

MNI Market Analysis: Worsening Outlook Leaves EM Cyclical Stocks Vulnerable

14 June 2022, Yvan Berthoux

Executive summary

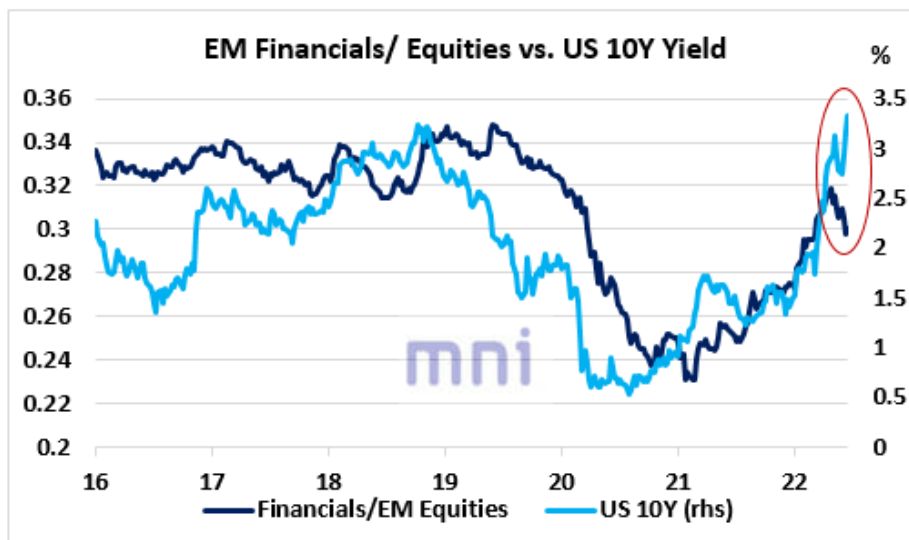
- Even though selling pressure on LT government bonds remain elevated (i.e. LT bond yields are surging), EM financials have been underperforming the market in recent weeks as global outlook worsens.
- In addition, the fall in China real M1 (in 2021) has been pricing in ‘cheaper’ financials for months.
- Hence, as the global outlook is not about to change anytime soon, the ‘cheap’ EM cyclical sectors may continue to underperform in the near term and defensive allocation should continue to be investors key allocation in the coming months.

EM Financials Underperform As Economic Slowdown Accelerates

The significant liquidity injections following the Covid shock combined with the surge in ST and LT bond yields had been a strong driver of EM financial stocks until the Ukraine invasion.

However, we mentioned after the start of the war in the end of February that the momentum on cyclical stocks was clearly unsustainable as the economic outlook was set to worsen considerably. Figure 1 shows that even though selling pressure on LT government bonds remain elevated (i.e. LT bond yields continue to surge), EM financials have been underperforming the market in recent weeks.

