Investment Strategy Note

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Upgrading Emerging Market equities to overweight

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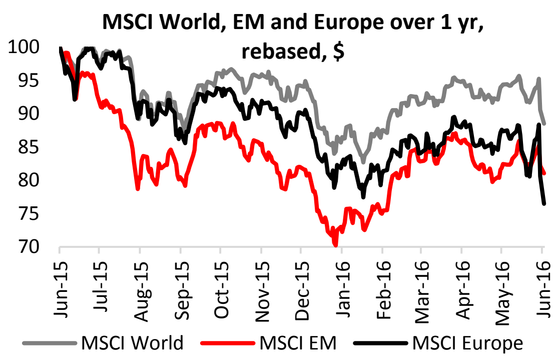
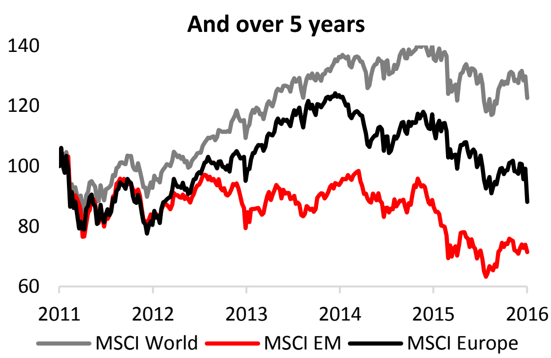
- **We remain underweight equities in our asset allocation and although we still see major headwinds for equities, Emerging Market equities have scope to outperform due to:**
  - **Depressed valuations**
  - **Heavy under-ownership by global equity funds, leading to;**
  - **A possible reallocation away from UK and European equities, into EM**
  - **A stabilisation in the US dollar as the Fed will likely postpone interest rate hikes, as well as a coordinated effort by central banks to limit dollar strength**
- **We upgrade EM equities to overweight from underweight on a tactical basis; meaning that fundamentally we are not positive on EM macro or equities, but this does not preclude EM from enjoying a period of outperformance at a time when DM is under severe pressure**
- **It should be noted that EM equities comprise just 10.3% of the global equity benchmark, therefore we recommend an EM overweight to not exceed 15% of total equity exposure**

When Emerging Markets can be defensive

Typically emerging market (EM) equities are considered more cyclical and higher beta than developed market (DM) equities. This is correct, most of the time. There are instances however when EM equities are in fact more defensive. We believe that the current environment could be such an instance. EM equities have badly underperformed DM equities over the last years (see charts) for reasons such as deteriorating macro, unorthodox monetary policy and political issues, to name a few. However, these are exactly the issues also plaguing the developed world. Whereas EM equities have suffered as a result of these issues, DM equities have been much less impacted until now. The Brexit referendum highlights the growing economic and political problems facing the developed world, and thereby also the performance gap between the two. Given the potential for a drawn out period of risk aversion, those markets which have already fallen and are already heavily under-owned are at lower risk, and can even benefit from shifting allocations. Near-term performance supports this view (see charts), EM equities have fallen much less in the wake of the Brexit referendum. Although there are still options available which could avoid a Brexit, such as a 2nd referendum or early general elections these are unlikely to be clear in the near-term. Whatever the outcome, there will be a prolonged period of uncertainty in the UK, and probably the EU as well. In that environment we suspect EM equities could be quite defensive.





