What Valuations Tell Us About Emerging Markets Today

White Paper

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ABS GLOBAL INVESTMENTS

SUMMARY

Performance in emerging market equities has been challenging over recent history. Not only have gains been lackluster, but the asset class has lagged developed markets, which trade at historical highs. While fatigued investors may question their emerging market allocations, a closer look at valuations and fundamentals would suggest that now may not be the time for investors to turn their back on the asset class.

Today, emerging markets are among the most mispriced asset classes in an investor's toolbox. No matter the preferred metric, the result is the same: these markets are cheap relative to their history and to developed markets. Meanwhile, the earnings outlook for the asset class has turned decisively optimistic, providing a catalyst on the horizon for a re-rating. While the combination of a brighter path ahead for a cheap asset class is encouraging, timing an investment often proves to be a futile exercise. The good news is that emerging markets' attractive dividend yields are effectively paying investors to wait. The final piece of the puzzle is the currency outlook, which seems to be pointing at a good entry point for investors.

KEY INSIGHTS

- **ASSET CLASS ON SALE:** Emerging market valuations are looking cheap relative to developed markets and trading well below their historical average. The trend is equally stark no matter the valuation metric lens applied.

- **A ROSIER EARNINGS OUTLOOK AHEAD:** While past earnings have been a drag on emerging market equity returns, it seems that the asset class is at a turning point with a much more upbeat future ahead. Unlike recent years, consensus estimates today point to emerging markets earnings not only growing but materially outpacing developed markets in 2024, 2025 and 2026. What is behind these upbeat earnings projections? Emerging markets are facing several long-term structural transformations that are setting them up for a sustained period of earnings growth.

- **PAID WHILE YOU WAIT:** Over the last twenty years, the number of companies paying dividends within the MSCI Emerging Markets Index has surged, and the dividends themselves have grown significantly outpacing developed markets. The result has been improved shareholder alignment with higher dividend yields. At present, emerging markets offer almost twice the dividend yield of US equity markets.

- **WEAK CURRENCIES DUE A RECOVERY:** At current levels, the US dollar is overvalued by most comparison metrics. Meanwhile, all emerging market currencies are undervalued, and some to a meaningful degree. While other reasons may have triggered the US dollar's strength, its trajectory from here is primarily expected to hinge on US interest rate policy. As the Federal Reserve's rate-hiking cycle comes to an end, the US dollar is expected to weaken, leaving room for emerging markets to benefit from the relative appreciation of their currencies.

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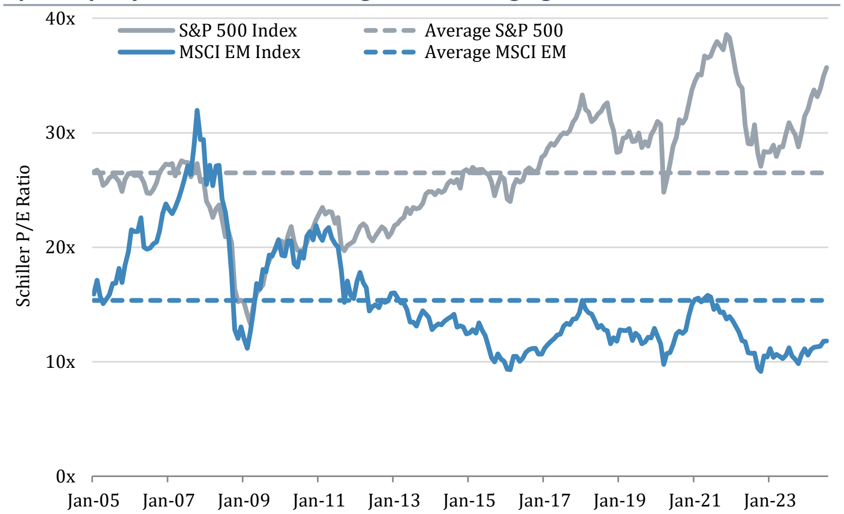
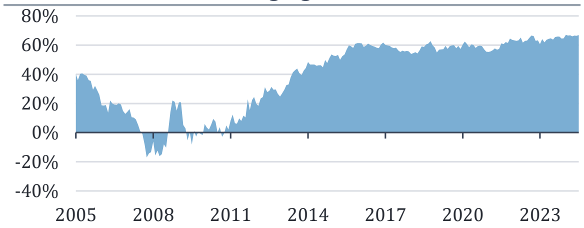
ASSET CLASS ON SALE