Figure 1

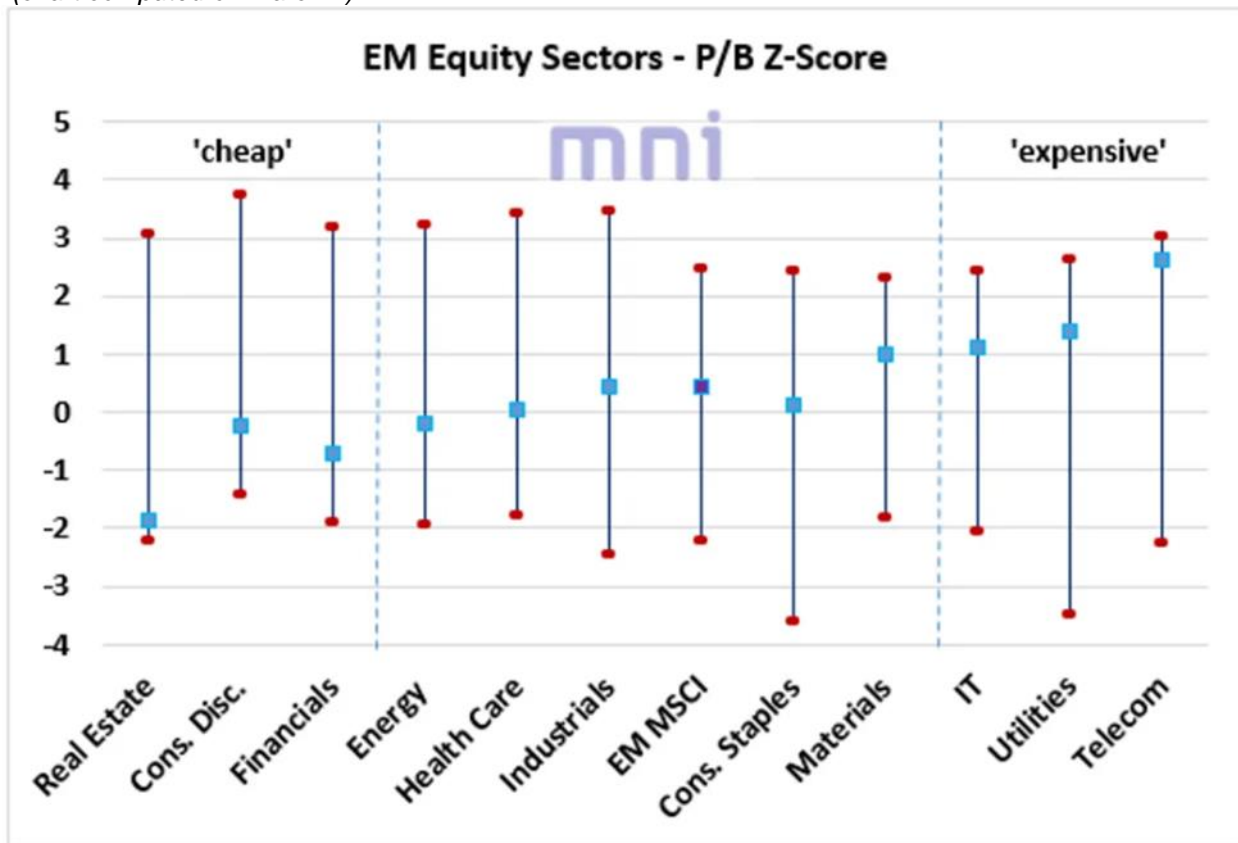


Source: Bloomberg/MNI

EM Financial: Cheap, But (Very) Risky!

Figure 2 shows the ranking of EM equity sectors from 'cheapest' to 'most expensive' in early March (following the start of the war) using a z-score P/B approach, indicating that financials were among the cheapest sector in the EM world. Traditional value investors would generally see an opportunity to buy the cheapest sectors for a potential LT interesting return.

Figure 2 (chart computed on March 2)

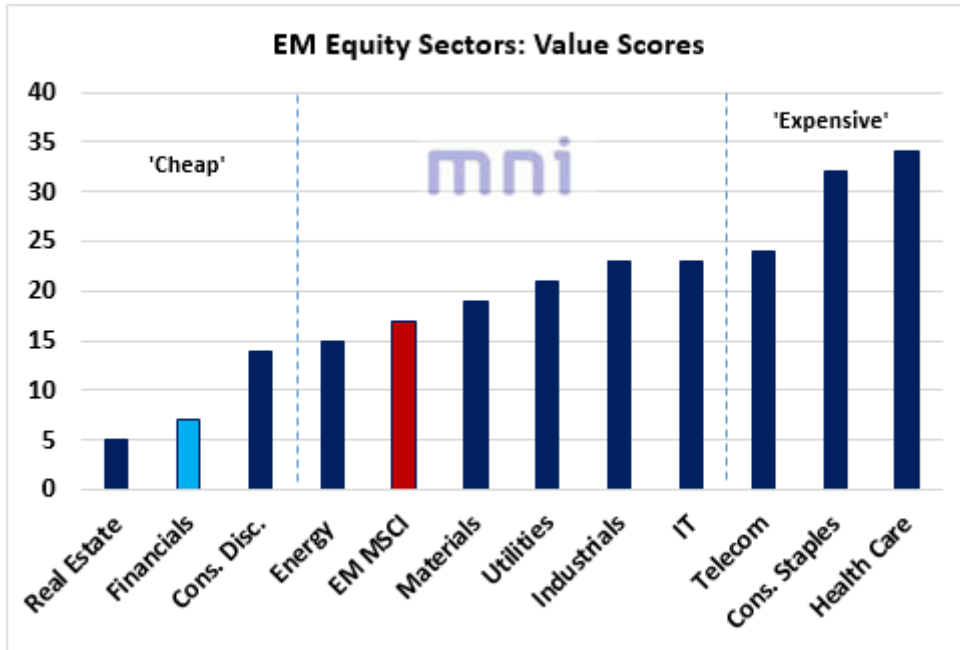


Source: Bloomberg/MNI

However, history has shown that a 'cheap' sector or asset can remain 'undervalued' for a long period of time and suffer significant drawdowns (sometimes even bigger than markets) in periods of market frictions.

