The BCA

Emerging Markets Strategist

Special Report

Emerging Markets Earnings: the "Good," the "Bad" and the "Ugly"

November 10, 1997

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Sharp drops in emerging equity markets over the past weeks and months have made many of them look "cheap" relative to their own history. At the same time, the global nature of recent turbulence raises the risk of contagion in both financial markets and real economies.

One way of looking beyond current volatility is to concentrate on differential *performance. As emerging markets mature, narrowing premia (relative P/E ratios) make their relative performance increasingly dependent on earnings. On that count, an earlier special report found the medium-term outlook for Latin America to be better than Asia's. This view is confirmed by a closer look at the prospects of Mexico, Brazil, Malaysia and Taiwan.*

Relative market performance is affected by three basic forces: relative earnings, relative market sentiment and relative liquidity. Our earlier special report suggested that, over the longer term, the significance of the first was rising on account of the latter two.[1]

The reason is twofold:

- Firstly, as emerging markets open up to capital flows, the impact of *global* liquidity conditions becomes paramount relative to that of local liquidity.
- Secondly, as emerging markets 'mature,' reduced uncertainty brings smaller fluctuations in relative sentiment.

Earnings projections suggest big upside for Mexico, large downside for Taiwan.

The significance of relative earnings is further augmented by the fact that this index generally tends to *lead* rather than lag major shifts in relative market performance.

An overview: Latin America *vs.* Asia

Charts 1 and 2 illustrate the relative price and earnings performance of Asia and Latin America. In both charts, the top panel expresses earnings per share (EPS) and price relative to the world average. Upward/downward movements in these ratios indicate out-performance and under-performance, respectively.

The bottom panel in each chart plots the market's discount or premium relative to the world average. This measure is derived from comparing the two P/E ratios. For instance, Asia's latest P/E ratio (September) is 19.2, compared with 24.3 for the world, meaning that Asian earnings in September were priced at a 21% discount to world earnings. The discount/premium index can also be obtained from the relative price and earnings indices in the top panel. For example, in Latin America, September's relative price was 1.0 against relative earnings of 1.3; dividing the second by the first gives 0.77 – a discount of 23%.

A comparison of Asia and Latin America reveals several significant similarities as well as differences:

- The general trend in Latin America has been one of narrowing discounts, whereas in Asia it has been narrowing premia. In other words, Latin America is still 'emerging,' with investors' confidence tending to rise. Asia, on the other hand, appears to be submerging,' with investors' confidence retreating from its earlier excesses.
- Because Asian premia and Latin American discounts are both *narrowing*, the result is that in both cases relative price performance is converging toward relative earnings performance.
- Despite their attempt to foresee the future, investors in both regions have been mostly backward looking. Relative earnings in Asia as well as Latin America have tended to lead, not lag, major shifts in relative market performance. Therefore, this relationship can give advance notice of significant market turns.
- Both Asian and Latin American earnings are presently traded at a discount to world earnings. Their medium-term outlook, however, is significantly different. This is because real earnings prospects in Asia are generally negative, whereas in Latin America they are still positive.

[1] See 'Back to Basics: Earnings Growth and the Relative Performance of Emerging Markets,' *The BCA Emerging Markets Strategist*, Special Report, June 26, 1997. For a copy, please contact our circulation department (Tel: 514-499-9550; e-mail: circ@bcapub.com).

