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Emerging Markets Outlook – A Focus on Valuation

We find that emerging markets currently offer attractive valuations which have the potential to underpin robust long-term returns. However, the composition and characteristics of the EM index mean that a selective, high conviction approach focused on "quality at a reasonable price" will continue to provide much greater opportunities.

This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.

2022 started with challenges for most markets. The developed markets (DM) index, MSCI World, finished January down -5.3% – the worst start to a year since 2016 – led by declines of -5.4% for the S&P 500 and -8.5% for the NASDAQ index. A further example of the flight away from risk, Bitcoin declined -17% and is now some -43% below its November 2021 peak.

Amidst this backdrop, the most resilient major equity index was MSCI Emerging Markets, which declined just -1.9% for the month in US dollars and finishing up +1.06% for the month in Australian dollars. Indeed, there are several compelling reasons to think that emerging markets stocks may continue to outperform their developed markets (DM) peers.

First, overall valuation looks very attractive relative to DM. In fact, as shown in Chart 1, EM relative valuations are at a twenty-year low.

Chart 1: EM Valuations are at the Lowest Point in Two Decades vs DM

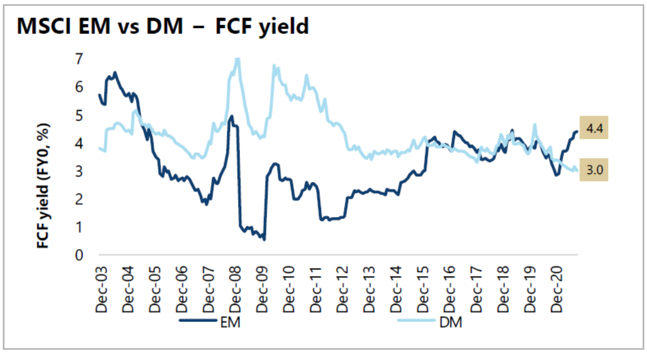
Source: Bloomberg, Northcape Capital

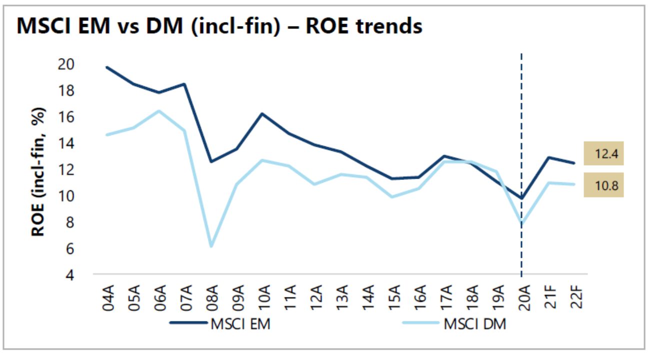
Remarkably, EM stocks now offer a better free cashflow (FCF) yield than DM peers, despite offering a higher average return on equity (ROE), as shown in Charts 2 and 3.

In essence, a decade of abnormally loose monetary policy by DM central banks through a combination of ultra-low rates and quantitative easing (money printing) has created negative real yields (interest rates lower than inflation). Thus creating a massive incentive for investors and traders to not hold too much cash, and instead invest in risk assets.

This dynamic has resulted in an avalanche of liquidity going into DM bonds and shares, making them very expensive relative to historical averages. Meanwhile, EM central banks have generally maintained orthodox monetary policy and, in many cases, positive real yields, as such valuations in EM are much lower than DM.

Charts 2 and 3:
EM is Cheaper on Free Cash Flow Yield Despite a Higher Average ROE



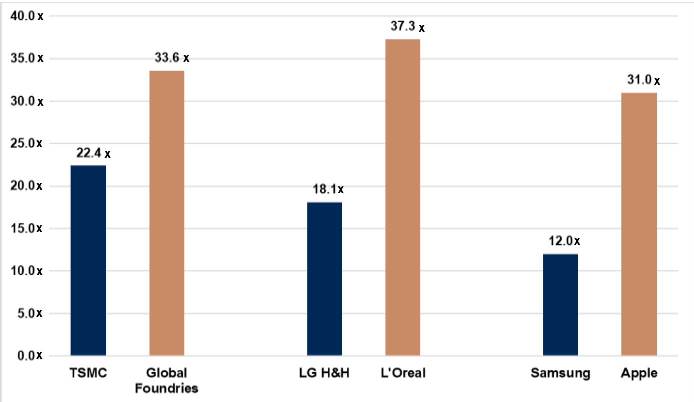


Source: Jefferies Research

The tide however is now shifting, with US inflation running at the highest level since 1982 and the US Federal Reserve now expected to hike rates four times this year, potentially beginning as soon as March. As DM monetary policy normalises, the relative overvaluation of DM shares should correct, leading to outperformance of EM equity markets.

