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EM Equities - 2023 outlook

Waiting for the stars to align

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FLASH NOTE

SUMMARY

- Emerging (EM) equities are entering 2023 at a somewhat depressed level, leaving them with some rebound potential if and when the macro environment improves. They are indeed more advanced in the earnings compression cycle than developed market (DM) equities while valuations remain low on a relative basis.
- EM equities tend to be driven by a narrow set of macroeconomic factors (such as the US dollar, growth differentials with DM, China, sovereign yields and commodities). Overall, we believe these should turn more supportive next year.
- Although we have a positive view of EM equities for end-2023, the first quarters may prove challenging if the US and Europe enter recession.
- We have set our 2023 year-end target for the MSCI EM at 1,000, based on a 12-month forward price-to-earnings (P/E) ratio of 12x and flat earnings per share (EPS).
- The main risks to our scenario are linked to China's reopening, stickier-than-expected global inflation, US/China relations and the Ukraine war.
- From a country perspective, we would hide in relatively "defensive" markets at first, before adding more cyclicality once macroeconomic data stops deteriorating and a pivot in major central banks' policy comes into view.

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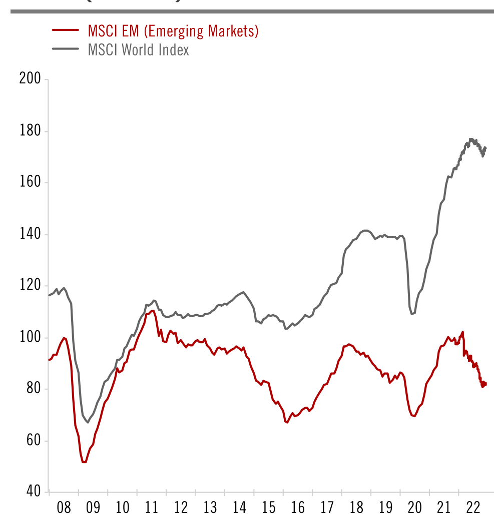
STARTING THE YEAR FROM A RELATIVELY LOW BASE

EM equities are entering 2023 at a relatively depressed level, which naturally leaves them with some rebound potential should the macro environment improve (as well as a buffer if near-term conditions keep deteriorating).

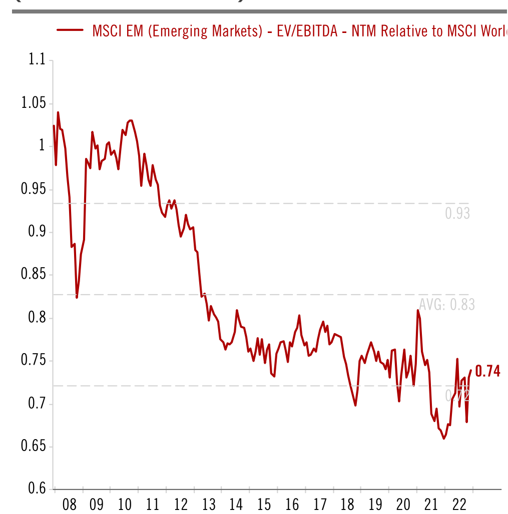
Unlike developed-market equities (the US in particular), 12-month forward earnings per share on the MSCI EM index are already below their pre-covid levels, and only 14% higher than their long-term lows excluding the Great Financial Crisis (GFC).

Chart 1: 12-month forward earnings per share (in USD)



Source: FactSet (16 December 2022)

Chart 2: Enterprise Value over EBITDA (EM relative to DM)



Source: FactSet (16 December 2022)

Having hit a trough in October, EM valuations have since rebounded thanks to improved risk appetite and faster-than-expected reopening in China. Nonetheless, valuations remain rather benign in absolute terms. The 12-month forward price-to-earnings (P/E) ratio on the MSCI EM index is now hovering close to its long-term average of 12x. Other valuation measures, such as the price to book (P/B) and enterprise value to EBITDA (EV/EBITDA) ratios are sending similar signals.

On a relative basis, however, all measures point to a higher-than-usual discount to developed markets, hence supporting our view that emerging markets are a bit more advanced than their developed peers in the current derating cycle.

MACRO DRIVERS LOOK SUPPORTIVE, DESPITE SHORT-TERM CHALLENGES

A narrow set of macroeconomic factors have historically correlated well with strong performance for EM equities, both in absolute and relative terms. Overall, we believe these factors should turn more supportive next year.

