October 17, 2024

EM Equities Are Primed To Rally

- EM firms' profits are poised for a strong cyclical rebound, underpinned by an upswing in global manufacturing, further EM monetary policy easing, and accelerating capital spending in non-tech Asian economies.

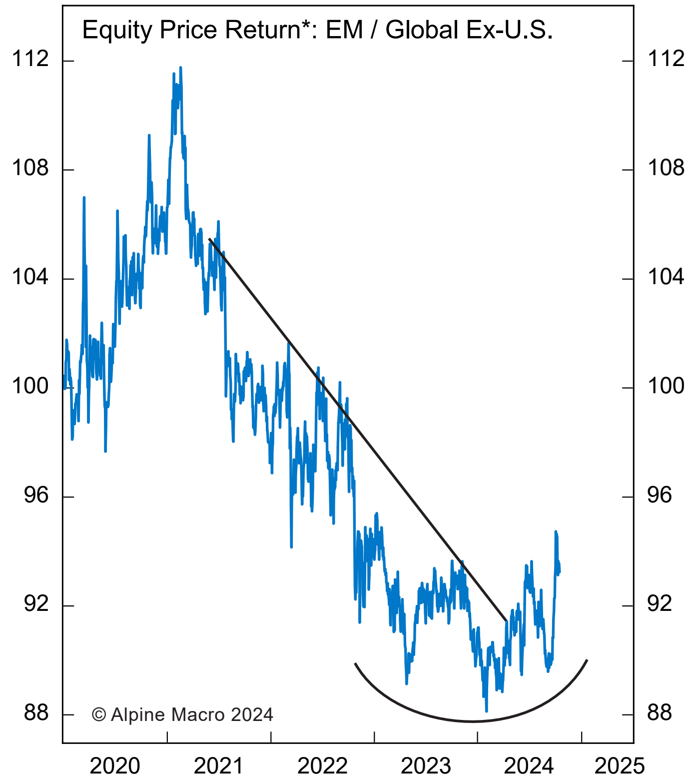
- Chinese policymakers are in the early stages of a reflationary push, with more fiscal measures likely on the way. A flurry of stimulus could supercharge earnings for both domestic firms and those in the broader EM complex.

- EM equities and currencies are markedly undervalued, providing a solid foundation for dollar-based outperformance against DM ex-U.S. stocks. Return upside will be dependent on how thoroughly China adopts a "whatever it takes" approach on reflation.

EM relative equity performance is turning a corner. Since early last year, EM stocks have been tracing out a broad bottom compared to their DM ex-U.S. counterparts, with China's recent policy reversal only reinforcing the brewing upside momentum (**Chart 1**).

This report contends that the propitious technical backdrop is backed by solid prospects for a cyclical profit upswing and more accommodative policy. Asset allocators should maintain at least a neutral exposure to EM stocks and prepare to go overweight

Chart 1 EM Equities: Girding For A Breakout?



*Large/mid/small-cap indexes expressed in USD terms and rebased to Jan 2020=100; source: MSCI

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on signs that China is committed to stimulating aggressively.

A Promising Outlook For EM Profits...

Relative equity performance over cyclical time horizons largely hinges on trends in fundamental factors such as corporate earnings, sales, and cash flows. This is especially relevant when assessing EM relative returns, particularly in the period following the Great Financial Crisis. Since 2010, EM relative stock performance has closely tracked relative return on equity (Chart 2).[1]

