GENERALI ASSET MANAGEMENT

FOCAL POINT

EM equities: poised for outperformance amid shifting global dynamics

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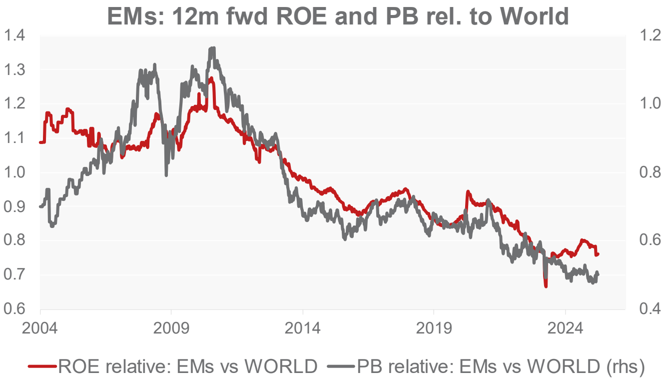
Our Focal Point series explores topical issues on macro, markets and investment

- **EM equities underperformed developed ones by nearly 60% since the 2021 peak and even 90% since 2018. The economic outlook, relative valuations and market positioning points to an impending catch-up of EM stocks.**
- **In terms of key market multiples (PE, PBV, PCF, and DY), EMs are fairly valued but trading at a discount of 40% and 12% relative to the US and EA. They look also quite attractive in terms of a longer-term valuations: the Shiller PE (CAPE) for the MSCI EM trades at a 18% discount, compared to US and EA premia at 37% and 12%.**
- **Investors' positioning in EM equities is quite low and macro surprises show some decent positive momentum. The recent de-escalation in trade uncertainty is also a positive factor, while resilient economic fundamentals largely support earnings.**
- **Most recently, China's macro momentum has stabilised thanks to fiscal and monetary support and renewed alignment between the government and the tech sector. Regarding the latter, there are increasing signs of global tech leadership emerging, especially when compared to US counterparts.**
- **As US exceptionalism looks fading and the USD is weakening, EMs equities have chances to outperform the advanced world (MSCI World). Risks include pressure on US long yields, renewed spikes in geopolitical (Iran/Israel war) and trade uncertainty, plus a lower-than-expected support for growth by Chinese authorities.**
- **Within EMs, we prefer China and China IT (policy support, growing tech leadership, undervalued), India (growth, less vulnerable to tariffs), Korea (undervalued, reforms), and Poland (growth, rate cuts, valuations).**

EM equities have underperformed developed markets for several years. Since 2018, the MSCI World rose 105% compared to a 14% increase for EM stocks, both in total return (TR) terms. Major EMs like China and India saw slower growth, worsened by structural issues. Trade tensions, especially US-China, added volatility. Compared to their developed market (EM) peers, EM firms showed lower profitability, with weaker ROEs and earnings growth, due to business models reliant on high global growth. China's 2023 tech crackdown hurt sentiment and key sectors like tech and consumer discretionary, dragging down EM indices. A stronger USD (+20% in 2020-2023) also weighed on EMs by raising debt servicing costs. Meanwhile, developed markets benefited from innovation-led investment in AI, quantum computing, and semiconductors (US especially).

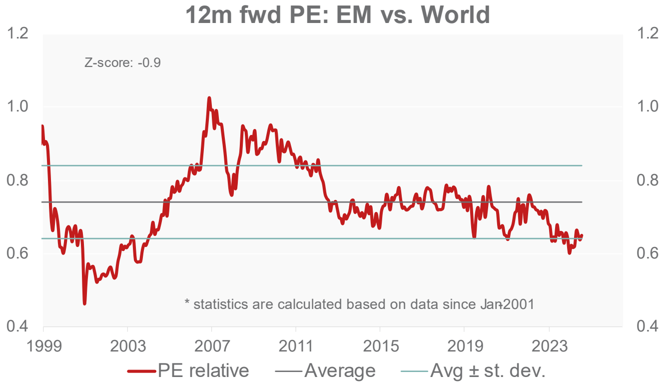


Source: Datastream, GenAM

In our view, there is a chance for some of the factors which contributed to the negative EM underperformance to reverse, at least in part. However, we recognise some risks, such as geopolitical frictions and uncertainties, more fragile regulatory global trade frameworks, and higher currency fluctuations.

