IMPERIUM CAPITAL

momentum

Emerging outperformance?

Global Matters Weekly

13 June 2022

– **Tom Delic**

An investor in Emerging Market (EM) equities over the last 12 years has had a torrid time. The asset class has not only suffered poor returns in both absolute terms since 2010, but also relative to Developed Market (DM) equities, with the latter being driven by the strength of the US equity market.

At the beginning of 2010, EM equities were valued at a premium to both its own historical average valuation, but also versus DM equity valuations. DM equities on the other hand, looked attractive relative to their own history. Starting valuations matter and EM's 4.6% annualised returns from 2010 to 2021 have significantly lagged the 11.6% annualised return of DM equities over the same period.

Today's investor is faced with a different proposition. Since the end of 2021, EM valuations are standing at their biggest discount to DM equities since the late 1990s. What followed in the 2000s was effectively zero returns for DM equities, while EM equities returned 10% annualised. It is early days yet but excluding the effect of Russia which made up around 4% of EM indices [1] at the beginning of the year, EM equities have outperformed DM equities year-to-date.

While relative valuation can be instructive, a more important consideration however is absolute valuation. Part of today's dispersion in valuation between EM and DM can be explained by the elevated absolute valuation of DM equities. After reaching a price-to-book ratio of 3.3 times at the end of 2021, DM equities almost reached bear market territory in May [2], before rallying over the last few weeks. At today's valuation of 2.8 times, the asset class still trades above its long-term average of 2.4 times.

EM equities however trade at 1.4 times price-to-book, below their long-term average of 1.6 times and around a 50% discount to DM equity valuations. This is a much more reasonable starting valuation, and while there is never any guarantee that markets cannot fall further (as we have seen so far this year), we believe a larger margin of safety exists in EM given both absolute and relative valuations.

There is plenty of opportunity for an active Emerging Market manager to deliver attractive returns

It is worth repeating that starting valuations matter, but only with a strong emphasis on future long-term returns.

Anything can happen in the intervening period, not least attractive valuations becoming even more attractive, which is a kind way of saying 'a period of poor performance can last even longer'. If you are willing to stay the course however, investing at low starting valuations puts the odds of a good outcome on your side. When EM equities have traded at a price-to-book ratio of 1.4 times or lower, 12-year annualised returns have at least been 10% and have averaged over 15% per annum. For DM equities, the picture is less rosy, with a premium starting valuation producing maximum 12-year returns of 6.9% per annum historically, but an average of just 3.4%. However, this year's weakness has already improved the return outlook for DM equities.

We are big believers in active investment strategies, more so in regions where considerable inefficiencies remain, like EM equities. Using a bottom-up universe of companies to analyse the attractiveness of equity markets, we calculate around one fifth of EM equity stocks trade below a price-to-earnings ratio of 10 times. This compares to just 6% of our North American universe.

Therefore there is plenty of opportunity for an active EM manager to deliver attractive returns, despite what occurs in the mainstream indices, over the next decade or more.

[1] Russia's weight In MSCI Emerging Markets Index (%), MSCI. [2] Bear market defined as a 20% fall from its prior peak.
All return and valuation figures sourced from Bloomberg Finance, L.P

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The Marketplace

- Global equities fell 2.0% last week
- The World Bank became the latest body to downgrade their global growth forecast and openly warned about the risk of stagflation, now projecting a 2.9% rise in GDP for 2022 compared to a 4.1% estimate in January
- Brent crude rose 2.8% to $123.1 a barrel
- Gold fell 0.1% to $1848.8 per ounce.

Market Focus

US

- US equities fell 2.2% last week
- Consumer Price Inflation (CPI) gained 8.6% year-on-year in May, above expectations of 8.3%
- Weekly initial jobless claims for the week ending 4 June came in higher than expected at 229k vs 206k, the highest level since January as well as the largest weekly jump in claims since July 2021
- The Atlanta Fed wage growth tracker increased to 6.1% in May, its highest reading since the series began
- The University of Michigan long-term inflation expectations series hit 3.3% vs the prior reading of 3.0%, its highest reading since 2008.

Europe

- European equities fell 1.7% last week
- German factory orders for April saw a 2.7% contraction; much weaker than the 0.4% expansion expected, the third consecutive monthly decline
- German industrial production grew by a weaker-than-expected 0.7% in April vs 1.2% expected
- Euro Area growth in Q1 was revised up to show a 0.6% expansion vs 0.3% previously
- The European Central Bank (ECB) met last week, confirming the end of the net Asset Purchase Programme (APP) purchases this month, paving the way for rates lift-off in July. Beyond July, they opened the door for 50bps hikes if inflation persists.

UK

- UK equities fell 0.6% last week
- The final Purchasing Manager Index (PMI) for May was revised up relative to the flash readings, with the composite PMI at 53.1 (vs 51.8 flash)
- A confidence vote was held for Prime Minister Boris Johnson and the final result saw him win by just 211-148, meaning that 41% of his own party's MPs voted against him.

