

MNI Market Analysis: Have EM Health Care Stocks Bottomed?

6 July 2022, Yvan Berthoux

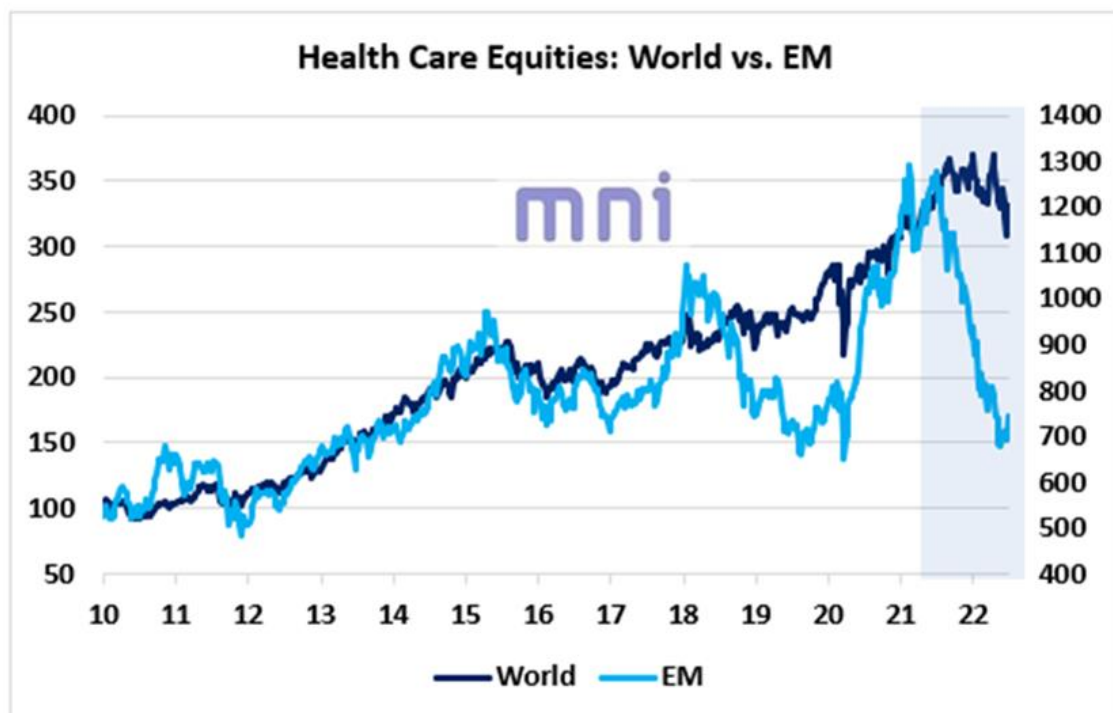
Executive summary

- The past year was marked by a significant divergence between EM and World health care equities; EM HC equities are among the worst performing stocks this year, down nearly 20%.
- Strong USD, rising LT bond yields and China crackdowns have been among the major factors behind EM equities weakness, particularly HC stocks.
- However, the consolidation in LT bond yields combined with China 'reopening' could actually lead to an outperformance of the 'defensive' health care EM equity sector in the medium term

EM Health Care Stocks Have Underperformed in The Past Year

We previously saw that the past year was marked by a significant divergence between EM and World health care equities. While world health care equities are down 12% since their January highs, EM health care stocks are down nearly 45% since in the past year, erasing 80% of their post-Covid gains.

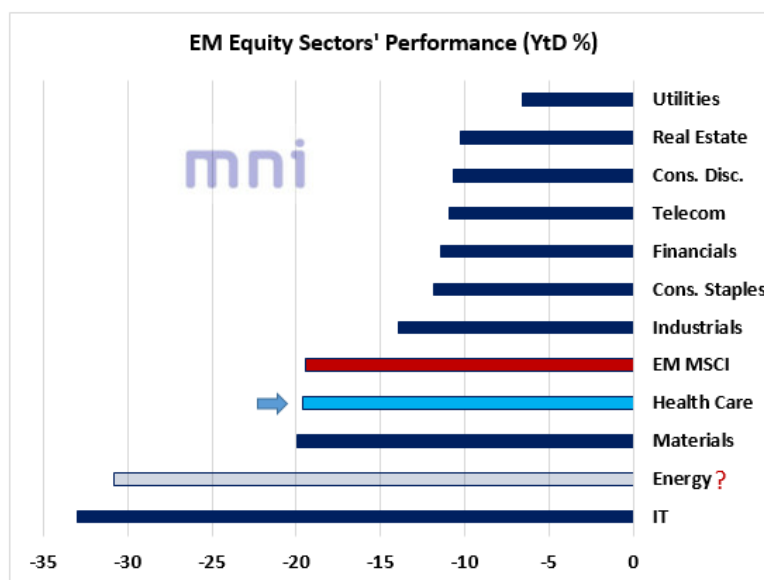
Figure 1



Source: Bloomberg/MNI

EM HC equities are among the worst performing stocks this year, down nearly 20%, along with IT (-33%) and Materials (-20%), which are classified as 'offensive' cyclical stocks.