Historically, it has not been unusual for emerging market equities to trade at a discount to developed markets. The discount typically reflects the perception of higher risk associated with these countries, which can include currency risk, geopolitical risk, economic risk, and general sentiment risk, among others. While there may be an argument for a consistent yet modest discount, this gap has ballooned to a more extreme level over recent years. More specifically, the valuation gap relative to developed markets has climbed from a historical long-term average discount of 25% to 50% today. The valuation discount relative to US equities has reached 67%.

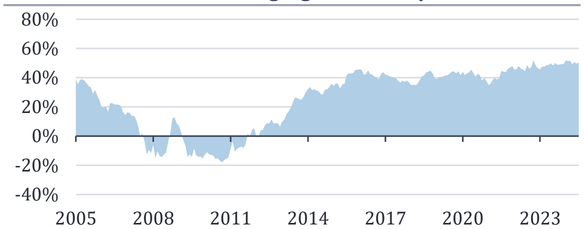
Cyclically Adjusted Price-to-Earnings Ratio: Emerging Markets vs US



Valuation Discount: Emerging Markets vs US



Valuation Discount: Emerging vs Developed Markets

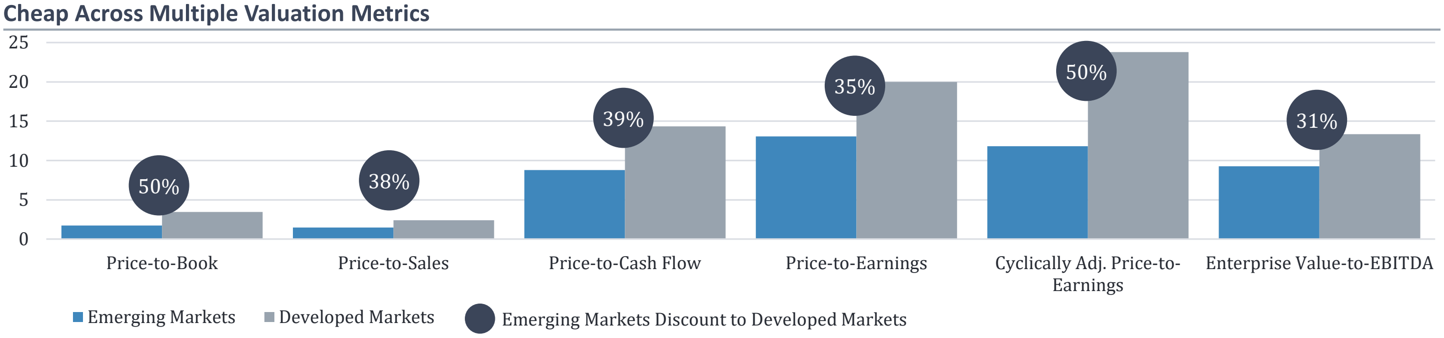


Source: Bloomberg as of July 31, 2024. Emerging Markets data reflects MSCI Emerging Markets Index. Developed Markets data reflects MSCI World Index. US Market data reflects S&P 500 Index. Averages are calculated from Jan 2005 – July 2024. Valuation discounts calculated based on cyclically adjusted price-to-earnings-ratio (also known as Schiller P/E ratio). Past performance is not an indicator of future performance. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision.

Not only are emerging market valuations looking cheap relative to developed markets, but they are trading well below their historical average. Today, the cyclically adjusted price-to-earnings ratio for the MSCI Emerging Markets Index stands close to 12x. Not only is this level well below the historical average of 15x, but it is also close to a historical minimum for the asset class. On the other hand, the S&P 500's cyclically adjusted price-to-earnings ratio trades at almost 36x, which is high relative to historical and global comparisons.

The trend is equally stark no matter the valuation metric lens applied. Price-to-earnings ratios, price-to-book value ratios and price-to-cash flow value ratios all point to the same conclusion that emerging markets are trading at historically unseen valuations.

