GLOBAL MARKETS FOCUS

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CAPITAL ECONOMICS

Which EM equity markets are set to shine?

- **Time will tell if the recent rebound in emerging market (EM) equities was a turning point, but we remain cautiously optimistic that they will outperform those in the developed world in 2016/17.**
- The underperformance of EM equities since 2011 has been due to three factors. First, a slowdown in EM economic growth. Second, a related fall in commodity prices. Third, and more recently, fears that the People's Bank of China will devalue the renminbi.
- **A return to the halcyon days of the 2003-08 emerging markets boom is unlikely.** Much slower aggregate EM GDP growth of 4-5% is probably the new normal and commodity prices are unlikely to return to their recent highs.
- **Nonetheless, we believe that there are reasons to be upbeat on the prospects for EM equities, especially given the near-apocalyptic scenario that appears to be priced into the market.** Not only do we anticipate a cyclical increase in EM economic growth, but we also forecast some rebound in key commodity prices. What's more, we do not believe that the People's Bank is about to devalue the renminbi.
- The upshot is that we forecast the MSCI Emerging Markets Index to rise by about 25% by the end of next year. That said, the better performance is unlikely to be spread evenly and we think stock markets in those countries with better growth prospects, or that will benefit from higher commodity prices, will outperform. These include India, Taiwan and parts of Latin America.

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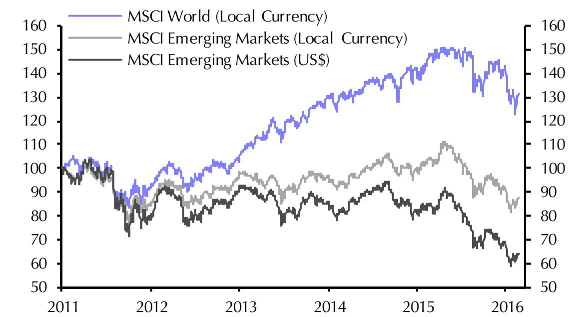
Which EM equity markets are set to shine?

We continue to expect EM equities to post solid gains in 2016/17. In this *Focus* we identify those markets that could perform relatively well.

Slow-burning underperformance

While stock markets in the developed world raced ahead after the sell-off triggered by the Greek crisis in 2011, those in emerging markets (EMs) were left behind. The MSCI World Index of developed market equities is about 30% higher since the start of 2011, but the MSCI Emerging Markets Index is almost 40% *lower* in US dollars. Of course, that decline has been exaggerated by a large depreciation of EM currencies in recent years, and this a key reason why we prefer to analyse EM equity markets in local currency terms. But even when ignoring exchange rate movements, they have still underperformed. (See Chart 1.)

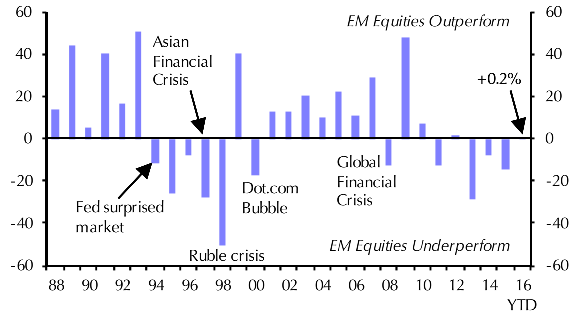
CHART 1: MSCI EQUITY INDICES (1ST JAN. 2011 = 100)



Source – Thomson Datastream

The prolonged underperformance has taken us by surprise. After all, since 1988 EM equities have only tended to underperform those in developed markets during crises – either at home or abroad. (See Chart 2.) For example, the slump in EM equities in 1994 came after the Fed caught many investors off guard when it raised interest rates relatively aggressively and triggered a rise in Treasury yields. That was followed by crises in Asia (1997) and Russia (1998). Thereafter, the bursting of the dot.com bubble dealt another blow to EM stocks in 2000, before the Global Financial Crisis struck in 2008. It has been more of a slow-burning underperformance this time around.