Figure 2



Source: Bloomberg/MNI

Interestingly, 'defensive' EM health care equities have experienced the same drawdown as EM equities this year. Figure 3 below shows that EM Health Care stocks have a raw beta of 0.84 when regressing the returns on EM equities in the past cycle, confirming the 'defensive' narrative (defensive stocks have a beta lower than 1).

Figure 3 (Regression on EM Financials on EM equities – source: Bloomberg)

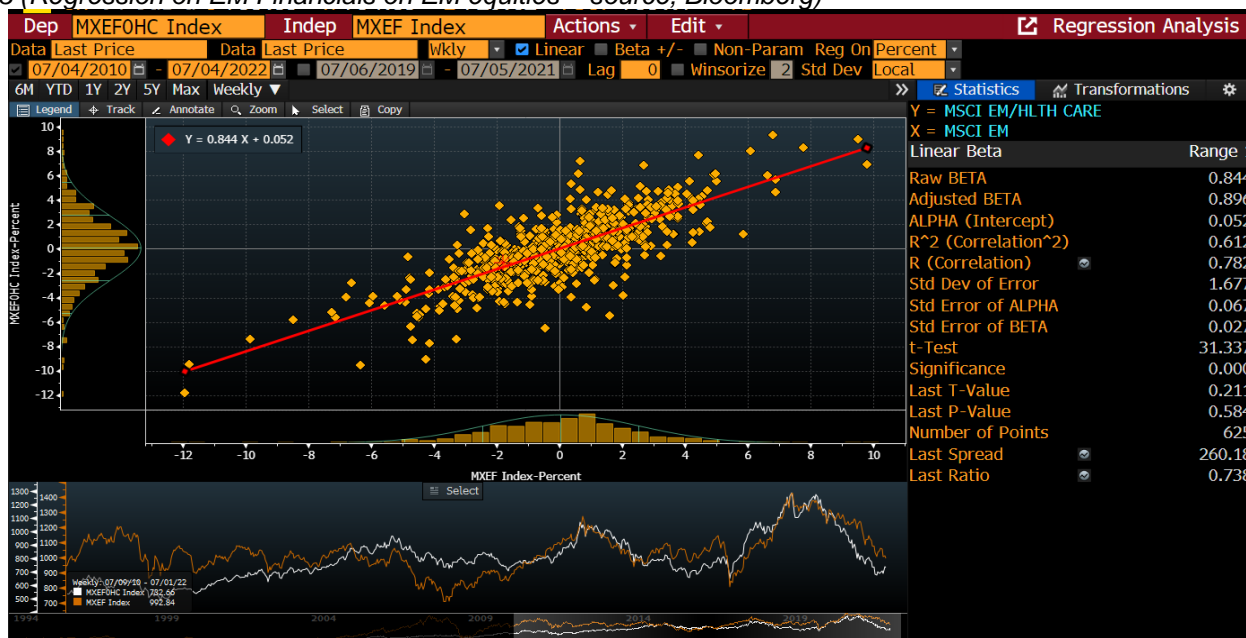
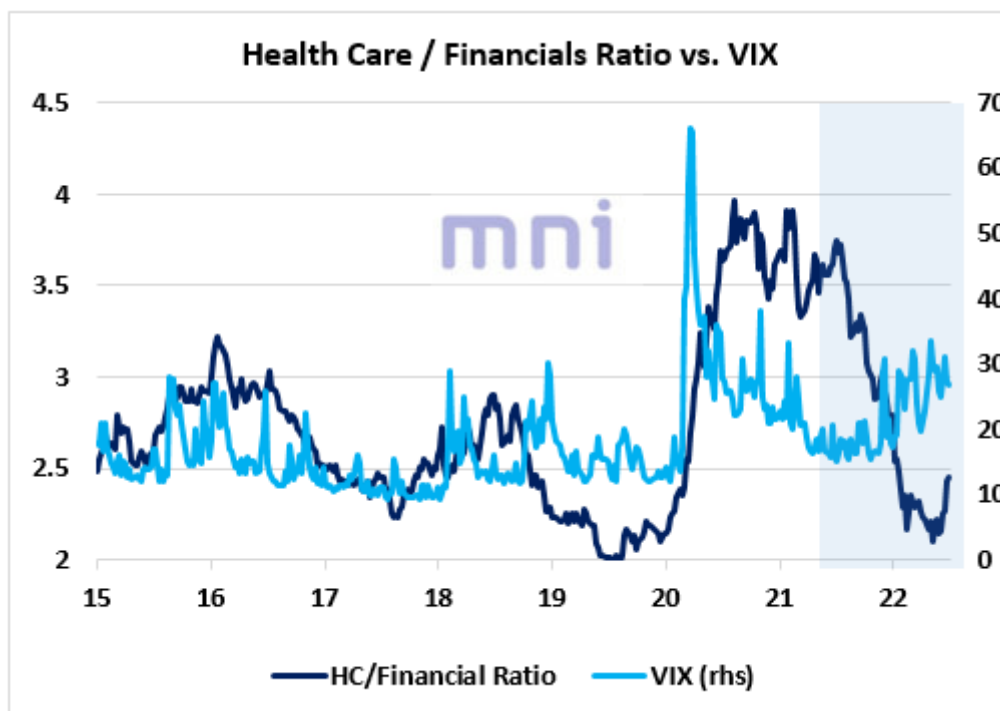