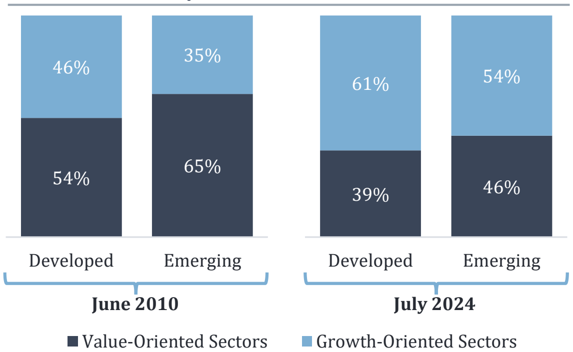
Cheap Across Multiple Valuation Metrics



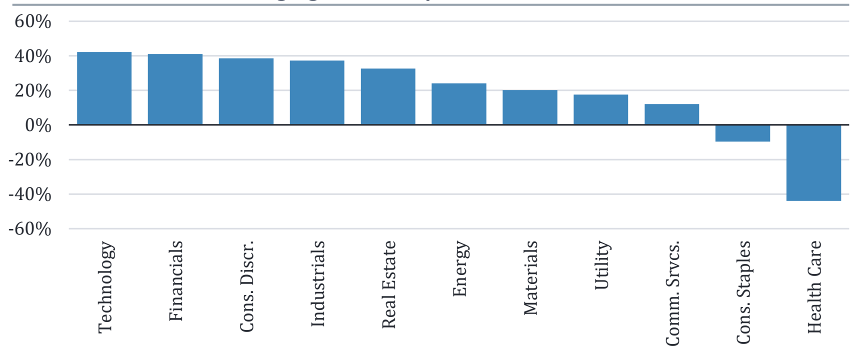
Source: Bloomberg as of July 31, 2024. Emerging Markets data reflects MSCI Emerging Markets Index. Developed Markets data reflects MSCI World Index. Past performance is not an indicator of future performance. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision.

Skeptics would highlight that emerging market valuation comparisons should be undertaken with caution given differences in sector composition among countries and over time given the evolution of the asset class. Indeed, as these countries have progressed in the economic development path, value-oriented companies associated with resource extraction have diminished in importance, giving way to domestic oriented businesses. These shifts are an important consideration for valuations as growth-oriented companies have higher price-to-book and price-to-earnings ratios. In contrast, value-oriented companies have strong fundamentals and, on average, have higher dividend yields. However, a closer look at sector fundamentals demonstrates that emerging markets are undervalued despite these considerations. Emerging markets are undervalued relative to developed markets in 9 out of the 11 GICS sectors. Health care and consumer staples are the only exceptions.

MSCI Sector Composition



Valuation Discount: Emerging vs Developed Markets Sectors



Source: Bloomberg as of July 31, 2024. Emerging Markets data reflects MSCI Emerging Markets Index. Developed Markets data reflects MSCI World Index. Value sectors: energy, materials, industrials, financials, utilities, real estate. Growth sectors: consumer discretionary, consumer staples, health care, IT, communication services. Valuation discounts calculated based on price-to-earnings-ratio. Past performance is not an indicator of future performance. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision.

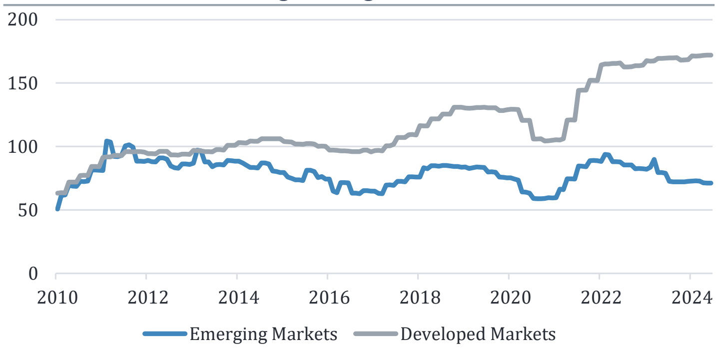
At the country level, most markets are cheap relative to developed markets on a price-to-earnings ratio basis. The main exceptions are India and Taiwan, both of which have benefitted from low exposure to value-oriented stocks and outlook tailwinds. On the other hand, the most undervalued markets include China, Brazil, and some Eastern European countries.

