EM Strategy Views

Flows vs. Fundamentals – the upside risk to EM EPS

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- The EM rally continued in July and August, albeit a much more potent equity than FX rally.
- A lot of discussion has revolved around flows and positioning...
- ...but there has been an underlying stability in growth and EPS.
- EM growth stability has so far been largely a commodity story...
- ...but the upside potential to EPS in 2H (+5%) comes from the loosening in financial conditions.

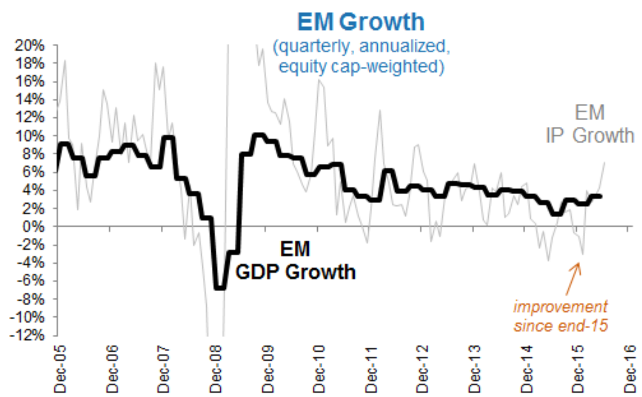
1. EM flows vs. fundamentals: growth has indeed improved in 2016

The EM equity rally continued in July and August (+8%), albeit at a slower pace than the furious January-March rally (+20%), with MSCI EM sitting at 898 currently, or 2% off the cycle highs from two weeks ago. EM FX has corrected a bit more sharply in recent days, and our EM FX index currently sits just 0.5% above its March 31 close. Although sovereign credit spreads remain near cycle-tight levels, EM credit and local bonds have softened their rally as well in recent days (USD debt +4%, local debt +1% since end-June). As we discussed earlier this summer, an EM-friendly environment with equity being the strongest performer tends to occur during a 'growth up, rates up' phase of the cycle, and this has indeed been the macro backdrop (see EM Cross-Asset Strategy Part 1: Identifying 'EM Risk').

Much of the discussion surrounding the EM rally has focused on flows and positioning, but EM fundamentals have shown signs of a tepid improvement. EM GDP growth accelerated sequentially in the first quarter of 2016, and monthly data (such as Industrial Production) continued to improve in 2Q (see Exhibit 1). This is not the first time that EM growth has picked up since the global financial crisis – we have seen a few oscillations in sequential growth momentum and the bounce came off a low base in 4Q 2015. However, perhaps more importantly, the differential of EM vs. DM growth has improved in the past two quarters, a development we have not seen since early 2012 (see Exhibit 2).

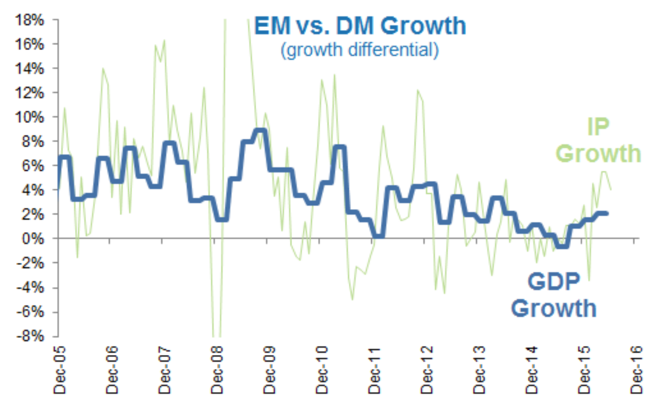
We have long argued that an improvement in the EM growth outlook is the essential ingredient in adopting a positive outlook on EM equity – both in absolute and relative terms. Consequently, while we are unsurprised that the EM rally coincided with improving growth earlier this year, we have remained sceptical on the rally for two mains reasons: (1) the GDP acceleration did not drive EM EPS higher, and (2) EM growth picked up off a very low base and amid a sharp rise in commodity prices (oil and metals) in late Q1 and Q2, something we do not expect to continue in 2H. Below, we discuss the upside risk.

