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# The Beginning of An Unrecognised Bull Market in Emerging Markets

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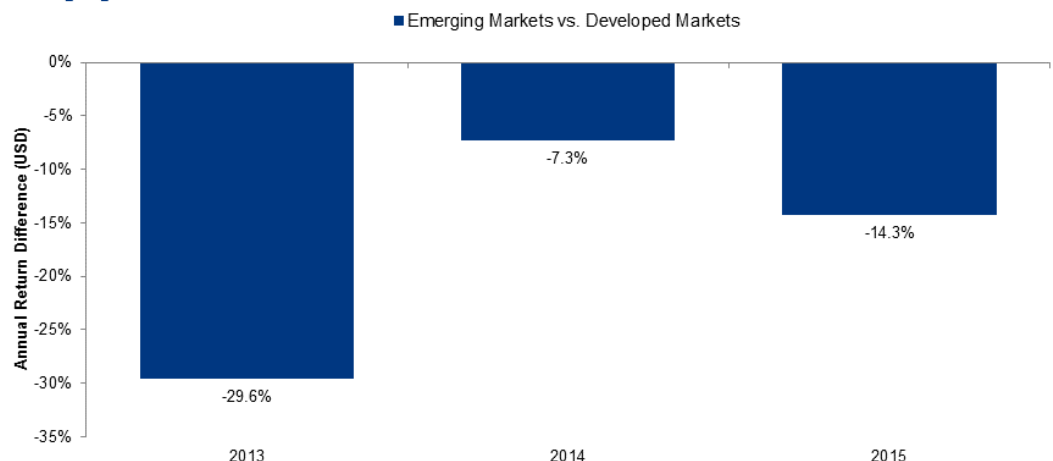
Emerging market equities have rebounded following several years of underperformance on both an absolute and relative basis, yet most investors remain pessimistic and are significantly underweight the asset class. Our expectation is that earnings growth will ultimately drive a change in sentiment, and the rebound in earnings expectations is signalling the start of a secular bull market in emerging market equities. Now is the time for investors to rethink their emerging markets exposure as the bull is outside its pen... and about to charge.



## Emerging Markets: Then & Now

In the 2013 to 2015 time period, emerging market equities suffered as investor fears overwhelmed the asset class. Specifically, market participants were overly fixed on the effect from imminent central bank rate hikes, the impact of low energy and commodities prices and slowing (albeit still high) growth in countries like China. During this period, valuation was cheap and got even cheaper relative to developed markets as emerging markets lagged, posting declines in each of the three calendar years and meaningfully trailed developed indices<sup>1</sup>.

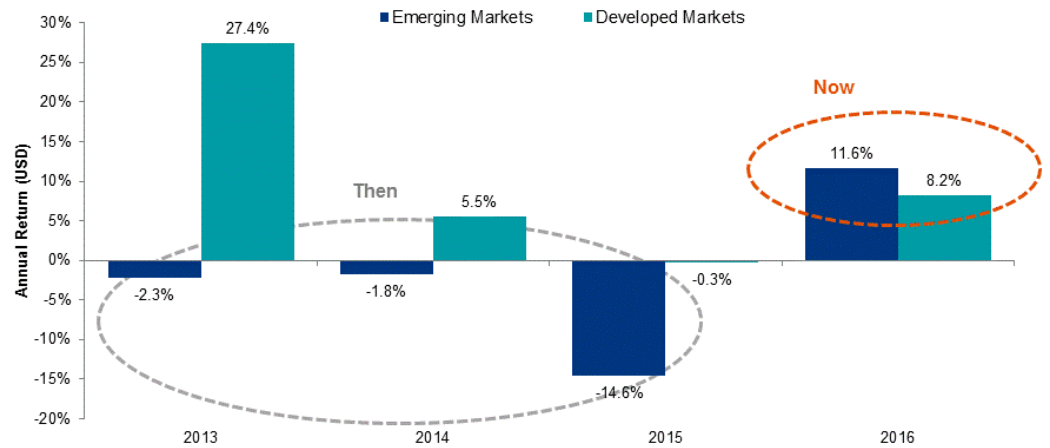
## Emerging Markets Relative Performance



Source: MSCI from January 2013 to December 2015. Emerging markets represented by the MSCI EM Index and developed markets by the MSCI World Index. Returns in USD. Past performance is not a reliable indicator of future results.

Fast forward to 2016 (and today) – the market dynamics have reversed. Central bank rate hikes are being priced in by the market and emerging market balance sheets are stronger than in the recent past. Energy and commodities prices have bottomed and are now near historical averages. The overall growth rates in emerging markets are again increasing, and the quality of growth is higher thanks to the rise of the local consumer. The icing on the cake is that emerging market currencies are also increasing relative to developed markets in the beginning of 2017, providing a nice tailwind for investors.