Source: MSCI, Thomson Reuters

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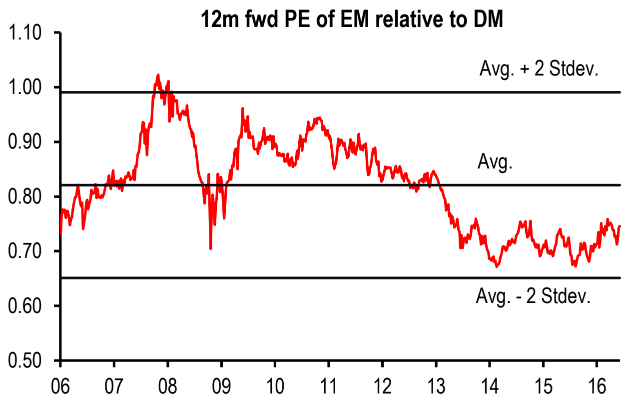
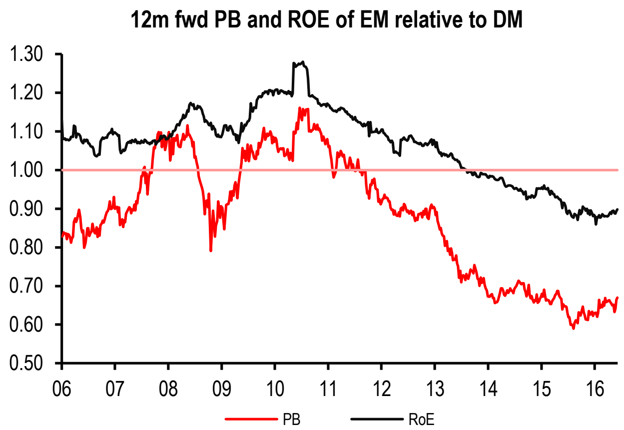
The equity case

Valuations discounted
EM valuations have traded substantially below their long-run averages for a number of years. This has never been enough justification for us to become more positive on EM equities. Cheap valuations can also become cheaper as many value investors have discovered in recent years. However, in the current landscape, we believe the EM valuation discount over DM looks attractive and could mean revert as a result of the challenges facing DM. The 12-month forward PE ratio for EMs is currently trading at roughly a 1-standard deviation discount to DM. While this could be justified in “normal” times, it seems more difficult to justify today. Equally the PB discount on EM relative to DM far exceeds the ROE discount, suggesting EM valuations have scope to catch-up.





Source: MSCI, Thomson Reuters, IBES, HSBC

Reallocation away from European equities, towards emerging markets
Investors have faced a plethora of uncertainties this year, including the Brexit referendum, when and by how much the Fed will raise interest rates, as well as worries over China’s currency. As a result, investors have moved heavily into cash in recent months. Before the Brexit vote, investor cash levels (at 5.7% of the portfolio) were at the highest level since November 2001 according to BofA Merrill Lynch’s Fund Manager Survey. This is cash is likely to be put to work, predominantly outside of Europe. Given that allocations to EM by global funds are still extremely low, it is likely that EM equity funds will see increasing inflows at the expensive of European equity funds

Investors have moved into cash as uncertainties have increased

Source: BofA Merrill Lynch Global Fund Manager Survey

The Macro case

Brexit uncertainty ties the Fed's hands, indirectly supporting EM

The Brexit vote, though, a disruptive development for Europe and the UK in particular, may provide a silver lining for EMs through looser domestic monetary policy as well as further delays in tightening by the Federal Reserve. Following the referendum, Fed funds futures not only expect no more rate hikes this year but also attach a meaningful probability to a rate cut in the coming months. This will constrain any upside potential in the US dollar, thereby supporting EM. A less strong US dollar (the flipside of which is stronger EM currencies) helps EMs to service vast amounts of US dollar denominated debt, as well as supporting commodity prices (which tend to suffer from a stronger dollar). According to the Bank of International Settlements, dollar credit to non-banks corporates in EMs was close to $4tn at the end of Q2 2015, while the IMF estimates total EM exposure (including banks and governments) to the US dollar was almost $18tn last year. Therefore, a delayed interest rate hike in the US and a stable (not strengthening) US dollar provide a big relief for EM balance sheets.

Potential for EM to attract long-term investment

Irrespective of whether the UK remains in the EU or goes out, the political hangover will generate uncertainty for the foreseeable future. The main casualty of this will be capital investment in Europe in the coming quarters and years. Some EMs with better macro-structures and growth potential could benefit as corporates may divert investments away from Europe and towards these countries.

Conclusion

Although we are not constructive on the medium to longer term outlook for Emerging Market economies and asset classes, we believe that the current environment, characterized by major uncertainty emanating from the developed world can provide a boost to the relative performance of EM equities, which remain extremely under-owned and inexpensive. We stress however, that EM equities comprise just 10.3% of the global equity benchmark, as such we advocate investors allocate no more than 15% to EM equities in an equity only portfolio.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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