Figure 4 shows the interesting divergence between the HC/Financials ratio and the VIX index, which we use as a barometer of the global risk appetite. As financials are 'classified' as a cyclical sector, the HC/Financials ratio generally tends to rise when market uncertainty starts to surge.

However, it has not been the case in recent months as the rise in risk off sentiment was associated with a sharp fall in the HC/Financials ratio, which has fallen back towards the 2 – 2.5 range this year.

Figure 4



Source: Bloomberg/MNI

Why Health Care stocks have underperformed in the current environment?

1. China economic slowdown, government crackdowns

An important factor behind the fall in EM equities has been the sharp deceleration in Chinese economic activity combined with the government crackdown on a range of industries including health care. China health care equities were down 60% from peak to trough (June 2021 – May 2022) before edging higher in the past month and therefore partly explain the sharp consolidation in EM health care equities.

As for the real estate and IT sectors, government crackdown has also hit health care firms, with Beijing setting stricter R&D guidelines and potentially slowing down drug approvals.

Figure 5



Source: Bloomberg

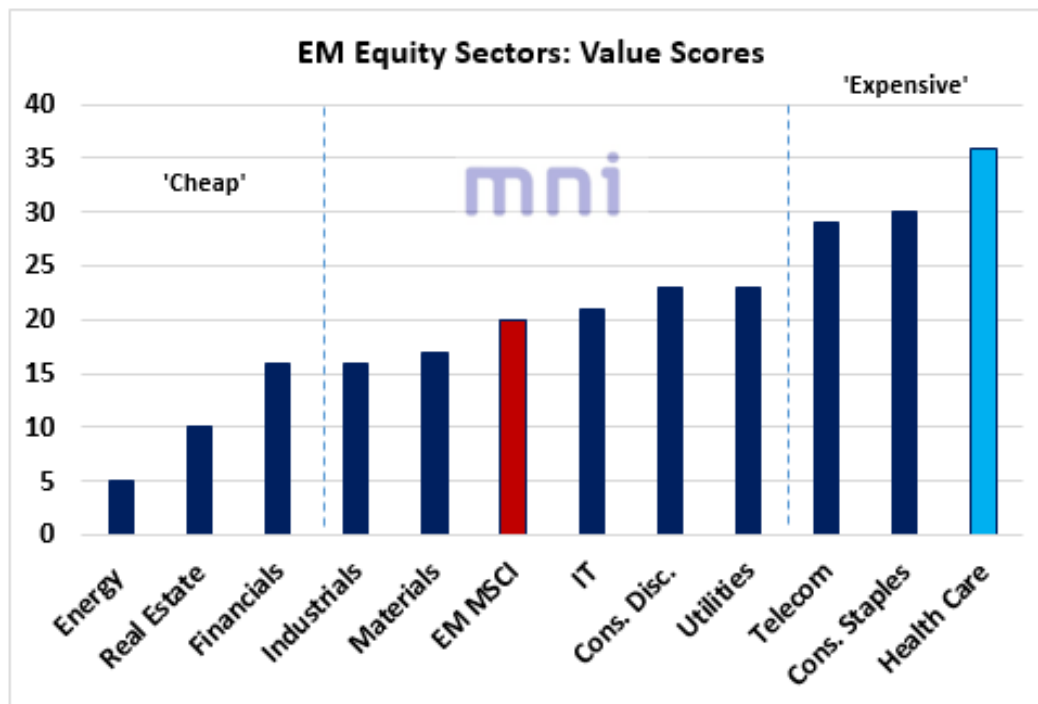
However, the trend has reversed in recent weeks and further improvement in the soft data could send Chinese equities to new highs. China HC stocks are now approaching their 249.70 resistance, which corresponds to 200DMA. Next level to watch on the topside stands at 276.50 (38.2% Fibo retracement of the 176 – 439 range).