Asia/Rest of The World

- The benchmark Global Emerging Markets index returned +0.6% last week.
- Japanese equities returned 1.9% over the week.
- Chinese equities rose 5.9% last week
- The Reserve Bank of Australia hiked rates by a larger-than-expected 50bps. Their statement also indicated further tightening ahead
- The final estimate of Japan's Gross Domestic Product (GDP) for Q1 showed a contraction of -0.5% year-on-year
- China's May exports advanced 16.9% year-on-year, stronger than the estimates of 8.0% and the prior 3.9% increase in April
- China's trade surplus grew to $78.76bn in May, compared to a $51.12bn surplus in April
- Producer Price Index (PPI) in China climbed 6.4% vs 8.0% last month, in line with estimates but the lowest point since March 2021. CPI was up 2.1% in line with last month but lower than expected.

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Asset Class/Region	Currency	Currency returns			
		Week ending 10 June 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	-2.2%	-2.7%	-15.3%	-4.3%
United Kingdom	GBP	-0.6%	-1.5%	5.6%	12.8%
Continental Europe	EUR	-1.7%	-2.1%	-12.0%	-5.1%
Japan	JPY	1.9%	2.9%	0.1%	3.0%
Asia Pacific (ex Japan)	USD	0.5%	-0.4%	-10.9%	-19.1%
Australia	AUD	-3.0%	-2.6%	-3.9%	0.1%
Global	USD	-2.0%	-2.4%	-15.1%	-8.1%
Emerging markets equities					
Emerging Europe	USD	-3.6%	-3.2%	-75.1%	-75.8%
Emerging Asia	USD	1.7%	0.1%	-12.9%	-21.6%
Emerging Latin America	USD	-5.3%	-6.2%	12.4%	-6.4%
BRICs	USD	2.8%	1.8%	-15.7%	-28.7%
China	USD	5.9%	4.6%	-12.9%	-32.1%
MENA countries	USD	-0.5%	-2.3%	6.6%	14.7%
South Africa	USD	-3.2%	-5.3%	0.5%	-12.7%
India	USD	-2.8%	-2.9%	-10.4%	-2.4%
Global emerging markets	USD	0.6%	-0.9%	-12.6%	-20.8%
Bonds					
US Treasuries	USD	-0.6%	-1.0%	-8.9%	-8.7%
US Treasuries (inflation protected)	USD	-0.7%	0.0%	-6.6%	-2.5%
US Corporate (investment grade)	USD	-0.8%	-1.2%	-13.0%	-12.4%
US High Yield	USD	-1.2%	-1.6%	-9.5%	-7.5%
UK Gilts	GBP	-1.3%	-1.5%	-14.1%	-13.1%
UK Corporate (investment grade)	GBP	-1.1%	-1.2%	-12.2%	-12.2%
Euro Government Bonds	EUR	-1.2%	-2.5%	-12.8%	-13.3%
Euro Corporate (investment grade)	EUR	-1.4%	-1.6%	-10.1%	-10.7%
Euro High Yield	EUR	-0.7%	-0.7%	-8.8%	-8.5%
Japanese Government	JPY	-0.3%	-0.2%	-2.3%	-2.5%
Australian Government	AUD	-0.7%	-1.5%	-10.3%	-11.4%
Global Government Bonds	USD	-1.4%	-2.2%	-13.3%	-16.0%
Global Bonds	USD	-1.2%	-1.9%	-13.3%	-15.9%
Global Convertible Bonds	USD	-0.7%	-0.7%	-16.3%	-20.7%
Emerging Market Bonds	USD	-2.2%	-2.6%	-23.2%	-24.6%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	-3.9%	-4.8%	-18.4%	-8.0%
Australian Property Securities	AUD	-4.9%	-6.0%	-20.4%	-11.6%
Asia Property Securities	USD	-0.2%	-0.6%	-3.6%	-16.3%
Global Property Securities	USD	-3.0%	-3.9%	-15.7%	-12.6%
Currencies					
Euro	USD	-0.7%	-0.7%	-6.4%	-12.5%
UK Pound Sterling	USD	0.0%	-0.8%	-7.5%	-11.7%
Japanese Yen	USD	-2.5%	-4.2%	-14.3%	-18.4%
Australian Dollar	USD	-1.3%	-0.9%	-2.1%	-8.2%
South African Rand	USD	0.6%	1.0%	3.2%	-11.9%
Swiss Franc	USD	-1.6%	-2.0%	-6.8%	-8.5%
Chinese Yuan	USD	-0.5%	-0.3%	-5.0%	-4.5%
Commodities & Alternatives					
Commodities	USD	1.9%	3.4%	40.6%	55.3%
Agricultural Commodities	USD	1.9%	0.7%	22.2%	33.1%
Oil	USD	2.8%	0.2%	58.2%	69.7%
Gold	USD	-0.1%	0.2%	1.1%	-2.4%
Hedge funds	USD	0.2%	0.4%	-3.0%	-3.2%

Source: Bloomberg. Past performance is not indicative of future returns

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