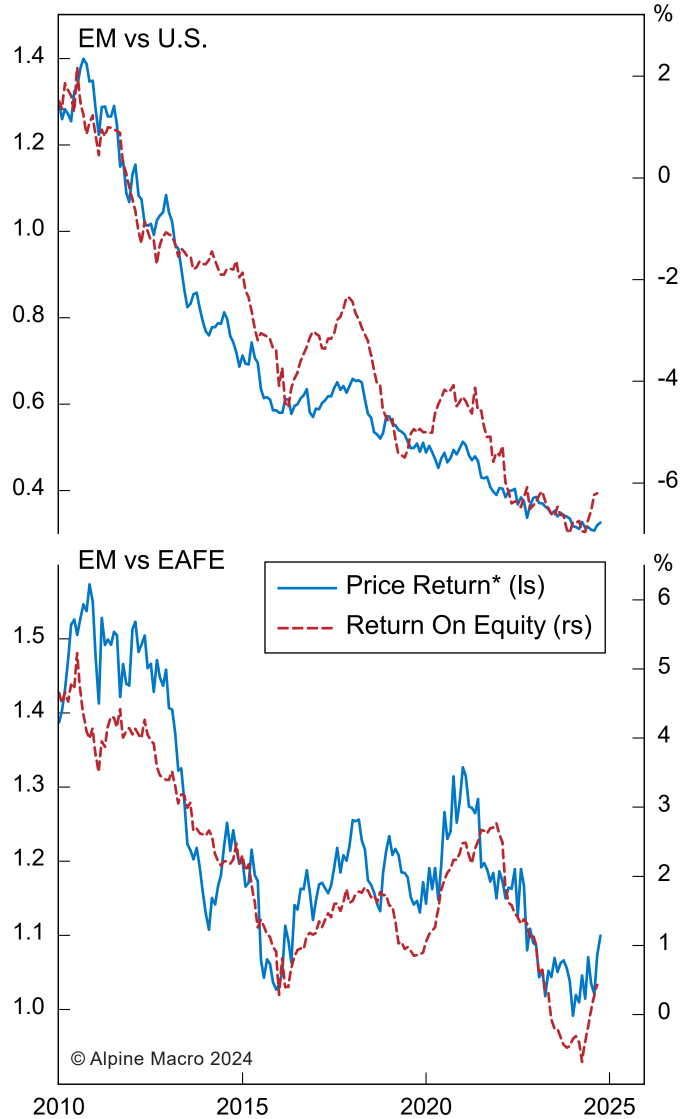
It therefore follows that a sustained rebound in return on capital is essential for EM equities to outperform other major markets. What are the odds for this materializing? A few key observations can shed light on the outlook.

First, EM economies are inherently pro-cyclical in nature and stand to benefit from a gradual recovery in global growth. Manufacturing activity, the primary source of cyclicality, bottomed out in the second half of last year as the post-pandemic surge in goods production normalized and the effects of monetary tightening began to wane.

While recent data hint at a relapse, it should represent a temporary dip rather than a full loss in momentum. In the absence of major shocks, global growth is largely shaped by financial conditions. As shown in Chart 3, the declines in U.S. yields, oil prices and the dollar will significantly ease these conditions. This will offer a powerful growth

1 Return on equity is often a more insightful metric than relative earnings, as it reflects the efficiency of capital use and leverage-adjusted profitability.

Chart 2 Falling Relative ROE Explains EM Underperformance



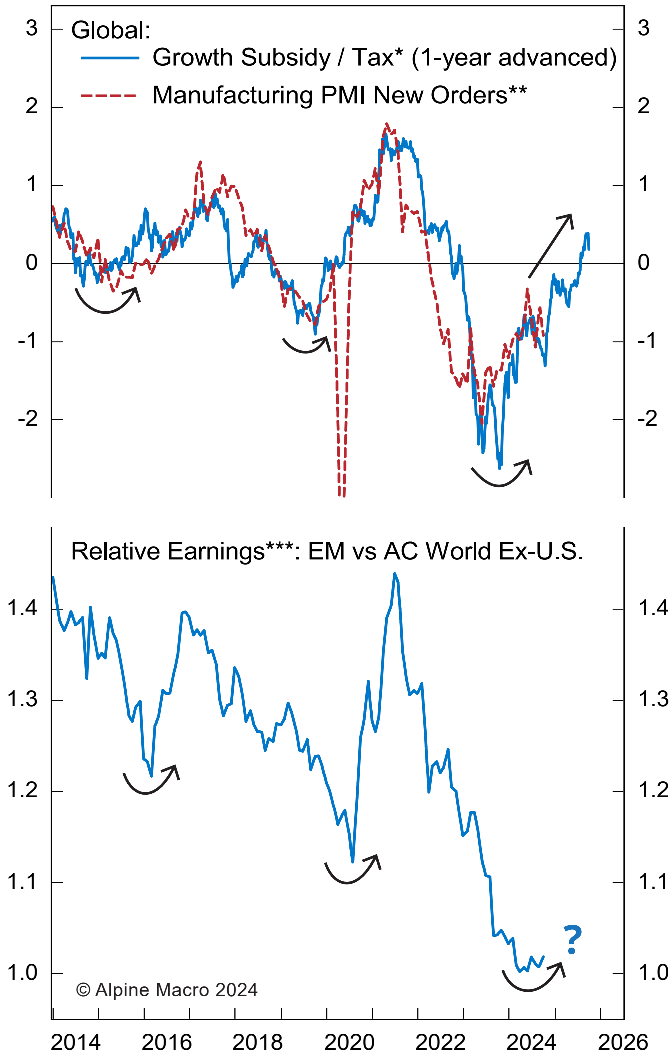
*Large/mid/small-cap index; expressed in USD terms
Source: MSCI, Alpine Macro calculation

"subsidy" to the global economy and EM corporate profits in the year ahead.