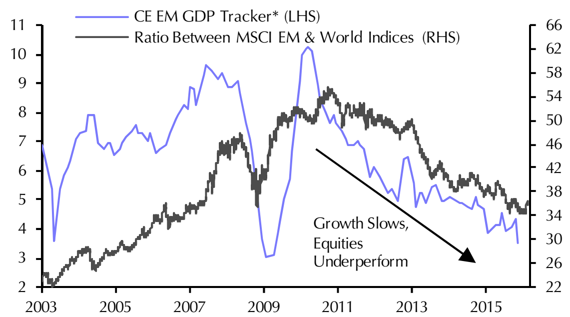
CHART 2: DIFFERENCE IN ANNUAL PERFORMANCE OF MSCI EMERGING MARKETS & WORLD INDICES (%-PTS)



Source – Thomson Datastream

There have been three key reasons for the underperformance of EM equities. **First, there has been a slowdown in EM economic growth.** Part of that has been a downturn following a period of rapid growth, but many major economies have also run into structural limitations. For example, China's economy appears to have reached the limits of investment-led growth, while a consumer boom in Brazil was driven by an unsustainable increase in bank lending. EM equities underperformed began to underperform as economic growth slowed. (See Chart 3.)

CHART 3: CE EM GDP TRACKER* & RATIO BETWEEN MSCI LOCAL CURRENCY EMERGING MARKETS & WORLD INDICES



Sources – Thomson Datastream, CE *Using CE CAP for China

Second, there has been a sharp fall in commodity prices. (See Chart 4 on page 3.) Whereas an investment boom in China had sucked in large amounts of industrial commodities, slower growth there has since coincided with steep declines in commodity prices.

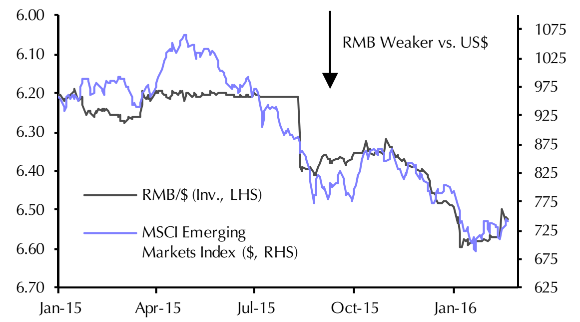
CHART 4: MSCI EMERGING MARKETS INDEX & S&P GSCI

Source – Thomson Datastream

Admittedly, countries that are net commodity exporters only account for about one third of the MSCI Emerging Markets Index by market capitalisation. But lower commodity prices have had an *indirect* impact on equity markets elsewhere. In particular, an absence of reliable information from China, and a widespread belief that its economy is in meltdown, has meant that many investors have used commodity prices (wrongly in our view) as a barometer of the general health of EM economies.

Third, more recently there have been fears that the People's Bank of China will devalue the renminbi in order to stave off an economic crisis, in the process undermining the competitiveness of other EMs. (See Chart 5.)

CHART 5: MSCI EMERGING MARKETS & RENMINBI VS. US$



Sources – Thomson Datastream, Capital Economics

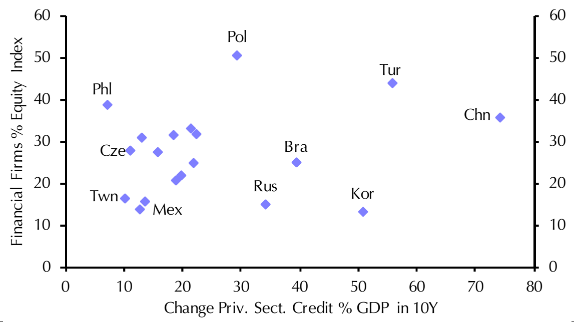
Return to the halcyon days of 2003-08 unlikely …

It is not clear where a new engine for emerging market economic growth will come from, and a return to the rapid rates of expansion during the EM boom seems unlikely. For a start, income levels are now higher, meaning there is less room for "catch-up" growth. And we doubt that there will be an EM-wide wave of reforms that would be required to raise potential rates of growth.

What's more, many countries are now in the process of deleveraging after the credit boom that swept through many parts of the emerging world during the past decade. This is something that we have analysed in detail on our dedicated Emerging Markets Economics services.[1] Even though there are reasons to think that the explosion in credit will not trigger an EM-wide financial crisis, deleveraging is still likely to weigh on economic activity. Not only will demand for credit be weaker, but banks may also be less willing and able to supply loans.

