIO Emerging Markets, jorge.mariscal@ubs.com; Lucy Qiu, CFA, Strategist, lucy-w.qiu@ubs.com; Emma Hu, Strategist

• We maintain a moderate pro-risk stance in our dedicated emerging market (EM) strategy, with an overweight on EM equities relative to corporate bonds.
• For 2018, growth will likely remain the key driver of our constructive view on EM equities. Earnings growth will likely moderate to around 10%, resulting in a total return for the asset class in the low-teens range.
• We upgrade Brazil this month to most preferred: valuations are attractive and we expect the macroeconomic outlook to improve even further next year, supporting earnings growth.
• Our most preferred markets are Brazil, Russia, China, Indonesia, Thailand and Turkey. Our least preferred markets are the Philippines, Malaysia and Taiwan.

Overview

With just six weeks to go before the year ends, EM equities are on track to deliver the best yearly performance since 2009. Earnings recovery has been the biggest driver, contributing two-thirds of the 30% year-to-date gain in USD terms.

For 2018, growth will likely remain the key factor behind our constructive view on EM equities. Earnings growth will likely moderate to around 8-10%, resulting in a total return for the asset class in the low-teens range. Valuations are moderately expensive on a standalone basis but remain attractive relative to developed markets. Trailing 12-month P/E stands at 14.2x, one standard deviation above the historical average but at a 24% discount to developed market peers (versus the historical average of a 18% discount).

Our most preferred markets are Brazil, Russia, China, Indonesia, Thailand and Turkey. We upgrade Brazil this month to most preferred: valuations are attractive and we expect the macroeconomic outlook to improve even further next year, supporting earnings growth. We like Turkey for its earnings growth. In Russia, we believe greater GDP growth and stable-to-higher commodity prices will support earnings and the market as a whole. In Asia, we like China for its attractive valuations, and Thailand and Indonesia for their earnings momentum and profitability.

Note: All positions are relative to the MSCI EM Index.
Source: UBS, as of 16 November 2017

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Our least preferred markets are Taiwan, Malaysia and the Philippines. Taiwan’s 2Q earnings releases were weak, and the market lacks near-term catalysts. In Malaysia and the Philippines, macro challenges may weigh on performance. And we upgrade South Africa to neutral despite the expensive valuations as we expect volatility to increase ahead of the African National Congress elections in December.

MSCI EM: Top-down views

We remain overweight on EM equities against USD corporate bonds in our dedicated EM portfolio. The former should benefit the most from strong corporate earnings growth, and the latter is more likely to be hit by rising global bond yields.

Stay invested despite bumpier markets

Global risk assets experienced some turbulence in recent days. The VIX index, a popular volatility gauge, reached an all-time low of 9.1 on 3 November and has since spiked to 12.9. MSCI EM has retreated almost 2% from its year-to-date high. We think this temporary consolidation is normal and healthy after a year of strong outperformance. Return for next year will likely be lower but remain in the low-teens range, supported by earnings growth.

Recent activity data suggests the EM macro backdrop remains solid, while momentum is peaking: the October manufacturing purchasing managers’ index (PMI) eased to 51.4 from 51.8 in September, but still signaled expansion across all regions. While top-line growth may no longer accelerate much, we see further upside from better profitability: return on equity (ROE) improved to 11.4% from a trough of 10.2%, but is still well below the pre-crisis level of around 15%.

3Q17 earnings season: Another positive surprise

The 3Q17 earnings season is almost over as almost 80% of the companies in MSCI EM have reported. EM companies continue to surprise on the positive side, with earnings beating estimates by 6.5%. This is the sixth consecutive quarter that MSCI EM has beaten estimates. Across sectors, consumer staples, utilities and financials had the largest beats, while materials, telecoms and energy showed the biggest misses (see Fig. 4). Another positive season supports our view that fundamentals are improving in emerging markets and there is room for further upside in the coming years.

MSCI EM: Valuations not stretched

The MSCI EM Index is trading at 14.2x its 12-month-trailing price-to-earnings (P/E) ratio, one standard deviation above the 10-year average, but at a 24% discount to developed markets.

