FLASH

Emerging markets: Why do they trade at a discount to DM?

Pictet Asset Management

August 2014

Patrick Zweifel,
Chief Economist, Pictet Asset Management

- Emerging stocks trade at a discount to their developed peers, partly due to lack of economic diversity and falling competitiveness
- EM's low economic diversity leads to higher macro volatility, in turn weighs on equity valuations
- China is leading the decline in competitiveness, but cyclical turnaround on the cards

Emerging economies have enjoyed healthy expansion in the last 30 years, with their growth rates often outpacing those of their developed counterparts. Curiously however, EM equities have generally traded more cheaply than developed markets. We think this price gap, which has increased in recent years, is partly due to the structural lack of diversity within developing economies, and a decline in their competitiveness.

What is an emerging market? Said to be coined by then World Bank economist Antoine van Agtmael[1] in the early 1980s, the term refers to market economies with low to middle per capita income.

Since then, emerging economies have made great strides. They have seen rapid growth while keeping inflation under control. Some countries such as Qatar and Singapore enjoy higher per capita income than Switzerland or the US.

However, equity prices have failed to reflect this positive economic story. The return on the benchmark EM equity index has trailed the developed one by 34 per cent since early 2010.[2] The asset class still bears all the hallmarks of highly-cyclical, risky and volatile investments.

Emerging stocks have generally traded more cheaply than their developed counterparts, at a long-term average discount of about 20 per cent.[3] However, since early 2010 – the recent peak in EM equities – the discount has widened to 30 per cent.

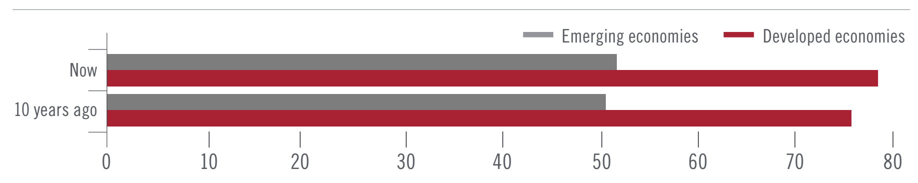
Although this valuation gap can be partly explained by the cyclical tilt of emerging stock benchmarks, there are clearly other factors at play.

Diversity: structural problem

However impressive their headline GDP figures may be, emerging economies have made little progress in the past decade or so in diversifying away from manufacturing. They have also failed to make industries less concentrated in order to reduce their vulnerability to external shocks. This, in our view, partly accounts for the discount in equity prices.

As economies expand and mature, not only do they begin to produce a broader range of goods, but they also typically experience a significant expansion of their services sectors. This shift can reduce an economy's sensitivity to the ups and downs of the global business cycle, because services companies are less exposed to trade and less volatile than manufacturers. In other words, a diverse economy with a significant service sector typically experiences low macroeconomic volatility, and therefore, asset price volatility.

FIGURE 1 – EMERGING VS DEVELOPED WORLD - SERVICES AS A % OF TOTAL ECONOMY



Source: International Monetary Fund

As shown in Fig. 1, manufacturing remains the major component of growth in the developing world. According to the IMF, the services sector forms only half of total emerging economies, compared with more than 70 per cent for developed counterparts, almost unchanged from 10 years ago.

[1] The Emerging Markets Century, Antoine van Agtmael
[2] MSCI EM equity index performance relative to MSCI World equity index
[3] PE ratio of MSCI EM index vs MSCI World index as of March 2014, Thomson Reuters Datastream

The lack of diversity is also reflected in an imbalance in emerging economies' import and exports. The wider the product variety in what a country imports and exports, the more diverse its economy becomes. We rank countries' import and export diversity using the Herfindahl-Hirschmann index, which measures diversity on a scale of 0 to 1 – a score of 0 would indicate that exports and imports are evenly distributed across all existing product categories. We find that there is a high correlation between the concentration of a country's economy and the volatility of its economic growth (see Fig. 2). For example, Russia, a USD2 trillion economy, has higher real GDP volatility as a result of its high dependency on crude exports.

