GLOBAL EMERGING MARKETS

MARTIN CURRIE
A Franklin Templeton Company

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Where's the Beef? It's Emerging Markets Earnings...

Back in the 80s, an American fast food chain made the memorable slogan, "Where's the beef?" to imply that its competitors were not providing enough substance – in this case - beef! In this update on the Emerging Markets (EM) we take some time to lay out why we believe EM is a compelling asset class story. **The question we get most often is "what's the catalyst that's going to drive EM forward?"**

In this case, we'd like to use this easy to remember analogy and highlight "the beef" for the asset class-earnings growth. As fundamental, stock-driven investors, this is a core lens through which we look at investments in our fund.

What's also interesting about EM earnings is how critical it is for driving asset class performance throughout longer-term cycles. When we look at EM's performance versus Developed Markets (DM) over the long term, we see that relative earnings growth is a major driver of EM's outperformance.

For example, the 35-year earnings per share (EPS) compound annual growth rate (CAGR) for the US has been 6.4%[1]. What we've observed historically is that during strong outperformance periods for EM equities, the earnings growth is double-digit (strong on both an absolute and relative basis).

Fortunately, we are right at a key turning point and the case for EM earnings outpacing DM is strong. It's driven by higher growth rates (GDP) and less margin pressure as inflationary forces abate. Furthermore, for technology companies in EM, it's also supported by strong market positioning and structural growth drivers such as artificial intelligence (AI).

As shown In Figure 1, emerging markets are expected to deliver higher earnings growth (relative to DM) over the next 12 and 24 months. In particular, the major EM constituents – China, India, South Korea, and Taiwan are set to deliver explosive earnings growth over the next 2 years.

Figure 1: Forecast earnings growth across regions

	Developed	US	Europe	Emerging Markets	China	Taiwan	India	South Korea
1 year EPS growth	5.0%	6.0%	4.0%	5.8%	18.1%	(2.3%)	19.5%	9.2%
2 years EPS growth	11.0%	11.9%	6.8%	18.2%	14.5%	23.6%	17.8%	66.6%

Source: FactSet as at 15 June 2023, using MSCI country indexes.

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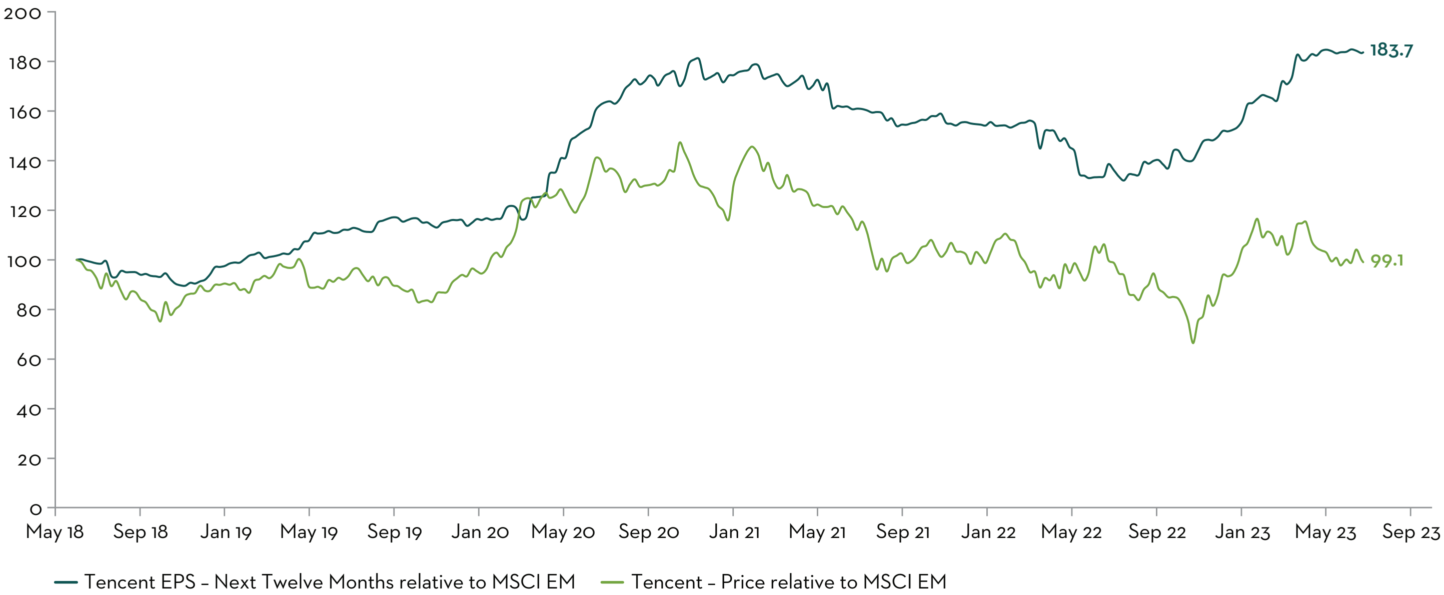
[1]Source: CLSA research report "CLSA Strategy 2Q23 Goldilocks Found" published 17 April 2023.

