

Can Emerging Markets Trade at a Premium?

Claudio Brocado, a senior portfolio manager on Batterymarch's Emerging Markets team, explains why emerging markets equity valuations are so attractive versus those of developed-market stocks.

Emerging markets—the world's fastest-growing economies—continue to gain attention from global equity investors. As company valuations have risen, some investors are wondering whether emerging markets equities can trade at a premium to developed market stocks.

In fact, emerging markets traded at a premium during the early to mid-1990s. Fundamentals were generally weak during this period in spite of high economic growth, especially relative to developed markets. Many emerging countries had large current account deficits, indicating low levels of domestic savings. The high stock valuations of the time reflected bubble-like conditions based on new-found enthusiasm by global investors, who were recognizing these promising markets for the first time.

Today the developing markets are much more mature, with solid fundamentals, and their equity markets are widely covered by analysts around the world. Earnings data and estimates are readily available, and comprehensive investment databases allow for robust quantitative analysis of emerging markets stocks.

Emerging markets began putting their financial houses in order in the late 1990s following their own debt crises. Most emerging markets entities reduced their debt levels well before the recent worldwide financial crisis and were therefore much better positioned to withstand its challenges. The Chinese and Indian economies, for example, continued to expand during the global slowdown, and the developing markets are now leading the recovery.

Sovereign fundamentals in emerging markets are not only significantly stronger than they once were, but now also surpass those of the developed countries. Economic growth has long been higher in emerging markets, if for no other reason than they started from a much lower base. More recently, however, the developing economies have been outperforming on nearly every other metric. For instance, governments, banks and households in the developed markets tend to be highly indebted, while balance sheets in emerging markets, including those for corporations, tend to be much healthier. This issue has become more important to global investors, who have increased their focus on leverage due to the global financial crisis and the cost of economic stimulus measures.

While emerging markets still trade at a discount in terms of earnings, they already trade at a premium on asset-based valuations such as price-to-book. The higher price-to-book ratio seems fully justified in light of their better return-on-equity (ROE). According to financial theory, a company whose returns exceed its cost of capital should trade above book value. Thus the higher the ROE, the higher the fair price-to-book ratio for a given stock or for an equity market as a whole.

Emerging markets have achieved their return-on-equity advantage despite a far more prudent use of leverage than in developed markets. Due to their relatively low debt levels, the return-on-asset superiority in the developing countries is even more significant than their ROE premium. Companies in emerging markets have the flexibility to leverage up to an even higher ROE, facilitated by the decreasing cost of capital (Figure 1).

Figure 1: Emerging Markets Financing Costs



Source: JP Morgan, Datastream

— EMBI + Sovereign Bond Blended Yield

Daily data beginning December 31, 1999 and updated through September 30, 2010

In general, emerging markets have historically had a significantly higher cost of capital than developed markets, putting them, all else being equal, at a cost-of-capital disadvantage. These markets have used other competitive advantages—lower labor costs, for example—to thrive in the global economy. As globalization broadens to include more aspects of corporate life, the cost of capital has become increasingly global, too, reducing the price of doing business for emerging markets companies. Their ability to add more value than developed markets has been climbing as the cost-of-capital gap narrows.

As long as emerging markets companies continue to deliver higher returns than those in the developed world, their price-to-book premium should remain intact. To the extent that their ROE superiority is magnified through a higher spread over their cost of capital, that valuation premium is justified and could even increase.

But can emerging markets eventually trade at a premium based on earnings-related valuations as well?

Just as ROE has a direct bearing on price-to-book value, sustainable earnings growth rates have an impact on the price-to-earnings (P/E) multiples investors are willing to pay. Emerging markets companies are generally expected to deliver faster earnings growth than those in developed markets well into the foreseeable future, theoretically leading to higher P/E ratios. While we currently don't count on an expansion in P/E multiples—let alone the development of a premium versus developed-market stocks—we believe that this is likely to happen in time.

Meanwhile, emerging markets offer particularly sound sovereign, corporate and household fundamentals relative to more developed economies, along with demographics conducive to further growth and domestic consumption. They continue to trade at a discount to developed markets on most valuation metrics, with superior long-term growth prospects. For these reasons, we expect emerging market equities to remain a core component of any long-term global investment strategy.

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