November 2016

By Robert Samson,
Senior Portfolio Manager,
Multi-Asset

nikko am
Nikko Asset Management

EARNINGS RECOVERY IS MUCH MORE ACHIEVABLE IN EM ASIA THAN LATAM OR EMEA

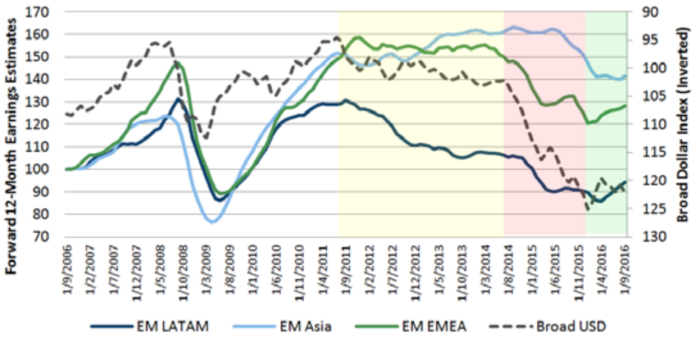
Conditions across emerging markets (EM) have improved markedly since the early months of 2016, when the Federal Reserve (Fed) determined to slow its efforts to normalize rates and China announced a "mini stimulus" in an effort to balance reforms with growth. Mild stimulus helped to stabilize demand, but immediate relief came from much improved financial conditions. Deservedly, valuations bounced from extreme lows, but for the rally to continue, it will be increasingly important for earnings to meet expectations.

Expectations have diverged significantly across regions mainly as a function of implied profit margin expansion[1] in Latin America (LatAm) and EMEA in anticipation of better growth ahead, while Asia is mainly a story of earnings normalization. In this article, we examine the relative risks in achieving these assumptions, specifically focusing on growth dynamics against still high levels of corporate debt and servicing costs.

Two phase decline and the current recovery

The history of forward earnings provides a useful starting point for distinguishing the different drivers of the downturn and potential sources of earnings improvement as headwinds turn to tailwinds. Chart 1 shows forward earnings estimates for each region compared to the dollar (inverted), which serves as a proxy for financial and liquidity conditions. The yellow area shows gradual tightening marked by slowing demand growth and falling commodity prices, while the red area defines the period of aggressive tightening as the Fed prepared to and eventually did lift rates in late 2015. The green area is the current period of easing financial conditions with the Fed on hold, and thus helping to stimulate stabilize demand.

Chart 1: Forward 12-Month earnings (local currency, rebased to Sep 2006=100)



Source: Bloomberg as of October 20, 2016

As a commodity exporter, LatAm suffered the most in the tightening period, with forward earnings declining since 2011. In contrast, falling commodity prices provided a tailwind to Asia, a region that is also benefiting from ongoing reforms. Estimates only began to decline late in the aggressive tightening cycle when China devalued its currency, spreading a growth scare across the region. EMEA consists of a mix of commodity exporters and importers with earnings downgrades mainly occurred throughout the aggressive tightening phase impacted by commodity declines combined with pockets of funding stress.

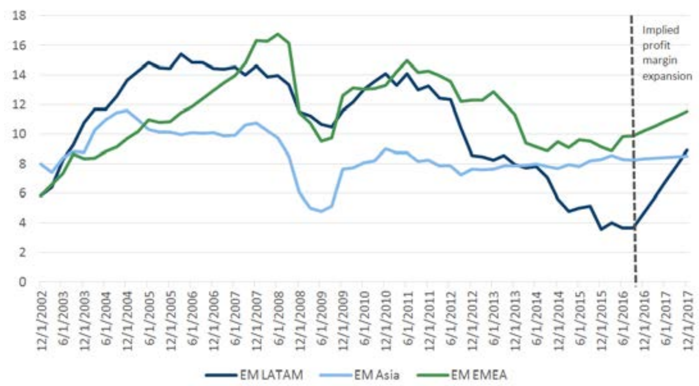
As financial conditions began to ease in early 2016, LatAm and EMEA have both experienced significant upgrades in earnings expectations, often associated with a return to an upcycle. Given the commodity rebound from multi-decade lows, coupled with returning flows and liquidity, the rebound seems justified, but with continually tepid global demand and high levels of corporate debt servicing cost, the trajectory of the recovery is uncertain. For Asia, forward earnings estimates have stabilized with such now basically recovering the earnings lost previously, as conditions normalize.

Divergence of expectations versus reporting earnings

To date, reported earnings across all three regions have stabilized but have yet to meaningfully turn upward, implying a meaningful divergence from expectations in LatAm and EMEA. Looking behind earnings estimates to their component parts – expected sales growth and implied profit margin expansion – the latter is the main driver of this divergence.

