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The emerging market equity rally has further to go

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Emerging market equities returned 75 per cent in dollars in 2009, outperforming developed market equities by about 50 per cent. Over the past decade they have returned more than 100 per cent in dollars with dividends reinvested, versus negative returns for developed market equities.

At Morgan Stanley, we estimate that emerging market economies will increase their gross domestic product by 6.5 per cent in 2010 against just 2 per cent for the advanced economies. But that is not the reason we expect further outperformance of emerging equity markets.

In a recent Insight column in the Financial Times ("Busting the myth of Brics"), Peter Tasker argued that strong GDP growth in emerging markets was not a reason to invest in their stock markets. He cited academic work showing the lack of positive correlation between GDP growth and stock market returns. Long-term bulls of emerging stock markets are also aware of this work. Rather, we have focused on the ability of companies in emerging markets to outperform their developed peers, selling both globally and into local markets.

Currently, the trailing return on equity (ROE) for the MSCI EM benchmark is 12 per cent versus 7 per cent for the developed markets MSCI World benchmark. On our estimates, 2010 is likely to be the 10th year in a row when the ROE of emerging market companies is superior to those in developed markets. In fact, ROE in emerging markets has already troughed well above the prior cycle low, while developed markets may currently be troughing at a level that is well below. For this record one is asked to pay a 2.1 times price to book multiple and a trailing price/earnings multiple of 18 times, which is a 35 per cent discount to developed markets. The forward p/e multiple on consensus earnings is 14 times. These valuations are hardly in bubble territory and well below peaks in 2007, 1999 and 1993.

Our analysis of data for 650 non-financial companies in emerging markets shows that the main driver of superior return on equity is operating efficiency. Corporate leverage has remained low after the deleveraging of the 1997-98 cycle. This is important because, in true bubbles, like Japan in the late 1980s, not only were equity valuations far higher than in EM today, but higher levels of corporate leverage flattered ROE in the upswing. They also reinforced the economic and stock market downswing once the bubble burst.

A further resort of the bears is the argument that the economic growth of China, the largest index constituent in MSCI EM, is characterised by over-investment and under-consumption. Official data indicate that Chinese households consumed just 36 per cent of GDP in 2008, while gross fixed capital formation amounted to 47 per cent of GDP. Our analysis suggests that Chinese household consumption spending, properly counted, is probably much larger both in absolute terms and as a share of GDP (perhaps $2,800bn, or 50 per cent of 2008 GDP).

A key area of understatement of both consumption and GDP is in relation to the income generation of those working in the services sector, especially in small companies. Its counterpart is under-estimation of services spending by households. China's official statistics currently suggest that while the dollar value of Chinese household consumption of tradeable goods amounts to 38 per cent of the US total, consumption of services amounts to just 6 per cent.

The ratio of consumption of housing services is lower still at just 3 per cent of the US total. Hence, in per capita terms, the data indicate that the average Chinese person consumes $38 per annum of housing services versus more than $5,000 in the US (or $500 in Brazil). It is most unlikely that this reflects reality on the ground, in particular given the transition to private rental markets and owner occupancy since the housing reforms of the late 1990s. China's statisticians also continue to struggle to account for the burgeoning development of consumer services in areas such as financial services and insurance, communications, private medical provision and recreation.

Consumption clearly played a key role in China's rapid exit from recession in 2009. It ended 2009 as the world's largest market (in unit terms) in cars and mobile phone handsets and seems likely to overtake the US as the largest flat screen television market in 2010. There was also a far more rapid take-up of property market inventory than most analysts expected, given the ratio of prices to official household income data.

There is every reason to believe that the secular bull market in emerging market equities is more robust than the sceptics suggest. The burden of proof is on developed market companies to deliver the structural improvement in return on equity achieved by their EM peers after the crisis of 1997-98.

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