MSCI EM targets

- Our six-month target for the MSCI EM Index in our base case is 1,165, which assumes 3–5% earnings growth. We expect the 12-month-trailing P/E to stay around current levels.
- In our positive scenario, the global economy improves and boosts EM earnings, raising investor confidence. The MSCI EM Index reaches 1,300 in six months with 7% earnings growth.
In our negative scenario, EM prospects are hit by deteriorating global growth due to weakness in the Eurozone, the US or China. Earnings plunge, pushing the index down to 970.

Latin America

The MSCI Latam Index has posted a 16% return in US dollars year-to-date. Multiple de-ratings due to political uncertainty in Brazil and NAFTA negotiations in Mexico have reduced the impact of the region’s strong earnings growth (+29% year-to-date). We expect volatility to stay high, but fundamentals are improving and we expect countries like Brazil and Argentina to outperform their benchmarks in the next 6-12 months.

We upgrade Brazil to Most Preferred as we expect a solid improvement in fundamentals to support our forecast of 3.1% GDP growth next year. Subdued inflation and a lower policy rate will help to maintain the economy’s momentum, in our view. High frequency indicators, such as the manufacturing PMI, are in expansionary territory (56 in October).

We see moderate food inflation keeping a lid on prices overall, so our inflation forecasts of 3.1% for this year and 3.7% in 2018 are both below the BCB’s inflation target. The Brazilian central bank should be able to maintain its monetary easing, in our view, and cut rates to 7% by the end of this year. We believe this lowest-ever monetary policy rate will be kept over 2018 as capacity utilization is very low and unemployment is high. On the reform front, we expect uncertainties to linger, but at the current valuation the market appears to have priced in a lack of progress.

Therefore, we upgrade Brazil as the valuation is attractive and we expect the macroeconomic outlook to improve even further next year, supporting earnings growth. Trailing corporate earnings have increased 15% this year, and consensus expects them to rise close to 12% in the next 12 months. MSCI Brazil trades at 13.3x its 12-month trailing P/E, and around one standard deviation above its 10-year average.

We are neutral on Mexico and keep a cautious stance as negotiations on NAFTA continue, adding volatility. A potential López Obrador presidency in 2018 may be another headwind for the asset class. We think Mexico’s political and economic backdrop is about to get more volatile. The potential for higher rates worldwide, an uncertain NAFTA outcome and rising political noise should all weigh on investor sentiment. Also, earnings expectations need to adjust for softening consumer trends, sluggish industrial activity and muted government spending. As a result, we prefer to remain on the sidelines and remain neutral.

In Argentina, we expect the government to take a gradual approach to reforms. Nevertheless, the economy is on the right track, with the monthly measure of activity showing an improvement of 4.3% year-on-year in August from the bottom of -5.6% y/y in July 2016. GDP is expected to expand 2.8% this year after contracting 2.6% last year, and inflation should slowly come under control, falling to 28% from last year’s 33%. Higher investment, particularly in construction, and a credit boom are the drivers of the recovery. Also, confidence indicators have been improving since the midterm election in October.
We advise investors to add exposure to Argentine equities in a broadly diversified manner. Over the next 12 months, we think MSCI Argentina will do better than both the MSCI Frontier Markets and MSCI Emerging Markets indexes. Despite this year’s rally (MSCI Argentina is up almost 70% in US dollar terms), we see further upside thanks to stronger fundamentals. Moreover, Argentina’s inclusion in the MSCI EM index, which we consider likely in the next 12 months, could enhance local equity returns.

Emerging Europe, Middle East and Africa

MSCI EMEA has been the laggard in 2017, with a 9.5% returns n US dollar terms (as of 13 November). Turkey and Poland are the best performing countries in the region. We expect 10-15% earnings growth in the next 12 months in EMEA.

South Africa is at a turning point. The ANC conference in December may drastically change the country’s fiscal and economic trajectory. The party’s, and potentially South Africa’s, next leader will face the challenging task of restoring public finances and boosting potential growth. We expect the race for ANC leadership to be a close contest. This increases the range of potential outcomes, and therefore political uncertainty. The most likely scenarios are a victory for the reformist Cyril Ramaphosa, the “status quo” candidate Nkosazana Dlamini-Zuma and the “compromise” contender Zweli Mkhize. We think the market would react positively to the first and third scenarios, at least initially, but less so in the second given lower reform prospects and lingering uncertainty around policies. A Zuma victory would likely trigger a sell-off in South African assets and further rating downgrades.