Exhibit 1: EM growth has improved in 2016...



Source: Haver, Goldman Sachs Global Investment Research

Exhibit 2: ... as has the differential vs. DM



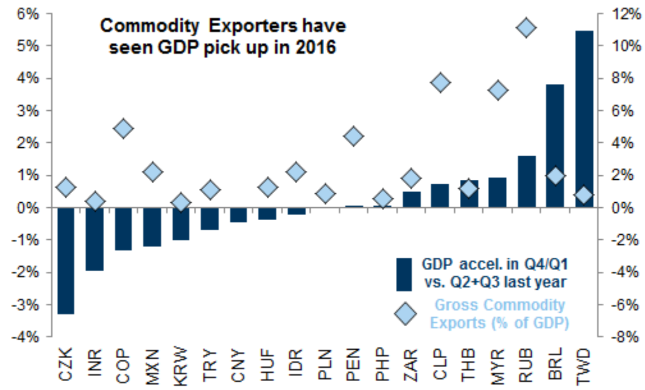
Source: Haver, Goldman Sachs Global Investment Research

2. Higher commodity prices have largely explained EM growth improvement, which may not continue in 2H

Looking underneath the surface of the headline GDP improvement of the past two quarters, we find that commodity-exporting EMs have, in general, led the charge (see Exhibit 3). The notable EM commodity exporters are Russia, Malaysia and Chile, which all registered accelerating activity in 1Q. Although their share of commodity exports is small relative to GDP, Brazil and South Africa (often perceived as commodity-exposed EMs) have also seen improving growth rates. The only EM with significant commodity exposure and falling growth rates is Colombia, an economy that has raised policy rates by 325bp over the past 12 months to combat accelerating inflation.

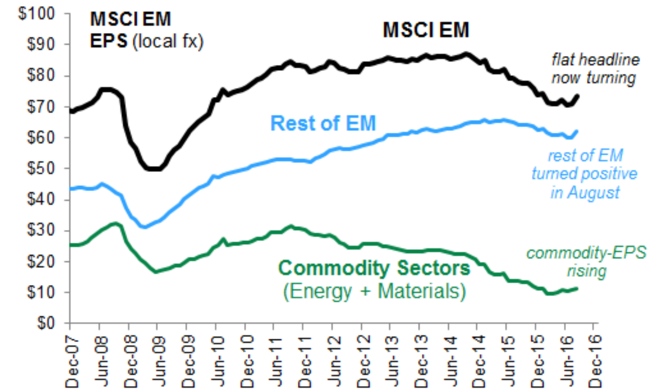
Digging into the EPS story, the same theme emerges: EM EPS stability earlier this year has been wholly attributable to commodities. Coming into the year, EM earnings expectations were on a dismal trajectory, consistently ratcheted lower by an average 1.1% per month from mid-2014 through early 2016. Between March and July, EM EPS stabilized at around $71, a result of rising commodity-related EPS offsetting weakness elsewhere. However, over the past month EM EPS expectations have finally increased, and meaningfully so, by 2.9% (see Exhibit 4). Importantly, this is a *local currency* increase in EPS, which is different from the 4% rise in USD EPS registered between February and April (wholly an FX translation issue, not a 'real' earnings improvement). As we discuss below, the turn in EM EPS in August was a non-commodity story.

Exhibit 3: Rising commodity prices helping EM GDP in 2016...



Source: Haver, UNCTAD, Goldman Sachs Global Investment Research

Exhibit 4: ... and commodity-related EPS drove stability as everything else fell



Source: FactSet, IBES, MSCI, Goldman Sachs Global Investment Research

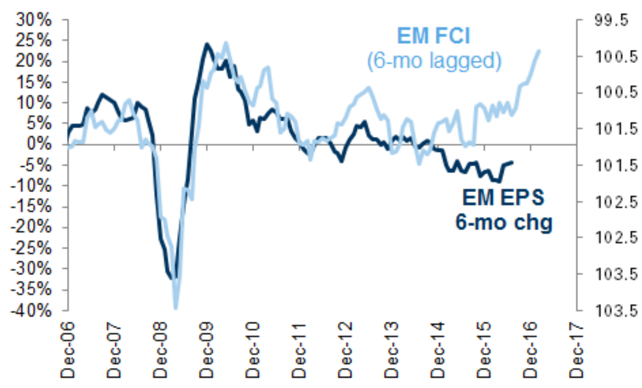
3. FCI loosening can likely drive further upside in forward EM EPS expectations to $75 by year-end