With such an accentuated mispricing, a case can be made that the current discount gap should narrow. However, low valuations alone are not reason enough to prompt a reversal in market fortunes. With that said, the earnings outlook in many of the emerging markets has turned firmly positive and could provide the trigger for a comeback.

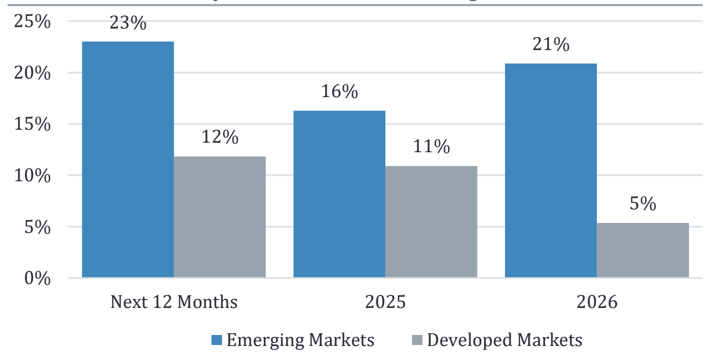
A ROSIER EARNINGS OUTLOOK AHEAD

In line with performance, emerging markets have faced a challenging decade for earnings. Indeed, over the last ten years, 12-month trailing earnings have plateaued, experiencing limited growth. Making matters worse, developed market earnings experienced a steep climb, rising to all-time highs during the same period. US earnings led this upswing, supported by lower interest rates which have reduced debt servicing costs and increased leverage as well as falling tax burdens.

The Past: 12 Month Trailing Earnings Per Share



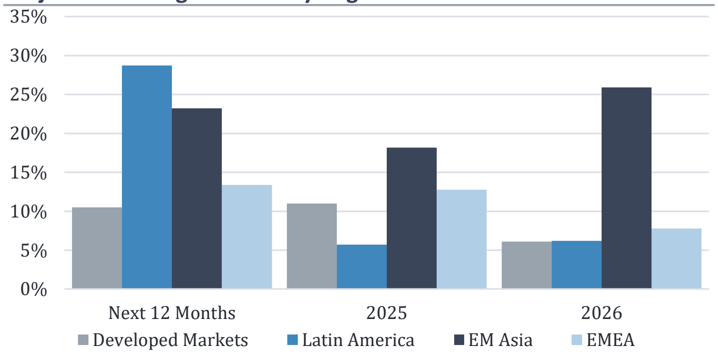
And the Future: Projected Consensus Earnings Growth



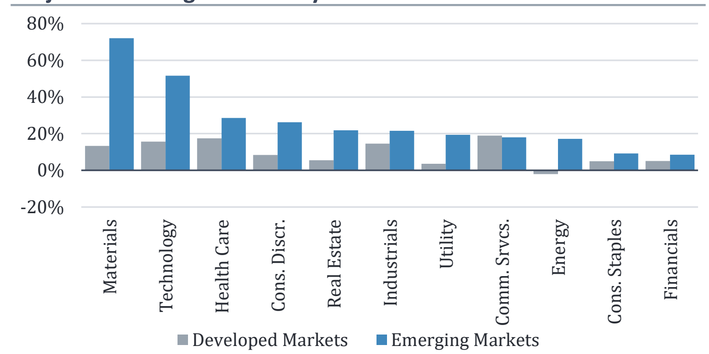
Source: Bloomberg as of July 31, 2024. Emerging Markets data reflects MSCI Emerging Markets Index. Developed Markets data reflects MSCI World Index. Consensus earnings projects reflect Bloomberg earnings consensus estimates as of August 21, 2024, as provided by the Bloomberg EEO function. Past performance is not an indicator of future performance. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision.

While these past earnings have been a drag on emerging market equity returns, the asset class seems to be at a turning point with a much more upbeat future ahead. Unlike recent years, consensus estimates point today to emerging markets' earnings not only growing but materially outpacing developed markets in 2024, 2025, and 2026. While Asian markets are expected to lead this earnings reversal in the near term, all regions within the asset class are projected to deliver solid results. Looking across sectors, the earnings reversal trend is similarly widespread. While technology, real estate, and materials are expected to drive earnings growth over the next 12 months, growth in other sectors is still meaningfully robust. Over half the sectors in the index are expected to experience earnings growth of more than 20% over the next 12 months. Piecing it all together, emerging markets offer investors earnings growth at a much more attractive price than developed markets.