Higher appeal after prolonged underperformance

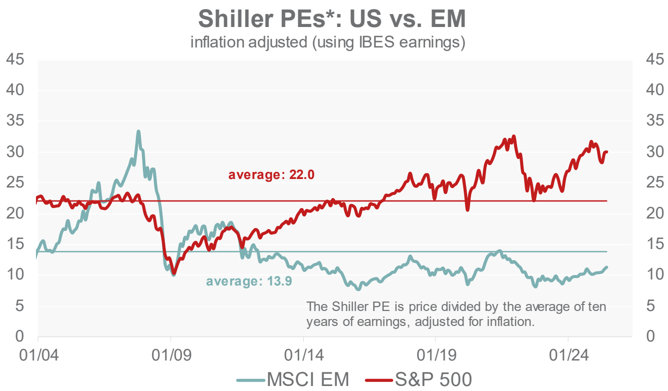
While EM stocks are fairly valued in terms of market multiples (price earnings (PE), price/book value (PBV), price/cash flow (PCF), and dividend yield (DY)) they look attractive relative to US and EA stocks, which are trading at a premium of 43% and 14%, respectively. This is different from the time of the first Trump's tariff war (2018), when EMs traded only at a discount of 8pp vs the US. Judging by the conventional PE only (based on 12-month forward earnings), EMs are undervalued relative to MSCI World by almost one standard deviation.



Source: Datastream, GenAM calculations

When we adjust the conventional PE by the expected long-term earnings growth (PEG ratio = PE/EPS growth in the next 3-5 years), we find that EMs are, on average, 35% cheaper compared to the euro area (EA) and the US. We perform then an "acid test", adjusting the PEG further, by including the ratio ROE/COE, i.e. the return on equity divided by the estimate of the cost of equity. This ROE/COE ratio signals the ability to produce a return on capital higher than the cost of it. The result is that EMs remain undervalued vs the US and EA: 1.9 vs 2.2 and 2.4, respectively, i.e. by an average discount of 20%.

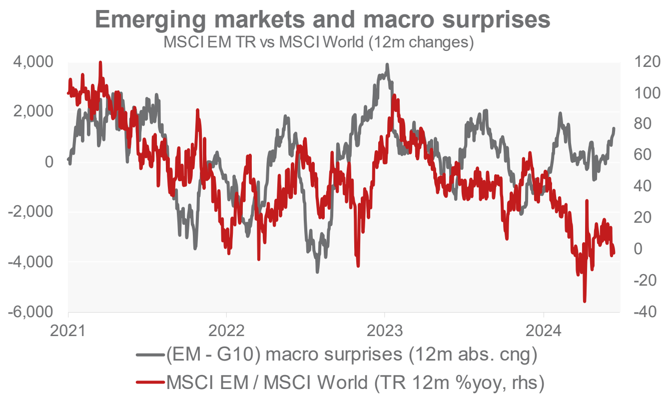
EMs look also quite appealing from a longer-term valuation measure – Shiller PE (or CAPE, cyclically adjusted PE), which is the index price divided by the average inflation-adjusted earnings over the past 10 years. While EMs (currently at 11.3X CAPE) trade at a discount of -18% vs their historical average since 2003, EA (17.4X) and US (30.1X) stocks are at a premia of 12% and 37% respectively. Overall, in our composite valuation approach[1], EMs rank 17th vs 48th for the US and 41st for the EA.



Source: Datastream, GenAM calculations

EM sentiment to improve further

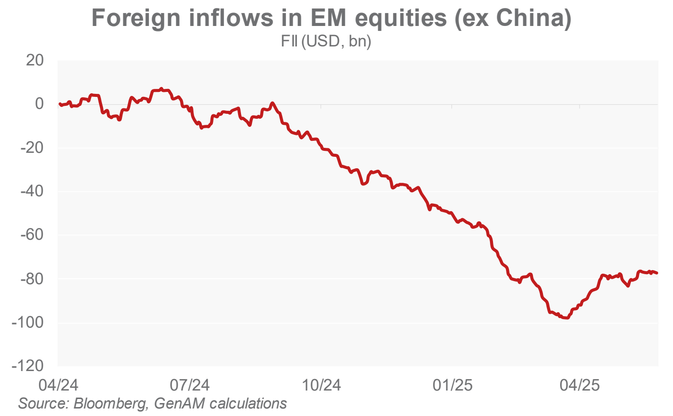
Recent macroeconomic data has shown positive surprise momentum, indicating that many EM economies are performing better than expected. This has boosted investor



Source: Datastream, GenAM

[1] Our compound valuation is based on 1) value gap based on the value indicator which takes into consideration 12-month forward earnings and 10-year (18%), 2) upside/downside according to Shiller PE (8%), 3) expected mid-term TR, which is derived from different estimation approaches using DY, next year's expected eps growth, ROE and payout ratios (29%), 4) PEG ratio adjusted by ROE/COE (29%), and 5) discount/premium derived from market multiples (PE, PBV, PCF, and DY) (16%). The rank (the lower the better) is then derived from the valuation score, which is calculated as a weighted average sum of these standardized factors, with weights shown in parenthesis.

confidence and driven up equity prices higher. Coherently, we expect fund inflows to follow. YTD, EM's TRs have increased by 12%, outperforming the MSCI World by 6pp. Diverging macro surprises between EMs and DMs are supportive for further EM outperformance. Investors' positioning in EM equities remains relatively low, though it has improved since mid-April. This underallocation can present opportunities for substantial gains once investors recognise the value of EM stocks.