Interestingly, the current bargains on offer in EM include some of the very best companies in the world. TSMC, LG Household & Health Care (LG H&H) and Samsung Electronics are global leaders in their respective industries, semiconductor logic chips, prestige cosmetics and DRAM/NAND semiconductor memory respectively. Yet each trade on a significant valuation discount to their DM peers, as shown in Chart 4.

Chart 4: EM Offers World Leading Companies at Discount Valuations



Source: Bloomberg, Northcape Capital

TSMC is the sole player at the leading "node" – a measure of chip density and hence technological proficiency – with a lead over DM players such as Intel. LG H&H has the leading prestige cosmetics brand, Whoo, in the all-important Chinese market, ahead of Western brand peers. Samsung Electronics has the highest R&D spend of any company in the world – EM and DM – and is the leader in cutting edge semiconductor memory, in addition to strong positions in logic chips, display (OLED screens) and smartphones.

So, we find that emerging markets valuations are attractive on many metrics. As always though with EM – a complex and heterogenous collection of twenty-five diverse countries – there are extremely important nuances to consider.

This means the best investment strategy is not simply "go long EM" by buying an EM index ETF. Rather, we assert that taking a very selective approach will provide much greater opportunities from the current very attractive valuations on offer in the EM equity asset class.

More specifically, the EM equity asset class, whilst containing some of the very best investment opportunities in the world, also contains many "value traps". Chinese banks, Russian oil & gas, all manner of state-owned enterprises which routinely destroy shareholder value in order to meet "other" objectives.

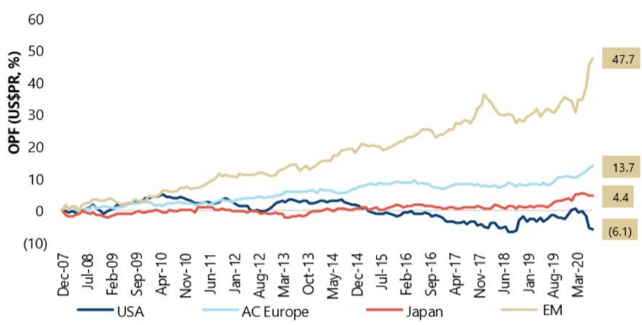
More recently, VIEs such as the platform monopolies of Alibaba and Tencent, have been caught operating in a regulatory vacuum. They are now being dismantled by brutal regulatory adjustments by the Chinese government under its "common prosperity dogma", thus stripping large chunks of shareholder value off these companies. These stocks now trade on justifiably low valuations. Although these companies may have periods of good performance, in the long run they are generally not attractive shareholder value creators given there is no real opportunity for regulatory relief in our view.

This is an issue for both passive investment into EM equities, given the preponderance of such companies in the index, but also for broad-based active funds that aim to run highly diversified strategies. It is of course a key reason why the Northcape approach is high conviction; a portfolio of 25 to 40 of the best ideas in emerging markets, carefully avoiding "value traps".

Another key feature of the EM index is the wide range of Environmental, Social and Governance (ESG) standards. Whilst many companies in emerging markets benchmark themselves to global best practice in ESG, there is a much longer "tail" of behaviour compared to DM, with some EM companies engaging in child and bonded labour, illegal deforestation and even outright fraud (particularly in mainland China).

This dynamic means that investors such as Northcape who carefully screen companies based on ESG and only invest in the leaders are likely to be rewarded by better investment returns over time. As Chart 5 shows, this is exactly what has happened in practice.

Chart 5: Outperformance of Leading ESG Companies by Index



Source: Jefferies Research

Chart 5 shows the outperformance of the leading companies in ESG, as scored by MSCI research, compared to their respective indexes. Interestingly, although allocating primarily to high quality ESG companies and avoiding the poor performers has many non-pecuniary benefits, in the US this has not brought investors better returns.

In EM, by contrast, the ESG leaders' group has dramatically outperformed the broader index (by 47.7% December 2007 to June 2020). Again, this highlights the benefits of a selective approach to EM investing, as compared to a broad portfolio or passive investment in an index fund.

Finally, another major difference of EM compared to DM is the tremendous diversity of the member countries. The range of per capita wealth and economic structures of the countries that make up the DM index is relatively narrow, meaning that country selection is typically a minor contributor to performance, while stock selection is all-important.

By contrast, the EM index encompasses a vast range of economic development, from South Korea at US$31,489 GDP per capita to India at US$1,900. There are countries with large current account surpluses (for example Taiwan, at 13.5% of GDP) and countries with deficits such as Turkey (-3.2% of GDP). Some export-oriented countries are clear beneficiaries of higher commodity prices, whereas this is a headwind for countries where economic growth is largely driven by internal demand.

As such, country selection is critically important in emerging markets; being a good stock picker is not sufficient to generate superior long-term returns without a proper country (or "Sovereign Risk" as we say at Northcape) overlay. Turkey provides an instructive example.