Projected Earnings Growth by Region



Projected Earnings Growth by Sector: Next 12 Months



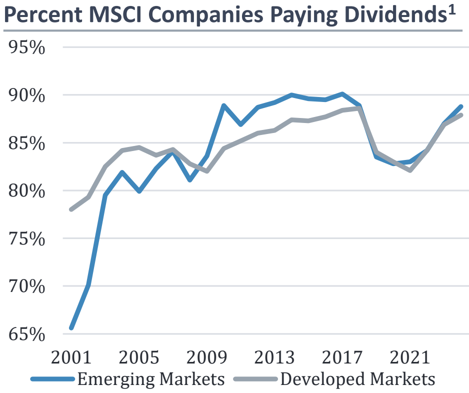
Source: Bloomberg. Emerging Markets data reflects MSCI Emerging Markets Index. Developed Markets data reflects MSCI World Index. Consensus earnings projects reflect Bloomberg earnings consensus estimates as of August 26, 2024, as provided by the Bloomberg EEO function. Past performance is not an indicator of future performance. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision.

What is behind these upbeat earnings projections? Emerging markets are facing several long-term structural transformations that are setting these markets up for a sustained period of earnings growth. Importantly, these markets have undergone meaningful changes over the last few decades, and they no longer rely on economic models of resource exploitation and cheap manufacturing. Instead, these markets present a more diverse and increasingly domestically oriented opportunity set. Further, these countries are home to some of today's most exciting investment prospects. Taiwan is the epicenter of the expansion of artificial intelligence trends and holds some of the world's largest and most sophisticated semiconductor companies. South Korea is a vital piece of the energy transition trend, with leading companies responsible for manufacturing batteries. In a world where trade relationships are being re-drawn, Mexico, India, and Southeast Asia are set to benefit from expanding bilateral relations. Meanwhile, the Middle East is undergoing a wide-ranging economic and cultural transformation as key countries diversify away from their reliance on hydrocarbons. While many of these are long-term transformations, the trend is clear.

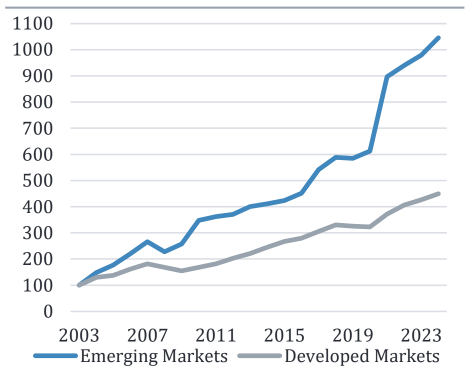
PAID WHILE YOU WAIT

While we are optimistic about the opportunities ahead for emerging markets, timing an entry point with any precision has long proved difficult, if not impossible. Fortunately, the pressure to time markets is mitigated by dividends. Contrary to popular perceptions, emerging markets today offer attractive dividends.

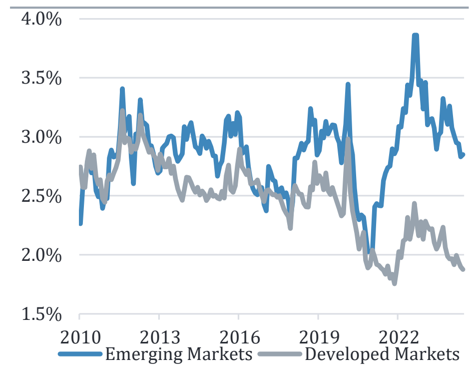
Percent MSCI Companies Paying Dividends[1]



Dividend Growth[2]



Dividend Yields[3]



[1]Using MSCI universe as it existed in the past. Based on local currency performance. Gross reinvested dividends without considering the impact of taxes. Source: Abderdeen, FactSet, Jefferies Equity Research, January 2024. [2] Dividend index rebased to 100 (local currency, current universe). Bottom-up aggregated with free float adjustment in a year-on-year like-to-like basis for the current MSCI universe. Source: Aberdeen, FactSet, Jefferies Equity Research, January 2024. [3] Source: Bloomberg as of July 2024. Emerging Markets data reflects MSCI Emerging Markets Index. Developed Markets data reflects MSCI World Index. Past performance is not an indicator of future performance. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision.