FIGURE 2 – MACRO VOLATILITY AND CONCENTRATION INDEX

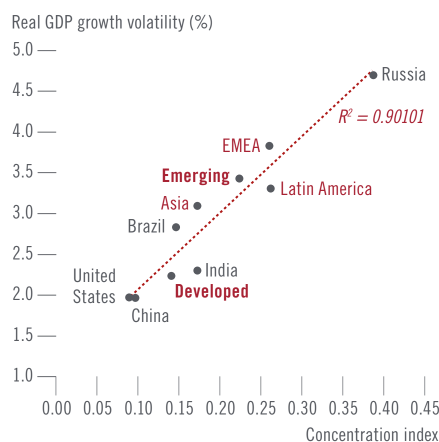
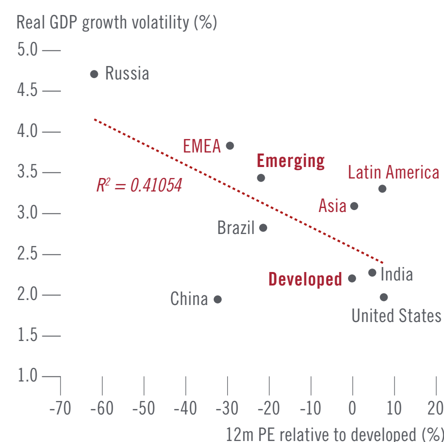


FIGURE 3 – RELATIONSHIP OF MACRO VOLATILITY AND EQUITY PRICES



Source: Pictet Asset Management, 2002-2013

Economic volatility has considerable investment implications. We find a strong link between economic volatility and stock market valuations. As Fig 3 shows, the stocks of EM countries exhibiting higher macroeconomic volatility tend to trade at a deeper discount to developed markets. Russia has by far the deepest discount to developed market stocks. Conversely, the equity markets of developed countries with the lowest economic volatility trade at a premium to their peers.

Moreover, while emerging economies have outgrown the developed world, our calculation shows their growth rates have been more volatile by a factor of approximately 1.5. We believe this higher macro volatility is one of the reasons why developing markets cannot easily close their discount.

In order to diversify, commodity-exporting emerging economies must re-invest their revenues into developing other industries, rather than feeding them back into the natural resource sector, which would lead to a Dutch disease.[4] The UAE has started diversifying to a certain extent – it is investing its oil windfalls in financial, construction and property sectors.

Other emerging governments must implement structural reforms and de-regulate industries which would help enhance the resilience of their economies to external shocks. On this point, we see good progress in India, where Prime Minister Narendra Modi is implementing tough reforms and cutting red tape to boost economic growth.

Competitiveness: a cyclical phenomenon

Competitiveness, a major influence on an economy's productivity and prosperity, could also explain the valuation gap between emerging and developed market stocks, especially since 2010.

A measure of a country's competitiveness is the relative prices of domestic and foreign products. For example, a country becomes less competitive when prices of its goods and services move out of line with those of its trading partners, due to wage costs or currency moves.

[4] Dutch disease refers to a negative economic consequence of having a dominant natural resource sector, which can lead to higher currency and drive down competitiveness in other sectors.

Falling competitiveness – the consequence of rising wages or deteriorating productivity -- reduces a company's profit margin, which in turn leads to lower earnings expectations.

Judging by unit labour costs – which shows how much output an economy makes relative to wages by measuring the average cost of labour per unit of output – emerging markets have in aggregate been losing competitiveness in recent years.

