GLOBAL PERSPECTIVES

EM Equities: No Longer Cheap, But Still Attractive on a Relative Basis

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Highlights

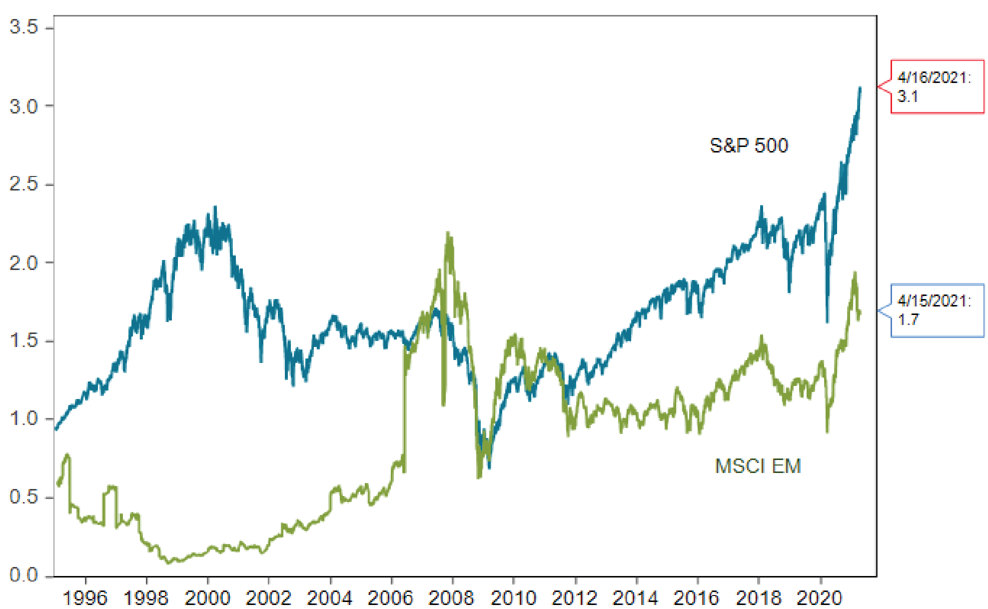
- Many global equity markets have reached record or near-record valuation levels against a backdrop of low interest rates and pro-growth policies to counter the pandemic.
- As a result, even emerging market (EM) equities look very expensive on a number of valuation measures relative to their own history.
- On almost all of the same measures, EM valuations trade at a discount versus the S&P 500. That suggests that EM equities remain a good complement to U.S. equity holdings.

Stimulus Has Elevated Equity Valuations Everywhere

Now that more than a year has passed since the pandemic began, investors have seen the power of aggressive monetary and fiscal policy in boosting asset prices. Many different measures of equity valuation are at or near all-time highs. This reflects a backdrop of low trailing inflation rates, very low interest rates, and widespread expectations of a global economic boom in response to aggressive monetary and fiscal stimulus and a fading of the pandemic.

A simple illustration of elevated equity valuations can be seen in the price-to-sales ratios of the S&P 500 Index and the MSCI EM Index. Those ratios traded respectively at 3.1 and 1.7 times as of mid-April **(Chart 1)**.

Chart 1: Price-to-Sales Ratios: S&P 500 vs MSCI Emerging Markets



Source: GW&K Investment Management, Bloomberg, MSCI, and Macrobond

The price-to-sales ratio of the S&P 500 Index has hit a record level of 3.1 times. That of the MSCI EM Index is 1.7 times and not too far from its 2008 record high level. EM remains cheap on a relative basis.

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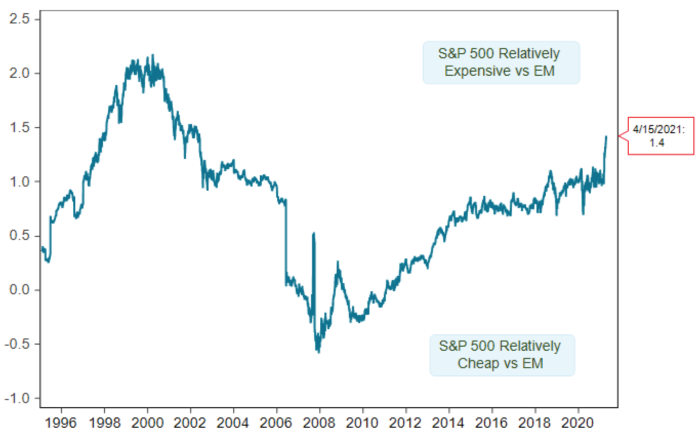
On this basis, EM equities are no longer cheap and have only been more expensive 5% of the time since 1995. That said, on a relative basis they are still considerably cheaper than U.S. equities. By looking at the gap between the S&P 500 and the MSCI EM price-to-sales ratio (3.1 – 1.7 = 1.4), the relative value comparison favors EM equities **(Chart 2)**. Indeed, on this simple valuation comparison, EM equities have only been relatively cheaper than the S&P 500 16% of the time since 1995.