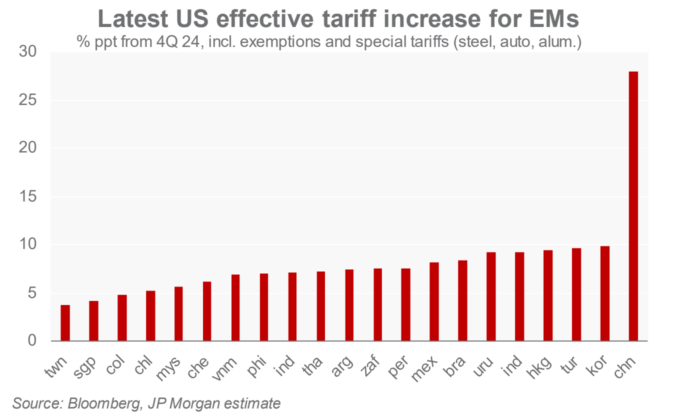


Source: Bloomberg, GenAM calculations

The recent reduction from peak in trade tensions in the wake of Trump's pausing of reciprocal tariffs has been a positive development for EM equities, helping to stabilise global trade flows and reduce the risk premium associated with investing in these markets. The recent framework agreement between the US and China on the supply of rare earths may decrease the uncertainty further.

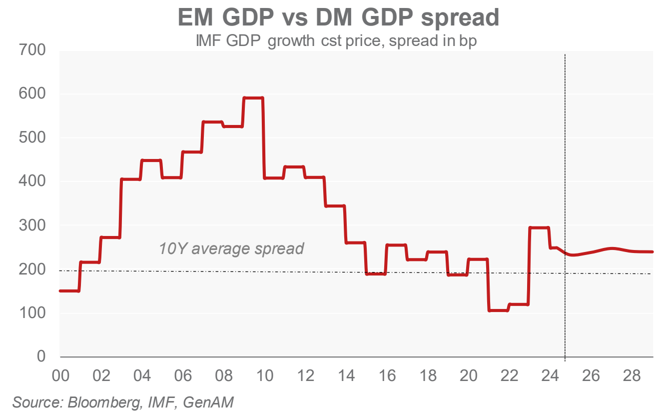
Resilient economic fundamentals to support EM equities

The rollback of US-China tariffs and the commencement of trade discussions with major Asian countries have partially mitigated the risk of a substantial slowdown in EM growth. Similarly, the risk of recession in countries such as Mexico has diminished significantly given the recent de-escalation in the trade conflict.



Source: Bloomberg, JP Morgan estimate

EM growth prospects are better than in early April. Assuming 2024 trade weights, the US's effective tariff rate on partner imports, excluding China, stood at 1% in Q4 of 2024, and is now at 9.4%. Effective tariffs on around two-thirds of EMs are below 10%, considering special tariffs on specific sectors such as steel and aluminium, as well as several exemptions. The latest IMF forecasts, computed before the last China tariff easing, expected an EM GDP slowdown to 3.7% in 2025 from 4.3%, so the risks are now likely to be skewed to the upside. In addition, the EM-DM GDP growth gap is still expected to remain above average and close to the top of its 10-year range, illustrating a relative resilience of EM activity.

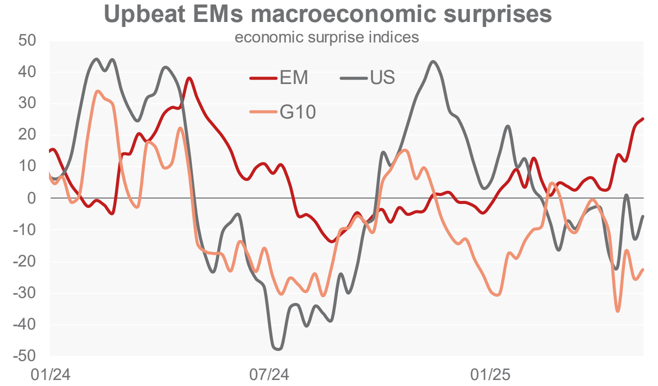


Source: Bloomberg, IMF, GenAM

The peak of EM growth uncertainty has probably passed, but we cannot rule out renewed uncertainty after the end of the 90-day pause in July (and early August when the US/China tariff truce expires), when pressure from the US on other countries to negotiate deals resumes. The recent announcement of new European tariffs is indicative of such a risk. US policymakers can also focus on rerouting of China exports which could threaten countries such as Vietnam, Thailand and Singapore with higher tariff rates. Additionally, specific tariffs on strategic sectors (notably semiconductors and electronics) could affect Taiwan in particular.