2. EM Health Care Are Still 'Expensive'

Despite the sharp consolidation in EM health care equities, the sector remains the most expensive one among the EM world. Some of the retracement could be explained by the 'reversal' factor where 'overbought' sectors tend to eventually experience a period of consolidation independently of the macro outlook.

In figure 6, we rank the 12 EM sectors (including EM MSCI index – MXEF Index) from 'cheapest' to 'most expensive' according to price-to-book, price-to-sales and PE ratios.

Figure 6



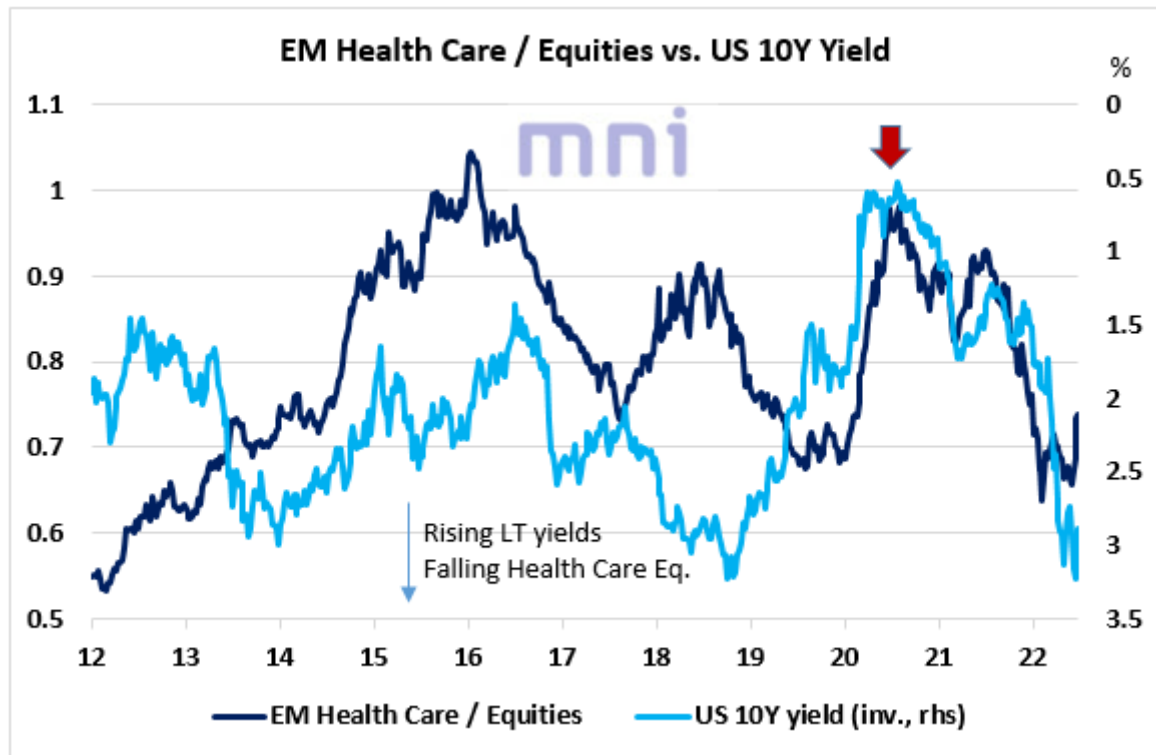
Source: Bloomberg/MNI

3. Health Care Sector is Long Duration

Health care stocks are usually considered to be 'long duration', therefore sensitive to sharp interest rate moves. Hence, the dramatic tightening in financial conditions in the past year has resulted in an underperformance of 'long duration' health care equities relative to EM equities.

Figure 7 shows that periods of sharp increase in LT bond yields have been associated with an underperformance of EM health care (vs. EM equities).

Figure 7



Source: Bloomberg/MNI

Conclusion: Have EM Health Care Stocks Bottomed?

Even though the market uncertainty is likely to continue to support the US dollar in the near term and therefore weigh on EM equities, the consolidation in LT bond yields combined with China 'reopening' could actually lead to an outperformance of the 'defensive' health care EM equity sector in the medium term while risk off sentiment remains elevated.

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