The market remains expensive at 19.6x 12-month-trailing P/E, almost two standard deviations above its 10-year average, amid low earnings growth (see Fig. 8). Despite the expensive valuations, we prefer to stay on the sidelines ahead of the uncertain election and the future direction of the economy.

We keep Turkey as Most Preferred given its strong fundamentals and attractive valuations. Volatility may decline in the coming months, in our view, as the country’s manufacturing PMI remains in expansionary territory (52.8 in October) and we expect GDP growth of 5.2% in 2017, with risks tilted to the upside. The government has introduced measures to increase job creation and ease its macro-prudential policies, while tourism recovered during the summer months. We also see confidence indicators improving gradually as the political outlook remains supportive.

MSCI Turkey is trading at 9.0x 12-month-trailing P/E, almost half a standard deviation below its 10-year average. Trailing earnings have increased 39% this year (see Fig. 9) and support valuations. Consensus estimates earnings growth of close to 11% in the next 12 months, and we see further re-rating potential as stocks are still attractively valued and earnings high.

Russia remains a Most Preferred market in our EM equity portfolio. Its index has recovered almost 20% (as of 13 November) in US dollar terms from the bottom it hit on 22 June, and its improving growth-inflation

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Fig. 7: Argentina – improving economic activity
Argentine Economic Activity indicator, UTDT leading indicator

Fig. 8: South African valuations expensive amid low earnings growth
MSCI South Africa, 12-month trailing P/E and EPS

Fig. 9: Strong earnings growth in Turkey relative to South Africa
12-month trailing earnings, South Africa and Turkey

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Note: UTDT=Universidad Torcuato Di Tella. Source: UBS, as of 30 September 2017
dynamics will likely translate into rising earnings, in our view. Still, there is further room to catch up as Brent has rallied 37% since the bottom in June. The index is trading at 7.0x its 12-month-trailing P/E, in line with its 10-year average. And it has a dividend yield of 5.0% – more than double MSCI EM’s 2.3%.

Inflation continued its downward trend, reaching 2.7% y/y in October. The 3Q GDP print came out lower than expected at 1.8% y/y (vs. +2.0% y/y consensus forecast) but we still expect GDP growth of 1.9% in 2017 and 1.7-1.8% in 2018-2019. As the country is leaving a recession, we expect further upside for earnings growth and the stock market. Also, the benign outlook for commodity prices and global growth will likely benefit MSCI Russia.

Asia ex-Japan

Asia ex-Japan (AxJ) companies reported double-digit earnings growth in 3Q, with signs of improvements in consumer staples and telecoms. The trend is expected to remain positive, and we forecast the EPS growth rate of AxJ equities to be 11% in 2018. Fundamentals in Asia remain solid, with robust capital expenditure and employment data announced. We believe that Asia’s equity markets are still in the middle stages of the cycle. We stay overweight in China, Indonesia and Thailand, and underweight in Malaysia, the Philippines and Taiwan. These positions have been working in our favor. Fundamentals in the Philippine market suggest the potential to rebound though so far they haven’t been translated into performance.

China has been one of the best performing markets year to date. Its IT sector has rallied this year and the banking sector looks promising. China’s October PPI was 6.9, which is still healthy. Industrial profits also suggest robust corporate earnings growth. Although we expect Chinese fixed asset investments in real estate to slow down slightly, policies in China will likely remain supportive of the government’s growth target and economic transition. The Taiwan market effectively serves as a buffer to the Chinese market and is one of the few markets in the region where consensus revisions are pointing downwards.

The performances of Indonesia and Thailand are also in line with our expectations. For Indonesia, our call that non-performing loans (NPLs) in the banking sector will improve was correct, and we see potential for improvements in the consumer sectors. On the political side, higher social spending planned by the Indonesian government ahead of the 2019 election will help improve near-term sentiment and likely lead to improved earnings. Thailand’s GDP growth has shown recovery in 2017, with exports gradually picking up and tourism expected to be strong in 4Q. In its banking sector, strong loan growth is mainly driven by the corporate sector, while the retail sector is suffering from high household debts.

Malaysia’s valuation – at 16x forward P/E – is still expensive relative to the region and its own long-term average. Besides, earnings growth in Malaysia is relatively weak at 6.9%, lower than AxJ’s 12.3%. Decelerating economic growth and slowing credit growth remain big challenges for EP.
The Philippine market has the potential to recover. Earnings growth expectations are relatively strong compared to other markets in the region and economic growth is robust. Higher interest rates are expected to benefit the banking sector. However, we haven’t seen the fundamentals translating into performance so far; so we are leaving the Philippine market as an underweight for now.