Chart 2: Gap in Price-to-Sales (P/S) Ratios: S&P 500 P/S minus MSCI EM P/S



Source: GW&K Investment Management, Bloomberg, MSCI, and Macrobond

The S&P 500 Index's relatively rich valuation versus MSCI EM is shown in the gap between its price-to-sales ratio and that of EM. That gap is at the 84th percentile of all data points since 1995.

We will show below that this simple example is not an anomaly. On a wide range of EM vs U.S. valuation comparisons the same pattern emerges: equity valuations in both EM and the U.S. are at the high end of their historic range. But on almost every measure EM equities trade at a valuation discount relative to those in the U.S. In the past, when relative valuations have favored EM to this degree, EM equities have usually gone on to substantially outperform U.S. equities over the next five years. That suggests that EM equities should be a good complement to U.S. equity holdings even if they are no longer cheap relative to their own history.

Numerous Valuation Measures Demonstrate EM's Valuation Discount

To make sure that the above comparison of price-to-sales ratios is not cherry-picking the data, we have looked at a wide range of equity valuation measures for the U.S. and MSCI EM going back to 1995. The measures we chose were:

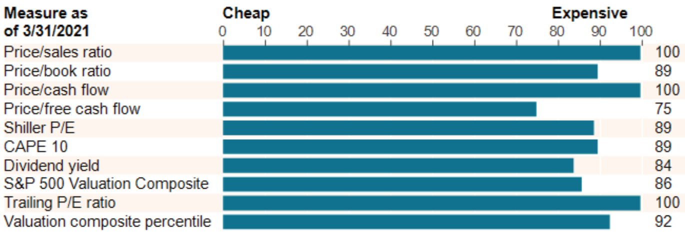
- Price/book ratios
- Price/sales ratios
- Price/cash flow ratios
- Price/free cash flow ratios
- Shiller P/E ratios
- Long-term P/E ratios (CAPE 10)
- Dividend yields
- Forward P/E ratios
- Trailing P/E ratios

Most of these valuation measures are well known, although Bloomberg's "Long-term P/E ratio" – or Cyclically Adjusted Price-Earnings Ratio (CAPE 10) - requires some introduction. This measure is conceptually very similar to the Shiller P/E ratio since it compares the current real price to a 10-year average of real earnings per share. These Bloomberg measures differ from conventional Shiller P/E ratios because they are not computed at the overall index level, but instead are computed on a security-by-security basis and use individual country inflation adjustments to measure real earnings. We also created composite valuation measures based on simple averages of the percentile rankings of each individual measure.

Such composite measures come with caveats. For example, the S&P 500 Index has a notably higher weight than the MSCI EM Index in Growth sectors like Information Technology (27% vs 21%) and Health Care (13% vs 5%) . Such sectors tend to have higher profit margins that support higher equity valuations than those found in Value sectors like Energy and Financials. So differences in sector composition across time between the S&P 500 and the MSCI EM Index may distort index-level valuation comparisons to some extent. Differences in country weights may also affect the comparisons, since China's weight in the MSCI EM Index has more than doubled over the past ten years from about 18% to 37%. From this perspective, the People's Bank of China's move to launch a central bank digital currency can be viewed as a defensive one to avoid a further erosion of its profitable currency-issuing franchise. They are very clearly telling the tech giants and commercial banks: you can create digital wallets for consumers but we alone will issue the digital yuan that go into those wallets.

That said, our composite valuation measure for the S&P 500 puts it at the 92nd percentile of its range since 1995, meaning it has been more expensive only 8 percent of the time since then **(Chart 3)**. That is based on all of the measures being near the top end of their historic range. The two least elevated are the price to-free cash flow ratio (75th percentile) and the dividend yield (84th percentile), while the three most elevated are the price-to-sales, price-to-cash flow, and trailing P/E ratio, all of which are more expensive than they have ever been (100th percentile).

Chart 3: Current S&P Valuation Measures Percentile Ranks Since 1995*



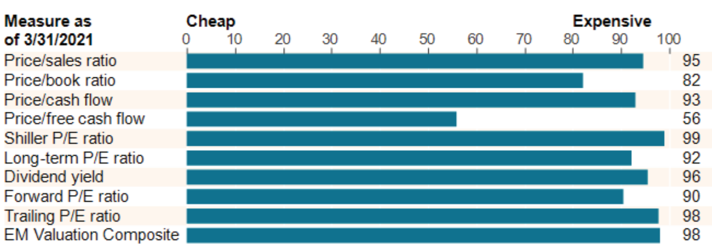
*Based on data from January 1995 through March 2021

Source: GW&K Investment Management, Robert Shiller, Bloomberg, S&P, and Macrobond

U.S. equities look richly valued on a range of conventional valuation measures. Based on our composite valuation measure based, U.S. equities have only been more expensive 8% of the time since 1995.