Second, another wave of synchronized EM monetary policy easing is likely, which will bolster domestic growth.

EM central banks began cutting rates in mid-2023, but rates in real terms have only gone sideways

Chart 3 A Global Growth "Subsidy" Particularly Benefits EM Profits

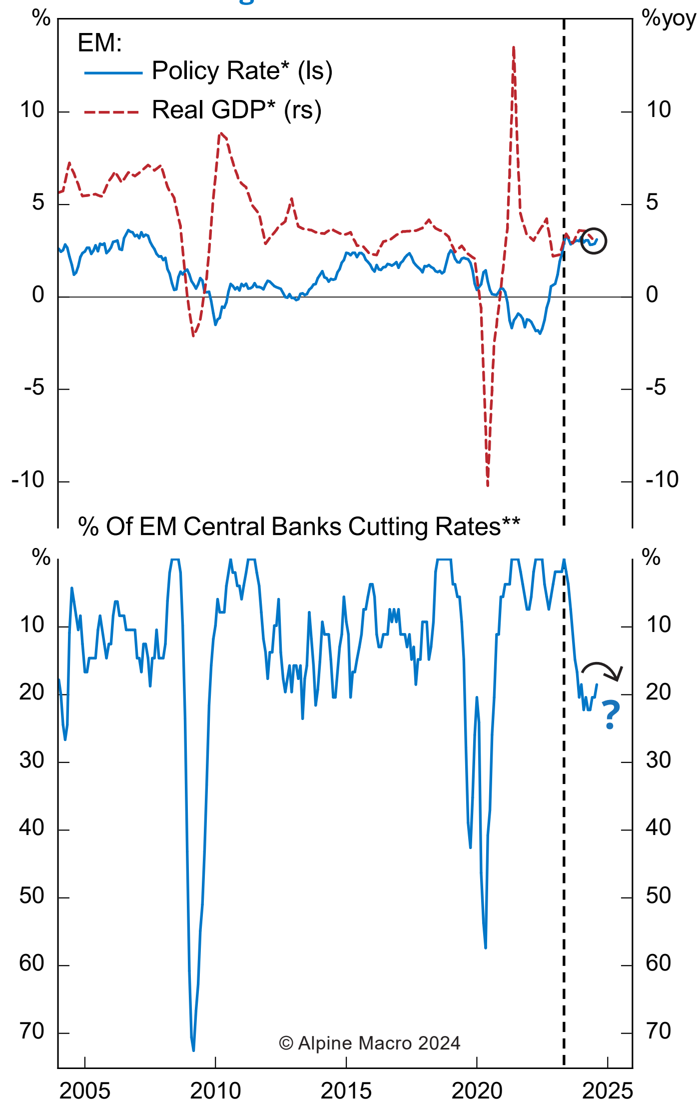


*Rising figure represents a growth subsidy; based on deviations from trend of the U.S. 10-year yield, trade-weighted U.S. dollar, and oil prices
**Proxied by the U.S., Sweden, Austria, Taiwan, and New Zealand; truncated at -3
***Expressed in dollar terms
Note: Both series in the top panel are shown standardized
Source: MSCI, Alpine Macro calculation

as inflation has subsided. Signs indicate that they remain too high:

- The real policy rate for EM is now on par with real GDP growth, an uncommon alignment as it has typically run roughly 1-2% below real growth in recent decades (**Chart 4**). This implies that the current monetary stance remains overly restrictive, leaving plenty of scope for easing.