Chart 1
Latin America

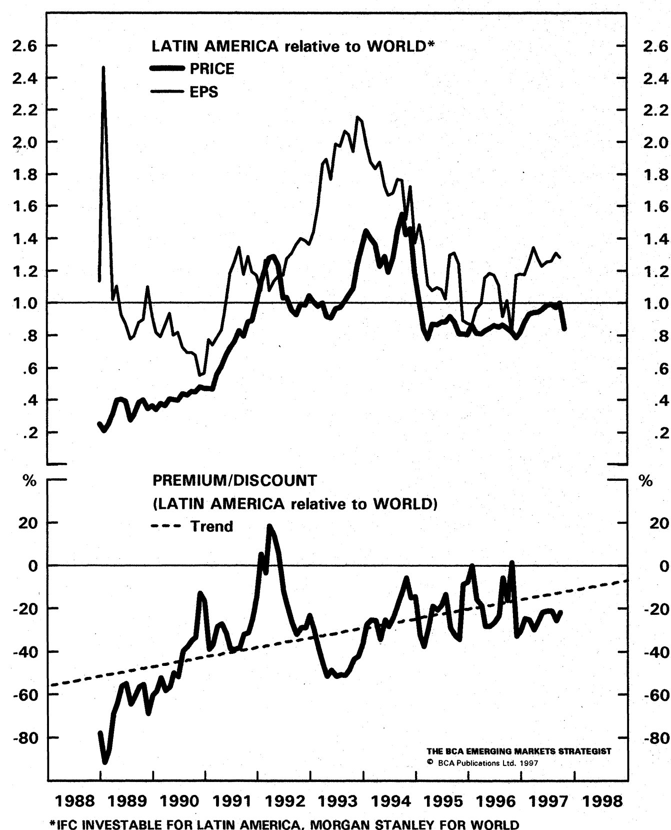
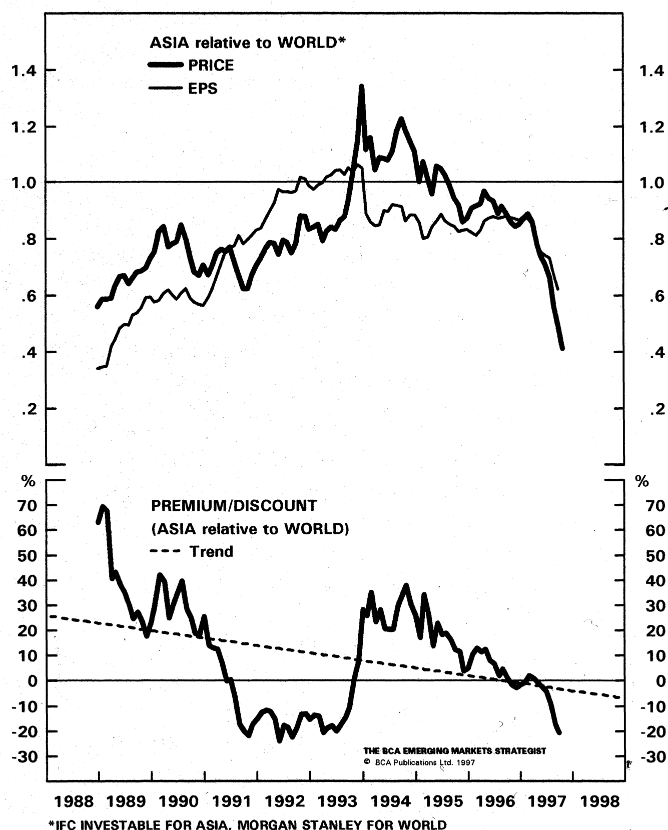


Chart 2
Asia



World earnings projections

Conceptually, earnings data could be built in two ways:

- From the "bottom up" – that is, by adding up forecasts for individual firms making up the index, as done by the Institutional Brokers Estimate System (IBES) for instance.
- An alternative method, presented in this report, is to look on market earnings from the "top down," projecting their overall trend on the basis of macro-economic indicators.

The latter method benefits from two facts: one is that currently-reported earnings are *trailing* earnings, that is, covering the annual period up to the report; the other is that EPS information is customarily reported as an annual moving average. The result is that EPS data published monthly by the IFC or Morgan Stanley Capital International reflect profits made up to *two* years prior to the reporting date.

For forecasting purposes, this makes it possible to predict *forward* EPS based on *currently* available macro-economic data.

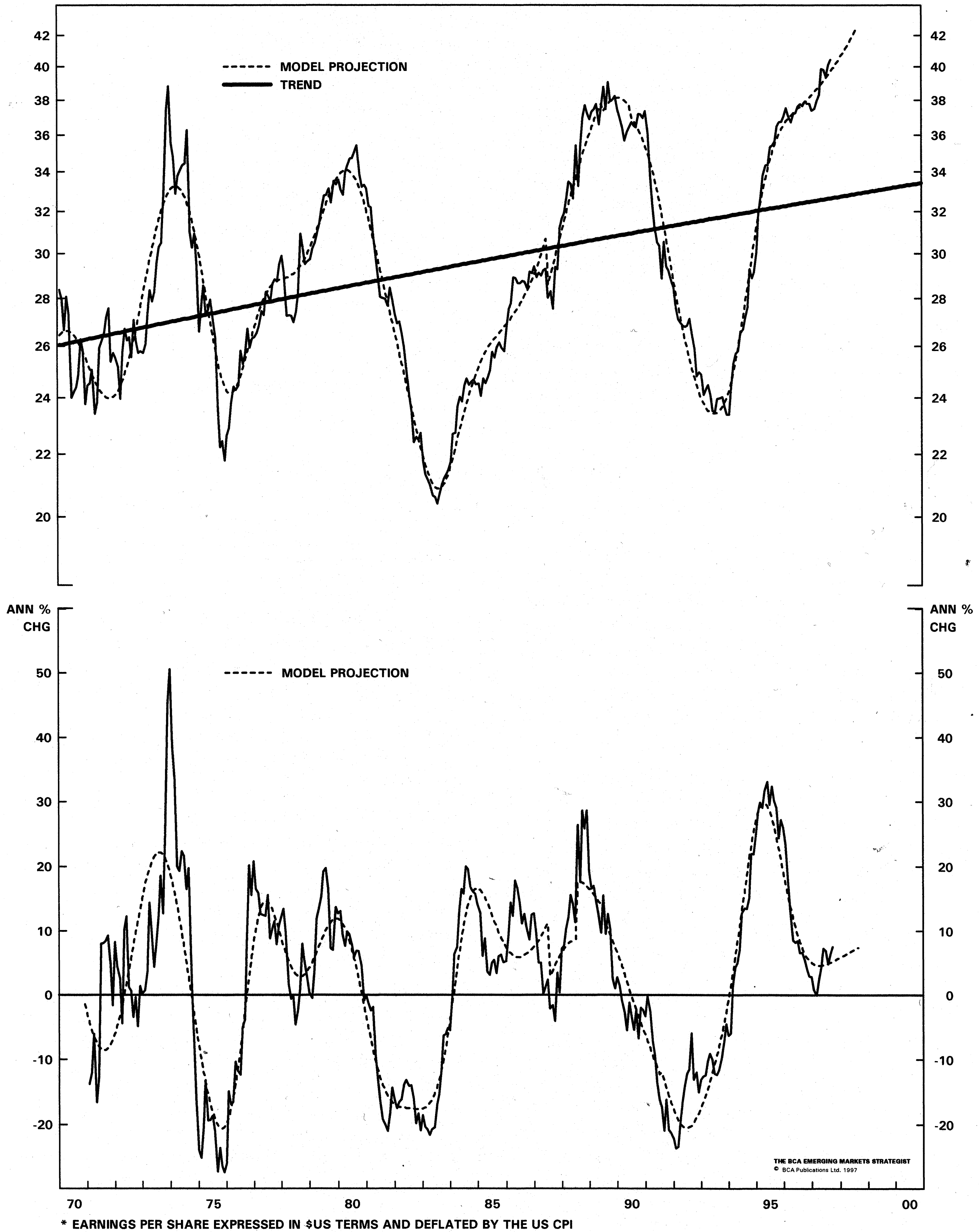
Chart 3 contains our model results for world EPS, based on variables such as leading economic indicators and interest rates.[2] (Throughout this report, EPS and equity prices are based on *investable* indices – that is, on instruments open to foreigners. The underlying data are expressed in real $US to avoid any inflation bias.)

