Emerging from the Shadows — the Case for Emerging Markets
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by Steve Cao
of Invesco

A closer look at catalysts

After an extended period of weakness, emerging market equities have rebounded nicely year-to-date — outperforming developed market stocks by a sizeable margin, as measured by the MSCI Emerging Markets Index and MSCI EAFE Index.¹ In my view, this strong performance has been driven by better macroeconomic conditions, strong earnings growth and discounted valuations relative to developed market equities.¹

Let’s take a closer look at these emerging market catalysts:

Improving macro conditions

- **China** posted better-than-expected gross domestic product (GDP) numbers for the first and second quarters of the year, and the structure of the Chinese economy continues to improve.
- **India**, important tax reforms have been enacted in the form of a national “goods and services tax,” which was implemented on July 1. This was watershed legislation — one of the most important reforms ever passed in India, in my view. The new tax makes India a common market, which eases the movement of goods across states, and should boost economic efficiency. I believe the tax will eventually have a positive long-term impact on productivity and economic growth.
- **Brazil**, political malfeasance has made headlines, but economic fundamentals continue to improve. Real wage growth has turned positive, unemployment has begun to fall, corporate balance sheets are being deleveraged and inflation has been kept in check. Despite political uncertainty, Brazil has also made progress enacting various reforms, with labor bills passed by both houses of the National Congress. On balance, I believe positive economic forces in Brazil outweigh the country’s political uncertainties.
- **Russia**, economic growth has accelerated after two years of recessions, while inflation has slowed even amid monetary easing. These are positive signs for an energy-dependent economy hurt by low crude oil prices.

Corporate earnings on the upswing

Corporate earnings are also on the upswing in many emerging markets. Consensus analyst estimates for earnings growth have been revised upward for both 2017 and 2018. In fact, some analysts are expecting 20% higher year-over-year corporate earnings growth from emerging markets equities for 2017.²
Valuations remain reasonable compared to developed markets

Despite these positive trends, emerging market stocks are still remarkably affordable — especially relative to developed market issues.

- On a trailing price-to-book value basis, emerging market equities are trading in line with historical valuations. Relative to developed markets, however, emerging markets equities remain at a roughly 26% discount.\(^3\)
- On a forward price-to-earnings basis, emerging market equities are trading at 12% premium to their historical valuations, but remain at a discount to developed market stocks.\(^3\)

While conditions appear to be improving for emerging markets as a whole, individual stock selection remains critical. The Invesco International and Global Growth team uses a fundamental, bottom-up approach to selecting stocks. We believe focusing on companies’ earnings, quality and valuation (EQV) characteristics can reward investors over the long term.

1 Source: FactSet Research Systems as of June 30, 2017. MSCI Emerging Markets Index year-to-date performance is 18.43%, compared to MSCI EAFE Index year-to-date performance of 13.81%, as of July 25, 2017.

2 Source: HSBC GEMS Equities Wrap Up, June 2017


Shuxin (Steve) Cao, CFA, CPA
Senior Portfolio Manager

Steve Cao is a senior portfolio manager for Invesco international/global growth strategies. He began his investment career in 1993 as an international equity analyst specializing in Asian securities at Boatmen’s Trust Co. In 1997, he joined Invesco and continued as an international equity analyst with a focus on Asia and Latin America until assuming his present duties in 1999.

A native of Tianjin, China, Mr. Cao earned a Bachelor of Arts degree in English from the Tianjin Foreign Language Institute and an MBA from Texas A&M University.

He is a Certified Public Accountant (CPA) and a CFA charterholder.

Important information

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Past performance is not indicative of future results.

An investment cannot be made into an index.

Forward price-to-earnings ratio is a variant of a company’s price-to-earnings ratio, and is calculated by dividing the company’s current share price by its expected earnings, usually for the next 12 months or next full fiscal year.

Price-to-book ratio is calculated by dividing the market price of a stock by the book value per share.

The risks of investing in securities of foreign issuers can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

An investment in emerging market countries carries greater risks compared to more developed economies.

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