One way to identify where these risks lie is to compare the size of the increase in credit to the concentration of financial firms in local stock markets. It seems that China, Brazil, Turkey and Poland are the most vulnerable. (See Chart 6.)

CHART 6: INCREASE IN PRIVATE SECTOR CREDIT & WEIGHT OF FINANCIAL SERVICES IN LOCAL EQUITY MARKET

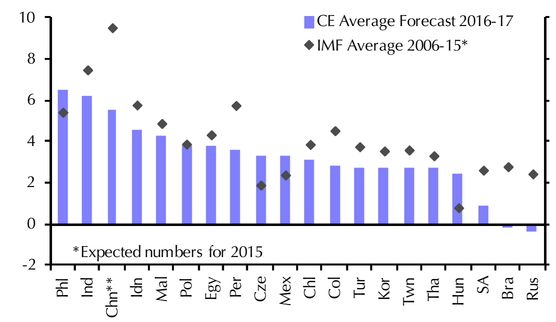


Sources – BIS, Thomson Datastream, National Sources, CE

The upshot is that we forecast that GDP growth in most countries will be slower in 2016/17 than during the past decade. (See Chart 7 on page 4.) Indeed, the only economies where we expect growth to be faster are those in Central Europe, along with Mexico and the Philippines. None of which are big enough to propel another EM boom.

[1] For example, see our *Emerging Markets Economics Focus*, "EM debt: recapping the risks", 22nd January 2016.

CHART 7: CE GDP GROWTH FORECASTS FOR 2016/17 VS. AVERAGE GROWTH IN THE PAST DECADE (%)



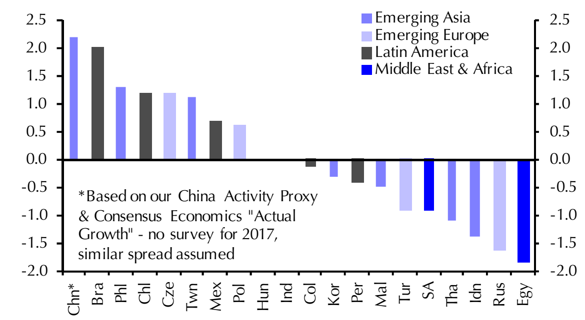
Sources – IMF, Capital Economics ** Using CE CAP for China

… but there are plenty of reasons to be positive

Even so, the unremittingly-negative sentiment towards EMs in recent years suggests to us that a dire scenario – including a meltdown in China and further collapse in commodity prices – is now largely priced into equity markets. **Given that we believe sentiment has become too negative, those downtrodden expectations could be *beaten*.**

Although we expect EM GDP growth to remain sluggish compared to the past decade, we do forecast a slight acceleration in the next couple of years. Admittedly, this is partly due to the current downturns in Brazil and Russia becoming less bad. **But we are also relatively positive on China and many of our country forecasts are less downbeat than the consensus.** (See Chart 8.)

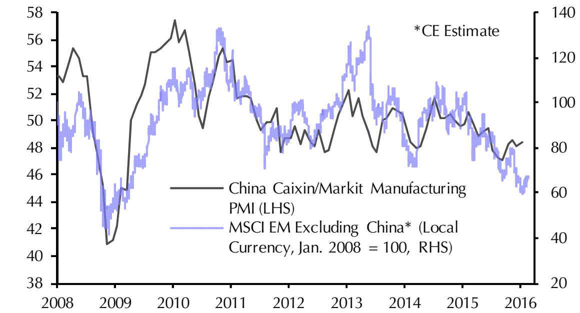
CHART 8: CE GDP FORECASTS VS. CONSENSUS (CUMULATIVE %-PT DIFFERENCE, 2016/17)



Sources – Capital Economics, Consensus Economics, Bloomberg

We would not usually pin too much on stronger growth as a driver of EM equities in the short term. After all, it does not always translate into higher equity prices, and changes in risk appetite tend to be more important. **But given that much of the risk aversion towards EM equities has been due to concerns that China's economy is tumbling towards a hard landing, evidence to the contrary would surely buoy investor sentiment and help to lift equities.** For example, there has been a decent relationship between EM equities and the manufacturing PMI for China. (See Chart 9.)