Two basic conclusions emerge:

- Measured in inflation-adjusted terms, world EPS moves in a fairly stylized cycle around a mild uptrend. Since 1970, it grew at an average annual rate of 2.55%, while its underlying trend rose at a far more modest rate of 0.86%. This stylized pattern is not carved in stone, of course, though present evidence does not suggest any pending change. Indeed, despite the heightened process of corporate restructuring and the accompanying 'information revolution' since the mid-1980s, our model, which is based strictly on cyclical variables, has remained

[2] In our June special report, we presented a preliminary version of this model, based on *rates of change*. The present model offers an improvement. It projects the *level* of earnings, and is far tighter than its earlier counterpart.

Chart 3
World real earnings per share*



* EARNINGS PER SHARE EXPRESSED IN $US TERMS AND DEFLATED BY THE US CPI

remarkably robust. The implication for the future is that once cyclical conditions in the developed countries deteriorate, earnings growth will begin reverting back to its long-term trend.

- So far, however, the cyclical earnings uptrend remains intact, albeit modest. Our model has a high explanatory power (R^2=0.94), and if that fit is sustained in the medium term, earnings growth in the year ending August 1998 should be up roughly 8% on an annual basis.

Taking this pattern and projections as our world benchmark, we can classify emerging markets into "good," "bad" and "ugly":

Table 1
Emerging markets relative to the world benchmark

	↑ Relative EPS	↓ Relative EPS
Discount	"Good" (unambiguous)	"Bad"
Premium	"Good"	"Ugly"

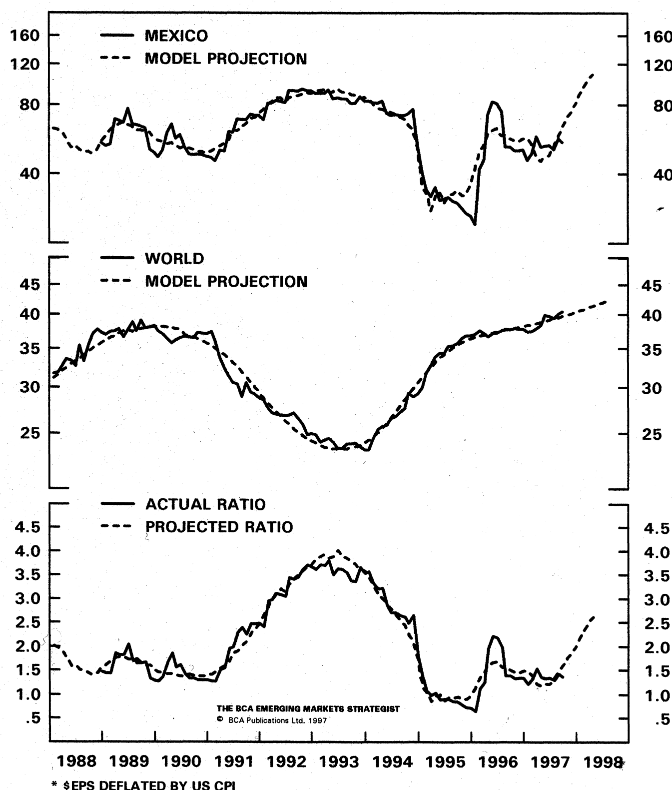
The classification is based on the two criteria of discount/premium and the direction of relative EPS. "Good" markets are those whose EPS rises relative to the world benchmark. (Unambiguously "good" markets have the added benefit of being traded at a discount.) "Bad" markets are those whose relative earnings are falling, although they may be traded at a discount. "Ugly" markets are traded at a premium *and* face falling relative earnings.