We have previously flagged the significant loosening of EM financial conditions as a potential for activity improvement this summer, and, extending the linkage to EM EPS, history suggests changes in FCI have the largest impact on earnings with a 6-month lag (see Exhibit 5). The recent bout of EM FCI easing began in February (six months ago), and the improvement in non-commodity EM EPS in August is therefore consistent with the historical pattern.

In terms of sectors, FCI easing has historically benefited the earnings expectations of the Info Tech, Financials and Consumer Discretionary sectors the most. Perhaps unsurprisingly, it is precisely these three sectors which saw the largest positive revisions in August (roughly 4.5% positive EPS revisions for each in August).

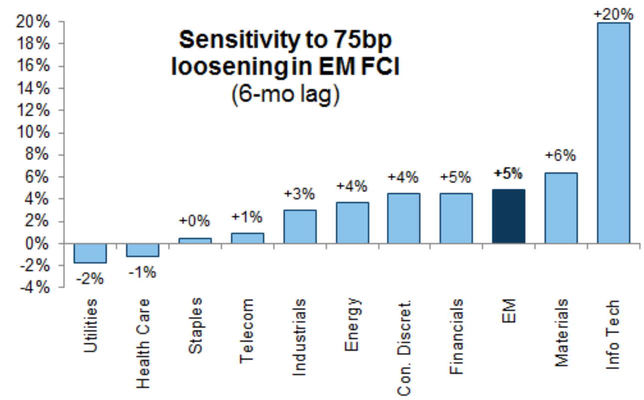
Over the past six months, EM financial conditions have eased by 75bp; and this has historically corresponded with an EM EPS upgrade of 4.8%. Given the 2.9% upgrade in August, the historical analogue would suggest we are around half-way through the upgrade cycle (assuming EM FCIs do not continue to loosen from here), and that EM EPS could reach $75 by year-end.