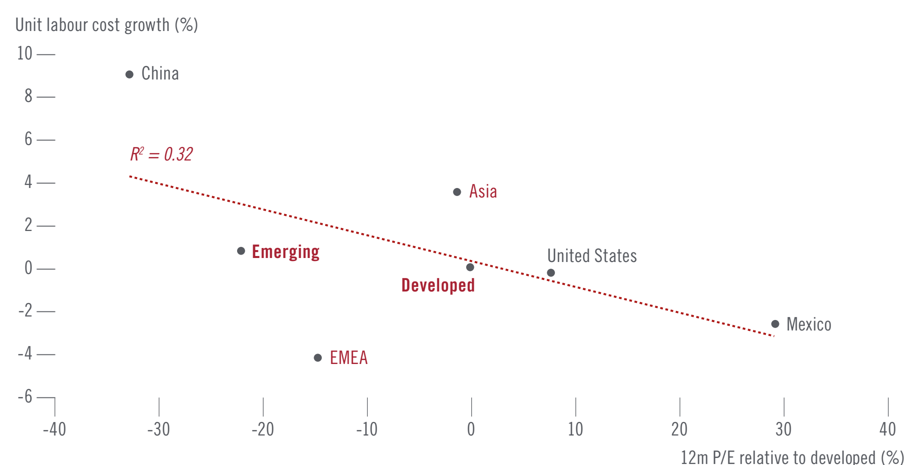
The unweighted EM unit labour cost increased by 2.8 per cent on average over the past five years, compared with a 1.3 per cent rise for developed markets.

This rise stems from higher wage growth and weakening manufacturing productivity. The unweighted five-year average of EM wage growth stands at 5.8 per cent, more than three times higher than that of developed markets. Here, much of growth comes from China.

At the same time, manufacturing productivity has weakened since the 2010 peak, troughing in early 2013. The weighted five-year EM average growth rate stands at 3 per cent.

As shown in Fig. 4, unit labour costs and the relative P/E ratio have a close relationship. The higher a nation's unit labour cost, the greater its stock market's discount to the global equity index. China, whose unit labour cost growth outstrips others, has the biggest discount in its P/E ratio.

FIGURE 4 – UNIT LABOUR COST GROWTH AND P/E RATIO



Source: Pictet Asset Management, 2008-2013

It is worth noting that despite the decline, the overall level of competitiveness is not too damaging because wages remain low. Today, a typical EM manufacturing worker gets USD6 for an hour's work, compared with USD28 a DM counterpart. This is also a reason why emerging markets have not seen their share of global exports decline.

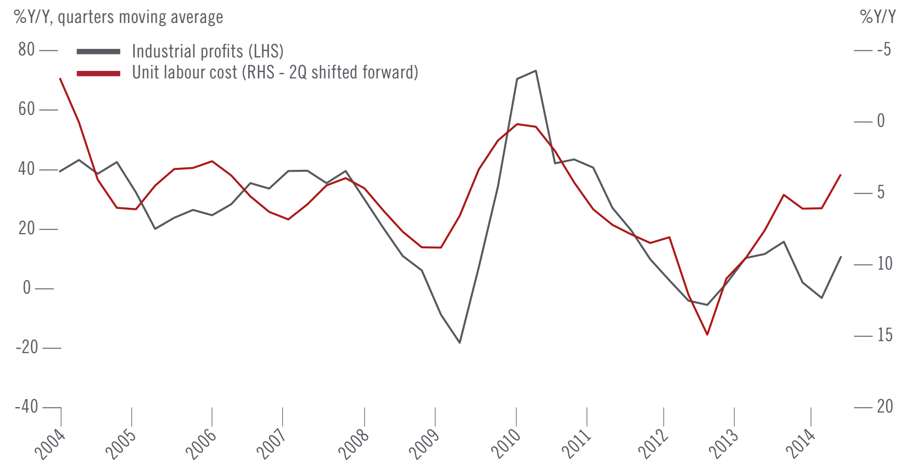
China: cyclical turnaround likely

China has been leading the decline in EM competitiveness. However, we think this is a temporary phenomenon and expect China's competitiveness to improve in the coming year as the global economy picks up.