- The US dollar (USD) is a major driver of EM equities. While 2022 generally saw a sharp rise in the USD as the war in Ukraine and persistent inflation forced the US Federal Reserve (Fed) to hike rates at the fastest pace ever, we now anticipate the USD to weaken by year-end 2023.

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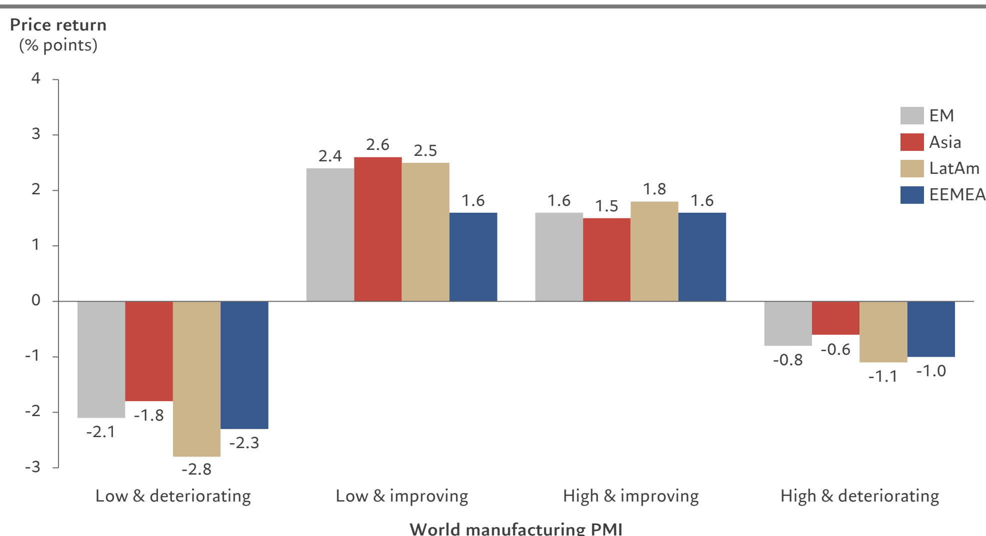
- According to International Monetary Fund forecasts, after two years of narrowing, the growth differential between emerging and developed economies should widen again next year and remain in favour of the former.
- China, after living in a covid-free bubble for three years, is expected to fully reopen next year, lifting domestic consumption and services, but also exports of other emerging economies. Yet, recent events have highlighted the risk of a disorderly exit from the country's 'zero-covid policy. This risk should not be underestimated.
- Commodity prices, global trade and policy stances in EM countries themselves are all expected to have a broadly neutral influence on EM equities' performance, although the first half of the year could be difficult as developed economies enter recession.

If the US dollar weakens as we expect, US TIPS yields moderate slightly and EM sovereign yields steadily decrease by the end of next year, then we would argue EM equities could perform positively in 2023 as valuations expand and earnings start recovering after an expected DM recession in the first half of the year. **We have set our 2023 year-end target at USD 1,000 (vs USD 957 at the time of writing on 16 December 2022), based on a 12-month forward P/E of 12x and earnings per share (EPS) at their current level (i.e. USD 82).**

We will particularly watch manufacturing-related survey, historically a good indicator of EM equities' performance. Nonetheless, this signal could be blurred somewhat by the chance that China's recovery is out of sync with the recovery in developed markets.

Chart 3: MSCI EM returns according to world manufacturing PMI (since 2010)



Source: Refinitiv, FactSet (10 November 2022)

The main risks to our central scenario at this stage pertain to a rocky reopening in China, a resumption – after a pause – of rate hikes by central banks because of stickier-than-expected global inflation, the state of US/China relations and, of course, the evolution of the war in Ukraine.

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REMAIN DEFENSIVE AT FIRST BUT STAND READY TO ADD CYCLICALITY

Although we have a positive view of EM equities for end-2023, the start of the year may prove challenging if the US and Europe experience a mild recession (we expect GDP contraction of 0.2% for both places in 2023) while a sluggish decline in inflation keeps central banks on their toes.

Hence, from a country perspective, we would first find refuge in relatively 'defensive' markets such as India (China may also fit the bill, provided the ongoing reopening does not prove too chaotic), before adding more cyclicality once macroeconomic data stop deteriorating and a pivot in major central banks' policies is within sight.

A weakening dollar, improving macroeconomic conditions and China's reopening should then support cyclical markets such as South Korea and Taiwan (both helped by a bottoming of the semiconductor cycle), while commodity producers such as South Africa, Brazil and Saudi Arabia would also benefit from rising demand for energy and raw materials.

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