Note that this classification is entirely *relative.* It identifies "good" markets as potential *out*performers, "bad" and "ugly" markets as *under*performers; it says nothing about *absolute* market movements. "Good" markets could move down and still outperform the world index, provided this falls even faster, while "bad" and "ugly" markets could move up and still underperform a rising world market.

"The Good" . . .

The medium-term outlook for the western hemisphere is determined largely by Brazil and Mexico, with close to 65% weighting in the region's IFC Investable Index. Relative to the world benchmark, both markets are unambiguously "good." Abstracting from currency risks, they are therefore likely to outperform.

Chart 4
Mexican real earnings per share



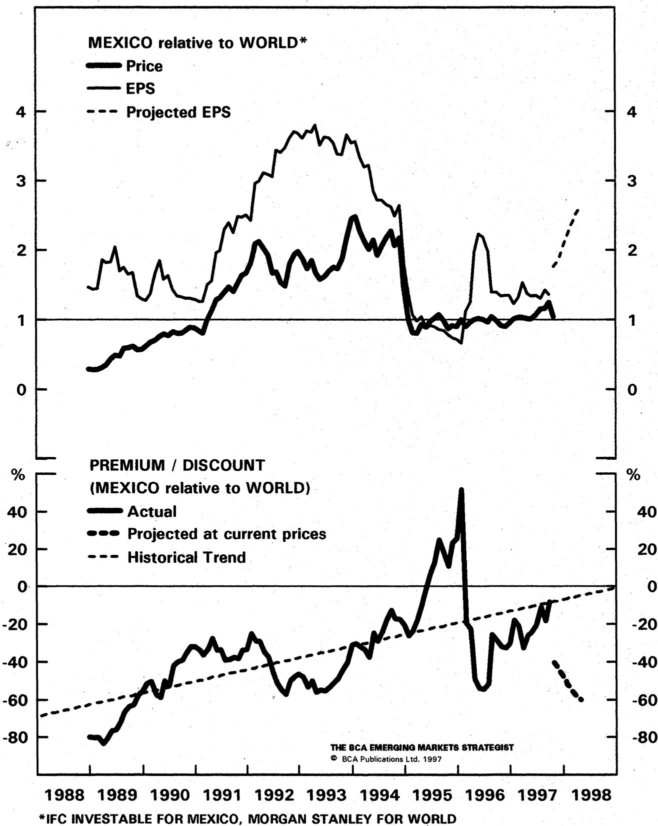
* $EPS DEFLATED BY US CPI

Chart 4 provides the background for Mexico's relative earnings performance. The top panel contains our model for Mexico's EPS; the second panel replicates the world EPS model from Chart 3; and the bottom panel contains the EPS ratio between Mexico and the world, computed on the basis of the actual data, as well as our model projections.

Historically, major *relative* shifts in Mexico's earnings performance occurred when the latter moved counter-cyclically vis à vis world earnings. This was clearly the case during 1991-92, when Mexican earnings shot up against a major world downtrend, and then during 1993-95 when they fell amid rising world earnings.

This time around, our models suggest Mexico's EPS is set to outperform even in the absence of a world downtrend. The basic reason is a highly favorable combination of cyclical conditions: rapidly growing economy, a relatively benign interest rate environment and a boost to margins (particularly for exporters) from sharply falling real wages. (Note that these favorable conditions prevailed in 1996-97, and only now begin feeding into higher earnings.)

Chart 5
Mexico



*IFC INVESTABLE FOR MEXICO, MORGAN STANLEY FOR WORLD

This backdrop has positive implications for Mexico's relative market performance, as illustrated in Chart 5. Over the past decade, Mexico, like other Latin American countries, progressively narrowed its discount to world earnings, as evident from the upward sloping trend line in the bottom panel of the chart. By 1997, this discount has been compressed to historically low levels, widening only marginally with the recent market drop. Even at today's narrow discount, however, Mexico has a good chance of strongly outperforming the world index in 1998.

The reason is the highly favorable earnings outlook. Based on our earnings models, by mid 1998 Mexico's relative EPS could be up 100% from its current level. Of course, this could be offset by a widening discount, though once relative earnings start moving up, there is a good chance that the exact opposite will happen.

Now, given that Mexican investors have tended to follow rather than lead earnings, the question remains as to *when* will the market begin outperforming the world benchmark? Although this is impossible to tell with confidence, a good indicator is the projected discount plotted at the bottom of Chart 5. If relative prices were to remain at present levels, the Mexican discount on projected earnings would approach 60% in six months. This would be the widest discount since 1989, and the largest deviation from the trend line. Under such conditions, investors should expect the discount to revert back to trend. With the earnings picture remaining positive, the adjustment will likely come from higher relative prices.

On the basis of relative value and earnings projections, equity investors should use current market weakness to overweigh their Mexican positions.