Divergence between earnings and share prices in China

Recently we have observed strong earnings delivery from two key areas in the Chinese stock market: 1) Chinese digital economy stocks and 2) Chinese financials – namely insurance companies.

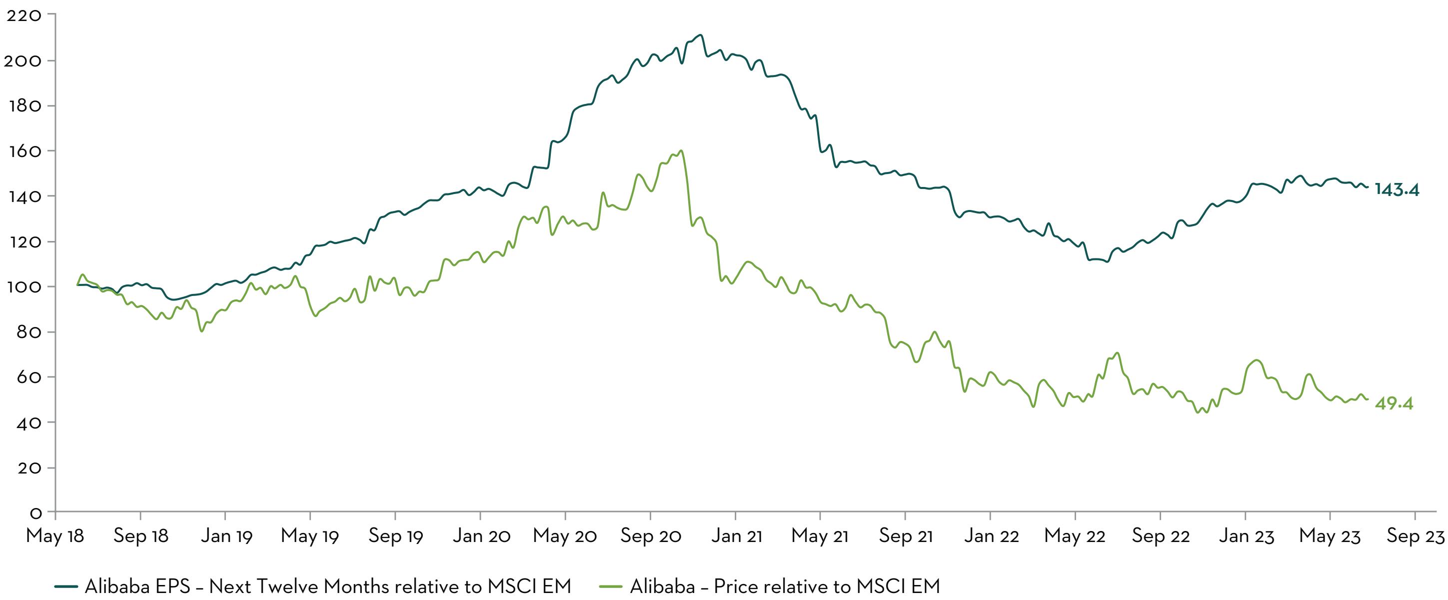
Below we highlight the positive divergence between fundamental earnings delivery (relative to MSCI EM) and the stock performance (relative to MSCI EM) using the two largest Chinese benchmark holding in the MSCI EM (Tencent and Alibaba). When we see such a divergence between share prices and stock earnings, we view this as an opportunity for fundamental, bottom-up investors. We have increasing confidence in the profitability of these quality growth companies in EM.

Tencent, Diverging EPS and Price Relative to Index



Source: FactSet as at 26 June 2023.

Alibaba, Diverging EPS and Price Relative to Index



Source: FactSet as at 26 June 2023.

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Where's the Growth? EM GDP vs DM GDP

While acknowledging the difficulty of predicting growth in 2023, the International Monetary Fund (IMF) has just published its forecasts for DM and EM. The IMF expects that EM will outgrow the advanced economies, forecasting 4.0% GDP growth for EM and 1.2% for DM. Global growth is estimated at just under 3.0% for 2023. Within that, China and India are expected to be key drivers of this, contributing to approximately 50% of that growth projection.