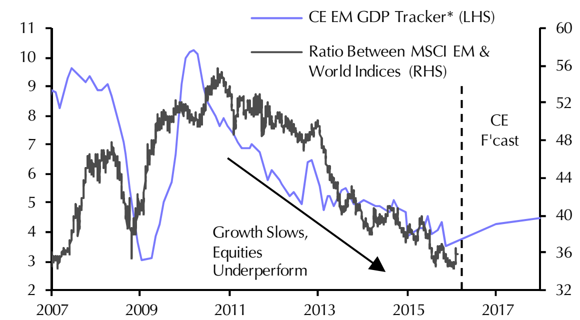
CHART 9: EM EQUITIES & CHINA MANUFACTURING PMI



Sources – Bloomberg, Capital Economics

And in our view there does not need to be another EM boom for equities to do better. Indeed, the small increase in growth that we forecast could be sufficient to trigger a stronger performance of EM equities. (See Chart 10.)

CHART 10: CE EM GDP TRACKER* & RATIO BETWEEN MSCI LOCAL CURRENCY EMERGING MARKETS & WORLD INDICES

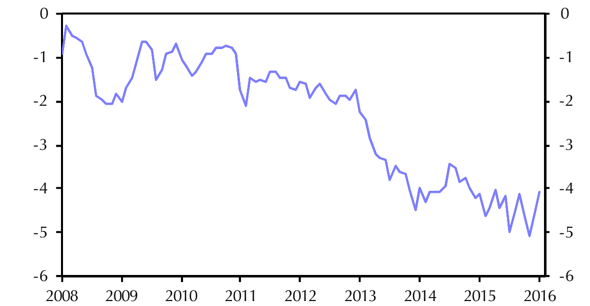


Sources – Thomson Datastream, CE *Using CE CAP for China

We also expect commodity prices to stabilise and, in several cases, begin to rise, which would lend support to equity markets in commodity-exporting countries. (A full breakdown of our latest forecasts can be found in our Q1 *Commodities Analyst*.)

Finally, EM equities could also benefit from bargain hunting given their low valuations. For example, the gap between the price/12month forward earnings ratios of the MSCI World and Emerging Markets Indices is as wide as it has been in recent history. (See Chart 11.)

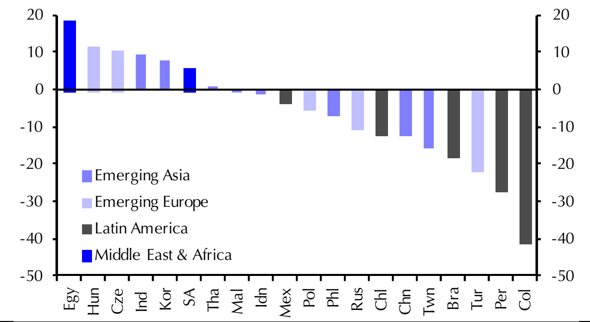
CHART 11: DIF. BETWEEN MSCI EM & DEVELOPED MARKET PRICE/12 MONTH FORWARD EARNINGS RATIOS (POINTS)



Source – Bloomberg

In addition, the ratios of the individual members of the MSCI Emerging Markets Index are generally below their five-year averages. (See Chart 12.)

CHART 12: DEVIATION OF PRICE/12MONTH FORWARD EARNINGS RATIO FROM 5-YEAR AVERAGE (%)



Sources – Bloomberg, Capital Economics

According to this metric, equities in every major Latin American market are currently trading at a discount, as are those in the two largest markets in Emerging Europe (Russia and Turkey). And the valuations of two countries in Emerging Asia – Taiwan and China – also stand out as being relatively low. Past form shows that, while there has been a high degree of variation, low valuations have tended to give rise to better returns (and vice-versa). (See Chart 13.)

CHART 13: MSCI EMS INDEX PRICE/12M FORWARD EARNINGS RATIO & AVERAGE ANNUAL RETURNS IN NEXT 2 YEARS (%)

Sources – Thomson Datastream, Capital Economics

Which markets look set to fare best and worst?