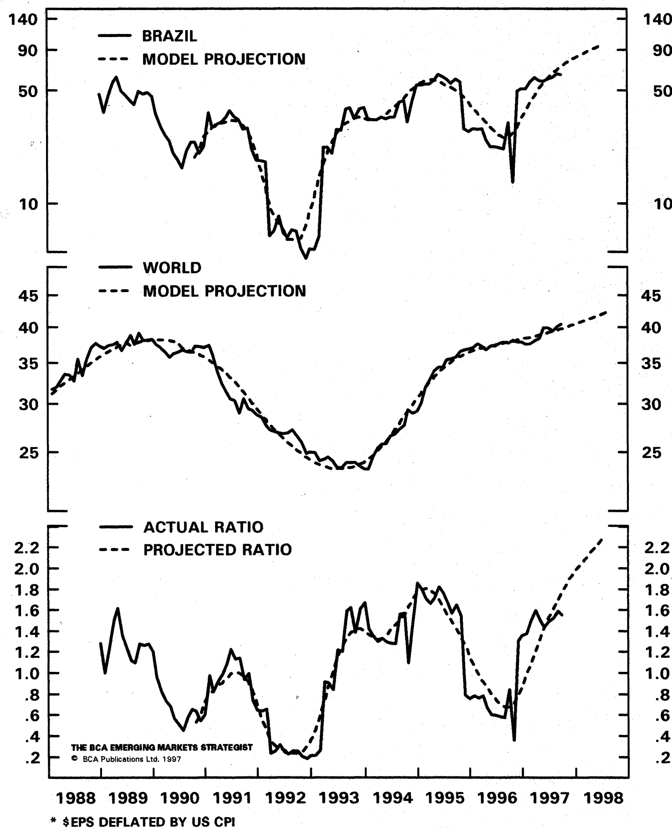
The principal caveat in such analysis is the currency. Our future EPS projections are based on the prevailing exchange rate. The technical effect of currency depreciation would therefore be to lower Mexico's relative earnings expressed in US$, as well as its relative, US$-denominated market performance; this effect will occur *regardless* of what happens to the underlying peso earnings and equity prices.

Massive intervention by the central banks in Brazil and Argentina has so far prevented the Asian currency crisis from spreading to Latin America *en masse.* However, all of the region's currencies have appreciated in real effective terms over the past few years, which suggests that a breakdown in one will likely spread quickly to the others. With Mexico's market upside being as large as it is, *investors may want to buy its equities with a hedged currency.*

The other "good guy" on the bloc, albeit with some qualifications, is Brazil (Charts 6 and 7). Unlike Mexico, the cyclical earnings recovery here is well under way, but our model indicates that it has further room to run. The bullish trend is underwritten by favorable conditions in 1996-97 feeding into currently reported profits: strong economic growth, lower interest rates and a sharp rise in real public sector prices (which benefit the large utilities dominating the IFC Investable Index). Based on our model, by mid-1998, Brazilian earnings could outperform world earnings by over 50%.

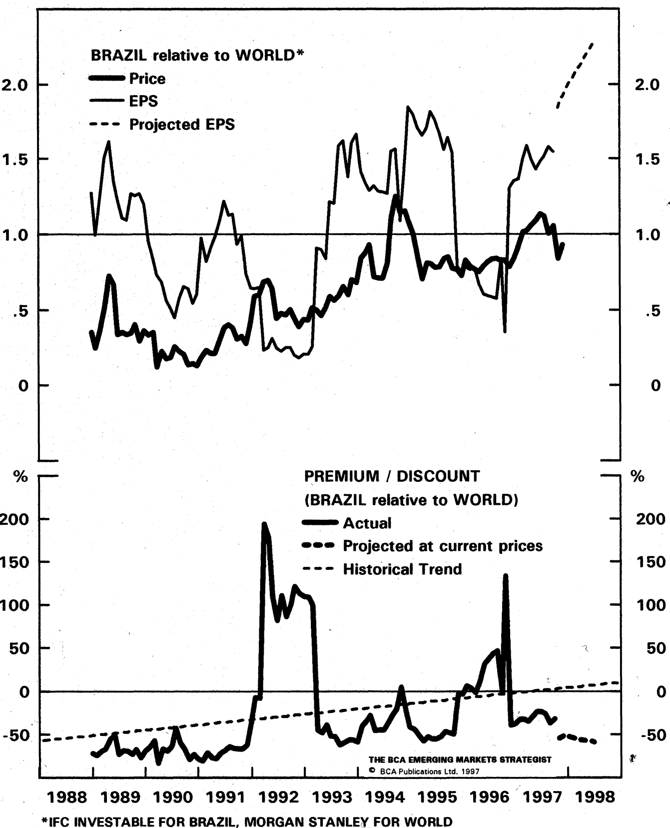
Much like in Mexico, investors have gradually upgraded Brazil's equity risk, as evident from the upward sloping trend line at the bottom of Chart 7. The market's recent downturn, however, has widened the discount to 47% on September's relative earnings. If these relative earnings continue to rise as projected by our model, the discount will widen to levels not seen since 1991, offering basement-bargain prices for investors.

Chart 6
Brazil real earnings per share*



* $EPS DEFLATED BY US CPI

Chart 7
Brazil



*IFC INVESTABLE FOR BRAZIL, MORGAN STANLEY FOR WORLD

Here, too, the principal risk – perhaps even more than in Mexico – is the currency. In fact, currency concerns are partly the reason why Brazil corrected much more sharply than Mexico.