A similar composite valuation measure for the MSCI EM Index is also elevated relative to its own history, trading at the 98th percentile of its range since 1995 **(Chart 4)**. In fact, all but two of the EM valuation measures in our composite are in in the top decile of their historic range. The two exceptions are the price-to-book ratio (82nd percentile) and the price-to-free cash flow ratio (56th percentile). As a group, the valuation measures are sufficiently elevated that the overall composite measure indicates that EM equities have only been cheaper 2% of the time since 1995.

Chart 4: Current MSCI EM Valuation Measures Percentile Ranks Since 1995



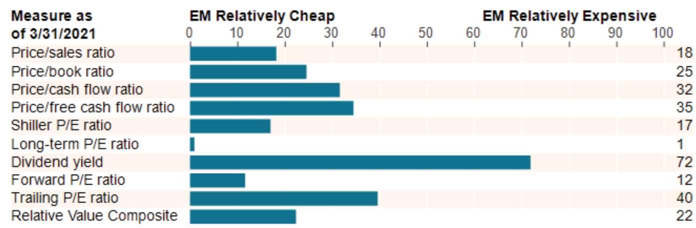
*Based on data from January 1995 through March 2021, except CAPE 10 data is from 2003 and Forward P/E from 2005.

Source: GW&K Investment Management, Robert Shiller, Bloomberg, S&P, and Macrobond

As in the U.S., valuation measures for EM equities are also at the high end of their historic ranges. On our composite measure, EM equities have been more expensive only 2% of the time since 1995.

Just as was seen in the simple comparison of U.S. to EM price-to-sales ratios, EM still looks modestly valued relative to the U.S. across a range of valuation measures **(Chart 5)**. The one notable exception is a comparison of dividend yields, which at the end of March showed an EM dividend yield of only 1.9% compared to 1.5% for the S&P 500. That is a very narrow dividend yield advantage for EM relative to history, reflecting the higher pressure on many EM companies relative to their U.S. counterparts to curb dividend payouts due to the pandemic.

Chart 5: Current MSCI EM Valuation Measures Percentile Ranks Since 1995



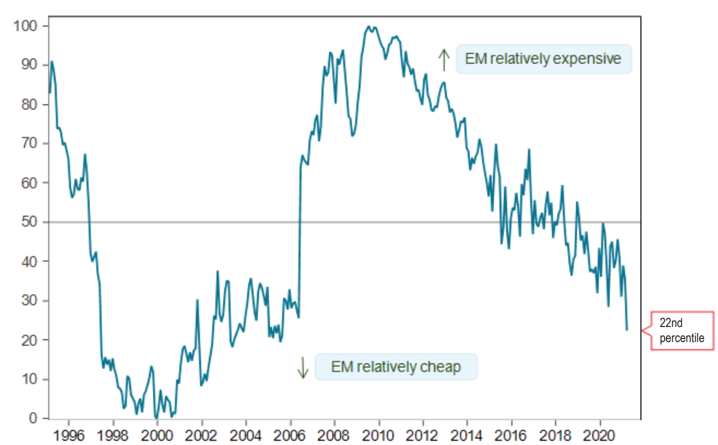
*Based on data from January 1995, except Shiller P/E is from 2005, EM CAPE 10 is from 2003 and EM Forward P/E from 2005.

Source: GW&K Investment Management, Robert Shiller, Bloomberg, S&P, and Macrobond

EM equities continue to look attractively valued (except on dividend yield) relative to the S&P 500. On our composite measures, EM has only been relatively cheaper 22% of the time since 1995.

On every other valuation measure, however, EM trades at a significant discount to the S&P 500. Our composite measure of EM vs S&P 500 relative valuation shows that the EM discount has only been more pronounced 22% of the time since 1995 **(Chart 6)**.

Chart 6: MSCI EM vs S&P 500 Relative Valuation Composite Percentile Rank Since 1995



Source: GW&K Investment Management, Robert Shiller, Bloomberg, MSCI and Macrobond

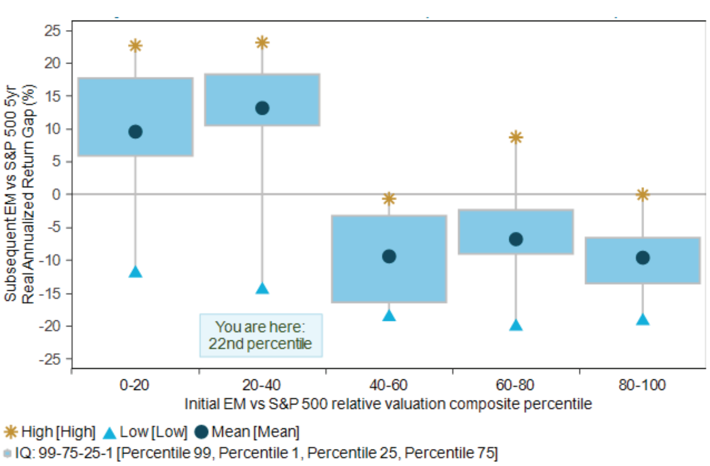
Although EM equities are richly valued relative to their own history, by our relative valuation composite measure they are trading at the largest discount to the S&P 500 seen since 2006.

