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Investing in emerging markets

Finding value in EM

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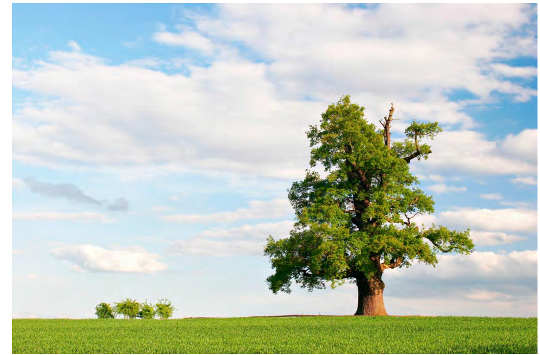
- Recovering emerging market (EM) economic growth and higher commodity prices should enable EM value stocks to outperform their growth peers over the next 12 months.
- After several years of underperformance, the MSCI EM Value index is trading near an all-time discount to the growth index and represents good value relative to it, in our view.
- Risks for this theme include continued weakness in commodity prices, significantly tighter global liquidity conditions derailing the EM recovery and continued outperformance in the IT sector.


Source: istock

Value has been the EM underdog in recent years. Since 2012, the MSCI EM Value index has underperformed its growth counterpart by almost 30%. Is value investing dead in EM?

Growth rebound favors value stocks

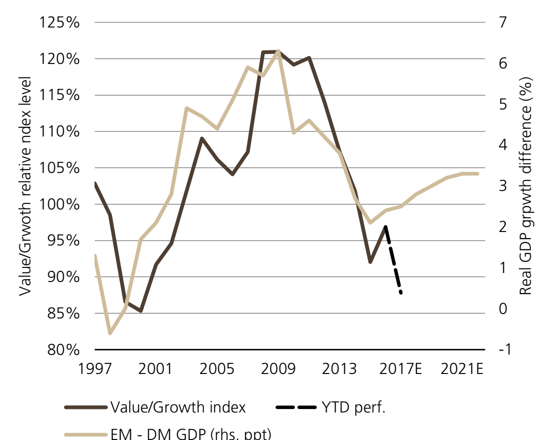
The underperformance of value stocks coincided with a sluggish EM economic environment. Growth stocks typically shine during a low-growth environment due to their scarcity value.

On the other hand, value stocks tend to thrive when growth becomes abundant and investors rotate toward slower-growing companies that have been ignored.

There are signs of a growth recovery underway in EM: manufacturing PMIs stood at 51.2 in May, with all three regions signaling expansion. Earnings per share (EPS) increases in the value index have also outpaced those of growth recently: trailing 12m EPS was up 11% for value stocks versus just 2% for growth names (Fig. 2).

Fig. 1: Value stocks tend to outperform during a growth rebound

MSCI EM Value/Growth relative index level and emerging and developed market real GDP growth difference, in %



Source: Bloomberg, IMF, UBS, as of 26 June 2017

Cyclical sector bias in value

The value index tilts heavily toward cyclical sectors such as financials, energy and materials (Fig.3). The financial sector remains in the early stage of an earnings recovery, in our view. Economic rebounds typically benefit banks first via improving asset quality (which is already underway in EM), followed by greater loan growth.

Other value heavyweights include the energy and materials sectors, which give the index a high correlation to commodity prices. This partly explains why value stocks have fared poorly the last few years. Weak oil prices have led to concerns about the whole commodity spectrum. But demand will likely outpace supply growth later this year amid the synchronized global recovery, so we expect oil prices to rise to around USD 55/bbl over the next 12 months.

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The main value underweights are the IT and consumer sectors. The MSCI EM IT index has rallied 37% this year, contributing to growth's outperformance. Although technology should be a long-term strategic holding since it's linked to structural trends such as e-commerce and artificial intelligence, significant near-term upside is less likely, in our view, after its run this year. Consumer sectors have done well in recent years as EM investors, faced with the weak external environment, have sought safe havens in domestic stocks. As global trade and the commodity outlook brighten, this may change, despite valuations in consumer sectors approaching all-time highs.

Valuation discount near all-time low

The wide discount that the MSCI EM Value index is trading at relative to growth is reflected in its trailing price-to-book (P/B) ratio, which stands at just 1.1x, an almost 60% discount to the growth index's. The 10-year average discount is 46%. The picture is similar with regard to the trailing 12m price-to-earnings (P/E) ratio; here value features a 43% discount to growth compared to a 10-year average of 28%.