The *real* is in a "dirty float" relative to the $US. Over the past few years, this kept its nominal rate of depreciation below Brazil's inflation gap (the difference between Brazilian inflation and the inflation of its trading partners). The result is an appreciating real effective exchange rate. This appreciation has occurred in the context of a current account deficit which is widening for structural as well as cyclical reasons. So far, large FDI, privatization and tight monetary policy have insulated the currency, though given the external imbalance and the loss of competitiveness to Asia, this cannot be a permanent fix.

Earnings projections and relative valuations argue for an overweighed position in Brazil – but not yet. As long as the *real* remains at risk, the equity discount is likely to stay under pressure. The key issues for investors are *timing* and *policy response*: Brazil needs to devalue soon, as well as to tighten its fiscal deficit. If the devaluation is postponed, or the fiscal issue remains unresolved, interest rates will have to remain very high, with negative consequences for the banking system and the economy. *Brazilian equities are a buy, but only after a "successful" devaluation.*

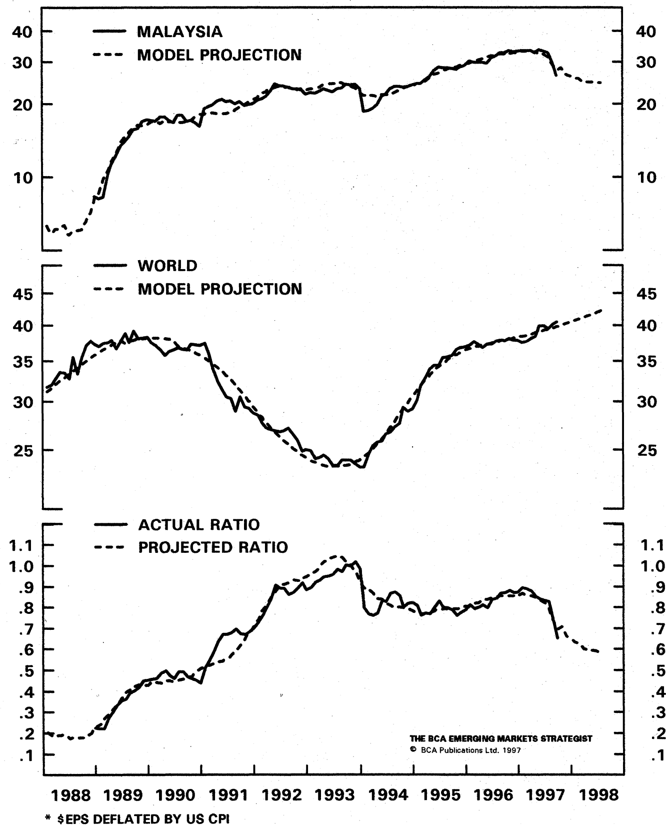
"The Bad" . . .

In contrast to Latin America, the medium-term outlook for Asia's two leading markets is not good. In Malaysia, with about 47% weighting in the IFC Investable Index for Asia, earnings have entered a period of consolidation. The downtrend began in early 1997 and is confirmed by our model projections in Chart 8. The main reason here is declining economic growth and rising real interest rates.

In addition, over the past few months, EPS expressed in US$ has been further hit by currency devaluation. Although this could have a positive effect on earnings, particularly through export sales, it will be reflected in *reported* earnings only a year or two down the road. In the meantime, the effect is entirely negative.

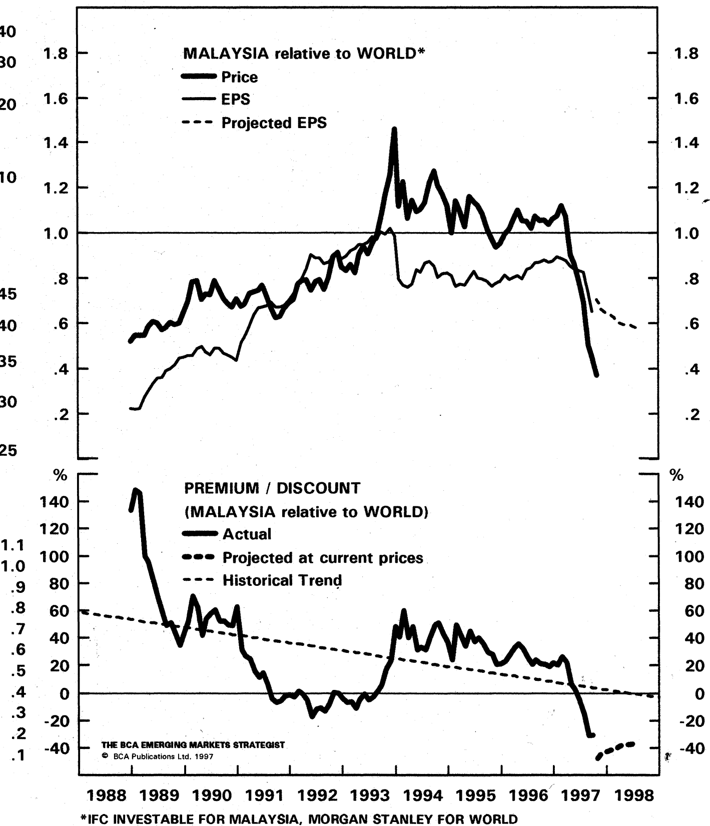
As indicated by Chart 9, the recent Asian crisis has made Malaysia again look like an "emerging market." Coming down from a premium of 60% over world earnings in 1994, Malaysian equities are now