Figure 3 shows that financials remain the second cheapest sector as of today looking at either a P/B z-score approach using historical data or from a relative approach at a specific time using a range of ratios (P/B, Price-to-sales, PE).

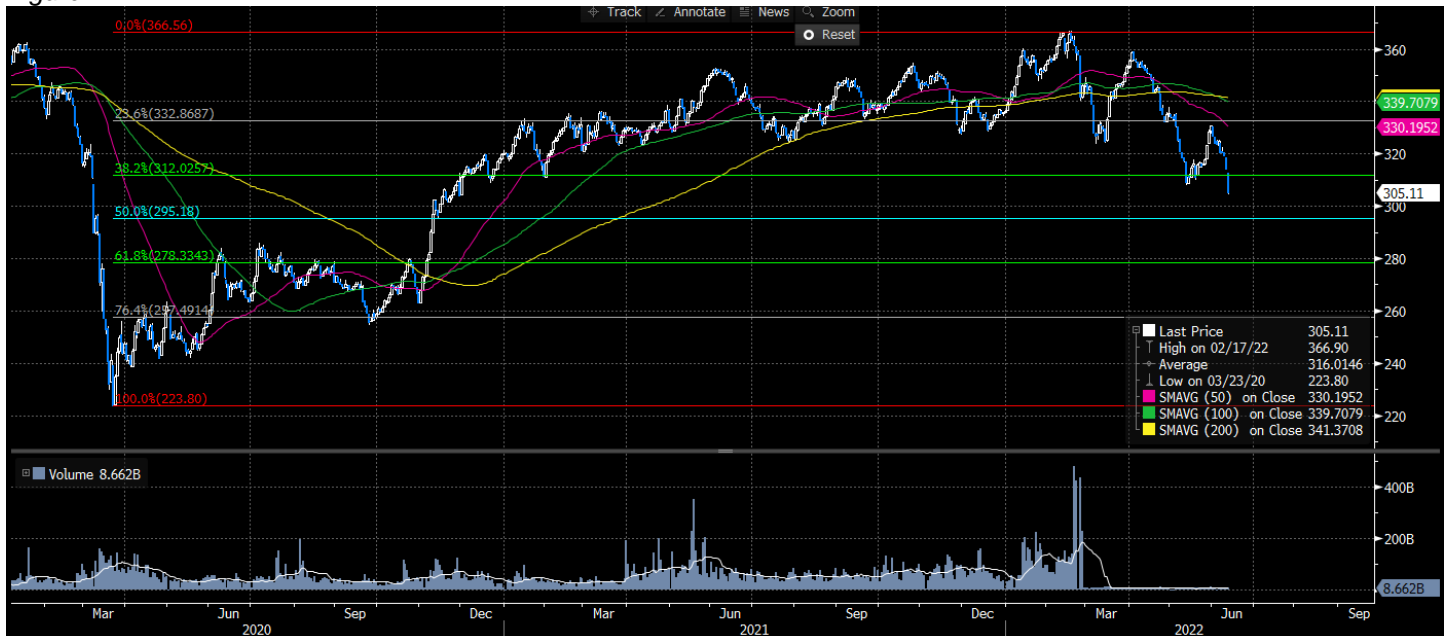
Figure 3. EM Financials Remain Cheap Today



Source: Bloomberg/MNI

EM Financials are down 17% since their January high and broke below the 307.90 support on Tuesday as global risk off sentiment intensifies. EM financials (MSCI) are currently trading at their lowest level since December 2020. Next key support to watch on the downside stands at 300.

Figure 4



Source: Bloomberg

China Real M1 Has Been Pricing In Cheap Financials For Months

Another important driver that we have been highlighting in the past year is China real M1, computed as the difference between China M1 money supply and PPI inflation, which has historically led cyclical stocks by 6 months (figure 5). The sharp plunge in China real M1 in 2021 has been pricing in ‘cheaper’ equities for months now as we can notice in the chart below.

As it does not seem that the global outlook is about to change anytime soon, the cheap EM cyclical sectors may continue to underperform in the near term and defensive allocation should continue to be investors’ key allocation in the coming months.

Figure 5



Source: Bloomberg/MNI

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