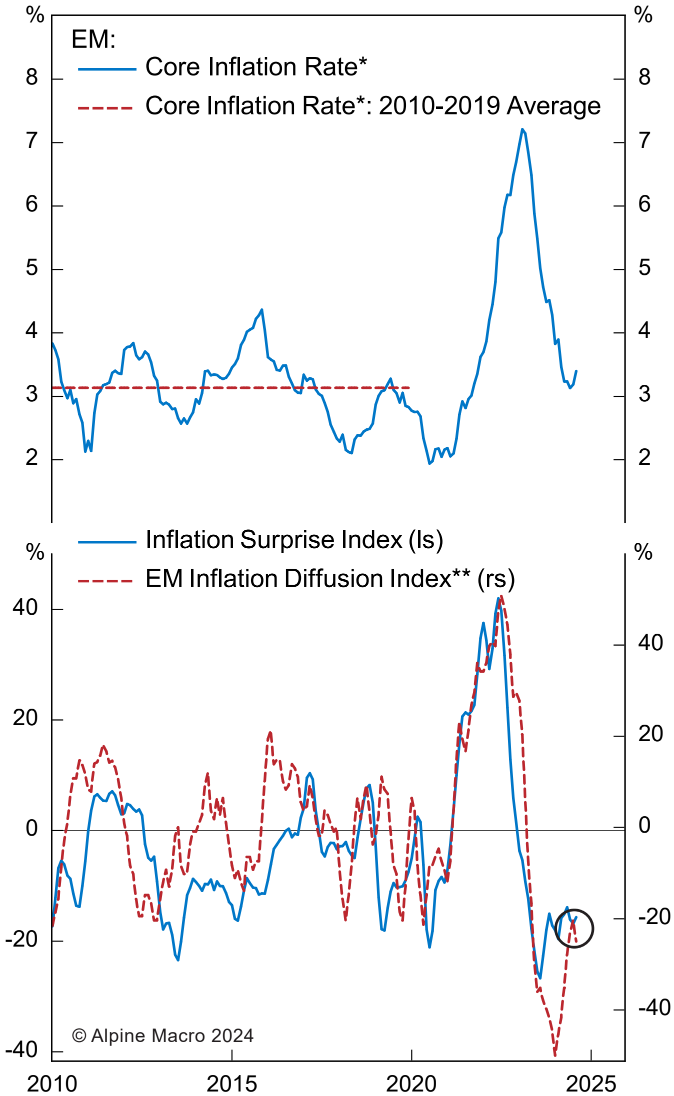
Chart 4 EM Monetary Policy Remains Too Tight...



*Proxied by the largest 8 EM economies in the MSCI index
**Based on monthly changes of 18 EM central banks; shown as a 3-month moving average
Source: World Bank, Alpine Macro calculation

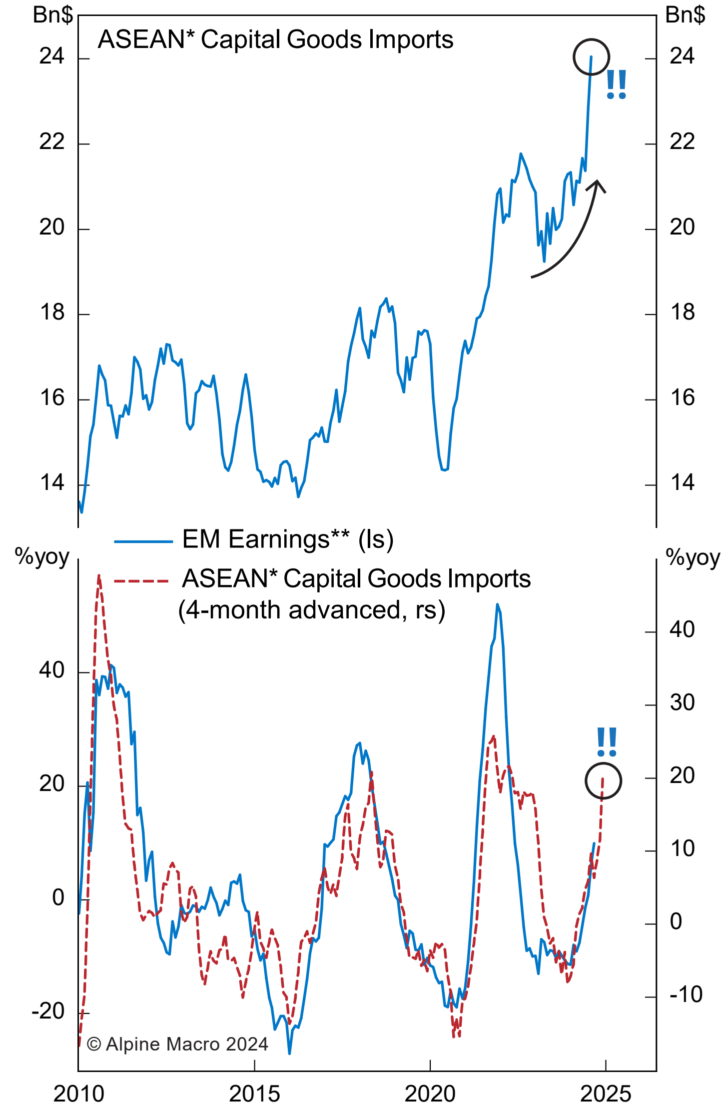
- Core inflation in EM has already returned to its pre-pandemic average, but the disinflation process may have further to go. Inflation numbers continue to undershoot expectations, with a majority of EM countries still reporting declining