Fig. 13: Philippine and Malaysian expectations are too optimistic

12-month trailing P/E vs. EM Asia

Source: Bloomberg, DataStream, UBS, as of 13 November 2017

Table 2: EM valuation overview; current valuations and averages for last 10 years

<table>
<thead>
<tr>
<th>Equity market</th>
<th>MSCI EM Weight</th>
<th>P/E¹, 12m trailing</th>
<th>P/B², 12m forward</th>
<th>DY³</th>
<th>Ret⁴</th>
<th>EV/EBITDA</th>
<th>EPS growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td>74.1%</td>
<td>14.3x (13.4x)</td>
<td>12.6x (11.7x)</td>
<td>1.8x (1.8x)</td>
<td>2.0% (2.4%)</td>
<td>11.7% (12.6%)</td>
<td>10.1x (8.0%)</td>
</tr>
<tr>
<td>Brazil</td>
<td>8.9%</td>
<td>13.4x (12.4x)</td>
<td>12.0x (11.5x)</td>
<td>1.8x (1.7x)</td>
<td>2.6% (2.8%)</td>
<td>9.7% (12.3%)</td>
<td>8.8x (8.8x)</td>
</tr>
<tr>
<td>Chile</td>
<td>1.2%</td>
<td>21.3x (17.4x)</td>
<td>19.2x (15.5x)</td>
<td>2.0x (2.1x)</td>
<td>2.2% (2.2%)</td>
<td>8.1% (10.5%)</td>
<td>10.7x (9.7x)</td>
</tr>
<tr>
<td>Colombia</td>
<td>0.4%</td>
<td>13.8x (16.7x)</td>
<td>13.3x (14.3x)</td>
<td>1.3x (1.7x)</td>
<td>2.7% (2.9%)</td>
<td>8.5% (8.8%)</td>
<td>7.2x (9.8x)</td>
</tr>
<tr>
<td>Mexico</td>
<td>3.0%</td>
<td>16.4x (13.6x)</td>
<td>15.9x (15.0x)</td>
<td>2.6x (2.8x)</td>
<td>2.3% (1.7%)</td>
<td>14.3% (15.0%)</td>
<td>8.6x (8.2x)</td>
</tr>
<tr>
<td>Peru</td>
<td>0.4%</td>
<td>16.3x (14.5x)</td>
<td>13.0x (12.2x)</td>
<td>2.5x (2.3x)</td>
<td>1.5% (1.3%)</td>
<td>9.7% (20.3%)</td>
<td>9.9x (11.8x)</td>
</tr>
<tr>
<td>Poland</td>
<td>11.5%</td>
<td>11.8x (10.3x)</td>
<td>11.8x (11.8x)</td>
<td>2.0x (1.3x)</td>
<td>2.9% (1.3%)</td>
<td>10.6% (22.8%)</td>
<td>8.9x (6.0x)</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>0.2%</td>
<td>13.5x (11.6x)</td>
<td>15.3x (11.9x)</td>
<td>1.8x (1.8x)</td>
<td>7.0% (6.5%)</td>
<td>11.1% (15.5%)</td>
<td>8.0x (11.4x)</td>
</tr>
<tr>
<td>Egypt</td>
<td>0.1%</td>
<td>12.7x (12.2x)</td>
<td>11.0x (9.7x)</td>
<td>3.2x (2.2x)</td>
<td>1.7% (3.2%)</td>
<td>22.7% (14.4%)</td>
<td>4.2x (5.7x)</td>
</tr>
<tr>
<td>Greece</td>
<td>0.3%</td>
<td>14.3x (13.1x)</td>
<td>12.6x (11.5x)</td>
<td>0.5x (1.1x)</td>
<td>1.8% (1.3%)</td>
<td>2.3% (8.4%)</td>
<td>6.5x (6.2x)</td>
</tr>
<tr>
<td>Hungary</td>
<td>0.3%</td>
<td>11.1x (10.6x)</td>
<td>10.8x (8.9x)</td>
<td>1.9x (1.3x)</td>
<td>1.9% (3.5%)</td>
<td>14.7% (12.3%)</td>
<td>6.3x (6.3x)</td>
</tr>
<tr>
<td>Ireland</td>
<td>1.3%</td>
<td>12.9x (12.3x)</td>
<td>12.6x (11.7x)</td>
<td>1.5x (1.4x)</td>
<td>2.0% (4.1%)</td>
<td>10.7% (12.5%)</td>
<td>10.8x (6.3x)</td>
</tr>
<tr>
<td>Qatar</td>
<td>0.5%</td>
<td>11.4x (10.0x)</td>
<td>10.6x (8.4x)</td>
<td>1.4x (2.0x)</td>
<td>2.6% (3.3%)</td>
<td>11.2% (14.7%)</td>
<td>8.3x (16.0x)</td>
</tr>
<tr>
<td>Russia</td>
<td>3.3%</td>
<td>7.0x (8.2x)</td>
<td>6.4x (5.8x)</td>
<td>0.8x (1.0x)</td>
<td>5.0% (3.2%)</td>
<td>10.3% (13.5%)</td>
<td>4.3x (14.1)</td>
</tr>
<tr>
<td>South Africa</td>
<td>3.2%</td>
<td>19.6x (14.8x)</td>
<td>16.9x (12.5x)</td>
<td>2.0x (3.5x)</td>
<td>2.7% (2.0%)</td>
<td>11.4% (14.7%)</td>
<td>16.2x (10.4x)</td>
</tr>
<tr>
<td>Turkey</td>
<td>1.0%</td>
<td>9.0x (9.6x)</td>
<td>8.6x (9.0x)</td>
<td>1.4x (1.6x)</td>
<td>2.9% (2.8%)</td>
<td>14.5% (15.9%)</td>
<td>6.0x (17.1)</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>0.7%</td>
<td>11.4x (9.5x)</td>
<td>10.5x (9.4x)</td>
<td>1.6x (1.5x)</td>
<td>2.0% (3.1%)</td>
<td>13.0% (10.5%)</td>
<td>10.5x (6.2x)</td>
</tr>
<tr>
<td>Greece</td>
<td>14.5%</td>
<td>13.5x (9.8x)</td>
<td>10.6x (9.0x)</td>
<td>1.8x (1.3x)</td>
<td>3.3% (1.3%)</td>
<td>10.8% (13.8%)</td>
<td>8.7x (2.0x)</td>
</tr>
<tr>
<td>Emerging markets</td>
<td>100.0%</td>
<td>14.2x (14.5x)</td>
<td>12.6x (11.0x)</td>
<td>1.8x (1.7x)</td>
<td>2.2% (2.5%)</td>
<td>11.4% (19.5%)</td>
<td>9.8x (8.8x)</td>
</tr>
<tr>
<td>EMU</td>
<td>24.4%</td>
<td>13.4x (11.2x)</td>
<td>14.9x (11.8x)</td>
<td>1.8x (1.6x)</td>
<td>2.6% (0.8%)</td>
<td>10.3% (9.8%)</td>
<td>15.5x (10.3x)</td>
</tr>
</tbody>
</table>