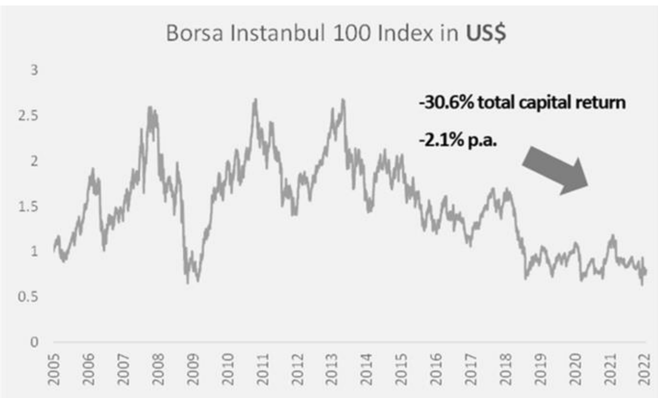
As Chart 6 demonstrates, on the surface Turkey has ostensibly provided good long-term returns. Stock pickers who ignore country risk have enjoyed a 12% annual return in local currency (the Turkish Lira). The problem is, unless you are a domestic Turkish investor then returns in Lira are irrelevant; we need to convert the returns to a neutral reserve currency such as the US Dollar. This is particularly important in emerging markets because hedging volatile currencies such as the Turkish Lira is often prohibitively expensive.

Chart 6: Long-term Performance of Turkish Equities in Local Currency

Source: Bloomberg, Northcape Capital

When we look at Turkish stock performance in US$ (see Chart 7) we see that rather than providing good double-digit returns, depreciation of the Lira has confiscated all of the equity returns (and more), resulting in a loss of capital over the same period.

Chart 7: Long-term Performance of Turkish Equities in US Dollars



Source: Bloomberg, Northcape Capital

The key message here is that selective investors who focus on macroeconomic risks in addition to stock-level risks are likely to avoid poor quality sovereigns, where currency depreciation is likely to confiscate equity returns. Instead, a tight focus on high quality countries where the currency will be neutral or even a tailwind for performance will enhance total returns from the stocks from these EMs.

The difference in performance over time can be considerable. We estimate that approximately 33% of Northcape EM value added outperformance (versus the benchmark) since inception in 2008 has come from managing EM currency risk through a sovereign risk overlay.

Update: Northcape's view and position on Russia

As the situation in Russia / Ukraine unfolds and since originally writing this paper, we have received several questions on the EM fund's exposure to Russia. A summary of our view and portfolio positioning is provided below.

We currently have no/zero holdings of Russian equities and haven't owned any for a long-time (since 2014, we had a very small position back then).

Moreover, **none of our portfolio companies** have material exposure to the country through operations based in Russia.

Additionally, we have no current holdings in what we describe as "bystander at risk" EMs at present, such as: Poland, Hungary, Czech Rep and Turkey.

The risk premium we apply to Russian equities is very high (circa 20% +) and under our sovereign country risk ranking system it is in the "Least preferred" category.

This has been a longstanding rating and is on account of Russia's rigged political system and ongoing risks of financial, trade and investment sanctions post annexation of Crimea in 2014.

The invasion of Ukraine was always a big risk, and obviously this has led to a further increase in sanctions, with more to come.

On top of Ukraine, Russian meddling in US elections, cyber-attacks on US and its neighbouring states, weak commitments to net zero, very poor human rights, no freedom of press and no ability to prosecute corporates in an independent judiciary have also necessitated the need to have a very high-risk premium.

There have been numerous examples where shareholders in Russian companies have had significant amounts of value confiscated by the state, and/or state sponsored individuals of the current Putin regime.

And there has been absolutely no ability to prosecute this behaviour and recover stolen funds/assets.

Not to pre-empt anything, but it is likely that at our next sovereign review Northcape's risk premium applied to Russia will be increased even further.

Crucial note: despite its foreign reserves, increased sanctions may eventually force Russia to erect tight capital controls in order to prevent a total collapse in the Ruble and domestic banking system.

Russia would then breach requirements to be in the MSCI EM index, as such it could be downgraded to "Frontier" paving way for another wave of debt and equity capital liquidations as EM passive index investors are forced to flee. Thus, creating a further down leg in Russia's debt and equity valuations.

In short Russia has become un-investible under our investment process.

Conclusion

We find that emerging markets offer attractive current valuations which have the potential to underpin robust long-term returns. However, the composition and characteristics of the EM index mean that a selective, high conviction approach focused on "quality at a reasonable price" will continue to provide much greater opportunities from the current very attractive valuations on offer in the EM equity asset class.

And more crucially, this process will continue to deliver much better risk/return dynamics than an index or broad exposure over the long-term.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au