Relative Valuations Matter for Long-term Returns

Valuation measures usually have close to zero correlation with short-term returns over, for example, one- to three-year periods. However, they tend to be more informative over longer-term periods of five to ten years. That means they can be helpful to long-term investors and asset allocators, even if they offer little guidance to short-term traders.

Based on data since 1995, our composite measure of EM vs S&P 500 relative valuation does appear to have given useful signals. Consider the gap between five-year annualized returns for the MSCI EM Index versus the S&P 500 Index. Historically, when EM initially traded at a significant discount, the MSCI EM Index subsequently tended to outperform the S&P 500 by a wide margin over the next five years **(Chart 7)**. The opposite was the case when EM initially traded at a premium to the S&P 500.

Chart 7: MSCI EM vs S&P 500 5-Year Real Return Gap By Initial Relative Valuation (1995-2021 data)



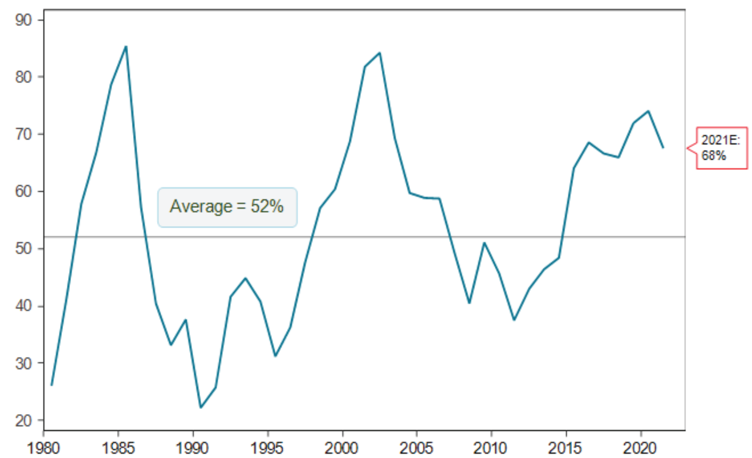
Source: GW&K Investment Management, Bloomberg, MSCI and Macrobond

When EM equities have been as cheap as they are now versus the S&P 500 they have frequently – but not always – delivered double-digit annualized outperformance versus the S&P 500.

To be sure, there can be a wide range of outcomes associated with any starting level of relative valuation for EM vs the S&P 500. That is indicated by the width of the shaded blue bars in Chart 7, which show the range of relative returns from the 25th to the 75th percentile depending on the initial comparison of relative valuations. The key message from Chart 7 is that there has historically been a definite skew toward EM outperformance of the S&P 500 when EM's starting discount is as pronounced as it is now. If history is any guide, the odds appear to favor EM outperformance versus the S&P 500 over the next five years.

Also, while our focus here has been on relative equity valuations, we would note that the U.S. dollar also remains richly valued on measures like purchasing-power parity (PPP) **(Chart 8).** That should create positive tailwinds for EM's relative performance if the dollar reverts to the mean in coming years.

Chart 8: U.S. Dollar Overvaluation vs Foreign Currencies Based on Purchasing Power Parity (%)



Source: GW&K Investment Management, IMF April 2021 World Economic Outlook, and Macrobond
Based on the ratio of IMF estimates of world ex US GDP in nominal vs PPP-based terms

Recent data from the International Monetary Fund estimates that the U.S. dollar is currently nearly 70% overvalued on a purchasing-power-parity (PPP) basis, which is toward the high end of its historic range.

In short, equity markets are up sharply over the last year and that has resulted in higher valuations for both DM and EM equities. We believe these valuations make sense relative to low real bond yields and accommodative central bank policies. We also think current equity valuations are rightly discounting a global economic boom that is likely as the pandemic fades and massive economic stimulus measures gain traction.

Although EM growth may trail U.S. growth over the next few quarters based on uneven vaccine rollouts and less aggressive fiscal stimulus, it seems highly likely that EM growth will outperform U.S. growth on a three-to-five year view. For long-term investors, with EM equity valuations trading at a substantial discount to the S&P 500, EM equities continue to represent a useful complement to U.S. equity holdings.

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