Exhibit 5: EM FCI easing has boosted EPS in the past, though less so recently



Source: FactSet, IBES, Goldman Sachs Global Investment Research

Exhibit 6: EM EPS may rise 5% (to $75) due to FCI loosening

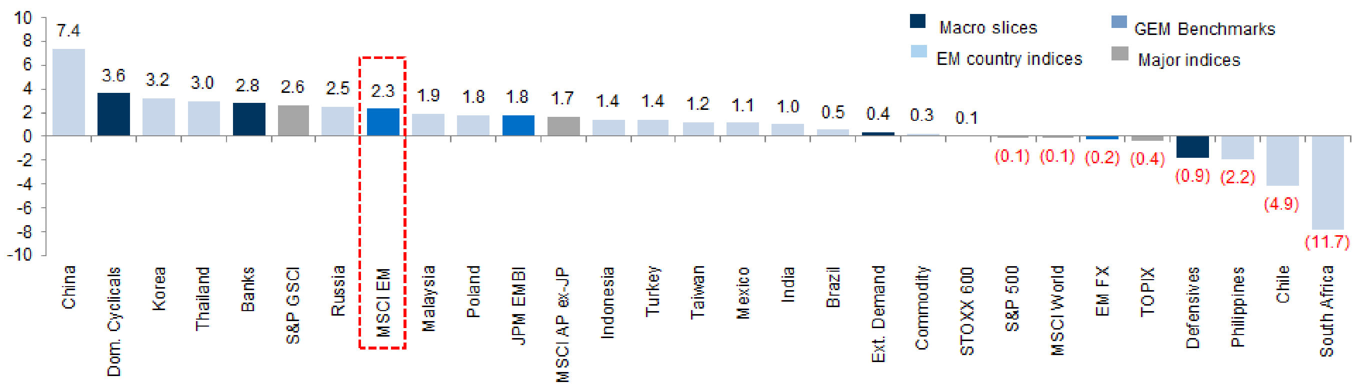


Source: FactSet, Goldman Sachs Global Investment Research

The shift in EM EPS trends is indeed an important development and would normally push us to adopt a more constructive view on EM equity. While we do expect the $68 EPS level seen in 1Q to be the cycle low in EM earnings and envisage further positive revisions in the short term, we remain near-term cautious on the space given stretched valuation (i.e., the market has largely already priced the improvement in EPS). Our view remains that the current 12.4x forward P/E will drop to the mid-11x range (MSCI EM support level of 800) on the combination of Fed tightening worries and China growth deceleration in 2H. At the margin, EM FCI loosening makes us more constructive on the Domestic Cyclical slice of EM equity, in addition to the External Demand slice that we already favour.

Appendix – Performance, Macro and Valuation

Global asset performance – one-month price return (USD, %), as of August 31, 2016



Goldman Sachs macro forecasts for major EMs and world aggregates

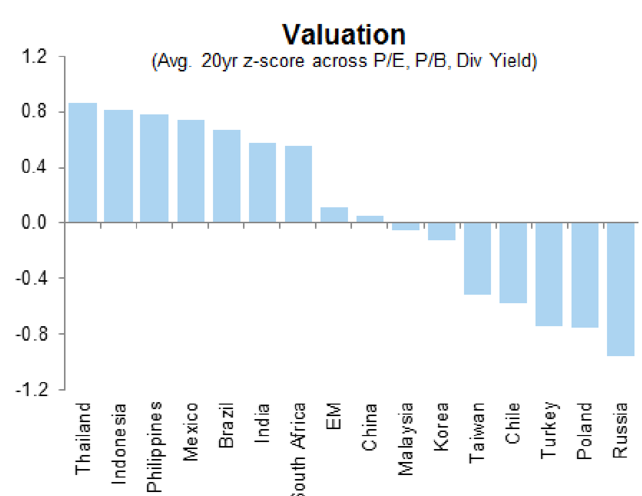
Market	GDP growth			Inflation			Policy Rates			FX Forecast (USD)			
	2015E	2016E	2017E	2015E	2016E	2017E	Current	2016E	2017E	Current	3-m	6-m	12-m
Brazil	-3.8	-3.1	1.1	9.0	8.8	5.6	14.25	13.25	10.75	3.23	3.20	3.30	3.50
Chile	2.1	1.6	2.4	4.3	4.0	3.0	3.50	3.50	4.00	681	700	720	730
China	6.9	6.6	6.4	1.4	2.0	1.7	2.40	1.50	1.50	6.68	6.70	6.80	7.00
India	7.5	7.8	8.0	4.9	5.5	5.5	6.50	6.50	6.50	66.99	67.50	68.00	68.50
Indonesia	4.8	5.1	5.7	6.4	3.9	4.8	6.50	5.00	5.00	13268	13400	13600	14000
Korea	2.6	2.7	2.9	0.7	0.9	2.2	1.25	1.00	1.50	1122	1180	1200	1250
Malaysia	5.0	4.1	4.3	2.1	2.4	2.7	3.00	3.00	3.00	4.08	4.10	4.20	4.40
Mexico	2.5	2.6	3.2	2.7	2.8	3.5	4.25	4.50	5.00	18.80	18.00	17.50	17.25
Philippines	5.9	6.7	6.1	1.4	2.0	3.1	3.50	3.00	3.50	46.73	47.50	48.50	48.50
Poland	3.5	3.0	3.4	-1.0	-0.8	1.3	1.50	1.50	1.50	3.92	4.12	4.18	4.25
Russia	-3.7	0.5	2.9	15.1	5.9	4.0	10.50	8.50	6.00	65.31	68.00	66.00	62.00
South Africa	1.3	0.2	0.9	4.6	6.9	6.7	7.00	7.50	8.00	14.66	15.50	16.00	17.00
Taiwan	0.6	1.1	2.0	-0.3	1.0	1.3	1.38	1.38	1.50	31.74	33.00	33.00	34.00
Thailand	2.8	3.3	3.4	-0.9	0.5	2.0	1.50	1.50	1.50	34.64	36.00	36.50	37.50
Turkey	4.0	3.0	3.3	7.7	6.8	6.8	8.50	7.50	9.00	2.96	3.10	3.10	3.25
EM	4.2	4.6	5.2	5.7	5.7	4.7	-	-	-		-	-	-
DM	2.0	1.5	1.7	0.2	0.7	1.6	-	-	-		-	-	-
World	3.1	3.1	3.5	2.9	3.2	3.2	-	-	-		-	-	-