Despite the faster trailing EPS growth for value stocks, the index has underperformed its growth equivalent by 6% this year. Weak commodity prices and the global tech rally are chiefly responsible for what we think now represents an attractive entry opportunity for investors to buy into the value index via broadly diversified solutions.

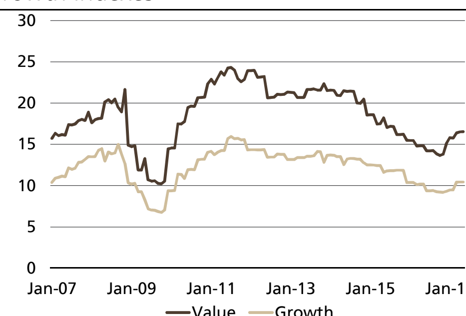
Risks

Risks for this theme include continued weakness in commodity prices, significantly tighter global liquidity conditions derailing the EM recovery and continued IT sector outperformance.

As highlighted earlier, the recent weakness in energy prices is supply driven, in our view, and we expect oil prices to trend higher over the next 12 months. Global monetary policy will likely become less accommodative in the second half of the year, but at a gradual and well-telegraphed pace. Since many EM external balances have been healing in the past couple years, moderately tighter global liquidity conditions should not derail the EM recovery. Furthermore, a higher rate environment fueled by better growth also benefits key value sectors such as energy and materials (Fig. 4). Although we have a favorable long-term view on IT given its link to structural trends such as e-commerce and artificial intelligence, significant near-term upside is less likely in the wake of its performance this year.

Fig. 2: Greater earnings recovery for value stocks

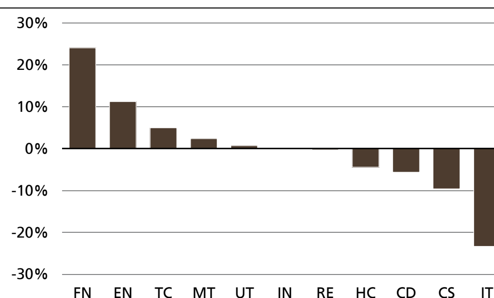
12-month trailing EPS, MSCI EM Value and Growth indexes



Source: Bloomberg, IMF, UBS, as of May-end 2017

Fig. 3: Cyclical sector bias in value index

Sector weightings differential: MSCI EM Value index relative to MSCI EM Growth index

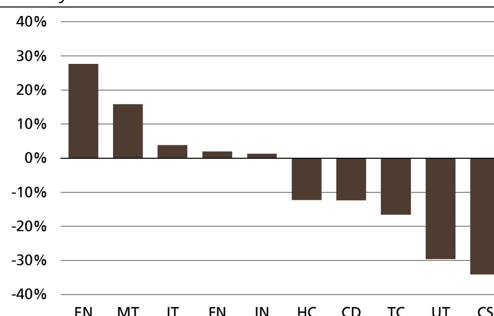


Source: Bloomberg, UBS, as of May-end 2017

Note: Consumer Staples (CS), Utilities (UT), Telecoms (TC), Healthcare (HC), Consumer Discretionary (CD), Industrials (IN), Information Technology (IT), Financials (FN), Real Estate (RE), Materials (MT) and Energy (EN).

Fig. 4: US interest rates: mixed correlations

MSCI EM 5y correlation with US Treasury 10y rate by sector



Source: Bloomberg, UBS, as of May-end 2017

Note: Consumer Staples (CS), Utilities (UT), Telecoms (TC), Healthcare (HC), Consumer Discretionary (CD), Industrials (IN), Information Technology (IT), Financials (FN), Materials (MT) and Energy (EN).

Appendix

Emerging Market Investments
Investors should be aware that Emerging Market assets are subject to, amongst others, potential risks linked to currency volatility, abrupt changes in the cost of capital and the economic growth outlook, as well as regulatory and socio-political risk, interest rate risk and higher credit risk. Assets can sometimes be very illiquid and liquidity conditions can abruptly worsen. CIO Americas, WM generally recommends only those securities it believes have been registered under Federal U.S. registration rules (Section 12 of the Securities Exchange Act of 1934) and individual State registration rules (commonly known as "Blue Sky" laws). Prospective investors should be aware that to the extent permitted under US law, CIO Americas, WM may from time to time recommend bonds that are not registered under US or State securities laws. These bonds may be issued in jurisdictions where the level of required disclosures to be made by issuers is not as frequent or complete as that required by US laws.
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