Emerging Markets – Buy or Bye?

Since 2011, Emerging Markets (EM) have significantly underperformed the US market. As the following chart of the MSCI EM Index in US Dollar terms shows, however, we may have seen a technical breakout on the price action of EM equities. Having said that, a broad based benchmark may not be the best way of looking at the argument, since, as we are frequently reminded, not all EM equities are created equally: while the Brazilian, Russian and South African economies are dominated by mining and energy stocks, for example; India and many Asian countries are looking to the technology and tourism sectors to drive growth forward.

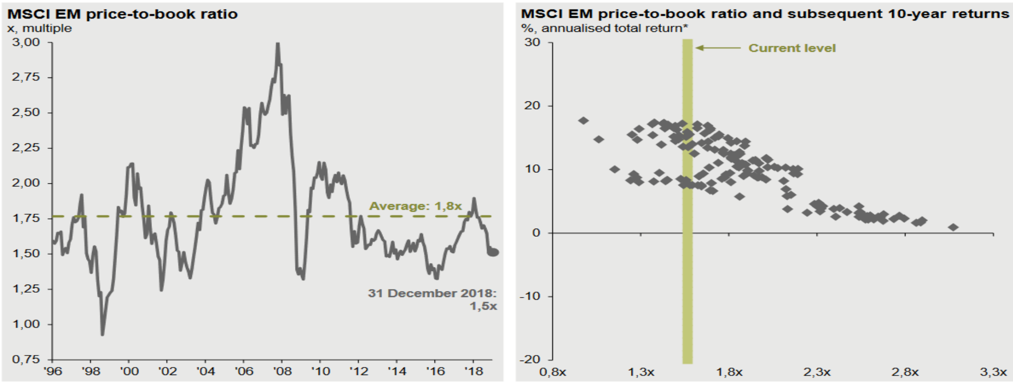
The MSCI EM Index in US Dollars

Source: Bloomberg

Moreover, valuation may not necessarily be the best short-term indicator of market direction as it usually is over the medium to long term. So where do we sit today?

A first important valuation criteria is price-to-book ratio. According to research from JP Morgan, the MSCI EM Index's price-to-book ratio at the end of last year was 1.5x, which, although some way above the 2015 low of 1.23x, is meaningfully below the long-term average of 1.8x and thus represents good value in historic terms. The second part of the chart overleaf highlights the subsequent 10 year returns from various starting price-to-book levels. This clearly shows a wide dispersion of 10 year returns (scatter points on the chart) but much higher overall returns from current 1.5x levels, than much more lofty valuations. Interestingly, at lower price-to-book levels, the next 10 years haven't increased as incrementally.

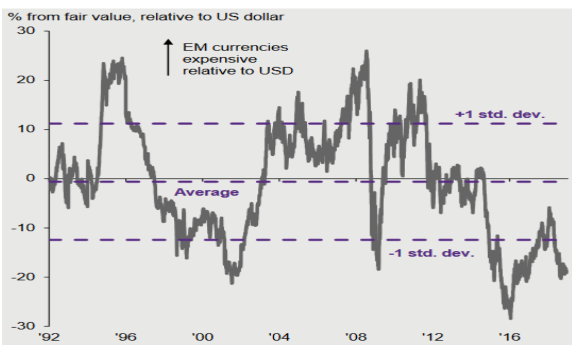
Emerging Markets equity valuations and subsequent returns



Source: (All charts) MSCI, Thomson Reuters Datastream, J.P. Morgan Asset Management. *Dots represent monthly data points since 1996, which is earliest available. MSCI EM index returns are in USD. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - Europe*. Data as of 31 December 2018.

The second important valuation criteria (and some may argue even more important) for Emerging Markets is currency value. Many fundamentalists have attempted to use Purchasing Power Parity and the simpler Big Mac Index as an indicator, but a simple look at the relative movement of a basket of EM currencies versus the US Dollar has generally shown good under and over valuation points.

EM currencies vs US Dollar



Taking the foregoing factors into account, our conclusion is that Emerging Market equity valuations are, on the whole, attractive value; currencies are cheap relative to the USD and investor flows into EM assets (a useful gauge of investor sentiment) are starting to pick up. While our view is that this is not the time to be underweight in this asset class, a careful selection of countries and sectors within the universe will always be important as the wide range of returns will undoubtedly be the same for the next 10 years.

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