Chart 2 shows reported profit margins, with the implied profit margin expansion shown to the right of the blue line. Implied margin expansion is essentially reversing a portion of the previous compression, with LatAm suffering the worst prior declines and, therefore, implying the strongest recovery, followed by EMEA. Asia profit margins were basically unaffected by the downturn, with implied margin expansion remaining modest, only expected to rise from 8.3% to 8.5%.

Chart 2: Reported profit margins versus implied expansion



Source: Bloomberg as of October 20, 2016

Improving fundamentals help to fill part of the expectation gap

For LatAm and EMEA, profit margins can improve considerably on the back of an economic recovery, partly driven by the removal of one-off expenses associated with the downturn (e.g. restructuring, write-offs, etc). Moreover, the outcome of these one-off costs has produced leaner, more profitable companies.

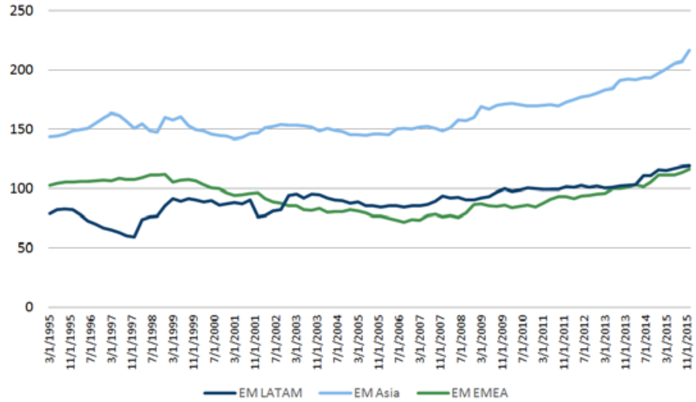
Downturns in LatAm and EMEA were exacerbated with deteriorating fiscal accounts coupled with rising political risks. Stabilizing demand and commodity prices offered a significant lift to confidence, further boosted in LatAm with improving political dynamics – mainly in Brazil with a shift in leadership bringing a reform agenda to contain the otherwise unsustainable fiscal deficit.

These elements together suggest a much improved outlook, but it is important to take stock of headwinds that could slow the trajectory of improvement – the largest being high levels of debt that impede growth and continued high debt servicing costs that continue to add pressure on profit margins.

High levels of debt and servicing costs to weigh on margin expansion

Since 2007, just prior to the financial crisis, corporate debt levels have steadily risen across and all three regions. As shown in Chart 3, debt levels are highest in Asia, with credit expansion mainly driven by China. However, the cost of debt service is quite different across the three regions – both as a function of the direction of interest rates and the proportion of dollar denominated debt, both impacting debt servicing costs.

Chart 3: Nonfinancial Corporate Debt

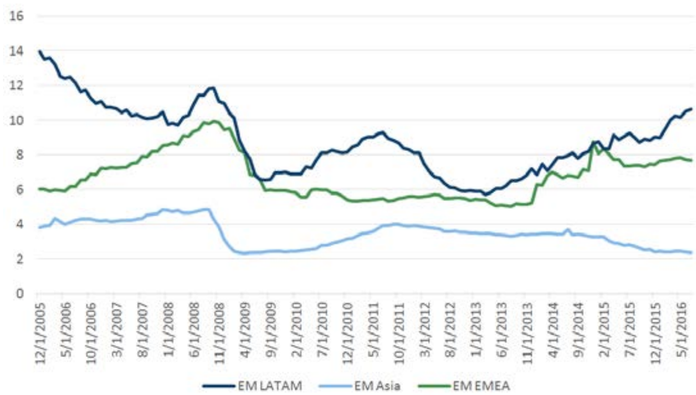


Source: BIS, October 2016

Interest rates implications

LatAm and EMEA both experienced about a 50% currency adjustment since 2011, which caused high levels of inflation. While Asia experienced a 13% currency adjustment, the pass through was more than offset by deflationary forces, including lower commodity prices, which pushed inflation to record lows. As shown in Chart 4, rising inflation brought higher interest rates both in LatAm and EMEA since 2013, whereas rates in Asia have been in steady decline.

Chart 4: Regional interest rates (MSCI EM weighted)



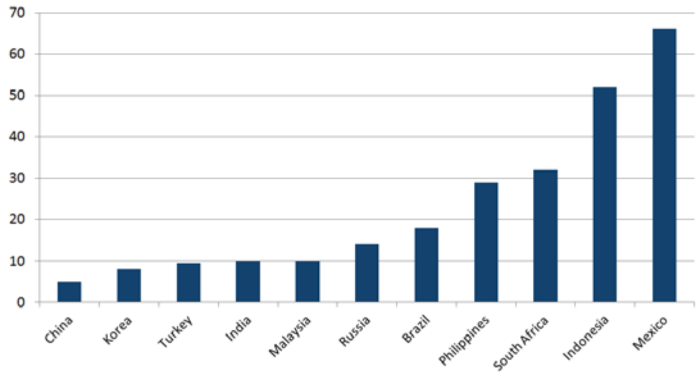
Source: Bloomberg as of October 20, 2016

Inflation peaked in EMEA several months ago allowing for rate cuts, while inflation is seems to be peaking in LatAm, allowing for possible rate cuts. Corporate profit margins should improve as interest rates decline, but cost savings will take time. Meanwhile, in Asia, interest rate declines have helped to keep profit margins steady despite rising levels of debt.