1 Price-to-earnings ratio / 2 Price-to-book value / 3 Dividend yield / 4 Return on equity

Source: DataStream, Bloomberg, UBS, as of 13 November 2017

Chief Investment Office Americas, Wealth Management 16 November 2017
Appendix

End notes

1. CIO-America WM determined the benchmark allocation by country of Emerging Market Equity in proportion to each country’s market capitalization.

2. See “Deviations from benchmark allocations” regarding the interpretation of the suggested tactical deviations from benchmark. The “current” column refers to the tactical deviation that applies as of the date of this publication. The “previous” column refers to the tactical deviation that was in place at the date of the previous edition of report.

3. The current allocation row is the sum of the benchmark allocation and the CIO-America WM tactical deviation rows.

Deviations from benchmark allocation

- The recommended tactical deviations from the benchmark are provided by CIO-America WM. They reflect our short- to medium-term assessment of market opportunities and risks in the market segments. Positive / zero / negative tactical deviations correspond to an overweight / neutral / underweight stance for each market segment relative to their benchmark allocation.

- Note that the country allocations on International Equities are provided on an unhedged basis (i.e., it is assumed that investors carry the underlying currency risk of such investments). Thus, the deviations from the benchmark reflect our views of the underlying equity market in combination with our assessment of the associated currencies.
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