Chart 8
Malaysian real $ earnings per share*



* $EPS DEFLATED BY US CPI

Chart 9
Malaysia



*IFC INVESTABLE FOR MALAYSIA, MORGAN STANLEY FOR WORLD

traded at a 43% discount on September's earnings. Based on this measure, Malaysia is as cheap as it was at any time since the late 1980s. However, given that earnings are likely to drift further downward in the medium-term, the discount may *narrow* even as the market continues to underperform.

Unlike in Mexico and Brazil, the ringgit is cheap. It has lost 25% against the US$ since March, its real effective exchange is approaching its record low of 1990, and export growth has accelerated sharply in recent months.

However, with a massive overhang of negative sentiment, an overextended banking system and a government unwilling to raise interest rates, the period of currency weakness is not likely over.

Malaysian equities are cheap, but investors should remain underweighted since both earnings and the currency are under downward pressure.

. . . and the "Ugly"

The major market to stay away from is Taiwan, with close to an 18% weight in Asia's IFC Investable Index (Charts 10 and 11). Equity prices are down 27% in US$ terms since July, but the correction is far from over.

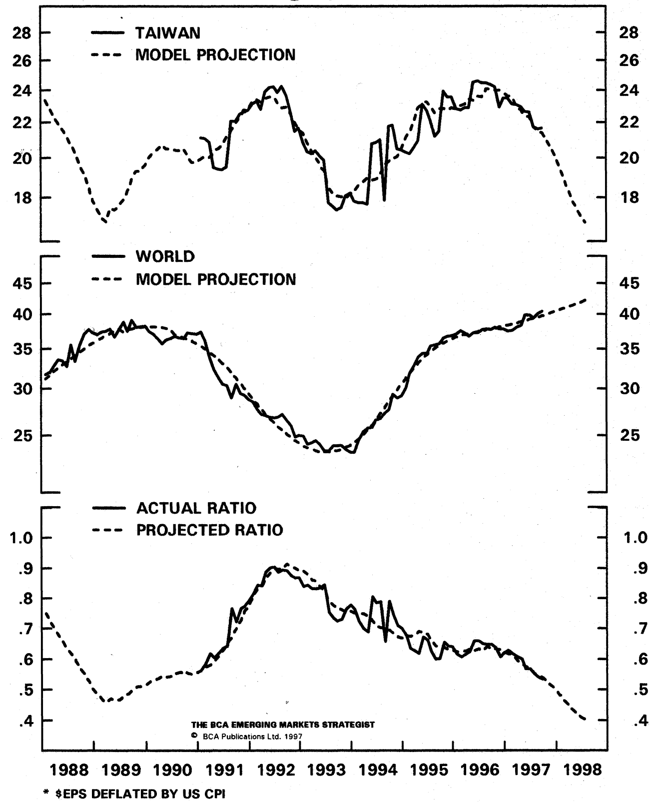
The reason is twofold. Much like in Malaysia, here too EPS is heading downward, and according to our model could lose another 20% relative to the world benchmark by March 1998. Although growth has recently accelerated, higher borrowing cost and an appreciating real effective exchange rate are now beginning to feed into lower profit margins.

Unlike Malaysia, however, Taiwan has no discount to soften the blow. As illustrated in Chart 11, Taiwan's equity premium over the world index is retreating from a cyclical high of over 60%. With relative earnings continuing to drop, the most likely scenario now is for an extended bear phase.

The "saving grace" for Taiwan – at least in the medium term – is that its market is relatively closed to foreigners, and that capital controls keep local liquidity locked in.[3] This has so far caused the premium on Taiwanese equities to trend upward, as indicated in the bottom panel of Chart 11. However, in a world of investment decontrols, this trend is unsustainable.