MSCI EM valuation and earnings growth

MSCI EM Valuation

	P/E	P/B	D/Y	Earnings Growth		
	(NTM)	(LTM)	(LTM)	2015E	2016E	2017E
Brazil	12.7	1.5	3.5	(24.2)	15.8	17.6
Chile	13.6	1.6	2.4	(5.1)	4.5	13.9
China	11.9	1.6	2.3	(3.8)	(0.9)	14.8
India	18.1	3.2	1.3	2.7	16.4	17.2
Indonesia	16.7	3.1	2.0	(9.4)	9.1	14.1
Korea	10.2	1.0	1.7	11.4	6.9	8.5
Malaysia	15.9	1.8	3.0	0.4	(3.9)	7.3
Mexico	18.6	2.7	1.7	6.8	27.3	20.1
Philippines	18.9	2.7	1.5	7.4	12.9	9.6
Poland	11.4	1.1	3.6	(32.5)	36.2	1.2
Russia	6.3	0.8	4.6	11.7	(14.8)	20.6
South Africa	14.9	2.3	2.8	2.7	16.0	13.9
Taiwan	13.5	1.8	3.9	2.8	(3.3)	10.7
Thailand	15.0	2.1	2.8	(2.0)	15.5	13.4
Turkey	8.0	1.2	2.8	15.8	10.6	13.0
EM (Local)	12.4	1.5	2.6	0.7	4.0	13.6
EM (USD)				(9.0)	8.2	11.1

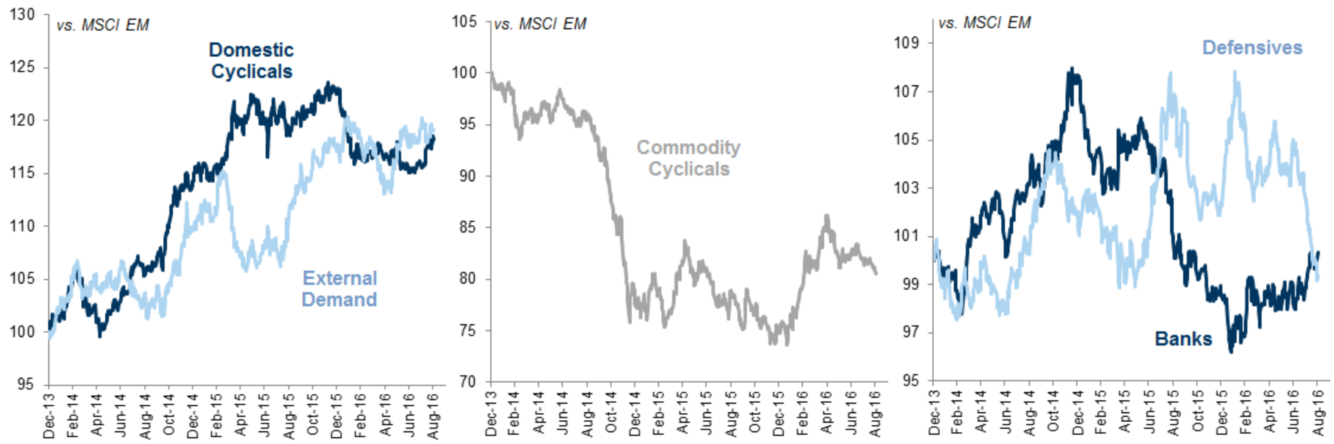
Earnings growth based on consensus estimates in local currency