Thus, there is a risk of a slowdown in Asia exports, but we believe that the impact will be manageable. Firstly, EM macroeconomic fundamentals are stronger than they were during Trump 1.0, with significant improvements in the external sector. The only deterioration has been in fiscal policy, but this is mainly in Latin America (Brazil and Colombia) and otherwise concerns only small and distressed economies.

Secondly, EM economies have remained resilient despite rising uncertainty. Indeed, macroeconomic surprises remain positive, EM PMIs have barely declined, and hard data has held up on average. There has been a surge in exports, likely due to pre-emptive ordering and transshipment. Strong gains in consumer spending were in Q1, driven by China, EM Asia and Latin America. Excluding China, real spending increased by 4.1% annually. While we do not rule out a slowdown in Q2 related to trade uncertainty, the momentum and starting point have been strong.



Source: Bloomberg, Citi, GenAM

The outlook for China has improved substantially over the past six months with the economy stabilising. We upgraded our growth forecast to 4.5% from 4.2% and see upside risk. Firstly, policymakers have room to manoeuvre in terms of monetary policy. China has cut the key rate by 10 bps to 1.40%, and we anticipate a further 30 bps of easing by the end of the year. The stabilisation of the CNY at better levels provides more room for action if needed. Secondly, they have also room on the fiscal front. The issuance of special bonds has accelerated over the past two months, demonstrating the initial effects of fiscal support. Thirdly, policymakers have demonstrated their commitment to achieving the 5% growth target in 2025. Business sentiment, particularly in the tech sector, is becoming increasingly positive. The symposium between President Xi and tech leaders in early March is a good illustration of this positive change in attitude.The next key step will be the Politburo meeting in July, when policymakers may provide additional support, if required. Finally, tariff negotiations are still possible. Risks are balanced but one cannot rule out that the 20% fentanyl tariffs could be lowered.

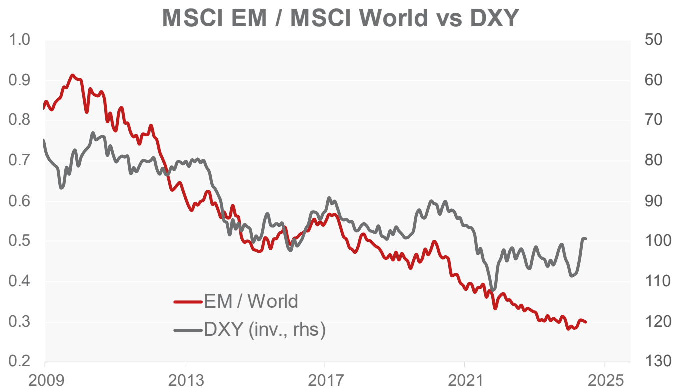
In this environment, EM consensus earnings growth can linger at a higher level vs. the US and EMU in the next year.

Expected EPS growth (%)	2025	2026	2027	F3F0 CAGR	eps in % vs linear trend
S&P 500	9.0	13.9	13.2	12.0	25.4
MSCI EMU	2.2	11.7	11.8	8.5	15.9
MSCI EM	11.4	12.5	11.3	11.7	-11.1
MSCI China	6.0	11.9	11.3	9.7	-17.0
MSCI India	13.9	15.7	13.5	14.4	26.0
MSCI Korea	23.5	12.7	12.7	16.2	6.7
MSCI Poland	43.2	2.2	3.1	14.7	15.6

Source: Datastream, GenAM

Upgrading EM equities

In our view, the factors which have contributed to the past prolonged underperformance of EM equities are either becoming less severe or improving. EM economic fundamentals look resilient, while their relative valuations vs. the US are quite attractive and positioning low. This should favour EM equities in the environment of softening US growth