China's decline in competitiveness has been due mainly to a slowdown in productivity growth, as a rigid labour market meant factories did not fire employees when both domestic and external demand for their goods was falling. In fact, after the financial crisis of 2008, Beijing encouraged state-owned enterprises (SOEs) not to fire employees to maintain social stability. As a result, big industrial SOEs kept running their coal mining processing plants like the ones in Shanxi province in the North or steel mills in the city of Tangshan in Hebei province southeast of Beijing instead of shutting them down.

It is no surprise, then, that the country's productivity growth fell below 4 per cent in 2012, compared with a mid-2009 rate of 12 per cent.

FIGURE 5 – CHINESE INDUSTRIAL PROFITS AND UNIT LABOUR COSTS



Source: Pictet Asset Management

But as the global economy regains momentum, we expect demand for China's goods to recover productivity growth to accelerate, boosting the country's competitiveness. As a result, margins will start rising again, which in turn should help reduce the discount at which China's shares trade to developed stocks – currently that gap is one of the biggest in EM at 30 per cent. Indeed, we find that in China, industrial profits tend to rise when unit labour costs fall (Fig. 5).

China's accelerating wage growth could also be explained by the fact that is producing more value-added goods and moving up the industrial value chain. In the 1990s, low-end goods processing, such as assembling vehicle parts, dominated China's exports, accounting for some 60 per cent of the total. Today, the country is increasingly producing high-end electronics such as smartphones and 3G antennas, with the amount of such goods doubling every 2-1/2 years since the 1990s to represent 5 per cent of total exports. These industrial goods need skilled labour which demands higher wages.

If this heralds a new era for China's manufacturing, it would improve the country's economic diversity.

Pictet Asset Management Limited
Moor House
120 London Wall
London EC2Y 5ET

www.pictetfunds.com
www.pictet.com

Disclaimer This material is for distribution to professional investors only. However it is not intended for distribution to any person or entity who is a citizen or resident of any locality, state, country or other jurisdiction where such distribution, publication, or use would be contrary to law or regulation.
Information used in the preparation of this document is based upon sources believed to be reliable, but no representation or warranty is given as to the accuracy or completeness of those sources. Any opinion, estimate or forecast may be changed at any time without prior warning. Investors should read the prospectus or offering memorandum before investing in any Pictet managed funds. Tax treatment depends on the individual circumstances of each investor and may be subject to change in the future. Past performance is not a guide to future performance. The value of investments and the income from them can fall as well as rise and is not guaranteed. You may not get back the amount originally invested.
This document has been issued in Switzerland by Pictet Asset Management SA and in the rest of the world by Pictet Asset Management Limited, which is authorised and regulated by the Financial Conduct Authority, and may not be reproduced or distributed, either in part or in full, without their prior authorisation.
For UK investors, the Pictet and Pictet Total Return umbrellas are domiciled in Luxembourg and are recognised collective investment schemes under section 264 of the Financial Services and Markets Act 2000. Swiss Pictet funds are only registered for distribution in Switzerland under the Swiss Fund Act, they are categorised in the United Kingdom as unregulated collective investment schemes. The Pictet group manages hedge funds, funds of hedge funds and funds of private equity funds which are not registered for public distribution within the European Union and are categorised in the United Kingdom as unregulated collective investment schemes.
For Australian investors, Pictet Asset Management Limited (ARBN 121 228 957) is exempt from the requirement to hold an Australian financial services license, under the Corporations Act 2001.
For US investors, the Shares of the funds managed by the Pictet Group are being offered to United States tax-exempt investors. Shares sold in the United States or to US Persons will only be sold in private placements to accredited investors pursuant to exemptions from SEC registration under the Section 4(2) and Regulation D private placement exemptions under the 1933 Act and qualified clients as defined under the 1940 Act. The Shares of the Pictet funds have not been registered under the 1933 Act and may not, except in transactions which do not violate United States securities laws, be directly or indirectly offered or sold in the United States or to any US Person. The Management Fund Companies of the Pictet Group will not be registered under the 1940 Act.
© Copyright 2014 Pictet - Issued in August 2014