Chart 5 ...In Light Of Subsiding Inflation



*Median of 18 EM economies
**% of EM countries with a headline inflation rate higher than one month ago minus those lower; shown as a 12-month moving average
Source: Citi, Alpine Macro calculation

Chart 6 An ASEAN Capital Spending Boom



*Sum of Malaysia, Thailand, Indonesia, and the Philippines; calculated as a 3-month moving average
**Expressed in USD terms

figures (**Chart 5**). This trend is being driven by the lagged impact of tight monetary policy and the deflationary pressures stemming from China up to this point.

Encouragingly, the recent depreciation of EM currencies - the result of the bloc's central banks moving unprecedently ahead of the Fed in cutting rates this cycle — has been reasonably orderly. This underscores the improved macro resilience of EM economies. With a significant easing cycle now expected from the Fed, EM central banks are likely to feel more confident in slashing rates further, with less worry about currency weakness or capital outflows.

Finally, capital spending is booming across many Asian economies. The spotlight remains on the global technology upcycle, fueled by semiconductors and AI, which should drive earnings higher in South Korea and Taiwan. Less discussed are the rising investment outlays in other Southeast Asian economies, where firms typically ramp up spending in anticipation of global consumption cycles. The 20% surge in their capital goods imports augurs for a further acceleration in EM profit growth in the coming quarters (Chart 6).

Bottom Line: The prospects for a cyclical rebound in EM firms' return on equity, both in absolute and relative terms, are strong. This is supported by a continued healing in global manufacturing, ample scope for further EM monetary policy easing, and an acceleration in capital spending across non-tech Asian economies.

...With China Providing The Kicker

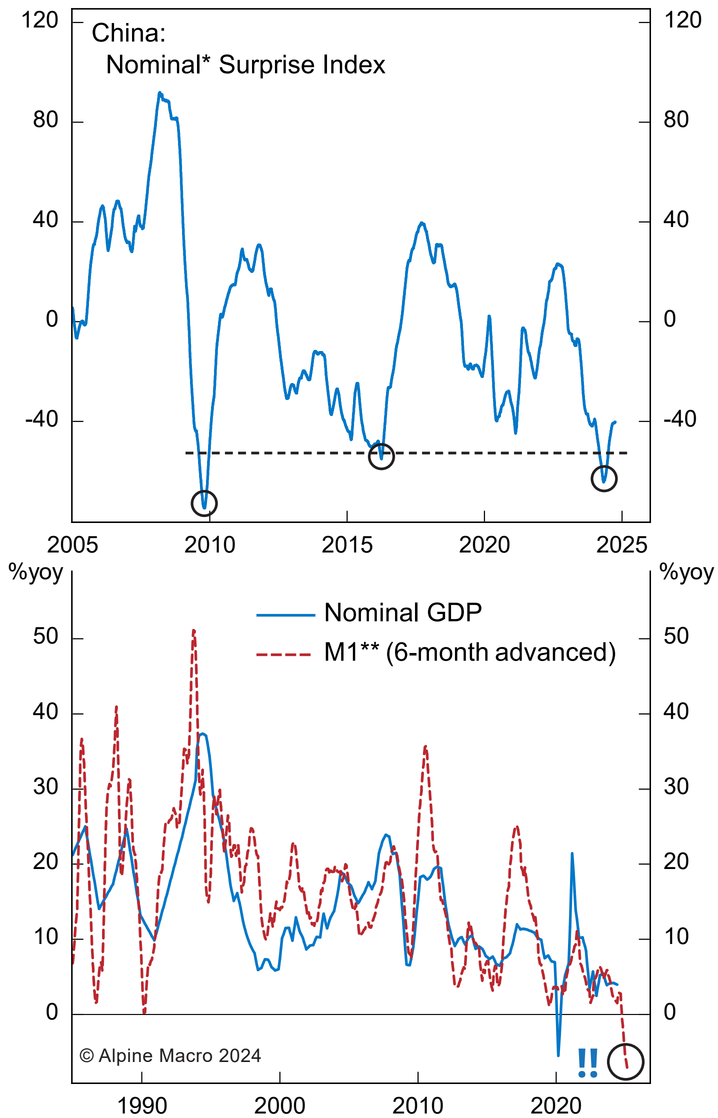
Of course, developments out of China can also have a large bearing on the trajectory of overall EM profits. We had noted prior to the easing announcement that cumulative growth and inflation disappointments in China were at levels comparable to those seen in 2009 and 2016 (Chart 7). That suggested that a "pain threshold" was close to being crossed, meaning a major policy reversal could not have been far off.[2]