Continued high costs of USD denominated debt

In LatAm and EMEA, USD-denominated debt has effectively doubled with the halving of the two currency blocs. As shown in Chart 5, this debt is particularly acute among commodity exporters which, by their heavy weighting in the regional equity indices, has impacted LatAm badly, while less so in EMEA.

Chart 5: USD Portion of Non-Financial Corporate Debt



Source: BIS as of October 2016

Asia was also negatively impacted by this currency mismatch, but with the impact being more on the macro-economic side via a liquidity squeeze.

The Asia Squeeze

The downturn in Asian profits was primarily driven by weak demand in China, driven by an ambitious reform agenda that impeded economic growth, coupled with tight conditions caused by its peg to the strong USD. The catalyst for earnings downgrades came in August 2015 when China devalued its currency by 3% as a policy step to de-link from the USD. Though aligned with its reform agenda, the move triggered fears of a deeper slowdown accompanied with a surge in capital outflows, inflicting a tight liquidity squeeze across the region.

Capital outflows can take different forms, but the unwind of the so-called "carry trade" (paying down USD denominated debt) was clearly a significant contributor to the large outflows that accelerated through the early part of this year. It is difficult to estimate the degree of speculative unwind, but given that capital outflows have slowed to manageable levels despite continued depreciation of the Chinese Renminbi – now down nearly 8% from just before the devaluation – suggests that much of the speculative unwind is complete.

Importantly, devaluation of the currency both relative to the USD and its trade basket helped to reverse most of the tightening inflicted by the aggressive USD rally. Also, China shifted its policy focus to a balance between reforms and growth. Of course, China walks a fine line given already very high levels of debt, but so far high savings rates and confidence in the system has kept the system functioning, as reforms continue to push the economy toward a more sustainable balance.

With negative conditions of the squeeze in Asia having largely been removed, liquidity and economic demand conditions are normalizing, with the still-important tailwinds of low commodity prices and a strong reform agenda that continues to gather pace across the region. Indeed, consensus earnings are forecast to grow 16% over the next year, retracing about three quarters of the earnings decline.

Market pricing of forward earnings

Meeting earnings expectations will be important, but even more so for those markets paying a premium on forward earnings (forward price to earnings) compared to historical averages. As shown in Chart 6, the forward PE is up across the board with all three regions currently priced at a premium, but to varying degrees. LatAm is pricing with the highest premium (+19%), followed by EMEA (+12.5%) and Asia (+6.6%).

Chart 6: Forward Price to Earnings (Forward PE)

Source: Bloomberg as of October 20, 2016

Conclusion

The dynamics of the earnings recovery across the three regions of EM differ widely. For LatAm and EMEA, the recoveries are from a much deeper downturn and are experiencing significant upgrades, as commodities and financial conditions have stabilized earlier this year.

Reported earnings have yet to turn upward, meaning that earnings will need to rise aggressively to keep up with market expectations – particularly in LatAm and EMEA. The key challenge is the high level of corporate debt, with high debt-servicing costs adding pressure on profit margins against forecasts that imply considerable expansion. If earnings fall short of delivery, forecast downgrades are likely to add pressure to these markets, particularly as their forward earnings are being priced at a fairly high premium compared to historical averages.

The earnings recovery in Asia is quite different from Latam and EMEA, with earnings simply expected to retrace most of the losses incurred by last year's liquidity squeeze and weak economic demand, as the conditions for such have been mainly removed. Also, the market trades at a small premium to forward expectations, but the path of recovery is not overly ambitious and is more tangibly achievable.

Footnotes

1. Analysts do not specifically forecast profit margins, but profit margin expansion is implied as making up the difference between expected sales growth versus earnings growth

Important Information

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor a guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association/Japan Securities Dealers Association.

United Kingdom and rest of Europe: This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules).

This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

United States: This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity.

Singapore: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you

Hong Kong: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong.

Australia: Nikko AM Limited ABN 99 003 376 252 (**Nikko AM Australia**) is responsible for the distribution of this information in Australia. **Nikko AM Australia** holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice

New Zealand: Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme and the Nikko AM NZ Wholesale Investment Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website www.nikkoam.co.nz).