Over the last twenty years, the number of companies paying dividends within the MSCI Emerging Markets Index has surged. Today, almost 90% of companies pay dividends, a similar proportion to what is experienced in developed markets. Moreover, dividends themselves have grown significantly, outpacing developed markets. The result has been improved shareholder alignment with higher dividend yields. Emerging markets are offering almost twice the dividend yield of US equity markets.

Latin America offers the most attractive yields by region, with Brazil and Colombia leading the asset class. Meanwhile, the only country with dividend yields lower than those of developed markets is India.

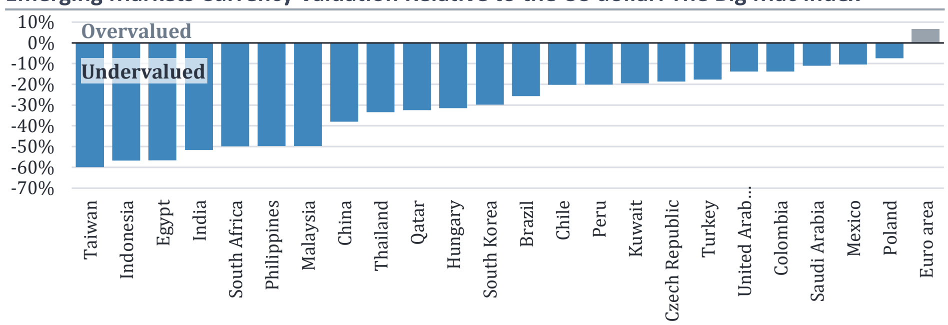
WEAK CURRENCIES DUE A RECOVERY

Company performance is not the only consideration when allocating internationally. Investors in foreign equity markets take on additional risks related to fluctuations in the exchange rate between the US dollar and the underlying emerging market currencies. Over the last ten years, the US dollar consistently climbed, creating meaningful headwinds for emerging market currencies and their investors. At current levels, the US dollar is overvalued by most comparison metrics. Meanwhile, all emerging market currencies are undervalued, and some to a meaningful degree, according to the "Big Mac" index. The Indonesian rupiah is 57% undervalued against the US dollar. The India Rupee is 52% undervalued. The South African Rand is trading at a 50% discount.

Unlike other periods characterized by broad emerging market currency weakness, today, most emerging countries have more robust economic fundamentals to justify an appreciation. They have stronger balance sheets and larger currency reserves. In addition, most emerging market central banks have been quick and successful in their efforts to combat recent inflation pressures, leaving room for rate cutting policies. As it stands, a recovery in emerging currencies depends more on the US dollar than domestic emerging market economic factors.

Real US Dollar Index[4]

Emerging Markets Currency Valuation Relative to the US dollar: The Big Mac index[5]



[4] Board of Governors of the Federal Reserve System (US), Real Broad Dollar Index [RTWEXBGS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/RTWEXBGS, August 23, 2024. [5] Source: The Economist's The Big Mac Index, retrieved from The Economist, https://www.economist.com/big-mac-index on August 23, 2024. Emerging Markets data reflects MSCI Emerging Markets Index. Past performance is not an indicator of future performance. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision.

While other reasons may have triggered the US dollar's strength, its trajectory from here is primarily expected to hinge on US interest rate policy. As the Federal Reserve's rate-hiking cycle ends, the US dollar is expected to weaken, leaving room for emerging markets to benefit from the relative appreciation of their currencies. All these trends suggest that current market levels may be attractive entry points from the perspective of both currencies and company valuations.

CONCLUSION: TIME TO STAY THE COURSE

Company and currency valuations send investors a clear message: emerging market equities are cheap. Beyond that, the outlook for the asset class is promising, given the massive transformations taking place, and investors are getting paid to wait for a market reversal. Barring any unforeseen adverse geopolitical, economic, or otherwise setback, investors can expect the valuation discount between emerging and developed markets to narrow meaningfully. All these factors considered, now is not a bad time to have an allocation to emerging markets.

DISCLOSURES