Although it is encouraging that Beijing has finally addressed growing deflationary pressures, it remains to be seen whether the Chinese economy will respond to the aggressive slate of stimulus measures. The growth malaise has been rooted in the preference of the private sector to save rather than spend. It may turn out that the influx of liquidity will be akin to "pushing on a string", failing to generate strong credit growth in the absence of loan demand.

The upshot is that the reflation push is likely still in its early stages. With the economy mired in a liquidity

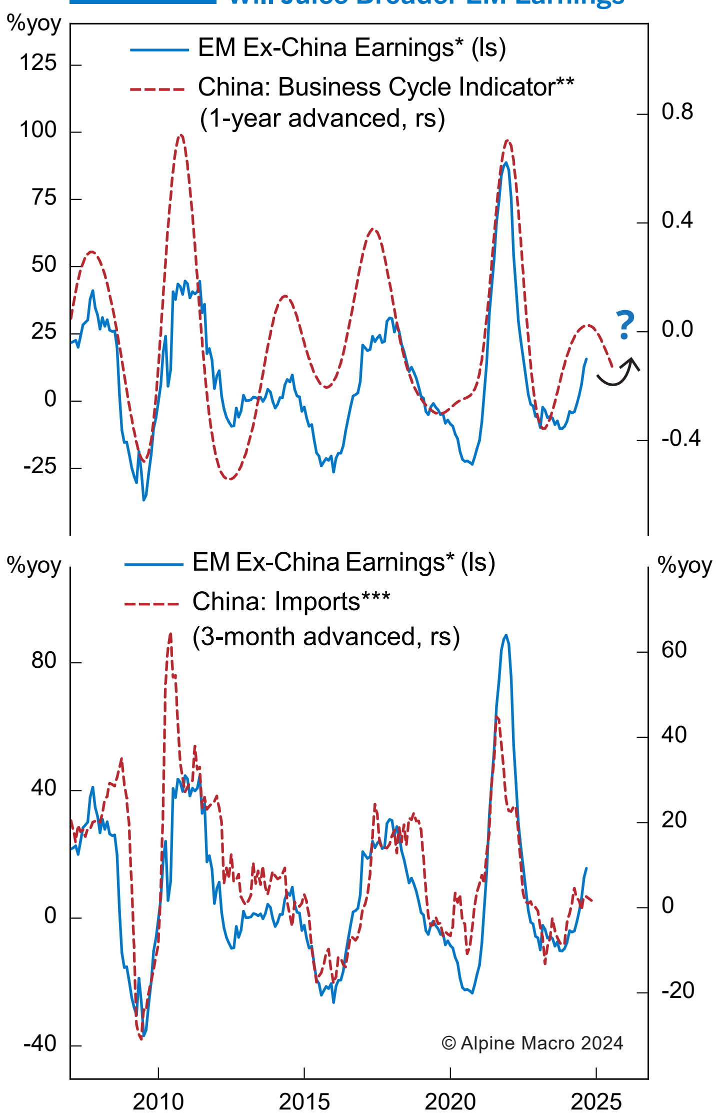
2 Alpine Macro *Global Asset Allocation* "Transition Blips Or Major Shifts?" (September 10, 2024)

Chart 7 Chinese Policymakers' "Pain Threshold" Was Crossed



*Combines both economic and inflation surprises; shown as a 1-year moving average; source: Citi
**Shown as a 3-month moving average