## Emerging Markets Annual Performance



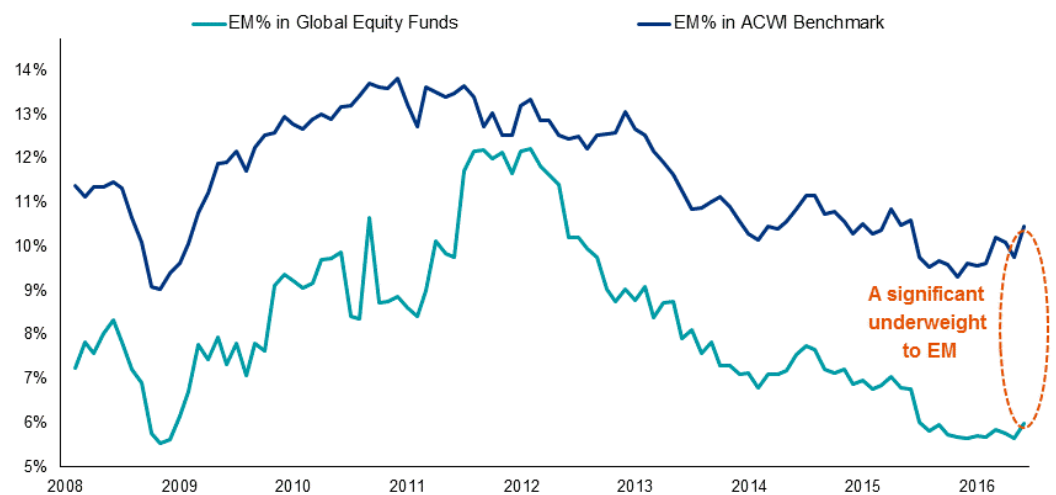
Source: MSCI from January 2013 to December 2016. Emerging markets represented by the MSCI EM Index and developed markets by the MSCI World Index. Returns in USD. Past performance is not a reliable indicator of future results.

## The Bull Is Outside Its Pen.....

In 2016, the MSCI Emerging Markets Index was in line with the MSCI USA and outperformed the MSCI World (including Japan, Australia, Asia, Far East and Europe), which suggests that investors have started to hop back on the emerging markets bandwagon, right? Not yet.

Although flows to emerging market equities have increased in eight of the last nine months<sup>2</sup>, the relative underweight to the asset class remains significant, and is at the lowest level since prior to the financial crisis. We attribute this to investors being fearful they may have missed the recent performance run, coupled with the anxiety that interference from developed markets (i.e. “Trumponomics”) may increase. In addition, key market metrics haven’t fully caught up with the turnaround in asset class expectations.

## Emerging Markets Weight in Global Equity Funds



Source: MSCI, EPFR Global, Thomson Reuters DataStream, HSBC. As of September 30, 2016. Past performance is not a reliable indicator of future results.

## .....And About to Charge

Our belief is that if there is a singular metric that drives markets performance over time, it is earnings growth – and the market’s collective ability to predict earnings growth will lead to the improved sentiment which moves equities higher. Investor expectations are critical to sentiment and admittedly, analysts tend to be hopeful and reset their level of optimism each year. This anomaly is clearly exhibited in the chart below, which shows a high level of optimism, whereby the beginning of the year is marked

with low double-digit earnings growth expectations (in blue), which eventually translated to flat or even negative earnings growth (in green) at the end of the year<sup>3</sup>. This optimism bias was especially true in the

#### Earnings Per Share (EPS) Growth Estimates: Annual

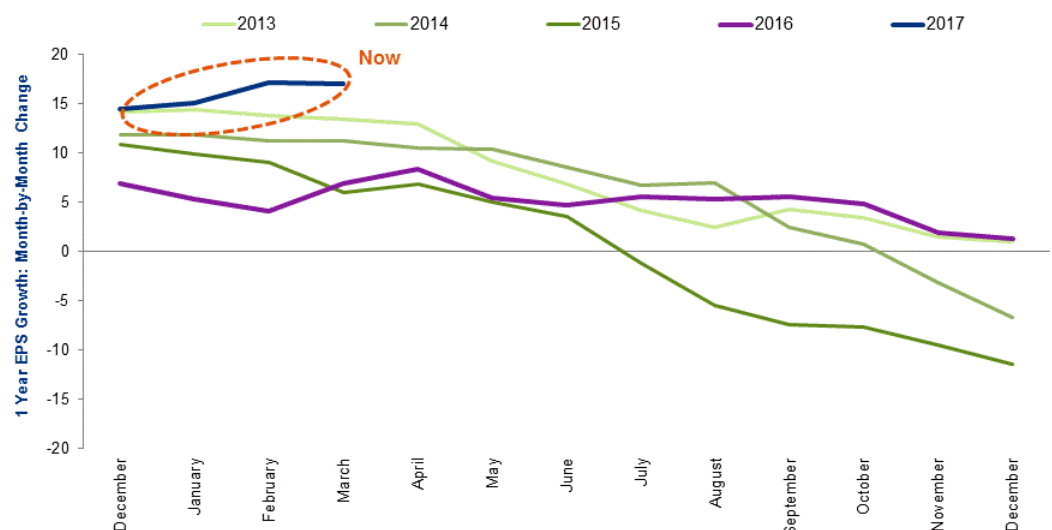


Source: FactSet. Actual earnings per share growth from 2013 to 2016, estimates for 2017 to 2018. Past performance is not a reliable indicator of future results.