Figure 2: Forecast real GDP growth across regions

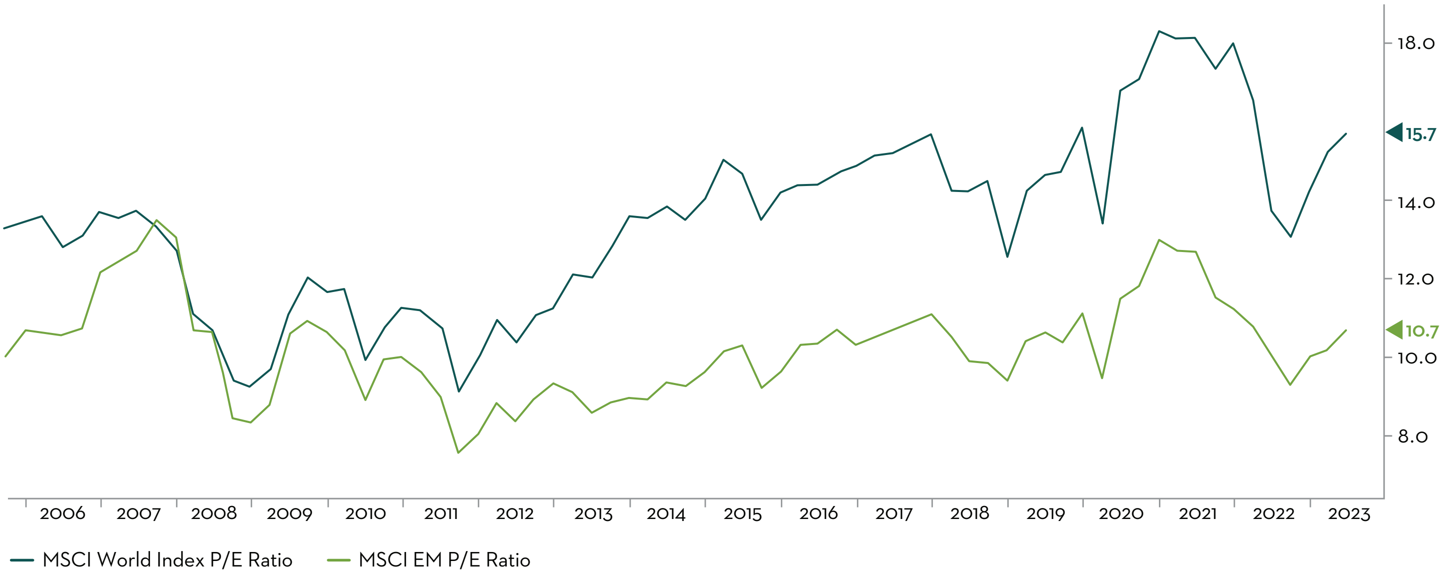
Forecast Real GDP growth	US	Europe	Emerging Markets	China	India	Latin America	MENA
2023	1.4%	0.7%	4.0%	5.2%	6.1%	1.8%	3.2%
2024	1.0%	1.6%	4.2%	4.5%	6.8%	2.1%	3.7%

Source: IMF as at June 2023.

Where's the Valuation? EM Valuation vs DM Valuation

Given this combination of GDP/macro growth and earnings growth, EM offers a once in a generation opportunity in terms of a reasonable absolute and relative valuation. The asset class is trading at a 35% discount to MSCI World. Using a medium-term outlook, MSCI EM is trading at 10x P/E versus MSCI World at 15x.

MSCI EM Index and MSCI World PE



Source: Bloomberg as at 15 June 2023.

Under the radar at the country level, we see that valuations within the EM complex are also very compelling. Most notably, China and Brazil are trading at single digit price-to-earnings (P/E) ranges over the next 2 years.

Figure 3: Forecast price-to-earnings ratios across regions

	World	US	Emerging Markets	China	India	Taiwan	Korea	Brazil	Mexico
P/E Forward	17.0	20.2	13.5	11.1	23.2	18.3	18.4	8.1	12.3
P/E FY 2	15.3	18.0	11.4	9.7	19.7	14.8	11.1	7.5	11.9

Source: Factset as at 15 June 2023, using MSCI country indexes.

So, where's the beef?

The beef may have been in DM over the past decade, but that does not mean it will continue and the current backdrop in EM looks exciting! With superior GDP growth expectations, trading at discounted valuations, and the expectations for stronger earnings growth going forward, it's clear the beef is now in EM.

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