Chart 8 Upturn In Chinese Business Cycle Will Juice Broader EM Earnings

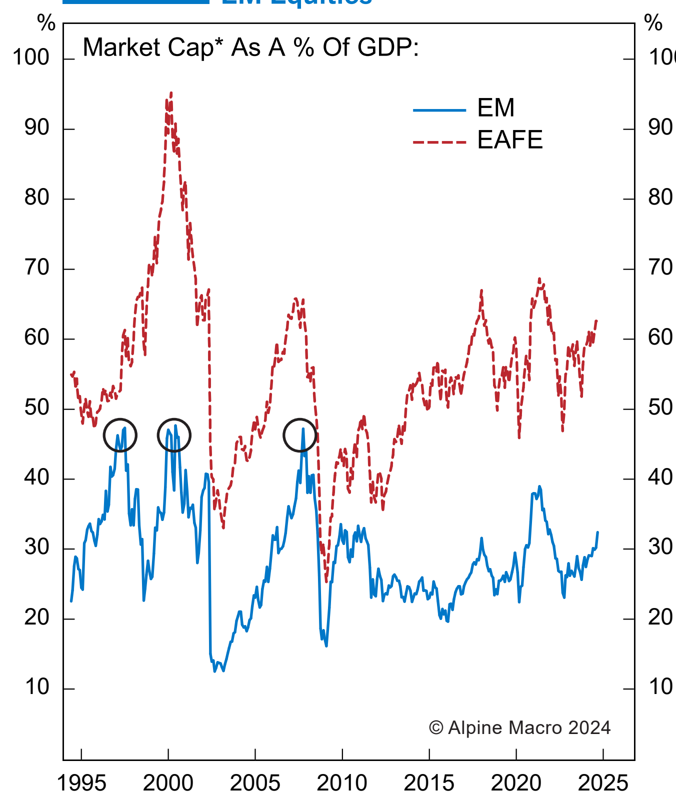


*Expressed in USD terms
**Alpine Macro proprietary indicator
***Expressed in USD terms; shown as a 3-month moving average
Source: MSCI

trap, it is reasonable to assume that Chinese policymakers will follow up with outright fiscal measures.

A sustained recovery in Chinese growth will not only reinforce domestic firms' earnings, but also that of the broader EM complex. Chart 8 illustrates how EM profits closely track the swings of the Chinese business cycle. The primary transmission mechanism

Chart 9 Scope For Structural Rerating Of EM Equities



*Based on large/mid/small-cap indexes, expressed in USD terms
Source: MSCI, IMF

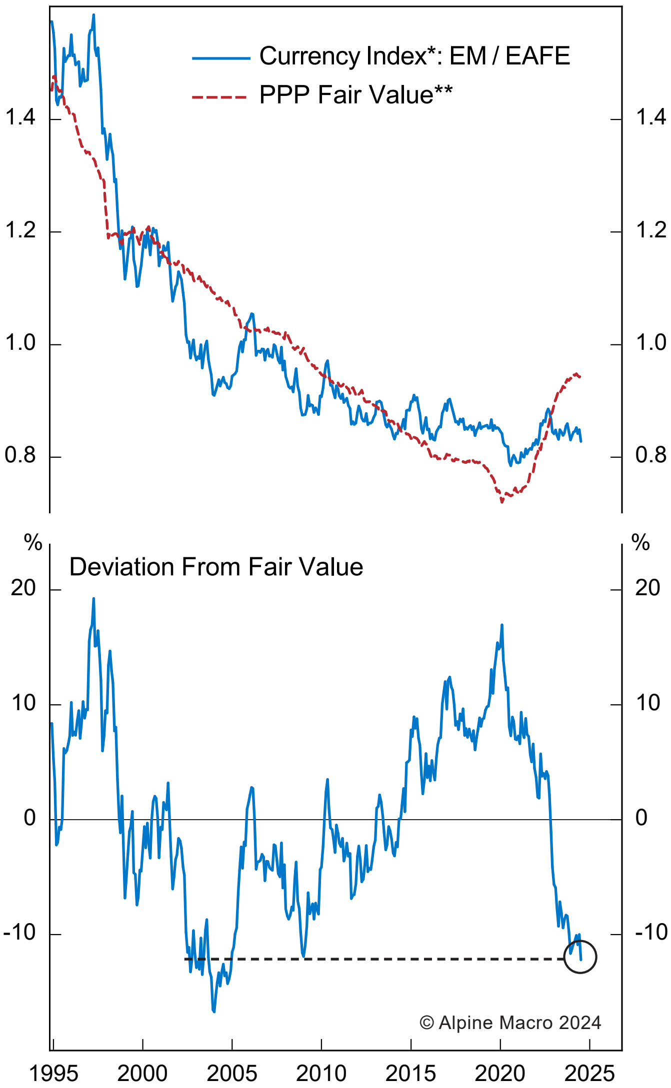
is through Chinese imports of raw materials and intermediate goods from other EM economies. Any spurring of investment and consumption in China should, therefore, directly translate into stronger corporate earnings for firms across these regions.