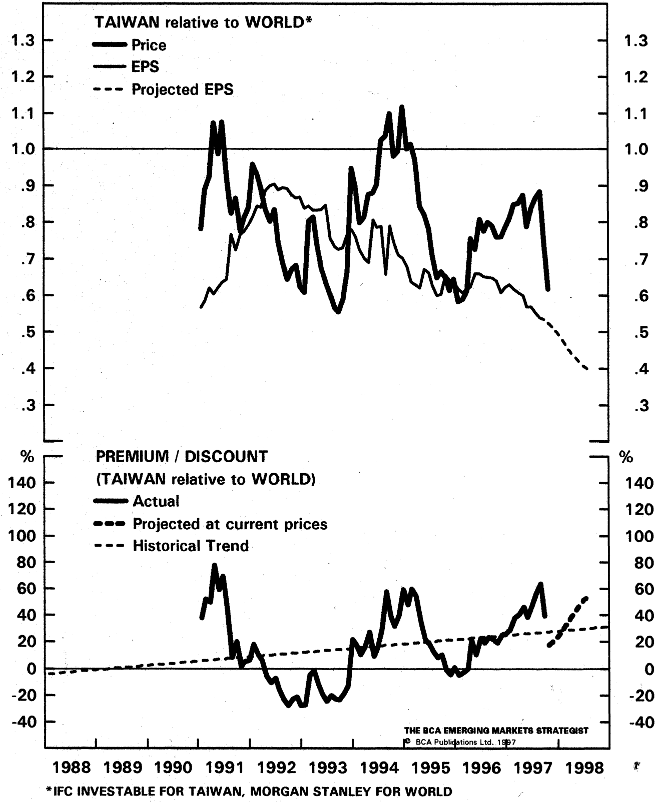
[3] Based on IFC data, only 30% of Taiwan's market is accessible to foreigners, compared to more than 80% in Brazil, and over 90% in Mexico and Malaysia.

Chart 10
Taiwan Real Earnings Per Share*



* $EPS DEFLATED BY US CPI

Chart 11
Taiwan



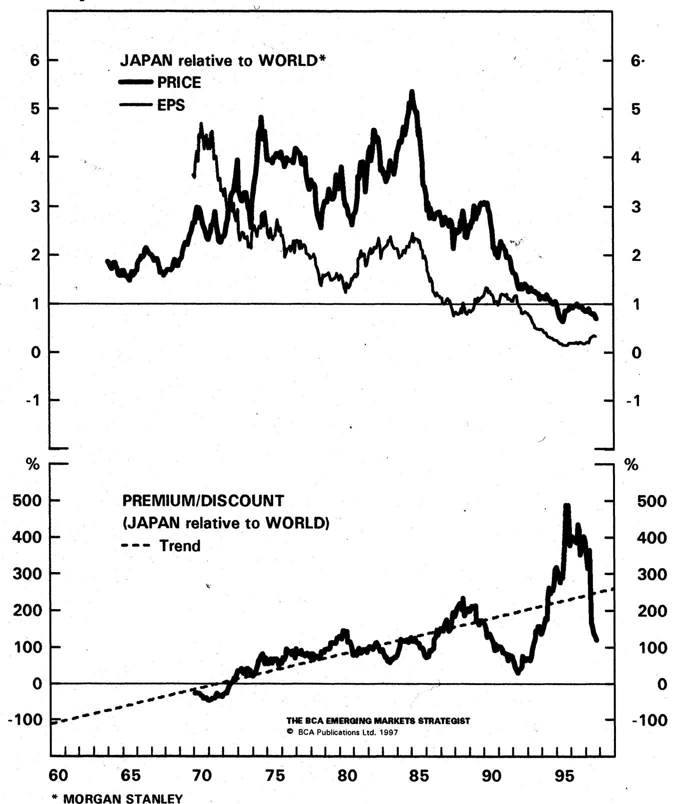
*IFC INVESTABLE FOR TAIWAN, MORGAN STANLEY FOR WORLD

In a certain respect, Taiwan shows a stark similarity to Japan (Chart 12). The two markets have both seen their relative EPS trending *downward*, against an *upward trending* premium. As the case of Japan until the early 1980s illustrates, relatively closed markets could outperform for an extended period of time, *even with lagging earnings growth.* The other side of the coin, of course, is that they do so by incorporating ever-growing premia. With international investing gaining prominence in the 1980s, the market's relative performance was finally coming under downward pressure. Yet even now, after under-performing the world index for more than 12 years, Japanese equities are traded at more than 100% permium to world markets. As Japan's financial system deregulates, such premia, could remain a serious drag on equity prices.

Although Taiwan's premium is not as large as Japan's, and it is too early to announce the end of its earnings growth, the parallels are obvious and their implications are negative.

Taiwanese equities are very expensive and falling earnings will make them look even more so. The risk is for an extended bear market and foreign investors should keep out.

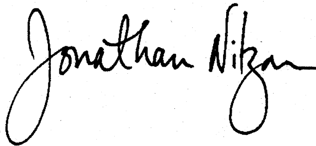
Chart 12
Japan



* MORGAN STANLEY

Investment conclusions

- In an environment of progressively narrowing discounts, *earnings growth* is increasingly important for global equity allocation.
- The upcycle of world earnings is intact, although in late stage. As long as that remains the case, *emerging markets are attractive only in the context of rapidly rising earnings, or massive discounts.*
- Among the big emerging markets, *Mexico* and *Brazil* are unambiguously "good." Both offer strong earnings growth and a sizable discount to boot. The main risk in both cases is the currency: in Mexico, the proper strategy is to hedge the currency, in Brazil it is to wait until after a devaluation.
- *Malaysia* remains a "bad" market. Although it offers an attractive discount, its market outlook is clouded by falling earnings.
- The "ugly" market is *Taiwan.* A large premium combined with negative earnings growth suggest its bear phase has more room to run.
- Investors inclined to a higher risk-reward strategy could benefit by hedging a long position in Mexico with a short position in Taiwan.



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