Source: FactSet, Datastream, Haver Analytics, Goldman Sachs, Goldman Sachs Global Investment Research

Thematic Slices and Flows

EM 'Macro Slice' performance vs. MSCI EM

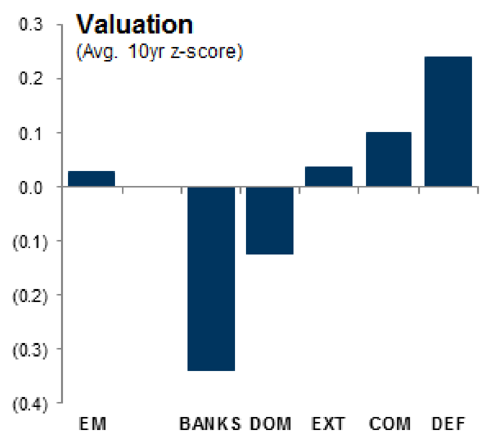


Source: FactSet, Goldman Sachs Global Investment Research

'Macro Slice' valuation and earnings growth

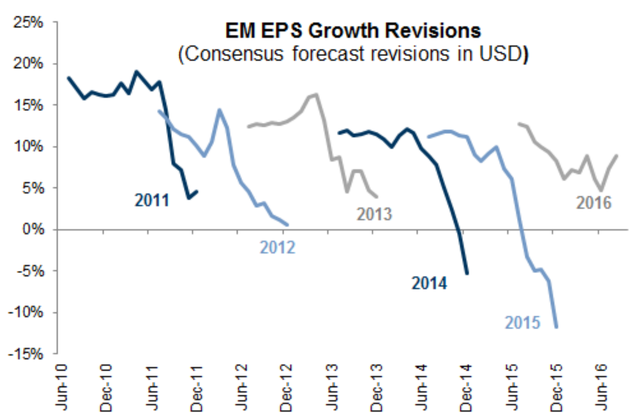
	Valuation			Growth		
	P/E (NTM)	P/B (LTM)	D/Y (LTM)	Earnings Growth 2015	2016E	2017E
Domestic Cyclicals	15.8	2.3	1.7	0.3	11.7	18.7
External Demand	12.6	1.7	2.1	0.2	3.8	13.3
Commodity Cyclicals	10.3	1.1	3.3	-20.8	12.8	21.8
Banks	8.2	1.2	3.6	9.2	-2.2	7.9
Defensives	16.1	2.3	2.7	8.9	1.2	11.7
EM	12.3	1.5	2.6	0.7	4.0	13.6

Earnings growth based on consensus estimates in local currency



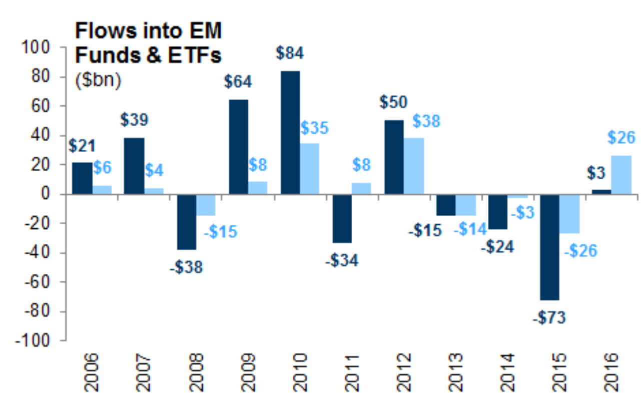
Source: FactSet, Goldman Sachs Global Investment Research