Bottom Line: Chinese policymakers are likely in the early stages of their reflationary push. A forthcoming pipeline of monetary and fiscal stimulus could supercharge earnings for both domestic firms and those in the rest of the EM complex.

Odds And Ends For Asset Allocators

This report outlined why the macro environment warrants greater optimism toward EM equities,

Chart 10 EM Currencies Have Cheapened Considerably



*Inferred from the local currency and USD large/mid/small-cap indexes
**Based on relative changes in consumer prices
Source: MSCI, World Bank, Alpine Macro proprietary model

building on the rationale that led us to raise exposure to neutral back in June. We are closely monitoring for additional signs that Chinese policymakers are fully embracing a "whatever it takes" mentality on reflation before considering whether to upgrade the EM position to overweight. For now, we advise investors to express EM bullishness relative to DM ex-U.S. stocks.

A few final portfolio considerations deserve attention.

The first is that valuations do not pose an impediment to EM outperformance relative to EAFE. Even after the recent pop higher, the former trades at a forward P/E of 12.4X, a roughly 10% discount to the latter.

EM valuations are even more compelling on a structural basis. Market cap-to-GDP stands at just 30%, well below previous peaks exceeding 45% (Chart 9). This ratio, which is much less prone to accounting distortions, effectively benches equity prices against the "cash flows" generated within an economy. Over the past decade, the EM measure has trended sideways, resulting in a substantial and growing divergence with EAFE.

Moreover, EM currencies have also swung from significant overvaluation to undervaluation in the post-pandemic period. With price increases in EM remaining much more subdued compared to DM ex-U.S. economies, the benchmark currency index now trades over 10% below its PPP-implied fair value (Chart 10). This level resembles the troughs seen in 2004 and 2009, which preceded strong rebounds in EM assets. A similar bounce today could significantly enhance dollar-denominated equity returns.

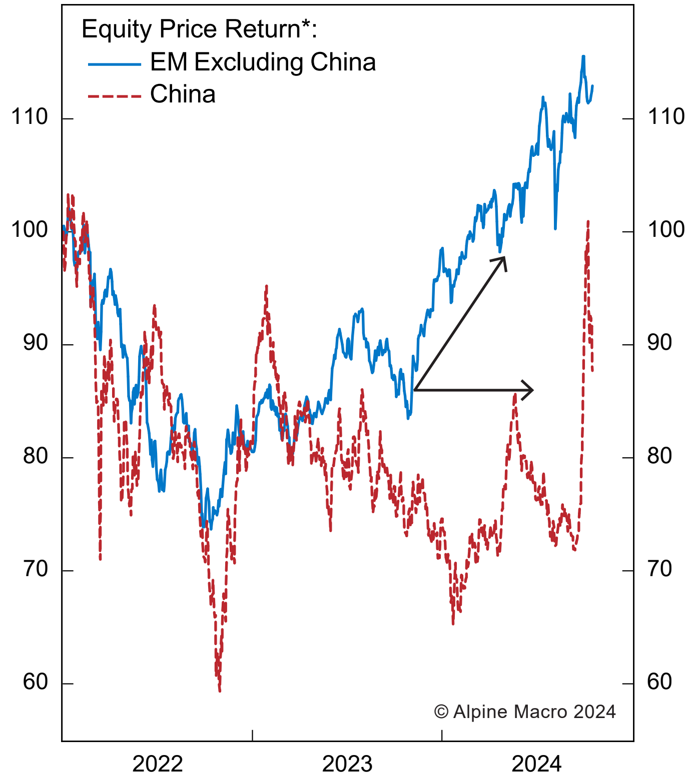
Asset allocators should also note that EM equities outside of China began decoupling from mainland stocks since early last year (Chart 11). This is partly due to China's sharp decline in the EM index, where its weight has dropped from a peak of 40% to 22%.

The key takeaway is that China's equity market derating appears to have largely run its course, making it unlikely to be a drag on overall EM performance. Conversely, further positive policy surprises from China could substantially boost both Chinese and broader EM indices. In essence, holding EM exposure should offer investors a call option on potentially powerful rallies in Chinese equities.

Bottom Line: EM equities and currencies are markedly undervalued, creating a solid basis for outperformance against DM ex-U.S. stocks in dollar terms. More decisive reflationary action from Chinese policymakers would amplify returns.

Bassam Nawfal
Chief Asset Allocation Strategist

Chart 11 EM Stocks Could Do Well Regardless Of China Factor



*Large & mid-cap, expressed in USD terms and rebased to Jan 2022=100; source: MSCI

A Unique Mind On The Markets