We think that the MSCI Emerging Markets Index will rise by about 25% by the end of next year. But some markets are likely to fare better than others and we have collated various indicators in an attempt to indentify which they will be. These are:

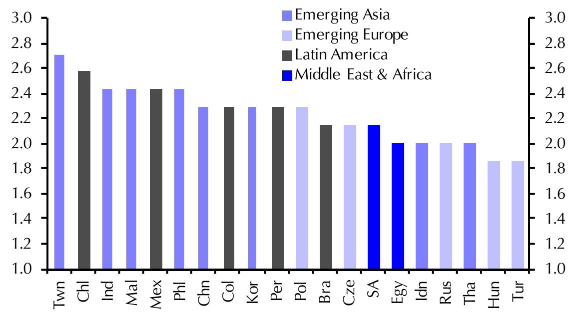
- The difference between our GDP growth forecasts in 2016/17 and the consensus.
- The deviation of the current price/12month forward earnings ratio from its 5-year average.
- The proportion of commodity-related firms in the local equity market.
- The proportion of industrial firms in the local equity market.
- Credit risks. (The change in private sector credit as a share of GDP in the past decade, multiplied by the proportion of financial firms in the local equity market.)
- The risk of a financial crisis, measured by our Risk Indicator (CERI).[2]
- The exposure of various markets to external shocks, measured by our Vulnerability Index.[3]

In an attempt to make the data more digestible, we have assigned each country a score out of 3 for each of the indicators; 1 being bad and 3 good.

[2] See our *Emerging Markets Economic Focus*, "Introducing the Capital Economics Risk Indicator", 16th April 2013.
[3] See our *Global Markets Update*, "Which EM currencies are most vulnerable to snap sell-offs?", 9th September 2015.

The average scores are plotted in Chart 14 and a breakdown is shown in Table 1.

CHART 14: AVERAGE SCORES OUT OF 3



Source – Capital Economics

Although this is only a rough guide, several points are worth making:

We think that the prospects for Taiwan's stock market (along with others in Emerging Asia) are bright. We expect economic growth to accelerate in an environment of ultra-low interest rates and close links to China, whose economy we expect to improve. Valuations are also low.

Low valuations suggest that equities in Chile will also perform well if, as we expect, the copper price rebounds. The same could be true in other parts of Latin America. Admittedly, the prior falls in commodity prices will take their toll on economies such as Brazil. But markets are forward looking and higher commodity prices could lift equities.

Meanwhile, although we have some reservations about the prospects for structural reform in India, and also the quality of the economic data there, reasonably bright growth prospects relative to the other BRIC nations could support equity prices.

The valuation of Turkey's stock market is low, but we believe that there are reasons to be cautious. Its fragile balance of payments position will probably ensure that the market remains volatile, while there may be a period of deleveraging and policymaking is also unpredictable.

Finally, we doubt that the Hungarian stock market will continue to boom. Valuations are high, and the economy may not meet those expectations.

TABLE 1: SCORES OUT OF 3 FOR ECONOMIC, MARKET AND RISK INDICATORS (1 BAD, 3 GOOD)

Country	CE GDP Growth vs. Consensus	Dif. Btwn. Price/12m Fwd Earn. & 5Y Avg.	Proportion of Commodity Firms in Local Equity Market	Proportion of Industrial Firms in Local Equity Market	Credit Risk	Risk of a Financial Crisis (CERI)	Vulnerability Index (CURVI)
Brazil	3	3	3	1	1	2	2
Chile	3	3	3	1	2	3	3
China	3	3	1	3	1	2	3
Colombia	2	3	3	2	2	2	2
Czech Rep.	3	1	1	1	3	3	3
Egypt	1	1	2	3	3	2	2
Hungary	2	1	3	1	1	2	3
India	2	1	2	3	3	3	3
Indonesia	2	2	1	2	2	3	2
South Korea	2	2	2	3	1	3	3
Malaysia	2	2	2	3	2	3	3
Mexico	2	2	1	3	3	3	3
Peru	2	3	3	2	1	2	3
Philippines	3	2	1	3	3	2	3
Poland	3	2	3	1	1	3	3
Russia	1	2	3	1	1	3	3
South Africa	1	2	3	2	2	3	2
Taiwan	3	3	2	3	3	2	3
Thailand	1	2	3	3	1	1	3
Turkey	1	3	2	2	1	2	2

Source – Capital Economics