2013-2015 time period.

If we take this analysis one step further and compare how earnings growth expectations have evolved during each calendar year, we see distinct pattern from 2013 to 2015 (each shown in green) whereby the perennial optimism slowly faded<sup>4</sup>. However, 2016 (shown in purple) marked the beginning of a change in tides, whereby the optimism at the beginning of the year had been lower than previous years and earnings growth actually came in only slightly below expectations. If the first ten weeks of 2017 (shown in dark blue) are an indicator, then earnings expectations are finally ratcheting higher – not lower. This is a sign of further bullishness to come.

#### Earnings Per Share (EPS) Growth Estimates: Monthly



Source: FactSet. Earnings per share growth estimates for each calendar year updated on a monthly basis from December 2012 to March 2017. Past performance is not a reliable indicator of future results.

#### “You Are Here” on the Emerging Markets Sentiment Roadmap

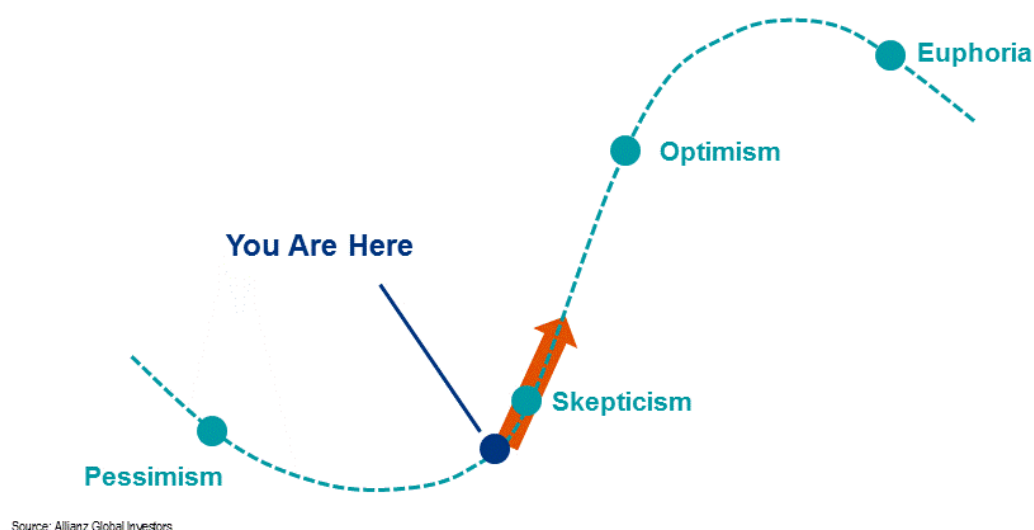
Like any other investment, emerging markets sentiment, and hence returns, are cyclical and driven by investor greed and fear. Our expectation is that while equity volatility may move higher off current

historical lows, impact from developed markets is less likely than investors are currently estimating and the asset class will instead be increasingly driven by internalised demand in emerging markets.

Our outlook for emerging market equities is favourable against the backdrop of continued attractive valuation, accelerating earnings growth expectations, Return on Equity (ROE) expansion and higher Gross

Domestic Product (GDP) growth. Emerging market balance sheets are stronger than previous years which should help counteract US Federal Reserve and other central bank rate hikes, and combat any further strength in the US dollar. In addition, the fact that investors are still massively underweight emerging market equities is a silver lining as they may reallocate to the asset class, which could translate to meaningful upside potential. This is particularly true as emerging market equities were among the top asset classes last year, and behavioural biases suggest investors are likely to chase returns, which could lead to greater asset flows. When considering the current level of pessimism, the attractive growth and valuation mix, and expanding earnings expectations, we firmly believe the asset class is at the beginning of an unrecognised bull market in emerging market equities.

### Sentiment Roadmap



<sup>1</sup> Source: MSCI, annual returns in USD from January 2013 to December 2016. Developed markets represented by the MSCI World Index.

<sup>2</sup> Source: Institute of International Finance, Emerging Markets Portfolio Flows as of February 2017.

<sup>3</sup> Source: FactSet. Actual figures from 2013 to 2016, estimates for 2017 and 2018.

<sup>4</sup> Source: FactSet. Monthly figures from 2013 to 2016 (example: the 2014 annual estimate is from December 2013, through the actual figure in December 2014).

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