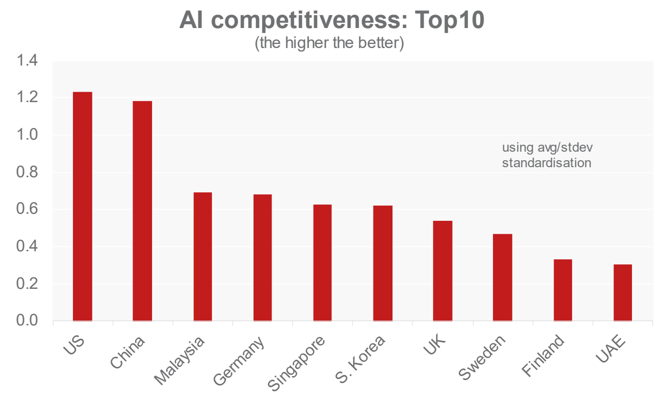


Source: Datastream, GenAM

(with no recession expected) as US dollar gets weaker and trade uncertainty has chances to decrease.

Within the EM universe, **we prefer China and China Tech, India, Korea, and Poland.**

As far as **Chinese equities** are concerned, we see increasing signs of technological growing leadership, while AI penetrations is rising. As we have analysed in our recent Core Matters "AI: Winning and losing countries", China is in a neck-to-neck competition with US in the AI race.

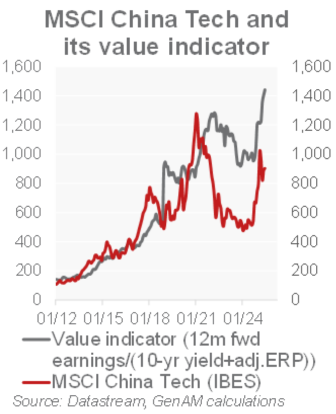


Source: Worldbank, Ourworldindata, Unctadstat, GenAM calculations

Between 2022 and 2023, China registered about 1.6 million **patents**—far surpassing the US (0.5 million) and Germany (0.2 million). It also leads in industrial **robot** installations, rising from 115 in 2018 to 268 in 2021, while US numbers declined slightly from 40 to 35.

The adoption of **AI** is on the rise, with 68% of A-share companies referencing "AI" in their 2024 annual reports, a substantial increase from 43% in the first half of 2024. The market anticipates faster earnings growth for the AI value chain in 2025, with infrastructure companies expected to experience higher growth compared to enablers and adopters.

China's Tech valuation remains attractive vs. US IT, and we believe a new Chinese Tech EPS cycle may have started. IT is undervalued vs its value indicator which takes into consideration 12-month forward earnings and 10-year yields. Based on Shiller PE, China Tech is quite attractive from a longer-term perspective, being undervalued by 21% (MSCI China by -17%).



India is set to benefit from a solid economic growth, less tariff risk, and supportive value assessment (based on 12-month forward earnings and 10-year yields), while Korea and Poland look particularly undervalued.

Following the recent early elections in **Korea**, there are high chances of fiscal stimulus as well as corporate governance reform. These should help to reduce the "Korea discount" in equities.

Polish equities should benefit from solid GDP growth (3.1% for 2025) and expected rate cute of around 75bps till YE 2025, which is supportive for higher PEs. However, they look vulnerable to a reversal in the short term after the YTD performance of 28%. The Polish economy is interconnected with the European Union, presenting an upside as the EA re-arms and accelerates.

In our composite valuation approach, Poland, Korea and China rank 4th, 6th and 9th, while the score for India (38) is better than that for EA (41) and US (48).

Our call for higher EM equity exposure is of course not without risks. Apart from political uncertainties, less established legal and regulatory regimes, and currency fluctuations, there is a risk of new upside pressure on US long yields and renewed spikes in trade uncertainty. There is also a risk of lower-than-expected support for growth from Chinese authorities. Furthermore, The Israel-Iran conflict heightens geopolitical risk via oil markets. Still, inflation in advanced economies may stay contained, and the dollar could strengthen due to its energy resilience—unlike the euro area and Japan. Of course, should higher oil prices reduce growth expectations, we could expect China as well as EU authorities (fiscal and monetary ones) to increase their support.

Conclusion

After several years of underperformance driven by structural economic challenges, trade tensions, regulatory headwinds (notably in China), and a strong US dollar, EM equities are showing signs of a turnaround. Valuations are now compelling across multiple metrics—PE, PEG, ROE/COE, and Shiller CAPE—especially relative to developed markets like the US and euro area. Recent macroeconomic surprises, easing trade tensions, and improving growth prospects (particularly in China, India, Korea, and Poland) support a more constructive outlook. While risks remain—such as geopolitical uncertainty, regulatory shifts, and potential trade disruptions—EM equities appear well-positioned for outperformance, especially in a scenario of softening US growth and a weaker dollar. Investor positioning remains light, suggesting room for further inflows as sentiment improves.

Imprint

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