MSCI EM EPS growth revisions



Source: Datastream, Goldman Sachs Global Investment Research

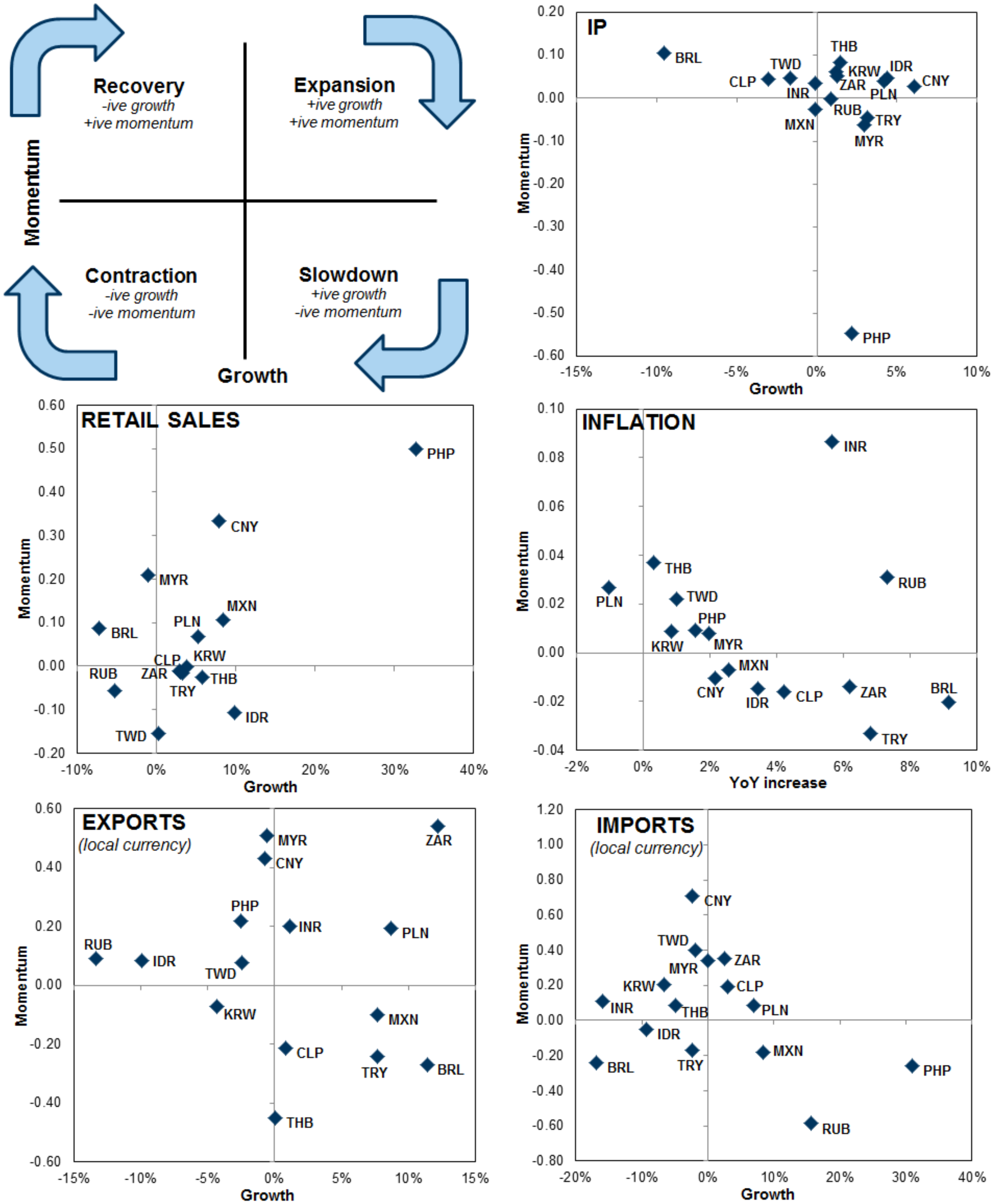
EM equity and debt flows



Source: EPFR, Goldman Sachs Global Investment Research

Activity Monitor

EM Macro Activity Monitor



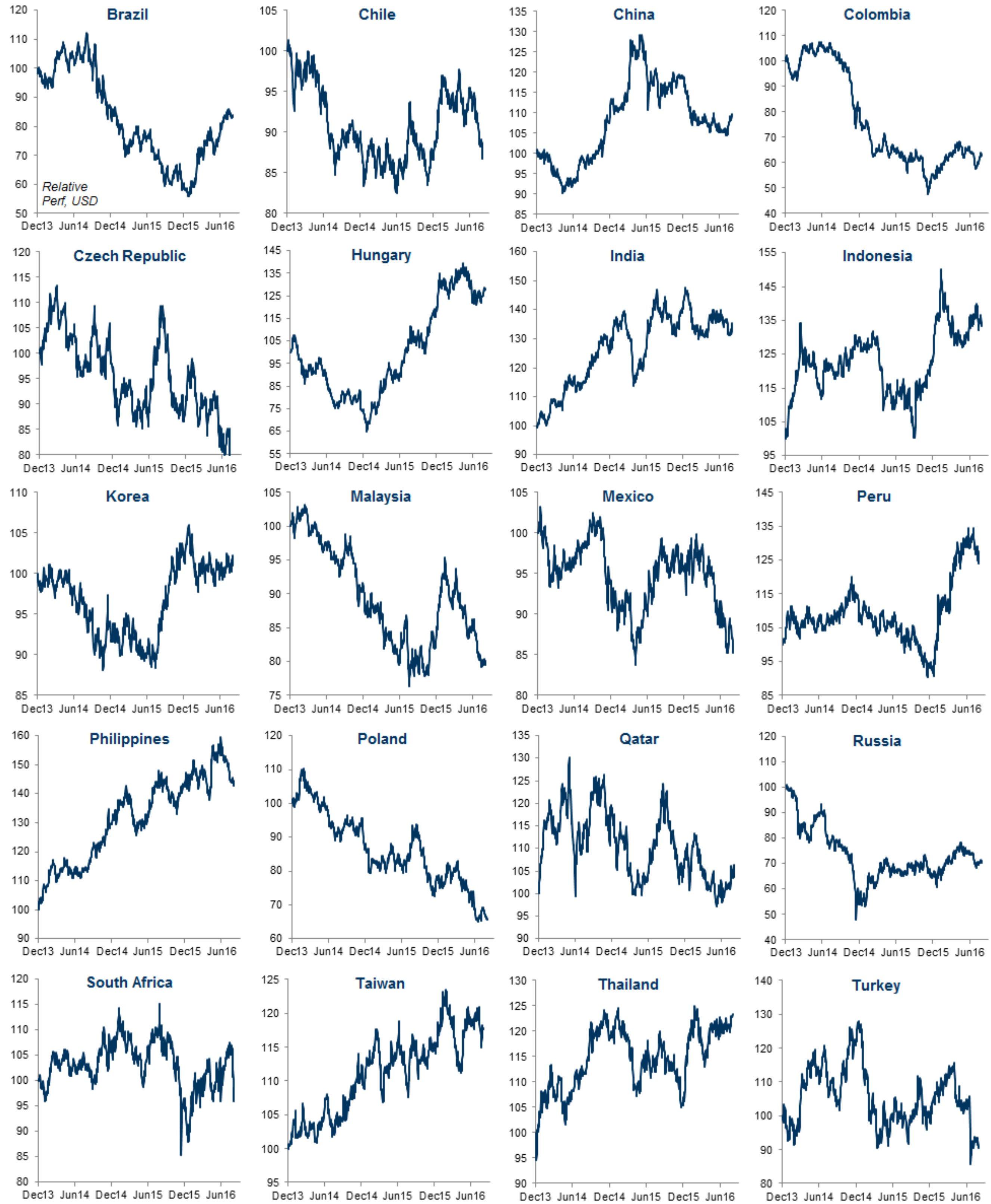
* Growth is the 3-month average of monthly YoY data readings

** Momentum is the change in the sequential growth rate (growth acceleration) of the last 3-months vs. the prior 3-months

Source: Haver Analytics, Goldman Sachs Global Investment Research

Relative Market Performance

EM equity performance vs. MSCI EM (in USD)



Source: FactSet, MSCI, Goldman Sachs Global Investment Research

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